

Funding our Future:



A Safe and Sound Approach to Defined Benefit Pension Plan Funding Reform



AMERICAN BENEFITS
COUNCIL

February 2005

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FOREWORD

At its October 2001 meeting, the Board of Directors of the American Benefits Council identified as an urgent priority the need for replacement of the 30-year U.S. Treasury bond interest rate used for defined benefit pension plan funding and other purposes.


Over the subsequent several months the Council, working in concert with other like-minded organizations, identified a long-term investment grade corporate bond rate as the appropriate permanent replacement rate. The Council has testified before Congress numerous times over the past few years on the need for replacement of the interest rate and other related pension funding reforms. The Council's work in recent years follows a long tradition of engagement on legislative reform efforts to improve pension funding, better secure the financial integrity of the Pension Benefit Guaranty Corporation (PBGC) and advocate for policies that will protect and promote defined benefit pension plans.

In 2004 Congress passed, and President Bush signed, legislation that addressed, on an interim basis, the need for replacement of the interest rate used for plan funding calculations. This year with the temporary legislation expiring and with heightened concerns over pension funding and the liabilities inherited by the PBGC, it is clear that

broader pension reforms should and will be a priority issue for the Congress and the executive branch.

The American Benefits Council has drawn upon the expertise and varied perspectives of its corporate membership, and developed what we firmly believe is a safe and sound approach to defined benefit pension plan funding. In addition to setting forth our own proposals, this document also critiques many of the Administration's proposals and indicates the principal areas where our views and Administration's are aligned, and where they differ. This analysis is based upon a review of the Administration's detailed proposals that were made available in early February as a comprehensive follow-up to the Administration's initial proposals previously released.

With adoption of the American Benefits Council's recommendations set forth in this paper, policymakers will take crucial steps toward "*Funding our Future.*"



James A. Klein
President
American Benefits Council

FUNDING OUR FUTURE:

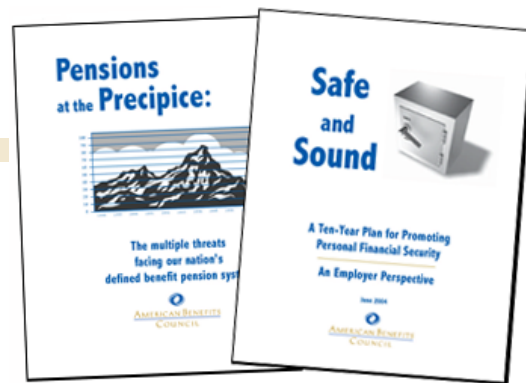
A SAFE AND SOUND APPROACH TO DEFINED BENEFIT PENSION PLAN FUNDING REFORM

INTRODUCTION

The American Benefits Council believes strongly in defined benefit pension plans. A recent Council publication enumerates in substantial detail the very serious challenges facing the defined benefit plan system. (See *Pensions at the Precipice: The Multiple Threats Facing our Nation's Defined Benefit Pension System* (May 2004)).

Moreover, the Council also last year issued a comprehensive long-term public policy strategic plan, *Safe and Sound: A Ten-Year Plan for Promoting Personal Financial Security – An Employer Perspective* (June 2004) that discusses the importance of a vibrant employer-sponsored retirement system (both defined benefit and defined contribution plans) and personal savings in meeting the income security needs of an aging population.

As discussed in more detail in both the *Safe and Sound* strategic plan and the *Pensions at the Precipice* report, the Council believes several legislative steps are needed to revitalize and support the defined benefit pension system.



Among these legislative steps are reform of the funding rules so that:

- (1) benefits promised to participants are funded, thus protecting participants and the Pension Benefit Guaranty Corporation (PBGC);
- (2) funding obligations are neither artificially inflated nor volatile, thus preventing employers from abandoning the system because of adverse effects on business planning;
- (3) plan participants are provided clear, timely information about the funded status of their plan; and
- (4) the funding rules do not unreasonably increase burdens on companies during economic downturns, since the best “insurance” for participants’ benefits is a healthy company that recovers from such downturns.

It is critical that reforms be focused on our ultimate goal: retirement security. Because of PBGC deficits, there is a risk that the reform efforts will be focused only on the PBGC.

While we wholeheartedly agree that the PBGC must be protected, it is critical that we not lose sight of the fact that the PBGC was set up to strengthen retirement security through the defined benefit plan system. In other words, if we protect the PBGC at the expense of the strength of the system, we will have failed in an ironic and sad manner.

The Administration has issued its funding and premium proposal. We believe that the proposal has strengths, but also has serious flaws that would have extremely adverse effects on plans, participants, companies, and the PBGC itself. The primary flaws of the Administration's proposal are:

- (1) a dramatic decrease in funding and premium predictability;
- (2) a counterproductive and troubling use of credit ratings;
- (3) creation of a strong disincentive to pre-fund; and
- (4) an increase in PBGC premiums that unjustifiably burdens the defined benefit plan system.

We look forward to the opportunity to work with the Administration on its proposal. In its current state, however, we believe that the flaws noted above would result in far fewer defined benefit plans, lower benefits, and far more pressures on troubled companies that jeopardize the companies' ability to recover.

Our proposals

This paper outlines our proposals for funding reform for plans other than multiemployer plans. There is a threshold question as to whether reform

should be based on modifications of current law or whether the current-law rules should be replaced in their entirety with a new structure. We support the former approach.

In a complex area that needs reform, there is always some temptation to throw out all the rules and to start from scratch. However, certainly in this

case, that would be both unnecessary and imprudent. The funding questions that must be addressed are the same regardless of which path is chosen. For example, how should liabilities be measured; how quickly should underfunding be funded; what contributions should be deductible; and what disclosure should be required? Starting from scratch does not make answering questions like this easier. On the

If we protect the PBGC at the expense of the strength of the defined benefit pension plan system, we will have failed in an ironic and sad manner.

contrary, starting from scratch makes it more difficult by requiring that all funding rules be reinvented in the new context. And the risks are far greater with wholesale reform because there will inevitably be issues missed, such as subtle important rules reflected only in regulations that are inadvertently omitted from the new regime.

Finally, modification of the current rules involves far less cost and disruption for plan sponsors. And it is critical to remember that this is a voluntary system. If plan sponsors face large and uncertain costs in adapting to an entirely new set of rules, many will abandon the defined benefit plan system.

In short, every important issue can be addressed by modifying the current rules without the uncertainty and cost of creating a whole new system.

PERMANENT REPLACEMENT OF THE 30-YEAR TREASURY RATE

The long-term corporate bond rate

Prior to the Pension Funding Equity Act of 2004, the 30-year Treasury bond interest rate was required to be used to determine the “current liability” of a defined benefit plan. “Current liabil-

ity” is, in turn, used in certain circumstances to determine how much the plan sponsor must contribute in a year to fund the plan. The 30-year Treasury bond interest rate was also required to be used for various other pension purposes, including determining the amount, if any, that is owed to the PBGC as a variable rate premium.

