PENSION FUNDING REFORM: IT'S TIME TO GET THE RULES RIGHT (PART 2)

By Kathryn J. Kennedy

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The author addresses the issue of pension funding reforms in two separate articles. Part one previously explained ERISA's historical funding and plan termination rules in order to show why plan sponsors, such as United Airlines' parent UAL Corporation, were permitted to create and maintain unfunded pension plans and why the Pension Benefit Guaranty Corporation assumed some of those unfunded liabilities.

Part two discusses the need for reform in ERISA's funding and plan termination rules. This article will examine various legislative and industry proposals and the policy considerations relevant to such proposals, in light of historical mistakes that should be avoided with subsequent legislation. The article's conclusion makes recommendations in support of preserving the defined benefit system.

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I. Introduction

There are many 2005 federal legislative and other industry proposals to cure the problems facing the Pension Benefit Guaranty Corporation with underfunded single-employer pension plans. In part one of a two-part article, the author discussed the evolution of the pension funding and plan termination rules of ERISA and the Internal Revenue Code to show why the rules are formulated as they are.[1] The author concluded in part one that, in order to learn from past mistakes, meaningful pension funding reform should be guided by the following principles:

- the funding rules of ERISA and the code should not presume that employers will continue indefinitely; thus lengthy amortization periods for unfunded pension liabilities should not be encouraged;
- use of a yield curve — possibly including an appropriate risk premium — makes sense in valuing plan liabilities, if a government benchmark bond yield curve is available (with virtually no benchmark default risk and no call features);
- immunization — matching the maturities of bond assets to anticipated plan outflows — enhances both the predictability of required employer contributions and the security of employee benefits, but in some investment circumstances these lowered risks might entail somewhat higher contribution levels;
- ERISA's plan termination structure should be modeled more closely as an insurance model, thereby shifting risk to the employers with the largest unfunded pension liabilities;
- the code's draconian 50 percent excise tax on any surplus assets retrieved from a terminated plan should be eliminated and defined benefit plans should be encouraged to permit surplus plan assets;
- lump sum distributions of large amounts should not be allowed from plans with large unfunded pension liabilities, because that practice shifts more risk to the remaining participants; and
- improved participant disclosure should be legislated so that participants and beneficiaries are made aware of plans with large unfunded pension liabilities.

The PBGC was created by ERISA to insure covered defined benefit plans that terminated with inadequate funds to pay pension benefits.[2] As of September 30, 2004, the PBGC reported a total deficit of $23.5 billion, more than double the fiscal 2003 year-end deficit of $11.5 billion.[3] The PBGC has also noted that it has a potential

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[1] *See* Kathryn J. Kennedy, "Pension Funding Reform: It's Time to Get the Rules Right (Part 1)," *Tax Notes*, Aug. 22, 2005, p. 907.

[2] *See* ERISA section 4022(a), 29 USC section 1322(a).

[3] *See* PBGC, *2004 Annual Performance and Accountability Report*, *available at* http://www.pbgc.gov/publications/annrpt/2004txt/2004finstatements.htm (July 1, 2005) and PBGC, *2003*

(Footnote continued on next page.)

deficit of $450 billion if *all* covered financially weak employers go bankrupt and shift underfunded pension liabilities to the PBGC.[4] As a result, the Government Accountability Office has placed the PBGC on its high-risk list.[5] How has this happened when, as recently as 2001, the PBGC was posting $7.7 billion in surplus?

As a pension plan's minimum funding contribution is a function of both plan assets and plan liabilities, the 1990s bull market in equities inflated plan assets, thereby reducing minimum contributions. Even conservative employers who wished to generate surplus plan assets by making contributions in excess of the minimum floor were cautioned not to do so, due to the draconian 50 percent excise tax imposed on surplus plan assets assessed at the time of plan termination. Thus, employers were counseled to fund plans according to certain funding targets, and not to contribute anything in excess. Then a perfect storm occurred at the beginning of 2000 with the decline in stock markets and the decline in interest rates used for funding purposes. Plan liabilities suddenly increased due to low interest rates and plan assets were seriously depressed — resulting in underfunded plans, that just years before had showed a healthy cushion of assets over liabilities.

While the PBGC's current financial status is certainly cause for concern, it's important to consider two important issues. The PBGC sets its own discount rates in determining its looming liabilities. Use of the PBGC's discount rate of 4.7 percent at the end of 2003 to 3.8 percent at the end of 2004 generated a deficit of $354 billion in 2004.[6] It is also important to step back and take a look at the *entire* single-employer defined benefit system — not just the financially weak plan sponsors. According to ERIC,[7] the private-sector defined benefit pension plan system pays about $110 to $120 billion in benefits to retirees each year, whereas the PBGC pays only about $3 billion in benefits, *or 2.6 percent as much*.[8] And while the PBGC has assumed liabilities for 3,277 plans from 1975 to 2003, 164,000 plans (50 times as many) terminated as *fully* funded plans, without shifting any liability to the PBGC.[9] Because of the deficits facing the PBGC, it makes sense that it is showcasing its potential liability with financially weak employers and requesting solutions that reduce such liabilities as its annual $1.5 billion in premiums which is insufficient to offset $3 billion in annual claims.[10] But caution should be exercised so that healthy employers are not driven out of the defined benefit market once benefits have become fully funded. Also, Congress should take the occasion to affirm the legality of cash balance and other hybrid plans — in aggregate, a healthier group of plans — keeping defined benefit plans in the system and paying premiums to the PBGC.

Potential exposure certainly varies according to the employer sponsor's industry — manufacturing showing a potential of $39.5 billion in potential liability for fiscal 2003; $32.9 billion for the transportation, communications and utilities industries; and the remaining $10 billion for the service industries, wholesale and retail, agriculture, mining and construction, finance, insurance, and real estate.[11] Exposure also is more evident with plan sponsors with below-investment-grade credit ratings, which is evident in some of the legislative proposals that would impose higher contributions for financially weak companies.[12]

II. Need for Legislative Change

As described in part one of this article, the pension funding and plan termination rules of ERISA and the code were not initially designed to provide true insurance risk-shifting, which would have subjected employers with larger unfunded liabilities to greater pension contributions and higher PBGC premiums. While the PBGC system has moved closer to a true insurance model, the landscape of retirement plans over the past 30 years has changed dramatically. While defined benefit plans were clearly the preferred form of retirement protection in 1974, defined contribution plans are now the preferred from of retirement savings, relying primarily on employee pretax contributions through IRC section 401(k) contributions.[13] Those shifts have long-term implications, especially for the baby boomer generation, whose retirement savings may be based on a single accumulated account balance that does not insulate them from investment and mortality risks during retirement. The focus of this article is not those code section 401(k)

Annual Performance and Accountability Report, *available at* http://www.pbgc.gov/publications/annrpt/2004txt/2004finstatements.htm (July 1, 2005). Note, the $23.5 billion deficit was computed using a 25-year select interest factor of 4.8 percent and the 1994 Group Annuity Mortality Table, set forward one year. To the extent that the PBGC has used a lower interest rate, its liabilities are overstated.

