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STATUS OF THE PENSION BENEFIT GUARANTY CORPORATION

HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ONE HUNDREDTH CONGRESS

FIRST SESSION

MAY 18, 1987

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STATUS OF THE PENSION BENEFIT GUARANTY CORPORATION

MONDAY, MAY 18, 1987

U.S. SENATE, SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE, OF THE COMMITTEE ON FINANCE,
Washington, DC.

The hearing was convened, pursuant to notice, at 10 a.m. in room SD-215, Dirksen Senate Office Building, the Honorable David Pryor (chairman) presiding.

[The press release announcing the hearing and opening statement of Senator Heinz and a staff paper on PBGC premiums follow:]

[Press Release]

FINANCE SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS ANNOUNCES HEARING ON THE STATUS OF THE PENSION BENEFIT GUARANTY CORPORATION

Washington, DC.—Senator David Pryor (D., Arkansas), Chairman of the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, announced today that the Subcommittee will hold a hearing on May 18, 1987 on the status of the Pension Benefit Guaranty Corporation (PBGC).

Senator Pryor stated that the Subcommittee will explore both long term and short term changes to ensure the continued stability of the PBGC. The Administration proposals to increase the PBGC premium and to change the rules governing minimum plan funding will both be considered.

The hearing will begin at 10:00 a.m. on Monday, May 18, 1987, in Room SD-215 of the Dirksen Senate Office Building.

Senator Pryor stated that testimony at the hearing will be received from invited witnesses only, including representatives from the Departments of Labor and Treasury and from the PBGC. A complete list of witnesses will be announced at a later date.

STATEMENT OF SENATOR JOHN HEINZ ON THE STATUS OF THE PBGC

I am pleased that Senator Pryor has called this hearing today on pension funding. Soon this committee will have to take on the thorny problems of financing the Pension Benefit Guaranty Corporation and tightening pension funding standards—too soon, I am afraid. We have been charged with raising PBGC's financing by $911 million in 1988—more than triple PBGC's current revenue—as part of budget reconciliation. This means we have only a month or two to figure out how we will raise this incredible amount of money and fix the Pension Guarantee Program to ensure its solvency. It is a tall order for a few months work, Mr. Chairman; so I am glad you have begun early with this hearing today.

Before we start today, I want to take a moment to express a few concerns about PBGC financing. First, I want to remind my colleagues that we just tripled the employer-paid PBGC premium last year. For years, the program was financed with a charge on pension plan sponsors of $2.60 per participant. Congress increased it to $8.50 in 1986. Now the PBGC is back again with a proposal that would raise it to an average of $24 per participant, and the figure the Senate adopted in the budget resolution would require us to raise it to nearly $40 on average. While the premium itself may not be unbearably high for most pension plans, the fact that it is rising rapidly, with no evidence that it will ever stop, is troubling to say the least.

Second, I feel strongly that if we are to justify any increase in the PBGC premium, we need to couple it with reforms that will work to prevent huge increases in PBGC's liabilities. Otherwise, this will be only the first of a series of premium increases. Certainly as part of this reform we will need to tighten pension funding standards to prevent today's funded plans from becoming underfunded. The administration has done a commendable job of developing proposals to do this. While I am not convinced that everything is there that we will need to prevent future PBGC financing problems, they are certainly a step in the right direction.

Third, it is not enough for us only to fund PBGC's existing liability and prevent funded plans from becoming underfunded. PBGC's real problem is the $45 billion in unfunded pension liability that PBGC has not assumed yet, that has existed for some time, and is not growing any smaller. Most of this liability is in a small number of very badly funded plans in financially troubled industries. The termination of just two of these plans—both in the steel industry—has raised PBGC's liabilities from $500 million to $4 billion. It would take only two more terminating in the next few years to double PBGC's liabilities. PBGC's own proposal for variable premium would not meet this need, and it may not be possible to meet this need solely through premium on defined benefit pension plans. We are going to have to do something about the very badly funded plans that are in troubled industries, however, before we will have a solution that will work.

Finally, I would like to simply comment that these are complex and important issues that deserve our serious and thoughtful attention. The administration has helped to get the ball rolling with their proposal, but we are not going to get a final package that makes sense in the next two months when our attention is on the budget deficit. I would like to urge my colleagues not to stampede to increase the PBGC premium simply because we need revenue so badly. Let's take our time to come up with a solution that will convince the people who operate the plans and pay the premiums that this program can work. Then we can raise the premium and not have to worry about the premium payers leaving the system.

CURRENT ISSUES RELATING TO PENSION BENEFIT GUARANTY CORPORATION (PBGC) PREMIUMS AND SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE

ON MAY 18, 1987

PREPARED BY THE STAFF

OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of current issues relating to Pension Benefit Guaranty Corporation (PBGC) premiums and defined benefit pension plans. This pamphlet includes discussion of the proposals contained in (1) the President's FY 1988 budget to increase per-participant annual premiums to the Pension Benefit Guaranty Corporation (PBGC) and to make structural revisions to the premium program, and (2) the President's competitiveness proposals as they relate to defined benefit pension plans.

Part I of the pamphlet is a summary. This is followed by a discussion of the PBGC single-employer insurance program and the variable rate premium proposal (Part II), minimum funding standard and deductions (Part III), termination of underfunded plans (Part IV), employer access to assets of overfunded plans (Part V), and post-retirement medical benefits (Part VI). In each of Parts II-VI, there is a description of present law, the Administration proposal, and the General Accounting Office (GAO) report recommendation (where made), as well as an analysis of issues.

The Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a hearing on May 18, 1987, which will focus on the proposals to increase and revise the PBGC premium program, to modify minimum funding requirements for defined benefit pension plans, to alter the rules governing the termination of underfunded pension plan, and to revise the conditions under which employers may recover excess assets from overfunded pension plans.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Current Issues Relating to Pension Benefit Guaranty Corporation (PBGC) Premiums and Single-Employer Defined Benefit Pension Plans* (JCS-12-87), May 15, 1987.

I. SUMMARY

PBGC Premiums and Funding

PBGC premiums

Unless exempted by ERISA, all defined benefit pension plans maintained by an employer are subject to the termination insurance rules. An employer maintaining a plan that is subject to the termination insurance rules is required to pay to the PBGC an annual per-participant premium.

Under the Single Employer Pension Plan Amendments Act of 1986 (SEPPAA), the annual per-participant premium was increased to $8.50 from $2.60, effective January 1, 1986.

Financial position of the PBGC

As of September 30, 1985, the PBGC reported a deficit of approximately $1.3 billion. As of September 30, 1986, the PBGC's deficit nearly tripled over the prior year, reaching $3.8 billion. The substantial increase in the deficit of the PBGC is generally attributed to the termination of certain steel-industry pension plans with insufficient assets to provide guaranteed benefits. The largest increase in the PBGC's liability was a result of the termination of plans maintained by the LTV Corporation.

In 1986, pension plans of the LTV Corporation were terminated. These plans had approximately $2.2 billion in unfunded guaranteed benefits, contributing substantially to the PBGC's current deficit.

The PBGC deficit has not affected its immediate ability to pay pensions to retired participants in terminated plans. However, PBGC officials estimate that the expected increase in asset drain could cause the program not to have enough funds to pay annual costs in approximately 15 years.

Defined Benefit Pension Plans

In general

Under a defined benefit pension plan maintained by an employer, employees who participate in the plan and satisfy the conditions for receipt of benefits under the plan are entitled to the benefit levels specified under the plan's benefit formula. An employee's benefits under the plan are not determined on the basis of an account for the employee. A defined benefit pension plan can provide benefits earned by employees only if contributions are made in sufficient amounts to pay an employee's expected retirement benefit. Under a defined benefit pension plan, the employer bears the risk of unfavorable investment experience.

For example, a defined benefit pension plan might provide a monthly benefit of $10 for each year of service completed by an employee. Benefits under a defined benefit pension plan may also be specified as a flat- or step-rate percentage of the employee's average compensation or career compensation.

Under present law, an employer is not required to maintain a defined benefit pension plan for employees (other than by reason of contractual obligations) nor, other than in the case of a top-heavy plan, required to provide minimum benefits to employees under the plan. However, if an employer elects to maintain a defined benefit pension plan, then present law provides that certain minimum standards are to be satisfied.

Under present law,[2] a defined benefit pension plan is required to satisfy certain minimum standards relating to the conditions under which employees may be excluded from plan participation, to the method under which plan benefits are accrued (i.e., the method under which plan benefits are earned), and the rate at which benefits are required to be vested (i.e., nonforfeitable). In addition, an employer's contribution to a defined benefit pension plan is required to meet minimum funding requirements.

Minimum funding requirements

Under the Code and ERISA, certain defined benefit pension plans are required to meet a minimum funding standard for each plan year. As an administrative aid in the application of the minimum funding requirements, each defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (including credits for contributions to the plan) are made for each plan year. If, as of the close of a plan year, the account does not have a balance of charges, the plan is treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan.

Qualified plans

If a defined benefit pension plan qualifies under the Code ("qualified plan"), then (1) a trust under the plan generally is exempt from income tax, (2) employers generally are allowed deductions (within limits) for plan contributions for the year for which the contributions are made even though participants are not taxed on plan benefits until the benefits are distributed, and (3) certain benefit distributions may be eligible to be rolled over, tax free, to another qualified plan or an IRA, or may be accorded special income averaging treatment.

An employer's contributions to a defined benefit pension plan for a year generally are not deductible if the contributions would not otherwise be deductible. Under the Code, if a contribution to a qualified plan for a year exceeds the deduction limits, then the excess generally may be deducted in succeeding years as a carryover. No deduction is allowed with respect to an employer contribution or a plan benefit in excess of the overall limits on contribu-

[2] The requirements of present law with respect to pension plans are contained in the Employee Retirement Income Security Act of 1974 (ERISA), and in the case of a plan that qualifies for special tax benefits, the Internal Revenue Code (the Code).

tions and benefits for employees. A nondeductible excise tax is imposed on an employer that makes a contribution to a qualified plan for a year in excess of the deduction limits.

Guaranteed benefits

ERISA established the Pension Benefit Guaranty Corporation (PBGC), a Federal corporation within the Department of Labor, to insure the pension benefits of employees when defined benefit pension plans terminate with assets insufficient to satisfy the plan's liability to provide benefits to employees.

Subject to limits, the PBGC guarantees basic benefits under a plan. Basic benefits consist of nonforfeitable retirement benefits other than those benefits that become nonforfeitable solely on account of the termination of the plan. Guaranteed benefits are limited to basic benefits of $750 per month adjusted for inflation since 1974 ($1,857.95 for 1987).

Guarantees are limited with respect to benefits in effect for fewer than 60 months at the time of plan termination unless the PBGC finds substantial evidence that the plan was terminated for a reasonable business purpose and not for the purpose of securing increased guaranteed benefits for participants.

Termination of underfunded plans

Prior to 1986, an employer generally could, subject to contractual obligations, terminate a single-employer plan at any time without regard to the financial health of the employer and without regard to the level of assets in the plan. If a terminated single-employer plan had assets that were sufficient to pay benefits at the level guaranteed by the PBGC, the employer had no further liability to the PBGC. If a single-employer plan was terminated with assets insufficient to pay benefits at the level guaranteed by the PBGC, the employer was liable to the PBGC for the insufficiency or for an amount equal to 30 percent of the employer's net worth, if less.

Under the Single Employer Pension Plan Amendments Act (SEPPAA), effective January 1, 1986, an employer may voluntarily terminate a single-employer defined benefit pension plan under which benefits are guaranteed by the PBGC only in a "standard termination" or in a "distress termination". A standard termination is permitted only if the plan holds assets sufficient to pay all benefit commitments under the plan.

For purposes of determining whether a standard termination is allowed, benefit commitments include all guaranteed benefits and all benefits that would be guaranteed but for the dollar limit on the amount guaranteed or the length of time that the benefit has been in effect. In addition, benefit commitments include certain additional benefits for which a participant has satisfied all conditions of entitlement prior to termination, irrespective of whether those benefits are guaranteed. Benefit commitments are less than plan termination liability, which includes all fixed and contingent liabilities to participants. Benefit commitments do not include benefits that vest solely due to plan termination or contingent benefits (such as early retirement benefits) for which the participant has not satisfied all conditions for entitlement prior to termination. Although contingent benefits and benefits that vest solely on account of plan termination are not included in benefit commitments, they are included in termination liability.

A plan with assets insufficient to provide benefit commitments may be terminated in a distress termination only if the PBGC determines that each contributing sponsor and each substantial member of the contributing sponsors' controlled groups satisfy at least one of four distress standards.

Upon the termination of a plan with assets insufficient to fund benefits guaranteed by the PBGC pursuant to the distress termination rules, each contributing sponsor and each member of the controlled groups that include the contributing sponsors is liable to the PBGC for the sum of (1) the outstanding balance of any accumulated funding deficiency, and (2) the balance of the amount of any waived funding deficiencies. The full amount of such liability is due and payable to the PBGC as of the date of plan termination.

In addition, in a distress termination, each contributing sponsor of the plan and each member of the controlled group of each contributing sponsor is jointly and severally liable to the PBGC for the sum of (1) the total amount of all unfunded guaranteed benefits, up to 30 percent of the collective net worth of those persons liable to the PBGC; (2) an amount equal to the excess (if any) of (a) 75 percent of the total amount of all unfunded guaranteed benefits over (b) the amount described in (1); and (3) interest on the amount due calculated from the termination date.

Termination of overfunded plans

Under the Code and ERISA, a trust forming part of a pension plan is not qualified unless, under the trust instrument, it is impossible, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the trust assets to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries.

However, if a defined benefit pension plan is terminated and assets exceed the level needed to satisfy all fixed and contingent liabilities to plan participants and beneficiaries, and if the excess is attributable to actuarial error, then the employer is permitted to recover the excess assets (i.e., the assets in excess of termination liabilities). Under present law, if the excess assets are recovered from a qualified defined benefit pension plan upon termination, then generally the amount recovered is included in the gross income of the employer and is subject to a 10-percent nondeductible excise tax imposed on the employer.

Vesting

Upon any termination of a plan, all benefits accrued to the date of termination must be 100 percent vested and nonforfeitable. In addition, plan benefits are to be distributed to plan participants or annuities providing for the payment of vested accrued benefits must be purchased and distributed to participants.

Administration Proposals

Defined benefit pension plans.—The President's competitiveness proposals (submitted to the Congress in March 1987) include proposals relating to the funding and termination of defined benefit pension plans. The proposals generally would make the following modifications:

(1) the funded status of underfunded defined benefit pension plans would be improved by requiring more rapid amortization schedules for certain unfunded liabilities and waived contributions, applying special minimum funding rules to prevent plans from becoming more underfunded, and imposing a minimum funding contribution for a year based on a plan's distributions and expenses during the year;

(2) employers would be required to accelerate the date by which contributions are to be made for a taxable year;

(3) the availability of waivers for contributions required under the minimum funding requirements would be limited;

(4) an employer's liability to plan participants and the PBGC upon termination of an underfunded plan would be increased;

(5) the employer would be required to transfer certain assets from any overfunded plans maintained by the employer to any underfunded, terminating plan maintained by the employer;

(6) employers would be permitted to withdraw excess assets from ongoing defined benefit pension plans provided a sufficient cushion of assets is maintained in all defined benefit pension plans maintained by the employer (calculated as if all such plans were a single plan);

(7) plan assets in excess of a plan's termination liability could only be recovered upon plan termination without regard to the asset cushion as long as all defined benefit pension plans of the employer are terminated, but the employer would be prohibited from covering its employees under a defined benefit pension plan for a 5-year period;

(8) the present-law rules permitting post-retirement health benefits to be provided under a pension plan would be repealed, and employers would be permitted to transfer excess assets otherwise available for withdrawal by the employer to tax-exempt welfare benefit trusts established by the employer to provide health benefits to retirees; and

(9) the funded status of a defined benefit pension plan and the ability of an employer to withdraw excess assets from an ongoing or terminated plan would be determined on a controlled group basis.

PBGC premiums.—Further, the President's 1988 fiscal year budget proposed an increase in the revenue collected from PBGC premiums and a restructuring of the premium program to assess higher premiums on employers that are more likely to shift liabilities to the PBGC.

General Accounting Office Report

On March 19, 1987, the General Accounting Office (GAO) submitted a report [3] to the Subcommittee on Oversight of the House Com-

[3] U.S. General Accounting Office, *Government Insurance Program Threatened by Its Growing Deficit* (GAO-HRD-87-42)

mittee on Ways and Means on the causes of large claims against the PBGC and the potential effects of SEPPAA on the plan termination insurance program.

The GAO concluded in its report that 70 percent of the claims against the PBGC during the 1983-85 period were a result of the present-law funding requirements not requiring sufficient contributions to pay for increases in unfunded liabilities (such as increases in liabilities due to benefit increases adopted by plan amendment) and that 30 percent of such claims were caused by the failure of employers to make contributions to a defined benefit pension plan prior to plan termination. The GAO studied the terminations of 33 plans maintained by 23 employers, which represented 90 percent of the increased claims to the PBGC during the period.

Further, the GAO concluded that, if the amendments made by SEPPAA had been in place for 1983-1985, the financial status of the PBGC would not have significantly improved because most of the employers who terminated plans would have qualified for distress terminations under SEPPAA and, because the employers were in bankruptcy proceedings in which the PBGC's claims have a low priority, the PBGC's recovery of claims would not have increased significantly.

The GAO suggested the following modifications to the defined benefit pension plan system and the plan termination insurance program to improve the long-term financial solvency of the PBGC:

(1) raising minimum contribution requirements for defined benefit pension plans;

(2) accelerating the date by which employers are required to make contributions for a plan year;

(3) reducing the amount of plan benefits guaranteed by the PBGC;

(4) raising the priority of PBGC claims against employers in bankruptcy proceedings; and

(5) increasing the PBGC per-participant annual premium.

II. PBGC SINGLE-EMPLOYER INSURANCE PROGRAM: VARIABLE RATE PREMIUM PROPOSAL

Present Law and Background

In general

The Pension Benefit Guaranty Corporation (PBGC) was created in 1974 by ERISA to provide an insurance program for benefits under defined benefit pension plans maintained by private employers. According to the PBGC's latest annual report, the single employer insurance program currently covers more than 30 million participants in more than 110,000 defined benefit pension plans.[4] PBGC revenues include premiums charged to private employers with defined benefit pension plans, earnings on investments, and collections from sponsors of terminated plans.

Flat rate premiums

Since its inception, the pension insurance program has charged a flat rate premium based on the number of plan participants. ERISA initially authorized an annual per participant premium of $1.00. The premium rate was raised to $2.60 for plan years beginning in 1978. The Single-Employer Pension Plan Amendments Act of 1986 (SEPPAA) increased the rate to $8.50, effective January 1, 1986.

Alternate premium schedules

In general.—The PBGC is authorized to develop premium bases and schedules other than a flat rate per-participant charge. Generally, the PBGC is not authorized to change the schedule applicable to basic benefits unless the new schedule is approved by the Congress.

Risk related premium.—The PBGC is authorized to develop a premium based on the risks it insures in each plan.

Guaranteed benefits method.—The PBGC may establish annual premiums for single employer plans composed of the sum of two charges. The first charge is based on a rate applicable to the excess, if any, of the present value of the basic benefits of the plan which are guaranteed over the value of the assets of the plan, not in excess of 1/10 of 1 percent of that amount. The additional charge is based on a rate applicable to the present value of the basic benefits of the plan which are guaranteed.

Under the guaranteed benefits method, the rate for the additional charge is to be set by the PBGC for every year at a level that the PBGC estimates will yield total revenue approximately equal to the total revenue derived by the PBGC from the first charge.

[4] The insurance program also covers multiemployer pension plans.

Unfunded benefit method.—The PBGC may establish an annual premium based on the level of unfunded guaranteed basic benfits. Under the unfunded benefit method, however, the premium rates are not to exceed 1/10 of 1 percent of the excess of (1) the present value of the guaranteed basic benefits of the plan, over (2) the value of the assets of the plan.

Total guaranteed benefits method. Under the total guaranteed benefits method, the PBGC may establish an annual premium determined by reference to the total guaranteed basic benefits under a plan. The rate determined under the total guaranteed benefits method is not to exceed the rate for the additional charge determined under the guaranteed benefits method.

Combinations of methods.—Under ERISA, if the PBGC uses a combination of two or more of the flat rate per capita method, the unfunded benefit method, or the total guaranteed benefits method, then the premium rates are to be designed to produce approximately equal amounts of aggregate premium revenue from each of the rate bases used.

Administration Proposal

In general

The Administration proposal provides that the annual premium payable by a single-employer plan would consist of two elements. Under the proposal, one element would consist of a minimum flat per-participant charge applicable to all single-employer plans. The flat per-participant charge would be indexed annually. The other proposed element would be a funding charge based on the excess of a funding target over the level of plan assets. The proposal provides that the total of the two premium elements would not exceed a maximum of $100 per participant for the 1988 plan year. The $100 annual limit would be indexed.

The Administration proposes that the funding charge rate be reviewed at three-year intervals and revised without the need for Congressional action.

The Administration also proposes that a surcharge should be imposed for missed contributions (e.g., contributions for which a funding waiver has been granted). The surcharge would be equal to a percentage of the funding charge otherwise due. The surcharge would not be taken into account in applying the annual limit on per-participant premiums ($100 for the 1988 plan year).

Flat rate charge

Under the Administration proposal, the flat rate per-participant charge would be $8.50 for plan years beginning in 1988, corresponding to the $8.50 premium imposed under present law. The flat rate charge is intended primarily to cover the administrative expenses of the PBGC ($1.00) and to retire its deficit ($4.75). The Administration projects that a portion of the flat rate premium could be applied toward the cost of new claims ($2.75). Under the proposal, the flat rate per-participant charge would be indexed for wage growth.

Funding charge

In general

Under the Administration proposal, the funding charge element of the annual premium would be imposed only on a plan that has a funding target insufficiency for the year. Under the proposal, a plan's funding target insufficiency would be computed on a per-participant basis. For a year, the per-participant funding target insufficiency would be equal to (1) the excess (if any) of 125 percent of its liability for vested benefits over the level of the plan's assets, divided by (2) the number of plan participants. The funding charge would be imposed at the rate of $6.00 per $1,000 of per-participant funding target insufficiency. The funding charge would, however, be subject to certain limitations.

Limitations

Small plans.—The Administration proposal provides that the funding charge would not apply to a plan with fewer than 100 participants.

Certain items excluded.—Under the Administration proposal, certain liabilities would be disregarded in calculating the funding charge. Under the proposal, liability for a benefit would be disregarded if the plan has purchased an annuity contract providing an irrevocable commitment to pay the benefit and the contract is owned by the plan. The contract would also be disregarded if the employer has provided a security interest to the PBGC equal to the amount of underfunding plus a cushion. The proposal does not describe the computation of the required cushion.

New plans.—The Administration proposal provides that the funding charge would not apply to a newly covered plan for its first three plan years. Under the proposal, this exemption for newly covered plans would not apply to a plan that is, in effect, a continuation of another plan.

Computations

Under the Administration proposal, the amount of plan assets and liabilities shown on the annual report of a plan (Form 5500) would be taken into account in determining the funding charge except that liabilities would be standardized on the basis of the PBGC's closeout interest rate (the interest rate applied by the PBGC for the valuation of liabilities under a terminated plan). The proposal would require that the PBGC provide simple valuation adjustment procedures for plan with more than 5,000 participants and conversion tables that would be used by smaller plans.

Maximum per-participant charge

Under the Administration proposal, the total of the flat per-participant charge ($8.50 for 1988) and the funding charge would not exceed $100 per participant for the 1988 plan year. The proposal provides that the $100 annual limit would be indexed to 1.5 times wage growth.

Surcharge for missed contributions

In general.—The Administration proposal includes a surcharge for a plan that (1) has obtained a recent funding waiver, (2) has obtained an extention of an amortization period under the minimum funding standard, or (3) has incurred an increase in an accumulated funding deficiency. Under the proposal, the surcharge would be a percentage of the funding charge that is otherwise due. The surcharge would not be taken into account in applying the $100 limit (as indexed). The proposal provides that the surcharge would apply prospectively to waivers, extensions, and funding deficiency increases for plan years beginning after 1987. Accordingly, the first surcharge would be payable in 1989.

Rate of surcharge.—Under the Administration proposal, the rate of the surcharge imposed with respect to a waiver of the minimum funding standard or an extension of an amortization period would depend upon the age of the waiver or extension. The rate would begin at 50 percent of the funding charge for the first year a waiver or extension is in effect and would decline by 10 percentage points with each subsequent year until it is eliminated after 5 years.

The Administration proposal provides that the surcharges would be cumulative. For example, if a plan was granted 3 consecutive waivers of the minimum funding standard (the maximum that would be permitted by the Administration proposal in a 15-year period), the surcharge would be 120 percent.[5]

Under the proposal, if a plan failed to meet the minimum funding standard without obtaining a waiver, the surcharge would be 50 percent for the lesser of 5 years or the period for which the deficiency continues. The proposal provides that the surcharges for failure to meet the minimum funding standard without a waiver would be cumulative and that the rate of the surcharge would not be phased out during the period for which it applies.

The proposal provides that the surcharge would be doubled for plans that have unfunded vested benefit liabilities and also have large contingent benefit obligations (e.g., shutdown benefits).

Triennial review

In general.—The Administration proposal provides for adjustments to the annual premium without action by the Congress. Under the proposal, the funding charge rate would be reviewed at 3-year intervals and revised on the basis of experience during those years. As discussed above, the proposal provides that the flat rate per-participant charge and the annual limit on per-participant premiums would be indexed annually by reference to wage growth. The flat rate per-participant charge would not be subject to the triennial review.

Review of funding charge.—Under the Administration proposal, the triennial adjustment of the funding charge would consist of (1) an adjustment to reflect any revision in projected annual net claims, (2) an adjustment to reflect any difference between the

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[5] The Administration proposal would reduce the maximum number of funding waivers in a 15-year period to from 5 to 3. If 5 consecutive waivers were in effect, the maximum surcharge under the Administration proposal would be 150 percent.

actual deficit at the end of the 3-year period and the deficit that had been projected for that date, and (3) an adjustment to take into account changes in the premium bases (the number of participants and the funding target insufficiency). The proposal provides that the funding charge, as previously adjusted, could not be changed by more than 50 percent by the combined adjustments as a result of a triennial review. The adjustment could not, however, cause the total premium to exceed the limit on per-participant premiums ($100 for 1988).

Review of projected claims.—For purposes of the proposed triennial review, average annual net claims for the 3-year period preceding the review would be adjusted for inflation. Projected annual net claims would be equal to that adjusted amount.

Deficit adjustment.—For purposes of the triennial review, any difference between the actual deficit at the end of the 3-year period and the deficit amount that had been projected for that date would be amortized through a further adjustment of the funding charge. The difference would be amortized by the PBGC over a period of 30 years.

Controlled group liability

The Administration proposal provides that each contributing sponsor of a single-employer plan and each member of its controlled group would be liable for the payment of premiums to the PBGC.

General Accounting Office Report

The General Accounting Office estimates that annual premium revenues of $446 million would be needed to retire a $4 billion deficit over 15 years at the PBGC's current interest rates. Projected annual premium revenue, however, is only $298 million, or 33 percent less than $446 million. Further, additional revenues would be needed to pay future expected claims and the program's administrative expenses. The report recommends that Congress consider an increase in PBGC premiums. The report also recommends that Congress consider reducing guaranteed benefits.

Analysis of Issues

Variable rate features

The Administration believes that a variable rate premium is more equitable than a flat rate premium because it would place the greatest burden on those employers whose plans present the greatest risk of potential loss to the PBGC. The Administration contends that a flat-rate increase of the magnitude needed to retire the deficit of the PBGC could encourage the termination of well-funded plans because those employers would incur a significant increase in the per-participant cost of maintaining their plans without a corresponding increase in benefits. Some who favor the Administration proposal are concerned that the termination of well-funded plans in response to premium increases would reduce the premium base of the PBGC by eliminating plans that present the least risk of loss to the PBGC. There is also concern that the termination of a defined benefit pension plan can adversely affect plan participants if the employer does not adopt a new plan with comparable benefits.

Those who oppose a variable rate premium structure argue that it would unduly burden financially distressed plans and employers. They believe that the guarantee program should not be evaluated under the same standards that would apply to a commercial insurance company. They refer to the tax exempt status of the PBGC as an indication that the Congress does not consider the PBGC as a commercial insurer, but as a program with important social aspects.

Some pension experts have expressed concern that the high variable-rate premium proposed by the Administration could have the effect of diverting funds from plans to the PBGC. Others have determined that, in some cases, the variable-rate per-participant premium could exceed the level of a participant's benefit because the funding target insufficiency is determined on an average (rather than an individual) basis.

Some of those who favor a risk-related premium believe that the variable-rate premium proposed by the Administration does not appropriately measure the PBGC's risk with respect to a plan because it does not measure the financial condition of the employer who maintains the plan. They believe that the PBGC's risk of loss with respect to a plan cannot be measured without taking account of the financial condition of the employer.

In rebuttal, those who favor a risk-related premium argue that although the premium proposed by the Administration does not directly measure the financial condition of the employer, the financial condition of a plan generally reflects the financial condition of the employer. They also believe that it would not be appropriate or practical to provide a premium that requires the PBGC to assess the financial strength of each employer that maintains a covered plan.

Surcharges

The Administration believes that employers who have obtained funding waivers present greater risks to the PBGC than employers who maintain underfunded plans but have not obtained funding waivers. Accordingly, the Administration believes that premiums payable by employers who have obtained funding waivers should be subject to surcharges.

The Administration believes that it is appropriate to impose surcharges on premiums paid by riskier employers (e.g., those who have obtained funding waivers). Those who favor surcharges contend that a similar approach is taken by private insurance companies under comparable circumstances. Those who oppose surcharges are concerned that the additional cost burden would make plan termination, and benefit loss, more likely.

Inflation adjustments

Those who favor an inflation-adjusted premium, as proposed by the Administration, believe that it is appropriate because an inflation adjustment is provided for the level of benefits guaranteed by the PBGC. Further, they believe that an inflation-adjusted premium would provide a more equitable allocation of the cost of providing guarantees.

Those who oppose an inflation-adjusted premium believe that premium increases for a program as significant as the guarantee of pension benefits should not be made without action by the Congress.

Triennial review

The Administration supports an administrative adjustment of the premium to reflect past and projected loss experience (the proposed triennial review) because it believes that an automatic adjustment feature is necessary to keep the program solvent. The Administration believes that employers and employees will have more confidence in the program if they understand that it is managed as a private insurance program. They argue that employers expect a private insurer to adjust its premium rates to take account of unanticipated losses that have been incurred and of projected future losses.

Those who oppose administrative adjustment of the premium believe that the premium should be regarded as a tax because guarantees are provided under the program whether or not the premium is paid. On that basis, they argue, the guarantee program is more similar to Social Security than a commercial insurance program. Because they regard the premium as a tax, opponents of an administrative adjustment believe that it is inappropriate, and possibly beyond the power of the Congress, to permit an administrative agency to determine the rate.

Controlled group liability

Supporters of controlled group liability for premiums believe that a controlled group of employers should be treated as a single economic unit. They argue that an economic unit should not be allowed to avoid payment of the premium because of its legal structure. They believe, for example, that in determining liability for premiums, an economic unit that is structured as a parent corporation with subsidiaries should be treated under the same principles that apply to an economic unit consisting of a single corporation.

III. MINIMUM FUNDING STANDARD AND DEDUCTIONS

Present Law and Background

Minimum funding standard

In general

Under the Code and ERISA, certain defined benefit pension plans are required to meet a minimum funding standard for each plan year. As an administrative aid in the application of the funding standard, each defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (including credits for contributions to the plan) are to be made for each plan year. If, as of the close of a plan year, the account reflects credits equal to or in excess of charges, the plan is treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan.

Accumulated funding deficiencies

If, as of the close of any plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Unless a minimum funding waiver is obtained, an employer who is responsible for contributing to a plan with an accumulated funding deficiency is subject to a 5-percent nondeductible excise tax on the amount of the deficiency (sec. 4971). If the deficiency is not corrected within the "taxable period," then an employer who is responsible for contributing to the plan is also subject to a nondeductible excise tax equal to 100 percent of the deficiency. The taxable period is the period beginning with the end of the plan year in which there is a deficiency and ending on the earlier of (1) the date of a mailing of a notice of deficiency with respect to the 5-percent tax or (2) the date on which the 5-percent tax is assessed by the Internal Revenue Service (IRS).

For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution in that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If the total contribution is not made, then the employer (or employers) responsible for contributing to the plan would be subject to an excise tax equal to 5 percent of the deficiency for the year. If the deficiency were not corrected within the specified period, then the 100-percent excise tax would be imposed on such employer (or employers).

Controlled group liability

The funding requirements applicable to a plan are imposed only on an employer who is responsible for contributing to that particular plan in which the deficiency arises. Another taxpayer that is a member of the same controlled group of corporations as the employer is not liable for a funding deficiency unless the other taxpayer is also responsible for contributing to that plan.

Actuarial cost methods

In general.—A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the balance in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of 2 elements for each plan year. These elements are referred to as (1) normal cost, and (2) past service liability.

Normal cost.—The normal cost of a plan for a year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. The normal cost will be funded by future contributions to the plan (1) in level dollar amounts, (2) as a uniform percentage of payroll, (3) as a uniform amount per unit of service (e.g., $1 per hour), or (4) on the basis of the actuarial present values of benefits accruing under the plan in particular plan years.

Past service liability.—The past service liability element represents the cost of future benefits under the plan that will not be funded by future plan contributions to meet normal cost (1) on the date the plan is first effective, or (2) on the date a plan amendment increasing plan benefits is first effective.

Acceptable methods.—Normal cost and past service liability are key elements in computations under the minimum funding standard. Although these costs may differ substantially, depending upon the actuarial cost method used to value a plan's assets and liabilities, they must be determined under an actuarial cost method permitted by ERISA. ERISA enumerates six acceptable actuarial cost methods and provides that additional methods may be permitted under Treasury regulations. Normal costs and past service liabilities under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. Generally, an actuarial valuation is required at least once every 3 plan years. More frequent valuations may be required by the Internal Revenue Service.

Charges and credits to the funding standard account

In general.—Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular year depends upon the nature of the cost. For example, the normal cost for a year is generally required to be funded currently. On the other hand, costs with respect to past service (for example, the cost of retroactive benefit increases), experience losses, and changes in actuarial assumptions, are spread over a period of years.

Normal cost.—Each plan year, a plan's funding standard account is charged with the normal cost assigned to that year under the particular acceptable actuarial cost method adopted by the plan. The charge for normal cost will require an offsetting credit in the funding standard account. Usually, an employer contribution is required to create the credit.

For example, if the normal cost for a plan year is $150,000, the funding standard account would be charged with that amount for the year. Assuming that there are no other credits in the account to offset the charge for normal cost, an employer contribution of $150,000 will be required for the year to avoid and accumulated funding deficiency.

Past service liability.—There are 3 separate charges to the funding standard account that may arise as the result of past service liabilities. The first applies to a plan under which past service liability has increased due to a plan amendment made after January 1, 1974; the second applies only to a plan that came into existence after January 1, 1974; and the third applies only to a plan in existence on January 1, 1974. Past service liabilities result in annual charges to the funding standard account for a specified period of years. Assuming that there are no other credits in the account to offset a charge for past service liability, and employer contribution will be required for the year to avoid and accumulated funding deficiency.

In the case of a plan that was in existence on January 1, 1974, the funding standard account is charged annually with a portion of the past service liability determined as of the first day of the plan year of which the funding standard applied to the plan (generally the plan year beginning in 1976). In the case of a single-employer plan, the amount of the liability with which the account is charged for a year is based on amortization of the past service liability over a period of 40 plan years. The liability is required to be amortized (in much the same manner as a 40-year mortgage) in equal annual installments over the 40-year funding period unless the plan becomes fully funded.

A plan that was not in existence on January 1, 1974, is generally required to determine past service liability as of the first day of its first plan year beginning after September 2, 1974 (the date ERISA was enacted). This liability is required to be amortized by a single-employer plan in equal annual installments over a period of 30 plan years. Accordingly, if there are no other credits in the account to offset the charge for this past service liability, and if the plan does not become fully funded, annual employer contributions will be required for 30 plan years to offset charges for this past service liability.

With respect to all plans (whether or not in existence on January 1, 1974), if a net benefit increase takes place as the result of a plan amendment, then the unfunded past service liability attributable to the net increase is determined that year and amortized over a period of 30 years.

For example, assume that a plan uses the calendar year as the plan year. Further, assume that, during 1987, the plan is amended to increase benefits and that the net result of plan amendments for 1987 is that the past service liability under the plan is increased by $500,000. In addition, the plan's actuary uses an interest rate of 8 percent in determining plan costs. The 30-year schedule requires that $44,414 be charged to the funding standard account each year to amortize the past service liability.

Accordingly, for each year in the 30-year period beginning with 1987, the plan's funding standard account is charged with the amount of $44,414. If there are no other credits in the account to offset the charge for past service liability, an employer contribution of $44,414 would be required for each of the 30 years to avoid and accumulated funding deficiency unless the plan becomes fully funded.

Gains and losses from changes in assumptions.—If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from charges in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 30 plan years, resulting in credits or charges to the funding standard account.

Experience gains and losses.—In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. The actuarial assumptions are required to be reasonable in the aggregate. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. For a single-employer plan, experience gains and losses for a year are amortized over a 15-year period.

Waived funding deficiencies.—Within limits, the Internal Revenue Service is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year. A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without substantial business hardship. The Internal Revenue Service generally takes the position that a waiver will not be granted unless the hardship is temporary and the employer demonstrates that recovery is likely. No more than 5 waivers may be granted within any period of 15 consecutive plan years. The Internal Revenue Service may require an employer to provide security as a condition of granting a waiver. The waived contribution is a waived funding deficiency.

Under the funding standard, the amount of a waived funding deficiency is amortized over a period of 15 plan years, beginning with the year in which the waiver is granted. Each year, the funding standard account is charged with the amount amortized for that year unless the plan becomes fully funded. Interest on the waived amount is equal to the rate applicable to late payment of taxes (Code sec. 6621(b)).

With respect to applications for waivers submitted after April 7, 1986, SEPPAA provides that the IRS is authorized to require security to be granted as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $2 million.

Switchback liability.—ERISA provides that certain plans may elect to use an alternative minimum funding standard account for any year in lieu of the funding standard account. ERISA prescribes specified annual charges and credits to the alternative account. No accumulated funding deficiency is considered to exist for the year if a contribution meeting the requirements of the alternative account is made, even if a smaller contribution is required to balance charges and credits in the alternative account than would be required to balance the funding standard account for a plan year.

During years for which contributions are made under the alternative account, an employer must also maintain a record of the charges and credits to the funding standard account. If the plan later switches back from the alternative account to the funding standard account, the excess, if any, of charges over credits at the time of the change ("the switchback liability") must be amortized over a period of 5 plan years.

Full funding limit

Under the minimum funding standard, the full funding limitation is the point at which the plan is considered to be sufficiently well-funded so that a contribution is not required. The full funding limit is designed to eliminate the requirement that additional employer contributions be made for a period during which a plan is fully funded. The funding standard, however, does not prohibit employers from making contributions in excess of the full funding limitation; however, an employer may not deduct contributions made to a plan that is funded at or above the full funding limit.

Time for making contributions

Under present law, an employer is treated as making a contribution that satisfies its minimum funding requirement for a year if the contribution is made within 8½ months after the close of the plan year. Of that 8½-month period, 6 months are provided under Treasury regulations.

Deductions for employer contributions

In general

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (Code sec. 404). No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employer covered by the plan is also covered by another plan of the employer. No deduction is allowed with respect to an employer contribution or a plan benefit in excess of the overall limits on contributions and benefits (secs. 404(j) and 415).

Under the Code, if a contribution for a year exceeds the deduction limits, then the excess generally may be deducted in succeeding years as a carryover. A nondeductible 10-percent excise tax is imposed on an employer that makes a contribution to a qualified plan in excess of the deduction limit and the excise tax continues to be imposed for each year until the excess contribution is eliminated.

Defined benefit pension plans

As outlined above, employer contributions under a defined benefit pension plan are required to meet a minimum funding standard. In the case of a group of affiliated employers, the deduction for employer contributions is allowed only to those members of the group that maintain the plan. The deduction allowed by the Code for an employer's contribution to a defined benefit pension plan is limited to the greatest of the following amounts:

(1) The amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year.[6]

(2) The level amount (or percentage of compensation) necessary to provide for the remaining unfunded cost of the past and current service credits of all employees under the plan over the remaining future service of each employee. Under the Code, however, if the remaining unfunded cost with respect to any three individuals is more than 50 percent of the cost for all employees, then the cost attributable to each of these employees is spread over at least 5 taxable years.

(3) An amount equal to the normal cost of the plan plus, if past service or certain other credits are provided, an amount necessary to amortize those credits in equal annual payments over 10 years.

Factors contributing to overfunding of defined benefit plans

The funding standard under present law provides for funding under an acceptable funding method on a "going concern" basis, rather than a "termination" basis. Accordingly, employers are permitted to provide funding for benefits that are expected to be provided in the future, even though there is no current liability for those benefits. For example, if benefits under a plan are based on the level of employees' pay and years of service during a period preceding retirement, the funding method used by the plan may require that current contributions be based on the anticipated future pay and rate of turnover of the employees. Under these circumstances, current funding may reflect pay raises that are anticipated to be provided under the plan's existing benefit formula, benefits

[6] Because the deduction limit is not less than the contribution required by the minimum funding standard, an employer is generally not required by that standard to make a nondeductible contribution. Contributions may be reduced or eliminated under a plan that has reached the full funding limitation.

expected to be earned, and the number of employees expected to vest, many years in the future.

In funding a plan, assumptions are made with respect to the anticipated rate of investment earnings. Because actual investment experience often differs from anticipated investment experience, plans periodically record experience gains (when the experience is better than anticipated) or experience losses (when the experience is worse than anticipated). These experience gains and losses are taken into account by plans, through changes in funding, over a period of at least 15 years. Similarly, changes in actuarial assumptions under a plan may result in increases or decreases in anticipated liabilities, which are taken into account over a 30-year period.

If a defined benefit pension plan is terminated, then no further benefits will be earned under the plan. In addition, pay raises and future service after the date of termination are not taken into account in determining benefits. Upon a termination, an employer may recover assets in excess of termination liability, provided that the excess is attributable to actuarial error. Actuarial error results because the anticipated expense of benefits expected to be earned, including benefits based on expected pay raises and future service, are not incurred. Similarly, actuarial error may arise because experience gains and losses, as well as gains and losses from changes in actuarial assumptions, may not have been fully amortized prior to the date of termination. The resulting reduction in liabilities may be offset by the cost of complying with the requirement that all accrued benefits under a defined benefit pension plan must be fully vested, to the extent funded, upon plan termination.

In addition, some terminated defined benefit pension plans have realized substantial experience gains in recent years because they have been able to meet their benefit obligations by purchasing annuity contracts providing a significantly higher rate of return than was assumed by the plan.

Factors contributing to underfunding of defined benefit plans

A plan is considered to be underfunded if, upon termination, it lacks sufficient assets to discharge its liabilities. One reason underfunding may arise is that, despite the minimum funding standard, the plan may terminate before the time required for amortization of its liabilities has expired.

For example, assume that, at the time a plan was adopted, it provided benefits measured (in part) by service performed before the plan was adopted. The liability for those benefits (past service liability) is amortized over a period of 30 years. If the plan terminates before the end of the 30-year period, then the plan will be underfunded unless investment gains exceed assumed investment gains by an amount that is sufficient to offset the unfunded liability arising from the past service benefit.

Underfunding may also be attributable to unamortized losses arising from investment experience or other experience (e.g., mortality, morbidity, employee turnover) that is less favorable than anticipated. In some cases, a plan is underfunded at termination because the employer obtained a waiver of the funding standard and the plan was terminated before the waived funding deficiency was fully amortized

Administration Proposal

In general

The Administration proposal would (1) impose new funding requirements with respect to certain defined benefit pension plans; (2) expand the group of employers that are required to make plan contributions; (3) increase the deduction limit applicable with respect to employer contributions to defined benefit pension plans; (4) expand the liability for required contributions to all members of a controlled group of corporations; (5) accelerate the due date for contributions for a year; and (6) limit the availability and attractiveness of minimum funding waivers.

The Administration proposal would impose funding requirements based on a four-part test. Under the proposal, the minimum required funding amount for the year would be the greatest of the following amounts: (1) the amount determined under the present-law funding requirements, (2) the amount determined under a "complement rule," which relates to certain accrued liabilities in underfunded plans, (3) the amount determined under the "funded ratio maintenance requirement", which prevents declines in the fundedness of a plan not taken into account under the complement rule, and (4) a cash-flow rule.

The proposal would apply to existing underfunded liabilities, and to increases in unfunded liability (e.g., by the adoption of a new plan or a benefit increase, or by the expansion of coverage under a plan).

The Administration has determined that many plans will not be affected by the new funding requirements, but will be able to continue to fund under the present-law rules.

Complement rule

The Administration proposal would provide shorter funding (amortization) periods under the minimum funding standard for certain defined benefit pension plans without assets at least equal to 110 percent of termination liability. Termination liability would be determined using the plan's actuarial assumptions. Generally, under the proposal, the funding period would not be shorter than 3 to 5 years, and, in most cases, would be between 10 and 20 years.

For a plan with assets less than 110 percent of termination liability, the exact length of the applicable funding period for a year would be directly related to (1) the extent to which the plan is underfunded, and (2) the maturity of the plan's benefits (i.e., the extent to which the plan's unfunded projected liabilities are attributable to past service). The funding period of a plan would not be reduced under the proposal merely because the plan's assets are less than 110 percent of termination liability.

Funded ratio maintenance requirement

To prevent the deterioration of a plan's funded status below 110 percent of termination liability generally due to experience losses and certain benefit increases not triggering a shorter funding period under the rules described above, the Administration proposal contains a funded ratio maintenance requirement. Generally, the funding period for liabilities subject to the funded ratio maintenance requirement would be 3 years.

Under the Administration proposal, if a plan's level of funding declines, then a portion of the plan's termination liability, measured by the decline, would be subject to a shorter funding period. For example, under the proposal, if a plan's funding declines by 10 percent, and if the termination liability of the plan after the decline is $1 million, then $100,000 of the plan's termination liability (10 percent of $1 million) would be subject to a shorter funding period.

Cash flow requirement

The Administration proposal provides that, if a plan's assets are less than 110 percent of termination liability, then the minimum required contribution for a year would not be less than the total distributions for the year or the amount needed to bring the plan up to that level of assets whichever is less. Total distributions would include benefit payments, as well as administrative and investment expenses. Under the proposal, special rules would be developed for plans that have frozen benefit accruals and for plans that have no active participants.

Controlled group liability

The Administration proposal provides that the particular employer who maintains a defined benefit pension plan, and each member of that employer's controlled group would be jointly and severally liable for contributions required under the minimum funding rules. The rules allowing deductions for employer contributions would be modified to permit a controlled group member to deduct contributions made to a plan maintained by another member of the controlled group.

Contribution due date

Quarterly payments would be required under the minimum funding standard. The last payment would be due not later than 2½ months after the close of the plan year. As under present law, failure to make a contribution by the applicable due date would result in the imposition of excise taxes.

Minimum funding waivers

The proposal would modify the rules governing the availability of minimum funding waivers in several respects. Under the proposal, a waiver application would have to be filed within 2½ months after the end of the plan year. The standards for obtaining a waiver would be clarified by providing that the employer seeking a waiver would have to establish that the financial hardship is temporary. Because all members of the controlled group of the employer maintaining the plan would be liable under the minimum funding rules, the hardship determination would be based upon the circumstances of the entire controlled group.

In order to make funding waivers more equivalent to commercial loans, the interest rate on waived contributions would be increased from the interest rate applicable to the late payment of taxes to the greater of the plan's interest rate for funding purposes and the market rate for loans to distressed companies.

To protect plans against protracted periods of serious underfunding and serious deterioration of the funded status of the plan, the number of annual waivers that could be granted with respect to any plan within a 15-year period would be reduced from 5 to 3.

Under the Administration proposal, the maximum funding period for waived contributions would be determined by reference to the plan's funded status. If the plan's assets are at least 110 percent of termination liability, then the funding period would be 15 years (as under present law). Under the proposal, if the plan's assets are less than 110 percent of termination liability, then the funding period would be reduced from 15 years to a period depending on the underfundedness of the plan.

An employer would be required to notify plan participants and beneficiaries of any funding waiver application and to provide them with an opportunity to comment in order to ensure that the participants are aware of the potential loss of contributions to the plan.

Finally, the Administration proposal states that any additional restrictions which would further ensure that waivers are granted only when absolutely necessary should be considered.

Deduction limits

Under the Administration proposal, the limit on deductions allowed with respect to employer contributions to defined benefit pension plans would be increased in certain cases. Under the increased limit, a contribution to a defined benefit pension plan in excess of the otherwise applicable limit would be deductible for a year to the extent that (1) it does not cause the level of assets in the plan to exceed the plan's termination liability, and (2) it does not cause the level of assets in all plans maintained by the controlled group to exceed the total termination liability of the controlled group's plans. The 10-percent excise tax on nondeductible contributions would not apply to these contributions.

General Accounting Office Report

The GAO report recommended that (1) the minimum contribution requirements be increased to reduce the amount of a plan's unfunded benefits, and (2) the date by which employers are required to make contributions be accelerated.

The GAO report pointed out that, during the years 1983–85, 70 percent of the claims against the PBGC for termination of underfunded plans resulted because the present-law funding standards do not require sufficient contributions to fund increasing unfunded liabilities arising in part from numerous benefit increases within 5 years of plan termination. Of 33 underfunded plans terminated during the period, which represented 90 percent of the PBGC's claims, 27 plans had increased benefits within 5 years of plan termination. The GAO report also found that 30 percent of the claims against the PBGC were caused by the failure of employers to make required contributions prior to plan termination.

Analysis of Issues

Increased funding rate

In its proposal, the Administration stated that the rate of funding required under the minimum funding standard exposes plan participants and the PBGC to excessive risk. The Administration further pointed out that, under present law, the funded status of a plan could deteriorate even if the minimum funding requirements are fully satisfied. Thus, it could be argued that, given the existence of a plan termination insurance program, the present-law rules providing long-term financing of increases in unfunded liabilities create an incentive for employers to provide benefit increases that might otherwise not be affordable. In addition, the existence of benefit guarantees makes it less likely that employees will express concern about the security of their promised benefits.

As a result, supporters of the Administration proposal believe that more rapid funding would more appropriately limit the ability of employers to delay or avoid funding obligations. They argue that an employer should not have the opportunity to make pension promises that exceed its financial capacity. They suggest that the purpose of sound funding is to protect employee benefits by insulating them from business risk of the employer, as well as to protect the PBGC from systematic loss.

Concerns have been expressed that the rate of funding proposed by the Administration is unnecessarily high, and that an employer who otherwise would have been able to fund fully plan liabilities may, instead, choose bankruptcy as a means of avoiding the faster funding of its unfunded liability. Sharply higher contribution requirements, particularly requirements imposed with respect to existing unfunded liabilities, could prove burdensome for employers in cyclical businesses. For employers who incur losses, the increased contributions may not be fully deductible when paid.

Others argue that the rapid rates mandated by the Administration proposal would unduly restrict funding flexibility under defined benefit pension plans and may cause termination of plans by employers that are unwilling to bear the increased current costs of funding. They argue that the objective of greater benefit security can be obtained with a less extensive increase in the rate of funding that is less likely to cause the termination of defined benefit pension plans.

Some who oppose faster funding believe that the requirements will interfere with collective bargaining. They suggest that the extent to which amounts earned by employees should be divided between pension plan contributions and other forms of compensation is more appropriately left to employee representatives and to employers. On the other hand, it can be argued that restraints on the collective bargaining process are appropriate in light of the PBGC's unique role as guarantor of an employer's benefit promises to employees. Because employees are assured of receipt of their benefits from the PBGC if the employer is unable to meet its benefit commitments, some argue that the normal arm's-length nature of the collective bargaining process is absent and that employees have less incentive to bargain for adequate funding by the employer.

Some argue that a more extensive evaluation of the present-law funding requirements is appropriate. For example, the flexibility provided to employers in selecting the method of funding to be used for a particular plan could be reexamined. The particular characteristics of employers in various industries could be studied to determine whether certain funding methods are more appropriate or desirable from a benefit security perspective.

In addition, consideration could be given to whether it is appropriate to allow an employer that maintains more than one defined benefit pension plan to use different funding methods in each plan, thereby creating different levels of benefits security for employees covered under different plans. The Administration proposal would indirectly address this issue in the context of asset reversions. Some question why this issue is not addressed directly.

Finally, some individuals have proposed restrictions on the present-law flexibility of actuarial assumptions used in calculating required plan contributions. This issue arises in two contexts—whether parameters should be imposed on any particular actuarial assumption (such as a permissible interest rate or interest rate corridor) and whether any or all actuarial assumptions should be required to be separately reasonable, rather than reasonable in the aggregate.

Contribution due date

Of the 8½ month post-year period for making required plan contributions, 6 months was provided under Treasury regulations issued during the transition period that followed the enactment of ERISA. Some question the need to continue this transition rule in light of the GAO report indicating that unpaid contributions are a significant element of the PBGC's cost. The GAO report found that a significant amount of claims against the PBGC occurred where plan contributions for a year were not made because the payment deadline did not expire before the date of plan termination. Requiring quarterly payments could provide an early warning to the PBGC, the IRS, and plan participants of possible employer difficulty in meeting its benefit obligations. It is not unusual to require that the contributions be paid on a quarterly basis. Due to enforcement and collection problems, the Code requires quarterly payments in a number of cases. For example, withholding taxes and estimated taxes must be paid on a quarterly basis.

Some question whether plan contributions should be made on a quarterly bsis during the year. They believe that in most cases such a requirement would impose additional administrative costs on plans without a corresponding increase in benefit security. An alternative to the Administration proposal would be to require quarterly payments only in the case of an employer that is experiencing financial distress or in the case of an under funded plan.

Funding waivers

Proponents of the Administration proposal to establish more stringent limits with respect to funding waivers argue that employers used waivers to minimize contributions during the period immediately preceding the termination of a plan. The GAO report found that 30 percent of the claims against the PBGC arising

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during the period 1983–85 resulted from the failure of employers to make required plan contributions prior to plan termination. The GAO concluded that significant percentages of the large claims represented required contributions that were overdue or had been waived by the IRS.

Under present law, funding waivers are equivalent to an extension of credit from a plan to the employer that normally would be treated as prohibited transactions. It is arguable that such an extension of credit is inappropriate unless the employer can demonstrate appropriate creditworthiness. Some argue that employers should not have the opportunity to avoid liability for pension promises by terminating underfunded plans at the expense of other employers who moderated their promises and remain in the defined benefit system.

