AMERICAN ACADEMY *of* ACTUARIES

Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives
1100 Longworth House Office Building

Hearing on:

Retirement Security and Defined Benefit Pension Plans

Testimony Presented By:

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June 20, 2002

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Chairman Houghton, Ranking Member Coyne, and distinguished committee members, thank you for inviting me to testify on retirement security and defined benefit pension plans. My name is Ron Gebhardtsbauer, and I am the Senior Pension Fellow at the American Academy of Actuaries. The Academy is the public policy organization for actuaries of all specialties within the United States. A major purpose of the Academy is to act as the public information organization for the profession. The Academy is non-partisan and assists the public policy process through the presentation of clear and objective actuarial analysis.

My written statement will focus on the three important issues for this hearing, namely:

(1) The advantages and disadvantages of defined benefit (DB) pension plans;
(2) Reasons for the decline in DB plans and implications; and
(3) Remedies that will strengthen the DB system and retirement security.

In particular, I suggest that since DB and DC plans are both valuable for retirement security, the law provide a level playing field for both of them, so that one is not advantaged over another, and so that employers can choose the one that is right for them and their employees.

Definitions

Defined benefit (DB) plans specify the *benefit* employees will receive whenever they retire from employment (or quit or die). Thus, DB benefits can be any amount, calculated according to a formula and defined in a legal document.[1] For example, a traditional DB formula might be 1% of average compensation for every year worked. Thus, someone who worked 30 years would get 30% of his average compensation when he or she retired (on top of Social Security). Because the *benefit* is defined, employees know what benefit to expect when they retire, thus enabling them to plan ahead for retirement.

DB plans can also require contributions from employees, but they would be after-tax and thus less attractive to employees. Very few DB plans have employee contributions now.

Defined contribution (DC) plans specify the *contribution* the employer pays into the plan each year for the employee. The amount that employees get at retirement depends on how well the assets are invested in the meantime.

In 1978, Congress enacted section 401(k) of the Internal Revenue Code (IRC) to allow employees to make pre-tax employee contributions to certain DC plans and allow employers to match them. In a typical private sector **401(k) arrangement**, an employee might contribute 6% of wages (pre-tax), and the employer might match it 50¢ on the dollar, for a total employer contribution of 3% of that employee's wages. Thus, private sector employees often contribute more than the employer.

The Federal Employees Retirement Savings program acts something like a 401(k). If employees contribute 5% of wages (pre-tax), the federal government will match the employee contribution with another 5% of wages into the account. Unlike most

[1] Pension laws restrict some of this flexibility for taxable employers, but they are less strict for churches and government plans.

private-sector 401(k) arrangements, however, the federal government contributes 1% of an employee's wages into his or her account, even if the employee contributes nothing.

Hybrid DB Plans that look like DC plans. DB plans can, if desired, mimic the benefits of DC plans, while providing flexibility in how much is contributed each year and where the funds are actually invested. They also have much more flexibility in design and can improve benefits quickly when needed (but are still funded gradually or in advance). Examples of hybrids can be found in church-wide plans in the U.S., and the Social Security system of Sweden. The U.S. rules for private-sector plans are unclear and thus make it difficult for companies to sponsor these plans, but many of them do exist and they are sometimes called cash balance plans.

Coverage History

Just after ERISA was signed into law in 1975, 40% of the labor force participated in a DB plan, and 16% participated in a DC plan (see Chart I). Today, however, the reverse is true: only 21% participate in a DB plan, while 46% participate in a DC plan[2]. As Chart I shows, almost anyone who participates in a pension plan is in a DC plan, and sometimes it is in addition to a DB plan.

Analysts have attributed the movement from DB to DC plans to: (1) larger DC plan benefits for young, mobile employees; (2) Employers attracting young employees with larger DC benefits upfront; and (3) DB benefits being more difficult to understand than DC benefits.

But I do not think that they have pinpointed the reason correctly, because, as I mentioned above, DB plans can look exactly like a DC plan to the participants. If the employer and employees wanted a DC plan, with employees being able to allocate their funds, they could simply change the DB plan formula to match the DC plan they wanted. There are plans in the U.S. that already do this. This approach would be much easier than having to terminate the DB plan and start up a DC plan from scratch. In addition, with the DB plan, the employer would keep the investment and contribution flexibility. So, there must be another reason.

I suggest that the biggest reason is that the playing field is not level for DB plans in the private sector. DC plans can have certain provisions, like pre-tax employee contributions, that DB plans cannot have. As evidence, I note that Canadian employers and state and local governments in the U.S. have a much more level playing field for DB plans (for example, they have pre-tax contributions), and all three have a much higher percentage of DB plans than in the U.S. private sector.[3]

The other primary reason is that pension law for private sector employers in the U.S. is much more onerous for DB plans. In fact, some pension professionals consider the regulations draconian. A study by the American Academy of Actuaries in 1993[4]

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[2] The 2000 Form 5500 data is not available yet, because pension plans file about 9 months after the end of the plan year, which could be September 2002 for plans with plan years starting in December of 2000.

[3] See Professor Robert Brown's paper discussing why it did not happen in Canada in the July 2001 issue of the North American Actuarial Journal (NAAJ), and discussions in the April 2002 NAAJ.

[4] *The Impact of Government Regulation on Defined Benefit Pension Plan Terminations*, a Special Report by the American Academy of Actuaries (March 1993).

showed that increased government regulation was the major factor in 44% of DB plan terminations in the late 1980s. Another study by Edwin Hustead of the Hay Group[5] noted that the administrative costs of a 10,000 person DB plan were less than the costs of a similar-sized DC plan in 1980, but by 1996, the DB costs had grown dramatically to almost 50% more than the DC plan's administrative costs. The important point here is that employers would like the flexibility to pick the plan that is right for both them and their employees. Because current law makes it difficult and expensive to maintain a DB plan, it creates a bias towards 401(k) arrangements. The law should let employers and employees make the right choice for their particular situations, not steer them to a particular option.

As further evidence, I note that there has also been a very large decline in DC plans that do not have a 401(k) arrangement. Chart II shows that of the 46% of the labor force participating in DC plans, 3/4ths of that number are in 401(k) arrangements. When you subtract out the 401(k) arrangements, you find that the remaining DC plans trail behind even DB plans. In fact, due to EGTRRA,[6] this 12% participating in "other DC plans" may practically disappear.

In fact, the "battle" has never been between DB and DC plans. It has been between 401(k) arrangements and all other plans. And 401(k)s are winning.

The third chart shows that two-thirds of all retirement contributions go to 401(k) arrangements, only 16% to other DCs and 17% to DBs.[7] This is a dramatic change during the past two decades. The elimination of so many DB plans represents an alarming reduction in retirement security, especially when the leading edge of the baby boom has reached age 55, a typical age for early retirement. The retirement dates of workers are now subject to the ups and downs of the markets, how well their funds are invested, and how much employees have contributed. And it could dramatically increase our nation's government assistance payments in 20 years for retirees who spend down their savings too fast.