[4] *Id.*

[5] *See* GAO, *Pension Benefit Guaranty Corporation Long-Term Vulnerabilities Warrant "High Risk" Designation*, GAO-03-1050SP (2003), *available at* http://www.gao.gov/new.items/d031050sp.pdf (July 1, 2005).

[6] *See* ERIC Pension Pointers, *Assessing the Status of the Pension Benefit Guaranty Corporation*, (July 2005), *available at* http://www.eric.org/forms/uploadFiles/3B430000004F.filename.PBGC_NUMBERS.pdf (last visited August 21, 2005).

[7] ERISA Industry Committee (ERIC) is a lobbying organization that represents employers' interests for employee benefit plans.

[8] *See* ERIC, "Consensus Proposals for Pension Funding, PBGC Reform, and Hybrid Pension Plans," (May 2005), *available at* http://www.eric.org/forms/uploadFiles/36DD00000003.filename.consensus052005.pdf (last viewed July 17, 2005).

[9] *Id.*

[10] *See* Fay Hansen, "Ante up for Pensions," *Workforce Management* (July 2005).

[11] *See* Susanna Moon, "Pension Fund Rule Overhaul Likely," 19 *Employee Benefits News* 51 (July 2005) (referencing the GAO report, *supra* note 5).

[12] *See Pension & Investments Review of Annual Reports*, July 11, 2005 (listing the funded status of the largest defined benefit plans and noting that the aviation companies made up the worst-funded plans).

[13] *See* Ken McDonnell, "The U.S. Retirement Income System," 26 *EBRI Notes* No. 4 (April 2005), *available at* http://www.ebri.com/publications/notes/index.cfm?fa=notesDisp&content_id=3302 (last viewed July 17, 2005).

plans, but the potential attenuation or loss of the defined benefit system that insulates participants and beneficiaries from investment and mortality risks.

There are multiple reasons that explain the move away from defined benefit plans and into 401(k) defined contribution plans. As most employers view the cost of employee benefits as a certain percentage of payroll, the 59 percent increase in healthcare costs over the past five years has resulted in employers shifting more of the costs of benefits to the participants.[14] As actuarial cost methods for defined benefit plans are generally designed to produce either a fixed or increasing percentage of payroll (or dollars), employers sponsoring those plans do not have the flexibility of reducing costs on a year-by-year basis. Certainly, future benefits could be curtailed, but a larger part of the employer's costs may be due to the amortization of past service liabilities under the funding rules. Those costs must be continued to be paid. In contrast, a 401(k) plan permits participants to make pretax contributions to a defined contribution plan (not a defined benefit plan), allowing participants to absorb increasing employee benefits costs.

The draconian 50 percent excise tax enacted in the late 1980s discouraged defined benefit employers from prefunding their plans to excess — something that would have helped employers survive the perfect storm of the 2000s. That tax also prevented those employers from terminating fully funded plans until the surplus has been used up by the cost of future accruals. Congress's moratorium on the use of Treasury's funds to provide determination letters and other guidance for cash balance and other hybrid plans causes more problems for surplused plans that desired to stay within the defined benefit system.[15]

With today's depressed asset values eliminating the surplus, it would certainly be the time for employers to voluntarily terminate the plan (once fully funded) and move toward a defined contribution plan. Thus, any increase in PBGC premiums will be viewed negatively by financially healthy employers who do not want additional administrative costs, especially for a benefit that is not meaningful to them.

ERISA should have prohibited financially weak employers from making promises for past service liabilities that they could not have afforded at the time of creation. Also, ERISA never should have guaranteed 100 percent of those promises. However, there are employers who were financially healthy when the past service liability was created and made their pension promises with good-faith expectation of continued financial health, that are now in depressed industries (for example, airlines and steel).[16] For them, Congress might decide to extend further PBGC protection to preserve the defined benefit system.

Thus, a balanced pension reform cannot be accomplished without compromises. The following factors should be utilized in critiquing any reform:

- Will any increased funding obligations imposed on financially weak employers result in an improved balance between providing those contributions and not increasing potential PBGC liability?
- Should employer-funded contributions be required within a shorter time after the end of the plan year?
- Should valuations of pension liabilities vary according to different interest rates and mortality tables, introducing complexity to the costs of those plans? Is there a valid reason to use different interest rates for determining liabilities? Should there be a single liability figure for pension purposes?
- In early August the Bush administration announced that it would bring back the 30-year Treasury bond rate in 2006. If Treasury adopts a 30-year bond rate in the first quarter of 2006, should employer contributions based on current liability continue to be valued under such a fixed rate?
- Will minimum required contributions be predictable from the employer's perspective? By definition, defined benefit plans are long-term commitments by employers to deliver lifetime annuity benefits at retirement. Unless costs can be relatively predictable over the term of the promise, with smoothing of unanticipated costs over a period of time, employers simply may not adopt those plans. While the financing of pension costs could be invested in fixed-income assets to reduce volatility, the traditional pension portfolio has been 65 percent in equities and 35 percent in fixed-income, reflecting the intent of plan sponsors to minimize long-term costs of pension plans. [17] Thus, a mark-to-market approach each year for funding purposes may cure yesterday's problems but increase the cost of defined benefit plans and lessen their desirability. Immunization of plan assets with plan liabilities reduces volatility but

[14]*See* the results of a joint Kaiser Family Foundation and HRET (Health Research Educational Trust) survey, *available at* http://www.kff.org/insurance/chcm090904nr.cfm (last viewed on July 17, 2005).

[15]The House passed by a vote of 237 to 162 an amendment to an appropriations bill to bar Treasury from using funds to weaken or overturn the decision in *Cooper v. IBM Personal Pension Plan*, 274 F. Supp.2d 1010, *Doc 2003-17946*, *2003 TNT 149-38* (S.D. Ill. 2003). That ruling held that IBM's cash balance plan discriminated against older workers.

[16]*See* "Burdened Pension System May Break Without Funding Rule Changes," *Employee Benefits News*, July 2005 (noting that the PBGC's largest claims were filed by reportedly shielded industries such as insurance and technology: the parent of Kemper Insurance for $529 million and Polaroid for $324 million).

[17] *See* Watson Wyatt Worldwide Insider, *Pension Fund Finances and Business Risk*, July 2005 (stating that for the Fortune 1000, "[t]he vast majority of companies have most of their assets allocated in equities: the average allocation was just over 64 percent, and equity allocations have generally ranged in the upper 60s for most of the last 20 years. This stable allocation suggests that defined benefit sponsors tend to rebalance their portfolios when markets move and that companies are sticking with their traditional reliance on equities. While sponsors have benefited from positive returns in the stock markets during the last two years, such equity-heavy allocations drove funding levels to uncomfortably low levels in 2002 when the market bottomed out.")

increases plan costs if assets are invested long-term in bonds as opposed to stocks.

- Will any increase in the PBGC premium necessary to fund existing liabilities keep financially healthy employers in the system as well as getting the revised premium increase from financially weak employers?
- Should the PBGC system be extended to small businesses who would gladly establish defined benefit plans or cash balance plans (without a conversion) if the additional minimum participation of IRC section 401(a)(26) were repealed?[18]
- Is there any consideration to allowing for the surplus funding of defined benefit plans without the draconian tax of 50 percent?
- What meaningful disclosure mechanisms can be proposed to aid participants in assessing the ability of their plans to pay in the event of employer insolvency or bankruptcy? If disclosure is mandated, will participants understand the disclosure?

