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April 1, 2003

Honorable Charles E. Grassley, Chairman
Honorable Max Baucus, Ranking Member
Committee on Finance
United States Senate
219 Dirksen Senate Office Building
Washington D.C. 20510-6200

Dear Senators Grassley and Baucus:

This is in response to your March 17, 2003, letter enclosing follow-up questions from the hearing that the Committee held on March 11, 2003. The hearing addressed the state of the defined benefit pension system.

Question 1: Please explain what shutdown benefits are and how they affect PBGC.

Response

Shutdown benefits are found primarily in the pension plans of large unionized companies in the auto, steel, and tire and rubber industries. Shutdown benefits are triggered by a plant shutdown or a permanent layoff.

In pension plans of integrated steel companies, shutdown benefits provide an unreduced early retirement benefit as early as age 42 (i.e., a worker would receive at age 42 the same monthly benefit that he would normally receive at age 62). Once triggered, this early retirement benefit continues to be paid, even if the worker finds new employment in the steel industry or any other industry. In addition, shutdown benefits in the steel industry provide a $400 monthly supplement payable from the time of shutdown or layoff until age 62. Because the increased benefits are usually available to an entire group of participants (e.g., all the eligible employees at the plant that shut down), the shutdown event can greatly increase a plan’s liabilities in one stroke. Shutdown benefits may double or even triple the cost of a worker’s benefit.

In general, shutdown benefits are not funded before a shutdown occurs. In the 1987 Pension Protection Act, Congress required employers to fund shutdown benefits on an accelerated basis (generally, in five to seven years), but beginning only after the triggering event occurs. This post-event funding can achieve its goals in the case of a small-scale shutdown, such as where an employer shuts down one or two plants or lays off just one group of employees, but continues in business and is able to fund the shutdown benefits for the affected employees. In recent years, however, PBGC has encountered increasing exposure from situations where an employer shuts down virtually all of its facilities at more or less the same time, usually while in bankruptcy. In these situations, the post-shutdown funding requirements are ineffective because the employer is going out of business. In addition, because plans are not required to recognize unfunded shutdown liabilities until after the shutdown occurs, employers do not pay premiums to the PBGC to reflect the risk (and potential cost) of these benefits.

Under a 1975 regulation, the subsidized portion of shutdown benefits is guaranteed by the PBGC only if the shutdown occurs prior to plan termination. The supplement part of shutdown benefits is generally not guaranteed regardless of when the termination occurs. However, both the subsidized portion and the supplements drain the plan of assets when they are paid out prior to the plan's termination.

The PBGC can institute court proceedings to terminate a pension plan if it makes one of several determinations, including that the PBGC's "possible long-run loss . . . may reasonably be expected to increase unreasonably if the plan is not terminated." ERISA section 4042(a)(4). The PBGC has exercised this authority in a number of cases to terminate plans whose liabilities were expected to increase substantially due to anticipated plant or company-wide shutdowns. This statutory scheme, however, sometimes results in a race between the company to shut down a facility and the PBGC to ask a court to terminate the plan (without notice to the company). In response to a question from Senator Rockefeller at the hearing, I stated that this "race to the courthouse" scenario, with no prior notice to the company or workers, was an unsatisfactory way to do business.

At present, there is a potential exposure of over $15 billion in shutdown benefits in PBGC-insured plans. Yet, less than 5% of workers in PBGC-insured plans have shutdown benefit provisions in their plans. Thus, the cost of unfunded shutdown benefits is borne by other companies, the vast majority of whose workers do not have shutdown benefits in their plans. Other companies and workers in the defined benefit system should not have to bear the large cost of these unfunded shutdown benefits for a small group of companies.

It is important to note that companies are not required to offer workers a defined benefit plan. It is a voluntary system. If premiums become too onerous, responsible companies with well-funded pension plans may terminate their plans and exit the system, thereby denying workers the security of a defined benefit plan, reducing PBGC's premium base, and putting in question the long-term viability of the defined benefit insurance system.

Question 2: Is the cost of a terminated plan's shutdown benefits discharged in the employer's bankruptcy case?

Response

Shutdown benefits are a liability of the pension plan, not of the employer. Thus, they are treated in bankruptcy like all other unfunded plan benefits. When a pension plan covered by Title IV of ERISA terminates, PBGC becomes responsible for collecting from the sponsoring employer all unfunded benefit liabilities, including the value of shutdown benefits. If the employer is a debtor in bankruptcy, PBGC files its claim as a general unsecured creditor for the plan underfunding. PBGC divides its recovery on the claim between itself (to help pay for unfunded guaranteed benefits) and participants (to help pay their non-guaranteed benefits). Any amount of the claim that goes unpaid in the bankruptcy is discharged.

