United States Senate

Republican Policy Committee

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A Broader Perspective on Social Security Reform

Retirement-Income Security: Strengthening the Private-Pension System

Executive Summary

- With Social Security reform as a top priority, President Bush has opened a debate on a critical aspect of a much broader issue – ensuring that Americans have adequate income for their retirement.
- At its inception, Social Security was viewed as one leg of a "three-legged stool," with personal savings and pension benefits making up the vast majority of retirement income. Today, Social Security is the primary source of retirement income for two-thirds of the program's beneficiaries.
- A vital and dependable private-pension system in this country is critical to the retirement-income security of 44 million Americans. Yet, the financial strength of the private-pension system has been called into question, with recent estimates indicating that the nation's single-employer pensions are underfunded by more than $450 billion – a new record.
- The expiration of the Pension Funding Equity Act of 2004 later this year creates an urgent need, and an opportunity, for Congress to strengthen and improve the nation's private-pension system. Specifically, future legislation should:
  - ➢ Provide consistent rules that enable companies to determine the extent of their pension promises as well as rules to ensure that companies are able to provide adequate funding to keep those promises.
  - ➢ Address the special problems posed by financially weak pension sponsors in a manner that protects employee pension benefits without unnecessarily aggravating the financial challenges facing the sponsoring companies.
  - ➢ Resolve the Pension Benefit Guaranty Corporation's current $23 billion deficit and assure that the insurance fund remains solvent and self-funding in the future.
- Failure to address these issues portends serious problems for the private-pension system. "The consequences of not honoring pension commitments are unacceptable – the retirement security of millions of current and future retirees is put at risk" (Ann Combs, Assistant Secretary of Labor).

Introduction

By embracing Social Security reform as a top priority, President Bush opened a debate on a critical aspect of a much broader issue facing this country – ensuring that Americans have adequate income for their retirement.[1]

When the Social Security program was established in 1935, President Roosevelt stressed that the program was intended to be a safety net to protect seniors "against poverty-ridden old age."[2] It was also a benefit that few were expected to receive since the life expectancy for seniors at that time was well below the 65-years-of-age necessary to qualify for Social Security benefits.[3] Accordingly, Social Security at its inception was viewed as one leg of a "three-legged stool," with personal savings and pension benefits making up the vast majority of an individual's income in retirement.[4]

Despite its original intent, Social Security has become the primary source of retirement income for two-thirds of Social Security beneficiaries.[5] By neglecting the other two legs of the stool, individuals relying on Social Security are effectively planning for subsistence-level income on which to live out their retirement years. With a long history of Americans raising their standard of living, Congress should help them maintain as high a retirement standard of living as possible.

Ensuring the permanent sustainability of the Social Security system so that it can provide protection from poverty in retirement is a worthy objective. But in the larger context of ensuring income security for Americans in retirement, it is not sufficient. Congress has the opportunity to improve the quality of retirement life by addressing the issue of retirement-income security in a comprehensive manner. Based on the Roosevelt-era analogy of the three-legged stool, that effort should include reform of Social Security, but also measures to encourage personal savings and strengthen the pension system.

This paper – the second in a series – focuses on the importance of pension benefits in providing retirement-income security, and it considers options for helping ensure that the nation's private-pension system remains strong and reliable.[6]

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[1] President George W. Bush, Report on the State of the Union Delivered to a Joint Session of Congress, February 2, 2005, *Congressional Record*, page S878.

[2] Statement of President Franklin D. Roosevelt upon signing the Social Security Act, August 14, 1935.

[3] Center for Disease Control and Prevention, "Estimated Life Expectancy at Birth," National Vital Statistics Reports, Volume 53, Number 6, November 10, 2004.

[4] Social Security Administration (SSA), "Research Note #1: Origins of the Three-Legged Stool Metaphor for Social Security" – http://www.ssa.gov/history/historianoffice.html.