III. Legislative Proposals and Hearings

A. President Bush's Proposal

The Bush administration's proposal for pension reform was announced by the secretary of Labor on January 10, 2005.[19] It recommended an extremely conservative approach to funding underfunded defined benefit plans. While the approach may have some appeal if the funding rules were first being created, employers have adopted defined benefit plans in light of the existing funding rules. Hence, changing the rules midstream would subject financially strapped employers to increased funding costs at a time when they could least afford it, while imposing additional administrative expenses on financially healthy employers who ask, "Where's the additional benefit for the extra cost?" Like the current funding rules, the Bush proposal imposes a series of "cliff" rules that will subject employers to potential volatility in the level of annual pension contributions.

Early in 2005 the Bush proposal adopted the PBGC's perspective by requiring funding on a plan termination basis for remaining airlines and other businesses.[20] The proposal would repeal the present-law funding rules (including the deficit reduction contribution rules) and replace them with a set of rules based on funding targets. Several new concepts are proposed. At-risk employers would be required to make additional funding contributions for underfunded plans. A single value of plan liabilities would be used, based on a corporate bond yield curve. The proposal includes the following:

- Assets should be valued at market value; hence, no smoothing as presently permitted by the regulations. Unless plan assets are invested in bonds with the same maturities as liabilities, there will be volatility in employer contributions using a fair market value for assets. Employers try to reduce costs by investing in potentially higher-yield assets than long-term bonds. Thus, the requirement of valuing assets at fair market value simply increases the costs for employers.
- Elimination of actuarial liability and the substitution of *one* liability number for plan liabilities and a single set of interest rates in determining that liability (however, no mention of a single mortality table for valuation purposes). The use of a single liability figure simplifies the minimum funding contribution but doesn't reflect the employer's demographics; however, it assumes that the correct interest rate and mortality table are utilized to evaluate those liabilities. If the single liability figure is valued too conservatively, it will discourage the adoption of newly defined benefit plans.
- Annual costs for current liabilities would be determined using a unit credit cost method (this would be the *sole* cost method available to actuaries). The restriction seems to be unduly restrictive — similar to requiring all homeowners to take out only 10-year loans. The band of costs produced by available actuarial cost methods does not pose any manipulative problems; yet there are legitimate reasons why employers opt for different cost methods to allocate costs to particular plan years.
- A corporate bond yield curve interest rate to be used in determining plan liabilities, which will be updated by the government on a regular basis (hence, volatility from interest rates would be diminished.)[21] That measure would reflect the employer's

[18]Code section 401(a)(26) imposes an additional coverage requirement on qualified defined benefit plans, requiring coverage of participants to at least equal the lesser of (a) 50 employees or (b) the greater of two employees (one employee if the employer has only one employee) or 40 percent of all the employees of the employer). There are prescribed exclusions that may be used in determining the 40 percent of all the employees' portion of the test.

[19]The Bush proposal, "Strengthen Funding for Single-Employer Pension Plans," Feb. 7, 2005, is documented at http://www.dol.gov/ebsa. *See also*, the Department of Labor, "Fact Sheet: The Bush Administration's Plan for Strengthening Retirement Security," *available at* http://www.dol.gov/opa/media/press/opa/retirementsecurityfactsheet.htm (last viewed July 17, 2005). A recent release from the PBGC revealed that the Bush proposal would increase contributions for plan sponsors of defined benefit plans to over $1 trillion over the next six years, $430 billion more than now required.

[20]*See PBGC Reform: Mending the Pension Safety Net: Before the Senate Comm. on Health, Educ., Labor, and Pensions* (109th Cong. 1st Sess.) (2005) (statement of Bradley D. Belt), *available at* http://help.senate.gov/bills/pen_78_bill.html (last visited June 22, 2005). ("The current problems in the system are not transitory, nor can they be dismissed as simply the result of restructuring in a few industries. They are the result of fundamental flaws in the statutory and regulatory framework of government defined benefit plans and the pension insurance program.")

[21]The corporate bond yield curve interest rate mirrors the expected corporate bond interest rate for the duration of the expected liability. For example, if benefits are expected to be paid over a duration of 20 years beginning in 2005, a 20-year corporate yield rate is used to determine the current value of the liability.

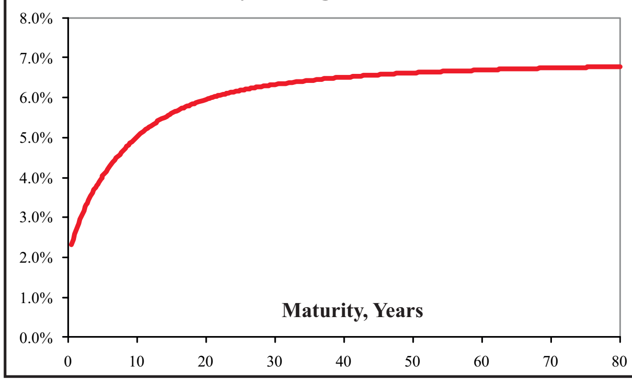
actual demographics as the duration for payment of each participant's liability would be determined using a given yield rate associated with that duration.

- Prior credit balances would not offset current contribution requirements (hence, past contributions intended to accelerate funding could not be used to offset current and future contributions). That result discourages prefunding of contributions. A better result would be to allow credit balances, carried forward at the interest rate actually earned on plan assets, not the actuarial assumed rate.

The notion of a yield curve is novel for ERISA's minimum funding requirements, but it certainly makes sense from an actuarial perspective. Generally, a yield curve moves in lock step associating expected interest rates with the specific durations associated with the liabilities. However, actuaries have protested that a simple cash flow liability stream does not necessarily coincide with a complex, multidecrement pension valuation.[22] If the employer's plan assets move in correlation with such liabilities, there would be little volatility in employer contributions. However, employers of defined benefit plans use the stock market to reduce the costs of those plans. The administration's proposal recommends a yield curve of high grade (AA) corporate bonds (averaged over 90 business days), which produces an interest rate for years 0 to 80. In August 2005, Treasury indicated that it was willing to offer 30-year securities beginning in 2006 — that proposal would allay problems associated with the use of corporate-bond rates that had to be discounted for default and callability risks.[23]

In his testimony before the House Education and Workforce Committee, Treasury Assistant Secretary Mark J. Warshawsky used a ''simple'' example to explain the use of the yield curve (see Figure 1) in determining liabilities for plan funding purposes.[24] For example, a defined benefit plan expects to make payments to three individuals: a 64-year-old Mr. Brown; a 59-year-old Ms. Scarlet; and a 54-year-old Mr. Green. Benefits begin at age 65 and continue until death. In year 5, $12,000 per year will begin for Mr. Brown for his expected life expectancy; in year 14, $9,000 per year will begin for Ms. Scarlet for her expected life expectancy; and in year 20, $6,000 per year will begin for Mr. Green's life expectancy. By aggregating these benefits, $12,000 begins in year 5, an aggregate of $27,000 in year 14, and an aggregate of $15,000 in year 20. Using life expectancy tables, aggregate benefits are expected for 26 years. For 2006, the aggregate of each year's benefits would be valued according to the interest rate associated with the expected duration of those payments. For example, if a liability was due in 5 years, a 5-year expected interest rate would be used to value that liability, whereas if the liability was due in 30 years, a 30-year expected interest rate would be used to value that liability. Use of such a yield curve is defended by the administration as those curves are routinely used by financial markets to value loans, mortgages, bonds and swaps.

