TESTIMONY OF SALLIE BALLANTINE BAILEY

ON BEHALF OF THE

NATIONAL ASSOCIATION OF MANUFACTURERS

AND THE

AMERICAN BENEFITS COUNCIL

BUSINESS ROUNDTABLE

ERISA INDUSTRY COMMITTEE

U. S. CHAMBER OF COMMERCE

BEFORE A HEARING OF THE

U.S. SENATE COMMITTEE ON
HEALTH, EDUCATION, LABOR & PENSIONS

SUBCOMMITTEE ON RETIREMENT SECURITY AND AGING

ON

PBGC REFORM: MENDING THE PENSION SAFETY NET

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on behalf of the

National Association of Manufacturers

and the

American Benefits Council

Business Roundtable

ERISA Industry Committee

U.S. Chamber of Commerce

Before a Hearing of the
Senate Health, Education, Labor & Pensions
Subcommittee on Retirement Security and Aging

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Chairman DeWine, Ranking Member Mikulski, and members of the Subcommittee, thank you for the opportunity to appear before you this morning on this critical issue. I appreciate the opportunity to discuss the challenges facing our nation's defined benefit system, as well as, the reforms that can meet these challenges.

My name is Sallie Ballantine Bailey. I am the Senior Vice President - Finance and Controller for The Timken Company, which is a leading global manufacturer of highly engineered bearings, alloy steels and related products and services. Timken has operations in 27 countries, sales of $4.5 billion in 2004 and employs 26,000 associates worldwide.

Today, I am serving as a spokesman for the National Association of Manufacturers and on behalf of the American Benefits Council, Business Roundtable, the ERISA Industry Committee and the U.S. Chamber of Commerce. These organizations are steering committee members of The Pension Coalition, a broad based business coalition which is dedicated to advancing retirement security through voluntary employer-sponsored plans. We come before you today with a single voice to emphasize the need to strengthen our nation's voluntary, employer-sponsored defined benefit pension system.

The Administration has stepped forward with proposals to reform the pension funding rules and the premiums payable to the Pension Benefit Guarantee Corporation (PBGC). There are a number of themes in the Administration's package that we support. For example, we agree that the funding rules need to be strengthened. We also agree that measures to allow employers to make larger contributions during good economic times are long overdue. Improved disclosure rules would also be beneficial. Meaningful safeguards should also be considered to protect the PBGC from benefit enhancements adopted at a time when the plan sponsor is unlikely to properly fund those enhancements.

At the same time, we are concerned that much of this reform effort is focused on reducing the deficits at the PBGC. Although the PBGC must be protected, we cannot lose sight of the fact that the PBGC was established to protect retirement security in the defined benefit system. It would be a distressing calamity if the PBGC was strengthened but the entire defined benefit system was weakened. We believe that the Administration's pension funding scheme will do far more harm than good. Taken as a whole, the Administration's package could have grave consequences for the millions of Americans who rely on defined benefit plans for their retirement security. It will be critical for Congress to find an appropriate balance between protecting the PBGC and strengthening the defined benefit pension system.

Pension plans play a vital role in the lives of American workers and retirees. Across the country, some 34 million Americans rely on single-employer, private-sector defined benefit pension plans as a critical element of their retirement security. More than 18 million of these Americans are active workers from a diverse range of industries. Single-employer defined benefit plans paid benefits to retired workers and their families of more than $120 billion during 1999 (the most recent year for which official Department of Labor statistics have been published). In the absence of defined benefit pensions, it is certain that fewer Americans would be financially prepared for retirement, more American seniors would live in poverty, and many more Americans would be forced to rely even more heavily on already strained federal entitlement programs.

For decades, The Timken Company has sponsored defined benefit pension plans to provide for our associates' retirement security. Over 29,000 of our active and retired U.S. associates are covered by defined benefit pension plans. In 2004 alone, we paid $189 million into our plans and made payments to retired participants in excess of $140 million. We are proud of our pension plans and look forward to maintaining them for years to come.

