



TESTIMONY OF BRADLEY D. BELT

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Before the Committee on Finance

United States Senate

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Chairman Grassley, Ranking Member Baucus, and Members of the Committee: I want to commend you for holding this timely and important hearing and your continued leadership on retirement security policy issues.

Just a little over three months ago, my colleagues, Assistant Secretary of the Treasury for Economic Policy, Mark Warshawsky, and Assistant Secretary of Labor for the Employee Benefits Security Administration, Ann Combs, and I appeared before this Committee to discuss the challenges facing the defined benefit pension system and the pension insurance program, as well as the Administration's proposals for meeting these challenges. In a supplement to this testimony, I again describe in detail why comprehensive pension reform is so urgently needed and how the Administration's comprehensive reform proposal will stabilize the defined benefit system, strengthen the insurance program, and protect the retirement benefits earned by tens of millions of American workers. I also address the claims made by some commentators regarding the Administration's proposals.

For this hearing, you have asked what lessons can be learned from the United Airlines pension situation. As discussed more fully below, United offers important, albeit painful, lessons that illustrate the flaws in current law and which should guide us in reforming the defined benefit system and pension insurance program.

But first, I would like to briefly highlight new information and marketplace developments in the three months since the last hearing that amplify the growing pressures on the insurance program and provide further evidence why the comprehensive reform measures proposed by the Administration should be enacted as promptly as possible.

The most recent source of information about the financial status of certain pension plans comes from 4010 reports that are required to be filed by companies with pension plans underfunded by more than \$50 million. The filing deadline for most companies is April 15, and PBGC has now aggregated the information from those reports. While the number of companies required to file such reports grew only modestly, the amount of underfunding reported by the 4010 filers grew by 27 percent as compared to a year ago – from \$279 billion to \$354 billion. These 1,108 plans covering 15 million workers and retirees had \$786.8 billion in assets to cover over \$1.14 trillion in liabilities, for an average funded ratio of 69 percent.

<i>Summary of Pension Underfunding Filings</i>					
	2000	2001	2002	2003	2004
Number of Plans	221	747	1058	1051	1108
Underfunding (Dollars in billions)	\$19.91	\$110.94	\$305.88	\$278.99	\$353.73
Funded Ratio	82.8%	80.0%	65.1%	69.7%	69.0%

Fortunately, not all of that underfunding is in plans sponsored by weak companies. Still, as I stated in my prior testimony, at the end of fiscal year 2004, PBGC estimated that non-investment grade companies sponsored pension plans with combined underfunding of \$96 billion, almost three times as large as the amount recorded at the end of fiscal year 2002. We anticipate that this number will increase significantly by the end of fiscal year 2005 due to growing underfunding in financially weak companies. I would also note that PBGC has approximately 350 active bankruptcy cases, a record for the agency, 36 of which have been opened in the past four months. Of the open cases, 37 have underfunding claims of \$100 million or more, including six in excess of \$500 million.

And, the growing financial challenges being faced by certain companies and industry sectors are a subject of almost daily coverage in the nation's newspapers. We have previously testified about the extent of pension funding

problems faced by the “legacy” carriers in the airline industry. In addition to the potential \$10 billion in losses from US Airways and Continental, the other legacy carriers – Delta, Northwest, American, and Continental – have plans with total underfunding of \$22 billion. Losses continue – in first quarter earnings reports, Delta reported a loss of \$1.1 billion, Northwest a loss of \$458 million, Continental a loss of \$184 million, and American a loss of \$162 million. Delta has publicly warned that the company may have to consider bankruptcy. If it does, it may follow United and US Airways and seek to terminate its defined benefit pension plans.

The pension insurance program also faces substantial exposure from other industries, the largest of which is the automotive sector. Assets of pension plans sponsored by this industry fall short of pension promises by \$55-\$60 billion. Credit rating agencies in May downgraded the debt of General Motors and Ford to below investment-grade status. While the manufacturers have substantial liquidity, their financial problems may cascade down to other companies in the automotive industry. For example, some auto supply firms have had their credit lines restricted because of the downgrades in the debt ratings of General Motors and Ford. At least a dozen auto suppliers’ credit ratings have been downgraded to below investment-grade status. More significantly, half a dozen automotive parts suppliers have filed for bankruptcy in recent months – three of them since the last Committee hearing. These bankrupt companies sponsor defined benefit plans with more than \$800 million in unfunded pension obligations that would become a loss to the pension insurance system should those companies’ plans terminate during their bankruptcies.

I would now like to turn to the focus of this hearing – the implications of the proposed United pension plan terminations for the stakeholders in the defined benefit system. In my view, there are two broad lessons stemming from the United pension situation.

The first lesson is that the current funding rules are demonstrably flawed. Simply put, they have failed to ensure that companies make good on the commitments they make to their workers and retirees. Indeed, the funding rules even allow companies to make new benefit promises when their plans do not have enough assets to meet existing obligations. United, US Airways, Bethlehem Steel, LTV, and National Steel would not have presented claims in excess of \$1 billion each – and with funded ratios of less than 50 percent – if the rules worked. Given its size and visibility, United provides an illustrative, if tragic, case study of the shortcomings of the current funding rules.

Provided below are four charts covering United’s four pension plans from 1998 to 2003. During the period from 2000 onward, when the true funded status of each of the company’s pension plans was deteriorating and the financial health of the company was becoming more precarious, the company:

- put little if any cash into the plans;
- rarely made a deficit reduction contribution;
- never provided any notices of underfunding to participants; and
- almost never paid a variable rate premium.

Yet the company still could claim that its plans were “fully funded” on a current liability basis.

United Airlines Ground Employees Plan

Termination Benefit Liability Funded Ratio 32%

Unfunded Benefit Liabilities \$ 2.8 billion

As of March 11, 2005

	1998	1999	2000	2001	2002	2003
Current Liability Funded Ratio*	101%	95%	100%	99%	104%	58%
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	Y \$303.5 million
Was the company obligated to send out a participant notice?	N	N	N	N	N	N
Did the company pay a Variable Rate Premium?	N	N	N	N	N	N
Actual Contributions	\$50.0 million	\$50.0 million	\$0	\$0	\$0	\$52.4 million
Prior Year Credit Balance	\$333.2 million	\$316.5 million	\$323.4 million	\$318.1 million	\$324.8 million	\$333.7 million

* Current Liability Funded Ratio is based on five-year smoothing of assets and smoothed, four-year weighted average interest rate on liabilities.

United Airlines Pilot Plan

Termination Benefit Liability Funded Ratio 50%

Unfunded Benefit Liabilities \$ 2.9 billion

As of December 30, 2004

	1998	1999	2000	2001	2002	2003
Current Liability Funded Ratio*	100%	98%	102%	98%	102%	80%
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	N
Was the company obligated to send out a participant notice?	N	N	N	N	N	N
Did the company pay a Variable Rate Premium?	N	N	N	N	N	Y \$6.7 million
Actual Contributions	\$15.0 million	\$40.0 million	\$0	\$0	\$0	\$0
Prior Year Credit Balance	\$346.2 million	\$393.3 million	\$496.6 million	\$513.1 million	\$560.5 million	\$525.5 million

* Current Liability Funded Ratio is based on five-year smoothing of assets and smoothed, four-year weighted average interest rate on liabilities.

United Airlines Management, Administrative and Contract Personnel Plan

Termination Benefit Liability Funded Ratio 39%

Unfunded Benefit Liabilities \$ 2.3 billion

As of May 11, 2005

	1998	1999	2000	2001	2002	2003
Current Liability Funded Ratio*	98%	94%	95%	93%	96%	71%
Was the company required to make a deficit reduction contribution?	N	N	N	N	N	Y \$149.0 million
Was the company obligated to send out a participant notice?	N	N	N	N	N	N
Did the company pay a Variable Rate Premium?	N	N	N	N	N	Y \$4.4 million
Actual Contributions	\$50.0 million	\$44.9 million	\$0	\$0	\$0	\$56.3 million
Prior Year Credit Balance	\$162.1 million	\$156.7 million	\$143.2 million	\$156.4 million	\$104.4 million	\$44.3 million

* Current Liability Funded Ratio is based on five-year smoothing of assets and smoothed, four-year weighted average interest rate on liabilities.

United Airlines Flight Attendant Plan

Termination Benefit Liability Funded Ratio 42%
Unfunded Benefit Liabilities \$ 1.9 billion

As of May 11, 2005

	1998	1999	2000	2001	2002	2003
Current Liability Funded Ratio*	91%	88%	91%	88%	94%	75%
Was the company required to make a deficit reduction contribution?	N	N	N	Y \$212.3 million	N	Y \$187.9 million
Was the company obligated to send out a participant notice?	N	N	N	N	N	N
Did the company pay a Variable Rate Premium?	N	N	N	N	N	N
Actual Contributions	\$84.9 million	\$65.0 million	\$0	\$0	\$0	\$24.7 million
Prior Year Credit Balance	\$254.4 million	\$311.6 million	\$357.9 million	\$357.8 million	\$289.8 million	\$262.6 million

* Current Liability Funded Ratio is based on five-year smoothing of assets and smoothed, four-year weighted average interest rate on liabilities.

