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Testimony on the Pension Funding Crisis

Chairman Harkin, Ranking Member Enzi, and distinguished members of the Senate HELP Committee: thank you for inviting me to testify on this very important issue.

A robust defined benefit (DB) system is important for the retirement security of our nation's retirees, for the management of our industries, and for our national economy.

While it is valuable for employers to provide both DB and DC plans, I want to note the important advantages of DB plans over 401(k)s. A major advantage was demonstrated by the recent crash in the stock market. We already knew that 1/3rd of employees were not contributing anything to their 401(k) and another 1/3rd were not contributing enough. Now we see that even the 1/3rd who contributed enough, are in financial distress, even if they responsibly invested in a target retirement date fund. Many that just retired are finding that they need to go back to work, even though now is not an easy time to find a job. Those workers planning on retiring soon, now suddenly realize they can't. They will need to continue working for they don't know how long, even though many of them are getting laid off. This is a problem for employers too. With a DB plan, employers could count on their workers retiring on a more regular basis. But now, with no one retiring, they will have to lay off employees, which is not easy to do.

We still haven't seen the biggest problem with the 401(k). In about 10 years or so, millions of retirees in their 80s will be running out of money, because they lived longer than they expected or there is another stock crash, and they didn't buy a lifetime income with their 401(k) funds. But, they will be too old to go back to work, so what will they do? With all these problems, we don't want 401(k)s to be the only way we provide for retirement, but that could easily happen. DB plans address these problems for workers and employers. With DB plans, these retirees would more likely have had lifetime incomes, and they would not have to return to the labor pool.

Retirees returning to the labor market also hurt the nation because this increases unemployment rates. Finally, DB plans help the nation with patient capital that is more efficiently invested in the markets than individual retirement money, and DB plans can hold investments that individuals cannot.

With this as a backdrop, it becomes clear that our national policy was more forward looking in the past when most large employers provided DB plans; now our rules encourage employers to choose 401(k)s, even when an employer would prefer a DB plan for their particular situation. Yes, we allow employers the choice of a DB and/or DC plan, but it is a false choice because current laws are much more onerous on DB plans, and much easier for 401(k)s.

The most onerous item to fix today is the spike in minimum pension contributions due to the market crash. With measured and temporary relief, employers can meet their contribution requirements that would otherwise double, triple, or even quadruple according to a recent Watson Wyatt analysis.[1] Without relief, their analysis shows that contributions would be much larger than they have ever been. And, with relief, we not only help employers meet their contribution requirements, we also help them return to building and hiring American workers much sooner. **Thus, we have the opportunity to help not only retirement security in America, but also the nation's Number #1 problem today: the jobless recovery.**

And this relief is not a subsidy. It will not cost the government one penny. In fact, according to a CBO memo[2], it will increase government revenues by about $10 billion over the next decade, and it will not hurt the PBGC.[3] In fact, it will increase premiums to the PBGC. Now, some may worry that PBGC will have to take over some worse-funded plans in the near future, but that won't happen in the aggregate. Their weak sponsors will not triple their contributions anyway. On the contrary, CBO noted (and I agree) that providing relief could decrease the

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[1] Analysis by Watson Wyatt Research and Innovation Center
[2] CBO's 7/31/09 Cost Estimate on HR 2989
[3] Per page 4 of CBO's 7/31/09 Cost Estimate on HR 2989

number of weak companies that will dump their pension plans on the PBGC. And relief will help keep healthy employers in the DB system, so that they will continue to pay their premiums to the PBGC.

Given that relief is needed and doesn't hurt the PBGC, it is a no brainer, but we need to make sure it is not too generous. Three House bills (H.R.2989, the Pomeroy bill, and the Boehner bill) are all in the same ballpark on relief according to the Watson Wyatt analysis. The Boehner bill may be unintentionally too generous in the first year. The Pomeroy bill provides a way around that problem by requiring an increase in the contribution by at least a certain percentage over the next few years. I encourage you to adopt something similar to those bills, with a possible minor change that reflects recent IRS relief.

Recent IRS Relief: Recent IRS guidance provided relief for many DB sponsors in 2009, so their problems have been moved to 2010 and 2011. Thus, it might make sense for your relief to be in those years. For the pension plans that were not helped by the IRS guidance, you could give them the relief for this year and either 2010 or 2011.

