STATEMENT OF STEVEN A. KANDARIAN
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Before the
SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON WAYS AND MEANS
UNITED STATES HOUSE OF REPRESENTATIVES
APRIL 30, 2003

Chairman McCrery, Ranking Member McNulty, and Members of the Subcommittee:

Good afternoon. I am Steven A. Kandarian, Executive Director of the Pension Benefit Guaranty Corporation (PBGC). I want to thank you for holding this hearing on pension plan funding and for your interest in the retirement security of America's workers. The way we address these complex issues is critically important to the financial well being of America's workers and retirees and to the financial health of plan sponsors.

I am going to focus on the state of the PBGC and the defined benefit pension system, as well as funding issues that directly impact PBGC. During FY 2002, PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion – a loss of $11.3 billion in just one year. This loss is more than five times larger than any previous one-year loss in the agency's 28-year history. Moreover, based on our midyear unaudited financial report, the deficit has grown to about $5.4 billion. Furthermore, data now coming in to PBGC confirm that the total underfunding in the single-employer defined benefit system exceeds $300 billion, the largest number ever recorded.

In light of these record deficits and staggering amounts of pension underfunding, we are concerned that a number of proposals now under consideration would weaken existing funding rules and grant permanent funding relief.

State of the PBGC

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

PBGC insures pension benefits worth $1.5 trillion. In addition, PBGC is responsible for paying current and future benefits to 783,000 people in over 3,000 terminated defined benefit plans. As a result of the recent terminations of several very large plans, PBGC will be responsible for paying nearly $2.5 billion in benefits to nearly 1 million people in FY 2003, up from $1.5 billion in FY 2002.

No Full Faith and Credit; No Federal Tax Dollars

While PBGC is a government corporation created under ERISA, it is not backed by the full faith and credit of the United States government. Moreover, PBGC receives no federal tax dollars. Instead, PBGC is funded by four sources: insurance premiums paid to PBGC by defined benefit pension sponsors; assets of pension plans that PBGC has trusteed; recoveries in bankruptcy from former plan sponsors (generally only cents on the dollar); and earnings on invested assets.

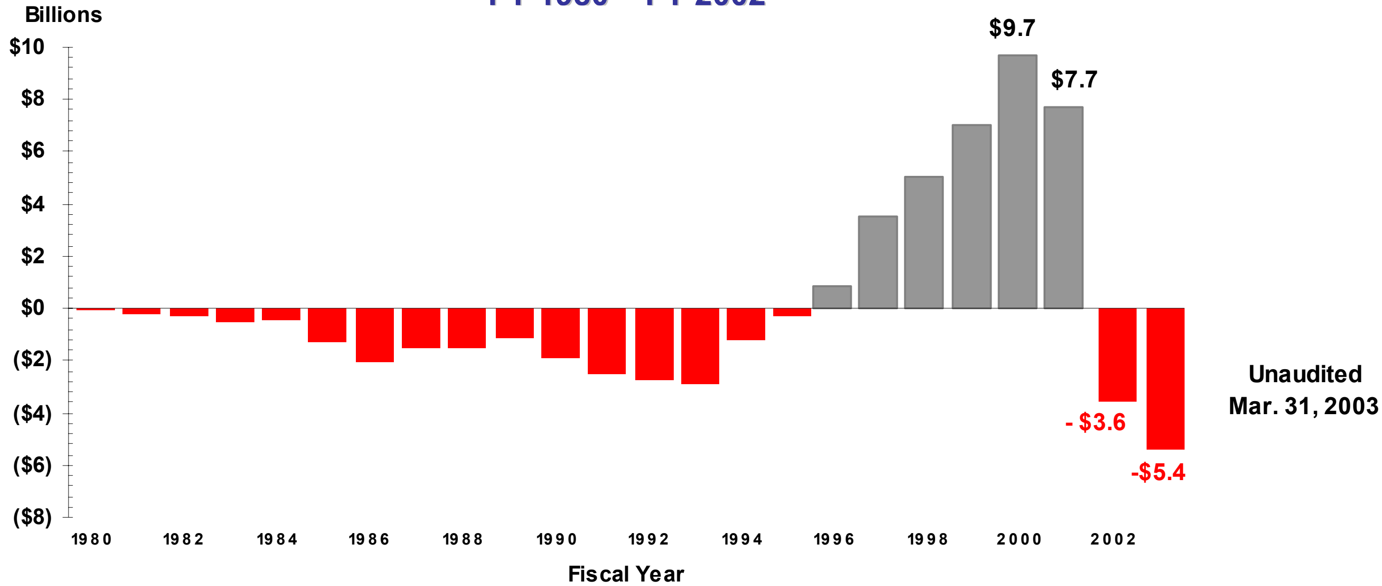
When PBGC takes over pension plans that are underfunded by billions of dollars, it is the premium payers – employers that sponsor defined benefit plans – who bear the cost. Financially healthy companies with well-funded pension plans end up subsidizing financially weak companies with chronically underfunded pension plans. As a result, over time, strong companies with well-funded plans may elect to leave the system. This potential for "adverse selection" could pose a serious problem for the insurance program.

