

STATEMENT OF STEVEN A. KANDARIAN
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Before the
COMMITTEE ON EDUCATION AND THE WORKFORCE
UNITED STATES HOUSE OF REPRESENTATIVES
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INTRODUCTION

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

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

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

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

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

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

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

- First, as the necessary initial step toward comprehensive reform of the funding rules, it improves the accuracy of pension liability measurement to reflect the time structure of each pension plan's benefit payments. This would be accomplished by measuring a plan's liabilities

using a yield curve of highly-rated corporate bonds to calculate the present value of those future payments.

- Second, it requires better disclosure to workers, retirees, investors and creditors about the funded status of pension plans, which will improve incentives for adequate funding.
- Third, it provides new safeguards against underfunding by requiring financially troubled companies with highly underfunded plans to immediately fund or secure additional benefits and lump sum payments. Similarly, it prohibits unfunded benefit increases by those severely underfunded plans sponsored by corporations with below investment-grade debt.
- And fourth, it calls for additional reforms to protect workers' retirement security by improving the funded status of defined benefit plans.

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

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

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

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

PBGC's Deteriorating Financial Condition

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

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

Reasons for PBGC's Current Financial Condition

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

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

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

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

CHALLENGES FACING THE DEFINED BENEFIT PENSION SYSTEM

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

Concurrent Falling Interest Rates and Stock Market Returns

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

In order to understand how pension plans got so underfunded, it is important to consider how mismatching assets and liabilities affects pension plan funding levels. Pension plan liabilities tend to be bond-like in nature. For example, both the value of bonds and the value of pension liabilities have risen in recent years as interest rates fell. Were interest rates to rise, both the value of bonds and the value of pension liabilities would fall. The value of equity investments is more volatile than the value of bonds and less correlated with interest rates. Most companies prefer equity investments because they have historically produced a higher rate of return than bonds. These companies are willing to accept the increased risk of equities and interest rate changes in

exchange for expected lower pension costs over the long term. Similarly, labor unions support investing in equities because they believe it results in larger pensions for workers. Investing in equities rather than bonds shifts some of these to the PBGC.

Pension Underfunding

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

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

Demographic Trends

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

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

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

Weaknesses in the Funding Rules

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

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

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

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

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

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

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

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

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

PBGC Premiums

As I noted earlier, because PBGC is not backed by the full faith and credit of the federal government and receives no federal tax dollars, it is the premium payers -- employers that sponsor defined benefit plans -- who bear the cost when underfunded plans terminate. Well-funded plans represent the best solution for participants and premium payers. However, PBGC’s premiums

should be re-examined to see whether they can better reflect the risk posed by various plans to the pension system as a whole.

REFORMS NEEDED TO PROTECT THE DEFINED BENEFIT SYSTEM

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

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

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

CONCLUSION

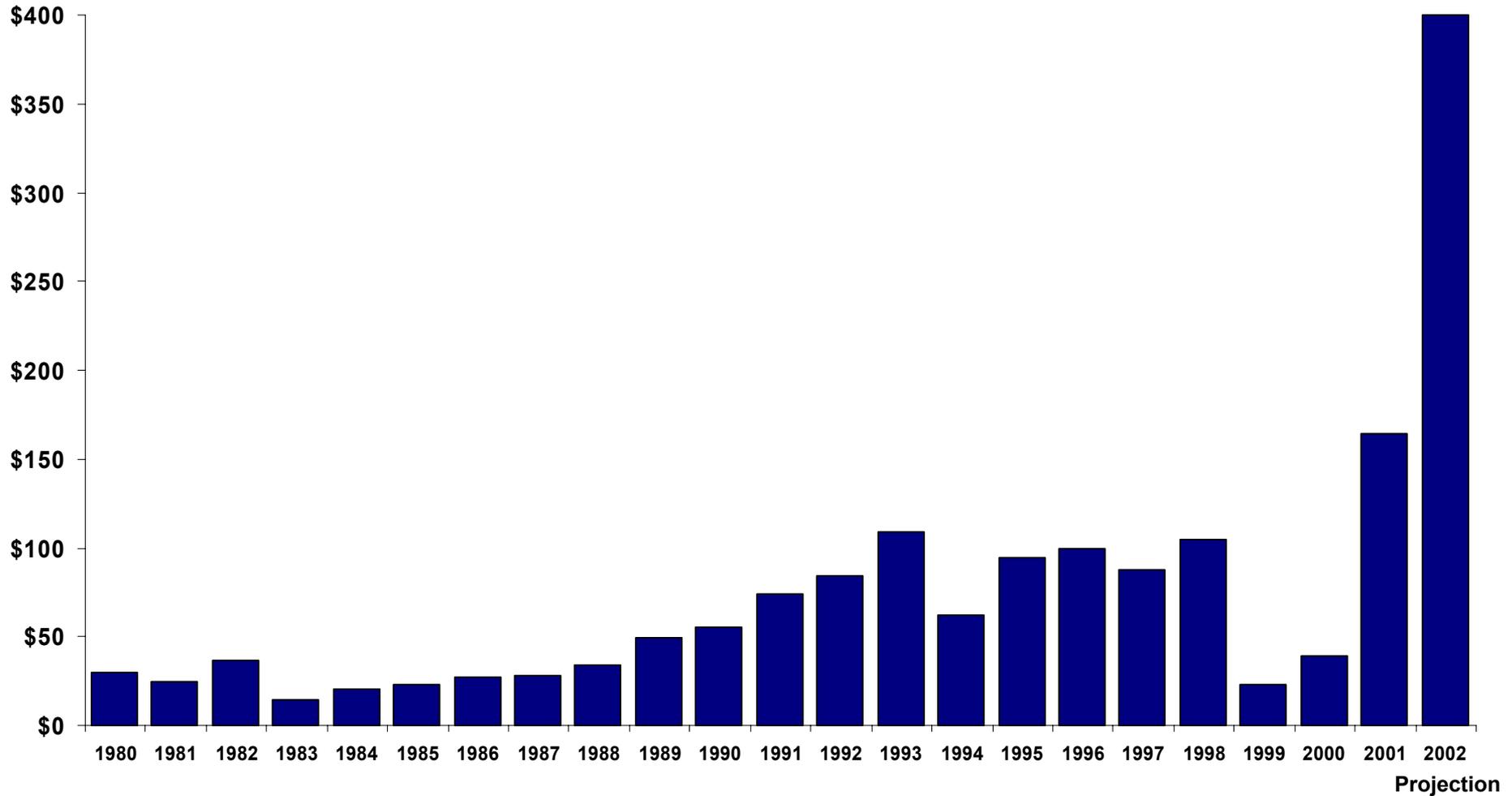
Mr. Chairman, we should not pass off the cost of today's pension problems to future generations. If companies do not fund the pension promises they make, someone else will have to pay -- either workers in the form of reduced benefits, other companies in the form of higher PBGC premiums, or taxpayers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