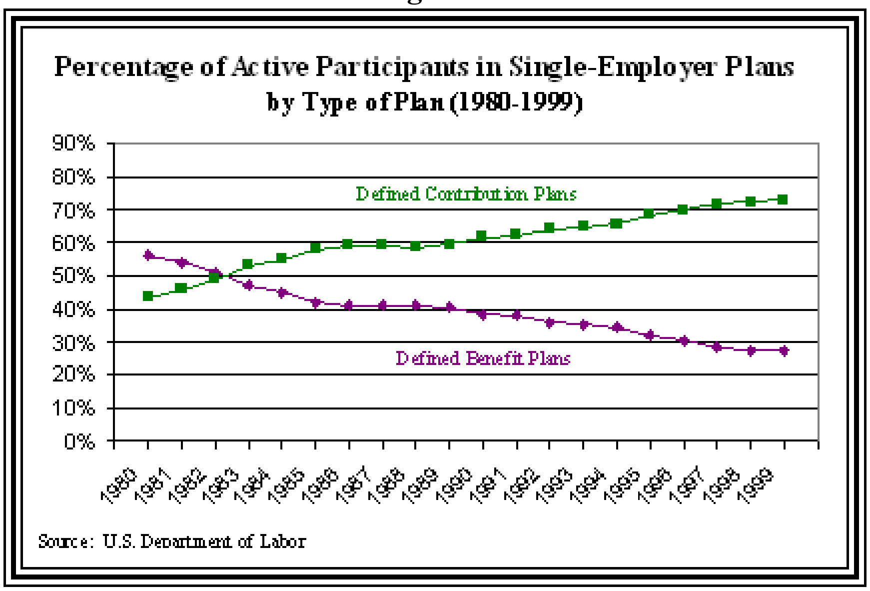
[5] SSA, "Income of the Aged Chartbook, 2001," April 2003, p. 4 – http://www.ssa.gov/policy/docs/chartbooks/income_aged/2001/iac01.pdf. SSA estimates that Social Security benefits provide 50 percent or more of total income for 65 percent of the beneficiaries, 90 percent or more of income for one-third of the beneficiaries, and are the only source of income for 20 percent of beneficiaries.

[6] For a discussion of the role of personal savings in retirement-income security, see the first paper in this series, "Retirement-Income Security: The Role of Personal Savings," February 28, 2005 – http://rpc.senate.gov/_files/Feb2805RISavingsMW.pdf.

The Third Leg of the Stool: Private-Pension Benefits

A vital and dependable private-pension system in this country is critical to the retirement-income security of millions of Americans. Despite the shift toward defined-contribution plans over the last two decades, as illustrated in Figure 1, employer-sponsored, defined-benefit plans are still fundamental to the retirement plans of 44 million workers and retirees.[7] A defined-benefit plan typically provides retirement benefits to an employee of the sponsoring company under a formula that is based on the employee's compensation and years of service.[8]

Figure 1



The financial strength of the private-pension system, however, has been called into question. Between 1986 and 2004, there were 101,000 terminations of single-employer pension plans covering approximately 7.5 million participants.[9] Of those, around 2,000 plans have been taken over by the Pension Benefit Guaranty Corporation (PBGC), which provides an insurance system for defined-benefit plans.[10] In addition, recent estimates indicate that the nation's single-employer pensions are underfunded by more than $450 billion – the highest level on record – in

[7]Bradley D. Belt, Executive Director, Pension Benefit Guaranty Corporation (PBGC), in testimony before the Senate Committee on Finance, March 1, 2005, p. 1 – http://finance.senate.gov/hearings/testimony/2005test/bbtest030105.pdf.

[8]Joint Committee on Taxation, "Present Law and Background Relating to Employer-Sponsored Defined Benefit Pension Plans and the Pension Benefit Guaranty Corporation (PBGC)," JCX-03-05, February 28, 2005, p. 9 – http://www.house.gov/jct/x-3-05.pdf. Other forms of defined-benefit plans, known as flat-dollar plans, provide a fixed benefit amount for every year of service.

[9]Belt, p. 3. When a pension plan terminates with sufficient assets to meet its benefit obligations, the plan typically purchases annuity contracts to cover the benefits that participants have earned.

[10]Belt, p. 3. The PBGC assumes responsibility for paying benefits when a terminated plan has insufficient assets to fulfill its benefit obligations. Benefits paid by the PBGC, however, are subject to a statutory cap. For plans with a 2005 termination date, the maximum amount is $45,613.68 yearly ($3,801.14 monthly) when a participant reaches age 65. PBGC, "General Pension Information" – http://www.pbgc.gov/about/benefits.htm.

part due to low interest rates and asset values.[11] The result has been an increasing strain on the PBGC, which could potentially jeopardize the retirement-income security of millions of Americans.

The Pension Funding Equity Act, enacted last year, provides short-term measures intended to address some of the problems facing the defined-benefit system.[12] In reaching a compromise on that legislation, however, Congress made the bill's provisions temporary. The expiration of this legislation at the end of ***this*** year creates an urgent need for Congressional action to strengthen and improve the nation's private-pension system.

Determining Pension Liability and Funding

The most pressing issue facing private pensions is the need for consistent rules that enable the employers sponsoring them to determine the extent of the pension promises as well as rules to ensure that employers provide adequate funding so that those promises can be kept. At the same time, companies sponsoring plans need pension rules that produce a reasonably predictable outcome and facilitate long-term financial planning.

The current underfunding situation facing the nation's private-pension system is not merely a symptom of the economic downturn at the turn of the century. It is also a symptom of structural problems inherent in the pension rules,[13] which were enacted more than 30 years ago with only periodic changes in response to funding and other problems in subsequent years. These structural problems can be seen by looking, for example, at the failure of the pension plans sponsored by Bethlehem Steel and U.S. Airways – both companies had complied with pension rules, but their plans were more than 50-percent underfunded when they were taken over by the PBGC.[14]

Pension funding essentially comes down to the determination of two issues: (1) a reasonable estimate of the amount of benefits that the plan will have to pay its participants over time; and (2) the amount that the plan sponsor needs to contribute annually to the plan's existing assets to ensure that the benefits can be paid.