Health of PBGC's Programs

PBGC operates two financially independent insurance programs, the larger single-employer program and a smaller program for multiemployer plans (i.e., plans set up between a union and two or more employers). The multiemployer program has been in surplus since 1980. The single-employer program, however, was in deficit for 21 years from 1974 until 1995.

For six years, from 1996 until 2001, the single-employer program was in surplus, reaching a surplus of nearly $10 billion in FY 2000. The surplus grew substantially during these years because of PBGC's investment gains during the stock market boom and because PBGC did not have to trustee any plans with large amounts of underfunding. During FY 2001 and FY 2002, however, PBGC's surplus rapidly deteriorated. At the end of fiscal 2002 (September 30, 2002), the surplus had disappeared altogether, leaving PBGC with a deficit of $3.6 billion. As of March 31, 2003, our unaudited deficit has grown to about $5.4 billion.

PBGC Net Position
Single-Employer Program
FY 1980 – FY 2002



Our deficit has been caused by the failure of a significant number of large companies with highly underfunded plans. These include the plans of Trans World Airlines; retailers including Bradlees, Caldor, Grand Union, and Payless Cashways; steel makers including LTV, Acme, Empire, Geneva, and RTI; other manufacturers such as Singer, Polaroid, Harvard Industries, and Durango. Mr. Chairman, pension claims for 2002 alone were greater than the total claims for all previous years combined. At current premium levels, it would take about 12 years of premiums to cover just the claims from 2002.

There are significantly underfunded plans in a number of industries, including steel, airlines, and the automotive sector. Two of these industries, steel and airlines, have accounted for 73 percent of the claims against PBGC, yet represent fewer than 5 percent of insured participants. Steel, with less than 3 percent of participants, has accounted for 56 percent of PBGC's claims, and airlines, with about 2 percent of participants, have constituted 17 percent of claims.

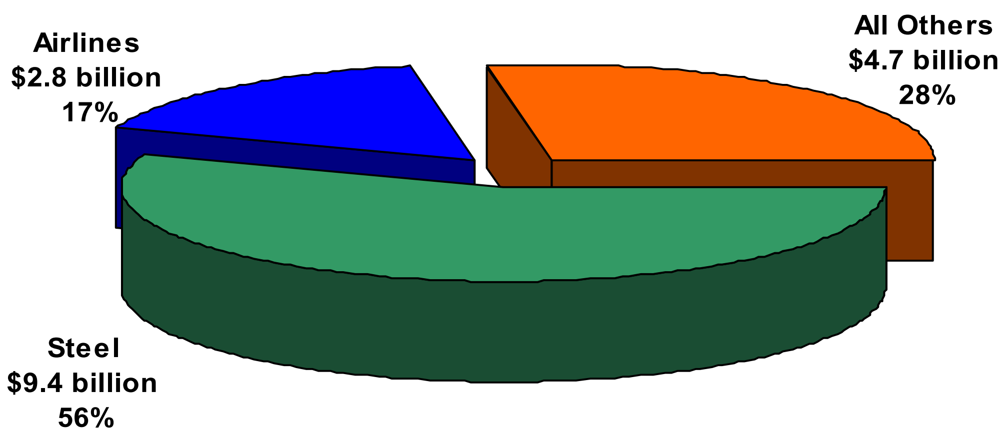
In December 2002, the plans of two major steel companies, Bethlehem and National Steel, terminated with combined underfunding of over $5 billion. And just last month, the US Airways pension plan for pilots terminated with underfunding of $2 billion.

