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Committee on House Education and the Workforce

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I appreciate the opportunity to appear before you today to discuss the an appropriate funding rule for America's defined benefit **pension plans.** This is an extremely important subject, and I would like to thank Chairman Boehner for scheduling this hearing. Let me begin by noting that while I am a Research Fellow in Social Security and Financial Institutions at the Heritage Foundation, the views that I express in this testimony are my own, and should not be construed as representing any official position of the Heritage Foundation. In addition, the Heritage Foundation does not endorse or oppose any legislation. What a difference a year makes. Last year, there was a great deal of discussion about the "dangers" of 401k retirement plans and other types of defined contribution plans. Experts warned, with some justification that retirement plans where workers had to invest their money faced investment risks. Many of those same experts and legislators called for a return of the good old days when employees were part of a defined benefit retirement plan. Under those plans, rather than having a retirement benefit based on one's investments, a worker receives a company paid benefit based on his or her length of employment and salary history. In theory, defined benefit plans are paid from a separate fund managed by the company or by financial professionals chosen by them.

Those experts implied that these defined benefit plans had little or no risk. They were wrong. Since then, a number of companies have dropped their defined benefit **pension plans** as part of a bankruptcy proceeding. Most recently, Weirton Steel became the latest company to try to dump their pension obligations on the taxpayer. Last week, I was a guest on a radio show that originates in the Ohio Valley area, and had the opportunity to speak to several steel workers whose pensions were going to be affected by Weirton's actions. Their stories were a forceful reminder that this is not just a policy issue, it affects real people's lives in the most direct way at the time when they are likely to be least able to change their circumstances.

Now Congress is debating legislation that would allow companies just a little more time to fund their **pension plans.** It is also looking a ways to change the regulatory framework so that under funded **pension plans** look like they have just a bit more in assets. Companies claim that without this help, jobs will be lost and the economy will suffer.

The S&L Crisis: Are We On the Same Track With Pensions?

Earlier this month, I testified at a Senate Special Committee on Aging hearing entitled "Americas Pensions: The Next S&L Crisis." That title could not be more to the point. It also brings back some painful memories. Back in the early 1980's, I worked as Legislative Director to a member of the House Banking Committee, former Rep. Doug Barnard of Georgia, as Congress considered legislation dealing with the early signs of the S&L crisis.

At the time, we were told that the industry was essential to America's economy, and that even though they were beginning to run deficits, all that was needed was a little forbearance. As a result, Congress created a regulatory form of capital called "good will" which allowed S&Ls to count an estimate of their reputations and business relationships as part of capital. At first, the gimmick worked like a wonder. S&Ls suddenly had not only enough capital to be "healthy" but to expand.

Of course, the net result was that when the industry finally collapsed the expanded S&Ls had lost even more money than they would have if they had been allowed to face economic reality several years earlier. The cost to America's taxpayers was somewhere around $500 billion. By showing forbearance, Congress had really just made the problem worse and increased the eventual cost. That example could also apply to America's pensions.

The S&L crisis has a direct parallel to what we are discussing today. The Senate Finance Committee has approved legislation that includes a three year holiday on the Deficit Reduction Contribution, a mechanism created in 1987 to require companies with chronically underfunded **pension plans** to increase the assets in those plans. Such a move, regardless of the problems faced by a few industries, would practically guarantee that we will be sitting here in a few years discussing a multi-hundred billion dollar bailout of the PBGC. It would be extremely irresponsible, and I would hope that the Administration would veto any bill containing such a funding holiday.

Currently, 12 percent of the labor force is covered by defined benefit **pension plans,** while an additional 7 percent is covered by both defined benefit and defined contribution plans. Under a defined benefit plan, a worker is promised a retirement benefit based on a percentage of salary for each year worked or similar measures. While the worker does not have the direct investment risk associated with a 401(k) plan, the benefits depend on whether or not the plan is fully funded. The risk that it is not fully funded can be as great or greater than the risk from stock and bond investments, but it is usually much harder for the worker to determine how high that risk is.

A Proper Discount Rate for Defined Benefit **Pension Plans.**

A key question is whether the **pension plan's** level of funding is being measured properly. A July 8 proposal by the U.S. Department of the Treasury addresses both the proper way to measure **pension plan** funding and ways to make it easier for workers and others to determine whether their company's **pension plan** is at risk. It also proposes ways to prevent companies that are in financial trouble from making promises to their workers and then making the taxpayers pay for them.

The Treasury Department's plan is far superior to the discount rate provisions in the July 18 version of the Portman-Cardin bill passed by the House Ways and Means Committee--H.R.1776, named for the bill's two principal sponsors, Representatives Rob Portman (R- OH) and Benjamin L. Cardin (D-MD)--and Congress should consider incorporating Treasury's proposed reforms into the final bill. As a short term alternative--with the full understanding that this is a temporary measure, Congress should consider a two year shift to a corporate bond rate, such as that contained in HR 3108.

