EBRI

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Statement of

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Select Committee on Aging

for the record of a hearing held on
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on the published subject of

"Corporate Misuse of Pension Assets"

* The views expressed in this statement are those of the author and do not necessarily reflect the views of the Employee Benefit Research Institute, its Trustees, members or other staff.

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Mr. Chairman, it is a pleasure to present this statement to the Committee on a most important subject: transfers of assets involving corporate sponsors and pension plans. As the Institute fully documented in statements submitted to this Committee on May 1, 1981, and on June 7, 1982, private pensions are playing a vital role in helping to assure economic security for the nation's aged. A growing number of the nation's retirees receive income from private pensions upon retirement, with public and private sector forecasts indicating that over two-thirds of new retirees will receive such benefits upon retirement from the current pension system by 1995. I stress, this is from the current pension system. You are holding these hearings because of your concern that the "present pension system" may not be with us in 1995. That concern arises because of what the Committee has characterized as "corporate misuse of pension assets."

WILL PRIVATE PENSIONS SURVIVE?

Corporations began creating private retirement income programs before the Congress of the United States even explicitly provided tax incentives through the Internal Revenue Code. Code provision for plans in 1921 actually represent recognition of what was already occuring. Pensions grew slowly from that period through the late 1940s, at which time wage price controls provided a boost to the development of these programs which has persisted through today.1/ Even in the presence of major changes in federal law, for example the Employee Retirement Income Security Act of 1974, total growth of the system has persisted. There is no reason to believe that the private pension system -- defined benefit and defined contribution -- will do anything but continue to grow in the future.

HOW IS THE PENSION UNIVERSE CHANGING?

The structure of the pension universe itself -- that is, the balance of defined benefit and defined contribution plans -- has been significantly affected by changes in public policy.2/ Passage of the Employee Retirement Income Security Act in 1974 (ERISA) brought with it a fundamental change in plan sponsor behavior. These changes are documented in Tables 1-5 attached to this statement. ERISA increased the attractiveness of defined contribution pension vehicles and decreased the attractiveness of defined benefit plans. The differences between these plan types are explained in the EBRI pamphlet attached to this statement: "The Defined Benefit and Defined Contribution Plans: Understanding the Differences." For purposes of the Committee's current concerns two differences are crucial:

- o Contributions to a defined benefit plan may vary from year to year and the employer may frequently have an unfunded liability attributable to the plan, while the defined contribution plan generally costs the same percentage of compensation each year and by definition carries with it no unfunded liabilities.
- o Under defined benefit plans all of the risk of poor investment performance resides with the sponsor who has a legal obligation to provide the funds for the payment of accrued pension benefits, while under the defined contribution plan the employee bears this risk of poor investment performance.

The Congress has never explicitly explored the subject of which type of pension program is most consistent with what public policy should be. Nevertheless, the Congress has passed an ongoing series of legislative proposals which affect relative incentives for the two systems. A change of major significance, for example, was creation of the Pension Benefit Guaranty Corporation under ERISA. The legislative history of ERISA is replete with concerns regarding the potential effects of this program on the future of the pension system. By 1976, only one year after the passage of ERISA, the concerns over the effect of this program were being widely discussed. In 1979, EBRI sponsored a forum entitled "Pension Plan Termination Insurance: Does the Foreign Experience Have Relevance for the United States?" to explore many of those issues.3/ The publication recounting the forum's proceedings provides concise analysis which make the behavior of concern to this Committee fully understandable.

Congress has considered bills which would amend ERISA with regard to PBGC for several years. Congress has also held a series of hearings on the subject. Taken together, this activity without resolution has simply exacerbated the affects of ERISA on defined benefit pension plans and has made corporate plan sponsors all the more sensitive to the relative advantages and disadvantages of defined benefit versus defined contribution programs. The more the Congress, or those in the private sector, discuss placing significant restrictions on the sponsors of defined benefit pension plans the more likely it becomes that corporate plan sponsors act based upon a worst case scenario. For example, this may mean shifting from a defined benefit to a defined contribution today because they believe they may not have the voluntary ability to do so tomorrow.