That is what's in the door. Still looming is $35 billion in vested underfunded claims in "reasonably possible" plans sponsored by financially weak companies, according to PBGC's FY 2002 estimates. When this number is updated for FY 2003, the reasonably possible figure will be much higher. Because PBGC has now absorbed most of the steel plans, the airline and automotive sectors represent our biggest exposure. The airline industry now has $26 billion of total pension underfunding. In the automotive sector – comprised of auto, auto parts, and tire and rubber companies – total pension underfunding exceeds $60 billion.

Historic PBGC Claims

PBGC Claims FY 1975 - 2002

(including Bethlehem, National Steel and US Airways Pilots)



Note: Historically, Steel has represented less than 3% of participants covered by PBGC and Airlines less than 2%.

The termination of large plans with low funding levels drove PBGC into deficit, and additional large claims may increase that deficit. Even though the current $5.4 billion dollar deficit is the largest in the Agency's history, it does not create an immediate liquidity problem for PBGC – we will be able to continue paying benefits for a number of years. But, putting the insurance program on a sound financial basis is critical. We should not pass off the cost of today's problems to future generations.

Recently, some have argued that, because PBGC is not in any immediate danger of running out of cash, there is no need to address the issue of pension underfunding. We believe this view is misguided.

Mr. Chairman, Congress heard the same argument in 1987 and again in 1994 when Congress strengthened pension security for workers. Without those reforms, workers and the PBGC would be in even worse shape today and plan sponsors would be digging themselves out of an even larger underfunding hole.

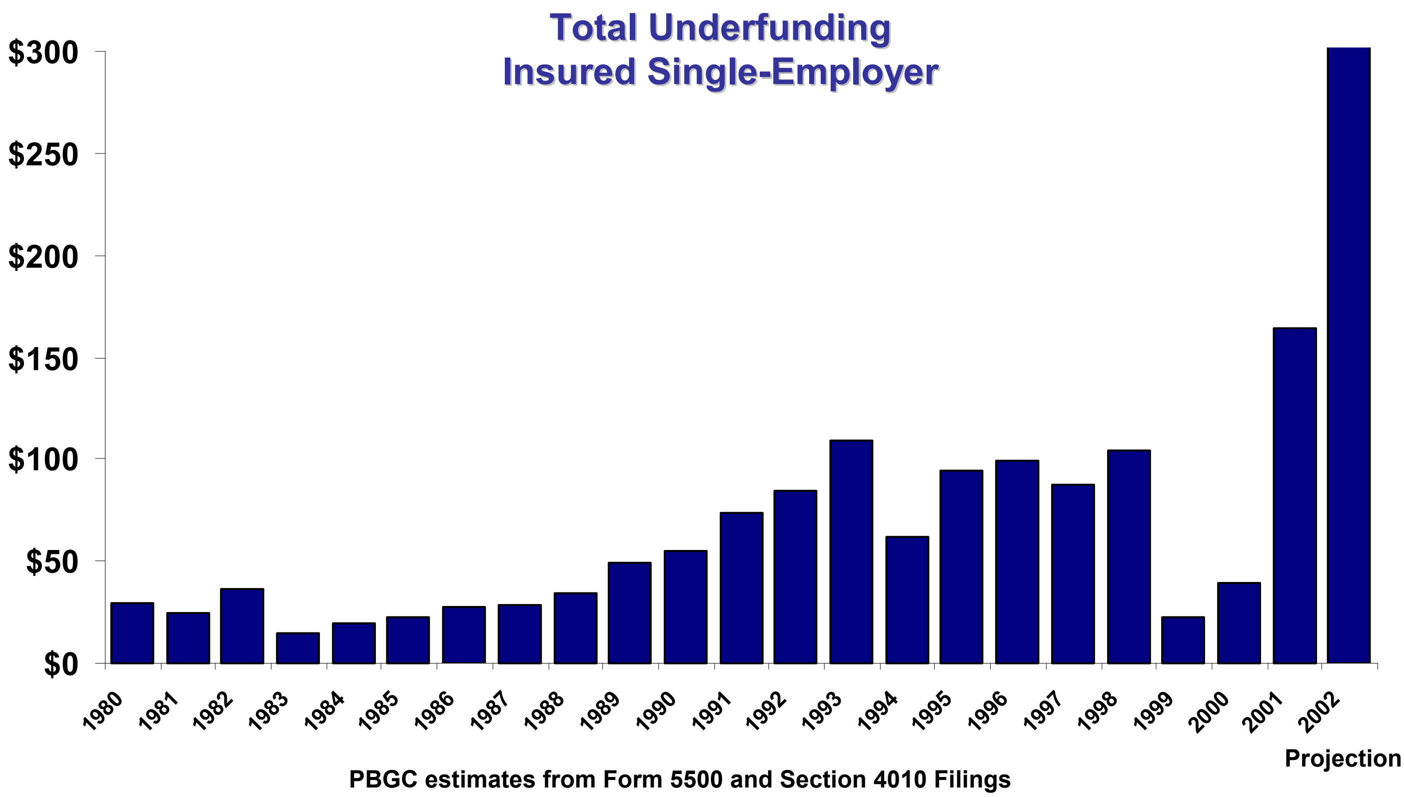
State of the Defined Benefit Pension System