Figure 1
Spot Yield Curve
Corporate AA Bonds
90-Day Average 12/30/2004



There are many problems associated with the proposal to utilize a yield curve:

- Defined benefit plan commitments are similar but not identical to loans, mortgages, bonds, and swaps. There are many variables that enter into the defined benefit commitment — earlier commencement of benefits due to termination of employment, early retirement provisions, and plan termination. Most loans, mortgages, and bonds have fixed interest rates or caps on floating-rate exposure to provide predictability — allowing those financial instruments to vary according to the change in the market may be financially sound but impose greater volatility for the employer.
- The proposed yield curve targets funding the current year's accrual to the purchase of a lump sum benefit at the plan's normal retirement age; however, funding of a defined benefit plan presumes that the benefit will be a life annuity at retirement for unmarried participants or a joint and survivor annuity for married participants.
- Use of a yield curve presumes that the underlying assets are invested in those long-term securities which is not the case with present defined benefit

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[22]*See* Kenneth A. Kent, ''Introduction to Yield Curve Forum,'' 15 *The Pension Forum* No. 1 (December 2004). *Also see* Holger Höfling, Rüdiger Kisele, and Gunther Löffler, ''Understanding the Corporate Bond Yield Curve,'' 15 *The Pension Forum* No. 1 (December 2004) (explaining that the use of a yield curve has unintended consequences when calculating and valuing lump-sum payments, alternative retirement ages, additional benefits for early retirees, and shutdown benefits).

[23]*See* ''Treasury Says 30-Year Bond Is Coming Back Next Year, A Move to Help Finance National Debt,'' *available at* http://www.theconservativevoice.com/ap/article.html?mi=D8BOCFLO0&apc=9004 (last visited Aug. 8, 2005) (indicating that 30-year bond auctions would take place in the first quarter of 2006, with auctions held twice a year, resulting in a revival of the long-term bond which would benefit pension funds, insurance companies, and other investors).

[24]*See The Retirement Security Crisis: The Administration's Proposal for Pension Reform and Its Implications for Workers and Taxpayers Hearing Before House Education and Workforce Committee* (109th Cong. 1st Sess.) (2005), (statement of Mark J. Warshawsky) *available at* http://edworkforce.house.gov/hearings/109th/fc/pension030205/warshawsky.htm (last visited August 21, 2005).

plan investments. Requiring the employer to invest in those investments to parallel costs and achieve predictability increases the overall cost of the plan if investment of stocks would have out-performed long-term corporate bond investments.

- As the yield curve changes over time, the future funding of benefits under a prior yield curve is no longer applicable as the yield curve has changed, resulting in even more volatility than is present under the current rules which use a consistent rule of the 30-year corporate bond yield rate. (For example, if benefits were due in 30 years and the current yield curve required funding at a 5 percent interest rate, and then 5 years passed by and the interest rate on a 25-year maturity (corresponding to the prior 30-year benefit) decreased to 4.5 percent, another valuation of funding would have to be calculated.) This is anything but simple from an actuarial perspective. However, to the extent assets have been matched to liabilities, changes in the interest rates along the yield curve are irrelevant, unless the anticipated timings of the liabilities change.

  Thus, the use of a yield curve would directly track the actual payment of assumed liabilities for an employer's *actual* demographics of participants or beneficiaries, not an artificial 30-year Treasury bond rate. From a policy perspective, use of such a yield curve makes perfect funding sense if we were starting with a clean slate — of course, fine-tuned as to whether a U.S. Treasury bond yield curve or a corporate bond yield curve should be used. However, changing the rules midstream, especially for employers with aging demographics, requires some compromise. Use of a U.S. Treasury bond yield curve would be more conservative, increasing plan liabilities and increasing funding requirements; however, use of a spread in a conservative corporate bond yield curve could provide some flexibility in annual contribution levels.

- At-risk employers (those employers with below-investment-grade bond rating for the past five years) would be subject to enhanced funding obligations; employees would be assumed to retire when first available under the plan; retirees would be presumed to elect lump sum distribution if available).[25] Those employers would be liable for the normal cost and a seven-year amortization of unfunded current liability. Those penalties are clearly in line with the level of risk that such employers pose for the PBGC. Additional considerations such as freezing future benefit accruals or phasing in benefit increases over a longer period would be consistent with such recommendations.

  If the plan achieves its full funding limit, no variable PBGC premium would be required. For purposes of IRC section 404 deductibility provisions, the Bush proposal would permit future salary increases to be assumed under the projected unit cost methods and, for hourly plans, would permit current costs to reflect future pay-related features.

B. Alternate Legislative Proposals

The congressional committees most interested in pension reform include the Senate Finance Committee (chaired by Sen. Chuck Grassley, R-Iowa, and vice chaired by Sen. Max Baucus, D-Mont.); Senate Health, Education, Labor and Pensions Committee (chaired by Sen. Michael B. Enzi, R-Wyo.); the House Education and the Workforce Committee (chaired by Rep. John A. Boehner, R-Ohio; and the Subcommittee on Select Revenue Measures (chaired by Rep. Dave Camp, R-Mich.) of the House Ways and Means Committee (chaired by Rep. William M. Thomas, R-Calif.).

On January 31 Sens. Grassley and Baucus introduced the National Employee Savings and Trust Equity Guarantee Act (NESTEG).[26] The proposal would extend the 2004-2005 temporary legislative fix through 2006 but then replace the interest rate with a yield curve. During the phase-in period, the interest rate used would be a combination of the prior rate and a yield curve rate, and funding up to the plan's accrued liability would be phased in from 2007 to 2009. Assets values could be smoothed over 5 years, within a range of 80 percent to 120 percent of their market value. Employers with junk-bond ratings would be required to freeze plan accruals if vested benefits dipped below 50 percent funding and to prohibit lump sum payments exceeding $5,000. Credit balances could continue to be used, but they must be ''marked to market'' (that is, adjusted with market value of investment gains and losses). Increased PBGC premiums would be assessed, but the increase would be phased in for new defined benefit plans.

Beginning in March 2005, the Finance Committee,[27] the Senate Health, Education, Labor and Pensions Committee,[28] the House Education and the Workforce

[25]*See* the quote from Belt, ''Burdened Pension System May Break Without Funding Rule Changes,'' *BenefitNews.com* (July 2005) (noting that 9 out of 10 plans that fail are tied to sponsors with junk-bond credit ratings in the decade before their collapse). For 2004 the PBGC estimated that unfunded plan liabilities tied to financially weak employers represented some $96 billion in exposure. *Id.*

[26]S. 219, *available at* http://thomas.loc.gov/cgi-bin/query/D?c109:2:.temp/~c109rXwXsu:: (last visited Aug. 18, 2005).