Those who oppose further restrictions on funding waivers suggest that the effects of recent restrictions on waivers should be examined before new restrictions are imposed. They argue that the impact of restrictions on funding waivers should be carefully examined and that the potential for plan terminations that will result in loss of employee benefits and in increased liability for the PBGC should be considered.

Opponents of further restrictions on funding waivers believe that if employers cannot accept the restrictions they will terminate plans that could have been continued. They argue that the effect of restrictions adopted in SEPPAA, in 1986, should be evaluated before further restrictions are considered.

Further, some pension experts believe that it may be appropriate to consider whether funding waivers should be granted under any circumstances. To the extent that an employer's request for a funding waiver represents an early indication of employer financial difficulty, some might argue that the granting of funding waivers puts the interests of plan participants at a lower priority than other employer creditors. Given the potential liability of the PBGC, some question whether this ordering of creditor priority should be sanctioned by the IRS.

It may also be appropriate to consider whether funding waivers should be permitted in the case of an underfunded plan of an employer when the employer also maintains a defined benefit plan that is overfunded on a termination basis.

Deductions

The allowance of a deduction for the full amount necessary to increase the assets of a plan to offset all termination liability promotes the theory that public policy should encourage funding that is optimal, rather than deficient or excessive.

On the other hand, the increased deduction limits may be used to best advantage by employers who present the least risk of benefit loss to their employees and the least risk of liability to the PBGC. If such a result occurs, expansion of the deduction limits for employers who are able to fund all termination liability under their plans with a single payment may be inconsistent with sound tax policy because it may cause a revenue loss that would not significantly decrease risk to the PBGC or increase benefit security.

IV. TERMINATION OF UNDERFUNDED PLANS

A. Conditions for Plan Termination

Present Law and Background

Law before 1986

Prior to 1986, an employer could, subject to contractual obligations, terminate a single-employer plan at any time without regard to the financial health of the employer and without regard to the level of assets in the plan. If a terminated single-employer plan had assets that were sufficient to pay benefits at the level guaranteed by the PBGC (described below), the employer had no further liability to the PBGC. If a single-employer plan was terminated with assets insufficient to pay benefits at the level guaranteed by the PBGC, the employer was liable to the PBGC for the insufficiency or for an amount equal to 30 percent of the employer's net worth, if less.

Guaranteed benefits

Subject to limits, the PBGC guarantees basic benefits under a plan. Basic benefits consist of nonforfeitable retirement benefits other than those benefits that become nonforfeitable solely on account of the termination of the plan. Guaranteed benefits are limited to basic benefits of $750 per month adjusted for inflation since 1974 ($1,857.95 for 1987).

Guarantees do not apply with respect to benefits in effect for fewer than 60 months at the time of plan termination unless the PBGC finds substantial evidence that the plan was terminated for a reasonable business purpose and not for the purpose of securing increased guaranteed benefits for participants. In cases in which they apply, guarantees are phased in at the rate of $20 per month or 20 percent per year, whichever is greater, for (1) basic benefits that have been in effect for less than 60 months at the time that the plan terminates, or (2) any increase in the amount of basic benefits under a plan resulting from a plan amendment within 60 months before the date of plan termination.

Voluntary terminations

In general

The Single Employer Pension Plan Amendments Act (SEPPAA), enacted in 1986, substantially modified the rules relating to the termination of single employer pension plans. Under SEPPAA, the conditions under which an employer may voluntarily terminate were revised and an employer's liability to plan participants and the PBGC was increased in the case of a termination of an underfunded plan.

Standard terminations

A single-employer defined benefit pension plan may be voluntarily terminated only in a standard termination or in a distress termination. A plan may be terminated in a standard termination only if it has sufficient assets to pay all benefit commitments under the plan. Benefit commitments are greater than guaranteed benefits, and include all benefits guaranteed by the PBGC and all benefits that would be guaranteed but for the dollar limit on the guarantee or the length of time and benefit has been in existence (see above). In addition, benefit commitments include early retirement supplements or subsidies and plant closing benefits, without regard to whether such benefits are guaranteed, with respect to participants who have satisfied all conditions for entitlement prior to termination.

Benefit commitments are less than plan termination liability. Termination liability includes all fixed and contingent liabilities. Benefit commitments do not include benefits that vest solely due to plan termination or contingent benefits (such as early retirement benefits) for which the participant has not satisfied all conditions for entitlement prior to termination.

If a plan is terminated in a standard termination so that the plan assets are sufficient to satisfy benefit commitments, then the employer has no further liability to the PBGC or to plan participants, even if the plan is not sufficiently funded to meet termination liabilities. In such cases, the participants lose their rights to benefit promises because the PBGC has no liability for benefits in excess of guaranteed benefits. Thus, participants may lose benefits that vest on account of plan termination. They may also lose certain contingent benefits.

Distress terminations

In general.—A plan with assets insufficient to provide benefit commitments may be terminated in a distress termination only if the PBGC determines that each contributing sponsor and each substantial member of the contributing sponsors' controlled groups satisfies at least one of four distress standards described in ERISA. ERISA provides that an entity is a contributing sponsor if it (1) is responsible for funding the plan or (2) is a member of the controlled group of an entity that is responsible for funding or formerly was responsible for funding, and has employed a significant number of participants under the plan while it was so responsible. The term "controlled group" means a group of entities under common control. A "substantial member" of a controlled group is generally any entity whose assets comprise at least 5 percent of the assets of the controlled group.

In order to terminate a plan in a distress termination, a plan administrator is required to demonstrate that (1) a petition in bankruptcy or a State insolvency proceeding has been filed seeking liquidation of each contributing sponsor of the plan and each substantial member of the controlled group of each contributing sponsor and that the petition has not been dismissed or converted to one seeking reorganization; (2) a petition in bankruptcy or a State insolvency proceeding has been filed seeking reorganization of each contributing sponsor of the plan and each substantial member of the controlled group of each sponsor and that the bankruptcy court has approved the plan termination; (3) unless a distress termination occurs, each of the contributing sponsors and the substantial members of the controlled group will be unable to pay its debts when due and will be unable to continue in business, or (4) with respect to the contributing sponsors and each substantial member of the controlled group, the costs of providing pension coverage have become unreasonably burdensome, solely as a result of a decline in the workforce covered as participants under single-employer defined benefit pension plans.

Liability to plan participants.—In a distress termination, if there are benefit commitments in excess of PBGC-guaranteed benefits that cannot be paid out of current plan assets ("outstanding benefit commitments"), then the PBGC is required to appoint an independent fiduciary with respect to a special termination trust maintained for the benefit of participants. The term "outstanding amount of benefit commitments" under a plan is defined as the excess of (1) the actuarial present value of the benefit commitments of each participant and beneficiary over (2) the actuarial present value of the benefits of each participant and beneficiary that are guaranteed by the PBGC or to which assets of the plan have been allocated under the distribution procedures of section 4044 or ERISA.

Each contributing sponsor of the plan and each member of the controlled group of a contributing sponsor is jointly and severally liable to the termination trust for the lesser of (1) 75 percent of the outstanding benefit commitments, or (2) 15 percent of the total benefit commitments. Amounts paid to the termination trust are to be distributed to the participants as collected, after payment of the trust's administrative expenses, without regard to the usual allocation priorities of ERISA.

In general, payment of liability by a contributing sponsor to a termination trust is to be made under commercially reasonable terms, with deferrals of certain amounts in years in which no person liable for the tax has pre-tax profits. Such deferred amounts are only payable after similar deferrals with respect to liability to the PBGC have been paid in full.

If payment is not deferred, then payment to the termination trust occurs contemporaneously with payment to the PBGC. Thus, additional amounts may be paid to plan participants even if the full liability to the PBGC has not been discharged.

Liability to PBGC.—In a distress termination, if the plan assets are insufficient to fund guaranteed benefits, each contributing sponsor and each member of the controlled group of each contributing sponsor is jointly and severally liable to the PBGC for the sum of (1) the outstanding balance of any accumulated funding deficiency, and (2) the balance of the amount of any waived funding deficiencies. The full amount of a contributing sponsor's liability to the PBGC is due and payable as of the date of plan termination.

In addition, upon the termination of a plan pursuant to a distress termination, each contributing sponsor of the plan and each member of the controlled group of each contributing sponsor is jointly and severally liable to the PBGC for the sum of (1) the total amount of all unfunded guaranteed benefits, up to 30 percent of the collective net worth of the entities that are liable, (2) the excess of 75 percent of the unfunded guaranteed benefits over 30 percent of the collective net worth of the entities that are liable, and (3) interest on such amounts from the date of termination. Payment of this liability is generally to be made under commercially reasonable terms, with deferrals of certain amount in years in which the liable entities have no pre-tax profits.

The rules described above apply without regard to whether the employer or any member of the controlled group also maintains one or more plans that have assets in excess of termination liabilities.

PBGC claims in bankruptcy

Under present law, up to the 30 percent of net worth limit, the PBGC's claim has the status of a Federal tax lien for bankruptcy purposes; the priority status of the remainder of the PBGC's claim is determined under generally applicable bankruptcy rules.

The typical PBGC claim generally will be based on underfunding that accrued prior to the date that a petition is filed in bankruptcy court. This is generally the case even if the PBGC's claim occurs as a result of a plan termination occurring after the petition date. Under generally applicable bankruptcy law, liens on property are to be perfected prior to the petition date and are not granted after that date without the consent of the bankruptcy court. Consequently, the PBGC's claims are almost never perfected prior to the petition filing date and the PBGC, therefore, will normally retain the status of an unsecured creditor in a bankruptcy proceeding.

Termination by PBGC

The PBGC is authorized to commence proceedings to terminate a plan under certain circumstances and is required to do so if the plan does not have assets available to pay benefits that are currently due under the terms of the plan.

Administration Proposal

Under the Administration proposal, the required plan asset level for a standard termination would be increased from the present-law requirement of benefit commitments to the full level of the plan's termination liability to participants. For this purpose, the plan's termination liability would include all fixed and contingent accrued benefits that would be provided if the plan had sufficient assets.

Under the proposal, a defined benefit pension plan with assets insufficient to provide its termination liability to participants would be unable to terminate unless the employer (and controlled group) could satisfy the criteria for a distress termination. Following a distress termination, the employer's (and controlled group's) liability to participants would be increased from the present-law percentage of benefit commitments to the full amount of the plan's unfunded termination liability. (Under the proposal, the change to termination liability would not modify the priority status of pension claims in bankruptcy.) Assets collected to satisfy the employer's liability would be allocated in accordance with the present-law priority rules, except that the value of PBGC's claim for 30 percent of net worth would be allocated exclusively to unfunded guaranteed benefits.

The Administration proposal provides that if a plan terminates with assets less than the plan's termination liability, a transfer of assets would be required. The proposal would require a transfer of assets from other plans of the controlled group to the terminating plan. Under allocation rules to be developed, the value of assets required to be transferred would be equal to the amount necessary to cover the termination liability of the terminating plan. Under the proposal, however, a transfer of assets from an ongoing plan would not be required to the extent the transfer would reduce the assets in that plan to less than the plan's termination liability. A transfer of a plan with assets less than its termination liability to a sponsor outside of the controlled group would be treated as a termination of the transferred plan for purposes of this rule requiring asset transfers. (Special provisions would be developed to take into account the relative benefit levels of the underfunded and overfunded plans and to protect against manipulation of the asset transfer requirement through benefit increases.)

Except to the extent permitted by the PBGC, an employer (and its controlled group) would be precluded from establishing retirement programs which, in whole or in part, provide substantially similar benefits within 5 years after termination of a plan that did not have adequate assets to provide PBGC guaranteed benefits.

General Accounting Office Report

The GAO report recommended raising the priority of the PBGC's claims against the employer in bankruptcy, and reducing the benefits guaranteed by the PBGC. For example, instead of phasing in PBGC guarantees over 5 years, guarantees might be made inapplicable to benefit improvements within 5 years of plan termination.

Analysis of Issues

Employer liability upon termination

The Administration believes that the proposal relating to termination of underfunded plans would improve the likelihood that employers will adequately fund their defined benefit pension plans and would prevent employers from improperly shifting their liabilities to the PBGC.

Some believe that it is inappropriate to allow an employer that is not in financial distress to deny participants promised benefits. Employers may have promised pension benefits in lieu of current compensation. On the other hand, some argue that requiring the ongoing operations of the plan until termination liabilities are satisfied could contribute to an employer entering into a distress situation and could contribute to additional liabilities being shifted to the PBGC.

Similar arguments apply with respect to the proposal to make employers liable for termination liabilities without limitations. Those who favor the termination liability standard question the propriety of allowing financially distressed but solvent employers to escape liability to the PBGC or to participants. Those who oppose the termination liability standard believe that the standard would make recovery of distressed employers less likely.

PBGC status in bankruptcy

Some contend that simply raising employers' liability in the case of distress terminations will be largely ineffective because the low priority accorded to PBGC and participant claims in bankruptcy makes it unlikely that any significant portion of those liabilities will be satisfied. These commentators recommend raising the priority of the PBGC or the participants or both in bankruptcy. The GAO report concluded that the mere increase in an employer's liability on plan termination would not be sufficient to reduce the potential liability of the PBGC. In examining the plan terminations that increased the PBGC claims for the 1983-85 period the GAO found that if SEPPAA had been in effect, only 4 percent of the total claims for the period could have been secured by the PBGC. However, any changes in the priority status of creditors in bankruptcy are normally subject to close scrutiny because of a concern that the rights of all creditors be appropriately balanced. Such a change in creditor status for the PBGC could have adverse consequences with respect to secured creditors and could diminish the general willingness of lenders to extend credit to finance business operations of firms that maintain defined benefit pension plans.

Certain experts question whether plan participants should receive nonguaranteed benefits, either under the plan or under a plan providing substantially similar benefits, before the PBGC has been made whole. They believe that giving priority to the PBGC would protect its financial condition and make it better able to provide a higher level of guaranteed benefits for more participants. They also believe that giving PBGC priority would be consistent with the result under present law that occurs when a plan is terminated with assets at a level that is sufficient to provide guaranteed benefits.

On the other hand, some who oppose the Administration proposal maintain that the primary objective should be to provide benefits to participants and that the existing structure should be modified to provide participants with priority respect to termination liabilities. These commentators contend that losses of the PBGC can be spread among an appropriately large group of employers or paid for through general revenues. This argument assumes more stringent funding requirements (see Part III, above); otherwise it would allow certain employers or industries in financial difficulty to use the rules to obtain an even greater subsidy from other employers (or taxpayers generally) than is available under present law.

Controlled group rules

Critics of the Administration proposal regarding mandatory transfers within the controlled group upon termination of an underfunded plan maintain that such a rule is inconsistent with the basic principle that a plan is maintained for the exclusive benefit of the participants and beneficiaries. They argue that this principle is especially important with respect to collectively bargained plans where often a specific plan contribution (rather than a benefit) is bargained for in lieu of a corresponding amount of current wages. Moreover, some commentators contend that this same process—offsetting wages by plan contributions—takes place with respect to all plans. To the extent that this is so, they maintain that it would be inappropriate to require one plan to subsidize another.

The Administration contends that it is inappropriate to deny certain employees promised retirement benefits to the extent that other plans have more than enough assets to fund termination liabilities. What offsets wages is not plan contributions, but the present value of promised benefits and, thus, all participants should receive such promised benefits to the extent of the controlled group's plan assets. In fact, some maintain that the Administration proposal does not go far enough in this regard; all plans within the controlled group should, according to these critics, be funded at the same level in proportion to termination liabilities and transfers should be required to achieve this. This rule would prevent the problem under the Administration proposal in the case of a controlled group with two or more underfunded plans and not enough excess assets to fund them all sufficiently. The first to terminate would be funded first under the Administration proposal.

With respect to the Administration proposal to treat a transfer of a plan outside of the controlled group as a termination, critics suggest that the rule would inhibit sound business transactions and is unnecessary where the acquiring entity is financially sound or has overfunded plans. Supporters of the Administration proposal point out that it is difficult to administer a rule that turns on the financial condition of a business.

The Administration proposal is designed to ensure that plans are not funded at the level of termination liability. If it is appropriate to require plans to fund above the level of termination liability, it is arguably inconsistent to limit the amount of excess assets included in a transferred plan to the amount available upon a withdrawal or termination. Accordingly, some argue that the funded level of the transferred plan should be at least equal to the funded levels of the other plans maintained by the transferring employer. Of course, such a modification of the Administration proposal would enable an employer to recover assets through transfers that could not be recovered through the mechanism of a direct withdrawal on termination.

B. Plan Investment in Employer Securities

Present Law and Background

Under ERISA, an employee pension benefit plan many acquire or hold securities of the employer sponsoring the plan (or affiliates of the sponsor) only if the securities are "qualifying employer securities". In general, any stock of the plan sponsor (or an affiliate) is a qualifying employer security. Debt securities, however, are only considered qualifying employer securities if the debt security is a "marketable obligation". In general, an obligation is marketable if (1) the obligation is traded on a national securities exchange or is part of an issue a substantial portion of which is sold to investors who are independent of the sponsor, and (2) the plan holds no more than a quarter of the issue and independent persons hold at least one-half of the issue (ERISA sec. 407).

Under the Tax Reform Act of 1986, nonpublicly traded employer stock that is acquired by an employee stock ownership plan (ESOP) is required to be valued by an independent appraiser for all plan purposes. The independent appraisal requirement applies to employer stock acquired after December 31, 1986 (Code sec. 401(a)(28)).

Also under ERISA, defined benefit pension plans and money purchase pension plans may not acquire qualifying employer securities in an amount in excess of 10 percent of the assets of the plan. "Eligible individual account plans," i.e., profit-sharing plans, stock bonus plans, and ESOPs are not subject to the 10-percent limit and may hold up to 100 percent of plan assets in qualifying employer securities (ERISA secs. 404(a)(2) and 407).

Currently, some employers maintain "floor-offset" arrangements. A floor-offset arrangement is a combination of a defined contribution plan and defined benefit pension plan. Under a floor-offset arrangement, a participant's benefits under the pension plan (the floor plan) are offset by the participant's benefits under the defined contribution plan (the offset plan). Many employers take the position that the defined contribution plan is an eligible individual account plan that qualifies for the exception to the 10-percent limit on investments in employer securities. Although the Internal Revenue Service has ruled that floor-offset arrangements may meet the qualification requirements of the Code if certain conditions are satisfied, the Department of Labor has not ruled that the defined contribution portion of these arrangements qualify for the exception to the 10-percent limit on investments in employer securities.

Administration Proposal

Under the Administration proposal, the present-law requirement that employer debt securities must be marketable obligations would be extended to all employer securities. Under the proposal, stock of the employer would not constitute a qualifying employer security unless the stock were a marketable obligation. Eligible individual account plans would not be subject to this the proposed marketable obligation requirement. Under the proposal, for example, a defined benefit pension plan maintained by a closely-held company with nontradable stock generally would not be able to hold employer securities but employer securities could be held by an ESOP maintained by the same company.

In addition, the Administration proposal would extend the 10-percent limitation on holding employer securities to the defined contribution portion of a floor-offset arrangement.[7] Thus, the defined benefit pension plan and the defined contribution plan would be considered as a single plan for purposes of the limitation on

[7] Under ERISA, the 10-percent limitation applies to the aggregate fair market value of employer securities and employer real property held by the plan. (Employer real property is real property and related personal property leased to the employer sponsoring the plan or an affiliate of the employer.) The Administration proposal would not change this aggregation. Thus, under the proposal, wherever the 10-percent limit applies, it would be a limit on the aggregate amount of employer securities and employer real property that could be held by a plan.

qualifying employer securities. Under the proposal, therefore, neither component plan under a floor offset arrangement could hold more than 10 percent of its assests in qualifying employer securities. Transition rules similar to the rules provided by ERISA when the 10-percent limit was introduced would apply to plans which currently do not meet the 10-percent limit.

Analysis of Issues

The present-law restrictions on investments in employer securities by pension plans are designed to limit the risks to which plan participants and the PBGC would be exposed through investments in the plan sponsor. Present law may not, however, ensure adequate protection in all cases.

For example, because employer stock held by a plan is not required to be a marketable obligation, many employers have issued stock to their employee benefit plans that is not readily tradable and that has features that are substantially different from stock issued by the employer to other investors. Proper valuation of employer stock is extremely difficult. Moreover, because this stock may never have been subject to a market test (i.e., confirmation of valuation by independent investors), plan investment in such stock may involve increased risks to plan participants and the PBGC.

To the extent that employers have floor-offset arrangements where the offset plan holds substantial amounts of employer securities, the protections intended to be provided to participants in defined benefit pension plans by the 10-percent limitation may be undercut. In such situations, the security of the participant's defined benefit promise may be substantially weakened. In addition, the risk of loss to plan participants and the PBGC may be greatly increased.

Those who favor the Administration proposal argue that it would reduce the risk to plan participants and the PBGC associated with investments in the plan sponsor by adding additional restrictions on the holding of employer securities by defined benefit pension plans and plans related to such plans. They also believe that, to further achieve this goal, it would also be appropriate to provide (or clarify) that the marketable obligation requirement applies to stock held by an eligible individual account plan which is part of a floor-offset arrangement. In addition, it should be clarified that, in the case of floor-offset arrangements, the defined contribution plan could hold no more qualifying employer securities than can the defined benefit plan. They argue that these further modifications would prevent employers from increasing the amount of employer securities a defined benefit pension plan can hold by utilizing a floor-offset arrangement.

Those who oppose the proposal are primarily concerned about the effect of the proposal on ESOPs maintained by closely held companies. Those who favor the proposal argue that such plans will not be affected unless they are part of a floor-offset arrangement.

Some commentators question why any employer securities should be held under a retirement plan. They contend that a prohibition against an investment in employer securities by a retirement plan would prevent an employee's retirement security from being linked to the same entity on which the employee relies for current income.

It is argued that the Administration proposal inappropriately prohibits investments in employer securities on the theory that such investments increase the risks to plan participants and the PBGC. Those who oppose the Administration proposal contend that the actual risk of an investment in employer securities should be measured and should not be subject to a mechanical rule which presumes that employers securities are high-risk investments. They believe that the proposed rule would reduce the status of employer securities relative to other investments without regard to the financial stability and earnings record of the employer.

Opponents of the Administration proposal argue further that the fiduciary responsibility standards of ERISA prevent any plan trustee from investing disproportionate amounts of plan assets in any investment medium if the investment would increase the risk of loss to plan participants.

V. EMPLOYER ACCESS TO ASSETS OF OVERFUNDED PLANS

Present Law and Background

Exclusive benefit rule

Under the Code, a trust forming part of a pension plan is not qualified unless under the trust instrument it is impossible, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the trust assets to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries (Code sec. 401(a)(2)). However, upon termination of the plan and after satisfaction of all fixed and contingent liabilities of the participants and beneficiaries (termination liability), the employer may recover any excess assets remaining in the trust that are due to erroneous actuarial computations (Treas. reg. sec. 1.401-2(b)(1)).

Similarly, under ERISA, the assets of an employee benefit plan may not inure to the benefit of any employer and are to be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan (ERISA sec. 403(c)). However, as under the Code, any excess assets of a plan may be distributed to the employer upon termination of the plan if (1) all liabilities of the plan to participants and their beneficiaries have been satisfied, (2) the distribution does not contravene any provision of law, and (3) the plan provides for such a distribution (ERISA sec. 4044(d)).[8]

Under present law, upon the termination of the plan, all accrued benefits must become 100 percent vested and nonforfeitable. In addition, the accrued benefits must be distributed or annuitized, that is, annuities providing for the payment of accrued benefits must be purchased and distributed to participants.

Under present law, whether the employer has the right to the excess assets or must share excess assets with plan participants is generally determined under the plan document. Thus, if the plan document provides that the employer is entitled to the reversion of excess assets, the employer is not required to share the reversion with participants. Case law generally provides that, subject to any applicable collective bargaining agreements, the plan can be amended at any time prior to termination of the plan to provide that the excess assets may revert to the employer, even if, prior to

[8] Both ERISA and the Code also permit the return of contributions to the employer in certain limited situations prior to the termination of the plan, for example, contributions made by mistake of fact, contributions conditioned on the initial qualification of the plan, and contributions conditioned on the deductibility of the contribution. ERISA sec. 403(c)(2), Code sec. 401(a)(2), Rev. Rul. 77-200, 1977-1 C.B. 98.

the amendment, the plan provided that any excess was to be distributed to employees.[9]

Under present law, the determination of whether there are excess assets is made on a plan-by-plan basis. Thus, if an employer maintains more than one defined benefit pension plan, the employer is permitted to recover excess assets in an overfunded plan, regardless of whether the other plans have sufficient assets to satisfy their liabilities. The present-law rules provide an incentive to employers to maintain multiple plans funded at varying levels in order to maximize their access to tax-favored plan assets at the expense of benefit security. Some employers have received assets reversions from their overfunded plans and then terminated their underfunded plans. Under these circumstances plan participants and their beneficiaries are deprived of their full benefits and, in some cases, unfunded liabilities are shifted to the PBGC.

Access to plan assets prior to termination

Although an employer technically is not permitted to recover excess assets except upon termination of a plan, present law permits certain transactions that in effect permit the withdrawal of assets from an ongoing plan. Typical examples of such transactions are termination-reestablishment and spinoff-termination transactions.

In a termination-reestablishment transaction, the employer terminates a defined benefit plan, recovers the excess assets, and then establishes a "new" plan that covers the same employees and provides the same or substantially similar benefits as the old plan. In a spinoff-termination transaction, a single plan is split into two plans, one plan covering retirees and one covering active employees. The excess assets are allocated to the plan covering retirees. That plan is then terminated, allowing the employer to recover the excess assets.

In response to concern that reversions can reduce the security of participants' benefits, procedural guidelines were developed jointly by the Department of the Treasury, the Department of Labor, and the PBGC. The procedures, referred to as the "Implementation Guidelines for Terminations of Defined Benefit Pension Plans" or the "Implementation Guidelines," were issued by the Administration as a news release on May 24, 1984.

The Implementation Guideines set forth administrative procedures for processing certain terminations of qualified defined benefit pension plans involving reversions of excess assets to the plan sponsor. The guidelines generally provide that a bona fide termination of a defined benefit pension plan will be recognized as having occurred under either a spinoff-termination or a termination-reestablishment transaction only if certain conditions are met.

A spinoff-termination is considered bona fide under the guidelines only if (1) the benefits of all employees are vested as of the date of the termination, (2) all benefits accrued by all employees as of the date of the termination are provided for by the purchase of annuity contracts, (3) the continuing plan adopts a special funding

[9] See e.g., *Washington-Baltimore Newspaper Guild Local 35 v. Washington Star*, 555 F.Supp. 257 (D.D.C. 1983), aff'd 729 F.2d 863 (D.C. Cir. 1984).

method (with the approval of the IRS), and (4) appropriate notice is provided to employees.

Under the Implementation Guidelines, termination-reestablishment transactions are generally recognized as bona fide. If the new plan provides credit for service before that plan was adopted, however, the guidelines do not treat the transaction as bona fide unless a special funding method is adopted (with the approval of the IRS).

The guidelines note that spinoff-terminations or termination-reestablishments may affect the qualified status of plans under the tax law because the Code requires that qualified plans be permanent. The guidelines generally provide that the permanency requirement prohibits an employer that has engaged in a spinoff-termination or termination-reestablishment transaction from engaging in another such transaction for at least 15 years.

By undertaking a termination-reestablishment or a spinoff-termination, an employer is effectively able to recover all assets in excess of the plan's termination liability from an ongoing defined benefit plan. Although all benefits earned to date would have to be vested and annuitized, the ongoing plan is not required to retain an asset cushion above the level of the plan's termination liability. The absence of this cushion reduces employees' security with respect to future benefits and may also discourage employers from providing for future benefit increases.

Under present law, the extent to which a defined benefit pension plan that is overfunded on a termination basis can transfer excess assets directly to a qualified defined contribution plan of the same employer is uncertain. Because such a transfer could have the effect of satisfying the employer's obligation to make a contribution to the transferee plan, the transaction can have the effect of a reversion, diverting assets from the exclusive benefit of participants.

Tax treatment of reversions

In general, asset reversions are fully includible in the gross income of the employer receiving the reversion, and thus, are subject to income tax. In addition, under the Tax Reform Act of 1986, reversions are generally subject to an excise tax equal to 10 percent of the amount of the reversion. Asset reversions transferred to an ESOP prior to January 1, 1989, are excepted from both these rules and, therefore, are not includible in the gross income of the employer or subject to the excise tax. The excise tax was added in order to recapture the tax benefit received by the employer from plan contributions, i.e., tax-free growth. The tax may or may not be adequate to fully recapture the tax benefit depending on the length of time the assets were held by the plan.

Administration Proposal

In general

The Administration proposal permits an employer to withdraw assets from an ongoing defined benefit pension plan provided that, following the withdrawal, an asset cushion in excess of termination liability remains in the plan and in all other defined benefit pension plans maintained by the employer and the employer's controlled group. Similarly, in the case of a termination of a plan, the employer is generally required to leave an asset cushion in the plan. An employer is not required to leave an asset cushion and may obtain all assets in excess of plan termination liability only in the case of a plan termination and only if the employer and the employer's controlled group do not maintain another defined benefit pension plan at the time of termination and for 5 years after the termination.

The proposal retains the present-law rule that full vesting and annuitization of accrued benefits are required upon termination of a plan, but does not impose these requirements in the case of a withdrawal from an ongoing plan. The proposal provides that all withdrawals and reversions, other than transfers to another defined benefit pension plan maintained by the employer (or the employer's controlled group) and certain transfers to fund retiree health benefits are fully includible in income and subject to the 10-percent excise tax on reversions.

Asset withdrawals from ongoing plans

Under the proposal, an employer would be permitted to withdraw assets from an ongoing defined benefit pension plan to the extent that, following the withdrawal, each of the following conditions is satisfied: (1) the value of the assets in the plan of withdrawal exceeds the "minimum benefit security level" for such plan, and (2) the value of the assets in all other defined benefit pension plans of such employer and the controlled group of which the employer is a member exceeds the minimum benefit security level for all such other plans (calculated as though such other plans were a single plan). For purposes of the second requirement, multiemployer plans to which the employer or a member of the employer's controlled group contributes are disregarded.

In general, the minimum benefit security level is the greater of (1) the full funding amount for the plan, or (2) 125 percent of the termination liability of the plan.

A reduced cushion would be allowed to the extent that benefits are annuitized under the plan. The minimum benefit security level is lower for annuitized benefits because the employees and the PBGC are not at risk due to investment losses to the extent accrued benefits are annuitized. Thus, a lower cushion is sufficient to protect those benefits. With respect to annuitized benefits, the minimum benefit security level would be equal to the greater of (1) the termination liability of the plan plus 40 percent of the excess of the full funding amount of the plan over the termination liability of the plan, or (2) 110 percent of the termination liability of the plan. For example, if 20 percent of the termination liabilities of a plan were annuitized, then the general formula for determining the minimum benefit security level would be applied to 80 percent of the plan's termination liabilities and the special formula would apply to 20 percent of the plan's termination liabilities.

In the case of a withdrawal, full vesting or annuitization of accrued benefits would not be required.

Asset reversions on plan termination

Employers with other defined benefit pension plans.—The proposal generally treats a reversion upon termination of a defined benefit pension plan the same as a withdrawal from a defined benefit pension plan. Thus, an employer (or a member of the employer's controlled group) would not be permitted to recover more assets through a plan termination than through an asset withdrawal if such employer (or a member of the employer's controlled group) continues to maintain a defined benefit pension plan. In such a case, the difference between the minimum benefit security level and the plan's termination liability would have to be transferred to the ongoing defined benefit pension plans maintained by the employer (or the controlled group) before the plan is terminated. The proposal anticipates that rules will be developed for allocating the transferred assets between the other defined benefit pension plans maintained by the employer and the controlled group. Following the termination, the employer could not cover the affected employees under another defined benefit pension plan (including a multiemployer plan) for 5 years.

Employers with no other defined benefit pension plans.—Under the proposal, the only time an employer could recover all assets in excess of termination liability would be when the employer (and the controlled group) does not maintain any other defined benefit pension plan. In such a case, the employer and the controlled group would be precluded from covering any employees under another defined benefit pension plan (including a multiemployer plan) for 5 years.

All terminations.—In the case of all terminations, the proposal would retain the present-law requirement that accrued benefits must be fully vested and annuitized upon plan termination.

The proposal anticipates that appropriate rules would be developed to deal with certain changes in the composition of a controlled group, e.g., the acquisition of a subsidiary or division with pre-existing defined benefit pension plans.

Transactions having the effect of a reversion

An employer can accomplish an economic result equivalent to a plan termination and asset reversion by transferring plan sponsorship to an employer outside the employer's controlled group. For example, assume an employer maintains a defined benefit pension plan for a division and that the plan is overfunded. The employer also maintains defined benefit pension plans that are underfunded, and therefore cannot make a withdrawal under the proposal or terminate the overfunded plan and obtain a reversion. If the employer sells the division outside the controlled group, the employer is able to realize the benefit of the excess plan assets through adjustments in the terms of the sale of the division.

In order to prevent avoidance of the restrictions on withdrawals and termination reversions in this manner, the proposal would treat a transfer of plan sponsorship to an employer that is outside of the controlled group as a plan termination for purposes of determining the extent to which assets in excess of such plan's termination liability may be transferred with the plan.

For example, if plan sponsorship is transferred beyond the controlled group in connection with the sale of a subsidiary or division, assets in excess of the plan's termination liability would be permitted to remain in the plan only to the extent that the employer could have recovered excess assets through a termination of the plan. Prior to the transfer of sponsorship, any assets not available to the employer on plan termination would have to be transferred to other defined benefit pension plans of the employer or controlled group.

To the extent that assets available for employer recovery on a plan termination remain in the plan that is being transferred to a new sponsor, such assets would be treated as having reverted to the transferring sponsor and, therefore, would be includible in the employer's gross income and subject to the 10-percent excise tax on reversions. If an employer (and controlled group) does not maintain any other defined benefit pension plans, then the amount of excess assets transferred would not be limited. Such an employer would be subject to the 5-year prohibition on maintenance of a defined benefit pension plan. Of course, the amount treated as a reversion would still be subject to income and excise taxes.

The proposal recognizes that strict rules on transfers of plan sponsorship beyond the controlled group could in some cases interfere with corporate transactions. Accordingly, the proposal states that special efforts will be made to minimize the disruptive effect of the asset recovery rules on such transactions, without undercutting the policies the proposal seeks to achieve.

The proposal would also treat all transfers of assets to a defined contribution plan of the employer or controlled group member as a reversion.

Frequency limits

After an employer has recovered assets from a plan through either a withdrawal or a reversion, neither the employer nor any member of its controlled group would be permitted to receive plan assets in a subsequent reversion or withdrawal for 10 years. However, if, through a reversion or withdrawal, an employer recovers less than the total amount available, the employer could recover assets in a subsequent reversion or withdrawal within the 10-year period provided that the subsequent reversion or withdrawal does not exceed the lesser of (1) the excess of the total amount available at the time of the initial reversion or withdrawal over the actual amount of such reversion or withdrawal, or (2) the amount available for reversion or withdrawal under the applicable rules at the time of the subsequent reversion.

In no case, however, would an employer or controlled group member be permitted to recover assets through a withdrawal or reversion on more than 3 occasions during any 10-year period. Also, an employer would be precluded from recovering a withdrawal or reversion from a newly established plan until the plan had been in effect for 10 years. An employer could at any time receive a reversion from a terminating plan if, following such reversion, neither the employer nor any member of the controlled group continued to maintain a defined benefit pension plan. Simultaneous recoveries from more than one plan within a controlled group would count as a single recovery for purposes of the application of the frequency limits.

Special rules would be applied to deal with sales and purchases of divisions and subsidiaries with defined benefit pension plans and with changes in the composition of the controlled group. For example, it generally would be appropriate to exempt an employer (and controlled group) from the 10-year limit if the employer (and controlled group) is departing entirely from the defined benefit pension plan system.

Taxation of withdrawals and reversions

All withdrawals, termination reversions and transfers of excess assets other than transfers to another defined benefit plan of the employer or controlled group and certain transfers to fund retiree health benefits (see part VI, below) would be includible in gross income and subject to the 10-percent excise tax. All excess assets transferred from a defined benefit pension plan to a defined contribution plan within the controlled group would be treated as a reversion.

General Accounting Office Report

In response to a request from the Chairman of the House Select Committee on Aging, the GAO issued, on April 30, 1986, a report on the termination of defined benefit pension plans involving the reversion of excess assets to employers. The purpose of the report was to obtain information on the reasons that defined benefit pension plans had excess assets on plan termination, the types of replacement plans provided for employees, and the effect of the Implementation Guidelines on employers' termination and replacement decisions.

The GAO concluded that, of the companies surveyed, the primary reason for excess assets was a higher-than-expected rate of return on plan assets. The reason cited most often for plan termination was the desire to use excess pension plan assets for nonpension purposes.

Analysis of Issues

The fundamental issues raised by the Administration proposal are whether the employer should have a right to any excess assets in a defined benefit pension plan maintained by the employer and, if so, whether the employer should be able to obtain the use of excess assets under a plan without terminating the plan.

With respect to the first issue, the proposal retains present law. That is, it permits the employer to retain the right to excess assets. Those in favor of the proposal argue that requiring that the employees share in the excess assets would ultimately reduce benefit security. There are two main reasons why such a reduction might occur.

They argue that employers may be reluctant to generously fund a plan if any surplus must be shared with employees. If the flexibility in funding methods and assumptions were reduced, then restricting employers' rights to the surplus might not have as much effect on funding simply because employers would not have as much choice as to how much they may contribute. To the extent employers do have a choice, however, they may be inclined to fund at a slower rate if they do not have a right to the reversion.

Supporters of the proposal also argue that, even if employers have little flexibility in funding, they may set benefits at a lower level and be more reluctant to grant benefit increases if the employees are entitled to share in the excess. Thus, employers may anticipate that the employees will be entitled to some or all of the excess by funding for a lower benefit. Those who oppose the Administration proposal argue that reducing flexibility in selecting funding methods and assumptions would not address this anticipated reaction. Critics of the proposal maintain that this speculative result should be weighed against the revenue costs of providing employers with a means to save on a tax-favored basis for purposes other than providing retirement benefits.

One of the main arguments advanced by critics of the proposal for entitling employees to the excess relates to the nature of the defined benefit promise, particularly in the context of plan terminations. Employees who participate in a defined benefit pension plan may expect that they will be able to continue working and to increase their service and compensation credit under the plan. If the plan is terminated before employees have earned the maximum benefit available under the plan, then they will not have received all that they expected; the ability to increase service and compensation credit would be eliminated. Accordingly, in such cases it may be appropriate to provide that a portion of excess assets must be applied to benefit increases. This argument has less application where a withdrawal is made and the plan is ongoing.

Another argument advanced by opponents of the proposal is best illustrated in the case of single-employer collectively bargained plans. In such plans a union may bargain for a specified contribution by the employer, rather than for a specified benefit. In such cases, there is an argument that the employees are entitled to whatever benefits the contributions made by the employer will provide. Even under nonbargained plans, it is argued, the salary or wage levels set by the employer may take into account the contributions made by the employer to the pension plan so that there it also may be appropriate for the employees to share in the excess.

From a tax-policy perspective, critics of the Administration proposal also argue that permitting an employer the right to obtain excess assets encourages the employer to use a pension plan as a device for obtaining tax-favored savings. Although the 10-percent reversion tax was designed to address this problem, and was designed to recapture, at least in part, the tax benefits received by the employer, it may not fully do so. The restrictions placed under the proposal on withdrawals and reversions may reduce the attractiveness of utilizing the plan as a device for obtaining tax-favored saving.

Even if it is determined that employers are entitled to some or all of the excess assets under a plan, the aggregation rules of the proposal raise the issue as to which employees should be entitled to share in the excess. As discussed above, in some circumstances, the proposal would require an employer to transfer excess assets from one defined benefit pension plan to another. Appropriate allocation rules for such transfers would be needed, particularly where the transferor plan or related bargaining agreement provides that the employees are entitled to some or all of the excess assets.

The second basic issue raised by the proposal is whether it is appropriate to allow an employer to obtain a transfer of excess assets from an ongoing plan that provides for such a transfer. In the past few years, the number of terminations of defined benefit pension plans and the amount of reversions have risen dramatically. There has been much concern about such terminations, partly because many employees may be better off in an ongoing plan. There is a concern that if employers are entitled to excess assets only on termination of a plan, they will terminate their plans in order to recapture the excess. On the other hand, under the termination guidelines, employers are not required to terminate their plans in any meaningful sense to access excess assets.

Proponents of the proposal argue that the proposal will reduce terminations because it favors withdrawals over reversions due to plan terminations. Thus, for example, vesting and annuitization are not required for a withdrawal, but are required in the case of a plan termination. Also, in order for an employer to recover all assets in excess of termination liability, neither the employer nor the controlled group can maintain another defined benefit plan (including a multiemployer plan) for 5 years. It is argued that most employers will not be willing to exit the defined benefit pension plan system completely. On the other hand, because the asset cushion is available only on such a plan termination, it is argued by some that the proposal encourages real terminations in a way that current law does not.

Proponents of the proposal further argue that the proposal toughens the present-law rules regarding reversions while the employer maintains a plan. The cushion requirements, the controlled group rules, and the rules aggregating all defined benefit pension plans are more restrictive than present law. On the other hand, opponents of the proposal argue that the present-law rules regarding vesting and annuitization should apply to withdrawals or any other case in which an employer gains access to plan assets.

VI. POST-RETIREMENT MEDICAL BENEFITS

Present Law and Background

Comparison with retirement plans

The tax treatment of post-retirement medical benefits differs in significant ways from the treatment of retirement benefits provided under qualified retirement plans. Subject to limits, an employer is entitled to a current deduction for a contribution to a trust under a qualified retirement plan to provide nonmedical retirement benefits to its employees. Moreover, the employees on whose behalf the contribution is made do not include any benefits in income until a distriution from the trust is received. In addition, income on amounts held in the trust is generally exempt from income tax until it is distributed.

Other rules apply to post-retirement medical benefits. As discussed in more detail below, there are two tax-favored funding arrangements to accumulate assets to provide post-retirement medical benefits separately from other retirement benefits. First, separate accounts in certain qualified retirement plans may be used to provide post-retirement medical benefits (Code sec. 401(h)).

Although assets allocated to a medical post-retirement medical benefit account are accorded tax treatment similar to that provided for other assets held by a qualified retirement plan, the benefits provided under post-retirement medical accounts are required to be incidental to the retirement benefits provided by the plan. The incidental benefit requirement may preclude funding the entire post-retirement medical benefit through a separate account in a qualified plan.

Post-retirement medical benefits may be excludible from the gross income of a plan participant or beneficiary when paid. Other benefits provided by a qualified plan are generally includible in gross income except to the extent they are attributable to nondeductible employee contributions.

The second funding medium that can be used to prefund post-retirement medical benefits is a welfare benefit fund (Code secs. 419 and 419A). Welfare benefit funds generally are not subject to the contribution limits applicable to the separate accounts under a qualified plan. In addition, medical benefits provided through a welfare benefit fund generally are excluded from the employee's gross income, which differs from the general rule applicable to distributions from a qualified retirement plan. However, income set aside in a welfare benefit fund to provide post-retirement medical benefits generally is subject to income tax.

Although post-retirement medical benefits are not accorded tax treatment comparable to that provided for retirement benefits under qualified retirement plans, they also are not subject to the same minimum standards applicable to retirement benefits. To be qualified, a plan is required to provide certain rights to active employees. A nondiscriminatory class of active employees is required to be covered under the plan. In addition, contributions under the plan either have to be allocated to accounts established for those employees (defined contribution plans) or have to be made to fund a promise made to those employees to provide them with a specified level of benefits after retirement (defined benefit pension plans). Under a defined benefit plan, benefits are required to be earned or "accrued" according to certain standards under which the accrual is to occur over the working life of the employee, rather than simply at or near retirement. In addition, the account balances in a defined contribution plan, or the accrued benefits in a defined benefit plan, are required to become vested after a certain period of service. In general, these and other requirements for qualification of a retirement plan are not required for tax-favored treatment of post-retirement medical benefits, even those provided under a separate account in a qualified retirement plan.

In addition, outside the tax area, the treatment of deferred cash compensation differs significantly from treatment of deferred medical benefits. Generally, any plan, regardless of whether it is tax-favored, that provides deferred cash compensation to employees other than certain highly compensated employees is required to be funded and to satisfy certain of the minimum standards applicable to qualified retirement plans. On the other hand, this requirement does not apply to deferred medical benefits which can be promised under a plan, but not funded or subject to the minimum standards.

Right to post-retirement medical benefits

As noted above, post-retirement medical benefits are not subject to the same minimum standards applicable to qualified retirement plans under which employees obtain the rights to benefits over their working lives. Thus, employees' rights to post-retirement medical benefits depend on the particular contractual arrangement between the employees and their employer. The binding nature of such arrangements, as they relate to post-retirement medical benefits, has been the subject of recent litigation. Case law has focused on the right of the employer to terminate post-retirement medical benefits with respect to current retirees. In general, courts have affirmed an employer's right to terminate such benefits if such right has been unambiguously reserved and clearly communicated to employees. However, the courts have been strict in applying these standards, looking not just at plan documents but also to oral representations.

Funding media

As noted above, under present law, employers have available two tax-favored funding mediums for prefunding post-retirement medical benefits: (1) separate accounts under a pension or annuity plan that satisfies Code section 401(h), and (2) a welfare benefit fund described in Code section 419. In addition, distributions from qualified retirement plans generally may be used by retirees to acquire post-retirement medical benefits.

Separate accounts (Code sec. 401(h)).—Under the separate account method of prefunding, a tax-qualified pension or annuity plan may provide for the payment of sickness, accident, hospitalization, and medical expenses for retired employees, their spouses, and their dependents provided certain additional qualification requirements are met with respect to the post-retirement medical benefits. First, the medical benefits, when added to any life insurance protection provided under the plan, are required to be incidental to the retirement benefits provided by the plan. The medical benefits are considered incidental to the retirement benefits if, at all times, the aggregate of employer contributions (made after the date on which the plan first includes such medical benefits) to provide such medical benefits and any life insurance protection does not exceed 25 percent of the aggregate contributions made after such date, other than contributions to fund past service credits. Additional medical benefits and life insurance protection may be provided with employee contributions.

The rationale for requiring that the post-retirement medical benefits provided under section 401(h) be incidental and be provided under a separate account is that such benefits generally are not subject to the minimum standards, such as vesting and accrual, generally applicable to qualified retirement plans. Thus, it was considered important not only to limit the tax-favored treatment of such benefits but also to ensure that these relatively unrestricted benefits did not reduce the funds contributed to provide nonmedical retirement benefits pursuant to the minimum standards.

Second, a separate account is to be maintained with respect to contributions to fund such medical benefits. This separate accounting generally is determined on an aggregate, rather than a per-participant basis, and is solely for recordkeeping purposes. Third, the employer's contributions to a separate account are to be reasonable and ascertainable. Fourth, the plan is required to preclude the use of amounts in the separate account for any other purposes at any time prior to the satisfaction of all liabilities with respect to the post-retirement medical benefits. Fifth, upon the satisfaction of all plan liabilities to provide post-retirement medical benefits, the remaining assets in the separate account are to revert to the employer and cannot be distributed to the retired employees. Similarly, if an individual's right to medical benefits is forfeited, the forfeiture is to be applied to reduce the employer's future contributions for post-retirement medical benefits.

The final requirement is that, in the case of an employee who is a key employee (Code sec. 416), a separate account is to be established and maintained, and benefits provided to such employee (and his spouse and dependents) are to be payable only from such separate account. This requirement applies only to benefits attributable to plan years beginning after March 31, 1984, for which the employee is a key employee. Also contributions to such a separate account are considered annual additions to a defined contribution plan for purposes of the limits on contributions and benefits applicable to retirement plans (Code sec. 415), except that the 25 percent of compensation limit (Code sec. 415(c)(1)(B)) does not apply.

If the requirements with respect to post-retirement medical benefits are met, the income earned in the separate account currently is not taxable. Also, employer contributions to fund these benefits are deductible under the general rules relating to the timing of deductions for contributions to qualified retirement plans. The deduction for such contributions is in addition to the deductions provided for contributions for retirement benefits. The amount deductible may not exceed the total cost of providing the medical benefits, determined in accordance with any generally accepted actuarial method that is reasonable in view of the provisions and coverage of the plan and any other relevant considerations. In addition, the amount deductible for any taxable year may not exceed the greater of (1) an amount determined by allocating the remaining unfunded costs as a level amount or a level percentage of compensation over the remaining future service of each employee, or (2) 10 percent of the cost that would be required to fund or purchase such medical benefits completely. Certain contributions in excess of the deductible limit may be carried over and deducted in succeeding taxable years.

Welfare benefit funds (Code sec. 419).—An employer may establish a fund to provide for post-retirement medical benefits. If such fund satisfies certain requirements, it generally will be exempt from income tax. In general, to be tax-exempt, the fund is required to be a voluntary employee's beneficiary association (VEBA) (Code sec. 501(c)(9)) providing for the payment of life, sick, accident, or other benefits to the members of such association or their dependents or designated beneficiaries, and no part of the net earnings of such association may inure (other than through such payments) to the benefit of any private shareholder or individual. In addition, the VEBA generally is required to satisfy certain rules prohibiting the provision of benefits on a basis that favors the employer's highly compensated employees (as defined in Code sec. 414(q)).

Although a VEBA generally is exempt from tax, it is taxable on its unrelated business taxable income (UBTI). Generally, income set aside to provide for post-retirement medical benefits is considered UBTI, although this rule does not apply to a VEBA if substantially all of contributions to it are made by employers who are exempt from income tax throughout the 5-taxable-year period ending with the taxable year in which the contributions were made.

Certain special rules apply to the deductibility of employer contributions to a welfare benefit fund without regard to whether the fund is a VEBA. Under these rules, contributions by an employer to such a fund are not deductible under the usual income tax rules, but if they otherwise would be deductible under the usual rules, the contributions will be deductible within limits for the taxable year in which such contributions are made to the fund.

The amount of the deduction otherwise allowable to an employer for a contribution to a welfare benefit fund for any taxable year may not exceed the qualified cost of the fund for the year. The qualified cost of a welfare benefit fund for a year is the sum of (1) the qualified direct cost of the fund for the year and (2) the addition (within limits) to the qualified asset account under the fund for the year, reduced by (3) the after-tax income of the fund.

In general, the qualified direct cost of a fund is the aggregate amount expended (including administrative expenses) that would have been allowable as a deduction to the employer with respect to the benefits provided, assuming the benefits were provided directly by the employer and the employer was using the cash receipts and disbursements method of accounting.

A qualified asset account under a welfare benefit fund is an account consisting of assets set aside to provide for the payment of disability payments, medical benefits, supplemental unemployment compensation benefits or severance pay benefits, or life insurance benefits. Under present law, an account limit is provided for the amount in a qualified asset account for any year.

The account limit with respect to medical benefits for any taxable year may include a reserve to provide certain post-retirement medical benefits. This limit allows amounts reasonably necessary to accumulate reserves under a welfare benefit plan so that funding of post-retirement medical benefits with respect to an employee can be completed upon the employee's retirement. These amounts may be accumulated no more rapidly than on a level basis over the working life of an employee with the employer of that employee. Funding is considered level if it is determined under an acceptable funding method so that future post-retirement medical benefits and administrative costs will be allocated ratably to future preretirement years.

Each year's computation of contributions with respect to post-retirement medical benefits is to be made under the assumption that the medical benefits provided to future retirees will have the same cost as medical benefits currently provided to retirees. Because the reserve is computed on the basis of the current year's medical costs, neither future inflation nor future changes in the level of utilization may be taken into account until they occur.

The Deficit Reduction Act of 1984 (DEFRA) directed the Secretary of the Treasury to study the possible means of providing minimum standards for employee participation, vesting, accrual, and funding under welfare benefit plans for current and retired employees. The study is to include a review of whether the funding of welfare benefits is adequate, inadequate, or excessive. The Secretary was required to report to the Congress with respect to the study by February 1, 1985, with suggestions for minimum standards where appropriate. The Tax Reform Act extended the due date for the study to October 22, 1987. This study has not yet been completed.

Qualified retirement plans.—Under a profit-sharing plan, a participant's account may be used to acquire post-retirement medical benefits under the rule generally applicable to distributions from a profit-sharing plan. Although this rule does not apply to pension plans, a retiree can use the amounts distributed to acquire post-retirement medical benefits.

Administration Proposal

Under the Administration proposal, an employer would be permitted to transfer all or a portion of the assets available for withdrawal from a defined benefit pension plan to a welfare benefit fund to provide medical benefits to current retirees. Such a transfer would not be subject to the 10-percent excise tax on asset withdrawals and reversions and would be exempt from current income tax. However, such a transfer would be counted as a withdrawal for purposes of the frequency limit on withdrawals and reversions.

Defined benefit pension plan assets that are transferred to a retiree health fund would be subject to various restrictions. First, the transferred assets only could be used to provide medical benefits to employees who had retired and were covered by an employer-maintained health plan at the time of the transfer. Second, the transferred assets would not be permitted to exceed the present value of the employer's liability for medical benefits for such current retired employees. Appropriate rules for calculating such present value would be developed to prevent inappropriate overfunding of the post-retirement medical benefit fund. Special rules also would assure that an employer's liability to provide a particular type or level of post-retirement medical benefits is not altered by such a transfer.

Income on assets transferred under this rule to a post-retirement medical benefit fund would be exempt from both income tax and unrelated business income tax if such assets are held in a segregated welfare benefit fund to which no other amounts are added (other than transfers of Code section 401(h) assets).

Accounts maintained under Code section 401(h) would be eliminated. Thus, tax-favored employer funding of post-retirement medical benefits would be permissible only under welfare benefit funds in accordance with the rules of Code section 419. Existing assets in Code section 401(h) accounts could be transferred without adverse tax consequences, however, to a post-retirement medical benefit fund of the type of which excess defined benefit plan assets could be transferred, including a post-retirement medical benefit fund to which such excess assets had been transferred. Such transferred Code section 401(h) assets would be subject to the same rules applicable to transferred defined benefit plan assets.

Analysis of Issues

The rationale for the Administration proposal is that it would increase the likelihood that retirees will receive medical benefits. Those who support the proposal argue that the availability of a tax-exempt funding arrangement for post-retirement medical benefits will reduce the cost to employers of establishing post-retirement medical benefit plans and will reduce their cost of improving benefits under existing plans. Further, supporters of the proposal believe that the reduced employer cost would permit some employers to avoid reduction or elimination of those benefits. In addition, to the extent that liabilities for post-retirement medical benefits are funded, proponents of the Administration proposal argue that it would increase the likelihood that employees will receive their promised benefits. Further, the availability of a tax-exempt funding arrangement for post-retirement medical benefits permits an employer to reduce its cost of such benefits by the amount of the tax benefits provided.

