Testimony of

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Examining the Challenges Facing PBGC and Defined Benefit Pension Plans

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Introduction

Chairman Roe, Ranking Member Andrews, and Members of the Subcommittee, I am grateful for the opportunity to appear before you on the challenges facing PBGC and defined benefit pension plans. My name is Ken Porter, and I worked for 35 years for The DuPont Company, from which I retired as the Finance Director for Corporate Insurance and Global Benefits Financial Planning. I also served as Global Risk Manager and Corporate Chief Actuary with responsibilities that included DuPont's defined benefit pension plans covering more than 160,000 participants in the United States and with about $18 billion in U.S. defined benefit plan assets. I also had actuarial oversight responsibility for defined benefit pension plans in every other country where the company sponsored defined benefit plans.

I am currently founder and owner of Benefits Leadership International, which provides consulting services. I formerly headed up the American Benefits Council's international and actuarial groups, and served as director of the Council's research and education affiliate, the American Benefits Institute.

I applaud this Subcommittee for holding this extremely timely hearing. The hearing is timely because there is one clear issue that is strangling the defined benefit system and causing job loss across the country. That issue is the application of today's artificially low interest rates to defined benefit pension plans.

Today's historically low interest rates are creating an artificial funding crisis for employers across the country. This crisis will divert billions of dollars away from job retention and creation and away from economic recovery. Instead, those billions will cause pension plans to be vastly overfunded in a few years when interest rates return to normal. That is a sad waste of America's resources.

In addition, as I discuss below, today's artificially low interest rates are costing the government billions of dollars because the same pension funding rules also apply to government contractors and the government must, in turn, reimburse the contractors for making these required contributions. Briefly, this is a shocking waste of government money. Moreover, correcting the problem will actually help both the government and the government contractors by preventing both from being required to waste resources.

Measurement of pension liability is not an exact science. Rather, it requires a myriad of assumptions about future economic behavior. Current rules effectively, but inadvertently, mandate the illogical assumption that today's economy will never improve. None of us wants that assumption to be true. Certainly, the Federal Reserve doesn't believe it will since they clearly expect interest rates to go back up. Nevertheless, it is the law for pensions to be funded as if the economy will not improve.

Similarly, the assumption that today's artificially low interest rates will continue forever creates the illusion that the PBGC is underfunded. It is clearly not underfunded by any responsible measurement of what might happen in the future, as I discussed in detail in a recent article and as I will summarize that article here today. In this context, any increase in PBGC premiums is not a premium increase, but simply a further tax on those American businesses that tried to do the right thing by providing retirement security for their employees.

Frankly, pension funding rules were promulgated without serious consideration that prolonged Federal Reserve activity aimed at stimulating the overall economy would have deleterious implications for pension funding and for the PBGC liability.

The problems described above are clear. The solution is correspondingly clear: apply historically stable interest rates for funding purposes and for determining PBGC's true longer-term economic status.

Funding Crisis

Background. As mentioned above, in order to address the critical challenges facing our economy, the government has made great efforts to keep interest rates at historically low levels. Within the last couple of weeks, the Federal Reserve signaled its intent to keep short-term interest rates at or near zero percent at least through the end of 2014. These valid government efforts to stimulate the economy are significantly negated by the extraordinary pension funding impacts on those companies that sponsor large defined benefit pension plans.

For pension funding purposes, plan liabilities are calculated by discounting projected future payments to a present value by using legally required interest rates based on corporate bonds: the lower the rate, the greater the liability. Thus, today's artificially low rates, which are expected to last until at least the end of 2014, are triggering artificially high pension liabilities. The obvious implication of the statement from the Federal Reserve is that low interest rates will ultimately go away and be replaced by higher rates. When rates do go back up to more normal levels, the measured pension liabilities will go back down.

For example, in the case of a typical pension plan, the effective interest rate required by law has dropped by approximately 70 basis points from 2011 to 2012, which increases liabilities by approximately 10%. Thus, a plan with $7 billion of liabilities a year ago would have $7.7 billion of liabilities today. That translates into an additional funding shortfall of $700 million. That in turn triggers a company obligation to make an additional contribution of approximately $119 million per year for seven years. That $119 million is not needed to pay benefits; that obligation is simply the result of artificially low interest rates that have no relationship to the plan's ability to pay long-term benefits. However, this reflects only one year of the Federal Reserve action to artificially lower interest rates which began in 2008. Thus for this example, the true annual amount of unnecessary contributions might be multiples of this amount since this year's amortization schedule is layered on top of similar amortization schedules from prior years.