[27]*See Financial Status of PBGC and the Administration's Defined Benefit Plan Funding Proposal: Hearing Before the Senate Finance Comm.* (109th Cong. 1st Sess.) (2005), *available at* http://finance.senate.gov/sitepages/hearing030105.htm (last visited March 1, 2005), for a list of the witnesses and their testimonies. *See Preventing the Next Pension Collapse: Lessons From the United Airlines Case: Hearing Before the Senate Finance Comm.* (109th Cong. 1st Sess.) (2005), *available at* http://finance.senate.gov/sitepages/hearing060705.htm (last visited June 22, 2005), for a list of witnesses and their testimonies.

[28]*See PBGC Reform: Mending the Pension Safety Net: Hearing Before the Senate Health, Educ., Labor and Pensions Comm.* (109th Cong. 1st Sess.) (2005), *available at* http://help.senate.gov/bills/pen_78_bill.html (last visited June 22, 2005), for a list of witnesses and their testimonies.

Committee,[29] and the House Subcommittee on Select Revenue Measures[30] held hearings to listen to representatives from the administration, the business community, organized labor, academia, and participants' right groups, inviting comments not only on the Bush proposal, but alternative pension reform models. As expected, the Department of Labor and the PBGC representatives defended the president's proposal, while representatives from the American Benefits Council, organized labor, and the Business Roundtable supported permanent continuation of the long-term corporate bond rate, if the 30-year Treasury bond rate was no longer available.

As a result of the hearings before the House Subcommittee on Select Revenue Measures, Rep. Lloyd Doggett, D-Texas, introduced the Pension Security Disclosure Act[31] on March 12, which would require the PBGC to publicly disclose information filed under ERISA section 4010 to participants and beneficiaries. Annual reports would have to be available within 90 days after the filing date to assure greater dissemination of information. Summary annual reports would have to be issued within 15 days after the filing of the annual report and would have to disclose total assets and liabilities over the last three years.

By June 9, Sen. Grassley agreed to make changes to the NESTEG proposal so as to adopt the Bush administration's yield curve proposal and to eliminate smoothing. He has publicly stated that he will not include pension reform measures in any Social Security legislation;[32] whereas Rep. Thomas has said that he will include the measures as a part of broader reforms for health, pensions, and Social Security. In mid-June, the Senate Budget Committee held hearings eliciting the advice of the executive director of the PBGC and the director of the Congressional Budget Office.[33]

The same day, Reps. Boehner, Thomas, and John Kline, R-Minn., introduced the Pension Protection Act.[34] That bill recommended a *modified* yield curve based on three categories — liabilities due within 5 years, liabilities due between 5 and 20 years, and liabilities due after 20 years. That would allow for some interest smoothing. The proposal invokes a number of funding targets:

- plans that were not 100 percent funded would have to make up shortfalls within seven years;
- plans that were not 80 percent funded could not use credit balances; increased benefits or lump sum distributions would be prohibited in most circumstances;
- plans that were not 60 percent funded would have greater funding requirements, and benefit accruals would be frozen; also, funding of nonqualified deferred compensation plans would be curtailed;
- the proposed $30 increase in PBGC premiums would be phased in over time depending on the plan's funded status; variable rate premiums would stay the same but would be indexed to annual wage growth; and
- accelerated and additional disclosure to participants regarding the plan's funded status would also be required.

The chairman's mark, in the nature of a substitute to the Pension Protection Act, was approved on June 30 by the House Education and the Workforce Committee including a number of amendments with 27 Republicans voting in favor of the bill and 22 Democrats voting present.[35] That bill is supposed to provide:[36]

- use of the modified yield curve based on three categories of liabilities (less than 5 years, between 5 and 20 years, and more than 20 years);
- credit balances can continue to offset future contributions only if the plan is funded at least at the 80 percent current liability level and the credit would be based on market value (not book value);
- lump sum payouts would be permissible based on three broad interest rate groups depending on the participants' demographics;
- flat rate premiums would be increased to $30 per participant, but plans with 80 percent funding levels would phase in the higher premiums over five

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[29]*See Pension Protection Legislation to Fix Outdated Worker Pension Law, Protect Taxpayers: Hearing Before the House Comm. on Educ. and the Workforce* (109th Cong. 1st Sess.) (2005), as noted in a press release from Rep. Boehner regarding H.R. 2830, the Pension Protection Act, *available at* http://edworkforce.house.gov/press/press109/first/06jun/ppa063005.htm (last visited July 17, 2005).

[30]*See President's Proposal for Single-Employer Pension Funding Reform: Hearing Before the House Subcomm. on Select Revenue Measures* (109th Cong. 1st Sess.) (2005) (statement of Ron Gebhardtsbauer of the American Academy of Actuaries), *available at* http://www.actuary.org/update/pdf/0405.pdf (last viewed July 17, 2005).

[31]H.R. 2321, *available at* http://thomas.loc.gov/cgi-bin/bdquery/D?d109:1:./temp/~bdSzVc:@@@D&summ2=m&|/bss/d109query.html (last visited July 17, 2005).

[32]*See* press release issued by Sens. Grassley and Baucus (June 9, 2005), *available at* http://finance.senate.gov/press/Gpress/2005/prg060905.pdf (last visited July 17, 2005).

[33]*See Solvency of the Pension Benefit Guaranty Corporation — Current Financial Condition and Potential Risks: Hearing Before the Senate Comm. on the Budget* (109th Cong. 1st Sess.) (2005) (statements of Bradley Belt and Dr. Douglas Holtz-Eakin), *available at* http://www.senate.gov/~budget/republican/hearing_schedule_and__testi.html (last visited June 22, 2005). The GAO has issued to Congress a discussion of the problems confronting single-employer defined benefit plans and the funding criteria. That proposal provides a cohesive and inclusive approach to the resolution of the funding problems for single-employer defined benefit plan sponsors. Many of the figures mentioned in this article come from that report.

[34]H.R. 2830, *available at* http://thomas.loc.gov/cgi-bin/bdquery/D?d109:1:./temp/~bdEYJh:@@@D&summ2=m&|/bss/d109query.html (last visited July 17, 2005). The House Employer-Employee Relations Subcommittee considered the legislation on June 23, 2005. Boehner also introduced a companion bill (H.R. 2831) that would clarify the legality of cash balance plans.

[35]The chair's version of the bill (referred to as the chairman's mark) was amended by several amendments. *See* details of the committee's bill at its Web site, *available at* http://edworkforce.house.gov/.

[36]The actual text of the chairman's mark was not available when this article was written.

years; variable rate premiums would increase according to annual wage growth; and
- cash balance and other hybrid plans would be valid as long as they offer the same benefit to all workers regardless of age (for example, 5 percent of pay) and employers could disregard early retirement benefits offered to older workers in calculating the level of benefits offered.

