STRENGTHENING PENSION SECURITY AND DEFINED BENEFIT PLANS: EXAMINING THE FINANCIAL HEALTH OF THE PENSION BENEFIT GUARANTY CORPORATION

HEARING

BEFORE THE

COMMITTEE ON EDUCATION AND THE WORKFORCE U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED EIGHTH CONGRESS

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C O N T E N T S

STRENGTHENING PENSION SECURITY AND DEFINED BENEFIT PLANS: EXAMINING THE FINANCIAL HEALTH OF THE PENSION BENEFIT GUARANTY CORPORATION

Thursday, September 4, 2003

U.S. House of Representatives

Committee on Education and the Workforce

Washington, DC

The Committee met, pursuant to notice, at 10:40 a.m., in room 2175, Rayburn House Office Building, Hon. John A. Boehner (Chairman of the Committee) presiding.

Present: Representatives Boehner, Ballenger, McKeon, Johnson, Biggert, Platts, Tiberi, Osborne, Carter, Porter, Musgrave, Blackburn, Burns, Miller, Kildee, Owens, McCarthy, Tierney, Grijalva, Majette, Van Hollen, and Bishop.

Staff present: David Connolly, Jr., Professional Staff Member; Stacey Dion, Professional Staff Member; Chris Jacobs, Staff Assistant; Ed Gilroy, Director of Workforce Policy; Christine Roth, Workforce Policy Counsel; Jo-Marie St. Martin, General Counsel; Kevin Smith, Senior Communications Counselor; Kevin Frank, Professional Staff Member; and Deborah Samantar, Committee Clerk/Intern Coordinator. Michele Varnhagen, Minority Labor Counsel/Coordinator; Mark Zuckerman, Minority General Counsel; Ann Owens, Minority Clerk; and Daniel Weiss, Minority Special Assistant to the Ranking Member.

Chairman BOEHNER. A quorum being present, the Committee on Education and the Workforce will come to order. We're holding this hearing today to hear testimony on strengthening pension security and defined benefit plans, and examining the financial health of the Pension Benefit Guaranty Corporation (PBGC).

Under Committee Rule 12(b), opening statements are limited to the Chairman and the Ranking Member of the Committee. Therefore, if other Members have statements, they will be included in the record. And with that, I ask unanimous consent for the hearing record to remain open for 14 days to allow Members' statements and other extraneous material referenced during the hearing to be submitted for the official hearing record. Without objection, so ordered.

STATEMENT OF THE HON. JOHN A. BOEHNER, CHAIRMAN, COMMITTEE ON EDUCATION AND THE WORKFORCE

I want to welcome all of you here today, and thank our distinguished witnesses for coming to testify on this very important subject. Strengthening the pension security of American workers is a top priority for this Congress, and today's hearing is the third in a series held by the Education and the Workforce Committee that examines the future of defined benefit plans.

Today's defined benefit system is in a very precarious state. The number of employers offering defined benefit pension plans has declined from 112,000 in 1985 to just more than 30,000 last year. More and more employers are freezing or terminating their defined benefit plans, and either shifting to 401(k) defined contribution plans, or stop offering pension plans to their workers altogether.

This situation is exacerbated by the fact that the financial health of defined benefit plans, and the Federal agency that insures them, the Pension Benefit Guaranty Corporation, are in jeopardy. On July 23rd, the General Accounting Office announced that it was including the PBGC on its list of "high risk" programs that require additional Federal oversight, noting that there are structural problems in the defined benefit pension system that are jeopardizing the financial health of the agency.

As we all know, over the last year the PBGC has been forced to assume the obligations of paying out basic pension benefits for several large pension plans, and the agency's surplus has quickly evaporated. During Fiscal Year 2002, PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion, a loss of $11.3 billion in just over a year. And as of April, that burden has grown to now $5.4 billion, the largest in agency history.

The cause of the deficit is no secret. There have been a number of companies in the steel and airline industries that have gone bankrupt and PBGC has been forced to take over their unfunded pension plans. To make matters worse, according to the PBGC there is an additional $35 billion in unfunded pension benefits among financially weak companies that are looming on the horizon, pension benefits that may eventually, I want to reiterate, may eventually become the PBGC's responsibility.

Although the agency has enough resources to make benefit payments for the near future, this poses a serious question of whether a taxpayer bailout of the PBGC would be necessary if the financial condition of the agency continues to deteriorate. It's another reason why we are exploring this issue. More than a decade ago, the Federal Government stepped in to bail out the savings and loan industry (S&L) at the cost of billions of dollars. According to the Federal Deposit Insurance Corporation (FDIC), the bailout cost taxpayers approximately $124 billion. While there are some obvious differences between the savings and loan bailout and the problems of defined benefit plans, it's important that we work to prevent another S&L-type bailout that saddles hard-working taxpayers with a tab for billions of dollars. The alarming trend of underfunded defined benefit plans we see today only increases the pressure on the PBGC, threatening its ability to protect and insure worker pension benefits and putting taxpayers' interests in real jeopardy.

While the financial condition of the PBGC certainly looks dire at the moment, we must also remember that the agency has been in deficit before. In fact, just over a decade ago, the agency was similarly designated "high risk" by the GAO. And the PBGC was taken off the list after its financial health improved, largely because of stock market gains and the improvement in our economy. Our goal, however, is not a PBGC whose financial condition is contingent on the state of the economy, but an agency that is on sound financial footing so that it can, in fact, meet its goal of protecting the pension benefits of American workers who have defined benefit plans.

Earlier this March, Congressman Johnson and I requested that the GAO study the PBGC and assess why the agency had accumulated such a significant deficit, and determine what other liability risks the agency faces. I am pleased that David Walker is here today to present some of the agency's findings. I am also pleased that Steven Kandarian is here to discuss the current financial condition of the agency, and the impact it has on workers and their benefits.

With more struggling companies facing severe underfunding problems in their pension plans, the financial health of the PBGC has become an even more critical issue for millions of workers who rely on defined benefit plans. We need to ensure that workers have as many retirement security choices available to them as possible. Strengthening the PBGC will enhance the retirement security of millions of working families who rely on the safe and secure benefits that defined benefit pension plans provide.

I am looking forward to working with the Administration and my colleagues on the Committee on this issue as we move ahead.

[The prepared statement of Chairman Boehner follows:]

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As we all know, over the last year the PBGC has been forced to assume the obligations of paying out basic pension benefits for several large pension plans, and the agency's surplus has quickly evaporated. During fiscal year 2002, PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion, a loss of $11.3 billion in just one year. And as of April, that burden had grown to $5.4 billion, the largest in agency history.

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Although the agency has enough resources to make benefit payments for the near future, this poses a serious question of whether a taxpayer bailout of the PBGC would be necessary if the financial condition of the agency continues to deteriorate. And that is another reason we are exploring this issue. More than a decade ago, the federal government stepped in to bail out the savings and loan industry at the cost of billions of dollars. According to the Federal Deposit Insurance Corporation (FDIC), the bailout cost taxpayers approximately $124 billion. While there are some obvious differences, it is important that we work to prevent another S&L-style bailout that saddles hard-working taxpayers with a tab for billions of dollars. The alarming trend of underfunded defined benefit plans we see today only increases the pressure on the PBGC, threatening its ability to protect and insure worker pension benefits and putting taxpayers" interests in real jeopardy.

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I look forward to working with the administration and my colleagues on this issue as we move ahead.

Chairman BOEHNER. Let me now yield to my colleague and friend, the gentleman from California, Mr. Miller.

STATEMENT OF THE HON. GEORGE MILLER, RANKING MINORITY MEMBER, COMMITTEE ON EDUCATION AND THE WORKFORCE

Mr. MILLER. Thank you very much, Mr. Chairman, and thank you for convening this hearing on what I consider a most important matter, and I'm sure many of our colleagues share that belief.

For over a year, the Bush administration has repeatedly ignored our urgent request to wake up to the serious problem of pension underfunding. For example, I wrote the administration in July of 2002 to take action when the pension deficits skyrocketed from $26 billion to over $100 billion, and we heard nothing.

Now, over a year later, the problem is worse and festering. As the PBGC will testify, the pension plans are now $400 billion in the red nationally, and the largest liability in history, and the PBGC is reporting a $5.7 billion deficit as of July 31st. The administration's failure to take decisive action on pensions, its failed economic policy, and its utter neglect of our manufacturing industries have together precipitated the largest underfunding of private pensions in history.

Today, hard-working Americans are already taking it on the chin. Three million private-sector workers have lost their jobs since 2001, the long-term unemployed have been left to fend for themselves when their extended unemployment benefits have run out, workers in the manufacturing sectors have seen their jobs vanish overseas, not to return, and their industry is ignored by the Bush administration's economic policies.

Working families have already lost billions in irreplaceable life savings in their 401(k) plans as the stock market crumbled and corporate abuse ran rampant. Pensions of millions of Americans are threatened by the administration's cash balance proposals, which may cost older workers up to half—half—of their expected pension benefits.

Mr. Chairman, as you know, the GAO is very concerned about the conditions of the private pensions and the strength of the agency that is responsible for guaranteeing those pensions. In July it was announced that it had placed the PBGC on a list of Federal programs that are "high risk" for failure.

Today, the GAO in its analysis further makes clear that our pension rules are clearly broken and in need of reform. Some of the biggest companies that PBGC has taken over or on the pension watch list have been able to exploit pension rules riddled with loopholes and escape hatches. Over the past few years, companies have been permitted to publish their annual reports of rosy financial pictures about their pensions, while at the same time running the plan into the ground through reductions and freezes in pension contributions. Conflicts between company managers push for bottom line and the plan's obligations to protect the participants clearly compromise the safe and sound pension practices at many companies.

Worse still, current law allows a plan's real financial condition to be kept secret from workers and investors. This failure of accountability and transparency has eerie similarities to the Enron debacle, while the CEO's were able to jump ship without even alerting the rank-and-file employees the ship was going down.

Today, Congressman Doggett and I will introduce legislation to open up these reports—referred to as the 4010 forms—to public scrutiny. There must be transparency and accountability for billions of dollars promised to hard-working employees. The administration now says it supports the publication of these secret rules, and my understanding is that PBGC is working toward that effort. And we welcome that.

But we also know that a request by the full Committee is a means by which we can get this material to the Committee. Now, I have made that request as the Ranking Member, and have been told it must come from the full Committee. I hope that the full Committee will join us in that request so that we can start the process of creating transparency and information that employees and pensioners are entitled to.

As overdue as this hearing is, it is still an important one, and I thank you for calling it, for our Committee and for the Congress. But it will be meaningless if the recommendations for change that will be discussed today are ignored and that Congress opts instead for a quick fix that will likely mask and the only deepen the problems of unfunded pension liabilities.

In July, the Ways and Means Committee and the administration proposed to scrap the 30-year treasury rate as an index for calculating the interest on future pension liabilities. They propose we jury-rig a new formula that by one estimate will cut pension contributions for the first 3 years by some $50 annually. This is in the system that has historic debts and historic contingent liabilities, and we're now talking about a major retreat in contributions to be made at the same time.

I am concerned about this approach. I am concerned that it will drive pension deficits higher. It was devised without the input of the PBGC and without the understanding of how it would impact on PBGC and its rising deficit. It was devised without the understanding of what it would mean to the future premium contribution hikes and liability claims. And it was devised without telling the taxpayers whether it would put them on the hook for billions of dollars of catastrophic claims that PBGC can't pay.

And even more irresponsibly, the backers of this approach are urging Congress to support the proposals without addressing the real causes of pension underfunding detailed in the GAO report that you have requested.

In mid-July, I requested the PBGC provide me the detailed analysis of these proposals. I specifically asked what effects these proposals would have on the short and long-term pension underfunding on PBGC's, at that time, $3.6 billion deficit, and on the premiums required to the fund's operations. The PBGC apparently doesn't have a clue at this time.

It appears that no one from the administration ever asked the PBGC to look at this before it made this proposal. I was promised this information for today's hearing, and we still don't have it. I think this Committee should be very concerned about this administration appears to have not done its homework when billions of hard-earned retirement benefits are at stake.

The administration must stop dithering and get on about pension reform.

Its neglect of the manufacturing industry, its mismanagement of our economy has resulted in devastating job loss for millions of employees, and now threatens the nest eggs for millions of other Americans. Creating one new job in the Commerce Department is hardly the adequate response. It is a blind eye to the of the baby boomers retiring in the next 10 to 15 years, to the chronic underfunding of plans, to the exploding PGBC deficits, and is negligent and it is irresponsible by the administration.

The American people's anxiety about the future of their retirement is highly justified in light of this administration's failure to seriously address the underlying problems of our pension system. The administration and this Committee have an obligation to get serious about retirement security and to develop real solutions that will do more than paper over the critical pension underfunding.

I know that some people have suggested that this thirty-year bond fix is just temporary. That we can fix it in 3 years from now. Well, those are the same people who gave us the tax cuts with sunsets and suggested we could just raise those taxes 3 years from now, or 4 years from now. It is simply not realistic in the political climate in this country, or the position of this administration, or the concerns about the corporations, about increasing those costs at that time.

I would also say that I think that this hearing takes on additional urgency with respect to the American people with the actions that were taken yesterday by Ella Spitzer. And that is the people, we have been told, that 60 percent of the American families own stock. They own it through their pension plans, and most of that is in mutual funds. And now we see that some of the great names in the American financial institutions are once again gaming—gaming the buying and selling of mutual funds for their own private personal benefit to the detriment of the pension plans that hold those mutual funds.

We need transparency, and we need it now. And we need it in mutual funds, we need it in pension funds, we need it in the PBGC. The American worker is entitled to this, and they must have this. And they must have it now. They have seen the three-legged stool of the 401(k) plan, their pension plans, threatened, in some cases devastated, in some cases wiped out. And this comes from the same people—the ignoring of this problem comes from the same people who are suggesting that the next operation is to simply have every American have a little voucher, go into the mutual fund system for themselves.

Well we've already seen now that the big boys are playing the mutual funds in a far different way. So now on every front where Americans have planned for their retirement, for their nest egg, for taking care of their future, for taking care of their children and their grandchildren. On every front, their assets are now under assault. On every front, their assets are now at greater risk now than they were a year ago, 2 years ago, or 3 years ago.

And yes, we understand the impact of the economy on that. But we cannot have a system that is just at the whim of the economy and/or the stock market. They're entitled to a stable system that they know that they can count on, that they can plan ahead for when they're 50, when they're 55, when they're 60, when they're 62, and they're 65. Today an American worker cannot do that. They cannot do that. They cannot be assured of where they will be in the future with their retirement nest eggs. This Congress owes them better.

And I thank you again, Mr. Chairman, for holding this hearing. It has been a long time coming. But it's urgent, and the information that we will receive today I think will make even additional hearing urgent in this matter with respect to our obligation to the American people. Thank you.

Chairman BOEHNER. Thank you for your opening statement, Mr. Miller. I appreciate your optimism.

Mr. MILLER. Hey, with this hearing, it's looking up.

Chairman BOEHNER. We have a distinguished panel with us today, and it's my pleasure to introduce them. Our first witness will be Mr. David Walker. Mr. Walker began his 15-year term as the seventh Comptroller General of the United States in November 1998. Prior to his appointment, Mr. Walker had extensive executive-level experience in both government and private industry, and we're glad that you're with us.

Our second witness will be Mr. Steven Kandarian. He is the Executive Director of the Pension Benefit Guaranty Corporation, a self-financing government corporation that provides insurance for defined benefit pension plans nationwide. The PBGC administers two insurance programs covering more than 44 million workers in about 32,500 plans. And as executive director, Mr. Kandarian is responsible for the corporation's operations that involve assets of more than $25 billion, benefit payments of more than $1.5 billion, and benefit obligations to some 783,000 workers and retirees in more than 3,100 pension plans.

Mr. Kandarian comes to the PBGC with extensive experience in financial asset management, investment banking, and government regulation. And prior to joining the PBGC, he was a founder and managing director of Orian Partners, L.P., managing director of Lee Capital Holdings, and an investment banker with Rotan Mosul, Inc., from Houston, Texas.

So with that, we want to welcome both of you to this hearing today, and I see that we have votes on the House floor. I think what would be in the best interest of the witnesses and the continuity of this hearing is that the Members go vote now. We have how many votes? We have two votes, and so for everyone's purpose, we will be back and resume in approximately 30 minutes. Committee will stand in recess.

[Recess.]

Chairman BOEHNER. The Committee will come to order. Let me apologize to our distinguished witnesses and all of the members of the audience for our delay. Welcome to the U.S. House. With that, Mr. Walker, you can begin your testimony.

STATEMENT OF DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, D.C.

Mr. WALKER. Mr. Chairman, Mr. Miller. It's a pleasure to be before you today in order to talk about the financial condition of the PBGC and related retirement income security issues.

As you know, Mr. Chairman, this is an issue that I have had a longstanding interest in while proudly serving as Comptroller General of the United States. For Members of the Committee, I was Deputy Executive Director and then Acting Executive Director of the PBGC from 1983 to 1985, and I was Deputy Assistant Secretary and then Assistant Secretary of Labor from 1985 until 1989. And so the issue of retirement income security in general and PBGC in particular is one of longstanding interest to me.

With regard to the issue at hand, as you mentioned, Mr. Chairman, GAO designated the single-employer insurance program within the PBGC as being added to our high-risk list in July of this year. We did it off cycle. We normally just update that list every 2 years in January of the odd year. In this particular case, we took not an unprecedented action, but a non-frequent action, and that was to add it off cycle.

The reason that we added the PBGC single-employer insurance program is several-fold. Number one, it is a very important program to millions of American workers and retirees. Number two, there are significant potential exposures to the American taxpayer. Number three, the PBGC had gone from a roughly $10 billion accumulated surplus to roughly a $5 billion accumulated deficit in less than 2 years. Number four, the degree of underfunding in the defined benefit plan universe had increased dramatically.

It is my understanding that Executive Director Kandarian is going to say that they estimate it is about $350 billion today. And the so-called watch list, or the higher-risk list for the PBGC, has increased, as I understand Executive Director Kandarian is going to say, to about $80 billion. Furthermore, if you analyze the risk that the PBGC faces, it faces a large and disproportionate degree of risk in industries that are affected by increasing global and domestic competition that are very much disproportionately affected by the transition from the industrial age to the knowledge age.

As a result, we believe there are serious issues that need to be addressed. There are a number of parties that say that we ought to take a wait-and-see attitude here. And it is true that the PBGC has over $25 billion in assets, and therefore there is not an immediate crisis. It has enough assets and investments to be able to pay benefits on a timely basis for a significant period of time.

However, based upon our analysis, and as noted in my testimony, we believe that there are certain structural problems that call for reform. And if I can, Mr. Chairman, I want to use Bethlehem Steel as a case study to illustrate some of those problems. And this is a matter of public record. As you know, Bethlehem Steel has been terminated. It represents one of the largest terminations in the history of PBGC. But I think it illustrates some of the systemic problems that we need to deal with.

The first board, which is also in my testimony, demonstrates how the funding percentage, or the funding ratio of Bethlehem Steel declined dramatically in the last several years. And that would be the solid black line. If you look at the dark gray bar, that represents liabilities. If you look at the white bar, that represents assets. We all know that there was a significant decline in the stock market over the last several years, combined with a dramatic decline in interest rates. The result of that was lower asset values, higher liability costs, and the funding percentage declined dramatically.

But what's interesting is the following two. Next, please. Despite the fact that there was a dramatic decline in the relative funding status of this plan, Bethlehem Steel did not make, nor was it required to make, under the current minimum funding requirements in Federal law, any contribution to its pension plan for the years 2000, 2001, or 2002.

The second chart after this makes another point. And that is that despite the fact that it obviously represented a significant risk to the PBGC, not solely because of the funding status of the plan, but because of the financial condition of the sponsor, because of a number of other factors, it did not pay any variable rate or risk-related premiums from 1998 forward. How can this be?

Now, there are a number of other factors associated with Bethlehem Steel, such as the fact that they have a number of very lucrative early retirement benefits that can be triggered by a plant shut-down or a significant lay-off that exist as well, and, frankly, was probably one of the reasons why PBGC took the decision to terminate it involuntarily in order to avoid additional losses on the insurance system. But to me, Bethlehem Steel illustrates a broader systemic issue.

We have got some fundamental systemic challenges that need to be addressed. And if I can, Mr. Chairman, just quickly, and then I'll turn it over to Executive Director Kandarian. There are several areas where we believe additional action is necessary as outlined in my testimony. Not only to assure the adequacy of the current system, but also as a matter of equity to plan sponsors and as a matter of retirement security for American workers and retirees.

First, there needs to be additional transparency in order to provide checks and balances to try to encourage sponsors who have poorly funded plans to fund their plans and additional transparency in the area of the funding status, plan investment, and PBGC guarantee limits.

Second, the minimum funding requirements need to be reviewed and hopefully strengthened, where they focus on underfunded plans that represent a real risk. And with consideration of cashflow, what the cash flow is with regard to the plans, and also potentially the waiver provisions.

Number three, consideration should be given to modifying the full funding limits to provide additional flexibility for sponsors with plans that are underfunded or not well funded, to be able to make more contributions in good times, because they may not have the ability to make better contributions in bad times.

Number four, the PBGC program guarantees, and its variable-rate insurance premium structure needs to be reviewed and possibly revised. For example, the basis under which so-called "shutdown benefits" are insured, whether or not the phase-in should begin as the guarantee as of the date of the shutdown, or the layoff, versus when it was put into the plan, needs to be reviewed and considered. Also issues such as the variable rate premium need review to base the variable rate premium more on real risk, not just the funding status of the plan.

And last, other possible reforms, dealing with issues such as whether or not there ought to be additional restrictions on the benefit increases when plans are significantly underfunded, additional restrictions on the ability to get lump sums, which could create a run on the bank, and whether or not we ought to close down so-called floor offset arrangements, which in substance allow plan sponsors to have significant investments in employer securities and circumvent the ERISA requirements for diversification when there are defined-benefit promises involved.

In summary, Mr. Chairman, Mr. Miller and other Members of the Committee, PBGC faces a serious challenge. There is not an immediate crisis. However, there are systemic problems which we believe call for reform. This is not just an issue of PBGC's financial condition. It's an issue of retirement security for American workers and retirees. And we look forward to working with this Committee and the Congress to try to address these issues. Thank you, Mr. Chairman.

