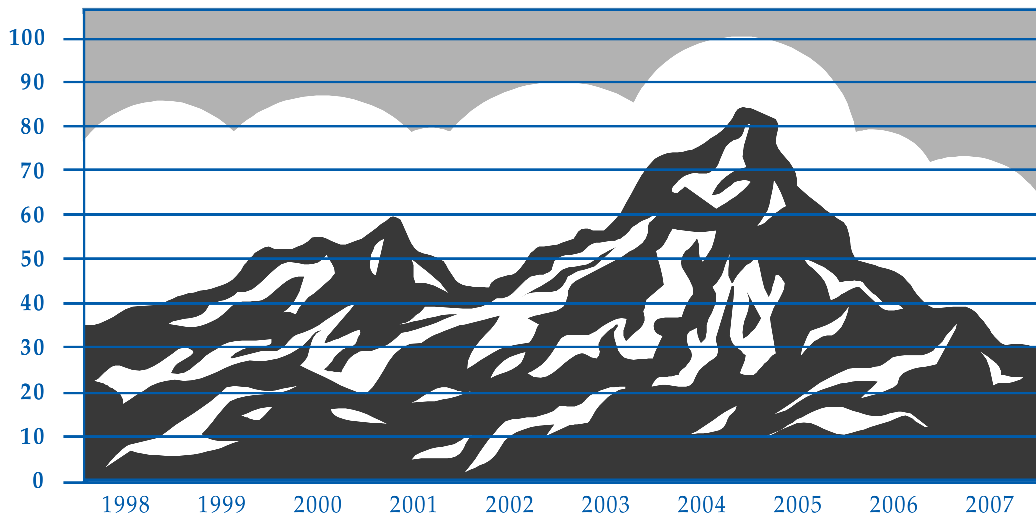
Pensions at the Precipice:



The multiple threats facing our nation's defined benefit pension system

American Benefits Council

May 2004

PENSIONS AT THE PRECIPICE:

THE MULTIPLE THREATS FACING OUR NATION'S DEFINED BENEFIT PENSION SYSTEM

Picture the scene. Prompted by questions from her board of directors, the CEO of a Fortune 500 company has grown concerned about the toll the company's defined benefit pension plans (one traditional and one hybrid) are having on the firm's financial position. She knows that required contributions to the plans have increased dramatically in recent years — to hundreds of millions of dollars annually — and that this has delayed construction of a new production plant and resulted in a downgrade of the company's stock value.

The CEO's senior management team has provided her with ominous reports of potential exposure to class-action litigation, even greater funding requirements threatening in a short two years, and changes in the way the company will have to account for its pension expense. With these threats in mind, the board of directors has asked the CEO to lay out a plan of action at the upcoming board meeting.

In preparation, the CEO once again assembles her team to brief her — senior executives from the company's finance, government affairs, public relations, legal, and accounting departments and the firm's outside counsel, auditors and benefits consultants. The members of the team speak in turn.

The general counsel reports the company's cash balance pension plan faces the prospect of class-action lawsuits on more than one front. Following up, outside counsel describes recent court cases ruling hybrid plan designs age discriminatory and ordering retroactive increases in cash balance pension payments to the tune of hundreds of millions of dollars.

Congress failed to enact a permanent replacement for the obsolete 30-year Treasury bond interest rate.

The vice president of government affairs chimes in that Congress prevented the Treasury Department from updating its guidance on hybrid plans to address these unsettled legal issues.

The chief financial officer and outside actuary tell the CEO that despite a recent temporary legal reprieve – signed into law a mere five days before a major federally required funding deadline — the company will soon be unable to plan for future pension costs because Congress failed to enact a permanent replacement for the obsolete 30-year Treasury bond interest rate historically required to be used for pension calculations.

Factors that threaten Retirement Plan Sponsorship: Top Three Threats to Defined Benefit and Hybrid Plans			
	Percent of employers (163 respondents)		
Threats	#1 Threat	#2 Threat	#3 Threat
Volatility of costs	33%	15%	13%
Level of overall costs	19%	9%	12%
Cash balance litigation and lack of regulatory certainty	13%	15%	8%
Lack of long-term/permanent interest rate relief and general congressional lack of support	12%	12%	15%
Possible accounting rule changes	7%	20%	16%
Employee perceptions and lack of appreciation	7%	5%	12%
Administrative/regulatory complexity	6%	12%	13%
Workforce mobility and decreasing appropriateness of defined benefit approach	2%	11%	10%

Source: Current Retirement Plan Challenges: Employer Perspectives 2003, Hewitt Associates, (October 2003).

The governmental affairs VP adds his skeptical prognosis for legislation that will resolve this issue once and for all. The extreme difficulties required to convince Congress and the executive branch to agree upon even the temporary fix raises legitimate questions about the government's long-term commitment to defined benefit plans. He also informs the CEO that administration proposals to "fix" the problem permanently by adopting a yield curve approach would further increase funding volatility and plan complexity.

These funding problems are not new, the vice president of public relations reminds the CEO. The company remains the subject of negative press coverage for its currently underfunded plan, despite the fact that only three years ago when the company still had an overfunded plan — and would have been penalized under current tax law for making additional contributions — it was being pilloried in the media for being stingy with benefit increases.

The chief accounting officer and outside auditor then tell the CEO that accounting standard-setters are also beginning to consider new pension accounting rules that would cause wild new swings in the company's profit and loss statements.

Battered by the negative reports from all quarters, the CEO returns to an idea previously raised but which she always rejected out of concern for the retirement security of the company's 37,000 employees. Perhaps the time has come to

freeze the company's pension plans. This would stem the financial bleeding by preventing any additional liabilities from accruing and would limit the damage should the company face a hostile lawsuit or changed accounting standards. She goes around the room and asks her senior team whether the time has come to freeze. With no guarantee of relief from these multiple threats, each reluctantly agrees that it has. The CEO resolves that this is the recommendation she will take to the board of directors: the company must freeze its defined benefit pension plans.

Introduction

We face a time of decision in our country. For decades, defined benefit pension plans have served as a foundation of our private retirement system. Generations of Americans have relied on these plans as a vital source of retirement income for themselves and their spouses.

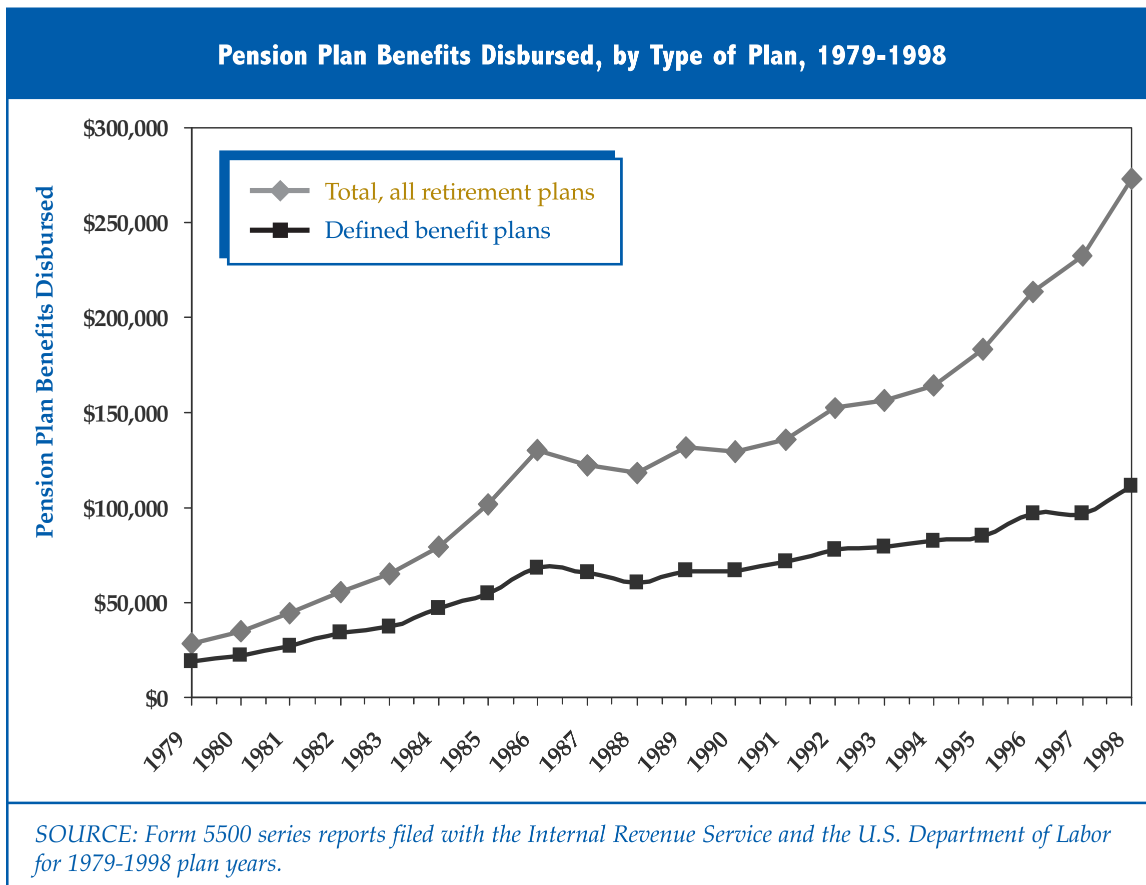
Today, however, defined benefit pensions face an unprecedented series of policy and legal threats that endanger their continued existence. These threats have reluctantly pushed many employers to the precipice of outright abandonment of these programs. In order to preserve these plans — and the retirement security they deliver to American families — Congress must decide whether to adopt the urgently needed policy prescriptions or to continue down the current road of policy hostility that will likely lead to these plans' demise.

The American Benefits Council (the Council) represents Fortune 500 employers and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

The Council prepared this paper to (1) provide background on defined benefit plans and our defined benefit system, (2) articulate the unique and unprecedented confluence of threats to this system, and (3) set forth the policy solutions that will alleviate these threats and allow us to back away from eroding the retirement futures of millions of Americans.

Specifically, this paper will discuss the following four threats to today's defined benefit system and what the Council believes must be done in each area to ensure defined benefit pension plans remain a viable retirement plan design for employers and employees in the 21st century.

- The attacks on hybrid defined benefit plans
- Failure to permanently replace the obsolete 30-year Treasury bond rate for pension calculations
- A flawed pension funding regime and flawed proposals for funding reform
- The movement to impose "snapshot" accounting standards



SOURCE: Form 5500 series reports filed with the Internal Revenue Service and the U.S. Department of Labor for 1979-1998 plan years.

Each of these threats, even individually, presents a significant danger of undermining our defined benefit pension system. Collectively, they amount to an outright assault.

While time is short and the stakes are high, Congress and other federal policymakers can still address these threats in a positive manner that will enable employers to continue providing financially sound pension programs to their employees. But, the time to act is now. If prompt action is not taken to provide appropriate policy solutions and a more supportive policy environment, the erosion in defined benefit plan sponsorship witnessed in recent years will accelerate and we will continue to move inexorably toward — and over — the precipice of pension extinction.

The Value of Defined Benefit Plans

Defined benefit pensions are valuable to employees, employers, our nation's retirement income system, and the economy as a whole.

Value to Employees

For employees, defined benefit plans offer a number of unique features that enhance retirement security at a time when America's savings rate is one of the lowest among industrialized nations.[1]

First, benefits typically do not depend upon employees making their own contributions to the plan, but instead are funded by the employer. Employers, rather than employees,

bear the investment risk of funding benefits, and investment professionals manage the assets of the plan.

In addition, plan benefits are guaranteed by the Pension Benefit Guaranty Corporation (PBGC), a federal government agency. Defined benefit pensions also offer benefits in the form of lifetime annuity payments, and include special spousal payment options so both retirees and their spouses can enjoy lifetime income. The bear stock market of recent years once again underscored the importance of these defined benefit plan features in providing a foundation of guaranteed retirement income for employees not common to defined contribution plans or personal savings vehicles.[2]

Value to Employers

Employers value defined benefit plans as an effective tool to manage their workforce. Sponsorship of a pension plan is a way of rewarding employees' service by providing meaningful retirement benefits, thereby increasing morale, productivity, and the quality of the work environment. With a valued pension plan, employees can focus on today, knowing that tomorrow will bring employer-provided, government-insured retirement income no matter how much they are able to save on their own.

Defined benefit pension plans also reward employee loyalty, serving as an important retention tool that encourages workers to remain with the employer over the long term. At the same time, employers can utilize defined benefit pensions to manage the retirement dates of their workforce (e.g., through early retirement incentives) with confidence that their retirees' income needs will be provided in the form of lifetime pension benefits. The use of early retirement incentives in the pension plan can also be a more benevolent response to changes in business conditions and the economic cycle than layoffs.

Value to Our National Retirement Income System

Defined benefit plans also play a critical role in our national retirement income delivery system. As of 1998 (the most recent year for which official Department of Labor statistics have been published), more than 18 million retirees were receiving benefits from defined benefit plans, with over $111 billion in benefits paid out in that year alone.[3]

Without these hundreds of billions of dollars paid to millions of retirees and their families, a huge hole would exist in our retirement income system.