I will discuss these concerns next in the section on the advantages and disadvantages of DB plans over 401(k) arrangements.

Advantages of DB Plans Versus 401(k)s to Employees

1. Retirement Security. DB plans provide employees with predictable incomes for life, no matter how long they live. That can help employees improve their retirement planning, because they have a better idea of what their pension will be.

2. Risks. DB plans can more effectively reduce the risks for employees than DC plans. Those risks include:

a. Investment risk. In a DB plan, the employer generally assumes the investment risk, so employees will not suffer if they retire in a "bear" market. In a 401(k), older employees experiencing a bear market might have to delay retirement. For example, Chart IV shows that in 1973-74, stocks fell about 40%, while inflation went up more than

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5 *Retirement Income Plan Administrative Expenses 1981 through 1996*, presented by Edwin C. Hustead of the Hay Group to the Pension Research Council conference (May 1996).
6 EGTRRA, the Economic Growth, Tax Relief and Reconciliation Act of 2001.
7 The DB percentage may increase over the next few years because of the recent poor investment returns.

20%. Under this scenario, retirement income from a 401(k) would have been cut in half. While today's economic circumstances may not be as severe as they were in 1973-74, the current bear market may make individuals reluctant to retire at this time.[8]

On the other hand, DB pension plans invested in stocks can smooth investment risk because:

(1) the large size and long-term nature of a pension fund; and

(2) the rules for funding and expensing allow employers flexibility in making contributions to the pension fund over time (although these are not as flexible as they used to be).[9]

b. Longevity risk. The DB plan assumes the employee's longevity risk by paying a pension for the life of the worker (and the spouse, unless waived), no matter how long they live. Employees in a 401(k) arrangement can do this by buying an annuity after they retire, but not many do. Chart V shows various ways of taking out one's retirement money. A lifetime annuity guarantees that your money will not run out, no matter how long you live. In fact, the data in Chart V show that the annuity can provide the retiree with a larger income than if they manage their investments themselves. Some investment advisors suggest waiting until one's late 70s before buying an annuity. However, Chart IV reminds us that one keeps the investment risk until one buys the annuity. On the other hand, a DB plan provides the same benefit no matter what the condition of the stock market when one retires. The DB pension is predictable, so the employee does not need to worry about investment or longevity risks.

c. Inflation risk. The employer generally assumes the inflation risk until the employee quits or retires. Some DB plans (such as Social Security) also take on the inflation risk after separation from employment by indexing benefits up to and after retirement. These plans are not common in the private sector, however, due to the volatile nature of inflation risk, and the complexities they bring to a pension plan. And since this benefits employees who no longer work for the employer, the employer has less incentive to assume this risk.

Many traditional DB plans provide "ad hoc" cost-of-living adjustment (COLAs) to retirees if inflation has been high, and assets have done well, but these are not a guarantee. Some analysts suggest that a 401(k) investing in stock can compensate for this risk, but as with variable annuities and stock indexes, stock returns do not correlate well with inflation over the short run. As mentioned before, in 1973 and 1974 stocks fell about 40%, while inflation went up more than 20% (see Chart IV). In difficult economic times, the best inflation hedge is staying in a DB plan or investing in inflation-indexed Treasury bonds, which a 401(k) or cash balance DB plan could do.

d. Contribution risk. DB plans generally cover almost all employees. However, in a 401(k) arrangement, even with tax advantages and employer matches, many workers will not or cannot contribute, and they will not have a benefit when they retire.

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8 Current workers could mitigate the effects of a bear market if they invest in GICs (Guaranteed Investment Contracts). But many people do not do so because GICs have lower average returns than stocks.

9 The ability to smooth investment risk and manage contributions to the pension fund can increase the risk of insolvency, *i.e.*, the employer could go under when the plan is not fully funded. However, the Pension Benefit Guaranty Corporation (PBGC) would take over the plan in this case and make sure the benefits are paid.

e. Leakage risk. This is a very important retirement security issue. Many DB plans still pay only annuities. However, in all 401(k) arrangements, employees can easily withdraw their money and spend it before retirement. Recent studies show that leakage occurs less often now for workers getting large lump sums, but it still happens often, especially with small lump sums. This means many employees will not have enough money to retire and may fall on government or family assistance in their old age. In addition, many employees will take their lump sum at retirement. They may think it is so large that they can retire early and/or spend some of it right away, assuming not all of it will be needed for retirement. Unfortunately, many people do not know how much money they will need to last the rest of their life, so they take too much out, too soon.

On the other hand, DB plans generally pay retirement benefits in the form of an annuity, not a lump sum. This is changing, but is still much less likely than in DC plans. In fact, some hybrid plans that look like DC plans are different in one respect – they do not pay lump sums. Employees may not appreciate this, but surveys of retirees suggest that they will appreciate it more after they retire. Cash is not the same thing as retirement security. For retirees, retirement security means a stable, lifetime income for life that is not affected by a bear market.

f. Disability risk. Many DB plans pay pensions upon disablement. DC plans are not as good at providing disability benefits as DB plans. For example, if disability occurs at a young age, a DC account will not be large enough to pay a disability pension. Thus, an employer that sponsors a DC plan often obtains disability coverage from an insurance company. However, that can be expensive or very difficult to find, especially for a small employer. With a DB plan, the employer self-insures this risk and does not have to pay for the insurer's loading charges and profits.

g. Death risk. DB pension plans pay pensions to spouses upon death of the employee, and the employer self-insures this risk. In a DC plan, the pension would be quite small for a young employee if it has to come from his or her account. Thus, many employers with only DC plans buy life insurance for the employees, for an extra charge.

h. Early retirement risk. In some DB plans, employees that are retired early can receive a subsidized early retirement benefit in order to manage the transition into retirement. In a 401(k), there will not be enough funds to provide a pension at an early age.

3. Higher Returns. DB plans have been more efficient at investing one large pot of funds, which means they can fund larger benefits with the same contribution, or the same benefit with a smaller contribution.

Recent figures from the DOL Abstract of Form 5500 data show that employees in 401(k) arrangements have been allocating just as much to stocks as the typical DB plan, so their average returns have been similar. However, much of this is due to their high concentration in employer stock. DOL data also show much higher levels of risk for employees in their 401(k) arrangements. The standard deviation of their returns is 2 to 3 times higher than in DB plans, per Table E24 of the DOL Abstract.

<u>Advantages of DB Plans Versus 401(k)s to Employers</u>

1. Workforce Management. DB plans help employers better manage their workforce. For example:

a. Retirement windows. Companies can use early retirement windows in DB plans to downsize in less painful ways than laying off employees, which can dispirit the workforce, the community, and customers. A 401(k) arrangement cannot provide early retirement windows.

b. Retire older employees with dignity. It is easier to retire older employees when one can give them a pension from a DB plan. If the employer had only a 401(k), the older employee may not have enough funds to retire due to a number of reasons: recent drops in the stock market, recent jumps in inflation, poor investing, low contribution levels, having borrowed against and spent his or her retirement funds. (This last situation can occur at employers with DB plans, but it is far less likely.)

c. Create promotion potential for younger employees. DB plans can help employers encourage workers to retire, allowing employers to promote and keep younger employees. As noted above, a 401(k) cannot be used this way.

d. Retain employees. DB plans can be somewhat "back-loaded" to provide incentives for employees to continue with the company. DC plans cannot be as back loaded as a final-pay DB plan.

e. Recruit employees. DB plans, like 401(k)s, can be more "front-loaded" if the employer wants to provide larger contributions upfront to attract employees.

f. Satisfy union demands. Unions are more likely to bargain for DB plans.

