Testimony of Scott D. Miller, President-Elect

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Subcommittee on Oversight
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Introduction

Thank you, Mr. Chairman and members of the subcommittee. My name is Scott Miller. I am a Principal of Actuarial Consulting Group, Inc., with offices in New York and Illinois. Actuarial Consulting Group, Inc. provides actuarial, consulting, and plan administrative services for retirement plans covering thousands of participants throughout the country. Although, many of the firm's clients are small businesses with less than 100 employees, the firm also provides retirement plan services to larger firms, including Fortune 100 companies.

I am here today to present the views of ASPPA, for whom I currently serve as President-Elect. ASPPA is a national organization of over 5,000 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. The vast majority of these plans are maintained by small businesses. ASPPA members are retirement plan professionals of all types, including consultants, administrators, actuaries, and attorneys. ASPPA's membership is diverse, but united by a common dedication to the private pension system.

ASPPA shares the concerns of this subcommittee, of Congress, and of America about the tragic consequences arising from the bankruptcy of Enron Corp. We applaud this subcommittee's leadership in exploring whether, and where, our nation's pension laws may need strengthening. We also commend the subcommittee for its stated commitment to maintaining the framework of laws upon which is built a strong, employer-based system of providing retirement income benefits to our nation's workers.

The current plight of the Enron 401(k) plan participants highlights the need to expand and reform the private pension system. The need for reform is especially acute with respect to encouraging plan sponsors to adopt and provide defined benefit pension plans. Unlike 401(k) and other defined contribution plans, defined benefit pension plans provide a defined monthly annuity retirement benefit for employees. This annuity benefit is guaranteed to continue for the life of the worker and cannot be exhausted. On the other hand, benefits provided under a 401(k) or other defined contribution plan are not guaranteed and are directly dependent on actual investment experience. Therefore, the level of benefits and how long they can continue to be paid is unknown to the retiree. As Americans live longer then ever before, this uncertainty regarding the actual amount of retirement benefits is increasingly a concern.[1] Without defined benefit pension plans, there is a great risk that many Americans will outlive their retirement savings.

Further, and very importantly, in a defined benefit pension plan, it is the employer, and not the employee, that bears the risk of investing the plan assets. This means that the employer has an obligation to make sure the defined benefit pension plan is properly funded to provide the promised benefits, regardless of investment experience. Therefore, the lower the investment returns, the higher the required employer contribution. Additionally, the Pension Benefit Guaranty Corporation insures the payment of a minimum level of retirement benefits under a defined benefit pension plan should the plan sponsor's financial stability falter and they are not able to properly fund the plan.

According to a recent survey, interest in defined benefit pension plan coverage among employees has increased by 20 percent as employees find it difficult to manage their 401(k) plan accounts.[2] However,

since the passage of ERISA, many restrictive and complex laws have been enacted, and complicated regulations issued, which have seriously impeded the ability of large and small businesses alike to maintain defined benefit pension plans for their employees.

The consequences of this have been dramatic, particular for small businesses. According to the Department of Labor, since 1983 the number of small business defined benefit pension plans has dropped over 70 percent. The termination of these defined benefit pension plans has occurred during a period of time when small businesses are employing an ever-increasing percentage of the U.S. workforce. Today, small businesses employ half of the nation's workers, and have created more than half of the new jobs in recent years. However, according to the Bureau of Labor Statistics, small business employees are only half as likely to be covered by any retirement plan, and only one-fifth as likely to be covered by a defined benefit pension plan, than their counterparts working at larger firms.

This disparity between small and large business employees is clearly unacceptable. Some of the most burdensome and complex rules in pension law apply to defined benefit pension plans. These rules are particularly challenging to small businesses that lack the in-house expertise to manage them. We need to reevaluate and modernize these rules so that defined benefit pension plans become more attractive to small businesses. This **can** be done while still protecting the interests of employees. If we can revitalize defined benefit pension plans, both small businesses and their employees will benefit from the enhanced retirement security.

The remainder of my testimony will focus on proposals that will help remove the major roadblocks faced by small businesses that want to establish and maintain defined benefit pension plans for their employees.

Proposals to Promote Small Business Defined Benefit Pension Plan Coverage

Facilitate Combination Defined Benefit/401(k) Plans (the "DB-K")

A defined benefit pension plan provides a guaranteed level of benefits to workers (insured by the federal government) that are not susceptible to the whims of the stock market. By contrast, benefits under a defined contribution plan, like a 401(k) plan, are dependent on investment returns - if the stock market goes down, benefits are reduced. Consequently, it would be ideal if workers were covered by both a defined benefit pension plan and a 401(k) plan to ensure that at least some retirement benefits are always protected.