This rosy picture is clearly in contrast with what we know to be the true status of the United plans – currently with an aggregate shortfall of almost \$10 billion and an aggregate funded ratio of only 41 percent. There are several aspects of the current funding rules that contributed to this disaster scenario, but I would single out two in particular, which were also noted in GAO’s report released last week.¹

One is the use of so-called credit balances. Just at the point in time when contributions to the plans were most needed as asset values were falling and liabilities growing, the company was able to use credit balances built up during the 1990s bull market to avoid putting cash into the plans. Remarkably, notwithstanding the fact that the United pilots plan is underfunded by almost \$3 billion, the company has not made, and has not been required to make, a cash contribution to that plan for the years 2000 through 2004 (and none would have been required until the end of this year). Some have argued that without credit balances, companies will have no incentive to make more than the required minimum contribution during good times. As discussed more fully in the supplement to my testimony, we believe the Administration’s proposal provides ample incentives to appropriately fund pension plans.

¹ United States General Accountability Office, “Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules” GAO-05-294, p. 22 (May 2005).

The other aspect of the funding rules that merits mention is the ability to “smooth” assets and liabilities. (Plans can smooth assets over 5 years and can smooth liabilities based on a four-year weighted average interest rate.) Those who want to retain these mechanisms argue that it is necessary to reduce volatility. But, of course, the volatility isn’t reduced, it is simply masked – hidden from the view of participants. The smoothed asset and liability calculations not only allowed companies to report a distorted funded ratio, it also enabled them to avoid the deficit reduction contribution (DRC) requirements, the variable rate premium, and the notice to participants. I would emphasize that these issues are hardly unique to United Airlines.

The second lesson is that the termination of underfunded pension plans adversely affects stakeholders in the defined benefit system. It can have particularly harsh consequences for workers and retirees. Their expectations of a secure future may be shattered, because in underfunded plans not all promised benefits are guaranteed. While United employees, in the aggregate, should receive about 80 percent of their accrued pension benefits, they could still lose more than \$3 billion in accrued benefits and would not accrue any future benefits that they had been counting on receiving. Many United employees, especially pilots, would be hard hit by the maximum guarantee limit.

Other companies that sponsor defined benefit plans also pay a price through higher premiums. Because the PBGC receives no federal tax dollars and its obligations are not backed by the full faith and credit of the United States, losses suffered by the insurance fund must, under current law, be covered by higher premiums. Not only will healthy companies be subsidizing weak companies with underfunded plans, they may also face the prospect of having to compete against a rival firm that has shifted a significant portion of its ongoing labor costs onto the government. This is clearly at issue in the airline industry. The CEOs of the legacy carriers have publicly stated that this scenario will give United an unfair advantage and may cause them to seek to terminate their pension plans.

Finally, taxpayers are at risk of being called upon to bail out the pension insurance program if losses continue to mount.

Mr. Chairman, the Administration is committed to strengthening the pension insurance program and keeping defined benefit plans as a viable option for employers and employees. This requires a careful balancing of interests and inevitably will require trade-offs among various stakeholder interests. We

believe the Administration proposal strikes an appropriate balance and will best protect the pension benefits earned by workers and retirees, minimize the need for future premium increases, and lessen the possibility that taxpayers will have to be called upon to rescue the insurance program.

SUPPLEMENT TO TESTIMONY: CHALLENGES FACING THE DEFINED BENEFIT SYSTEM AND PENSION INSURANCE PROGRAM AND THE ADMINISTRATION'S PROPOSALS FOR MEETING THOSE CHALLENGES

Introduction

Private-sector defined benefit plans have been and are intended to be a source of stable retirement income for more than 44 million American workers and retirees. Unfortunately, as I discuss more fully below, the defined benefit system is under severe stress – the number of defined benefit plans has fallen precipitously over the past two decades, the percentage of the workforce covered by such plans has dropped by half, and, in many cases, benefits are being frozen or the plans are being closed to new participants.

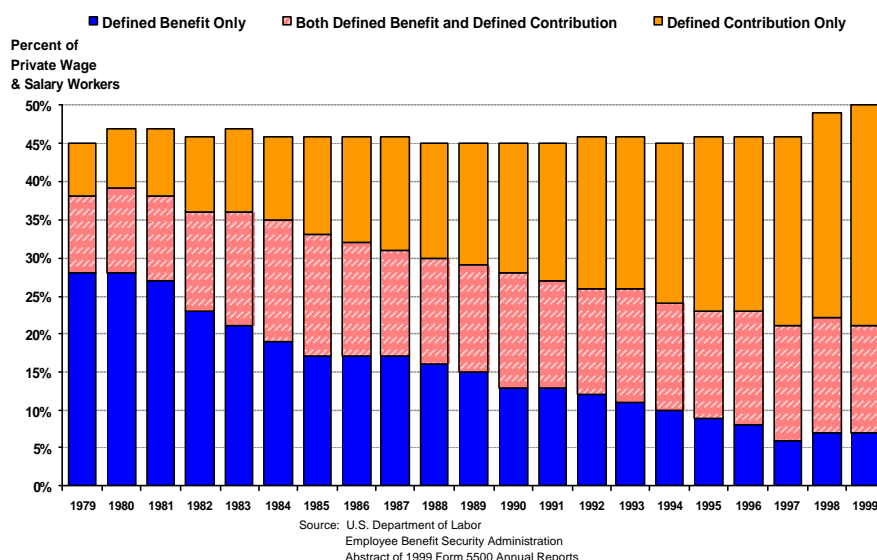
More ominously, there have been a growing number of instances in which plans have been terminated by their sponsors with assets far insufficient to pay the promised benefits. This results in lost benefits for a number of participants in those plans, threatens the long term financial solvency of the insurance program, requires sponsors that have acted responsibly to pay higher premiums, and potentially could lead to a call for a rescue of the program with taxpayer funds.

I would emphasize that this has occurred under the current statutory and regulatory framework. In order to stop the hemorrhaging in the system, to put the insurance program on a sound financial footing, and to best protect the benefits of millions of workers and retirees, the Administration believes that comprehensive pension reform is critically needed. If we do nothing or merely tinker at the margins the inevitable outcome will be a continued erosion of this important retirement security leg and continued large losses for participants, premium payers and potentially taxpayers.

State of the Defined Benefit System

Traditional defined benefit pension plans, based on years of service and either final salary or a flat-dollar benefit formula, provide a stable source of retirement income to supplement Social Security. The number of private sector defined benefit plans reached a peak of 112,000 in the mid-1980s. At that time, about one-third of American workers were covered by defined benefit plans.

Pension Participation Rates 1979 - 1999



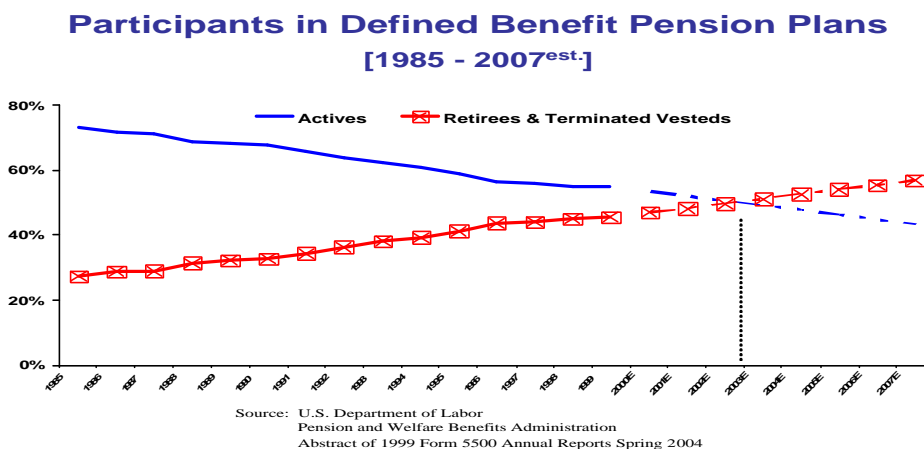
In recent years, many employers have chosen not to adopt defined benefit plans, and others have chosen to terminate or freeze their existing defined benefit plans. From 1986 to 2004, 101,000 single-employer plans with about 7.5 million participants terminated. In about 99,000 of these terminations the plans had enough assets to purchase annuities in the private sector to cover all benefits earned by workers and retirees. In the remaining 2,000 cases, companies with underfunded plans shifted their pension liabilities to the PBGC.

Of the roughly 30,000 defined benefit plans that exist today, many are in our oldest, most mature industries. These industries face growing benefit costs due to an increasing number of retired workers. Some of these sponsors also face challenges due to structural changes in their industries and growing competition from both domestic and foreign companies.