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

—*from the Council’s Pensions at the Precipice: The Multiple Threats Facing our Nation’s Defined Benefit Pension System*

The 30-year Treasury bond rate has become artificially low compared to other interest rates because of Treasury’s buyback program (which started in the late 1990s) and because of the discontinuance of the 30-year Treasury bond in 2001. The use of this low rate for pension purposes artificially inflates pension liabilities and fund-

ing obligations. If applicable, these inflated obligations will have adverse effects on the nation’s economy.

In addition, concerns regarding unrealistic funding obligations have already led companies to freeze plan benefits and many more companies will likely do so if a permanent replacement for the 30-year Treasury bond rate is not enacted soon.

Congress recognized that the 30-year Treasury bond rate was a “broken rate” in 2004 and enacted a temporary solution, permitting the use of a

long-term investment grade corporate bond rate for 2004 and 2005. That was the right action at the time. Now is the time to make that change permanent.

Businesses need to be able to make projections about future cash flow demands so that they can make sound plans for the future. The temporary nature of the rule in effect today makes planning difficult and can undermine a company's commitment to the defined benefit plan system.

The Council strongly recommends that the 30-year Treasury bond rate be permanently replaced by the long-term investment grade corporate bond rate. As under current law and as discussed further below, for funding purposes, the four-year weighted average of such rate would be used.

This rate is a conservative estimate of the rate of return a plan can expect to earn and thus is an economically sound and accurate discount rate. In addition, it is a clear, simple rule that can be understood and administered easily by employers of all sizes.

The yield curve proposal

The Administration has proposed, as an alternative to the long-term corporate bond rate, a "yield curve." This proposal differs in two fundamental respects from the Council's proposal.

First, the yield curve interest rate is a "near-spot rate" rather than a four-year weighted average rate. This aspect of the Administration's proposal is discussed in a subsequent section of this paper.

Second, the yield curve proposal would apply a different interest rate to every expected payment to be made by the plan based on the date on which that payment is expected to be made. For example, the interest rate applicable to a liability to be paid in 19 years would be based on a 19-year corporate bond.

The Administration's yield curve proposal does not reflect the real yield curve applicable to defined benefit plans.

The yield curve proposal is flawed in several respects. First, the proposal would generate hundreds of different interest rates for *each* participant. This level of complexity may, at best, be manageable by some large companies; it

would impose an unjustifiable burden on small- and mid-sized companies across the country.

Second, the proposal is intended to reflect the market and thus be "accurate;" in fact, the markets for corporate bonds of *many* durations are so thin that the interest rates used would actually need to be "made up," *i.e.*, extrapolated from the rates used for the other bonds.

Moreover, the Administration's proposal does not reflect the real yield

curve applicable to defined benefit plans. A real yield curve would reflect the fact that for long-term obligations, plans generally invest in equities in order to lower their costs (since over time equities earn a greater rate of return). For mid-term liabilities, plans generally invest in a mix of equities and bonds; plans invest more in non-equities for short-term liabilities.

Accordingly, if a real yield curve were used and it were simplified so that it could be administered by plans of all sizes, it might look something like the following:

Mid-term liabilities (*e.g.*, five to 20 years) would be valued based on the four-year weighted average of the long-term corporate bond rate; long-term liabilities (over 20 years) would be valued based on the four-year weighted average of the long-term corporate bond rate plus a specified number of basis points (such as 100); and short-term liabilities (less than five years) would be valued based on the four-year weighted average of the long-term corporate bond rate minus the same number of basis points.

The long-term liability basis point adjustment would reflect the fact that ongoing plans generally invest in equities to provide for long-term liabilities,

and equities historically have a higher rate of return than long-term corporate bonds. The short-term basis point adjustment would reflect the fact that investments to meet short-term liabilities generally have a rate of return lower than long-term corporate bonds.

“The yield curve should not be adopted, particularly in light of the many unanswered questions about the approach and the incomplete analysis of its ramifications on funding volatility and asset allocation.”

—*from the Council’s Pensions at the Precipice: The Multiple Threats Facing our Nation’s Defined Benefit Pension System*

The Council strongly opposes the yield curve proposal, especially if it were to reduce the effective discount rate for the typical plan. Even the simplified version described above would introduce unnecessary complexity and disruption. The vast majority of plans would attain almost the same results using the long-term corporate bond rate alone; those few plans that would have a higher liability using the simplified

yield curve are the most mature plans in industries that can least afford to have a sudden required increase in funding obligations.

DEFINITION OF PLAN LIABILITY

Use of “current liability” versus “termination liability”

As noted above, under present law, current liability is used for funding and other purposes. Current liability is a type of “snapshot liability,” *i.e.*, it does

not include future liabilities based on future compensation or service. Current liability is, in this respect, similar to termination liability. Termination liability is the value of the benefits that would be owed if the plan terminated, measured using PBGC standards and assumptions. Some in the executive branch agencies have argued that current liability should be replaced or supplemented by termination liability; they argue that termination liability, which is greater than current liability, is the proper measure of a plan's liability.

For the vast majority of plans that are not terminating, the use of termination liability for funding and other purposes would be inappropriate and would grossly overstate plan liabilities. There are clear examples of this overstatement. Generally, under present law, the biggest difference between current liability and termination liability is the interest rate used to value liabilities.

For example, for October 2004, the four-year weighted average of the long-term corporate bond rate (which, as noted above, is used to determine current liability) was 6.21 percent; the termination liability interest rate developed by the PBGC for October 2004 was 4 percent for liabilities of 20 years or less and 5 percent for longer liabilities. The termination liability interest

rate is far below even the 30-year Treasury rate, which was 5.14 percent (four-year weighted average) or 4.9 percent (spot rate) for October 2004.

The termination liability interest rate developed by PBGC is generally too low even for terminating plans, as will be addressed by a future Council paper. The numbers set forth above demonstrate that it is *extremely* low for an ongoing plan.

The 'termination liability' interest rate developed by the PBGC is generally too low even for terminating plans.

Termination liability also includes "shutdown benefits" and other similar "unpredictable contingent event benefits." Generally, those are additional benefits contingent on an adverse business event, such as the closing of the facility where a participant works. Because of the speculative nature of these benefits, they are very difficult to value and thus

are not included in current liability. Without any practical way to value such contingent benefits, the Council opposes any proposal to include them in current liability.

The Council has reviewed the differences between current liability and termination liability and recommends that current liability be reformed in one significant respect for all plans (not just "at-risk plans"). Under present law, current liability is determined based on the assumption that all participants

receive their benefits in the form of an annuity.