Why an Appropriate Discount Rate Is Important

The funding of a defined benefit **pension plan** is measured using a "discount rate." A plan is assumed to be fully funded if the assets that it currently has can be expected to grow at a certain interest rate until the resulting level of assets then equals the total amount of pension payments that the plan promises to make in the future. For example, if a fund will owe $1,000 in 30 years and assumes that its assets will earn an average of 5 percent every year after inflation, it must have $231 today in order to be fully funded. (Invested at a 5 percent interest rate, $231 will grow to $1,000 in 30 years.)

The discount (interest) rate used to measure a plan's funding is crucial. If a plan assumes that its assets will grow at 7 percent a year instead of 5 percent, it needs only $131 today to be fully funded (rather than the $231 it would need if it used a 5 percent rate). On the other hand, if a plan uses a discount rate of only 3 percent, then it must have $412 on hand today to be fully funded.

The discount rate has no actual relationship to how much a **pension plan's** investments are earning. While the law requires that plans make prudent investments, these investments can change over time and are greatly affected by short-term swings in the stock, bond, and property markets. The discount rate is intended to measure whether or not the plan has sufficient assets to meet its obligations over a long period of time; thus, a defined benefit plan uses the rate for long-term government or corporate bonds instead of the rate of interest the plan is earning on its investments.

Over the years, Congress has tinkered with the appropriate discount rate in order to address specific problems as they arose. From 1987 to 2002, the law required that defined benefit **pension plans** use a weighted four-year average of the returns of the 30-year U.S. Treasury bond rate as their discount rate for determining funding adequacy. Under the 1987 law, plans were allowed to use any number between 90 percent and 110 percent of that rate. The spread between 90 percent and 110 percent was intended to allow the **pension plan** a slight amount of flexibility in its calculations. In 1994, Congress narrowed this range to between 90 percent and 105 percent of that weighted average. This discount rate is also used to determine lump-sum benefits for workers who want a one-time payment instead of a monthly check.

However, using this rate presents two problems. First, the Treasury Department announced in 2001 that it would stop issuing the 30-year Treasury bond. As a result, market prices for these bonds are distorted by the realization that they will no longer be issued. Second, interest rates in general are at a historic low, reaching levels not seen for almost 50 years. While economists expect them to rise gradually, **pension plans** argue that using today's low rate would make **pension plans** look far more underfunded than they actually are. Continued use of today's rate would force companies to assign **pension plans** literally billions of dollars that could be used more effectively to build the company.

Recognizing that the old discount rate was too low, in 2002, Congress allowed **pension plans** to use instead a number equal to 120 percent of the four-year average of the 30-year Treasury bond rate. However, this law expires after 2003. Some corporations have proposed that Congress substitute a longer-term corporate bond rate for the 30-year Treasury rate. Since corporate bonds do not have the full faith and credit of the United States behind them, they have higher interest rates. Using those higher interest rates would sharply reduce the amount of money that a **pension plan** must have on hand in order to avoid being underfunded while still protecting the **funding status** of the plan.

The changes in the discount rate between 1987 and now have had an effect. Each, along with other changes in the law including the establishment of a 90 percent minimum full funding rate in 1994, have addressed specific problems. In most cases, there has been at least a temporary improvement. For instance, the 1994 law saw a chronic underfunding of these **pension plans** (in the aggregate) change into a significant surplus. However, despite improvements after each change, these changes have proven to be temporary until the next change in circumstances requires yet another urgent debate.

Recent circumstances are forcing Congress to yet again examine the appropriate discount rate. As will be discussed below, the Treasury Department has made a proposal that would significantly improve the discount rate. However, simply looking at the discount rate for current liabilities may not be enough. For both the affected workers and for taxpayers as a whole, it may be even more important to look at the termination liability of chronically underfunded **pension plans.**

How the Treasury Department Proposal Would Affect the Discount Rate

On July 8, the Treasury Department proposed that a two-stage change in the **pension plan** discount rate be substituted for the current 30-year Treasury bond rate. For the next two years, the Treasury proposal would allow plans to use Congress's choice of either the 20-year or 30-year corporate bond rate. After that two-year period, companies would begin a three-year transition to using a corporate bond interest rate determined by the average age of an individual company's workforce.

Since companies with older workers will begin to pay out pension benefits sooner than companies with younger workers, the Treasury Department proposal would require companies with older workers to use a shorter-term corporate bond rate. Short-term bonds of all types have a lower annual interest rate than longer-term bonds do. This lower discount rate means that those companies would have to have proportionately more assets available to pay pension benefits. Companies with younger workers could use a longer corporate bond rate, which would allow them to have proportionately less cash and other assets available. This is an important reform that should be carefully considered.