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

Total Underfunding Insured Single-Employer Plans

Chart 1

Billions

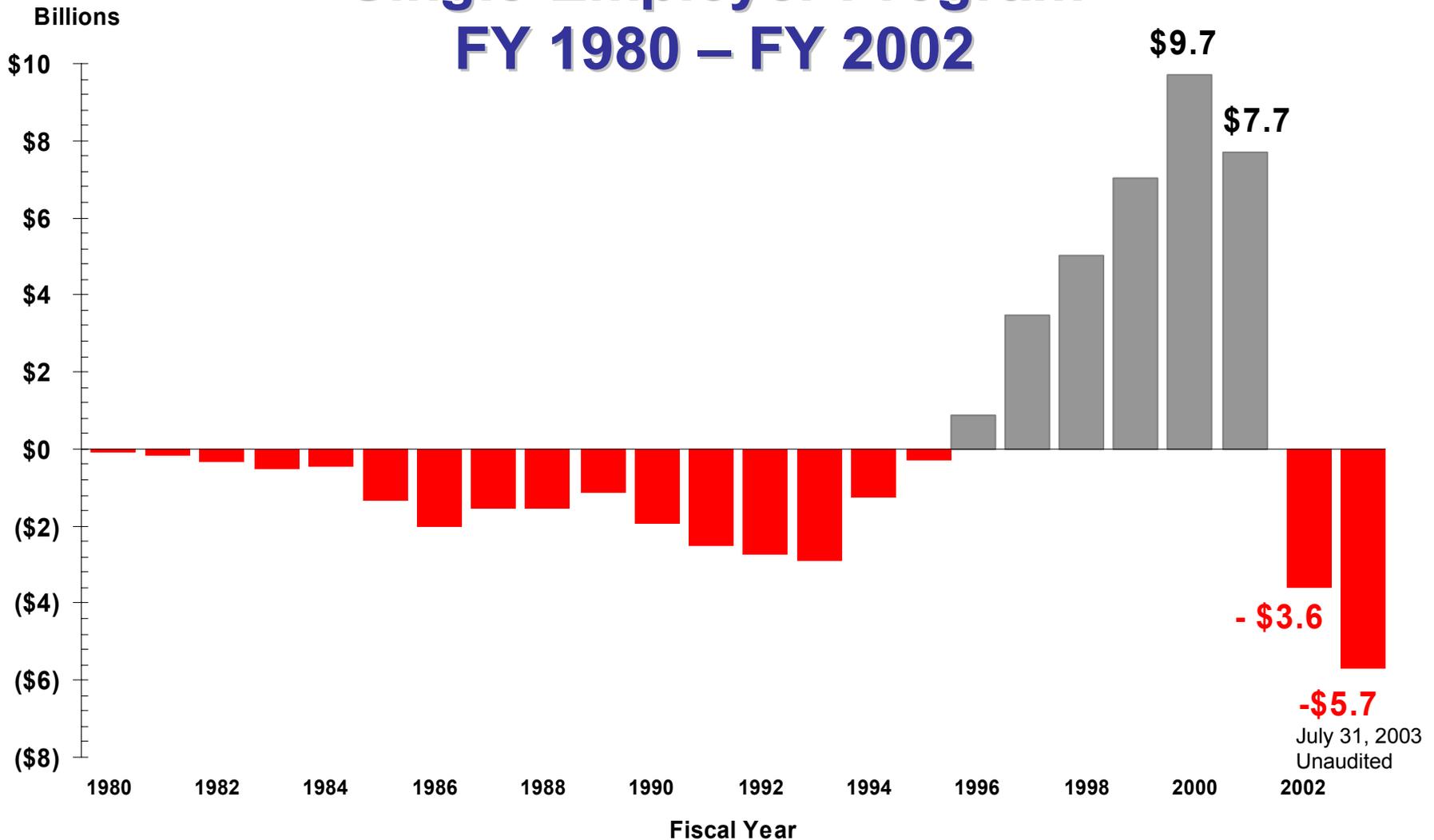


Projection

PBGC estimates from Form 5500 and Section 4010 Filings