Indeed, in the absence of defined benefit pensions, it is certain that fewer Americans would be financially prepared for retirement, more American seniors would live in poverty, and many more Americans would be forced to rely even more heavily on already strained federal entitlement programs such as Social Security, Medicare, Medicaid, and Supplemental Security Income (SSI).

Value to the Economy

One of the most important ways defined benefit plans aid our national economy is by providing a ready source of professionally managed investment capital. Even following declines in defined benefit plan sponsorship in recent years, private-sector defined benefit

plans held $1.6 trillion in assets as of 2002,[4] including 6 percent of all U.S. stock equity holdings.[5] Pension plan assets increase the pool of long-term capital, which makes possible additional productivity-enhancing investments by corporations. The result is greater production of goods and services and increases in real wages for both skilled and unskilled workers.

The Decline in Defined Benefit Plan Sponsorship

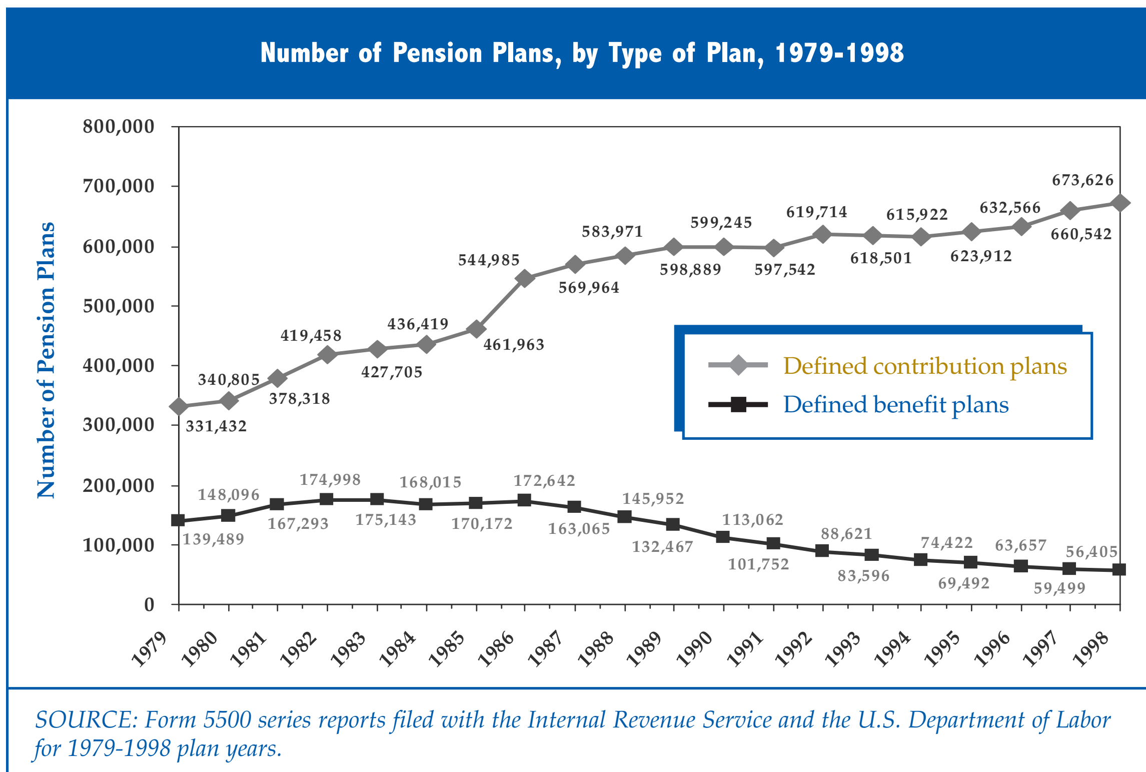
In spite of the value defined benefit plans provide to employees, employers, our national retirement income system and our economy, employers have been forced to exit the defined benefit system in alarming numbers in recent years. The total number of PBGC-insured defined benefit plans decreased from approximately 114,396 in 1985 to 32,321 in 2002.[6] Looking at this decline over just the past several years makes this downward trend all the more stark. The PBGC reported that it insured 39,336 defined benefit plans in 1999 – a loss of more than 7,000 defined benefit plans, or 18 percent, in just four years.[7]

Further highlighting the decline in the defined benefit system, the quoted statistics do not take into account pension plans frozen by employers (rather than terminated) — an event that, like termination, typically results in no additional accruals for existing employees and no pension benefits whatsoever for new hires. If frozen plans were tracked, the decline of our nation's defined benefit pension system would be even more severe.[8]

Just since 2001, 23 percent of Fortune 1000 companies announced their decision either to freeze or actively consider freezing their defined benefit pension plans. The trend shows no sign of slowing with a number of large employers announcing similar disturbing news in recent months.[9] Unfortunately, virtually no precedent exists for frozen plans "thawing out" such that benefits begin to accrue once again. Freezes are a permanent decision to exit the defined benefit system.

The decline in sponsorship of defined benefit plans is in stark contrast to the increase in sponsorship of defined contribution plans (such as 401(k) plans) over the same time period. While defined benefit plan sponsorship declined sharply, Department of Labor statistics indicate the number of defined contribution plans increased from 462,000 to 673,000 from 1985 through 1998.[10]

This migration from defined benefit to defined contribution plans is due to a number of factors, including the greater complexity and myriad of other funding and administrative burdens associated with defined benefit plans today, but also a number of defined contribution plan features that make them attractive to employers and employees alike. For example, defined contribution plan benefits are more transparent (i.e., participants are able to easily determine total benefit value), assets are more portable, and many employees value the investment control and investment choice that these plans provide. For employers, they offer predictable budgeting of retirement plan costs, significantly less financial risk, and a program highly valued by employees.

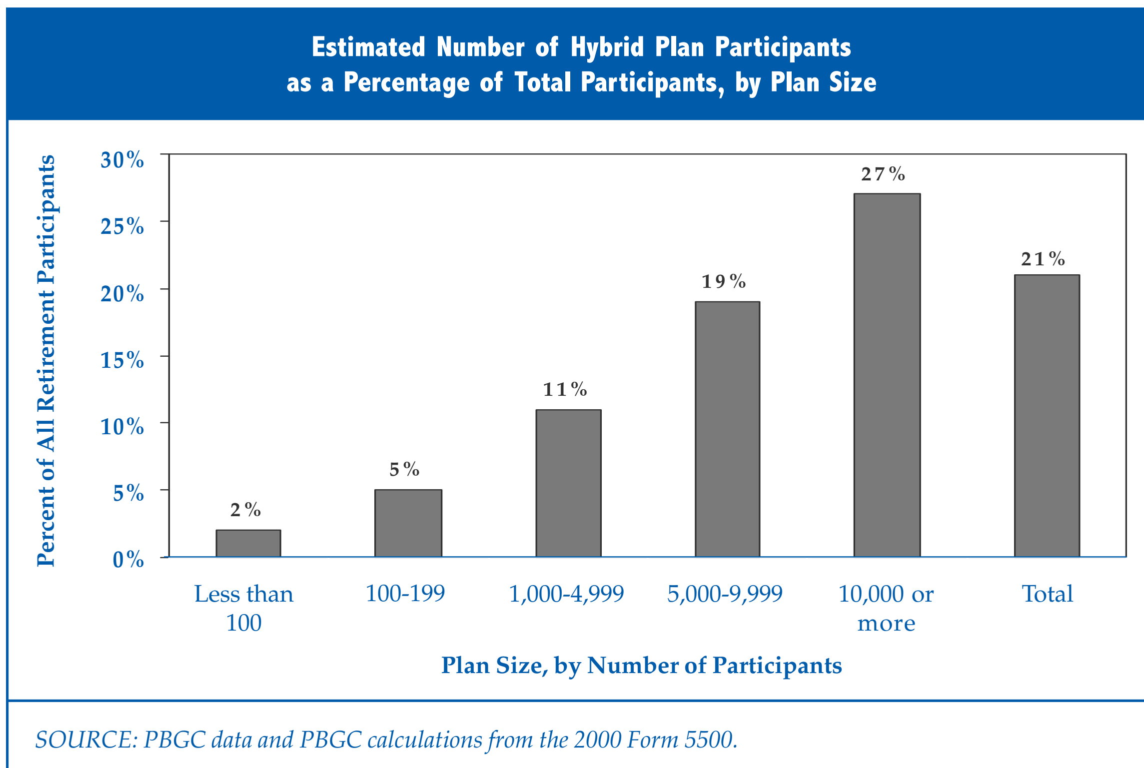


SOURCE: Form 5500 series reports filed with the Internal Revenue Service and the U.S. Department of Labor for 1979-1998 plan years.

Both defined benefit and defined contribution plans have unique features and strengths not easily replicated in the other form of plan. Our national retirement income policy should be designed so employers and employees can utilize the plan or plans that best suit their needs. In many cases, employees are best served when they can participate in both types of plans. By strengthening both defined benefit and defined contribution plans, federal policymakers can ensure a flexible and comprehensive retirement system that assists all Americans in achieving a secure retirement.

Threat #1: The Assault on Hybrid Defined Benefit Plans

Hybrid pension plans (such as cash balance and pension equity plans) were developed to correct a mismatch between the traditional defined benefit pension design and the needs of today's more mobile workers and to respond to the popularity among employees and employers of defined contribution plans. The traditional pension design can award benefits disproportionately to employees with very long service relative to employees with less than career-long employment at their firm. In contrast, hybrid plan designs deliver benefits more evenly over employees' working lives, and typically produce higher benefit levels for the majority of workers.[11] At the same time, hybrid plans — which are a form of defined benefit plan — retain all the traditional features employees, employers, and policymakers value (e.g., employer responsibility for funding and investment risk, PBGC insurance, spousal protections, etc.). Hybrid plans also provide other features that employees desire, such as greater portability than traditional pensions and a more transparent and tangible account-based benefit.[12]



SOURCE: PBGC data and PBGC calculations from the 2000 Form 5500.

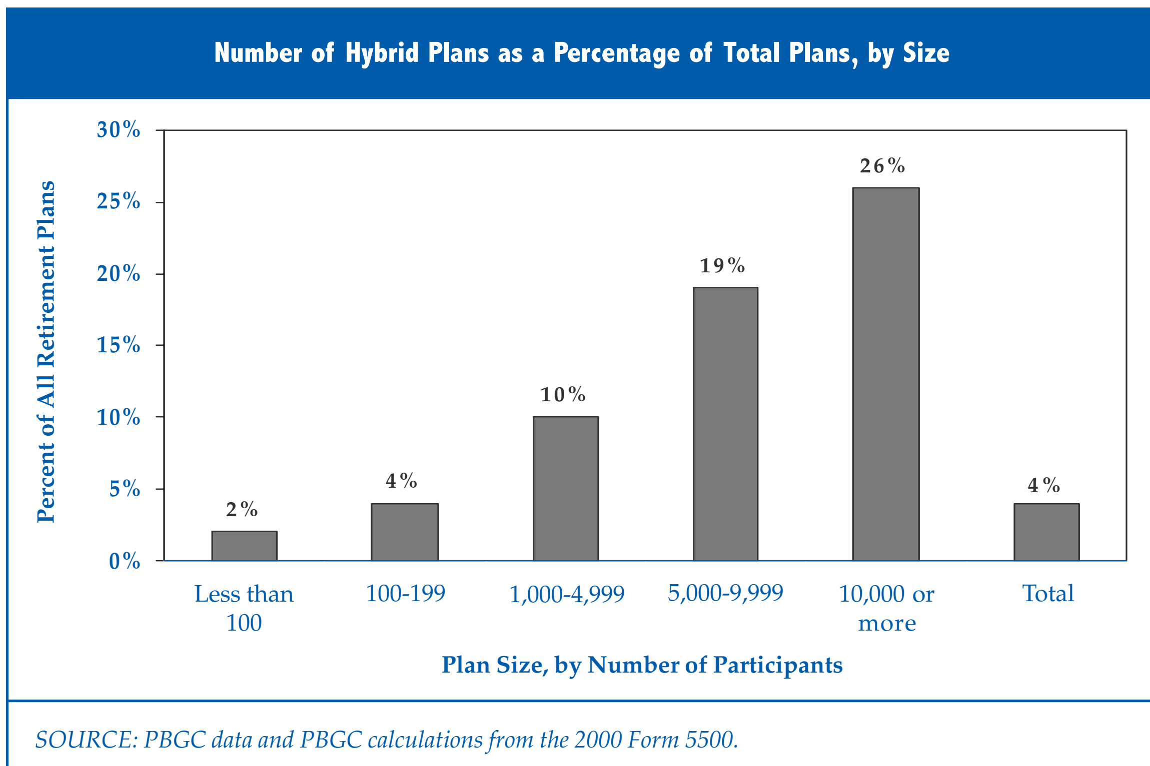
In today's mobile workforce, hybrid plan design features have been popular with employees and employers alike. Indeed, hybrid plans have been a rare source of vitality within our defined benefit pension system. Today, according to the PBGC, more than 1,200 hybrid pension plans in the U.S., cover more than 7 million employees.[13]

In a few high-profile instances, conversions of traditional defined benefit plans to hybrid plans and the effect of the conversions on older workers caused controversy. Some critics charge that conversions are motivated solely by employers' desire to reduce pension costs. However, recent research disproves this myth.[14]

In fact, a variety of factors underlie an employer's decision to convert to a hybrid pension plan.[15] Rather, conversions attempt to provide more transparent benefits, meet the demands of a mobile workforce, and allow companies to remain competitive in the global business environment.[16]

Employers recognize that some long-service workers will not do as well in the future under hybrid designs as under traditional designs. A March 2004 Watson Wyatt study reported that in 89 percent of conversions, employers provide long-service employees with significant transition assistance (e.g., grandfathering participants in the prior plan, choice between the prior and new plan, or extra transition contributions to their accounts).[17]

As with traditional defined benefit plans, hybrid pension plans face serious endangerment to their continued existence. The most pressing of these threats are an absence of regulatory guidance on critical hybrid plan compliance and interpretive questions, courts reaching conflicting and sometimes harmful results in the absence of



SOURCE: PBGC data and PBGC calculations from the 2000 Form 5500.

such guidance, Congress tying the hands of regulators, and a number of policymakers seeking to impose onerous mandates on hybrid plan conversions.