WHAT ARE THE ISSUES?

1. Who does the money belong to?

For the defined benefit pension plan the "deferred wage" is the accrued benefit promise. This promise can be viewed separately and apart from the amount of money in the pension fund. This is recognized by ERISA with its provision for employer funding flexibility. It is further recognized by the plan type itself in placement of risk on the employer in the event that investment return is poor and gain for the employer if investment performance is good. This gain has most frequently simply meant lower future pension contributions. The concern of this Committee is that it has come to mean recovery of excess assets.

For the defined contribution plan the deferred wage is the contribution itself. The employee will receive more than that absolute contribution, if investment performance is positive, but could even receive less than that contribution in the event that investment performance is poor.

2. Does plan type matter?

Plan type matters a great deal as the attached pamphlet explains. The Congress, however, has chosen to authorize and allow two types of pension programs. Both are voluntary, and both can legally be terminated. The Congress clearly has the power to change those rules. But, the Congress must first deal with the explicit issue of what it wishes public policy to be. The problem with that exploratory process is that it provides significant incentive for employers to make decisions and plan sponsorship changes in expectation of what Congress might do that they would not have otherwise undertaken had Congress not been discussing the issue.

It should be made clear, however, that this behavior will be present among only a small minority of the hundreds of thousands of pension plan sponsors in the United States. The Congress must carefully evaluate the long-term consequences of policy changes made to restrict the few and what that might mean for the many.

3. Should employers be allowed to terminate, or partially terminate, defined benefit pension plans?

The law has explicitly allowed this since 1921. The clear ability, under specified circumstances, to take these actions was reiterated in ERISA. Creation of the PBGC makes the determination decision easier for sponsors of plans that are under-funded, and probably motivates it for those that are well-funded and choose not to bear the risk of bad decisions on the part of other corporate managers. Creation of the PBGC created a "market intrusion" and many disruptions should have been expected. If a corporate manager has an "over-funded" defined benefit pension plan and is looking at the possibility of paying the same dollar level premium to the PBGC in the future as the sponsor with a severely under-funded pension plan, what is appropriate behavior? Premiums paid to the PBGC represent a reduction in the amount of money that could be going to pension benefits for that employer's employees. Can it not be viewed as in the best interest of those employees for the employer to terminate the defined benefit plan and replace it with a target benefit plan with what would have been PBGC premiums enhancing the value of those target benefits?

The resolution of the three issues noted above is neither as clean nor as simple as most of those who have testified before this Committee have implied. Some, for example, have implied that defined benefit assets are clearly the property of the employee and that the assets, not the accrued benefit, represents the employee's deferred wage. This is not as clear as they would suggest. It is inconsistent with the concept of employer risk for under funding and inconsistent with employer provison for postretirement pension increases long after the retiree has left the "wage earner" status.

Other witnesses have referred to the the AMAX situation. This corporation has proposed to terminate the defined benefit pension plan for its retirees while fully funding those benefits, and to maintain a defined benefit plan for its active workers. This employer has two alternatives. One is to maintain the entire plan, which they do not appear to be obligated by law to do. But this also is subject to multiple opinions. The other is to terminate the entire plan and replace it with a defined contribution program. Without suggesting what appropriate policy is, it is irrefutable that PBGC, as a premium-supported institution, is far better off receiving premiums on the active work force of AMAX rather than on no AMAX employees at all.

In a statment to the ERISA Advisory Council of the U.S. Department of Labor, Roger Thomas, Pension Counsel, House Select Committee on Aging, suggested three points or issues.