2. Flexibility of DB plans. As mentioned earlier, the DB plan is as flexible and creative as the ideas of its designer.

a. Contribution flexibility. Employers have some flexibility in the amount of contributions they make to DB plans each year. In good years, they can put in more, so that in tough years, they can afford to put in less. Employees do not need to worry about this because pension law has:

(1) minimum contribution requirements to keep DB plans well funded; and

(2) the PBGC protects employees in case the contribution requirements fail and lead to insolvency.

A 401(k) does not have this flexibility. If an employer commits to a 50% match, the employer must pay it, no matter how much the employees contribute that year. The employer can reduce the contribution the next year.

b. Investment flexibility. Employers with DB plans can invest more in experimental assets classes, hard-to-value assets, and non-liquid assets. Since many other investors (including DC plans) will not or cannot do this, DB plans may earn a premium from these investments.

c. Design flexibility. DB benefit formulas can be amended easily. For example, an employer can:

(i) open a retirement window to encourage some quick retirements and pay for it gradually;

(ii) increase benefits to younger employees when the labor market is tight; and

(iii) provide an ad hoc COLA to retirees if inflation has been high and/or the pension plan's investments have done well.

A 401(k) could not make these design changes.

3. Tax Advantages. All retirement plans get tax advantages, but DB plans can get larger ones, because employers can put more into a DB plan for older workers than into their 401(k). That result is possible because Congress at one time wanted to encourage DBs over 401(k)s, since DB plans were more likely to cover most employees than a 401(k). This particular DB advantage has been greatly reduced in the recent past, as the maximum allowable contributions to 401(k)s have been increased.

4. Increased Productivity. Like 401(k)s and other DC plans, DB plans can improve employee morale and reduce employee fears about retirement, which can increase employee productivity. DB plans are more effective in reducing employee fear among older employees because DB pension benefits are more predictable.

<u>Advantages of DB Plans Versus 401(k)s to the Nation</u>

1. DB pension plans are broader based. Generally, a higher percentage of an employer's workforce is covered in a DB plan than in a 401(k), where the employee's contribution is voluntary. Thus, low-income workers are more likely to get a benefit from a DB plan and not depend on government assistance programs in retirement.

2. DB surpluses helped the nation become competitive again. In the 1980s and early 1990s, pension plan surpluses helped U.S. employers become competitive in world markets again. Early retirement windows helped companies become lean and pension funds made American markets among the most efficient in the world. 401(k)s cannot provide early retirement windows and may not be as good as DB plans at making our markets efficient.

3. The trillions in DB assets promote national saving, investing, and certain markets that 401(k)s cannot, such as real estate. DB plans provide huge sources of funds that reduce interest rates (and hence, borrowing costs) and provide start-up funds for IPOs, etc. In addition, DB plans can provide these funds to the real estate sector, and other less-liquid and hard-to-value assets. These sectors are already hurting due to the movement to 401(k)s and other DC plans that generally do not or cannot invest in these areas. In addition, the average amount of money per person is larger in DB plans than in DC plans.

4. Reduces the nation's dependence on Social Security and government assistance programs. Both DB and DC plans reduce the nation's dependence on government programs, but DB plans are better at it because DB participants are more likely to get a stable, predictable benefit for the rest of their lives.

5. DB plans reduce poverty rates for the elderly. Lifetime pension benefits from DB plans are more likely to help reduce poverty rates where they are the highest (very elderly single women), because they are level incomes payable for life.

6. Defer tax revenues for a time when the country needs them. The pension tax deferral moves tax revenues from the current year to a time when the country will most need them. In a decade or so, the nation will probably need more income taxes to pay for the bonds that Social Security will redeem to pay benefits. However, future income taxes may decrease as retirees pull money out of their Roth 401(k)s and IRAs free of taxation. Thus, the taxes on DB benefits will be needed more then than they are now.

Furthermore, it should be noted that pensions should not be seen as a tax expenditure over the long run: they are tax-deferred, not tax-exempt. Over time, the tax revenues on pension income received in the future will likely exceed the tax revenues lost today (because pension plans earn higher returns than the additional borrowing required by the Treasury Department today when it gets less in taxes). A Cleveland Federal Reserve[10] report bolsters this point. It reported that tax rates in retirement are higher for many people because of the complex way in which Social Security is taxed above certain thresholds. Ultimately, the government may get more tax revenues from retirees than it lost by giving pension plans the benefit of tax deferral. (This quirk in Social Security taxation could be fixed by taxing it like pensions.)

Disadvantages and Challenges of DB Plans

The primary disadvantage of DB plans is that they do not provide much benefit to mobile employees. That may be true of traditional DB plans, but it does not have to be that way. DB plans can mimic DC plans. Front-loaded DB plans, for example, can pay just as much to mobile employees as DC plans.

Some analysts also point out that DC plans are more popular because they are easier to understand. There are two responses to that:

(1) cash may be more transparent to young employees, but when one is closer to retirement, a level pension is more transparent. Cash does not equal retirement security--a stable lifetime income does; and

(2) young employees could convince the employer to sponsor a hybrid DB plan, which is just as transparent as a DC plan to younger employees. If given clear flexibility in pension law, private sector employers could make the monthly income from a hybrid plan more stable and transparent for older employees.

Since employees have the option of choosing their employer (and retirement benefits are part of that decision), federal policy has generally allowed employers flexibility to structure their compensation packages. Some employers and some employees will prefer more wages, some will prefer more benefits. The marketplace can sort out who works with whom.

Since DB plans can mimic DC plans, they have few disadvantages in comparison with DC plans, except that this flexibility itself can make DB plans more complex.

Finally and most importantly, the biggest disadvantage facing DB plans is that the law is more difficult on DB plans than DC plans. For example, DB plans cannot have pre-tax employee contributions and employer matches, and it is difficult to implement hybrid plans. More will be provided on this later.

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[10] *Does Participating in a 401(k) Raise Your Lifetime Taxes?*, Working Paper 0108, by Jagadeesh Gokhale, Laurence J. Kotlikoff and Todd Neumann, Federal Reserve Bank of Cleveland (June 2001).

Why the Move Away from DB Plans to 401(k)?

If DB plans have all these advantages and there are remedies for the disadvantages, why are so many employers moving to 401(k) arrangements (especially if a DB plan can mimic a DC plan)?