Defined benefit plans are an important source of retirement income security for rank-and-file American workers. The defined benefit system, however, has serious structural problems that need to be addressed.

As you know, Mr. Chairman, our pension system is voluntary. In recent years, many employers have chosen not to adopt defined benefit plans, and other employers have chosen to terminate their existing defined benefit plans. Since 1986, 97,000 plans with 7 million participants have terminated. In 95,000 of these terminations the plans had enough assets to purchase annuities in the private sector to cover all benefits earned by workers and retirees. The remaining 1,800 were PBGC terminations where companies with underfunded plans shifted their unfunded pension liabilities to the insurance program, resulting in benefit reductions for some participants and premium increases for other pension plan sponsors.

Of the 32,000 defined benefit plans that remain ongoing, many are in our most mature industries. These industries face growing benefit costs due to an increasing number of retired workers.

At the same time, plan assets, which typically are invested over 50 percent in equities, have suffered a large decline and pension liabilities have ballooned due to falling interest rates. Last year over 270 corporations reported to PBGC that they had pension plan underfunding greater than $50 million. This is more than three times the number of corporations that have reported to PBGC in any year in the past, and we expect the number to be higher still this year.



Top 10 Firms Presenting Claims
FY 1975 – Present

	Fiscal Year of Plan Termination	Claims (Billions $)	Covered Participants	Funded Ratio*
Bethlehem Steel	2003	$ 3.9	95,000	48%
LTV Steel	2002	1.9	79,600	50%
National Steel	2003	1.3	35,400	54%
Pan American Air	1991, 1992	0.8	37,500	31%
Trans World Airlines	2001	0.7	34,300	47%
US Airways Pilots	2003	0.6	7,200	71%
Eastern Air Lines	1991	0.6	51,200	65%
Wheeling Pitt Steel	1986	0.5	22,100	27%
Polaroid	2002	0.4	11,400	67%
Sharon Steel	1994	0.3	6,900	21%

* Funded ratio at termination for PBGC benefits; participants lose additional benefits not covered by PBGC

During the last economic downturn in the early 1990s, the pension insurance program absorbed what were then the largest claims in its history -- $600 million in underfunding for the Eastern Airlines plans and $800 million for the Pan American Airlines plans. Those claims seem modest in comparison to the plans we have taken in lately: $1.3 billion for National Steel, $1.9 billion for LTV Steel, and $3.9 billion for Bethlehem Steel. Underfunding in some troubled airlines is even larger.

With pension promises growing and plan funding levels at their lowest point in more than a decade, the dollar amount of pension underfunding has skyrocketed. Meanwhile, PBGC's premium collections over the past decade have remained flat at roughly $800 million a year. In fact, premium revenue for FY 2002 was at its lowest level since 1991.