Question 3: During the hearing, you testified that you were in favor of legislative changes regarding shutdown benefits. Can you explain in more detail what kind of changes you are thinking of and why?

Response

Unlike other pension benefits, shutdown benefits are not pre-funded and companies pay no specific premium to PBGC to reflect the additional risk these benefits impose on the guarantee system. PBGC should not be exposed to liabilities that are not funded. I favor legislation limiting PBGC's exposure to these benefits.

The current treatment of shutdown benefits is not in anyone's interest. As discussed above, PBGC must rush to court without notice to the parties to terminate a plan before the shutdown. It also means that the parties are negotiating benefits that the workers may never receive, often resulting in the frustration of participant expectations.

Question 4: If Congress were to adopt a corporate bond rate as a replacement for 30-year Treasuries, what effect would that have on plan funding and on PBGC premium income?

Response

The liabilities of a pension plan are a stream of future payments owed to participants entitled to benefits under the plan. Each year, the plan's actuary determines the value of plan liabilities (and the value of plan assets) in order to determine how much the employer must contribute to its plan for the year and the amount of premiums owed to PBGC. To calculate the value of the liability stream, the actuary uses certain assumptions such as the expected rate of future salary increases, when participants are expected to retire, when participants are expected to die, and the interest rate used to discount future payments to reflect the time value of money. Each of these assumptions is important in determining the value of a plan's liabilities.

Interest rate assumptions have the following impact on pension funding. A higher interest rate reduces the value of plan liabilities for funding purposes. When liabilities are reduced, funding requirements are reduced. For companies paying the variable rate premium, reduced liabilities would also mean reduced premiums. Currently, there is significant underfunding in the defined benefit system.

Under current law, different interest rates are used for different purposes. The interest rate on 30-year Treasuries is used in a number of calculations: to determine the amount of lump sums given to participants, to determine the PBGC variable rate premium, and to determine plan liabilities for purposes of the additional funding requirement for underfunded plans.

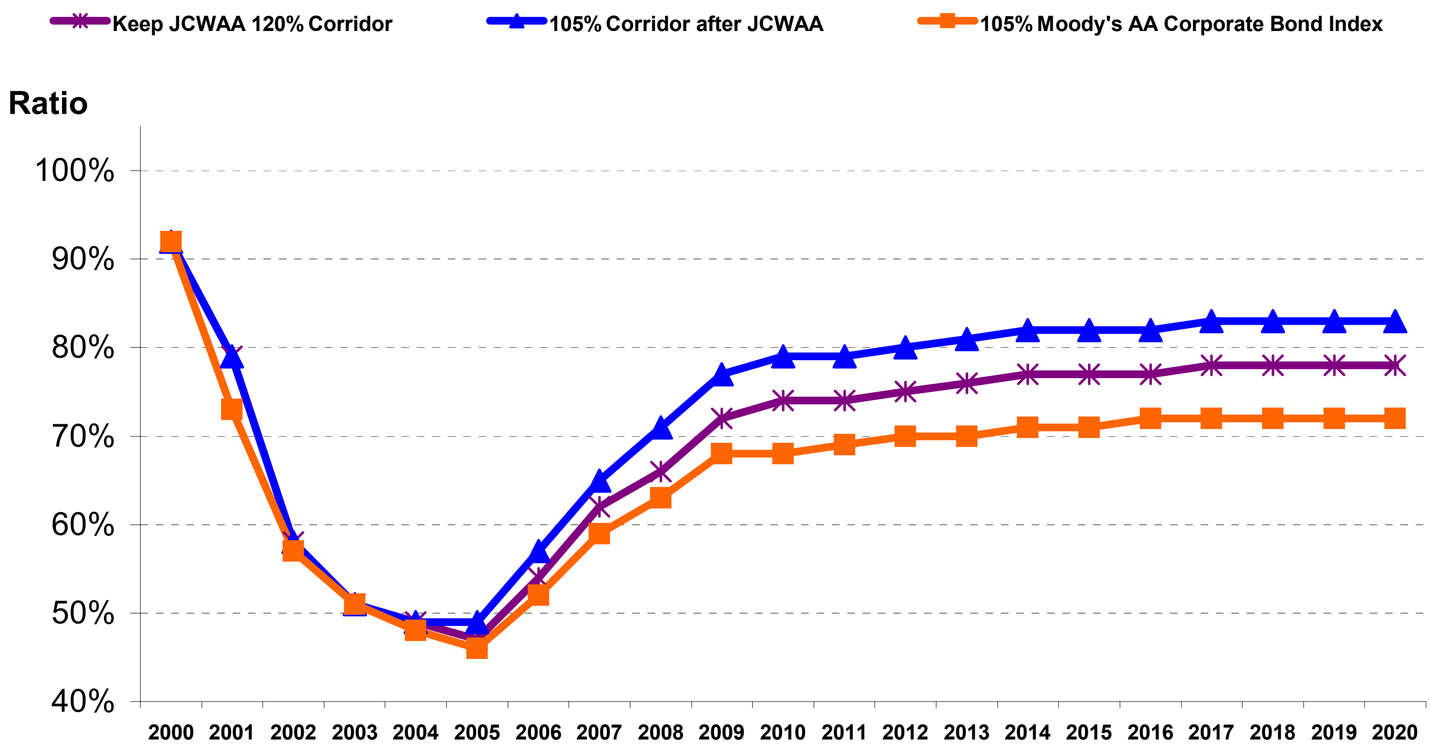
The Federal government has discontinued the issuance of 30-year Treasury bonds. In addition, the spread between yields on Treasury bonds and high quality corporate bonds has grown recently. In 2002, as part of the Job Creation and Worker Assistance Act, Congress provided funding relief for 2002 and 2003 by raising the top of the permissive corridor in the funding rules from 105% to 120% of the 4-year weighted average of the 30-year Treasury rate. The corridor will drop again to 105% in 2004 if legislative action is not taken.