[The prepared statement of Mr. Walker follows:]

United States General Accounting Office

GAO

Testimony
Before the Committee on Education and the Workforce, House of Representatives

For Release on Delivery
Expected at 10:30 a.m.
Thursday, September 4, 2003

PENSION BENEFIT GUARANTY CORPORATION

Single-Employer Pension Insurance Program Faces Significant Long-Term Risks

Statement of David M. Walker,
Comptroller General of the United States

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Highlights

Highlights of GAO-03-873T, a testimony before the Committee on Education and the Workforce, U.S. House of Representative

Why GAO Did This Study

More than 34 million participants in 30,000 single-employer defined benefit pension plans rely on a federal insurance program managed by the Pension Benefit Guaranty Corporation (PBGC) to protect their pension benefits, and the program's long-term financial viability is in doubt. Over the last decade, the program swung from a $3.6 billion accumulated deficit (liabilities exceeded assets), to a $10.1 billion accumulated surplus, and back to a $3.6 billion accumulated deficit, in 2002 dollars. Furthermore, despite a record $9 billion in estimated losses to the program in 2002, additional severe losses may be on the horizon. PBGC estimates that financially weak companies sponsor plans with $35 billion in unfunded benefits, which ultimately might become losses to the program.

This testimony provides GAO's observations on the factors that contributed to recent changes in the single-employer pension insurance program's financial condition, risks to the program's long-term financial viability, and options to address the challenges facing the single-employer program.

www.gao.gov/cgi-bin/getrpt?GAO-03-873T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

July 22, 2003

PENSION BENEFIT GUARANTY CORPORATION

Single-Employer Pension Insurance Program Faces Significant Long-Term Risks

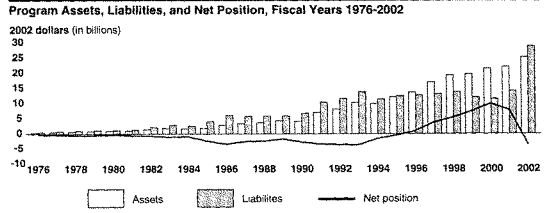
What GAO Found

The single-employer pension insurance program returned to an accumulated deficit in 2002 largely due to the termination, or expected termination, of several severely underfunded pension plans. Factors that contributed to the severity of plans' underfunded condition included a sharp stock market decline, which reduced plan assets, and an interest rate decline, which increased plan termination costs. For example, PBGC estimates losses to the program from terminating the Bethlehem Steel pension plan, which was nearly fully funded in 1999 based on reports to IRS, at $3.7 billion when it was terminated in 2002. The plan's assets had decreased by over $2.5 billion, while its liabilities had increased by about $1.4 billion since 1999.

The single-employer program faces two primary risks to its long-term financial viability. First, the large losses in 2002 could continue or accelerate if, for example, structural problems in particular industries result in additional bankruptcies. Second, revenue from premiums and investments might be inadequate to offset program losses. Participant-based premium revenue might fall, for example, if the number of program participants decreases. Because of these risks, we have recently placed the single-employer insurance program on our high-risk list of agencies with significant vulnerabilities to the federal government.

While there is not an immediate crisis, there is a serious problem that relates to the need to protect the retirement security of millions of American workers and retirees and should be addressed. Agency officials and others have suggested taking a more proactive approach and have identified a variety of options to address the challenges facing the single-employer program that should be considered. The first, would be to improve the transparency of information about plan funding, plan investments, and PBGC guarantees; a second would be to strengthen funding rules to ensure that poorly funded plans are better funded in the future; and a third would be to reform PBGC by restructuring certain unfunded benefit guarantees, such as so-called "shutdown benefits," and program premiums.

Program Assets, Liabilities, and Net Position, Fiscal Years 1976-2002



Source: PBGC annual reports.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the serious financial challenges facing the Pension Benefit Guaranty Corporation's single-employer insurance program. This federal program insures the benefits of the more than 34 million workers and retirees participating in private defined-benefit pension plans.[1] Over the last few years, the finances of PBGC's single-employer insurance program,[2] have taken a severe turn for the worse. From a \$3.6 billion accumulated deficit in 1993, the program registered a \$10.1 billion accumulated surplus (assets exceeded liabilities) in 2000 before returning to a \$3.6 billion accumulated deficit, in 2002 dollars.[3] More fundamentally, the long-term viability of the program is at risk. Even after assuming responsibility for several severely underfunded pension plans and recording over \$9 billion in estimated losses in 2002, PBGC estimates that as of September 30, 2002, it faces exposure to approximately \$35 billion in additional unfunded liabilities from ongoing plans that are sponsored by financially weak companies and may terminate.[4]

[1]A defined-benefit plan promises a benefit that is generally based on an employee's salary and years of service. The employer is responsible for funding the benefit, investing and managing plan assets, and bearing the investment risk. In contrast, under a defined contribution plan, benefits are based on the contributions to and investment returns on individual accounts, and the employee bears the investment risk.

[2]There are two federal insurance programs for defined-benefit plans: one for single-employer plans and another for multiemployer plans. Our work was limited to the PBGC program to insure the benefits promised by single-employer defined-benefit pension plans. Single-employer plans provide benefits to employees of one firm or, if plan terms are not collectively bargained, employees of several related firms.

[3]PBGC estimates that its deficit had grown to about \$5.4 billion at the end of March 2003 based on the midyear financial report.

[4]According to PBGC, for example, companies whose credit quality is below investment grade sponsor a number of plans. PBGC classifies such plans as reasonably possible terminations if the sponsors' financial condition and other factors did not indicate that termination of their plans was likely as of year-end. See PBGC 2002 Annual Report, p. 41. The independent accountants that audited PBGC's financial statement reported that PBGC needs to improve its controls over the identification and measurement of estimated liabilities for probable and reasonably possible plan terminations. According to an official, PBGC has implemented new procedures focused on improving these controls. See Audit of the Pension Benefit Guaranty Corporation's Fiscal Year 2002 and 2001 Financial Statements in PBGC Office of Inspector General Audit Report, 2003-3/23168-2 (Washington, D.C.: Jan. 30, 3003).

This involves an issue beyond PBGC's current and future financial condition it also relates to the need to protect the retirement security of millions of American workers and retirees. I hope my testimony will help clarify some of the key issues in the debate about how to respond to the financial challenges facing the federal insurance program for single-employer defined-benefit plans. As you requested, I will discuss (1) the factors that contributed to recent changes in the single-employer pension insurance program's financial condition, (2) risks to the program's long-term financial viability, and (3) options to address the challenges facing the single-employer program.

To identify the factors that contributed to recent changes in the single-employer program's financial condition, we discussed with PBGC officials, and examined annual reports and other available information related to, the funding and termination of three pension plans: the Anchor Glass Container Corporation Service Retirement Plan, the Pension Plan of Bethlehem Steel Corporation and Subsidiary Companies, and the Polaroid Pension Plan. We selected these plans because they represented the largest losses to PBGC in their respective industries in fiscal year 2002. PBGC estimates that, collectively, the plans represented $4.2 billion in losses to the program at plan termination. In particular, I will focus on the experience of the Bethlehem Steel plan because it provides such a vivid illustration of the immediate and long-term challenges to the program and the need for additional reforms. To identify the primary risks to the long-term viability of the program and options to address the challenges facing the single-employer program, we interviewed pension experts at PBGC, at the Employee Benefits Security Administration of the Department of Labor, and in the private sector and reviewed analyses and other documents provided by them.

Let me first summarize my responses to your questions. The termination, or expected termination, of several severely underfunded pension plans was the major reason for PBGC's single-employer pension insurance program's return to an accumulated deficit in 2002. Several underlying factors contributed to the severity of plans' underfunded condition at termination, including a sharp decline in the stock market, which reduced plan asset values, and a general decline in interest rates, which increased the cost of terminating defined-benefit pension plans. Falling stock prices and interest rates can dramatically reduce plan funding as the sponsor approaches bankruptcy. For example, while annual reports indicated the Bethlehem Steel Corporation pension plan was almost fully funded in 1999 based on reports to IRS, PBGC estimates that the value of the plan's assets was less than 50 percent of the value of its guaranteed liabilities by the time it was terminated in 2002. The current minimum funding rules and other rules designed to encourage sponsors to fully fund their plans were not effective at preventing it from being severely underfunded at termination.

Two primary risks could affect the long-term financial viability of the single-employer program. First, and most worrisome, the high level of losses experienced in 2002, due to the bankruptcy of companies with large underfunded defined-benefit pension plans, could continue or accelerate. This could occur if the economy recovers slowly or weakly, returns on plan investments remain poor, interest rates remain low, or the structural problems of particular industries with pension plans insured by PBGC result in additional bankruptcies. Second, PBGC might not receive sufficient revenue from premium payments and its own investments to offset the losses experienced to date or those that may occur in subsequent years. This could happen if participation in the single-employer program falls or if PBGC's return on assets falls below the rate it uses to calculate the present value of benefits promised in the future. Because of its current financial weaknesses, as well as the serious, long-term risks to the program's future viability, we recently placed PBGC's single-employer insurance program on our high-risk list.

While there is not an immediate crisis, there is a serious problem that needs to be addressed. Some pension professionals have suggested a "wait and see" approach, betting that brighter economic conditions might ameliorate PBGC's financial challenges. However, the recent trends in the single-employer program's financial condition illustrate the fragility of PBGC's insured plans and suggest that an improvement in plan finances due to economic recovery may not address certain fundamental weaknesses and risks facing the single-employer insurance program. Agency officials and other pension professionals have suggested taking a more proactive approach and have identified a variety of options to address the challenges facing PBGC's single-employer program. In our view, several types of reforms should be considered. The first would be to improve the availability of information available to plan participants and others about plan funding, plan investments, and PBGC guarantees. A second would be to strengthen funding rules applicable to poorly funded plans to help ensure plans are better funded should they be terminated in the future. A third would be to reform PBGC by restructuring its benefit guarantees and premiums. Guarantees for certain unfunded benefits, such as so-called "shutdown benefits," could be modified. With respect to variable-rate premiums, in addition to the plan's funding status, consideration should be given to the economic strength of the plan's sponsor, the allocation of the plan's investment portfolio, the plan's benefit structure, and participant demographics. These options are not mutually exclusive, either in combination or individually and several variations exist within each. Each option also has advantages and disadvantages. In any event, any changes adopted to address the challenge facing PBGC should improve the transparency of the plan's financial information, provide plan sponsors with incentives to increase plan funding, and provide a means to hold sponsors accountable for adequately funding their plans.

Background

Before enactment of the Employee Retirement and Income Security Act (ERISA) of 1974, few rules governed the funding of defined-benefit pension plans, and there were no guarantees that participants of defined-benefit plans would receive the benefits they were promised. When Studebaker's pension plan failed in the 1960s, for example, many plan participants lost their pensions.[5] Such experiences prompted passage of ERISA to better protect the retirement savings of Americans covered by private pension plans. Along with other changes, ERISA established PBGC to pay the pension benefits of participants, subject to certain limits, in the event that an employer could not.[6] ERISA also required PBGC to encourage the continuation and maintenance of voluntary private pension plans and to maintain premiums set by the corporation at the lowest level consistent with carrying out its obligations.[7]

Under ERISA, the termination of a single-employer defined-benefit plan results in an insurance claim with the single-employer program if the plan does not have sufficient assets to pay all benefits accrued under the plan

[5] The company and the union agreed to terminate the plan along the lines set out in the collective bargaining agreement: retirees and retirement-eligible employees over age 60 received full pensions and vested employees under age 60 received a lump-sum payment worth about 15 percent of the value of their pensions. Employees whose benefit accruals had not vested, including all employees under age 40, received nothing. James A. Wooten, "'The Most Glorious Story of Failure in Business:' The Studebaker – Packard Corporation and the Origins of ERISA." *Buffalo Law Review*, vol. 49 (Buffalo, NY: 2001): 731.

[6] Some defined-benefit plans are not covered by PBGC insurance; for example, plans sponsored by professional service employers, such as physicians and lawyers, with 25 or fewer employees.

[7] See section 4002(a) of P.L. 93-406, Sep. 2, 1974.

up to the date of plan termination.[8] PBGC may pay only a portion of the claim because ERISA places limits on the PBGC benefit guarantee. For example, PBGC generally does not guarantee annual benefits above a certain amount, currently about $44,000 per participant at age 65.[9] Additionally, benefit increases in the 5 years immediately preceding plan termination are not fully guaranteed, though PBGC will pay a portion of these increases.[10] The guarantee is limited to certain benefits, including so-called "shut-down benefits," -- significant subsidized early retirement benefits that are triggered by layoffs or plant closings that occur before plan termination. The guarantee does not generally include supplemental benefits, such as the temporary benefits that some plans pay to participants from the time they retire until they are eligible for Social Security benefits.

Following enactment of ERISA, however, concerns were raised about the potential losses that PBGC might face from the termination of underfunded plans. To protect PBGC, ERISA was amended in 1986 to require that plan sponsors meet certain additional conditions before terminating an underfunded plan. (See app I.) For example, sponsors could voluntarily terminate their underfunded plans only if they were bankrupt or generally unable to pay their debts without the termination.

Concerns about PBGC finances also resulted in efforts to strengthen the minimum funding rules incorporated by ERISA in the Internal Revenue Code (IRC). In 1987, for example, the IRC was amended to require that

[8]The termination of a fully funded defined-benefit pension plan is termed a standard termination. Plan sponsors may terminate fully funded plans by purchasing a group annuity contract from an insurance company under which the insurance company agrees to pay all accrued benefits or by paying lump-sum benefits to participants if permissible. The termination of an underfunded plan is termed a distress termination if the plan sponsor requests the termination or an involuntary termination if PBGC initiates the termination. PBGC may institute proceedings to terminate a plan if, among other things, the plan will be unable to pay benefits when due or the possible long-run loss to PBGC with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated. See 29 U.S.C. 1342(a).

[9]The amount guaranteed by PBGC is reduced for participants under age 65.

[10]The guaranteed amount of the benefit increase is calculated by multiplying the number of years the benefit increase has been in effect, not to exceed 5 years, by the greater of (1) 20 percent of the monthly benefit calculated in accordance with PBGC regulations or (2) $20 per month. See 29 C.F.R. 4022.25(b).

plan sponsors calculate each plan's current liability,[11] and make additional contributions to the plan if it is underfunded to the extent defined in the law.[12] As discussed in a report[13] we issued earlier this year, concerns that the 30-year Treasury bond rate no longer resulted in reasonable current liability calculations has led both the Congress and the administration to propose alternative rates for these calculations.[14]

Despite the 1987 amendments to ERISA, concerns about PBGC's financial condition persisted. In 1990, as part of our effort to call attention to high-risk areas in the federal government, we noted that weaknesses in the single-employer insurance program's financial condition threatened

[11]Under the IRC, current liability means all liabilities to employees and their beneficiaries under the plan. See 26 U.S.C. 412(l)(7)(A). In calculating current liabilities, the IRC requires plans to use an interest rate from within a permissible range of rates. See 26 U.S.C. 412(b)(5)(B). In 1987, the permissible range was not more than 10 percent above, and not more than 10 percent below, the weighted average of the rates of interest on 30-year Treasury bond securities during the 4-year period ending on the last day before the beginning of the plan year. The top of the permissible range was gradually reduced by 1 percent per year beginning with the 1995 plan year to not more than 5 percent above the weighted average rate effective for plan years beginning in 1999. The top of the permissible range was increased to 20 percent above the weighted average rate for 2002 and 2003. The weighted average rate is calculated as the average yield over 48 months with rates for the most recent 12 months weighted by 4, the second most recent 12 months weighted by 3, the third most recent 12 months weighted by 2, and the fourth weighted by 1.

[12]Under the additional funding rule, a single-employer plan sponsored by an employer with more than 100 employees in defined-benefit plans is subject to a deficit reduction contribution for a plan year if the value of plan assets is less than 90 percent of its current liability. However, a plan is not subject to the deficit reduction contribution if the value of plan assets (1) is at least 80 percent of current liability and (2) was at least 90 percent of current liability for each of the 2 immediately preceding years or each of the second and third immediately preceding years. To determine whether the additional funding rule applies to a plan, the IRC requires sponsors to calculate current liability using the highest interest rate allowable for the plan year. See 26 U.S.C. 412(l)(9)(C).

[13]U.S. General Accounting Office, *Private Pensions: Process Needed to Monitor the Mandated Interest Rate for Pension Calculations*, GAO-03-313 (Washington, D.C.: Feb. 27, 2003).

[14]*The Pension Preservation and Savings Expansion Act of 2003*, H.R. 1776, introduced April 11, 2003, would make a number of changes to the IRC to address retirement savings and private pension issues, including replacing the interest rate used for current liability calculations (currently, the rate on 30-year Treasury bonds) with a rate based on an index or indices of conservatively invested, long-term corporate bonds. In July of 2003, the Department of the Treasury unveiled *The Administration Proposal to Improve the Accuracy and Transparency of Pension Information*. Its stated purpose is to improve the accuracy of the pension liability discount rate, increase the transparency of pension plan information, and strengthen safeguards against pension underfunding.

PBGC's long-term viability.[15] We stated that minimum funding rules still did not ensure that plan sponsors would contribute enough for terminating plans to have sufficient assets to cover all promised benefits. In 1992, we also reported that PBGC had weaknesses in its internal controls and financial systems that placed the entire agency, and not just the single-employer program, at risk.[16] Three years later, we reported that legislation enacted in 1994 had strengthened PBGC's program weaknesses and that we believed improvements had been significant enough for us to remove the agency's high-risk designation.[17] Since that time, we have continued to monitor PBGC's financial condition and internal controls. For example, in 1998, we reported that adverse economic conditions could threaten PBGC's financial condition despite recent improvements;[18] in 2000, we reported that contracting weaknesses at PBGC, if uncorrected, could result in PBGC paying too much for required services;[19] and this year, we reported that weaknesses in the PBGC budgeting process limited its control over administrative expenses.[20]

PBGC receives no direct federal tax dollars to support the single-employer pension insurance program. The program receives the assets of terminated underfunded plans and any of the sponsor's assets that PBGC recovers

[15]Letter to the Chairman, Senate Committee on Governmental Affairs and House Committee on Government Operations, GAO/OCG-90-1, Jan. 23, 1990. GAO's high risk program has increasingly focused on those major programs and operations that need urgent attention and transformation to ensure that our national government functions in the most economical, efficient, and effective manner. Agencies or programs receiving a "high risk" designation receive greater attention from GAO and are assessed in regular reports, which generally coincide with the start of each new Congress.

[16]U.S. General Accounting Office, *High Risk Series: Pension Benefit Guaranty Corporation*, GAO/HR-93-5 (Washington, D.C.: Dec. 1992).

[17]U.S. General Accounting Office, *High-Risk Series: An Overview*, GAO/HR-95-1 (Washington, D.C.: Feb. 1995).

[18]U.S. General Accounting Office, *Pension Benefit Guaranty Corporation: Financial Condition Improving but Long-Term Risks Remain*, GAO/HEHS-99-5 (Washington, D.C.: Oct. 16, 1998).

[19]U.S. General Accounting Office, *Pension Benefit Guaranty Corporation: Contracting Management Needs Improvement*, GAO/HEHS-00-130 (Washington, D.C.: Sep. 18, 2000).

[20]U.S. General Accounting Office, *Pension Benefit Guaranty Corporation: Statutory Limitation on Administrative Expenses Does Not Provide Meaningful Control*, GAO-03-301 (Washington, D.C.: Feb. 28, 2003).

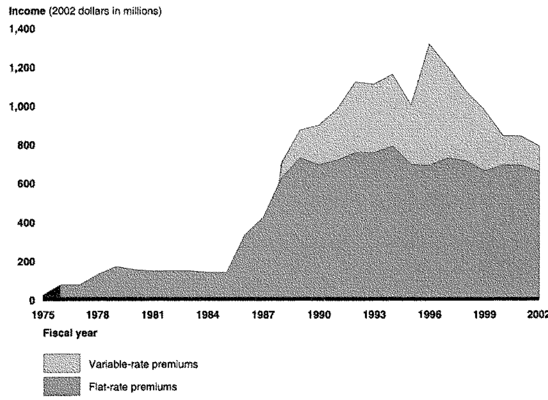
during bankruptcy proceedings.[21] PBGC finances the unfunded liabilities of terminated plans with (1) premiums paid by plan sponsors and (2) income earned from the investment of program assets.

Initially, plan sponsors paid only a flat-rate premium of $1 per participant per year; however, the flat rate has been increased over the years and is currently $19 per participant per year. To provide an incentive for sponsors to better fund their plans, a variable-rate premium was added in 1987. The variable-rate premium, which started at $6 for each $1,000 of unfunded vested benefits, was initially capped at $34 per participant. The variable rate was increased to $9 for each $1,000 of unfunded vested benefits starting in 1991, and the cap on variable-rate premiums was removed starting in 1996. After increasing sharply in the 1980s, flat-rate premium income declined from $753 million in 1993 to $654 million in 2002, in constant 2002 dollars.[22] (See fig. 1.) Income from the variable-rate premium fluctuated widely over that period.

[21]According to PBGC officials, PBGC files a claim for all unfunded benefits in bankruptcy proceedings. However, PBGC generally recovers only a small portion of the total unfunded benefit amount in bankruptcy proceedings, and the recovered amount is split between PBGC (for unfunded guaranteed benefits) and participants (for unfunded nonguaranteed benefits).

[22]In 2002 dollars, flat-rate premium income rose from $605 million in 1993 to $654 million in 2002.

Figure 1: Flat- and Variable- Rate Premium Income for the Single-Employer Pension Insurance Program, Fiscal Years 1975-2002

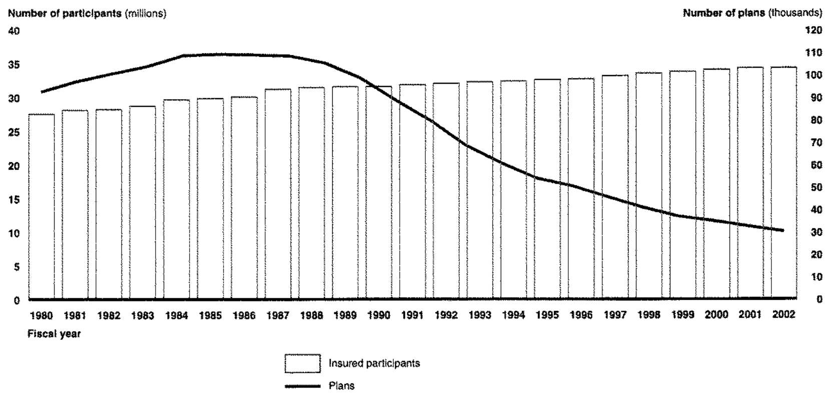


Source: PBGC.

Note: We adjusted PBGC data using the Consumer Price Index for All Urban Consumers: All Items.