As suggested in the coverage section, the reason is that pension laws and regulations do not provide a level playing field for DB plans. Other DC plans (the ones without 401(k) features) are in decline too, so it is not the DC nature of the plan that is making employers switch. It is the advantages found in IRC Section 401(k). Thus, the first step might be to modify IRC Section 401(k) to include DB plans.

Furthermore, pension law is much more complex for a DB plan than for a DC plan. For example, we can create a DB plan to pay exactly the same benefits as a DC plan, but the law will not allow it. What is the policy reason for that? We need to level the playing field, so employers can choose the type of plan that works best for them and their employees.

Ways to Level the Playing Field

One quick way to level the playing field would be to include DB plans in IRC Section 401(k)[11] -- in essence, creating a "DB 401(k)." It would be difficult to comply with all of the DB and 401(k) rules at the same time, some of which would contradict others. Thus, it will be preferable for the "DB 401(k)" plan generally to follow DB rules, with the following modifications:

1. Allow voluntary pre-tax employee contributions in DB plans.
This is similar to what employers can do in 401(k)s now (and government employers can do in DB plans using the Section 414(h) pick-up rules). Employee deferrals could be tested using the 401(k) non-discrimination tests or the DB non-discrimination tests (but not both). These employee deferrals should be exempt from the 411(c)(2)(C) requirement to accumulate at 120% of the federal mid-term rate, as long as all participants can choose a market-related rate.

2. Allow employer matches in DB plans.
Currently, many hospitals and other non-profits match employee 403(b) deferrals and put the match into the DB plan. However, for-profits cannot do that.

Allowing the match in the DB plan under IRC §401(k)(4)(A) could benefit employees by reducing investment and longevity risks on the match portion. Employers could benefit because they could pay for it out of surpluses in the DB plan. This would also raise revenue for the government.

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[11] Congress could make a few changes to IRC 401(k) to allow 401(k) features in DB plans. For example, add the words "defined benefit plan" to the first sentences of IRC § 401(k)(1), §401(k)(2), §§ 401(k)(2)(B)(i)(III) and (IV), and §401(m)(1), and add a sentence to §401(k) that Treasury will specify in regulations how the words "contributions" and "deferrals" can include pay credits to DB plans, as long as they have a market-related rate of return. Other sections of the law may need revisions, as well.

Note: Non-profits test these matches under the DB general test non-discrimination rules. Matches could be tested under either the 401(m) or the DB non-discrimination rules, but it does not make sense to force it to comply with both sets of non-discrimination rules.

3. Concerns on contingent accruals.

Some people may be concerned about allowing contingent accruals in DB plans. Non-profits, however, can already do it in DB plans, and for-profits can do it in profit-sharing plans. Banning the practice in DB plans simply encourages more profit-sharing and ESOP plans, where the risks for employees are higher.

Currently, DB plans generally provide benefits for most employees. Contingent accruals would mean that some employees (more likely lower-paid ones) might not make a contribution, and therefore would not get an accrual. Some possible remedies are:

a. Non-elective employer contributions. Some employers provide non-elective employer contributions to everyone in order to meet the 401(k)(3) nondiscrimination tests. Pay credits that already exist in a cash balance plan could also help satisfy these rules.

When the 401(k) merges into a cash balance plan, the 401(k) accruals could be on top of the non-elective cash balance accruals. (Employee advocates will be interested in surveys showing that pay credits in cash balance plans and other hybrid plans are less likely to be integrated than traditional DB plans.)

b. Safe harbor rules. IRC Section 401(k)(12)(C) allows employers to avoid the non-discrimination tests in their 401(k) if they promise a 100% match on the first 3% of pay, and a 50% match on the next 2% of pay. Allowing that on the DB side might raise concerns for employees.

Past remedies for this concern have been to require the employer to make the first contribution. For example, in the federal employee Thrift Savings Plan, the employer makes an automatic contribution equal to 1% of pay to everyone first, and then contributes the match on top.

Policymakers need to be careful about placing more requirements (like an automatic or minimum contribution) on the "DB 401(k)" than they have for the DC 401(k). If they do, the playing field will not be level, and the law will bias employers to 401(k)s, even if they and their employees would prefer a DB plan.

One remedy would be to also require the automatic contribution for the DC 401(k), but that would probably result in some employers dropping their DC 401(k). Another possible remedy would be to give the DB 401(k) an offsetting advantage over the DC 401(k), such as allowing employers to use the DB plan's surplus to pay for the match. This might be enough to motivate some employers (those with over-funded DB plans) to move their 401(k) to the DB side.

c. Allow the IRC Section 25B tax credit match in the DB 401(k). Low-income employees should be able to get the tax credit match in a DB plan, just as they can now have in a DC plan (due to EGTRRA[12]). This will help encourage more low-income employees to participate.

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[12] In EGTRRA, the current tax credit rule has cliffs. The tax credit match drops from 50% to 20% when adjusted gross income (AGI) goes over $15,000. Thus, someone earning one more dollar means they could

d. Better returns than Treasury rates: This is a very important change in the law. In order to encourage employees to make contributions, it will help greatly if the law made it easier for DB plans to provide higher rates of return on employee contributions (deferrals, matches, and non-elective contributions). Some people in the IRS use section 417(e) to make it difficult to provide a rate of return higher than the Treasury rate. Since employees can get a higher return in their DC 401(k), why would they voluntarily contribute into their DB 401(k) if the return were less?

Lawmakers could clarify that the IRC handles this well in section 411(a)(7)(A)(i) already. That would ensure that DB accounts could provide a market-related rate without causing myriad problems for the DB plan.[13] The 417(e) rule was created for traditional DB plans that promise a pension at retirement. It was enacted in the early 1980s when discount rates were very high and lump sums were very small. Employees then sued for larger lump sums.

This is not a problem for account balances. For example, one would never have thought to apply this rule to a 401(k), and similarly, it does not make sense to apply it to this DB 401(k). Doing so would not level the playing field.

It would make more sense for the law to have a minimum rate of return based on market rates (not a maximum rate). That would especially help older employees who are more likely to have large accounts due to their longer periods of service.

Other ideas are suggested by Pension Equity Plans (PEPs), which are similar to cash balance plans except that they effectively increase the account by the increase in the employee's wages. Other plans might want to increase accounts by a productivity index or the GDP (like Sweden).

If IRC Section 417(e) is fixed for account-based plans, it should include these possibilities too. For example, it could allow interest credits equal to any market-related return or any wage index.

e. Allow the special rule 401(k)s have for early participation. Policymakers could encourage employers to provide DB plans with automatic deferral elections at hire. This can be done by opening up IRC Section 401(k)(3)(F) to deferrals in DB plans, and as in 401(k), exempting people who have not met the age and service rules in ERISA from the non-discrimination tests.

f. Encourage default automatic elections. Pension law could encourage employers to have automatic deferral elections at hire and at each pay anniversary. The law could give specific approval to have a default amount placed in a default fund. (It could increase an employee's deferrals by 1% or 2% of pay, up to a total of 6% of pay unless the employee affirmatively requests otherwise.) A DB fund with a default return equal to a long-term Treasury rate, plus 1% or 2%, or a corporate bond rate, could make this default more appealing.

g. Phased retirement. Employees over age 59 ½ who are phasing into retirement and taking distributions from their 401(k) will not want to lose this ability if it is merged into their DB plan. Employees in DB plans should be able to get distributions at age 59½ just as in their DC 401(k) plan, as permitted under IRC §401(k)(2)(B). Otherwise, employees might contribute less to the DB 401(k).