In contrast to the dramatic reduction in the total number of plans, the total number of participants in PBGC-insured single-employer plans has increased. In 1980, there were about 28 million covered participants, and by 2004 this number had increased to about 35 million. But these numbers mask the downward trend in the defined benefit system because they include not only active workers but also retirees, surviving spouses, and separated vested participants. The latter three categories reflect past coverage patterns in defined benefit plans. A better forward-looking measure is the trend in the number of active participants, who continue to accrue benefits. That trend is moving downward.

In 1985, there were about 22 million active participants in single-employer defined benefit plans. By 2002, the number had declined to 17 million. At the same time, the number of inactive participants has been growing. In 1985, inactive participants accounted for only 28 percent of total participants in single-employer defined benefit plans, a number that has grown to about 50 percent today.

In a fully advance-funded pension system, demographics wouldn't matter. But when \$450 billion of underfunding must be spread over a declining base of active workers, the challenges become apparent.



The decline in the number of plans offered and workers covered doesn't tell the whole story of how changes in the defined benefit system are impacting retirement income security. There are other significant factors that can undermine the goal of a stable income stream for aging workers.

For example, in lieu of outright termination, companies are increasingly “freezing” their plans. Surveys by pension consulting firms show that a significant number of their clients have frozen their plans or are considering instituting some form of plan freeze.¹ Freezes not only eliminate workers' ability to earn additional pension benefits but often serve as a precursor to plan termination, which further erodes the premium base of the pension insurance program.²

¹ See, e.g., Aon Consulting, *More Than 20% of Surveyed Plan Sponsors Froze Plan Benefits or Will Do So*, Oct. 2003; Hewitt Associates, *Survey Findings: Current Retirement Plan Challenges: Employer Perspectives* (Dec. 2003).

² Some of the trends in the defined benefit system are captured in a PBGC publication issued less than two weeks ago, the *Pension Insurance Data Book 2004* (available at www.pbgc.gov). The *Data Book* shows that since PBGC's inception in 1974, 68 percent of its losses were incurred in the five years from 2000 through 2004. As a result of all these recent terminations, PBGC's annual benefit payments have almost tripled, from a little over \$1 billion in 2001 to \$3 billion in 2004.

Given the increasing mobility of the labor force, and the desire of workers to have portable pension benefits that do not lock them into a single employer, many companies have developed alternative benefit structures, such as cash balance or pension equity plans that are designed to meet these interests. The PBGC estimates that these types of hybrid structures now cover 25 percent of participants in defined benefit plans.³ Unfortunately, the legal status of these types of plans is in question, further threatening the retirement security of millions of workers and retirees.⁴

The Role of the PBGC

The Pension Benefit Guaranty Corporation (PBGC) was established by the Employee Retirement Income Security Act of 1974 (ERISA) to guarantee private-sector, defined benefit pension plans. Indeed, the Corporation's two separate insurance programs—for single-employer plans and multiemployer plans—are the lone backstop for hundreds of billions of dollars in promised but unfunded pension benefits. The PBGC is also the trustee of nearly 3,500 defined benefit plans that have failed since 1974. In this role, it is a vital source of retirement income and security for more than 1 million Americans who would have lost benefits without PBGC's protection, but who currently are receiving or are promised benefits from the Corporation.

PBGC is one of the three so-called "ERISA agencies" with jurisdiction over private pension plans. The other two agencies are the Department of the Treasury (including the Internal Revenue Service) and the Department of Labor's Employee Benefits Security Administration (EBSA). Treasury and EBSA deal with both defined benefit plans and defined contribution benefit plans, including 401(k) plans. PBGC guarantees benefits of defined benefit plans only and serves as trustee for underfunded defined benefit plans that terminate. PBGC is also charged with administering and enforcing compliance with the provisions of Title IV of ERISA, including monitoring of standard terminations of fully funded plans.

PBGC is a wholly-owned federal government corporation with a three-member Board of Directors—the Secretary of Labor, who is the Chair, and the Secretaries of Commerce and Treasury.

Although PBGC is a government corporation, it receives no funds from general tax revenues and its obligations are not backed by the full faith and credit of the U.S. government. Operations are financed by insurance premiums, assets from pension

³ Table S-35, PBGC Pension Insurance Data Book 2004 (April 2005).

⁴ *Cooper v. IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003) (holding that cash balance plans violate age discrimination provisions of ERISA). Other courts, however, have disagreed. *Tootle v. ARINC, Inc.*, 222 F.R.D. 88 (D. Md. 2004); *Eaton v. Onan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000).

plans trusted by PBGC, investment income, and recoveries from the companies formerly responsible for the trustee plans (generally only pennies on the dollar). The annual insurance premium for single-employer plans has two parts: a flat-rate charge of \$19 per participant, and a variable-rate premium of 0.9 percent of the amount of a plan's unfunded vested benefits, measured on a "current liability"⁵ basis.

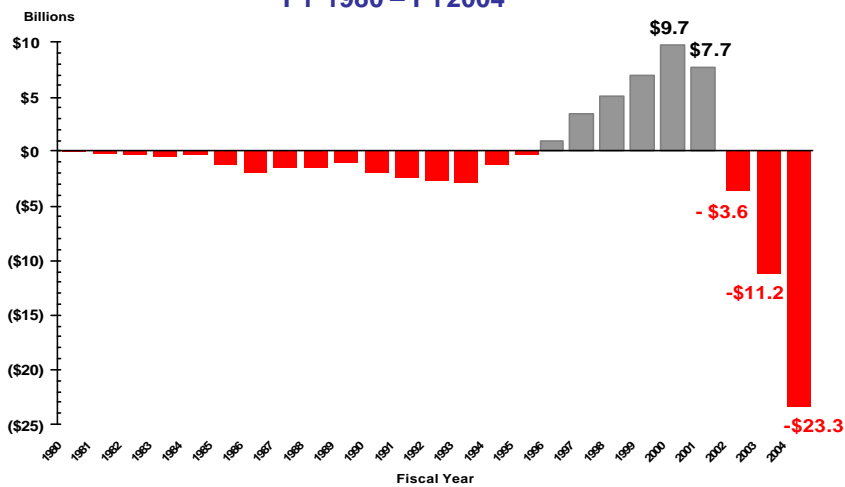
The PBGC's statutory mandates are: (1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of participants; (2) to provide for the timely and uninterrupted payment of pension benefits to participants; and (3) to maintain premiums at the lowest level consistent with carrying out the agency's statutory obligations. In addition, implicit in these duties and in the structure of the insurance program is the duty to be self-financing. *See, e.g.*, ERISA § 4002(g)(2) (the United States is not liable for PBGC's debts).

These mandates are not always easy to reconcile. For example, the PBGC is instructed to keep premiums as low as possible to encourage the continuation of pension plans, but also to remain self-financing with no recourse to general tax revenue. Similarly, the program should be administered to protect plan participants, but without letting the insurance fund suffer unreasonable increases in liability, which can pit the interests of participants in a particular plan against the interests of those in all plans the PBGC must insure. The PBGC strives to achieve the appropriate balance among these competing considerations, but it is inevitably the case that one set of stakeholder interests is adversely affected whenever the PBGC takes action. This conflict is most apparent when PBGC determines that it must involuntarily terminate a pension plan to protect the interests of the insurance program as a whole and the 44 million participants we cover, even though such an action may adversely impact participants in the plan being terminated.

The pension insurance programs administered by the PBGC have come under severe pressure in recent years due to an unprecedented wave of pension plan terminations with substantial levels of underfunding. This was starkly evident in 2004, as the PBGC's single-employer insurance program posted its largest year-end shortfall in the agency's 30-year history. Losses from completed and probable pension plan terminations totaled \$14.7 billion for the year, and the program ended the year with a deficit of \$23.3 billion. That is why the Government Accountability Office has once again placed the PBGC's single employer insurance program on its list of "high risk" government programs in need of urgent attention.

⁵ Current liability is a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if a plan terminates.

PBGC Net Position Single-Employer Program FY 1980 – FY2004



Data does not include restored LTV plans in 1986

Notwithstanding our record deficit, I want to make clear that the PBGC has sufficient assets on hand to continue paying benefits for a number of years. However, with \$62 billion in liabilities and only \$39 billion in assets as of the end of the past fiscal year, the single-employer program lacks the resources to fully satisfy its benefit obligations.

The most recent snapshot taken by the PBGC finds that corporate America's single-employer pension promises are underfunded by more than \$450 billion. Almost \$100 billion of this underfunding is in pension plans sponsored by companies that face their own financial difficulties, and where there is a heightened risk of plan termination.

Of course, when the PBGC is forced to take over underfunded pension plans, we will provide the pension benefits earned by workers and retirees up to the maximum amounts established by Congress. Unfortunately, notwithstanding the guarantee provided by the PBGC, when plans terminate many workers and retirees are confronted with the fact that they may not receive all the benefits they have been promised by their employer, and upon which they have staked their retirement security. In an increasing number of cases, participants lose benefits that were earned but not guaranteed because of legal limits on what the pension insurance program can pay. It is not unheard of for participants to lose two-thirds of their promised monthly benefit.