To the extent that the plan offers lump sums, current liability should take into account lump-sum distributions reasonably projected to be taken (subject to a transition rule to prevent a sharp increase in current liability). For this purpose, reasonable projections could be made regarding the applicable lump-sum discount rates, provided that the projected discount rates may not be higher than the interest rate otherwise applicable in determining current liability.

The Administration's proposal would create a new type of termination liability for at-risk plans, based on the assumption that all employees take lump-sum distributions (to the extent available) and retire early. The lump-sum issue is discussed above. The proposed early retirement assumption would be unrealistic in the vast majority of cases, and would severely burden any "at-risk company," thereby jeopardizing the company's ability to recover. This is contrary to the interests of participants, the company, and the PBGC.

PREVENTING THE VOLATILITY THAT WOULD BE CREATED BY SPOT VALUATIONS

From business' perspective, perhaps the most important issue relating to defined benefit plans is predictability.

Companies need to be able to make plans based on cash flow and liability projections. Volatility in defined benefit plan costs can have dramatic effects on company projections and thus can be very disruptive. It is critical that these costs be predictable.

The critical elements facilitating predictability under current law are:

- (1) the use of the four-year weighted average of interest rates discussed above; and
- (2) the ability to smooth out fluctuations in asset values over a short period of time (which is subject to clear, longstanding regulatory limitations on such smoothing).

The Administration has testified before Congress that the measurement of assets and liabilities should be based on spot valuations and that volatility can be addressed through smoothing contribution obligations. This approach is seriously flawed in three respects.

First, spot valuations are not necessarily accurate. For example, the spot interest rates from late 2002 were very poor indicators of interest rates for 2003. It simply is not logical to conclude that a spot interest rate for one short period is "the" accurate rate for a subsequent 12-month period.

Second, the Administration's proposal does not contain any smoothing mechanism to make contribution or premium obligations predictable.

Third, the Administration has not even acknowledged the *numerous* other rules that do not relate to contribution obligations that would become volatile if asset and liability measurements were based on spot valuations (*e.g.*, deduction limits, benefit restrictions). It is critical that the current-law smoothing rules be preserved.

DISCLOSURE

The Council strongly supports enhanced disclosure of a plan's funded status. In fact, the Council's disclosure proposal would provide disclosure to more plans on a more timely basis than any other proposal (including the Administration's).

The current-law disclosure tool, the summary annual report (SAR), provides information that is almost two years old. That is inadequate. Under our proposal, within 2½ months after the end of the year, *all* plans would be required to disclose to participants year-end data on the plan's funded level.¹

Year-end data would consist of year-end asset valuation, as well as beginning-of-the-year current liability figures projected forward to the end of the year, taking into account any significant events that occur during the year

(such as a benefit increase). Plans would have the option to use year-end SFAS 87 data in lieu of the above data.

Other proposals achieve less disclosure, and some of the other proposals have serious adverse effects. Some proposals have been based on the SAR and thus give rise to disclosures that are out-of-date.

Other proposals require disclosure only from employers with plans that are more than \$50 million unfunded. Those proposals are inadequate. For example, those proposals would not apply to a plan with \$60 million of assets and only \$20 million of liabilities. Moreover, those proposals inappropriately target large plans. A large plan that is 99 percent funded could be subject to disclosure under the proposals (*e.g.*, in the case of a plan with over \$5 billion of liabilities) with the accompanying inappropriate stigma of being "so underfunded" as to be one of the few plans subject to this additional disclosure.

Certain executive branch agencies have discussed using termination liability (instead of current liability) for disclosure purposes, which is significantly higher than current liability. That could mislead and alarm participants in the vast majority of plans that are not terminating. The executive branch

¹ Because of the need to collect data from so many sources with different circumstances, more than 2½ months should be permitted for multiple employer plans and multiemployer plans.

agencies' concerns can be addressed, to the extent appropriate, by moving current liability closer to termination liability, as discussed above.

Critics of present law point out that although the vast majority of plans are ongoing, participants in plans that may well terminate in the near-term need information about their plans' funding status on a termination basis. We recognize this concern. We believe, however, that in conjunction with any expansion of the use of "termination liability," there would need to be a thorough reexamination of the assumptions used by PBGC to determine termination liability. As discussed previously, PBGC's assumptions are clearly unrealistic. These assumptions can have adverse effects on participants' benefits and should not be broadened in their application until corrected.

Even after the termination liability assumptions are corrected, we urge that any disclosure of termination liability be restricted to severely underfunded plans. As noted, in the case of a well-funded ongoing plan, disclosure of a plan's funded status on a termination basis will only alarm and mislead participants.

Finally, H.R. 5006 (the Labor-Health and Human Services appropriations bill, in the 108th Congress) would have required disclosure of confidential corporate information, pursuant to an amendment offered by Rep. George Miller (D-CA). This was clearly

inappropriate and we assume unintended, as it departs sharply from the Administration's proposal on which it was expressly based.

AVOID DIRECT OR INDIRECT INCENTIVES TO MOVE PLAN INVESTMENTS AWAY FROM EQUITIES

There has been a significant amount of discussion by government officials and members of the media indicating that defined benefit plans should be invested in bonds rather than in equities. The bond proponents argue that this would address business' concerns with volatility, as well as protect PBGC and plan participants. In the strongest possible terms, the Council opposes any legal structure that penalizes plans for investments in equities. For the reasons discussed below, we believe that any such structure would be disruptive and harmful to plans, companies, participants, and the economy as a whole.

Effect on the markets

If a yield curve or other fundamental change in the pension funding rules should force a movement of pension funds out of equities and into bonds or other low-yielding instruments, it would have a marked effect on the stock market, the capital markets, and capital formation generally. Hundreds of billions of dollars could move out of the equity markets with economic consequences that could potentially be staggering.

Effect on the cost of defined benefit plans

Over time, pension plans earn more on investments in equities than in bonds. If plan earnings decline because plans are compelled to invest in bonds or other low-yielding instruments, plans' overall costs will rise. As plans become more expensive, it goes without saying that there will be fewer plans and lower benefits in the plans that remain.

The myth of immunization

One primary argument made by the bond proponents is that plan investment in bonds can be used to "immunize" the plan with respect to its liabilities. The bond proponents contend that employers can insulate themselves from both volatility and liability by investing in bonds.

'Immunization' is theoretically viable until a company encounters difficulties, at which time it will inevitably become underfunded.

hold up to scrutiny. When asked, even the staunchest bond proponents admit that there are numerous pension liabilities that cannot be immunized. For example, because mortality cannot be predicted with precision, it is not

First, it is far from clear that there could ever be enough bonds or other instruments available to permit plans to immunize in this manner. But even if there were enough, the immunization arguments do not

possible to immunize a plan that makes life annuity payments. Even more problematic are early retirement subsidies. Again, the number of people who retire and take available subsidies can only be estimated and thus that liability cannot be immunized.