On a national basis, a study by the Society of Actuaries indicates that required pension funding contributions for 2012 and later years will be far greater than the amount required for prior years, unnecessarily diverting billions of dollars away from job retention and creation and from business investments. As discussed further below, reducing those pension contributions not only saves jobs, but increases tax revenue and decreases government spending by many billions of dollars.

Recommendation. With respect to interest rates, we need to learn from the lessons of the last few years. Economic conditions can change quickly, and interest rates are often maintained at very low levels during difficult economic periods. Under the current funding rules, that will mean that when we encounter a downturn in the economy, interest rates may well fall, exacerbating the problems for pension plan sponsors and undermining any economic recovery by unnecessarily diverting assets away from business investments. Conversely, if interest rates were to temporarily return to the double-digit levels of the early 1980's, pension liabilities could be slashed by, perhaps, two thirds. This does not make sense, especially since pension plan obligations are long-term obligations.

We need to move to a sounder system for setting interest rates. Why should obligations due over 50 years be calculated based on interest rate movements that may be aberrational and/or attributable to governmental economic policy? It would make far more sense to base interest rates on a long-term average, such as 25 years, that is consistent with the long-term nature of pension liabilities. This one change would solve the short-term funding crisis and provide American businesses with the predictability and stability they need to make business plans and manage risk.

Budget effects. As noted, this change in the law would have very positive budget effects in the billions of dollars. First, during this period of low interest rates, basing funding interest rates on historical averages will reduce funding. (Correspondingly, during periods of high interest rates, this will increase funding.) Decreasing funding has, over the years, had two positive budget effects. First, it increases tax revenues by decreasing deductible contributions to a tax-exempt trust. Second, decreasing funding creates negative outlays on the spending side by increasing the variable rate premiums paid to the PBGC.

The proposal would also decrease government spending in a very significant manner. Generally, government contractors in the energy area are reimbursed for their pension contributions. In the defense area, new rules have just been adopted under which defense contractors will, subject to a phase-in period, generally be reimbursed for their full pension contributions. Thus, since the proposal reduces required funding contributions during this period of low interest rates, federal government spending would appear to be correspondingly reduced, likely by billions of dollars.

Moreover, the government spending being reduced appears to be spending that is completely unnecessary in economic terms. There is widespread agreement that interest rates are being held artificially low to stimulate the economy at least through the end of 2014. In this context, if contributions are made to pension plans based on the artificially low interest rates, and the plans become fully funded or close to fully funded based on such rates, those same plans will be vastly overfunded when interest rates return to normal levels. In fact, it is distinctly possible that many of the plans will be overfunded indefinitely, which means that the required contributions were wasteful.

The solution to the government spending issue is not to reduce government reimbursements. That would simply mean the government does not believe those contributions will be necessary over the long term even though the law requires the contractors to make them. If the government believed otherwise, the contributions would need to be reimbursable. The solution, therefore, is to correct the interest rates being used so that no one has to make completely unnecessary payments.

Conclusion. To maintain the current funding rules would be to ignore the painful lessons of the last few years. Interest rates are susceptible to artificial fluctuations that can hide the true value of pension liabilities. This can result in unnecessary expenditures by businesses and the government, slowing economic growth and leading to government waste. My recommendation would address this conflict by preventing artificially low interest rates from slowing any economic recovery or creating unnecessary spending. In addition, my recommendation would give American businesses the predictability they desperately need to make business plans.

PBGC premiums

The Pension Benefit Guaranty Corporation is charged with protecting the pension benefits of workers and retirees in the event a company sponsoring a defined benefit pension plan goes bankrupt. The PBGC is partially financed through premiums paid by the sponsors of defined benefit pension plans. Premiums paid to the PBGC would be increased under two recent proposals. Under the first proposal, the Administration's proposal calls for PBGC to have the power to raise its own premiums, with the increase focused primarily or exclusively on plans maintained by "high-risk" companies". This proposal was estimated to raise $16 billion over the 10-year budget window. Under the second proposal, the House Budget Committee proposed raising premiums by $2.7 billion.