The Administration states that its proposal does not fully address the problem of funding post-retirement medical benefits. The Administration rejected broader proposals to allow tax-favored prefunding of a welfare benefit fund over the lifetime of active employees. The reasons that such broader approaches were rejected include: (1) the revenue cost, and (2) concern that tax-favored prefunding is not appropriate unless the public costs are matched by the public benefits, such as through the application of minimum standards similar to those applicable to qualified retirement plans.

Critics of the Administration proposal maintain that, to some extent, the proposal would grant significant tax-favored prefunding without imposing minimum standards. They argue that the Administration proposal would not prevent an employer from creating a surplus in a defined benefit pension plan through excessive contributions. The flexibility that employers have with respect to their funding methods and their actuarial assumptions enables them to create a surplus. Critics are concerned that the Administration proposal would encourage tax-favored prefunding of post-retirement medical benefits through excessive contributions to a defined benefit pension plan.

Other commentators question why tax-favored prefunding needs to be linked to the application of minimum standards. These commentators point out that any reversion from a welfare benefit fund to an employer is subject to a 100-percent excise tax. Thus, amounts contributed to a welfare benefit fund almost certainly will be used to provide benefits to employees. Because of the excise tax, they maintain that tax-favored prefunding should be allowed. These commentators argue that minimum standards are inappropriate restraints on an employer's ability to modify its post-retirement medical benefit plans to adjust to changing practices in the medical insurance area.

In response to these arguments, others contend that the minimum standards are essential to providing active employees security with respect to their retirement. If post-retirement medical benefits do not accrue or vest prior to retirement, and may not accrue or vest even on retirement, then an employee essentially cannot rely on the likelihood of receiving a benefit and cannot make reasonable plans with respect to retirement. Moreover, in many cases in which the employer enjoyed significant tax benefits with respect to post-retirement medical benefits, many long-service employees who were taken into account for funding purposes will receive no benefits. This can occur for any of several reasons: (1) the employee separates from service prior to retirement, (2) the employer terminates the benefit with respect to a class of employees that includes the employee, or (3) the plan is insufficiently funded (post-retirement medical benefits are not guaranteed by the PBGC). In short, some maintain that it is incongruous to provide tax benefits to an employer with respect to employees who are provided such meager rights. These same commentators also point out that minimum standards, if applicable to a dollar value of benefits, would not affect an employer's ability to modify its post-retirement medical benefit plans to adjust to changing practices in the medical insurance area.

Some employee benefit experts maintain further that minimum standards generally should apply to any deferred medical benefits regardless of whether such benefits are accorded tax-favored status, as is the case with respect to deferred cash compensation. The rationale is that even where tax benefits are not provided, it is inappropriate for an employer to establish a plan of deferred compensation if the plan is not structured to ensure satisfaction of the reasonable expectations of employees covered under the plan.

Some commentators contend that no legislative action is necessary with respect to post-retirement medical benefits because qualified retirement plans currently allow tax-favored prefunding of post-retirement medical benefits through higher levels of retirement benefits and because minimum standards already apply to qualified retirement plans. One drawback to this approach that has been noted by some employers is that it will not allow them to fund for their highly compensated employees who are already entitled to the maximum benefit allowed under a qualified retirement plan (Code sec. 415).

With respect to separate accounts under Code section 401(h), supporters of the proposal to repeal the section point out that the accounts provide tax-favored prefunding without applying many of the minimum standards applicable to qualified retirement plans generally. They further argue that it is inappropriate to have two different sets of standards for the funding of post-retirement medical benefits. They believe that post-retirement medical benefits should not be funded through a qualified retirement plan, but rather should be funded through a mechanism designed to address the specific characteristics and problems associated with the funding of health benefits. Other commentators argue that the section 401(h) limits should simply be lifted because an employer's ability to fund fully its post-retirement medical benefits are unduly limited by the requirement that they be subordinate to the retirement benefits.

Certain commentators raise health policy concerns regarding the effect of post-retirement medical benefits. They point out that such benefits often serve to pay for the Medicare deductibles and copayments. Such benefits may thus undermine the cost-containment function served by deductibles and copayments, raising the cost of Medicare and of health benefits generally. These commentators maintain that this effect should be taken into account in providing tax-favored treatment to post-retirement medical benefits, possibly by restricting the tax benefit to certain types of medical benefits. Other commentators argue that cost containment concerns should not override the needs of the elderly for benefits to supplement Medicare.

Senator PRYOR. The committee will come to order.

This subcommittee has scheduled hearings today to consider the financial status of the Pension Benefit Guaranty Corporation and to discuss the Administration's proposal to restore both the short-term and the long-term viability of that institution.

The Pension Benefit Guaranty Corporation guarantees the retirement benefits of over 38 million Americans provided under the defined benefit pension plans. The continued stability of the Pension Benefit Guaranty Corporation is critical to the retirement security of those individuals and to the retirement system as a whole.

The private retirement system is a success. There is currently almost $2 trillion set aside in tax qualified pension plans, but the ultimate sign of success is demonstrated by the steady improvement in the standard of living of this country's retired citizens.

The private retirement system has contributed substantially to this improvement. Despite the staggering amounts that have been set aside, some defined benefit plans do not have enough money to pay promised benefits. This pool of unfunded plans poses a very serious long-term threat to the stability of the PBGC. The recent terminations of plans maintained by the LTV Corporation, for example, with combined underfunding in excess of $2 billion, have not only placed immediate demands on the resources of the PBGC, but have also served to demonstrate the magnitude of the potential long-term problem.

The PBGC is not facing an immediate crisis. The PBGC has the ability to pay promised benefits to retired participants under its jurisdiction into the next century. But something must be done—let us underline this—something must be done to deal with the long-term problem that we will face. The question we are considering this morning is what should be done to deal with this long-term problem?

We all know that Congress increased the PBGC premium from $2.60 to $8.50 last year. Now just 15 short months after that massive increase was enacted the PBGC is telling us that it was not enough, in fact, that it was not even close.

It would seem that simply raising the premium again is not a solution. We must examine the underlying reasons which result in the PBGC's ever increasing deficits and we must deal with them.

Let me hazard one other observation before we hear from the witnesses this morning.

This nation is faced with another more immediate and even more staggering problem, the enormous federal budget deficit. Congress and the Administration must deal with the budget deficit. In considering possible solutions to the PBGC's problem, there will be some who will argue for massive increases in the premium in order to help reduce the budget deficit. That would be wrong, in my opinion. We should consider proposals regarding the PBGC based on the need to adequately fund the PBGC and not use the PBGC as a mechanism to reduce the federal budget. We must be very careful not to allow budget considerations to lead us down the path of unsound pension policy.

We have three panels this morning. The first witness we will hear from is Mr. Harry Conaway, the Department of the Treasury. Is that Conway or Conaway?

Mr. CONAWAY. Conaway, sir. A-w-a-y, Conaway.

Senator PRYOR. Conaway. They misspelled your name on your marque there I might say.

The Department of Labor, Mr. David Walker, the Deputy Assistant Secretary of the Pension and Welfare Benefits Administration. And from the Pension Benefit Guaranty Corporation, Dr. Kathleen Utgoff, the Executive Director. We look forward to hearing your statements this morning. And, Mr. Conaway, we will ask you first to give your statement.

STATEMENT OF HARRY CONAWAY, ASSOCIATE TAX LEGISLATIVE COUNSEL, DEPARTMENT OF THE TREASURY

Mr. CONAWAY. Thank you, Mr. Chairman.

As you mentioned, the Administration recently offered a proposal that would significantly alter the rules relating to the funding and termination of defined benefit pension plans maintained by employers. These plans are subject to the provisions of the Employer Retirement Income Security Act of 1974, better known as ERISA.

One of the main purposes of ERISA is to improve the security of the benefit promises that employers have made to employees under defined benefit plans.

Two recent trends relating to defined benefit plans, however, have led the Administration to conclude that certain weaknesses in current law permit employers to act in ways that could diminish the security of employees' benefits and lead to an increased financial burden on the PBGC.

Effectively, the Administration has concluded that under current law employers are not sufficiently accountable for their benefit promises to employees.

The first trend involves asset reversions from overfunded to defined benefit plans. In recent years there have been a significant number of employers that have terminated their overfunded defined benefit plans to recover assets in excess of the plan's termination liabilities. Some of these employers have undertaken this transaction even though they continue to maintain ongoing defined benefit plans for the affected employees.

These reversion transactions then are effectivety withdrawals from ongoing plans permitted under current law, and, in our view, may erode the protections afforded by ERISA's minimum funding rules, thus potentially diminishing the security of employees' benefits and making future benefit accruals and benefit increases less likely.

The second trend involves the recent increase in terminations of large, seriously underfunded defined benefit plans. Such terminations have deprived many employees of their full benefits because, under current law, neither the employer nor the PBGC is liable for all unfunded benefits after termination.

In addition, these terminations have caused the financially strained PBGC, and, thus, PBGC premium payors, to incur liability for significant unfunded benefits for which the employer is not fully responsible.

In many cases, these underfunded plan terminations have involved plans of employers that had at all times complied with ERISA's minimum funding requirements. This indicates that the current funding rules do not adequately protect either employees or the PBGC against reasonably avoidable losses.

In addition, in some cases, employers have undertaken underfunded plan terminations even though they also maintain overfunded defined benefit plans. It is troubling, in our view, that employers can shift unfunded liabilities to the PBGC and impose benefit losses on some employees when, at the same time, there are tax-favored assets in other defined benefit plans that could be used to provide such benefits.

The Administration spend nearly a year developing its funding proposal. The primary goals of the proposal, as it was submitted as part of the President's competitiveness package, are to enhance the security of employees' retirement benefits and protect the PBGC and its premium payors from reasonably avoidable unfunded liabilities, while still permitting employers to recover plan assets that are truly in excess of reasonable funding needs.

In our view, public policy should encourage optimal rather than excessive or deficient funding of defined benefit plans.

The proposal seeks to achieve these twin goals of increased benefit security and PBGC protection without interferring with employers to make their own benefit promises. The proposal thus embodies the view that employers should remain able to make their own benefit promises provided that they are fully responsible for those benefit promises that they choose to make.

Increased employer accountability for promised pension benefits is the keynote of the proposal.

The proposal would increase an employer's accountability for its pension promises in the following specific ways:

First, the proposal would modify the funding rules to limit the ability of employers to delay or maintain or avoid making minimum funding contributions, and, second, would modify the minimum funding rules to improve the funded status of underfunded plans by requiring that certain benefits be funded over shorter periods and that the required minimum contribution for a year be sufficient to prevent deterioration in the plan's funded status.

The second component of the proposal would rationalize the rules governing the terminations of underfunded defined benefit plans, first, to assure that employers are fully liable to employees and to the PBGC for their pension promises after plan terminations, and, second, to limit the extent to which employees suffer benefit losses and the PBGC assumes unfunded liabilities upon termination of underfunded plans maintained by employers that also maintain overfunded plans.

The third component of the proposal would rationalize employer access to plan funds by, first, permitting employer withdrawals from ongoing plans without requiring plan terminations, and, second, by limiting the extent to which employers that continue to provide defined benefit plans for their employees are able to recover assets through withdrawals or terminations.

I will now describe in more detail the proposed improvements to the minimum funding rules and the treatment of underfunded plan terminations. In addition, I will discuss in some detail the aggregate plan approach that underlies the entire proposal.

Deputy Assistant Secretary Walker will then discuss the remaining two elements of the proposal, namely, the employer's access to defined benefit plan assets withdrawals and asset transfers to retiree health benefit funds.

First, let me turn to the minimum funding standards. ERISA's minimum funding standards are generally based on the assumption that a plan will continue in existence, that is, that the plan is a going concern. Thus, the standards generally require that an employer make annual contributions to a plan to fund not only a portion of the employees' benefits earned to date but also a portion of the employees' projected benefits. However, because the funding rules focus on projected benefits, the amount of an employer's require contribution is unaffected by the extent to which current accrued benefits under the plan are funded. As a result, even where an employer fully complies with the minimum funding standards, unfunded accrued benefits can build to levels that threaten employees' benefit security and produce potentially large claims against the PBGC.

One of the major reasons for such systematic plan underfunding is that the period for funding the past service component of benefit increases is quite lengthy. Pre-ERISA past service cost may be funded over as long as 40 years and post-ERISA past service cost may be funded over as long as 30 years. Each of these periods generally is longer than the expected remaining working years of a plan's participants.

A second reason for the systematic plan underfunding relates to large experience losses. A third reason involved the payment of large, often unexpected benefits to employees. Examples are shutdown benefits and lump sums distributions.

A fourth reason involves funding waivers. A second on funding waivers. Under current law, if an employer is able to demonstrate that the required minimum funding contribution for a year would impose a substantial business hardship the employer may request a funding waiver from the Internal Revenue Service. The amount of the waiver would have to be funded over 15 years.

The proposal contains two sets of proposed revisions to the funding rules. The first set of revisions involve funding rules for underfunded plans, that is, generally those plans with assets less than the plan's termination liabilities.

In general, consistent with the objective of improving the accountability of employers for their pension promises, the proposal would require that an employer's annual contribution to an underfunded plan be based not merely on the employees' projected benefits, as I mentioned is the case under current law, but also on the extent to which employees' current accrued benefits are funded. Thus, the revised rules would require faster funding of employees' accrued benefits.

The absence of short-term financial accountability for pension promises under current law can too easily result in unfunded benefits for employees and avoidable liabilities for the PBGC. By requiring faster funding of employees' accrued benefits, the proposal is intended to discourage employers from making benefit promises that are unlikely to be properly funded in the near future.

Also, if an employer with an underfunded plan encounters financial difficulty in making a required annual contribution, the proposal would have the effect of forcing the employer to take earlier action with respect to the plan, thereby reducing the likelihood that unfunded benefits would continue to grow unchecked.

The proposal is designed to have a minimal effect on plans with respect to which the current funding rules present little or no short-term threat to employees' benefit security or the PBGC.

I have attached to this testimony charts reflecting models run by the PBGC which illustrate this point. I will not walk through them at this point unless you would be interested.

Senator PRYOR. Those charts will be placed in the record, Mr. Conaway.

Mr. CONAWAY. Thank you.

More specifically, with respect to any defined benefit plan that is less than 100 percent funded, the proposal would require improved funding of existing unfunded accrued benefits and future benefit increases. In addition, the proposal would protect such plans from deteriorations in their funded ratios due to experienced losses and significant and often unexpected benefit payments.

Under the proposed complement rule, an employer would be required to fund unfunded benefits existing on the effective date of the proposal and unfunded benefits attributable to benefit increases after the effective date on a level basis over the funding period, the length of which would be shorter than the funding periods provided under current law and the particular length for any plan would be based on two factors.

The first factor would be the extent to which the plan is underfunded, that is, the complement of the plan's funded ratio. Generally, the more underfunded the plan the shorter the applicable funding period and the higher the annual amount determined under the complement rule.

The second factor that would be taken into account in setting the funding period under the complement rule is the maturity of the plan's benefits. An example of a plan with mature plan benefits is a recently improved defined benefit plan that covers relatively older employees who have significant past service credits. Essentially, the more mature a plan's benefit, the shorter the applicable funding periods and the higher the annual amount determined under the complement rule.

The particular period to be used in calculating the required annual contribution for a particular plan would be derived by direct application of an actuarial formula or by reference to a table developed to show the applicable periods.

It is important to note that it is our expectation that the applicable funding periods under the complement rule would range from the current law amortization periods, which are generally 30 years, to, for those plans with the lowest funded ratios and the most mature benefits, three years. Indeed, even in many of the better funded plans with funded ratios less than 100 percent, that is, the plans that are 70, 80, or 90 percent funded, would use the current law periods and thus would be unaffected by the complement rule.

An example is that most new plans that do not grant excessive past service credit would still be permitted to use a 30-year period.

The second revised funding rule is the funded ratio maintenance rule. This rule is designed not to increase the funded ratio of a plan, but rather is to prevent the deterioration of a plan's funded status due generally to experienced losses. Under the funded ratio maintenance rule, an employer would have to fund deteriorations in a plan's funded ratio over a year that are below 100 percent due to experienced losses over three years.

The third new rule for plans with funded ratios less than a hundred percent is what is called the cash flow rule. Again, this is designed to protect against deterioration in a plan's funded status resulting from large often unexpected benefit distribution such as lump sums and those associated with plant closings.

The cash flow rule would require that an employer make an annual contribution to a plan with a funded ratio of less than 100 percent at the end of the year equal to the total benefit distributions and expenses of the plan for the year. The amount required under the cash flow rule, however, would never be greater than the amount necessary to bring the funded ratio up to 100 percent.

The second set of proposed minimum funding rules would apply to all plans rather than to merely underfunded plans. The proposal contains several specific proposed revisions that would apply to all defined benefit plans. First, the proposal would make all employers of a control group to which the plan sponsor belongs liable for the required contributions under the minimum funding rules.

Second, the employer would be required to make quarterly payments for the minimum funding contribution for a plan year under rules analogous to the estimated income tax rules. Furthermore, the total required contribution for a plan year would be due no later than two and a half months after the end of the plan year. Under current law, the employer can delay making any contributions with respect to a plan year until eight and a half months after the end of the plan.

Third, the proposal would modify the rules governing the availability of minimum funding waivers. It is our view that funding waivers have too often been used to generate funds for distressed companies at much better than commercial terms, and employees and the PBGC end up paying. Under the proposal, a waiver application would have to be filed within two and a half months after the end of the plan year. In addition, the standards for granting a waiver would be clarified by providing that the employer seeking a waiver would have to establish that the hardship was temporary and that the hardship affected the entire control group. And to make the minimum funding waivers more equivalent to commercial loans, the interest rate required on the waived amounts would be increased from the current rate to the greater of the plan's assumed interest rate for funding purposes or the market rate for loans to distressed companies.

Senator PRYOR. Excuse me, Mr. Conaway. Do you think you can complete your statement in the next two or three minutes? I will put all of the statements in the record.

Mr. CONAWAY. That's fine.

Senator PRYOR. Do you need just one or two more points?

Mr. CONAWAY. That's fine.

Senator PRYOR. Well why don't we put the balance of the statement in the record so that we can hear from the other members of our panel. We appreciate your statement this morning. I do have a couple of questions, but we will pose those at the completion of the other two members of the panel.

From the Department of Labor, Mr. David Walker. Mr. Walker.

[The prepared written statement of Mr. Conaway follows:]

For Release Upon Delivery
Expected at 10:00 a.m., EDT
May 18, 1987

STATEMENT OF
HARRY J. CONAWAY
ASSOCIATE TAX LEGISLATIVE COUNSEL
OFFICE OF TAX POLICY
DEPARTMENT OF THE TREASURY
BEFORE THE SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS
AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE
COMMITTEE ON FINANCE
UNITED STATES SENATE

Mr. Chairman and Members of the Subcommittee:

The Administration recently offered a Proposal (the "Proposal") that would significantly alter the rules relating to the funding and termination of defined benefit pension plans. Private pension plans are an important source of retirement income for many American workers, and the Administration believes that recent trends demonstrate the need to provide additional protection for employees' benefits under such plans.

I am privileged to have with me this morning David M. Walker, Deputy Assistant Secretary (Pension and Welfare Benefits Administration), Department of Labor, and Dr. Kathleen P. Utgoff, Executive Director of the Pension Benefit Guaranty Corporation (PBGC). The agencies represented here have worked in close cooperation to develop this Proposal. We welcome this opportunity to discuss our views with you.

OVERVIEW OF THE PROPOSAL

Employer-maintained pension plans are subject to the provisions of the Employee Retirement Income Security Act of 1974 ("ERISA"). One of the main purposes of ERISA is to improve the security of the benefit promises that employers have made to employees under defined benefit pension plans. To this end, ERISA imposes minimum funding standards on employers that maintain defined benefit plans, regulates the investment of plan assets, and limits employer access to such assets. In addition, ERISA provides for the PBGC to guarantee certain benefits under defined benefit plans that terminate with insufficient assets.

The rules of ERISA have largely accomplished their purposes. However, two disquieting trends relating to defined benefit plans have led the Administration to conclude that certain weaknesses in current law permit employers to act in ways that could diminish the security of employees' benefits and lead to an increased financial burden on the PBGC.

Asset Reversions

In recent years, a significant number of employers have terminated their overfunded defined benefit plans to recover assets in excess of the plans' termination liabilities. PBGC data indicate that, since May 1980, asset reversions involved in completed and pending plan terminations total about $16 billion. This amount represents about 45 percent of the total assets in the affected plans and about 2 percent of the total assets in all defined benefit plans.

Current law permits these reversions even though employers continue to cover the affected employees in ongoing defined benefit plans. (The legality of such transactions was formally recognized by the Asset Reversion Guidelines, issued in May 1984 by the Departments of Treasury and Labor, the Internal Revenue Service, and the PBGC.) By enabling an employer to recover all assets in excess of the plan's termination liability (i.e., the benefits that have to be provided out of plan assets on plan termination before an employer may receive a reversion), such reversion transactions may erode the protections afforded by the current minimum funding rules, thus potentially diminishing the security of employees' benefits and making future benefit accruals and benefit increases less likely.

In addition, current law permits an employer to undertake a reversion transaction with respect to a defined benefit plan even though the employer also maintains another, seriously underfunded defined benefit plan that, in a subsequent termination, may be unable to provide employees with their full, promised benefits and may shift unfunded liabilities to the PBGC. We are concerned that employers that maintain more than one defined benefit plan are able to recover tax-favored funds from one plan for non-pension purposes without first ensuring that pension benefits under the other plans are secure.

Terminations of Underfunded Plans

The second trend is the recent increase in the terminations of large, seriously underfunded defined benefit plans. Such terminations have deprived many employees of their full benefits because, under current law, neither the employer nor the PBGC is liable for all unfunded benefits after termination. In addition, these terminations have caused the financially strained PBGC (and, thus, other premium payors) to incur liability for significant unfunded benefits for which the employer is not fully responsible. By the end of its 1986 fiscal year, the PBGC estimates that its deficit had risen to almost $4 billion.

In many cases, these underfunded plan terminations have involved plans of employers that had at all times complied with ERISA'S funding requirements. This indicates that the current funding rules do not adequately protect either employees or the PBGC against reasonably avoidable losses. In addition, in some cases, employers have undertaken underfunded plan terminations even though they also maintain overfunded defined benefit plans. It is troubling that employers can shift unfunded liabilities to the PBGC and impose benefit losses on some employees when, at the same time, there are tax-favored assets in other defined benefit plans that could be used to provide such benefits.

Policy Objectives

The primary goals of the Proposal are to enhance the security of employees' retirement benefits and protect the PBGC (and its premium payors) from reasonably avoidable unfunded liabilities, while still permitting employers to recover plan assets that are truly in excess of reasonable funding needs. Public policy should encourage optimal, rather than excessive or deficient, funding of defined benefit plan benefits. An employer should have neither the incentive nor the opportunity to make pension promises that exceed its own legal liability or financial capacity. The purpose of sound funding is to protect employees' benefits by insulating them from the business risk of the employer, as well as to protect the PBGC from systematic loss. In addition, for reasons of both tax policy and economic efficiency, employers should not be required to fund their benefit promises beyond a level that reasonably assures that such benefits will be paid when due.

The Proposal seeks to achieve these twin goals of increased benefit security and PBGC protection without interfering with the ability of employers to make their own pension promises. For example, the Proposal does not condition an employer's recovery of plan assets upon the provision of a mandatory benefit increase and does not require that assets in excess of a plan's termination liability be shared with employees. Requiring a mandatory benefit increase on plan termination would not necessarily result in a net increase in benefits because employers could lower their benefit formulas in order to take the mandatory benefit increase into account. In addition, it is likely that requiring that employees share in excess assets would discourage employers from proper plan funding. The Proposal thus embodies the view that employers should remain able to make their own pension promises, provided that they are fully responsible for whatever pension promises they make. Increased employer accountability for promised pension benefits is the keynote of the Proposal.

The Proposal would increase an employer's accountability for its pension promises in the following specific ways:

1. Modify the minimum funding rules to (i) limit the ability of employers to delay or avoid making minimum funding contributions, and (ii) improve the funded status of underfunded plans by requiring that certain benefits be funded over shorter periods and that the required minimum contribution be sufficient to prevent deterioration in the plan's funded status.

2. Rationalize the rules governing terminations of underfunded defined benefit plans to (i) assure that employers are fully liable to employees and to the PBGC for their pension promises after plan terminations, and (ii) limit the extent to which employees suffer benefit losses and the PBGC assumes unfunded liabilities upon termination of underfunded plans maintained by employers that also maintain overfunded plans.

3. Rationalize employer access to plan funds by (i) permitting employer withdrawals from ongoing plans without requiring plan terminations and (ii) limiting the extent to which employers that continue to provide defined benefit plans for their employees are able to recover assets through withdrawals or terminations.

Retiree Health Benefits

There is concern that some employers, particularly those with rapidly maturing workforces, are discouraged from providing retirees with health benefits because there is no adequate funding mechanism. The Proposal seeks to mitigate this problem by permitting employers to transfer, without current tax consequences, all or a portion of the assets that would otherwise be available for withdrawal by the employer to a welfare benefit fund, such as a voluntary employee beneficiary association, to provide an actuarially reasonable reserve for health benefits for current retirees. The transferred amounts would have to be used to provide health benefits to current retirees, and such transfer would not otherwise alter the employer's legal liability to retirees for health benefits.

Transferred amounts under the Proposal would be granted three important tax advantages not present in current law. First, defined benefit plan assets could be used to discharge a separate liability of the employer without either income or reversion tax consequences to the employer. Second, the transferred amounts for retiree health benefits would grow on a tax-exempt basis. Third, unlike cash retirement benefits, the transferred amounts for health benefits would not be included in the incomes of the retirees.

The Proposal would repeal section 401(h) of the Internal Revenue Code, which permits limited tax-favored employer prefunding of retiree health benefits in a side-fund to a pension plan. However, existing amounts in a 401(h) fund could be transferred tax-free to a welfare benefit fund. Amounts so transferred would continue to grow on a tax-exempt basis.

The Administration does not intend the Proposal to be a comprehensive solution to the complex issues relating to the funding of retiree health benefits. Rather, the Proposal should be viewed more modestly, as merely giving employers that maintain overfunded defined benefit plans an alternative to using the excess assets for purposes other than the provision of benefits to retirees. It is arguable, however, that making the tax-favored funding of retiree health benefits contingent on the continuation and proper funding of a defined benefit plan may encourage some employers to fund such plans more fully.

In developing the Proposal, the Administration considered including a comprehensive retiree health funding proposal. For a variety of reasons, we concluded that it is not appropriate to permit broader, tax-favored prefunding of retiree health benefits. First, permitting tax-favored prefunding of retiree health benefits would accord such benefits more generous tax treatment than the treatment provided to any other type of income: an employer deduction and employee exclusion for contributions and benefit accruals, tax-free growth of reserves, and an employee exclusion upon benefit receipt. We question whether tax treatment this generous is justified for any type of income. Second, current budgetary constraints do not permit broader tax benefits for prefunding retiree health benefits. Third, tax-favored prefunding should be permitted only if it is structured so that the public costs are matched by the public benefits, such as through the application of minimum standards similar to those that apply under ERISA to pension plans. There are many complex issues to address in assuring that such benefits match these costs. For example, should employers that make retiree health promises be required to fund their promises, just as employers that make pension promises are required to fund these promises? These and similar issues require more consideration than we have yet been able to give them.

DISCUSSION OF THE PROPOSAL

The Proposal embodies four elements: (1) improvements to the minimum funding rules; (2) the treatment of underfunded plan terminations; (3) employer access to defined benefit plan assets; and (4) asset transfers to welfare benefit funds to provide health benefits to current retirees. The following discussion describes in more detail the first two elements and the aggregate plan approach that underlies the entire Proposal. Deputy Assistant Secretary Walker will discuss the last two elements of the Proposal.

1. Minimum Funding Standards

Current Law

ERISA's minimum funding standards are generally based on the assumption that a defined benefit plan will continue in existence; i.e., that a plan is a going concern. Thus, the standards generally require that an employer make annual contributions to a defined benefit plan to fund not only a portion of the employees' benefits earned to date, but also a portion of the employees' projected benefits. However, because the funding rules focus on projected benefits, the amount of an employer's required annual contribution is unaffected by the extent to which current accrued benefits are funded. As a result, even where an employer fully complies with the minimum funding standards, unfunded benefits can build to levels that threaten employees' benefit security and produce potentially large claims against the PBGC insurance program.

The determination of an employer's required annual contribution with respect to a defined benefit plan involves two steps. First, an actuary must estimate the total cost of the employees' projected benefits under the plan, using actuarial assumptions with respect to future salaries, investment return, interest rates, turnover, mortality and morbidity rates, expected retirement ages, and similar variables that affect a plan's projected benefits. Such actuarial assumptions must be reasonable in the aggregate. Second, an actuary must use a permitted actuarial funding method to determine the rate at which the total cost of the projected benefit is to be funded.

Actuarial funding methods allocate the estimated total cost of a plan's projected benefits over future contribution years. Some of the funding methods accomplish this by allocating the total cost between past years (i.e., past service costs) and the expected remaining working years of the participants (i.e., future normal costs) and then requiring that a portion of the past service cost and a portion of the future normal cost be contributed for the current year. Other methods do not allocate any portion of the total cost to past years, but rather allocate all of such total cost to the participants' expected remaining working years and require that a portion of such future normal costs be contributed for the current year.

An employer's choice of actuarial funding methods can significantly affect the rate of funding of a plan's projected benefits. Pre-ERISA past service costs may be funded over as long as 40 years and post-ERISA past service costs may be funded over as long as 30 years; each of these periods generally is longer than the expected remaining working years of a plan's participants. Accordingly, as a larger portion of the estimated total cost of projected benefits is allocated not to past years but rather to the expected remaining working years of participants, the more rapid will be the funding of the plan's projected benefits. In addition, the manner in which future normal costs are spread over future years affects the extent to which such costs are allocated to the current year; spreading such costs over future years on a level basis will result in more rapid funding of a plan's projected benefits than allocating such normal costs over future years based on the incremental accrual of benefits.

In addition to the actuarial assumptions for determining the total cost of employees' projected benefits and the actuarial funding method for allocating such total cost over future contribution years, other factors affect the rapidity and adequacy of plan funding. For example, frequent benefit increases generally will contribute to larger unfunded benefits, particularly if such increases are retroactive for past years of service. Similarly, the investment experience of the plan will affect the required funding contribution.

The total annual required contribution must be paid to the plan no later than 2-1/2 months after the close of the year to which the contribution relates. Treasury regulations generally extend this due date by six months. If an employer is able to demonstrate that the required minimum funding contribution for a year would impose a substantial business hardship, the employer may request a minimum funding waiver from the Internal Revenue Service. The amount of such waiver must be funded over 15 years.

Proposal: Minimum Funding Rules for Underfunded Plans

In General.--Consistent with the objective of improving the accountability of employers for their pension promises, the Proposal would require that an employer's annual contribution to an underfunded defined benefit plan be based not merely on the employees' projected benefits, as under current law, but also on the extent to which employees' current accrued benefits are funded. Thus, the revised rules would require faster funding of a plan's projected benefits until employees' accrued benefits are reasonably well funded, and then the remaining projected benefits could be funded at the slower pace permitted under current law.

The absence of short term financial accountability for pension promises under current law can too easily result in unfunded benefits for employees and avoidable liabilities for the PBGC. By requiring faster funding of employees' accrued benefits, the Proposal is intended to discourage employers from making pension promises that are unlikely to be properly funded in the near future. Also, if an employer with an underfunded plan encounters financial difficulty in making the required annual contributions, the Proposal would force the employer to take earlier action with respect to the plan, thereby reducing the likelihood that unfunded benefits will continue to grow unchecked.

The Proposal is designed to have a minimal effect on plans with respect to which the current funding rules present little or no short-term threat to employees' benefit security or the PBGC. In addition, the revised standards would have a greater effect on the funding requirements for those plans that, if terminated, would expose employees and the PBGC to larger losses.

With respect to any defined benefit plan that has a funded ratio of less than 100 percent, the Proposal would require improved funding of existing unfunded accrued benefits and future benefit increases. In addition, the Proposal would protect such plans from deteriorations in their funded ratios due to experience losses and significant and often unexpected benefit payments. (Under the Proposal, a plan's funded ratio is the actuarial value of the plan's assets divided by 110 percent of the plan's termination liability to employees.)

More specifically, the Proposal would alter the basic structure of the minimum funding rules by requiring that an employer's contribution to a defined benefit plan with a funded ratio of less than 100 percent be at least equal to the greatest of the following four amounts: (1) the amount determined under the current minimum funding standards; (2) the amount determined under the Complement Rule; (3) the amount determined under Funded Ratio Maintenance Rule; and (4) the amount determined under the Cash Flow Rule. Funding credit balances would be recognized only for annual contributions in excess of the greatest of these four amounts.

Complement Rule.--The amount determined under the Complement Rule for a year would be the annual contribution necessary to fund (i) unfunded benefits existing on the effective date of the Proposal and (ii) unfunded benefits attributable to benefit increases after the effective date on a level basis over an applicable funding period the length of which would be based on two factors. The first factor is the extent to which the plan is underfunded (i.e., the complement of the plan's funded ratio): the more underfunded the plan, the shorter the applicable funding period, and the higher the annual amount determined under the Complement Rule.

The second factor is the maturity of the plan's benefits. The maturity of a plan's benefits would be the portion of the total cost of the plan's total unfunded benefits that is allocable to past years under the plan's actuarial funding method. An example of a plan with mature plan benefits is a recently improved defined benefit plan that covers relatively older employees who have significant past service credits. Of course, because different funding methods produce different allocations of total costs between past years and future years (indeed, some methods allocate all costs to future years), the amount determined under the Complement Rule will depend on the employer's choice of funding methods. Essentially, the more mature a plan's benefits, the shorter the applicable funding period, and the higher the annual amount determined under the Complement Rule.

The applicable period to be used in calculating the contribution required under the Complement Rule for a particular year could be derived by direct application of an actuarial formula or by reference to a table developed to show the applicable periods. In simplified terms, the applicable period generally would be derived, first, by determining the sum of (i) the annual amount that would fund on a level basis over the current law amortization periods (usually, 30 years) a total amount equal to the plan's funded ratio times the plan's unfunded termination liability and (ii) the annual amount that would fund on a level basis over three years a total amount equal to the complement of the plan's funded ratio times the plan's unfunded termination liability. (For this rule, the unfunded termination liability of a plan would be 110 percent of its termination liability less the actuarial value of its assets.) Second, the applicable period for the Complement Rule would be the same as the period over which the plan's unfunded past service costs (calculated using the plan's actuarial funding method) would be funded on a level basis to produce an annual contribution equal to the sum of the annual amounts determined under the first step.

At present, we expect that the applicable funding periods for unfunded benefits under the Complement Rule will range from the current law amortization periods (usually, 30 years) to, for those plans with the lowest funded ratios and most mature benefits, three years. Indeed, many of the better-funded plans with funded ratios of less than 100 percent would use the current law periods and thus would be unaffected by the Complement Rule. For example, most new plans that do not grant excessive past service credit would use a 30-year period.

Application of the Complement Rule to a year does not create an ongoing contribution requirement for the applicable period. Instead, the applicable period and thus the contribution required under the Complement Rule would be recalculated for each year. Thus, as the funded ratio of a plan increases over time, the applicable periods under the Complement Rule will also increase and thus the annual contributions required under this Rule will decrease.

Finally, as proposed, the Complement Rule does not differentiate between unfunded benefits existing on the effective date of the Proposal and unfunded benefits attributable to benefit increases after the effective date. Thus, an employer maintaining a seriously underfunded plan on the effective date would be required to make significantly larger annual contributions for the first several years after the effective date until the benefits on the effective date become better funded. Of course, the Administration recognizes that consideration will be given to a transition rule under the Complement Rule that would permit employers to fund the unfunded benefits existing on the effective date over somewhat longer periods than the periods applicable to unfunded benefits attributable to post-effective date benefit increases.

Funded Ratio Maintenance Rule.--In order to prevent the deterioration of a plan's funded status due generally to experience losses and to certain benefit increases not triggering a shorter funding period under the preceding rule, the Proposal would also require employers to fund certain deteriorations in a plan's funded ratio below 100 percent over three years.

More specifically, the Funded Ratio Maintenance Rule would require that an employer contribute for each of three years an amount necessary to fund on a level basis over such years a total amount equal to the decline in the plan's funded ratio due to experience losses over the year times 110 percent of the plan's termination liability to participants. For example, assume that 110 percent of a plan's termination liability at the end of a year is $1,000,000 and its funded ratio declines from 70 percent to 60 percent during the year. Assuming the entire decline is due solely to experience losses, the contribution required under the Funded Ratio Maintenance Rule for this year would be the annual amount required to fund on a level basis over three years the product of $1,000,000 times 10 percent, or $100,000. For better funded plans subject to this rule, the amount required would never be greater than the amount necessary to bring the plan's funded ratio up to its previous high level.

Cash Flow Rule.--In order to protect against a deterioration in a plan's funded status resulting from large, often unexpected benefit distributions, such as lump sum distributions and those associated with plant closings and other business reductions, the Cash Flow Rule would require that an employer make an annual contribution to a plan with a funded ratio of less than 100 percent at the end of the year equal to the total benefit distributions and expenses of the plan for the year. The amount required under the Cash Flow Rule, however, would never be greater than the amount necessary to bring the plan's funded ratio up to 100 percent. Special rules would be developed for retiree-only plans, frozen plans, and other plans with respect to which benefit distributions in excess of annual funding contributions will not result in the premature insolvency of the plan.

Discussion.--The PBGC has prepared two figures to illustrate the effects of revised minimum funding rules on the funded ratios of defined benefit plans over a 20-year period under two different model groups--Group I and Group A--developed by the American Academy of Actuaries. Figures 1 and 2, attached to this testimony, illustrate that the revised funding rules are well targeted at plans that present the greatest threat to employees' benefit security and the PBGC.

Group I sets forth a scenario under which the funded ratio of the defined benefit plan under current funding rules steadily declines over a 20-year period. This scenario greatly threatens employees' benefit security and the PBGC. The plan in Group I is an hourly employee plan with a high average age and high years of service. Almost 50 percent of the employees under the plan are over age 50. Also, the initial ratio of active employees to retired employees is nearly 1.14-to-1. As the size of the employer's workforce in Group I declines over the 20-year period, the replacement of retiring employees causes the average age and service of the employees to decline. The benefit formula under the Group I plan provides employees with a non-salary-related, flat dollar amount per year of service.

Group A presents a scenario under which the funded ratio of the defined benefit plan under current funding rules steadily improves over the 20-year period. Thus, this scenario poses relatively little threat to employees' benefit security or to the PBGC. The plan in Group A is a salaried employee plan covering a reasonably mature and stable workforce that is projected to increase over the 20-year period. The initial ratio of active employees to retired employees is nearly 7-to-1. Benefits under the Group A plan are salary-related and offset by employees' social security retirement benefits. The Group A scenario is typical of many large companies.

Figure 1 charts the future funded ratios of three defined benefit plans under Group I. These three plans are identical in all respects except for their funded ratios at the start of the 20-year period; plan X's initial funded ratio is 75 percent, plan Y's initial funded ratio is 50 percent, and plan Z's initial funded ratio is 25 percent.

Figure 1 shows that over the 20-year period, the funded ratios of all three plans under the current rules would fall to between 30 percent and 50 percent. In comparison, under the revised rules (without transition rules), the funded ratios of the plans would approach the 90 percent to 110 percent range.

Figure 2 charts the future funded ratios of the three defined benefit plans under Group A. It shows that over the 20-year period, the revised funding standards would have relatively little effect on the plans' funded ratios. Indeed, the future ratios for plans X and Y are nearly identical. Absent transition rules, the revised rules would have the greatest effect on plan Z, particularly during the early portion of the period. This is appropriate in light of plan Z's initial funded ratio of only 25 percent.

Proposal: Minimum Funding Rules for All Plans

In addition to revising the funding rules for underfunded defined benefit plans, the Proposal would modify several of the funding rules applicable to all defined benefit plans.

First, the Proposal would make all members of the controlled group to which the plan sponsor belongs liable for required contributions under the minimum funding rules. This is consistent with both the current law controlled group "distress" determination made by the PBGC as a condition to the termination of an underfunded plan and the current law controlled group liability to the PBGC for unfunded guaranteed benefits after plan termination.

Second, the employer would be required to make quarterly payments toward the minimum contribution for a plan year under rules analogous to the estimated income tax rules. Furthermore, the total required contribution for a plan year would be due no later than 2-1/2 months after the end of the plan year. As under the estimated tax rules, reasonable estimates would be permitted and safe harbors would be provided so that multiple actuarial funding determinations during a year would not be necessary to comply with the quarterly payment rule. An acceleration of contribution due dates would not only result in amounts being contributed to plans at an earlier time--an obvious but very important result--but would also improve the short term accountability of employers for their pension promises and, indeed, would serve as an early warning system of possible employer financial difficulty. It is difficult to justify why an employer should be able to defer contributions to a plan for periods that are significantly longer than the typical payment periods for other creditors of the employer.

Third, the Proposal would modify the rules governing the availability of minimum funding waivers. Under the Proposal, a waiver application would have to be filed within 2-1/2 months after the end of the plan year. In addition, the standards for granting a waiver would be clarified by providing that the employer seeking a waiver would have to establish that the hardship was temporary and that the hardship affected the entire controlled group. To make minimum funding waivers more equivalent to commercial loans, the interest rate required on waived contributions would be increased from the interest rate applicable to the late payment of taxes under section 6621(b) of the Code to the greater of the plan's assumed interest rate for funding purposes or the market rate for loans to distressed companies. The number of waivers permitted for any 15-year period would be reduced from five to three, and the period over which waived contributions would have to be funded would be reduced from 15 years to a period of time that would be based on the extent of plan underfunding (i.e., the lesser of 15 years or 15 years times the plan's funded ratio).

There has been much discussion about the continuation of the funding waiver program. However, there may be valid pension policy reasons for the continuation of funding waivers in certain circumstances; the elimination of waivers could prompt some employers to discontinue their pension plans while they were recovering from temporary financial reverses. Nevertheless, waivers have often been used to generate funds for distressed companies at terms much better than the companies could obtain commercially. The Proposal would limit much of the unjustified use of the waiver program.

In addition, the Administration believes that it would be appropriate to consider special rules to address the funding problems created by certain types of contingent benefits, such as shutdown benefits. For example, shutdown benefits generally are not funded before a plant shutdown occurs, due in part to the difficulty in predicting a major shutdown for a particular employer. Thus, a plan's payment of these benefits depletes assets that have been accumulated to pay other retirement benefits. Because plant shutdowns often occur with respect to employers that are encountering financial difficulty and thus are less able to fund their plans properly, the inclusion and payment of shutdown benefits under defined benefit plans may both undermine a plan's ability to pay employees' retirement benefits and increase the PBGC's exposure with respect to such plans. The approaches for consideration range from special funding rules for shutdown benefits in defined benefit plans to precluding the inclusion of such benefits in defined benefit plans.

2. Terminations of Underfunded Plans

Current Law

An employer may voluntarily terminate a defined benefit plan if the plan has assets sufficient to provide "benefit commitments." Benefit commitments generally include all vested pension benefits for which all eligibility conditions have been satisfied as of the date of termination. In nearly all cases, benefit commitments are less than the benefits that constitute a plan's termination liability. (A plan's termination liability to employees generally includes all benefits that are vested or unvested, including certain contingent benefits.) Accordingly, in some cases employers may freely terminate plans that are without sufficient assets to provide employees with their total benefits even though the employer has no continuing obligation to provide such benefits after the plan termination. In such cases, the employees are simply deprived of their promised benefits.

An employer may voluntarily terminate a defined benefit plan that does not have sufficient assets to cover benefit commitments only in a PBGC-approved "distress termination" (i.e., the employer must be in financial distress). The PBGC may, through an involuntary termination procedure, terminate such a plan when the plan can no longer pay benefits when due. Following the distress or involuntary termination of a plan without sufficient assets to satisfy benefit commitments, an employer's liability to employees is less than the full amount of the unfunded benefit commitments (which amount is less than the full amount of the plan's termination liability to employees), and an employer's liability to the PBGC is less than the full amount of the unfunded guaranteed benefits.

Current law thus permits an employer to agree to provide employees with pension benefits for which it is not ultimately responsible. It follows naturally then that employers have an incentive to fund their plans below the level of their liability for unfunded benefits after plan termination. Because this level generally is less than the plan's termination liability to employees, it is more likely that employees will not receive their full promised pension benefits after a plan termination and that the PBGC will be required to provide unfunded guaranteed benefits. As a result, the rules prescribing an employer's ultimate liability for funding benefits may cause employees to be misled with respect to their ultimate pension benefits. Moreover, experience demonstrates that even arm's length collective bargaining may not ensure that pension promises will be properly funded.

Proposal: Uniform Post-Termination Liability

Consistent with the goal of increasing employer accountability, the Proposal would adopt a uniform level of employer liability to make an employer liable for its full pension promise to employees. First, an employer would be prevented from voluntarily terminating a plan (other than through a PBGC-approved distress termination) unless the plan had assets sufficient to provide employees with all benefits (i.e., assets equal to the plan's termination liability). Second, an employer would be liable to employees and the PBGC for the entire amount of the plan's termination liability. Thus, after the termination of an underfunded plan, the employer would be liable to the PBGC for all unfunded benefits covered by the PBGC and to the employees for all unfunded plan benefits not covered by the PBGC.

Assets collected in satisfaction of the expanded employer's liability would be allocated among participants' benefits under the current law asset allocation rules, except that the value of the PBGC's claim for 30 percent of the employer's net worth would be allocated exclusively to unfunded guaranteed benefits. The Proposal would not affect the priority of the claims of employees and the PBGC in bankruptcy.

Finally, the Proposal would clarify that if an employer terminated a plan that did not have adequate assets to provide PBGC guaranteed benefits, such employer would be prohibited from establishing a retirement program with substantially similar benefits within a five-year period. Such prohibition could be waived at the discretion of the PBGC. (Appropriate exceptions would be developed for employers acquiring businesses with pre-existing defined benefit plans.)

3. Aggregate Defined Benefit Plan Approach

Current Law

Under current law, whether a plan has sufficient assets to cover benefit commitments, and thus whether an employer may voluntarily terminate such plan without PBGC approval, is determined on a plan-by-plan basis, without regard to whether the employer also maintains other defined benefit plans that have sufficient assets to cover benefit commitments. In addition, the extent to which employees suffer benefit losses on termination of an underfunded plan depends entirely on the funded status of the terminating plan; the funded status of another defined benefit plan maintained by the employer is immaterial. Accordingly, employees are more likely to suffer benefit losses on plan termination and the PBGC is more likely to take on unfunded liabilities if an employer maintains more than one defined benefit plan than if the employer maintained a single plan for all employees.

Similarly, the current rules regulating the employer's access to plan assets operate on a plan-by-plan basis. Thus, it generally is easier for an employer with multiple plans to recover plan assets than for an employer with a single defined benefit plan. For example, under current law, if an employer maintains only one defined benefit plan, the employer may not recover plan assets unless the plan has sufficient assets to satisfy the benefits of all covered employees. However, if an employer maintains more than one plan, the employer is permitted to recover excess assets upon termination of an overfunded plan regardless of whether the other plans have sufficient assets to satisfy the benefits of the employees in such plans.

Many employers currently maintain both relatively well-funded plans and underfunded plans for their employees. In some situations, the disparately funded plans are in different lines of business, but in other situations the plans are in a single line of business. In recent years, some employers have received asset reversions from their overfunded plans and then terminated their underfunded plans, thereby using tax-favored funds for nonretirement purposes, depriving employees of their full benefits and, in some cases, shifting unfunded liabilities to the PBGC. Thus, the plan-by-plan approach rewards employers that maintain multiple plans funded at different levels because such employers are better able to access tax-favored assets at the expense of employees' benefit security and the premium payors of the PBGC.

Proposal: Aggregate Defined Benefit Plan Approach

In General.--The Proposal generally adopts an aggregate defined benefit plan approach to terminations of underfunded plans and asset recoveries from overfunded plans. The notion underlying the aggregate plan approach is that it should not be easier for an employer to shift benefit losses to employees or unfunded liabilities to the PBGC or to have better access to plan assets either through plan termination or an asset withdrawal merely because the employer maintains more than one defined benefit plan. Similarly, before employees and the PBGC are forced to suffer losses upon the termination of an underfunded plans, tax-favored assets in ongoing defined benefit plans should be used to fund the employer's promised benefits.

A reinsurance analogy well illustrates the theory underlying the aggregate plan approach adopted in the Proposal. Essentially, an employer makes pension promises to its employees and, under ERISA and the minimum funding rules, is required to self-insure those promises through a defined benefit plan. These requirements effectively put the PBGC in the position of a reinsurer of the employer's benefit promises. However, unlike a reinsurer in the private sector, the PBGC is unable to vary its premium and impose special requirements, such as minimum reserve levels, as a condition to the reinsurance. Indeed, the PBGC is forced to reinsure employers' pension promises even if the required premiums are not paid.

The Administration's variable rate PBGC premium proposal would partially address this situation. The Funding and Termination Proposal takes the additional step of applying what are effectively improved reserve requirements on the availability of the PBGC's reinsurance benefit by tightening the minimum funding requirements for certain plans and by applying an aggregate plan approach to terminations of underfunded plans and asset recoveries from overfunded plans. More specifically, the Proposal takes the view that all assets set aside to self-insure an employer's pension promises should be available to provide benefits to employees before the PBGC is forced to accept liability as a reinsurer of an employer's pension promises. An employee should not be forced to suffer a benefit loss so long as there remain assets set aside by the employer to self-insure its pension promises. Certainly, the exposure to the PBGC and employees should not depend on whether an employer self-insures its pension promises through a single plan or through multiple plans.

The Proposal does not apply the aggregate plan approach to the full extent logically possible. For example, the Proposal does not require that all defined benefit plans maintained by an employer actually be merged into a single plan or even that all of an employer's plans be funded using uniform actuarial assumptions and a uniform actuarial funding method. Instead, the Proposal provides that an employer's defined benefit plans be treated as though they were a single plan only in the case of certain transactions, such as terminations, reversions, withdrawals, and sponsorship transfers, that may reduce the security of the employees' benefits.

Underfunded Plan Terminations.--In the case of terminations of underfunded plans, the aggregate plan approach is reflected by a proposed rule that if a plan terminates with assets less than the plan's termination liability, assets would have to be transferred from other better-funded plans of the employer to the terminating plan up to the level of such plan's termination liability. Assets may not be transferred from an ongoing plan to the terminating plan to the extent that the transfer would reduce the assets in the ongoing plan to less than the termination liability of the ongoing plan.

Some have expressed concern about transferring assets from an ongoing defined benefit plan for the benefit of participants in a terminating plan. However, without such a rule, employers with multiple plans would be able to terminate their underfunded plans so as to increase the amount of excess assets in the remaining plan(s) and, by so doing, recover additional assets through a subsequent withdrawal or termination. Moreover, such transfers promote equity by protecting the benefits of employees under a plan to which contributions will no longer be made, at the cost of removing excess assets from an ongoing plan, to which contributions will continue to be made.

Asset Withdrawals and Reversions.--The aggregate plan approach also underlies the portion of the Proposal that permits an employer to withdraw assets from an ongoing defined benefit plan. The Proposal provides that the amount of assets available for withdrawal from a particular plan depends not only on whether an adequate asset cushion would remain in such particular plan after the withdrawal, but also on whether there is an adequate cushion in the employer's other defined benefit plans. Thus, unlike the current law rules governing asset reversions, the amount available for withdrawal would not depend on whether the employer maintained a single plan or multiple plans.

Also consistent with the aggregate plan approach, the Proposal treats a reversion on termination of a plan by an employer that continues to maintain other defined benefit plans as equivalent to a withdrawal from an ongoing plan, thereby preventing an employer from defeating the cushion requirement on withdrawals by maintaining multiple plans and terminating one of those plans to recover assets that would not have been available through a withdrawal. However, if an employer is terminating its last defined benefit plan (other than a multiemployer plan), there would be no basis for requiring an asset cushion and thus the employer would be able to recover all assets in excess of the plan's termination liability (as under current law). To assure that such a termination is bona fide and not undertaken simply to recover the additional plan assets, such an employer would be precluded from covering the employees under another defined benefit plan (including a multiemployer plan) for five years.

Controlled Group.--The Proposal does not limit the aggregate plan approach to the defined benefit plans of a particular employer, but rather applies the approach to the employer and the controlled group containing the employer. Thus, for example, under the various rules discussed above, the Proposal would aggregate the defined benefit plans maintained by separate lines of business within a single controlled group. This controlled group application of the aggregate plan approach is simply an expansion of the current law controlled group "distress" determination made by the PBGC as a condition to the termination of an underfunded plan and the current law controlled group liability to the PBGC for unfunded guaranteed benefits after plan termination.

The aggregate plan approach is applied on a controlled group basis to broaden the accountability for pension promises beyond any particular employer to the entire controlled group so that the entire group, including separate lines of business, will restrain each particular employer within the group from making unaffordable pension promises. For example, assume that a controlled group includes two separate businesses, each of which maintains a defined benefit plan. The profitable business maintains a well-funded plan, while the unprofitable business maintains an underfunded plan. Even though the controlled group insists that each business separately finance its own pension promises, the controlled group does not significantly affect the amount or funding of the pension promises of the unprofitable business. However, if the assets in the well-funded plan are made available to pay unfunded benefits under the plan of the unprofitable business, as would be the case under the aggregate plan approach, the controlled group will undoubtedly take action to assure that the unprofitable business properly funds its plan and does not make promises that it cannot afford.

Transfers of Plan Sponsorship.--Under the aggregate plan approach, it also is necessary to address the potential that transfers of plan sponsorship from one employer or controlled group to another may reduce the security of employees' promised benefits. Many employers, particularly controlled groups, engage in sales and acquisitions of businesses that involve transfers of defined benefit plan sponsorship from one employer or controlled group to another. Indeed, it is common for a defined benefit plan to accompany a business and its employees when such business is sold by one controlled group to another. There may of course be significant tax consequences to both the seller and buyer in such sales, including consequences that relate to transferred defined benefit plans. More importantly, however, transfers of plan sponsorship also may adversely affect the security of employees' benefits by enabling employers to defeat the improved accountability intended by the aggregate plan approach.