Bond proponents answer by saying that in a large pool, mortality and retirement assumptions can be predicted with reasonable accuracy. This answer contains two gaping holes. First, it is not applicable to small- and mid-sized plans where there is not a large pool. Second, retirement assumptions are made based on reasonable predictions regarding a business' future prospects. Obviously, these assumptions do not anticipate the retirement of substantially all early retirement eligible employees. To do so would be both unrealistic and enormously expensive.

However, when the sponsoring company's business deteriorates, there may well be layoffs and possibly widespread use of the subsidy by substantially all early retirement eligible employees. In those circumstances, the plan will, *by definition*, be substantially underfunded. And, with the company having difficulties, it is at exactly this time that the plan may well be turned over to the PBGC with significant unfunded liabilities.

In other words, "immunization" is theoretically viable until a company encounters difficulties, at which time it will *inevitably* become underfunded.

Thus, the end result of “immunization” is:

- (1) a lower rate of plan earnings and correspondingly higher company costs,
- (2) resulting lower benefits, and
- (3) a system that systematically ensures large PBGC liabilities whenever a company’s fortunes decline.

This is not an answer but a formula for disaster for participants and for the PBGC.

The higher long-term rate of return available with equities is what makes plans affordable for companies. These rates of return also are the most effective means for all affected parties to weather a downturn in the business of the sponsoring employer. Investing in equities involves some short-term volatility but is critical to the successful functioning of the defined benefit plan system for companies, participants, and the PBGC. Thus, it is critical that the law not establish rules that adversely affect plans investing in equities.

PREVENTING VOLATILITY BY SMOOTHING THE TRANSITION BETWEEN THE ERISA FUNDING RULES AND THE DRC

Overview

Under present law, generally, there are two distinct funding regimes. All plans are subject to the “ERISA funding

rules.” In addition, plans that fall below certain funding levels are required to make deficit reduction contributions (DRCs) to the extent such contributions exceed the amount required under the ERISA funding rules.

The DRC and ERISA funding rules serve distinct purposes and, in general, should both be preserved. The ERISA funding rules reflect the long-term nature of the pension promise by incorporating future projections. With respect to this aspect of the funding rules, current law provides appropriate flexibility to apply assumptions based on reasonable plan-specific projections regarding, for example, plan rates of return and mortality.

The DRC rules were designed to function as a backstop to the ERISA funding rules. The DRC rules ensure that on a snapshot basis, the plan does not become too underfunded. Because of the backstop nature of the DRC rules, plans are restricted with respect to their discount rate and mortality assumptions. In other words, it may make

definition

Deficit Reduction Contribution (DRC)

An amount in addition to the required minimum annual contribution if the pension plan is less than 100 percent funded. It consists of old liabilities (such as benefit increases granted before 1988), which are to be amortized over 18 years, and a share of new liabilities (resulting from benefit increases or plan amendments)

— Source: *International Foundation on Employee Benefits, Employee Benefits: A Glossary of Terms*

sense to prohibit the use of plan-appropriate assumptions under the DRC so as to create a mechanically applied backstop. But such a prohibition would not make sense under the ERISA funding rules, which serve a different purpose based on each plan's circumstances and accordingly are structured to apply in a more plan-specific manner.

Although we believe that the basic structure of the DRC and ERISA funding rules should be preserved, we believe that the rules should be reformed in certain important respects.

ERISA funding rules

In certain aspects, the ERISA funding rules permit funding to be made over too long a period. Specifically, the ERISA funding rules permit the cost of a plan amendment to be amortized over 30 years. Yet amendments typically have the greatest effect on employees who have had significant service with the employer already and accordingly tend to be older. A more appropriate amortization period would be related to such employees' expected future service with the employer. One approach would be to determine the amortization period using a methodology based specifically on such expected future service. However, a comparable result can be achieved much more

simply by reducing the amortization period for plan amendments to a shorter period representative of typical workforces, such as 15 years.

Deficit Reduction Contribution (DRC)

The DRC requirements generally only apply to plans that are less than 90 percent funded on a current liability basis. However, a plan that is less than 90 percent funded is exempt from the DRC requirements if (a) the plan is at least 80 percent funded, and (b) for two consecutive years (out of the preceding three years), the plans was at least 90 percent funded (the "90 percent/80 percent rule").

Under the main component of the DRC regime, an employer subject to the regime generally must contribute a specified percentage of its unfunded liability. The percentage varies from 30 percent for the worst funded plans (plans at 60 percent or less) to just over 18 percent (for plans just below the 90 percent level).

At the same time that the ERISA funding rules are made more demanding by shortening the amortization period for plan amendments, the DRC rules should permit more funding flexibility. This is important for two reasons. First, employers experience jarring volatility when they first move from the ERISA funding rules to

DRC rules tend to put far too much pressure on businesses in cyclical industries or other companies experiencing a temporary downturn.

the DRC regime. The sudden increase in funding attributable to the application of the DRC rules can be difficult to foresee and can be very disruptive for an employer attempting to revitalize its business. Accordingly, it is important to smooth out the transition from the ERISA funding rules to the DRC regime by making the ERISA funding rules more demanding (as described above) and by permitting more flexibility under the DRC rules.

Second, the DRC rules tend to put far too much pressure on businesses in cyclical industries or other companies experiencing a temporary downturn. Requirements to fund up to 30 percent of a plan's funding shortfall in one year may simply be unmanageable for such companies. On the other hand, it is very important that the funding status of underfunded plans improve. Weighing these two competing considerations, the Council makes the following recommendations.

The DRC requirements should not be so severe as to hinder the recovery of the company and thus the plan. Accordingly, the percentage of the funding shortfall that must be contributed should be reduced so that it ranges from 20 percent (for plans funded at 60 percent or less) to just above 8 percent (for plans just below 90 percent funded) (instead of the current-law range of 30

percent to just over 18 percent). The 20 percent figure corresponds in an approximate manner to the five-year amortization of experience gains and losses under the ERISA funding rules, which is the shortest amortization period applicable under those rules.

At the same time, we recommend that the universe of plans to which the DRC rules apply be expanded. Specifically, we recommend reexamining the 80

percent component of the 90 percent/80 percent rule (except for purposes of related disclosure rules). And, as discussed in the next section of this paper, the Council recommends stricter rules with respect to the benefits provided by underfunded plans.

The Council recommends stricter rules with respect to the benefits provided by underfunded plans.

It is important that the 90 percent/80 percent rule not be replaced with a 100 percent rule subjecting all plans below 100 percent funded to the DRC rules. A 100 percent rule would unreasonably discourage new plans and benefit increases, as well as unduly "punish" normal fluctuations of interest rates and asset values. Such a rule would also materially increase the number of plans subject to the volatile movement between the ERISA funding rules and the DRC regime.