Age Discrimination Laws and Hybrid Plans

Until 2003, no comprehensive administrative guidance had been issued on the application of the pension age discrimination laws to hybrid plans. While employers felt confident based on existing authority and the issuance by the Internal Revenue Service of positive determination letters that the cash balance and pension equity designs were age appropriate, the lack of comprehensive guidance created a degree of legal uncertainty. However, federal courts that examined the issue in the absence of such guidance generally concluded cash balance pension plans complied with federal age discrimination requirements.[18]

In December 2002, the Treasury Department and IRS issued proposed regulations addressing age discrimination requirements for hybrid and other retirement plans. The proposed regulations reach the same conclusion as the earlier federal court decisions with respect to cash balance plans, i.e., their design is not inherently age discriminatory. The proposed regulations were drafted in consultation with the Equal Employment Opportunity Commission and the Labor Department, thousands of comment letters were submitted, and two days of public hearings were held on the proposed regulations.

Contrary to the proposed regulations and other federal court rulings, a recent federal court decision in the case of *Cooper v. IBM* held that hybrid pension plan designs are age discriminatory.[19] The *Cooper* decision is likewise inconsistent with the legislative history and structure of the pension age

discrimination statute.[20] Under the judge's extremely flawed logic, simple compound interest is ruled illegal in pension plans. Even the Social Security program would be deemed age discriminatory if the *Cooper* decision were applied to it. In light of these infirmities, the *Cooper* decision may very likely be overturned, and should not be relied upon by policymakers as a source of guidance.

The *Cooper* decision may very likely be overturned, and should not be relied upon by policymakers as a source of guidance.

Those who believe that traditional defined benefit plans are the only type of pension design that should be allowed for certain employees have used the *Cooper* decision to once again criticize hybrid pension plans. Specifically, Representative Bernard Sanders (I-VT) and Senator Tom Harkin (D-IA) successfully included in the Fiscal Year 2004 Omnibus Appropriations Act a provision denying funding to the Treasury Department to complete the pending age discrimination regulations.[21] The same act directed the Treasury Department to make legislative recommendations dealing with conversions from traditional to cash balance plans. The Treasury issued these recommendations in February 2004 as part of the Bush Administration's fiscal year 2005 budget submission to Congress.

These recommendations include a provision recognizing the age appropriateness of hybrid pension designs.[22] Unlike the proposed regulations, however, this provision would be effective only prospectively (with no inference as to the status of the issue under current law), leaving existing hybrid plans vulnerable to age discrimination challenges against their very designs. Without completion of the original Treasury regulations (or comparable clarification by Congress as to the validity of the hybrid designs under *existing* law), the legal status of all 1,200 hybrid plans could be jeopardized, a potentially disastrous outcome for the more than 7 million Americans and their families who rely on these plans.

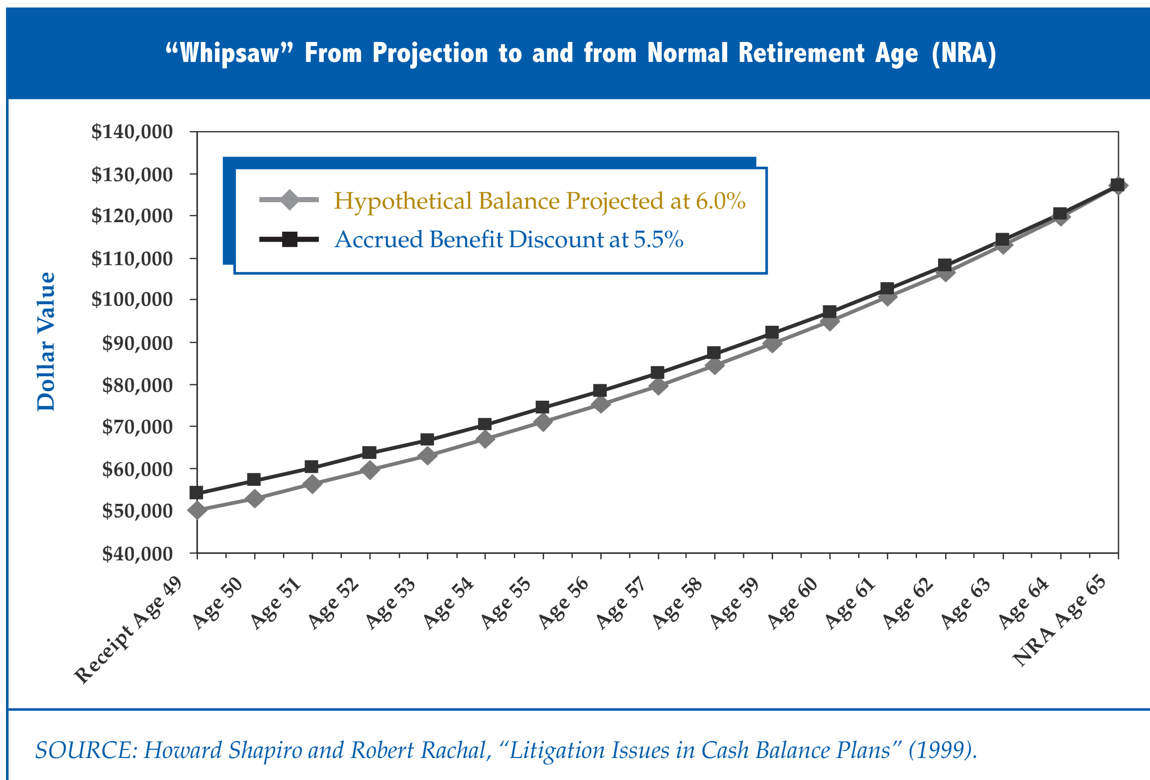
If such certainty is not achieved, employers will surely be discouraged from moving to hybrid plans (even though such plans may better serve employee needs) and, lacking this design alternative, many employers with either traditional or hybrid plans will be driven from the defined benefit system altogether.

Recommended Policy Action:

Congress should lift the prohibition on the Treasury Department's completion of the age discrimination regulations, allowing Treasury to clarify that the cash balance and pension equity plan designs are not age discriminatory. Alternatively, Congress must itself clarify the age appropriateness of these designs under current law.

Benefit Payouts in Cash Balance Plans ("Whipsaw")

Another threat to hybrid plans is a legal theory adopted by a number of courts requiring employers to pay cash balance benefits to departing employees that are greater than these employees' cash balance plan account balances. Under this theory,



"Whipsaw" From Projection to and from Normal Retirement Age (NRA)

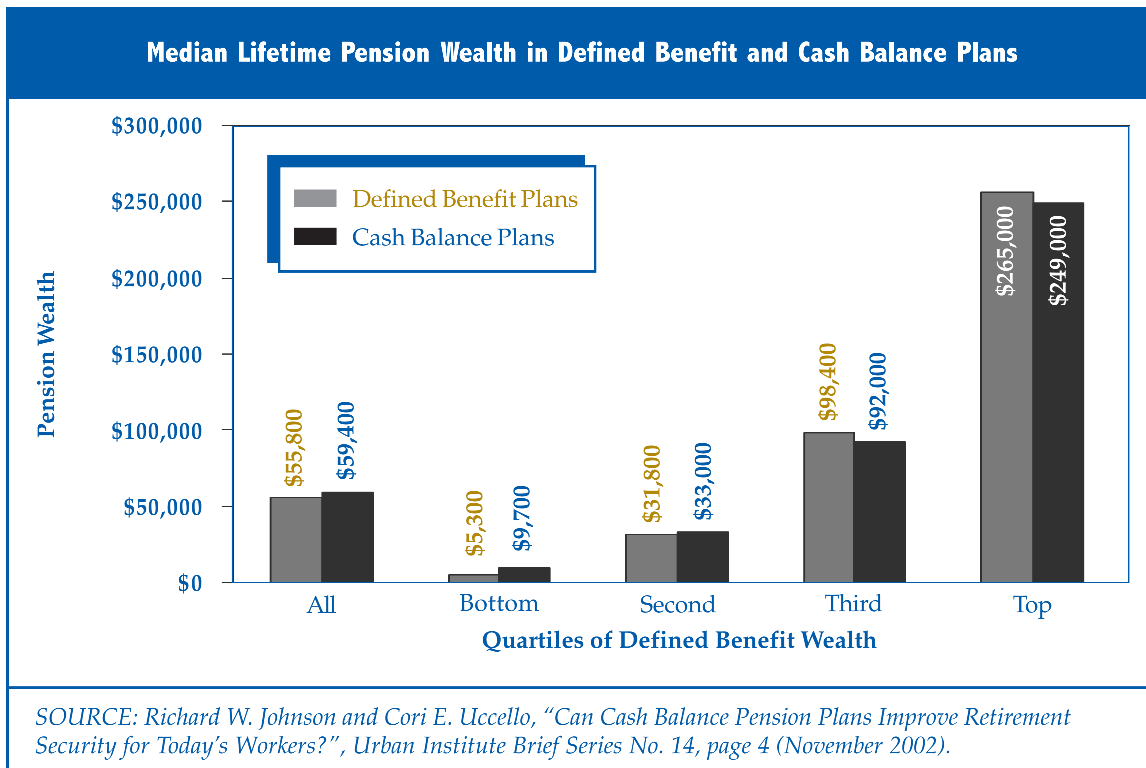
SOURCE: Howard Shapiro and Robert Rachal, "Litigation Issues in Cash Balance Plans" (1999).

employers must project a departing employee's cash balance account forward to normal retirement age using the plan's interest crediting rate and then must discount the resulting amount back to a present value using the statutorily-mandated 30-year Treasury rate. When the plan's interest crediting rate is higher than the 30-year rate, the amount resulting from this project forward/discount back process is greater than the account balance, hence "whipsaw."

A number of courts have embraced this theory, imposing huge retroactive benefit payments on companies for benefits neither they nor their employees anticipated.[23] The whipsaw theory defeats the transparency and simplicity intended by the cash balance design since the ultimate benefit ends up being different than the account balance. Ironically, the largest whipsaw windfalls are bestowed on the youngest workers who are furthest from retirement.

Employers seeking to insulate themselves from whipsaw liability have reduced their interest crediting rates to the same 30-year rate the law requires for discounting future benefits into present value lump sums. When the same rate is used to project the balance forward and discount it back, the whipsaw effect is avoided. Unfortunately, this compliance technique — necessitated by litigation against only a few companies — means employees in cash balance plans often earn *lower* rates of interest on their accounts than would otherwise be the case. The unanticipated liabilities and design restrictions imposed by the whipsaw cases are yet another deterrent to employers to sponsor or maintain hybrid defined benefit plans and directly harms participants.

The Treasury Department included a proposed resolution of the whipsaw problem in the legislative recommendations it issued in February 2004, providing that a cash



SOURCE: Richard W. Johnson and Cori E. Uccello, "Can Cash Balance Pension Plans Improve Retirement Security for Today's Workers?", Urban Institute Brief Series No. 14, page 4 (November 2002).

balance plan may distribute an employee's account balance as a lump sum as long as the plan does not credit interest in excess of a market rate of return.[24] As with the age discrimination clarification, however, this resolution would be prospective only, meaning it would apply only to benefit accruals after the enactment date of eventual legislation.

Recommended Policy Action:

Legislative or regulatory guidance is needed clarifying that in a cash balance plan, as long as the interest paid on accounts is reasonable, the lump-sum benefit to which employees are entitled at termination of employment is their account balance.

Mandated Choice

Another threat to hybrid plans are legislative proposals (e.g., S. 825, H.R. 1677, H.R. 2101) mandating that employers converting a traditional defined benefit plan to a hybrid pension plan allow employees to choose at the time of conversion (or at retirement) whether they wish to receive the hybrid plan benefit or the benefit provided under the traditional defined benefit plan.

The Treasury Department included similar conversion requirements in its February 2004 legislative recommendations to Congress.[25] Under the Treasury proposal, employers would be required to provide employees with benefits at least as generous as provided under the prior traditional plan for a period of five years following the conversion. Providing choice to employees between the prior and new plans or grandfathering employees in the prior plan would satisfy this requirement.