The slight decline in flat-rate premium revenue over the last decade, in real dollars, indicates that the increase in insured participants has not been sufficient to offset the effects of inflation over the period. Essentially, while the number of participants has grown since 1980, growth has been sluggish. Additionally, after increasing during the early 1980s, the number of insured single-employer plans has decreased dramatically since 1986. (See fig. 2.)

Figure 2: Participants and Plans Covered by the Single-Employer Insurance Program, 1980-2002



Source: PBGC.

The decline in variable-rate premiums in 2002 may be due to a number of factors. For example, all else equal, an increase in the rate used to determine the present value of benefits reduces the degree to which reports indicate plans are underfunded, which reduces variable-rate premium payments. The Job Creation and Worker Assistance Act of 2002 increased the statutory interest rate for variable-rate premium calculations from 85 percent to 100 percent of the interest rate on 30-year U.S. Treasury securities for plan years beginning after December 31, 2001, and before January 1, 2004.[23]

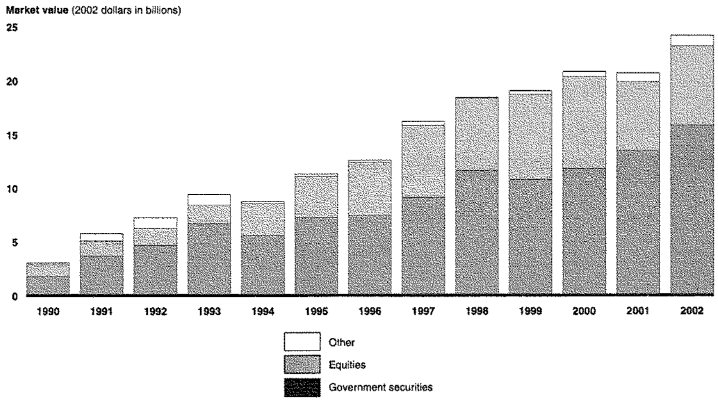
Investment income is also a large source of funds for the single-employer insurance program. The law requires PBGC to invest a portion of the funds generated by flat-rate premiums in obligations issued or guaranteed by the United States, but gives PBGC greater flexibility in the investment of other

[23]See section 405, P.L. 107-147, Mar. 9, 2002.

assets.[24] For example, PBGC may invest funds recovered from terminated plans and plan sponsors in equities, real estate, or other securities and funds from variable-rate premiums in government or private fixed-income securities. According to PBGC, however, by policy, it invests all premium income in Treasury securities. As a result of the law and investment policies, the majority of the single-employer program's assets are invested in Treasury securities. (See fig. 3.)

[24]PBGC accounts for single-employer program assets in separate trust and revolving funds. PBGC accounts for the assets of terminated plans and plan sponsors in a trust fund, which, according to PBGC, may be invested in equities, real estate, or other securities. PBGC accounts for single-employer program premiums in two revolving funds. One revolving fund is used for all variable-rate premiums, and that portion of the flat-rate premium attributable to the flat-rate in excess of $8.50. The law states that PBGC may invest this revolving fund in such obligations as it considers appropriate. See 29 U.S.C. 1305(f). The second revolving fund is used for the remaining flat-rate premiums, and the law restricts the investment of this revolving fund to obligations issued or guaranteed by the United States. See 29 U.S.C. 1305(b)(3).

Figure 3: Market Value of Single-Employer Program Assets in Revolving and Trust Funds at Year End, Fiscal Years 1990-2002

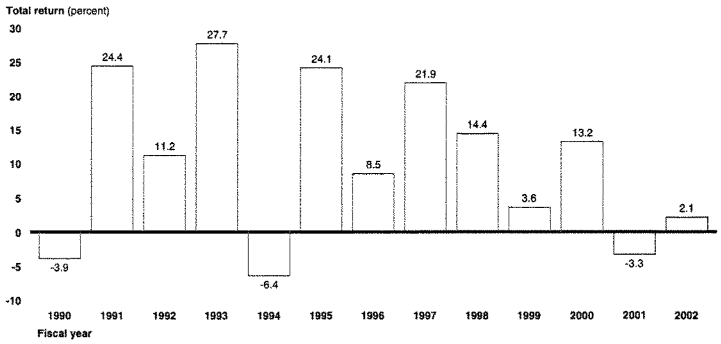


Source: PBGC annual reports.

Note: We adjusted PBGC data using the Consumer Price Index for All Urban Consumers: All Items.

Since 1990, except for 3 years, PBGC has achieved a positive return on the investments of single-employer program assets. (See fig 4.) According to PBGC, over the last 10 years, the total return on these investments has averaged about 10 percent.

Figure 4: Total Return on the Investment of Single-Employer Program Assets, Fiscal Years 1990-2002



Source: PBGC annual reports.

For the most part, liabilities of the single-employer pension insurance program are comprised of the present value of insured participant benefits. PBGC calculates present values using interest rate factors that, along with a specified mortality table, reflect annuity prices, net of administrative expenses, obtained from surveys of insurance companies conducted by the American Council of Life Insurers.[25] In addition to the estimated total liabilities of underfunded plans that have actually terminated, PBGC includes in program liabilities the estimated unfunded liabilities of underfunded plans that it believes will probably terminate in the near future.[26] PBGC may classify an underfunded plan as a probable termination when, among other things, the plan's sponsor is in liquidation under federal or state bankruptcy laws.

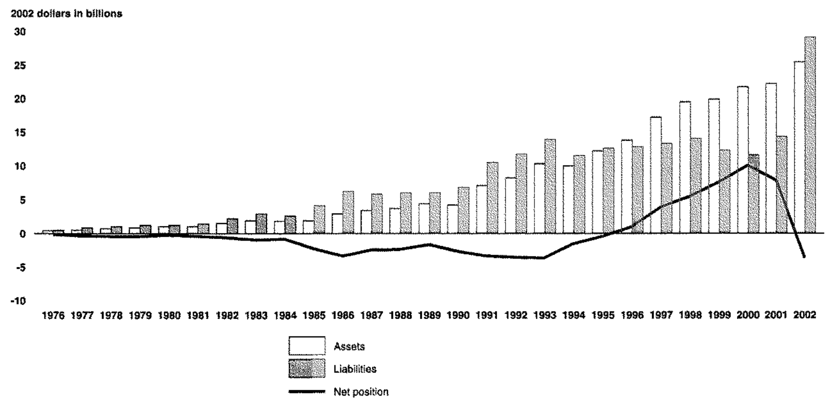
The single-employer program has had an accumulated deficit—that is, program assets have been less than the present value of benefits and other liabilities—for much of its existence. (See fig. 5.) In fiscal year 1996, the

[25]In 2002, PBGC used an interest rate factor of 5.70 percent for benefit payments through 2027 and a factor of 4.75 percent for benefit payments in the remaining years.

[26]Under Statement of Financial Accounting Standard Number 5, loss contingencies are classified as probable if the future event or events are likely to occur.

program had its first accumulated surplus, and by fiscal year 2000, the accumulated surplus had increased to almost $10 billion, in 2002 dollars. However, the program's finances reversed direction in 2001, and at the end of fiscal year 2002, its accumulated deficit was about $3.6 billion.

Figure 5: Assets, Liabilities, and Net Position of the Single-Employer Pension Insurance Program, Fiscal Years 1976-2002



Source: PBGC annual reports.

Note: Amounts for 1986 do not include plans subsequently returned to a reorganized LTV Corporation. We adjusted PBGC data using the Consumer Price Index for All Urban Consumers: All Items.

Termination of Severely Underfunded Plans Was Primary Factor in Financial Decline of Single-Employer Program

The financial condition of the single-employer pension insurance program returned to an accumulated deficit in 2002 largely due to the termination, or expected termination, of several severely underfunded pension plans. In 1992, we reported that many factors contributed to the degree plans were underfunded at termination, including the payment at termination of additional benefits, such as subsidized early retirement benefits, which have been promised to plan participants if plants or companies ceased operations.[27] These factors likely contributed to the degree that plans terminated in 2002 were underfunded. Factors that increased the severity of the plans' unfunded liability in 2002 were the recent sharp decline in the stock market and a general decline in interest rates. The current minimum funding rules and variable-rate premiums were not effective at preventing those plans from being severely underfunded at termination.

PBGC Assumed Responsibility for Several Severely Underfunded Plans in 2002

Total estimated losses in the single-employer program due to the actual or probable termination of underfunded plans increased from $1.5 billion in fiscal year 2001 to $9.3 billion in fiscal year 2002, in 2002 dollars. In addition to $3.0 billion in losses from the unfunded liabilities of terminated plans, the $9.3 billion included $6.3 billion in losses from the unfunded liabilities of plans that were expected to terminate in the near future. Some of the terminations considered probable at the end of fiscal year 2002 have already occurred; for example, in December 2002, PBGC involuntarily terminated an underfunded Bethlehem Steel Corporation pension plan, which resulted in the single-employer program assuming responsibility for about $7.2 billion in PBGC-guaranteed liabilities, about $3.7 billion of which was not funded at termination.

Much of the program's losses resulted from the termination of underfunded plans sponsored by failing steel companies. PBGC estimates that in 2002, underfunded steel company pension plans accounted for 80 percent of the $9.3 billion in program losses for the year. The three largest losses in the single-employer program's history resulted from to the termination of underfunded plans sponsored by failing steel companies: Bethlehem Steel, LTV Steel, and National Steel. All three plans were either completed terminations or listed as probable terminations for 2002. Giant vertically integrated steel companies, such as Bethlehem Steel, have faced

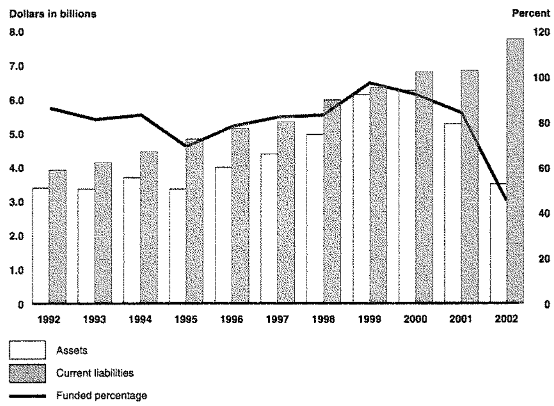
[27]U.S. General Accounting Office, *Pension Plans: Hidden Liabilities Increase Claims Against Government Insurance Programs*, GAO/HRD-93-7 (Washington, D.C.: Dec. 30, 1992).

extreme economic difficulty for decades, and efforts to salvage their defined-benefit plans have largely proved unsuccessful. According to PBGC's executive director, underfunded steel company pension plans have accounted for 58 percent of PBGC single-employer losses since 1975.

Plan Unfunded Liabilities Were Increased by Stock Market and Interest Rate Declines

The termination of underfunded plans in 2002 occurred after a sharp decline in the stock market had reduced plan asset values and a general decline in interest rates had increased plan liability values, and the sponsors did not make the contributions necessary to adequately fund the plans before they were terminated. The combined effect of these factors was a sharp increase in the unfunded liabilities of the terminating plans. According to annual reports (Annual Return/Report of Employee Benefit Plan, Form 5500) submitted by Bethlehem Steel Corporation, for example, in the 7 years from 1992 to 1999, the Bethlehem Steel pension plan went from 86 percent funded to 97 percent funded. (See fig. 6.) From 1999 to plan termination in December 2002, however, plan funding fell to 45 percent as assets decreased and liabilities increased, and sponsor contributions were not sufficient to offset the changes.

Figure 6: Assets, Liabilities, and Funded Status of the Bethlehem Steel Corporation Pension Plan, 1992-2002



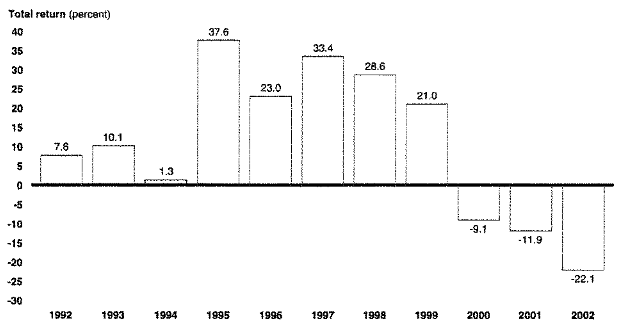
Source: Annual form 5500 reports and PBGC.

Note: Assets and liabilities for 1992 through 2001 are as of the beginning of the plan year. During that period, the interest rate used by Bethlehem Steel to value current liabilities decreased from 9.26 percent to 6.21 percent. Assets and liabilities for 2002 are PBGC estimates at termination in December 2002. Termination liabilities were valued using a rate of 5 percent.

A decline in the stock market, which began in 2000, was a major cause of the decline in plan asset values, and the associated increase in the degree that plans were underfunded at termination. For example, while total returns for stocks in the Standard and Poor's 500 index (S&P 500) exceeded 20 percent for each year from 1995 through 1999, they were negative starting in 2000, with negative returns reaching 22.1 percent in 2002. (See fig. 7.) Surveys of plan investments by Greenwich Associates indicated that defined-benefit plans in general had about 62.8 percent of their assets invested in U.S. and international stocks in 1999.[28]

[28]2002 U.S. Investment Management Study, Greenwich Associates, Greenwich, CT.

Figure 7: Total Return on Stocks in the S&P 500 Index, 1992-2002



Source: Standard and Poor's.

A stock market decline as severe as the one experienced from 2000 through 2002 can have a devastating effect on the funding of plans that had invested heavily in stocks. For example, according to a survey,[29] the Bethlehem Steel defined-benefit plan had about 73 percent of its assets (about \$4.3 billion of \$6.1 billion) invested in domestic and foreign stocks on September 30, 2000. One year later, assets had decreased \$1.5 billion, or 25 percent, and when the plan was terminated in December 2002, its assets had been reduced another 23 percent to about \$3.5 billion—far less than needed to finance an estimated \$7.2 billion in PBGC-guaranteed liabilities.[30] Over that same general period, stocks in the S&P 500 had a negative return of 38 percent.

In addition to the possible effect of the stock market's decline, a drop in interest rates likely had a negative effect on plan funding levels by increasing plan termination costs. Lower interest rates increase plan

[29]Pensions & Investments, Vol. 29, Issue 2 (Chicago; Jan. 22, 2001).

[30]According to the survey, the Bethlehem Steel Corporation pension plan made benefit payments of \$587 million between Sept. 30, 2000, and Sept. 30, 2001. Pensions and Investments, www.pionline.com/pension/pension.cfm (downloaded on June 13, 2003).

termination liabilities by increasing the present value of future benefit payments, which in turn increases the purchase price of group annuity contracts used to terminate defined-benefit pension plans.[31] For example, a PBGC analysis indicates that a drop in interest rates of 1 percentage point, from 6 percent to 5 percent, increased the termination liabilities of the Bethlehem Steel pension plan by about 9 percent, which indicates the cost of terminating the plan through the purchase of a group annuity contract would also have increased.[32]

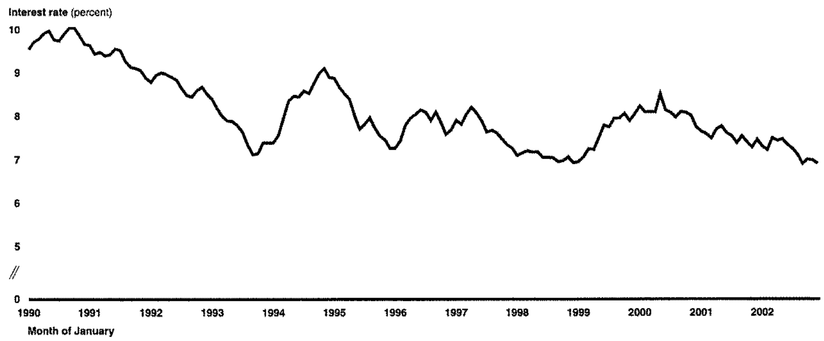
Relevant interest rates may have declined 3 percentage points or more since 1990.[33] For example, interest rates on long-term high-quality corporate bonds approached 10 percent at the start of the 1990s, but were below 7 percent at the end of 2002. (See fig. 8.)

[31]Present value calculations reflect the time value of money: a dollar in the future is worth less than a dollar today because the dollar today can be invested and earn interest. The calculation requires an assumption about the interest rate, which reflects how much could be earned from investing today's dollars. Assuming a lower interest rate increases the present value of future payments.

[32]The magnitude of an increase or decrease in plan liabilities associated with a given change in discount rates would depend on the demographic and other characteristics of each plan.

[33]To terminate a defined-benefit pension plan without submitting a claim to PBGC, the plan sponsor determines the benefits that have been earned by each participant up to the time of plan termination and purchases a single-premium group annuity contract from an insurance company, under which the insurance company guarantees to pay the accrued benefits when they are due. Interest rates on long-term, high-quality fixed-income securities are an important factor in pricing group annuity contracts because insurance companies tend to invest premiums in such securities to finance annuity payments. Other factors that would have affected group annuity prices include changes in insurance company assumptions about mortality rates and administrative costs.

Figure 8: Interest Rates on Long-Term High-Quality Corporate Bonds, 1990-2002



Source: Moody's Investor Services.

Minimum Funding Rules and Variable-Rate Premiums Did Not Prevent Plans from Being Severely Underfunded

IRC minimum funding rules and ERISA variable rate premiums, which are designed to ensure plan sponsors adequately fund their plans, did not have the desired effect for the terminated plans that were added to the single-employer program in 2002. The amount of contributions required under IRC minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years.[34] Also, the rules require the sponsor to make an additional contribution if the plan is underfunded to the extent defined in the law. However, plan funding is measured using current liabilities, which a PBGC analysis indicates have been typically less than termination liabilities.[35] Additionally, plans can earn funding credits, which can be used to offset minimum funding contributions in

[34]Minimum funding rules permit certain plan liabilities, such as past service liabilities, to be amortized over specified time periods. See 26 U.S.C. 412(b)(2)(B). Past service liabilities occur when benefits are granted for service before the plan was set up or when benefit increases after the set up date are made retroactive.

[35] For the analysis, PBGC used termination liabilities reported to it under 29 C.F.R. sec 4010.

later years, by contributing more than required according to minimum funding rules. Therefore, sponsors of underfunded plans may avoid or reduce minimum funding contributions to the extent their plan has a credit balance in the account, referred to as the funding standard account, used by plans to track minimum funding contributions.[36]

While minimum-funding rules may encourage sponsors to better fund their plans, the rules require sponsors to assess plan funding using current liabilities, which a PBGC analysis indicates have been typically less than termination liabilities. Current and termination liabilities differ because the assumptions used to calculate them differ. For example, some plan participants may retire earlier if a plan is terminated than they would if the plan continues operations, and lowering the assumed retirement age generally increases plan liabilities, especially if early retirement benefits are subsidized.

Other aspects of minimum funding rules may limit their ability to affect the funding of certain plans as their sponsors approach bankruptcy. According to its annual reports, for example, Bethlehem Steel contributed about $3.0 billion to its pension plan for plan years 1986 through 1996. According to the reports, the plan had a credit balance of over $800 million at the end of plan year 1996. Starting in 1997, Bethlehem Steel reduced its contributions to the plan and, according to annual reports, contributed only about $71.3 million for plan years 1997 through 2001. The plan's 2001 actuarial report indicates that Bethlehem Steel's minimum required contribution for the plan year ending December 31, 2001, would have been $270 million in the absence of a credit balance; however, the opening credit balance in the plan's funding standard account as of January 1, 2001, was $711 million. Therefore, Bethlehem Steel was not required to make any contributions during the year.

Other IRC funding rules may have prevented some sponsors from making contributions to plans that in 2002 were terminated at a loss to the single-employer program. For example, on January 1, 2000, the Polaroid pension plan's assets were about $1.3 billion compared to accrued liabilities of about $1.1 billion—the plan was more than 100-percent funded. The plan's actuarial report for that year indicates that the plan sponsor was precluded by the IRC funding rules from making a tax-deductible

[36]See 26 U.S.C. 412(b).

contribution to the plan.[37] In July 2002, PBGC terminated the Polaroid pension plan, and the single-employer program assumed responsibility for $321.8 million in unfunded PBGC-guaranteed liabilities for the plan. The plan was about 67 percent funded, with assets of about $657 million to pay estimated PBGC-guaranteed liabilities of about $979 million.

Another ERISA provision, concerning the payment of variable-rate premiums, is also designed to encourage employers to better fund their plans. As with minimum funding rules, the variable-rate premium did not provide sufficient incentives for the sponsors of the plans that we reviewed to make the contributions necessary to adequately fund their plans. None of the three underfunded plans that we reviewed, which became losses to the single-employer program in 2002 and 2003, paid a variable-rate premium in the 2001 plan year. Plans are exempt from the variable-rate premium if they are at the full-funding limit in the year preceding the premium payment year, in this case 2000, after application of any contributions and credit balances in the funding standard account. Each of these four plans met this criterion.

PBGC Faces Long-Term Financial Risks from a Potential Imbalance of Assets and Liabilities

Two primary risks threaten the long-term financial viability of the single-employer program. The greater risk concerns the program's liabilities: large losses, due to bankrupt firms with severely underfunded pension plans, could continue or accelerate. This could occur if returns on investment remain poor, interest rates stay low, and economic problems persist. More troubling for liabilities is the possibility that structural weaknesses in industries with large underfunded plans, including those greatly affected by increasing global competition, combined with the general shift toward defined-contribution pension plans, could jeopardize the long-term viability of the defined-benefit system. On the asset side, PBGC also faces the risk that it may not receive sufficient revenue from premium payments and investments to offset the losses experienced by the single-employer program in 2002 or that this program may experience in the future. This could happen if program participation falls or if PBGC earns a return on its assets below the rate it uses to value its liabilities.

[37]See 26 U.S.C. 404(a)(1) and 26 U.S.C. 412(c)(7). The sponsor might have been able to make a contribution to the plan had it selected a lower interest rate for valuing current liabilities. Polaroid used the highest interest rate permitted by law for its calculations.

Several Factors Affect the Degree to Which Plans Are Underfunded and the Likelihood That Plan Sponsors Will Go Bankrupt

Plan terminations affect the single-employer program's financial condition because PBGC takes responsibility for paying benefits to participants of underfunded terminated plans. Several factors would increase the likelihood that sponsoring firms will go bankrupt, and therefore will need to terminate their pension plans, and the likelihood that those plans will be underfunded at termination. Among these are poor investment returns, low interest rates, and continued weakness in the national economy and or specific sectors. Particularly troubling may be structural weaknesses in certain industries with large underfunded defined-benefit plans.