Finally, it is important to focus on the purpose of the DRC rules. The DRC regime is a backstop to the ERISA funding rules and, as such, is based on

an artificial snapshot measurement of the funded status of an ongoing plan; it would not be appropriate to turn this artificial measurement into an overly restrictive rule that controls the funding of most plans, the vast majority of which are not terminating.

RESTRICTIONS ON UNDERFUNDED PLANS

The Council has significant concerns regarding benefit increases in underfunded plans. If a plan is significantly underfunded, that is the time to improve its funded status, not to exacerbate the underfunding.

Under present law, an employer must provide security to a plan to the extent that a plan amendment causes the plan's funded level to fall below (or further below) 60 percent. The 60 percent figure should be raised to 75 percent (instead of 80 percent, as proposed by the Administration).

Also, underfunded plans that permit lump-sum distributions can spiral downward very quickly. In some circumstances, there can be a "rush to retire" by employees who fear that the last participants in the plan will not receive their full benefit.

Even if there is not such a rush, lump-sum distributions can drain a plan of assets at a low point in the market and deprive the plan of a realistic chance to recover. Accordingly, under a possible

proposal, lump-sum distributions would be suspended for plans that fall below 75 percent funded. However, the Council remains very concerned that a forthcoming freeze could trigger an even greater move to retire and thus have a counterproductive effect on the plan. This possibility should be carefully evaluated before moving forward on this proposal (or on the Administration's *similar* proposal).

PERMITTING AND ENCOURAGING ADDITIONAL CONTRIBUTIONS IN GOOD TIMES

The lesson of the last 10 years is that companies need to be permitted and encouraged to make additional contributions in "good economic times" so that plans have a funding cushion to rely on during "bad economic times." Trying to squeeze huge contributions from companies during a downturn in the economy will only lead to freezes on benefits, company bankruptcies, and large liabilities shifted to the PBGC. The time to build up pension assets is during good economic times, not bad times.

In this regard, the Council strongly recommends the following.

Increase in the deduction limit

The Finance Committee pension bill (the National Employee Savings and Trust Equity Guarantee (NESTEG) Act of 2004, S. 2424 in the 108th Congress) provided that an employer may always

deduct the excess of 130 percent of current liability over the value of plan assets. This proposal increases the deduction limits currently in Code section 404(a)(1)(D) from 100 percent of current liability to 130 percent. The Administration includes this provision in its proposal as well.

We strongly support this proposal. In fact, we would recommend increasing the 130 percent figure to 150 percent based on the following analysis. For deduction purposes, current liability is today based on the 30-year Treasury bond rate, not the long-term corporate bond rate.

Under our proposal, current liability would in the future be based on the long-term corporate bond rate for all purposes. This would, in isolation, actually decrease the deduction limit for many plans by 10 percent or 15 percent (and by more for a few plans). Accordingly, to ensure that the deduction limit for most plans is increased by 30 percent compared to current law, the limit should be increased to approximately 150 percent.²

It would be appropriate for both policy and revenue reasons to limit the increase in the deduction limit to plans insured by the PBGC.

Repeal of the excise tax on nondeductible contributions

Under current law, an excise tax is imposed on employers that make certain nondeductible contributions. This tax was enacted when the tax on reversions was much lower. With a very high excise tax on reversions, there is no reason to be concerned about excessive funding of defined benefit

plans. On the contrary, the excise tax on nondeductible contributions can only discourage employers from desirable advance funding. Accordingly, the excise tax on nondeductible contributions should be repealed with respect to defined benefit plans.

The time to build up pension assets is during good economic times.

Repeal of the combined plan deduction limit on employers that maintain both a defined benefit plan and a defined contribution plan

Under present law, if an employer maintains both a defined contribution plan and a defined benefit plan, there is a deduction limit on the employer's combined contributions to the two plans. Very generally, that limit is the greatest of:

- (1) 25 percent of the participant's compensation;
 - (2) the minimum contribution required with respect to the defined benefit plan;
- or

² This increase will, *inter alia*, allow employers to fund collectively bargained benefit increases more quickly than under current law.

(3) the unfunded current liability of the defined benefit plan.

This deduction limit can cause very significant problems for an employer that would like to make a large contribution to its defined benefit plan. And there is no policy reason for preventing an employer from soundly funding its plan.

Repeal of the combined plan deduction limit is the simplest, most direct solution to the problems created by the present law limit.

Accordingly, the Council recommends that the combined plan deduction limit be repealed for any employer that maintains a defined benefit plan insured by the PBGC. Defined benefit plans

and defined contribution plans are each subject to appropriate deduction limits based on the particular nature of each type of plan. There is no policy rationale for an additional separate limit on combined contributions.

In many ways, repeal of the combined plan deduction limit is a conforming change to the repeal in 1996 of the combined plan benefit limit, which limited the combined benefit that an individual participant could receive from a defined benefit plan and a defined contribution plan.

We believe that repeal of the combined plan deduction limit is the simplest,

most direct solution to the problems created by the present law limit. However, in general, other proposals would also effectively address the problems being encountered.

Specifically, the current combined plan deduction limit could be modified to disregard employer contributions to defined contribution plans up to 6 percent of the participants' aggregate compensation. (See Section 204 of The Pension Presentation and Savings Expansion Act of 2003, H.R. 1776 as passed by House Ways and Means Committee in the 108th Congress and Section 407 of S. 2424 (as passed by the Senate Finance Committee in the 108th Congress.)) In addition, the current-law reference to unfunded current liability should be conformed to the change recommended above, so that contributions to a plan insured by the PBGC would always be deductible to the extent necessary to increase the plan's funded level to 150 percent.

We are supportive of the proposals passed by the Ways and Means Committee and the Finance Committee in 2004. But, as noted, we recommend repeal of the combined plan deduction limit. We do not believe that the additional complexity of the narrower proposals is necessary. Those proposals would create significant issues for multiemployer plans; since multiemployer plan benefits are not based on participants' compensation, deduction rules based on percentages of participants' compensation can be difficult to apply.

Preservation of credit balances

Under current law, an employer maintaining a defined benefit plan is generally required to make certain minimum contributions to the plan. An employer may, however, choose to contribute amounts in excess of the minimum required. Such “extra” contributions give rise to a “credit balance,” *i.e.*, a type of bookkeeping record of the excess contributions made by an employer.

Present law neither encourages nor discourages “extra” contributions. Instead, in years after a credit balance is created, an employer’s minimum funding obligation is determined as if the amount of any credit balance were not in the plan. Then, the credit balance is applied against the minimum funding obligation determined in this manner.

In this way, the law is carefully crafted to be neutral with respect to a company’s decision whether to make extra contributions. The law is structured to treat a company that makes an extra contribution in one year and uses the resulting credit balance in a subsequent year in the same manner as a company that only makes the minimum contribution in all years.