For example, a steelworker in the Bethlehem Steel plan, like many other steelworkers, started working just before his 20th birthday. He worked until he was 50 years old and retired, like many other steelworkers, under his plan's 30-and-out provision with a \$3,600 per month pension. About 6 months later, the PBGC trusted the Bethlehem Steel plan. Although the maximum monthly benefit for plans terminating in 2003 was

about \$3,600, we are required by law to reduce the maximum benefit for workers who start receiving their pension benefits before age 65. As a result, this worker's benefits were cut by two-thirds to about \$1,200 per month.

Other companies that sponsor defined benefit plans also pay a price when underfunded plans terminate. Because the PBGC receives no federal tax dollars and its obligations are not backed by the full faith and credit of the United States, losses suffered by the insurance fund must ultimately be covered by higher premiums. Not only will healthy companies that are responsibly meeting their benefit obligations end up making transfer payments to weak companies with chronically underfunded pension plans, they may also face the prospect of having to compete against a rival firm that has shifted a significant portion of its labor costs onto the government.

In the worst case, PBGC's deficit could grow so large that the premium increase necessary to close the gap would be unbearable to responsible premium payers.⁶ If this were to occur, there undoubtedly would be pressure on Congress to call upon U.S. taxpayers to pay the guaranteed benefits of retirees and workers whose plans have failed.

If we want to protect participants, premium payers and taxpayers, we must ensure that pension plans are adequately funded over a reasonable period of time. As I will discuss in more detail, the status quo statutory regime is inadequate to accomplish that goal. We need comprehensive reform of the rules governing defined benefit plans to protect the system's stakeholders.

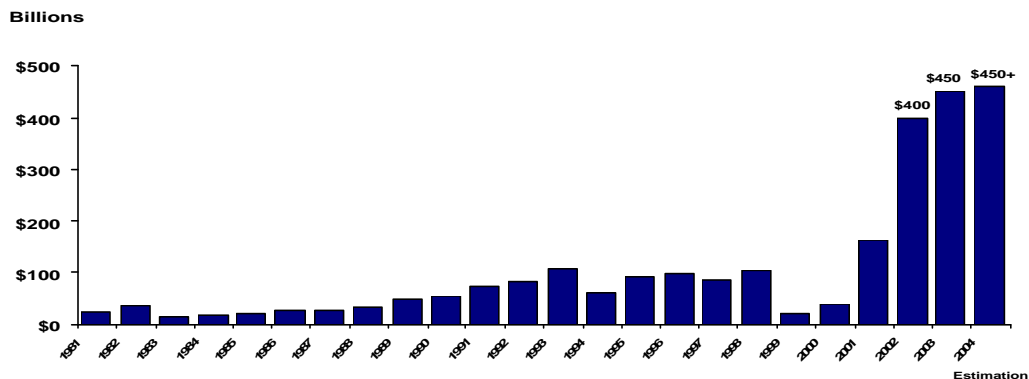
Mounting Pressures on the Pension Safety Net

These broad defined benefit trends, and financial market and business cycles, combined with flawed funding rules, have translated into severe financial pressures on the pension insurance program. In addition to the \$23 billion shortfall already reflected on the PBGC's balance sheet, the insurance program remains exposed to record levels of underfunding in covered defined benefit plans. As recently as December 31, 2000, total underfunding in the single-employer defined benefit system came to less than \$50 billion. Two years later, as a result of a combination of factors, including declining interest rates and equity values, ongoing benefit payment obligations and accrual of liabilities, and minimal cash contributions into plans, total underfunding exceeded \$400 billion.⁷ As of September 30, 2004, we estimate that total underfunding exceeds \$450 billion, the largest number ever recorded.

⁶ See page 3, *Pension Tension*, Morgan Stanley, Aug. 27, 2004. "[I]n today's environment healthy sponsors may well decide that they don't want to foot the bill for weak plans' mistakes through increased pension insurance premiums."

⁷ See page 14, *The Magic of Pension Accounting, Part III*, David Zion and Bill Carcache, Credit Suisse First Boston (Feb. 4, 2005). "[F]rom 1999 to 2003 the pension plan assets grew by \$10 billion, a compound annual growth rate of less than 1%, while the pension obligations grew by \$430 billion, a compound

Total Underfunding Insured Single-Employer Plans



PBGc estimates from Form 5500 and Section 4010 Filings

Not all of this underfunding poses a major risk to participants and the pension insurance program. Indeed, the vast majority of companies that sponsor defined benefit plans are financially healthy and should be capable of meeting their pension obligations to their workers. At the same time, the amount of underfunding in pension plans sponsored by financially weaker employers has never been higher. As of the end of fiscal year 2004, the PBGC estimated that non-investment-grade companies sponsored pension plans with \$96 billion in underfunding, almost three times as large as the amount recorded at the end of fiscal year 2002.

The losses incurred by the pension insurance program to date have been heavily concentrated in the steel and airline industries. These two industries, however, have not been the only source of claims, nor are they the only industries posing future risk of losses to the program.

The PBGC's best estimate of the total underfunding in plans sponsored by companies with below-investment-grade credit ratings and classified by the PBGC as "reasonably possible" of termination is \$96 billion at the end of fiscal 2004, up from \$35 billion just two years earlier. The current exposure spans a range of industries, from manufacturing, transportation and communications to utilities and wholesale and retail trade. Some of the largest claims in the history of the pension insurance program involved companies in supposedly safe industries such as insurance (\$529 million claim for the parent of Kemper Insurance) and technology (\$324 million claim for Polaroid).

annual growth rate of roughly 10%." See also page 2, *Pension Tension*, Morgan Stanley (Aug. 27, 2004). "DB sponsors were lulled into complacency by inappropriate and opaque accounting rules, misleading advice from their actuaries causing unrealistic return and mortality assumptions, and mismatched funding of the liabilities, and the two decades of bull equity markets through the 1990s veiled true funding needs."

Reasonably Possible Exposure

(Dollars in Billions)

Principal Industry Categories	FY 2004	FY 2003
Manufacturing	\$ 48.4	\$ 39.5
Transportation, Communication & Utilities	30.5	32.9
Services & Other	7.9	2.5
Wholesale and Retail Trade	5.8	4.3
Agriculture, Mining & Construction	1.9	1.8
Finance, Insurance & Real Estate	1.2	1.1
Total	\$95.7	\$82.1

Some have argued that current pension problems are cyclical and will disappear once equity returns and interest rates revert to historical norms. Perhaps this will happen, perhaps not. The simple truth is that we cannot predict the future path of either equity values or interest rates. It is not reasonable public policy to base pension funding on the expectation that the unprecedented stock market gains of the 1990s will repeat themselves. Similarly, it is not reasonable public policy to base pension funding on the expectation that interest rates will increase dramatically.⁸ The consensus forecast predicted that long-term interest rates would have risen sharply by now, yet they remain near 40-year lows.⁹ And a recent analysis by the investment management firm PIMCO finds that the interest-rate exposure of defined benefit plans is at an all-time high, with more than 90 percent of the exposure unhedged.¹⁰

More important, while rising equity values and interest rates would certainly reduce the amount of current underfunding, this would not address the underlying structural flaws in the pension insurance system.

⁸ See page 1, *Pension Update: Treading Water Against Currents of Change*, James F. Moore, PIMCO (Feb. 2005). “Unfortunately things are likely to get worse before they get better. . . As of the beginning of February, the Moody’s AA long term corporate index was below 5.50% and 30-year Treasuries were below 4.5%.”

⁹ Long-term rates have declined in Japan and Europe – to 2.5 percent and 4.0 percent, respectively – two economies facing the same structural and demographic challenges as the United States. See page 1, *Pension Update: Treading Water Against Currents of Change*, James F. Moore, PIMCO (Feb. 2005).

¹⁰ See page 1, *Defined Benefit Pension Plans’ Interest Rate Exposure at Record High*, Seth Ruthen, PIMCO (Feb. 2005).

How Did We Get Here?

Unfortunately, the current problems in the system are not transitory, nor can they be dismissed as simply the result of restructuring in a few industries. They are the result of fundamental flaws in the statutory and regulatory framework governing defined benefit plans and the pension insurance program. If we want to retain defined benefit plans as a viable option for employers and employees and avoid insolvency of the insurance program, fundamental changes are needed.

The defined benefit pension system is beset with structural flaws that undermine benefit security for workers and retirees and leave premium payers and taxpayers at risk of inheriting the unfunded pension promises of failed companies.

The first structural flaw is a set of funding rules that are needlessly complex and fail to ensure that pension plans are adequately funded. Some companies that have complied with all of the statutory funding requirements have still ended up with plans that are less than 50 percent funded when they terminated.