Estimating Pension Liabilities

A pension plan's ongoing liability consists of the accrued benefits of all its participants. In order to take into account the fact that employees have different life expectancies and retire at different times with varying benefits, a pension's liability is generally stated as the present value

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[11] Belt, p. 8.

[12] Public Law 108-218, H.R. 3108, 108th Congress, 2d Session, April 10, 2004.

[13] The Employee Retirement Income Security Act (ERISA) of 1974 (29 U.S.C. § 1001 *et seq.*) and the Internal Revenue Code (26 U.S.C. § 1 *et seq.*) are the primary statutes governing defined-benefit plans. For purposes of this paper, they will be referred to generally as the "pension rules."

[14] Belt, p. 12; Richard A. Ippolito, "How to Reduce the Cost of Federal Pension Insurance," Cato Institute, August 24, 2004, p. 9 – http://www.cato.org/pub_display.php?pub_id=2304.

of all the participants' accrued benefits.[15] The present value indicates the amount that a plan would need to invest today at a given rate of return in order to have sufficient funds to pay the required benefits as they come due.

The key to present-value calculation is the rate of return. Historically, the law looked to the 30-year Treasury bond for that rate, based on the belief that long-term Treasury bonds would closely approximate the rise and fall of the marketplace. In the late 1990s, however, the Treasury Department initiated a buyback program for 30-year bonds, and ultimately the issuance of the 30-year bond was discontinued in 2001. As a result, the 30-year Treasury bond rate no longer provides an accurate reflection of the marketplace. In addition, because of the inverse relationship between the rate of return and the present value, the current low rate on existing 30-year Treasury bonds produces inflated future pension liabilities.[16]

To address this situation, last year Congress enacted a temporary, substitute rate for determining pension liabilities based on a four-year weighted average of long-term, investment-grade corporate bonds.[17] The expiration of this temporary rate at the end of 2005, however, resurrects the need for a more enduring solution. While many in the business community and organized-labor groups have called on Congress simply to make the four-year corporate-bond average permanent,[18] the Administration has offered an alternative that also addresses a fundamental weakness in that average (and the 30-year Treasury bond rate before it).

The Administration's Yield-Curve Proposal

The Administration has taken the position that a single interest rate – as required under current law – is a one-size-fits-all approach that does not measure pension liabilities accurately. Under the Administration's proposal, instead of applying a single rate of return to determine all pension obligations regardless of when they come due, the rate would be matched to the timing of the liability. This concept – referred to as the "yield curve" – would be based on a schedule of individual rates for high-quality corporate bonds determined by the Treasury Department on a

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[15] Present value is determined by discounting a future payment using the following formula: $PV = FV/(1+i)^n$, where FV is the future value, i is the discount rate (i.e., rate of return), and n is the time period between the present and future value. A similar, albeit more complex, formula is used to determine the present value of an annuity or series of equal payments that occur in the future, such as retirement benefits paid to an employee upon reaching retirement age.

[16] American Benefits Council, "Funding our Future: A Safe and Sound Approach to Defined Benefit Pension Plan Funding Reform," February 2005, p. 3 – http://www.americanbenefitscouncil.org/documents/fundingpaper021604.pdf.

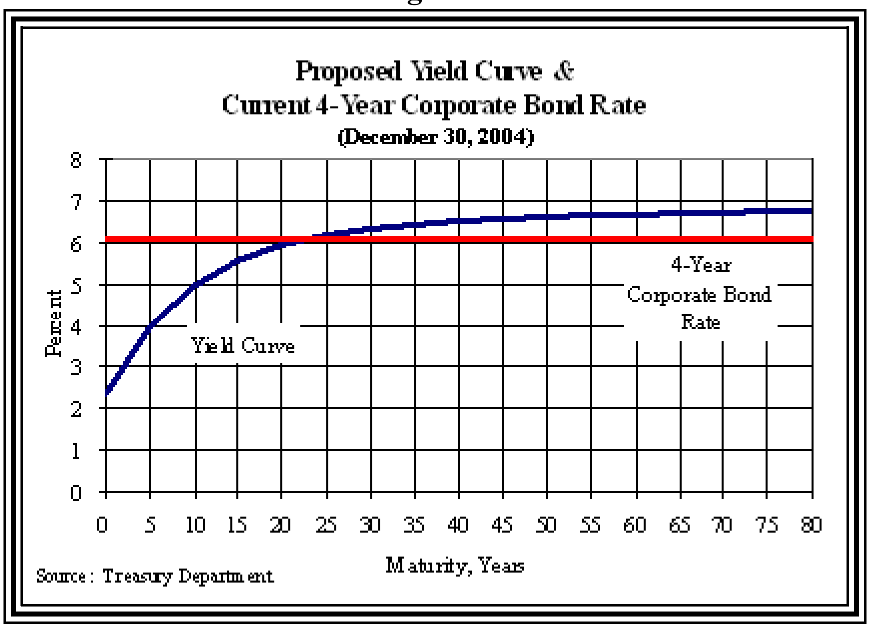
[17] Pension Funding Equity Act of 2004, § 101. The Treasury Department determines the four-year average and publishes it on a monthly basis.