That reforms are needed is clear. Employers have been exiting the defined benefit system in alarming numbers in recent years. Just since 2001, nearly a quarter of Fortune 1000 companies announced their decision to either freeze or actively consider freezing their defined benefit pension plans. Both terminations and freezes have truly unfortunate consequences for American workers -- current employees typically earn no additional pension benefits and new hires have no defined benefit program whatsoever.

The primary factors driving this trend are uncertainty regarding funding obligations; barriers to contributing during good times; and the lack of clear guidance on cash balance and other hybrid plans. Reforms are needed to address these issues and encourage employers to stay in the voluntary defined benefit plan system. We support taking the following steps:

FIVE PENSION REFORM PROPOSALS THAT WOULD IMPROVE RETIREMENT SECURITY

- **MAKE THE LONG TERM CORPORATE BOND RATE PERMANENT**. The best way to protect the pension system for future retirees is to make permanent the long-term corporate bond rate that Congress adopted last year. The long-term corporate bond rate reflects a conservative and realistic rate of return that will provide an economically sound measure of future pension obligations.

- **ALLOW EMPLOYERS TO CONTRIBUTE TO PLANS DURING GOOD ECONOMIC TIMES**. Barriers that prevent employers from making contributions to their plans should be eliminated. Reforms are needed to rules that prevent employers from contributing. In the past, The Timken Company would have liked to contribute more, but ultimately was forced to limit contributions to the maximum amount that would be tax deductible.

- **ADJUST CREDIT BALANCES FOR REAL MARKET RETURNS**. Credit for prefunding ("credit balances") encourages companies to fund their plans during good times, which helps employers better plan their product investments, accelerates plan funding and reduces risk to the PBGC. However, plans with poor investment results have been able to use credit balances to meet their minimum required contributions. We support reforms to the application of credit balances.

- **PROVIDE TIMELY AND APPROPRIATE DISCLOSURE**. Participants should have timely and meaningful funding information on their retirement plans. Reforms are needed to provide full and fair disclosure without creating undue administrative burdens or unnecessary concerns among participants.

- **CONFIRM THE LEGALITY OF HYBRID PLAN DESIGNS**. Nearly a third of large employers with defined benefit plans maintain hybrids and, according to the PBGC, there are more than 1,200 of these plans providing benefits to more than seven million Americans as of the year 2000. It is critical that Congress confirm the legality of hybrid plan designs.

These reforms will help create a robust and sustainable defined benefit plan system. As mentioned above, there are a number of elements of the Administration's proposals that are consistent with our reform proposals. For example, we both agree that better disclosure to plan participants is needed. Similarly, we support proposals to change the tax rules to permit employers to contribute more to their plans when they have the ability to do so.

TOP FOUR CONCERNS WITH THE ADMINISTRATION'S PROPOSALS

However, we have serious concerns about other elements of the Administration's proposals. Our primary concerns are that the Administration's proposals would:

- **DRAMATICALLY REDUCE THE PREDICTABILITY OF FUNDING AND PREMIUM OBLIGATIONS**. The Administration's proposal to use a spot interest rate to value pension liability and mark-to-market treatment of assets would make the funding rules even more volatile and unpredictable than they already are, without improving accuracy or plan funding. This would severely handicap the ability of employers to make long-term business plans.

- **INTRODUCE A TROUBLING AND COUNTERPRODUCTIVE USE OF CREDIT RATINGS**. The Administration's proposal to base contributions and PBGC premiums on credit ratings would create the potential for a vicious downward corporate spiral. Lower credit ratings that increase funding liability, premium burdens and business pressures could lead to further downgrades, creating a vicious circle that drags a company down and prevents its recovery.

- **CREATE A STRONG DISINCENTIVE TO FUND**. Employers need to be encouraged to make extra contributions in good times so that they will have a sufficient cushion for the bad times. We support reforms to the credit balance provisions. The Administration's proposal to eliminate credit balances would discourage employers from making extra contributions except in unusual circumstances. It goes without saying that such a restriction would be a major step backward.