The simple fact is that some industries and companies have workforces that are older on average than others. Since these companies will have to begin paying their workers' pension benefits sooner, the health of their **pension plans** is a significant factor in their ability to remain in business. If their **pension plans** are underfunded and the company has to make significant payments to them, that company is at a higher risk of bankruptcy than if the same company had a younger average workforce. Rather than using a uniform measure for all companies, it is much more prudent to use a discount rate that is customized to reflect a particular company's workers.

Using a customized discount rate as proposed by the Treasury Department would allow workers and investors to better understand a company's overall financial health. The customized discount rate also should allow earlier identification of problem companies so that changes can be required before they become critical.

Balancing the Interests of Workers, Companies, and Taxpayers

It is tempting to see the issue of discount rates as affecting only the amount that cash-strapped companies will have to divert to their **pension plans.** However, much more is at stake. Changing the discount rate to just a single long-term corporate rate might benefit companies by lowering the amount that they have to contribute to **pension plans,** but it also might hurt both workers and taxpayers in the long run. Workers who want to take a lump- sum pension distribution instead of monthly payments would receive less under such a system than they would under the current discount rate.

Lump-sum pension benefits are calculated by determining the total amount of pension benefits owed over a lifetime and calculating how much money invested today at the discount rate is needed to grow into the promised total amount. The higher the discount rate, the lower the amount of money that will be necessary to grow into that promised benefit, and the lower the lump sum benefit. At the same time, too low a discount rate may mean a lump-sum payment that is too high, thus further draining the plan of needed assets.

In determining an appropriate discount rate, Congress must balance the needs of both **pension plans** and retirees wishing to take a lump sum benefit. Similarly, if Congress only substitutes a higher uniform discount rate for the present one, taxpayers could find themselves required to pay higher taxes to make up for Pension Benefit Guarantee Corporation (PBGC) deficits. The PBGC is the federal insurance agency that takes over insolvent **pension plans** and pays benefits to retirees. Even though the PBGC limits the amount that it pays to each retiree, taxpayers can expect Congress to bail out the agency with additional tax money if the agency runs major deficits.

When Congress considers the appropriate discount rate, it must take into consideration the risk that an overly generous discount rate will result in more underfunded **pension plans,** and thus that more of those plans will be turned over to the PBGC for payment. This is especially true if legislation contains a holiday on the Deficit Reduction Contribution. This is not just an issue that concerns companies; taxpayers have an equal stake in its outcome.

Termination Liability

As important as the debate over the appropriate discount rate is, its use is not sufficient to protect either workers or taxpayers. As the PBGC has pointed out, many chronically underfunded plans look reasonably healthy until they are terminated. For instance, Bethlehem Steel's **pension plan** reported that it was 84 percent funded under current liability rules, but proved to be only 45 percent funded when the plan terminated. The US Airways pilots' plan reported that it was 94 percent funded, but proved to be less than 35 percent funded when it was terminated. Most recently, Weirton Steel's **pension plan** was only about 39 percent funded when it terminated. I spoke to one worker with over 20 years service who was told by both management and his union head that the **pension plan** was funded. They were not lying, they were just using another measure--one that proved to be meaningless when the plan went under PBGC control.

The simple fact is that while there is some value to measuring current liabilities, it is not sufficient. Pension accounting is a regulatory game that must come closer to reality. It is meaningless to the Weirton Steel worker if his plan looks relatively healthy before it is terminated. What is important is finding out that his pension will be reduced. Similarly, as a taxpayer, I could care less if Bethlehem Steel's plan met minimum funding requirement for most of the years prior to its end. What does interest me is the $4.3 billion shortfall that I or my children may have to help cover.

PBGC is a Market Distortion

PBGC, despite having an important mission, is a creation of government and would not exist in the marketplace in its current form. Just like the FDIC and the old Federal Savings and Loan Insurance Corporation, its protection is not free. Because PBGC is a distortion in the market, its politically set insurance premiums and regulatory guidelines are open to gaming by corporations and others who want to pass part of the cost of their **pension plans** to the taxpayer. The current debate over an appropriate discount rate is another example of this.

This is not to say that the agency does not serve a valuable purpose, but to recognize that its presence increases the risk that taxpayers will end up paying for the protection it offers. Until PBGC is either reformed to include a premium rate that includes a more effective measure of risk or changed into an agency that helps to arrange properly priced private sector insurance, debates about pension **funding status** are going to reoccur on a regular basis.

Two Other Important Reforms

The Treasury Department proposal includes two additional reforms that would increase the information available to workers and investors and lower the potential liability to the PBGC. Even if agreement on the discount rate cannot be reached for now, Congress should swiftly consider making the following reforms:

1. Improved Information All too often, the true status of a defined benefit **pension plan** is unknown to the affected companies' workers and investors. The Treasury Department proposal would require **pension plans** that are underfunded by more than $50 million to make a more timely and accurate disclosure of their assets, liabilities, and funding ratios. In addition, while phasing in the new discount rate changes, all plans would have to make an annual disclosure of their pension liabilities using the duration matched yield curve. This reform would further improve the ability of workers and investors to judge whether a **pension plan** is properly funded.