Maintenance of DB plan: Some employee groups have suggested denying relief to employers that froze their DB accruals. Much as I prefer DB plans with accruals, I have to note that a rule like that would cause an injustice. For example, employers that froze their DB plans may have already replaced it with a generous DC plan. They would have to reinstate their DB accruals which would be doubly expensive, unless they froze their new DC plan. That would create a lot of disturbance just to get temporary relief. A rule requiring DB accruals would also treat companies in the same industry differently. Companies that replaced their DB plan with a DC plan would not get relief, thus putting them at a competitive disadvantage to others in their industry.

In fact, I don't understand the imposition of a maintenance rule in difficult times. The penalty doesn't fit the problem. It would make our pension laws schizophrenic. I'll explain. If a market crash causes a plan to be worse than 60% funded, a PPA provision requires the freezing of accruals. But then this new rule would penalize the employer for the freeze we just imposed on them. That's inconsistent, and doesn't make sense. We shouldn't have both the law freezing benefits and the maintenance rule operating at the same time. Dutch pension laws, which people have been enamored of late, are much more sensible in this area. After a market crash in the Netherlands, a recent pension accrual (or cost-of-living adjustment) can be reduced. And then when the market comes back, the accrual is restored. No wonder a greater percentage of Dutch workers are covered by DB plans. Their pension laws make more sense.

If a maintenance rule is really important, something like the one in the Pomeroy bill makes more sense. It requires a minimum accrual in either the DB or DC plan. Some employers may even be too weak to provide either DB or DC accruals. Since those companies would be the ones in need of the most help, prohibiting relief to them (or giving them only partial relief) is going in the wrong direction. In this case, the Pomeroy bill requires those employers to freeze their NQDC (Non-Qualified Deferred Compensation) plan for executives. That makes more sense. If a company can't afford benefits for their rank and file, then they can't afford them for their executives either.

Permanent Fix to Funding Rules: After Congress solves this temporary problem, they should revisit long-term pension funding policy, so that they don't have to return to this issue again and again. A fix could be a fairly simple change to the existing rules. If Congress fixes the funding rules on a permanent basis, employers will get the certainty they need, so that they can plan ahead and make decisions (for example, how much of the plan assets should be allocated to stocks). The recent past showed that the current funding rules break down after a crash. We knew that when they were created, which is why the American Academy of Actuaries pushed for an anti-volatility mechanism in PPA. The new rules will also have problems in a market bubble, because minimum contributions will go to zero under the PPA rules. And when the inevitable crash comes, contributions will spike to 200% or 300% of what they were in the past, which is way more than employers can handle. When health costs go up by just 15% or 25% employers, workers, and retirees scream. So a 100% or 200% increase can be cataclysmic. At these times, pension contributions need more smoothing than the current rules allow.

A concern caused by giving relief today is that employers will hope for relief on the next crash, and not make the changes they need to make in their policies. Thus, if Congress fixes the funding rules in a permanent way so that they provide an appropriate amount of smoothing that works even after a crash, then employers won't expect relief next time. Here are several different ways to do it, with different levels of complexity.

One method suggested by the actuarial consulting firm Mercer (sometimes called the Anti-Volatility Mechanism or AVM) caps the contribution increase (or decrease) at 25% of the cost of the plan's current year accruals. (Congress could set the percent in the law after consultation with the PBGC.) Here is how it would work. If the contribution of a pension plan that was 100% funded was $100 million and the market crashed, so that next year's minimum contribution doubled, the AVM would kick in and cap it at $125 million. Each year, the minimum contribution would go up another 25% until it reaches the actual amount of the contribution. Applying this rule to past experience shows that the cap may not be needed for more than 1 to 3 years generally, due to the market reverting to mean Price/Earnings ratios (after fears subside) and the cumulative nature of the cap. An Academy paper[4] suggested the plan's funding levels would not be much worse off due to the cap.

Because this cap smoothes out the volatile contribution, some employers might forgo the use of smoothing their asset and liability numbers.

