

**APA RESPONSE TO THE ERISA INDUSTRY COMMITTEE
TESTIMONY BEFORE THE COMMITTEE ON FINANCE, U.S. SENATE,
MARCH 11, 2003**

The Allied Pilots Association (APA), collective bargaining agent for all 16,000 active and retired American Airlines pilots, endorses the intent of Congress and the Bush Administration to enhance pension security. However, we consider the testimony the ERISA Industry Committee (ERIC) presented on March 11, 2003 before the Senate Finance Committee regarding lump-sum distributions to be misleading.

The following responds to key points (in italics) raised in the section entitled “What about lump-sum distributions?” on pages five and six of ERIC’s testimony.

- *“It is important that the lump-sum discount rate reflect the plan’s discount rate. Any disconnect between the lump-sum rate and the funding rate will cause plan distributions to either exceed or fall short of estimates used in the plan.”*

Not True. The Lump-Sum Rate and the Funding Rate Are Now and Should Remain Separate. These two rates have been different for almost 24 years (see IRS Revenue Ruling 79-90). The reason for the difference is that pension plan sponsors have contrasting investment objectives and time horizons compared to retirees. Large plan sponsors invest for capital accumulation for thousands of employees over long time periods. Retirees invest for capital preservation to provide for their personal financial security over relatively limited periods. Put another way, the time allotted for the accumulation of funds versus their payout differs significantly, with an employee’s work life covering a substantially longer period than their retirement life. These different scenarios therefore require separate discount rates.

Any variance between the funding rate and the lump-sum rate could be offset by favorable asset returns. On the other hand, even if the rates were the same, a plan could experience funding difficulties if the actuarial assumptions used to value the plan are significantly different from the plan’s actual performance.

The Discount Rate Is One of Many Assumptions Used In Funding a Defined Benefit Pension Plan. ERIC’s testimony focused on the discount rate used to determine lump-sum distributions. The focus should instead be on a plan’s actuarial assumptions, which determine the funded level of a plan. Plan sponsors enjoy significant autonomy in setting and adjusting the actuarial assumptions to compensate for all forms of benefit payment and plan experience. The plan sponsor and actuary are jointly responsible for setting actuarial assumptions that reasonably reflect plan experience and expectations. The plan sponsor is responsible for ensuring that the plan is appropriately funded to meet the benefit payments promised to retiring participants.

- *“Today’s low rate also presents participants deciding between a lump-sum distribution and an annuity a choice that is overwhelmingly weighted toward the lump sum. This is in direct contravention of long-established policy that the*

choice be economically neutral. As use of a lump-sum increases, fewer joint and survivor benefits are selected, adversely affecting long-term participant security. In addition, the plan's funding level is adversely impacted."

Annuities Are Not a Panacea. ERIC's testimony presumes that annuities provide "long-term participant security," which is not necessarily accurate. Each form of payout contains inherent risks. Participants taking lump sums assume investment risk, mortality risk (they could outlive the proceeds), and inflation risk (investment performance could lag inflation). With an annuity, participants also assume inflation risk (the monthly payment at retirement may be insufficient 20 years later), selection risk (which form of annuity is best?), mortality risk (the participant could die prematurely), and business risk (will the company and plan be around to pay my annuity?).

Lump Sums Also Reduce Plan Liabilities. When a Defined Benefit Plan pays a lump sum, the liability associated with that participant goes away. On the other hand, an annuitant whose lifespan exceeds actuarial expectations causes the plan to experience a loss that the employer must fund, thus adversely affecting the funding level.

Joint and Survivor Annuities Do Not Always Provide Long-Term Participant Security. A participant who selects a joint and survivor annuity receives a reduced amount payable for his or her lifetime. In most cases, this reduced annuity is fixed for the participant's lifetime and not protected from inflation, thus eroding the participant's retirement security. In cases where the joint annuitant does not survive the retiree—such as death or divorce—there is no taxable inheritance to pass onto a beneficiary.

The individual will choose the payment form that they feel will best serve their interests. If an individual has a family history of heart disease, they may opt for the lump sum. Or, if the individual is concerned about the long-term viability of the company or industry, they may choose the lump sum to avoid shouldering the additional business risk for the period of their retirement.

- *"Lump sums paid under a defunct Treasury rate are, in fact, windfall benefits that have damaging side effects for long-term retirement policy and for the company sponsoring the plan."*
- *"Actuarial estimates indicate that a lump-sum benefit under the current inappropriate discount rate increases the cost of the benefit to the plan by 17-40%. Many plans cannot absorb these costs and have been freezing or curtailing benefits. Thus, while some current retirees receive a windfall based on an anomaly in the government debt structure, future retirees will receive reduced benefits overall."*

Low Interest Rates and Not The End of New 30-Year Treasury Bonds Have Primarily Caused Higher Benefits. During The 1980s, Interest Rates Were At Historic Highs, With Correspondingly Lower Benefits, With No Outcry From Plan Sponsors. Plan sponsors are aware of the cyclical nature of interest rates, but choose not to protect themselves with additional funding. Also, lump sums are actuarially equivalent

to the annuity otherwise payable. By law, there is no windfall since the lump sum is equivalent to the annuity. The discount rate used by the PBGC for paying lump sums is even lower. Based on ERIC's criteria, does this mean the PBGC pays even more than "windfall benefits?" Insurance companies are permitted to sell annuities at even lower discount rates, while the Pension Benefit Guarantee Corporation pays out lump sums that are not tied to the discount rate, but are instead based on annuity purchase rates used by insurance companies.

- *"Elderly widows and widowers who outlive their assets and have no retirement income stream other than Social Security constitute one of the most vulnerable pockets of poverty today. The current lump-sum structure will increase the number of spouses and others left adrift in the future if that lump sum is dissipated."*
- *"Finally, Internal Revenue Code section 417(3) not only dictates the minimum lump-sum rate, but also the rate that regulations encourage companies to use as the interest credit rate in cash balance plans. Thus, maintaining an artificially low lump-sum rate for some current retirees means that millions of participants in cash balance plans are losing benefits compared to what they would be earning if the rate were rational."*

If True, Then Perhaps Congress Should Mandate That All Companies Must Have A Minimal Defined Benefit Plan For Employees. Annuities Are Not The Answer. Consider the following:

--A single life annuity (which provides the greatest monthly payment) leaves the surviving spouse with no income following the death of the annuitant.

--An annuity with payments guaranteed for a specified period, known as a period-certain annuity, also leaves nothing to the surviving spouse.

--A joint and survivor annuity reduces the annuity payment for the rest of the annuitant's life. Following the retiree's death, the joint annuitant typically receives 50 percent of the amount the retiree received, which could leave the survivor with insufficient financial resources.

--A participant taking an annuity from a financially troubled company may have the annuity reduced if the plan is terminated under PBGC provisions.

For More Information:

- First Officer John Bury, APA Secretary-Treasurer, tel. 817-302-2117
- Captain Bill Purcell, APA Pension Committee Chairman, tel. 817-302-2205
- Raymond Vickery, Williams Aron & Associates, tel. 202-756-3632