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Comments to the ERISA Advisory Council

by Jeremy Gold

Chair Thierman and Members of the Advisory Council, thank you for inviting me to talk with you today about funding defined benefit pension plans.

The "issue of the day" in defined benefit funding is the search for a discount rate to be used to determine the current liability as referenced in Internal Revenue Code Section 412(l). After having operated under a lenient temporary standard for the past two years, we are warned that imposing a strong standard in the near term might inflict a disastrous shock upon the system. Thus it appears that stronger standards can only be phased in over several years. The length and strength of the phase-in is primarily a political concern. The endpoint of the phase-in is a matter of science. Today I address where we need to place that endpoint.

Why do we, society, require defined benefit pensions to be funded?

Realizing that pension plans are promises made by employers to employees, we have collectively concluded that promises made must become promises kept. This is the message of ERISA which included provisions to form the PBGC and to require employers to set aside funds to back pension promises. Unfortunately ERISA's implementation fell far short of its message.

Why do we require both federal insurance AND funding?

We provide insurance because it is the people's will that promises be kept. We insist on minimum funding levels with the goal that every employer will pay for the benefits that it has promised and not become a burden on the rest of corporate America.

Funding becomes critical when the employer goes bankrupt and the plan beneficiaries and the PBGC must depend on the funded assets to meet the benefit promises. If, at bankruptcy, the plan has enough money to buy a portfolio of liability-matching Treasury securities, the assets are adequate. If the assets are less, some party – the employees, the PBGC, other companies or taxpayers – must provide additional money or accept the risk that assets will be inadequate in the future.

What do we find under current standards and what might we expect under the standards proposed by Representatives Portman and Cardin and under the most recent administration modifications thereto?

Companies that sponsor defined benefit plans do go bankrupt and are more likely to do so during periods of economic weakness. During these same periods, pension plans invested in equities are likely to be poorly funded and there is a substantial correlation between bankruptcy and poor funding. Companies approaching insolvency often fund at minimum statutory levels.

The Portman-Cardin legislation proposes that the existing rules be weakened by substituting corporate bonds for the no-longer-issued 30- year Treasury bond. It is clear that weaker future standards mean that tomorrow's bankruptcies will inflict more damage on the PBGC and –in turn– on the entire system.

The administration argues that its proposed liability measurements will be more accurate than those using the existing standards because it will use a yield curve and because 90-day averaging will replace four-year averaging. Although I agree that this will be more transparent and more plan and date sensitive, the use of corporate bond rates rather than Treasury bond rates guarantees us that the standard will be weaker than it must be. Companies that meet all of the proposed funding rules will continue to go bankrupt and will have insufficient assets when they do so.

Companies approaching bankruptcy will aggravate any insufficiency by making the smallest contributions allowed while taking investment risk in the hope that their gamble will pay off.

A sound system should not only specify strong permanent standards but must be designed to encourage prudent behavior by plan managers. Society's rules should incent managers to be:

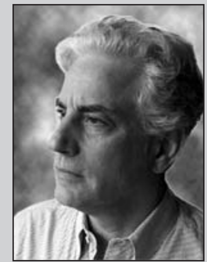
- Cautious in granting benefits
- Quick to fund promised benefits
- Reluctant to mismatch assets and liabilities

Society must hold promise makers responsible. Some suggest that allowing greater funding in good times is an effective substitute for the prudence that we should encourage. Being well-funded when the stock market is bubbling is not the answer; any additional funding allowed during the run-up to the stock market peak in March of 2000 would merely have increased the aggregate losses that have been suffered since. Full funding at all times, within practical limits, should be the endpoint of the process we now begin.

I have provided three additional documents in my written testimony. These address:

1) A Treasury yield curve to define the current liability (*See http://users.erols.com/jeremygold/usingtreasury.pdf*).
2) Solvency as the paramount societal issue– we should discard all statutory funding rules that do not directly relate to solvency (See "How to Stop the Insanity!", *Pension Section News*, June 2003, pages 6-7).
3) How the PBGC is effectively forced to guarantee loans made to our weakest companies. (See page 22).

Thank you for your attention. ◆



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