Challenges Facing the Defined Benefit System

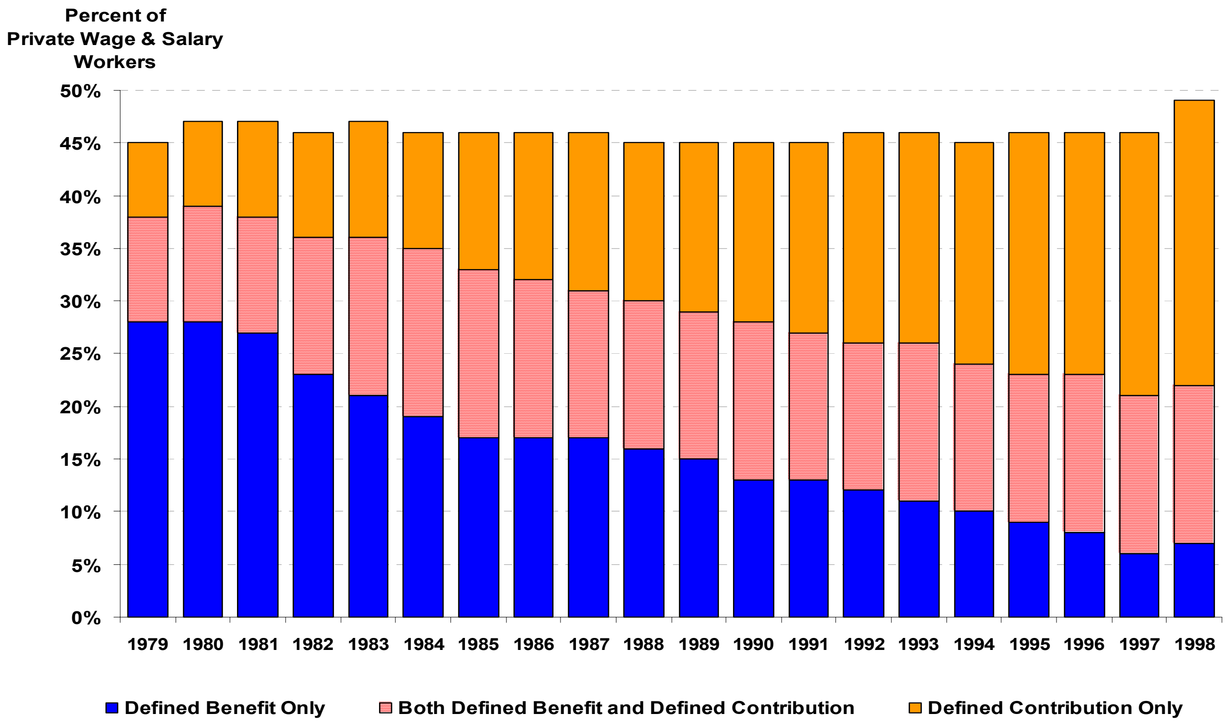
Mr. Chairman, there are a number of challenges facing the defined benefit system. One of the most fundamental challenges is that the current funding rules are inadequate to ensure sufficient pension contributions for those plans that are chronically underfunded. To our knowledge, none of the defined benefit pension plans responsible for the $300 billion in underfunding is in violation of law. Companies with hugely underfunded plans have followed the funding requirements of ERISA and the Internal Revenue Code.

When PBGC trustees these underfunded plans, participants often complain that "there ought to be a law" requiring companies to fund their plans. Mr. Chairman, there is a law, but it is inadequate to fully protect the pensions of America's workers when their plans terminate. The funding targets are simply not high enough for the plans of companies at the greatest risk of termination. Another defect in the funding rules is permitting plan assets and liabilities to be smoothed, which can reduce contributions. Finally, nothing in the funding rules requires companies with underfunded pensions to make annual cash contributions to their plans.

Another trend impacting the defined benefit system is increased competitive pressures that have led companies to reexamine their entire cost structure. In the 1990s, companies noticed that many workers did not place a high value on their defined benefit plans, compared to the value they placed on their 401(k) plans. Furthermore, companies became concerned that their financial obligations to defined benefit plans were highly volatile, in part because of fluctuations in interest rates and a dependence on equity investment gains. This volatility can make business planning difficult. As a result, many companies have been increasingly unable to afford, or unwilling to maintain, defined benefit plans.

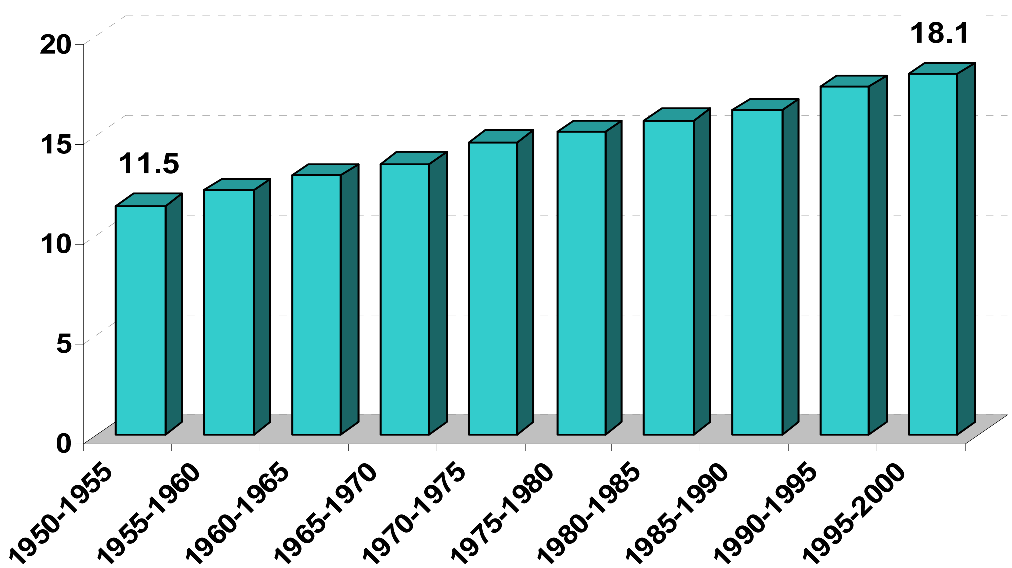
In addition, companies found that demographic trends have made defined benefit plans more expensive. With workers retiring earlier and living longer, plans must pay annuities for far longer. Today, an average male worker spends 18.1 years in retirement compared 11.5 years in 1950, an additional seven years of retirement that must be funded.