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lose 30% of $2,000 or $600 in taxes. This could be fixed by making the tax credit match equal to 50% of the contribution minus, for example, 3% of their AGI.

[13] Alternatively, the accrued benefit could be defined to be the account balance in hybrid plans.

The law might also allow phased retirement after 30 years of service, if the employee is at least age 55. This would help employees who want to go part-time to get some of the early retirement subsidy in the plan, if applicable.

h. Maximums applied separately: The maximum benefit, contribution, and deferral rules should be applied separately to the DB and 401(k) parts. Otherwise, if an employer folds its 401(k) into a generous DB plan, some contributions/deferrals might have to be reduced.

4. Allow employers to change asset choices.

Employers should still be able to change asset options, just as in a 401(k), without worrying about any requirements in Section 411(d)(6). The plan could be required to continue having at least a couple market-related returns, a bond rate, and a money market rate available.

For example, if an index or mutual fund disappeared, the plan would need to change it to some other market-related return.

5. Accrual rules.

It might be preferable to have the DB 401(k) accounts follow the DC accrual rules, not the DB accrual rules (or at the very least, allow the plan to have "greater of" formulas and allow them to test using the DB accrual rules on each formula separately). This would also ensure that increases (and decreases) in an employee's contribution (and therefore their match in the DB plan) would not cause any violation of the accrual rules.

This might also give policymakers a chance to clarify and simplify accrual rules for hybrid plans. It would make sense to test pay credits by using an age-weighted formula with a maximum discount rate of 8%, for example. It would still produce accruals that were much less age-weighted than a traditional DB plan because DB plans are also age-weighted through the increase in the final pay average. If less age weighting is desired, the rule could limit the discount rate to, for example, 6% or 5%.

6. Switching between DB and account.

As long as the account earns a market rate, employees could be allowed to switch the lump sum value of their DB benefit to the account side when they leave the employer -- instead of taking the lump sum -- and move it back at old age in order to convert to an annuity, perhaps at the date minimum distributions are required. Some pension plans do this already, but one has to move between plans in order to do it.

7. New funding rule for "DB 401(k)s."

In addition, the minimum funding rules will need to be modified to accommodate the "DB 401(k)." A simplified funding rule might work, such as 90% of the current pay credits to the account or, if greater, 20% of the amount by which the account balances (with minimum) exceed the plan assets.

8. Other uses of 401(k) funds in DBs.

In addition, this new feature could be added to an already existing DB plan. It would create a plan that has significant accounts for young employees and old-style annuity guarantees for older employees. Other uses for this idea would be as follows:

a. The extra assets in the accounts could be used to provide COLAs to traditional DB pensions or past service credits for prior service or prior jobs (which would help make DB plans more portable).

b. The "DB 401(k)" idea could allow floor-offset plans to be aggregated into one DB plan, so the employee would get the greater of an account and a traditional DB benefit. It would make more sense to the employee (since it will get rid of the offset) and entail less risk to the employer, since the assets would all be in one plan. Currently, the assets needed in the DB component of a floor-offset arrangement can be very unpredictable. It could be large, if the DC plan has poor investment returns, or it could be zero, if the DC plan has great investment returns (in which case, the employer will have a difficult time trying to get the assets back).

9. Conversions from 401(k) to "DB 401(k)."

This idea should not be limited only to new plans. Allowing conversions would mean the 401(k) would not have to be terminated in order to convert it. To encourage employers to convert their current 401(k)s to this plan, it will be important to enact the suggestions in the above section. Whenever a new advantage is provided to the current DC 401(k)s rules, it would need to be provided on the DB side too,[14] or employers might convert back to the original 401(k).

10. Other ideas for leveling the playing field that do not involve §401(k) include:

a. Simplify minimum funding rules for DB plans. The current rules are incredibly complex and the Academy has assigned a task force to make suggestions in this area.

b. Fix the discount rate for funding liabilities. Due to the current abnormally low Treasury rates, the IRC was going to force employers to contribute too much to their pension plans. Congress resolved this concern by passing a temporary rule that allows employers to use a higher discount rate, but it is in effect only through 2003. A permanent fix is needed, and policymakers should consider using annuity prices or corporate bond rates (which is what annuity pricing is based on) for setting the discount rates. Some have suggested using government rates, but they are not capable of estimating annuity prices and can create problems. If Treasury rates went back to having the same margins with corporate bond rates, a fix based on a government rate would not encourage adequate funding which would cause problems for the PBGC.

c. Clarify the laws for hybrid plans. Hybrid, cash balance, and pension equity plans have been around for about two decades, but the laws have not been modified to handle these new kinds of retirement plans. Consequently, new rules are being created through court decisions, which try to adapt the old rules to the new plans. Since there has been no clear guidance from Congress to the courts, some employers are falling into traps that they did not know existed.

d. Allow employers to raise the pension plan's normal retirement age. Currently a pension plan cannot raise its normal retirement age above 65. Congress has already raised the retirement age for Social Security. It is inconsistent with Congress' pro-

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[14] And similarly, if the "DB 401(k)" has a restriction placed on it, it should also be placed on the 401(k), too. That is why it makes sense to have the rules in the same place in IRC § 401(k) for both DB and DC plans.

work policy for older Americans for the retirement age for pension plans to be kept at age 65. Allowing pension plans to use the same normal retirement age as Social Security would make sense.

e. Revise Congressional budget rules to reflect future tax revenue received on pensions. Whenever Congress tries to improve retirement security by increasing pension coverage to the part of the working force without pensions, current budget rules show the loss in revenue today. But this misses the fact that tax revenue in the out years will increase and pay back the loss in revenue today (as discussed on page 9) .

If the budget rules could reflect these pension tax deferrals as budget neutral, it would be easier to pass solutions to the pension coverage problem.

The budget rules already allow this under the Credit Reform Act of 1990 for government loans by offsetting the payments received in the out years for housing loans, school loans, rural electrification loans, the Disaster Loan fund, loans for rural development, the Business Loan Investment Fund, mortgage guarantees, international aid, the Export-Import Bank, foreign military sales, and the Overseas Private Investment Corporation. The reason behind passing the Credit Reform Act was similar: it helped Congress make the best financial decision when deciding whether to provide loans or loan guarantees. This law could also be used to handle the pension tax deferral, showing that it is clearly a tax deferral, not a tax exemption.

Conclusion

DB plans were once the most common way of providing retirement security to America's workers. However, due to the non-level playing field created by pension laws, many employers have switched to 401(k) plans, which do not provide the same level of retirement security as traditional DB plans. One way to level the playing field is to allow DB plans the same flexibility as 401(k)s. Other ideas (such as fixing the discount rates and simplifying the minimum funding rules[15]) are discussed in my testimony, and I would be glad to analyze the effects of any proposals you wish to consider. Thank you for the opportunity to share my views today.