Poor investment returns from a decline in the stock market can affect the funding of pension plans. To the extent that pension plans invest in stocks, the decline in the stock market will increase the chance that plans will be underfunded should they terminate. A Greenwich Associates survey of defined-benefit plan investments indicates that 59.4 percent of plan assets were invested in stocks in 2002.[38] Clearly, the future direction of the stock market is very difficult to forecast. From the end of 1999 through the end of 2002, the stock market, as measured by the S&P 500, declined by about 40 percent, but has since partially recovered those losses, increasing by over 13 percent (of a smaller base) during 2003, as of August. From January 1975, the beginning of the first year following the passage of ERISA, through July 2003, the S&P 500 grew at an average compounded nominal annual rate of 9.8 percent.

A decline in asset values can be particularly problematic for plans if interest rates remain low or fall, which raises plan liabilities, all else equal. The interest rate on 30-year U.S. Treasury securities, from which discount rates to value plan current liabilities are derived, has remained below 5 percent since September 2002, its lowest level in over 25 years.[39] Falling interest rates raise the price of group annuities that a terminating plan must purchase to cover its promised benefits and increase the likelihood that a terminating plan will not have sufficient assets to make such a

[38]2002 U.S. Investment Management Study, Greenwich Associates, Greenwich, CT.

[39]The U.S. Treasury stopped publishing a 30-year Treasury bond rate in February 2002, but the Internal Revenue Service publishes rates for pension calculations based on rates for the last-issued bonds in February 2001. Interest rates to calculate plan liabilities must be within a "permissible range" around a 4-year weighted average of 30-year Treasury bond rates; the permissible range for plan years beginning in 2002 and 2003 was 90 to 120 percent of this 4-year weighted average.

purchase.[40] An increase in liabilities due to falling interest rates also means that companies may be required under the minimum funding rules to increase contributions to their plans. This can create financial strain and increase the chances of the firm going bankrupt, thus increasing the risk that PBGC will have to take over an underfunded plan.

Economic weakness can also lead to greater underfunding of plans and to a greater risk that underfunded plans will terminate. For many firms, slow or declining economic growth causes revenues to decline, which makes contributions to pension plans more difficult. Economic sluggishness also raises the likelihood that firms sponsoring pension plans will go bankrupt. Three of the last five annual increases in bankruptcies coincided with recessions, and the record economic expansion of the 1990s is associated with a substantial decline in bankruptcies. Annual plan terminations resulting in losses to the single-employer program rose from 83 in 1989 to 175 in 1991, and, after declining to 65 in 2000, the number reached 93 in 2001.[41]

Weakness in certain industries, particularly the airline and automotive industries, may threaten the viability of the single-employer program. Because PBGC has already absorbed most of the pension plans of steel companies, it is the airline industry, with $26 billion of total pension underfunding, and the automotive sector, with over $60 billion in underfunding, that currently represent PBGC's greatest future financial risks. In recent years, profit pressures within the U.S. airline industry have been amplified by severe price competition, recession, terrorism, the war in Iraq, and the outbreak of Severe Acute Respiratory Syndrome (SARS), creating recent bankruptcies and uncertainty for the future financial health of the industry. As one pension expert noted, a potentially exacerbating risk in weak industries is the cumulative effect of bankruptcy; that is, if a critical mass of firms go bankrupt and terminate their underfunded pension plans, others, in order to remain competitive, may also declare bankruptcy to avoid the cost of funding their plans.

[40] A potentially offsetting effect of falling interest rates is the possible increased return on fixed-income assets that plans, or PBGC, hold. When interest rates fall, the value of existing fixed-income securities with time left to maturity rises.

[41] The last three recessions on record in the United States occurred during 1981, 1990-91, and 2001. (See www.bea.gov/bea/dn/gdpchg.xls.)

Because the financial condition of both firms and their pension plans can eventually affect PBGC's financial condition, PBGC tries to determine how many firms are at risk of terminating their pension plans and the total amount of unfunded vested benefits. According to PBGC's fiscal year 2002 estimates, the agency is at potential risk of taking over $35 billion in unfunded vested benefits from plans that are sponsored by financially weak companies and could terminate.[42] Almost one-third of these unfunded benefits, about $11.4 billion, are in the airline industry. Additionally, PBGC estimates that it could become responsible for over $15 billion in shutdown benefits in PBGC-insured plans.

PBGC uses a model called the Pension Insurance Modeling System (PIMS) to simulate the flow of claims to the single-employer program and to project its potential financial condition over a 10-year period. This model produces a very wide range of possible outcomes for PBGC's future net financial position.[43]

Revenue from Premiums and Investments May Not Offset Program's Current Deficit or Possible Future Losses

To be viable in the long term, the single-employer program must receive sufficient income from premiums and investments to offset losses due to terminating underfunded plans. A number of factors could cause the program's revenues to fall short of this goal or decline outright. For example, fixed-rate premiums would decline if the number of participants covered by the program decreases, which may happen if plans leave the system and are not replaced. Additionally, the program's financial condition would deteriorate to the extent investment returns fall below the assumed interest rate used to value liabilities.

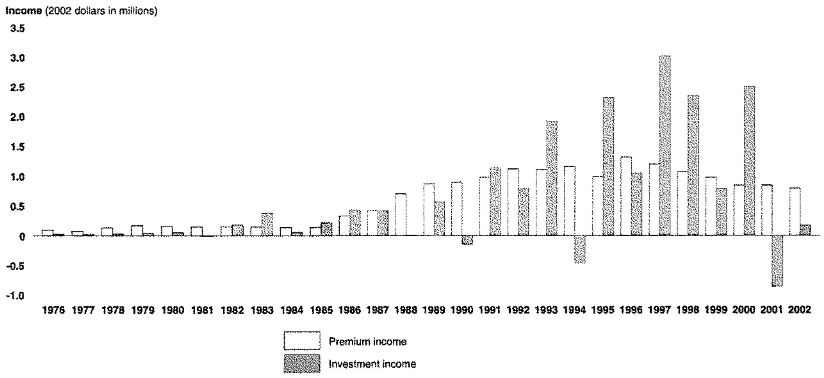
Annual PBGC income from premiums and investments averaged $1.3 billion from 1976 to 2002, in 2002 dollars, and $2 billion since 1988, when variable-rate premiums were introduced. Since 1988, investment income has on average equaled premium income, but has varied more than premium income, including 3 years in which investment income fell below

[42] This estimate comprises "reasonably possible" terminations, which include plans sponsored by companies with credit quality below investment grade that may terminate, though likely not by year-end. Plan participants have a nonforfeitable right to vested benefits, as opposed to nonvested benefits, for which participants have not yet completed qualification requirements.

[43] PBGC began using PIMS to project its future financial condition in 1998. Prior to this, PBGC provided low-, medium-, and high-loss forecasts, which were extrapolations from the agency's claims experience and the economic conditions of the previous 2 decades.

zero. (See fig. 9.) In 2001, total premium and investment was negative and in 2002 equaled approximately $1 billion.

Figure 9: PBGC Premium and Investment Income, 1976-2002



Source: PBGC annual financial reports.

Note: We adjusted PBGC data using the Consumer Price Index for All Urban Consumers: All Items.

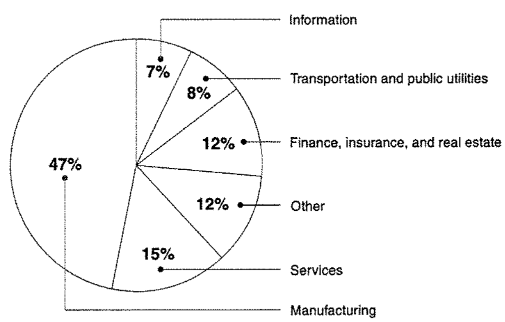
Premium revenue for PBGC would likely decline if the total number of plans and participants terminating their defined-benefit plans exceeded the new plans and participants joining the system. This decline in participation would mean a decline in PBGC's flat-rate premiums. If more plans become underfunded, this could possibly raise the revenue PBGC receives from variable-rate premiums, but would also be likely to raise the overall risk of plans terminating with unfunded liabilities. Premium income, in 2002 dollars, has fallen every year since 1996, even though the Congress lifted the cap on variable-rate premiums in that year.

The decline in the number of plans PBGC insures may cast doubt on its ability to increase premium income in the future. The number of PBGC-insured plans has decreased steadily from approximately 110,000 in 1987 to around 30,000 in 2002.[44] While the number of total participants in PBGC-insured single-employer plans has grown approximately 25 percent since 1980, the percentage of participants who are active workers has declined from 78 percent in 1980 to 53 percent in 2000. Manufacturing, a sector with virtually no job growth in the last half-century, accounted for almost half of PBGC's single-employer program participants in 2001, suggesting that the program needs to rely on other sectors for any growth in premium income. (See fig 10.) In addition, a growing percentage of plans have recently become hybrid plans, such as cash-balance plans, that incorporate characteristics of both defined-contribution and defined-benefit plans. Hybrid plans are more likely than traditional defined-benefit plans to offer participants the option of taking benefits as a lump-sum distribution. If the proliferation of hybrid plans increases the number of participants taking lump sums instead of retirement annuities, over time this would reduce the number of plan participants, thus potentially reducing PBGC's flat-rate premium revenue.[45] Unless something reverses these trends, PBGC may have a shrinking plan and participant base to support the program in the future and that base may be concentrated in certain, potentially more vulnerable industries.

[44]In contrast, defined-contribution plans have grown significantly over a similar period—from 462,000 plans in 1985 to 674,000 plans in 1998.

[45]If a plan sponsor purchases an annuity for a retiree from an insurance company to pay benefits, this would also remove the retiree from the participant pool, which would have the same effect on flat-rate premiums.

Figure 10: Distribution of PBGC-Insured Participants by Industry, 2001



Source: PBGC.

Note: Percentages do not sum to 100 due to rounding.

Even more problematic than the possibility of falling premium income may be that PBGC's premium structure does not reflect many of the risks that affect the probability that a plan will terminate and impose a loss on PBGC. While PBGC charges plan sponsors a variable-rate premium based on the plan's level of underfunding, premiums do not consider other relevant risk factors, such as the economic strength of the sponsor, plan asset investment strategies, the plan's benefit structure, or the plans demographic profile. Because these affect the risk of PBGC having to take over an underfunded pension plan, it is possible that PBGC's premiums will not adequately and equitably protect the agency against future losses. The recent terminations of some plans that showed credit balances shortly before terminating with large underfunded balances lend some evidence to this possibility. Sponsors also pay flat-rate premiums in addition to variable-rate premiums, but these reflect only the number of plan participants and not other risk factors that affect PBGC's potential exposure to losses. Full-funding limitations may exacerbate the risk of underfunded terminations by preventing firms from contributing to their plans during strong economic times when asset values are high and firms are in the best financial position to make contributions.

Also, it may be difficult for PBGC to diversify its pool of insured plans among strong and weak sponsors and plans. In addition to facing firm-specific risk that an individual underfunded plan may terminate, PBGC faces market risk that a poor economy may lead to widespread underfunded terminations during the same period, which potentially could cause very large losses for PBGC. Similarly, PBGC may face risk from insuring plans concentrated in vulnerable industries that may suffer bankruptcies over a short time period, as has happened recently in the steel and airline industries. One study estimates that the overall premiums collected by PBGC amount to about 50 percent of what a private insurer would charge because its premiums do not account for this market risk.[46]

The net financial position of the single-employer program also depends heavily on the long-term rate of return that PBGC achieves from the investment of the program's assets. All else equal, PBGC's net financial condition would improve if its total net return on invested assets exceeded the discount rate it used to value its liabilities. For example, between 1993 and 2000 the financial position of the single-employer program benefited from higher rates of return on its invested assets and its financial condition improved. However, if the rate of return on assets falls below the discount rate, PBGC's finances would worsen, all else equal. As of September 30, 2002, PBGC had approximately 65 percent of its single-employer program investments in U.S. government securities and approximately 30 percent in equities. The high percentage of assets invested in Treasury securities, which typically earn low yields because they are considered to be relatively "risk-free" assets, may limit the total return on PBGC's portfolio.[47] Additionally, PBGC bases its discount rate on surveys of insurance company group annuity prices, and because PBGC invests differently than do insurance companies, we might expect some divergence between the discount rate and PBGC's rate of return on assets. PBGC's return on total invested funds was 2.1 percent for the year ending September 30, 2002, and 5.8 percent for the 5-year period ending on that date. For fiscal year 2002, PBGC used an annual discount rate of 5.70 percent to determine the present value of future benefit payments through 2027 and a rate of 4.75 percent for payments made in the remaining years.

[46]Boyce, Steven and Richard A. Ippolito, "The Cost of Pension Insurance," *The Journal of Risk and Insurance*, (2002) Vol. 69, No.2, p. 121-170.

[47]The return on fixed-income assets sold before maturity may also be affected by capital gains (or losses). The price of a bond moves in the opposite direction as interest rates, and so if interest rates fall, bondholders may reap capital gains.

The magnitude and uncertainty of these long-term financial risks pose particular challenges for the PBGC's single-employer insurance program and potentially for the federal budget. In 1990, we began a special effort to review and report on the federal program areas we considered high risk because they were especially vulnerable to waste, fraud, abuse, and mismanagement. In the past, we considered PBGC to be on our high-risk list because of concern about the program's viability and about management deficiencies that hindered that agency's ability to effectively assess and monitor its financial condition. The current challenges to PBGC's single-employer insurance program concern immediate as well as long-term financial difficulties, which are more structural weaknesses rather than operational or internal control deficiencies. Nevertheless, because of serious risks to the program's viability, we have placed the PBGC single-employer insurance program on our high-risk list.

Options That Address Challenges to PBGC Have Advantages and Disadvantages

Although some pension professionals have suggested a "wait and see" approach, betting that brighter economic conditions improving PBGC's future financial condition are imminent, agency officials and other pension professionals have suggested taking a more prudent, proactive approach, identifying a variety of options that could address the challenges facing PBGC's single-employer program. In our view, several types of reforms should be considered. The first would be to improve the availability of information about plan funding, plan investments, and PBGC guarantees available to plan participants and others. A second would be to strengthen funding rules applicable to poorly funded plans to help ensure plans are better funded should they be terminated in the future. A third would be to reform PBGC by restructuring its benefit guarantees and premiums. Guarantees for certain unfunded benefits, such as so-called shutdown benefits, could be modified. With respect to variable-rate premiums, in addition to the plan's funding status, consideration should be given to the economic strength of the plan's sponsor, the allocation of the plan's investment portfolio, the plan's benefit structure, and participant demographics. Several variations exist within these options and each option has advantages and disadvantages. In any event, the changes adopted to address the challenges facing PBGC should improve the transparency of the plan's financial information, provide plan sponsors with incentives to increase plan funding, and provide a means to hold sponsors accountable for adequately funding their plans.

To address challenges to PBGC's financial condition include, we could:

Increase transparency of plan information. Improving the availability of information to plan participants and others about plan funding, plan investments, and PBGC guarantees may give plan sponsors additional incentives to increase plan funding and make participants better able to plan for their retirement.

ERISA could be amended to require:

- **Disclosing termination liability.** Under a recent administration proposal,[48] sponsors would be required to report plan termination liability annually. Under current law, sponsors are required to report a plan's current liability for funding purposes, which often can be less than termination liability. In addition, only participants in plans below a certain funding threshold – based on current liability rather than termination liability – receive annual notices of the funding status of their plans. In either case, plan participants may be unaware of the degree to which their plan is underfunded until it terminates. However, representatives of plan sponsors have stated that financially strong companies that are able to make good on their pension promises should not be burdened with additional complex and costly disclosure requirements that could be confusing or irrelevant to plan participants.
- **Disclosing plan investments.** Disclosing plan asset allocation information may give plan sponsors an incentive to increase funding of underfunded plans or limit the level of equity investments in their plans. Currently, only participants in plans below a certain funding threshold receive annual notices of the funding status of their plans, and the information plans currently must provide does not reflect how the plan's assets are invested. For example, notices to participants could include how much is invested in the sponsor's securities.
- **Disclosing plan funding status and benefit guarantee limitations to additional participants.** Expanding the circumstances under which sponsors must notify participants of plan underfunding and PBGC guarantee limitations might give sponsors an additional incentive to increase plan funding and would enable more participants to better plan their retirement. The ERISA requirement that plan sponsors notify participants and beneficiaries of the plan's funding status and limits on the PBGC guarantee currently goes into effect

[48]*The Administration Proposal to Improve the Accuracy and Transparency of Pension Information.* (July 8, 2003).

when plans are required to pay variable-rate premiums and meet certain other requirements.[49] As a result, many plan participants, including participants of the Bethlehem Steel pension plan, have not received such notifications in the years immediately preceding plan termination. Termination of a severely underfunded plan can significantly reduce the benefits participants receive. For example, 59-year old pilots were expecting annual benefits of $110,000 per year on average when the US Airways plan was terminated in 2003, while the maximum PBGC-guaranteed benefit at age 60 is $28,600 per year.[50]

Strengthen funding rules. Funding rules could be strengthened to increase minimum contributions to underfunded plans and to allow

[49] See 29 U.S.C. 1311 and 29 C.F.R. 4011.3.

[50] However, the actual benefit paid by PBGC depends on a number of factors and may exceed the maximum guaranteed benefit. For example, PBGC expects that the average annual benefit paid to U.S. Airways pilots who are 59 years of age with 29 years of service will be about $85,000, including nonguaranteed amounts. PBGC said that many US Airways pilots will receive more that the $28,600 maximum limit because, according to priorities established under ERISA, pension plan participants may receive benefits in excess of the guaranteed amounts if there are enough assets or recoveries from the plan sponsors. For example, a participant who could have retired three years prior to plan termination (but did not) may be eligible to receive both guaranteed and nonguaranteed amounts. PBGC letter in response to follow-up questions from the Committee on Finance, United States Senate (Washington, D.C.: Apr.1, 2003).

additional contributions to fully funded plans.[51] This approach would improve plan funding over time, while limiting the losses PBGC would incur when a plan is terminated. However, even if funding rules were to be strengthened immediately, it could take years for the change to have a meaningful effect on PBGC's financial condition. In addition, such a change would require some sponsors to allocate additional resources to their pension plans, which may cause the plan sponsor of an underfunded plan to provide less generous wage or other benefits than would otherwise be provided.

The IRC could be amended to strengthen the funding rules by:

- **Basing minimum contributions on termination liabilities.** One way to strengthen funding rules is to require plans to base minimum funding contributions and full-funding limits on plan termination liabilities, rather than current liabilities. Since plan termination liabilities are typically higher than current liabilities, such a change would likely reduce potential claims against PBGC. One problem with

[51]If the Congress chooses to replace the 30-year Treasury rate used to calculate pension plan liabilities, the level of the interest rate selected can also affect plan funding. For example, if a rate that is higher than the current rate is selected, plan liabilities would appear better funded, thereby decreasing minimum and maximum employer contributions. In addition, some plans would reach full-funding limitations and avoid having to pay variable-rate premiums. Therefore, PBGC would receive less revenue. Conversely, a lower rate would likely improve PBGC's financial condition. In 1987, when the 30-year Treasury rate was adopted for use in certain pension calculations, the Congress intended that the interest rate used for current liability calculations would, within certain parameters, reflect the price an insurance company would charge to take responsibility for the plans pension payments. However, in the late 1990s, when fewer 30-year Treasury bonds were issued and economic conditions increased demand for the bonds, the 30-year Treasury rate diverged from other long-term interest rates, an indication that it also may have diverged from group annuity purchase rates. In 2001, Treasury stopped issuing these bonds altogether, and in March 2002, the Congress enacted temporary measures to alleviate employer concerns that low interest rates on the remaining 30-year Treasury bonds were affecting the reasonableness of the interest rate for employer pension calculations. Selecting a replacement rate is difficult because little information exists on which to base the selection. Other than the survey conducted for PBGC, no mechanism exists to collect information on actual group annuity purchase rates. Compared to other alternatives, the PBGC interest rate factors may have the most direct connection to the group annuity market, but PBGC factors are less transparent than market-determined alternatives. Long-term market rates may track changes in group annuity rates over time, but their proximity to group annuity rates is also uncertain. For example, an interest rate based on a long-term market rate, such as corporate bond indexes, may need to be adjusted downward to better reflect the level of group annuity purchase rates. However, as we stated in our report earlier this year, establishing a process for regulatory adjustments to any rate selected may make it more suitable for pension plan liability calculations. See GAO-03-313.

this approach is the difficulty plan sponsors would have determining the appropriate interest rate to use in valuing termination liabilities. As we reported, selecting an appropriate interest rate is difficult because little information exists on which to base the selection.[52] In addition, requiring financially strong sponsors to fund a plan's termination liabilities may encourage them to curtail or terminate those plans.

- **Strengthening minimum funding rules.** Altering the threshold for the additional funding rule or the accumulation and use of credit balances would likely increase contribution requirements for some underfunded plans. To determine whether the additional funding rule applies to a plan, the IRC requires sponsors to calculate current liability using the highest interest rate allowable for the plan year, which results in the lowest possible value for current liability. Basing the threshold on a termination liability rate rather than the highest possible current liability rate, might help prevent the sponsor of an underfunded plan to avoid making an additional contribution. In addition, if a sponsor makes a contribution in any given year that exceeds the minimum required contribution, the excess plus interest would be credited against future required contributions. Limiting the use of credit balances to offset contribution requirements might also prevent sponsors of significantly underfunded plans from avoiding contributions. Such limitations might also be applied on the basis of the plan sponsor's poor cash flow position or credit rating. However, significantly reducing the existing funding flexibility of financially strong sponsors might encourage them to curtail or terminate their plans.

- **Raising full-funding limitations**. Raising full-funding limitations may help decrease the level of underfunding in pension plans. The IRC and ERISA impose full-funding limitations that restrict certain tax-deductible contributions to prevent plan sponsors from contributing more to their plan than is necessary to cover accrued future benefits.[53] The advantage to raising these limitations is that such additional contributions might result in pension plans being better funded, decreasing the likelihood that they will be underfunded should they terminate. In addition, increasing full-funding limitations may be

[52]GAO-03-313.

[53]Employers are generally subject to an excise tax for failure to make required contributions or for making contributions in excess of the greater of the maximum deductible amount or the ERISA full-funding limit.

advantageous to plan sponsors because contributions made during times of prosperity may carry over, allowing them to avoid minimum funding contributions during less prosperous times. For example, the current limitation on tax-deductible contributions for plans with assets at 100 percent of current liability could be increased.[54] The disadvantage of raising the full-funding limitations is that the federal government would receive less tax revenue because of increases in tax-deductible contributions.