These calls for increased premiums are premised on the belief that doing so is necessary to address concerns about the PBGC's financial stability. But the PBGC is actually extremely stable financially.

No deficit. Defenders of a premium increase point to the PBGC's $26 billion deficit. Using historically normal interest rates, the PBGC has no deficit, according to a study I recently completed.

- Almost 80% of the PBGC's self-reported deficit is directly attributable to the Federal Reserve action beginning in 2008 to reduce interest rates to historically low levels. While this national policy is expected to help stimulate the economy, such action translates into a calculation of *temporarily higher* pension liabilities. Therefore, when interest rates rise in the future, that PBGC's artificially created deficit will shrink, if not evaporate.
- Much, if not all, of the remaining 20% of the deficit results from PBGC using an interest rate that is materially lower than the rates employer-sponsored plans are required to use by the Financial Accounting Standards Board (FASB) and pursuant to the Pension Protection Act of 2006. There is no logic for the government to use one rate, and to require private employers to use another.

- Finally, current rules implicitly presume that yields on the investment of PBGC assets will perpetually match the current, artificially low interest rates. Thus, there is no recognition that these billions of dollars held by the PBGC are expected to outperform current, near zero interest rates over the long term. While this cannot be guaranteed, it is instructive to recognize that the PBGC annual reports show actual investment returns of 13.2%, 12.1% and 5.1% for fiscal years 2009, 2010 and 2011, respectively. Thus, it is fair to expect investment performance to also mitigate some of PBGC's reported deficit.

I have not been able to review the American Airlines plans and the effect on the PBGC if those plans were terminated. But based on the methodology used by PBGC to calculate its deficit, their estimates of the shortfalls in those plans could well be overstated.

Tax, not a premium. If Congress were to raise PBGC premiums following a careful analysis of the true market value of the protection being provided by the PBGC, that could be rightly labeled a premium increase. If, however, Congress were to raise premiums without such a careful analysis, that would not constitute a premium increase; it would be a tax on defined benefit plan sponsors. At this point, there is no economic basis established for the Administration's proposed increase. In that context, such a premium increase would simply be an additional tax increase on those employers that tried to do a good thing by maintaining a defined benefit plan.

According to PBGC itself, no bailout is foreseeable. Some argue that a premium increase is necessary now to avoid a taxpayer bailout. This is simply wrong. It is clear that the PBGC does not pose a risk to taxpayers for the foreseeable future. ***PBGC's own annual report states: "Since our obligations are paid out over decades, we have more than sufficient funds to pay benefits for the foreseeable future."*** This gives policymakers and the defined benefit plans most affected by a premium increase the opportunity to thoughtfully consider ways to strengthen the defined benefit pension system in a way that protects plan benefits and taxpayers but does not impose unwarranted increases in costs on plans and the participants they benefit.

Moreover, on November 10, 2011, PBGC announced projections of its deficit in 2020. The agency concluded, based on 5,000 simulations, that the chances of the single-employer insurance guaranty program running out of money in 2020 were ***zero***. Moreover, in a majority of the 5,000 simulations, PBGC's position improved over the next ten years. So even using its extremely unfavorable assumptions, PBGC concedes that the financial condition of its single-employer program will likely improve over the next decade.

Administration's proposal would undermine economic recovery. Congress should continue to reject calls to weaken its own authority to set PBGC premiums. The Administration's budget proposal would give the PBGC Board the authority to set and adjust the level of premiums that a retirement plans sponsor would pay, taking into account an employer's financial condition. ***This would require the government to evaluate the financial condition of private companies, including tax-exempt organizations, a very disturbing intrusion of the government into private business***.

Moreover, under the Administration's proposal, per-participant premiums could quadruple for the companies in the worst financial condition, which could cost these struggling companies tens of millions of dollars annually. Accordingly, basing PBGC premiums on the plan sponsor's financial condition could create a downward corporate spiral for companies that are facing financial difficulties, increasing their cash flow burden and potentially forcing unnecessary bankruptcies with devastating consequences for workers and our economy.