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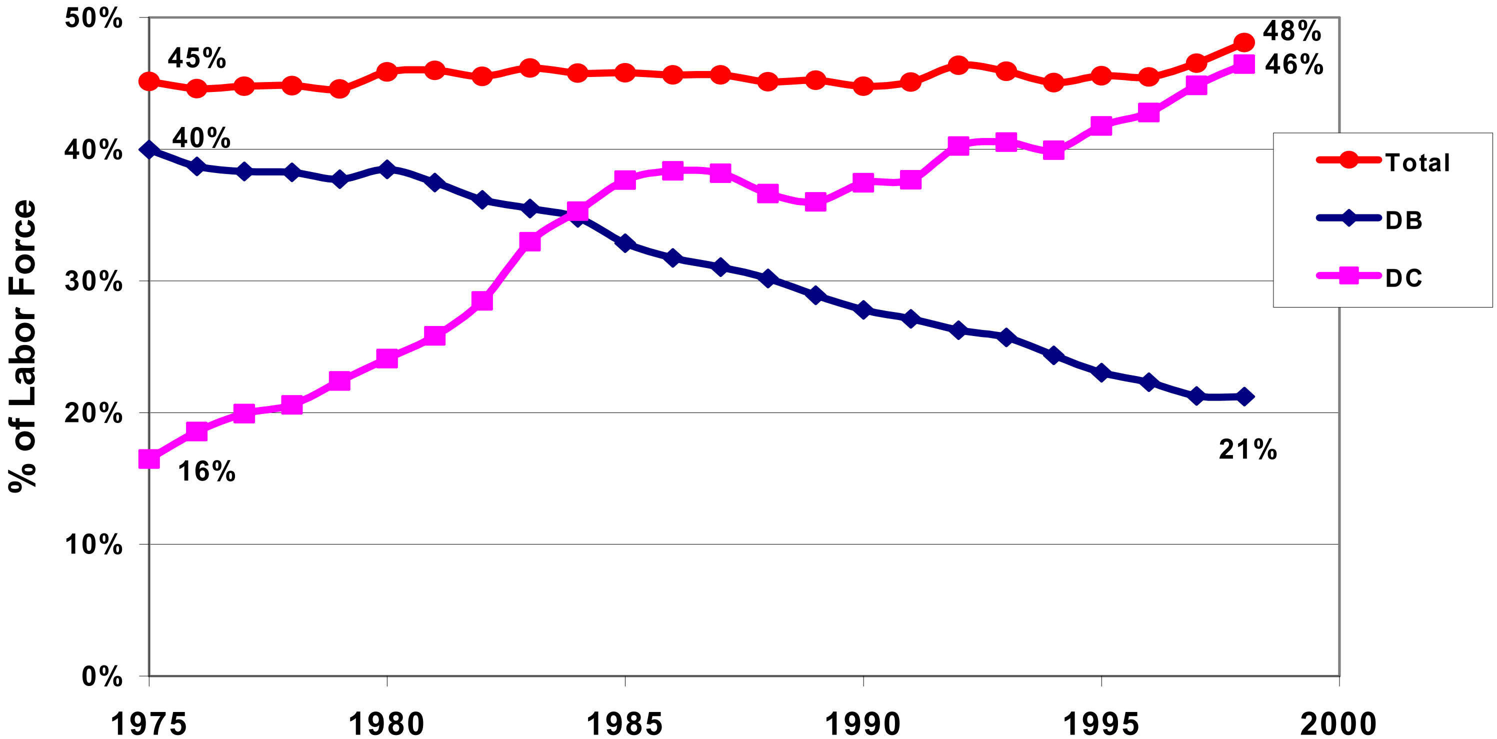
[15] Also, see the suggestions in my testimony before the U.S. Department of Labor's ERISA Advisory Board (available on the Academy's web site at http://www.actuary.org/pdf/pension/ERISA_071701.pdf).

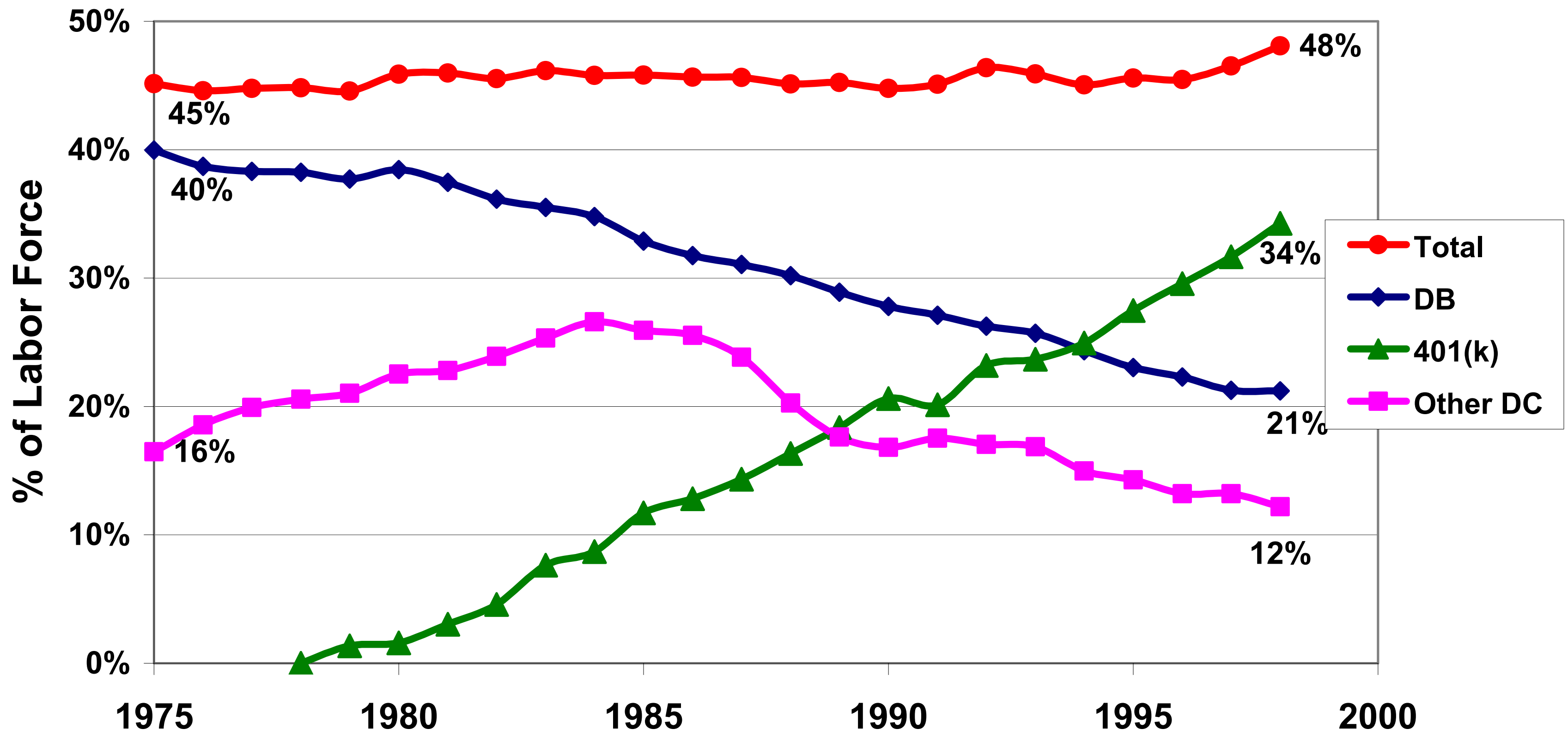
Chart I - Participation Rates in Pension Plans (by type)



About half of the labor force participates in a pension plan, and almost all of them are in a DC-type plan (for some it's on top of their DB plan). Note: Don't add % in DC and DB, because some workers are in both.