[18] American Benefits Council, p. 4; Alan Reuther, International Union, United Automobile, Aerospace & Agricultural Implement Workers of America (UAW), in testimony before the Senate Committee on Finance, March 1, 2005, p. 4 – http://finance.senate.gov/hearings/testimony/2005test/artest030105.pdf.

regular basis in order to reflect periodic economic changes in the interest rates.[19] Yield curves are commonly used to value mortgages, certificates of deposit, and other securities.[20]

The benefit of the yield curve is that it provides a more accurate measure of a company's pension liability by matching the applicable rate of return with the liability at a particular time.[21] For example, Figure 2 illustrates the yield curve as it would have applied on December 30, 2004, as well as the current four-year corporate-bond rate on that date. Under the yield curve proposal, a pension's liability for benefits payable to a participant who will retire in five years will be determined using the applicable rate along the curve for each annual benefit payment beginning at year five. Benefits for a younger participant who is expected to retire in 40 years would be based on the applicable interest rates starting in year 40.[22]

Figure 2



[19]Department of the Treasury, Office of Economic Policy, White Paper, "Creating a Corporate Bond Spot Yield Curve for Pension Discounting," February 7, 2005 – http://www.treas.gov/offices/economic-policy/reports/pension_yieldcurve_020705.pdf.

[20]Mark J. Warshawsky, Assistant Secretary for Economic Policy, Department of Treasury, in testimony before the Senate Committee on Finance, March 1, 2005, p. 5 – http://finance.senate.gov/hearings/testimony/2005test/mwtest030105.pdf.

[21]Critics have argued that the use of a yield-curve would impose undue burdens on small and mid-sized companies given the calculations necessary to match benefit payments with their relevant rate of return. Larry Zimpleman, Principal Financial Group, in testimony before the Senate Committee on Finance, March 1, 2005, p. 5 – http://finance.senate.gov/hearings/ testimony/2005test/lztest030105.pdf. In 1999, however, only about one percent of firms with fewer than 100 employees – typically small and mid-sized companies – sponsored defined-benefit plans (the latest data available). U.S. Census Bureau, "Statistics of U.S. Businesses, 1999" – http://www.census.gov/csd/susb/susb99.htm; Department of Labor, Employee Benefits Security Administration, "Abstract of 1999 Form 5500 Annual Reports," Table E2, Private Pension Plan Bulletin, Number 12, Summer 2004 – http://www.dol.gov/ebsa/PDF/1999pensionplanbulletin.PDF. Notwithstanding that few businesses would be affected, the availability of computer technology should make such burdens manageable.

[22]For an example of the calculation of a hypothetical pension plan's liability under the yield-curve proposal, see the testimony of Mark J. Warshawsky before the Senate Committee on Finance, March 1, 2005, pp. 6-10.

In contrast, under the current four-year corporate-bond average, the single rate continues to determine all pension liabilities, regardless of when the benefit payments come due. In addition, as economic conditions alter interest rates, those changes are only gradually factored into the rate due to the four-year averaging.[23]

As noted above, there is an inverse relationship between the applicable rate and the resulting present value of the liability. In Figure 2 above, the rates of return under the yield curve are lower until the yield curve crosses above the current four-year corporate-bond average. Accordingly, the lower rates in the first 23 years will produce higher pension liabilities for many companies, as compared to the current four-year corporate-bond rate.[24] This will be especially true for companies with significant numbers of older workers who will begin receiving pension benefits in the near term. However, the reality of pension liabilities is that the sooner they are payable, the less time a company has to make necessary contributions and realize investment earnings in order to have sufficient funds to pay the benefits. To ensure that the retirement income of the millions of Americans relying on defined-benefit plans is secure, it is only reasonable for pension liabilities to be determined as accurately as possible.[25]

It is important to note that the Administration's yield-curve proposal would simply govern the calculation of pension liabilities. While some critics have suggested that the use of a yield curve would adversely affect the investment options available to pension sponsors,[26] the Administration's proposal would not change current law, which generally permits pensions to invest their assets in any prudent manner.[27] In essence, the corporate bond rates making up the yield curve represent the conservative end of the spectrum of prudent investing. Pension plans will arguably continue investing their assets in a mix of bonds and equities, allowing them the opportunity to achieve higher returns.

