

POLICY ISSUES RELATING TO DEFINED BENEFIT PENSION PLANS

A. General Policy Issues Relating to the Defined Benefit Pension Plan System

In general

Almost all changes to pension laws require the balancing of competing policy objectives, including concerns regarding retirement income security, simplification, reduction of administrative burdens, and fiscal and tax policy. In some cases, a single policy concern may result in competing issues. For example, concerns regarding retirement income security may lead to the enactment of provisions giving employees greater rights under pension plans; however, if the new provisions are too severe, plan sponsors may modify plans or reduce benefits, thereby potentially reducing retirement income security.

Any legislative changes to the rules relating to defined benefit pension plans are likely to involve such balancing. General policy issues that may arise in connection with legislative proposals relating to defined benefit pension plans are discussed below.

Retirement income security

Helping to ensure that individuals have retirement income security is the major objective of the U.S. private pension system. Defined benefit pension plans are considered by many to provide greater retirement income security than defined contribution plans. Factors that contribute to this view include the fact that such plans offer a specified benefit payable as an annuity for life, the employer bears the risk of investment loss, and benefits are guaranteed (within limits) by the PBGC in the event the plan terminates and plan assets are not sufficient to pay promised benefits. In addition, defined benefit pension plans are required to provide certain annuity benefits to the spouse of the employee, unless both the spouse and employee elect otherwise, thus providing some degree of income security for spouses.

In contrast, defined contribution plans do not promise a specific benefit, but instead pay the value of the participant's account. Under defined contribution plans, the plan participant, rather than the employer, bears the risk of investment loss. Defined contribution plans are generally not required to offer benefits in the form of an annuity, and benefits provided by defined contribution plans are not guaranteed by the PBGC. The spousal rules applicable to defined contribution plans vary based on the specifics of the plan; however, in most cases, the spouse has only the right to be named the beneficiary of the amount (if any) remaining upon death. Thus, spousal rights are not as great as under defined benefit pension plans.

The relative decline in defined benefit pension plan coverage has caused some to be concerned about a possible decline in retirement income security. This concern has focused attention on both defined contribution plans and defined benefit pension plans.

The reasons for the decline in defined benefit pension plan coverage are not entirely clear. A number of possible reasons have been cited, including changing worker demographics, administrative burdens on employers, applicable legal restrictions, worker preferences, and employer cost. The need for and design of any legislative changes relating to the defined benefit pension plan system depend in part on what is viewed as the source of the decline in coverage. For example, EGTRRA made a variety of changes with respect to the rules relating to employer sponsored retirement plans with a stated goal of expanding coverage. The changes relating to defined benefit pension plans include increases in the amount of benefits that can be provided, provisions designed to reduce administrative burdens, and greater flexibility in funding rules.

The EGTRRA changes may make defined benefit pension plans more attractive to employers, owner-employees, and highly compensated employees, thus leading to the establishment of new plans or the expansion of existing arrangements.¹¹⁷

Some view the decline in defined benefit pension plan coverage as part of a natural shift toward defined contribution plans. Some suggest that, in today's business environment, the long-term costs associated with defined benefit pension plans makes them impractical for many employers. In addition, some argue that many employees prefer defined contribution plans to defined benefit pension plans and are better off under such plans. For example, traditional defined benefit pension plans provide the greatest level of benefits to longer-service employees; employees who terminate employment after only a few years of service may have a very low accrued benefit under a traditional defined benefit pension plan. Workers who change jobs relatively frequently may prefer the portability typically offered by a defined contribution plan; their account balance can be rolled over and continue to accumulate earnings. While some defined benefit pension plans may offer lump-sum benefits that would provide the same portability opportunities, not all do. Thus, in some cases, defined contribution plans may enable employees to accrue greater benefits than under a defined benefit pension plan, thereby increasing retirement security.¹¹⁸ Employees often find defined contribution plans easier to understand than defined benefit pension plans, and also often like the opportunity provided by some defined contribution plans to make their own investment decisions. Some argue that legislative changes addressing retirement income security should adapt to the shift toward defined contribution plans, and focus on ways in which to enhance security with respect to such plans.