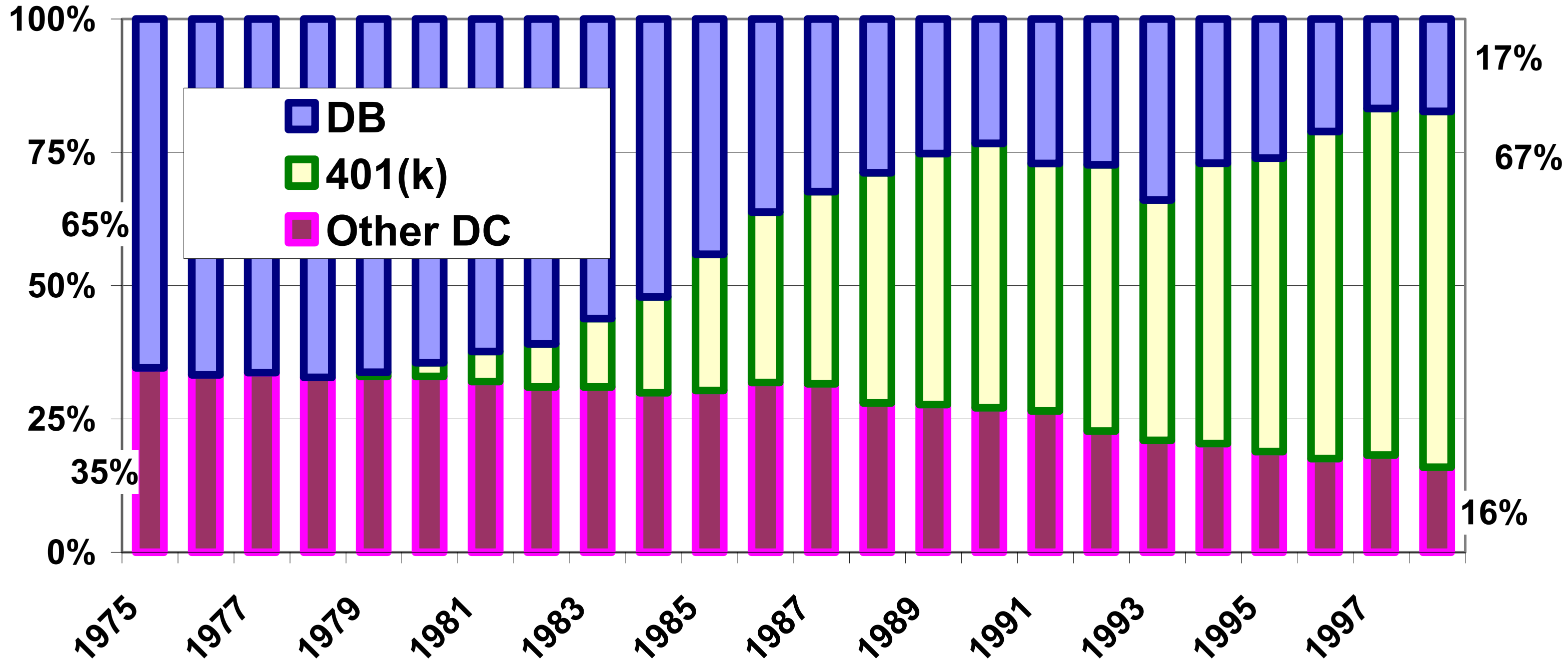
Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers. Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4 & E8.

Chart II - Participation Rates in Pension Plans (by type)



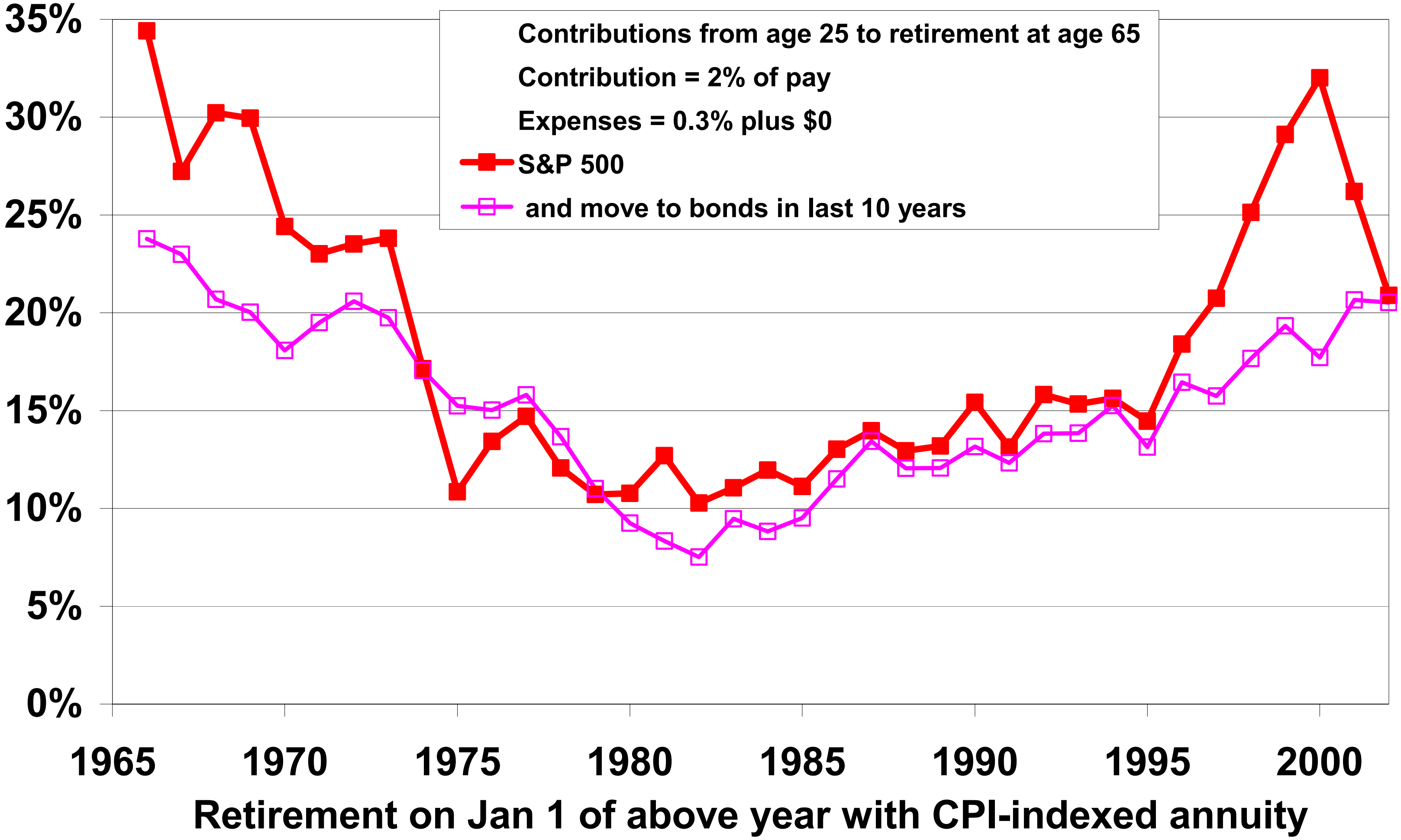
It's not a battle between DB and DC. It's a battle between 401(k) and the others, and 401(k) is far ahead.
Why? Favorable laws for 401(k), especially pre-tax contributions and match.
Sources: Workers from BLS statistics: employed (FT & PT) and unemployed wage & salary workers. Coverage from DOL/PWBA Abstract of 1998 Form 5500 data (Winter 2001/2002) Tables E4, E8, & E23.