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[23] Ann L. Combs, Assistant Secretary, Department of Labor, in testimony before the Senate Committee on Finance, March 1, 2005, p. 4 – http://finance.senate.gov/hearings/testimony/2005test/actest030105.pdf. Industry groups have argued that the yield-curve proposal factors in economic changes too rapidly, since it is based on a 90-day moving average of the relevant corporate bond rates. The result, they contend, would be significant volatility in a pension's liabilities over time. Zimpleman, p. 6. While Congress should evaluate the merits of this argument, if the volatility of interest rates is to be smoothed out, it would be preferable to do so with respect to the funding rules. Smoothing out interest-rate changes in the yield curve would simply distort the determination of a pension's overall liabilities, which the Administration's proposal is designed to correct.

[24] Employment Policy Foundation, "Pension Funding Reform: An Analysis of the Bush Administration's Proposal," Policy Backgrounder, January 20, 2005, p. 2 – http://www.epf.org/pubs/newsletters/2005/pb20050120.pdf.

[25] The yield curve also provides a more accurate measure for calculating the value of lump-sum distribution – a single payment of a participant's accrued benefits rather than a stream of payments spread over the participant's life expectancy. Lump-sum distributions are still determined under the 30-year Treasury rate, even though the four-year corporate-bond average currently applies for determining a pension's ongoing liabilities. Department of Treasury, General Explanations of the Administration's Fiscal Year 2006 Revenue Proposals ("Treasury Blue Book"), February 2005, p. 7 – http://www.treas.gov/offices/tax-policy/library/bluebk05.pdf.

[26] American Benefits Council, pp. 9-10.

[27] Warshawsky, p. 3.

Funding Pension Liabilities

Once the pension's liabilities are determined, the question then becomes: How much does the company need to add to existing plan assets to ensure that the pension obligations can ultimately be paid? Here, too, the current pension rules are in need of change. Their inadequacy is evident from several illustrations:

- To be "fully funded," a pension plan is not required to have current assets equal to 100 percent of its current liabilities – it only has to meet a 90-percent threshold. Accordingly, a plan may represent that it is fully funded when, in fact, it is as much as 10-percent underfunded.
- Pension plans are permitted to determine their asset values on an actuarial basis – in effect, averaging the value over a period of time. This can inflate asset values above their actual fair market value, resulting in a "fully funded" plan with far too little in assets to meet its obligations.
- Underfunded plans are allowed to eliminate deficiencies in their funding over as much as 30 years, during which the financial condition of the sponsoring company can change dramatically and financial markets can adversely affect the value of the plan's assets.
- Pensions are permitted to apply extra contributions made in one year to reduce a required payment in a subsequent year – creating a so-called "credit balance." This permits a "funding holiday" – even though the assets, in which that extra contribution were originally invested, have declined substantially in value. At the same time, current law restricts the deductibility of contributions over the full-funding limit, thus discouraging companies from funding their pension obligations in advance.

With these "byzantine and often ineffectual" funding rules under current law,[28] it is little wonder that the private-pension system is nearly one-half trillion dollars underfunded.

The Administration's Pension Funding Proposal

At a minimum, the funding rules should require a company to fund the benefits accrued during the current year. In addition, to the extent that the plan's assets are insufficient to cover existing liabilities, companies should be required to eliminate the deficit over a reasonable period of time. The Administration has proposed to replace the existing discordant funding rules with a single set of consistent rules that provide a 100-percent funding target based on determination of pension liabilities pursuant to the yield curve and fair-market valuation of assets.[29]

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[28]Treasury Blue Book, p. 92.

[29]Treasury Blue Book, p. 97. For an example of the Administration's proposed funding rules and their interaction with the yield-curve proposal, see the testimony of Mark J. Warshawsky before the Senate Committee on Finance, March 1, 2005, pp. 13-14.

The Administration has also recommended a seven-year period for companies to correct underfunding.[30] In setting that time frame, Congress must be mindful that there is often a delicate balance between a company's ability to make additional pension contributions and the continued viability of the business, particularly in slow economic periods. Too short of a period risks adverse financial pressure, especially on struggling companies, while too long of a period places the participants' pension benefits at risk should the pension fail.

The funding rules should also encourage companies to prefund their liabilities in good economic times in order to provide a cushion against future economic downturns. The Administration has proposed to increase the limit on deductible contributions so that companies may deduct the funding for the current year's accrued benefits plus an additional 30 percent.[31]

While supporting the Administration's prefunding proposal, business groups have also advocated eliminating the 10-percent excise tax on non-deductible contributions in order to remove an additional barrier to prefunding of pension liabilities.[32] Together, these changes would help companies manage their pension obligations better as they go through the business cycle and, in so doing, would ensure more consistent funding of retiree benefits.

Dealing With Financially Weak Pension Sponsors

The current pension-funding rules generally envision healthy companies that are able to meet their annual funding obligations and to correct for periodic declines in the value of their pension assets. Companies, however, do encounter periods of financial weakness and undoubtedly will in the future, as well.