Unless the aggregate plan approach is applied to transfers of plan sponsorship, an employer maintaining multiple plans would be able to avoid properly funding its full pension promises to employees of the transferred business and indirectly to recover excess plan assets for purposes other than the provision of pension benefits to the employees remaining with the employer (through adjustments in the terms of the business transaction). Thus, the transfer of an underfunded plan or an overfunded plan to another employer or controlled group is treated under the aggregate plan approach as a termination of the plan by the transferor employer. This means that a transferor employer may be required to transfer assets from overfunded plans to the transferred plan if such plan is underfunded or to limit the extent to which assets in excess of the transferred plan's termination liability may be transferred with the plan. In this way, employers are not able to reduce their accountability for their pension promises merely by maintaining multiple defined benefit plans and transferring the sponsorship of some plans to another employer or controlled group.

For example, if plan sponsorship is transferred from one employer to another in connection with the sale of a subsidiary, plan assets in excess of the plan's termination liability would be permitted to remain in the plan only to the extent that the employer could have recovered such assets through a termination of the plan and an asset reversion. Prior to the transfer of plan sponsorship, any assets that would not have been available to the employer on plan termination would have to be transferred to other defined benefit plans of the transferor employer. Some have suggested that it would be appropriate under the aggregate plan approach to permit assets in excess of the transferred plan's termination liability to remain in the plan if the funded status of such plan is not better than the funded status of the other remaining plans of the transferor employer. This rule would be consistent with the aggregate plan approach. In either case, if the transferor employer does not maintain any other defined benefit plan after a sponsorship transfer, there would be no limit on the assets that could be transferred with the plan.

<u>Alternatives to Asset Transfers</u>.--Some have suggested that the aggregate plan approach be implemented in certain circumstances without requiring asset transfers from overfunded plans to underfunded plans. The Administration of course welcomes consideration of alternative methods to implement this

approach. For example, some have suggested that, in lieu of transferring assets from a terminating overfunded plan to an ongoing underfunded plan, the aggregate plan approach could be implemented by increasing the minimum funding contribution for the ongoing plan and, in certain cases, requiring that the employer provide security to the ongoing plan and the PBGC. The amount of the funding increase would be based on the amount of assets that the employer recovered from the terminating plan in excess of the amount that would have been available through an asset withdrawal. Thus, the amount available through an asset withdrawal would be determined as though all defined benefit plans maintained by the employer were a single plan, but increased funding and security requirements would apply in lieu of an asset transfer. The Administration will consider this and any other proposal that effectively achieves the policy objectives of the aggregate plan approach by alternative means.

CONCLUSION

I would like to close by reemphasizing that the objectives of the Administration's Proposal on the Funding and Termination of Defined Benefit Plans are to enhance the security of employees' pension benefits and to protect the PBGC (and thus its premium payors) from liability for avoidable unfunded plan benefits by increasing employers' accountability for their pension promises. The Proposal is not intended as a quick fix or short-term solution to the problems of employee benefit security or the PBGC, but rather is designed as a comprehensive and rational approach to improving benefit security over an extended period.

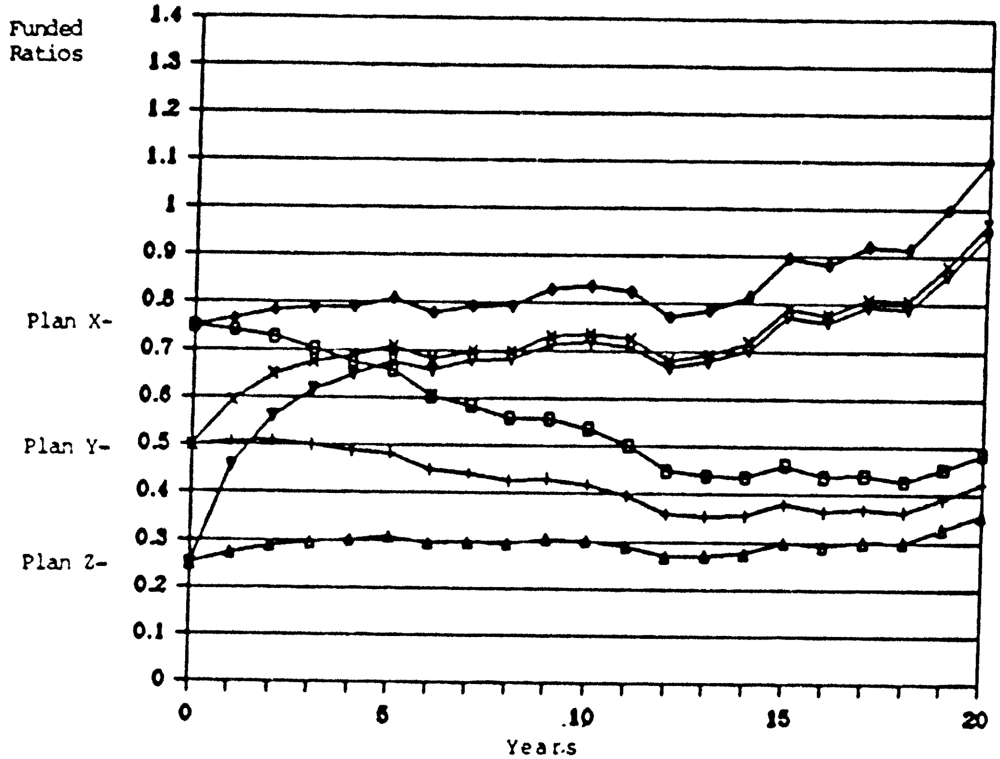
The Administration looks forward to working with the Subcommittee, as well as the full Finance Committee, in considering this Proposal. We hope that in the very near future we can begin working together with all of the appropriate committees to draft statutory language reflecting this Proposal for formal legislative consideration.

Thank you very much.

FIGURE 1

CURRENT AND REVISED FUNDING STANDARDS

Plans With Significant Continual
Underfunding Under Current Law
(American Academy of Actuaries Group I)



Plan X: Initial Funded Ratio 75%
□ -- Current Funding Standards
◇ -- Revised Funding Standards

Plan Y: Initial Funded Ratio 50%
+ -- Current Funding Standards
× -- Revised Funding Standards

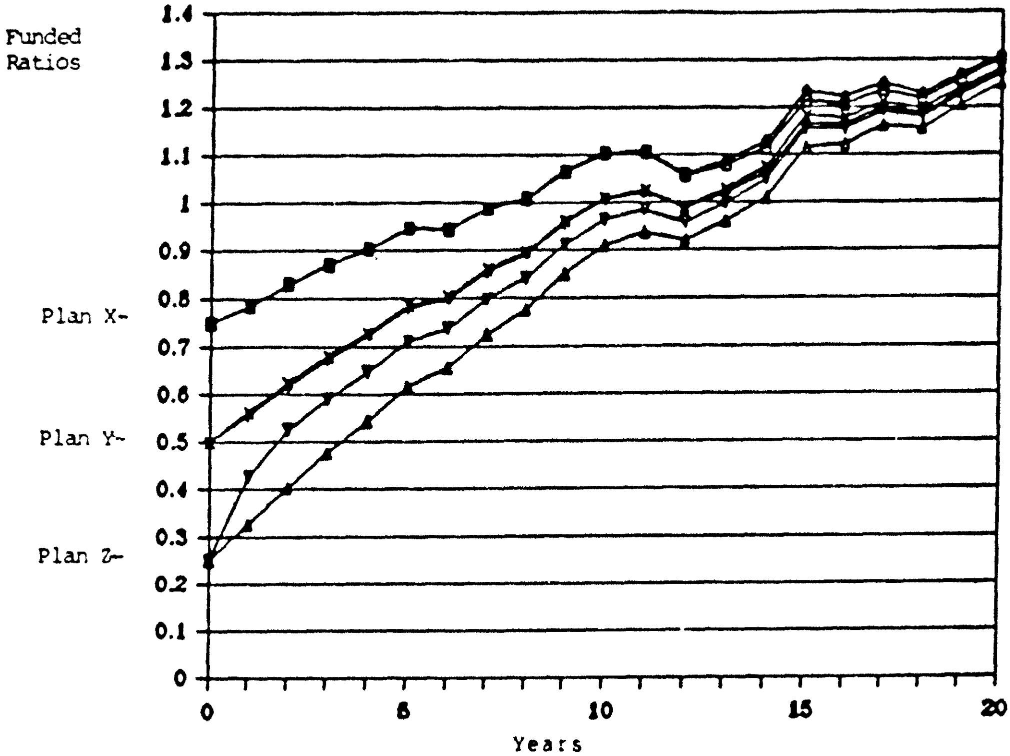
Plan Z: Initial Funded Ratio 25%
△ -- Current Funding Standards
▽ -- Revised Funding Standards

NOTE: Without Transition Rules

FIGURE 2

CURRENT AND REVISED FUNDING STANDARDS

Plans With Increasing Funding
Levels Under Current Law
(American Academy of Actuaries Group A)



Plan X: Initial Funded Ratio 75%
□ -- Current Funding Standards
◇ -- Revised Funding Standards
Plan Y: Initial Funded Ratio 50%
+ -- Current Funding Standards
× -- Revised Funding Standards
Plan Z: Initial Funded Ratio 25%
△ -- Current Funding Standards
▽ -- Revised Funding Standards

NOTE: Without Transition Rules

STATEMENT OF DAVID WALKER, DEPUTY ASSISTANT SECRETARY, PENSION AND WELFARE BENEFITS ADMINISTRATION, U.S. DEPARTMENT OF LABOR

Mr. WALKER. Thank you, Mr. Chairman. I appreciate the opportunity to be with you here today. We recognize that this committee has a great interest in the issue of retirement income policy, and, clearly, the rational termination and funding of defined benefit plans is an important element to assure retirement income security, and the credibility and stability of our private pension system.

Mr. Chairman, I have a statement that I would like to have submitted for the record which is designed to address the withdrawal, the termination and the retiree health provisions of the proposal.

Senator PRYOR. We will put your entire statement in the record, Mr. Walker.

Mr. WALKER. Thank you.

Senator PRYOR. Do you want to summarize that statement?

Mr. WALKER. Let me summarize if I can, Mr. Chairman, the important policy concepts underlying this proposal because I think my statement on the withdrawal, termination and retiree health provisions speaks for itself.

As Mr. Conaway mentioned, the Administration's proposal is a result of a 1-year comprehensive effort on behalf of all the ERISA agencies to address some very important problems that we have identified since ERISA's passage some 12 years ago. And in that regard I think it might help you and the other members of the committee if I put into perspective the policy concepts objectives that we are trying to achieve as part of this proposal.

First, we feel that it is extremely important that the termination and funding rules of ERISA be structured in a manner that will provide assurance that all participants within an employer or a controlled group will receive their full accrued benefits.

Second, we think it is important that employers be free to make their own pension promises, whether it be due to competitive situations or through the collective bargaining process. At the same point in time, they should be held fully accountable and fully responsible for all the pension promises that they choose to make.

Third, they should not have incentive nor opportunity to make promises that exceed their reasonable ability to meet or their financial capacity to pay.

Fourth, obviously, they should not be able to impose avoidable or systematic losses on plan participants or the PBGC. Fifth, the minimum funding rules should be structured to encourage the optimal funding of all defined benefit pension plans, not excessive or deficient funding, and as such, we do not feel it is appropriate or necessary to maintain huge surpluses in these plans, specifically, there is no compelling reason either from a tax policy standpoint or an economic efficiency standpoint for employers to be required to retain funds in these plans in excess of the amounts that are necessary to reasonably assure that their participant promise will be kept and their benefit security will be maintained.

Next, we believe that the ERISA rules that deal with plan investments in employer securities should be structured in a fashion that does not make the retirement income security of plan participants over-reliant on the future financial strength of the employer.

And, last, we feel that it is important that government policy should encourage employers to provide retiree health benefits for their retirees.

If I can, let me hit the highlights as to what we are proposing rather than a lot of detail, and then, second, and I think very importantly, what we are not proposing as part of this proposal.

First, we are proposing that employers have the ability under appropriate circumstances and with appropriate safeguards to assure that benefit security is not compromised to withdraw certain funds from an ongoing pension plan in lieu of current spinoff/termination and termination/re-establishment transactions. Spinoff/terminations and termination/re-establishments are defined in my testimony.

We feel that requiring termination, which current law does, in order to access surplus assets is disruptive, costly, and undercuts the security and stability of the private pension system.

Furthermore, and more importantly, by requiring termination of the pension plan employers are able to access all surplus assets down to termination liabilities, which is inconsistent with the minimum funding standards and which does not provide adequate security with regard to projected benefits and future benefit accruals.

Second, we believe that an aggregation concept is important for withdrawal purposes, termination purposes, transfer purposes, and funding purposes, rather than just looking at the plan in question, which is the case under current law.

Third, we believe that strengthening the minimum funding standards and increasing deduction limits in the case of underfunded plans is critical in order to, in the long term, reduce the number of underfunded plans and the relative degree of underfunding which will clearly result in enhanced benefit security, and a less losses being imposed on the PBGC, and therefore lower premiums eventually, or at a minimum lower premium pressure for their premium payors.

We feel that a uniform level of termination liability should be adopted that is not dependent upon the funding status of the plan. This is consistent with the idea that an employer should be free to make their own promises; however, once they make that promise, they should not be charged with an additional surcharge because they funded well; likewise, they should not get any discounts because they have not funded well.

Next, we believe that tax-free transfers of amounts that are available for withdrawal should be allowed to fund retiree health insurance for current retirees. Given the importance of this benefit, the cost of this benefit, and the fact that there is at least $100 billion in unfunded promises out there we would like to take a step towards trying to make sure the participants will receive those benefits.

Importantly, Mr. Chairman, I think there are several things that are not in this proposal that I think bear some note and clarification.

First, we are not proposing to change the definition of termination liabilities with regard to determining how much an employer could access in the case of a full termination. By that, I mean when they exit the defined benefit system in its entirety.

We are proposing a uniform level of termination liability for all plans, but under current law, the liabilities that would have to be provided, and under this proposal, before a termination and reversion could take place would be those liabilities that are currently required under Section 4044 of ERISA.

Second, we are not proposing a surcharge or an increase in termination liabilities that would be allocated to participants or otherwise on termination of the plan for several reasons.

First, we feel that such a surcharge would serve to penalize sponsors who have funded their plans responsibly.

Second, we feel that such a surcharge or increase in liability on termination would serve to discourage proper funding of defined benefit plans and possibly the creation and maintenance of defined benefit plans.

And, third, we feel that such an approach might prove to be an illusionary benefit. Specifically, we feel that sponsors would be able to adjust their benefit formulas or contributions in anticipation of such a surcharge, and therefore make it illusionary.

In addition, we are not—and we recognize—proposing extensive changes in the area of retiree health insurance. Our proposal is designed to take a modern step in the right direction to try to address the large and growing problem of unfunded retiree health benefits.

As you know, Mr. Chairman, retiree health plans come under ERISA. They are welfare benefit plans. But unlike pension plans, they are not subject to minimum vesting, minimum accrual, or minimum funding requirements. And as a result, the security of these promises can well be in question.

As a result, we are asking the Congress to take a positive step to try to address this problem, but we fully recognize that there are many other issues in the area of retiree health that need to be addressed.

We considered the possibility of allowing for additional prefunding on a tax-favored basis of retiree health insurance for active employees, but rejected it as part of this proposal for two reasons. Number one, the significant revenue implications that that would entail, especially in light of the current federal budget deficit; and, second, the fact that we feel that such a broad prefunding, while it may be appropriate and may ultimately be necessary, would require minimum standards for welfare benefit plans or at least with regard to these benefits to be funded in order to be sure that benefits would be provided in a nondiscriminatory manner, to insure benefit security and to prevent tax abuse.

Last, in closing, Mr. Chairman, I think the proposal will do five things, which are things that I think we both share as being laudible objectives.

First, it will better protect the retirement income security of American workers;

Second, it will improve the stability and credibility of the private pension system;

Third, it will significantly reduce the burdens that are being imposed on the Pension Benefit Guaranty Corporation and their premium payors, especially over the long-term;

Fourth, it will increase the probability that retirees who currently are receiving retiree health insurance will indeed receive it, and will encourage other employers who have overfunded defined benefit plans to provide these benefits to their retirees.

And, last, it will enhance overall competitiveness through improving the retirement income security and state of mind of plan participants, and providing employers with an additional access to capital.

Thank you, Mr. Chairman.

Senator PRYOR. Thank you, Mr. Walker. And there will be a couple of questions to follow later on. And now we will hear from Dr. Kathleen Utgoff, the Executive Director of the Pension Benefit Guaranty Corporation. Thank you for coming, Dr. Utgoff. We look forward to your statement.

[The prepared written statement of Mr. Walker follows:]

STATEMENT OF
DAVID M. WALKER
DEPUTY ASSISTANT SECRETARY
PENSION AND WELFARE BENEFITS ADMINSTRATION
U.S. DEPARTMENT OF LABOR
BEFORE THE
SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND
OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE
COMMITTEE ON FINANCE
U.S. SENATE

May 18, 1987

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you to discuss the Administration's Proposal on the Funding and Termination of Defined Benefit Pension Plans. I recognize that this Committee has a keen interest in the development of retirement income policy. Clearly, the rational funding and termination of defined benefit pension plans is essential to protect retirement income security and insure the stability and credibility of our voluntary private pension system.

My testimony today will focus on those aspects of the Administration's funding proposal that relate to employer access to plan assets through withdrawal or termination, and the proposal's provision for transfer of certain excess pension plan assets to a special welfare benefit trust dedicated to the payment of retiree health benefits.

Withdrawals

The Administration's funding proposal would change the means by which employers could access funds in excess of those needed to satisfy their obligations under defined benefit pension plans. Excess assets accumulate for a number of reasons, including better investment performance than anticipated by the plan's actuaries and other favorable plan experience.

Under ERISA, an employer may not access assets in excess of accrued benefit obligations unless the plan is terminated and certain conditions are met. In addition, the law clearly allows for reversions of such excess assets when a sponsor does not offer a successor plan to its active workers or only offers a successor defined contribution plan. However, in 1984 the Adminstration issued guidelines which provided that an employer may recover such excess assets and continue to cover active workers under a defined benefit plan. These guidelines were issued to eliminate what otherwise would have been a significant economic incentive for employers to exit the defined benefit system merely to recover all assets in excess of termination liabilities. They also included certain conditions to fully protect the accrued benefits of plan participants. Specifically, these guidelines provide that an employer can terminate the plan, take assets left after meeting all termination liabilities, and then reestablish the same or a nearly identical plan. This is commonly referred to as a termination/reestablishment.

Alternatively, the guidelines also indicate that an employer can spin off a group of participants (usually retirees) to a new defined benefit plan along with assets of the original plan in excess of termination liabilities. The spun-off plan is then terminated and assets in excess of termination liabilities revert to the employer. This is commonly referred to as a spinoff/termination.

Although the guidelines represent the proper approach within the context of current law, current law needs to be changed in order to better assure benefit security. Specifically, requiring the termination of a plan to recover excess assets can be disruptive to employee relations by causing uncertainty for plan participants and may impose significant transaction costs on an employer. More importantly, under this structure employers can draw plan assets down to termination liabilities. Thus, appropriate reserves are lacking to fund projected benefits and provide protection against any near-term adverse investment experience.

Drawing the assets down to termination liabilities in situations where employees continue to be covered under a defined benefit plan is inconsistent with both the intent of the current minimum funding standards and sound practices for funding ongoing pension plans. Generally, current law minimum funding standards provide that an employer must fund a defined benefit pension plan not only for employees' accrued benefits, but also for a portion of employees' projected benefits. Thus, most properly funded plans have assets in excess of termination liabilities. Moreover, under current law an ongoing plan is not considered fully funded until the assets in the plan exceed the plan's full funding limitation based on the plan's funding method and actuarial assumptions. The concepts embodied in these current definitions and limits for ongoing plans are consistent with sound financing practices. Therefore, under the Administration's proposal, an employer may withdraw assets from an ongoing pension plan only to the extent that such assets exceed the plan's full funding limitation.

More specifically, under the proposal the full funding limitation for withdrawal purposes would be calculated using the projected unit credit method. Of course, an employer could choose an alternative funding method, provided it resulted in a full funding limitation higher than that which would result under the projected unit credit method. In some cases, the plan's funding method or demographics results in a full funding limitation that is close or equal to termination liabilities. Therefore, to assure adequate protection of all plans, the asset reserve remaining after a withdrawal would have to be at least 125 percent of termination liabilities. An asset reserve of 125 percent will adequately assure against a plan's becoming seriously underfunded should the plan, soon after the withdrawal, suffer serious losses through a drop in the market value of its assets or some other adverse actuarial experience.

It is important to note that we have not changed the definition of termination liabilities for recovery of excess assets from pension plans. There seems to have been some confusion here. Under the Administration's proposal, termination liabilities would be defined in the same way as the current law practice for a termination and plan reestablishment. Specifically, those benefits for which participants are currently eligible would have to be recognized as well as early retirement benefits which would be required to be recognized under section 411(d)(6) of the Internal Revenue Code. In the case of an unannuitized withdrawal, termination liabilities would only have to include early retirement benefits that might reasonably be expected to occur and all other benefits that must, under current law, be provided on plan termination before an employer may receive a reversion.

The Administration's proposal also contemplates that some of the actuarial assumptions used in calculating the amount of plan assets available for withdrawal would be specified by law or through regulation. Because the Administration's proposal does not require annuitization when assets are withdrawn from an ongoing plan, assumptions become important to the calculation of termination liabilities and the full funding limitation.

While the Administration's proposal would not require that benefits be annuitized for withdrawal purposes, it would allow a reduced cushion to the extent any benefits are annuitized. Specifically, the asset cushion for any annuitized benefits would be equal to the greater of (i) the termination liability of the plan plus 40 percent of the difference between the full funding limitation and the termination liability of the plan, or (ii) 110 percent of the termination liability of the plan. This reduced cushion seems appropriate since by purchasing annuities participants' accrued benefits would not be subject to risk of adverse investment or other actuarial experience. At the same time, an asset cushion of 10 percent above termination liabilities is essential to protect the projected benefits and future accruals of plan participants.

In addition to requiring a substantial cushion of assets before certain excess assets may be withdrawn from a plan, the proposal also would require that the funding level of all an employer's defined benefit plans be considered before assets could be withdrawn from any of its plans.

Under current law, an employer can take assets from an overfunded plan while maintaining one or more other defined benefit plans that are funded poorly. To correct this inequity, the proposal would require not only that the plan from which a withdrawal is being made have an adequate cushion, but, in addition, that all plans of an employer, in the aggregate, meet the cushion requirement before the employer would be permitted to withdraw assets from any plan. Thus, all plans, when considered collectively, would retain assets equal to the greater of the aggregate full funding limitation or 125 percent of the aggregate termination liability. This will assure that all defined benefit plans of the employer, when considered as a group, will be adequately protected before any funds can revert for non-pension purposes.

In the absence of such an aggregation test, employers could manipulate the asset levels in plans by minimally funding some plans in the controlled group and generously funding other plans. Too often employers have overfunded salaried worker plans while underfunding hourly worker plans. Thus, to protect the benefit security of all participants, all single-employer plans in the controlled group, including collectively-bargained plans, must be taken into account.

To further assure that employers cannot continue to obtain large asset reversions by terminating an overfunded plan while maintaining poorly funded plans, the Administration's proposal would prohibit employers with multiple defined benefit plans from obtaining more assets upon termination of a plan than could be obtained through a withdrawal from the plan. This does not prevent an employer from terminating a plan for a legitimate business reason, such as more appropriately structuring the compensation of a particular group of employees. At the same time, however, retaining the cushion from the terminating plan in the pool of assets available to the other defined benefit plans in the group assures the benefit security of the remaining defined benefit plan participants. It also serves to discourage terminations of individual plans within a controlled group merely to recover all assets above termination liabilities.

Only when an employer completely departs from the single-employer defined benefit system would all assets in excess of the termination liability of the plan be available. The proposal is designed to ensure that only such bona fide terminations would be undertaken. For instance, although full vesting and annuitization of accrued benefits would not be required in the case of an asset withdrawal, they would continue to be required on plan termination. In addition, an employer would be prohibited from maintaining a defined benefit plan for the previously covered group of employees for five years after a termination. This rule would prevent employers from circumventing the cushion requirement by terminating the plan and then reestablishing a plan with no asset cushion.

The Administration's overriding concern in developing a new set of rules pertaining to employer access to plan assets through withdrawal or termination was enhancing benefit security. As outlined above, the proposal would require adequate asset cushions and safeguards for an employer's ongoing plans. Once the benefit promise for all of an employer's plans has been adequately secured, the assets remaining in the plan would be available to the employer.

Government policy should encourage the creation and optimal funding of defined benefit pension plans. In a defined benefit system, employers promise a certain benefit level. The assets in a defined benefit plan are used to insure that the benefits promised under a plan can be paid when due. An employer who sponsors a defined benefit pension plan commits to adhere to strict funding rules which require him to make payments to the plan in good times and bad. In addition, the employer assumes the risk of adverse investment and other experience by assuring that participants will receive their stated benefit. Therefore, any assets in excess of those needed to fund the obligations to pay benefits under the plan should, in appropriate circumstances, continue to be available for recapture by the employer. Any attempt to mandate benefit increases at the point at which a plan is terminated would only serve to discourage optimal funding and may well prove to be an illusory benefit increase, since employers could reduce their contributions or lower their future benefit promises to offset the mandated increase.

Rather than creating an illusory benefit, the proposal directly enhances benefit security for all participants in all plans. Under current law, employers who terminate inadequately funded plans are responsible only for "benefit commitments." This is less than full termination liabilities. The proposal would increase the employer's liability upon plan termination to full termination liabilities, thus creating a uniform level of termination liability for all employers, regardless of the funding status of their plans.

Retiree Health Benefits

Retiree health benefits may currently be funded on a tax-favored basis through either a trust established as part of a pension plan under Section 401(h) of the Internal Revenue Code or a retiree health fund described in Section 419 of the Code. Funds may accumulate tax-free in a Section 401(h) account, but the amount of the deductible contribution is limited. On the other hand, an account established under Section 419 allows for a deductible contribution, but funds in the account are not permitted to accumulate tax free.

Although these two tax-favored vehicles are available for prefunding retiree health benefits, for a variety of reasons very few employers have set aside funds for this purpose. Consequently, most active and retired employees have little assurance that they will actually receive retiree health benefits from their employers. Even if such benefits are deemed to be fully vested for life under contract law, if they are not prefunded fulfillment of the promise is dependent upon the continued economic viability of the employer. In this regard, the Department of Labor recently estimated that the present value of the future cost of promised retiree health benefits in 1983 was $98 billion.

Because of the Administration's concern over the growing importance and cost of retiree health benefits, the proposal would allow employers to transfer, on a tax-favored basis, amounts otherwise available for withdrawal to a special welfare benefit fund established under Section 419 of the Internal Revenue Code. The amounts transferred would be limited to the present value of the liabilities attributable to retiree health benefits for current retirees and must be dedicated for this purpose. We anticipate that certain assumptions would be prescribed either by statute or regulation to calculate this amount. The transferred amounts would be exempt from income tax and the ten percent excise tax on reversions. The funds also would be allowed to accumulate on a tax-exempt basis. While the transfer would not affect an employer's liability to future retirees for health insurance, the transferred amounts would be irrevocably earmarked to provide benefits to those who were currently retired.

We would allow this one exception to an otherwise taxable event, the withdrawal, because of our concern about the large and growing cost of the current coverage for retiree health, because of the great importance of these benefits, and because of the vulnerability of these benefits under the current system.

This proposal is limited in that it is not intended to address the many other retiree health issues which need to be considered, including the possible prefunding of future retirees' health insurance. In this regard, the Administration considered the possibility of allowing tax-favored prefunding over an employee's working life. However, two considerations prevented our taking that step at this time. First, such an approach has significant revenue implications which warrant particular concern in this time of large Federal budget deficits. Second, and more importantly, we believe such prefunding would not be appropriate without some minimum standards, such as those that apply to qualified retirement plans. In our opinion, to justify the tax expenditure and ensure that appropriate benefits are delivered, participation, vesting, benefit accrual and funding standards need to be considered. In addition, the employer's liability to retirees would have to be defined and fixed. These are complex and important issues that merit a more thorough consideration outside the context of this bill.

We believe that the importance of retiree health benefits dictate that they should be funded separately from pension benefits. We also believe that, for administrative simplicity, a single preferred vehicle should be used to fund these health insurance benefits. As a result, the proposal would also repeal Section 401(h) of the Internal Revenue Code, which allows some limited prefunding of health insurance as an incidental benefit in the pension plan. The proposal does, however, provide that any amounts currently set aside in a Section 401(h) account would be transferred on a tax-free basis to a welfare benefit fund and continue to grow tax free thereafter.

Conclusion

In closing, I would like to emphasize that the retirement security of American workers was our primary concern in the formulation of this proposal. Under the proposal, employers will remain free to set their own pension benefit promises but will be held fully accountable for the promises that they choose to make. We believe these proposals will help assure that all employees will receive their full promised pension benefits, thereby increasing the probability that the promise of retirement income security will be fully realized. Moreover, the overall stability of our single-employer defined benefit pension plans will be enhanced, and there will be a substantial reduction of risk to PBGC and its premium payers. Finally, we believe that America's overall productivity and competitiveness will be improved through a workforce made more secure in their retirement planning and an employer community with improved access to capital.

STATEMENT OF DR. KATHLEEN UTGOFF, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION

Dr. UTGOFF. Thank you, Mr. Chairman, for the opportunity to testify here today. As head of the PBGC, I am particularly grateful for your interest in the problems of the Agency, and I couldn't agree with you more that the answer to our problems should not be budget-driven.

Today, my testimony will concentrate on one of the Administration's proposals. That is the variable rate premium proposal. But I will also describe why the Administration proposals that have been talked about in more detail by the other panelists are an important part of the solution to PBGC's problem.

The Administration's proposal for a variable-rate premium represents a truly fundamental reform in the way we collect premiums from the 110,000 pension plans covered by our single-employer insurance program. In recent years, as costs have escalated, people have talked about the need for a fairer and more efficient premium structure. The sharp deterioration in the PBGC's financial condition means that now is the time to act.

Our insurance program provides vital and very reassuring protection for over 30 million American workers and their families. But that protection is in danger and the promises made by the PBGC are at risk. Why? Because the PBGC raises too little money to meet its commitments and, even more important, because it raises money in the wrong way.

The problem of too little money has received a great deal of attention. With a balance sheet deficit approaching $4 billion and a huge overhang of potential claims from seriously underfunded plans, the PBGC can no longer live on revenue of $8.50 per participant per year.

The Senate's budget resolution recognizes this fact by calling for a fourfold increase in PBGC premiums, to an average amount per participant that would be even higher than the amount that we are requesting.

Despite the magnitude of the PBGC's financial problems, Some have suggested that the solutions can wait until "tomorrow". This attitude disregards the very high cost of delay. If our premium remains at its current level, the PBGC's deficit will grow. At the end of the current fiscal year, our deficit will equal $136.39 for each participant in a PBGC-insured plan. If current trends continue without a premium increase, the deficit will rise to $200.00 per participant, in 1987 dollars, by 1992 and to $300.00 per participant by 1999.

Paying off deficits of this magnitude will be a painful task. As the deficit mounts, more employers with soundly funded pension plans are likely to conclude that they do not want to be part of the solution. These firms will have a strong incentive to terminate their plans, leaving a smaller and smaller premium base to solve an increasingly intractable problem.

PBGC's premiums are reaching a level where we need to think carefully about the impact that they have on employee benefit planning and what will happen if the current premium structure remains in place indefinitely.

Right now the PBGC charges every single-employer plan the same premium per participant regardless of how well or poorly funded it is, or how likely it is to terminate with a claim against the pension insurance system. The risk that we face with escalating flat-rate premiums is that the premium base will erode leading to further premium increases and more departures from the defined benefit plan universe until the system reaches a point where very high premiums are paid by the only firms that remain, those with very poorly funded plans.

Our premium proposal is designed to prevent this real threat to the defined benefit pension system.

Under the premium structure that we are proposing, all covered plans would pay a flat per participant premium. Plans that represent greater benefit exposure to the insurance program would also pay a variable funding charge. The flat rate portion of the premium would be set at the current premium level, $8.50 per participant. This amount would be indexed to changes in the Social Security contribution and benefit base, the same base that is used to adjust the maximum benefit guaranteed by the PBGC.

The second part of the premium is called the funding charge. A plan would pay this charge only if it had 100 or more participants and was less than 125 percent funded for vested benefits. The funding charge initially would be $6.00 per thousand dollars of funding below the 125 percent level. The total premium—the flat-rate plus the funding charge—would be initially limited to $100.00 per participant. This cap would increase at 1.5 times the rate of increase of the Social Security wage and contribution base. Limiting the maximum premium will ease the immediate burden of the increase for plans subject to the funding charge. The cap will gradually increase in real terms and it will be phased out over a very long period of time.

Benefits for which a plan has purchased insurance company annuities would be disregarded for the purpose of calculating the funding charge, and a similar rule would apply if the plan sponsor gave the PBGC a security interest in assets equal to the amount of plan underfunding plus a cushion.

The funding charge would be adjusted upon review every three years to permit reduced premiums when the single employer program's experience is more favorable than anticipated and increased premiums when experience is worse than anticipated. The funding charge would be adjusted by no more than 50 percent as a result of this review, and the minimum rate of $8.50 would not be affected, and any adjustments in the funding charge would still be limited by the $100.00 indexed cap.

The proposal also includes surcharges that are directly related to the risk of termination. Our evidence indicates that failure to make required contributions is a very excellent indicator of risk that does not require an independent analysis of financial condition. By failing to make required contributions, an employer declares that a plan represents a significant risk to the program. A surcharge would apply to plans that fail to satisfy the minimum funding standards in the future without obtaining a waiver or an extension of the amortization period.

A plan that receives a funding waiver or an extension in the future would also pay a surcharge. This surcharge on waived or missed contributions is included in our proposal because an employer that does not make required contributions is, in effect, taking out a loan from the pension plan. The effect of these surcharges is to increase the cost of that financing, placing it on a more equal footing with other types of credit, such as commercial loans. As a result, participants' benefits are less likely to be jeopardized when a troubled company evaluates financing alternatives. This is in conjunction with the changes in the minimum funding waivers that have been described by other panelists.

The Administration believes that this proposal meets several critical criteria. First, it will raise the additional revenue needed by the PBGC. We estimate that the proposed premium structure will produce about $750 million in single-employer premium receipts in fiscal year 1988, $470 million more than the current flat rate premium, and that premium receipts will increase to about $900 million, $610 million more than under current law in fiscal year 1989, the first full year that the new rates will be in effect.

Second, the proposal will equitably allocate premium charges. Only those plans that present a significant risk to the insurance program will pay the funding charges and surcharges. Well-funded plans—the ones that represent little risk to the program—will pay a lower premium. In fact, 92 percent of all PBGC-insured plans, covering nearly two-thirds of all participants, would pay this minimum $8.50 premium.

Third, the premium for employers that maintain less well-funded plans will not be unreasonable. The maximum premium for a plan that meets its funding obligation would be $100.00 per participant. And that would only be paid by about 1 percent of plans. This is about one-third of 1 percent of the total compensation of an employee in the manufacturing sector, less than most companies pay in a year for life insurance, workers' compensation or unemployment insurance on an employee's behalf, and less than a typical monthly health insurance premium.

The maximum premium that we are proposing is less than 5 percent of the average pension contribution that we calculated from a sample of 38 Fortune 500 companies. Since many of the employers that are liable for the maximum premium have plans that are underfunded by more than $15,000 per participant, we believe that the maximum premium of $100.00 is a very reasonable amount for the protection it provides.

The premium structure that the Administration proposes will provide the PBGC insurance program with enough revenue to meet its pressing needs. A flat-rate premium could do the same only by grossly overcharging well-funded plans and inspiring an unhealthy race to the door that would ultimately result in much higher premiums for all surviving defined benefit plans.

Our proposal includes a limited adjustment feature that recognizes the fact that future claims against our insurance program really cannot be forecast with any degree of confidence. We must recognize the possibility of other large terminations like LTV. But it would be unfair to our premium payors to collect enough revenue to make sure we could cover several large claims. The only alternative to a flexible premium schedule that adjusts to accommodate a range of future claims is an unflexible schedule that is almost certain to raise too much or too little revenue. Because of the adjustment mechanism in the Administration's proposal, we are able to propose a lower initial premium and a lower premium cap than would otherwise be prudent. Without automatic adjustment the premium level would need to be higher in order to insure that our program had enough revenue to cover claims.

In recent testimony before the House Ways and Means Subcommittee on Oversight, the General Accounting Office reviewed the PBGC's financial condition and came to the conclusion that some kind of automatic adjustment feature was needed to cope with the Corporation's volatile claims experience.

The GAO made the same recommendation in 1983 and they believe that the need is even stronger today.

The adoption of a variable-rate premium such as we have proposed with automatic rate adjustments is essential if the PBGC is to have any real hope of recovering and overcoming its current distress. Premium reform is, however, not the only step that must be taken to care PBGC's problem. Also vital are measures to strengthen pension plan funding.

When ERISA was enacted in 1974, many observers assumed that its minimum funding standards would guarantee that all plans would gradually become well funded, and that the PBGC's role would lessen with time. Instead, the opposite has occurred. Those plans that most need better funding have not improved; often their situation has gotten worse despite the minimum funding standards. And claims against the PBGC have skyrocketed.

The minimum funding standards have failed to bring about better funding where it is most crucially needed. Like premium reform, minimum funding reform is essential to the development of a sound pension insurance program.

Mr. Chairman, since I have been Executive Director of the PBGC, we have had to step into three large pension plans that had essentially no money in them that were in complete compliance with the minimum funding standards. They did not have waivers. They had always complied with the minimum funding standards. Yet these plans with total underfunding of nearly half a billion dollars had virtually no money in them.

Finally, the last point that I want to make is that the long-term health of the PBGC depends upon the continued health of the great majority of plans, those that are now fully funded or better. It is particularly important to allow employers reasonable access to truly surplus plan assets after full provision has been made for benefit promises to participants.

Measures that would forbid pension asset reversions or drastically limit the amount that employers could recover when they terminate a plan would make companies very cautious about their contributions. Thus, paradoxical as it may sound, allowing employers access to true pension surpluses protects plan participants because it helps to produce better funding in those plans.

In summary, let me emphasize three points.

First, the PBGC faces a real financial crisis which can only be made worse by half-measures or delay.

Second, a variable-rate premium that relates premium charges to plan underfunding is the only truly viable method of financing the PBGC's insurance program. Continuing a flat-rate premium, with no differentiation among plans, will eventually drive well-funded plans out of the system and leave the remaining plans with an impossible load to bear.

Third, premium reform is only one of the steps needed to place pension insurance on a sound footing.

Thank you, Mr. Chairman. And we will be happy to answer any questions that you have.

[The prepared written statement of Dr. Utgoff follows:]

TESTIMONY OF
DR. KATHLEEN P. UTGOFF
EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION
BEFORE THE
SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND
OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE
SENATE COMMITTEE ON FINANCE

May 18, 1987

Mr. Chairman and Members of the Committee:

I am pleased to come here today to testify concerning the Administration's proposals to strengthen the security of private pension plans. My testimony will deal primarily with our proposal to adopt a variable rate premium for the Pension Benefit Guaranty Corporation's single-employer insurance program. I will also explain briefly why the Administration's other proposals, which have been described in detail by the other panelists, are an important part of the package of reforms needed to resolve the PBGC's problems.

The Adminstration's proposal for a variable-rate premium represents a fundamental reform in the way in which we collect premiums from the 110,000 pension plans covered by our single-employer insurance program. In recent years, as costs have escalated, people have talked about the need for a fairer and more efficient premium structure. The sharp deterioration in the PBGC's financial condition now makes this the time to act.

Our insurance program provides vital and reassuring protection for over thirty million American workers and their families. But that protection is in danger and the promises made by the PBGC are at risk. Why? Because the PBGC raises too little money to meet its commitments and - even more important - because it raises money in the wrong way.

The problem of "too little money" has received a great deal of attention lately. With a balance sheet deficit approaching four billion dollars and a huge overhang of potential claims from seriously underfunded plans, the PBGC can no longer live on revenue of $8.50 per participant per year. The Senate's budget resolution recognizes this fact by calling for a fourfold increase in PBGC premiums, to an average amount per participant that would be even higher than the amount we are requesting.

Despite the magnitude of the PBGC's financial problems, some have suggested that solutions can wait until "tomorrow". This attitude disregards the high cost of delay. If our premium remains at its current level, the PBGC's deficit will grow alarmingly. We project that our deficit at the end of the current fiscal year will equal $136.39 for each participant in a PBGC-insured plan. If current trends continue without a premium increase, the deficit will rise to $200 per participant, in 1987 dollars, by 1992 and to $300 per participant by 1999.

Paying off deficits of this magnitude will be a painful task. Moreover, as the deficit mounts, more employers with soundly funded pension plans are likely to conclude that they don't want to be part of the solution. These firms will have a strong incentive to terminate their plans, leaving a smaller and smaller premium base to solve an increasingly intractable problem.

PBGC premiums are reaching the level where we need to think carefully about what impact they have on employee benefit planning and what will happen if the current premium structure remains in place indefinitely.

Right now, the PBGC charges every single-employer plan the same premium per participant, regardless of how well or poorly funded it is or how likely it is to terminate with a claim against the pension insurance program.

The risk that we face with escalating flat-rate premiums is that the premium payment base will erode, necessitating further increases and precipitating further departures from the defined benefit plan universe - until the system reaches equilibrium at a very high premium paid by the firms with the worst-funded plans.

Our premium reform proposal is designed to prevent this threat to the defined benefit system.

The Proposed Premium Structure

Under the premium structure that we are proposing, all covered plans would pay a flat, per-participant premium. Plans that represent greater benefit exposure to the insurance program would also pay a variable "funding charge".

The flat-rate portion of the premium would be set at the current premium level, $8.50 per participant. This amount would be indexed to changes in the Social Security contribution and benefit base, the same base that is used to adjust the maximum benefit guaranteed by PBGC.

The second part of the premium is a "funding charge". A plan would pay this charge only if it had 100 or more participants and was less than 125 percent funded for vested benefits. The funding charge initially would be $6.00 per $1,000 of funding below the 125% level.

The total premium -- flat rate plus funding charge -- would be initially limited to $100 per participant. This cap would increase at 1.5 times the rate of increase of the Social Security wage and contribution base. Limiting the maximum premium will ease the immediate burden of the increase for plans subject to the funding charge. The cap will gradually increase in real terms and thus will be phased out over a long period of time. Benefits for which a plan has purchased insurance company annuities would be disregarded for the purpose of calculating the funding charge and, a similar rule would apply if the plan sponsor gave the PBGC a security interest in assets equal to the amount of its plan's underfunding plus a cushion.

The funding charge would be adjusted upon review every three years to permit reduced premiums when the single-employer program's experience is more favorable than anticipated and increased premiums when experience is worse than anticipated. The funding charge would be adjusted by no more than 50% as a result of this review. The minimum rate of $8.50 would not be affected and any adjustments in the funding charge would still be limited by the $100 indexed cap.

The proposal also includes surcharges that are directly related to the risk of termination. Our evidence indicates that failure to make required contributions is an excellent indicator of risk that does not require an independent analysis of financial condition. By failing to make required contributions, an employer declares that a plan represents a significant risk to the program. A surcharge would apply to plans that fail to satisfy the minimum funding standards in the future without obtaining a waiver or an extension of an amortization period. A plan that receives a funding waiver or an extension in the future would also pay a surcharge.

This surcharge on waived or missed contributions is included in our proposal because an employer that does not make required contributions is, in effect, taking out a loan from the pension plan. The effect of these surcharges is to increase the cost of that financing, placing it on a more equal footing with other types of credit, such as commercial loans, so that participants' benefits are less likely to be jeopardized when a troubled company evaluates financing alternatives.

Analysis of the Proposal

The Administration believes that this proposal meets several critical criteria. First, it will raise the additional revenue needed by the PBGC. We estimate that the proposed premium structure will produce about $750 million in single-employer premium receipts in Fiscal Year 1988, $470 million more than the current flat rate would yield, and that premium receipts will increase to about $900 million, $610 more than under current law, in FY 1989, the first full year that the new rates will be in effect. These estimates may change based on the distribution and degree of underfunding that actually exists in those years.

Second, the proposal will equitably allocate premium charges. Only those plans that present a significant risk to the insurance program will pay the funding charges and surcharges. Well-funded plans -- the ones that represent little risk to the program -- will pay a lower premium. In fact, 92 percent of all PBGC-insured plans, covering nearly two-thirds of all participants, would pay this minimum $8.50 premium.

Third, the premium for employers that maintain less well-funded plans will not be unreasonable. The maximum premium for a plan that meets its minimum funding obligations would be $100 per participant. This is about one-third of 1% of the total compensation of an employee in the manufacturing sector in 1985 -- less than most companies pay in a year for life insurance, workers' compensation, or unemployment insurance on an employee's behalf and less than a typical monthly health insurance premium. In a sample of 38 Fortune "500" companies that have defined benefit plans, the average pension contribution was over $2,200 per employee in 1982. The maximum premium we are proposing is less than 5% of that amount. Since many of the employers that are liable for the maximum premium have plans that are underfunded by more than $15,000 per participant, we believe the premium is very reasonable for the protection it provides.

The way to evaluate the effect of this change in premium structure is to compare it to the most likely alternative, a flat rate premium at a much higher level than now exists. The burden would not be equitably shared under that approach.

The premium structure that the Administration proposes will provide the PBGC insurance program with enough revenue to meet its pressing needs. A flat-rate premium could do the same only by grossly overcharging well-funded plans and inspiring an unhealthy "race to the door" that would ultimately result in much higher premiums for all surviving defined benefit plans.

In addition to distributing premium costs in a more rational manner, our proposal includes a limited adjustment feature that recognizes the fact that future claims against our insurance program cannot be forecast with any degree of confidence. We must recognize the possibility of other large terminations like LTV. But it would be unfair to our premium payers to collect enough revenue to make sure we could cover several large claims. The only alternative to a flexible premium schedule that adjusts to accomodate a limited range of future claims is an unflexible schedule that is almost certain to raise too much or too little money.

Because of the adjustment mechanism in the Administration's proposals, we were able to propose lower initial premium rates and a lower premium cap than would otherwise have been prudent. Without automatic adjustment, the premium level would need to be higher in order to ensure that our program had enough revenue to cover claims.

In recent testimony before the House Ways and Means Subcommittee on Oversight, the General Accounting Office (GAO) reviewed the PBGC's financial condition and came to the conclusion that some kind of automatic adjustment feature was needed to cope with the Corporation's volatile claims experience.

The GAO made the same recommendation in 1983 and they believe the need is even stronger today.

The adoption of a variable rate premium such as we have proposed, with automatic rate adjustments, is essential if the PBGC is to have any real hope of overcoming its current distress and preventing similar crises in the future. Premium reform is, however, only a necessary, not a sufficient, condition for recovery. Also vital are measures to strengthen pension plan funding.

When ERISA was enacted in 1974, many observers assumed that its minimum funding standards would guarantee that all plans would gradually become well-funded and that the PBGC's role would lessen with time. Instead, the opposite has occurred. Those plans that most need better funding have not improved; often their situation has gotten worse despite the minimum funding standards. And claims against the PBGC have skyrocketed.

The minimum funding standards have failed to bring about better funding where it is most crucially needed. Like premium reform, minimum funding reform is essential to the development of a sound pension insurance programs. Other reforms which focus on the responsibility of employers for plan funding and benefit security are also vital to the solvency of the insurance program and the healthy funding of pensions.

Finally, the long-term health of the PBGC depends upon the continued health of the great majority of plans, those that are now fully funded or better. It is particularly important to allow employers reasonable access to truly surplus plan assets after full provision has been made for benefits promised to participants. Measures that would forbid pension asset reversions or drastically limit the amount that employers could recover upon plan termination would make companies very cautious about their contributions. Thus, paradoxical as it may sound, allowing employers access to pension surpluses protects plan participants because it helps to produce better funding.

In summary, I want to emphasize three points:

First, the PBGC faces a real financial crisis, which can only be made worse by half-measures or delay.

Second, a variable rate premium that relates premium charges to plan underfunding is the only viable method of financing the PBGC's insurance program. Continuing a flat-rate premium, with no differentiation among plans, will eventually drive well-funded plans out of the system and leave the remaining plans with an impossible load to bear.

Third, premium reform is only one of the steps needed to place pension insurance on a sound footing.

I will now be happy to answer any questions that you may have.

Senator PRYOR. Thank you, Dr. Utgoff.

Now the first question I have is, from its very inception PBGC has had the ability under the law to institute a variable-rate premium. Now why have you not done this before this time? You say we are headed for a crisis. We have got to have a variable-rate premium. You have the authority. Why has not that authority been exercised?

Dr. UTGOFF. Well I have asked that very question. Some people have recommended that to me, have made that suggestion to me. And I have had our legal staff check into that assertion, and they feel that going ahead and using the limited authority that exists under the law would really not be in line with the authority granted by the Congress that set up that law. That authority is limited and no proposal could be implemented without specific Congressional approval. In other words, we do not have full authority under the law to institute the kind of variable-rate premium that I am talking about.

Senator PRYOR. All right.

If we take all this issue to the Congress, and we start tinkering around with these programs and these funding mechanisms, should we very clearly specify this go around that that authority for a variable-rate premium increase is vested in you? Should that authority be clear or should we not even have it?

Dr. UTGOFF. What I think is needed here is a congressional approval of the conflict of a variable-rate premium and one that allows that premium structure to vary within limits so that we are not forced to every year project truly unprojectable claims. We now have to set a premium schedule that is going to last, that is going to keep us from coming back to the Congress every six months. We have to project claims. And we have just completed a study, and the GAO has looked at it, and they have concluded that that is impossible, that we will never be able to tell what is going to happen in the future. So that what we need is a variable-rate premium that will raise enough revenue to cover our claims in the future.

I also think it is necessary to set limits among that path so that we are forced to come back to the Congress when it is clear that the whole structure of the program has changed.

Senator PRYOR. Would the limit in your case be $100.00—is this right—$100.00 a year for that 1 percent?

Dr. UTGOFF. The limit here would be the kind of premium structure where everybody would be at the minimum or everybody would be at the maximum. And it would again not be a variable-rate premium proposal. And so that we would not raise any additional revenue if in fact claims got worst and it would be clear that the PBGC's deficit was lowering.

Senator PRYOR. Now 15 months ago we raised from $2.60 to $8.50 the premium. Now 15 months ago what were you saying about the adequacy of the $8.50 rate to keep the program solvent and on track?

Dr. UTGOFF. In December when the conference committee considered the bills that became the single-employer bill, the PBGC—I sent a letter to all the conferees telling them that the $8.50 premium would not be enough; that the $8.50 premium was based on calculations that had been done before the termination of the Allis

Chalmers' plan, before the termination of the Wheeling-Pittsburgh plant, and certainly did not consider the LTV plan. We said that if the $8.50 premium was passed that the PBGC would have a growing deficit.

Senator PRYOR. And this was in December of 1986. Is this correct?

Dr. UTGOFF. That was in December of 1985.

Senator PRYOR. Oh, of 1985. All right. Excuse me. Before all the LTVs.

Dr. UTGOFF. Yes. When the bill was in conference.

Senator PRYOR. All right.

Now the question is, are there other LTVs out there in the wings? Are we looking at some real major problems with regard to companies going down and causing undue resources to come out of the PBGC funding?

Dr. UTGOFF. Sir, the distinct possibility that the PBGC will face other large terminations of the size of LTV.

Senator PRYOR. As large as LTV?

Dr. UTGOFF. Yes.

Senator PRYOR. Allis Chalmers?

Dr. UTGOFF. Yes.

Senator PRYOR. And others?

Dr. UTGOFF. Yes.

Senator PRYOR. How soon will that occur? Do we know?

Dr. UTGOFF. It is very hard to predict the exact timing of any large claim. Right now it is almost totally contingent upon when a company with a large amount of funding files for bankruptcy. And I think everyone's experience is that that event is very hard to predict.

Senator PRYOR. Are all of these, I hate to say pending problems, going to be created by the steel industry or related industries?

Dr. UTGOFF. Much of the underfunding that we now face are in a few industries. But the basic structure of our problem is that when an industry gets into trouble—it was the meat packing industry a few years ago—we picked up virtually all the plans in the meat packing industry a few years ago. Now it is steel. Tomorrow it will be some other industry. Whenever an industry gets into trouble, the current structure of the insurance program encourages those companies to turn to their pension plan as a source of financing. And it becomes a competitive way to survive, to prop up the weakest of the companies.

So where the underfunding is today is really not indicative of the problem. That underfunding could go away. Those industries might survive. But tomorrow troubled industries would also incur the same kinds of problems that we faced yesterday in meat packing, that we face in steel today, that we may face in other industries like automobiles tomorrow.

So right now there is a concentrated amount of underfunding, a great deal of it in steel. But that does not mean that if we cured the problems in steel that the PBGC's problems would go away without major structural reform and incentives. That has led to underfunding. Not all steel companies are underfunded.

Senator PRYOR. A few moments ago you made reference to a recent GAO report. Was that the report of March of 1987?

Dr. UTGOFF. Yes, I believe that is the case.

Senator PRYOR. Now GAO presented five recommendations in the area of change. Three of these options, I think, were accepted by the Administration. Correct me if I am wrong.

Dr. UTGOFF. Yes.

Senator PRYOR. Two were, I guess, by implication, rejected. The two rejected, one, the GAO proposed raising the priorities of PBGC's claims against employers that file bankruptcy. That was the first, by implication, rejected. The second was that they suggest eliminating PBGC's coverage of any benefit improvements that become effective within five years of plan termination.

Now, did the Administration object to these or turn those down? And if so, why? And, by the way, Mr. Conaway or Mr. Walker may want to address themselves to that issue.

Dr. UTGOFF. Let me say that the Administration did consider changing the PBGC priorities in bankruptcy, and I have talked to Secretary Brock about this, and I can tell you that he agrees with me that that is an important step that needs to be taken.

The decision was made not to include the specific changes that we have been discussing in this proposal because they were not at the time as fully developed as the understanding of them. The technical working out of those proposals were not as fully developed as the other proposals that I have been describing today.

For instance, I think that there is a genuine, genuine understanding that something has to be done about the minimum funding standard. It is obvious when you look at a plan like Allis Chalmers or LTV, with no money in it, that the minimum funding standards are not working.

In the past when the PBGC has tried to change, even in a small way, the priorities in bankruptcy has met a considerable amount of resistance and it is easy to understand why. Because it is sometimes viewed as interrupting the rights of existing creditors; it is threatening to the survival of companies. We wanted to make sure that when we came out with a proposal for changing the priorities of PBGC in bankruptcy it was one that recognized the existence—the rights of existing creditors; that it was understood by the various committees involved here—we are, in fact, maybe dealing with three committees rather than the two sets on each side—and, in particular, that the legal community understood the basic motivating factor behind it, which is to insure better sounder funding, and to put pension plan funding on an equal footing with other sources of credit.