This idea also works in the other direction. If a market bubble occurs, the minimum contribution would not decrease by more than 25%. This keeps the contribution from going to zero too quickly. The pension plan can become overfunded, but there will still be a contribution. That is a positive attribute if you are the PBGC, because having a surplus in the pension plan can help in the future if there is a stock crash. However, it destroys wealth if a company is forced to contribute to an overfunded plan, because surpluses are locked into the plan. Thus, employers will be strongly against being forced to put more money into an overfunded pension plan, unless the IRC Section 420 rules on asset transfers are relaxed (which I will discuss later).

There are a couple other concerns to address with the AVM idea. It is a big change from current rules, so it needs to be tested before put into law. Some concerns follow:

The AVM calculation could be complex. For example, contributions delayed would have to create a new loss, and the interplay with credit balances could be confusing. Also, a company shouldn't be able to increase benefits, and then avoid the increase in their contribution due to the AVM cap. Thus, the increase in contribution due to a benefit increase should not be capped (ditto if an employer shuts down a plant which increases benefits).

Mature plans: The AVM cap is modified if the cost of accruals is zero, because otherwise the contribution increase would be 25% of zero, which is zero. So the AVM cap has another minimum increase equal to 2% of a plan's value of accrued liabilities (if larger than the above cap). This 2% number could also be set by Congress in consultation with the PBGC, but it would be very difficult to agree upon. Mature employers with large retiree populations compared to their current workforces will find this minimum will blow them out of the water, while PBGC will most likely want it stronger than these companies will want.

AVM cap doesn't vary with interest rates: Unlike the 7-year amortization rule, the AVM cap has problems because it doesn't vary with interest rates. The 7-year amortization payment to a pension plan works like a loan. When interest rates are high, the loan payment is high relative to the loan amount. When interest payments are low, the loan payment is low. For the same reason, a pension plan sponsor has to pay a much larger 7-year amortization payment to get back to 100% funding when interest rates are high, and a lower payment when interest rates are lower. However, the 2% cap will still just be 2%. For example, if interest rates are high, the funding ratio won't improve by 2% as intended, and if assets don't do as well for awhile, the funding ratio could actually deteriorate over the period, not get closer to 100%. On the other hand, if interest rates are low and if stocks do well, the funding ratio would snap back much quicker than expected (possibly overfund, if assets revert to prior levels), so the cap would have been higher than necessary.

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[4] Pension Funding Reform for Single Employer Plans (dated 2/28/05)

Method II: Another idea suggested by the actuarial consulting firm Towers Perrin (TP) would use market values of assets and liabilities to determine a pension plan's funding ratio for the current and prior two valuations. It would then average them, with heaviest weighting on the current funding ratio. This average funding ratio could then determine the underfunding to be paid off over 7 years, as under the current PPA rules.

TP's suggestion uses market values at each valuation date, so it would work for sponsors using LDI (liability determined investment) techniques to immunize their pension plans from market and interest risks (by, for example, holding bonds). It would also work for plans that held stocks due to the averaging of the funding ratios. It would be more responsive to market crashes than the AVM method: the greater the crash, the larger the next year's contribution, but the increases would be tempered by the averaging of the funding ratios. The averaging of the funding ratios would also help with predictability, since a certain portion of the contribution would already be fixed before the valuation date, as in current rules.

This idea would have *some complexity*, in that prior funding ratios should probably be revised to reflect subsequent contributions, benefit accruals, and benefit improvements, but otherwise it could operate under the PPA rules as they are now.

Problems with the corridor: Unfortunately, there is one aspect of the PPA funding rules which if retained would undo all the good that the TP idea provides. It is the tight corridor restriction that assets must be within 10% of the market value of assets. The TP proposal didn't keep the corridor. I will use an example to explain why. If a pension plan's market value of assets equaled plan liabilities at $100 million, and then a stock crash brought the assets down temporarily to $70 million right around the valuation date, and then came back to $100 million over the next year, the use of average funding ratios would smooth the contribution and make it predictable, but the 90%/110% corridor would override it, so that the contribution would double, which would be way more than needed. It would overfund the plan. The following year, the overfunding would eliminate the minimum contribution requirement. It doesn't make any sense to double contributions one year and then eliminate them the next year. Employers are not going to want to maintain a DB pension plan, if that happens. It makes much more sense to keep contributions relatively stable.