Proposals have been put forward to substitute corporate bond rates for 30-year Treasury rates in the current liability formula, when the corridor reverts back to 105%. Because 105% of the weighted average of corporate bond rates is higher than the rate based on 120% of the weighted average of 30-year Treasuries, reported pension liabilities will be lower. As a result of lower reported pension liabilities, plan funding will decrease and PBGC variable rate premium income will also decline.

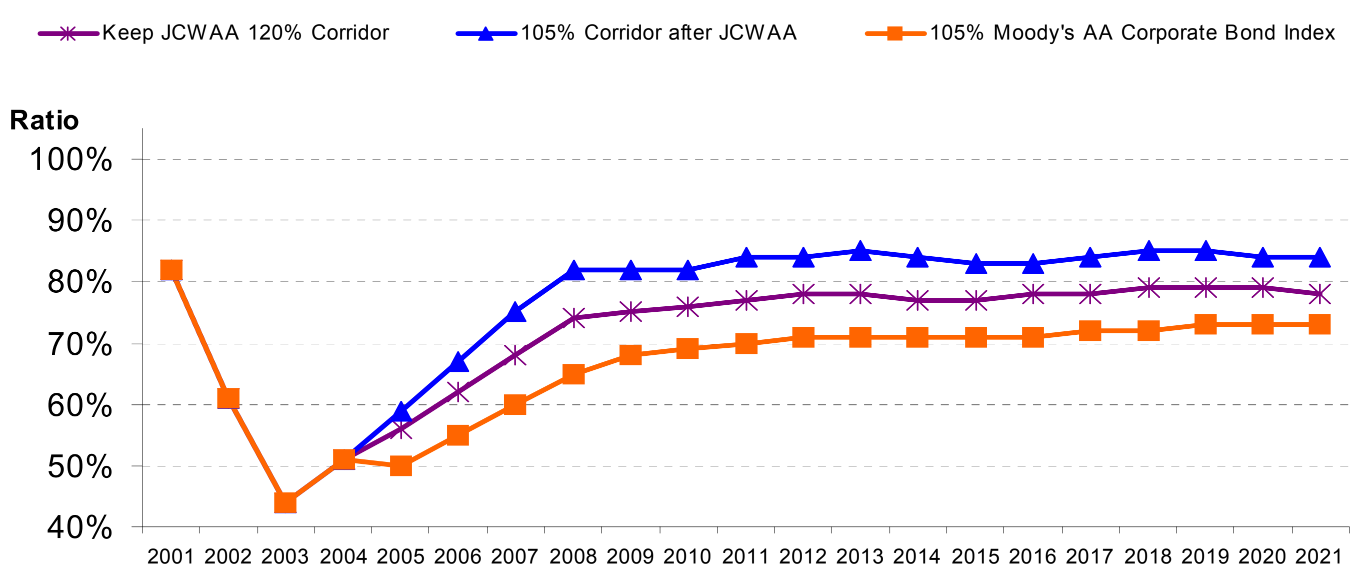
Some groups want to substitute corporate bond rates for 30-year Treasury rates as a means of providing permanent funding relief. This confuses two concepts. We must first find an accurate measure of pension liabilities. Once pension liabilities are accurately measured, appropriate funding rules can be addressed.