Our voluntary pension system is premised on the idea embodied in current law that *benefits already earned are absolutely protected* (the "anti-cutback" rule)[26] but employers have

flexibility to adjust to changing circumstances by increasing or decreasing benefits to be earned *in the future*. Moreover, Congress took constructive action in the Economic Growth and Tax Relief Reconciliation Act of 2001 to require employers to provide employees with expanded information about how their retirement benefits will be affected by hybrid plan conversions.

The mandated choice proposals introduced in Congress would prohibit employers that adopt a hybrid pension from ever changing the benefit levels provided to the current employees eligible for the choice. Likewise, the Treasury Department's "hold harmless" approach would delay employers' ability to convert to a hybrid plan for five years after they had concluded this was the right course to take. Changing business circumstances — such as increased international competition, the threat of layoffs or bankruptcy, the need to attract new workers, or employee preference for other benefit programs — can sometimes necessitate adjustments to pension plans.

In *no* other area of the law are employers prevented from altering future employment conditions in such a manner. Such a change would mark a radical departure from the norms of both our pension and general employment laws. If forced to make such unalterable benefit commitments, prudent businesspeople will simply choose to make minimal benefits promises or abandon the voluntary defined benefit system altogether.

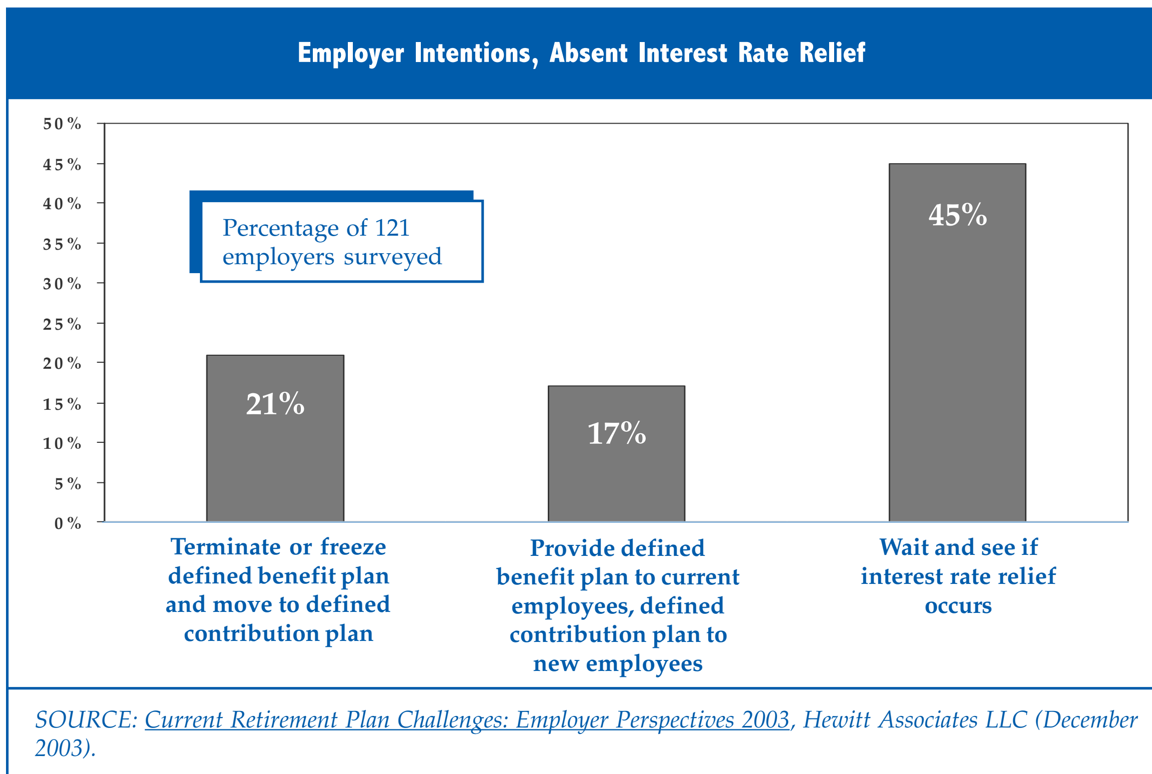
Recommended Policy Action:
Congress should reject mandated choice proposals and similar conversion mandates that will drive employers from the voluntary pension system. The cumulative effect of the various assaults on hybrid plans greatly discourages their use. For many employers, hybrid pensions will deliver the most meaningful retirement benefits to employees. Absent a significant shift in attitude and position by policymakers, the great promise held by these plans will prove illusory.

Threat #2: Failure to Permanently Replace the Obsolete 30-Year Treasury Rate for Pension Calculations

Of the many threats facing the defined benefit system, one of the most pressing is the need for a permanent replacement for the obsolete 30-year Treasury bond interest rate for pension calculations. Until legislation was passed in April 2004, federal law required employers to use the 30-year rate for a variety of pension calculation purposes, including plan liability determinations and funding requirements, and liability for payment of variable pension insurance premiums to the PBGC.

The various provisions of federal law requiring the use of the 30-year Treasury bond rate for pension calculations were enacted in 1987 and 1994 when the market was robust for 30-year Treasury bonds and the yields on those bonds were an acceptable proxy for corporate bonds and other long-term debt instruments.[27]

Beginning in 1998, the U.S. Treasury Department began retiring federal debt by buying back 30-year Treasury bonds. In



SOURCE: Current Retirement Plan Challenges: Employer Perspectives 2003, Hewitt Associates LLC (December 2003).

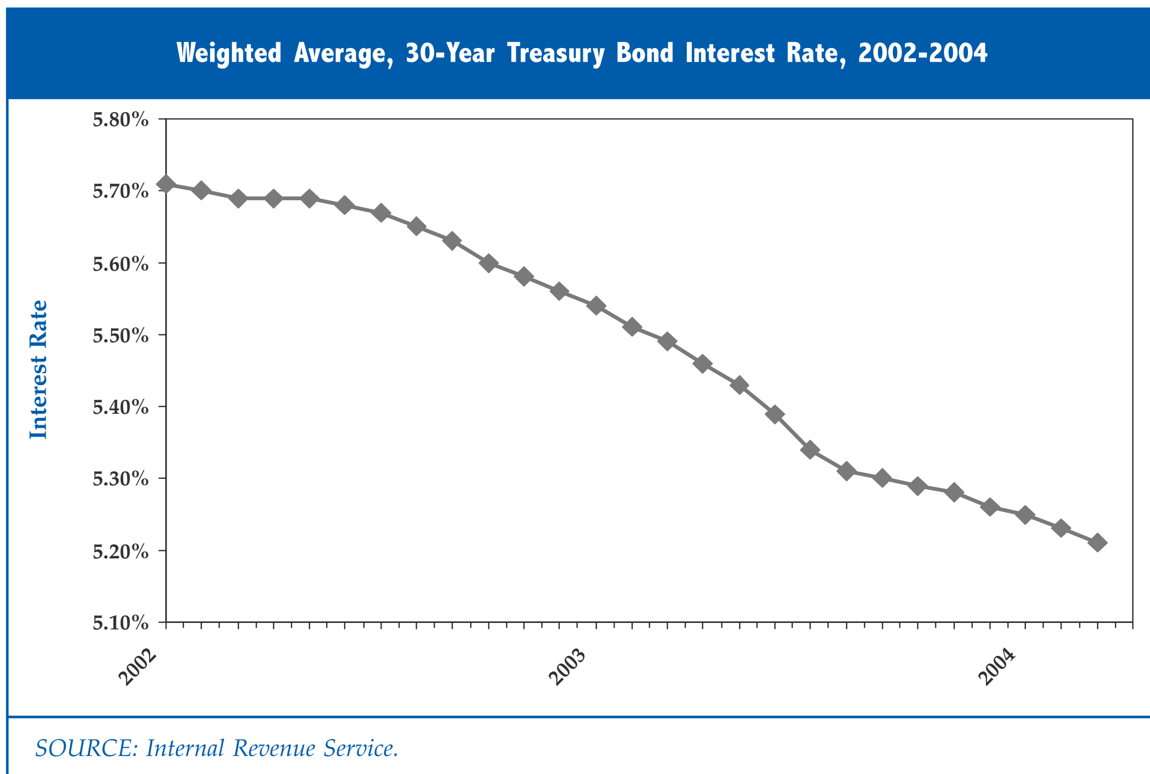
October 2001, the Treasury Department discontinued issuance of 30-year Treasury bonds altogether. With commencement of the buyback program, yields on 30-year Treasury bonds began to drop and to deviate from the rest of the long-term bond market – a divergence that increased precipitously after the October 2001 discontinuation. As a result of the shrinking supply of these bonds (particularly when coupled with continuing demand by worldwide investors for the relative safety of U.S. government debt), the interest rate on existing 30-year Treasury bonds plummeted to historic lows and no longer correlates with the rates on other long-term bonds.

Negative Effects of the 30-Year Treasury Rate on Pension Plans and the Economy

The result of the required use of the 30-year Treasury rate was to artificially but substantially inflate pension liabilities and consequently to increase the pension contributions and insurance premium payments required of employers.

To illustrate, total contributions by Fortune 1000 companies to defined benefit plans averaged $13.7 billion annually between 1999 and 2001. 2002 contributions by these same companies totaled $43.5 billion, and contributions in 2003 and 2004 were projected to be more than $80 billion per year without the temporary correction enacted by Congress. More than half of those 2003 and 2004 projected contributions were attributable to the inflationary effect of the broken 30-year Treasury bond rate rather than representing cash needed to fund promised benefits, and are indicative of the need to fix this interest rate on a permanent basis.[28]

The low 30-year Treasury rate also artificially inflates lump-sum payments from defined benefit plans, which was not addressed in



SOURCE: Internal Revenue Service.

the 2004 law. These inflated amounts result from discounting future lifetime annuity streams into lump-sum present values based on the low 30-year Treasury rate. However, the 30-year rate is lower than any reasonable estimate of what a retiree could actually earn on his money in the intervening years, producing a present value lump sum larger than is needed to fund an annuity of equal economic value.

Because the use of the obsolete 30-year Treasury rate inflates the value of lump-sum payments relative to annuity payments, employees are effectively given an incentive to take the lump sum. Since temporary interest rate relief does not affect the rate used for lump sums, this problem remains as severe as ever. Pension policy should only provide incentives for retirees to receive benefits in a certain form if the policy underlying such an incentive is carefully considered.

Today's incentive to take inflated lump sums represents a case where the mandatory obsolete interest rate — and not good policy — is driving employee decisions. If anything, retirees should be educated regarding the value of annuity benefits, which protect against the risk of outliving one's assets and provide a safety net against spousal poverty.

The inflated funding and PBGC premium requirements caused by the 30-year Treasury rate also harmed the economy as companies were forced to divert resources from investments that create jobs and contribute to economic growth. For example, the Council learned of one company forced to set aside $7.1 millon in anticipation of making a quarterly pension contribution based upon the 30-year Treasury rate that instead, more appropriately, became $200,000 following calculations using the corporate bond rate. For other companies, these artificially inflated financial obligations contributed to

decisions to impose hiring freezes or even to lay off workers.

Permanent replacement of the 30-year rate is critical if employers are to create new jobs and help grow the economy.

Moreover, financial analysts and markets have penalized companies with defined benefit pension plans because of the unpredictable future pension liabilities that result from uncertainty as to what will permanently replace the obsolete 30-year Treasury bond rate. The resulting pressure on credit ratings and drag on stock prices, which harm not only the company but also its shareholders, is a further impediment to strong economic growth. Permanent replacement of the 30-year rate is critical if employers are to create new jobs and help grow the economy.

Temporary Adjustments to the 30-Year Treasury Rate

Passage in April 2004 of a temporary corporate long-term bond rate replacement for the 30-year Treasury rate for plan funding purposes and for calculation of PBGC premiums has brought some interim relief for employers. The law follows enactment of the March 2002 economic stimulus act, in which Congress provided a temporary upward adjustment to the 30-year Treasury rate for plan funding and PBGC premium purposes that helped to alleviate some of the negative effects of the obsolete rate. Congress, however, had allowed the economic stimulus act reform rate to expire at the end of 2003 necessitating emergency legislation.

Congress' failure to permanently replace the 30-year rate leaves employer sponsors of defined benefit plans facing yet another short respite from unfairly inflated pension obligations. The pending cash calls and the absence of a permanent replacement rate only contribute to the already significant increase in plan freeze activity.