Pension Participation Rates 1979 - 1998



Source: U.S. Department of Labor
Pension and Welfare Benefits Administration
Abstract of 1998 Form 5500 Annual Reports Winter 2001 - 2002

Changing World … Demographics
Average Number of Years Spent in Retirement (Males)



Problematic Pension Proposals

Mr. Chairman, we have seen or heard of a number of proposals for changes in ERISA that would allow companies to reduce their pension contributions. There are proposals to lengthen the amortization periods for funding; to allow the use of weaker mortality tables; to reduce variable rate premiums paid to PBGC by seriously underfunded plans; to weaken pension contributions for certain companies and industries; and to allow benefit increases even when a pension plan is less than 60% funded.

These proposals all have the same impact of reducing contributions to seriously underfunded plans. To grant temporary relief to pension sponsors in financial difficulty is one thing. But to change ERISA in the ways being proposed would institutionalize greater long-term underfunding with potentially grave consequences for the defined benefit system.

Reform Principles

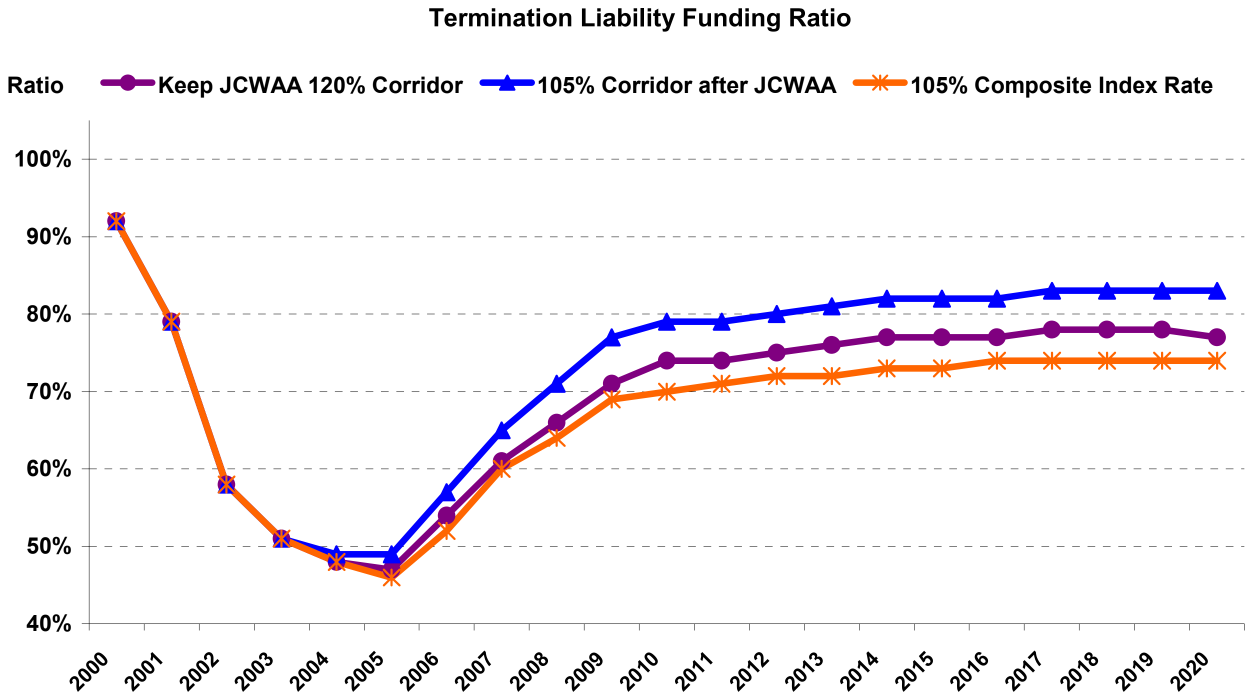
In an effort to improve pension security for workers and retirees by strengthening the financial health of the defined benefit system, PBGC and the Departments of Labor, Treasury, and Commerce are currently examining a number of long-term reforms. These ideas are still being refined, but I would like to share with you some of our thoughts.