- **BURDEN PENSION PLANS WITH PBGC PREMIUM INCREASES THAT ARE UNWARRANTED**. No one denies that the PBGC faces a serious situation. However, the PBGC's unspecified but potentially enormous increase in premiums could be devastating for many plans, particularly plans sponsored by midsize to smaller employers.

Taken as a whole, we believe the Administration's proposals would have very adverse consequences for the retirement security of American workers. The additional barriers, risks and burdens under the Administration's proposals will only force employers to exit the system through plan freezes and terminations, thereby eroding the retirement security of American workers. In the worst case, the Administration's proposals could tip some employers into bankruptcy – costing those workers not only their retirement savings but potentially their jobs.

We owe it to American workers and their families to ensure that changes, no matter how well-intentioned, are not counter-productive. We support proposals strengthening, without tearing down, a system that is a core part of how employers provide, and millions of Americans receive, retirement income security.

We also owe it to American workers and their families to have a full debate on pension funding reform. In recent weeks, there has been discussion of including proposed increases in the premiums payable to the PBGC in the FY 2006 budget resolution. The House budget resolution, for example, appears to contemplate premium increases of $18 billion over the next five years -- which is effectively a tax increase of over 240 percent for companies maintaining defined benefit plans. Setting premium increase targets in the FY 2006 budget resolution will make a full examination of pension funding reform virtually impossible. Pension funding and PBGC premiums are inextricably intertwined. Changes to PBGC premiums should only be considered in conjunction with changes to the funding rules as a whole. Any premium increases to hit budget targets will only handicap reform discussions. Excessive and unreasonable premium increases in the budget resolution would inevitably put short-range budget objectives ahead of the long-term retirement security that is needed. The budget process is simply the wrong place to make comprehensive pension law and we urge you to not include premium increases in the FY

2006 budget resolution. Pension policy must be driven by what is best for American workers and retirees, not by the need to fill an arbitrary hole in the Federal budget.

The remainder of this testimony describes the reforms that we believe should be enacted and highlights our concerns with the Administration's pension reform proposals.

FUNDING THE PBGC APPROPRIATELY

The financial stability of the PBGC is important but not at the expense of the health of the defined benefit system overall. To put this in perspective, private sector defined benefit pension plans pay more than $110 billion in benefits to retirees every year. By comparison, in 2004 the PBGC paid just over $3 billion in benefits. Similarly, over 44 million Americans receive or will receive benefits from defined benefit plans, while the PBGC's present and future benefit population at the end of 2004 was only one million. It is critical that any reforms target the specific problems. The vast majority of defined benefit pension plans are not a threat to the PBGC – but onerous and volatile rules will threaten the vast majority of plans and the companies that sponsor them.

The Administration has proposed dramatic increases in premiums to address the PBGC's reported deficit. This proposal gives us great concern for several reasons. First, the proposed increase in the flat dollar premium from $19 to $30 and its indexing is strikingly inappropriate. This is a substantial increase on the employers that have maintained well-funded plans through a unique confluence of lower interest rates and a downturn in the equity markets. It is wrong to require these employers to pay off the deficit created by underfunded plans that have transferred liabilities to the PBGC. Second, the unspecified increase in the variable rate premium will become a source of great volatility and burden for companies struggling to recover. This could well cause widespread freezing of plans by companies that would otherwise recover and maintain ongoing plans. Many of these plans are well-funded by any other measure, but under the Administration's proposal might be deemed "underfunded" and now be required to pay variable rate premiums on top of the higher base premium. This would only be exacerbated by the fact that the PBGC has proposed an unprecedented delegation of authority to its Board, rather than Congress, to determine the required premiums. A premium increase misses the point. The solution to underfunding is better funding rules, not higher premiums.

We are very concerned that PBGC premium increases not become a tool used to reduce the Federal budget deficit. The Administration's FY 2006 budget reflects a $26 billion increase in revenue attributable to the PBGC's premium increase. Proper pension policy should be driven by what is best for American workers and retirees, not by the need to fill an arbitrary hole in the federal budget.