A second structural flaw is what economists refer to as “moral hazard.” Unlike most private insurers, the PBGC cannot apply traditional risk-based insurance and premium methods.

A third flaw is the lack of information available to stakeholders in the system. The funding and disclosure rules seem intended to obfuscate economic reality. The PBGC’s record deficit and the historic levels of pension underfunding underscore these structural defects – flaws that must be corrected to better protect workers’ benefits, responsible plan sponsors from further premium increases, and taxpayers from being called upon to rescue the pension insurance program.

Weaknesses in Current Funding Rules

The current defined benefit pension funding rules, which micromanage annual cash flows to the pension fund, are in need of a complete overhaul. Current rules are needlessly complex, don’t reflect economic reality, and don’t ensure that plans become well funded. Some of the pressing problems with the funding rules are described below.

- Current measures of liabilities and assets are not accurate and meaningful.
 - The original ERISA funding targets were set too low and can be manipulated. Under current funding rules, there is no uniformity in liability measures. In addition, a plan actuary has substantial discretion in selecting actuarial assumptions that are used to determine liabilities. For example, the actuary

must assume an interest rate that reflects future investment earnings on plan assets; an actuary will commonly assume the high rate of return that is anticipated from investments in equities. As a result, companies can report that their pension plans are fully funded when in fact they are substantially underfunded using a more meaningful and accurate measure of liability. In a study released last week, GAO found that from 1995 to 2002, because of this actuarial discretion, underfunding may actually have been more severe and widespread than reported.¹¹

- The later deficit reduction contribution rules are also ineffective. The deficit reduction contribution rules, adopted in 1987, override the minimum funding requirements for many underfunded plans and require accelerated contributions to plans. These rules are based on “current liability,” which is a somewhat more standardized measure of liability. It is a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if the plan terminates. Employers can avoid having to make deficit reduction contributions by maintaining plan funding at 90 percent of current liability.

The interest rate used in determining current liability can be selected from a corridor that is based on an average of interest rates over the prior 48 months, and thus can be significantly out-of-date during periods of rapidly changing interest rates. In addition, the current liability is measured using a long-term interest rate that does not take into account the actual timing of when benefit payments will be due under the plan, which often is considerably sooner.

- Risk of plan termination is not recognized in funding. The same funding rules apply regardless of a company’s financial health. PBGC studied 41 of its largest claims that represented 67 percent of total gross claims. Over 90 percent of these largest claims against the insurance system were from plans sponsored by companies that had junk-bond credit ratings for 10 years prior to termination. Yet current funding targets do not reflect the substantial risk of termination and losses to plan participants and the pension insurance system posed by financially weak employers. As the recent GAO report notes, speculatively rated sponsors represent greater risks to the PBGC. Plan sponsors that are in financial distress may have a more limited time horizon and place other financial priorities above funding their pension plans.¹²

¹¹ United States General Accountability Office, “Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules” GAO-05-294, p. 15 (May 2005).

¹² United States General Accountability Office, “Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules” GAO-05-294, p. 4 (May 2005).

- Asset values are smoothed. Current funding rules permit the use of an actuarial value of plan assets, which is determined under a formula that “smooths” fluctuations in the market value of assets by averaging the value over a number of years. These smoothing mechanisms were created in an attempt to reduce the year-to-year fluctuations of plan contribution requirements. Masking current market conditions is an imprudent and unnecessary way to avoid volatility in funding contributions, it obscures the funded status of a plan, and it distorts the risks posed to participants and shareholders. The recent GAO report notes that, by smoothing annual contributions and liabilities, a plan’s reported level of funding may be distorted.¹³
- Underfunded plans have too long to make up shortfalls and employers can take funding holidays without regard to a plan’s funding level.
 - Amortization periods are long. The current law 30-year amortization period for plan amendments is too long given the default risk for many plan sponsors. Furthermore, collectively bargained plans often increase benefits every few years and as a result are perennially underfunded. The deficit reduction contribution override – with amortization periods from four to seven years – was designed to address this problem, but its effectiveness has been limited.
 - Funding rules allow companies with unfunded pension liabilities to take funding holidays or reduce their required contributions. Under current law, companies can build up a “credit balance,” for example, by contributing more than the minimum required amount or by favorable investment performance of pension assets. They can then treat the credit balance as an offset to the minimum funding requirement for the current year. This allows a plan to take a contribution holiday without regard to whether the additional contributions have earned the assumed rate of interest or have instead lost money in a down market, and regardless of the current funded status of the plan.
 - The result is that some sponsors are able to avoid making any contributions to plans that may be hundreds of millions or even billions of dollars underfunded. According to the recent GAO study, from 1995 to 2002 on average 62 percent of the 100 largest plans each year received no cash contributions, including 41 percent of plans that were underfunded.¹⁴

¹³ United States General Accountability Office, “Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules” GAO-05-294, p.22 (May 2005).

¹⁴ United States General Accountability Office, “Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules” GAO-05-294, p. 11 (May 2005).

Bethlehem Steel made no contributions to its plan for the three years immediately preceding plan termination. US Airways made no contributions for the four years immediately before terminating.

- Maximum deductible contributions are set too low.

The current funding rules prohibit tax-deductible contributions whenever the plan's assets exceed the greater of the plan's accrued liability and the plan's current liability. In some cases, a plan sponsor may be in the position of being unable to make deductible contributions in one year and then being subject to accelerated deficit reduction contributions in a subsequent year. As a result, a sponsor's ability to build up an adequate surplus in good economic times to provide a cushion for bad times is constrained.

- Underfunded plans are allowed to increase benefits.

Under current funding rules, sponsors of badly underfunded plans can continue to provide for additional accruals and, in many situations, even make benefit improvements. Restrictions apply only if the actuarial value of a plan's assets would be less than 60 percent of current liability after a plan amendment increasing benefits; in that case, the employer is required to post security in the amount by which the assets are less than 60 percent, but only to the extent this amount exceeds \$10 million. Plan sponsors in financial trouble have an incentive to promise generous pension benefits, rather than increase current wages, and employees may go along because of the PBGC guarantee. This increases the likelihood of losses for participants and the PBGC. Plan assets are depleted when seriously underfunded plans allow retiring employees to elect lump sums and similar accelerated benefits.

Several failed pension plans provide cases in point for the structural defects in the current funding rules. Bethlehem Steel's plan was 84 percent funded on a current liability basis, but turned out to be only 45 percent funded on a termination basis, with a total shortfall of \$4.3 billion. Despite these funding levels, for a number of years prior to termination, Bethlehem Steel was not required to make a deficit reduction contribution, and for the three years immediately preceding termination it relied on credit balances to avoid making contributions.

Bethlehem Steel

Termination Benefit Liability Funded Ratio 45%

Unfunded Benefit Liabilities \$4.3 billion

	1996	1997	1998	1999	2000	2001	2002
Current Liability Ratio	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
Debt Rating	B+	B+	BB-	BB-	B+	D	Withdrawn

US Airways’ pilots’ plan was 94% funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a \$2.5 billion shortfall. Similarly, US Airways was not subject to a deficit reduction contribution for six years leading up to the year of termination and relied on credit balances to avoid making any contributions for the four years immediately before terminating.

Moral Hazard

A second structural weakness in the current defined benefit system is that there is little to prevent financially weak employers from creating unfunded pension costs that they can shift to the insurance system if the company fails. This is what economists call “moral hazard.”

A fundamental principle of insurance design is to eliminate or minimize moral hazard. That is why banks have risk-based capital standards, drivers with poor driving records face higher premiums, smokers pay more for life insurance than non-smokers, and homeowners with smoke detectors get lower rates than those without.

The current insurance program is replete with moral hazards. Benefits can be increased as long as the plan is at least 60 percent funded, regardless of the financial capacity of the company. Management and workers in financially troubled companies may agree to increase pensions in lieu of wage increases. For a company, the cost of wage increases is immediate, while the **cost** of new pension benefits is spread out over 30 years. In addition, labor may choose to bargain for wages or other benefits rather than

for full funding of a plan because of the federal backstop.¹⁵ If the company recovers, it may be able to afford the increased benefits. If not, the costs of the insured portion of the increased benefits are shifted to other companies through the insurance fund.

Similarly, a company with an underfunded plan may increase asset risk to try to make up the gap, with much of the upside gain benefiting shareholders (but not necessarily participants) and much of the downside risk being shifted to other premium payers. In the recent report, GAO notes that moral hazard from the presence of PBGC insurance may cause financially troubled sponsors to alter their funding behavior, which would increase PBGC's exposure.¹⁶

The standard insurance industry safeguards against moral hazard are risk-based underwriting and risk-based premiums. These safeguards are absent from the pension insurance program. Unlike most private insurers, the PBGC cannot apply traditional risk-based insurance underwriting methods. It cannot turn away bad risks and it cannot charge more for them. As a result, there has been a tremendous amount of cost shifting from financially troubled companies with underfunded plans to healthy companies with well-funded plans.