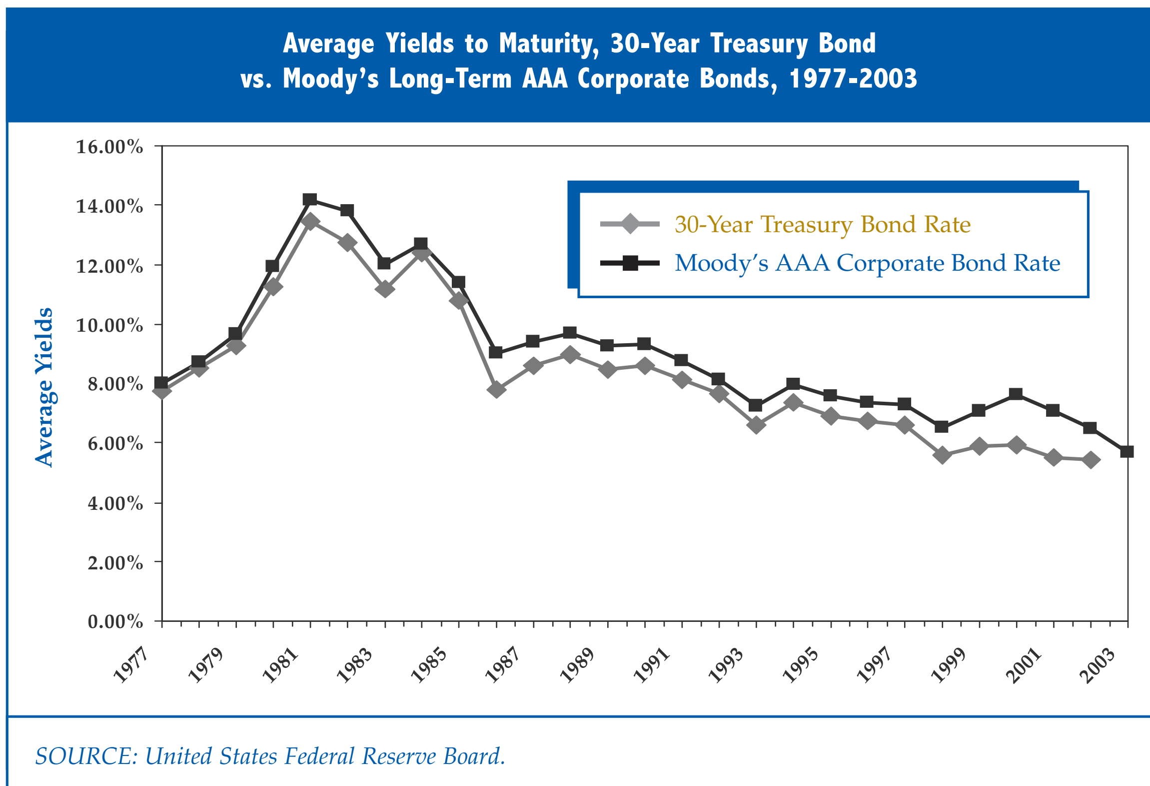
Use of a Corporate Bond Rate to Permanently Replace the 30-Year Treasury Rate

Certainly, Congress is to be commended for replacing the 30-year Treasury rate for 2004 and 2005 with a rate based on a blend of high-quality corporate bond indices (a "corporate bond rate").[29] High-quality corporate bond rates are known and understood in the marketplace and are not subject to manipulation. These rates steer a conservative middle course between the rates of return actually earned by ongoing plans and the rates earned by the insurers that underwrite the annuities of terminating plans.

Replacement by a corporate bond rate on a permanent basis would ensure plans are funded responsibly, and the strict funding requirements Congress adopted in 1987 and 1994 — quarterly contributions and deficit reduction contributions — would continue to apply. Permanent replacement by a corporate bond rate has the support of pension stakeholders from across the ideological spectrum, from business to organized labor.[30]

Companies that sponsor defined benefit plans need to be able to plan for future pension costs – a task that can be challenging under the best of circumstances, but which is

Average Yields to Maturity, 30-Year Treasury Bond vs. Moody's Long-Term AAA Corporate Bonds, 1977-2003



SOURCE: United States Federal Reserve Board.

completely impossible when the rate used to measure those costs is not known for more than two years out.

Failure to fix the problem on a permanent basis also runs the risk of reverting back to the obsolete 30-year Treasury rate simply because Congress is unable to resolve the issues surrounding a permanent solution before the temporary replacement expires – precisely what happened this year, requiring emergency temporary legislation.

In addressing the 30-year Treasury rate problem permanently, it is also important that the same replacement rate be used for calculating pension funding obligations and lump-sum payments. The April 2004 law does not do this. Proposals to use a different (and typically lower) interest rate for lump-sum purposes create a permanent financial imbalance between contributions made to the plan (based on the higher rate) and benefits actually distributed from the plan (based on the lower rate). They also continue to reward today's retirees (who choose inflated lump sums) at the expense of tomorrow's retirees since the drain of funds from the plan can necessitate benefit reductions or plan freezes.

Moreover, use of a different and lower interest rate for lump-sum calculations continues to prompt retirees to take their benefits in lump-sum form, resulting in a lack of resources late in retirement as well as negative implications for surviving spouses.[31] This mismatch of interest rates creates distortions in our pension rules, and indeed aggravates (rather than ameliorates) the policy problems that exist today.

Recommended Policy Action:

Congress is to be commended for enacting the temporary corporate bond replacement rate as it is the best short-term solution to the difficulties described above. Employers,

however, need longer-term certainty to make forward-looking business decisions based upon how pension liabilities will be valued in the future. The Council urges Congress to make the corporate bond rate the permanent solution and to do so quickly.[32]

Yield Curve Proposals

Others however — including officials at the Treasury Department — have put forward permanent proposals that would utilize a so-called "yield curve" concept in place of the 30-year Treasury rate, following the current brief transition period using the corporate bond rate.[33] This yield curve proposal raises serious technical and policy questions.

While the Bush Administration has yet to issue a developed yield curve proposal, it would likely involve a significant change to a regime under which the interest rates used for measuring pension liabilities would vary with the schedule and duration of payments due to each participant in each pension plan.

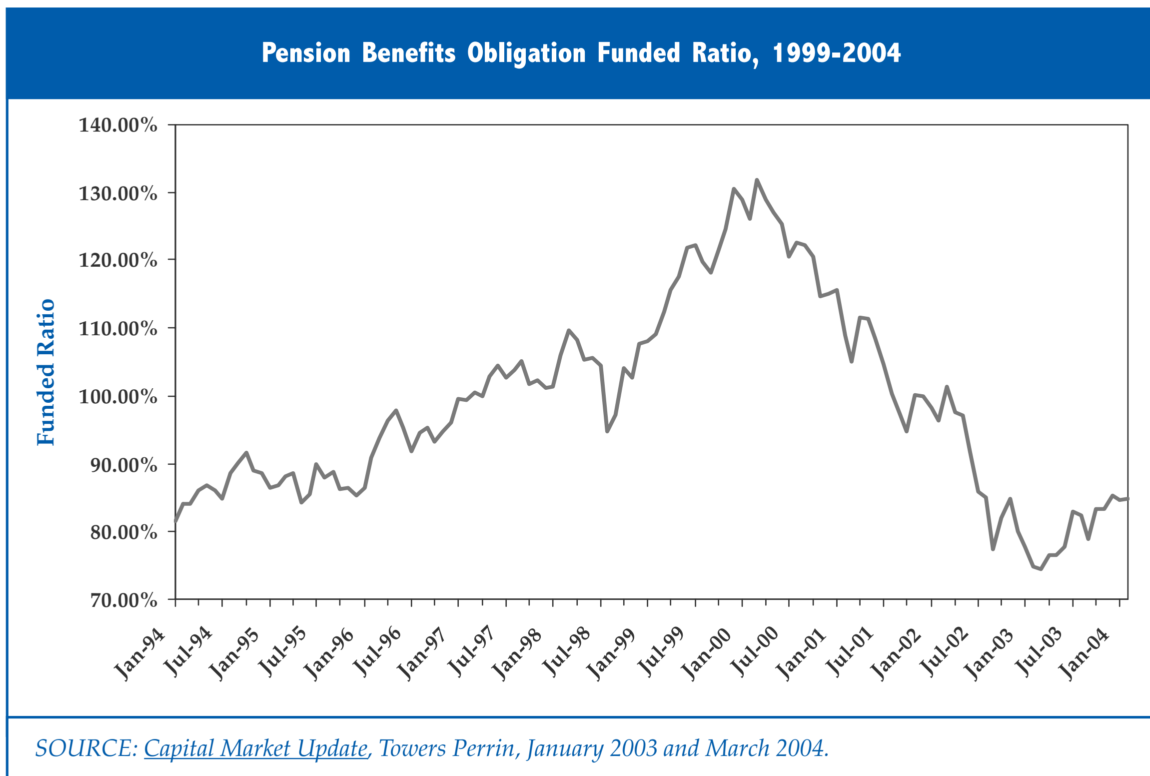
Current rules allowing employers to use the average of the relevant interest rate over four years would also be repealed, adding volatility in funding calculations from year to year. In addition, important flexibility would be lost by removing the corridor surrounding the computed interest rate (historically 90 percent to 105 percent of the averaged rate). These changes would greatly exacerbate volatility and complexity in pension funding, two of the main problems already plaguing the system, all for what might only be a marginal increase in accuracy.

The yield curve proposal also raises a series of unanswered questions. For example, it is unclear how such a concept would apply to issues such as the calculation of lump sums, the valuation of contingent forms of distribution, the payment of interest credits under hybrid pension plans, and the calculation of PBGC insurance premium obligations. The yield curve approach would also compel pension plans to shift assets out of equities and into bonds. Two primary factors in determining a plan's funding obligation are the interest rate used to calculate plan liabilities and the assets of the plan set aside to meet those liabilities.

Because the yield curve will increase interest rate volatility (by eliminating interest rate averaging and shifting to a spot rate), as many as one-third of large U.S. employers will likely seek to ameliorate the resulting funding volatility by making significant moves to more conservative investments (e.g., in bonds) that reduce volatility on the asset side of the equation.[34] Such moves would result in higher costs for pension plan sponsors because equities have historically outperformed other asset classes over the long term. The repercussions of this seismic pension asset shift on other market participants (including the Baby Boom investors now approaching retirement age) have simply not been analyzed.

Recommended Policy Action:

The yield curve should not be adopted, particularly in light of the many unanswered questions about the approach and the incomplete analysis of its ramifications on funding volatility and asset allocation. Congress should instead adopt a corporate bond rate as the permanent measure for valuing pension liabilities.



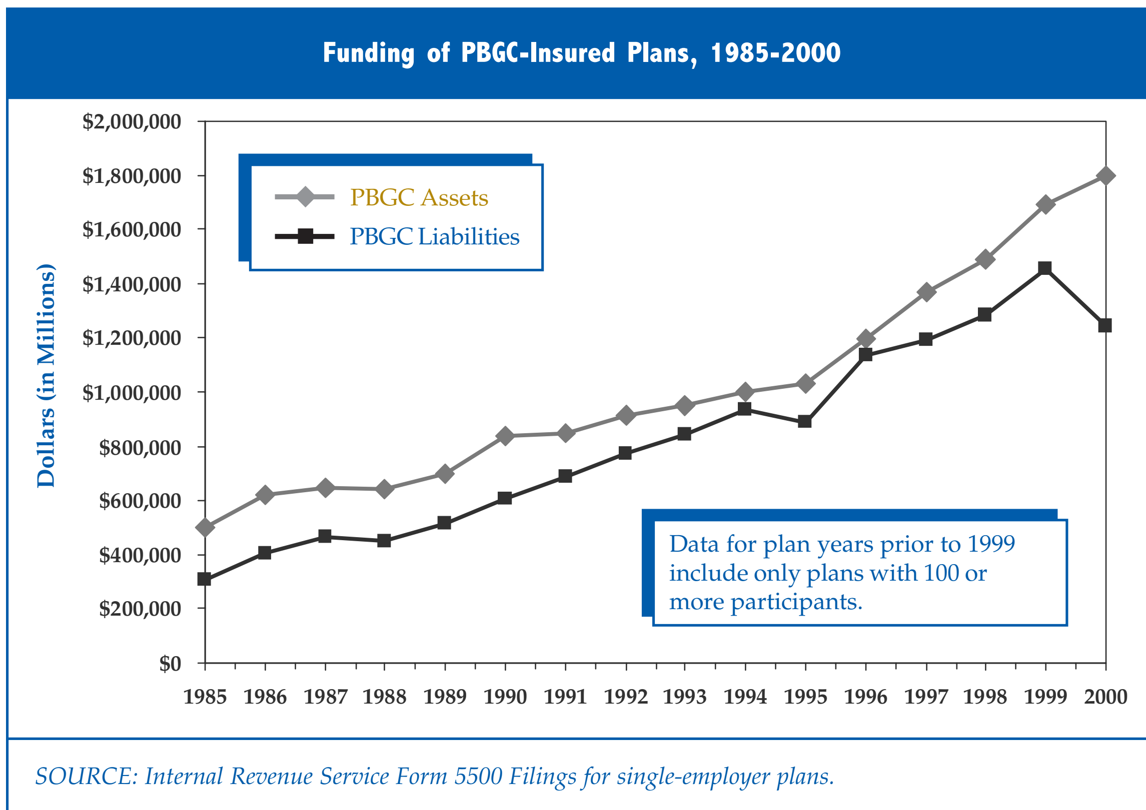
SOURCE: Capital Market Update, Towers Perrin, January 2003 and March 2004.

Threat #3: A Flawed Pension Funding Regime and Flawed Proposals for Funding Reform

Largely as a result of the unique combination of historically depressed asset values and historically low interest rates (exacerbated by the required use of the obsolete 30-year Treasury bond rate), the funded status of today's pension plans can appear bleak.[35] Historically depressed asset values and interest rates are not the only reason for the swing from the abundant pension funding levels of the 1990s to today's increasing pension deficits, however. Another significant cause is the counter-productive changes to pension funding rules adopted over the last few decades.