Reform PBGC's benefit guarantee and premium structure.

Reduce benefit guarantees. Reducing certain guaranteed benefits that plan sponsors are not currently required to fund could decrease losses incurred by PBGC from underfunded plans. This approach could preserve plan assets by preventing additional losses that PBGC would incur when a plan is terminated. However, participants would lose benefits provided by some plan sponsors. In addition, PBGC's premium rates could be increased or restructured to improve PBGC's financial condition. Changing premiums could increase PBGC's revenue or provide an incentive for plan sponsors to better fund their plans. However, premium changes that are not based on the degree of risk posed by different plans may force financially healthy companies out of the defined-benefit system and discourage other plan sponsors from entering the system. Various actions could be taken to reduce guaranteed benefits. These include:

- **Phasing-in the guarantee of shutdown benefits.** PBGC is concerned about its exposure to the level of shutdown benefits that it guarantees. Shutdown benefits provide additional benefits, such as significant early retirement benefit subsidies to participants affected by a plant closing or a permanent layoff. Such benefits are primarily found in the pension plans of large unionized companies in the auto, steel, and tire industries. In general, shutdown benefits cannot be adequately funded before a shutdown occurs. Phasing in guarantees from the date of the applicable shutdown could decrease the losses incurred by

[54] For example, one way to do this would be to allow deductions within a corridor of up to 130 percent of current liabilities. Gebhardtsbauer, Ron. American Academy of Actuaries testimony before the Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce, U.S. House of Representatives, Hearing on *Strengthening Pension Security: Examining the Health and Future of Defined Benefit Pension Plans.* (Washington, D.C.: June 4, 2003), 9.

PBGC from underfunded plans.[55] However, modifying these benefits would reduce the early retirement benefits for participants who are in plans with such provisions and are affected by a plant closing or a permanent layoff. Dislocated workers, particularly in manufacturing, may suffer additional losses from lengthy periods of unemployment or from finding reemployment only at much lower wages.

- **Eliminating or reducing unfunded benefit increases.** Currently, plan sponsors must meet certain conditions before increasing the benefits of plans that are less than 60 percent funded.[56] Eliminating benefit increases or increasing this percentage could decrease the losses incurred by PBGC from underfunded plans. Plan sponsors have said that the disadvantage of such changes is that they would limit an employer's flexibility with regard to setting compensation, making it more difficult to respond to labor market developments. For example, a plan sponsor might prefer to offer participants increased pension payments or shutdown benefits instead of offering increased wages because pension benefits can be deferred—providing time for the plan sponsor to improve its financial condition—while wage increases have an immediate effect on the plan sponsor's financial condition.

Two actions that could be taken to change premiums are

- **Increasing fixed-rate premium.** The current fixed rate of $19 per participant annually could be increased. Since the inception of PBGC, this rate has been raised four times, most recently in 1991 when it was raised from $16 to $19. Such increases generally raise premium income for PBGC, but the current fixed-rate premium has not reflected the changes in inflation since 1991. By indexing the rate to the consumer price index, changes to the premium would be consistent with inflation. However, any increases in the fixed-rate premium would affect all plans regardless of the adequacy of their funding.

- **Increasing or restructuring variable-rate premium.** The current variable-rate premium of $9 per $1,000 of unfunded liability could be

[55] Currently, some measures exist to limit the losses incurred by PBGC from newly terminated plans. PBGC is responsible for only a portion of all benefit increases that the sponsor adds in the 5 years leading up to termination.

[56] IRC provides generally that a plan less than 60 percent funded on a current liability basis may not increase benefits without either immediately funding the increase or providing security. See 26 U.S.C. 401(a)(29).

increased. The rate could also be adjusted so that plans with less adequate funding pay a higher rate. Premium rates could also be restructured based on the degree of risk posed by different plans, which could be assessed by considering the financial strength and prospects of the plan's sponsor, the risk of the plan's investment portfolio, participant demographics, and the plan's benefit structure – including plans that have lump-sum,[57] shutdown benefit, and floor-offset provisions.[58] One advantage of a rate increase or restructuring is that it might improve accountability by providing for a more direct relationship between the amount of premium paid and the risk of underfunding. A disadvantage is that it could further burden already struggling plan sponsors at a time when they can least afford it, or it could reduce plan assets, increasing the likelihood that underfunded plans will terminate. A program with premiums that are more risk-based could also be more challenging for PBGC to administer.

Conclusion

The current financial challenges facing PBGC and the array of policy options to address those challenges are more appropriately viewed within the context of the agency's overall mission. In 1974, ERISA placed three important charges on PBGC: first, protect the pension benefits so essential to the retirement security of hard working Americans; second, minimize the pension insurance premiums and other costs of carrying out the agency's obligations; and finally, foster the health of the private defined-benefit pension plan system. While addressing one or even two of these goals would be a challenge, it is a far more formidable endeavor to fulfill all three. In any event, any changes adopted to address the challenges facing PBGC should provide plan sponsors with incentives to increase plan funding, improve the transparency of the plan's financial information, and provide a means to hold sponsors accountable for funding their plans adequately. Ultimately, however, for any insurance program, including the single-employer pension insurance program, to be self-financing, there must be a balance between premiums and the program's exposure to losses.

[57]For example, a plan that allows a lump-sum option—as is often found in a cash-balance and other hybrid plan—may pose a different level of risk to PBGC than a plan that does not.

[58]Under the floor-offset arrangement, the benefit computed under the final pay formula is "offset" by the benefit amount that the account of another plan, such as an Employee Stock Ownership Plan, could provide.

A variety of options are available to the Congress and PBGC to address the short-term vulnerabilities of the single-employer insurance program. Congress will have to weigh carefully the strengths and weaknesses of each option as it crafts the appropriate policy response. However, to understand the program's structural problems, it helps to understand how much the world has changed since the enactment of ERISA. In 1974, the long-term decline that our nation's private defined-benefit pension system has experienced since that time might have been difficult for some to envision. Although there has been some absolute growth in the system since 1980, active workers have comprised a declining percentage of program participants, and defined-benefit plan coverage has declined as a percentage of the national private labor force. The causes of this long-term decline are many and complex and have turned out to be more systemic, more structural in nature, and far more powerful than the resources and bully pulpit that PBGC can bring to bear.

This trend has had important implications for the nature and the magnitude of the risk that PBGC must insure. Since 1987, as employers, both large and small, have exited the system, newer firms have generally chosen other vehicles to help their employees provide for their retirement security. This has left PBGC with a risk pool of employers that is concentrated in sectors of the economy, such as air transportation and automobiles, which have become increasingly vulnerable. As of 2002, almost half of all defined-benefit plan participants were covered by plans offered by firms in manufacturing industries. The secular decline and competitive turmoil already experienced in industries like steel and air transportion could well extend to the other remaining strongholds of defined-benefit plans in the future, weakening the system even further.

Thus, the long-term financial health of PBGC and its ability to protect workers' pensions is inextricably bound to this underlying change in the nature of the risk that it insures, and implicitly to the prospective health of the defined-benefit system. Options that serve to revitalize the defined-benefit system could stabilize PBGC's financial situation, although such options may be effective only over the long term. Our greater challenge is to a more fundamental consideration of the manner in which the federal government protects the defined-benefit pensions of workers in this increasingly risky environment. We look forward to working with the Congress on this crucial subject.

Appendix I: Key Legislative Changes That Affect the Single-Employer Insurance Program

As part of the Employee Retirement and Income Security Act (ERISA) of 1974, the Congress established the Pension Benefit Guaranty Corporation (PBGC) to administer the federal insurance program. Since 1974, the Congress has amended ERISA to improve the financial condition of the insurance program and the funding of single-employer plans (see table 1).

Table 1: Key Legislative Changes to the Single-Employer Insurance Program Since ERISA Was Enacted

Year	Law	Number	Key provisions
1974	ERISA	P.L. 93-406	Created a federal pension insurance program and established a flat-rate premium and minimum and maximum funding rules.
1986	Single-Employer Pension Plan Amendments Act of 1986 enacted as Title XI of the Consolidated Omnibus Budget Reconciliation Act of 1985	P.L. 99-272	Raised the flat-rate premium and established financial distress criteria that sponsoring employers must meet to terminate an underfunded plan.
1987	Pension Protection Act enacted as part of the Omnibus Budget Reconciliation Act of 1987	P.L. 100-203	Increased the flat-rate premium and added a variable-rate premium based on 80 percent of the 30-year Treasury rate. In addition, established a permissible range around the 30-year Treasury rate as the basis for current liability calculations, increased the minimum funding standards, and established a full-funding limitation based on 150 percent of current liability.
1994	Retirement Protection Act enacted as part of the Uruguay Rounds Agreements Act, also referred to as the General Agreement on Tariffs and Trade	P.L. 103-465	Raised the basis for variable-rate premium calculation from 80 percent to 85 percent of the 30-year Treasury rate (effective July 1997). Phased out the cap on the variable-rate premium. Strengthened funding requirements by narrowing the permissible range of the allowable interest rates and standardizing mortality assumptions for the current liability calculation. Also, established 90 percent as the minimum full-funding limitation.
2001	The Economic Growth and Tax Relief Reconciliation Act of 2001	P.L. 107-16	Accelerated the phasing out of the 160 percent full-funding limitation and repealed it for plan years beginning in 2004 and thereafter.
2002	The Job Creation and Worker Assistance Act of 2002	P.L. 107-147	Temporarily expanded the permissible range of the statutory interest rates for current liability calculations and temporarily increased the PBGC variable-rate premium calculations to 100 percent of the 30-year Treasury rate for plan years beginning after December 31, 2001, and before January 1, 2004.

Source: Public Law.

Chairman BOEHNER. Mr. Walker, thank you very much for your testimony. We appreciate your willingness to come today and all of the efforts of the GAO to help us get the substance of what really is a longer-term problem that this Committee will address.

Mr. Kandarian, you may begin.

STATEMENT OF STEVEN A. KANDARIAN, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, D.C.

Mr. KANDARIAN. Mr. Chairman, Ranking Member Miller, Members of the Committee. Thank you for holding this hearing on pension funding and the financial health of PBGC.

Defined benefit pension plans continue to be important for the retirement security of millions of Americans. But recently, there has been a sharp deterioration in plan funding. When underfunded plans terminate, three groups can lose. Participants lose when their benefits are reduced, other businesses lose if premiums go up, and ultimately, taxpayers lose if Congress calls on them to support PBGC.

In July, the Administration proposed improving the ways pension liabilities were calculated, increasing the transparency of pension funding, and providing new safeguards against underfunding by financially troubled companies. The Administration also called for funding reforms. In addition to urging the Committee to act upon these important measures, my testimony today will focus on PBGC's financial condition, plan underfunding and some of the challenges facing the defined benefits system.

During Fiscal Year 2002, PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion. A loss of $11.3 billion in just 1 year. Based on our latest unaudited financial report, the deficit has grown to $5.7 billion as of July 31, 2003. As David Walker has just testified, GAO recently placed PBGC's single-employer insurance program on its high-risk list. My hope is that GAO's high-risk designation will spur reforms to better protect the retirement security of American workers.

As of December 31, 2000, total underfunding in single-employer plans was less than $50 billion. Because of declining interest rates and equity values, as of December 31, 2002, 2 years later, underfunding exceeded $400 billion; the largest number ever recorded. Even with recent rises in the stock market and interest rates, PBGC projects the underfunding still exceeds $350 billion today.

Because large plans typically invest more than 60 percent of their assets in equities, there is a mismatch between pension assets and pension liabilities, which tend to be bond-like in nature. With the market conditions over the last 3 years, this asset/liability mismatch caused many plans to become significantly underfunded.

In addition to massive underfunding and vulnerability to equity market volatility, the defined benefits system faces other serious challenges, including adverse demographic trends and weaknesses in the pension-funding rules. While each of these challenges is discussed in my written testimony, given time constraints I will focus on four key weaknesses in the funding rules.

First, the funding targets are set too low. Employers will stop making contributions when the plan is funded at 90 percent of current liability, a measure that reflects past legislative compromises, not the amount of money needed to pay all benefit liabilities if a plan terminates. As a result, employers can stop making contributions before a plan is sufficiently funded to protect participants.

In its last filing prior to termination, Bethlehem Steel reported that it was 84 percent funded on a current liability basis. At termination, the plan was only 45 percent funded on a termination basis, with total underfunding of $4.3 billion. Similarly, in its last filing prior to termination, the U.S. Airways pilots plan reported that it was 94 percent funded on a current liability basis. At termination, it was only 33 percent funded on a termination basis, with total underfunding of $2.5 billion.

Second, the funding rules also allow contribution holidays. Even seriously underfunded plans may not be required to make annual contributions. Bethlehem Steel, for example, made no cash contributions to its plan for 3 years prior to termination. U.S. Airways pilots plan had no contributions for 4 years prior to termination.

Third, the funding and premium rules do not reflect the risk of loss to participants and premium payers. The same funding and premium rules apply regardless of a company's financial health. But PBGC has found that nearly 90 percent of the companies representing large claims against the insurance system have had junk bond credit ratings for 10 years prior to termination.

Fourth, because of the structure of the funding rules, contributions to plans can be extremely volatile. After years with little or no required contributions, companies could be faced with sharp spikes in funding. Although our complicated funding rules were designed, in part, to minimize the volatility of contributions, the current rules have failed to achieve this goal.

Mr. Chairman, we must make fundamental changes in the funding rules that will put underfunded plans on a predictable, steady path to better funding. The Administration is working on comprehensive reforms that will get pension plans better funded and eliminate some of the risk shifting and moral hazard in the current system. It is our hope that these reforms will put the defined benefits system on a stable footing for the long term. If companies do not fund the pension promises they make, someone else will have to pay. Either workers, in the form of reduced benefits, other companies, in the form of higher premiums, or taxpayers in the form of a PBGC bailout. We should not pass off the cost of today's problems to future generations.

Thank you for inviting me to testify. I will be happy to answer any questions.

[The prepared statement of Mr. Kandarian follows:]

Statement of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation, Washington, DC

INTRODUCTION

Mr. Chairman, Ranking Member Miller, and Members of the Committee:

Good morning. I am Steven A. Kandarian, Executive Director of the Pension Benefit Guaranty Corporation (PBGC). I want to thank you for holding this hearing on pension funding and the financial health of PBGC, and for your continuing interest in the retirement security of America's workers.

PBGC was created as a federal corporation by the Employee Retirement Income Security Act of 1974 (ERISA). PBGC protects the pensions of nearly 44 million workers and retirees in more than 32,000 private defined benefit pension plans. PBGC's Board of Directors consists of the Secretary of Labor, who is the chair, and the Secretaries of the Treasury and Commerce.

PBGC insures pension benefits worth $1.5 trillion and is responsible for paying current and future benefits to 783,000 people in over 3,000 terminated defined benefit plans. As a result of the recent terminations of several very large plans, PBGC will be responsible for paying benefits to nearly 1 million people in fiscal year 2003. Similarly, benefit payments that exceeded $1.5 billion dollars in fiscal year 2002 will rise to nearly $2.5 billion in fiscal year 2003.

Defined benefit pension plans continue to be an important source of retirement security for 44 million American workers. But there has been a sharp deterioration in the funded status of pension plans, and the PBGC now has a record deficit as the result of the recent terminations of large underfunded plans.

When underfunded pension plans terminate, three groups can lose: participants can see their benefits reduced, other businesses can see their PBGC premiums go up, and ultimately Congress could call on taxpayers to support the PBGC.

Recently, the Administration issued our initial set of proposals to deal with the problem of pension underfunding. It has four parts:

> First, as the necessary initial step toward comprehensive reform of the funding rules, it improves the accuracy of pension liability measurement to reflect the time structure of each pension plan's benefit payments. This would be accomplished by measuring a plan's liabilities using a yield curve of highly rated corporate bonds to calculate the present value of those future payments.
>
> Second, it requires better disclosure to workers, retirees, investors and creditors about the funded status of pension plans, which will improve incentives for adequate funding.
>
> Third, it provides new safeguards against underfunding by requiring financially troubled companies with highly underfunded plans to immediately fund or secure additional benefits and lump sum payments. Similarly, it prohibits unfunded benefit increases by those severely underfunded plans sponsored by corporations with below investment- grade debt.
>
> And fourth, it calls for additional reforms to protect workers" retirement security by improving the funded status of defined benefit plans.

Treasury Under Secretary Peter Fisher and Labor Assistant Secretary Ann Combs testified on July 15 about these proposals. In my testimony today I would like to focus on plan underfunding, PBGC's financial condition, and the challenges facing the defined benefit system that need to be addressed with additional reforms.

PBGC estimates that the total underfunding in the single-employer defined benefit system exceeded $400 billion as of December 31, 2002, the largest number ever recorded. (See Chart 1) When the PBGC is forced to take over underfunded pension plans, the burden often falls heavily on workers and retirees. In some cases, participants lose benefits that were earned but not guaranteed by the pension insurance system. In all cases, workers lose the opportunity to earn additional benefits under the terminated pension plan.

PBGC's premium payers—employers that sponsor defined benefit plans—also pay a price when an underfunded plan terminates. Although PBGC is a government corporation, it is not backed by the full faith and credit of the U.S. government and receives no federal tax dollars. When PBGC takes over underfunded pension plans, financially healthy companies with better-funded pension plans end up making transfers to financially weak companies with chronically underfunded pension plans. If these transfers from strong to weak plans become too large, then over time strong companies with well-funded plans may elect to leave the system.

In the worst case, PBGC's deficit could grow so large that the size of the premium increase necessary to close the gap would be unacceptable to responsible premium payers. If this were to occur, Congress could call upon U.S. taxpayers to pick up the cost of underfunded pension plans through a Federal bailout of PBGC. In essence, all taxpayers would shoulder the burden of paying benefits to the 20 percent of private-sector workers who still enjoy the security of a defined benefit plan.

PBGC's Deteriorating Financial Condition

As a result of record pension underfunding and the failure of a number of plan sponsors in mature industries, PBGC's financial position has deteriorated sharply in the last two years. During fiscal year 2002, PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion—a loss of $11.3 billion in just one year. The $11.3 billion loss is more than five times larger than any previous one-year loss in the agency's 28-year history. Moreover, based on our latest unaudited financial report, the deficit had grown to $5.7 billion as of July 31, 2003. (See Chart 2)

Because of this extraordinary one-year loss, the dramatic increase in pension underfunding, and the risk of additional large claims on the insurance program, the General Accounting Office (GAO) recently placed PBGC's single-employer program on its "high risk" list. In its report to Congress, GAO points to systemic problems in the private-sector defined benefit system that pose serious risks to PBGC. For example, the insured participant base continues to shift away from active workers, falling from 78% of all participants in 1980 to only 53% in 2000. In addition, GAO's report notes that the insurance risk pool has become concentrated in industries affected by global competition and the movement from an industrial to a knowledge-based economy. My hope is that GAO's "high risk" designation will spur reforms to better protect the stakeholders in the pension insurance system—participants and premium payers.

Reasons for PBGC's Current Financial Condition

PBGC's record deficit has been caused by the failure of a significant number of highly underfunded plans of financially troubled and bankrupt companies. (See Chart 3) These include the plans of retailers Bradlees, Caldor, Grand Union, and Payless Cashways; steel makers including Bethlehem, LTV, National, Acme, Empire, Geneva, and RTI; other manufacturers such as Singer, Polaroid, Harvard Industries, and Durango; and airlines such as TWA. In addition, PBGC has taken over the failed US Airways pilots plan. Mr. Chairman, pension claims against PBGC for 2002 alone were greater than the total claims for all previous years combined. At current premium levels, it would take about 12 years of premiums to cover just the claims from 2002.

During the last economic downturn in the early 1990s, the pension insurance program absorbed what were then the largest claims in its history—$600 million for the Eastern Airlines plans and $800 million for the Pan American Airlines plans. Those claims seem modest in comparison to the steel plans we have taken in lately: $1.3 billion for National Steel, $1.9 billion for

LTV Steel, and $3.9 billion for Bethlehem Steel. Underfunding in the financially troubled airline sector is larger still, totaling $26 billion.

PBGC premiums have not kept pace with the growth in pension claims or in pension underfunding. (See Chart 4) Premium income, in 2002 dollars, has fallen every year since 1996, even though Congress lifted the cap on variable-rate premiums that year. The premium has two parts: a flat-rate charge of $19 per participant, and a variable-rate premium of 0.9 percent of the dollar amount of a plan's underfunding, measured on a "current liability" basis. As long as plans are at the "full funding limit," which generally means 90 percent of current liability, they do not have to pay the variable-rate premium. That is why Bethlehem Steel, the largest claim in the history of the PBGC, paid no variable-rate premium for five years prior to termination.

CHALLENGES FACING THE DEFINED BENEFIT PENSION SYSTEM

The funding of America's private pension plans has become a serious public policy issue. Recent financial market trends—falling interest rates and equity returns—have exposed underlying weaknesses in the pension system, weaknesses that must be corrected if that system is to remain viable in the long run. In addition to falling interest rates and equity returns, there are serious challenges facing the defined benefit system: substantial underfunding, adverse demographic trends, and weaknesses in the pension funding rules.

Concurrent Falling Interest Rates and Stock Market Returns

The unprecedented, concurrent drops in both equity values and interest rates have caused the unfunded liabilities of most defined benefit pension plans to increase dramatically over the last three years. (See Chart 5) Some argue that the current problems are cyclical and that they will disappear as the stock market recovers, but it is not reasonable to base pension funding on the expectation that the stock market gains of the 1990s will repeat themselves.

In order to understand how pension plans got so underfunded, it is important to consider how mismatching assets and liabilities affects pension plan funding levels. Pension plan liabilities tend to be bond-like in nature. For example, both the value of bonds and the value of pension liabilities have risen in recent years as interest rates fell. Were interest rates to rise, both the value of bonds and the value of pension liabilities would fall. The value of equity investments is more volatile than the value of bonds and less correlated with interest rates. Most companies prefer equity investments because they have historically produced a higher rate of return than bonds. These companies are willing to accept the increased risk of equities and interest rate changes in exchange for expected lower pension costs over the long term. Similarly, labor unions support investing in equities because they believe it results in larger pensions for workers. Investing in equities rather than bonds shifts some of these to the PBGC.

Pension Underfunding

Pension liabilities represent financial obligations of plan sponsors to their workers and retirees. Thus, any pension underfunding is a matter of concern and may pose risks to plan participants and the PBGC. In ongoing, healthy companies, an increase in the amount of underfunding can affect how secure workers feel about their pension benefits, even though the actual risk of loss maybe low, at least in the near-term. Of immediate concern is chronic underfunding in companies with debt below investment-grade or otherwise financially troubled, where the risk of loss is much greater. Some of these financially troubled companies have pension underfunding significantly greater than their market capitalization.