Consider: Bethlehem Steel presented a claim of \$3.7 billion after having paid only \$60 million in premiums over the 10-year period 1994 to 2003, despite the fact that the company was a deteriorating credit risk and its plans were substantially underfunded for several years prior to the time the PBGC had to step in. Similarly, while United Air Line's credit rating has been junk bond status and its pensions underfunded by more than \$5 billion on a termination basis since at least 2000, it has paid just \$75 million in premiums to the insurance program over the 10-year period 1995 to 2004. Yet the termination of United's plans would result in a claim on the fund of roughly \$6.6 billion.

Transparency

A third structural weakness is that the current funding and disclosure rules shield relevant information regarding the funding status of plans from participants, investors and even regulators. This results from the combination of stale, contradictory, and often misleading information required under ERISA. For example, the principal governmental source of information about the 30,000 private-sector single-employer defined benefit plans is the Form 5500. Because ERISA provides for a significant lapse

¹⁵ See page 3, *The Most Glorious Story of Failure in the Business*, James A. Wooten, 49 Buffalo Law Rev. 683 (Spring/Summer 2001). "Termination insurance would shift default risk away from union members and make it unnecessary for the UAW to bargain for full funding."

¹⁶ United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules" GAO-05-294, p. 34 (May 2005).

of time between the end of a plan year and the time when the Form 5500 must be filed, when PBGC receives the complete documents the information is typically two-and-a-half years old. It is exceedingly difficult to make informed business and policy decisions based on such dated information, given the dynamic and volatile nature of markets.

The PBGC receives more timely and relevant information regarding a limited number of underfunded plans that pose the greatest threat to the system, but the statute requires that this information not be made publicly available. This makes no sense. Basic data regarding the funded status of a pension plan, changes in assets and liabilities, and the amount that participants would stand to lose if an underfunded plan was terminated are vitally important to participants. Investors in companies that sponsor the plans also need relevant and timely information about the funded status of company pensions. More can and should be done to provide better information to regulatory bodies and the other stakeholders in the defined benefit system.

Congress added new requirements in 1994 expanding disclosure to participants in certain limited circumstances, but our experience tells us that these disclosures are not adequate. The notices to participants do not provide sufficient funding information to inform workers of the consequences of plan termination. Currently, only participants in plans below a certain funding threshold receive annual notices of the funding status of their plans, and the information provided does not reflect what the underfunding likely would be if the plan terminated. Workers in many of the plans we trustee are surprised when they learn that their plans are underfunded. They are also surprised to find that PBGC's guarantee does not cover certain benefits, including certain early retirement benefits.

What Needs to be Done?

The Administration believes that comprehensive pension reform is needed to address the problems and challenges noted above. We have proposed several reforms to the single-employer defined benefit system that are intended to improve pension security for workers and retirees, stabilize the defined benefit system, and put the federal pension insurance program on a solid financial footing. The President's proposal has three primary elements:

- First, the funding rules must be reformed to ensure that plan sponsors adequately fund their plans and keep their pension promises.
- Second, premiums must be increased and made more risk-related, and protections must be provided against unreasonable losses due to sponsor bankruptcy and shutdown.

- Third, disclosure to workers, investors and regulators about pension plan status must be improved.

Administration's Proposed Changes in Funding Rules

The President's solution to today's systemic pension underfunding begins with fundamental reform of the rules governing plan funding. The Administration proposal is designed both to simplify funding rules and to enhance pension plan participants' retirement security. The federal government has an interest in defining and enforcing minimum prudent funding levels, but many other funding, investment, and plan design decisions are best left to plan sponsors. Under this proposal, pension plans would be required to fund towards an economically meaningful funding target – a measure of the currently accrued pension obligations. Plans that fall below the minimum funding target would be required to fund up to the target within a reasonable period of time. Plans that fall significantly below the minimum acceptable funding level would also be subject to benefit restrictions.

(1) Meaningful and Accurate Measures of Liabilities and Assets

In order to encourage plan sponsors to manage volatility and to pre-fund benefits in good times, the Administration's proposal will use more accurate measures of plan assets and liabilities and base funding targets on the plan sponsor's financial health. Liabilities will be measured on an accrual basis using a single standard liability measurement concept. Within this single measure, a plan's accrued liability will reflect whether the plan is likely to remain ongoing or poses a risk of termination. "Ongoing liability" will be measured using assumptions that are appropriate for a financially healthy plan sponsor (investment-grade rated) while "at-risk liability" will be measured using assumptions that are appropriate for a less healthy plan sponsor (below-investment-grade rated) that is more likely to default on pension obligations in the short to medium term.

Ongoing liability is defined as the present value on the valuation date of all benefits that the sponsor is obligated to pay (salary projections are not taken into account in determining the level of accrued benefits). Expected benefit payments will be discounted using a corporate bond spot yield curve that will be published by the Treasury Department. Retirement assumptions will be developed using reasonable methodologies, based on the plan's or other relevant recent historical experience. Finally, unlike the current liability measure under current law, plans will be required to recognize expected lump sum payments in computing their liabilities.

At-risk liability measures liabilities that accrue as a plan heads towards termination because of the deteriorating financial health of the plan sponsor. At-risk liability includes the present value of accrued benefits under an ongoing plan, plus additional costs that arise when a plan terminates. These costs include acceleration in early retirements, increases in lump sum elections when available, and the administrative costs associated with terminating a plan.

Accuracy requires that the discount rates used in calculating the present value of a plan's benefit obligations satisfy two criteria: (i) they should reflect the timing of future payments, and (ii) they should be based on current market-determined interest rates for similar obligations. The corporate bond yield curve will reflect the timing of future payments by matching appropriate market interest rates to the time structure of a pension plan's projected cash flows. The Department of the Treasury will derive discount rates from a spot yield curve based on high grade (AA) corporate bond rates averaged over 90 business days. It recently published a white paper¹⁷ detailing its methodology that is available on the Treasury Department web site.

Under the Administration's proposal, asset values used in determining minimum required and maximum allowable contributions will be based on market prices on the valuation date. No smoothed actuarial values of assets will be used, as they mask the true financial status of the pension plan.

(2) Funding Targets and Credit Ratings

Under the Administration's proposal, accrued liability (appropriately measured as described above) serves as a plan's funding target. Plans sponsored by financially healthy firms (investment-grade rated) will use 100 percent of ongoing liability as their funding target. Less healthy plan sponsors (below-investment-grade rated) will use 100 percent of at-risk liability as their funding target.

A sponsor is considered financially weak if the plan sponsor OR any significant member of the sponsor's controlled group has NO senior unsecured debt that is classified as investment grade by at least one of the nationally recognized rating agencies.

¹⁷ Creating a Corporate Bond Spot Yield Curve for Pension Discounting Department of the Treasury, Office of Economic Policy, White Paper, February 7, 2005.

(3) Funding Accrued Benefits

Under the proposal, if the market value of plan assets is less than the funding target for the year, the minimum required contribution for the year will equal the sum of the applicable normal cost for the year and the amortization payments for the shortfall. Amortization payments will be required in amounts that amortize the funding shortfall over a seven-year period. This will extend the amortization periods for many underfunded plans from as little as four years under the deficit reduction contribution, which will counteract the effect of other funding changes that may increase costs under the proposal.

The initial amortization base is established as of the valuation date for the first plan year and is equal to the excess, if any, of the funding target over the market value of assets as of the valuation date. The shortfall is amortized in seven annual level payments. For each subsequent plan year, if the sum of the market value of assets and the present value of the future amortization payments is less than the funding target, that shortfall is amortized over the following seven years. If the sum of the market value of assets and the present value of future amortization payments exceeds the funding target, no new amortization base is established for that year and the total amortization payment for the next year is the same as in the prior year. When, on a valuation date, the market value of the plan's assets equals or exceeds the funding target, the amortization charges will cease and all existing amortization bases will be eliminated.

(4) Increased Deductibility

The Administration-proposed reforms provide real and meaningful incentives for plans to adequately fund their accrued pension obligations. These new funding requirements are matched with new opportunities to pre-fund obligations on a tax-preferred basis. Pension sponsors believe that their inability, under current rules, to build sufficiently large funding surpluses during good financial times has contributed to current underfunding in the pension system. The Administration proposal addresses this problem directly by creating two funding cushions that, when added to the appropriate funding target, would determine the upper funding limit for tax-deductible contributions.

The first cushion allows funding to 130 percent of the funding target and is designed to allow firms to build a sufficient surplus so that plans do not become underfunded solely as a result of asset and liability value fluctuations that occur over a business cycle. A second funding cushion allows plan sponsors to pre-fund for salary and benefit increases. In addition, plans will always be able to deduct contributions that bring a plan's funding level up to at-risk liability.

(5) *Credit Balances*

The Administration proposal eliminates credit balances. Because credit balances currently are not marked to market and can be used by underfunded plan sponsors, they have in many cases resulted in plans having lengthy funding holidays, while becoming increasingly underfunded. Some companies have avoided making cash contributions for years through the use of credit balances, heedlessly ignoring the substantial contributions that may be required when the credit balances are used up.