1. "Termination of an overfunded pension plan, therefore, can wreck financial havoc with financial security of a worker and his family." He bases this statement on a judgment about plan type by noting: "Even if some form of defined contribution plan replaces the terminated plan, it is unlikely that the worker will be able to achieve the level and security of benefits previously offered under the terminated plan." These statements represent a flat judgment about the relative merits of defined benefit and defined contribution plans -- judgments that are not currently incorporated in law. In fact, since 1974 the Congress has passed no fewer than ten statutes which make defined contribution plans increasingly attractive vis a vis defined benefit plans. Corporations are now responding to the incentives created by Congress -- whether they were intentionally or unintentionally created by Congress. Condemnation hearings are not what is needed. Decisions on the nature of the pension system that the Congress actually desires are needed.
2. "One recent trend involves the contribution by corporate sponsors of employer stock, oil and gas royalty interests, lease hold interests or employer real property to their pension plan. Contributions of these types enable an

employer to retain cash it would otherwise have to contribute to the plan or, in some instances, to provide a financing mechanism for the company stock, real estate, lease holds, or other investments which are held by the employer." Again, multiple witnesses before this Committee have condemned this behavior as inappropriate. It may in fact be. This Committee, however, must look at the broader issues involved. Would the PBGC or the employees have been better off if the employer had obtained a total funding waiver from the Internal Revenue Service? Would the employees have been better off if the employer, if in the cash bind characterized by Mr. Thomas, had chosen to terminate the defined benefit pension plan? Since the employer is at risk for poor investment performance and will eventually have to contribute more cash if the "in-kind" contributions do not prove to be of full value, how has the employee been harmed? For defined contribution plans these "in-kind" contributions raise a different set of issues. Congress, however, has passed multiple statutes aimed at encouraging employers to create employee stock ownership plans. Would it not be more logical for the Congress, and this Committee, to review that entire subject than to criticize companies that are responding to this legal incentive? Further, since the Congress has encouraged ESOP formation, is it now logical for employers to believe that contributing employer stock to their plan is consistent with Congress' desires to have employees own more of the company?

WHY ARE PENSION DECISIONS INCREASINGLY FINANCIAL DECISIONS?

The set of issues of concern to this Committee revolve around the increasing degree to which pension plan decisions are corporate financial decisions. Congress has played a major role in making this so. First, it has provided significant tax incentives for the creation of plans. Second, it has actually provided tax credits rather than tax reductions for the creation of certain forms of defined contribution pension programs. Third, it has created the significant defined benefit plans funding standards enacted with ERISA. Fourth, it has structured the Pension Benefit Guaranty Corporation in such a way that employers pay premiums that have no relationship to risk or exposure yet simultaneously allows ongoing employers to shift liabilities through the termination of under funded pension plans.

The economy in general, and private regulatory groups in particular, have added to this movement towards financial decison making. First, inflation placed major cost pressures on employers to focus on employee benefit cost inflation and its effect on corporate profitability. Second, employee desires for greater early age total compensation and capital accumulation programs with a degree of portability have affected corporate decision making. Third, the changing nature of pension liabilities attributable to ERISA and multiple actions of the Financial Accounting Standards Board have combined to move pension assets and liabilities toward the corporate balance sheet and therefore towards the realm of the Chief Financial Officer.

The Congress and this Committee should not be surprised by this trend. In fact, it has taken hold in government itself. Witness the Social Security Act Amendments of 1983 and current concern over the future of Medicare.

Economics, demographics, and changing government policy guaranty that with each passing year, cost and financial effect will increasingly influence decisions in the entire realm of employee benefits, both public and private.

WHAT CAN BE DONE?

The issues are not as simple as Thomas C. Woodruff, Ph.D., has implied to the ERISA Advisory Council of the U.S. Department of Labor or this Committee. The issues are as complex as Michael S. Gordon so articulately pointed out to that Council and this Committee. They are not as easily partitioned as was implied by the title of your hearing, "Corporate Misuse of Pension Assets." They are complex. And, as Roger Thomas has articulately stated, they have far reaching implications for the future of retirement income security in America.