Nevertheless, the current funding rules are not predicated on the financial health of a company sponsoring a defined-benefit plan. Instead, the funding rules focus on the extent to which a pension is underfunded, which can be distorted by assumptions used to calculate pension liabilities and the valuation of pension assets at other than their fair market value, as noted above. Under current law, companies sponsoring underfunded pensions are required to make a "deficit reduction contribution" or DRC.[33] Yet, this requirement has proven to be ineffective in protecting employees' pension benefits in too many cases, as evidenced by the significant growth in underfunded pension plans over the past several years.

The problem with the DRC rules stems in large measure from the fact that it is only triggered when a pension's funding falls below 90 percent of its current liability and that techniques and exceptions are available, which permit companies to avoid paying the DRC without actually strengthening the health of their pension plan.[34] In addition, under the Pension Funding Equity Act, certain steel manufacturers and commercial airlines were permitted to make

[30]Treasury Blue Book, p. 97.

[31]Treasury Blue Book, p. 101. Under the proposal, a company could also take into account anticipated salary and benefit increases in certain cases when determining the increased deductible-contribution limit.

[32]Zimpleman, pp. 7-8.

[33]ERISA § 302(d)(2); Internal Revenue Code § 412(l)(2).

[34]Treasury Blue Book, pp. 87-88, 93.

reduced DRC payments due to their tenuous financial conditions[35] – a provision that further weakened pension funding and increased the PBGC's exposure.[36]

The Administration's Risk-Based Proposal

The Administration has proposed to replace the DRC provisions with new rules that take into consideration the financial health of the company sponsoring the pension plan, in the same manner that banks and insurance companies assess the risk of their customers. The new rules would look to a company's bond rating.[37] A company with a below investment-grade – "junk bond"– rating would be subject to special funding provisions and limitations on certain benefits unless plan funding levels improved. The PBGC points out that 90 percent of companies representing significant claims against the agency's insurance program had junk-bond credit ratings for 10 years prior to the termination of their pension plans.[38]

The Administration's risk-based proposal consists of three primary aspects. First, companies with junk-bond credit ratings would be required to recalculate their pension liabilities based on the assumption that participants would retire at the earliest permitted date and that participants would opt for lump-sum distributions if the plan provides such an option.[39] This aspect of the Administration's proposal warrants careful consideration by Congress, since it would likely increase the funding costs for financially weak companies,[40] which could further threaten their financial status.[41] The benefits of strengthening the plan's funding status must be weighed against the costs of potentially pushing the sponsor to discontinue the pension plan, or, worse, declare bankruptcy.[42]

The second aspect of the Administration's risk-based proposal addresses the potential for companies to increase employee benefits – especially in collectively bargained pension plans – rather than wages as a means of retaining employees during difficult financial periods.[43] Current law encourages this questionable practice since the increased pension liability can be funded over 30 years, whereas, additional wages are immediately payable, adding to the company's financial strains. Additionally, if the pension should fail, the PBGC stands ready to insure a majority of the promised benefits in most cases.[44]

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[35]Pension Funding Equity Act of 2004, § 102.

[36]Susan Schmidt Bies, Federal Reserve Board Governor, Remarks to Financial Executives International Baltimore Chapter, January 18, 2005 – http://www.federalreserve.gov/Boarddocs/speeches/2005/20050118/default.htm; Ippolito, p. 13; "Your $450 Billion," *Washington Post*, January 25, 2005, p. A14.

[37]For companies without rated debt, Treasury regulations would gauge financial health on other financial measures, such as the company's debt-to-equity ratio. Treasury Blue Book, p. 98.

[38]Belt, p. 14.

[39]Treasury Blue Book, p. 99.

[40]If the assumptions concerning early retirement and lump-sum distributions were realized, the pension would have to make distributions sooner than it would over an indefinite period of operations, which would increase the present-value liability of the pension plan. Treasury Blue Book, p. 99.

[41]Zimpleman, p. 9 ("In short, a creditworthiness test would make it more difficult for a struggling company to recover.")

[42]American Benefits Council, p. 3.

[43]Combs, pp. 10-11.

[44]Belt, pp. 14-15.

The Administration proposes to change this dynamic (which has been likened to a "moral hazard")[45] by limiting the ability of underfunded pensions to increase benefits or make certain distributions according to the degree of risk posed by the pension's sponsor, as illustrated in Figure 3.[46]

Figure 3
Administration's Proposed Limitations on Underfunded Pensions

Percentage Points Below Required Funding Level	Investment-Grade Plan Sponsor (Baa Bond Rating or Better)	Junk-Grade Plan Sponsor (Below Baa Bond Rating)	Bankrupt Plan Sponsor
0 to 19	➧ No new restrictions	➧ No new restrictions	➧ Freeze the plan
20 to 39	➧ No benefit increases	➧ No benefit increases ➧ No lump-sum distributions	➧ Freeze the plan
40 or more	➧ No benefit increases ➧ No lump-sum distributions	➧ Freeze the plan ➧ No preferential funding of executive compensation	➧ Freeze the plan

Note: Freezing the plan includes no benefit increases, no lump-sum distributions, and no accrual of additional benefits under the plan.
Source: Department of Labor, "Administration Single-Employer Pension Reform Proposal."