That bill is now under consideration by the Ways and Means Committee, where it has Thomas's support.[37] However, to the extent this bill must be folded into a bigger retirement bill that includes Social Security changes, its prospect for passage grow dim.[38]

On July 22, 2005, Sens. Grassley and Baucus amended NESTEG, moving closer to the administration's proposal than the Boehner proposal. The chairman's mark to NESTEG provides the following:
- replace the 30-year Treasury rate with the yield curve and eliminate smoothing techniques;
- credit balances must be reflected with actual investment gains or losses on the underlying assets;
- funding target is 100 percent of liabilities, with excess funding permitted up to 180 percent of current liabilities;
- amortization of unfunded liabilities over seven years;
- assessment of excise taxes and benefit restrictions if funding goes below 60 percent funding;
- approve increase of the PBGC premium to $30;
- comprehensive disclosure of pension information to participants and public access to what used to be confidential disclosure to PBGC; and
- affirmation of cash balance and other hybrid plans and the elimination of the whipsaw effect provided the plan's interest rate for valuing lump sums is no greater than the market rate of return.

On July 26, the Finance Committee unanimously approved the chairman's mark of the NESTEG bill.[39] The modified NESTEG bill is similar to the Administration's proposal, but affords more phase-in rules and delayed effective dates.

Ancillary bills that have been introduced include:
- On April 28, 2005, Reps. Rob Portman, R-Ohio, and Benjamin L. Cardin, D-Md., introduced the Pension Preservation and Savings Expansion Act of 2005, relating to disclosure information for participants and beneficiaries.[40]
- H.R. 2233 was introduced by Rep. George Miller, D-Calif., and S. 991 was introduced by Sen. Edward M. Kennedy, D-Mass., both on May 10, 2005. Those bills would make the employer's ability to make nonqualified deferred compensation to executives contingent on the funding status of the qualified plans for the rank and file. Also, any elimination or reduction of future benefit accruals under the defined benefit plan or reduction in future employer contributions under a defined contribution plan would require full disclosure as to the employer's executive compensation plans. They would also impose a six-month moratorium (beginning on May 1, 2005) on termination of plans when the plan sponsor had unfunded termination liabilities of at least $1 billion and is seeking reorganization in bankruptcy or insolvency. The effect would undo the PBGC's assumption of UAL's unfunded guaranteed liabilities and restore the plan to its prior status. The House approved the labor appropriations bill, H.R. 3010, on June 24, 2005, prohibiting funds appropriated by the bill to be used by the PBGC to enforce or implement its April 22, 2005, settlement agreement with UAL.
- S. 685 was introduced by Sen. Daniel K. Akaka, D-Hawaii, on March 17, 2005, to require the PBGC to raise the guarantee level of benefits for pilots at age 60 instead of age 65.
- H.R. 2106 was introduced by Rep. Tom Price, R-Ga., on May 4, 2005, and S. 861 was introduced by Sen. Johnny Isakson, R-Ga., on April 20, 2005, allowing airlines to spread the deficit reduction contribution over 25 years while freezing benefits at current levels.[41]

C. Industry Solutions

ERIC represents the employee benefits interests of America's largest employers and rejects the administration's proposal. Describing the Bush proposal as self-defeating to PBGC security, it proposed alternate legislative solutions for Congress to consider:

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[37]*See* press release issued by Rep. Thomas (June 9, 2005), *available at* http://waysandmeans.house.gov/news.asp (last viewed July 17, 2005). (''[t]his is a realistic package that would help ensure that employers strengthen their pension plans and make good on those promises.'') For charts summarizing the current law and details about the administration proposal and the pension funding proposals, see the Davis & Harman Benefits Group, ''Summary and Comparison of Leading Single-Employer Pension Funding Proposals,'' *available at* http://edworkforce.house.gov/hearings/109th/fc/pension030205/warshawsky.htm (last visited August 21, 2005) and Towers Perrin, ''Legislative Tracking Chart — Retirement — Updated August 9, 2005,'' *available at* http://www.towersperrin.com/hrservices/webcache/towers/United_States/publications/Periodicals/Leg_Tracking_Charts/2005_08_09/LTC_RET_2005_08_09.pdf (last visited August 21, 2005).

[38]*See* ''Pension Protection Act,'' *Workforce Management* (August 2005) (''[t]he level of controversy pales in comparison to the level of controversy around Social Security reform.'')

[39]*See* Joint Committee on Taxation, *Description of the Chairman's Mark of ''The National Employee Savings and Trust Equity Guarantee Act of 2005,''* JCX-56-05 (July 22, 2005) and Patrick Purcell, CRS Report for Congress on S. 219, Aug. 12, 2005, *available at* http://edworkforce.house.gov/issues/109th/workforce/pension/ppasummarylong.htm (last visited Aug. 21, 2005); however, text of the bill has not yet been released.

(Footnote continued in next column.)

[40]H.R. 1960 and 1961, *available at* http://thomas.loc.gov/cgi-bin/bdquery/D?d109:1:./temp/~bdmeXT:@@@D&summ2=m&|/bss/d109query.html and http://thomas.loc.gov/cgi-bin/bdquery/D?d109:1:./temp/~bdVCua:@@@D&summ2=m&|/bss/d109query.html (last visited July 17, 2005).

[41]*See* Hewitt, *Federal Legislation Quick Guide* (July 12, 2005), *available at* http://was4.hewitt.com/hewitt/resource/legislative_updates/united_states/quick_guide/ret_07 1205.pdf (last visited July 17, 2005).

- for the minimum funding rules, retain the present-law composite corporate bond rate as the permanent interest rate and retain smoothing of that rate by using a weighted four-year average; reduce amortization periods for plan amendments from 30 years to 10 years;
- allow plan-specific mortality assumptions if plan-specific interest rates are used in the current liability determination;
- continue smoothing of asset values with an 80 percent to 120 percent corridor of fair market value;
- include lump sum distributions in the calculation of current liabilities and use a corporate bond rate to calculate minimum lump sum amounts;
- accelerate funding not based on the employer's credit risk but instead when current liability dips below 90 percent funded;
- retain credit balances with modifications;
- allow deductible contributions up to 130 percent of current liability and allow deductible funding above 130 percent of current liability for future salary and benefit increases;
- repeal the 25 percent compensation limit for employers with both defined benefit and defined contribution plans; eliminate the 10 percent excise tax on nondeductible contributions;
- allow pension plans to fund savings plan contributions on behalf of pension plan participants;
- reject any increases in the PBGC premium;
- have the PBGC treat shut-down benefits as a plan amendment for funding, and guarantee the benefits when triggered;
- in the context of bankruptcy, freeze the benefit the PBGC will guarantee at the time of bankruptcy; prohibit increases in benefits if plan is less than 70 percent funded and has been less than 100 percent funded for more than a year; limit the percentage of any lump sum that can be paid; encourage distributions as annuity payouts by using the same interest rate applicable to lump sums to the corporate rate used in funding and by providing tax incentives for annuity payouts; and
- regarding disclosure, provide participants with an annual statement regarding the plan's funded status by using the information as compiled for SFAS 87 purposes and eliminate the use of the summary annual report for this purpose.[42]

The Pension Practice Council and the Pension Committee of the American Academy of Actuaries have also formulated alternate legislative proposals to solve the pension funding issues for single-employer plans.[43] Their proposals include:

- ERISA's funding rules should move to a point where the market value of plan assets cover the market value of accrued liabilities, but phase in the requirement over a reasonable period. Various alternatives are proposed to achieve this result (for example, increase the full funding limit to 100 percent of accrued benefit liabilities);
- make required minimum funding contributions predictable and hedgeable;
- promote transparency of the financial position of the plan and its effect on the plan sponsor;
- provide greater incentives to fund pension plans (for example, increase deductible limits to 150 percent of current liability);
- avoid moral hazards such that financially weak plan sponsors are not permitted to improve benefits or take large risks at the expense of the PBGC or other premium payers;
- make the rules simpler; and
- allow for transition to the new rules.