In addition, there has been a striking lack of clarity about the real nature of the PBGC deficit. The PBGC has reported a $23 billion deficit as of the end of FY 2004 but there are a number of questions about the PBGC's situation. First, nearly three quarters ($17 billion) of the PBGC's reported deficit represents "probable" terminations rather than claims from plans already trusteed by the PBGC. Second, the PBGC's numbers are based on a below-market interest rate. The deficit would be substantially less using a market-based interest rate. Third, swings in the PBGC surplus-deficit do not provide Congress with an accurate picture of the PBGC's ability to pay benefits. In fact, the PBGC can pay benefits for many, many years into the future. Finally, it is not clear why the PBGC has unilaterally moved away from equities to lower-earning investments that hinder its ability to reduce its deficit. No one denies that the PBGC faces a serious situation, and our proposals for funding reform are evidence that the employer community is serious and committed to shoring up the PBGC's financial condition. However, these are troubling questions that should be addressed before taking the very harmful step of increasing PBGC premiums.

The best way to ensure a stable defined benefit system is to encourage plan sponsors to remain in the system, not to make the system so costly that they cannot afford to stay. The proposed substantial increase in the flat premium and the potentially huge increase in the variable rate premium will force plan sponsors to divert resources to the PBGC and away from pension plan contributions, capital investments, job creation, research & development and other growth activities.

MAKE THE LONG TERM CORPORATE BOND RATE PERMANENT

Since last year, a long-term corporate bond rate averaged over four years has been used to determine "current liability" for the funding and deduction rules and to determine unfunded vested benefits for purposes of PBGC variable rate premiums. However, the measurement rate defaults to the rate on the now defunct 30-year Treasury bond beginning in 2006 if no further action is taken. It is widely agreed that the 30-year Treasury bond is no longer a realistic measure of future liabilities and would inappropriately inflate pension contributions and PBGC variable rate premiums. A return to an inappropriate and inaccurate measure of pension liabilities and the resulting inflated contributions caused by the defunct 30-year Treasury bond rate would be devastating for the ongoing vitality of defined benefit plans. It would be enormously disruptive for plan sponsors who must be able to project future cash flow demands as a part of prudent business planning. The uncertainty of the interest rate in effect today severely hinders effective planning and could curtail economic growth.

We strongly believe the best way to support and enable the defined benefit pension system is to make permanent the four-year weighted average of the long-term corporate bond rate that Congress adopted last year. As Congress has already recognized, the long-term corporate bond rate provides a realistic picture of future pension liabilities and is the best measure to ensure the adequacy of pension funds for future retirees. It reflects a very conservative estimate of the rate of return a plan can be expected to earn and thus is an economically sound and realistic discount rate.

The Administration has proposed, as an alternative to both the 30-year Treasury bond rate and the long-term corporate bond rate, a near-spot rate "yield curve" comprised of conservative, high-quality corporate bonds. We agree with the Administration that there is a compelling need for a permanent interest rate so that employers can project their future contribution obligations and make long-term business plans. In addition, we agree that the permanent interest rate should be based on high-quality corporate bonds. However, we have serious concerns about four aspects of the Administration's "yield curve" proposal. First, the yield curve interest rate is a "near-spot rate" rather than a four-year weighted average rate. It will saddle employers with unpredictable and potentially volatile funding obligations. Second, the yield curve proposal would apply different interest rates to different payments to be made by the plan based on the date on which that payment is expected to be made. This is an unnecessarily complex methodology. Third, we are concerned that the Administration's mechanisms for creating interest rate assumptions would require excessive and unnecessary contributions for some mature plans, which could be very harmful for employers, workers, and the economy. Fourth, the proposed yield curve is opaque and will be difficult for businesses to use in long-term planning and for Congress to oversee. We discuss these concerns in more detail below.