Unfortunately, present law discourages the formation of defined benefit pension plans in combination with 401 (k) plans, particularly for small businesses. For example, a defined benefit pension plan and a 401(k) plan cannot be maintained as a single plan with a single trust. Requiring two separate plans adds thousands of dollars of unnecessary annual administrative costs. Further, present law includes nondiscrimination testing safe harbors that make it easier for employers to maintain 401(k) plans. For instance, an employer that offers a 3 percent profit-sharing contribution on behalf of employees automatically satisfies complicated nondiscrimination testing requirement applicable to 401(k) plans. However, there is no analogous 401(k) plan safe harbor for employers who maintain a defined benefit pension plan, thus discouraging employers from offering both 401(k) and defined benefit plans.

In addition, special corporate deduction limits are triggered when an employer funds both a defined benefit pension plan and a 401(k) plan. These deduction limits are often problematic for small businesses since they are based on a percentage of aggregate employee compensation and small businesses naturally have fewer employees and therefore a limited contribution level. If the small business is offering a 401(k) plan with matching contributions, a fairly typical scenario, these deduction limits greatly inhibit the ability of the small business to offer an additional defined benefit pension plan.

Finally, present law also does not permit employees to earn higher defined benefit accruals in the form of matching contributions, that relate to the amount an employee contributes to a 401(k) plan. If it did, this would allow employers to reward employees who save for retirement on their own behalf, with greater employer guaranteed defined benefits.

ASPPA supports a proposal, called the "DB-K", which would address these roadblocks making it easier for small businesses to offer both 401(k) and defined benefit pension plans to their employees. Although there are several technical details which we would be happy to outline for you, in summary the DB-K proposal

would accomplish four objectives:

- First, a 401(k) plan and a defined benefit pension plan could be maintained as a single plan with a single trust with reduced administrative costs.

- Second, under a new 401(k) plan safe harbor, the nondiscrimination test applicable to 401(k) plans will be satisfied if a defined benefit pension plan maintains a sufficient level of benefit (*e.g.,* 1 percent per year final average pay plan accumulated over 20 years) that is always fully vested.

- Third, certain matching and/or profit sharing contributions under a 401(k) plan (including a 401(k) arrangement that is maintained as part of a defined benefit pension plan) would be disregarded in determining whether the special deduction limits for combined plan funding are exceeded.

- Fourth, the law would be modified to allow for defined benefit pension plans to provide higher benefit accruals for employees who take the responsibility to save, through matching benefit accruals based on the level that employees defer from their compensation.

Clarify Rules Governing Hybrid or "Cash-Balance" Plans

Employees are sometimes less enthusiastic about defined benefit pension plans because the benefits are admittedly harder to understand than 401(k) account balances. In a traditional defined benefit pension plan, the benefit is typically based on final average pay and is expressed in the form of a monthly annuity that commences at retirement age, which is often far off into the future. Employees find account-based plans, that track current account values, easier to understand and thus more attractive.

In response, new kinds of hybrid or "cash balance" plans have been developed. A cash balance plan is a defined benefit pension plan under which the promised benefit is expressed as a hypothetical account balance. The account is "hypothetical" because there is no actual account established on behalf of the participant. Nonetheless, the participant is entitled to the benefit provided in the account. This account is really just a bookkeeping notion. An eligible employee accrues a benefit by earning a right to a hypothetical contribution (usually a percentage of compensation) for each year of participation, which is credited to the employee's account. The hypothetical account balance is also increased each year by a guaranteed interest rate. When benefits are distributed from a cash balance plan, the hypothetical account balance is converted into the actuarial equivalent of the form of annuity or installment benefit payable under the plan (or chosen by the participant, if the plan provides multiple payment options). These options could include a single lump sum distribution.

There are a number of significant legal uncertainties associated with cash balance plans because of the way benefits are accrued and distributed as compared to traditional defined benefit pension plans. Although these issues are technical in nature, they are critical to the legal operation of the plan. In general, these legal issues involve application of the accrual and benefit backloading rules to cash balance plans, application of the Age Discrimination and Employment Act to cash balance plans, and distribution of the benefit under a cash balance plan (the so-called "whipsaw" problem).

There has also been some controversy when employers, generally larger employers, have converted traditional defined benefit pension plans to cash balance plans. However, conversions are generally not an issue for small businesses considering a cash balance plan, since there is often no preexisting defined benefit pension plan.