(6) *Benefit Restrictions*

The Administration believes that companies should make only benefit promises they can afford, and keep the promises already made by appropriately funding their pension plans. When companies are unable to keep their pension promises, the losses are shifted to the pension insurance system and to workers. It is these hollow promises that harm workers by putting their retirement security at risk.

Under the reform proposal, plans with financially weak sponsors that are funded at a level less than or equal to 80 percent of their targets will be restricted from offering lump sums or increasing benefits. If funding is less than or equal to 60 percent of target liabilities, accruals will also stop and there will be no preferential funding of executive compensation. Plans with healthy sponsors will be restricted from increasing benefits if they are funded at a level less than or equal to 80 percent of their funding target and from offering lump sums if they are at a level less than or equal to 60 percent of their funding target. Underfunded plans with sponsors in bankruptcy will also be subject to benefit limits.

These proposals will create a strong incentive for employers to adequately fund their plans – making it more likely that workers’ retirement expectations will be met.

Administration’s Proposed Changes to Restore PBGC to Financial Health

Reforming PBGC’s Premium Structure

The Administration proposes a more rational premium structure that will meet the program’s long-term revenue needs, provide incentives for full funding of covered plans, and better reflect the different levels of risk posed by plans of strong and weak companies.

There are two fundamental problems with the PBGC premiums. First, the premium structure does not adequately reflect risk. Second, the current premium structure does not raise sufficient revenue to cover expected losses.

By law, the principal funding source for the insurance program is the premiums paid to PBGC by covered plans. Premium rates are prescribed by law. While claims against the program have skyrocketed, premium revenue has not kept pace. The \$19 per participant flat-rate premium has not been increased in 14 years, not even to reflect wage growth over that period. Because the number of participants has remained relatively stable, the flat-rate premium has not been a source of additional premium revenue.

Premium revenue growth in recent years has come only from the variable-rate premium (VRP). While the VRP charge of \$9 per \$1,000 of unfunded vested current liability appears reasonable, the VRP does not raise the amount of revenue it should for two reasons. First, the “full funding limit” exemption generally relieves plans that are funded for 90 percent of current liability, from paying a VRP. As a result, less than 20 percent of participants are in plans that pay a VRP. The full funding limit exemption is also why some of the companies that saddled the insurance fund with its largest claims ever paid no VRP for years prior to termination. In addition, VRP revenue is artificially low because current liability understates liabilities at plan termination, often dramatically so. In the last several years, premium revenue has not even been sufficient to pay monthly benefits in trusteed plans, let alone pay the underfunding in new terminations.

Under the Administration proposal, the flat per-participant premium will be immediately adjusted to \$30 initially to reflect the growth in worker wages since 1991, when the current \$19 figure was set in law. This recognizes the fact that the benefit guarantee continued to grow with wages during this period, even as the premium was frozen. Going forward, the flat rate premium will be indexed for wage growth.

In addition to the flat-rate premium, a more risk-based premium would be charged based on the gap between a plan’s funding target under the proposed funding reforms and its assets. As noted earlier, the funding target is a more accurate measure of liability than current liability, capturing the sponsor’s financial condition. Moreover, the current “full funding limit” exemption would be eliminated, so that all underfunded plans would pay the risk-based premium. The PBGC Board – which consists of the Secretaries of Labor, Treasury and Commerce – would be given the ability to adjust the risk-based premium rate periodically so that premium revenue is sufficient to cover expected losses and improve PBGC’s financial condition. Charging underfunded plans more gives employers an additional incentive to fully fund their pension promises.

Protections Against Unreasonable Losses

The proposal also provides the PBGC with better tools to carry out its statutory responsibilities in an effective way and to protect its ability to pay benefits by shielding itself from unreasonable costs.

1. Protections in Bankruptcy

The Corporation faces special problems when a plan sponsor enters bankruptcy. Guarantees continue to grow even though plan sponsors may no longer be making contributions. A lien automatically arises against the assets of a plan sponsor and members of its controlled group if required pension contributions of \$1 million or more are missed. However, because the automatic stay and avoidance provisions of the Bankruptcy Code prevent PBGC from perfecting liens for missed required contributions in bankruptcy, companies are able to avoid making contributions to the plan as otherwise required by federal law, and can do so without consequence. As a result, plan participants and the PBGC insurance program both may suffer greater losses if an underfunded plan later terminates while the plan sponsor or members of its controlled group are in a bankruptcy proceeding.

The PBGC guarantee limit would be frozen when a company enters bankruptcy, and PBGC would be allowed to perfect liens for missed required pension contributions against companies in bankruptcy.

2. Contingent Liability Benefits

There are also inadequate protections for the insurance program against accrual of potentially large, and unfunded, contingent liability benefits. One example is when a plan sponsor provides plant shutdown benefits -- benefits triggered by a plant closing or other similar condition. The Administration believes that shutdown benefits are severance benefits that should not be paid by pension plans. These benefits generally are not funded until the shutdown occurs, by which time it is often too late, and no PBGC premiums are paid for them. However, despite the lack of funding, shutdown benefits may be guaranteed if the shutdown occurs before the plan termination date, often imposing large losses on the insurance program.

The Administration proposal would prospectively eliminate the guarantee of certain unfunded contingent liability benefits and prohibit such benefits under pension plans. These severance benefits generally are not funded and no PBGC premiums are paid for them. Such benefits could continue to be provided outside the pension plan.

Administration's Proposed Improvements in Disclosure

The financial health of defined benefit plans must be transparent and fully disclosed to workers and their families who rely on promised benefits for a secure and dignified retirement, as well as to investors and shareholders who need this information because the funded status of a pension plan affects a company's earnings and creditworthiness.

While ERISA includes a number of reporting and disclosure requirements that provide workers with information about their employee benefits, the timeliness and usefulness of that information must be improved.

Provide broader dissemination of plan information

Under the Administration's proposal, the Section 4010 information filed with the PBGC would be made public, subject to existing Freedom of Information Act protections for corporate financial information, including confidential "trade secrets and commercial or financial information."

Broadening the dissemination of information on pension plans with unfunded liabilities, currently restricted to the PBGC, is critical to workers, financial markets, and the public at large. Disclosing this information will both improve market efficiency and help encourage employers to appropriately fund their plans.

Provide more meaningful and timely information

The President's proposal would change the information required to be disclosed on the Form 5500 and summary annual report (SAR). Plans would be required to disclose their ongoing liability and at-risk liability in the Form 5500, whether or not the plan sponsor is financially weak. The Schedule B actuarial statement would show the market value of the plan's assets, its ongoing liability, and its at-risk liability.

The information provided to workers and retirees in the SAR would be more meaningful and timely. It would include a presentation of the funding status of the plan for each of the last three years. The funding status would be shown as a percentage based on the ratio of the plan's assets to its funding target. In addition, the SAR would include information on the company's financial health and on the PBGC guarantee. The due date for furnishing the SAR for all plans would be accelerated from two months to 15 days after the filing date for the Form 5500.

The proposal also would provide for more timely disclosure of Schedule B information for plans that cover more than 100 participants and that are subject to the requirement to make quarterly contributions for a plan year (i.e., a plan that had assets less than the funding target as of the prior valuation date). The deadline for the Schedule B report of the actuarial statement would be shortened for those plans to the 15th day of the second month following the close of the plan year -- February 15 for a calendar year plan.¹⁸ If any contribution is subsequently made for the plan year, the additional contribution would be reflected in an amended Schedule B that would be filed with the Form 5500.

Responses to Concerns Raised about the Administration's Proposals

Several questions have been raised regarding the impact of the Administration's proposals on defined benefit plans and their sponsors. Many of the questions posed and issues raised have merit and warrant careful consideration and a delicate balancing of interests. Some of these objections, however, do not withstand scrutiny.

Will Employers Exit the System?

The most frequent general complaint we have heard is that the Administration's proposal does not provide enough incentives for plan sponsors to remain in the defined benefit system.

The Administration believes that defined benefit plans should remain a viable option for companies that want to provide guaranteed retirement benefits to their employees. Unfortunately, in our view, the current funding system is not sustainable in the long run. Defined benefit sponsors are aware that the complexities of the current system and the funding rules allow some sponsors to transfer the risks of their funding and investment decisions to the insurance system. We want to eliminate artificial impediments that unnecessarily and avoidably raise the costs of offering DB plans. And, we believe that the Administration's proposal would revitalize the system by placing both the insurance program and individual pension plans on a solid financial footing.

Numerous meetings have been held with stakeholders over the past two years to gain a better understanding of the issues of concern to them, and, as a result, have incorporated many of the key elements sought by plan sponsors and others. For example, there have long been complaints about regulatory complexity and excessive costs associated with compliance with overly burdensome rules and regulations. We agree with this assessment, and the Administration's proposal greatly simplifies and streamlines the pension funding rules. Sponsors said they wanted to be able to use a corporate bond rate, rather than the risk-free Treasury rate, to discount liabilities.