PREVENTING THE VOLATILITY THAT WOULD BE CREATED BY SPOT VALUATIONS

Our primary concern with the Administration's yield curve proposal is the use of spot valuations. Companies need to be able to make business plans based on cash flow and liability projections. Volatility in pension costs can have dramatic effects on company projections and thus can be very disruptive. It is critical that these contribution obligations be predictable. The essential elements facilitating predictability under current law are use of the four-year weighted average of interest rates and the ability to smooth out fluctuations in asset values over a short period of time (subject to clear, longstanding regulatory limitations on such smoothing). The Administration's yield curve proposal would, however, eliminate both smoothing elements, dramatically increasing the volatility and unpredictability of funding requirements.

Let us be clear -- spot valuations do not mean tighter funding standards. The spot or smoothed rate only relates to when contributions are due. As interest rates rise, a spot rate will result in smaller contributions and vice versa. Over the long-term -- which should be the focus in pension funding -- contributions will essentially be the same regardless of whether a spot or smoothed rate is used. Similarly, the value of pension assets will essentially be the same over the long term, regardless of whether spot or smoothed asset valuations are used. Further, spot valuations would not add any appreciable accuracy. Pension liabilities span many years and spot valuations are not meaningful for these liabilities. A spot interest rate for 90 days is simply not a particularly accurate measure of liabilities that in many cases span more than 40 years.

Spot rates would also have very negative implications for the U.S. economy. Spot valuations likely would require larger contributions during economic downturns and smaller contributions during economic upturns. Larger contributions reduce capital spending. This exaggerates downturns and upturns. The result is that the economy overheats during upturns and has deeper recessions during downturns. The two key elements of smoothing under the current rules provide a significant counter-balance to this phenomenon, and should be preserved.

Some have suggested that sponsors of defined benefit plans can manage the spot rate by investing in bonds and financial derivatives that hedge against interest rate movements. Hedging in this way would be very expensive. Plans should not be effectively forced to incur this cost. Over time, pension plans earn more on investments in equities than in bonds. If plan earnings decline because plans are compelled to invest in bonds or other low-yielding instruments, the overall costs for plan sponsors will rise. As plans become more expensive, it goes without saying that there will be fewer plans remaining and that the heightened cost will discourage employers from increasing benefits in the plans that do remain.

Further, if a fundamental change in the pension funding rules should force a movement of pension funds out of equities and into bonds or other low-yielding instruments, it could have a marked effect on the stock market, the capital markets, and capital formation. At the end of 2003, private-sector defined benefit plans held equities worth about $900 billion and the market impact of a portfolio shift of this magnitude is extremely difficult to predict.

It is far from clear whether plans can insulate themselves from both volatility and liability by investing in bonds. First, it is doubtful that there could ever be enough high-quality corporate bonds, particularly at the long durations that characterize pension liabilities. Second, even if there were enough high-quality bonds to go around, it is not possible to immunize all risks. Even the staunchest bond proponents acknowledge that there are numerous pension liabilities that cannot be accurately anticipated. For example, because mortality cannot be predicted with precision, it is not possible to shield a plan that makes life annuity payments. Similarly, the number of people who retire and take available subsidies can only be estimated and thus that liability cannot be protected against.

AVOIDING UNNECESSARY COMPLEXITY AND LACK OF ACCOUNTABILITY

We are concerned that the Administration's yield curve would add significant complexity without providing any real benefit. The proposal would generate numerous and different interest rates for each participant. This level of complexity could be managed by some large companies but it will impose an unjustifiable burden on small and mid-sized companies across the country.

Further, we are concerned that the interest rate constructed by the Treasury Department would be opaque. The markets for corporate bonds of many durations are so thin that the interest rates used would actually need to be "made up", i.e., extrapolated from the rates used for the other bonds. Considerable discretion is exercised in creating a yield curve and, in some respects, it appears to be as much art as science. This type of a discretionary, non-market interest rate would be virtually impossible for employers to model internally as part of corporate planning and would also be particularly difficult for Congress to oversee.