Small businesses wanting to provide a defined benefit pension plan for their employees are attracted to cash balance plans since they are easier to explain to employees and the benefits tend to be more portable. Unfortunately, most small businesses are reluctant to establish these defined benefit pension plans because of the legal uncertainties. Unlike their larger firm counterparts, small businesses cannot afford high-priced lawyers to provide legal opinions allowing them to sort through the various unanswered questions. Small businesses will not provide these valuable defined benefits for their employees unless these legal uncertainties are resolved in a clear and unambiguous way. It is critical that these issues are quickly resolved through Treasury regulations, or through corrective legislation to the extent Treasury lacks the legal authority to do so.

Modernize Actuarial Assumptions

Current laws with regard to actuarial assumptions required for defined benefit funding and benefit calculations are outdated. For example, current rules require the use of 30-year Treasury bond interest rates when calculating the current liability of the plan. Last October the Department of Treasury announced that it was no longer issuing 30-year Treasury bonds. However, defined benefit pension plan funding calculations are still based on these rates, which is now artificially low since no new bonds are being issued. Use of this artificially low 30-year Treasury bond rate has contributed to the unnecessary overfunding of many larger defined benefit pension plans, making them less attractive to these employers. Fortunately, this year Congress enacted a temporary solution that will last through 2003. However, a permanent replacement interest rate benchmark must be found soon to address employer's uncertainties about future funding obligations.

The fluctuations in the 30-year Treasury bond rate have also had a negative impact on small business defined benefit pension plans. Under current law, the 30-year Treasury bond rate is also used for calculating the defined benefit pension plan limit under IRC Section 415(b) for lump sum distributions. A reduction in the rate yields a higher limit, putting added funding pressure on plans, especially smaller plans that suddenly are required to make higher than anticipated lump sum payments to participants. This unanticipated increase can amount to tens of thousands of dollars, simply due to a minor change in the monthly interest rate (*e.g.,* ¼ of a percent). A small business may not be able to afford such uncertainty. These consistently changing interest rates cause required funding levels to often fluctuate significantly making financial planning for small businesses difficult.

Prior to 1994, this problem did not exist. A fixed 5 percent interest rate was used for calculating the defined benefit pension plan limit under IRC Section 415(b) for lump sum distributions. ASPPA believes that we should return to this benchmark to give small businesses more stability with respect to plan funding requirements. This would also give small business owners, who are often subject to the 415 limit, a precise measure of what their benefit will be at retirement. Because of present law, you cannot tell many small business owners exactly what their benefit will be at retirement, because an interest rate fluctuation at the time of retirement could significantly affect their benefit amount. This uncertainty makes the defined benefit pension plan less attractive to the small business owner when deciding whether or not to adopt a plan for herself and her employees.

Allow for Flexible Funding of Defined Benefit Pension Plans

Employers, particularly small employers, are also often reluctant to adopt defined benefit pension plans because of mandatory funding requirements. These mandatory funding requirements are designed to ensure that defined benefit pension plans are adequately funded. They require that employers contribute at least a minimum amount to the plan each year - a minimum funding requirement. Employers, particularly small businesses, are often worried that they may not be able to afford the minimum funding requirements if there is a business downturn. Unfortunately, present law also limits the maximum amount employers can contribute to the plan in any year, and thus prevents prospering employers from contributing an additional amount when the business is doing well, and can afford it, to cover a potential future business downturn. This presents an unacceptable risk to many small businesses whose revenue can be dramatically affected by an economic recession in a manner disproportionately greater than larger firms. Ironically, the operation of current law funding requirements generally require higher minimum funding requirements during an economic downturn and restrict funding during a stronger economy.

ASPPA believes that an employer maintaining a defined benefit pension plan should be permitted to contribute an additional amount (within reasonable limits) during an economic upswing to prepare for the potential of a future economic downturn. This could be allowed, for example, once every five years. Under such a proposal, the total amount contributed to the plan over the given period would not change. It would simply allow the small business to make larger contributions in the years the additional financial resources are available.

Conclusion

ASPPA greatly appreciates this subcommittee's interest in revitalizing defined benefit pension plans. In addition to the proposals discussed in my testimony, ASPPA is developing other proposals to promote defined benefit pension plan coverage and we would welcome the opportunity to discuss them with you. The

retirement security of American workers will certainly be enhanced if we can revitalize defined benefit pension plans and once again make them attractive to small business employers.

Thank you, Mr. Chairman and members of the subcommittee, for this opportunity to make our views known. I would be pleased to answer any questions you may have.

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[1] The average life expectancy of Americans born in 1960 was 69.7 years. It has been estimated that those born in 2000 will live for an average of 76.4 years. U.S. National Center for Health Statistics, *Vital Statistics of the United States.*

[2] PlanSponsor.com (June 5, 2002).

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