Thus, even if assets come back fairly quickly, the PPA funding calculation is stuck using the assets within the 90%/110% corridor on the valuation date. In fact, this is the primary reason PPA's funding rule didn't work this past year after the crash. So this brings us to the simplest fix of them all.

Method III: Reduce contribution volatility by simply changing the permissible asset corridor back to 80%/120% of the market value (and allow partial use of market values). Changing back to the 80%/120% asset corridor doesn't require much change to the law. It would let PPA's 2-year smoothing rules work the way they were intended.

In fact, PPA's 10% corridor causes problems even for plans that partially immunize against interest rate risk. That's because it restricts the value of assets, but not the value of liabilities. So, for example, if interest rates increased say 200 basis points in one year, the liabilities and bond values would decrease by about the same amount (more than 10%). Since the employer only partially immunized, they would probably still be using asset smoothing for the stock values, but that would cause a problem with the bond values. They would be pulled down by the 10% corridor restriction. One way to fix that problem would be to allow employers to use market values of assets and liabilities for the portion of liabilities that are immunized, and use smoothed values for the portion not immunized.

There is good theory behind smoothing contributions. In recent US history, assets have come back after a crash. And if they don't come back, then the 2-year smoothing will quickly revert to the new level of assets. When I took an informal poll of some leading Finance and Economics professors at my University, I asked if they had increased their contributions to their retirement funds over the past year, and <u>not one of them</u> had, even though they all held stocks whose value had crashed. When I asked them why they had used such severe smoothing, they looked at me with surprise, and some said "is that what you mean by smoothing?" When we discussed why they had not increased their contributions, they said they were assuming that their assets would come back way before

they retire. This is not a perfect analogy, but it helped them understand why employers argue for some smoothing of contributions. (By the way, some people may be thinking that I am arguing for smoothing pension assets and liabilities in financial statements. I am not. The need for market values makes sense there, since companies are constantly being bought and sold, and in that case you need to know the accurate values that day.)

The theory of smoothing contributions goes in both directions. It is not used to just decrease contributions. It also increases contributions. For example, smoothing assets during a bubble makes the appropriate assumption (as in 1999) that the equity market can be overvalued, so that smoothing would require a contribution. Using market values would eliminate a contribution requirement.

Dr. Richard Thaler of the University of Chicago, one of the top behavioral economists in the country, wrote an Opinion Piece in the August 4, 2009 *Financial Times* entitled "In Support of Actuarial Smoothing". He wrote that market prices are not always right, and suggested that government create automatic stabilizing activities. Such an idea in the pension world would be to smooth pension contributions through market bubbles and crashes. That would dampen the business cycles of boom and bust caused by current rules that don't smooth contributions adequately during market crashes. In addition, I note that using the 80%/120% corridor has a lot less smoothing in it than the AVM method after a large stock crash, so I don't understand why supporters of the AVM rule think that the 80%/120% corridor rule is bad. Maybe there is an inconsistency in their thinking.

Trapped Pension Surplus: In addition to reducing contribution volatility, there are a few other items needed for pension funding to work. As noted earlier, requiring plans holding stocks to have surplus assets in their plans makes sense in case there is a future crash in stock values, but it will only succeed if employers can access plan surplus that will never be needed. Employers will not want to be forced to contribute surplus funds to plans, knowing that they can never get it back if it is not needed to pay promised benefits. Currently, if an employer were to transfer surplus assets out of a plan to help them pay for say the employee health plan costs, it is assessed a federal income tax of 35% plus a reversion excise tax of 50% and a state income tax of maybe 5%, so that the government gets 90% of any reversion. But the government gets no income from this, since no employer will do it at such high tax rates. The 50% excise tax was instituted in the 1980s when investors would buy a company, and pay for the purchase by raiding the company's pension surplus. Fortunately, thanks to mark-to-market accounting and rules putting the pension plan on the company books, the purchaser would have to pay for that surplus in order to buy the company, so it wouldn't happen anymore. The law already allows transfers of pension surplus to retiree health plans under IRC section 420, but that has no value to companies that don't have a retiree health plan. If Congress wants to encourage well-funded plans, it should expand IRC section 420 to also allow transfers to say the health plan of employees in the pension plan, without bringing pension raids back. They could provide restrictions, such as:

1. Only allow small amounts of pension surplus to come out in any one year,
2. Use the IRC 420 rules that requires the plan to have a 20% margin in the plan after the asset transfer,
3. Require continuation of the pension plan for 5 years, and/or
4. Require the approval of any union.