ENSURING APPROPRIATE FUNDING

We are deeply concerned that the yield curve aspect of the proposal could produce an effective interest rate for some plans that is too low and therefore will overstate liability. Relative to the weighted long-term corporate bond rate in effect this year, the Administration's proposal could increase pension liabilities for some mature plans by 10 percent or more. In some cases, the immediate liability increase could be even greater. Using a lower effective discount rate than the long-term corporate bond rate could result in contributions that far exceed what is needed to pay benefits. Excessive contributions are in no one's interest, especially for mature plans in industries that can least afford to have a sudden required increase in funding obligations.

The consequences of excessive contribution obligations are painfully clear. This is precisely what happened when inflated pension contributions were mandated by the obsolete 30-year Treasury bond rate. Employers that confront inflated contribution obligations will have little choice but to stop the financial bleeding by freezing or terminating their plans. Both terminations and freezes have truly unfortunate consequences for workers -- current employees typically earn no additional pension accruals and new hires will not be able to participate in a defined benefit plan. Government data reveals that defined benefit plan terminations accelerated prior to the temporary long-term corporate bond rate fix in the Pension Funding Equity Act of 2004, with a 19 percent drop in the number of plans insured by the PBGC from 1999 to 2002. Just as troublesome, the statistics above do not reflect plans that have been frozen. While the government does not track plan freezes, reports make clear that these freezes are already on the upswing.

Further, inflated pension contributions divert precious resources from investments that create jobs and contribute to economic growth. In fact, a recent study by Business Roundtable concluded that the use of a spot rate during 2003 would have cost the economy approximately 300,000 jobs. Facing pension contributions many times greater than they had anticipated, employers will not hire new workers, invest in job training, build new plants, and pursue new research and development. Furthermore, inflating pension liabilities and forcing unnecessary contributions would drive up the cost of doing business and will put U.S. companies at a further competitive disadvantage relative to foreign corporations that do not have similar obligations. For these reasons, it is important for funding to remain rational, predictable, and stable. These are precisely the steps that would help lower our nation's unemployment rate, spur individual and corporate spending, generate robust economic growth, and keep U.S. companies competitive in the global marketplace.

PREVENTING UNNECESSARY BANKRUPTCIES

It is important to recognize that an employer's credit rating is not directly tied to the ability of the sponsor of a defined benefit plan to provide promised benefits. Corporate debt is not the same as pension obligations. The pension plan is a separate entity. One of the hallmarks of U.S. pension law is that pension assets must be held in a separate trust or similar dedicated vehicle. The ability of a company to continue to make benefit payments and appropriate levels of contributions is not determined by its credit rating. A plan that has sufficient assets to pay benefits will pay those benefits even if the plan sponsor does not have adequate assets to pay its debts or has debt that is rated below investment grade.

We are deeply concerned about the Administration's proposal to base the application of the pension funding and premium rules on the creditworthiness of the employer sponsoring the plan. The Administration's package of proposals creates a serious risk of potentially forcing unnecessary bankruptcies on "at risk" companies that could have otherwise continued to fund their pensions for many years. Its proposals to trigger variable funding rules and base PBGC premiums and benefit guarantees on the determination of the creditworthiness of the plan sponsor and the members of the sponsor's controlled group are wrongheaded. In effect, the employer's liability is treated as increasing when the employer's credit rating slips, even though the plan's benefit payment obligations remain unchanged.

Forcing "at risk" employers to fund their plans based on termination liability is not appropriate. Termination is not relevant to an on-going plan, especially if the plan sponsor is not going bankrupt. On the consumer side, this proposal is analogous to the relationship between a mortgage lender and homeowner. If the homeowner receives a job-related demotion, does having that knowledge give the lender the right to automatically increase the interest rate and payoff amount on the mortgage loan? The use of credit ratings to determine funding or PBGC premium obligations could have significant macroeconomic effects. Such use would put severe additional pressures on employers experiencing a downturn in their business cycle. If the lower credit ratings create additional funding burdens and business pressures, which could lead to further downgradings, creating a vicious circle that further drags a company down. This could well happen to a company that today is able to fund additional contributions to pull itself out of the underfunding problem and thus raise its credit ratings. In short, a creditworthiness test would make it more difficult for a struggling company to recover. That is not in anyone's interest, including the PBGC, which could be forced to assume plan liabilities if the company does not recover. We must be careful not to lose sight of the fact that the best insurance for plans, participants and beneficiaries, and for the PBGC is a healthy plan sponsor. The best way to protect the PBGC is to ensure that plans are appropriately funded, regardless of the plan sponsor's credit rating.