This Committee has a vital role to play. It has the opportunity to move Congress, for the first time, in the direction of articulating a national retirement income policy. I respectfully suggest that a broader approach would allow this Committee to most effectively contribute to future economic security of the aging.4/ The Employee Benefit Research Institute stands ready to work with you in carrying out your mission.

Endnotes

1/ Sylvester J. Schieber and Patricia M. George, Retirement Income Opportunities in an Aging America: Coverage and Benefit Entitlement (Washington, D.C.: Employee Benefit Research Institute, 1981) and EBRI, Retirement Income Opportunities in an Aging America: Income Levels and Adequacy (Washington, D.C.: Employee Benefit Research Institute, 1982).
2/ Economic Survival in Retirement: Which Pension Is For You? (Washington, D.C.: Employee Benefit Research Institute, 1982).
3/ Pension Plan Termination Insurance: Does the Foreign Experience Have Relevance for the United States? (Washington, D.C.: Employee Benefit Research Institute, 1979).
4/ Retirement Income and the Economy: Policy Directions for the 80s (Washington, D.C.: Employee Benefit Research Institute, 1981), and America in Transition: Implications for Employee Benefits (Washington, D.C.: Employee Benefit Research Institute, 1982).

TABLE 1

SUMMARY OF QUALIFICATIONS AND TERMINATIONS

Period Ending	Number of Qualification Rulings to Date	Number of Terminations to Date	Net Number of Plans in Effect	Increase in Net Number of Plans Over Previous Period	% Annual Growth
March 31, 1983 5/	15,721	152,773	776,223	11,743	1.5
Dec. 31, 1982	908,275	148,795	764,480	70,200	10.1
Dec. 31, 1981	822,924	133,644	694,280	68,095	11.0
Dec. 31, 1980	741,387	120,202	626,185	56,063	9.9
Dec. 31, 1979	672,045	106,923	565,122	46,036	8.9
Dec. 31, 1978	615,168	96,084	519,086	50,398	10.8
Dec. 31, 1977	549,484	80,796	468,686	19,601	4.4
Dec. 31, 1976	514,068	64,981	449,087	3,494	0.8
Dec. 31, 1975	485,944	40,351	445,593	21,931	5.2
Dec. 31, 1974	455,905	32,243	423,662	54,781	14.8
Dec. 31, 1973	396,520	27,639	368,881	55,475	17.7
Dec. 31, 1972	336,915	23,509	313,406	45,815	17.1
Dec. 31, 1971	287,580	19,989	267,591	37,329	16.2
Dec. 31, 1970	246,916	16,654	230,262	30,268	15.1
Dec. 31, 1969	214,342	14,348	199,994	26,346	15.2
Dec. 31, 1968	186,267	12,619	173,648	22,339	14.8
Dec. 31, 1967	162,485	11,176	151,309	19,214	14.5
Dec. 31, 1966	141,964	9,869	132,095	16,973	14.7
Dec. 31, 1965	123,781	8,659	115,122	12,496	12.2
Dec. 31, 1964	110,249	7,623	102,626	10,667	11.6
Dec. 31, 1963	98,541	6,582	91,959	10,250	12.5
Dec. 31, 1962	87,397	5,688	81,709	9,359	12.0
Dec. 31, 1961	77,179	4,829	72,350	8,652	13.5
Dec. 31, 1960	67,792	4,094	63,698	9,399	17.3
Dec. 31, 1959	57,835	3,536	54,299	6,792	14.2
Dec. 31, 1958	50,569	3,062	47,507	6,551	15.9
Dec. 31, 1957	43,615	2,659	40,956	6,074	17.4
Dec. 31, 1956	37,190	2,308	34,882	4,944	16.5
Dec. 31, 1955	31,943	2,005	29,938	1,769(1)	6.3
June 30, 1955	30,046	1,877(2)	28,169(2)	3,290(2)	13.2
June 30, 1954	26,464	1,585	24,879	4,204	20.3
June 30, 1953	22,069	1,394	20,675	3,657	21.5
June 30, 1952	18,289	1,271	17,018	2,347	16.0
June 30, 1951	15,899	1,125	14,671	2,517(3)	20.7
June 30, 1950	13,899	--	--	--	--
June 30, 1949	12,865	711	12,154	896	8.0
June 30, 1948	11,742	484	11,258(4)	1,888	20.1
Aug. 31, 1946	9,370	--	9,370(4)	1,584	20.3
Dec. 31, 1944	7,786	--	7,786(4)	5,839	300.0
Sept. 1, 1942	1,947	--	1,947(4)	1,288	195.0
Dec. 31, 1939	659	--	659(4)	549	--