If credit balances were not available to satisfy future funding obligations, employers would have a clear economic disincentive to fund above the minimum levels; funding above the minimum levels would, in the short term,

decrease funding flexibility and increase cumulative funding burdens. If an employer does not receive credit for extra contributions, the employer would have an incentive to defer making contributions until they become required.

The credit balance system has been criticized on the following grounds: Critics have pointed to examples of underfunded plans that have not been required to make contributions because of credit balances. Some of those plans have had their liabilities transferred to the PBGC.

“Current pension funding rules ... severely limit the ability of companies to fund their plans during good economic times, while requiring additional contributions during difficult economic times.”

— *from the Council’s Pensions at the Precipice: The Multiple Threats Facing our Nation’s Defined Benefit Pension System*

One possible reaction to this criticism would be to prohibit the use of credit balances in the case of underfunded plans, as the Administration has proposed. At first blush, this type of proposal would seem to increase funding. In fact, the opposite is true. Such a proposal would lead to more underfunding and more PBGC liability. If contributions above the minimum amount are discouraged, few if any companies will make extra contributions. That can only lead to more underfunding.

For example, if the use of credit balances were restricted, the companies cited by the critics would likely not have made extra contributions and accordingly, even greater liabilities would have been shifted to the PBGC and the PBGC would have assumed these liabilities sooner.

The other criticism of credit balances is that they are not adjusted for market performance. For example, assume that a company makes an extra \$10 million contribution. Assume further that the plan experiences a 20 percent loss with respect to the value of its assets during the following year. Under current law, the \$10 million credit balance grows with the plan's assumed rate of return (*e.g.*, 8 percent) until it is used. So after a year, the credit balance would be \$10.8 million. The critics argue that the credit balance should actually be \$8 million in this example, to reflect the plan's 20 percent loss.

This concern regarding market adjustments is a valid concern that should be addressed legislatively on a prospective basis and should apply to increases and decreases in market value.

As noted above, employers need to be encouraged to make extra contributions in "good times" so that they will have a sufficient cushion for the "bad times." If the use of credit balances is restricted, companies would not make extra contributions except in unusual circumstances. It goes without saying that that

would be a major step backward. If we want companies to fund more in good times, it is essential that we preserve the credit balance system.

Credit balance terminology

One cosmetic issue could actually help put the credit balance discussion into perspective. The term "credit balance" does not appropriately capture the clear policy justification for the structure of the rules. It may be more appropriate to refer to a credit balance as a "pre-payment account." That would highlight the inconsistency of the credit balance critics' two positions:

- (1) they seek to deny companies the ability to use their funding pre-payments; and
- (2) at the same time, they express a desire to encourage companies to make such pre-payments.

Credit balances under the DRC

As discussed above, present law is structured to be neutral with respect to a company's decision whether to make contributions above the minimum required amount. From a policy perspective, we believe that companies should actually be encouraged to make such additional contributions. On the other hand, we need to be careful not to create incentives that can permit underfunding in later years.

With this delicate balance in mind, we recommend that for purposes of determining the percentage of the funding

shortfall that must be funded under the DRC rules, credit balances not be subtracted from plan assets.

Assume, for example, that a plan with \$75 million of assets is 75 percent funded and has a \$5 million credit balance. Under present law, the DRC would apply as follows. The funding shortfall would be determined by subtracting the \$5 million credit balance from the \$75 million in assets. Thus, the funding shortfall would be treated as \$30 million, not \$25 million. The percentage of that shortfall that must be contributed would be determined on the same basis, *i.e.* as though the plan had only \$70 million. Thus, the percentage would be 26 percent (rather than 24 percent, which would have applied if the plan were treated as having \$75 million of assets).

In short, under present law, the DRC required contribution would be 26 percent of \$30 million, *i.e.*, \$7.8 million. The company could offset its credit balance against that amount and would be required to contribute the remaining \$2.8 million.

We recommend a modification of this structure to provide a small incentive for companies to pre-fund. Under our proposal, the percentage of the funding shortfall that would be contributed would be based on the plan's actual assets, *i.e.*, \$75 million rather than \$70 million in the above example. The funding shortfall would not be affected; it would be treated as \$30 million, as


under present law. In the example, this would mean that the DRC required contribution would be 24 percent (as opposed to 26 percent) of \$30 million, *i.e.*, \$7.2 million (as opposed to \$7.8 million). As discussed above, the company would be required to contribute the excess of this amount over its credit balance, *i.e.*, \$2.2 million.

Our proposal would tilt the rules slightly to favor pre-funding without disturbing the fundamental purpose of the DRC rules. In fact, by basing the DRC percentage on actual plan assets, the proposal would actually make the rules more solidly grounded in the actual funded status of the plan.

PBGC premiums

The Administration has proposed dramatic increases in PBGC premiums in order to address the PBGC deficit. This proposal gives us great concern for several reasons.

First, the large proposed increase in the flat-dollar premium and its indexing is strikingly inappropriate. This is a very large increase on the employers that have maintained a well-funded plan through the "perfect storm" of lower interest rates and a downturn in the



The credit balance system has been criticized on the grounds that some underfunded plans have not been required to make contributions.

equity markets. It is wrong to “reward” these employers with the obligation to pay someone else’s debt.

Second, the unspecified increase in the variable rate premium will become a source of great volatility and burden for

companies struggling to recover. This could well cause widespread freezing of plans by companies that would otherwise recover and maintain ongoing plans.

Third, a premium increase misses the point of the last 10 years. The solutions to underfunding is better funding rules, not higher

premiums that, on a dollar for dollar basis, hurt the defined benefit plan system.

Fourth, there has been a striking lack of clarity about the real nature of the PBGC deficit. The PBGC’s numbers are based on a below-market interest rate. Our questions are:

(1) with a market-based interest rate, what would the deficit be?

(2) What effect would a small increase in interest rates and the equity markets do to address the PBGC deficit? and,

(3) Why has PBGC unilaterally moved away from equities to lower-earning investments that hinder its ability to reduce its deficit?

These are troubling questions that should be addressed before the very harmful step of increasing PBGC premiums is taken.

SHUTDOWN BENEFITS (OR OTHER UNPREDICTABLE CONTINGENT EVENT BENEFITS)

Shutdown benefits generally occur in collectively bargained plans and are a form of “unpredictable contingent event benefits.” They are analogous to a severance benefit; they generally “spring into existence” if and only if a unit, division, or workplace is closed and workers are laid off. A company cannot effectively pre-fund shutdown benefits for two reasons. First, there are clear difficulties and problems with a healthy company making funding judgments based on its determination of the likelihood that a unit will be shut down in the future. Second, even if such a likelihood could be determined, the plan would still be woefully underfunded if there is actually a shutdown since the likelihood would presumably have been fixed far below 100 percent (at least until shortly before the shutdown).