It is also clear that the PBGC's proposal would classify many plans as at risk that will never be terminated. The mere fact that a company's debt is not rated as investment grade does not mean that it will terminate its plans. However, the consequence of these "false positives" could well be self-fulfilling, with employers forced to terminate as a result of a downward spiral. Moreover, employers that have non-investment grade debt but are improving their situation would get no credit for such improvement.

Finally, a creditworthiness test would inevitably result in the government determining the creditworthiness of at least some American businesses. Many privately held employers are not rated by any of the nationally recognized agencies. The PBGC has recommended conferring regulatory authority to develop guidelines for rating private companies. This would be a disturbing and far-reaching expansion of the PBGC's authority beyond its original legislative intent.

ELIMINATING PREFUNDING BARRIERS

One aspect of the Administration's proposal that we strongly support is the proposal to reform the tax rules governing the deductibility of pension plan contributions. Specifically, we support the Administration's proposal to increase the deduction limits from 100 percent of current liability to 130 percent. In fact, we would recommend increasing the 130 percent figure to 150 percent to ensure that there is an adequate cushion. For deduction purposes, current liability is today based on the 30-year Treasury bond rate, not the long-term corporate bond rate. We propose that current liability should be based on the long-term corporate bond rate for all purposes. This would, in isolation, actually decrease the deduction limit for many plans by 10 or 15 percent (and by more for a few plans). Accordingly, to ensure that the deduction limit for most plans is increased by 30 percent compared to current law, the limit should be increased to approximately 150 percent.

We also support repealing the excise tax on nondeductible contributions with respect to defined benefit plans. The excise tax on nondeductible contributions only discourages employers from desirable advance funding. Finally, we support repealing the combined plan deduction limit for any employer that maintains a defined benefit plan insured by the PBGC. Under present law, if an employer maintains both a defined contribution plan and a defined benefit plan, there is a deduction limit on the employer's combined contributions to the two plans. Very generally, that limit is the greatest of:

(1) 25 percent of the participant's compensation,

(2) The minimum contribution required with respect to the defined benefit plan, or

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

Without repeal of this provision, the sponsor of a plan with large numbers of retirees might lose its ability to make deductible contributions to its defined contribution plan because, in a mature plan, the number of active participants is small compared to the number of retired participants. This deduction limit can also cause very significant problems for any employer that would like to make a large contribution to its defined benefit plan. There is no supportable policy reason for preventing an employer from soundly funding its plan. Defined benefit plans and defined contribution plans are each subject to appropriate deduction limits that are based on the particular nature of each type of plan. There is no policy rationale for an additional separate limit on combined contributions.

ENCOURAGING ADVANCE FUNDING

We are concerned about elements of the Administration's funding proposal that could discourage employers from contributing more than the minimum required contribution. Under current law, if a company makes a contribution in excess of the minimum required contribution, the excess plus interest can be credited against future required contributions. This credit for prefunding ("credit balances") helps to mitigate volatile and unpredictable funding requirements by allowing and encouraging a sponsor to increase funding during good times. The proposal, however, does not give employers who prefund direct credit for their excess contributions.

There have been suggestions that the current law credit balance system has been a factor in terminating plans assumed by the PBGC. These suggestions ignore the fact that but for the credit balance system, companies would have contributed less, resulting in more underfunding and more liabilities assumed by the PBGC.