Since the enactment of the basic pension funding rules in the Employee Retirement Income Security Act (ERISA) of 1974, Congress has alternated between strengthening the pension plan system and weakening it by limiting tax-deductible pension contributions. By way of example, beginning in 1986, Congress enacted short-sighted, revenue-driven restrictions that lowered the maximum tax-deductible contribution, imposed a significant excise tax on contributions that were not tax-deductible, and placed heavy penalties on employer withdrawals of surplus assets. Each of these actions served to discourage employers from contributing to their pension plans.[36]

Although some limited relief from these restrictions has been provided since 1997, the current pension funding rules strongly encourage employers to keep their plans as near as possible to the minimum funding level instead of providing a healthy financial cushion above that level. These rules severely limit the ability of companies to fund their



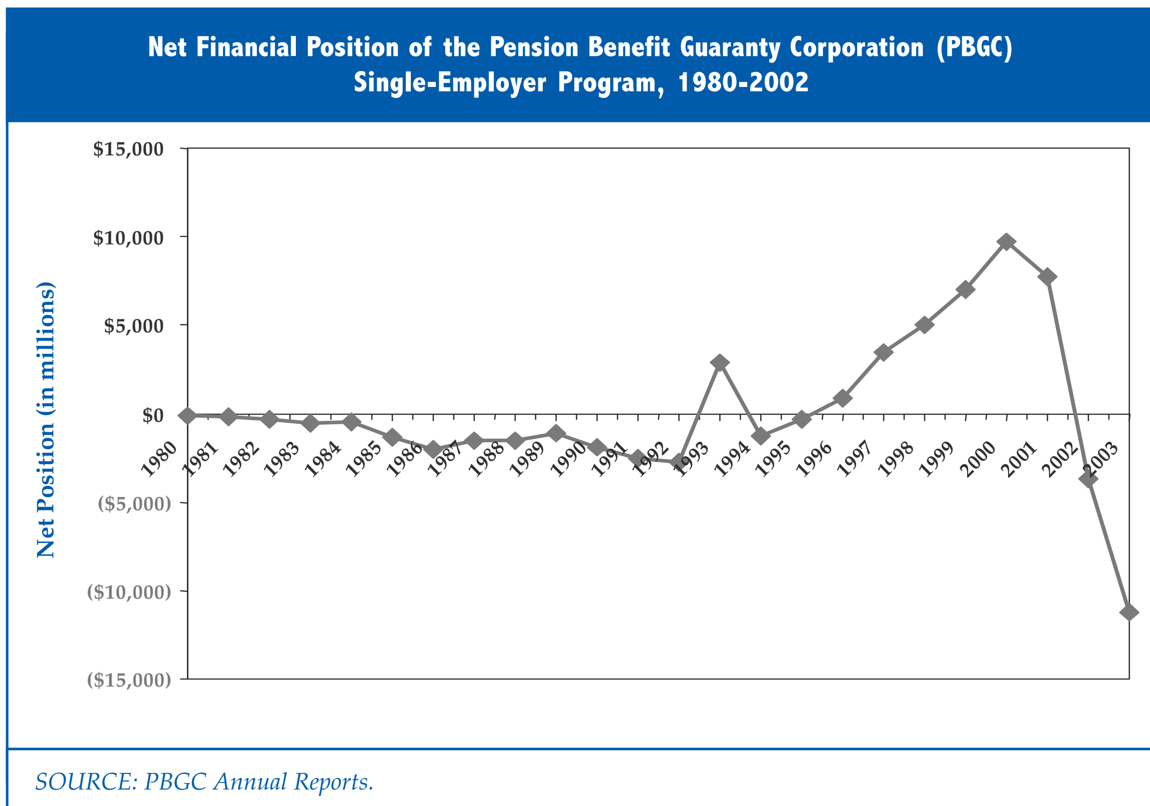
plans during good economic times, while requiring additional contributions during difficult economic times — an unwelcome result from a business planning perspective and one that discourages companies from sponsoring defined benefit plans.[37]

Financial Status of the PBGC

Because of fears about the overall funded status of defined benefit plans, some have raised concerns about the PBGC taking over more plans and the effect this could have on the agency's financial condition. The PBGC has moved from a net surplus to a net deficit in recent years. However, the long-term financial position of the PBGC is strong.

While the PBGC's deficit is a serious matter, the agency is likely to move through numerous surpluses and deficits resulting from changing economic circumstances over the period of decades that the agency will pay promised benefits to retirees whose plans it takes over. In fact, the gravest long-term threat to the fiscal integrity of the agency is not that the agency's deficit grew substantially from 2002 to 2003. Rather, the most significant threat is the declining number of defined benefit plans that support the overall pension system and that pay premiums to maintain the PBGC insurance guarantee mechanism. Consequently, one of the most important steps to improve the long-term health of the PBGC is to resist policies that will accelerate the pension system's current decline and, rather, to adopt policies that permit the system to flourish.

Today, the PBGC holds total assets of approximately $35 billion,[38] and it earns money from investing those assets. While the PBGC currently reports liabilities of approximately $46.5 billion,[39] the annuity pension obligations underlying those



SOURCE: PBGC Annual Reports.

liabilities come due over many decades, during which time the PBGC can be expected to experience investment gains to offset any "paper" deficit that exists today. Moreover, the PBGC's liability projections are overly pessimistic and make liabilities appear larger than they actually are. The projected liability figures, in particular, are based on a flawed interest rate methodology and unrealistic mortality assumptions, and include plans not taken over by the PBGC.

When the PBGC takes over a plan, it assumes all of the plan's assets, but not all of its liabilities. Instead, the PBGC insures a maximum guaranteed benefit for each participant ($44,386 at age 65 for 2004). While this limits the benefits of some pensioners, it also serves to limit the maximum exposure of the PBGC.

The substantial assets the PBGC holds ensure that the agency will remain solvent far into the future.

In times of economic hardship, more pension plans (and the companies that sponsor them) confront economic difficulty (including bankruptcy), more pension plans suffer declines in asset values, and more pension liabilities are assumed by the PBGC. At the same time, the PBGC may experience sub-par investment gains on its assets. As the economy improves, this cycle reverses itself, helping to return the PBGC to robust financial health.

The substantial assets the PBGC holds — and the relatively modest size of its deficit when viewed in the context of the economic cycle and its capped and long-term liabilities —

ensure the PBGC will remain solvent far into the future – a point the PBGC itself has acknowledged repeatedly.[40]

Funding-Related Proposals

In response to the funding shortfalls some plans face, federal policymakers have put forward proposals that, while well-intentioned, could actually aggravate the decline in defined benefit plan sponsorship. For example, the Department of Labor proposed two different disclosure proposals that would:

- Require plans to disclose their assets and liabilities on a termination basis (in addition to making such disclosures on a current liability basis)
- Provide for publication of certain information that today is provided on a strictly confidential basis to the PBGC whenever a plan is underfunded by more than $50 million.

Misleading disclosures could unnecessarily and falsely alarm employees, financial markets, and share-holders.

The first disclosure proposal would offer a misleading picture of pension plan finances for ongoing, adequately funded plans because these plans are not in any danger of terminating with unfunded liabilities.[41] The second proposal would disseminate private corporate data and also mislead the public. Plan participants would likely be alarmed to know their employer filed the required information with the PBGC. However, for many pension plans with billions of dollars in assets and obligations, $50 million in underfunding is quite normal and certainly no cause for alarm. Many of these plans remain extremely well-funded on a percentage basis. Such misleading disclosures could unnecessarily and falsely alarm employees, financial markets, and shareholders.

The Bush Administration has also proposed freezing private-sector pension plans and removing the lump-sum rights of employees when a company reaches a certain level of underfunding and receives a below investment grade credit rating.[42] While it is appropriate for the Administration to have concerns about PBGC guarantees of benefit promises made by financially troubled companies (and indeed the Council shares such concerns), this specific proposal raises technical and policy issues that require further examination.

For example, the Administration's proposal does not indicate who would determine the company's credit rating. Policymakers should carefully consider, in addition, whether it is appropriate to mandate a cutback in participants' benefits based on a credit rating determination or whether employees should lose their rights to certain forms of benefit when their company experiences financial trouble.

The Bush Administration is currently formulating additional reforms to the pension funding rules and indeed indicated it is pursuing a fundamental restructuring of the entire pension funding regime. The Council

provided input into this process and hopes to work collaboratively with the Administration to produce a less volatile, more rational and more flexible funding system.

We sincerely hope that, considering the problems inherent in the yield curve, disclosure and underfunded plan proposals, the Administration does not propose a funding regime that will instead increase volatility, impair flexibility and push employers to end their defined benefit programs for employees.

Recommended Policy Action

The complex nature of the pension funding rules, and the potential for unintended negative consequences from policy changes, require that any reforms to these rules be considered in a thoughtful and deliberative manner.

As Congress addresses these broader funding questions, it should focus on constructive reforms to the current funding rules to encourage more employers to sponsor defined benefit plans. For example, pension funding volatility could be reduced by allowing for more regular and predictable contributions regardless of the funded status of the plan.

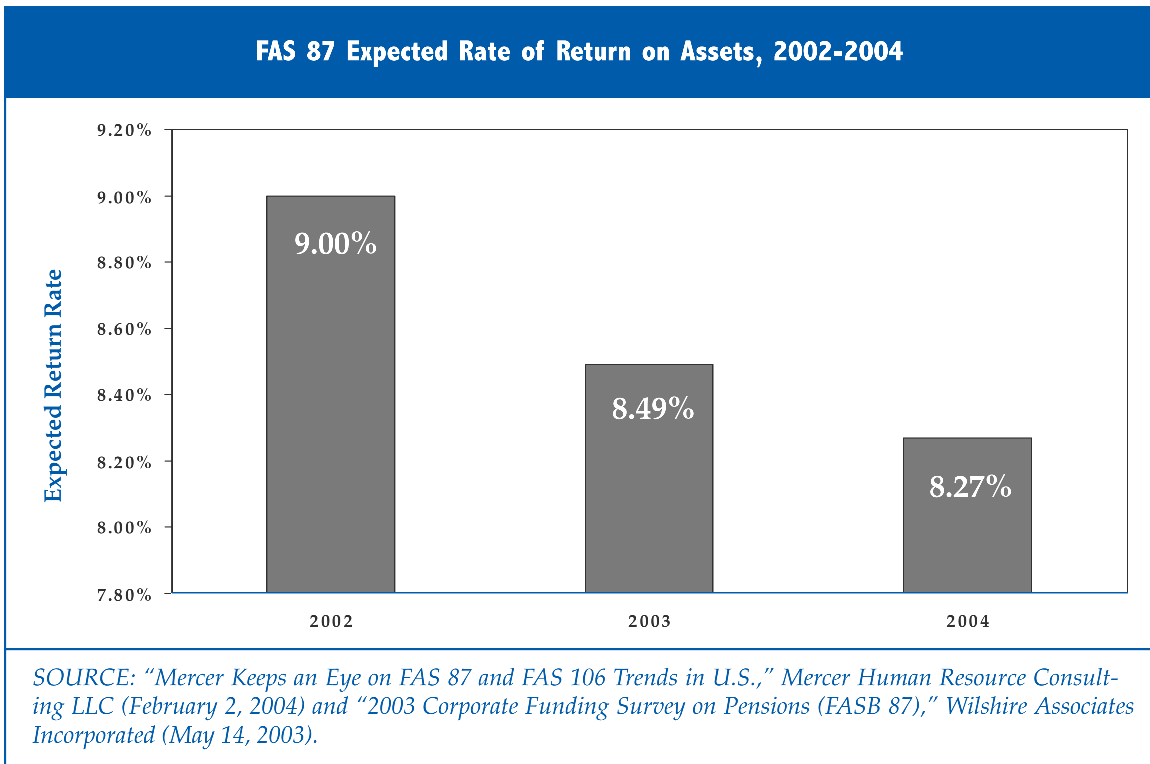
Similarly, significant improvements could be made to current rules that disallow employer deductions for defined benefit plan contributions when plans are reasonably well-funded. Moreover, the pension funding regime should be restructured so it still achieves the underlying goal of ensuring that plans are well-funded, but in a less punitive manner.

Threat #4: The Movement to Impose Snapshot Accounting Standards

The current rules governing accounting for pension income and expenses are under review by the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB).[43] One area of interest is the smoothing of pension asset gains and losses over time, with some critics of the current rules advocating for immediate recognition of asset and liability experience. Changes to the current accounting rules for pensions present another serious threat to the continued sponsorship of defined benefit plans.

Changes to the current accounting rules for pensions present yet another serious threat to the continued sponsorship of defined benefit plans.