The Administration's proposal would also cause many companies to offer lump sums to former employees so as to potentially reduce their PBGC premiums by tens of millions of dollars annually. This would have serious policy implications and would dramatically shrink the PBGC's premium base.

In short, we should not use defined benefit plan sponsors as a revenue source in the attempt to tackle the budget, without a policy basis. The PBGC's issues should be carefully studied before any new taxes or premium increases are imposed.

Proponents of the proposal to allow the PBGC set its own premiums have pointed to the ability of commercial insurance companies to set their own premiums. This insurance company analogy collapses quickly on analysis. Sponsors of defined benefit pension plans already purchase commercial insurance for a variety of business purposes. In these commercial insurance situations, it is the purchaser who decides: (a) Whether to buy any insurance; (b) How much insurance to buy; (c) Which insurance company or companies to do business with, usually based on cost and quality considerations; and, (d) Whether to modify its insurance "wants" based on extant market conditions. Pension plan sponsors have no such rights with respect to benefits protected by the PBGC.

Moreover, commercial insurance companies must: (a) Remain cost competitive or face loss of business to competitor insurers; (b) Work collaboratively with their customers to tailor insurance products to meet those customers' needs; and, (c) meet rigid requirements imposed by various state insurance laws, as regulated by the respective state-level insurance commissioners. None of these consumer protections exists in the governance of the PBGC.

In short, the ability of commercial insurance companies to set their own premiums does not provide sufficient precedent to justify granting similar authority to the PBGC. Since none of the above characteristics of commercial insurance exist relative to the PBGC, Congress must continue its significant oversight role. Only Congress is in a position to consider all aspects and assure that premiums charged by the PBGC remain at appropriate levels that are fair to all parties.

Sales and Movements of Business Units

I also want to mention briefly one PBGC regulatory issue that is causing great concern within the pension community.

In the summer of 2010, the PBGC issued proposed regulations dealing with liabilities to the PBGC that arise under ERISA in connection with a shutdown of a facility. The proposed regulations were not consistent with the statute, previously published PBGC guidance, or PBGC's historical enforcement practices. Under the statute, liability is triggered if "an employer ceases operations at a facility in any location". The statute was clearly intended to apply to situations where operations at a facility are shut down. Instead, under the proposed regulations, liability can be triggered where no operations are shut down, but rather operations are, for example, (1) transferred to another stable employer, (2) moved to another location, or (3) temporarily suspended for a few weeks to repair or improve a facility.

Moreover, the liability created by the proposed regulations can be vastly out of proportion with the transactions that give rise to the liability. For example, in many cases, a *de minimis* routine business transaction affecting far less than 1% of an employer's employees can trigger hundreds of millions of dollars of liability, even in situations where a plan poses no meaningful risk to the PBGC.

The PBGC correctly identified the proposed section 4062(e) regulations as needing review pursuant to Executive Order 13563 on Improving Regulation and Regulatory Review. The PBGC stated:

> In light of industry comments, PBGC will also reconsider its 2010 proposed rule that would provide guidance on the applicability and enforcement of ERISA section 4062(e).

However, it is my understanding that PBGC personnel, in communications with plan sponsors, continue to refer to the proposed regulations as current law, and are enforcing them as such. It is inconsistent with the President's Executive Order to announce a reconsideration of troublesome proposed regulations, while at the same time actively enforcing them as current law.

This situation needs to be addressed. The PBGC's enforcement practices are having a severely detrimental effect on business' efforts to enter into business transactions that pose no meaningful risk to the PBGC and that are essential to a functioning business world where transactions can facilitate our economic recovery.

<u>Conclusion</u>

In conclusion, the use of today's artificially low interest rates is:

- Creating pension funding obligations that undermine job retention and economic recovery,
- Resulting in billions of dollars of wasteful government spending, and
- Creating an illusion that the PBGC has a deficit, triggering consideration of unneeded new taxes on defined benefit plan sponsors.

These issues need to be fixed through the use of historically stable interest rates.

Thank you for the opportunity to testify. I would be happy to answer any questions you may have.