D. General Concerns About the Various Proposals

Employers of fully funded defined benefit plans made prudent economic decisions during the 1990s, especially when current liability came closer to the value of plan assets, to terminate those plans as there was no advantage in having a surplus plan and many employers preferred the IRC section 401(k) plan to recruit younger workers and to limit plan costs. If the cost of the PBGC-fixed premium becomes too high, employers of fully funded defined benefit plans may decide to terminate such plans as the administrative costs associated with the plans are too high — why pay for a premium if the plan and employer are solvent? Therefore, any proposals to substantially increase the funding requirements for underfunded plans and to substantially increase premiums for all covered plans must be seriously questioned. Otherwise, the PBGC is confronted with a smaller pool of employers of defined benefit plans and the remaining employers tend to be financially weak and therefore unable to terminate under the standard termination rules.

Criticism of the Bush proposal focuses on the lack of smoothing for employers for annual pension costs and the lack of a proposed mortality table in determining liabilities. The Society of Actuaries and American Association of Actuaries recommend the Retired Pensioner 2000 Table, which provides flexibility between white collar and blue collar employees; active and retiree participants; and projection scale.[44] Also release of data from the PBGC indicating the dramatic increase in required pension funding contributions under the Bush proposal — up by $430 billion over the next six years — highlights serious concerns for plan sponsors.[45]

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[42]*See supra* note 8.

[43]*See* American Academy of Actuaries, *Pension Funding Reform for Single Employer Plans* (Feb. 28, 2005), *available at* http://www.actuary.org/pdf/pension/funding_single.pdf (last visited July 17, 2005). *See also* the testimony of Ron Gebhardtsbauer for the American Academy of Actuaries, *supra* note 30.

[44]*See* the summary of the RP 2000 Table, *available at* http://www.soa.org/ccm/content/research-publications/experience-studies-tools/the-rp-2000-mortality-tables/ (last visited July 17, 2005).

[45]*See Miller FOIA Requests Reveal Bush Pension Plan Would Cost Companies Another $430 Billion Over 6 Years* (July 29, 2005), *available at* http://www.house.gov/apps/list/press/ed31_democrats/rel72905.html (last visited August 25, 2005).

While use of a yield curve may make sense from a theoretical perspective in determining plan liabilities, actuaries have raised a number of practical problems regarding its use for valuation. These issues were discussed earlier in the critique of the administration's proposal. If Treasury is going to reissue long-term bonds beginning in 2006, a governmental bond yield curve, if mandated, is preferable to a corporate bond yield curve to avoid reflecting default and callability risks.

IV. How to Fashion a Rational Solution

It is usually easier to fashion rules from the beginning than to alter the rules as they evolve. Unfortunately, Congress is not in a position to start with a clean slate in the context of the minimum funding rules and plan termination rules of ERISA and the code. Congress's initial and continued responses to funding problems have been consistently *reactive*, instead of *proactive*, resulting in financially healthy employers leaving the defined benefit system and financially unhealthy employers unable to leave the system. From 1986 to 2004, 101,000 single-employer plans with about 7.5 million participants left the defined benefit system.[46] In 99,000 of those terminations, assets were sufficient to cover all benefits for workers; for the remaining 2,000 cases, liabilities shifted to the PBGC.[47] Of the 30,000 defined benefit plans that are in existence, many are in the most mature industries in which benefit costs are dramatic due to the increasing number of retired workers.[48] Also, most employers have become more conscious of the dramatic increase in healthcare costs, as compared to pension costs, and thus have focused their efforts on curbing both sets of costs. Renewed initiatives to increase pension costs will result in resistance as healthcare costs continue to soar.

The PBGC has determined that its current shortfall is $23.3 billion with a potential of liability of $96 billion if companies with below-investment-grade credit ratings had to terminate their plans.[49] As the PBGC has produced those figures, it is imperative for the benefits community to critique the validity of those figures. The interest rate used in its valuation of liabilities may be artificially low, causing shortfalls to appear to be higher. Those types of numbers will definitely attract Congressional attention, but the solution is anything but straightforward. The solution must take a multidimensional approach — encouraging current employers of defined benefit plans to continue coverage, increasing the funding requirements for employers of underfunded defined benefit plans, preserving the financial security of the PBGC, and informing participants and beneficiaries of the risks inherent in employers' funding of defined benefit plans.

The defined benefit system affords numerous benefits to participants and beneficiaries — guaranteed annuity protection and avoidance of interest and mortality risks. Participants may not realize the importance of that protection, as experienced in the Social Security debate — when participants and beneficiaries are covered under a guaranteed defined benefit plan financed as a defined contribution system. However, it is difficult to compete with the defined contribution IRC section 401(k) model that permits pretax contributions by employees, shifting investment and mortality risks to employees, with either required matching or discretionary employer contributions. This article will not offer a legislative model that will cure all the ills of the past. But any meaningful pension reform should be approached with six criteria in mind: fairness, transparency, recognition of the prior funding rules, retention of the defined benefit system, expansion of coverage, and encouragement to add to the funding of defined benefit plans.

Fairness means those employers who promised past service liabilities either on plan establishment or due to subsequent plan amendments should be required to pay for such promises over an appropriate period, and future pension accruals should be frozen if such funding is not attained within a reasonable period. The appropriate period should be dependent on the employer's actual demographics, not an artificial number of amortization years.

Improved transparency means that plan participants and beneficiaries should be informed as to the plan's funding status under two separate scenarios — on a plan termination basis and on a continuing plan basis. Those results should be determined using a *single* and *uniform* determination of liabilities and assets, not one determined by the plan sponsor. The employer's financial health should also be disclosed so that participants and beneficiaries may evaluate the potential for employer insolvency or bankruptcy. Employer contributions for underfunded plans should be required at the end of the plan year, not 8½ months after the end of the plan year.

Recognition of prior funding rules means that employers who have been following the minimum funding rules of the past are not asked to undertake enormous new pension funding costs in the short term. Why employers have funded defined benefit plans as they have is certainly in direct reaction to Congress's funding targets and the inability to add surplus to plans. To penalize employers too harshly will only force healthy employers out of the defined benefit system, leaving unhealthy employers with a disproportionate share of the deficit. However, the funding rules should move away from a series of funding targets to a system that strives to provide full security to employees' benefits on a plan termination basis.

Retention of the defined benefit system means that public policy should encourage the continuation and formation of defined benefit plans — as they are designed to provide replacement income as an annuity stream of payments — shifting investment and mortality risks to employers who are able to spread those costs over the entire participant population, and over the timeline represented by the employer's existence. Defined contribution plans provide a meaningful supplement to the core retirement protection, but they should not be regarded as replacements of the defined benefit model. Thus, funding of defined benefit plans with a surplus should be encouraged instead of discouraged,

[46]*See supra* note 20.
[47]*Id.*
[48]*Id.*
[49]*Id.*

and PBGC premiums should not be set at a level that discourages the adoption of new defined benefit plans due to the increased administrative costs. The legality of cash balance and other hybrid plans should be affirmed by Congress to keep those plans in the defined benefit system.