Chart III - Distribution of Total Contributions to Private Pension Plans



It's not a battle between DB and DC. It's a battle between DB/DC and 401(k), and 401(k) is far ahead.
Why? Favorable laws for 401(k), especially pre-tax contributions and match.
Source: Tables E14 and E23 of DOL/PWBA's Abstract of 1998 Form 5500 data. The 401(k) amounts are estimated in years 1978 to 1983

Chart IV - Replacement Rates from Qualified Savings



Should you move to bonds in last 10 years? It varies less over short periods, but it yields less 86% of the time. Will you know which years to switch?

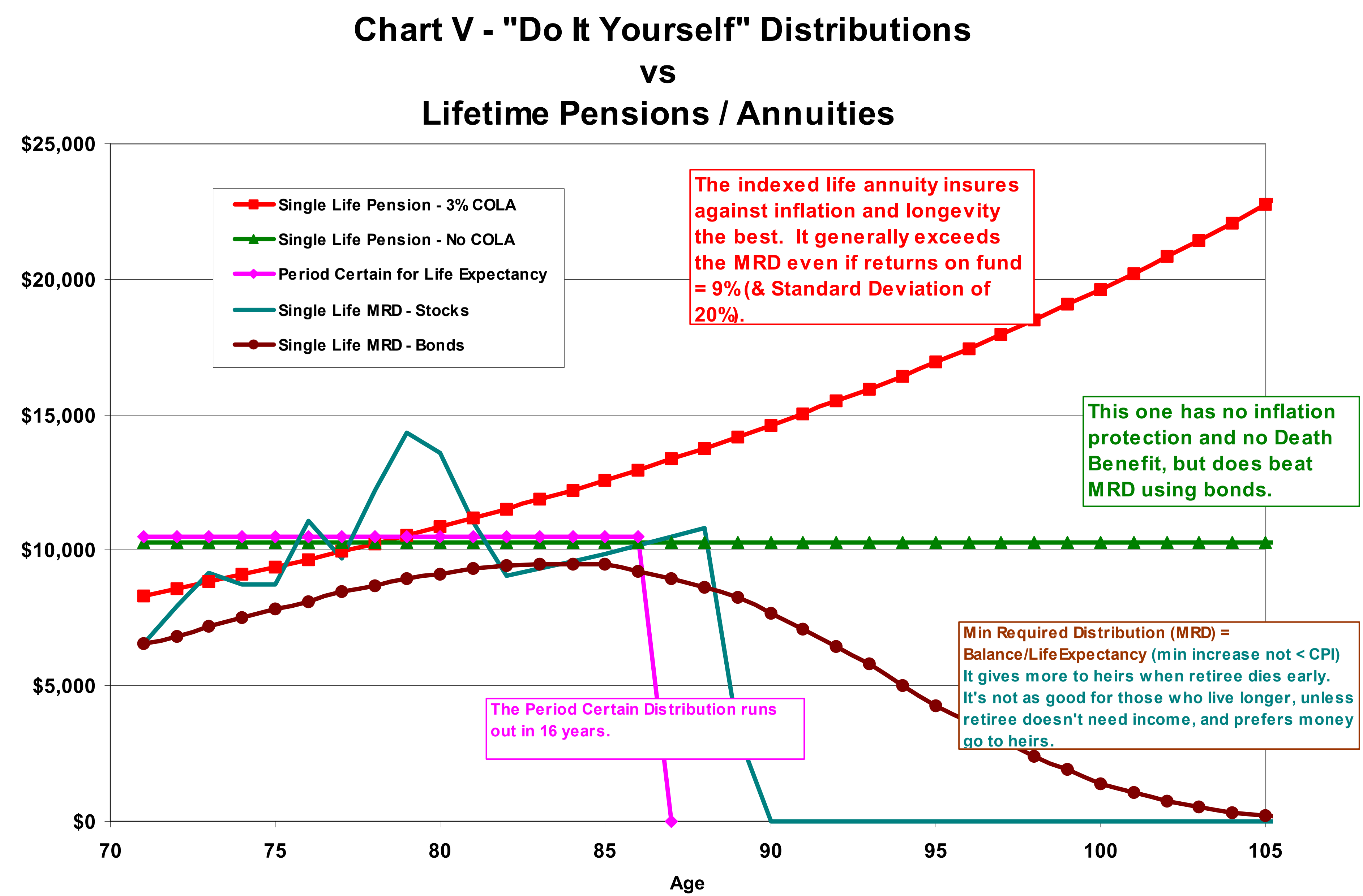


Chart V - "Do It Yourself" Distributions
vs
Lifetime Pensions / Annuities
$25,000
$20,000
$15,000
$10,000
$5,000
$0
70
75
80
85
90
95
100
105
Age
Single Life Pension - 3% COLA
Single Life Pension - No COLA
Period Certain for Life Expectancy
Single Life MRD - Stocks
Single Life MRD - Bonds
The indexed life annuity insures against inflation and longevity the best. It generally exceeds the MRD even if returns on fund = 9% (& Standard Deviation of 20%).
This one has no inflation protection and no Death Benefit, but does beat MRD using bonds.
The Period Certain Distribution runs out in 16 years.
Min Required Distribution (MRD) = Balance/Life Expectancy (min increase not < CPI)
It gives more to heirs when retiree dies early.
It's not as good for those who live longer, unless retiree doesn't need income, and prefers money go to heirs.