Critics have pointed out that credit balances are not immediately adjusted if the underlying value of the assets decreases. Consequently, plans with poor investment results have been able to use credit balances that are larger than the assets they represent. We support carefully targeted reforms that address this investment result problem. These reforms must be administrable and need to be applied prospectively. It would be fundamentally unfair to change the rules retroactively for employers that made contributions in reliance on current law credit balance rules. It is critical, however, that we preserve appropriate incentives to advance fund. Without these incentives, there is a significant risk that employers will only pre-fund to the minimum required by law. The result would be a less well-funded system, which is in no one's interest.

PROVIDING TIMELY AND APPROPRIATE DISCLOSURE

We believe that participants should have timely and high-quality data regarding the funded status of their plans. It is important that participants have the information they need to evaluate their retirement security. These rules should be structured to provide full and fair disclosure without creating undue administrative burdens on plans or causing unnecessary alarm among participants.

In this context, existing disclosure requirements should be enhanced, while at the same time avoiding the creation of costly and confusing new requirements. A starting point might be the Administration's general proposal to improve the summary annual report ("SAR"), but with significant modifications that would make the information disclosed more immediate and more meaningful. One of the problems with the SAR under current law is that the information disclosed is not timely, a problem which is not addressed by the Administration's proposal. In fact, the information currently provided can be almost two years old.

One possible solution would be to require plans to disclose in the SAR their funded percentage. However, instead of reporting percentages as of the first day of the plan year for which the SAR is provided (information that is almost two years old), the percentage could be reported as of the first day of the subsequent year, using (1) the fair market value of assets as of that date and (2) the liabilities as of that date based on a projection from the preceding year. This would mean more timely disclosure. A plan maintained by a public company could also be required to disclose the year-end funded status of the plan as determined for purposes of financial accounting for the two most recent years available. This approach would provide much more information than under present law or under the Administration's proposal. In addition, unlike the Administration's proposal, financial accounting information that is already circulated and disclosed for the company as a whole could be disaggregated into the amounts for individual plans and provided to participants. By using information available to employees through financial reports and media statements, the possibilities for confusion would be greatly reduced.

CONFIRMING THE LEGALITY OF HYBRID PLAN DESIGNS

Hybrid defined benefit pension plans, such as cash balance and pension equity plans, were developed to meet the needs of today's mobile workforce by combining the best features of traditional defined benefit plans and defined contribution plans. Nearly a third of large employers with defined benefit plans maintain hybrids and, according to the PBGC, there are more than 1,200 of these plans providing benefits to more than seven million Americans as of the year 2000. These plans are defined benefit plans and many of the same funding issues described above are relevant. They also face unique issues.

Despite the significant value that hybrid plans deliver to employees, current legal uncertainties threaten their continued existence. As a result of one court decision, every employer that today sponsors a hybrid plan finds itself in potential legal jeopardy. It is critical that this uncertainty be eliminated. Legislation is needed to clarify that the cash balance and pension equity designs satisfy current age discrimination and other related ERISA rules. In addition to clarifying the age appropriateness of the hybrid plan designs, we believe it is essential to provide legal certainty for the hybrid plan conversions that have already taken place. These conversions were pursued in good faith and in reliance on the legal authorities in place at the time.

Some legislators propose imposing specific benefit mandates when employers convert to hybrid pension plans. For example, they would require that employers pay retiring employees the greater of the benefits under the prior traditional or new hybrid plan. Others would require employers to provide employees the choice at the time of conversion between staying in the prior traditional plan or moving to the new hybrid plan. We strongly urge you to reject these mandates. Mandates are fundamentally anathema to the voluntary nature of our employer-provided retirement system. Inflexible mandates will only drive employers from the system and reduce the competitiveness of American business. Employers must be permitted to adapt to changing business circumstances while continuing to maintain defined benefit plans.

CONCLUSION

Mr. Chairman and members of the Committee, thank you for the opportunity to present our views. We look forward to participating with the Committee in a comprehensive discussion of the long-term funding challenges facing our pension system and proposals to provide additional protection to the PBGC. Our nation's defined benefit system stands at a cross-roads. There are reforms that will revitalize the system and there are reforms that will be too much for the system to bear. We owe to American workers and their families to ensure that any reforms preserve a robust defined benefit system well into the future.