¹⁸ Under current law, defined benefit plans subject to minimum funding standards are required to file a Schedule B with the Form 5500, which is generally due 7 months after the end of the plan year (July 31 for calendar year plans), with a 2 ½ month extension available (October 15 for calendar year plans).

The Administration believes that the measure of pension liabilities should be based on market rates of interest for quality corporate bond issuers and this view is reflected in the Administration's proposal. They said they want greater flexibility to fund up their plans in good economic times, to provide a cushion during more lean times. The Administration's proposal significantly increases the ability of sponsors to make tax deductible contributions to their plans. Some sponsors have complained about the cliff effect of the deficit reduction contribution rules, which in some cases requires funding deficits to be made up in as few as three years. The Administration proposal provides seven years to amortize funding deficits.

Risk and Volatility

There are a few more specific issues that have been raised about the Administration's proposal. One is that it would increase volatility and make contributions more unpredictable. The fact is that the risk and volatility associated with defined benefit plans stems from the investment and business decisions made by plan sponsors, along with changes in longevity and retirement patterns, none of which are changed by the Administration's proposal. Companies have the means under current law to manage these risks in accordance with their own risk tolerances. And, the Administration's proposal provides additional tools to manage volatility, including amortization over seven years and the enhanced ability to prefund benefits in good economic times.

What is not acceptable is to mask risk or pretend that it doesn't exist by artificially smoothing asset and liability values and distorting current economic reality. That is precisely what has allowed the funding gaps we've experienced. Ultimately, it is participants, shareholders, other companies, and potentially taxpayers, that stand to lose. Companies should be free to take risks and make business decisions that they believe to be in the best interests of their stakeholders, so long as the impact of those risks and decisions is transparent and the costs cannot be readily transferred to participants or other third parties.

Yield Curve

Another issue relates to the use of a yield curve in discounting liabilities. Some commenters support the use of a corporate bond rate, but object to applying those bond rates against a yield curve. They argue that it is unnecessarily complex and will create unpredictable funding obligations.

The Administration believes that discounting future benefit cash flows using the rates from the spot yield curve is the most accurate way to measure a plan's liability because it recognizes the real costs of operating defined benefit pension plans. Accurate measurement of liabilities does not advantage one type of plan sponsor over another, as is the case under current law with a single rate. The pension benefit obligations that make up plan liabilities are not changed in any way by use of the yield curve.

The yield curve simply recognizes that older plans must make a relatively high proportion of benefit payments in the near future. Conversely, use of the yield curve also recognizes that younger plans will make a high proportion of benefit payments in the more distant future. Current law, by using a single long-term bond rate to discount all future payments, largely ignores this fact and therefore measures liabilities inaccurately.

Yield curves are regularly used in valuing other financial instruments, including mortgages and certificates of deposit, and therefore will not pose a difficult technical challenge for actuaries. There is no evidence that implementation of the yield curve will cause significant increases in pension plan expenses, but to avoid any sudden changes in cash flow demand, the Administration's proposal includes a three-year transition period to the yield curve.

Credit Ratings

Some have objected to the use of credit ratings to determine funding and premium levels. It is not clear whether the principal concern is with the use of the ratings agencies themselves, or with the concept of incorporating credit risk into the funding and premium requirements.

As to the former point, it should be noted that a company's cost of capital is, to a significant degree, derived from the rating agencies' calculation of creditworthiness. That leads to the second point – the concept of credit risk itself. As discussed more fully above, it is both reasonable and fair to require higher plan contributions and premium payments from companies that pose a higher risk of underfunded terminations. At-risk funding targets are likely to be higher than ongoing targets, so the Administration provides a five-year phase-in period to the higher target for any plan whose sponsor becomes financially weak. The funding target during the phase-in period will be a weighted average of the ongoing and at-risk targets. Other provisions designed to reduce the effects of the proposal on financially weak firms include a three-year transition period to the yield curve and an extension of the amortization periods for many underfunded plans from as little as four years (under the deficit reduction contribution) to seven years.

Credit Balances

Another criticism that has been leveled against the Administration proposal is that sponsors will have no incentive to make more than the minimum required contributions if they can't take advantage of credit balances. First, I want to reiterate that the credit balance feature of current law allowed companies like Bethlehem Steel, US Airways, and United (PBGC's largest claims) to avoid making contributions to their plans for several years prior to their termination – notwithstanding the fact that they were already substantially underfunded and the amount of grew significantly during the run-up to termination. Allowing companies to take "funding holidays" when they

are underfunded (other than through the waiver process) does not make business or policy sense and runs counter to the whole notion of steadily improving the funding status of underfunded plans.

Moreover, we believe that sponsors would have ample incentive under the Administration's proposal to make more than the minimum required contribution without the use of credit balances. First, they would be able to generate a larger tax deduction. Second, they would shorten the relevant amortization period. And, third, their risk-based premiums would be lowered.

PBGC Premiums

A number of issues have been raised about the Administration's proposed changes to the structure and level of premiums that finance the pension insurance program. The argument has been made that the increase in and indexing of the flat per-participant premium puts an inappropriate burden on employers with well-funded plans; that the provision to adjust the risk-based premium may result in greater volatility and burden on financially stressed companies; and that the solution should be limited to improved funding rules, not increased premiums.

Understandably, plan sponsors would rather not pay greater premiums or subsidize underfunded plans of financially weak sponsors. However, the deficit in the pension insurance single-employer fund is already substantial and likely will grow, which imperils the ability of the PBGC to meet its long run commitments to participants in terminated plans. The fact is that under current law, the PBGC is supposed to be self-financing; the agency does not receive any taxpayer monies and its obligations are not backed by the full-faith-and-credit of the United States. At the same time, PBGC has very little control over its primary revenues and expenses. Congress sets PBGC premiums, ERISA mandates coverage for all defined benefit plans whether they are adequately funded or not, and companies sponsoring insured plans can transfer their unfunded liability to the PBGC as long as they meet the statutory distress criteria.

Plan funding reforms, by themselves, will not eliminate PBGC's deficit. The Congressional Budget Office scored the Administration's premium proposal as raising \$18 billion of revenue over five years. This was based on the assumption that the risk-based premium is assessed against all underfunding, that the flat-rate reforms are enacted, and that total premium revenue will cover expected future claims and amortize the PBGC's \$23 billion deficit over 10 years.

The issue ultimately is who pays for past and future claims. The Administration believes that companies that make the promises to their workers should pay for them, which is why we have put so much emphasis on strengthening the funding rules. But, changes to premiums are still necessary to compensate for the losses that have and inevitably will occur. The Administration believes that the proposed balance between

the flat per-participant premium and the risk-based premium for plan underfunding is reasonable. The proposed increase in the flat per-participant premium is only to reflect wage growth since the last increase in 1991 and in the future.

The risk-based premium rate would be established by the PBGC's Board on a periodic basis. This is similar to the approach taken in the federal bank insurance program. Since 1993, the Board of Directors of the Federal Deposit Insurance Corporation has reviewed and adjusted semiannually the premium rates that it assesses each insured bank and thrift. Moreover, the FDIC uses a risk-based premium system that assesses higher rates on those institutions that pose greater risk to the insurance funds.

Premiums also need to be viewed in context – relative to contributions that sponsors will have to make to their plans. The fact is that premiums are and would continue to be a very small percentage of pension costs for most employers. Total premiums collected by the PBGC have averaged about a billion dollars a year. Plan contributions have averaged more than \$20 billion per year (constant dollars) – twenty times higher than premiums. Estimates are that companies contributed more than \$70 billion to their plans in 2003.

Conclusion

Companies that sponsor pension plans have a responsibility to live up to the promises they have made to their workers and retirees. Yet under current law, financially troubled companies have shortchanged their pension promises by nearly \$100 billion, putting workers, responsible companies and taxpayers at risk. As United Airlines noted in a recent bankruptcy court filing, “the Company has done everything required by law”¹⁹ to fund its pension plans, which are underfunded by nearly \$10 billion.

It is difficult to imagine that healthy companies would want to continue in a retirement system, or that prospective employers would want to become part of a retirement system, in which the sponsor-financed insurance fund is running a substantial deficit. By eliminating unfair exemptions from risk-based premiums and restoring the PBGC to financial health, the Administration's proposal will revitalize the defined benefit system.

That, Mr. Chairman, is precisely why the rules governing defined benefit plans are in need of reform. At stake is the viability of one of the principal means of predictable retirement income for millions of Americans. The time to act is now. Thank you for inviting me to testify. I will be pleased to answer any questions.

¹⁹ Page 26, United Air Lines' Informational Brief Regarding Its Pension Plans, in the US Bankruptcy Court for the Northern District of Illinois, Eastern Division (Sept. 23, 2004).