Correct Measurement of Assets and Liabilities

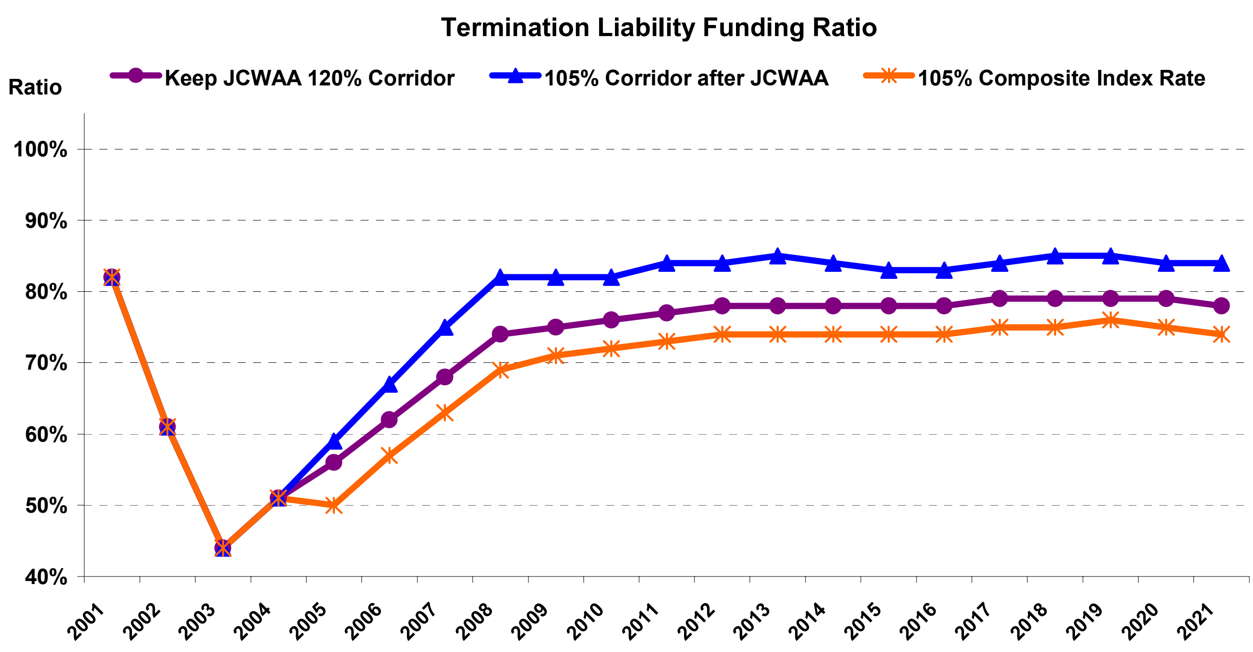
Secretary Fisher has discussed some of the issues that would need to be addressed before settling upon a permanent replacement for the 30-year Treasury rate. As he said, the Administration believes that Congress should provide a temporary solution for two more years. The Administration also recognizes the importance of accuracy, transparency, and the time structure of these liabilities. I would like to emphasize the importance we place on strengthening the funding rules at the same time that a permanent replacement is adopted for 30-year Treasuries.

Some groups want to substitute a single, smoothed long-term corporate bond rate for the 30-year Treasury rate as a means of providing permanent funding relief. But as PBGC's calculations indicate, this proposal would allow plan funding to fall below the already low levels permitted under current law.

Proposal Illustration (effective 01/01/2004)
Mature Manufacturing Company



Proposal Illustration (effective 01/01/2004)
Airline Company



Composite Rate consists of Moody's Aa Long Term Corporate Bond Index, Merrill Lynch 10+ High Quality Index, Salomon Smith Barney High Grade Credit Index, and Lehman Brothers Aa Long Credit Index.