The legislative response must therefore be a delicate balance to promote financially healthy employers to stay or enter the defined benefit market, but require financially unhealthy employers to contribute greater levels of minimum funding obligations but not to the level that would subject them to insolvency or bankruptcy. Unfortunately, the steel and the airline industry have been particularly hard-hit in the past few decades — not in an attempt to avoid pension obligations but as an inability to stay solvent within a depressed industry. In a white paper by Watson Wyatt, a proposed solution offered for the underfunding within those depressed industries was an overall consumption tax or levy on raw or finished materials.[50] To the extent that any tax drove down demand for the products or services of depressed industries, the tax would be counterproductive.

During 1984, minimum funding contributions were increased over a presumed 18-year amortization period. The president's and NESTEG's proposal of a seven-year amortization period may be too draconian — perhaps a phase-in approach, reducing the amortization period over a series of years — or an amortization period based on the average remaining working life time for active participants. The variable portion of the PBGC premium increases the premium for employers with unfunded pension liabilities — regardless of whether that underfunding was due to past service credits (something that the employer was in control of) or due to depressed asset values and increased liability values.

Because the employer is in direct control of the underfunding due to past service credits, increase in the variable portion of the PBGC premium is warranted and should be directly proportional to the liability shifted to the PBGC. However, volatility due to market-induced shifts in asset and liability values should not subject the employer to increased premium levels. That obviously assumes that employers are investing prudently; otherwise employers opting for more risky plan investments to lower costs expose the PBGC to potential liability. Heads, the employer wins; tails, the PBGC loses.

Expansion of coverage: The PBGC's coverage should extend to small employers who desire to establish traditional defined benefit plans and cash balance plans in an effort to increase its premium base. To encourage small employers to adopt defined benefit plans, a repeal of the harsh minimum participation rule of IRC section 401(a)(26) should be adopted. Small employers establishing defined benefit plans are not likely to have funding deficiencies as the employers wish to maximize their deductions to provide for the retirement of a senior shareholder or partner in the business.

Encouraging employers to surplus: A surplus asset cushion should be encouraged in the defined benefit context, and therefore the draconian 50 percent excise tax should be repealed. If Congress is concerned that that surplus would be raided for alternative purposes, it could limit the use of the surplus for the payment of any benefits required by the employer in the current or subsequent years of termination.

Before formulating any legislative solutions for those underfunded pension plans, the public should also be aware of the enormous underfunded *retiree health* coverage that has been promised but cannot be prefunded and is certainly not guaranteed by the U.S. government. The real question may be: Can we afford to pay baby boomers the *aggregate postretirement* benefits they were promised? If not, what is the solution?

V. Conclusion

Before any discussion of pension funding reforms, it is imperative that Congress try to preserve the defined benefit system model. Although employee demographics and the notion of ''career service'' employee have changed over time, all employees hope to retire with an appropriate replacement income level, with some protection against investment and mortality risks on retirement. The defined contribution model does not provide that security to the participant — which may result in delayed retirement for most participants, especially those who have not saved appropriately over their careers.

It is almost impossible to propose an effective set of pension funding reforms prospectively that purports to cure the deficiencies that have developed over the past 30 years. However, to ''pretend'' that we can impose funding rules as if there was a clean slate available is naïve and will force healthy employers out of the defined benefit system. Also, the problems for sponsors of cash balance and other hybrid plans cause concerns that should be resolved one way or the other. The legislative proposals should affirm the validity of those arrangements in order to shore up the level of premiums required by the sponsors of those defined benefit plans as well as encourage the establishment of new plans by small employers.

A recommended solution includes the following initiatives as part of an overall package:

- If the funding rules are to move to a plan termination model where assets and liabilities are to be valued at fair market value, that move should occur over a staggered period (say 5 to 10 years, depending on the current funding status of the plan). In the interim, continue to use a long-term corporate bond yield rate (or the 30-year Treasury bond rate if available) for valuing liabilities and an actuarial value of assets with a corridor between the 80 percent to 120 percent of fair market value. While this introduces volatility in the level of employer contributions during the phase-in period, smoothing can be achieved with investment in long-term bonds that reflect the value of liabilities and the ability to surplus the plan assets without penalty (see below).

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[50]*See* Julia L. Coronado and Sylvester J. Schieber, *Saving Private Pension Insurance: An Evaluation of Current Proposals to Shore Up the PBGC* (Watson Wyatt, April 2005), *available at* http://www.watsonwyatt.com/research/whitepapers/wprender.asp?id=wp-26 (last visited July 17, 2005).

- Amortization of unfunded past service liability should be changed from the deficit contribution rule of the *lesser* of the current 18 years or the actual *difference* between the weighted average age of participants and the expected normal retirement age (for example, if the weighted average age of participants is age 50 and normal retirement age is 65, amortization is over a 15-year period), where the average age is weighted by the amount of liabilities.
- Financially weak employers should be required to freeze benefit accruals and prohibit voluntary lump sum distributions.
- Plans may continue to use one of the six prescribed actuarial cost methods to determine actuarial liability.
- Repeal the 50 percent excise penalty tax for surplus assets of terminated defined benefit plans, permit funding and deductibility for contributions up to 130 percent of current liability, and repeal the combined 25 percent of payroll limit for defined benefit and defined contribution plans maintained by the same employer.
- PBGC premiums of $30 would be phased in over five years for plans that are currently 95 percent funded, with the variable portion should be adjusted according to increases in wage growth, and consideration could be made to substantially reduce premiums for financially healthy employers with funded plans that immunize plan assets by investing in duration-matched bonds.
- Disclosure must be made to participants and beneficiaries within 2½ months after the end of the plan year, showing the current liabilities, the portion of the liabilities that are guaranteed by the PBGC, and the fair market value of assets.
- Cash balance and other hybrid plans that provided the same percentage of compensation to all covered participants would be deemed in compliance with the age discrimination rules.
- Small employers establishing defined benefit plans would be covered under Title IV of ERISA, if the additional minimum participation rule of IRC section 401(a)(26) is repealed.

The intent of this package is to minimize short-term changes for sponsors of plans that are fully funded or close to fully funded under the current rules, but accelerate deductions for sponsors with underfunded plans. However, after five years, ERISA's funding system will move to a more rational system, in which sponsors are penalized for overcommitting. For healthy employers, volatility can be reduced by making additional contributions in ''good years'' without the threat of losing such surplus in later years. Affirming the legality of cash balance plans and expanding coverage of small-employer defined benefit plans will strengthen the stream of premium revenue for the PBGC.

The intent of this article will be achieved if policymakers and plan sponsors continue to effectively dialogue as to what should be required to keep financially healthy employers in the defined benefit system without unduly burdening in the short run financially weak employers. Certainly the long-term solvency of the PBGC is at stake, but if the legislative solution results in the demise of the defined benefit system, the PBGC will become a dinosaur of ERISA's past, and the real loss will be to workers' security.