So, no. The short answer is no. The idea was not rejected because of its merits. It was rejected because it was not viewed as ready to be put on a proposal now. And I have, and will continue, to pursue that concept with the approval of the Secretary.

Now the other panel members may want to add to that.

Mr. WALKER. Yes, Mr. Chairman.

Clearly, there needs to be some revisions with regard to the bankruptcy law as it relates to employee benefit claims, not only with regard to the PBGC, but, as you know, under current law, there are benefits that are lost by plan participants that are not guaranteed by the PBGC. These benefits should also be addressed.

As you know, the Senate is currently considering the bankruptcy status of retiree health benefits. There is at least one bill currently in the Senate to deal with that issue, which is also an employee benefit issue.

I think we also have to ask whether or not our current bankruptcy laws deal effectively with industries that are restructuring, such as the steel industry, while they may be adequate to deal with individual companies that are having difficulty, in my opinion, in certain circumstances they have proved to be, in fact, counterproductive by creating a vicious cycle, especially in the steel industry.

In summary, I think there is a need to review bankruptcy not only within the context of employee benefits but in the larger context of competitiveness.

As you know, the Congress not too long ago did look at the bankruptcy law, while there are a number of interests that have to be balanced, and we can understand there is probably some hesitancy to open it back up, I think eventually we are going to need to.

Senator PRYOR. Well what about now the second suggestion by GAO? And that calls for the elimination of PBGC coverage of any benefit improvement that become effective within five years of plan termination. What about that proposal? Did you touch on that a while ago?

Dr. UTGOFF. No, I did not.

Senator PRYOR. All right.

Dr. UTGOFF. Right now, the PBGC is protected from what I would call midnight benefit increases to a 5-year phase in rule.

The GAO feels that that is not enough protection because some benefits can kick in because they have been collectively bargained awhile ago, or because, in particular, plant shutdown benefits which were bargained 20 years ago can kick in essentially the night before plan termination.

I think that the GAO points out a number of flaws in the system that has to be examined, and, in particular, the Administration's proposal, funding proposal, talks about the problems of shutdown benefits, and we plan to deal with that.

Let me add though that to solve PVGC's financial problems like cutting back on benefit guarantees, because our guarantee now is $1858.00 a month, and our average benefit is on the order of $400.00 a month right now. Now we would have to cut back an awful lot to really cure PBGC's problems, and it would add to the kinds of stark circumstances that you see now where people really anticipate a pension that is collectively bargained that they anticipate using for their retirement would not be paid. I am not sure that the approach to solving PBGC's problems is to really put the burden on plan participants. I think it is the incentive to give the employer the incentive to fund the promises that they have made, not to jeopardize those promises through weaker insurance.

Senator PRYOR. Well, I respectfully suggest that you take a second look at both of these suggestions by GAO. For example, our studies indicate that about 70 percent of the program's claims during the 1983-1984 period were due to frequent benefit increases during the five years just preceding the termination of the plan. Now is that a correct figure'' That is pretty astounding if that is. I think we have got to address that issue, and I don't know that you have in your suggested changes.

Dr. UTGOFF. We have not addressed the issue of benefit guarantees because we do not believe that that is the solution to PBGC's problems. It is a 5-year phase in, and normal benefit increases is a way to protect from truly aggregious behavior on the part of firms, and that short of the problems caused by the shutdown benefits, that not guaranteeing employees' promised pension is not the solution to PBGC's problems.

We were there at the set up. The PBGC was set up so that people could get the benefits that they have been promised. To say that the solution is to not guarantee those promises is really not the approach that the Administration wants to take.

Senator PRYOR. Now this question could apply to all three of our witnesses at this time, and the question is this: If we have an $8.50 premium and it is indexed, what is this going to do to small business and small business participants in the program? Mr. Walker, you are smiling. Now what do you think it would do?

Mr. WALKER. Well, I think Dr. Utgoff probably would like to answer it. But there is a provision in the proposal that would exempt small business from the proposed funding charge. I think it would be better for her to respond.

Dr. UTGOFF. All businesses will continue to pay the $8.50 premium. All small businesses with 100 or less participants would be, under this proposal, much more protected, much more encouraged to have defined benefit proposals than almost any other alternative. This proposal, I think, focuses on that community at risk, the small plan sponsors that really have enormous burdens to maintain a defined benefit system, and really encourages them very strongly to maintain those plans. The small plant sponsors are really not the group of sponsors that pose the risk for the PBGC and they will continue to pay $8.50 under this proposal.

They will have a horizon. They will have a 30-year horizon that says if I continue the defined benefits plan, I know that the premium that I will pay will be never more of a burden than it is today. And we want to provide that horizon so plant sponsors do not always have to fear that they will have to pay something that they have no control over. And we really believe that this proposal has a very, very significant chance of giving a long-term, stable horizon that is acceptable and conducive to define benefit plan formation over a very long horizon. And plant sponsors have not had that before. They have had continual knowledge that something has to be done and they do not know what it is going to be. They do not know who will pay for the benefits that have been promised.

Senator PRYOR. Are you factoring in inflation into all these projections? Is this being factored?

Dr. UTGOFF. Let me describe why—let me make it clear why we haven't—the question is, why is this indexed? All right.

Senator PRYOR. Right.

Dr. UTGOFF. We project that claims will increase with roughly the increase in wages, because pensions are tied to wages; wages won't normally rise. So that what you have is the projection of increasing claims over the next 30 years. To cover those claims, we can either have the premium roughly going up with that increase or we can charge a flat rate premium that raises more now and less later in real terms. Since we believe that the premium should not be devised in such a way to give us money before we need it to level out the burden, it is much more protective of the defined benefit pension system to leave the premium as low as we can for as long as we can, yet at the same time insure that the benefits will be paid.

So the indexing feature is really a feature that allows the premium to be as low as possible for as long as possible. It is less front-loaded than a premium would be if it had to be constant in nominal terms.

If we had to raise a premium that was always constant in nominal terms, we would now have to prepare. We would have to raise more money now to make up for the day when that non-indexed premium would not be worth very much in real terms. And then, again, our claims would be higher.

Senator PRYOR. But if we were to choose the variable-rate proposal that you have suggested, if we also institute the $8.50 premium rate indexed, et cetera, would not the claims on PBGC decline over a period of years?

Dr. UTGOFF. But we hope that the claims will because of the increase in the minimum funding standards, because of other changes that we hope to propose. And if that happens, then, in fact, the PBGC will raise less money because it is based on the amount of underfunding and plan. If all plans become well-funded, then the PBGC's revenues will go down and they will go down by a good deal.

Mr. WALKER. Mr. Chairman, that is one of the important aspects of the Administration's termination in funding proposal. Our objective is to try to reduce the number of underfunded plans and the extent of underfunding in the universe as a whole, including in those industries that today may not be distressed, but they may be tomorrow. We want to try to make sure that they are putting money into their plans before they get into a distressed status, because if we wait to that point in time it is too late. And as a result, to the extent that the Congress adopts the concepts embodied in the termination/funding proposal, that will enure to the benefit of PBGC both in the short-term and much more so over the long-term as the minimum funding standards start doing their job to get these plans fully funded.

Senator PRYOR. Have we ever considered segregating some of the real problem areas like the steel industry, and phasing them in another plan? Have we considered this?

Dr. UTGOFF. Yes. That proposal has been suggested several times. It will not, however, diminish the problems. Putting a fence around the liabilities simply does not cure the problem that those liabilities need to be funded or the problems that are left with our system when you segregate the steel industry.

So, yes, it has been proposed, but it is not clear at this time what problems would that solve.

Senator PRYOR. If I were an employee in Camden, Arkansas, would the premium for my retirement program be increased because of LTV and Allis Chalmers, and because of all the other upcoming companies that are going to be in serious trouble?

Dr. UTGOFF. Yes.

Senator PRYOR. Is this correct? Is that principle correct?

Dr. UTGOFF. It depends upon how well-funded the plan sponsor is. If the plan sponsor is well-funded, then about $4.80 of that premium will go to pay off the existing deficit. That plan sponsor, if it is well-funded, will pay about $8.00—would pay $8.50. The remaining amount would go to cover future claims. $8.50 per person per year for pension insurance to protect a system that is very important to all workers is really not a kind of burden that should cause plan sponsors to feel that the system is totally inequitable. Certainly it is a better distribution of the burdens of the system than an increase in the flat-rate premium.

Senator PRYOR. One or two quick panel questions and then we will go to our next panel.

I believe I will ask this to David Walker. In September of 1986, the PBGC filed to terminate the Republic Steel salaried employees retirement plan. We have heard a lot about this plan. This was the plan that had, I believe, $8,000 in assets and $230 million in liabilities. Now how did this particular plan get into such trouble before some action was taken to terminate it? And I don't want a long explanation, but you may want to supply that for the record. I would like to see how the process works, because it just appears to me that you are stepping in too late. By the time you know a plan is in trouble, are you stepping in far too late to take care of it?

Mr. WALKER. Well let me say two things, Mr. Chairman. First, I was not at the PBGC in September of 1986, and so, therefore, I think Dr. Utgoff would be the better person to ask about Republic Steel.

Senator PRYOR. Dr. Utgoff, would you like to respond to that?

Dr. UTGOFF. Yes.

Mr. WALKER. But if I could before she responds.

Senator PRYOR. Yes. All right.

Mr. WALKER. I think it is important to know that we have analyzed the generic reasons why these plans become underfunded, and to a great extent it is a combination of several factors. Number one, current law provides for long amortization periods for past service credits and new liabilities that are created; number two, the current minimum funding standards are not adequate to assure that sponsors they are putting enough money in to meet their benefit promises. One example is they do not include a cash flow standard. As a result there is no standard to ensure that the plan will be solvent.

Third, we are proposing some tightening up on minimum funding waivers in certain situations where we feel they are inappropriate.

There also, in the case of hourly plans, are situations where employers are not able to make deductible contributions to anticipate future benefit increases, et cetera. As a result, this proposal includes a liberalization of current deduction limits to allow an employer always to be able to make deductions up to a point that would make the plan or the control group fully-funded on a termination basis.

So without commenting specifically on Republic, I think Dr. Utgoff would be better to do that, my point is that there are provisions in this proposal that are designed to address every major recurring problem that we have been able to identify which allow, and in some situations encourage employers not to fund their promises adequately.

Senator PRYOR. Dr. Utgoff, would you like to talk about that particular plan for just a moment?

Dr. UTGOFF. The primary problem in the Republic salaried plan was that the plan had a provision allowing people who retired to what is called "lump out" their pension so that they would get the present value.

Senator PRYOR. Lump out?

Dr. UTGOFF. Yes. In other words, that they would get lumped out.

Senator PRYOR. I have to get used to all of the terminology here.

Dr. UTGOFF. They would get lump sums instead of an annuity; that the plan provided two kinds of pension benefits, and you had the choice of taking a monthly annuity from the time you retired until the time you died, or a cash equivalent of that in one lump sum. Now in the early 1980s when interest rates were rising rapidly, the company faced a situation where people were unsure of what the lump sum would be because it is a function of the interest rate. It is a discounted present value of that annuity, all right. And it is technical. But as it turns out, the higher the interest rate, the less money that you get when you have a lump sum cash out of your pension provision.

So that the plan sponsors decided to provide more predictability and to keep some of the managers that it wanted to keep on board, that it would provide a single interest rate of about 8 percent that would always be used to cash out a person's pension plan.

Now when interest rates were very, very high that meant that it was very advantageous for a person to lump out their pension plan; that, in effect, you could take the cash value that you could get from your pension plan, walk across the street and purchase the exact annuity that your pension plan provided and have money left over.

So virtually everyone, after the plan decided to provide for a constant interest rate used to determine lump sums, almost everyone took the lump sum alternative. Often that was $100,000, $200,000. Because of that, the plan was virtually stripped of assets, and the company was funding the people that remained in—those people who did choose annuities, and the people that would come into pay status later—it was funding those through monthly contributions. It was basically on a pay as you go basis.

Senator PRYOR. Now is there anything in your proposals that you are making this morning to change that?

Dr. UTGOFF. Yes.

Senator PRYOR. Or to change that as a future possibility?

Dr. UTGOFF. The most important part of the proposal would require a company that was severely underfunded that had significant cash distributions like that to have a significant increase in the minimum contributions to make sure that the plan was made solvent. Because in this case when the company files for bankruptcy they were unable because of the requirements of bankruptcy to fund that plan on a monthly basis. And we were required under the law to step in and assume that responsibility for $230 million of underfunding.

So, basically, the forces that had been set in motion many, many years ago required the steps that were taken after LTV filed for bankruptcy. We had no other choice but to step in and take over that plan. And the people that remained in it, that took annuities, or the people that were not yet retired took a very, very significant loss in their pension benefits, compared to the people who had already lumped out their pension. And we feel that this is a signficant problem, when a plan gets into trouble, and it has a provision for lump sum cashouts, that it can quickly destroy a plan. And minimum funding standards would say that if you are going to do that you have to put enough money in there to make sure that the plan remains solvent.

Senator PRYOR. Mr. Walker.

Mr. WALKER. Mr. Chairman, in the minimum funding standards that we are proposing, we are proposing to adopt for the first time a cash flow rule, a solvency test, which, among other things, would be designed to address this type of situation.

Senator PRYOR. Good. We need to address this.

Mr. WALKER. Absolutely.

Senator PRYOR. And, Mr. Conaway, we haven't picked on you for a moment. And my final question is going to be to you. In 1982, we had TEFRA; 1984, DEFRA; in 1985 it was REA. Last year, we had the massive Tax Reform Act which was put together in this very room that we are in this morning. Everyone—or all of the statutes, I should say—added more pension rules, increased administrative burdens, and increased costs. I don't think anyone will deny that.

Now my question is: Are we driving employers, and especially small business, those people who do not have batteries of accountants or batteries of lawyers, are we driving them out of the system with all these new rules, regulations, uncertainties, et cetera?

Mr. CONAWAY. Mr. Chairman, I think I would like to make two points with respect to that. First, under this proposal, I think with the exception of the withdrawal provision there would be no plan amendments required by employers. Employers would be able to maintain their plans without the significant revisions that were required, say, by TEFRA, REA and the Tax Reform Act.

The second point is, I think that these proposals will not affect any employer that properly funds it pension promises, and makes promises that are affordable to that employer. So I think the basic point is there are administrative costs associated with these proposals, clearly, but I think it is fair to say that the burden will fall on those employers that are not really being accountable for the pension promises they make.

Mr. WALKER. Mr. Chairman, to the extent that this will discourage plan formation or to the extent it would encourage plan terminations, it is our feeling it would only do so to the extent that you have an employer who wanted to make promises that they could not reasonably expect to keep or whether there was a plan that eventually was going to terminate, it was underfunded, and it may accelerate the inevitable in order to minimize potential losses to participants in PBGC.

But as you can see, we have attempted to minimize administrative burdens. The only case where a plan amendment would be required is to be able to enable an employer to get a withdrawal which, presumably, they would have the incentive to be able to make that plan amendment, and, secondly, where we could, for example, in the variable-rate premium proposal, is to, in fact, exempt small business from the funding charge, which, again, is designed to try to minimize a burden.

Senator PRYOR. Well, please be very aware that one of the challenges of this particular subcommittee is oversight. And, yes, we want a sound pension policy. We want those employers and those employees out there protected to every degree that we can protect them. But also we want to produce as little as possible in the area of new regulations or new bureaucracy of new complexities for those people that can least afford them. So we are going to constantly engage in oversight in that particular area. And I hope that you will cooperate in that in any recommendations you make.

I want to thank you. We are going to call our next panel. Between you and the next panel, the committee will be in recess for four minutes and we will be back in four minutes.

[Whereupon, at 11:20 a.m., the hearing was recessed.]

AFTER RECESS

Senator PRYOR. We have three witnesses now. One is Mr. Chester Labedz. Is that the correct pronunciation?

Mr. LABEDZ. Very well.

Senator PRYOR. And you are with ERIC. That is the ERISA Industry Committee. Is this correct?

Mr. LABEDZ. Yes, sir.

Senator PRYOR. We have from AT&T, Mr. Michael Gulotta, who is President and Chief Actuary, AT&T, Actuarial Sciences Associates, Incorporated. We also have Mr. Keith Goodell, Member, APPWP, Manager Actuarial Services, United Technologies Corporation. I believe that is the correct title. Is that so?

Mr. GOODELL. Yes, sir.

Senator PRYOR. So we look forward to hearing from you at this time. Now I am going to impose a 5-minute rule, and I probably should have done that a while ago, but we were into some very interesting statements, and we wanted to get the record as clear as possible. So I will ask you to summarize your statements within five minutes. We will also include the full text of your statements in the record.

Why don't we hear from Mr. Labedz at this time.

STATEMENT OF CHESTER S. LABEDZ, JR., CHAIRMAN, ERIC TITLE IV TASK FORCE, BENEFITS COUNSEL TO TEXTRON INC.

Mr. LABEDZ. Thank you, Mr. Chairman. Good morning.

Mr. Chairman, the most important need facing the Congress this year in the pension area is to improve the funding of pension plans. This is really what the first panel pointed out to you this morning.

ERIC strongly supports the strengthening of the minimum funding standards under ERISA. The accelerated funding of pension promises will put sponsors' pension dollars where they most belong, in providing benefits to their employees. This is also how you head off the threat of PBGC deficits into the future—put more money into plans.

For this reason, ERIC recommends that serious consideration be given to the reduction, to 15 years, of the maximum amortization period for unfunded past service liabilities and plan investment experience. In addition, in the context of funding waivers, ERIC recommends that these waivers be limited to situations involving temporary business hardship.

We offer these proposals as an alternative to the Administration's proposals. If you contrast the simplicity of a general 15-year standard with current law, plus the complement rule, the funded ratio maintenance rule, and the cash flow rule, you will see that all employers who sponsor defined benefit plans, and especially small employers without those batteries of attorneys and actuaries, will be better off in funding under a simple standard that does the job over the long term.

Additionally, ERIC recommends that surplus pension assets be permitted to be transferred to provide retiree health benefits for both currently-active and already-existing retirees. And in addition, that surplus pension plan assets be permitted to be withdrawn by employers on a plan by plan basis. Again, we are talking about the encouragement of pension funding, through making those surplus assets available in certain contexts.

Further, ERIC strongly opposes the Administration's proposed controlled group rules, for two reasons. First, they will interfere with employees' career-long pension accruals, and, secondly, they will interfere with the normal course of business transactions involving the buying and selling of ongoing businesses. This is an area in which we are talking about minimizing burdens to employers—those controlled group rules, I submit, will be an additional major complication in the actuarial work of companies maintaining many plans.

We turn now to the question of the PBGC premium. The pension insurance system was not designed to handle a situation involving substantial problems in a major industry like the steel industry. ERIC strongly disagrees with the Administration's proposal, therefore, because it would place the burden of the steel situation solely upon the sponsors of ongoing defined benefit plans who will pay the funding charge, and upon their employees, because their employers' money is going to the funding charge, as opposed to employee benefits or other good purposes.

Also, ERIC strongly opposes the indexing of PBGC premiums, which is proposed by the Administration, and the proposed delegation to the PBGC by the Congress of jurisdiction over the setting of premium levels. We submit that only Congress is in a position to take a look at the broad issues, and to decide whether the PBGC should be entitled to more funds, against the backdrop of the macroeffects on the business community.

Further, ERIC recommends that the PBGC guarantee (of which you spoke earlier) of pension benefits be correlated more closely to the principles which govern the funding of those benefits.

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PBGC shortfalls are bound to arise if those benefits are being guaranteed over a short period of time and being funded either because of the requirements of law or convention, over a much longer period.

Also, ERIC recommends that underfunded plans be permitted to be terminated only if the employer liquidates its business under Chapter 7 of the Bankruptcy Code. This would exclude the opportunity under Chapter 11 to seek a reorganization and thereby leave your pension liabilities behind, on the PBGC.

ERIC agrees that the target for revenue purposes of any premium proposal should be the anticipated liabilities of the PBGC after reform proposals which we are talking about have been enacted and have taken effect. Judged against this standard, the budget proposal to raise $900 million in PBGC premiums amounts simply to a tax on pension plans in order to fund non-pension elements of the budget.

Finally, from a conceptual standpoint, there are some ERIC members who support a variable-rate premium and believe that it would be desirable. However, it is the consensus position of ERIC members that the Administration's current approach has significant problems and surprisingly adverse consequences.

Thank you very much.

Senator PRYOR. Five minutes on the nose. I congratulate you. [Laughter.]

You are a great American. [Laughter.]

I am going to make a request. I am new at this, and I am having to learn all the words and all the magic phrases. What I would like you to do if you would be so kind—and we will insert this in the record—I would like, if you would, Mr. Labedz, to take the Administration's proposal and very simply, even where I can understand it, I want you to say we agree on point 1, 2, 3; we disagree on 4, 5, 6, so we can see exactly where you agree, and for the reasons, and disagree and for the reasons in disagreement. I think that would be helpful not only to myself but the other members of this committee and the members of the Senate.

Mr. LABEDZ. We would be happy to do that.

Senator PRYOR. We will have a couple of questions in a moment. Now Mr. Michael Gulotta, from AT&T.

[The prepared written statement of Mr. Labedz follows:]

STATEMENT OF
THE ERISA INDUSTRY COMMITTEE
TO THE SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS
AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE
OF THE COMMITTEE ON FINANCE
U.S. SENATE

HEARING ON THE
STATUS OF THE
PENSION BENEFIT GUARANTY CORPORATION

May 18, 1987

My name is Chester S. Labedz, Jr. I appear today on behalf of The ERISA Industry Committee, commonly known as ERIC. I also serve as Benefits Counsel to Textron Inc.

ERIC is an association of more than 100 of the Nation's largest employers concerned with national retirement and benefit issues. As the sponsors of pension and savings plans covering some ten million participants and beneficiaries, ERIC's members share with the subcommittee a deep interest in the success and expansion of the private pension system.

Over the years, ERIC has devoted thousands of hours and committed a substantial portion of its resources to improving the single employer pension plan termination program. Others, including labor and other business groups as well as the members and staff of the Subcommittee and the Administration, also have committed substantial time and energy to this endeavor. Only last year, as a result of these efforts, Congress enacted the Single-Employer Pension Plan Amendments Act of 1986 ("SEPPA"), which was designed to strengthen the single employer termination program.

ERIC also has a long-standing and serious commitment to the sound funding of private pension plans. This commitment is based on ERIC's recognition of the vital role that the private pension system plays in providing retirement security for our Nation's workers and on the realization that private pension plans will not be able to fulfill that role unless they are funded sufficiently to deliver the benefits they promise.

INTRODUCTION

Over the past several years, we have testified on plan funding and benefit security. For the record, we reiterate several observations we have made in the past.

First, sound pension funding requires an employer to fund pension benefits for its employees many years in advance of the time that the employees actually retire. If an employer could not fund its employees' pensions in advance, the security of its employees' pensions would depend on the employer's financial condition after the employees retire. Adequate advance funding for pensions was a primary goal of ERISA.

Second, the termination of an underfunded pension plan can have serious adverse consequences for the employees and beneficiaries covered by the plan; for the employer that sponsors the plan; for the Pension Benefit Guaranty Corporation ("PBGC"), which insures benefits under terminated plans; and for the other plan sponsors that pay premiums to the PBGC.

Third, although the PBGC insures certain benefits under terminated plans, not all plan benefits are covered by PBGC insurance. Thus, a plan termination can cause employees and beneficiaries to lose a portion of the benefits that the plan had undertaken to provide. To the extent that PBGC insurance applies, the PBGC must cover the cost of unfunded benefits by attempting to collect employer liability payments from the employer that sponsored the plan and by collecting mandatory annual premium payments from the employers that sponsor plans that have not terminated. Thus, ERIC's members, as the sponsors of on-going pension plans, have a strong interest in the sound funding of both their own plans and the plans of other employers.

Fourth, the private pension system is a voluntary system. Thus, any funding standards that make unreasonable financial demands on plan sponsors will discourage the formation and expansion of pension plans in the future. Excessively rigid funding standards also could cause the termination of many existing plans. As a result, minimum funding standards must strike a proper balance between the need for pension plans to be soundly funded, on the one hand, and the need to preserve and expand the voluntary private pension system, on the other.

Fifth, any unwarranted increase in termination insurance premium levels, any unnecessary restrictions on a plan sponsor's ability to dispose of segments of its business, and any rules that make it more difficult for an employer to terminate a plan that has met all of its benefit commitments will damage the private pension system by making it unduly burdensome for employers to adopt and maintain voluntary pension plans, thereby making it unlikely that they will do so.

It is in this context that we offer the following observations on the Administration's "Proposal on the Funding and Termination of Defined Benefit Pension Plans" (the "Funding Proposal") and its "Proposal for a Variable-Rate Premium" (the "VRP Proposal").

MINIMUM FUNDING STANDARDS

The Administration's Funding Proposal recommends a number of measures that are designed to strengthen ERISA's minimum funding standards. ERIC strongly supports the Administration's emphasis on funding as a primary means of strengthening the benefit security of plan participants and of reducing the potential liability of the PBGC.

In recent years, it has become apparent that the existing funding standards do not always provide adequate assurance that a plan will be sufficiently funded. For example, a number of plans that have met the minimum funding standards have nevertheless terminated in a substantially underfunded condition. The burden of the underfunding has been borne both by plan participants and by the sponsors of other defined benefit plans, who have been required to bear substantially escalating payments to the PBGC in order to shore up its financial condition.

While ERIC agrees that strengthening the minimum funding standards is in order, ERIC cannot support the specific measures proposed by the Administration. Instead of proposing revisions in the existing funding standards, the Administration recommends that Congress engraft upon those standards several layers of additional standards, including --

(1) special minimum funding rules for a plan with a "Funded Ratio" of under 100%;

(2) complex amortization rules that would be based on the plan's Funded Ratio and the maturity of its liabilities;

(3) a Funded Ratio maintenance rule; and

(4) a cash flow rule.

Although the Administration's Funding Proposal requires considerable amplification before it can be fully understood, it is apparent, even from the general terms of the Proposal, that the measures proposed by the Administration are unnecessarily complex. During the past three years, plan sponsors have been subjected to a barrage of new regulations under the Deficit Reduction Act, the Retirement Equity Act, the Single-Employer Pension Plan Amendments Act, the Tax Reform Act, and the Omnibus Budget Reconciliation Act. The last thing we need is yet another series of complex rules.

We believe that Congress should fashion a more simple and direct approach. For example, Congress might consider simply adjusting the 30-year amortization period permitted by current law. In addition, ERIC is examining other specific approaches.

Congress also should focus on striking a better balance between the required amortization periods (for funding and deduction purposes) and the five-year phase-in of benefits guaranteed by the PBGC. It is not appropriate to phase in the PBGC's guarantee over a five-year period, while permitting 30-year amortization of past service liabilities and imposing tax penalties on an employer that amortizes its past service cost over less than ten years. This issue can be addressed by shortening the minimum amortization periods under the funding standards and tax deduction rules, by lengthening the PBGC phase-in period, or by a combination of these approaches.

ERIC also believes that Congress should not allow the tax deduction limits to stand in the way of sound plan funding. The Administration's Funding Proposal would allow an employer to deduct a contribution to the extent that it did not either cause the plan's assets to exceed the plan's termination liability or cause the assets in all plans of the controlled group to exceed the total termination liability of the controlled group's plans. ERIC believes that the concept of allowing funding up to a plan's termination liability is a sound concept, but opposes the imposition of the controlled group limit.

Because their sales and net income are subject to the fluctuations of the business cycle, plan sponsors often are able to contribute substantially more to their pension plans in strong financial years than in "lean" years. In the past, the tax deduction limits have prevented employers from contributing more in the years when their financial performance would have supported substantially higher contributions to make up for those lean years. In effect, the existing tax deduction limits have prevented employers from adding to the benefit security of their employees when the employers have been most able to provide that added protection.

The Administration's Funding Proposal, however, still would not permit the employer to anticipate future increases in the plan's liability. It also provides no deduction to an employer who makes a contribution to an underfunded plan when other plans in the controlled group currently have assets in excess of their total termination liability. We oppose both of these limitations.

ERIC agrees in general with the Administration's proposed additional limitations on the availability of minimum funding waivers. It is appropriate to clearly limit the use of funding waivers to temporary hardship circumstances. However, it is an inappropriate intrusion on the reality of business circumstances, and potentially harmful to the viability of a particular business or plan, to determine hardship on the basis of a controlled group. ERIC strongly opposes this portion of the Administration's Funding Proposal.

ERIC also has reservations about the Administration's recommendation that an employer's minimum funding contributions be made on a quarterly basis, rather than when the employer's tax return is due, as is now the case. This proposal would interfere with the cash flow needs and normal business operations of many employers. We recommend that Congress focus on what is really important here: the basic funding standards.

VARIABLE-RATE PREMIUM

Strengthening the funding standards should go a long way to improving the financial condition of the PBGC. More rigorous funding requirements will cause plans to be better funded, which will, in turn, reduce potential PBGC liabilities.

In assessing whether it is also necessary to increase the PBGC premium rate to fund the PBGC's existing liabilities, it is important to recognize that approximately 80% of those liabilities are directly attributable to the financial difficulties of several large companies in the steel industry.

Many have questioned whether the termination insurance program should be expected to resolve a financial crisis for which the insurance program was not designed: the bankruptcy of a major portion of a basic U.S. industry. For example, if the liabilities of several bankrupt companies within the steel industry were removed from the PBGC's books, the current $8.50 premium level would be more than sufficient to amortize the PBGC's remaining liabilities. While ERIC has no position on what measures Congress should adopt to address the problems of the steel industry, we think it is important to point out the extent to which the PBGC's present financial condition is attributable to problems within that industry.

From a conceptual standpoint, while some ERIC members believe that a VRP would be desirable, ERIC members generally agree that the Administration's current approach toward a VRP has significant problems. Three important factors shaping their views on the VRP concept are (1) the magnitude of any premium increase -- both for those who have well-funded plans and for those who do not, (2) the extent to which a VRP is phased in, and (3) the specific factors and types of risks taken into account in determining an employer's premium.

If, for example, Congress decides to defray the pension liabilities created by several bankrupt companies in the steel industry through a mechanism other than increased premium payments, the PBGC's unfunded liability will be substantially reduced, and the differential between the highest and lowest rates under a VRP structure also would be reduced. In addition, if a VRP is phased in over a period that gives plan sponsors sufficient time to implement fully any new funding standards that Congress might adopt, the ultimate impact of a VRP might be significantly reduced: the sponsors of plans that today are not strongly funded will be able to increase their plan contributions and thereby strengthen their plans' funding before any VRP would become fully or even partially applicable.

We stress the close relationship between the Funding Proposal and the VRP Proposal. They have the same primary objectives: to strengthen the benefit security of plan participants and to reduce the potential liability of the PBGC. Accordingly, we believe that both Proposals should be considered together.

Before the VRP Proposal can be fully evaluated, there are a number of aspects of the Proposal that must be clarified, including the following: Does the VRP Proposal measure the value of a plan's assets on the basis of their fair market value or their actuarial value? Does the Proposal measure a plan's liabilities on the basis of the plan's mortality and early retirement assumptions or the PBGC's?

Issues such as these must be resolved before the impact of the VRP Proposal can be adequately assessed.

Furthermore, and wholly apart from the details of the VRP itself, ERIC believes strongly that Congress should not alter the current law under which only Congress may change the payments made by employers to the PBGC. Those payments represent a substantial cost to plan sponsors. Any increase in those payments, which more resemble a tax than they do "premiums," will discourage the maintenance and expansion of private pension plans. Only Congress is in a position to determine periodically whether a change in employer payments to the PBGC is warranted. In no event should the PBGC be allowed to change the payments unilaterally.

Accordingly, ERIC strongly opposes the Administration's proposal for giving the PBGC the unilateral discretion to increase the funding charge periodically. This proposal would give the PBGC the power to impose substantial additional costs on plan sponsors without advance Congressional approval, as is now the case. It would enable the PBGC, on the basis of its own arbitrary interest rate assumptions and its predictions of future claims, to determine how much a plan sponsor will pay to it each year. This would not only represent an excessive delegation of legislative power; it would also empower the PBGC to resolve its own financial problems through "self-help," by unilaterally increasing premiums without Congressional approval.

We also oppose indexing the basic premium (currently \$8.50) and the per participant limitation (proposed to be \$100). There is no reason to believe that the PBGC's liability will increase in proportion to inflation. The \$8.50 premium is designed only to cover the PBGC's <u>existing</u> deficit and its administrative expenses. Indeed, if the Funding and VRP Proposals have their intended effect, the PBGC's liabilities and administrative expenses should actually decline, regardless of what happens to inflation.

The premium rate is too important to the health of the private pension system to be subject to the PBGC's discretion or to automatic indexing. Only Congress should determine whether any change in the premium rate is warranted.

Preliminary indications are that, in operation, the VRP Proposal will produce very surprising results. Many employers whose plans are well funded under current law will find that the VRP Proposal would require them to pay a substantial additional funding charge over and above the basic $8.50 premium. Preliminary studies by two major employers, neither of which poses any realistic threat to the PBGC's solvency, indicate that under the VRP Proposal their premiums could increase by 300% and 700% in a single year.

Several factors contribute to these surprising results. One factor is the VRP Proposal's use of the PBGC closeout interest rates, rather than the plan's own interest assumption, to measure the plan's unfunded liabilities. Another is the 125% factor that the VRP Proposal uses to inflate the plan's actual unfunded vested benefits. Because of these factors, and perhaps others as well, many employers are surprised to discover that the VRP Proposal would require them to pay a substantial funding charge on plans they consider to be well-funded.

In addition, the number of plans that are subject to a funding charge is likely to increase over time. While the stock market's recent performance has enhanced the value of the assets of most plans, there are inevitably dips in the road ahead. When asset values decline, we may well find that far more plans, involving far more employers and participants, would be subject to a funding charge than are indicated by the Administration's current projections. The Tax Reform Act's accelerated vesting standards, which generally become effective in 1989, will also tend to increase unfunded vested liabilities and thereby subject additional plans to higher funding charges under the VRP Proposal.

We also believe that Congress should seriously consider alternatives to the funding charge called for by the VRP Proposal. Although the Administration has suggested two alternatives -- the purchase of insured annuities and the provision of a security interest to the PBGC -- neither of these approaches is an appropriate alternative for the vast majority of plan sponsors who would otherwise be subject to a funding charge and who in fact pose no threat to the PBGC.

The purchase of an annuity contract reflects an investment decision; we question whether it is appropriate for Congress to interfere with the efficient allocation of capital in our economy by encouraging plans to favor fixed-income investments over equities. We are also concerned that, by encouraging employers to purchase insured annuities for their retirees, Congress will unwittingly encourage employers to distance themselves from their retirees and make employers less likely to provide retirees with benefit increases.

Most plan sponsors will not be in a position to give the PBGC a security interest in sufficient assets to avoid a funding charge. Pre-existing security arrangements and loan covenants, and the employer's need to operate its business efficiently and flexibly, make the security interest proposal an impractical alternative. Furthermore, we doubt that the PBGC has the resources to negotiate security arrangements with a significant segment of the employer community. We also question whether it is appropriate, in a democratic, free enterprise society, for an agency of the Federal Government to obtain security interests in a large number of businesses.

We urge Congress to consider seriously a workable VRP that contains both risk and exposure factors. The VRP Proposal relies exclusively on a plan's funded status (i.e., the PBGC's "exposure") to determine whether the plan should be subject to a funding charge and disregards the employer's financial condition. As a result, the VRP Proposal fails to take into account one of the most important factors that determines whether a plan poses a significant risk to the PBGC: the employer's capacity to fund the plan. Because a risk-related premium would take this factor into account, it may well be far more equitable and effective than the Administration's VRP Proposal. For example, a risk-related premium could be based on an objective measure of the employer's credit-worthiness. We are prepared to work with the Subcommittee and its staff on a risk-related premium that would take both risk and funding level into account and, like the VRP Proposal, encourage better plan funding.

Another alternative that Congress might consider is a bond that an employer might post to protect the PBGC against the termination of the employer's plans.

We are also concerned that the VRP Proposal frequently would put an employer in a "Catch 22" situation. For example, an employer that establishes a new plan with vested benefits, provides a benefit increase to retirees, or increases the past service benefits of active employees could be subjected immediately to an additional funding charge under the VRP Proposal. Moreover, the employer might not be permitted to make deductible contributions that would be sufficient to avoid a funding charge and would be subject to a 10% penalty tax if it made a nondeductible contribution. Employers should not pay funding charges to the PBGC for benefit promises that are not yet guaranteed by the PBGC.

The Administration's Funding Proposal would not solve the "Catch 22" problem, since it provides for a deduction only to the extent that the contribution does not cause either the plan's assets to exceed 100% of the plan's termination liability or the assets in all plans of the controlled group to exceed the total termination liability of the controlled group's plans. This is another instance in which the Funding Proposal and the VRP Proposal would require coordination in order to produce a coherent regulatory scheme.

An employer should not be subject to a funding charge until it has had an adequate opportunity to fund any new benefits it establishes. If Congress does not provide this opportunity, a VRP would act as a powerful disincentive against the expansion and improvement of the private pension system. The five-year phase-in of the PBGC's guaranty must also be coordinated with any new premium structure. We suggest that Congress consider lengthening the phase-in period and allowing the employer to use the lengthened phase-in period to fund the plan's benefits sufficiently to avoid an additional funding charge.

We also think that the funding target of 125% of vested benefits is excessive and that it is unnecessary to establish a target exceeding 100% of vested benefits. Indeed, it would be punitive to impose a funding charge on an employer that has fully satisfied ERISA's funding standards and has funded 100% of the plan's vested benefits. Moreover, it would be draconian to impose the charge in 1988, as the Administration proposes, before giving the employer an adequate opportunity to fund for an entirely new 125% funding objective. In any event, a VRP should exempt from the additional funding charge any employer that makes the maximum tax-deductible contribution to a plan in each year after the VRP becomes effective.

We also are concerned about the arbitrary way in which the PBGC establishes its interest rate assumptions. We recommend that the rates be based on an objective standard, such as specified rates published by the Federal Reserve, to assure that the PBGC's rates are appropriate and that they are fairly and objectively established.

In addition, if Congress concludes that it is necessary to enact legislation to improve the PBGC's financial condition, Congress should consider a wide range of approaches, and should not limit the range of options to more rigorous funding standards and a VRP. For example, we believe that Congress should consider limiting the circumstances under which a plan may qualify for a distress termination. To illustrate, Congress might require that only an employer that liquidates its business under chapter 7 of the Bankruptcy Code will qualify for a distress termination and that reorganization under chapter 11 of the Bankruptcy Code would not suffice. Congress might also consider whether it is possible to improve the PBGC's status as a creditor in the event of bankruptcy. Although ERIC takes no position on whether this would be an appropriate measure, ERIC believes that Congress should investigate this option.

Among the other measures that Congress should consider are an extension of the phase-in period for the PBGC's guarantee, a reduction or elimination of the PBGC guarantee with respect to certain ancillary types of benefits (for example, enhanced early retirement supplements), a requirement that the PBGC maximize its investment return (so that the PBGC will not continue to invest such a high percentage of its funds in fixed-income assets), and measures that would reduce the PBGC's overhead expenses.

THE PROPOSED CONTROLLED GROUP RULE

ERIC opposes the provisions in the Administration's Funding Proposal that would cause any transfer of a plan outside of the employer's controlled group to be treated as a plan termination. This rule would seriously interfere with the purchase and sale of companies in the normal course of business. In addition, the proposed requirement that surplus assets be transferred from well-funded plans to less well-funded plans in connection with such plan terminations ignores the fact that most major employers are in a variety of lines of business, each of which operates as a separate profit center. It would be highly inappropriate to require the pension plan in one line of business to subsidize the pension liabilities incurred by another line of business. This is particularly true where one line of business is a defense contractor, and the federal government has, on a cost-reimbursement basis, financed the contributions that have enabled the defense contractor to maintain a well-funded plan. Similar issues would arise if one line of business were a utility or other regulated industry or if one or more of the plans required employee contributions.

To the extent that the Administration is concerned about a plan sponsor that might attempt to terminate an underfunded plan, while continuing to maintain one or more ongoing pension plans with excess assets, we believe that a more limited remedy would suffice. For example, as we mentioned earlier in this testimony, Congress might wish to re-examine the requirements for a distress termination in a bankruptcy situation.

The Administration seems to be concerned that an employer would attempt to evade its funding obligations by selling a business with an underfunded plan to a buyer that is not financially capable of maintaining the plan. We would point out that only last year Congress addressed and resolved this issue. SEPPA added Section 4069 to ERISA to deal with transactions that are designed to evade liability under the termination insurance program. Congress should not second-guess a judgment it made only a year ago. Before any additional legislation is enacted, Congress should give this provision a chance to work. We believe that experience and analysis will establish that Section 4069 adequately addresses the problems raised by plan transfers.

PLAN ASSET WITHDRAWALS AND TRANSFERS OF ASSETS TO RETIREE HEALTH PLANS

ERIC applauds the recognition in the Administration's Funding Proposal that an employer should be able to withdraw excess assets from a plan without terminating the plan. However, we are unable to support legislation that would make it more difficult for a plan sponsor to have access to such assets than it is under current law. The concepts in the Funding Proposal that would permit plan sponsors to withdraw excess assets and transfer the assets to retiree health plans are strongly supported by our membership. The Funding Proposal's methodology for accomplishing the withdrawals and transfers, however, appears to be so restrictive that few, if any, of ERIC's members would be better off under the Funding Proposal than they are under current law. The controlled group and termination liability concepts set forth in the Funding Proposal represent another example of the proverbial "Catch 22" in that they seem to deprive employers of the ability to do that which the Proposal suggests is its objective.

In addition, ERIC has reservations about the proposal to limit such transfers to health benefit funds for current retirees. There is no compelling justification for limiting the welfare benefit fund proposal to current retirees. If an employer plans to provide post-employment benefits to active employees when they retire, it should be permissible to transfer excess pension assets to fund these future benefits.

Although ERIC supports the concept of a tax-free transfer of excess pension assets to a welfare benefit fund, it will not support this approach if it is accompanied by an unreasonable price tag. If a tax-free transfer provision can be adopted only if objectionable measures proposed by the Administration are also enacted, many employers will strongly oppose the entire package.

Moreover, ERIC strongly opposes the Administration's proposal to eliminate section 401(h), which provides the only tax-favored mechanism for pre-funding retiree health benefits. The Administration's transfer proposal does not permit pre-funding of these benefits. Members of Congress, other policy-makers, and workers are becoming increasingly concerned about the growing problem of post-employment health care. It would be wrong to eliminate the only mechanism now available to secure some measure of health coverage for workers who look forward to retirement.

EXPANSION OF TERMINATION LIABILITY DEFINITION

ERIC strongly opposes the broad definition of "termination liability" contained in the Administration's Funding Proposal. Under that definition, a plan's "termination liability" would include all of a plan's fixed and contingent accrued benefits, including even benefits that have not vested and benefits for which an employee has not qualified at the time of plan termination.

The Administration is asking Congress to revisit an issue that Congress addressed and resolved last year. In SEPPA, Congress determined that a plan would satisfy all of its obligations if it had assets sufficient to meet its benefit commitments at the time of termination. A plan's benefit commitments include all guaranteed benefits, all other vested benefits that would be guaranteed if it were not for specific limitations imposed by ERISA, and all early retirement supplements or subsidies or plant closing benefits that the participant has qualified for prior to plan termination. We believe that any expansion of this definition would unjustifiably expand the plan's pension obligations.

The Administration's definition of "termination liability" would go far beyond what is necessary to protect the PBGC and far beyond what a plan may promise to its participants. For example, if a plan offered special plant closing benefits, the Administration's Funding Proposal appears to prevent the sponsoring employer from terminating the plan in a standard termination unless the plan has assets sufficient to provide the plant closing benefits in the event that a plant closing occurs in the future -- after the plan termination.

The Funding Proposal thus would expand the scope of the plan's commitment to events that occur after the plan terminates. This would extend the employer's pension promise beyond the provisions of the plan, beyond what labor and management have agreed to in a bargained plan, and beyond the termination of the plan. Such an interference with the design of private pension plans is inappropriate and inconsistent with the decision that Congress made just last year when it limited a plan's obligation to its benefit commitments.

It bears emphasis that the private pension system is a voluntary system. Employers are not required to maintain a pension plan. If Congress now enacts legislation that makes it difficult or impossible for an employer to terminate a plan -- if adopting a plan becomes an open-ended commitment that an employer cannot terminate -- employers will be strongly discouraged from adopting pension plans and from adding additional benefits to their existing plans. Since the Administration's "termination liability" concept would have precisely this effect, we believe that the Administration's concept of "termination liability" would severely damage the private pension system as we know it today. We oppose this concept.

We very much appreciate the opportunity to present our views to the Subcommittee. As in the past, we will be pleased to continue to work constructively with the Subcommittee and its staff on these issues.

Thank you for your consideration of our views.

STATEMENT OF MICHAEL GULOTTA, FSA, PRESIDENT AND CHIEF ACTUARY, AT&T, ACTUARIAL SCIENCES ASSOCIATES, INC.

Mr. GULOTTA. Good morning, Mr. Chairman.

This is a tough subject, and it is arcane.

Senator PRYOR. You see how much interest we have, the members of the Finance Committee.

Mr. GULOTTA. Yes.

Senator PRYOR. It is a very complex subject. And the more complex the subject is, the fewer of the members show up.

Mr. GULOTTA. Well, I wanted to inject a little informality into this process here.

Senator PRYOR. Please.

Mr. GULOTTA. You said my name was Gulotta. That is an Italian name. And at the same time I am an actuary. And that is a fairly unique combination, an Italian actuary. Do you know what the difference between an Italian actuary and any other actuary is?

Senator PRYOR. I would like to know. [Laughter.]

I have been waiting all morning for something like this.

Mr. GULOTTA. Well, any other actuary will tell you, or will predict how many people will die, whereas, an Italian actuary will tell you which ones and when.

Senator PRYOR. All right.

Mr. GULOTTA. My formal statement, Mr. Chairman. [Laughter.]

Senator PRYOR. We won't take that from your five minute allocation.

Mr. GULOTTA. All right. [Laughter.]

AT&T appreciates this opportunity to present its views on the critical issues affecting the Pension Benefit Guaranty Corporation. We support a revision in the premium structure for the PBGC, as well as more stringent minimum funding standards. Not only will such a combination of changes help to improve the financial integrity of private defined benefit pension plans, but it will also help to combat further deterioration of the PBGC's current financial condition, and it will assure that the PBGC has a resonable source of revenues to meet its future obligations.

We think that the most critical issue in the debate over a flat rate versus a variable rate PBGC premium is the concern over the future vitality of the defined benefit pension plan system. And that vitality directly affects the future benefit security of tens of millions of current and future retirees who are going to be relying on the defined benefit pension plan system for their financial well being.

We recognize that a variable rate premium alone will not prevent empty pension promises. More stringent minimum funding standards are also required and must be implemented. However, it is clear that a variable premium structure will encourage plan funding, and by doing so, more dollars will be there to pay promised benefits when they become payable in the future.

A variable premium structure will also be a more equitable and more efficient premium structure. Higher per capita premiums are simply an unjustified tax on plan sponsors of well-funded pension plans.

Unlike the flat rate premium structure, the variable approach reflects the reality that underfunded plans pose a greater risk to the PBGC. A flat rate PBGC premium is like a life insurance company charging the same premium to an 85 year old male with a one million dollar life insurance policy as it would to a 20 year old female with a $10,000 policy.

Sponsors who have chosen to use their resources to fund their plans responsibly and well are discouraged by the fact that acting in a responsible manner also brings with it the burden of bearing others' obligations. If they become discouraged enough, there could be an exodus from the defined benefit pension plan system. For these plan sponsors, a variable premium would show that the premium structure itself encouraged sounder funding and more responsible benefit planning.

AT&T endorses the framework for a variable rate premium as proposed by the PBGC, and commends the PBGC for its thoughtful recommendation. We have some relatively minor reservations about certain aspects of the PBGC's proposal, but we believe that a change, in general, is very much needed.

For example, the PBGC has proposed a threshold for determining when the exposure to the PBGC justifies the application of a variable charge in addition to a base premium rate. We believe that the PBGC's proposed threshold of 125 percent of vested liabilities is too high and that 110 percent would be a more appropriate threshold.

The PBGC has also proposed indexing of the base premium rate to the Social Security wage base. Automatic increases in premium are not appropriate, we believe, except perhaps for a portion of the premium attributable to administrative expenses.

Increases in premium may or may not be needed in the future, depending upon the financial condition of the PBGC, and how plan sponsors undertake the funding of plans in the future as a result of incentives such as a variable premium and strengthened minimum funding standards.

There are some further refinements to the PBGC's proposals that we would encourage the Congress to make but they are relatively minor.

We would again emphasize that the introduction of a variable PBGC premium should occur in conjunction with substantial reform in minimum funding standards. Changes in those standards should include required amortization of any unfunded liability, shorter amortization periods for plan amendments, a restriction on amendments in cases of severe underfunding, and a cash flow rule.

Before I close, I would like to note that AT&T has been working with existing trade associations on these issues and I have, in fact, testified on behalf of the National Association of Manufacturers before other subcommittees of the Congress. The NAM also endorses both the adoption of a variable premium and strengthen minimum funding standards.

Mr. Chairman, thank you for this opportunity to testify on AT&T's behalf. And, in conclusion, again, we support the PBGC's efforts to solve its financial problem, and to protect the interest of the participants in the system.

My colleagues at AT&T and I would be more than happy to provide any additional assistance we may be able to.

Senator PRYOR. Thank you, Mr. Gulotta.

Mr. Goodell, now you are with the Association of Private Pension and Welfare Plans. In real life, you are with United Technologies Corporation. Is this correct?

Mr. GOODELL. Yes, sir.

Senator PRYOR. All right. Thank you. You may proceed. I will have a couple of questions for you.

[The prepared written statement of Mr. Gulotta follows:]

STATEMENT OF

MICHAEL J. GULOTTA
PRESIDENT AND CHIEF ACTUARY
AT&T COMPANY - ACTUARIAL SCIENCES ASSOCIATES, INC.

Mr. Chairman and members of the Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance, my name is Michael J. Gulotta. I am the President and Chief Actuary of Actuarial Sciences Associates Inc., a subsidiary of AT&T. I am testifying today on behalf of AT&T.

On behalf of AT&T, I wish to thank you for the opportunity to discuss ways in which the Pension Benefit Guaranty Corporation can accomplish its purpose more effectively . That purpose is to protect private pension plan participants against the loss of benefits upon the termination of a plan without adequate assets to meet the promised pension benefits for its participants. AT&T has some definite views on how this can be more effectively accomplished.

The need for such a discussion is derived from the deteriorating financial condition of the PBGC since its inception in 1974. Such condition is due to the steadily increasing amounts of terminated underfunded liabilities of pension plans which have been passed onto the PBGC. This need is further driven by an interest in improving the financial stability of all private pension plans, combatting further deterioration of the PBGC's current financial condition, and assuring that the PBGC has a reasonable source of revenues to meet its future obligations.

AT&T is in favor of a two-pronged approach to the PBGC's problems. First, AT&T would welcome specific actions to strengthen the requirements and incentives for adequate funding of pension plans. Second, AT&T would welcome some of the ideas being discussed in the employee benefit community for changing the scope of the PBGC's obligations. For example, the liabilities of the PBGC might be limited by restricting the insurable event to business liquidation, as opposed to bankruptcy.

The focus of today's discussions, however, should be on the first approach, that of specific actions to strengthen the requirements and incentives for adequate funding of pension plans. AT&T supports a revision in the premium structure for the PBGC as well as more stringent minimum funding standards. Both changes are feasible and appropriate. Not only would such a combination of changes help to improve the financial stability of all private pension plans, but it would also help to combat further deterioration of the PBGC's current financial condition and assure that the PBGC has a reasonable source of revenues to meet its future obligations.

THE PREMIUM STRUCTURE

With regard to the premium structure, the PBGC has proposed a change from a flat rate to a variable rate. AT&T endorses the concept of a variable rate premium and commends the PBGC for its thoughtful recommendations. AT&T has some relatively minor reservations about certain aspects of the PBGC's proposal but believes that the change in general is very much needed.

The most significant advantage of a variable rate premium is the enhanced vitality of the defined benefit pension plan system. Together with strengthened minimum funding standards, a variable premium will increase the chances that pension promises will not be empty. A variable premium structure would also be a more equitable and more efficient premium structure. It reflects the reality that underfunded pension plans pose greater risks to the PBGC. Furthermore, a variable structure would result in greater economic efficiencies and in greater competitiveness.

VITALITY OF THE DEFINED BENEFIT PENSION PLAN SYSTEM

The most critical issue in the debate over a flat rate versus a variable rate for the PBGC premium is the concern over the future vitality of the defined benefit pension plan system. That vitality is highly correlated with the future benefit security of tens of millions of current and future retirees who will rely on their defined benefit pensions for their financial well being.

When establishing the PBGC in 1974, Congress believed that an annual premium of $1.00 per participant would provide more than adequate funding for the PBGC to meet the benefit obligations it would assume. While Congress did consider a risk-related premium at the time, it felt that the relatively insignificant amount of the required premium did not warrant any additional administration associated with a variable rate premium.

From its inception, however, the PBGC's experience in assuming the benefit obligations of private pension plans far exceeded expectations as some companies capitalized on the opportunity to shift their unfunded benefit obligations to the PBGC and, ultimately, to the companies paying the PBGC premiums. By 1978, the premium was raised from $1.00 to $2.60, and four years later, the PBGC requested an increase to $6.00. Response to this request was delayed for another four years, until 1986, when the premium was raised to $8.50 per participant, an amount already deemed to be woefully inadequate.

With drastic increases in the PBGC's obligations in the past year, the needed premium income has increased drastically. On a flat rate basis, the premium would have to be increased as much as $40.00 per participant. Such an increase is untenable on a flat rate basis.

One approach to increasing the PBGC's revenues is to broaden its base of revenue support. Some argue that the guarantee system is really a social program that should be supported by general revenues when underfunded plans are terminated. Others contend that the premium should be assessed on participants in defined contribution plans as well as those in defined benefit plans.

These arguments fail to recognize that the risk exposure of the PBGC is directly determined by the benefit and funding practices of the sponsors of defined benefit plans. To broaden the revenue base, whether through general revenues or through a form of tax on retirement savings plans which do not have a defined benefit guaranteed upon retirement, would merely redefine the universe of those who subsidized the sponsors of underfunded plans. Such an approach will only spread the financial burden without providing the structural changes required to ease this burden over the long term.