As detailed in our most recent annual report, plans that are sponsored by financially weak companies had $35 billion in unfunded vested benefits. Of this $35 billion, about half represented underfunding in airline and steel plans. By the end of this fiscal year, the amount of underfunding in financially troubled companies could exceed $80 billion. As I previously noted, the Administration has already made specific legislative recommendations to limit the PBGC's growing exposure to such plans.

Demographic Trends

Demographic trends are another structural factor adversely affecting defined benefit plans. Many defined benefit plans are in our oldest and most capital intensive industries. These industries face growing pension and health care costs due to an increasing number of older and retired workers.

Retirees already outnumber active workers in some industries. (See Chart 6) In some of the plans we have trusteed in the steel industry, only one out of every eight pension participants was an active worker. The Detroit Free Press recently reported that pension, retiree health and other retiree benefits account for $631 of every Chrysler vehicle's cost, $734 per Ford vehicle, and $1,360 for every GM car or truck. In contrast, pension and retiree benefit costs per vehicle for the U.S. plants of Honda and Toyota are estimated to be $107 and $180 respectively. In a low-margin business, retiree costs can have a serious impact on a company's competitiveness.

Demographic trends have also made defined benefit plans more expensive. Americans are living longer in retirement as a result of earlier retirement and longer life spans. Today, an average male worker spends 18.1 years in retirement compared to 11.5 in 1950, an additional seven years of retirement that must be funded. (See Chart 7) Medical advances are expected to increase life spans even further in the coming years.

Weaknesses in the Funding Rules

When PBGC trustees underfunded plans, participants often complain that companies should be legally required to fund their pension plans. The fact is, current law is simply inadequate to fully protect the pensions of America's workers when their plans terminate. There are many weaknesses with the current funding rules. I would like to focus on six:

First, the funding targets are set too low. Employers can stop making contributions when the plan is funded at 90 percent of "current liability." The definition of current liability is a creature of past legislative compromises, and has no obvious relationship to the amount of money needed to pay all benefit liabilities if the plan terminates. As a result, employers can stop making contributions before a plan is sufficiently funded to protect participants, premium payers and taxpayers.

Current liability assumes the employer will continue in business. As a result, it doesn't recognize the early retirements—often with subsidized benefits—that take place when an employer goes out of business and terminates the pension plan. Current liability also doesn't recognize the full cost of providing annuities as measured by group annuity prices in the private market. If the employer fails and the plan terminates, pension benefits are measured against termination liability, which reflects an employer's cost to settle pension obligations in the private market.

For example, in its last filing prior to termination, Bethlehem Steel reported that it was 84 percent funded on a current liability basis. At termination, however, the plan was only 45 percent funded on a termination basis—with total underfunding of $4.3 billion. (See Chart 8) Similarly, in its last filing prior to termination, the US Airways pilots plan reported that it was 94 percent funded on a current liability basis. At termination, however, it was only 33 percent funded on a termination basis—with total underfunding of $2.5 billion. (See Chart 9) It is no wonder that the US Airways pilots were shocked to learn just how much of their promised benefits would be lost. In practice, a terminated plan's underfunded status can influence the actual benefit levels. Under the Administration's already-announced transparency proposal, participants would have been aware of the lower funding level on a termination basis.

Second, the funding rules often allow "contribution holidays" even for seriously underfunded plans. Bethlehem Steel, for example, made no cash contributions to its plan for three years prior to plan termination, and US Airways made no cash contributions to its pilots plan for four years before the plan was terminated. When a company contributes more than the minimum required contribution, it builds up a "credit balance" for minimum funding. It can then treat the credit balance as a payment of future required contributions, even if the assets in which the extra contributions were invested have lost some or all of their value.

Third, the funding rules do not reflect the risk of loss to participants and premium payers. The same funding rules apply regardless of a company's financial health, but a PBGC analysis found that nearly 90 percent of the companies representing large claims against the insurance system had junk-bond credit ratings for 10 years prior to termination. (See Chart 10)

Fourth, the minimum funding rules and the limits on maximum deductible contributions require companies to make pension contributions within a narrow range. Under these minimum and maximum limits, it is difficult for companies to build up an adequate surplus in good economic times to provide a cushion for bad times.

Fifth, current liability does not include reasonable estimates of expected future lump sum payments. Liabilities must be calculated as if a plan will pay benefits only as annuities. Even if it is clear that most participants will choose lump sums, and that these lump sums may be more expensive for the plan than the comparable annuity, the minimum funding rules do not account for lump sums because they are not part of how current liability is calculated.

Sixth, because of the structure of the funding rules under ERISA and the Internal Revenue Code, defined benefit plan contributions can be extremely volatile. After years of the funding rules allowing companies to make little or no contributions, many companies are suddenly required to make contributions of hundreds of millions of dollars to their plans at a time when they are facing other economic pressures. Although the law's complicated funding rules were designed, in part, to minimize the volatility of funding contributions, the current rules clearly have failed to achieve this goal. Masking market conditions is neither a good nor a necessary way to avoid volatility in funding contributions.

PBGC Premiums

As I noted earlier, because PBGC is not backed by the full faith and credit of the federal government and receives no federal tax dollars, it is the premium payers—employers that sponsor defined benefit plans—who bear the cost when underfunded plans terminate. Well-funded plans represent the best solution for participants and premium payers. However, PBGC's premiums should be re-examined to see whether they can better reflect the risk posed by various plans to the pension system as a whole.

REFORMS NEEDED TO PROTECT THE DEFINED BENEFIT SYSTEM

Mr. Chairman, we must make fundamental changes in the funding rules that will put underfunded plans on a predictable, steady path to better funding. Improvements in the funding rules should set stronger funding targets, foster more consistent contributions, mitigate volatility, and increase flexibility for companies to fund up their plans in good economic times.

At the same time, we must not create any new disincentives for companies to maintain their pension plans. Pension insurance creates moral hazard, tempting management and labor at financially troubled companies to make promises that they cannot or will not fund. The cost of wage increases is immediate, while the cost of pension increases can be deferred for up to 30 years and shutdown benefits may never be pre-funded. In exchange for smaller wage increases today, companies often offer more generous pension benefits tomorrow, knowing that if the company fails the plan will be handed over to the PBGC. This unfairly shifts the cost of unfunded pension promises to responsible companies and their workers. At some point, these financially strong companies may exit the defined benefit system, leaving only those companies that pose the greatest risk of claims.

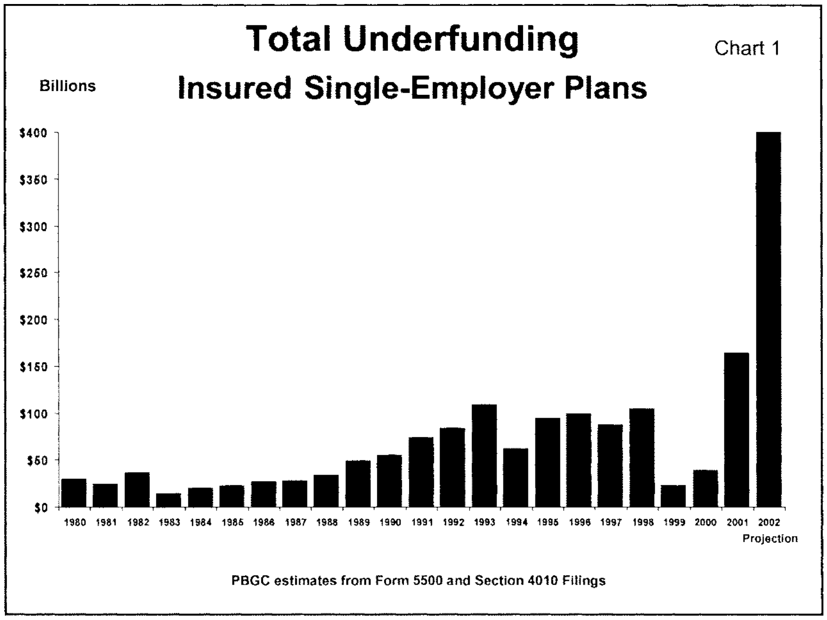
In addition to the proposals the Administration has already introduced to accurately measure pension liabilities, improve pension disclosure, and protect against underfunding, the Departments of Labor, Treasury, and Commerce, and the PBGC are actively working on comprehensive reform. We are examining how to eliminate some of the risk shifting and moral hazard in the current system. We are crafting proposals to get pension plans better funded, especially those at risk of becoming unable to meet their benefit promises. And we are re-evaluating statutory amortization periods and actuarial assumptions regarding mortality, retirement, and the frequency and value of lump sum payments to ensure they are consistent with the goal of improved funding.

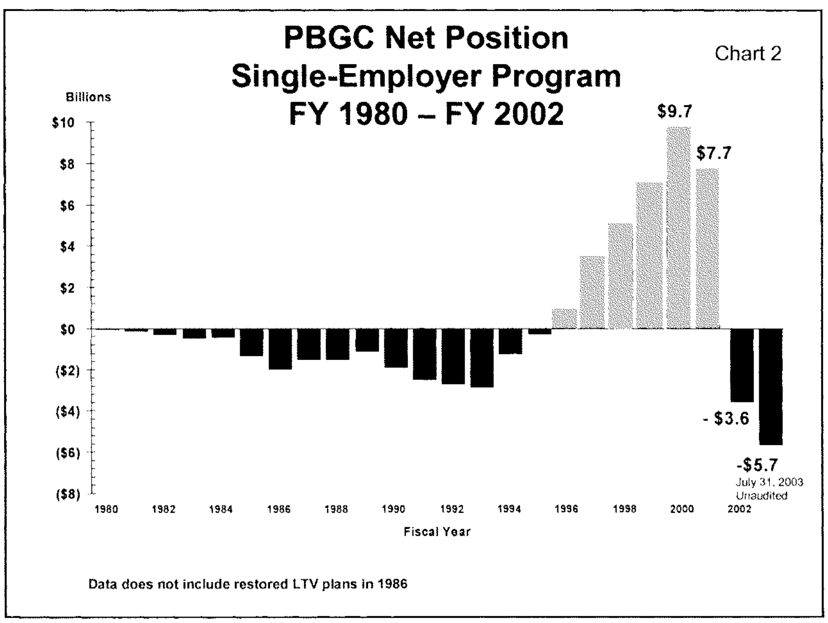
CONCLUSION

Mr. Chairman, we should not pass off the cost of today's pension problems to future generations. If companies do not fund the pension promises they make, someone else will have to pay—either workers in the form of reduced benefits, other companies in the form of higher PBGC premiums, or taxpayers in the form of a PBGC bailout.

Thank you for inviting me to testify. I will be happy to answer any questions.

[Attachments to Mr. Kandarian's statement follow:]


Total Underfunding
Chart 1
Billions
Insured Single-Employer Plans
$400
$350
$300
$250
$200
$150
$100
$50
$0
1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002
Projection
PBGC estimates from Form 5500 and Section 4010 Filings


PBGC Net Position
Single-Employer Program
FY 1980 – FY 2002
Chart 2
Billions
$10
$8
$6
$4
$2
$0
($2)
($4)
($6)
($8)
$9.7
$7.7
- $3.6
-$5.7
July 31, 2003
Unaudited
1980 1982 1984 1986 1988 1990 1992 1994 1996 1998 2000 2002
Fiscal Year
Data does not include restored LTV plans in 1986

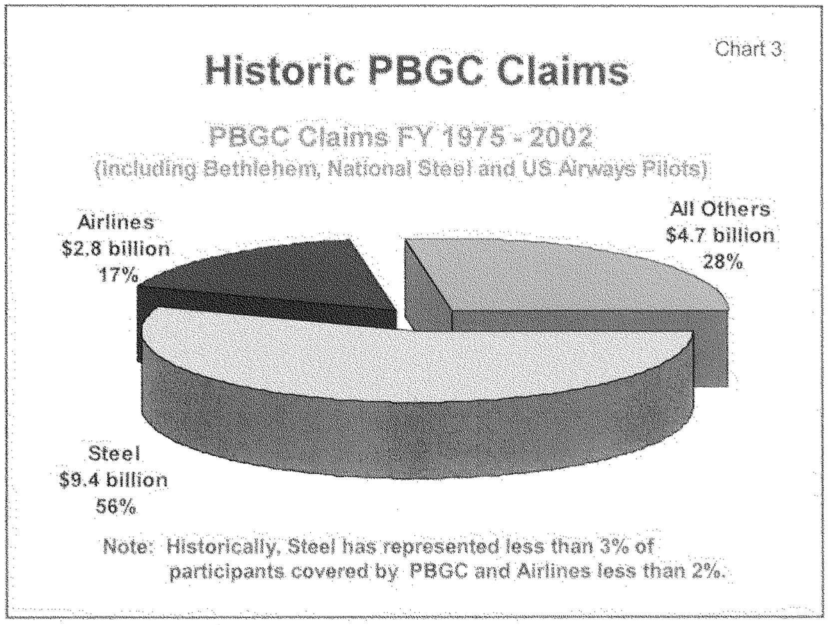


Chart 3
Historic PBGC Claims
PBGC Claims FY 1975 - 2002
(including Bethlehem, National Steel and US Airways Pilots)
Airlines
$2.8 billion
17%
All Others
$4.7 billion
28%
Steel
$9.4 billion
56%
Note: Historically, Steel has represented less than 3% of participants covered by PBGC and Airlines less than 2%.

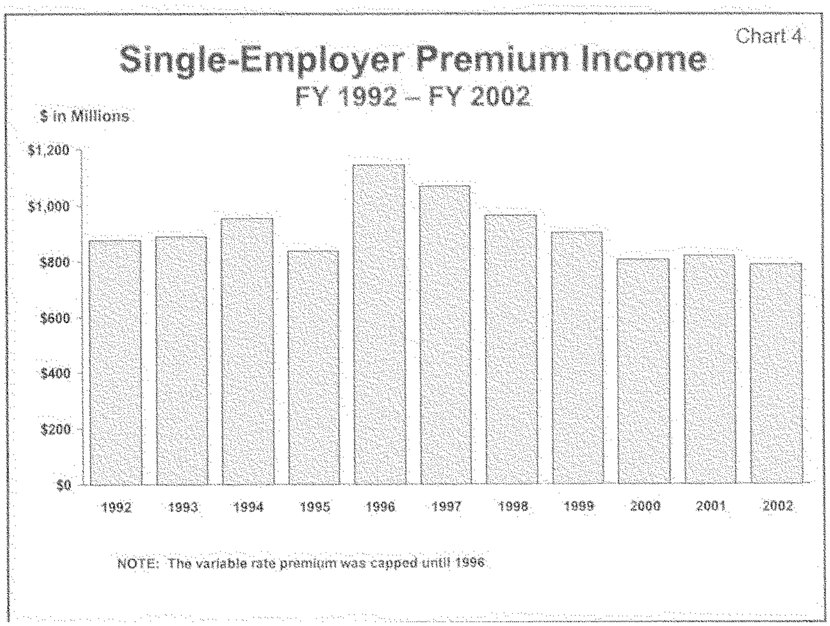
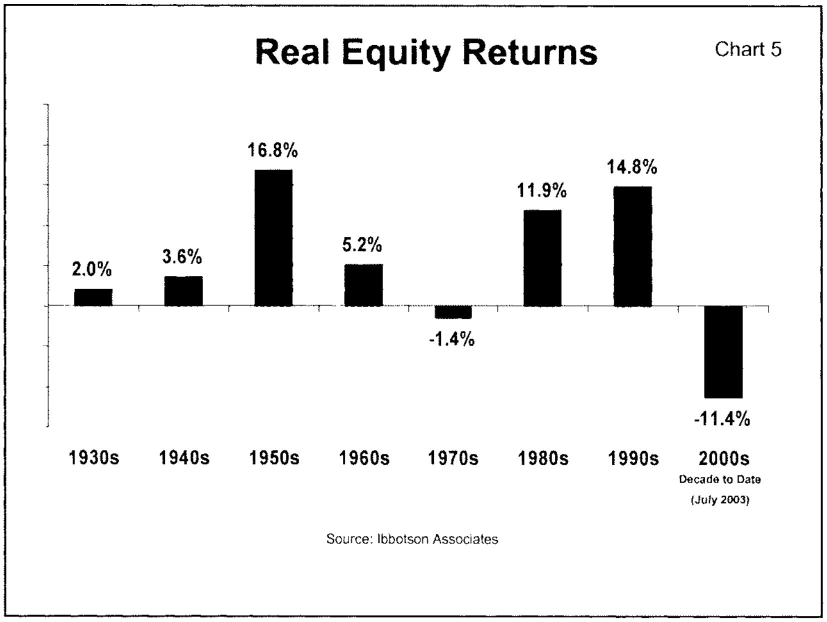


Chart 4
Single-Employer Premium Income
FY 1992 – FY 2002
$ in Millions
$1,200
$1,000
$800
$600
$400
$200
$0
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
NOTE: The variable rate premium was capped until 1996


Real Equity Returns
Chart 5
16.8%
14.8%
11.9%
5.2%
3.6%
2.0%
-1.4%
-11.4%
1930s
1940s
1950s
1960s
1970s
1980s
1990s
2000s
Decade to Date
(July 2003)
Source: Ibbotson Associates

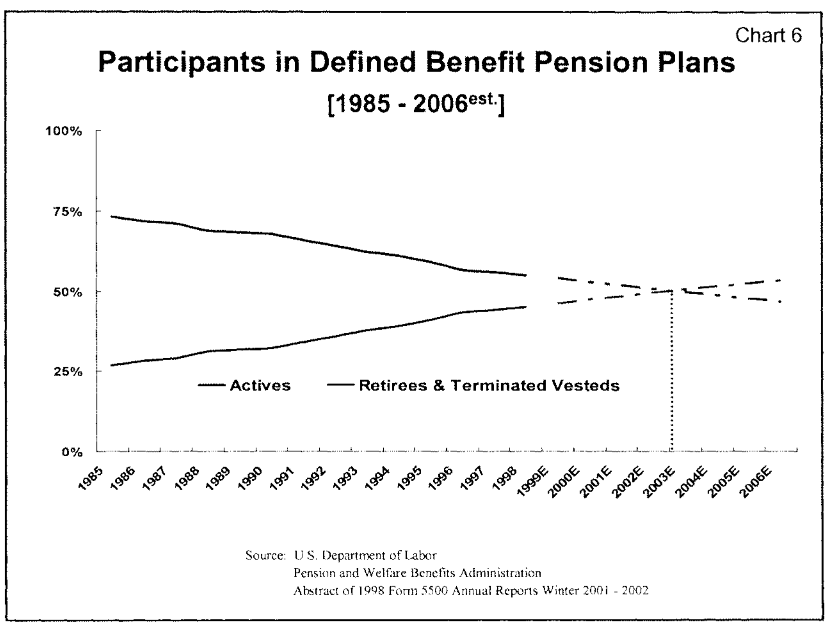


Chart 6
Participants in Defined Benefit Pension Plans
[1985 - 2006est.]
100%
75%
50%
25%
0%
Actives
Retirees & Terminated Vesteds
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999E
2000E
2001E
2002E
2003E
2004E
2005E
2006E
Source: U.S. Department of Labor
Pension and Welfare Benefits Administration
Abstract of 1998 Form 5500 Annual Reports Winter 2001 - 2002

Chart 7

Average Number of Years Spent in Retirement

(Males)

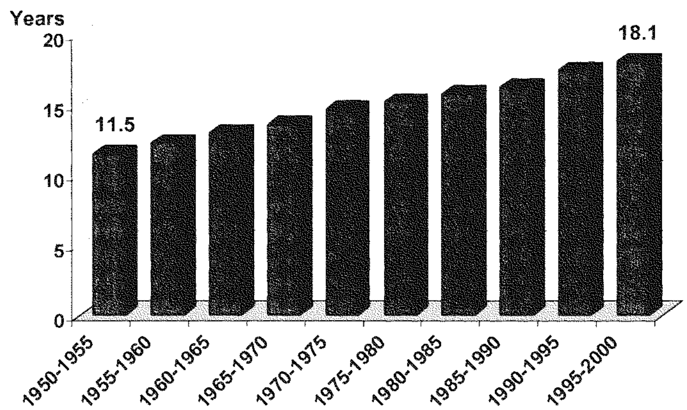


Chart 8

Bethlehem Steel

	1996	1997	1998	1999	2000	2001	2002
Current Liability	78%	91%	99%	96%	86%	84%	NR
Was the company required to make a deficit reduction contribution?	Y	N	N	N	N	NR	NR
Was the company obligated to send out a participant notice?	Y	Y	N	N	N	N	N
Did the company pay a variable rate premium?	$15 million	$17 million	N	N	N	N	N
Actual Contributions	$354 million	$32.3 million	$30.9 million	$ 8.1 million	$0	$0	$0

Termination Benefit Liability Funded Ratio 45%

Unfunded Benefit Liabilities $4.3 billion

US Airways Pilots

Chart 9

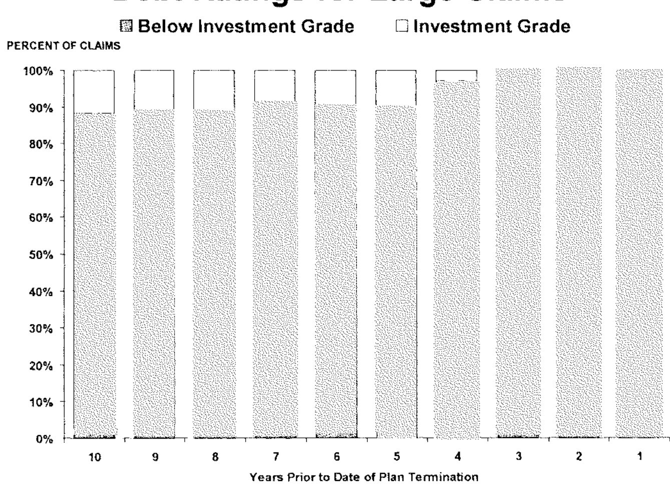
	1996	1997	1998	1999	2000	2001	2002
Current Liability	97%	100%	91%	85%	104%	94%	NR
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	N	NR
Was the company obligated to send out a participant notice?	N	N	N	N	N	N	N
Did the company pay a variable rate premium?	$4 million	N	N	N	$2 million	N	N
Actual Contributions	$112.3 million	$0	$45 million	$0	$0	$0	$0

Termination Benefit Liability Funded Ratio 33%

Unfunded Benefit Liabilities $2.5 billion

Debt Ratings for Large Claims

Chart 10



NOTE: Based on 27 of PBGC's largest claims representing over 50% of all claims.