(1) Six month total
(2) See RR 101.-4
(3) Increase from June 30, 1949 (see RR 101.4)
(4) 28 month period, average 2,507 plans per year
(5) 3 month period, 1/1/83 - 3/31/83

*Does not include plans covering self-employed individuals (Keogh Act plans).

SOURCE: Charles D. Spencer Associates for 1930 to 1975, EBRI tabulations of IRS data for 1976 to 1982.

TABLE 2

PENSION PLAN GROWTH

Year	Net Total Plans Created	Defined Benefit	Defined Contribution	Total Plans	Total Plans % Growth
1956	4,944	2,983	1,961	35,503	16.2
1957	6,044	3,347	2,727	41,577	17.1
1958	6,551	3,659	2,892	48,128	15.8
1959	6,792	3,554	3,238	54,920	14.1
1960	9,399	4,711	4,688	64,319	17.1
1961	8,652	4,545	4,107	72,971	13.5
1962	9,359	4,712	4,647	82,330	12.8
1963	10,250	5,399	4,851	92,480	12.4
1964	10,667	6,072	4,595	103,247	11.5
1965	12,496	6,983	5,513	115,743	12.1
1966	16,973	9,521	7,452	132,716	14.7
1967	19,214	10,690	8,524	151,930	14.5
1968	22,339	12,224	10,115	174,269	14.7
1969	25,905	13,824	12,522	200,174	14.9
1970	30,268	15,370	14,898	230,442	15.1
1971	37,329	20,888	16,441	267,771	16.2
1972	45,815	26,520	19,295	313,586	17.1
1973	55,475	31,608	23,868	369,061	17.7
1974	54,601	30,002	24,599	423,662	14.8
1975	21,931	10,769	11,162	445,593	5.2
1076	3,494	-4,180	7,674	449,087	.8
1977	19,601	1,616	17,985	468,688	4.4
1978	50,398	5,103	45,295	519,086	10.8
1979	46,036	12,488	33,548	565,122	8.9
1980	56,063	14,552	41,511	626,185	9.9
1981	68,095	19,253	48,842	694,280	11.0
1982	70,200	23,146	47,054	764,480	10.1
1983 1/	11,743	4,325	7,418	776,223	1.5

SOURCE: IRS Disclosure Data; EBRI tabulations.

1/ 1983 is for 1/1/83 to 3/31/83.

TABLE 3

PENSION PLAN GROWTH
1975-1983

Year	Defined Benefit Net Created	Defined Benefit Total	Defined Benefit Annual Growth %	Defined Contribution Net Created	Defined Contribution Total	Defined Contribution Annual Growth
	10,769	124,766	-	11,162	320,872	-
1976	-4,180	120,586	(3.4) 1/	7,674	328,501	2.4
1977	1,616	122,202	1.2	17,985	346,486	5.5
1978	5,103	127,305	4.0	45,295	391,781	13.1
1979	12,488	139,793	9.8	33,548	425,329	8.6
1980	14,552	154,345	10.4	41,511	466,840	9.8
1981	19,253	173,598	12.5	48,842	515,682	10.5
1982	23,146	196,744	13.3	47,054	562,736	9.1
1983 2/	4,325	201,069	2.2	7,418	570,154	1.3

SOURCE: IRS Disclosure Data; EBRI tabulations.