To implement another increase in the flat rate, and a substantial one at that, would not create the incentive to adopt responsible benefit and funding practices. We recognize that a variable rate premium alone will not prevent empty pension promises. More stringent minimum funding standards are also required and should be implemented. However, it is clear that a variable premium structure will operate as an incentive for the adequate funding of pension promises. A variable structure will encourage plan funding, and by doing so, the dollars will be there to pay promised benefits in the future.

A variable rate premium structure is a small price to pay for the greater long-term vitality of the private pension system. Those who would be adversely affected in the short run because of the unfunded status of their pension plans would have to weigh the cost of a higher variable premium against their other obligations and the exposure that underfunding as such imposes on the PBGC. As the GAO pointed out in a recent report to the Oversight Subcommittee of the House Committee on Ways and Means, the greatest exposure to the PBGC in recent years has been from plans that were underfunded and not from plans whose adequate funding had been undercut by the subsequent market performance of those funds.

Short term adjustments to a variable premium are far less costly than the more severe long-term problems. The GAO also pointed out in recent testimony before the Oversight Subcommittee that in an example of a significantly underfunded plan which caused the largest claim against the PBGC as of September 1985, a variable premium would have represented about 5 per cent of the plan's required annual contributions and less than 1 per cent of its ultimate claim against the program.

The mere existence in 1987 of severely underfunded programs, at precisely the same time that the market value of equities in pension funds is at an all-time high, is evidence that the incentives to fund pension promises are inadequate. The incentive to fund which would be generated by a variable premium is a timely one to implement. A variable premium will also help protect against the risk of less than superior capital market performance.

EQUITY AND EFFICIENCY

A variable rate premium structure would also be a more equitable and more efficient premium structure. Higher per capita premiums are simply an unjustified tax on plan sponsors of well-funded pension plans. Responsible plan sponsors who fund their pension plans such that their liabilities are fully met on a plan termination basis are sponsors of plans which pose no risk to the PBGC. Yet, these same sponsors, while continuing to act responsibly, are being penalized. This penalty results from higher and higher premiums to underwrite the actions of others who have not funded their plans properly or who have increased plan liabilities through benefit improvements which could not, given financial circumstances, be adequately funded.

Unlike the flat rate premium structure, the variable approach reflects the reality that underfunded pension plans pose a greater risk to the PBGC. The logical appeal of such a variable rate approach is easily recognized, whereas the inconsistency of a flat rate premium is equally obvious. A flat rate PBGC premium is analogous to a life insurance company charging an 85-year-old male with one million dollars of life insurance coverage the same premium as a 20-year-old female with a $10,000 policy.

Furthermore, the current flat-rate premium structure results in a number of economic inefficiencies. First, it does not encourage sound funding of pension plans. Why fund? There is no real penalty. In fact, there may be some reward. Others will ultimately bear the burden of your benefit promises. It is a simple matter to enhance pension plan benefits, allow those plan benefits to be phased in over five years for purposes of PBGC's guarantee, and to avoid making any significant contribution toward the payment of those benefit liabilities by using the maximum allowable period of time to fund for the benefits - 30 years. Meanwhile, the sponsor is able to use his available resources in his ongoing business.

Second, the sponsors of well-funded plans who have chosen to use their resources to fund their plans more responsibly, are discouraged by the fact that acting in a responsible manner brings with it the obligation of bearing others' burdens as well. If they become discouraged enough, there could be an exodus from the defined benefit pension plan system.

For these plan sponsors, a variable premium would show that the premium structure itself encouraged sounder funding and more responsible benefit planning. It would serve as a mechanism for efficiency in the system by increasing premium rates as the excess of liabilities over assets increased,

SUGGESTED MODIFICATIONS TO THE PBGC PROPOSAL

Overall, the PBGC should be commended for its thoughtful recommendations with respect to a variable rate premium. AT&T agrees with the PBGC's proposal that the new premium structure should combine a base rate segment and a variable rate segment. The base rate segment is the appropriate vehicle for amortizing the PBGC's current deficit and for financing the PBGC's administrative costs.

AT&T also agrees with the PBGC's recommendation that the variable rate segment should be a simple one, requiring a minimum of additional administrative and implementation costs. The reliance on exposure for the calculation of the variable portion of the premium provides a reasonably reliable correlation to the risk of an underfunded termination while also being far simpler to calculate than a complicated formula which also reflects the plan sponsor's financial standing in general.

With regard to the threshhold for determining when the exposure to the PBGC justifies the application of a variable charge in addition to the base rate, AT&T believes that the PBGC has set the threshhold too high. The variable segment should be a function of the excess of some percentage of vested liabilities over assets, as the PBGC has suggested, but the PBGC has proposed that a plan have assets totalling at least 125% of vested liabilities to avoid the variable charge. This is too high. We believe that no more than 110% would be a more appropriate threshhold.

The PBGC has also proposed indexing of the base and variable segments to the Social Security wage base.Automatic increases in premium are not appropriate except perhaps for the portion attributable to administrative expenses. Increases in premium may or may not be needed, depending upon the financial condition of the PBGC and how plan sponsors undertake the funding of plans in the future as a result of such incentives as a variable premium and strengthened minimum funding standards. In addition, the pattern of future benefit improvements could also affect the funded status of pension plans in the future and therefore the PBGC's ultimate obligations. Congress should retain control over the determination of any need for a premium increase or decrease.

In addition, some further refinements would improve the proposal. First, AT&T would recommend the use of a more realistic interest rate for the calculation of vested liabilities than the rate proposed by the PBGC. Second, we believe that the automatic adjustment mechanism for deviation between the actual and expected deficit should be made once every five years, rather than once every three years as proposed by the PBGC. Furthermore, for purposes of determining future anticipated experience, we believe that a three year period is too limited a time horizon. Instead, AT&T would recommend a five year or longer period of claims experience for the adjustment. Any significant actuarial losses incurred over a period of years should be amortized commencing in the subsequent year as a flat rate, thus changing the base rate, and not in the variable segment as the PBGC would propose. Including the increase or decrease in the premium requirements arising from an actuarial loss or gain based on the PBGC's current liabilities is consistent with the original idea for the base rate.

Two exemptions to the imposition of a variable segment to the premium have been proposed. For small plans with less than 100 participants, the PBGC has proposed that there be no variable segment to the premium but that all of them pay only the base rate. AT&T finds this to be an acceptable exemption, but it should be limited to small plans in controlled groups which are also small, with less than 100 employees. Also, for newly established plans, the PBGC has recommended that the premium be only the base rate for the first three yearsof their existence. AT&T would prefer that this be for the first five years.

Finally, the PBGC has proposed an initial total maximum rate of $100. A maximum premium represents a realistic transition to the variable approach because it avoids excessively high premiums for plans that are seriously underfunded and that need some time to correct that underfunding. However, AT&T favors a more gradual approach to a wider variation in premium rates, especially since the current system is based on a flat rate premium.

CONCLUSION

In conclusion, AT&T endorses the concept of a variable rate premium and commends the PBGC for its thoughtful recommendations. AT&T has expressed some relatively minor reservations about certain aspects of the PBGC's proposal but believes that the change in general is very much needed. The vitality of the defined benefit pension plan system would be enhanced with a variable premium structure for underwriting the liabilities of the PBGC because it would operate as an incentive for pension promises to be adequately funded. In addition, a variable premium structure would reflect the reality that underfunded pension plans pose greater risks to the PBGC and would therefore be more equitable and efficient. Finally, it would result in greater economic efficiencies and in greater competitiveness by shifting away from the subsidizing nature of an ever growing flat rate premium.

AT&T would again emphasize that the introduction of a variable premium for the PBGC should occur in conjunction with substantial reform in the minimum funding standards. Shorter amortization periods, cash flow restrictions, and control over the introduction of new benefits into an already underfunded plan are among the changes in minimum funding standards which Congress should be encouraged to implement. A variable premium structure is, then, one of the many desirable incentives for improved stability of the private defined benefit pension system.

Thank you for this opportunity to testify on AT&T's behalf. AT&T supports the PBGC's efforts to solve its financial problems and to protect the interests of the participants in the system. My colleagues at AT&T and I will be happy to provide you with any additional information to further these goals.

STATEMENT OF KEITH J. GOODELL, MEMBER APPWP, MANAGER, ACTUARIAL SERVICES, UNITED TECHNOLOGIES CORP.

Mr. GOODELL. My name is Keith Goodell, and I, as we have just discussed, manage the actuarial function at United Technologies Corporation. I am here today representing the Association of Private Pension and Welfare Plans, and I am a member of the Termination Insurance/PBGC Committee of that organization.

The APPWP is a non-profit organization founded 20 years ago with the primary goal of protecting and fostering the growth and stability of America's private benefits system. We are very pleased to have the opportunity to share our views today with you on both the minimum funding proposals and the PBGC's variable premium proposal.

We strongly believe that defined benefit plans are the most secure and reliable retirement vehicles of the many kinds of retirement programs that are in existence today. Accordingly, our approach in this statement is based on our concern that these plans not be driven out of existence by additional costly and complex regulation. We recognize that some changes need to be made in these areas.

The Administration's minimum funding proposal contains several steps, as we heard earlier from the first panel, that would be necessary to determine a plan's funded status, and then, depending on the outcome of that calculation, would mandate a shortened amortization period for any shortfall of assets versus the liability. We believe these calculations are unnecessarily complex, and would be expensive to administer. Instead, we would suggest that the minimum funding standards for all plans, not just those which are poorly funded, be tightened.

We propose a simple rule that would simply require plans to fund past service benefit improvements over 15 years rather than the 30 years that exist today. And as a further step, we would suggest that gains and losses be amortized over 5 years rather than the 15 years in today's environment.

Now these changes would be a simple adaptation of the calculations that are done today, and they would improve the funding of plans. Further, we would endorse the restrictions that are proposed for the funding waivers. We think that is definitely a good move.

With regard to the overfunding of plans, we believe that the Administration's proposal on reversion of excess assets needs a good deal of rethinking. This proposal is too complex and is restrictive on the normal course of business of emerging and spinning off of divisions and companies.

However, we are very happy to see that the proposal would allow excess assets to be transferred to fund the retiree health care benefits. This is a very appropriate step in the direction of securing these benefits for retirees. We certainly wholeheartedly support this part of the proposal. However, we question the need to repeal Code Section 401(h). Last September, the Board of Directors of the Association of Private Pension and Welfare Plans approved a resolution that would urge employers be permitted and encouraged to reallocate within the pension trust excess assets for funding retiree health care benefits and this was under Section 401(h).

Senator PRYOR. What is 401(h)?

Mr. GOODELL. I am sorry. That is a section of the Code that allows certain prefunding of health care benefits for retirees.

We urge that Congress consider the PBGC premium proposals in conjunction with the minimum funding standards. A discussion of any proposed premium increase should be accompanied by the full disclosure of PBGC's current financial status, and the assumptions as to what its projections for future needs are.

We certainly want to emphasize that we are opposed to a premium increase on a flat-rate basis, and we urge that the debate focus on the details of the PBGC's variable-rate proposal.

In addition, we are not convinced that the fully funded level in the PBGC variable premium proposal need be set at 125 percent of termination liabilities. Instead, we would suggest a smaller cushion is appropriate.

We are also opposed to the automatic indexing that we heard about earlier in the proposal.

In conclusion, we urge you to approach these proposals armed not only with a clear understanding of the importance of defined benefit plans to American workers but also the burdens already placed on employers who have chosen to maintain the defined benefit plans. We are eager to assist you in this process.

[The prepared written statement of Mr. Goodell follows:]

TESTIMONY OF

THE ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. Chairman, Members of the Subcommittee, I am Keith J. Goodell, Manager of Actuarial Services at United Technologies and I am here today representing the Association of Private Pension and Welfare Plans ("APPWP"). The APPWP is a non-profit organization founded in 1967 with the primary goal of protecting and fostering the growth of this country's private benefit system. The APPWP's over 400 members represent hundreds of plan sponsors as well as the leading support organizations to benefit plans: investment firms, banks, insurance companies, accounting firms, and actuarial firms.

We are pleased to have the opportunity to share our views on the proposals in the President's Competitiveness Initiative that affect funding and termination of defined benefit plans, and the PBGC premium proposal as well. We recognize that the ERISA funding proposal is in its early stages and, accordingly, many of our initial reservations may be answered by detail not yet disclosed or transition rules not yet formulated. We welcome the chance to work with the Congress and the Administration to achieve a workable solution to the issues addressed in both of these proposals.

Introduction

Over the last five years, the financial soundness of the Pension Benefit Guaranty Corporation has been the subject of hearings before this Subcommittee and before other committees in both Houses. In addition, we have often testified before the Congress on the appropriateness of reversions of excess assets from defined benefit plans, and the part that reversions play in encouraging the sound advance funding of these plans. Defined benefit plans are the most secure and reliable retirement vehicles of the many kinds of plans that exist today. Defined benefit plans promise a benefit that depends on an employer's ability to make adequate contributions, rather than on the market's ability to perform. Additional security is provided by the existence of the ERISA Title IV insurance system, which backs up the benefit promises if an employer is financially unable to maintain the plan. Employees covered by defined benefit plans have a basis for assessing their financial needs during retirement, because they know in advance the level of their annual lifetime pension benefit. The rate at which they save is often a function of the defined benefit promises made by their employers.

In 1974, many employers were alarmed at the rate at which ERISA required an employer to fund these promises. Today, most employers recognize that this rate is not rapid enough. The correlation between troubled employers and troubled plans is strong. An employer who is not permitted to fund these promises as fully as possible in its productive, successful years is often unable to fund them at all in the lean years. The result has been unacceptably large losses at the PBGC and a very real threat of even larger losses in the future. Although we have some serious concerns with the Administration's proposal for underfunded plans, we are encouraged by the direction of both this initiative, and the variable rate premium initiative, as ultimately supportive of defined benefit plans. We want to emphasize, however, that an increase in the PBGC premium on a flat rate basis is unacceptable to the APPWP.

In the last dozen years, defined benefit plans have been battered relentlessly with legislative and regulatory change -- the effective lowering of the Code section 415 limits to cure budget ills, and to address perceived over-pensioning; changes in the rules regarding terminations to deal with the abuses inherent in the ERISA Title IV insurance program. Thus, before Congress acts again to change the rules of the game for defined benefit plans, it is important to make very sure that the legislative proposals are critically needed. With respect to underfunded plans, we think the Administration has identified a real problem which I will discuss in detail in a moment. With respect to overfunded plans, however, we are not at all convinced that there is a problem which needs to be addressed at this time, or in this fashion.

There is no reason to believe that the 1984 Administration reversion guidelines and other recent changes in the law, such as the strengthening of the anti-cutback rules, are ineffectual in protecting employees. Defined benefit plans promise a benefit that once earned, may not be diminished by the employer through plan amendment, changes in interest rates, or other actions which can leave an employee with less than he or she was promised. Both the Retirement Equity Act of 1984 and the 1986 Tax Reform Act addressed these issues directly.

These statutes require an employer to meet its pension promises for so long as the plan is continued, but they do not require plan continuation, nor do they change a voluntary system into a compulsory one. The 1984 reversion guidelines also address these issues by requiring that an employer obtaining a reversion protect the interests of all employees in the terminating and the ongoing plans. While the guidelines are not perfect and create some economic inefficiencies in "phantom terminations", we do not believe that they should be hastily discarded. Congress may want to consider some refinements now: for example, a requirement that a successor defined benefit plan grant past service credit for all years of service to protect employee expectations and perhaps some restrictions on reversions that an employer may take if it maintains under-funded plans.

The original Labor Department Advisory Council recommendations last year would have permitted withdrawals from ongoing plans in addition to the termination/ reestablishment and spin-off termination transactions permitted under the guidelines. In addition greater incentives would have been provided not to terminate plans. The Administration proposals ignore the possibilities of incentives and focus only on the possible penalties of plan termination. That approach -- over-regulation and undue restrictions on defined benefit plans -- will not inure to anyone's benefit. To the extent that employers decide that defined benefit plans are not worth their cost and burden, all employees will suffer, as they become the risk takers with respect to their retirement security. We believe that any revisiting of the subject of reversions should be addressed with full recognition of the dangers of radically departing from the current legal frame work which has encouraged the growth and maintenance of defined benefit plans.

Underfunded Plans

While we may disagree with some of the details in the Administration's proposed minimum funding rules, their premise is consistent with the legislative changes to Title IV in the last Congress, and would further the goal of limiting PBGC's exposure to future large losses. We recognize that further tightening of the amortization periods is necessary and we are interested in working with the Congress to explore whether funding standards that are related to the strength of plan funding can be administered in a relatively simple fashion. Further restrictions on funding waivers are also a positive change; often, the granting of a waiver is simply prolonging the existence of a severely troubled plan.

We urge that Congress consider the PBGC's premium proposals in connection with the minimum funding standards. Discussion of any proposed premium increase should be accompanied by the full disclosure of the PBGC's current financial status and its assumptions for its future needs. After adequate public debate on whether -- and the extent to which -- a premium increase is needed, we would be eager to work with Congress to see if a variable rate premium is a reasonable approach.

There is another issue to grapple with as well. In the last several years, a handful of employers have shifted enormous liabilities to the PBGC and then left the defined benefit system. If the entire burden of these losses is shouldered by current sponsors of defined benefit plans, these employers will be disproportionately responsible for a problem which might more reasonably be borne by society as a whole. Title IV was never designed to finance the problems created by the basic restructuring of an entire industry. In sum, we look forward to working with you on these issues, for it is incumbent on us to support changes which will stem the losses that the Title IV program has suffered, often from plans fully in compliance with the minimum funding standards.

The Minimum Funding Proposals

As noted earlier, some of the proposals, such as shortened amortization periods, with appropriate transition rules, may both encourage and achieve better funding for badly underfunded plans. However, in the course of fashioning these rules, the Administration proposal redefines the commonly understood definition of fully funded; devises a new set of very complicated amortization rules using this new definition and factoring in the maturity of liabilities; and adds new rules to govern the maintenance of funding and a plan's cash flow. These rules are badly in need of simplification and targetting.

In our view, "fully funded" should not be defined as 110% of the assets needed to cover all benefits, including those, like early retirement subsidies, which are contingent on events which have not yet, and may never, occur. The proposal needs to fasten on a more realistic definition. We would suggest assets equal to the Form 5500 definition of liabilities without a cushion. If there is evidence that some plans do not realistically value early retirement subsidies, that problem ought to be addressed through clearer direction on what constitutes reasonable actuarial assumptions and not by redefining "fully funded".

We are also very concerned about the new cash flow minimum contribution rule. Because it is keyed off the 110% of all liabilities definition, it would require minimum contributions even where the plan is overfunded on a termination basis. While we recognize that excessive lump sum payments or annuity purchases can strip assets from a plan, the cash flow rule as drafted here is overkill. An overriding minimum contribution, narrowly focussed as in the Multiemployer Act, is a much more rational approach.

We must consider the effect shortened amortization periods will have on new plans and on the granting of benefit increases. The purpose of this proposal should be to strengthen defined benefit plans, and not to make them so onerous to maintain that there will be no new sponsors of such plans in the future. Thus, the rules must be drafted so that employers will not be discouraged from establishing new plans. Moreover, without adequate transition rules, industries which are already on the brink of financial insolvency will be dealt the final blow if sudden, far stricter funding standards are enacted.

In addition, we need to keep in mind the additional administrative costs of the new rules and weigh the advantages, if any, of requiring additional calculations -- such as determining plan liabilities as if all contingent liabilities will become accrued benefits regardless of the likelihood of such an event -- against the added costs of calculating liabilities several times for different purposes -- shareholders reporting, funding, FASB, internal corporate reporting, etc. We need to remember that defined benefit plans are long range plans that were intended to be funded over a period of years, rather than fully funded at all times. We should not rush headlong into so over-tightening the standards that defined benefit plans are abandoned in favor of "fully funded" defined contribution plans.

All of these proposals deserve further discussion, in order to fashion appropriate rules. Ultimately, not all of the proposals may be necessary to strengthen underfunded plans. Only a handful of plans are seriously underfunded; yet these rules create uncertainty, higher contribution requirements, earlier due dates and ongoing controlled group responsibility for all plans.

The Variable Rate Premium

While we do not agree with all of the components of PBGC's variable rate premium proposal, we do agree with the concept of assessing the costs of the risk of future losses on the plan sponsors who are most likely to terminate underfunded plans. Among those sponsors, it appears reasonable that the amount of underfunding in the plan should be correlated to the level of the premium. We also agree that for the most part, amortization of the deficit and the PBGC's administrative expenses ought to be shared by all sponsors of defined benefit plans. The APPWP was particularly pleased that the definition of liabilities in the premium proposal would be the number derived for Form 5500 purposes, rather than some new, artificial definition. We suggest, however, that plans using interest rate assumptions lower than the PBGC's need not be required to revalue liabilities and plans using assumptions within 50 basis points of the PBGC's rate similarly be exempt from the revaluation requirement. In addition, we are not convinced that the fully funded level need be set at 125% of termination liabilities; we suggest a smaller cushion and we would like to work with you on that issue. We are also opposed to the automatic indexing in the proposal. As proposed, the flat-rate part of the premium, initially pegged at $8.50 would be indexed to wage growth, and the funding charge would be automatically adjusted every three years to reflect any revision in annual net claims and any difference between the actual deficit and the projected deficit. Finally, the $100 per participant cap on the premium would be indexed to one and one-half times wage growth. With no control over the assumptions used to calculate the deficit, and no clear picture of the basis that would be used to determine wage growth, we are reluctant to support any kind of automatic adjustments or indexing. Finally, we question whether there exist sufficient program constraints to ensure that severely underfunded plans do not grant benefit increases which become phased-in before they are funded.

Assuming a premium increase is necessary, we are opposed to a premium increase on a flat rate basis. We suspect, however, that the variable rate basis could pose hazards for new plans, for legitimate benefit increases, and for the continued maintenance of those plans which are not now well funded. We would like to continue to explore these and other premium-related issues with you.

Overfunded Plans

We are particularly concerned with that part of the proposal that deals with overfunded plans. As we have testified in the past, we believe that overfunded plans do not pose a risk to the defined benefit system, nor present a problem which Congress needs to address. The Administration proposal suggests that plan terminations are costly and expensive, that they reduce participants' benefit security with respect to future benefit accruals, and that they discourage the employer from granting ad hoc benefit increases or cost of living allowances to retirees. We disagree. While plan terminations may be costly, under current law, they provide full benefit security to participants and all of the excess assets to the employer. Some employers may prefer a direct withdrawal approach; few, if any, however, would support the elaborate cathedral that is before you today. Many would like to take advantage of the opportunity to transfer excess pension funding to tax favored retiree health arrangements; few would meet the proposal's requirements for doing so. We were pleased that the proposals would allow excess assets to be transferred to fund retiree health benefits, because we see this as a very appropriate step in the direction of securing retiree health benefits. For the reasons set forth below in more detail, however, the opportunity to make such a transfer under this proposal is too restricted. We also question the need to repeal Code section 401(h), especially since no justification for its repeal has been put forth.

The proposal imposes complex requirements, revised actuarial calculations, and frequency limitations on the amount of excess assets that can be withdrawn, even where an employer only maintains overfunded plans. For example, under the proposal, an employer who decides to replace a defined benefit plan with a defined contribution plan, and who fully vests and annuitizes all participants, as the Code and ERISA currently require, would not be permitted to receive all the excess assets that remain after annuitization, so long as that employer maintains any other defined benefit plan, regardless of how well-funded the remaining defined benefit plans may be. The remaining excess assets would have to be distributed among the employer's other overfunded plans. We fail to see any reason for such a result.

Large controlled groups would find the proposal nearly impossible to live with. Some large controlled groups maintain hundreds of defined benefit plans, some of which are collectively bargained, some of which are not, some well-funded, some not. The rules are very complex with respect to these groups, and appear to sanction, and indeed under some circumstances, require, wholesale transfers of assets among plans in a controlled group, in a way that seems quite inconsistent with the exclusive benefit rules of current law. Such transfers might well violate other laws as well, such as overfunding in plans maintained by government contractors, where the government has or could assert a legitimate claim to the excess. Moreover, mergers and acquisitions would be made far more complicated, and would need to take into account phantom excess funding or underfunding in order to price a transaction. Despite the vague promise of "special frequency rules" for sales and purchases of divisions or subsidiaries, an employer would need to carefully time a transaction to coincide with either other business transfers or planned withdrawals in order to ensure that these "limits" are not inadvertently exceeded. In many ways, the proposal is a Catch-22 in this area: if an employer initially takes the full permissible withdrawal in year 1 of a 10-year period, and in year 9, sells a division with an overfunded plan, it cannot receive the overfunding because of the "frequency limit" but is taxed on the overfunding transferred, as if it had removed the excess before the transfer.

Many more examples could be given to illustrate our concern that this proposal is ambitious far beyond the scope of any conceivable abuse. Rather than take the time here, we would urge that business groups and labor groups sit down with the relevant government officials and fully explore reasonable rules, with appropriately focussed goals.

Conclusion

We urge you to approach this proposal armed not only with a clear understanding of the importance of defined benefit plans to American workers, but also of the burdens already placed on employers who have chosen to maintain these plans.

The trend toward defined contribution plans has escalated significantly in the last 10 years and shows no sign of slowing. Indeed, 1984 was the first year in which the number of defined benefit plan participants covered under the Title IV insurance system declined. In large part, however, the investment strategy of defined contribution plans is short term, in recognition of the fact that it is the participant who takes the risk. In contrast, defined benefit plans are the single largest accumulation of funds for long term capital formation. These are plans which can afford the investment in American industry's future over the long haul; to the extent these plans are discouraged, their investment support is eliminated as well.

In addition, defined contribution plans, as a means of controlling corporate benefit costs, are very attractive. Because contributions are generally based on a percentage of payroll, annual costs are always known. Administrative costs are also much lower than in defined benefit plans, since complicated actuarial valuations are not necessary and complex annuity rules may be avoided. The defined contribution plan may also alleviate protracted recordkeeping -- once an employee is cashed out, there is no obligation to track this employee in the future. The Administration's proposal makes the cost and administrative burden of defined benefit plans even greater, further skewing the incentives toward defined contribution plans. If enacted in the form in which it has been proposed, you may see large-scale defections from the system. In our view, that result would be tragic. We would hope that by working with staff, rather than their working in a vacuum, we could avoid it.

Senator PRYOR. Thank you, Mr. Goodell.

Now why are you opposing the automatic indexing? Why the opposition?

Mr. GOODELL. We believe that we haven't learned quite enough yet about all the background of the PBGC liabilities, and we are working to learn more about how their liabilities are majors with some precision. But, in general, we think it is just too much of a blank check.

Senator PRYOR. Mr. Labedz.

Mr. LABEDZ. Mr. Chairman, if you look at the nature of the flat rate, which is the one being indexed to wage growth, and take into consideration what the components are of the PBGC liability and the burden that are supposed to be covered by that flat rate—there are two. There are amortization of current liabilities and administrative expense. And while administrative expense may grow somewhat in relation to wages, as Mr. Gulotta has suggested, we question whether existing liability of the PBGC right now can be expected to grow as a percentage of wages.

In fact, in buying into an indexed flat rate, we are committing to a $8.50 rate for 1988, and a $9.01 rate in 1989, and $9.54 in 1990, assuming a 6 percent increase. So it is really not a flat rate and those are the facts behind it.

Mr. Gulotta.

Mr. GULOTTA. Mr. Chairman, we simply do not know what the claims against the PBGC are going to be in the future and how its deficits will increase or perhaps decrease. And so indexing the base premium is tantamount to assuming that we are going to have an increase in burden on a continuing basis and it is not appropriate. There are other ways of taking care of differences between what the PBGC expected its deficit to be and what it actually comes out to. They have an automatic adjustment mechanism in their proposal. With that automatic adjustment mechanism, apart from the indexing, you will take care of the fact that the deficit is not where we thought it was going to be, and you do not need that $8.50 increasing automatically each year.

Senator PRYOR. Let me just ask you all this. We have a separate program in the pension area for railroad retirees. I, frankly, assume there is some historic reason for that. I guess I had better go back and find out. I guess the railroads were in great trouble at one time and Congress sort of fenced them off and segregated them.

What do you witnesses think about fencing off the steel industry and treating them in a different way?

Mr. LABEDZ. You could consider it. And we urge the Congress to take a good look at that question.

There is another side to it, of course, and that is the improved minimum funding standards. If you require employers to fund their promised benefits over a period shorter than 30 years, you are going to be attacking that problem in other industries in one of the best possible ways you can, and that is going to take care of, we trust, of the next meatpackers or steel industry down the line.

Mr. GOODELL. I would just suggest that we considered both sides of the question of the steel industry special fix, and we are concerned that what happens with one industry will just likely fall in place with the next industry. On the other hand, it would possibly work to the advantage of the defined benefit system in that it would not place that steel burden and next industry burden completely on the defined benefit plan system. So there are advantages and disadvantages.

Senator PRYOR. Mr. Labedz.

Mr. LABEDZ. Mr. Chairman, I think that the focus needs to be on the future. And while some of the problems with the steel industry have not yet occurred, what we need to do is put a set of minimum funding standards together which will improve the funded status of plans on a going forward basis, and put a set of incentives together, like a variable premium structure, which will encourage employers to fund those plans.

The steel industry, or the steel industry carve out, or fencing them in, may be a temporary solution to a unique problem in this industry, but we will have meat packers, and we had steel, and perhaps have rubber and perhaps auto, so we really on a going forward basis we need to have a solution which is a long run solution, especially in the steel industry, and they may sort of put off the point and time that we have to deal with the problems of the PBGC. But, really, it is not going to deal with the basic issues, and that is encouraging minimum funding and get the dollars into those plans to pay benefits.

Senator PRYOR. Mr. Goodell, a while ago I asked Mr. Labedz if he would do sort of a section by section analysis and comment on the Administration's proposal. I would like you to do the same. We would like the areas where you agree and the areas of disagreement and the reasons why. I think that would be very helpful.

Mr. GOODELL. We certainly would be glad to do that.

[The information follows:]

ERIC
THE
ERISA
INDUSTRY
COMMITTEE

An Integrated Proposal for Reform of Funding, Termination, and Premiums of Defined Benefit Plans
June 3, 1987

Funding

1. Strengthen ERISA's funding standards.

   a. Shorten all maximum amortization periods to 15 years, except that the amortization period would be shortened to 10 years for liabilities attributable to benefit increases for retirees.

2. Reject the Administration's proposed cash flow rule.

3. Reject the Administration's proposed minimum funding and Funded Ratio maintenance rules.

4. Make no change in due date of the minimum required contribution under the funding standards, except that quarterly contributions would be required for a plan with an outstanding funding waiver.

5. Limit, on a controlled group basis, the availability of minimum funding waivers to temporary hardship circumstances.

6. Determine the employer's exposure on plan termination on the basis of the plan's benefit commitments as defined in SEPPA, not the plan's termination liability as defined in the Administration's proposal.

7. Allow an employer to deduct contributions up to the amount that makes the plan sufficient to satisfy its benefit commitments.

   a. Other plans in the same controlled group should be disregarded in applying this rule.

8. Make no change in an employer's right to recover excess assets following a plan termination.

   a. Excise tax on reversions would be increased to 20% for reversions resulting from a plan termination and for any withdrawals from the same plan during the five years preceding plan termination.

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9. Permit withdrawals of excess assets on a plan-by-plan basis, without termination and without regard to controlled group.

   a. Except as provided in paragraph 8.a., above, the excise tax on a withdrawal would be 10% of the amount withdrawn.

10. Retain section 401(h).

11. Permit tax-free transfers of surplus assets to a VEBA, a section 401(h) account, or a new vehicle established for the purpose of providing retiree benefits on a tax-favored basis.

    a. No frequency limitations.

    b. Also permit tax-free transfers to fund the post-employment health benefits of active employees.

12. Reject the Administration's proposed controlled group rule, under which any transfer of a plan outside of the controlled group would be treated as a termination.

VRP and PBGC Reforms

1. Do not impose the liabilities incurred by the PBGC as a result of the termination of plans in the steel industry on the sponsors of on-going defined benefit plans.

   a. Finance these liabilities by using other revenues, by crediting tax advantages (*e.g.*, net operating losses) to the PBGC or to the deficient pension plan of the companies that created the liabilities, or by applying another solution limited to the companies that created the liabilities.

2. Make a distress termination available only if the employer liquidates its business under chapter 7.

3. Increase flat rate premium to $9.50 (unindexed) per participant, of which $.50 is to defray part of new net claims.

   a. Reduce the $9.50 premium to reflect the extent to which steel industry liabilities are financed from sources other than premium payments.

4. Impose a funding charge equal to $2.00 for each $1,000 of unfunded guaranteed benefits, subject to a cap of $50 per participant, to be applied to defray new net claims.

   a. Unfunded guaranteed benefits to be determined on the basis of PBGC interest and mortality assumptions.

   b. Plan assets to be valued on the basis of current fair market value.

   c. Simple approximation factors to convert unfunded vested benefits to unfunded guaranteed benefits should be available; at minimum, unfunded vested benefits should be a safe harbor for this calculation.

5. Retain current law under which only Congress can change PBGC premium rates.

   a. PBGC would continue to report to Congress on any need to change premium rates.

   b. No indexing of PBGC premiums.

6. Change the five-year phase-in to a ten-year phase-in with respect to benefit increases that become effective in the future.

   a. Eliminate the $20 rule with respect to benefit increases that become effective in the future.

7. Require the PBGC to establish its interest rate assumptions on the basis of an objective "published" standard.

06/03/87

Senator PRYOR. Mr. Gulotta has stated that his organization pretty well supports the Administration's proposals, so I won't ask him to do the same. But I will ask you, Mr. Goodell and Mr. Labedz, not to compare notes; don't cheat. We want independent feelings from both of you. [Laughter.]

Now, if there is one problem I see with this hearing—while we are talking about problems in the pension and funding—the one problem that I see is that we have the Administration represented. We have actuaries. We have big business. We have utilities, et cetera. You all are pretty well big business representatives. Then we have the American Association of Retired Persons and two unions. But you know who we are not hearing from today are the small business interests.

I think, if I am not mistaken, we made contact with the small business interest and, frankly, I am not aware that they were aware about the indexing issue. We may have to have hearing number two. We are really getting a tough schedule in the Finance Committee. It is hard to get a subcommittee time. So we may have to have an evening session some night or maybe even a 7:00 a.m. session some morning. But I do want to hear from the small business people and the representatives of small business because I think there are particular problems for small business vis-a-vis what we call the larger industries presented.

I want to thank you very much and we will call our next panel.

Ladies and gentlemen, we are proud this morning to have a panel of, I thought three but it looks like five here, Mr. John Rother of the American Association of Retired Persons; David Hirschland, Senior Consultant, Social Security Department of the International Union, United Automobile, Aerospace and Agricultural Implement Workers of America, UAW; and Miss Karin Feldman, Chief Counsel for United Steel Workers. Is that right? Or counsel.

Ms. FELDMAN. No. I am an assistant general counsel. And with me, and actually who will be giving the Steelworkers' statement is Jack Sheehan, our Legislative Director here in Washington.

Senator PRYOR. How do we spell that?

Ms. FELDMAN. S-h-e-e-h-a-n.

Senator PRYOR. All right.

I also notice the presence of two beautiful technicolor charts that have just been placed here near the witness table. John Rother.

Mr. ROTHER. I will take responsibility for the charts.

Senator PRYOR. By the way, how many members now do you have of AARP?

Mr. ROTHER. Well, we officially passed 25 million last month.

Senator PRYOR. I remember when you were a million and a half people and now you are 25 million. The fastest growing organization in the world.

Mr. ROTHER. It is about 15,000 new members every working day.

Senator PRYOR. Amazing. I am glad you are here, Mr. Rother. We are going to invoke the 5-minute rule.

STATEMENT OF JOHN ROTHER, DIRECTOR OF LEGISLATION, RESEARCH AND PUBLIC POLICY, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. ROTHER. We do have a full statement which I hope you will include in the record.

Senator PRYOR. It will be included in the record.

Mr. ROTHER. Mr. Chairman, AARP has long had an interest in the fairness, security and adequacy of the private pension system, and we do commend the Administration for its attempt to address the problems of pension overfunding and underfunding. We believe that the Administration's approach is a useful conceptual foundation for needed legislation in the area. However, we do believe it is inadequate in several respects.

I would like to start by reviewing the three basic criteria that we believe should govern changes in pension law, especially related to terminations and reversions.

First, we believe that workers and retirees do have an equitable interest in the assets built up in the plan so that at least part of the so-called surplus belongs to the plan participants, representing deferred compensation.

Second, we think that withdrawals from plans make sense only as a disincentive to actual out and out terminations, so that a termination should always be less attractive to the employer than a withdrawal.

And, finally, if withdrawals are permitted, we believe there should be an additional cushion above recommended funding levels to guard against future asset fluctuation and to allow for future benefit improvements.

Now, unfortunately, we find that the Administration's proposal fails to fully satisfy these principles. First, it does not recognize the equitable interest of plan participants. It is really based on the idea that all of the assets belong to the employer.

Second, while the proposal does allow withdrawals—a radical departure from current law—it does not sufficiently discourage terminations.

Under that proposal, many plan sponsors will find that they can get greater amounts if they terminate a plan than if they make a withdrawal.

Mr. Chairman, chart 1 illustrates the situation under certain conditions. Under the Administration's plan, you can see an employer facing a choice between a withdrawal or a termination would realize much greater revenues from a termination, on the right, than from the withdrawal rules on the left.

Finally, the cushion required in the Administration's plan is not sufficient because it does not fully protect the benefit and security of plan participants.

AARP recommends that any proposal to allow withdrawals must at least have the following three elements:

On withdrawal, the cushion left in the plan should be an additional 10 percent above the Administration's proposal;

On termination, the cushion amount would be paid out as benefit enhancements to plan participants, both workers and retirees;

In addition, a 20 percent excise tax would be imposed on any reversion amount.

This combination makes terminations much less attractive and recognizes the participant's equitable interest.

The second chart illustrates the effect of these recommendations in the same circumstances as chart 1 on the Administration's plan. So chart 1 is the Administration's recommendations; chart 2 represents AARP's recommendations. You can see that under chart 2, under our recommendations, the withdrawal is relatively more attractive than a termination, and that the plan participants would realize the same in either situation.

Finally, I would like to say that I think we should approach any departure from the ERISA exclusive benefit rule with very great caution. Any changes must insure greater protection for plan participants and greater security for the pension system as a whole. We believe it is inappropriate to require the transfer of pension plan funds to other pension or welfare plans.

The Administration's proposal also addresses the need to strengthen minimum funding rules. We agree that the current minimum funding rules do need to be tightened. The question is whether the proposal overfixes the problem.

We do have some question about the recommendations. First, we need appropriate transition rules to protect currently troubled plans. Second, funding rules should not restrict the establishment of new defined benefit plans nor hamper the ability of plans to grant benefit improvements. And, third, the problem of actuarial reasonableness and plan assumptions should be addressed.

Mr. Chairman, in conclusion, we do think that the time is right to address the whole range of problems in the pension area. We should not just limit debate to the question of minimum funding standards and whether we should have variable premiums, but also, very definitely, we call your attention to the problem of withdrawals and terminations.

We pledge to work with the committee, as always, so that we can make good on the promise of ERISA that when a pension is promised, it will be there, in fact, when needed. Thank you.

Senator PRYOR. Thank you, Mr. Rother. We appreciate not only your statement but also supplying of the charts.

Do you have in your statement the charts so that we can place them in the record? I think you do, don't you?

Mr. ROTHER. In the full statement in the back.

Senator PRYOR. Yes. We will place the statement and also the charts in the body of the record.

Mr. David Hirschland, Senior Consultant, with UAW. And, Mr. Hirschland, we look forward to your statement.

[The prepared written statement of Mr. Rother follows:]

STATEMENT

of the

AMERICAN ASSOCIATION OF RETIRED PERSONS

The American Association of Retired Persons (AARP) is the nation's largest membership organization, representing the interests of 25 million members age 50 and above. The Association is pleased to testify today on the Administration's Proposal on the Funding and Termination of Defined Benefit Pension Plans (hereafter the Proposal).

AARP commends the Administration for its efforts to address the problems of overfunding and underfunding in pension plans. The Proposal is a responsible attempt to deal with problems that threaten retirement benefit security. Nevertheless, the Association believes modifications are necessary to ensure a solution more consistent with good pension policy.

I. PRIVATE PENSIONS STILL NOT SECURE

The ultimate goal of changes in the income support structure serving retired Americans must be the establishment of a minimum standard of living for all older persons and a reasonable guarantee of adequacy, stability and security of retirement income so that individuals can plan for economic security in their later years. To be adequate, a retired person's income should be sufficient to prevent a significant decline in the living standard achieved earlier in life. Social Security is the basic foundation for retirement income planning. But to achieve the adequacy goal, Social Security must be supplemented by income from other sources, particularly private pensions, employment, savings and other income-producing assets.

The private pension system has grown dramatically over the past generation, but it must continue to expand in order to better meet the retirement income needs of older Americans. While the Employee Retirement Income Security Act of 1974 (ERISA) stands as the watershed of pension benefit security, recent events have pointed to deficiencies in the law that could severely undermine the security of the pension promise.

II. THE PROBLEM

The first disturbing trend has been the recent wave of pension plan terminations for the purpose of recovering so-called "excess" assets. While terminations for reversions were rare before 1980, since that time, well over $10 billion covering over 1 million plan participants have reverted to employers. The tremendous stock market boom, along with other economic factors, has currently raised pension assets to about $200 billion more than is presently required by the ERISA minimum funding standard, thus creating a tempting pot of money that threatens the stability and integrity of the private pension system.

A second problem is the recent trend in terminations of several large, significantly underfunded defined benefit pension plans. Neither the employer, nor the Pension Benefit Guarantee Corporation (PBGC) is currently liable for all unfunded benefits; thus, many plan participants have not received their full promised benefits. These terminations have also increased the strain on the financially troubled PBGC, which generally assumes terminated underfunded plan liabilities.

III. PRINCIPLES FOR REMEDIAL LEGISLATION

In order to correct these weaknesses, the Administration has proposed a broad and interwoven solution to the problems of overfunding and underfunding. Comprehensive in scope, the proposal also embodies a radical departure from ERISA's current rules, particularly the "exclusive benefit" rule. To determine whether a departure of this kind is both an effective solution and consistent with basic tenets of private pension law, this proposal must be considered against the following principles, which AARP puts forth as a framework for remedial legislation:

1. "Equitable interest" - Part of the so-called "excess assets" built up in a pension plan, established with tax incentives in order to promote adequate retirement income, belongs to plan participants.

2. Funds in any pension plan have been put there for the "exclusive benefit" of that plan's participants, and the security and integrity of that plan must be foremost protected.

3. A "withdrawal" of pension fund assets makes sense only as a less onerous alternative to plan termination; therefore, terminations should be discouraged and always made less attractive than withdrawals.

4. In any withdrawal, a plan should be left fully funded, and must also include an added "cushion" to guard against asset fluctuation and to promote benefit enhancement.

5. Pension law should encourage present and future benefit security, including plan continuity, adequate funding, and benefit enhancement.

IV. ADMINISTRATION PROPOSAL- ACCESS TO PLAN FUNDS

a. Reasons for Change

The Administration's Proposal on the Funding and Termination of Defined Benefit Pension Plans (Proposal) correctly identifies the problems of current law under the Asset Reversion Implementation Guidelines (Guidelines). The Guidelines, instead of slowing the trend of terminations for reversions, formally allowed such practices as "termination/reestablishments" and "spinoff terminations." In both these transactions, a remaining or reestablished plan is generally stripped of any assets above the plan's termination liability. There are no restrictions on employer use of these recaptured assets. The net result has been to encourage terminations.

The Proposal squarely recognizes that change is needed because the reserve of assets above the plan's termination liability-- any "cushion" -- is eliminated. The Proposal is completely on point when it reasons: "The absence of this cushion reduces participants' benefit security with respect to future benefit accruals and may also discourage employers from granting ad hoc benefit increases or cost of living allowances for retirees." (Proposal, pg 5).

The Proposal also correctly reasons that it is poor policy to allow an employer who has both well-funded and underfunded plans to benefit from reversions from tax-favored retirement funds while other plans of that employer remain underfunded.
Current law does not require that the remaining plans of the employer recapturing assets be adequately funded.

b. Proposed Change

The Proposal would allow a radical alternative in its attempt to resolve the problem of terminations for reversions. To halt outright terminations, the Proposal sets forth a "withdrawal" option. An employer would be permitted to withdraw assets from an ongoing plan if the following conditions are met:

- the plan is maintained at the new "minimum benefit security level" (the so called "cushion")

- all other plans of the employer, in the aggregate, exceed the "minimum benefit security level"

The "minimum benefit security level" -- the "cushion" -- would equal the greater of:

- 125 percent of the termination liability

OR

- the "full funding amount" of the plan (the point at which the minimum funding rules require no additional contributions for the year)

However, the Proposal would permit a substantially reduced cushion for any annuitized benefits.

The Proposal would continue to allow terminations, but would limit the amount an employer may recover to the "permissible reversion amount":

- If the employer continues to sponsor other underfunded defined benefits plans, the permissible reversion amount would equal the same as for a withdrawal (that is, amounts above the cushion), but the cushion itself would be allocated to the remaining defined benefit plans.

- If the employer has no other defined benefit plans, or other adequately funded plans, the permissible reversion amount would be all assets over termination liability (the entire cushion). Thus, a termination in this instance would allow the same reversion as current law.

- The only disincentive added is that an employer leaving the defined benefit system entirely would be precluded from establishing a defined benefit plan for those employees for five years (the so-called "5-year curse").

V. ANALYSIS-ACCESS TO PLAN FUNDS

ERISA was adopted at a time of concern for plan underfunding, while the current trend of overfunding in plans is the result of a unique set of economic events (stock market, bond market, interest rates). This is illustrated by the fact that before 1981, such terminations for reversions were rare (only $18 million in 1980), while now, they have become a part of corporate boardroom strategy (over $10 billion since 1980). While the trend is new, and may only last a short time, it is clearly capable of repetition, and must be curtailed in order to protect plan security and the integrity of the pension system. In order to curb this abuse, the law can either: (1) prohibit terminations for reversions, (2) encourage withdrawals and/or (3) discourage terminations for reversions.

a. Withdrawal Option

The first question that must be answered is whether a "withdrawal" option is warranted. Current ERISA law, as well as general trust law, clearly prohibits a sponsor from withdrawing money from a plan that is intended for the "exclusive benefit" of others.

The only reason for a departure from this basic principle would be to correct a flaw in the current system. Such a flaw exists since current law, which is premised upon maintaining the voluntary nature of the private pension system, gives all employers the option to terminate a pension plan and recapture assets above termination liability. Under current law, not only does the employer receive the benefit of a plan windfall, but the employee suffers the adverse effect upon termination of the loss of the benefits of plan continuity. (For further information, see the attached study, "The Impact of 'Overfunded' Pension Terminations on Workers.")

Current law is thus clearly inadequate. Since a prohibition of plan termination is inconsistent with the voluntary nature of the pension system, a withdrawal option must be considered.

The second question then becomes what type of withdrawal is appropriate. Returning to the principles set forth above, any withdrawal must recognize that:

1. part of the assets in the fund belong to participants;
2. it is only appropriate as a disincentive to termination; and
3. a fully funded plan, with an adequate cushion, should be maintained.

While recognizing some of the basic problems of withdrawals, the Administration Proposal does not go far enough in adhering to these principles.

First, there is no acknowledgment that any of the funds in pension plans, or any of the return on the equity of the plans, belongs in some part to plan participants. In fact, the very basis of the Proposal's withdrawal and termination options is just the opposite: that despite the tax incentive, and despite the "exclusive benefit" rule, pension plan money belongs to the employer. Thus, there is insufficient recognition of the "equitable interest" of plan participants in assets accumulated in the plan.

Second, the withdrawal option under the Proposal is not necessarily a disincentive to termination. In many instances, the amounts to be recaptured in a withdrawal are nearly equal to that of a termination. Worse yet, the employer may still be able to recapture more assets in some terminations than in the withdrawal option. This is true where the employer has only one plan or other plans are adequately funded. Since the withdrawal option does not always discourage terminations, in many instances it will serve only as a legitimate sanction to withdraw assets without serving any useful disincentive function. Stronger disincentives to termination than those embodied in the Proposal are needed.

Third, the Proposal does not leave a sufficient cushion to adequately protect the original plan participants. First and foremost, the participants of the plan from which money is withdrawn must be fully protected. Because the withdrawal option is so radical a departure from basic pension law, we should, if anything, err on the side of benefit security. Because each plan embodies a different set of employees, and often a different set of promised benefits, it is essential that the employer's promised benefits are not compromised. The Proposal suggests a cushion equal to the greater of 125 percent of termination liability (an arbitrary approximation) or the full funding amount of the plan (generally higher). The full funding amount is a superior starting point, since on a plan specific basis that amount is based on both earned benefits and projected benefits of an ongoing plan. However, the full funding amount does not completely recognize the needs of that plan's participants. In addition to the full funding amount for active participants, an appropriate cushion should incorporate two other factors:

- the need to guard against asset fluctuation, and
- the need to maintain assets to enhance benefit security, including benefit improvements and ad hoc retiree adjustments.

The Proposal would permit a substantial reduction in the cushion amount if the benefits are annuitized. The cost of annuitizing benefits is a major factor in determining excess asset amounts. When interest rates are high, and the cost of an annuity is inexpensive, less assets are needed to cover plan liability. The result is that the low cost of annuitization may fuel the increase in assets. To reward standard industry practice in the event of withdrawals (or terminations) by also allowing a lesser cushion is inconsistent with the need to maintain an adequate cushion for future benefit security. Shifting of retirement income security from well-funded pension plans to individual annuities should not be encouraged. In addition, withdrawals themselves should be limited by requiring a larger cushion amount.

The "controlled group" concept for determining whether a withdrawal will be permitted will generally increase the cushion and therefore improve benefit security. The aggregation requirement for withdrawals will also prevent an employer with largely underfunded plans from recapturing assets from any overfunded plans. In instances where there is one plan (or other adequately funded plans), however, the controlled group concept will not increase the protective cushion, and additional amounts above the full funding amount are more essential. Even in the controlled group concept, the benefit security of the original plan is compromised when there is no recognition of the benefit promises made by <u>that</u> plan (often different from the promises made by other plans) to <u>that</u> set of employees. Leaving the original plan with only the full funding amount denies that any special relationship exists between the employer-sponsored plan and that plan's participants. In effect, the "exclusive benefit" rule is washed away, and future benefit security and benefit expectation for that plan's participants is jeopardized.

b. <u>Termination Option</u>

The third question, assuming an acceptable withdrawal option and cushion, is what type of termination recapture is appropriate. While the Administration's proposed withdrawal option is based on a conceptually workable set of principles, the termination option as proposed is inadequate. Again, returning to our principles, any termination must recognize that:

1. part of the assets in the fund belong to plan participants;
2. the "exclusive benefit" of that plan's funds must be primarily maintained for those participants' benefit security; and
3. the termination itself must be strongly discouraged.

First, there is again no acknowledgment that any of the pension plan money belongs to plan participants. While the withdrawal option at least recognizes that a cushion must be left for benefit security and benefit enhancement, the termination option completely ignores the concept that plan funds above termination liability belong to the participants of the terminated plan. Two basic facts are disregarded in determining how to divide assets in a termination: pension contributions are part of the entire salary package, and a tax advantage has been conferred for the purpose of benefitting those participants in the plan. This disregard for the participants' equitable share is especially true where an employer leaves the defined benefit system, in which case the recaptured amount will be the <u>same</u> as current law. Thus, no solution or deterrent is even offered to remedy a recognized problem.

Second, the Administration's Proposal would ignore the "exclusive benefit" rule entirely in a termination and require the terminated plan to transfer assets above the termination liability to other underfunded plans. This would effectively give the employer the <u>same</u> reversion amount as under a withdrawal, but at the same time disregard the future benefit security of the terminated plan's participants. The proper funding of other employer plans, already an obligation of the employer, would be addressed by taking assets from a plan where benefits were promised to a different set of employees. The employer, by dipping into this newly-formed pension pool, can gain a windfall through a reversion from one plan, relieve an already existing obligation to another plan, and leave the participants of the first plan with less benefit security, even if a new plan is established. The simple result is that the participants in the terminated plan -- who have believed they were in a plan that was ongoing, well-funded, and a source of future benefit security -- may now be <u>worse off</u>. Participants are hurt because their plan did better than expected in the short term snapshot view based on termination liability.

This transfer of assets again ignores any return on equity for participants of the terminated plan, and does not recognize the primacy of the future benefit security of that plan's participants. In fact, assets may be transferred to plans that have much higher benefit promises, and therefore greater liability, at the expense of participants of a plan in which money was originally intended for their exclusive benefit.

Third, the Proposal does not create sufficient disincentives to plan termination for reversion. Pension law should encourage both the formation of pension plans and the benefit security of those plans in existence as well. By maintaining termination as a comparable option to withdrawal, or in some instances an even better option as a means to recapture funds, the Proposal fails to solve the very problem this Proposal should address -- the termination of pension funds merely to recapture assets. Since a withdrawal option is created to allow employer access to plan funds, the termination option should be used only by plans that wish to terminate for reasons <u>other</u> than the recapture of assets. Therefore, recaptured amounts should always be less in a termination than a withdrawal, and penalties upon termination should be higher.

VI. AARP RECOMMENDATIONS- ACCESS TO PLAN FUNDS

Based on the framework established by the Administration Proposal, and guided by the set of principles already discussed, AARP recommends the following modifications to the withdrawal and termination options.

a. Withdrawal Option

In our view, the law should recognize that part of the assets in the fund belong to plan participants. In order to provide adequate protection against asset fluctuation, and to maintain assets needed for benefit enhancement, an increase in the minimum benefit security level (the "cushion") beyond the "full funding amount" is needed.

AARP recommends a 10 percent increase in a withdrawal cushion to the greater of:

- 135 percent of termination liability

  OR

- 110 percent of the "full funding amount"

The plan aggregation rule would continue to be used to determine withdrawal availability. However, a reduction in the cushion would not be allowed for annuitized benefits. Annuitization is often part of the reason for the large surplus (due to low cost from high interest rates), and should not be used as a further incentive to lower the cushion. The 10 percent excise tax would also be maintained.

b. Termination Option

In our view, the law should recognize that part of the assets accumulated in the plan represent a return on equity and that the integrity of the plan -- whose purpose is the exclusive benefit of that plan's participants -- must be maintained. In addition, the termination itself should be discouraged.