“The substantial assets the PBGC holds — and the relatively modest size of its deficit when viewed in the context of the economic cycle and its capped and long-term liabilities — ensure that the PBGC will remain solvent far into the future — a point the PBGC itself has acknowledged repeatedly.”

— from the Council’s Pensions at the Precipice: The Multiple Threats Facing our Nation’s Defined Benefit Pension System

Thus, it is difficult to pre-fund shutdown benefits. On the other hand, shutdown benefits are guaranteed by the PBGC, subject to the generally applicable five-year phase-in. This phase-in appears to commence when the plan document first provides for shutdown benefits, not when the shutdown occurs. Thus, if the shutdown occurs when the employer is declaring bankruptcy, the PBGC can become liable for shutdown liabilities that have not been funded.

Shutdown benefits are clearly a problem area. Some have suggested that the law be changed so that the phase-in of the PBGC guarantee of shutdown benefits begins when the shutdown occurs. With respect to shutdown benefits that have not yet been bargained for and included in a plan document, that might be the right answer. But it seems unfair to apply this rule to benefits already contained in plans.

The Council recommends consideration of alternative solutions. For example, currently the variable rate premium payable to the PBGC by underfunded plans is determined without regard to shutdown benefits (where the shutdown has not occurred). Thus, PBGC is not even collecting premiums on these insured benefits.

Shutdown benefits, a form of ‘unpredictable contingent event benefits,’ are clearly a problem area.

One alternative that could be considered is requiring shutdown benefits (and other unpredictable contingent event benefits) to be taken into account at full value (or at a percentage of full value) for purposes of determining the variable-rate premium payable to the PBGC. Before moving forward on such a proposal, it would be critical to assess possible repercussions (such as benefit freezes to avoid variable rate premiums).

LUMP-SUM DISTRIBUTIONS

The discount rate used to determine the amount of a lump-sum distribution should be conformed to the funding discount rate (which, as discussed above, should be the long-term corporate bond rate).

Under current law, a rate no higher than the 30-year Treasury rate must be used to determine the lump-sum distributions payable to participants in defined benefit plans that offer lump sums. As the 30-year Treasury rate has become artificially low, it has had the corresponding effect of artificially inflating lump-sum distributions (*i.e.*, the lump sum projected forward using a reasonable rate of return is more valuable than annuity on which it was based). This has had very unfortunate consequences. First, these artificially large sums are draining plans of their

assets. For example, if a plan determines its funding obligations based on the long-term corporate bond rate, but pays benefits based on a much lower rate (such as the 30-year Treasury rate), the plan will be systematically underfunded. For the defined benefit plans that offer lump sums (roughly half the plans), the centerpiece of

funding reform — the replacement of the 30-year Treasury bond rate — will simply be illusory unless the lump-sum discount rate is conformed to the funding rate.

Second, participants have clear economic incentives to take lump-sum distributions, instead of annuities. The discount rate should not artificially create an uneven economic playing field that discourages annuities.

We recognize that the artificially large lump sums of recent years have built up employee expectations. For employees near retirement (e.g., within 10 years of normal retirement age) who have made near-term plans based on present law, transition relief is clearly appropriate.

But in the strongest terms, we urge policymakers not to go further than that. If over the next 10 to 15 years, plans are required to give inflated distributions to retirees, that can only hurt the defined benefit plan system and future participants. In the competitive world we live in, pensions are *at best* a zero-sum arrangement. If employers have to pay inflated benefits for 10 or 15 years, they will have to recoup that cost in some way. It is our fear that many will feel compelled to reduce benefits for the next generation, a reduction that will likely carry forward to all future generations.

The Administration’s proposal to apply the yield curve to determine lump sums would

- (1) appear to further increase the value of lump sums and thus exacerbate the current law problems described above;
- (2) increase benefits for higher paid employees who can afford to let their benefits remain in the plan longer; and
- (3) force a significant reduction in cash balance plan benefits.

We cannot support this proposal.

DEFINED BENEFIT PLAN VALUATION DATE

Prior year rule

The Administration’s proposal would repeal the rule enacted in 2001 permitting well-funded plans to use a

definition
<p>Lump-Sum Distribution A distribution that qualifies for forward averaging or rollover treatment. The basic requirements are that the distribution be made within one taxable year of the recipient, that it include the entire balance to the credit of the employee, and that it be made on account of the employee’s death, attainment of age 59½, separation from service (except for the self-employed), or disability (self-employed persons only).</p> <p>— Source: <i>International Foundation on Employee Benefits, Employee Benefits: A Glossary of Terms</i></p>

valuation date in the preceding plan year. This prior-year rule was carefully limited so as not to unintentionally encourage underfunding. Repealing it is, accordingly, unjustified and would hurt those well-funded plans that have relied on this rule to make business planning more efficient.

Asset valuation

Under present law, a defined benefit plan's assets and liabilities must be valued as of the same date. Subject to certain exceptions (such as the prior year rule discussed above), that date must be within the plan year for which the valuation is being performed. This valuation is performed for purposes of determining the funding requirements and deduction limits with respect to the plan.

For large defined benefit plans, it is generally impractical to have a valuation date other than the first day of the plan year. Because records are kept on a plan year basis, the only other potentially practical alternative generally is the last day of the plan year. The last day, however, is impractical because valuing a plan's liabilities is an extensive process. If that process were to begin on the last day of the plan year, an employer would be unable to complete the valuation in time to satisfy certain funding requirements. The one item used in the valuation that is

readily obtainable on the last day of the plan year is the value of the assets.

In a falling market, using the first day of the plan year as the valuation date inordinately delays the recognition of asset losses occurring during a plan year. For example, assume that assets are valued at \$100 million on the first day of the plan year but have fallen to \$80 million on the last day of the plan year. For funding purposes, the employer must treat the plan as if it had, as of the last day of the plan year, \$100 million plus the assumed rate of return for the year, for a total of, for example, \$108 million. With \$108 million in the plan, there may, for instance, be little or no funding obligation; in fact, any amount contributed

may be nondeductible. This could leave the employer in the odd position of being unable to fund the plan while knowing that the plan has \$28 million less funding than the valuation implies. The \$28 million shortfall will eventually trigger an additional funding obligation in later years.

We recommend that an employer be permitted to elect to value assets as of a later date than it values liabilities, but no later than the end of the plan year for which the valuation is being performed. (See sections 704(a)(2) and 704(b)(2) of the Pension Preservation

For large defined benefit plans, it is generally impractical to have a valuation date other than the first day of the plan year.

and Savings Expansion Act (H.R. 1776, as introduced in the 108th Congress). This is appropriate because updated asset values are much more readily available than new liability figures.