In some cases, particular plan features may give rise to concerns regarding retirement benefit security. For example, conversions of more traditional defined benefit pension plans to cash balance plans have raised issues with respect to whether employees in general and in specific cases are better off under the new plan design or the old plan design and whether employees have sufficient information to understand the plan

changes. Concerns regarding conversions to cash balance plans led to the enactment in EGTRRA of new notification requirements regarding a significant reduction in future benefit accruals. Some argue that the flexibility to adopt new plan designs, such as cash balance plans, helps to make defined benefit pension plans more attractive to employers and thus to preserve the defined benefit pension plan system

B. Issues Relating to Funding and the Solvency of the PBGC Insurance Program

General issues

As discussed above, present law imposes minimum funding requirements with respect to defined benefit pension plans and a limit on the maximum amount of deductible contributions. In addition, nondeductible contributions are discouraged through the imposition of an excise tax. Contributions in excess of the amount needed to provide plan benefits are also discouraged through the restrictions on reversions of plan assets. These rules are a cornerstone of the defined benefit pension plan system and, over time, have been a frequent source of discussion and change.

Like many of the qualified retirement plan rules, the funding rules for defined benefit pension plans involve balancing competing policy interests. The minimum funding rules are designed to promote benefit security by helping to ensure that plan assets will be sufficient to pay promised benefits when due. The minimum funding rules also address moral hazard concerns relating to the PBGC insurance program by preventing employers from purposely under-funding plans. Such under-funding can increase costs to the Federal government as well as PBGC premium payors.

On the other hand, the minimum funding rules recognize that pension benefits are often long-term liabilities that can be funded over a period of time. Some argue that if minimum funding requirements are too stringent, funds may be unnecessarily diverted from the employer's other business needs and may cause financial problems for the business, thus jeopardizing the future of not just the employees' retirement benefits, but also their jobs. This suggestion tends to arise during a period of economic downturn, either generally or in a particular industry. Some also argue that overly stringent funding requirements may discourage the establishment of defined benefit pension plans.

The limits on deductible contributions, the excise tax on nondeductible contributions, and the rules relating to reversions of defined benefit pension plan assets have as a major objective preventing the use of defined benefit pension plans as a tax-favored funding mechanism for the business needs of the employer. They also serve to limit the tax expenditure associated with defined benefit pension plans. Some argue that if the maximum limits on plan funding are too low, then benefit security will be jeopardized. They argue that employers need flexibility to make greater contributions when funds are available, in order to ensure adequate funding in years in which the

business may not be as profitable. Others note that such flexibility is available as a result of the increases in the deduction limits under EGTRRA, but the full effect of the increases may not be apparent yet because of recent economic conditions. With respect to reversions, some argue that if restrictions on reversions are too severe, employers may be discouraged from making contributions in excess of the required minimums.

Some criticize the present-law funding rules as being both overly complex and ineffective in light of the large unfunded liabilities that the PBGC has had to assume in recent years. Some suggest that certain aspects of the present-law funding rules enable financially troubled companies with under-funded plans to make minimal plan contributions and at the same time to increase benefits, thus increasing the financial risk to the PBGC and to companies with adequately funded plans. Some raise concerns that changes to the funding rules that have the effect of increasing required contributions or making required contributions more unpredictable will discourage employers from continuing to maintain defined benefit pension plans.

Some have suggested that PBGC premiums applicable with respect to a plan should better reflect the risk presented by the plan. Some have also suggested that better and more timely information about the funded status of plans should be available to employees and the public.

The desire to achieve the proper balance between these competing policy objectives has resulted in a variety of legislative changes to address the concerns arising at particular times. For example, the Omnibus Budget Reconciliation Act of 1987 made comprehensive changes to the minimum funding rules promoted by concerns regarding the solvency of the defined benefit pension plan system. That Act also added the current liability full funding limit. Legislation enacted in 1990 allowed employers access to excess assets in defined benefit pension plans in order to pay retiree health liabilities. The Retirement Protection Act of 1994 again made comprehensive changes to the funding rules. Recent changes to the funding rules have focused on increasing the maximum deductible contribution, and on the interest rate that must be used to determine current liability for purposes of calculating required contributions.

For example, EGTRRA increased the current liability full funding limit and repealed the current liability full funding limit as of 2004. Temporary increases in the interest rate used to determine current liability were included in the Job Creation and Worker Assistance Act of 2002 and the Pension Funding Equity Act of 2004.