The current accounting rules for pension gains and losses are grounded in Statement of Financial Accounting Standards No. 87 (FAS 87), which FASB adopted in 1985. FAS 87 requires employers to allocate the cost of future retirement obligations over the working lifetime of employees in a reasonable manner. The purpose of FAS 87 is to recognize the long-term nature of the compensation cost of a pension over the employee's period of service. FAS 87 requires plan sponsors to make a reasonable current estimate of pension costs. These are estimates because the actual



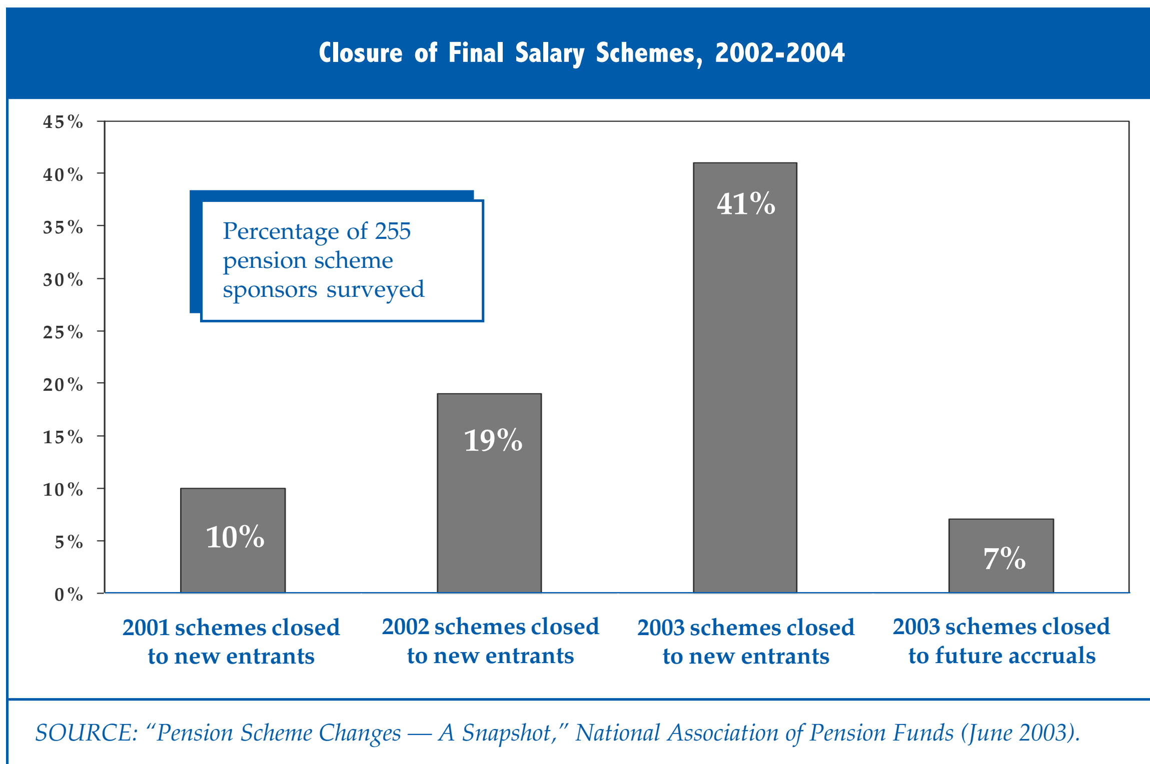
SOURCE: "Mercer Keeps an Eye on FAS 87 and FAS 106 Trends in U.S.," Mercer Human Resource Consulting LLC (February 2, 2004) and "2003 Corporate Funding Survey on Pensions (FASB 87)," Wilshire Associates Incorporated (May 14, 2003).

pension payments may not be incurred for decades into the future. Employees may work for 20 or 30 years into the future and then receive payments over an additional 20 to 30 years. In the process of making this cost estimate, pension asset investment performance is taken into account by using an estimate of expected earnings.

FAS 87 does not require a specific expected rate of return to be used. Rather, plan sponsors can determine a reasonable estimate in part based on historical performance and the plan's investment strategy. A plan funding survey found the average expected rate of return on assets that employers intended to use in 2004 was 8.27 percent.[44] This estimate represents the expected long-term rate of return on the portfolio, i.e., it is not meant to be the expected return for the current year. Differences between the expected rate of return and the actual returns experienced by the plan are then spread over average future years of employee service.

Some critics of the current pension accounting rules claim the use of these smoothing techniques and an expected rate of return unfairly report pension income (or a lowered pension expense) at a time when asset values have actually declined. They argue companies should be required to immediately recognize pension asset and liability experience on financial statements (a so-called "mark-to-market" approach).

Indeed, IASB is reported to be considering the prohibition of smoothing techniques for pension accounting purposes. Yet shifting to an approach that immediately recognizes pension asset gains and losses would dramatically increase the volatility of pension expense (presuming plans continue to have substantial investments in equities). The use of an average expected rate of return, reflecting all market outcomes, does not mean that actual investment returns are ignored; differences in the expected and actual experience are fully recognized, but over time.



SOURCE: "Pension Scheme Changes — A Snapshot," National Association of Pension Funds (June 2003).

Current expected rates of return reflect all possible outcomes, including the bull markets of the 1990s and the more recent bear markets.

Similarly, the assumed rates of return used for pension plans in the 1990s did not reflect the huge returns pension assets were actually getting at that time, and these gains could only be recognized over time as is the case with the losses of more recent years. The smoothing approaches currently permitted by FAS 87 merely remove some of the unpredictable volatility that occurs on the path to funding any long-term promise.

Foreign pension plan sponsors have already reacted negatively to the "mark-to-market" approach. The accounting standard-setting body in the United Kingdom adopted Financial Reporting Standard 17 (FRS 17), which follows this approach. All U.K. companies were initially to comply by June 2003, but the compliance deadline was extended until 2005 during which time considerable debate is taking place over the prudence of the FRS 17 approach. In a recent survey by the National Association of Pension Funds, a British trade group, 86 percent of British pension sponsors surveyed indicated the imposition of FRS 17 would make the offering of pension plans less attractive.[45]

Another effect of the mark-to-market approach is to cause employers to seek to reduce volatility by investing more heavily in bonds and reducing their exposure to stocks.[46] Such a shift in investment strategy could have profound and destabilizing effects on the financial markets, as 45 percent of responding large U.S. employers indicated in a recent Committee on Investment of Employee Benefit Assets survey that they would make significant changes from long-term equities to long-term bonds and a corresponding reduction in benefits to participants based upon this issue alone.[47]

While FASB has not moved toward a mark-to-market approach at this time, it has decided to begin discussions with IASB on pension accounting.[48] Moreover, FASB has announced plans to work closely with IASB to harmonize accounting regimes generally.[49] There remains a distinct possibility of a change to mark-to-market accounting by FASB in the future. If such an approach is adopted in the U.S., the British experience is likely to be replicated and many companies may be similarly forced to consider abandoning their defined benefit pension programs.

Recommended Policy Action:
Enhanced disclosure regarding the financial repercussions of pension sponsorship is appropriate to ensure shareholders have the information they need. However, because of the adverse effect mark-to-market accounting would have on defined benefit plan sponsorship, accounting standard setters should be extremely cautious when evaluating this approach and should recognize that adoption of a mark-to-market standard could lead to a reduction in the pension promises made by employers to better insulate themselves from the volatility injected into pension funding, or possibly a wholesale abandonment of defined benefit plans.

Conclusion

For over half a century, defined benefit pension plans have been a cornerstone of our private retirement system and have been invaluable to employees, employers and our national economy. For employees and their families, they have been the vehicles for retirements of security and dignity — regardless of the ability of that family to save individually for their future. For employers, they have been the key to a motivated workforce. And for our economy, they have been engines of investment capital and economic growth.

Today, however, the members of the American Benefits Council and other employers that sponsor these plans stand at a precipice. Pushing them ever closer to the edge, toward outright abandonment of these defined benefit programs, is a uniquely hostile policy and legal environment. Threats come from all directions — legal and congressional assaults on hybrid plan designs, the likely return of inflated funding requirements caused by the failure to permanently replace an obsolete interest rate, the prospect of even greater and more volatile funding mandates resulting from adoption of an untested yield curve regime, and pension accounting standards that will produce untenable volatility in corporate earnings.

For over half a century, defined benefit plans have been a corner-stone of our private retirement system.

Without immediate action by policymakers to chart a different and more supportive course — through adoption of the Council's recommended policy actions — American companies and their employees will be flung into the culvert where defined benefit plans simply are no more. With adoption of our recommendations, however, employers will find an altogether different landscape and will be able to back away from the pension precipice they currently face.

Picture the scene. Our CEO assembles her team to brief her – senior executives from the company's finance, government affairs, legal, and accounting departments and the firm's outside counsel, auditors and benefits consultants. The members of the team speak in turn.

On the legal front, the general counsel reports the Treasury Department issued final regulations on age discrimination and pension design, greatly alleviating the risk of a class action lawsuit challenging the legality of the company's cash balance plan. And outside counsel notes Treasury has also remedied the problematic whipsaw legal theory that contributed to the retroactive pension awards in a number of the class-action cases.

The vice president of government affairs reports Congress enacted a corporate bond rate to permanently replace the obsolete 30-year Treasury rate.

The chief financial officer and outside actuary tell her this will remove the artificial increase in required pension contributions experienced over the last several years. The CFO also notes this will provide the predictability regarding funding requirements that Wall Street analysts have been seeking and should lead to a rebound in the company's stock price. He also mentions this correction of the artificial funding requirements will likely allow the company to proceed with construction of its new production facility and the hiring of new workers that will follow.

The government affairs VP goes on to report that the yield curve concept was rejected by Congress as creating untenable volatility, and that policymakers are, in fact, considering reforms to the funding rules that would encourage the company to build a healthy financial cushion in its plan against future market and interest rate downturns.

Finally, the chief accounting officer and outside auditor tell the CEO that FASB rejected a mark-to-market accounting standard in light of the devastating effects on pensions that followed adoption of such a standard in Great Britain.

Heartened by these reports, the CEO is hopeful that past discussions by the board to freeze the company's pension plans can be set aside, allowing the company's 37,000 employees to continue to build employer-funded, government-insured pension benefits. She goes around the room and asks her senior team whether the company should consider a freeze.

With relief from many of the threats to defined benefit plans now in place and additional policy assistance from policymakers a distinct possibility, each agrees a freeze is not necessary. The CEO resolves this is the recommendation she will take to the board of directors: the company should preserve its defined benefit pension plans.

Notes

[1] The Organization for Economic Cooperation and Development. *Main Economic Indicators* (Paris: OECD, January 2004).

[2] The average monthly pension payment for retirees over 65 is $781 ($9,372 annually). On average, younger retirees receive higher pension incomes with an average monthly pension of $1,281 ($15,372 annually) for retirees age 55-64, and an average monthly pension of $920 ($11,040 annually) for all retirees over age 55. See Jim Jaffe, Employee Benefit Research Institute, EBRI Notes, "Will Today's Workers Retire With Adequate Income? How Are Today's Retirees Surviving From a Financial Perspective?", Page 1, April 2003. Moreover, income from pensions and annuities has accounted for an increasing share of elderly Americans' income in recent years. In 1974, these sources accounted for 14 percent of the elderly's income; by 2000, the percentage increased to over 19 percent. Employee Benefit Research Institute, *Employee Benefits Databook*, Table 7.5, 4th edition revised June 2002.

[3] U.S. Census Bureau, *Statistical Abstract of the United States: 2002*, No. 524 (Source: U.S. Department of Labor, Pension and Welfare Benefits Administration, *Private Pension Plan Bulletin*, Number 10 winter 2001, and unpublished data).

[4] Joint Committee on Taxation, Present Law and Background Relating to the Funding Rules for Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation, JCX – 39-03, April 29, 2003, Page 49.

[5] *Flow of Funds Accounts of the United States*, Board of Governors of the Federal Reserve System, June 5, 2003, Page 103; U.S. Census Bureau, *Statistical Abstract of the United States: 2002*, Page 732, Table 1173.

[6] *PBGC Pension Insurance Data Book 2002*, Pages 44, 72. According to the most recent Department of Labor statistics available, the total number of defined benefit plans has decreased from a high of 170,102 in 1985 to about 56,405 in 1998. *Private Pension Plan Bulletin*, Abstract of 1998 Form 5500 Annual Reports, U.S. Department of Labor, Number 11, Winter 2001-2002, Table E1.

[7] *PBGC Pension Insurance Data Book 2002*, Page 44, 72.

[8] The Council believes it would be very useful to federal policymakers and pension system stakeholders to have official information and data available on defined benefit plan freezes, and strongly encourages the federal government to begin collecting such information. See 12/27/03 Letter from Barbara Bovbjerg, General Accounting Office, to the Honorable Earl Pomeroy, U.S. House of Representatives, Private Pensions: Timely and Accurate Information is Needed to Identify and Track Frozen Defined Benefit Plans, GAO-04-200R Private Pensions.

[9] See Eric Hazard, "Sears Unwraps Compensation Changes," PLANSPONSOR.com (1/29/04) (reporting on pension changes at Sears in which all employees under age 40 will be moved out of the company's defined benefit plan); Jeff Bliss, "House Passes Temporary Cut in Pension Funding Requirements", *Chicago Sun-Times* (10/9/03) (reporting on pension freezes at Rockwell Collins, Inc. and Avaya Inc.); Eric Hazard, "Rockwell Collins Amends Pension Plan", PLANSPONSOR.com (8/8/03); Reuters News Service, "Avaya to Freeze U.S. Salaried Pension Accruals", (9/12/03). In addition, a recent study by Aon Consulting of more than 1,000 private-sector defined benefit plan sponsors found that 23 percent have frozen the plans or are actively considering a freeze. Perhaps most alarming, 15 percent of plans have taken action to freeze benefits since the beginning of 2001, with most of the freezes (13 percent of the 15 percent) already in effect. Moreover, an additional 6 percent of plans stated that they were actively considering a freeze. (An additional 2 percent of plans instituted a freeze prior to 2001.) See Aon Consulting Alert, "More Than 20% of Surveyed Plan Sponsors Froze Plan Benefits or Will Do So" (October 22, 2003). See also *Survey Findings – Current Retirement Plan Challenges: Employer Perspectives 2003*, Hewitt Associates LLC (December 2003).