Accordingly, a substantially underfunded pension – underfunded by 20 to 39 percentage points – whose sponsor has a junk-bond rating would not be permitted to increase pension benefits unless they can be funded currently. Moreover, even for pensions sponsored by investment-grade companies, underfunding would result in limitations on benefit increases and lump-sum distributions for which there is not current funding. And, for pensions in the weakest financial condition – in particular, those with bankrupt sponsors – the Administration recommends that pension benefits be frozen until the pension's funding status improves.

Concerns have been raised about the viability of using a company's credit rating as a trigger for imposing limitations on underfunded pensions, which is an issue that Congress must carefully examine.[47] Nevertheless, enacting a system that restricts financially weak companies from increasing benefits, unless they can be funded, would encourage pension sponsors to act responsibly and reduce the burden that failed pension plans place on the PBGC.[48]

Third, the Administration's proposal calls for improving both the timeliness and content of disclosures about the financial status of their pension plans. Currently, pension plans are required to file an annual information return with the Department of Labor – a Form 5500 – and they must provide a summary report to participants as well. The information included in these documents, however, can be significantly out of date, since the period between the valuation date of the plan's assets and the filing deadline for the report can be almost two years in some cases.

[45] Belt, pp. 14-15; Combs, pp. 10-11.
[46] Treasury Blue Book, p. 103.
[47] Zimpleman, pp. 8-9.
[48] Warshawsky, p. 15.

Additionally, certain underfunded pensions must provide more timely information to the PBGC, although the agency is required by statute to keep that information confidential.

Under the Administration's proposal, companies would be required to provide expanded information on the financial status of their pension plans, and financially weak companies would be required to report their financial status to the government and participants at an earlier date.[49] Information reported to the PBGC by financially weak companies would also be made publicly available.[50] More timely information would help pension participants monitor their benefits and enable them to respond to adverse changes more quickly.[51] Nevertheless, it comes at the expense of increased burden and compliance costs on pension plans, which should be held to a minimum. This is especially true for financially weak plan sponsors, which would also bear additional financial obligations under the Administration's proposal to strengthen the financial health of the pension and protect the benefits of the plan's participants.

In the end, changes to the rules governing pension liabilities and funding cannot focus solely on the protection of participant benefits. They must also recognize that companies will only continue to sponsor pension plans if the rules produce outcomes that are reasonably predictable for long-term financial planning. If a company cannot ascertain its future pension obligations with a reasonable degree of certainty, it is unlikely to continue sponsoring a pension plan, or start one in the first place. Additionally, Congress must give special care to the transition rules that are applied to ensure that sufficient time exists for the new rules to be implemented without prejudicing the expected benefits of pension participants nearing retirement and the strategic business plans of company sponsors.

Strengthening the PBGC

Even with better rules for determining pension liabilities and improved procedures for funding them, pension failures will inevitably occur, and it is the role of the PBGC to ensure that affected workers' retirement benefits are protected. The strain on the PBGC has increased in recent years with several large pension failures in the steel and airline industries.

In fiscal year 2004, the increased number of pension plans administered by the PBGC resulted in a $23 billion deficit in the assets under the agency's management that are necessary to satisfy all of the potential claims that the PBGC would be required to pay, as illustrated in Figure 4 (on page 13).[52] Taking into account non-investment grade companies, that deficit could rise to as much as $96 billion if every such company were to fail.[53] The PBGC's exposure covers a broad range of industries from "manufacturing, transportation and communications to utilities

[49] Treasury Blue Book, pp. 102-103.

[50] Combs, p. 15. Information protected by the Freedom of Information Act (e.g., trade secrets) would still be confidential under the Administration's proposal.