PBGC has modeled the impact of simply substituting the Moody's AA corporate bond rates for 30-year Treasury rates for 10 very large plans, some of which are sponsored by employers experiencing financial difficulty. Under current law (i.e., 120% dropping to 105% in 2004) the average termination funded ratio of these plans is projected to be 77% in five years. This five-year average funded ratio is projected to drop to 70% if the current 120% cap on the interest rate corridor is extended indefinitely. Using corporate bond rates, this five-year average is projected to drop even further to 63%. The attached charts illustrate projected termination funding ratios for two sample plans.

Proposal Illustration (effective 01/01/2004)
Mature Manufacturing Company
Termination Liability Funding Ratio



Proposal Illustration (effective 01/01/2004)
Airline Company
Termination Liability Funding Ratio



Question 5: Various media articles have reported that US Airways pilots will lose about 75 percent of their retirement benefits due to PBGC maximum guarantee limits. Can you comment on this?

Response

Based on the most recent information available, we believe that the assets in the US Airways pilots plan are sufficient so that US Airways pilots who were retired or were eligible to retire three years prior to the date of plan termination will receive benefits in excess of the maximum guaranteed limit. For example, we expect that pilots who are 59 years old with 29 years of service and who have spent their entire careers with US Airways will receive from PBGC, on average, annual benefits of about $85,000 of the $110,000 they were expecting at age 60. This is significantly more than the PBGC maximum guaranteed benefit of $28,600 per year that PBGC would otherwise pay starting at age 60.

For pension plans terminating in 2003, the maximum guaranteed benefit amount is $3,664.77 per month ($43,977.24 per year) for a participant who commences benefit payments at age 65. This maximum guaranteed amount is lower if payments commence before age 65 or if the pension includes benefits for a survivor or other beneficiary. The limit is about $28,600 per year for a participant who begins receiving benefits at age 60. (The guarantee limit is higher if a participant commences benefits after age 65 or is older than age 65 when the plan terminates.)

However, many US Airways pilots will receive more than the $28,600 maximum limit because a participant may receive benefits in excess of the guaranteed amounts if there are enough plan assets or recoveries from employers. Section 4044 of ERISA establishes priorities for allocating the assets of a terminated pension plan. First, assets are allocated to employee contributions (Priority Categories 1 and 2). Priority Category 3 (PC-3) includes the benefits of participants who were in pay status, or who could have been in pay status, as of the beginning of the three-year period ending on the date of plan termination, based on the least generous benefit provisions in effect during the five years before termination. For a participant who could have been, but was not, retired three years before plan termination, the benefit allocated to PC-3 is computed using the participant's age and service three years prior to the termination date. PC-3 contains both guaranteed and nonguaranteed amounts.

Question 6: How will PBGC rules affect the US Airways pilots who were previously employed by Eastern Air Lines and who will receive PBGC benefits based on their years of participation in the Eastern Air Lines plan that was previously trusteed by PBGC?

Response

As noted above, for pension plans terminating in 2003, the maximum guaranteed benefit amount is $3,664.77 per month ($43,977.24 per year) for a worker who retires at age 65. If a worker is entitled to benefits under two or more plans, however, the aggregate benefit payable by PBGC from its guarantee funds is limited by law. Essentially, the maximum guarantee would be reduced by any amounts that PBGC had to pay from its own funds under the first plan for unfunded guaranteed benefits.

In the Eastern pilots plan, there were sufficient assets to pay all guaranteed benefits. Thus, PBGC is not paying any Eastern pilots benefits from its own funds. As a result, the maximum Title IV benefit for a pilot under the US Airways pilots plan would be unaffected by the fact that the pilot is also receiving benefits from PBGC under the Eastern pilots plan.

Question 7: At the hearing, you also testified that the steel and airline industries have accounted for about 70 percent of the claims against PBGC but fewer than 5 percent of insured participants. What is the percentage of total claims against PBGC from companies with collectively bargained plans?