Chairman BOEHNER. Well, thanks both of our witnesses for your excellent testimony.

Before I ask Mr. Walker the first question, I should mention to all of my colleagues that there has been some discussion about a short-term fix to the 30-year interest rate. And in discussions with various colleagues on both sides of the aisle, there is some concern that the 3-year short-term fix may be too long. I would put myself in the category of one of those who believes that if we are going to extend the short-term fix, that 2 years is probably more than enough.

Second, as I mentioned in my opening statement, this is our third in a series of hearings, and it is my intention, and I think the intention of Mr. Miller and others that this Committee, and this Congress take its responsibility seriously to look at the long-term health and the long-term problems of defined benefit plans, and for us to do the hard work of dealing with it.

This is a very important issue for over 40 million Americans who depend on defined benefit plans. And for us to look the other way at this very serious problem, which has gone on for some time, would be criminal neglect on the part of public-policymakers. What I would like to see is a short-term, 2-year adjustment to the 30-year rate, with a commitment on the part of the Congress to complete our work on defined benefit plan restructuring by the end of next year, so that the plan's sponsors have a year to get ready for the new rules. I think this is a reasonable and responsible way to proceed, and without a lot of consultation from my staff and colleagues, I have just said it.

So having said that, Mr. Walker, let's get back to your first chart. As we begin to see in the year 2000, the liabilities were beyond the assets in the Bethlehem Steel plan. From the year 2000 until the plan was terminated, were there any increases in benefits offered by the company to its employees?

Mr. WALKER. I would have to ask Mr. Kandarian to answer that, since they are the ones providing the guarantees.

Chairman BOEHNER. All right. Mr. Kandarian?

Mr. KANDARIAN. The answer is yes, Mr. Chairman. In 1999, Bethlehem negotiated significant improvements in the pension plan with its workers. At that point in time, Bethlehem Steel was a very weakened company. Our guarantee phases in over 5 years, 20 percent a year, so we guaranteed 60 percent of those increased benefits. It cost the agency about $80 to $100 billion, we estimate.

Chairman BOEHNER. $80 to $100 billion?

Mr. KANDARIAN. Million dollars.

Chairman BOEHNER. Million dollars.

Mr. KANDARIAN. Excuse me.

Chairman BOEHNER. Under the current rules, can companies that are underfunded, in some cases seriously underfunded, in fact, negotiate higher benefits for their employees?

Mr. KANDARIAN. They can. There is a very weak rule that says if you are below 60 percent of the so-called current liability measure, that there are some restrictions. But that measure often times does not apply, as you can see from the slide up there. The current liability measure was at the 80 to 90 percent level for a number of years with Bethlehem Steel before termination.

Mr. WALKER. One of the things you may want to consider, Mr. Chairman, is whether that 60 percent ought to be raised. I think another factor that has to be considered is what the cash-flows related to these plans are, and whether or not plan sponsors ought to be required to make certain minimum contributions if they have significant negative cash-flows, while obviously being concerned about volatility, as well.

Chairman BOEHNER. Let me ask both of you. The PBGC does, in fact, have about a $25 billion net balance, or cap. Would that be correct? Describe what the typical billion is.

Mr. KANDARIAN. Let me get the numbers. Yes, we have over $30 billion in liquid assets, which are mostly in U.S. Treasury, and some in the liquid end of the stock market, and our liabilities are higher than that.

Chairman BOEHNER. Now, we understand from the testimony of both of you that from a long-term basis, there is trouble ahead. But from a short-term basis, in terms of the assets that you have available and the liabilities that you have currently, and those that you foresee, look into your crystal ball. Where does the problem really show up in terms of your cash-flow?

Mr. KANDARIAN. It is hard to say, but let me give you some facts. We have a little over $30 billion in assets today. We are currently paying out at a running rate of $2.5 billion in benefits.

Chairman BOEHNER. Annually?

Mr. KANDARIAN. Annually. We think that number will go up to about $3 billion starting next year. Now, what happens from there is anyone's guess, based upon what ends up being taken by the agency over the next few years.

Chairman BOEHNER. And the $30 billion that you have today, I presume you have additional premiums coming. Where do you expect that balance to be in the future?

Mr. KANDARIAN. The premiums run about $800 million a year currently. We anticipate that number could go up a little bit, based upon the variable rate premium increasing over time. But still it would be less than $1 billion a year, based upon current law. Now that would have to account for any new terminations that came into the system, and one of the things I have been concerned about as Executive Director is the size of the underfunding of these terminated plans as of late.

Back in 1991, during the last economic slump, a very large plan for us was $600 million or $800 million underfunded. As mentioned, Bethlehem Steel's claim against the insurance system was $3.9 billion, so owers of a magnitude larger than the kinds of claims we received a decade ago. And the premiums have been essentially flat, or declining, in the last decade.

Mr. WALKER. Mr. Chairman, you are correct that $30 billion in cash and liquid investments are obviously available to pay benefits for a considerable period of time. However, I would respectfully suggest that they have serious structural issues that cry out for reform now. I mean, the real question is, they face a disproportionate amount of risk in industries that are faced by increasing global competition. For example, steel, airlines, auto, heavy equipment manufacturing. The magnitude of the potential losses in those industries are huge.

And furthermore, we have to keep in mind, this is a voluntary system. The risk exists that you could have a lot of healthy sponsors exit the system, and therefore we can have a run on the system and create a real problem. And so I think the sooner that Congress acts, the better. I am very encouraged by your comment, Mr. Chairman, about the need for fundamental reform in a timely manner.

Chairman BOEHNER. My time has expired. I may come back for a second round of questions. Let me recognize Mr. Miller.

Mr. MILLER. Thank you very much.

Mr. Walker, do you have an estimate of what you think that universe of potential liability is? You mentioned, we know there are a couple of other steel companies that are in play that people are talking about either going under or being taken over. The airlines, you can read it both ways. From the competitors or from the market, what-have-you, whether all of them are going to survive. Do you have an estimate of what the—

Mr. WALKER. Mr. Miller, I think that the PBGC is in the best position. As I understood Executive Director Kandarian, their latest watch list, if you will, comprises about $80 billion in potential underfunding. And presumably in doing that, they are looking not only at the amount of underfunding in the plan, but also the financial strength of the sponsor. For example, does it have a junk bond rating for its debt, or whatever it might be?

Mr. MILLER. Can you elaborate on that, Mr. Kandarian?

Mr. KANDARIAN. That is correct. The $80 billion estimate that we have right now relates to companies with less than investment-quality credit ratings; junk bond ratings, and termination liability for their pension promises.

Mr. MILLER. Let's look at that universe for a second, because I think it raises kind of a central point of tension. And that is, how much can you get those companies that are in that situation, to help us cure the problem? They would argue that if they have to make these contributions, then they can't make an investment that is necessary to turn the company around, or they can't stay afloat because they have a cash-flow problem.

So what do we do with those companies? I mean, there is a bias in the marketplace today against defined benefit plans. You don't go there if you don't have to go there. Now you are telling companies that theoretically, for one reason or another, are sick that they may continue in existence for a considerable period of time that we need a greater call—PBGC needs a greater call on some of their assets in terms of premiums or—something so that we don't inherit the full load. What are you tipping?

Mr. WALKER. Well, first, it is a complicated issue. Number two, there is no question that you have to address this in a manner that recognizes reality. You can't end up having a huge increase in contribution requirements happen all at once, especially in circumstances where they are struggling to survive.

I do think you need three things, and we have some specific suggestions in our testimony. We clearly need additional transparency. Because right now, the plan participants, beneficiaries, and other stakeholders don't necessarily know the funding condition of the plan. They don't necessarily have an appreciation for the PBGC guarantees. They need to know that, and if they know that, not only will they be able to plan better, but they will be able to bring together pressures for people to consider additional funding as appropriate and possible, if you will.

Second, some of these industries have good times. Bethlehem Steel had some good times, OK? And we need to provide more flexibility for them to make additional contributions on a tax-deductible basis when they do have good times. So you need transparency, and you need incentives, which can also charge them more premiums.

There are a number of specific examples that we have, but I think you need to get on with these reforms, because the real risk exists; there's never going to be a good time. And the longer we wait, the bigger the problem is going to be, and the higher the risk that the good companies who don't represent a risk might exit the system.

Mr. MILLER. If I could encourage that the Chairman has suggested the timeline that he has suggested for this Committee to look at your reforms. Two, I would hope that with the administration, if the PBGC or whatever would forward those recommendations to us. I know you have been working on them, and trying to make them all come together, but it obviously would help this process greatly if we would have the recommendations from the administration. You have articulated those recommendations and those positions, but technically this is a very complicated business. We need to see how you translate those into the technical changes that have to be made.

And the third thing would be, it seems to me, that if we are going to have a short-term fix, the shorter I think the better, because I think it forces decisions to be made. I would also hope that we would have immediate transparency, so that while we are working on the problem, we will have a full understanding of what really is taking place within this universe of actual liabilities and potentially future liabilities and the status of those claimants. Those potential claimants. I mean, I think we kind of have to know where we are before we start recalculating this system. I think it would be very important that we have that kind of transparency as soon as possible, while we are engaging in the legislative process.

Mr. WALKER. Mr. Miller, if I could also address your concerns expressed about the funding rules. The current funding rules are relatively weak on what are called basic ERISA funding rules of 1974. You then have something called the deficit reduction contribution component of the funding rules, which unfortunately kick in rather late in the process. But when they do kick in, they are extremely strong, and can be very, very harsh in terms of the impact upon companies at a time when they are least able to make contributions to their underfunded pension plans, which is the point that you are referring to.

And one of the things we are looking at within the Administration is trying to make the system less volatile so that the funding rules going forward would have more predictable, steady contributions, even during good years, and then wouldn't have such harsh spikes during the difficult times for these companies.

Mr. MILLER. Let me just say, if I might. One of the problems, it seems to me, is that the good years sometimes are represented by paper assets. We had a good year during the stock market increases, and it evaporated one March. The good years don't reflect the long-term commitments. Obviously companies want to take advantage of that appreciation in their stock, or the stocks that they hold in their pension plans, and to some extent they should be able to. But you're writing a high percentage of assets based upon the whims of the market that have nothing to do with the health of the company, necessarily. And I would assume that in the industry, if you were going to provide an annuity, you wouldn't have this same mix of assets supporting that annuity.

Mr. WALKER. Well, I think part of the idea touching on the same thing is there needs to be a more stable, more certain and predictable level of funding that plans have to make in good times and bad. Now, the fact of the matter is, we have had a significant decline in asset values over the last several years, but they are starting to turn around. The market is starting to come back up, interest rates are starting to go back up, which is generally bad, but for pension plans good, believe it or not. And for the PBGC good.

And so we have to have a system that recognizes reality. We have to have more stable and certain contributions in good times and bad to eliminate this volatility. And that means strengthening the minimum funding requirements, and also providing somewhat additional flexibility for tax deductibility within the corridor when plans are reasonably well funded.

Mr. MILLER. Thank you.

Mr. KANDARIAN. Mr. Miller, you correctly point out the asset liability mismatch oftentimes seen in pension plans, and there is a tradeoff. Corporations want to offer plans that are affordable, and they feel that historically equity returns have outperformed bond returns, and this is a long-term promise. Therefore, this helps make the plans more affordable to corporations, and helps them retain these plans.

At the same time, unions want these plans to offer generous benefits to the workers. They also look at long-term equity returns in excess of bond returns and say, if the company invests some percentage in the stock market, we can have better benefits for our workers.

But the problem is the one you note. During bad times, when things reverse, interest rates go down, so liabilities go up. Stock market values go down, so assets go down. And especially if a plan terminates with a financially weak company, the impact upon the PBGC and the system can be pretty dramatic. We saw that with Bethlehem Steel.

Mr. MILLER. The corporate management of these plans is, in some cases, and with the agreement of unions and others, it becomes a little island of fantasy in this huge sea of reality. It just doesn't reflect either the obligations of the PBGC or the potential obligations of the taxpayer. Now, we hope to be able to postpone all of that.

Mr. KANDARIAN. Well, there are some historical aspects to this. At one time, when these plans first were created and first invested along these bases, plans were relatively small, and corporations, in terms of market caps, were very large. So the relatively small change in asset values was not overwhelming to some of these companies.

Today, some of these plans are very, very large compared to the market caps of those same businesses, because of how many retirees there are today in these more mature industries. So the dynamics have changed, and corporations themselves have to look at this issue and make a decision as to what level of risk they feel they can assume in their pension plans.

Mr. MILLER. Thank you, Mr. Chairman.

Chairman BOEHNER. The Chair recognizes the gentleman from North Carolina, Mr. Ballenger. And after Mr. Ballenger's questions, we are going to the floor for another 15-minute vote.

Mr. BALLENGER. Thank you, Mr. Chairman. I have a basic question. If you look at the Bethlehem Steel pension plan, and instead of the statistics that you have there, you drew a line for the number of employees working at Bethlehem Steel over that same period of years, and the number of retirees of the same period of years, I think you are going to have two lines going in the opposite directions. This shows why you compounded the whole situation with fewer and fewer people working, maybe because they figured out a better way to make steel, or because business stunk and they lost business overseas.

Therefore, you have fewer people paying in, and you have more people living longer, and it obviously is a no-win situation. It is going to be a disaster. It didn't take a genius to see there was going to be a train wreck. That is one of the problems.

Another one that you see is a lot of corporations that are going bankrupt are now being sold to somebody else. Do the liabilities that they have go with that purchase of their bankrupt corporation?

Mr. WALKER. Let me address the first. I will let Executive Director Kandarian address the second.

You are correct, that if you had a line that showed employment and number of retirees, they would be going in the opposite direction. That deals with the dependency ratio. A lot of these industries that represent a high risk to the PBGC have that type of factor.

It also means that their cash-flows, the amount of money they are going to have to start paying out for benefits, are going to be a lot quicker than otherwise the minimum funding standards would assume, because they are basically shooting for funding targets over 15 to 30 years. That is one of the reasons why I believe that one of the things that has to be considered is to look at the cash-flows here, and how the cash-flows might have to be built into the minimum funding requirements more.

Mr. KANDARIAN. Let me make two statements. One, in the case of Bethlehem Steel, I think there was one active worker to eight retirees and terminated vested workers. So you saw that kind of imbalance. That actually would not be a financial problem for either Bethlehem Steel or the PBGC if the plan were fully funded. When the plan is not fully funded, you now have this enormous underfunded liability in the case of Bethlehem that has to be, in effect, amortized over a number of years going forward upon their existing labor base, which as you noted, had shrunk dramatically.

In competitive markets, both in terms of domestic competition from non-unionized steel companies and international competitions, that is a very difficult thing for a company like Bethlehem to overcome.

When Bethlehem finally came to an end as a company, it had roughly $8 billion in liabilities. Over $4 billion was pension liabilities, and over $2 billion was health care-related for retirees. So $6 billion out of $8 billion were related to so-called legacy costs. That was overwhelming, and they were unable to afford those kinds of benefits going forward, and pay for those kinds of benefits.

Your second question concerns what happens to those liabilities. In the case of the pension liabilities, they came to us. And workers, in most cases, will get 100 percent of the benefits that had accrued and vested at that point in time.

Mr. BALLENGER. Does that mean the other steel companies that bought the assets didn't pick up any of the liabilities?

Mr. KANDARIAN. That's correct. In bankruptcy, they were able to buy assets and assume whatever liabilities they choose to assume in an auction process.

Now, let's pop up the Bethlehem case. There was a company called International Steel Group that bought that business. They had already bought LTD Steel's assets before, and they paid about $1.5 billion for those assets they picked up. Again, remember, there is over $4 billion of liabilities on the pension plan alone. So if you think the assets are worth $1.5 billion positive, if you can subtract out the liabilities that someone is asking you to assume for the pension liability, you have a negative purchase price, which obviously doesn't work.

Once the bankruptcy process ran its course, and the best bids came in, there was no way that plan could be assumed any longer in the private sector.

Mr. BALLENGER. But the steel company that bought the assets didn't pick up any of the liabilities, so it was a pretty good bargain at $1 billion, or $600 million, whatever.

Mr. KANDARIAN. Well, I won't speak to whether it was a good or bad bargain.

Mr. BALLENGER. It is better than it would have been if they had to pick up all the liabilities. They would never have bought the liabilities.

Mr. KANDARIAN. The same case occurred when U.S. Steel purchased National Steel's assets, the pension plan came to us.

Mr. BALLENGER. Thank you, Mr. Chairman.

Chairman BOEHNER. The Committee will stand in recess for 15 to 20 minutes.

[Recess.]

Chairman BOEHNER. The Committee will come to order.

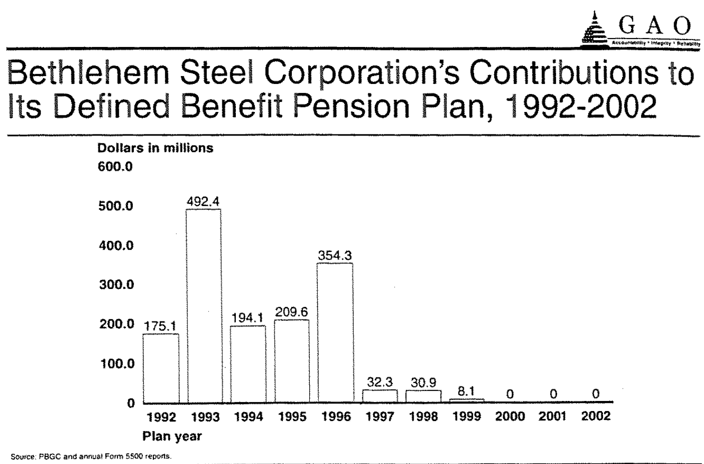
With the continuing uncertainty as to the floor schedule, I think it would be in the best interest of our witnesses and all of our guests that we end today's hearing. For Members who may have questions, I suggest that they submit their written questions to either Mr. Walker or Mr. Kandarian and, obviously, I would think both of you would be in a position to replay.

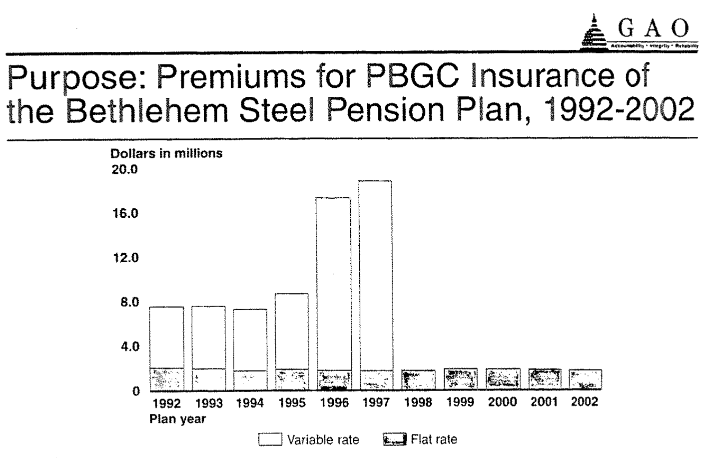
There will be other opportunities as the series of hearings continues for you to be back and help us as we begin to not only assess the problems that exist in the current defined benefit system, but, more importantly, the fine line that we are going to have to walk in terms of the possible solutions to fix these problems to ensure the retirement security of millions of American workers. So I want to thank all of you. This hearing is concluded.

[Whereupon, at 12:55 p.m., the Committee was adjourned.]

[Additional material provided for the record follows:]

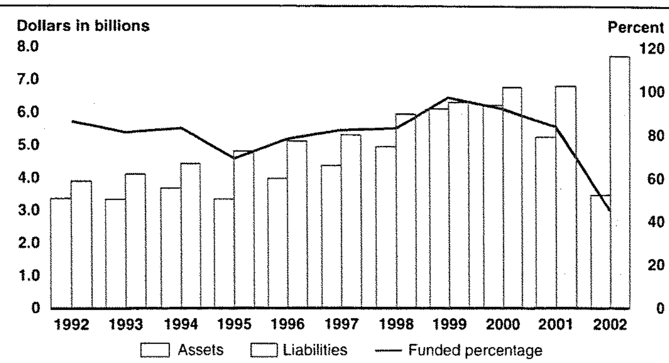
Graphs Submitted for the Record from the U.S. General Accounting Office





GAO

Assets, Liabilities, and Funded Percentage of the Bethlehem Steel Pension Plan, 1992-2002



Source: Annual Form 5500 reports and PBGC.

Note: Liabilities for 1992-2001 are current liabilities at the start of the plan year, and for 2002 are PBGC-estimated total benefit liabilities at termination.

The Next Big Bailout?

How Underfunded Pensions Put Taxpayers at Risk

NTUF Policy Paper 143
By Alex Pagon
August 18, 2003

The Pension Benefit Guaranty Corporation (PBGC), a quasi-public institution that insures private pensions, faces falling income, rising liabilities, and expected losses that are greater than its assets. In addition, the pension programs of the companies insured by the PBGC have record levels of underfunding. The General Accounting Office classifies the PBGC as a "high risk" program requiring urgent transformation and reform.[1] Tough luck for pensioners getting ready to retire? Not really, because someone else—the American taxpayer—is the ultimate guarantor of those pensions.

In the past two years falling asset prices and failing manufacturers have eroded the financial foundation of the PBGC, and the crushing weight of the troubled programs it insures portends a potential collapse that would require taxpayers to rescue the affected pensions. The pension plans of the companies in the S&P 500 that offer defined benefit pensions face deficits totaling at least $182 billion, and possibly more if the economy performs erratically.[2] Furthermore, pension failures are on a rising trajectory. In 2002 and 2003, the PBGC sustained losses significantly greater than its assets and posted its worst deficit in the PBGC's 29-year history.[3] The PBGC manages more failed pensions than ever before, and the yearly benefits it disburses more than doubled over the past two years.[4]

However, even if better economic times (i.e., rising asset prices and healthier companies) were to relieve some financial pressure, the PBGC still faces changing demographics that threaten the institution's long-term solvency. Nearly all the firms in the service and technology sectors, which contain healthy companies driving much of the growth in the economy, no longer offer defined benefit pensions. Thus, the PBGC relies on mature, often sclerotic, companies for the bulk of its income from insurance premiums. Also, as Americans now spend more time in retirement than ever before, the ratio of workers to pensioners continues to decline.[5] Consequently, the shifting demographics continually force the PBGC to do more with less. A decline in asset prices will not create a collapse; it will, however, accentuate the unsustainable current trends and bring the day of reckoning closer for taxpayers.