1/ Represents a percentage decrease in the annual growth rate of defined pension benefit plans.
2/ 1983 is for 1/1/83 to 3/31/83.

TABLE 4

PENSION PLAN GROWTH
BY TYPE OF PLAN

Year	Defined Benefit %	Defined Contribution %
1956	60.3	39.7
1957	55.1	44.9
1958	55.9	44.1
1959	51.3	47.7
1960	60.1	49.9
1961	52.5	47.5
1962	50.3	49.7
1963	52.6	47.4
1964	56.9	43.1
1965	55.9	44.1
1966	56.1	43.9
1967	55.6	44.4
1968	54.7	45.3
1969	53.4	46.6
1970	50.8	49.2
1971	56.0	44.0
1972	57.9	42.1
1973	56.9	43.1
1974	54.9	45.1
1975	49.1	50.9
1976	0	100
1977	8.2	91.8
1978	10.1	89.9
1979	27.1	72.9
1980	26.0	74.0
1981	28.3	71.7
1982	33.0	67.0
1983 1/	36.8	63.2

SOURCE: IRS Disclosure Data; EBRI tabulations.

1/ 1983 is for 1/1/83 to 3/31/83.

TABLE 5

CORPORATE AND SELF-EMPLOYED PENSION PLAN CREATIONS, TERMINATIONS AND NET PLAN INCREASES

	Defined Benefit Plans			Defined Contribution Plans			
Year	Plans Qualified	Plans Terminated	Net Plans Created	Plans Qualified	Plans Terminated	Net Plans Created	Net Total Plans Created
1956	3,175	192	2,983	2,072	111	1,961	4,944
1957	3,527	180	3,347	2,898	171	2,727	6,074
1958	3,883	224	3,659	3,071	179	2,892	6,551
1959	3,824	270	3,554	3,442	204	3,238	6,792
1960	5,011	300	4,711	4,946	258	4,688	9,399
1961	4,919	374	4,545	4,468	361	4,107	8,652
1962	5,188	476	4,712	5,030	383	4,647	9,359
1963	5,840	441	5,399	5,304	453	4,851	10,250
1964	6,581	509	6,072	5,127	532	4,595	10,667
1965	7,495	512	6,983	6,037	524	5,513	12,496
1966	10,124	603	9,521	8,059	607	7,453	16,973
1967	11,292	601	10,690	9,229	705	8,524	19,214
1968	12,896	672	12,224	10,886	771	10,115	22,339
1969	14,692	969	13,824	12,383	861	12,522	25,905
1970	16,512	1,142	15,370	16,062	1,164	14,898	30,268
1971	22,493	1,605	20,888	18,171	1,730	16,441	37,329
1972	28,265	1,745	26,520	21,070	1,775	19,295	45,815
1973	33,830	2,222	31,608	25,608	1,908	23,867	55,475
1974	32,579	2,577	30,002	26,806	2,207	24,599	54,601
1975	15,319	4,550	10,769	14,720	3,558	11,162	21,931
1976	4,790	8,970	-4,180	23,334	15,660	7,6741	3,494
1977	6,953	5,337	1,616	28,463	10,478	17,985	19,601
1978	9,728	4,625	5,103	55,956	10,661	45,295	50,398
1979	15,755	3,267	12,488	41,122	7,574	33,548	46,036
1980	18,849	4,297	14,552	50,493	8,982	41,511	56,063
1981	23,789	4,536	19,253	51,748	8,906	48,812	68,095
1982	28,189	5,043	23,146	57,162	10,108	47,054	70,200
1983 1/	5,745	1,420	4,325	9,976	2,558	7,418	11,743

SOURCE: IRA Disclosure Data; EBRI tabulations.

1/ 1983 is for 1/1/83 to 3/31/83.

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The Defined Benefit And Defined Contribution Plans:

Understanding the Differences

EMPLOYEE
BENEFIT
RESEARCH
INSTITUTE