Finally, **pension plans** would have to disclose whether they have enough assets available to pay the full amount of benefits that workers have already earned. As mentioned above, requiring disclosure of "termination basis" would ensure that if the company files for bankruptcy and seeks to terminate its **pension plan,** workers are not suddenly surprised to find that the plan cannot pay the pension benefits they have already earned.

2. Reduced Taxpayer Liability

Companies that are in severe financial trouble often try to keep their workers happy by promising them higher pension benefits. Similarly, companies in bankruptcy sometimes seek to improve pension benefits in return for salary concessions. In both cases, these higher pension promises often get passed on to the PBGC, and thus to the taxpayers, for payment when the company seeks to terminate its **pension plan.** The proposed reforms would prevent severely underfunded **pension plans** from promising higher pension benefits or allowing lump-sum payments unless the company fully pays for those improvements by making additional contributions to its **pension plan.** Similar restrictions would apply to companies that file for bankruptcy.

How Not to Improve the Situation.

The one thing that Congress should not do is to repeat the sad experience of the 1980's. Unless there is hard evidence that a company will recover its economic health, Congress should not casually extend the amount of time that corporations have to fund their **pension plans.** While this may be justified on a case-by- case basis, a general rule is likely to just mean that taxpayers will have to pay more to bail out the PBGC when it runs out of money.

And that day is inevitable unless Congress takes a serious look at PBGC and the entire retirement situation. This is not a problem where individual mini-crises should be considered to be unrelated. PBGC has an investment portfolio that includes a sizeable proportion of government bonds. It is true that unlike Social Security, which simply stores the special issue treasury bonds in its trust fund, PBGC builds its portfolio by trading its special issue bonds with the Bureau of the Public Debt. However, that portfolio growth gives a false sense of assurance.

When the time comes for PBGC to liquidate its portfolio to pay benefits, we may see the "perfect storm" where both Social Security and Medicare are liquidating their government bond portfolio at the same time. Even though PBGC is the smallest of these agencies by a large margin, the only way that it will be able to raise the money that it needs for benefit payments is to either sell its bond portfolio on the open market or to return them for repayment. Neither option looks promising at this point. If the government is borrowing massive amounts of money, the prices of bonds can be expected to be unstable at best. And if Social Security and Medicare are consuming massive amounts of government resources, PBGC can expect a place behind them.

Thoughts for the Future.

As an alternative, Congress should consider a close examination of the entire retirement situation ranging from Social Security to private **pension plans** to incentives for people to work. Among steps that could be considered are:

1. Reform PBGC: PBGC has done a fine job with what it has, but the structure is fundamentally flawed. Premiums are inadequate, and are not based on any measure of the risk that the employer will turn its **pension plan** over to the agency. Investment strategies are less than adequate. Rather than a piecemeal review, Congress should begin now a thorough review of the agency .

2. Encourage Small Business to Form Retirement Pools: About 50 percent of the US workforce has no private **pension plan.** Many of these workers are employed by smaller businesses that cannot afford to sponsor any sort of retirement plan. Current legislative efforts to remedy this situation have centered on reducing the regulatory burden that is a major part of the cost of having a **pension plan.** Instead, Congress should consider an alternate approach. Rather than expecting every small business to have its own retirement plan, encourage them to form pools, perhaps based around associations, chambers of commerce, or other affinity group. This would work best with defined contribution retirement plans.

3. Phase Out Defined Benefit Plans: Sadly, it may be time to recognize that in the future workers will have more job mobility than they even do now, and that a defined benefit plan may not be in their best interests. Congress should consider developing incentives for companies to shift their retirement plans to defined contribution plans.

4. Encourage Workers to Work Longer: In the future, there will be fewer younger people to take the jobs of those who retire, and a resulting demand for older workers who are willing to stay in the workforce--even if it is only on a part-time basis. Congress should examine the various workplace rules now to remove regulatory and other obstacles

5. Reform Social Security: Every day that Congress and the Administration delays reforming Social Security, there is one less day that the program will have surpluses. The Social Security trustees warn that the program will begin to run cash flow deficits within 15 years. There is a pool of IOUs known as the trust fund, which can be used to help pay benefits until they run out in 2042, but in order to liquidate them, Congress will have to come up with about $5 trillion (in today's dollars) from general revenue. The last thing that future retirees need is to find out that both their company **pension plan** and Social Security are unable to pay all of their promised benefits.

Thank you for the opportunity to testify. I look forward to your questions.

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