Issues related to the interest rate used to value benefits under a plan

In general

Recent attention has focused on the issue of the rate of interest used to determine the present value of benefits under defined benefit pension plans for purposes of the

plan's current liability (and hence the amount of contributions required under the funding rules) and the minimum amount of lump-sum benefits under the plan. For plan funding purposes, the use of a lower interest rate in determining current liability results in a higher present value of the benefits and larger contributions required to fund those benefits. Alternatively, the use of a higher interest rate results in a lower present value of future liabilities and therefore lower required contributions. Because minimum lump-sum distributions are calculated as the present value of future benefits, the interest rate used to calculate this present value will affect the value of the lump-sum benefit. Specifically, the use of a lower interest rate results in larger minimum lump-sum benefits; the use of a higher interest rate results in lower minimum lump-sum benefits.

Under present law, the theoretical basis for the interest rate to be used to determine the present value of pension plan benefits for funding purposes is an interest rate that would be used in setting the price for private annuity contracts that provide similar benefits. Some studies have shown that it is not practicable to identify such a rate accurately because of variation in the manner in which prices of private annuity contracts are determined.¹¹⁹ As a result, the interest rate used to value pension benefits (specifically, the 30-year Treasury rate) is intended to approximate the rate used in pricing annuity contracts.¹²⁰ Some have described this standard as a rate comparable to the rate earned on a conservatively invested portfolio of assets.

Under present law, the interest rate used to determine current liability and minimum lump-sum benefits has been based on the interest rate on 30-year Treasury obligations. The interest rate issue has received attention recently in part because the Treasury Department stopped issuing 30-year obligations. As a result, there is no longer a 30-year Treasury interest rate, and statutory changes are necessary to reflect this. In addition, as discussed below, concerns have been raised that the 30-year Treasury rate has been too low and use of the 30-year Treasury rate has therefore caused inappropriate results.

Some have argued that the 30-year Treasury rate has been too low compared to annuity rates, resulting in inappropriately high levels of minimum funding requirements on employers that are not necessary to maintain appropriate retirement income security.¹²¹

In addition, some argue that the 30-year Treasury rate has been so low as to make lump-sum benefits disproportionately large in comparison with a life annuity benefit payable under the plan, thus providing an incentive for employees to take benefits in a lump sum rather than in the form of a life annuity. Some argue that lump sums should not be favored as a form of benefit, because they can cause a cash drain on the plan. In addition, an annuity assures the individual of an income stream during retirement years, which may not be available in the case of a lump-sum payment, depending on what use the individual makes of the payment (e.g., whether the individual spends the lump sum currently or uses the funds to purchase an annuity).

Some have pointed out that a variety of policy issues relating to the funding requirements may arise in the context of the interest rate discussion, and that some of these issues are better resolved through means other than the interest rate. For example, recent declines in defined benefit pension plan assets have adversely affected the funded status of many plans, resulting in what some view as unduly burdensome funding requirements on employers. Some in favor of funding relief believe it should be provided through interest rate adjustments. Others argue that, if funding relief is desired, it would be better to prescribe a more theoretically correct interest rate, and make other changes in the minimum funding requirements. They suggest that this type of approach would provide relief to employers without resulting in potentially inappropriate results in other cases, e.g., in determining lump-sum benefits. On the other hand, some argue that funding relief is not appropriate at all, and that higher contributions should be required in order to increase funding levels, thereby enhancing retirement security and reducing potential PBGC liabilities

Other issues that arise in the context of the interest rate discussion include employer flexibility in making contributions and the appropriate level of tax benefits for defined benefit pension plans.¹²² For example, a given employer may prefer a lower interest rate that enables the employer to make large deductible contributions and thereby maximize the tax benefit from maintaining the plan. Alternatively, another employer may prefer a higher rate that would reduce required contributions, thus freeing up funds for other business uses. Some argue that the degree of flexibility in contributions to be provided to employers should be addressed through means other than the choice of interest rate.

Possible replacement interest rate

Recent proposals for replacing the interest rate used to determine pension liabilities have involved the use of an interest rate based on corporate bonds. In addition, under PFEA 2004, the interest rate used in determining current liability for plan years beginning in 2004 and 2005 is based on long-term corporate bond rates. Some believe that, compared with the rate of interest on 30-year Treasury securities, an interest rate based on long-term corporate bonds better approximates the rate that would be used in determining the cost of settling pension liabilities, i.e., by purchasing annuity contracts to provide the benefits due under the plan.¹²³

Some have suggested that use of an interest rate based solely on long-term corporate bonds is inappropriate, and rather that multiple interest rates should be used to reflect the varying times when benefits become payable under a plan, because of, for example, different expected retirement dates of employees. The rationale for this approach is that interest rates differ depending, in part, on the term of an obligation. In general, longer term bonds pay a higher rate, and shorter term bonds a lower rate. (A graph of this relationship is known as the “yield curve.”) Because plan liabilities may be payable both in the short term and the long term, this approach would determine the

present value of these liabilities with multiple interest rates, chosen to match the times at which the benefits are payable under the plan. Thus, in general, a shorter-term interest rate would be used to determine the present value of plan liabilities expected to be payable in the nearer term, and a longer-term interest rate would be used to determine the present value of plan liabilities expected to be payable in the more distant future.