Mr. Chairman, we are concerned about the financial integrity of the defined benefit system. While we support extending the current temporary solution for another two years, we believe that this time should be used to carefully examine the current funding rules and strengthen them so as to put the system on a sound financial footing over the long run.

Funding

Plan sponsors must not make pension promises that they cannot or will not keep. For example, under current law benefits can be increased as long as the plan is at least 60% funded. In too many cases, management and workers in financially troubled companies may agree to increase pensions, in lieu of larger wage increases. The cost of wage increases is immediate, while the cost of pension increases can be deferred for up to 30 years and may ultimately be passed on to PBGC's premium payers if the company fails.

Under current law, many companies with underfunded plans are not required to make annual pension contributions. A significant number of highly underfunded pension plans recently trusteed by PBGC were not required to make contributions for a number of years prior to termination. Moreover, in several cases, these companies paid little or no variable rate premiums to PBGC in the years leading up to termination. These and other weaknesses in the current rules underscore the importance of getting pension plans funded to an appropriate target level over a reasonable period of time without putting a company in financial distress.

Transparency/Disclosure

Mr. Chairman, pension plan information must also be transparent. Pension plans must be required to provide understandable information that best reflects the current state of plan assets and liabilities. The current value of plan assets and liabilities is not transparent to workers, retirees, investors, or creditors, and the current disclosure rules do not require timely data that would help participants and shareholders understand the funding status of plans and the consequences of pension underfunding. Timely, accurate data would enable the capital markets to inject further discipline into the system and allow all stakeholders to better protect their interests.

Congress added new requirements in 1994 providing more timely data to PBGC and expanding disclosure to participants in certain limited circumstances, but our experience tells us these disclosures are not adequate. The information provided to PBGC is confidential, so its impact is limited. And 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.

Long-term Stability of the Pension Insurance Program

Mr. Chairman, we believe changes should be made to strengthen the long-term stability of the defined benefit insurance system. For example, in many cases current law requires that PBGC pay shutdown benefits – early retirement benefits triggered by plant shutdowns or permanent layoffs – that companies typically do not fund and for which no specific premium is paid to PBGC. These shutdown benefits – which are similar to severance benefits not guaranteed by PBGC -- account for billions of dollars of PBGC's unfunded liability exposure. We are considering whether plan sponsors should be allowed to offer shutdown benefits as part of an insured pension plan.

PBGC is also examining its premium structure in light of the massive increase in claims. Under the current structure, premiums are computed based solely on the number of plan participants and the dollar amount of pension underfunding. The formula does not attempt to reflect the risk of a claim from a given plan. While we continue to believe that well-funded plans represent a better solution for participants and the pension insurance program than any changes on the premium side, we should not rule out premium increases as an option at a time when PBGC has a large and growing deficit.

Conclusion

In closing, I would like to cite the remarks of the former chairman of the Ways and Means Oversight Subcommittee the last time ERISA funding was considered. Representative J.J. [Jake] Pickle was one of the chief advocates of the 1987 and 1994 reforms. His comments on the floor at the time the 1994 pension reforms were enacted are worth remembering:

> "I note that I would have personally preferred to make these reforms much stronger, and I caution my colleagues that they should not expect these reforms to immediately solve all the problems caused by underfunded pension plans. In order to overcome strenuous objections by certain automobile, steel, and airline companies we have included very generous transition rules for companies which have maintained chronically underfunded pension plans. . . . I deeply regret that we have given another reprieve to companies who have shirked their pension obligations for the 20 years since the passage of [ERISA]."
>
> Congressional Record, 103rd Cong., 2nd Sess., H11477, Nov. 29, 1994.

Mr. Chairman, the existence of the pension insurance program creates moral hazard, tempting management and labor at financially troubled companies to make pension promises the companies later find they are unable to keep. These unfunded promises increase the cost that chronically underfunded pension plans at weak companies impose on the defined benefit system. Over time, this leads to higher premiums for all plan sponsors. Financially strong companies at some point will have had enough, and will exit the defined benefit system, leaving only those which pose the greatest risk of claims. We need to make sure that the incentives in the system are changed so this doesn't happen.

The funding rules need to be carefully examined and then strengthened to ensure the long-term viability of the pension system. The funding rules should encourage companies to make regular contributions to reach an appropriate funding target. Making defined benefit plans better funded is important to providing retirement security to American workers.

Again, I thank the Chairman for inviting me to testify this afternoon. I will be happy to answer any questions.