AARP recommends that, in a termination:

- assets required to remain in the plan in a withdrawal (the cushion) be <u>paid out</u> to plan participants
- a 20 percent excise tax be imposed on the reversion amount

While plan aggregation is good policy in determining withdrawal availability, there are less compelling reasons in a termination. Mandated asset transfers between plans runs counter to the exclusive benefit rule. AARP is mindful of the problem of underfunded plans, but mandated asset transfers between plans undermines a basic ERISA protection and may raise more problems than it may solve. (For example, what is the proper fund transfer where plans have widely varied levels of promised benefits). A two-step approach, in which employers are required to fund-up any plan in a controlled group before taking a reversion, should be explored. Special rules involving the transfer of plan sponsorship beyond the controlled group will also need to be developed.

A 20 percent excise tax is recommended in order to further discourage terminations as compared to withdrawals. In addition, consideration should be given to earmarking part of the excise tax to the Pension Benefit Guarantee Corporation (PBGC).

Further, AARP questions the need for a "5 year curse," fearing that employees may be hurt by such a prohibition. If a moratorium on new defined benefit plan establishment is necessary to prevent abuse, a shorter period may suffice.

c. Transfers to Other Plans

In part, the Proposal mandates asset transfers in some instances, while allowing excise tax forgiveness for other transfers, particularly transfers to retiree health plans. The Association believes the problem of unfunded retiree health benefits is a major problem that requires a comprehensive solution. In this regard, this Proposal should in no way be seen as remedy for the large unfunded liabilities of retiree health plans. Further, AARP believes it inappropriate to permit pension plan funds to be used for other welfare plans such as retiree health plans before basic retirement income needs are met.

Therefore, AARP proposes, as a general guideline, the following hierarchy for the division of any remaining plan assets:

1. the security of the participants of the original pension plan;
2. the security of the participants of other pension plans of the employer;
3. the security of participants of retiree health plans of the employer; and

4. the reversion to the employer, with the appropriate excise tax.

VII. ADMINISTRATION PROPOSAL - MINIMUM FUNDING

a. Reasons for Change

The Administration Proposal also includes substantial changes in the minimum funding standards for pension plans. Change is needed because current law does not fully insure that plans will have sufficient assets to pay participants' benefits. As a result, unfunded liabilities have in many cases threatened the benefit security of plan participants as well as increased the financial strain on the PBGC.

b. Proposed Change - Underfunded Plans

The Proposal would, for underfunded plans, generally shorten the amortization period for existing unfunded accrued liabilities, benefit increases, experience losses, and funding waivers. The new amortization period will generally be determined by looking at the funding status of the plan and the maturity of the plan's liabilities. (Details on assumptions and methods are not yet developed).

The Proposal would also require a minimum contribution -- the cash flow rule -- equal to the total distributions paid by the plan during the year.

c. Proposed Change - All Plans

The Proposal would also require all plans to comply with certain changes. Specifically, liability for contributions would fall on the controlled group, the timing of contributions would be increased, minimum funding waivers would be restricted, deduction limits would be revised, and employer liability would extend beyond benefit commitments to termination liability.

VIII. ANALYSIS - MINIMUM FUNDING

a. Stricter Funding Standards

As recent events have demonstrated, and the PBGC's increased deficit proves, the minimum funding rules need to be strengthened. The question is whether the proposed solution goes beyond the scope of the problem. Since details are not fully available, AARP notes some potentially troublesome questions.

The biggest problem area may be that of plans currently in trouble. To the extent plans are now underfunded and therefore unable to absorb the change to a shorter amortization period, stiffer funding rules may force these plans over the edge. Appropriate transition rules will need to be developed to safeguard these plans.

Second, since the new rules require much stricter funding, the establishment of new defined benefit plans may be severely hampered. This is especially true where new plans attempt to provide credit for past service. To the extent such liabilities prove too great under the new funding method, past service credit may not be feasible. This results in a disincentive to more comprehensive plan coverage. For similar reasons, any type ofbenefit enhancement, for both new and old plans, may be unnecessarily discouraged. Funding rules should not be so strict that the costs of benefit improvements become unreasonable.

A third problem left unresolved is that of actuarial reasonableness in plan assumptions. As long as plans are free to use wide parameters of reasonableness, there will be great variation in plan funding, and continued opportunity for abuse.

b. PBGC's Increased Deficit

A recent report generated by the General Accounting Office ("Government Insurance Program Threatened by Its Growing Deficit," March 1987), corroborated by the PBGC's Annual Report for FY 1986, points up the need to resolve these three major problems, as well as to institute improved and preventive monitoring of plans before they develop serious underfunding problems.

PBGC's deficit problems have essentially arisen from problems experienced by 33 plans of 23 employers, and especially from a handful of steel companies, primarily within the last fiscal year. According to the PBGC Report, eight plans constituting less than 1 percent of all claims have accounted for nearly 68 percent of total net claims. The FY 1986 claims of but two sponsors account for 83 percent of the PBGC deficit, with claims of one alone accounting for 54 percent of the $3.9 billion for all single employer plan claims made since 1974.

It is instructive to note that the aggregate liabilities of steel industry terminations are responsible for 80 percent of the 12-year PBGC deficit, with the majority of these liabilities having occurred within the past 16 months; the net claims resulting from the remaining 96 plans that terminated during this latter period accounted for $491 million. It is also instructive to note that, despite the new premium rate having been in force for only five months, FY 1986 premium revenues increased by a multiple of 2.25 times over FY 1985. Similarly, investment and other PBGC income nearly doubled in the same time period.

Looking to the future, proposals for some type of risk related premium, including variable rates, will not make up for the steel industry-created PBGC deficit. If enacted, a risk-related premium would put this existing burden on already troubled plans. Such a burden will likely cause some plans to terminate, thereby increasing the total number of participants owed guaranteed benefits. Such proposals also do not provide for adequate monitoring to avoid future problems that may occur, but that are unlikely to duplicate the unusual circumstances and magnitude of the problems of the past two years. In any event, any premium increase should be accompanies by carefully considered funding reforms.

c. Proposed Measures

The Proposal does set forth several changes that AARP can support. If underfunded plans are still small in number, and confined to certain sectors of the economy, then drastic changes may not be essential. Any solution to the underfunding problem should avoid overprotecting the PBGC at the expense of the private pension system. With this as a guideline, the following measures, for example, should promote benefit security without overburdening the pension system:

- the cash flow rule - a yearly minimum contribution equal to total yearly distributions should increase plan security;
- control group liability - all related employers should be liable for contributions required by the minimum funding standards for all plans maintained by the group;
- timing of contributions - while speeding payments up to a quarterly basis may not be needed, certainly requiring earlier payments, as well as an earlier final payment, will provide a quicker signal if adequate funding is a problem;
- restricting funding waivers - requiring that waivers be determined on a controlled group basis is consistent with insuring that a real and temporary hardship exists; in addition, notification to plan participants should always accompany plan action; and
- extension of employer liability - the employer should be liable for the full level of the plan's termination liability, including all fixed and contingent accrued benefits.

IX. CONCLUSION

AARP again commends the Administration for its comprehensive approach to the problems of overfunding and underfunding. The Association maintains, however, that the Proposal fails to sufficiently recognize that part of the assets above termination liability belong to plan participants. Because of this, the Proposal does not require an adequate cushion upon withdrawal, and fails to require a pay-out of assets upon termination. In any event, both withdrawals and terminations should be discouraged, with the strongest disincentives always attached to terminations.

Although a number of the minimum funding standards have been improved, AARP is concerned the proposed solution may be unnecessarily burdensome in some situations. Since details are still undeveloped, the Association simply cautions against overburdening an entire system to correct a more isolated problem. Any premium increase, however, should be accompanied by appropriate systemic reforms.

AARP looks forward to continued work with both the Administration and this subcommittee to formulate a legislative solution. The problems have been identified and been given serious consideration by the Administration's Proposal. AARP believes that a more acceptable solution can be devised by building further upon the framework of this Proposal.

STATEMENT OF DAVID HIRSCHLAND, SENIOR CONSULTANT, SOCIAL SECURITY DEPARTMENT, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA—UAW ACCOMPANIED BY, ALAN REUTHER, ASSOCIATE GENERAL COUNSEL, UAW, WASHINGTON, DC

Mr. HIRSCHLAND. Thank you very much. I am accompanied today by Alan Reuther, Associate General Counsel, out of our legislative office in Washington. We are appearing today on behalf of one and a half million active and retired UAW members and their spouses, most of whom are participants in defined benefit pension plans.

Senator PRYOR. You have many thousands of those who live in Arkansas.

Mr. HIRSCHLAND. We do indeed. Arkansas is one of the States to which many, many of them have retired.

Senator PRYOR. Well I want to tell you a story about that. I was not planning to. But years ago in the vocational schools in our state we had a real problem finding the proper instructors. This was back when I was Governor. We could not find the instructors to teach tool and die making and such as this, so, fortunately, someone came up with a brillant idea of calling up UAW. And they sent us a list, and all of a sudden, almost overnight, here came all these retired UAW people out of the hills and hollows, and they became vocational teachers and they did a splendid job. And I think some of them are still involved with that process. So we want to thank your organization for that.

I interrupted you just to supply that little bit of trivia for the record.

Mr. HIRSCHLAND. Thank you very much.

Senator PRYOR. That will not count against your time.

Mr. HIRSCHLAND. I appreciate that.

The UAW believes that the most urgent need today is to provide additional financing for the PBGC. We support an immediate increase in the PBGC premium. We support provisions for additional annual premium increases in the future or a permanent indexing of the premium.

We also believe that other revenue sources, such as earmarking the excise tax on reversions for the PBGC, should be considered by Congress. And we would also support initiatives to deal separately with the large pension liabilities associated with the troubled steel industry.

PBGC recently submitted a proposal to Congress to modify the existing premium structure so that it would be based upon the unfunded vested liabilities of a pension plan. The UAW strongly opposes this variable-rate premium proposal for a number of reasons. The PBGC proposal would drastically increase the premiums for some employers to $100.00 per participant. Such a drastic increase in the premiums could cause serious financial difficulties for certain economically troubled companies. It would also discourage the formation of new defined benefit plans and encourage some companies to terminate their existing plans. All of this would be counterproductive and harmful both to plan participants and to the long-run financial condition of the PBGC.

The PBGC's proposal is also fundamentally unfair because it does not reflect at all the actual risk that a plan will be terminated and have to be taken over by the PBGC. Under the proposal, some large, financially healthy employers would be charged very high premiums because their plans have unfunded liabilities, even though there is very little risk that the plans will be terminated and the liabilities transferred to the PBGC. These employers would shoulder virtually the entire burden of paying for the additional liabilities that will be assumed by the PBGC as a result of future plan terminations. The UAW submits that if the PBGC premium has to be increased to deal with these anticipated terminations, at a minimum these costs should be distributed as broadly as possible over all employers that maintain defined benefit plans.

The UAW also strongly objects to the premise which underlies the PBGC's variable-rate premium proposal—namely, that companies should be discouraged from ever creating unfunded liabilities. Unfunded liabilities in pension funds primarily result when credit for past service is recognized at the time benefit increases are provided or when a plan is established. This is a very desirable practice which permits pensions more adequately to meet current retirement income needs. Such increases in liabilities are amortized over a period of years much like a home mortgage, and for most employers these unfunded liabilities do not present any risk to the PBGC at all. The companies are financially healthy and can manage the increased cost.

Finally, the UAW submits that the problem of assuring adequate funding of pension plans should be addressed directly through changes in the minumum funding standards rather than indirectly through a variable-rate premium proposal.

The UAW recognizes that some changes in the minimum funding standards are necessary. In making such changes, we would stress that a balance must be struck between retirement income needs and funding security. We support the principle that a cash flow rule should be established, which would require the contributions to a plan exceed benefit payments and expenses for each year. A cash flow rule would assure that the funding status of a plan does not deteriorate. Had such a provision been in effect, it would have prevented the Allis Chalmers and the LTV steel plans from deteriorating.

The UAW also believes it would be appropriate for the government to consider faster funding for newly created liabilities. This would assure that these liabilities are funded on a more conservative basis and would also result in better funding for all plans. If such funding requirements are limited to new liabilities, and these requirements are gradually phased in over a period of years, we believe that faster funding can be implemented without disrupting the defined benefit pension system and without creating undue economic hardships for those employers who are already experiencing serious financial difficulties. We would, however, note that any proposal for faster funding must be coupled with reforms related to the reversion of excess assets upon the termination of a plan since faster funding will otherwise aggrevate the already serious problems which have arisen in this area.

The Administration's proposal to require faster funding for existing pension liabilities causes great concern. This amounts to changing the rules in the middle of the game and is unfair. Moreover, it would impose serious financial hardship on some employers and would also endanger the adequacy of retirement monies provided by the defined benefit pension system.

The Administration would shorten the amortization period for existing unfunded liabilities for some plans to as little as three to five years. Moving to such a short period could double or even triple pension costs for existing benefits. Even 15 year amortization for existing liabilities could increase such costs by 30 percent.

I think I had better stop there. I thank you very much.

Senator PRYOR. Thank you, Mr. Hirschland. Your entire statement will be placed in the record.

Mr. Sheehan, I believe you are going to be speaking for the United Steel Workers. We are proud that you are here this morning and look forward to your statement.

[The prepared written statement of Mr. Hirschland follows:]

Statement
of
International Union, UAW

Mr. Chairman, my name is David Hirschland. I am a Senior Consultant in the UAW's Social Security Department. I am appearing today on behalf of 1.5 million active and retired UAW members and their spouses, most of whom are participants in defined benefit pension plans. As such, we represent about 5% of the participants in our nation's defined benefit pension plans. The UAW commends you for holding hearings on the status of the PBGC and the critical issues associated with the funding of defined benefit pension plans, and for your past efforts in support of the private pension system.

We are proud of the role the UAW has played in the struggle to achieve adequate and secure retirement income for workers and their families. We have been active in this pursuit for nearly forty years at the collective bargaining table, as well as in the legislative arena.

In 1950, UAW members struck the Chrysler Corporation to establish the principle that pension plans should be adequately funded. Chrysler's approach was to pay pension benefits out of its general treasury, instead of funding them through a trust fund. The UAW insisted that the pension benefits be funded in order for the pension promises to be secure. After striking for 104 days, the UAW finally prevailed. The principle that pension benefits should be funded became the standard pattern for UAW negotiated contracts.

The UAW was also one of the first organizations to call for the enactment of federal legislation establishing minimum funding standards for all pension plans. We wholeheartedly supported the funding standards that were ultimately included in the Employee Retirement Income Security Act of 1974 (ERISA). Most UAW collective bargaining agreements already required 30 year funding of past service liabilities.

Nevertheless, we recognized that the enactment of statutory minimum funding standards was necessary for pension plans.

In our judgment, the minimum funding standards mandated by ERISA have been a success. They have played an important role in assuring that most pension plans are adequately funded.

However, when Congress enacted ERISA, it recognized that the establishment of minimum funding standards would not be enough to solve the "Studebaker" type of problem which had so shocked the conscience of the nation - that is, situations in which workers and retirees lost a substantial portion of their vested pension benefits because a company experiencing severe economic difficulty terminated its pension plan and the plan had insufficient assets to pay all vested benefits. To address the "Studebaker" problem, Congress also provided for the establishment of the pension plan termination insurance program in Title IV of ERISA.

The UAW believes that the termination insurance program has been largely successful in achieving its intended objectives. The Pension Benefit Guaranty Corporation (PBGC) has been instrumental in guaranteeing that thousands of participants and beneficiaries received at least a portion of their anticipated benefits when economically-troubled companies terminated their pension plans and there were insufficient assets to pay all vested benefits.

In 1986, after years of debate, Congress finally enacted the Single Employer Pension Plan Amendments Act (SEPPAA). This legislation greatly strengthened the termination insurance program by providing the PBGC with a long overdue premium increase, and by closing loopholes in ERISA which had enabled some profitable employers to dump unfunded pension liabilities onto the PBGC and to evade responsibility for certain vested non-guaranteed benefits which had been earned by participants. However, developments since the enactment of SEPPAA demonstrate that additional legislation is required to address a number of problems facing the defined benefit pension system.

Several pension plans with large unfunded liabilities have recently terminated. In particular, the termination of the LTV Steel pension plans has nearly doubled the PBGC's liabilities. These terminations and the resulting increases in PBGC's liabilities make it clear that some action is needed to address the PBGC's financing problems. Some action is also needed to assure that the funding status of existing pension plans does not deteriorate in the future, thereby exposing the participants and the PBGC to further losses.

We must approach solutions to these problems with precision and great care. A so-called "solution" which undermines the defined benefit pension systems' ability to provide adequate retirement income through overly conservative, stringent requirements is no solution at all. We need a balanced approach between retirement income needs in an ongoing plan on the one hand and funding and other provisions in anticipation of termination on the other.

In addition, there is a need for action to resolve the various abuses which have occurred in recent years in connection with the termination of so-called "over funded" plans and the reversion of excess assets to employers. Let me address each of these issues in turn.

Financing of the Pension Benefit Guaranty Corporation (PBGC)

The UAW believes that the most urgent need is to provide additional financing for the PBGC. The $8.50 premium is insufficient to cover PBGC's anticipated claims and current deficit. The recent LTV pension plan terminations added in excess of $2 billion of unfunded liabilities to the PBGC's $2.3 billion shortfall. Increased financing is needed to eliminate this deficit as well as to cover anticipated claims.

The UAW supports an immediate increase in the PBGC premium. We support provisions for additional, annual premium increases in the future or a permanent indexing of the premium. We also believe that other revenue sources, such as earmarking the excise tax on reversions for the PBGC, should be considered by Congress. And we would also support initiatives to deal separately with the large pension liabilities associated with the troubled steel industry.

The UAW supports making employers fully liable for all promised pension benefits, both under a "standard" and a "distress" termination. In our judgment, this will help to provide increased protection for participants, and also will have a positive impact on the financial condition of the PBGC.

The PBGC has recently submitted a proposal to Congress to modify the existing premium structure so that it would be based upon the unfunded vested liabilities of a pension plan. The UAW strongly opposes this variable rate premium proposal for a number of reasons.

The PBGC's proposal would drastically increase the premiums for some employers to $100 per participant (and even up to $220 per participant for employers who obtain funding waivers). Such a drastic increase in the premium could cause serious financial difficulties for certain economically troubled companies. It would also discourage the formation of new defined benefit plans, and encourage some companies to terminate their existing plans. All of this would be counterproductive and harmful both to plan participants and to the long-run financial condition of the PBGC.

The PBGC's proposal is also fundamentally unfair because it does not reflect at all the actual risk that a plan will be terminated and have to be taken over by the PBGC. Thus, under the PBGC's proposal, some large financially healthy employers would be charged very high premiums because their plans have unfunded liabilities, even though there is very little risk that the plans will be terminated and the liabilities transferred to the PBGC. On the other hand, small employers would pay the lowest premium even though there may be a much greater risk that their plans will be terminated and have to be taken over by the PBGC.

In addition, the PBGC's proposal is unfair because it would basically require a small number of companies who currently maintain plans with unfunded liabilities to shoulder virtually the entire burden of paying for the additional liabilities that will be assumed by the PBGC as a result of future plan terminations. The UAW submits that if the PBGC premium has to be increased to deal with these anticipated terminations at a minimum these costs should be distributed as broadly as possible over <u>all</u> employers that maintain defined benefit plans. Ideally, these costs should be assumed by society as a whole. But certainly it is wrong to single out a small group of employers to pay these costs.

When the pension plan termination insurance program was established in 1974, it was intended to be a social insurance program under which all employers that maintain defined benefit pension plans would be required to share equally in paying for the costs associated with the termination of underfunded plans. The PBGC's variable rate premium proposal would violate this basic principle of social insurance, by effectively requiring 2 percent of the plans covering only 7 percent of the participants to pay 30 percent of the total premiums collected by the PBGC. In our judgment, such a drastic change in the PBGC's premium structure represents the first step towards "privatization" of the entire termination insurance program, which the Administration has repeatedly announced is its long-term objective.

The UAW also strongly objects to the premise which underlies the PBGC's variable rate premium proposal -- namely, that companies should be discouraged from ever creating unfunded liabilities by charging them a higher premium. Unfunded liabilities in pension funds primarily result when credit for past service is recognized at the time benefit increases are provided or when a plan is established. This is a very desirable practice which permits pensions more adequately to meet current retirement income needs. Such increases in liability are amortized over a period of years much like a home mortgage. For most employers, these unfunded liabilities do not present any risk to the PBGC. The companies are financially healthy and can manage the increased costs. The PBGC's variable rate premium proposal will simply discourage such economically healthy employers from granting credit for past service (and even from granting cost of living increases to retirees), and thus will undermine the retirement income needs of participants.

The PBGC's premise that employers should never create unfunded liabilities in their pension plans can be analogized to the notion that individuals should always pay cash for a home, rather than taking out a mortgage which may be paid over a period of years. The net result would be to make it virtually impossible for many individuals to ever afford to own a home. Similarly, if employers are discouraged through a variable rate premium from paying for past service liabilities over a reasonable period of time, pension plans will never be able to afford to provide participants with a decent level of retirement income.

Finally, the PBGC's proposal that employers be required to pay a premium surcharge whenever they obtain a funding waiver would actually conflict with the policies underlying the minimum funding standards. If the IRS, in consultation with the PBGC, has determined that a company needs a funding waiver because it is in financial difficulty, then it makes no sense to hit the company with a premium surcharge, thereby aggravating the company's economic difficulties. More generally, the UAW submits that the problem of assuring adequate funding of pension plans should be addressed directly through changes in the minimum funding standards, rather than indirectly through a variable rate premium proposal. As discussed below, the UAW believes that a number of changes can be made in the minimum funding standards which would ensure that pension plans are better funded, without unduely burdening employers and the private pension system. These funding changes would reduce the PBGC's exposure, and eliminate the need for drastic changes in the premium structure such as those proposed by the PBGC.

Minimum Funding Standards

Pension plans are generally better funded today than in 1976 when ERISA's minimum funding standards became effective. The recent termination of several pension plans with large unfunded liabilities should not be viewed as evidence that ERISA's minimum funding standards have failed.

Nevertheless, the UAW recognizes that some changes in the minimum funding standards are appropriate to assure that the funding status of existing plans does not deteriorate in the future. In making such changes, we would stress that a balance must be struck between retirement income needs and funding security.

The UAW supports the principle that a cash flow test should be established which would require that contributions to a plan exceed benefit payments and expenses for each year. A cash flow test would assure that the funding status of a plan does not deteriorate. Had such a provision been in effect, it would have prevented the assets of the Allis Chalmers and the LTV Steel salaried plans from deteriorating.

The UAW also strongly supports making the entire controlled group of a plan sponsor liable for funding the plan. This will help assure that funding continues in situations where the controlled group is solvent, notwithstanding the demise of the plan sponsor itself.

The UAW also supports the principle of accelerating the due date for pension contributions.

The UAW supports a requirement that the IRS evaluate the entire controlled group of a plan sponsor in deciding whether a waiver is appropriate. However, we are opposed to proposals to tighten the standards for granting a waiver and the amortization periods for repaying waived contributions. The IRS already has wide discretion over whether and under what terms a waiver should be granted. We do not believe it would be useful to put the IRS in a straightjacket, especially since these determinations must necessarily depend on the facts of each particular case.

It is also important to recognize that actuarial assumptions have a large impact on employer contributions to a pension plan. These assumptions vary tremendously from plan to plan and employer to employer. The UAW believes these assumptions should be more carefully scrutinized by the IRS and, where appropriate, challenged.

In addition to the various changes discussed above, the UAW believes it would be appropriate for the government to consider requiring faster funding for newly created pension liabilities. Faster funding of newly created liabilities, such as future benefit improvements, would assure that these liabilities are funded on a more conservative basis and would also result in better funding for all plans. If such funding requirements are limited to new liabilities, and these requirements are gradually phased in over a period of years, we believe that faster funding can be implemented without disrupting the defined benefit pension system and without creating undue economic hardships for those employers who are already experiencing serious financial difficulties. We would note, however, that any proposals for faster funding must be coupled with reforms (discussed below) relating to the reversion of "excess" assets upon the termination of a plan since faster funding would otherwise aggravate the already serious problems which have arisen in this area.

The Administration's proposals to require faster funding for existing pension liabilities cause us great concern. Despite repeated requests, the Administration has not released details on the new amortization schedules which would be required under their proposals. Thus, it is impossible to determine what the precise impact would be on any particular plan or employer.

Notwithstanding the lack of specificity, it is apparent that the Administration is proposing that plans which are less than fully funded for all accrued benefits could be subjected to faster funding for <u>all</u> unfunded liabilities. I would like to emphasize that this accelerated funding proposal would apply to <u>existing</u> liabilities. This amounts to changing the rules in the middle of a game and is unfair. Moreover, it would impose serious financial hardship on some employers, and could also endanger the adequacy of retirement monies provided by the defined benefit pension system.

Under current law unfunded liabilities are amortized over thirty years. Liabilities which were in existence prior to 1976 were allowed to be reamortized over forty years.

The Administration would shorten the amortization period for existing unfunded liabilities for some plans to as little as three to five years. Moving from current law to such a short period could double or even triple pension costs for existing benefits. Even fifteen year amortization of existing liabilities could increase such past service costs by 30%. Had such a proposal been enacted when Chrysler was in financial trouble, Chrysler might not have recovered. This would have been counterproductive and harmful to the PBGC, as well as the workers and retirees of Chrysler.

The issue which must be addressed here is one of balance. It is important to properly fund a pension plan. It is also important to maintain a pension system that meets current retirement income needs. To reduce the amortization period of existing liabilities, as the Administration proposes, would dramatically and unnecessarily increase costs and, I believe, significantly undermine the retirement income available to workers and retirees.

Reversion of Excess Assets to an Employer

In recent years there has been a growing problem associated with employers terminating pension plans in order to obtain a reversion of so-called "excess" assets -- that is, assets in excess of the amount needed to cover all accrued benefits. These termination-reversions have frustrated the legitimate retirement expectations of thousands of workers and retirees. They have also raised a serious threat to the stability of and confidence in the private pension system.

Unfortunately the Administration has chosen to ignore this problem and the recommendations of the Task Force on Reversions appointed by Secretary Brock and of the ERISA Advisory Council concerning termination-reversions. Instead of building on the groundwork established by the Task Force and Advisory Council, the Administration has developed a new proposal -- a proposal which appears to be guided solely by a desire to protect the interests of the PBGC, rather than the interests of plan participants.

As a matter of principle, the UAW submits that any "excess" assets should belong entirely to the plan participants because the pension contributions represented deferred wages. However, we recognize that there are contrary views on this point. In the interests of furthering a legislative compromise which will provide an early solution to the problems posed by termination-reversions, the UAW is willing to support legislation that would provide for some equitable sharing of the "excess" assets between participants and employers. We must stress, however, that the UAW cannot support any legislative proposal in this area unless it provides, at a minimum, that upon the termination of a plan any "excess" assets must first be used to compensate active and retired participants for the legitimate benefit expectations which have been frustrated by the plan termination. Only after such benefit expectations have been satisfied should assets be allowed to revert to the employer.

There are many arguments for allowing active and retired participants to share in a portion of the excess assets. Under the Internal Revenue Code, contributions to a "qualified" pension plan are immediately tax deductible for employers. However, one of the conditions which must be met in order for a pension plan to be "qualified" is that the plan must be intended to be permanent. In many cases, the reason pension plans have assets in excess of their termination liability is precisely because the plans were terminated prematurely. For example, in salary-related plans the excess assets typically represent monies that were contributed for the purpose of funding benefits which would have been paid had the plan continued and salaries increased. Similarly, in flat-benefit plans the excess assets may often result from the fact that many workers are just shy of eligibility for early retirement benefits, such as an unreduced lifetime benefit or supplementary benefits payable until the age at which Social Security benefits commence. In addition, premature termination of a pension plan clearly jeopardizes the future retirement security of participants by effectively foreclosing the possibility of future cost of living and real income increases. For all of these reasons, active and retired participants have a right to share any excess assets which exist when a plan is prematurely terminated.

In our judgment, the Administration's proposal is fatally flawed because it fails to recognize this basic principle. But the Administration's proposal also contains numerous other problems.

Under current law, an employer may receive a reversion of excess assets upon the termination of a plan only if the plan contains express language allowing such a reversion. The Administration's proposal would effectively repeal this rule, and allow employers to obtain reversions regardless of the plan provisions (and indeed, even if the plan expressly prohibited reversions). The UAW believes that this proposed dilution of the protections afforded by existing law is outrageous, and we trust that Congress will not countenance such suggestions.

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The Administration has also proposed that employers be permitted to withdraw a portion of the excess assets from an ongoing plan. However, the way the proposal is structured, the amount of assets an employer could obtain upon termination of a plan would often exceed the amount which could be withdrawn from an on-going plan. Thus, the Administration's proposal would not discourage employers from terminating plans, it would simply give employers an additional mechanism for obtaining access to "excess" assets. This simply does not make sense. The UAW submits that any withdrawal mechansim should be considered only if it is coupled with sufficient restrictions on termination-reversions so that employers will be discouraged from terminating their plans. In addition, sufficient assets should always be left in the plan to cover all accrued benefits plus the additional amount which would be paid out to participants if the plan terminates. The withdrawal should be treated as an actuarial loss for funding purposes. In order for a withdrawal to take place, the plan should have language which permits a withdrawal.

The Administration's proposal also would require that the excess assets in a particular pension plan be transferred to other pension plans maintained by the same employer or other member of that employer's controlled group in various situations. This part of the Administration's proposal violates the exclusive benefit rule which lies at the heart of ERISA's fiduciary duty provisions. The UAW submits that it would be fundamentally unfair to require pension funds which have been contributed on behalf of one group of participants (and which represent deferred wages for those participants) to be suddenly transferred to another pension plan for the benefit of an entirely different group of participants. The Administration's rationale for this proposal, presumably, is to provide maximum protection for the PBGC. But this puts the cart before the horse. The basic objective of our pension laws should be to promote the interests of participants, not the interests of a government agency.

The Administration's proposal also contains a number of elements that would tend to undermine the defined benefit pension system. Specifically, the Administration has proposed that employers be allowed to receive a larger reversion if they terminate all of their defined benefit pension plans. The Administration has also proposed that employers be precluded from establishing any new defined benefit pension plans for the same group of participants for a period of five years after the termination of an underfunded or overfunded plan. The UAW submits that these proposals are ill-conceived and counterproductive. Rather than strengthening the defined benefit pension system they would encourage employers to flee the system (thereby further undermining the PBGC).

The Administration has also proposed that employers be granted an additional tax incentive if, upon withdrawing excess assets from an ongoing pension plan, the employer immediately transfers those assets to a fund which would be used to provide health insurance benefits to current retirees. The problems associated with providing adequate and secure health care benefits to retirees are extremely complex and difficult. The proposal advanced by the Administration, however, will not provide any meaningful solution to those problems. Even worse, the Administration's proposal would countenance the transfer of pension assets from one group of participants, such as rank and file workers, to an entirely different group of persons, such as salaried retirees. Again, this violates the exclusive benefit principle and is fundamentally unfair.

The termination of pension plans with a reversion of so-called "excess assets" to employers remains an area of serious concern to the UAW. The UAW is willing to work with the Administration and Congress in fashioning a proposal which will stop the serious abuses in this area and recognize the legitimate benefit expectations of participants.

In closing, I would like to emphasize the importance of pension plans to the retirement income security of UAW members and other working and retired Americans. Defined benefits plans are the best vehicle for providing this security:

1. They allow increases in benefits for past service thus allowing periodic benefit adjustments to meet current income needs.
2. They have the flexibility to provide adequate levels for disability retirement benefits, survivor benefits and early retirement benefits.
3. They do not place investment risk on the plan participant.
4. They allow the plan sponsor reasonable flexibility in funding.

The UAW strongly supports sound pension funding. It is now apparent that some adjustments in the minimum funding requirements of ERISA are needed, as well as additional financing for the PBGC. As these needs are considered, we urge you to balance them with other needs; the needs of participants in defined benefit plans to continue to have these plans provide them with adequate levels of income, as well as to have their benefits securely financed.

The UAW would like to thank Chairman Pryor for holding hearings on these important issues. On behalf of the UAW, I want to express our wish to work with you in shaping solutions to these problems.

Thank you.

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STATEMENT OF JOHN J. SHEEHAN, LEGISLATIVE DIRECTOR, UNITED STEEL WORKERS OF AMERICA

Mr. SHEEHAN. Thank you, Mr. Chairman.

I thought I would try to summarize this statement. Hopefully, I will not take too long.

Senator PRYOR. Your full statement will be placed in the record.

Mr. SHEEHAN. First off, Mr. Chairman, I think it is important that we separate the PBGC's deficit problem from the pressure which the steel industry's termination may be causing. In effect, there may actually be two problems here. One is the PBGC's deficit problem, the other is the problem of termination of pension plans in the steel industry.

Now while the steel industry is one industry with very severe restructuring problems—and we are all recognizing them—other industries may be following. Hence, we are concerned about an industry-specific approach that not only handles the PBGC's problem but disallows pension plans from being terminated as part of a restructuring strategy. When these pension plans are terminated there are two problems that arise. One is the loss of unprotected pension benefits, especially early shutdown benefits. Because when PBGC takes over, these benefits, some of them are not guaranteed.

A second problem, Mr. Chairman, occurs when the PBGC intervenes in subsequent collective bargaining negotiations between the union and the company with regard to the future pension plan. Now with regard to each of those two problems, I would like to quote from our text. And on page 14 we make special reference to an industry approach which we feel addresses not only pension funding problems but the cost of retiree insurance as well.

The onslaught of imports has already affected, for example, the steel industry and threatens others. Revenues could be raised from a duty on imports dedicated specifically to the funding of pension and health insurance promises made to retirees and employees. But a detailed mechanism remains to be developed. We believe that this approach more fairly addresses a wide ranging social problem, rather than shifting the burden solely to the retirees and the employees themselves, or to the struggling employer, or, as you have heard earlier today, to the PBGC.

Now another alternative solution, more specifically perhaps related to the steel industry, is early access to tax credits from net operating losses. Due to the depression throughout the steel industry, these credits will not be exhausted in the near future. Early access would be conditioned upon using the funds available to support early pension retiree insurance obligations, relieving some of the pressures on the PBGC.

Financing of the employers' contractural obligation for pension benefit would thus remain a private sector responsibility. There would be no termination of pension plans. Although annual Treasury obligations would be advanced in the early years to be discounted later. But again in this context, Mr. Chairman, we don't feel variable premium rates are going to handle the current problem confronting us in the steel industry.

There is one other aspect of the problem that I related to, namely, that after these plans have terminated, and we proceed to negotiate the subsequent pension plan, the PBGC intervenes into that collective bargaining relationship to prevent the union from making whole the loss of the benefits to the retirees.

The proposal that you have before you from the Administration puts into the statute what is not now a statutory right of the PBGC, and we are, in our text, opposing that.

Now having said that much about the specific approach to the steel industry, let me just briefly indicate, Mr. Chairman, that the main purpose of the hearing today is to relate to the PBGC's deficit problem.

Now the PBGC has a deficit of approximately $4 billion. But before the more recent LTV termination, it also had a deficit problem. Looking in the records, it amounts to about $1.7 billion. So, again, there is justification for separating out the two problems. The PBGC had a deficit problem of $1.7 billion before LTV.

With regard to the handling of that problem, the question of the variable premium rate or risk-related premium is interjected. Mr. Chairman, we do oppose that proposal. Suffice it to let the statement stand for what we are saying here. But let me strongly indicate to you, Mr. Chairman, that we feel that the premium structure of the PBGC related to a social insurance system covering the risk among all of the plans in the country. And if we revert to—or if we convert to variable premium rates, then we are really, in effect, turning this system into a private sector insurance approach.

In the private sector approach you may need to proceed on that basis with high premiums for high risks, but our main contention, Mr. Chairman, right from the beginning, is that there was a social responsibility to protect workers' pensions by spreading the risk among all employers in the country. Otherwise, I am afraid, Mr. Chairman, you will really be threatening the integrity and the credibility of a private pension system.

Senator PRYOR. How do we prevent another LTV? What safeguards now must we take to prevent a situation like LTV or Allis Chalmers?

Mr. SHEEHAN. Well, first of all, the answer goes on two different tracks. One is how do you relate to LTV and our basic manufacturing industries which are in such difficult structural situations?

The answer to that relates to more macroeconomic policies than to trade policies. I don't think that is an area to which you really wanted me to respond, but I felt obligated to make a brief comment there. But with regard to the pressure on the PBGC due to the LTV restructuring, Mr. Chairman, we have to confront the fact that other firms in the steel industry—perhaps other industries—will be confronted with the same problem.

Now the question is: Is the steel industry beginning to come out of its restructuring problem? Is there some kind of temporary separate financing which we could develop to handle, as the union is indicating, just that category of benefits which arise at the time of the shutdown? In other words, we are not saying that all of the pension liabilities of the company should be taken care of. But when a company does shut down a plant or facility during restructuring, it provides early shutdown benefits to the laid off workers.

Indeed it induces senior workers to take early pension benefits so it does not have to lay people off at the lower seniority level.

Now the question is, whether there is some way of separating those obligations and financing them separately? We are suggesting in this testimony, Mr. Chairman, at least for steel, that there are unused net operating loss credits available to the companies to which we could allow immediate access. The government would eventually be paying those credits to the steel industry when the steel finances come into a profitable situation. Accessing them now to handle the cost of paying for early retirement benefits is our proposal.

Incidentally, too, Mr. Chairman, sometimes a large portion underfunding in steel pension plans that we are hearing complaints about occurs immediately when there is a very large shutdown, and a number of people go on early retirement. Their pension benefits have not been "actuarially funded." That is what causes a real sharp drop in the funding of a plan. If it is not expected under our funding regulations, it certainly is not funded.

So we are trying to off-track that kind of obligation without putting a pressure on the rest of the pension plan nor, obviously, on PBGC.

[The prepared written statement of Mr. Sheehan follows:]

STATEMENT

of

JOHN J. SHEEHAN
Legislative Director of the
UNITED STEELWORKERS OF AMERICA

On behalf of the United Steelworkers of America, I welcome this opportunity to address the important issues associated with the status of the PBGC and the funding of defined benefit pension plans, and the Administration's proposals for legislative action in these areas. We commend you for holding these timely hearings, and thank the Subcommittee for the opportunity to present the Steelworkers' views.

The Steelworkers played a leading role in the enactment of the Employee Retirement Income Security Act, the landmark legislation that established minimum vesting and funding standards, as well as fiduciary standards, for all pension plans and created the federal pension termination insurance program. We are proud of the role our Union played in that effort and in subsequent efforts, such as last year's Single-Employer Pension Plan Amendments Act, to improve the pension protections afforded to employees.

The termination insurance program of Title IV of ERISA has been of enormous benefit to retirees, both in and out of the steel industry. The unfortunate fact is that, over the pst several years, the domestic steel industry has been in chaos, with a number of steel companies driven to bankruptcy. We are all painfully aware of the LTV Steel bankruptcy. That case embraces three steel companies: Jones & Laughlin Steel, Republic Steel, and Youngstown Sheet and Tube. And we have witnessed the bankruptcies of Wheeling-Pittsburgh Steel and Mesta Machine, both based in Pittsburgh. Continental Steel in Indiana filed for bankruptcy and subsequently ceased operating, and many of its workers were completely deprived of early retirements when the PBGC terminated its pension plan. Most recently, Sharon Steel in Western Pennsylvania and Phoenix Steel in Eastern Pennsylvania, for the second time, have sought the protection of the bankruptcy court. These companies joined, among others, Kaiser Steel of Los Angeles, McLouth Steel of Detroit, Eastern Stainless Steel of Baltimore, and Guterl Steel and Roblin Steel in the Buffalo area. Even without naming other smaller companies and any number of steel foundries, the length of this list is indeed shocking.

In most, if not all, of these cases, the financial plight of the companies has led to the termination, or threatened termination, of the employees' pension plans. Where the pension plans have been terminated, the PBGC has guaranteed many -- but by no means all -- of the pension benefits for retirees. I cannot overstate the critical importance of the PBGC's guarantees for employees and retirees in the steel industry, for their families, and for their communities.

While the main focus of today's hearing is on the status of the PBGC and the funding of pension plans, the wave of bankruptcies and the accompanying loss of pension and retiree health benefits in steel and other basic industries cannot be ignored.

For the past six years, we have implored the government to prevent the very kinds of problems we discuss today through the development of an industrial policy. We are aware that the steel industry is in the throes of restructuring, during which time the acceleration of steel imports eroded the industry's ability to respond to the restructuring pressure. As a result, a chaotic course has been followed as capacity is reduced in a nonefficient manner. But more than that, there has been an unbelievable toll on workers, retirees, and their communities. While belated action was taken against the onslaught of dumped and subsidized steel that robs Americans of their jobs and retirement security, it has been inadequate and the unrestrained restructuring proceeds without any rational consideration of the consequences.

To address the source of the pension problems confronting American industry, the Senate should follow the lead of the House of Representatives and adopt, among other more comprehensive measures, forceful trade legislation. The devastation facing retirees and employers alike, which we describe more fully below, can no longer be ignored.

The Crisis of Early Pension Supplements

Despite the crucial protections that ERISA provides, the fact remains that there is a crisis for tens of thousands of steel industry retirees and their families. That crisis is not addressed by the Administration proposals. That crisis involves early pension benefits.

In the steel industry, the wave of plant shutdowns left many workers jobless, qualifing tens of thousands of workers under age 62 for retirement. Each of these individuals would have preferred to work, but was forced on a pension well before eligibility for Social Security. At LTV alone, there are almost 8,000 early pensioners.

With this problem in mind, the steel industry's early pensions were designed to pay pension "supplements." These are payments -- usually $400 per month -- for early retirees who lose their jobs, through no fault of their own, as a result of plant shutdowns, job reductions, extended layoffs, or permanent disability. These supplements are added to an individual's basic monthly pension until he or she qualifies for Social Security, usually at age 62. The supplement is an essential part of the early pensioner's basic income.

Today's crisis arises because the PBGC does not guarantee the $400 supplements. Early retirees whose pension plans are terminated face the loss of $4,800 of their annual income. The loss of these special supplements, by people who have already lost their jobs, is nothing less than tragic.

Allow me to give a few examples. One man in Aliquippa, Pennsylvania, a married father of five, had been on long-term layoff. Even with 27 years seniority, he could no longer hold a job with LTV. After depleting his life savings and selling the family's only car, he finally accepted early retirement. Before the PBGC's recent termination of the LTV pension plans, his monthly income was $950, which he supplemented with food stamps. The loss of the supplement reduced his monthly income to $550, and he has been forced to go on welfare.

Another LTV retire and his wife, both in their late fifties, have had their monthly income reduced to $267. Rent and food alone cost them more than $270 per month, and they are now living off the local union food bank. Thousands of LTV, and other steel retirees have had their monthly incomes similarly cut by one-third, one-half, or more.

Even more tragically, one Youngstown, Ohio retiree, anxious about his continued health insurance coverage and worried about the loss of his monthly supplement of $400 was driven to suicide. This fifty-nine year old man, who worked a lifetime in the steel industry, received a net monthly income, including his supplement, of $622. Fearful of losing his supplement, he sought and was denied food stamps, household assistance and general relief. His life was destroyed by his anxiety over the loss of retirement income and health insurance. Human tragedies of this sort have no place in our society. If no relief is forthcoming, other retirees may feel they have no option but to end their lives.

The Steelworkers have attempted to alleviate the financial hardship for its retired members resulting from the loss of pension suplements and other non-guaranteed benefits, including future early or disability retirement benefits, lost by active employees. The Union has negotiated with employers to create new pension plans that pay at least some of the amounts they lost when the companies' pension plans were terminated and monthly benefits reduced. The PBGC, however, has condemned these programs. Without justification, it has taken the position that, if such programs are implemented, it will undo the termination and restore the company's pension plans, reimposing the terminated plans' unmanageable liabilities on these bankrupt employers.

Wheeling-Pittsburgh and the Steelworkers have thus been forced to file suit against the PBGC, seeking a declaration of their right to establish a program to assist injured present and future retirees. And, at LTV -- after the PBGC itself terminated the pension plans without even informing the Union of its intention -- the PBGC now objects to the Union's efforts to enforce its collective bargaining agreement with LTV, which independently requires the payment of pension supplements. Again, the PBGC threatens to "un-terminate" LTV's pension plans if any relief is provided to retirees, only a few weeks after the PBGC's sneak attack on the LTV pension plans created those very hardships. More recently, the PBGC has asserted that it is authorized to reduce the payment of guaranteed benefits should the Union succeed.

Nothing in ERISA supports the PBGC's position. ERISA's guaranteed benefit levels were intended as a floor, not a ceiling, on pension benefits. Congress intended those guarantees to protect employees and retirees, not to punish them. Moreover, nothing in ERISA forbids, or even suggests that it is improper, for an employer, in cooperation with its employees' bargaining representative, to attempt to pay promised pension benefits that exceed the PBGC's guaranteed levels.

At Wheeling-Pittsburgh, for example, the Steelworkers have negotiated a new pension program that is paid for by the agreement of active employees to accept $1.05 per hour less in wages. These contributions fund both a future service plan for active employees and a program designed to make up for some, but not all, of the losses incurred by retirees and employees as a result of the termination of the defined benefit plans. Both pieces of this new pension program are defined contribution plans, plans not covered by Title IV's termination insurance. The new pension program is funded entirely by the agreement of active employees to give up, unselfishly, a portion of their present wages in order to fund benefits both for themselves and their already-retired colleagues. Thus, this program will impose no cost on the PBGC. At bottom, the program promotes what we understand to be Congress' paramount purpose in enacting ERISA -- the assurance that employees with long years of service realize the pension benefits promised.

The legality of the program adopted at Wheeling-Pittsburgh and the Steelworkers' suit to compel LTV to abide by its collectively bargained pension promises will be determined under existing law. But, the Administration's pension funding proposal suggests for the first time that an employer be prohibited from establishing any retirement program, within five years after the termination of an underfunded defined benefit plan, if the new program is designed to make up benefits lost as a result of the termination. While the exact strictures of the Administration's proposal remain unclear, the Steelworkers are unalterably opposed to any amendment that compels retirees and employees to accept only the benefits which PBGCC guarantees., and that would prevent the Union from negotiating with an employer to make up, in whole or in part, for its broken pension promises. No such provision presently exists in ERISA. And, such an amendment would be directly contrary to ERISA's paramount purpose -- to provide income security to retired employees and thier families, and to protect the pension commitments made to those employees.

Of course, rejection of the PBGC's misguided position regarding follow-on programs will provide, at best, only a short-term remedy for part of this problem. The real solution to the pension crisis now being suffered by thousands of steel retirees is to guarantee these supplements under Title IV of ERISA. As we have stated, the employees who qualify for these early pension benefits have lost their jobs through unforeseen tragedies. These $400 per month supplements are only a fraction of the total liability of any steel industry pension plan. Nevertheless, the supplements, paid until Social Security eligibility, are a crucial part of retirement income. If ERISA's ultimate purposes are to be achieved and pension promises fulfilled, these benefits, too, must be guaranteed.

The Steelworkers recognize that special funding provisions will be needed if these benefits are guaranteed. Alternatives include funding these benefits on an estimated basis, based on honest projections of the likely number of qualifying events in the near future, or on a pay-as-you-go basis, thus imposing the obligation when an employer actually closes or idles a facility.

I have addressed at some length a specific pension crisis confronting tens of thousands of steel industry retirees. The Steelworkers sincerely appreciate the Subcommittee's attention to this critical social problem, and look forward to working with Congress to fashion appropriate legislative solutions. Only through that process will the pension expectations of the nation's working men and women be truly protected.

Let me turn my attention now more directly to the Administration's proposals addressing the financial status of the PBGC and pension plan funding and termination, and employer access to pension plan assets.

The Financing of the Pension Benefit Guaranty Corporation

The Steelworkers agree that the long-term PBGC deficit, estimated to be in excess of four billion dollars, must be addressed. We also agree that the current annual PBGC premium of $8.50 per employee is simply too low and must be increased. But as explained below, the Steelworkers cannot support the variable rate premium proposal which PBGC recently submitted.

To be sure, the Steelworkers support an increase in the annual PBGC premium. We would support provisions for additional, annual premium increases or a permanent indexing of the premium. And before hasty adoption of a variable rate premium, other potential revenue sources for the PBGC, including the recently adopted excise tax on reversions, should be considered.

The PBGC's proposed variable rate premium represents a fundamental departure from the social insurance program established in 1974. At that time, a "risk-related" premium system was rejected. Instead, all employers maintaining insured defined benefit pension plans were to equally share the costs of terminating underfunded pension plans. Now, little more than a decade after its creation, the PBGC has decided that its initial charter was in error and that it should now be a private insurance company. In "Promises at Risk," its report and recommendations, the PBGC asserts that "... that flat-rate premiums that do not take into account either exposure or risk have serious flaws. Under the current system, premium dollars are in effect transferred from strong sponsors of healthy pension plans to weak sponsor of poorly funded plans. These subsidies undermine the economy and penalize firms that desire to establish or maintain PBGC-insured plans."

The current proposal is also unfair. It drastically increases the premiums some employers must pay. The "cap" of $100 is no cap at all, since additional surcharges are imposed if funding waivers are sought <u>and</u> granted. Indeed, the proposal goes even further since the surcharges are increased even more if the pension plan provides, like many bargained by the Steelworkers, for early retirement in the event of a plant closing or other job loss. As structured by the PBGC, the variable rate preimum is no longer a premium, but a penalty. This time a penalty for plans who can least afford it.

Moreover, the proposal imposes upon a small group of plans, 4.7 percent, the heavy weight of 39.8 percent of the premiums. Instead of spreading future PBGC liabilities over the universe of defined benefit plans, only a select group of plans will be burdened with the cost.

The premium proposal, particularly together with the funding changes, assumes that unfunded pension liabilities are a social evil to be eradicated. While the Steelworkers believe that pension promises should and must be adequately funded, this issue should be confronted directly by appropriate changes in the statutory funding standards, not through the backdoor of increased PBGC premiums. Indeed, in order to provide adequate retirement income, which defined benefit pension plans are uniquely qualified to do, unfunded vested benefit liabilities may be created. The PBGC's proposal, however, discourages even healthy plan sponsors from considering benefit improvements because not only must the improvement be financed but additional premiums as well.

As we noted before, the protections afforded to plan participants by the PBGC have been critical during this chaotic period in the American steel industry. The Steelworkers do not fault the PBGC for its concern about the long term deficit and seeking solutions to its financing problems. But, the variable rate premium is not the solution.

The PBGC was created to protect the pension promises of millions of workers across the country. And, if the nation chooses to allow its industrial and manufacturing base to decline, a choice with which we vehemently disagree, the costs of economic restructuring should not be borne, as the PBGC would have it, by the employees, retirees and the companies which employed them. The recent surge of pension plan terminations is but one symptom of realignment, and the cost of curing the financial problems of PBGC must be shared by all.

Pension Plan Underfunding

Underfunding of defined benefit plans has been a problem for some -- although by no means all -- employers in the steel industry. While ERISA's minimum funding standards have been successful in many instances, they have fallen short of assuring adequate funding of all defined benefit plans.

Even prior to the last five years of depression in the steel industry, some steel pensions -- like those in other industries -- were underfunded because the minimum funding standards were lenient. Actuaries, who in large part determine a company's required annual contributions, may have too much discretion. Seemingly small changes in assumptions regarding interest rates, investment experience, or retirement expectations have dramatic effects on actual funding obligations. All too often, actuaries were willing to use overly optimistic assumptions, reducing their client's funding obligations.

At the same time, the statutory timing for making pension contributions encouraged a lax attitude toward funding. Because pension obligations were paid in a "balloon" payment, due some eight and a half months after the end of the plan year, the annual funding obligation could be regarded as something other than a "real" bill. Some steel companies, especially those with cash shortages, met all of their other bills and left the pension bill for last. Companies rarely set aside money during the year to assure that the proper amount would be available when the pension bill came due. And, when the contribution was due, the cash sometimes wasn't there. These companies then turned to the Internal Revenue Service for funding waivers, which increased the present underfunding of the plans.

Then, of course, the crisis in steel hit. It is a crisis of world overcapacity, and has produced the double bind of rapidly shrinking markets and falling prices. The result has been the well-known wave of plant shutdowns, bankruptcies, and forced joblessness. Cash shortages have meant, for some companies, an inability to meet even the existing minimum funding standards. More companies have sought and received funding waivers. Often, the companies defaulted even on these waivers, only to leave their pension plans that much more underfunded.

Some legislative changes are certainly in order. Too many retirees and employees have seen their pension promises broken. Pension benefits must be appropriately funded to avoid the tragedy of lost retirement income. But Congress must be careful that the establishment of stronger pension funding standards does not create undue economic hardships for already troubled companies. That result would benefit no one, not the troubled companies, not the PBGC, and -- most importantly -- not the plan participants. Thus, in establishing funding standards, Congress must follow a balanced approach, one which will adequately protect the benefit expectations of workers, but does not disrupt the defined benefit pension system, as we think the Administration's proposal would do.

While more rapid funding of pension liabilities may be one approach, the Administration's proposal causes us great concern. The proposed amortization periods of three to five years are such a drastic change from present law that many troubled employers might be unable to maintain their present plans.

It may be appropriate to apply different funding standards to new liabilities, those created after the enactment of any legislation. A prospective application would limit the adverse impact on existing plans, yet avoid the creation of future underfunded liabilities.

Another possibility is an industry-specific approach, addressing not only pension funding problems, but the costs of retiree insurance as well. The onslaught of imports has already affected, for example, the steel industry, and threatens others. Revenues could be raised through a duty on imports, dedicated to funding the pension and health insurance promises made to retirees and employees. While a detailed mechanism remains to be developed, we believe that this approach more fairly addresses a wide-ranging social problem, rather than shifting the burden solely to the retirees and employees themselves, struggling employers or the PBGC.

Another alternative solution, more specifically related to the steel industry, is early access to the tax credits from net operating losses (NOLs). Due to the depression throughout the industry, these credits will not be exhausted in the near future. Early access would be conditioned upon using the funds available to support pension and retiree insurance obligations, relieving some of the pressure on PBGC. Financing of the employer's contractual obligation for pension benefits would thus remain a private sector responsibility, although annual Treasury obligations would be advanced in early years to be discounted later.

Another concern is the Administration's proposals regarding the availability and amortization of funding waivers. While changing the timing of a waiver request and considering the financial circumstances of the controlled group may be appropriate, the suggested standards for granting a waiver and paying it back are unduly restrictive. Such changes would often eliminate the beneficial effects of funding waivers. The Single-Employer Pension Plan Amendments Act has already given the Internal Revenue Service useful new tools to apply in the funding waiver process, including the requirement that in certain circumstances an employer provide security for a waiver. In our view, these changes should be given an opportunity for meaningful application before imposing further restrictions.