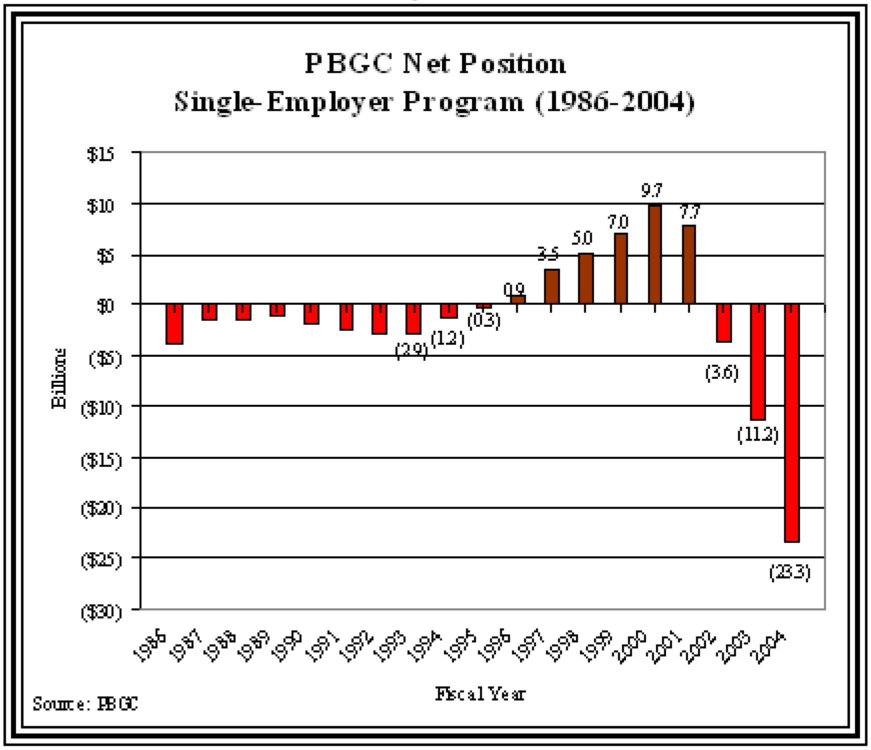
[51] *Financial Times*, "A Promise Made," January 12, 2005 ("It is better that employees know they cannot rely on unrealistic pension promises than maintain the illusion that all is well until it is too late to do anything about it.")

[52] Belt, p. 7. The deficit figure also includes pension plans likely to be taken over by the agency.

[53] Belt, p. 8. One company in this group is United Airlines, which sponsors several pension plans that are estimated to be underfunded by more than $8 billion, of which the PBGC would guarantee $6 billion. Belt, p. 9.

and wholesale and retail trade."[54] Despite its record deficit, the PBGC has emphasized that it has sufficient assets to continue paying benefits for a number of years.[55]

Figure 4



In addressing the structural problems of the pension rules discussed above, Congress must also resolve the PBGC's current deficit and provide adequate resources to ensure the solvency of the insurance fund in the future. At the outset, with only about 20 percent of workers participating in a defined-benefit pension plan, it would be unreasonable to put the burden of solving the PBGC's deficit on the 80 percent who do not. In other words, a taxpayer bailout of the agency is not an option.

At its inception, the PBGC was designed to be a self-funding insurer of pension benefits. Currently, its revenues are derived from a fixed-rate premium for each participant in a defined-benefit pension plan as well as variable rate premiums imposed on underfunded companies. The fixed-rate premium of $19 has not been adjusted for inflation since 1991, and because of exceptions to the variable-rate premium, only about 20 percent of plans covered by the PBGC paid it.[56]

The Administration's PBGC Proposal

The Administration has proposed several changes to the PBGC premium structure to obviate the need for taxpayer funds to restore the PBGC's financial status. First, the fixed-rate

[54] Belt, p. 10.
[55] Belt, p. 10.
[56] Belt, p. 15.

premium would be adjusted up to $30 for 2006 – a level that approximates what the premium would be had it been adjusted for inflation. Additionally, the fixed-rate premium would be adjusted each subsequent year in proportion to the annual increase in wages. Second, the Administration proposes to convert the variable-rate premium into one based on the risk of the insured pension plan. Accordingly, underfunded plans would pay an additional risk-based premium established by the PBGC.

The immediate adjustment in the fixed-rate premium is reasonable given that it has lost value due to inflation over the past 14 years, while the maximum benefit that the PBGC insures each year has continued to increase based on the growth in wages. The automatic subsequent adjustments, however, should be carefully considered. If the Administration's proposed modifications to the funding rules discussed above achieve their stated purpose, the private-pension system will be stronger and the burden on the PBGC will decrease. Yet, an ever-increasing fixed-rate premium would produce continually larger revenues for the agency, which would be unnecessary.[57]

Moreover, basing PBGC premiums on risk is conceptually sound since a primary purpose of the agency is to insure pension benefits.[58] Nevertheless, since such risk-based premiums would only apply to underfunded plans, Congress must be careful not to increase the difficulties facing the plan's sponsor by adding to its financial burdens. This is especially true for non-investment grade companies with underfunded pensions since they would also be required under the Administration's proposal to increase their funding contributions. Placing too great a burden on these companies could easily result in their failure and jeopardize the pension benefits of their workers.

Conclusion

With Social Security reform as a national priority, Congress has an important opportunity to take a broader view. By addressing the issue of retirement-income security for Americans, Congress can provide comprehensive solutions, including steps to strengthen and improve the private-pension system in this country.

The expiration of the Pension Funding Equity Act later this year and the strains on the PBGC's pension insurance fund portend serious problems for the private-pension system. To ensure that companies are able to fulfill their pension promises and American workers can continue to rely on them, Congress must act this year to reform the pension funding rules and secure the nation's pension-insurance program. In the words of Assistant Labor Secretary Ann Combs, "The consequences of not honoring pension commitments are unacceptable – the retirement security of millions of current and future retirees is put at risk."[59]

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[57] Zimpleman, p. 10.
[58] ERISA § 4002(a).
[59] Combs, p. 1.