Some have raised concerns that a yield-curve approach is more complicated than the use of a single rate, particularly for smaller plans and for purposes of determining lump-sum distributions. Some have suggested that this could have the effect of increasing administrative costs associated with maintaining a defined benefit pension plan and discourage the continuation and establishment of such plans. Some have also suggested that the use of a yield curve to determine minimum and maximum lump-sum distributions may make it more difficult for plan participants to understand and evaluate their distribution options under the plan. Some have suggested that the use of a single rate, such as the long-term corporate bond rate, with an appropriate adjustment factor can produce results similar to the use of a yield curve, but much more simply.

Others have responded to these concerns by suggesting that, although a single interest rate is used to determine required contributions under the present-law funding rules, a yield-curve approach is commonly used for other purposes, such as corporate finance. Some also note that the determination of current liability and lump-sum values already involve the application of complicated actuarial concepts (particularly the determination of current liability) and the proposal does not add significant complexity. They argue moreover that any additional complexity is outweighed by the importance of measuring pension liabilities accurately, including the timing of benefit payments from the plan. In addition, it has been suggested that simplified methods (such as the use of a single composite rate) can be provided for smaller plans and for purposes of determining lump-sum distributions.

Miscellaneous issues

Other issues also arise in connection with the interest rate used to determine the present value of pension plan benefits. One such issue relates to the fact that the interest rate used for pension purposes is not the 30-year Treasury rate per se, but is based on that rate. For example, in determining current liability, the present law uses a weighted average of 30-year Treasury rates and an interest rate corridor that allows plans to adjust the otherwise applicable rate higher or lower. Some have suggested that such an averaging period is necessary to prevent rapid interest rate changes from causing corresponding changes in current liability, which in turn may result in volatility in the amount of minimum required and maximum deductible contributions. Others believe that the interest rate used to value pension liabilities should be designed to measure those liabilities as accurately as possible and that volatility in required contributions and deductible contributions should be addressed through modifications to the funding and deduction rules.

An issue arises also as to whether the same interest rate should be used for purposes of determining current liability and for purposes of determining minimum lump sum benefits. Although an interest rate based on the 30-year Treasury rate has applied for both purposes under present law (except for 2004 and 2005), the rules for calculating the applicable rate (such as the measurement period and averaging rules) are quite different and the rate that applies for the two purposes can be quite different. In addition, some have suggested that a rate that is appropriate for purposes of determining current liability (such as an interest rate that would be used in setting the price for group annuity contracts) might be higher than the rate that is appropriate in determining minimum lump-sum benefits.

Another issue that arises is whether transition rules are appropriate, e.g., because employers or employees have relied on present-law rules, and, if so, what transition rules should be provided.

117 - On the other hand, some have raised concerns that some of EGTRRA's changes may serve merely to increase benefits for highly compensated employees without any change in benefits for rank and file workers.

118 - On the other hand, some argue that this increased retirement security may not materialize if the individual incurs investment losses or low investment earnings on his or her account balance.

119 See, e.g., Victor Modugno, *30-Year Treasury Rates and Defined Benefit Pension Plans* (2001), Commissioned for Society of Actuaries, <<http://www.soa.org/sections/dbpp.pdf>>.

120 In practice, the price of an annuity contract encompasses not only an interest rate factor but also other factors, such as the costs of servicing the contract and recordkeeping. Under present law, the interest rate used for determining current liability is intended to embody all of these factors. See H.R. Rpt. No. 100-495, at 868 (1987).

121 As discussed above, temporary increases in the permissible interest rate for purposes of determining current liability were enacted in 2002 and 2004.

122 A tax benefit results from the pre-funding of the retirement benefit, which produces tax-free inside buildup on the earnings from the assets held by the plan.

123 Some also argue that the interest rate used for funding purposes should be based on the expected return on plan investments, rather than on annuity purchase rates.