The Steelworkers believe that other legislative changes contained in the Administration's proposal are in order. Actuarial assumptions should be carefully scrutinized, so as to prevent the intentional underfunding of pension obligations. Pension obligations should be funded on a more current basis. Quarterly funding, with the total annual obligation being paid no more than two and a half months after the end of the plan year, makes good sense. We also support the principle of a cash flow test, in general requiring that annual contributions to an underfunded plan exceed benefit payments and expenses for the year. The Steelworkers endorse the proposition that members of the employer's controlled group be jointly and severally liable under the minimum funding rules. Finally, the tax deduction limits should be revised to allow an employer with an underfunded pension plan to contribute in excess of the otherwise applicable deduction limits. It simply makes no sense as a matter of pension policy to punish an employer seeking to improve the funding of its underfunded defined benefit plans.

In each of these areas, we look forward to seeing, and to assisting in the development of, proposed statutory language. The goal of all changes in this area must be to improve the funding of underfunded pension plans. As we have already noted, industry-specific solutions may also be appropriate. In considering this critical area, however, an appropriate balance must be found so that the survival of employees and pension plans is not undermined.

<u>Plan Terminations</u>

The Steelworkers wholeheartedly endorse the Administration's proposal to make employers fully liable for all promised pension benefits, both under standard and distress terminations. The paramount purpose of ERISA is to protect employees' and retirees' expectations in their pension benefits. That purpose is best served if an employer is liable not only for its "benefit commitments," as defined in present law, but for all pension benefits that had been promised.

<u>Employer Access to Plan Assets</u>

In its proposal, the Administration seeks to address the problem of plans with so-called "excess assets," plans which at a point in time have assets greater than the present value of accrued benefits. This proposal is flawed, however, because it is based on the erroneous assumption that the money held in these tax-exempt trusts, dedicated to provide retirement benefits to employees and pensioners, belongs to the employer.

It is the Steelworkers' position that the assets in pension plans belong to plan participants, both active and retired, not the employer. In bargaining, for example, the cost of any economic package includes contributions made for pension benefits. To obtain improved pension benefits, workers forego current income or other fringe benefits. The deferred compensation aspect of pension contributions is best illustrated by a situation where the Steelworkers and employer agreed to a fixed hourly contribution to a defined benefit pension plan. Subsequently, the bargained funding mechanism was altered to eliminate the required contribution, permitting the employer to contribute only the amount the law required. No contributions were made because the plan was "overfunded," and remained so. When the employer sought to recapture the excess, the Steelworkers opposed the improper seizure. The fundamental unfairness of the Administration's proposal which provides the employer with the excess is strikingly obvious. Employees who gave up current wages in exchange for a well-funded future pension would be deprived of their bargain. Their deferred wages would be appropriated for the employer's use. Even leaving a "cushion" in the plan may not provide adequate protection. If a withdrawal were made and a business reversal occurred shortly thereafter, the plan could be without adequate assets to provide the expected benefits.

In reality, these "excess pension assets" do not represent excessive employer contributions; rather, they represent, to a large degree, higher than expected investment returns, caused by inflation and unusual short-term market conditions. This is confirmed by a recent study of the Employee Benefit Research Institute which showed that the recent growth of pension funds results from investment returns, not contributions.

The evanescent nature of pension surpluses is well illustrated by a recent Steelworker experience. Public filings for the corporation showed excess pension assets in the billions, using an interest rate of 9% to value pension liabilities. Upon closer examination, we learned that this figure combined a number of plans maintained by the employer and its wholly-owned subsidiaries, and that the supposed surplus attributable to the contracting employer's plan was in fact half of the reported amount. More significantly, ten months after the filing of these corporate reports, a decrease of 1% in the interest rate, reflecting subsequent market conditions, wiped out almost 60% of the surplus. Permitting withdrawals from ongoing plans, whose liabilities fluctuate with each market swing, jeopardizes the benefit security of workers.

In formulating legislation, the Steelworkers proposed that neither reversions upon plan termination nor withdrawals from ongoing plans be permitted. Plan assets should remain available to improve benefits, particularly those paid to retirees and to protect these individuals from the ravages of inflation. Without inflation protection, participants in defined benefit plans see the real value of their benefits deteriorate because of increasing prices. Ironically, the same higher interest rates generate high investment returns and surplus assets which employers now seek to obtain. In effect, when a reversion occurs, workers and retirees subsidize the employer at a time when they can least afford it.

This result runs contrary to the principle that pension fund assets are "owned" by the workers and retirees and are for their benefit. Workers who gave up wage increases in exchange for employer pension contributions end up receiving less than the wages deferred. It is this fundamental structural injustice which must be addressed, not exacerbated as the Administration proposal would do.

One troubling aspect of the Administration's proposal is the concept that assets from a terminated pension plan, or a plan transferred in a business transaction, would be moved to other plans maintained by the employer or members of the controlled group. The injustice of this proposal is illustrated by our prior example of the collectively bargained contribution. Instead of seeing their deferred compensation used to provide pension benefits, the employees would subsidize other workers.

Yet another concern about the Administration's proposal is its effect on the continued existence of defined benefit plans. There is no limit on the reversion an employer obtains if it maintains no defined benefit plans. The penalty of 10% excise tax plus current income tax may be a small price to pay to recapture millions of dollars. Moreover, the proposed five-year ban on the establishment of defined benefit plans serves little purpose, other than to deprive employees of adequate pension income. Indeed, taken in combination withpermitting a full reversion, the five-year ban is an invitation to establish defined contribution plans.

One aspect of the Administration's proposal which, in principle, the Steelworkers support is an incentive to pre-fund retiree health and life insurance benefits, so long as the only time pension assets may be used is upon plan termination.

The importance of retiree medical insurance cannot be gainsaid. In fact, for many retirees with serious medical problems, the insurance is even more precious than the monthly pension. Our members worked hard to win retiree insurance at the bargaining table. The Union has fought for the principle that these health and life insurance benefits last for the lifetime of the retiree and surviving spouse. Today, facing a wave of bankruptcies throughout the the Union is working to save these retiree benefits in Chapter 11 reorganizations through its support for the Retiree Benefits Security Act of 1987.

As the Administration recognizes, health insurance is generally not funded, and unlike pensions, is not guaranteed. The ultimate solution for unfunded retiree insurance promises may very well entail, in addition to funding, some combination of Medicare improvements, a PBGC-type system to guarantee insurance promises, or nationalhealth insurance. These reforms will not be won quickly or easily, but in the meantime, consideration should be given to providing appropriate incentives to employers able to pre-fund retiree insurance benefits.

The Administration's proposal permits an employer to use "excess" pension assets to fund retiree insurance, but there is little incentive to do so. The complex rules of Section 419 of the Internal Revenue Code, which limit pre-funding, must be altered.

There are, however, two (2) problems with the proposed transfer rules. First, the Administration's proposal limits the group which may benefit to individuals retired as of the transfer. This is inappropriate since the available pension plan assets are derived from the deferred wages of active employees who will enjoy future retiree benefits, as well as those already retired. The arbitrary line should be eliminated. Second, the proposal does not limit the use of assets to benefit employees and retirees covered by the "overfunded" plan. Such a limitation is necessary since plan assets should only be used to benefit the individuals covered by the particular plan.

Conclusion

The importance of defined benefit pension plans to the workers and pensioners represented by the United Steelworkers of America, as well as other employees and retirees across the country, is clear. That there are current problems, both with the PBGC and the funding requirements of ERISA, to be addressed is apparent to all. The Steelworkers look forward to working with the Subcommittee and others in shaping appropriate legislation.

Senator PRYOR. Mr. Hirschland?

Mr. HIRSCHLAND. Yes. I think there is—and we have elaborated a little bit in our statement—but there are really three things that we think could be done to improve the funded status of plans and to avoid other LTVs.

First of all, we think that there ought to be faster funding of new liabilities.

Senator PRYOR. The faster what?

Mr. HIRSCHLAND. The faster funding of new liabilities. So that when there is a benefit increase, it would be funded over a faster period than is currently required by law, which is 30 years.

Second, we think that there ought to be a cash flow rule which would take a look at the cash position of a plan and make sure that it didn't deteriorate.

One of the things that happened both in the LTV plan and the Allis Chalmers' plan was that toward the end the assets deteriorated rapidly and there was a net outflow of funds. If you had a cash flow rule, that would ameliorate that situation.

And, finally, one thing in the Administration's proposal that we support would be to require contributions to a plan to be made earlier. The Administration essentially proposed that contributions would go in during a current year as opposed to the year after the plan year. And that would also help improve the cash situation of a plan and would help to ameliorate some of those situations. And we think this that type of an approach would substantially improve the funded situation of pension plans.

Senator PRYOR. I have heard some comments or maybe even criticism—let's just say at this point comments—that some of the major problems we have had in, well, once again, back to LTV and Allis Chalmers, that those were part of collected bargaining agreements, and that many times collected bargaining agreements result in significant under funding of pensions plans.

What does your organization say to these allegations?

Mr. HIRSCHLAND. I can speak about our plans only. But I know that in the Allis Chalmers' plan the benefits that were provided by that plan were not comparable to the other plans in the industry. They were lower. There had only been, I think, one increase in the prior five years before that plan was terminated and that increase was minimal.

What happened in Allis Chalmers was that we had a company that had about 10,000 people working for them, a unit that had about 10,000 people working in it, and over a space of about five to seven years it went down to about 200 people. Now that is what happened in Allis Chalmers.

Senator PRYOR. Was that because of the eroding farm economy?

Mr. HIRSCHLAND. It was part of the eroding farm economy. It was maybe management in some cases in Allis Chalmers because other companies are better. The farm economy has not done well.

And the ratio of actives to retired workers deteriorated tremendously too. We had several thousand retired people at Allis Chalmers.

One of the things that happens when a company deteriorates in that situation is that people who are eligible to retire but would rather be working now see that there is no job for them. So they will, in fact, retire. And that also would have an impact.

Senator PRYOR. Mr. Sheehan, would you like to respond to the collective bargaining question?

Mr. SHEEHAN. Yes, sir, I would, Mr. Chairman.

And I think maybe there are two comments that I would add. Number one, I don't think it is the level of the pension benefit itself that was negotiated that is causing the pressure, but actually it is the fact, Mr. Chairman, that in many cases now in the steel industry where we have early shutdown retirement benefits those benefits are being paid earlier than had been anticipated. That itself creates the problem. And part of that problem obviously also is accelerated by the fact that we have too few active employees paying for the benefit of retirees. Take the steel industry. In 1979, we had about 415,000 steel workers at work. Today—as a matter of fact, right now—we are about 168,000 people working. That is a tremendous drop. Some of them obviously had already retired. Some of them went on to this accelerated rate. And so it is trying to fund that problem that creates "the steel pension crisis." Not the level of the benefits themselves but the fact that we have too few supporting them and we are paying them sooner.

Senator PRYOR. Ms. Feldman?

Ms. FELDMAN. I would like to add one thing. There were some comments from an earlier panel this morning about pension improvements being the result of collective bargaining. At least in the basic steel industry before the round of negotiations completed in January of this year, the last improvement in terms of the level of benefit were in 1980 bargaining.

So, for example, the newest form of pension benefit, a whole new benefit, if you will, being created for the so-called shutdown situation came into being in 1977. Now the rule of 1965 is the one that came in last in 1977. All of those would have been pretty close to fully—the 1977 improvement is fully phased in under the PBGC rules. That is not part of the problem of the PBGC. And the last round of pension improvements are generally fully phased in.

So I don't think that collective bargaining alone has been the problem because in terms of when we negotiate costs, we consider a cost package. There is a pension cost factor that all employees, in effect, pay for. That is part of the wage and benefit package. Whether the employer puts the money in or seeks a waiver then becomes the issue later in the life of the contract.

Senator PRYOR. You know, we have gone all morning and we have not talked about an issue—in fact, I even hate to mention it—we have really not gone into the reversion issue, whether it belongs to the employee or the employer. That is going to be looked at by the Senate Labor Committee, I understand, and maybe other committees, and ultimately it may come back to the Finance Committee.

I won't even ask your comments on this right now because we are about to adjourn in about one minute. But I do want you to know that this is going to be a very, very volatile sort of a philosophical issue that this Congress is going to have to deal with.

Finally, one question to Mr. Rother, who represents 25 million retired or about to be retired Americans. You have lowered the retirement, I mean, the membership, I believe, age.

Mr. ROTHER. Right.

Senator PRYOR. I think you can join the AARP now if you are 50.

Mr. ROTHER. That is correct.

Senator PRYOR. What do you hear from people who are 50, 52, or 53 who are looking now to just a few years for retirement? Is there a great deal of worry? Is there concern? Is there fear about whether their retirement program is going to be liquid or not?

Mr. ROTHER. I think once ERISA was passed everyone assumed that once they were promised a pension and they were vested, not to worry. And recent events, particularly LTV, have injected a real concern, not just in the steel industry but across the board, as to whether those pensions will be there.

Senator PRYOR. Right.

Mr. ROTHER. It comes out in two ways. One is the problem of a terminated plan or a bankruptcy. And the other is the problem associated with inflation, and the consciousness that what may be an adequate benefit when you first retire 20 years later may not mean very much. And so there is concern on both of those aspects.

Mr. HIRSCHLAND. One of the reasons that we are concerned about some of the fast-funding provisions is we realize that there does need to be a balance between those issues; that if the funding rules are so—if the new funding rules are so draconian that it really takes all of resources that could have been provided to just fund existing liabilities; that even if a company is, as we said in our statement, in a sound position and fully able to handle those, we can lose the ability to provide those inflation increases which also become very important.

Mr. SHEEHAN. A final word?

Senator PRYOR. Mr. Sheehan. And you can have the last word.

Mr. SHEEHAN. The last word. And let me make it very short, I hope.

The issue on underfunding both with regard to a faster funding requirement and to the so-called variable interest rates, I think is based on the assumption that underfunding is a violation; that underfunding is a crime; that underfunding somehow or the other was the employer, if you wish, the union's fault, and therefore, the Administration's proposal on very rapid underfunding sometimes between three to five years to amortize the debt, and to come in with the variable interest rate relative to your underfunding, that somehow or the other that is to be viewed as a penalty for the problem of underfunding.

What we are trying to tell you this morning is that underfunding comes from many factors, sometimes just market conditions, and other times it comes from restructuring circumstances. And that, therefore, we ought not to look upon it as something to penalize but to arrive at a solution to this problem which we are all in agreement on, on more rapid funding and other provisions.

Senator PRYOR. Thank you, Mr. Sheehan.

And I want to thank all of the panelists this morning. We express our gratitude and thanks. The hearing is adjourned.

[Whereupon, at 12:28 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF MR. JARED KAPLAN
ON BEHALF OF THE ESOP ASSOCIATION
ON THE ADMINISTRATION'S PROPOSAL ON THE FUNDING
OF DEFINED BENEFIT PENSION PLANS, TO THE FINANCE
COMMITTEE'S SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS
MAY 18, 1987

Mr. Chairman, my name is Jared Kaplan. I am a partner in the law firm of Keck, Mahin & Cate, in Chicago, Illinois. I am also Chairman of the ESOP Association's Legislative and Regulatory Advisory Committee.

My statement today is made on behalf of the ESOP Association. The ESOP Association is a national, non-profit organization with approximately 1000 members. The Association's regular members are companies with ESOPs, and associate members are those individuals and firms that provide services to ESOP companies.

We of the ESOP Association realize that the ESOP-related provisions of the Administration's defined benefit proposal are relatively minor when viewed in the context of the overall proposal.

In other words, our statement today will be brief, as we recognize that the ESOP tail can not wag the Administration's defined benefit dog.

We feel, however, that the Administration's proposal contains negative ESOP provisions, and we must speak out against this negative attack on ESOPs and employee ownership.

The proposal would limit the acquisition and holding of employer securities with respect to floor-offset arrangements as follows:

1. The individual account plan portion of a floor-offset arrangement would be subject to the 10% limitation on acquisitions of qualifying employer securities; and

2. Existing investments in qualifying employer securities by the individual account portion of the arrangement in excess of 10% of plan assets would be permitted for a specified period under rules similar to those in Section 407(a) of ERISA.

The Administration's stated reason for its Proposal is that if an ESOP constitutes the individual account portion of the floor-offset arrangement, the security of participants' defined benefit promise is substantially weakened and the risk of loss to the PBGC is greatly increased.

The perceived problem in this instance may be more imagined than real: The ESOP Association has indicated that, of its more than 500 regular members not more than ten have floor-offset arrangements. While not every ESOP employer is a member of The ESOP Association, this is certainly a representative sample.

The Proposal concentrates on the down-side risk only; floor-offset arrangements using ESOPs also give participants the opportunity to realize greater retirement benefits than the defined benefit plan can provide. Furthermore, where an employer has an existing defined benefit plan and uses an ESOP to buy out a current shareholder, the use of the floor-offset arrangement for prospective accruals can preserve employee's pension expectations. In that instance, if a floor-offset arrangement utilizing the ESOP cannot be used, the defined benefit plan will likely be terminated or frozen because of cash flow requirements.

Finally, the divestiture of employer securities to comply with the 10% limitation, even over a transition period, may cause great difficulty for a employer which may have to simultaneously repurchase shares at appraised fair market value if a closely-held corporation, or dump its stock on the open market at a time not beneficial to employees, if a publicly-traded corporation.

Others may terminate the defined benefit plan, which would be the opposite of the Administration's supposed goal of encouraging defined benefit plans.

We oppose the Administration's proposal.

Because the ESOP Association recognizes that the Administration's concerns about floor-offset plan liabilities being dumped on PBGC are serious theoretical concerns, we will explore with your staff various ideas to minimize the risk to the PBGC.

We also believe that a key provision of the 1986 Tax Reform Act ESOP provisions protects employees in a floor-offset arrangement. We refer to the new diversification rule all ESOPs must meet. (Code Section

401(a)(28)(B)). This rule allows employees to diversify their ESOP accounts from employer stock as they near retirement.

In sum, we ask the Committee to reject the Administration's floor-offset proposal because:

1. Its fear of unfunded liabilities from existing floor-offset plans being dumped on the PBGC are unfounded;

2. The 1986 Tax Reform Act's diversification requirement provides protection to ESOP participants of a floor-offset arrangement;

3. It is basically unfair, and economically unsound, to force termination of existing floor-offset plans.

Now, Mr. Chairman, I turn to an area that is unclear in the Administration's proposal.

To explain, the Tax Reform Act of 1986 enacted new Code section 4980, which provides, generally, that the surplus amounts from a terminated defined benefit plan were subject to the regular corporate tax plus a 10% excise tax. But Code section 4980(c)(3) exempts from tax those surplus amounts transferred to an ESOP, under certain circumstances.

Code section 4980(c)(3) was adopted by the Senate Finance Committee in its version of tax reform on the motion of Senator Max Baucus. The House version of tax reform did not contain this ESOP provision.

The House-Senate conference committee retained the Baucus amendment, but provided for it to expire as of January 1, 1989.

The Administration's Proposal before you states that all allowed asset withdrawals, and all surplus assets reverting to an employer, would be subject to the 10% excise tax and the income tax, except for those amounts transferred to fund a plan providing health benefits to current retirees.

Furthermore, the Administration's proposal provides for an effective date of January 1, 1987, and implies some changes may be applied retroactively.

If the intent of these provisions is to repeal the Baucus amendment one year early, we express our strong opposition to any such intent.

In fact, the ESOP Association is a strong supporter of making the Baucus amendment a permanent part of the Code.

We oppose the repeal of the Baucus amendment because:

1. As Senator Packwood generally commented when the Baucus amendment was proposed, transferring the surplus away from the employer back to the employee is a positive thing, and should be encouraged;

2. The Baucus amendment has resulted in several large, publicly-traded corporations sharing ownership with employees. The ESOP Association is well aware that if ESOPs are ever going to break the objectionable concentration of wealth in America, there will have to be more employee ownership of large corporations.

We look forward to continuing to work with you, Mr. Chairman, and your staff.

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May 22, 1987

The Honorable David Pryor, Chairman
Senate Finance Subcommittee on Private
Retirement Plans
Senate Dirksen Office Building 205
Washington, D.C. 20510

Dear Mr. Chairman and Members and Staff
of the Subcommittee:

<u>Single Employer Pension Plan Insurance Program</u>

We appreciate the opportunity afforded us by the Senate Finance Subcommittee on Private Retirement Plans to comment on long- and short-term changes to provide adequate funding of the Pension Benefit Guaranty Corporation (PBGC). We applaud the subcommittee's leadership in considering the Administration's proposals to increase the PBGC premium and to change the minimum plan funding.

The Institute's interest in this area is enhanced by the fact that many of its member companies were pioneers in providing defined pension benefit plans to their employees. Indeed, our members have long been committed to making the private pension system a viable and significant contributor to the income needs of the retirement segment of our society.

In large part because of this leadership role, our members find themselves in the paradoxical position of being forced to contribute a lion's share of the bail-out monies needed by PBGC to meet the pension promises of the unsuccessful companies comprising the PBGC client list. This unenviable position is a major reason why the Institute has such a keen interest in the legislative issues before the subcommittee.

An Overview

The central issue before this subcommittee is what to do about the financial "troubles" confronting the single employer insurance program. The starting point in seeking solutions is to put that issue in context. When viewed in proper perspective, we believe that it is apparent Congress should proceed with extreme caution and, in effect, avoid any futile search for a long-run or "permanent" fix. Under these conditions, but only under these conditions, we think a variable rate structure for PBGC makes sense. We start by looking at the issues in context.

The Key Issues in Context

The goal of the current study effort and the Administration's proposals is to improve the financing and long-run stability of the single employer pension plan termination insurance program. Before examining the alternative approaches, it is important to recognize that the PBGC program is not an insurance program in any meaningful sense. More specifically, the occurrence of a claim is not the result of an accident, or an act of God, or in the nature of an actuarial probability. Rather, the occurrence of a claim is the result of a human decision that is knowingly made as to its consequences. Thus, PBGC insurance against termination could be likened to a commercial carrier providing insurance covering fires set by the property owner.

In a major sense it is this absence of a meaningful parallel between PBGC's program and commercial insurance plans that brings the PBGC to Congress for funding relief. There is no valid basis for projecting future claims on the system. As PBGC points out, the claims have been extremely volatile in recent years--ranging from $40 million in 1984 to $2 billion in 1986. Claims have arisen primarily from "catastrophic events"--the termination of a few employers' plans that were unfunded by large amounts. Indeed, PBGC tells us there is no methodology available at this time to forecast the program's claims and hence revenue needs with precision.

By the same token, the premium is not risk-related--nor in any real sense can it be. It thus appears curious, if not unfair, to argue that the PBGC program should be expected to resolve a "financial crisis" for which it was not designed: the bankruptcy of a significant portion of a basic U.S. industry. More particularly, it has been pointed out that if the liabilities of several bankrupt companies within the steel industry were removed from the PBGC's books, the current $8.50 premium level would be more than sufficient to amortize the PBGC's remaining liabilities. The "Catch 22" character of the premium is further underscored by the real risk of any significant increase in the premium under the variable rate proposal or otherwise. This is the concern that such an increase would deter new plans, benefit increases, and/or the maintenance of plans not now well funded. With a legislatively induced "race-to-the-door" effect, the defined benefit plan providers would have to weigh the merits of continuing their plans, given unknown but likely significant future costs.

A final background caution. The current financial problems are not urgent in character. The Congressional Budget Office informs us as follows:

> . . . [C]orrective measures may not be immediately essential. A high proportion of the agency's liabilities actually represents benefits that will not be paid for several years, so that the program does not have immediate unmet cash needs. While CBO estimates that the PBGC will have to transfer assets from its trust fund to its revolving fund to meet benefit payments beginning in 1989, the program is not expected to deplete its assets for several years. Indeed, given its current assets, future premium receipts, and assets derived from future terminations of partially funded pensions, the PBGC could probably make benefit payments on a pay-as-you-go basis for more than a decade.

Viewed in context, we see the PBGC program as inherently shaky--its design has proven to be faulty; its predictability is very limited; and the potential of its negative impact is quite significant. To us, this adds up to a need for action. Since there is not, however, a simple answer nor one that is inherently without risk, we also believe there is need for caution.

Some Possible Directions

To provide less exposure to cost runups under the PBGC program, we believe several modest steps should be explored, including the following:

1. A variable-rate premium.--We approve and support the concept of a variable-rate premium. However, the Administration's proposal has some serious flaws which we cannot support:

   -- The indexing provisions should be eliminated. Given the unfairness of the current premium system and the lack of predictability of the costs confronting PBGC, Congress should exercise continuing control and oversight over the premiums.

   -- The threshold for the variable segment is too high at 125 percent of the vested termination liabilities. Whether it is set at 100 percent or 110 percent, the goal should be to minimize penalizing well-funded plans where there are some funding fluctuations due to benefit level changes under the current minimum funding rules. We do not believe PBGC has a clear handle on the impact of the variable portion and again we urge extreme caution.

2. <u>Simplified funding rules</u>.--While we find the Administration's proposals for minimum funding standard reforms overly complex and too rigid, we think it would be appropriate to provide shorter amortization periods and establish certain controls over the introduction of new benefits into an already underfunded plan.

3. <u>Lower benefits</u>.--We think it would be appropriate to freeze at current levels or even reduce PBGC benefits for new claimants. Expenditures could be reduced by lowering benefit protection across the board or by reducing insurance coverage for particular types of benefits. Limiting insurance protection for unfunded benefits that result from past service credits or plan liberalizations could have a marked impact on PBGC's future claims. While this might appear to be a harsh solution, it would be in the larger sense an equitable cost-sharing solution.

4. <u>Other areas for consideration</u>.--It seems reasonable to consider moving up PBGC's standing in bankruptcy court. Along the same lines, if a "catastrophic event," e.g., a major bankruptcy, threatens the solvency of PBGC or would trigger an untenable increase in premiums, perhaps Congress should consider on a case-by-case basis the merits of a "bail out" using PBGC standards of protection as a guide but employing general revenues to accomplish the task. This would recognize the extraordinary character of such events and lessen the burden on well-funded plans.

<u>Conclusion</u>

Again, we appreciate this opportunity to express our views and commend the subcommittee for its leadership role in reviewing these important proposals.

Our analysis raises a number of concerns. What was a modest program at the time of its creation in 1974 has become a very costly one. However, the solutions are difficult because the risks of "going too far" include damage to the voluntary pension system and future retirement protection for employees. To us, this dilemma suggests caution. Fortunately, time is not of critical essence, thus Congress can move modestly now and still have adequate opportunity to take additional steps later if necessary.

If the Institute can be of further assistance in your deliberations, please feel free to contact us.

Respectfully submitted,

Ken McLennan

President

WILLIAM M.
MERCER-Meidinger-Hansen

David M. Cantor, F.S.A. Principal

May 21, 1987

Ms. Laura Wilcox
Hearing Administrator
United States Senate
Committee on Finance
Room SD-205
Dirksen Senate Office Building
Washington, D.C. 20510

Written Statement Regarding the Administration's
Proposal on the Funding and Termination of
Defined Benefit Pension Plans: Floor-Offset Plans

A number of companies have adopted "floor-offset" arrangements which consist of a defined benefit pension plan offset by an ESOP. The motivation of these companies has been twofold:

1) to allow the employees to become shareholders in their company, and

2) to provide the employees with a secure retirement income arrangement.

Both of the above concepts have been repeatedly supported by the government and this support should continue.

The proposal to extend the limitation on acquiring employer securities to the defined contribution portion of a floor-offset arrangement is an inappropriate response to the perceived risk of these plans.

The current financial problems faced by the PBGC has not in any way been caused by these arrangements. The questions therefore should be: is there a risk, and if there is one, how should it be addressed?

The Joint Committee on Taxation's Staff Pamphlet (JCS-12-87) describes two risks - the risk to the participants and the risk to the PBGC.

The participant faces the risk that at retirement the defined benefit plan obligation is more than the plan can provide. Because the bulk of the liability under a defined benefit plan is associated with the older employees, this problem has substantially already been addressed by the ESOP diversification rules of the Tax Reform Act of 1986 and current minimum funding requirements for defined benefit plans. Certainly the participant faces far less risk under these arrangements than he would if his only retirement plan was an ESOP.

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The PBGC faces the risk that it will have to assume the obligation of a defined benefit pension plan with liabilities that have increased due to a decline in value of the employer stock. While such a condition could conceivably occur, there are many alternative approaches to eliminate or reduce the risk to the PBGC including:

(1) Considering such retirement programs to be primarily defined contribution arrangements exempt from PBGC coverage.

(2) Discounting the value of employer securities held by the retirement program when computing the "risk-related premium" as described elsewhere in the Administration's Proposal.

(3) Establishing special minimum funding standards for such arrangements.

(4) Increasing the diversification requirement of the ESOP in a manner consistent with the Tax Reform Act of 1986 if the ESOP is used to offset a defined benefit pension plan.

The Administration's Proposal approaches the problem of potential risk to the PBGC by "throwing out the baby with the bath water." Instead it should consider whether the threat of risk is "real" or "perceived", and if necessary take a sensible action to manage that risk.

Respectfully submitted,

David M Cantor

David M. Cantor
Fellow, Society of Actuaries
Principal

/df
DMC4/008-1

OLD STONE CORPORATION

May 29, 1987

Ms. Laura Wilcox, Hearing Administrator
Committee on Finance
United States Senate
Room SD-205
Dirksen Senate Office Building
Washington, DC 20510

Re: The Administration's Proposal on the Funding and Termination of Defined Benefit Pension Plans: Floor-offset Arrangements

Dear Ms. Wilcox:

We appreciate the opportunity to comment on the Administration's Proposal on the Funding and Termination of Defined Benefit Plans.

We agree that many of the concerns set forth in the Executive Summary of the Proposal are legitimate. We also welcome the Administration's commitment to address these concerns and thereby to resolve many of the deficiencies in the present system before they reach crisis proportion. We are deeply concerned, however, with one aspect of the Proposal which we believe is ill-conceived. If enacted, this particular provision would seriously undermine our company's extremely sound retirement program and the interests of our employees without, in any meaningful way, furthering or even serving the Administration's purposes...i.e., bolstering the financial integrity of the Pension Benefit Guaranty Corporation (PBGC).

The particular provision we are concerned about is the portion of the Proposal which would preclude the use of an "employee stock ownership plan" (ESOP) in floor-offset arrangements. Since an ESOP is a plan which, by definition, must invest "primarily" in employer securities, an ESOP could not be used as a part of a floor-offset arrangement if the individual account portion of a floor-offset arrangement is subject to the 10% investment limitation presently found in ERISA Section 407. The Executive Summary of the Proposal states that the investment of substantially all of a participant's individual account under a floor-offset arrangement in employer securities substantially weakens the security of the participant's defined benefit promise and greatly increases the risk of loss to the PBGC.

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We strongly disagree and take exception to the Administration's premise, which is apparently unsupported by any evidence. Indeed our own experience to date with a floor-offset arrangement leads to a diametrically opposite conclusion --namely, that such arrangements substantially enhance retirees' retirement benefits while at the same time reducing the risk of loss to the PBGC.

Old Stone Corporation is a savings and loan holding company headquartered in Providence, Rhode Island. Its principal subsidiary, Old Stone Bank, a Federal Savings Bank, the second largest financial institution in the state, dates back to 1819. The Corporation employs 2300 employees throughout the United States and has assets in excess of $3.9 billion. The Corporation's shareholders adopted a floor-offset arrangement in 1983. Its stock is publicly traded over the counter. Since the implementation of its ESOP, Old Stone's common stock has increased in value from $16.625 per share to $29 per share at May 1, 1987. As of January 1, 1987, the ESOP owned 1,894,963 shares of the common stock of Old Stone Corporation (a market value of approximately $53,532,704), of which approximately $27,689,774 was allocated to employees' accounts under the ESOP offset, the amount of their benefit entitlement under the Old Stone defined benefit Pension Plan. At January 1, 1987, the defined benefit plan had assets of $13,623,000. Thus between the two plans there was at January 1, 1987, a combined total of assets valued at more than $41,300,000 (not including the $25,842,000 in stock held in suspense to pay off ESOP loans) backstopping the defined benefit total liability of $14,735,000. Old Stone's ESOP has been extremely well received by participants who have benefited substantially from the increase in value of the Company's stock. At the same time they enjoy the security of knowing that if the stock should decline in value, they would not lose the retirement security of the well funded defined benefit plan.

We also bring to your attention that the Tax Reform Act of 1986 has already taken additional steps to provide benefit security to ESOP participants through the new diversification requirements which are contained in Section 401(a)28 of the Code. Participants who are nearing retirement age must now be given the option to diversify a part of their ESOP account balance into investments other than employer securities. The new rules require that an employee must be offered at least three investment options (other than employer securities). Thus, individuals who are near retirement will be able to further insure their benefit security by diversifying up to 50% of their ESOP account balance into non-employer securities. These rules will also provide additional security to the PBGC in floor-offset arrangements because greater investment diversification in the ESOP will mean less potential liability for the defined benefit promise.

In view of the foregoing, we urge that as legislation is drafted concerning defined benefit plans, floor-offset plans not be restricted in their ability to invest in employer securities. There is no evidence that any floor-offset arrangement has ever resulted in a liability to the PBGC. Moreover, there are as yet no statistics even with respect to the number of companies that have established floor-offset arrangements and what their particular funding circumstances are. In short, it would be wrong to legislate in a factual vacuum; it would also be unduly harsh on employees who have come to rely upon the potential for greatly enhanced retirement benefits made possible by such floor-offset arrangements.

Very truly yours,

Winfield W. Major

Winfield W. Major
Senior Vice President,
Secretary and
General Counsel

WWM:jrg

cc: Hon. David Walker, U. S. Dept. of Labor
Hon. Claiborne Pell
Hon. John Chafee
Hon. Fernand St Germain
Hon. Claudine Schneider

STATEMENT OF

PACIFIC TELESIS GROUP

ON

PENSION BENEFIT GUARANTY CORPORATION FUNDING

Senate Committee on Finance

Private Retirement Plans and Oversight of the
Internal Revenue Service Subcommittee

May 18, 1987

INTRODUCTION

The Pension Benefit Guaranty Corporation (PBGC) was established with the enactment of Title IV of the Employee Retirement Income Act of 1975 (ERISA). The role of this agency is to protect pension plan participants against the loss of earned retirement benefits in the event of the termination of an underfunded pension plan. By assuming the responsibility for these benefit payments, the PBGC serves as a safety net for the approximately 38 million participants in the private pension system.

When the PBGC was created in the 1970's, Congress believed that an annual premium of $1.00 per participant would provide more than adequate funding to meet the benefit obligations that the PBGC would assume. This belief was based upon a study of actual plan terminations in 1972. While a risk-related premium was considered, it was felt that the relatively insignificant amount of the required premium did not warrant any additional administration associated with a variable rate premium structure.

From the beginning, however, the PBGC's experience in assuming the benefit obligations of private pension plans far exceeded expectations as some companies capitalized on the opportunity to shift unfunded benefit obligations to the PBGC and, ultimately, to the comp~~anies paying~~ the PBGC premium. By 1978, the premium was raised to $2.60 per participant in the face an increasing deficit. In 1986, the premium was increased to $8.50 per plan participant.

The current PBGC deficit is in excess of $4 billion. This represents that portion of the benefit obligations already assumed by the PBGC which the agency cannot meet from current assets. It is estimated that the flat-rate premium required to address this deficit would range from $24.00 per participant to in excess of $40.00 per participant.

The growth in the PBGC's deficit and the accompanying upward pressure on the PBGC premium have focused attention on the financial condition of the pension guarantee system and the need for reform in this area. This is a serious situation and Pacific Telesis believes that a single, well-coordinated reform package addressing both the pension plan solvency standards applied to defined benefit pension plans and the PBGC premium system is needed.

I. PENSION PLAN SOLVENCY STANDARDS

As used in this paper, solvency refers to a plan's ability to meet its liabilities on plan termination; an insolvent plan is one which is not projected to have sufficient assets to cover current plan liabilities on termination. The minimum funding requirement discussed below is, therefore, based on plan termination liabilities. The proposed test of solvency compares the measured liability for current benefits to available assets adjusted for near-term experience.

Solvency, as defined above, will be tested based on the following inputs:

1. Current Benefits

The liabilities for which the PBGC and ultimately the premium payers may become responsible are guaranteed benefits after taking into account the 5 year phase-in of the PBGC guarantee.

To facilitate calculation, liabilities for the purpose of determining solvency are defined as the present value of vested and nonvested accrued benefits as reported in the plan's Schedule B, Form 5500 filing. However, as described below these liabilities would be adjusted to reflect the PBGC's immediate annuity rate at valuation date rather than the individual plan's assumed investment return.

2. Actuarial Assumptions

Much of the current difficulty of the PBGC is due to the use of excessively liberal assumptions for the determination of minimum funding requirements. By far the most significant of these assumptions is that of the interest rate. Current solvency should be calculated based upon the same interest rate assumption as the PBGC would use to determine its liabilities, i.e., the exposure of the PBGC (the insurer) should be determined based on the assumptions of the PBGC, not the assumption of the plan sponsor (the insured). In recognition of the above, for purposes of testing solvency, we recommend that plan liabilities be computed based on the PBGC's immediate annuity rate.

Other actuarial assumptions will not as significantly effect the calculation of liabilities. Therefore, we recommend using the plans "other" assumptions in testing solvency.

3. Asset Values

The market value of assets most clearly measures the exposure of the PBGC for an immediate termination. However, the volatility of the market value could induce undesirable swings in the value of the solvency test and hence in the required minimum contribution.

To mitigate the volatility inherent in the use of market value, it is recommended that solvency be tested using the actuarial value of assets.

4. Load Factor

To allow for short-term adverse investment experience and accrual of additional benefits, a margin above the termination value liabilities (i.e., Schedule B, vested and nonvested liabilities computed at the PBGC's immediate annuity rate) is suggested. The proposed solvency test, and the resulting supplemental contributions for those plans which fail the test, are designed to prevent the termination of an unfunded plan over the short term. Using reasonable assumptions as to the variance of investment returns in capital markets, a Load Factor of 10% would provide approximate by a 75% probability of plan assets exceeding plan liabilities over a five year period.

Statement/Definition of Funded Ratio Test (Solvency Ratio)

In accordance with the above discussion, the following summarizes the proposed Funded Ratio Test which is to be performed at the end of each plan year and reported concurrently with the filing of Form 5500:

$$\text{FUNDED RATIO TEST (FRT)} = \frac{\text{ACTUARIAL ASSET VALUE}}{\text{110\% OF TERMINATION LIABILITY}}$$

The FRT is a measure of solvency and a minimum ratio of 100% is suggested. If the FRT exceeds 100%, the plan is considered to have met the solvency target and is free of restrictions. To the extent that the plan falls short of the target, (i.e., "fails" the FRT), progressively restrictive provisions should be imposed upon the sponsors.

Funding Deficiency Level and Maturity Factor

For any year in which a qualified company pension plan fails the Funded Ratio Test, specific Minimum Funding and/or other requirements will be imposed above and beyond the ERISA requirements. The amount of additional contributions and the nature of restrictive provisions should be determined by (1) the level of funding deficiency and (2) the maturity of the particular group covered by the plan.

The degree of funding deficiency will be measured by the Funding Deficiency Level (FDL) as defined below:

$$\text{FUNDING DEFICIENCY LEVEL (FDL)} = \frac{\text{ADDITIONAL AMOUNT OF ASSETS NEEDED TO MEET THE FRT}}{\text{ASSETS USED IN FRT}}$$

The maturity of the covered group will be measured by the Maturity Factor defined as follows:

$$\text{MATURITY FACTOR (MF)} = \frac{\text{NUMBER OF ACTIVE PARTICIPANTS}}{\text{TOTAL NUMBER OF PLAN PARTICIPANTS}} \times \text{PRESENT VALUE OF FUTURE WORKING LIFETIME}$$

The degree of funding deficiency measures the level of underfunding in a pension plan. This indicator not only looks at the dollar amount of asset shortfall (i.e., a plan is $10 million short), but it also compares the shortfall to the total assets in the plan. This is important since a $10 million deficiency is more significant if total plan assets are $20 million than if total plan assets are $10 billion. A high degree of funding deficiency indicates a poorly funded plan.

The degree of funding deficiency is an important benchmark in determining the timeframe for amortizing asset shortfalls. A shorter amortization period is imposed for the more financially troubled plans, to insure that such plans reach a minimal funded standard as quickly as possible.

The maturity of a group refers to the average age of the employees covered by the pension plan. This is an important indicator in determining the timeframe for amortizing asset shortfalls. A low maturity factor indicates an older group and should translate into a shorter amortization period for funding shortfalls.

The failure of existing statute to incorporate maturity factors is a contributing cause of the PBGC deficit — the minimum funding standards permit certain liabilities to be amortized over relatively long periods, even when benefits are being paid out over relatively short periods. As the PBGC has stated:

> "...if a plan covers an aging, retiree-heavy population, ERISA's contribution requirements do not prevent its funded level from declining sharply, nor, if funding is already low, does ERISA compel rapid improvement."

<u>Required Contributions</u>

Once the FDL and MF are calculated, the funding period is determined based on the following schedule:

Funding Deficiency Level	MATURITY FACTOR				
	<5	$5\leq MF<10$	$10\leq MF<15$	$15\leq MF<20$	$MF\geq 20$
1-20%	4 yrs.	5 yrs.	6 yrs.	7 yrs.	8 yrs.
21-50%	3	4	5	6	7
51+%	2	3	4	5	6

For example, assume a Company fails the FRT in year 1990 and has the following statistics:

Asset Value = $100,000
Termination Value Liability = $100,000
Actives = 5,000
Non-Actives = 2,000
PV future working lifetime = 15 years

The Computed FRT is: $$FRT = \frac{\$100{,}000}{110\% \text{ of } \$100{,}000 = \$110{,}000}$$

$$FRT = 91\%$$

The Funding Deficiency is $10,000 ($100,000 available less $110,000 required) or on a % basis:

$$\text{FDL} = \frac{\text{Additional Assets Needed to Meet FRT}}{\text{Assets Used in FRT}}$$

$$\text{FDL} = \$10{,}000/\$100{,}000$$
$$\text{FDL} = 10\%$$

The plan requires an additional $10,000 to meet the FRT and the FDL is 10%.

The Plan's Maturity Factor is:

$$\text{MF} = \frac{\text{5,000 Active Participants X 15 Years Average Worklife}}{\text{7,000 Total Participants}}$$

$$\text{MF} = \text{10.7 Years}$$

So, from the preceding matrix table, a 6 year amortization period would be used and additional contributions of $1,667 ($10,000/6) would be required.

Other Requirements

Beyond the requirement of additional contributions, the following restrictions would be imposed on plans "failing" the FRT:

1. With FRTs below 90%, plans should be prohibited from implementing amendments which would create prior service liabilities. Such amendments exacerbate the plan's underfunding and contribute to further declines in the funded ratio. In addition, participants would be notified within 90 days of the plan's failure to pass the FRT (as reported under the plan's Form 5500 filing) of any restrictions or payments required of plan sponsors. Further, IRS funding waivers would not be granted for any plan year in which the FRT falls below 90%.

2. With FRTs below 70%, the plan should be required to suspend benefit accruals.

3. A 50% FRT should be established as a "Floor" below which the Solvency Ratio could not be allowed to fall in an ongoing plan. Any decline in the ratio below the Floor would trigger immediate recognition, i.e., the sponsor would have to offset the shortfall in full rather than amortizing experience and investment losses.

If these requirements cannot be met, the PBGC should initiate involuntary termination procedures (i.e., under provisions of the Single-Employer Pension Plan Amendments Act of 1986, the PBGC is required to initiate involuntary termination of any plan that lacks sufficient assets to make current benefit payments. This recommendation, therefore, represents an expansion of an existing PBGC authority). The PBGC (and by inference responsible plan sponsors) has a right and obligation to protect itself and participating pension plans from the progressive deterioration of an underfunded member.

The above provisions should be subject to a 5 year phase-in to allow plan sponsors to adjust to the new requirements and any additional contributions which might be required to meet the Funded Ratio Test would be tax deductible.

Review of Administration Proposal

In formulating the proceeding "Solvency Standards" Pacific Telesis has reviewed recent Administration proposals and is in general agreement that revisions are necessary in regulations regarding the minimum funded status of pension plans. Reflecting this agreement, the discussion of maturity ratios and shortened amortization periods is largely based on proposals which the Administration has presented. However, there are several major points of difference where the proposed Administration standards are not strong enough to significantly reduced the PBGC's exposure to underfunded plan terminations.

These differences are summarized below:

1. Standardization of Assumptions

   To determine the plan's funded status the Administration proposal advocates the use of plan actuarial assumptions in the measurement of liabilities. Pacific Telesis proposes standardization of the discount rate assumption to limit possible manipulation by plan sponsors.

2. "Floor" Funded Level

   Pacific Telesis recommends establishment of a lower limit (a FRT of 50%) below which the sponsor may not continue the plan without immediately providing the assets necessary to restore the FRT to at least the 50% level. Recognizing that such measures are stringent Pacific Telesis has recommended a phase-in period before the full force of the new requirements applies. It is Pacific Telesis' belief that companies which are advised now of significant future penalties will take steps to see that the penalties do not apply.

   The Administration proposal includes no comparable provision.

3. Accelerated Contribution Schedule

   The Administration proposes to require plan sponsors to make quarterly contributions to their pension plans. Pacific Telesis does not believe that it is appropriate to require accelerated contributions from sponsors who pass the Funded Ratio Test.

   The timing of data collection may prevent plan sponsors from accurately determining contribution levels early in the year. Further, even for plans which fail the FRT, the Administration's proposed requirement that the annual contributions be made within 75 days after the close of the plan year would appear to be sufficient and would mitigate the difficulty of determining the appropriate level of contributions during the early quarters of the year.

4. Interest on Waivers of Contributions

The Administration proposes to limit the availability of funding waivers and to increase the applicable interest rate on those occasions when waivers are granted.

Pacific Telesis proposes the elimination of waivers for plans which are poorly funded. For adequately funded plans Pacific Telesis sees no need to change the interest rate provisions in current law.

5. Tax Deductibility of Contributions to Eliminate A Funding Deficiency

Pacific Telesis strongly supports the Administration proposal to allow full deductibility of contributions up to the amount necessary to remove any funded deficiency.

6. Controlled Group Provisions

Pacific Telesis disputes the controlled group concept in the Administration's proposal. The rules appear to permit wholesale transfers of assets among plans in a controlled group, in apparent inconsistency with the exclusive benefit rules of current law. Moreover, mergers and acquisitions would be made far more complicated, since any transfer of a pension plan outside the employer's controlled group would be treated as a plan termination. In addition, Pacific Telesis feels that it would be wrong to require that pension plans in one line of business subsidize the pension liabilities incurred by another line of business. Although especially true for a regulated entity, it also would affect government contractors, negotiated plans and even plans requiring employee contributions. Pacific Telesis strongly advocates minimizing cross corporate subsidies.

7. Cash Flow Test and Funded Ratio Maintenance Test

Pacific Telesis's proposal does not include these tests. Given the floor limit on the FRT of 50%, Pacific Telesis does not see the need for these two additional tests.

II. PBGC VARIABLE RATE PREMIUMS

Long-term premium structural reforms are needed if the PBGC is to avoid the kinds of losses that it has recently experienced. PBGC insurance covers risks related to both market fluctuations and the inability of sponsors to provide sufficient funding to meet their pension promises.

The current flat rate premium structure results in economic inefficiencies:

- It does not encourage sound funding of pension plans. There is no penalty for maintaining an underfunded plan. Others will ultimately bear the burden of unfunded plan benefits.

- Sponsors of well-funded plans are discouraged by the fact that they bear the burdens of less responsible sponsors as well as their own. If they become discouraged enough, there could be an exodus of the well-funded plans from the defined benefit plan system.

- The flat rate premium structure represents a subsidy. Sponsors of well-funded plans are subsidizing sponsors of poorly-funded plans and sponsors in industries which are in good financial condition are subsidizing sponsors in declining industries. Such subsidy is clearly undesirable.

A properly structured variable rate premium will provide adequate coverage and, at the same time, help restore the health of the PBGC's single-employer pension insurance program without adversely effecting soundly funded defined benefit plans. Under a variable rate premium structure, all covered plans would pay a flat, per-participant charge. However, plans that represent greater potential exposure would also be required to pay a "funding charge". A variable rate premium structure, thus, reflects the reality that underfunded pension plans pose a greater risk to the PBGC.

A variable rate premium structure would also provide a more equitable approach to allocating insurance costs than the current flat rate. Higher per capita flat rate premiums are simply an unjustified tax on the sponsors of well funded pension plans. Responsible plan sponsors who fund their pension plans so that assets exceed liabilities on termination pose no risk to the PBGC. Yet, these same sponsors, while continuing to act responsibly, are being penalized by the higher premiums caused by the actions of others who have not funded their plans properly and who have increased their liabilities through benefit improvements which are not adequately funded.

Review of PBGC Proposal

The PBGC's proposal for a variable rate premium is generally a sound one. It is based on five criteria:

- simplicity,
- equitable allocation of premium charges,
- avoidance of unreasonable burdens,
- adequate revenues for the program's needs, and
- automatic adjustment of premiums to reflect future experience.

Under this approach, the premium paid to the PBGC would be composed of two parts, a fixed portion and a variable portion (the "funding charge"). The fixed portion would provide for the administrative expenses of operating the PBGC and for the amortization of the current PBGC deficit. The variable rate premium could range from 0 to $91.50 per plan participant. Thus there would be a minimum (fixed portion) and maximum (fixed portion plus maximum funding charge). The maximum premium would increase annually at a rate equal to 150% of the increase in national average wages.

The variable rate portion of the PBGC premium would be a function of the amount of underfunded liability of a pension fund. The unfunded liability would be the difference between 125% of the plan's vested liability and the plan's assets. The resulting liability would be multiplied by $6.00 per

$1,000 of such unfunded liability to determine the portion of the premium representing the variable portion. For example, for a plan with the following characteristics:

Vested Liability	$1,000,000
125% of Vested Liability	$1,250,000
Assets	$ 750,000
Number of Participants	250

then, the unfunded liability per participant would be $2,000. Multiplying this by $6.00 per $1,000 of underfunding would yield $12.00 per participant which would be added to the fixed premium to determine the plan sponsor's per-participant premium.

The PBGC's proposal would automatically adjust the base premium each year according to the national average wage increase. This is the same index used for determining increases in the Social Security wage base. In addition, the PBGC's proposal would automatically adjust the variable portion of the premium at specified intervals to reflect the differences between the program's actual and projected financial condition. Specifically, the $6.00 funding charge rate appplied to each $1,000 of unfunded liability would be adjusted to reflect both (1) any changes in projected net claims, and (2) any difference between the actual and the projected PBGC deficit.

The PBGC also proposes a surcharge for plan sponsors who are granted funding waivers. There would be a 50% variable premium surcharge if the waiver related to the year in which the premium was due or the previous year, 40% if the waiver related to the second preceeding year, 30% to the third, 20% to the fourth and 10% to the fifth. Each funding waiver would carry with it a required additional surcharge payment.

Finally, the PBGC proposes that, in lieu of current law provisions under which premiums are liabilities of the plan, the responsibility for the payment of premiums would be with the controlled group maintaining the plan.

Pacific Telesis Group Recommendations

The PBGC should be commended for its thoughtful recommendations with respect to the variable rate premium. Since the PBGC is designed to protect plan participants against pension plan failures, it should be on a sound acturarial basis.

Pacific Telesis makes the following recommendations with regard to the PBGC premium structure:

1. Bifurcated Premium Structure

   Pacific Telesis agrees with the bifurcation of the premium structure into the flat rate and variable rate segments. Such a structure would require minimal additional administration and cost of implementation, yet it would go a long way towards strengthening the PBGC system. The variable portion of the premium should be a function of some percentage of the vested liabilities over assets. However, we feel that the PBGC's proposed use of 125% of vested liabilty as a threshold is too high. A threshold of 110% would be more appropriate. We agree that the discount rate for purposes of computing the vested liability should be equal to the PBGC rate.

2. Small Plan Exception

For small plans (plans with less than 100 participants), an average premium rate should be used. This would avoid the requirement of computing the vested benefit at PBGC rates if that computation is not already made by the plan sponsor. An average rate which includes the "funding charge" should be used for these plans.

3. New Plan Exception

Pacific Telesis believes that provisions must be made for newly established plans. If past service credit is granted, such plans would be significantly underfunded for vested benefits at the date of establishment. This will lead to large initial and continuing problems until the sponsor has had time to fund the plan. Unless special provisions are made for new plans, the variable rate premium structure could serve as a disincentive to establishing a new plan. We encourage the adoption of a "flat rate only" approach, requiring no variable charge for plans that have been in existence for ten years or less.

4. Adjustment of PBGC Premium

We oppose the automatic adjustment of the base premium, since Pacific Telesis is not convinced that the PBGC's obligation will automatically rise with the rate of increase in national wages. Automatic increases in the premium rate would create an endlessly increasing premium structure. Such increases may or may not be needed, depending on the financial conditions of the PBGC and how well plan sponsors undertake their plan funding responsibilities. We therefore feel that Congress should determine the need for premium increases by periodically reviewing the financial soundness of the PBGC system.

However, Pacific Telesis agrees that the PBGC's premium needs should reflect any deviations between actual claims experience and projected claims experience. Such an approach is consistent with the way private pension plans are funded.

We feel any actuarial gains or losses incurred over a five-year period should be amortized as a part of the flat rate, thus changing the basic rate. The amortization of any such gain or loss should be over a period of 15 years, which is the ERISA standard and which also represents the approximate future working lifetime of plan participants in many employee populations. Including the increase or decrease in the premium requirements arising from an actuarial gain or loss in the flat rate is consistent with the idea that such rate should be adequate for both administrative expenses and the amortization of the PBGC's deficit.

Pacific Telesis's preference with regard to the amortization of any such actuarial gains or losses would be for the PBGC to adopt a "corridor" approach similar to that used in FASB 87. The PBGC should determine its cumulative gains or losses since the inception of the variable rate premium and only the excess of such gain or loss over 10% of its total liabilities should be amortized. In addition, the adjustment to the base premium should be made only once every five years. This avoids frequent changes in the premium rate.

The PBGC proposes that the "funded rate charge" should be revised every three years to reflect any revision in the projected annual net claims. Projected claims would be computed as the average of the most recent three years' actual net claims, adjusted to current dollars. Pacific Telesis believes that a three year period is a very limited time horizon during which net claims experience may not be representative of anticipated future experience and suggests five years instead.

5. <u>Transition Rules</u>

A maximum premium rate represents a logical transition to the variable rate approach. Therefore, Pacific Telesis supports the maximum rate of $100. In theory, the maximum variable rate premium could be much higher for plans that are seriously underfunded. However, a more gradual approach is appropriate since the current system is based solely on a flat rate premium. The maximum rate, however, should be increased from year to year. The PBGC recommendation of an increase factor of 150% of average wages is acceptable to Pacific Telesis.