Response

Collectively bargained plans have accounted for between 71% and 83% of the total amount of PBGC's claims over the 28-year period 1975 - 2002. Total claims during that period were $16.7 billion. Claims by collectively bargained plans, not including salaried plans that were related to collectively bargained plans, were $11.92 billion. Claims by collectively bargained plans, including salaried plans related to those collectively bargained plans, were $13.92 billion. Generally, these salaried plans incorporated the benefit formulas of the related bargained plans, with some modifications.

Question 8: Can you briefly explain PBGC's multiemployer insurance program and describe the underfunding in multiemployer plans?

Response

PBGC administers a separate guarantee program for multiemployer defined benefit pension plans. PBGC's multiemployer program covers about 9.5 million workers and retirees in about 1,650 insured plans. The multiemployer program covers only collectively bargained plans involving two or more unrelated employers. Multiemployer plans are common in certain industries, including construction, trucking, mining, the hotel trades, and segments of the grocery business. Multiemployer plans pay PBGC a yearly premium of $2.60 per participant for benefit insurance coverage.

The current PBGC monthly benefit maximum guarantee level for multiemployer plans is 100 percent of the first $11 multiplied by the participant's years of service under the plan plus 75 percent of the next $33 multiplied by the participant's years of service. For example, the benefit for a worker with 30 years of service in a multiemployer plan is $1,072.50 per month ($12,870 per year). For multiemployer plans, the event triggering PBGC's guarantee is the inability of a covered plan to pay benefits when due at the guaranteed level, rather than plan termination as required under the single-employer program. PBGC provides financial assistance through loans to insolvent plans to enable them to pay guaranteed benefits.

The multiemployer program received two new requests for financial assistance during 2002. These requests raised to 31 the total number of plans that have received financial assistance from PBGC. Since 1980, PBGC has provided assistance with a total value of approximately $159 million (net of repaid amounts). During 2002, 23 plans were receiving financial assistance totaling about $5 million.

The multiemployer program has been in surplus since 1982, with a surplus of $158 million for FY 2002. The multiemployer program reported a gain of $42 million in 2002 compared to a net loss of $151 million in 2001. The change in net income was due to a smaller loss related to future financial assistance and an increase in investment income. Premium income increased slightly to $25 million. Because the multiemployer program has a positive net position and most of its assets are invested in highly liquid Treasury securities, PBGC has sufficient resources to meet its liquidity requirements. In 2003, we expect premium receipts to total approximately $25 million while benefit payments and financial assistance are expected to be about $6 million, based on known claims.

Question 9: Can you explain how the funding rules for multiemployer pension plans differ from those of single-employer plans.

Response

In general, defined benefit plans are subject to minimum funding requirements and maximum funding limitations, but there are differences between the funding rules for multiemployer plans and single-employer plans. The differences reflect the fact that contributions to multiemployer plans are set by multi-year collective bargaining agreements. As a result, multiemployer plans cannot immediately adjust to large swings in contribution requirements. Multiemployer plans are allowed to amortize actuarial gains and losses over a 15-year period, versus 5 years for single-employer plans. In addition, while multiemployer plans are not subject to the "deficit reduction contribution" requirements that apply to underfunded single-employer plans, poorly funded multiemployer plans are subject to enhanced "reorganization funding" rules.

Question 10: Does the Administration grant funding waivers to multiemployer plans and have any been granted in the past 2 years? Are any pending? What is the procedure for approving a funding waiver for multiemployer plans?

Response

The IRS has jurisdiction over all requests for waivers of the minimum funding standards, and we understand that it typically receives 1 to 3 requests per year from multiemployer plans. Multiemployer plans can obtain a funding waiver only if at least 10 percent of contributing employers demonstrate that they are suffering from a "substantial business hardship." A plan can receive no more than 5 waivers in a 15-year period.

There are detailed IRS regulations that specify the information a plan must file to request a waiver, and IRS is allowed to share that information with PBGC under a special exception to the taxpayer confidentiality rules of Section 6103 of the Code. Under those restrictions, however, PBGC cannot disseminate any specific information about waiver applications.

Question 11: If a multiemployer plan is requesting a funding waiver, what does that suggest about the security of the plan that requested the waiver?

Response

The IRS will grant a waiver only if it agrees that: (1) the employers who support the plan are suffering from a substantial business hardship; (2) the plan can be continued only if the waiver is granted; and (3) enforcement of the funding requirements would be adverse to the interests of plan participants.

I thank you again for giving me the opportunity to testify at the hearing. Please let me know if I can be of any further assistance.

Sincerely,

Steven A. Kandarian

Steven A. Kandarian
Executive Director