Fortunately, several measures to reform the current system could reduce the burden placed on taxpayers. Correction of the problems in the current insurance pricing schedule, conversion to defined contribution plans, and competition in the pension insurance market would ensure the long-term security of the private pension system and remove taxpayers" ultimate liability for failed pension plans. [6]

The Pension Benefit Guaranty Corporation—Born from Hard Times

In 1963, the auto manufacturer Studebaker terminated its employee pension plan, leaving its workers without the retirement benefits promised them. This prompted the federal government to introduce legislation to ensure that workers would receive a portion of their promised pensions even if their employer went bankrupt or closed out its pension plan.

In 1974, Congress passed the Employee Retirement Income Security Act, which created the PBGC. The PBGC's mission is to insure private pension plans as a quasi-public institution that is entirely self-sufficient. That is, the agency does not rely on taxes for its operating budget. Instead, the PBGC finances its operations through income from insurance premiums charged to the companies it insures and income from its investments. However, since the PBGC is a federally chartered agency, there is an implicit guarantee that Congress would not allow this institution to fail.

When a private pension fails or is in danger of failing, the PBGC terminates and assumes control of the pension accounts and disburses the promised benefits to the plan's participants. If the pension accounts have insufficient funds to cover the promised benefits, the PBGC uses its assets in order to make pensioners whole. However, in some scenarios the PBGC, due to its limited resources, can only provide the retirees it supports with a fraction of their original pensions.

The agency only insures defined benefit pension plans, which are traditional pensions controlled and managed by the employer. The employer promises to pay the employee a certain amount of money every month (a defined benefit) upon retirement. These pension programs stand in contrast with defined contribution plans, which are pensions controlled by the employee. The employer regularly places a certain amount (a defined contribution) of money in the employee's account, and the employee controls and manages his or her own pension portfolio.

The concept of a defined contribution pension is newer than the defined benefit plan, but the popularity and prevalence of such arrangements (e.g. 401(k) plans) are rapidly increasing. In fact, many companies, especially in the service sector, are converting their defined benefit pensions into defined contribution plans. Now defined benefit plans remain almost exclusively in heavily unionized manufacturing industries.

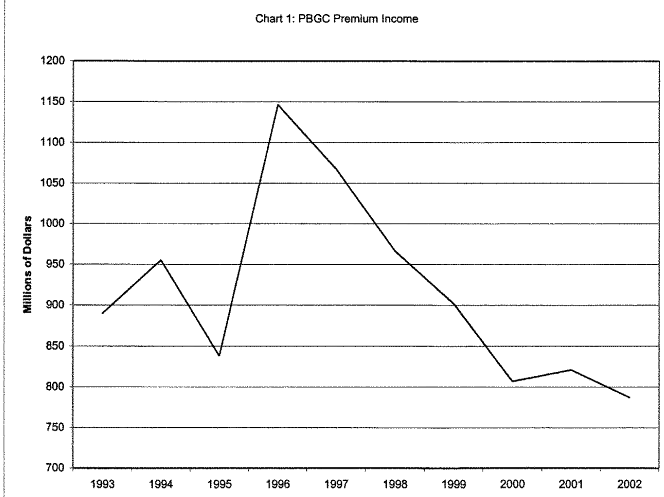
Throughout its 29-year history, the PBGC has generally met its obligations to the pensioners it supports, but it now faces a predicament that threatens its self-sufficiency.

The Hard Times Continue

The defined benefit pension plan is fast becoming a relic of past decades in which workers spent their entire careers with the same company, yet the PBGC was designed for that rigid employment structure. Consequently, the PBGC is struggling to stay ahead of the changing demographics that threaten to stretch the agency's responsibilities beyond its resources.

The pool of performing pension plans that contribute to the insurance premium income of the PBGC is shrinking as many of the new firms (especially in the technology sector) have never offered defined benefit plans, while existing healthy firms (most prevalently in the service sector) are transferring their employees into defined contribution programs (e.g. 401(k) plans). Since the PBGC insures only traditional defined benefit plans, the agency loses premium income as companies leave the defined benefit system.

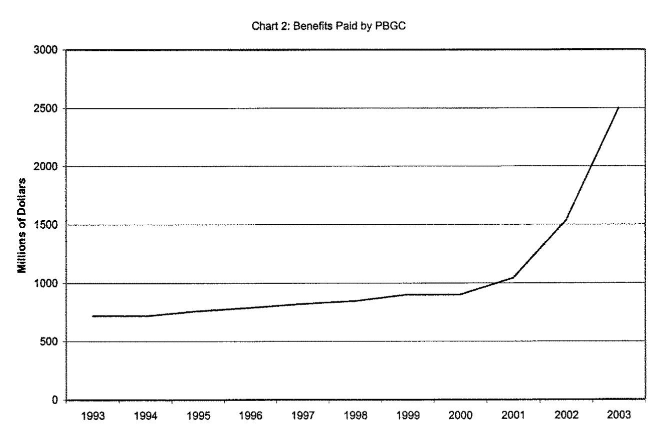
Further exacerbating the flight of firms from the traditional pension system is the principle of adverse selection. Due to several inadequacies of the PBGC's current insurance premium pricing schedule, healthy firms that responsibly manage their pensions pay a higher insurance premium due to the losses incurred by mismanaged funds. As a result, well-run firms understandably restructure their pension programs into defined contribution plans in order to eliminate the cost of subsidizing poorly performing funds through insurance premiums. The PBGC's 2002 annual report illustrates a steady decline in premium incomes over the past seven years. [7]



Source: PBGC 2002 Annual Report.

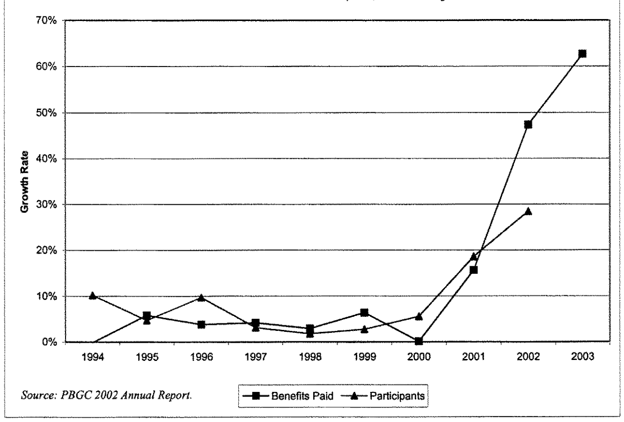
While the number of workers and companies paying insurance premiums to the PBGC is variable, the PBGC is still obligated to pay the pensions of all the retirees it supports. The continual increases in the number of years Americans spend in retirement further exacerbates the PBGC's mounting difficulties in supporting a body of pensioners that is growing relative to the active workforce. The number of participants in plans managed by the PBGC rose 53 percent from 2000 to 2002 (the estimates for 2003 are not yet available). [8]

Furthermore, the average length of retirement increased 20 percent, from 15 years in 1975 (the year of the PBGC's inception) to 18 years in 2000. [9] Consequently, the number of beneficiaries supported and the amount of benefits paid by the agency continue to grow at accelerating rates. In the past two years alone, the benefits paid by the PBGC increased by 140 percent, from $1.043 billion in 2001 to $2.5 billion in 2003. [10] These troubling trends reflect the rising number of bankruptcies in the manufacturing sector, which holds the large majority of programs insured by the PBGC.



Source: PBGC 2002 Annual Report.

Chart 3: Growth Rates of Benefits and Participants, PBGC-Managed Plans



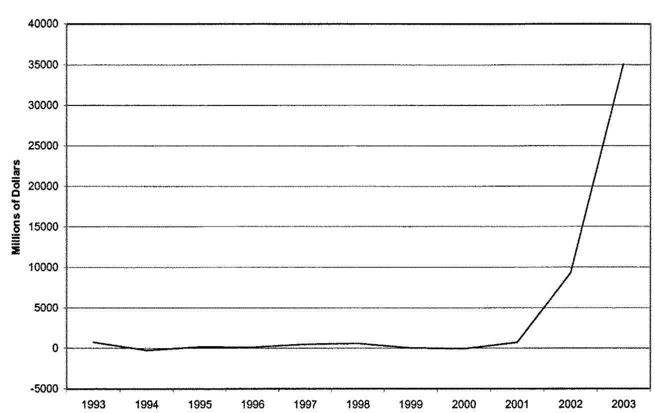
Source: PBGC 2002 Annual Report.

Furthermore, the PBGC projects an increase in the coming years in the number of failures among these pension plans.

The PBGC incurs losses when it terminates an underfunded pension plan. In the past, the agency covered the losses with little difficulty because its premium income exceeded the losses. However, losses sustained from completed and probable terminations of pension plans increased nearly 50-fold over the past two years. [11]

In addition, the losses registered by the PBGC in the past two years (2002 and 2003) alone is 18 times greater than all the combined losses incurred from 1993 to 2001. [12] Most ominous is the fact that the PBGC estimates that it will sustain a $35 billion loss from plan terminations in 2003, and its assets total only $25.43 billion. [13] Its projected losses for the current year are 138 percent of its total assets.

Chart 4: Losses from Terminations, PBGC-Managed Plans



Source: PBGC 2002 Annual Report. Losses are the difference between the assets and liabilities of terminated plans.

The concurrence of declining premium income, rapidly rising benefits obligations, and astronomical increases in losses sustained from plan terminations have eroded the PBGC's positive financial situation and drives the agency closer to insolvency.

Private Pension Problems

As of August, Standard & Poor's estimated that those companies in the S&P 500 offering defined benefit pension plans would face an accumulated underfunding amount of $182 billion by year-end. Although this is somewhat better than the $212 billion S&P estimate made in early 2003, The Wall Street Journal cautioned that "the woes—are far from over...," and other sources have placed the figure above

$300 billion.[14] Even the lower amount still represents more than 12 percent of the value ($1.5 trillion) of all pension benefits insured by the PBGC.[15]

Why such huge shortfalls? As interest rates decrease, a company must place more money in its pension program because the plan must have enough funding to guarantee its ability to meet its future pension obligations. When interest rates fall, the company assumes a lower rate of return on the money in the pension program. Therefore, to meet the prescribed level of expected future funding, the firm must put more money into the fund to make up for the lower expected returns. Most companies did not place any more money in their pensions as interest rates fell during the end of the last decade because the significant appreciation of the equity assets in the funds covered the assumed future decline in returns from a lower interest rate.

Then asset prices declined sharply, leaving pension funds with record levels of underfunding. Further compounding the current deficits is the fact that many companies used the surpluses in their pension programs during the good times of the late 1990s to pay for non-pension activities. A study by Goldman Sachs has estimated that these firms will have to direct $160 billion toward their pension plans over the next two years in order to reach an adequate level of funding in pension accounts.[16]

Two probable consequences of this action are a decline in reported earnings and a small reduction in output. The portion of cash flow or retained earnings devoted to filling the deficit in pension plans will effectively decrease a company's reported earnings. This decline, in turn, might contribute to a decline in the respective firm's share price as investors begin to worry about the company's earnings. Also, some analysts predict that placing cash in pension accounts to cover deficits could trim output, as firms must divert funds from more productive capital investment.[17] Thus, even under current trends of slightly rising interest rates and asset prices, the threat these shortfalls now pose to a recovery underscores the need for long-term reform.

There are several companies and industries that best demonstrate the difficulties facing individual pension plans and the potential losses the PBGC would incur if these companies went bankrupt or the PBGC terminated their pension plans for lack of adequate funding.

Perhaps the current situation of General Motors's (GM) pension plan best illustrates the dire straits in which many companies find their pension programs. After the recent decline in asset prices, the value of the company's pension plan assets fell considerably, and a recent report by Credit Suisse First Boston estimated that GM's pension plan has been underfunded by $29.4 billion (137 percent of the corporation's market capitalization).[18]

Recently, the auto manufacturer issued $17.6 billion in debt, using about $10 billion of the proceeds to shore up its pension position.[19] GM didn't use any of the cash it has on hand for fear that such a move would negatively impact its reported earnings. (Earnings placed in the pension program can't be reported as earnings for financial statement purposes. However, revenues from a bond offering are not considered earnings. Therefore, placing the proceeds from its debt issuance in the pension plan allows the company to claim the money that would have otherwise been placed in the pension fund as earnings.) Nonetheless, a further decline in asset prices (motivated, perhaps, by worries about the quality of earnings) would leave the automaker holding onto a hugely underfunded pension and a significant chunk of debt.

Furthermore, when one considers how the shifting demographics affect GM, the situation begins to look a lot like Social Security's predicament. GM currently supports about 450,000 pensioners, and it only employs roughly 200,000 workers, many of whom are nearing retirement.[20] As the average life expectancy continues to rise and retirees live longer after leaving the workforce, the ratio of workers to pensioners will continue to decline. So, GM must somehow raise the ratio of workers" contributions to pensioners" benefits, but the United Auto Workers Union has voiced its opposition to cuts in benefits. If the automaker cannot convince workers to accept reduced benefits or to switch their pensions to defined contribution plans, GM will continually face rising pension obligations, which undermine a company's profitability. When the music stops it will be the taxpayer left without a chair.

Unfortunately, GM is not the only large company continuing to face pension difficulties. In fact, the airline and steel industries represent the two most imminent (and sizable) threats to the solvency of the PBGC. Even though the two industries combined represent less than five percent of the total participants in plans insured by the PBGC, they account for 71 percent of the claims against the PBGC.[21]

US Airways and United Airlines are currently in bankruptcy proceedings, while Delta Airlines and the parent company of American Airlines both have pensions underfunded by amounts greater than 300 percent of their respective market capitalizations.[22] The airline industry has a total pension underfunding of $18 billion, and almost all carriers are losing money.[23] In the past two years, the PBGC terminated the pension plans of Bethlehem Steel ($3.9 billion), LTV Steel ($1.9 billion), and National Steel ($1.3 billion)—which are the three largest pensions ever terminated by the PBGC—and their combined liabilities equal 44 percent of all the claims in the 29-year history of the PBGC.[24]

Furthermore, companies in the manufacturing sector hold many of the pension plans facing significant deficits. Over the past decade, this sector experienced, and continues to experience, a disproportionate share of business failures. If this trend continues, more companies like Bethlehem, National, and LTV Steel will fold, leaving large pension programs in the care of the PBGC. The mounting risks of pension failures and the changing demographics of defined benefit pensions are worrisome trends that threaten to inundate the PBGC with responsibilities much larger than its resources can manage.

Recommendations

Government-sponsored enterprises are renowned for their economic inefficiency, and the PBGC is no exception. Reforms are necessary to prevent a taxpayer-financed bailout. The recommendations for reform center on three principles: correction of the insurance pricing schedule, conversion to defined contribution plans, and competition among private insurers to produce an optimal pension insurance market.

The current method of levying insurance premiums on pension plans has several flaws that reduce the PBGC's income and fail to create a strong incentive structure to encourage the responsible management of pension funds. The adjustment of premiums to better reward prudent administration and punish sloppy supervision of pension plans offers a simple market-based solution.

Currently, the PBGC charges each pension fund $19 yearly per participant to insure the plan, and it may also levy a small, additional charge on underfunded plans.[25] This gives rise to the dangers of adverse selection and moral hazard by not creating a substantial differentiation between the charges imposed on well-managed funds and poorly-run plans. A formula that accounts for the financial situation of each fund more completely would determine the premium based on the plan's underfunding and risk of failure. This will create the proper incentives for a company and ensure adequate funding of its pension. If the firm pays a higher premium when its fund runs a deficit, the company in question bears additional insurance costs, which serve as an inducement to restore the proper level of funding.

Pension insurance differs from nearly every other form of insurance due to the principle of market risk. Other types of insurance, such as auto, life, and medical insurance, do not have to account for changes in the market. That is, fluctuations in the economy do not significantly affect the probability of car collisions and medical emergencies. However, changes in economy-wide variables influence bankruptcy rates and pension underfunding. This principle, that economic fluctuations affect pension failures, is market risk.

The PBGC's current insurance premium pricing schedule does not completely account for this market risk. In a study of the PBGC's formula, Steven Boyce, a Senior Economist at the PBGC, and Richard A. Ippolito, a Professor at the George Mason Law School, conclude "the pricing schedule currently enforced by the PBGC only vaguely resembles one that meets a market standard [and] the premium structure ignores the fact that claims are highly correlated with wealth in the economy.[26] Furthermore, this failure to effectively account for market risk creates a yearly subsidy of $1 billion.[27] The underwriters of the insurance, the taxpayers, will bear the costs of this subsidy.

Thus, creating a pricing schedule that includes the market risk of a pension will add $1 billion every year to the PBGC's premium income, which will enable the agency to better meet its obligations and improve its financial situation. Taxpayers will likewise save a considerable amount of money in the long term through the elimination of this subsidy. The adjustment of the PBGC's premium pricing schedule will create strong, positive incentives for companies to better fund and manage their pension plans, and a formula that will completely account for the market risk in each pension.

Furthermore, the elimination of this subsidy will remove a significant distortion of the market that dissuades employers from properly funding their defined benefit plans and offering defined contribution plans. This will give employees more options from which they can choose their preferred pension plan.

While public policy ought to be neutral in the realm of personal choice, defined contribution plans are rapidly gaining popularity. Both defined benefit and defined contribution plans have their advantages and disadvantages, so employers and employees must decide which option is best for them. However, the current subsidization of defined benefit plans distorts this principle of choice. Today's workforce is much more flexible than those of the past decades. Employees rarely stay with one employer throughout their career and many now work for a considerable time beyond the age of retirement. Defined contribution plans better accommodate this flexible workforce than defined benefit programs because the defined contribution plans are portable between different employers, the employee controls his or her pension fund, and there is no penalty for working beyond the age of retirement. Defined benefit plans tend to work in the opposite direction.

Current trends show that defined contribution plans are rapidly gaining popularity and many more workers are choosing to place their retirement funds in these plans while the number of employees enrolled in defined benefit plans continues to decline. [28] Consequently, this subsidy is an obstacle to the employees who wish to convert their pensions into defined contribution plans, and its elimination will encourage the conversion of defined benefit plans into defined contribution plans.

Finally, the economic distortions of a monopoly are well recognized, and the PBGC is a government-created monopoly. Therefore, it is in the best interests of consumers to introduce competition into this market. State governments require all automobile drivers to purchase auto insurance, but they do not sanction a monopolistic insurance company that possesses the sole right to offer insurance to drivers within the state. In fact, the competition among auto insurance companies is strong and beneficial to drivers, as well as taxpayers.

Pension insurance is no different. Competition among insurance firms to provide insurance for pension holders would effectively remove the PBGC from the pension insurance market. Then insurance companies and their shareholders, who are willing to voluntarily bear the risk of pension failure, would replace taxpayers, who do not voluntarily bear the same risk, as the ultimate guarantors of the private pension plans. Competition on the open market for pension insurance would reduce the costs of providing pensions for employees and remove the risk and responsibility of pension failures from taxpayers.

Correction of the insurance pricing schedule, conversion to defined contribution plans, and competition among private insurers will ensure the long-term stability and security of private pension plans. Furthermore, taxpayers will no longer bear the costs of possible pension failures. Instead, those willing to bear the risk of providing and insuring pensions will be responsible for the successes and failures of those pension plans.

Conclusion

Congress must reform its regulation of the private pension system to ensure the security of pensions (correction), expand the personal pension choices available to employees (conversion), and remove the potential cost to taxpayers (competition). A resolution of the PBGC's conundrum may not be as easy as "A–B–C", but remembering the "Three Cs" is sure to save tax dollars and give lawmakers a valuable economics lesson to boot.

About the Author

Alex Pagon served as an Associate Policy Analyst for the National Taxpayers Union Foundation, the research and educational arm of the non-partisan National Taxpayers Union. For further information, visit www.ntu.org.

Notes

[1] "Long–Term Vulnerabilities Warrant "High Risk" Designation," General Accounting Office Press Statement, July 23, 2003.

[2] Bryan–Low, Cassell, "Gloom Lifting for Pension Plans," The Wall Street Journal, August 15, 2003.

[3] Pension Benefit Guaranty Corporation, 2002 Annual Report, p. 15, p. 51.

[4] Statement of Steven A. Kandarian before the Committee on Finance, United States Senate, March 11, 2003, p. 1.

[5] Ibid, p. 5.

[6] The terms correction and conversion as propositions for pension reform are the creation of James H. Smalhout. Smalhout, James H., The Uncertain Retirement, (Chicago: Irwin Professional Publishing, 1996).

[7] PBGC, 2002 Annual Report, p. 51.

[8] Ibid.

[9] Statement of Steven A. Kandarian before the Committee on Finance, United States Senate, March 11, 2003, p. 6.

[10] PBGC, 2002 Annual Report, p. 51.

[11] Ibid, p. 46, p. 51.

[12] Ibid.

[13] Ibid.

[14] Bryan–Low, Cassell, "Gloom Lifting for Pension Plans," The Wall Street Journal, August 15, 2003. For the higher estimate, see Svaldi, Aldo, "Underfunded Pensions Poised to Steal Accounting Spotlight Nationwide," Denver Post, March 17, 2003.

[15] Statement of Steven A. Kandarian before the Committee on Finance, United States Senate, March 11, 2003, p. 1.

[16] Evans, David, "Earnings Time Bomb Looms in US as Pension Fund Losses Mount," Bloomberg, December 30, 2002, p. 4.

[17] Ibid, p. 3.

[18] "Filling the Big Hole in Pension Plans," David L. Babson & Company, Inc., July 8, 2003, p. 4.

[19] "GM Pleased with Record Debt Offering," AFX News, Ltd., July 7, 2003.

[20] Schneider, Greg, "Pension Needs Fueling GM's Sales Push," The Washington Post, June 25, 2003, p. E1.

[21] Statement of Steven A. Kandarian before the Committee on Finance, United States Senate, March 11, 2003, p. 7.

[22] "AMR Pension Underfunding Estimated at 601% of Market Value," Communications Workers of America Press Statement, July 7, 2003, p. 1.

[23] Statement of Steven A. Kandarian before the Committee on Finance, United States Senate, March 11, 2003, p. 7.

[24] Ibid, p. 4.

[25] "Retirement Protection Act of 1994—Summary of Major Reforms," Pension Benefit Guaranty Corporation, p. 1.

[26] Boyce, Steven, and Richard A. Ippolito, "The Cost of Pension Insurance," The Journal of Risk and Insurance, 2002, Vol. 69, No. 2, p. 124.

[27] Ibid.

[28] Foster, Ann C., "Defined Contribution Retirement Plans Become More Prevalent," Compensation and Working Conditions, June 1996, pp. 42–44.