As a practical matter, for an employer that uses this new rule, the proposal will generally mean that liabilities will be valued as of the first day of the plan year and assets will be valued as of the last day of the plan year. In the falling market example described above, use of this new rule would enable — and in

The Council’s recommended proposal would not undermine funding in rising markets and would significantly improve funding in falling markets.

many cases compel — the employer to make additional contributions to the plan. This will allow — or compel — a better matching of the need for increased funding with the requirement to fund.

In a rising market, the proposal would not undermine funding. Briefly stated, the increased asset value that can be taken into account under the proposal never decreases a funding obligation on a greater than dollar-for-dollar basis, thus resulting in no overall asset shortfall.

Moreover, the proposal is not subject to abuse or manipulation. First, a plan’s valuation date is part of the funding method, which can only be changed

with IRS approval. Thus, an employer cannot switch in and out of this new rule in order to use it only when it meets the plan sponsor’s current wishes. Second, in order to compare “apples to apples,” plan liabilities would be projected forward actuarially to the last day of the year (*i.e.*, the date as of which assets are valued).

In short, this proposal would not undermine funding in rising markets but would significantly improve funding in falling markets. In addition, the proposal has safeguards to ensure that it cannot be manipulated to avoid funding obligations.

REFORM OF FUNDING WAIVER RULES

Generally, under present law, employers are technically able to obtain a short-term waiver of the funding requirements upon a showing of temporary substantial business hardship. These rules were intended to provide a safety valve to accommodate downturns in the business cycle.

In practice, the rules have not worked well. There are no clear standards for obtaining a waiver and the application process is long, difficult, and unpredictable. The rules governing funding waivers should be made more mechanical and less dependent on IRS discretion. For example, a waiver should be available where, in the absence of plan

amendments or similar events, there is an excessive increase in funding requirements from one year to the next.

In certain circumstances, an employer may need a waiver of only a portion of its funding obligation. Current law does not technically permit partial waivers, though informally the IRS has on occasion permitted partial waivers in an indirect manner. We recommend formally allowing partial waivers. It is important to formalize the partial waiver system so that partial waivers do not count as a full waiver for purposes of the rule limiting waivers to no more than three of any 15 consecutive plan years (five of 15 in the case of a multiemployer plan).

INTERACTION WITH POTENTIAL ACCOUNTING RULE CHANGES

The accounting issue is discussed at greater length in *Pensions at the Precipice: The Multiple Threats Facing our Nation's Defined Benefit Pension System* (May 2004) prepared by the Council. That document discusses the possibility that the accounting rules will be changed to require that pension assets be marked to market.

Enhanced disclosure regarding the financial repercussions of pension sponsorship is appropriate to ensure shareholders have the information they need. However, because of the adverse effect mark-to-market accounting

would have on defined benefit plan sponsorship, accounting standard setters should be extremely cautious when evaluating this approach and should recognize that adoption of a mark-to-market standard could lead to a reduction in the pension promises made by employers to better insulate themselves from the volatility injected into pension funding, or possibly a wholesale abandonment of defined benefit plans.

MORTALITY ASSUMPTIONS

The Treasury Department has begun the process of evaluating issues related to mortality assumptions used with respect to defined benefit plans. The Council looks forward to a meaningful dialogue with Treasury as the administrative process moves forward.

RULES BASED ON AN EMPLOYER'S CREDITWORTHINESS

Under the Administration's proposal, the application of pension funding and premium rules would turn on the creditworthiness of the employer sponsoring the plan. Very briefly, the Council is strongly opposed to this proposal and the dramatic expansion of government regulation that underlies this proposal.

Use of credit ratings to determine funding or PBGC premium obligations

would be harmful to plans, companies, participants, and the PBGC. Such use would put severe additional pressures on companies experiencing a downturn in their business cycle. Those pressures will undermine companies' ability to recover which adversely affects all parties, including the PBGC.

Use of credit ratings to determine funding or PBGC premiums would be harmful to plans, companies, participants and the PBGC.

This proposal would clearly lead to some level of government oversight of the credit rating entities and to some form of government approval of such ratings. This would be a

frightening precedent. In addition, having PBGC premium levels or funding rules turn on an employer's creditworthiness would also exacerbate the downward spiral currently experienced by companies that are downgraded. Finally, there is no practicable way to apply a creditworthiness test to non-public companies.

SURPLUS ASSETS

We fully recognize the political sensitivities involved in the issue of employers' access to surplus assets in their defined benefit plans. And because of that sensitivity, we do not put forward any

specific proposal on this topic. However, we urge Republican and Democrats together to reexamine this issue in a bipartisan manner.

It seems inevitable that new funding rules will require significant new defined benefit plan contributions. If the equity markets recover, these new contributions could well result in large surpluses that are virtually unusable. The fear of creating unusable capital will clearly discourage many employers from maintaining defined benefit plans.

On the other hand, if our objective is to encourage both sound funding and defined benefit plan sponsorship, few proposals would be more effective than proposals allowing employers tax-free access to surplus assets to pay for other benefits.

RESTRUCTURING FOR TROUBLED PLANS

In certain circumstances, a combination of economic forces — such as competitive changes within an industry, the aging of a company's workforce, falling interest rates, and a downturn in the equity markets — can result in a dramatic change in the viability of a company's defined benefit plan. In those cases, following the otherwise applicable rules can only lead to plan termination and severe economic troubles for the company sponsoring the plan. It is critical that we develop a

different solution for these troubled plans.

The Council recommends that alternative approaches be developed that would address this situation in a way that does not increase PBGC exposure, but rather is structured to reduce that exposure. In this regard, proposals should be developed that generally permit a company in this situation to cease benefit accruals (or pay for any new accruals currently) and to fund the funding shortfall over a longer period of time. This benefit-freeze approach can help revitalize the company, increase the funding level of the plan, avoid termination of the plan, and correspondingly avoid shifting liabilities to the PBGC.

MULTIEMPLOYER PLANS

Multiemployer plans serve a unique and critical role in the private pension system. As the population of employers participating in these plans changes, new challenges arise for the plans and

participating employers. This is especially true in the case of plans where employer departures have thinned the number of participating employers considerably.

The Council looks forward to working with the multiemployer plan community to address the critical issues facing these plans.

TRANSITION RULES AND PHASE-INS

As pension funding reform moves forward, transition issues need to be carefully studied. Large additional funding burdens that are suddenly imposed can disrupt business plans and cause otherwise viable companies to become insolvent. Such insolvencies would only increase burdens on the PBGC.

Fairness also dictates that the rules be phased in slowly for participants, unions, and companies that have structured their arrangements based on present-law rules.

“Concerns about the volatility of the funding liability have complicated the task of preserving [defined benefit] plans and pose a challenge for designing new plans that will be attractive to employers.”

—*from the Council’s Safe and Sound: A Ten Year Plan for Promoting Personal Financial Security*