Even unions have testified in favor of a provision to transfer pension assets to the employee health plans (since it was successfully used with the UMW plan in the 1990s, and it could help employers retain their health plans).

Other Abuses that need to be fixed: I used to be the Chief Actuary of the PBGC, so I want to make sure we don't harm it, but strengthen it. As noted above, temporary relief shouldn't hurt the PBGC as long as we don't encourage employers to think that we will continue to provide relief at every crash. The way to do that, is to fix the rules permanently so that they handle crashes better, as discussed above, and discourage abuses, such as the ones below.

Bethlehem Steel was a weak company with a huge pension fund invested heavily in stocks. When the stock market did well, good returns eliminated the need for contributions to the pension plan, but Bethlehem Steel was gambling. When the stock market crashed, they were not able to afford the pension plan, and in fact, the crash gave them the ability to put their pension promises to the PBGC. Heads they won, tails the PBGC loses. We need to avoid that abuse. One way would be to prohibit large weak companies from having such large amounts in stocks. If a prohibition is too strong, an alternative would be to let the PBGC charge these weak companies with

unusually large allocations to stocks (e.g., greater than 50% or 60% or their active liability if less), a risk related premium. The premium could reflect their probability of going bankrupt (by comparing their borrowing rate to a Treasury rate). The calculating could also incorporate what the plan assets might be after a crash (using recent volatility in the assets held by the plan). The premium might be enough to keep the sponsor from "overinvesting" in stocks. Thus, it doesn't punish weak companies for being weak. It only punishes them if they overinvest in stocks.

Companies like United Airlines went into reorganization, enabling them to put their pension promises to the PBGC. An opinion piece in the Wall Street Journal co-authored by the CEO of a major airline, the former head of the PBGC, and the head of the major airline union suggested that companies going thru reorganization should have to keep the responsibility for their pension promises, instead of dumping them on the PBGC. Their solution required the 3 parties involved to work out an Alternative Funding Arrangement where the contributions were temporarily decreased in exchange for frozen guarantees and possible benefit reductions that would be less harsh than if the PBGC took over the plan. The Senate had a provision that would have implemented such an idea in Section 402 of their version of PPA, and the American Academy of Actuaries wrote about this in a paper entitled Keeping Employers Responsible for Their Promises. The Administration was concerned that it would give the Treasury Department and PBGC too much influence over an individual company and allow them to aid one company in an industry over its competitors, but the aid pales in comparison to the benefits of the PBGC completely taking over the pension plan from the reorganizing company. If consistency is a problem, Congress could set parameters around the relief provided.

PBGC Premiums: Finally, I would be remiss if I didn't note that PBGC has a deficit and needs additional income to completely fulfill its mission. It may be difficult to get enough funds from the remaining companies in the DB system, since so many companies have terminated their pension plans. PBGC's current underfunding is primarily due to taking over underfunded pension plans in the airline and steel industries, which means that the customers of those industries underpaid for their services. This suggests that one source of funding for PBGC could be the current customers of those industries. For example, a fee of $1 per person could be charged for each commercial flight (domestic or international) that takes off or lands at a US airport. In addition, there could be a $1 fee for every ton of raw steel sold in or imported into the US. Without these changes, PBGC will have to rely on premium income from covered pension plans, whose numbers are shrinking, and possibly withdrawing employers.

In conclusion, measured temporary relief can help both retirement security and the nation's unemployment problem. And it can be done in a way that doesn't hurt the PBGC, and works for employers, if it is done without unfair restrictions on which firms get it. In addition, so that employers can plan ahead, Congress should fix the funding rules on a permanent basis so that they don't have such volatile results after a market crash. Otherwise, employers will expect relief after the next crash. In addition, the pension asset transfer rules should be expanded so that employers are more likely to add surplus assets to their pension plans. A few abuses described above also need to be closed. I appreciate the opportunity to discuss this topic and look forward to your questions.