[10] *Private Pension Plan Bulletin*, Abstract of 1998 Form 5500 Annual Reports, U.S. Department of Labor, Number 11, Winter 2001-2002, Table E1.

[11] Richard W. Johnson and Cori E. Uccello, "Can Cash Balance Pension Plans Improve Retirement Security for Today's Workers?", Urban Institute Brief Series Number 14, Page 6 (November 2002).

[12] In a typical cash balance plan, employers contribute a percentage of the employee's pay each year into a notional account (a "pay credit") and the funds in the account are credited with a rate of interest spelled out in the plan (an "interest credit"). The ultimate benefit paid to the employee is the sum of the compounded pay and interest credits earned during the employee's service. In a typical pension equity plan, employers credit employees with a percentage of their pay and these credits often increase with the age or service of the worker. To determine the ultimate benefit, total credits earned by the employee are multiplied by his or her final pay.

[13] *PBGC Pension Insurance Data Book 2002*, Pages 5-6.

[14] Watson Wyatt studied 55 of the known 80 large companies that converted to cash balance or pension equity plans after 1999. Studied companies saw post-conversion costs increase by an average of 2.2 percent including protections for workers during the conversions and 401(k) plan enhancements. Were seven companies near or in bankruptcy in that period not included in the study the average cost increase would have been 5.9 percent. Janemarie Mulvey, et al, "Hybrid Pension Conversions Post-1999: Meeting the Needs of a Mobile Workforce", Watson Wyatt Worldwide Research Report (March 2004).

[15] Instead, a study shows that the most important factors are (1) improving employee appreciation of the pension plan, (2) improving communication about the plan, and (3) being able to show benefits in a lump sum format. Kyle N. Brown, et al, "The Unfolding of a Predictable Surprise: A Comprehensive Analysis of the Shift from Traditional Pensions to Hybrid Plans", Watson Wyatt Worldwide Research Report, Page 18 (2000). Conversions to hybrid plans are often accompanied by improvements to other benefit programs (e.g., 401(k) plans, bonuses) and when these are taken into account, costs were projected to be the same or greater in 67 percent of cases. PriceWaterhouseCoopers, "A Survey of Conversions from Traditional Pension Plans to Cash Balance Plans: July 2000," Page 58 (2000). This was confirmed by Watson Wyatt's "Hybrid Pension Conversions Post-1999: Meeting the Needs of a Mobile Workforce", Watson Wyatt Worldwide Research Report (March 2004).

[16] See Phillip C. Copeland and Julia Lynn Coronado, "Cash Balance Plan Conversions and the New Economy," Page 3, Federal Reserve Board of Governors (October 2003) ("Cash balance conversions have not reduced overall benefit generosity at the firm level, although some redistribution may be occurring among individual employees . . . [T]hese conversions have generally been undertaken in competitive industries that are characterized by tight and highly mobile labor markets. Since mobile workers benefit most from such conversions, we conclude that this trend may have positive implications for the eventual retirement wealth of participants.")

[17] Most of the 11 percent of companies not supplying special transition benefits for workers were in severe financial distress at the time of the plan's conversion.

[18] See *Eaton v. Onan Corporation*, 117 F.Supp. 2d 812 (S.D. Ind. 2000); *Campbell v. BankBoston, N.A.* (206 F. Supp. 2d 70 (D. Mass. 2002), aff'd 327 F.3d 1 (1st Cir. 2003)). No court cases in this period addressed the application of the pension age discrimination statute to pension equity plans.

[19] 2003 U.S. Dist. LEXIS 13223 (July 31, 2003). The judge in the *Cooper* case failed even to cite to the other federal cases holding cash balance plans to be age appropriate, one of which comes from within the very same federal circuit.

[20] The legislative history makes clear the intent of Congress was limited to prohibiting the practice of ceasing pension accruals once participants attained a certain age (e.g., normal retirement age). H.R. Conf. Rep. No. 1012, 99th Cong., 2d Sess. at 376-379. The erroneous interpretation of the statute in the *Cooper* decision — that it is age discriminatory to make equal contributions on behalf of participants of different ages — is inconsistent with that legislative history. In fact, an example in the 1986 legislative history clarifies a separate but related pension issue by describing approvingly a type of plan (i.e., a "flat dollar" plan) that would be deemed age discriminatory under the *Cooper* decision. Id. at 381. It makes absolutely no sense that Congress would define as an example of a viable pension design one that would fail the age discrimination prohibition it had just enacted.

[21] Section 205 of the FY2004 Omnibus Appropriations Act (PL 108-199). Section text available at http://www.americanbenefitscouncil.org/documents/112503omni.pdf.

[22] The Bush Administration's Hybrid Plan Legislative Recommendations from the FY2005 Budget released on February 2, 2004, can be found at http://www.americanbenefitscouncil.org/documents/0104fy05section.pdf.

[23] See *Berger v. Xerox*, 338 F.3d 755 (7th Cir. 2003); *Esden v. Bank of Boston*, 299 F.3d 154 (2d Cir. 2000); *Lyons v. Georgia-Pacific Corporation Salaried Employees Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000). See also IRS Notice 96-8, 1996-1 C.B. 359.

[24] The Bush Administration's Hybrid Plan Legislative Recommendations from the FY2005 Budget released on February 2, 2004, can be found at http://www.americanbenefitscouncil.org/documents/0104fy05section.pdf.

[25] Ibid.

[26] See Internal Revenue Code Section 411(d)(6); Employee Retirement Income Security Act, Section 204(g).

[27] Defined benefit plans are generally subject to a two-tiered funding regime. The first tier, applicable to all defined benefit plans, requires plans to contribute an amount that approximates the cost required to fund future benefits. Under the second tier, plans with assets less than projected liabilities are required to make certain additional contributions (i.e., quarterly contributions for plans funded at less than 100 percent of current liability and "deficit reduction" contributions for plans funded at less than 90 percent of current liability). It is this second tier that is dependent on the 30-year Treasury bond rate.

[28] These figures and analysis were prepared by Ken Steiner of Watson Wyatt Worldwide, and are contained in his June 26, 2003, testimony on behalf of the American Benefits Council delivered before the Working Group on Defined Benefit Plan Funding and Discount Rate Issues of the Labor Department's ERISA Advisory Council. See http://www.americanbenefitscouncil.org/documents/steinertestimony.pdf.

[29] The two-year time period was a compromise based on bills previously passed during the 108th Congress. These included two measures passed by the House of Representatives late in 2003 to institute a corporate bond replacement for the next two years. H.R. 3108 was adopted by a vote of 397 to 2 on October 8, 2003. H.R. 3521 was adopted by voice vote on November 20, 2003. On January 28, 2004, the Senate adopted its version of H.R. 3108 (after failing to act on the measure at the end of 2003) quickly in conference and be signed by President Bush. Now known as PL 108-218, the legislation was signed by President Bush on April 10, 2004.

[30] In a letter dated May 9, 2003, from William Samuel, Director, Department of Legislation, AFL-CIO, to House Ways and Means Committee Chairman William Thomas, Mr. Samuel stated, "The AFL-CIO strongly favors a permanent, rather than temporary, replacement rate . . . Specifically, for purposes of calculating a plan's current liability under IRC sec. 412(l), we would support a rate based on a high-quality corporate bond index or composite of indices . . . Similarly, for purposes of measuring a plan's vested benefit obligations to asses variable rate premiums owed to the PBGC, we would support a rate that is equal to 100 percent of the annual rate of the applicable corporate bond index or indices."

[31] Ironically, the AARP, which represents Americans age 50 and older, has resisted any change to the replacement of the obsolete 30-year Treasury rate for lump-sum calculations. See Statement for the Record, Senate Finance Committee hearing on "The Funding Challenge: Keeping Defined Benefit Plans Afloat" (March 11, 2003) ("In short, while it is appropriate to review the use of the 30-year Treasury rate for funding purposes, the use of a . . . 30-year Treasury rate for determining lump sums should be maintained."). The AARP's position is largely responsible for the fact that Congress is unlikely to address this critical lump-sum issue in 2004. Yet failure to replace this rate encourages election of lump sums rather than the annuities that provide lifetime income for the retirees and their spouses that AARP ostensibly represents. Moreover, retirees in their sixties who are taking lump sums today do so to the detriment of workers in their forties and fifties who may well see future benefit reductions because of the drain on plan assets caused by today's inflated lump sums.

[32] Representatives Rob Portman (R-OH) and Ben Cardin (D-MD) included a permanent corporate bond replacement in their Pension Preservation and Savings Expansion Act of 2003, H.R. 1776 (see section 705).

[33] The Senate Finance Committee adopted this approach to 30-year Treasury rate replacement when it reported the National Employee Savings and Trust Equity Guarantee (NESTEG) Act, a pension reform bill, on September 17, 2003.

[34] In the recent *CIEBA Survey on Emerging Issues*, 75 percent of plan sponsors surveyed responded that they are likely to make significant changes to their asset allocations by lowering long-term equity holdings by 15 percent and investing those proceeds in long-term bonds. Of the respondents mentioned, 45 percent responded that adoption of the yield curve proposal would cause them to make this shift. *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*, the Committee on Investment of Employee Benefit Assets of the Association for Financial Professionals (CIEBA of AFP) (March 2004).

[35] By way of example, one report from a national benefits consulting firm found that the pension benefit obligation funded ratio – the ratio of market value of assets to pension benefit obligations for a benchmark plan – reached its lowest point in 13 years in 2003, and has made little improvement since. *Capital Market Update*, Towers Perrin, January 2003 and March 2004.

[36] In another unhelpful development, frequent changes were made throughout the 1980s and early 1990s to the statutes and regulations governing defined benefit plan administration. Congress adopted many of these changes to eliminate isolated or hypothetical abuses attributable to small employer pension plans, but these rules were applied across the board to employers of every size. The result was that defined benefit pension plans became increasingly expensive and complicated to administer and plan design flexibility was impaired. During this same period, Congress repeatedly reduced the benefits that could be earned and paid from defined benefit plans in order to increase federal tax revenues.

[37] To further clarify the effect of these counterproductive legislative changes adopted in the late 1980s and early 1990s, 45 percent of plans had a funded ratio of assets over accrued liabilities of at least 150 percent in 1990 as compared with only 18 percent in 1995. Table 11.2, *EBRI Databook on Employee Benefits*, 1997, 4th Edition, the Employee Benefit Research Institute, Washington, D.C.

[38] PBGC 2003 *Annual Report*, Page 22.

[39] PBGC 2003 *Annual Report*, Page 23.

[40] PBGC *2003 Annual Report*, Page 1.

[41] Moreover, termination calculations are among the most costly and administratively burdensome calculations a plan can be asked to perform.

[42] A brief statement of the Bush Administration's proposal of July 7, 2004, is located at: http://www.americanbenefitscouncil.org/documents/07-03/bush_proposal.pdf.

[43] Separately, FASB recently adopted expanded disclosure requirements regarding pension plan investments, investment strategies and assumptions, benefit obligations and future cash flow repercussions. See FASB Statement No. 132 (Revised 2003), Employers Disclosures about Pensions and Other Postretirement Benefits.

[44] "Mercer Keeps an Eye on FAS 87 and FAS 106 Trends in U.S.," FAS 87 Assumption Survey, Mercer Human Resource Consulting LLC, February 2, 2004. Another plan funding survey found that the median expected rate of return on assets at the end of 2002 was 9.0 percent. "2003 Corporate Funding Survey on Pensions (FAS 87)," Wilshire Associates Incorporated, May 14, 2003.

[45] National Association of Pension Funds, "Twenty-Eighth Annual Survey of Occupational Pension Schemes" (2002).

[46] While other factors also may affect investment decisions, it is noteworthy that a recent official government study of British pension funds found pension funds have more than doubled their fixed-income holdings in the past three years. *Newsdash*, PLANSPONSOR.com (12/24/2003).

[47] "Analysis and Comments on Individual Emerging Pension Initiatives: Elimination of Smoothing (FASB)," *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*, the Committee on Investment of Employee Benefit Assets of the Association for Financial Professionals (CIEBA of AFP), March 2004, Page 20.

[48] See Financial Accounting Standards Board Action Alert 04-03, Report on actions taken at the January 14, 2004, board meeting (1/27/04), http://www.fasb.org/action/aa012204.shtml.

[49] See Financial Accounting Standards Board News Release, "FASB Issues Exposure Drafts to Improve Accounting Guidance and Support Convergence of Global Accounting Standards" (12/15/2003); Financial Accounting Standards Board News Release, "FASB and IASB Agree to Work Together Toward Convergence of Global Accounting Standards" (10/29/2002).

AMERICAN BENEFITS COUNCIL

1212 New York Avenue, N.W. • Suite 1250
Washington DC 20005-3897
202-289-6700 • fax 202-289-6700
http://www.americanbenefitscouncil.org