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

Chart 2

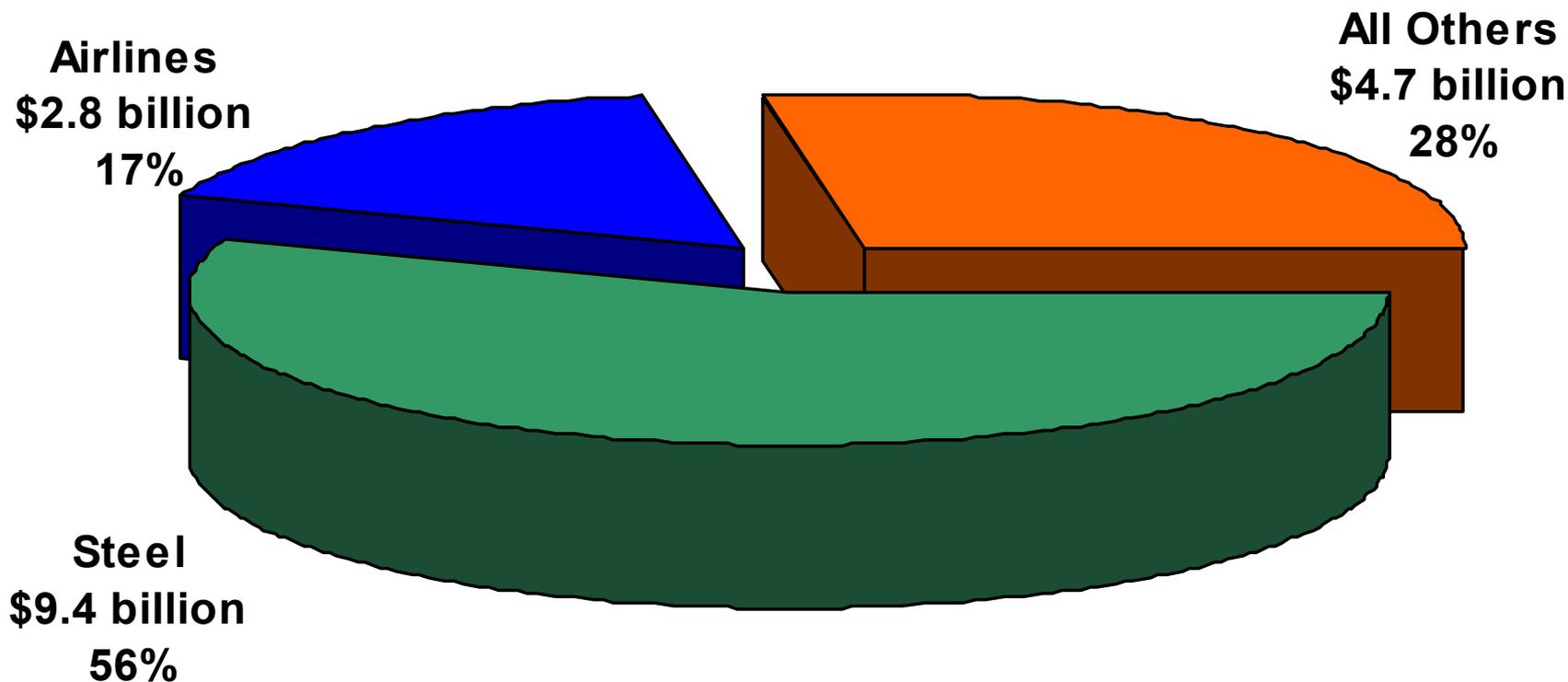


Data does not include restored LTV plans in 1986

Historic PBGC Claims

PBGC Claims FY 1975 - 2002

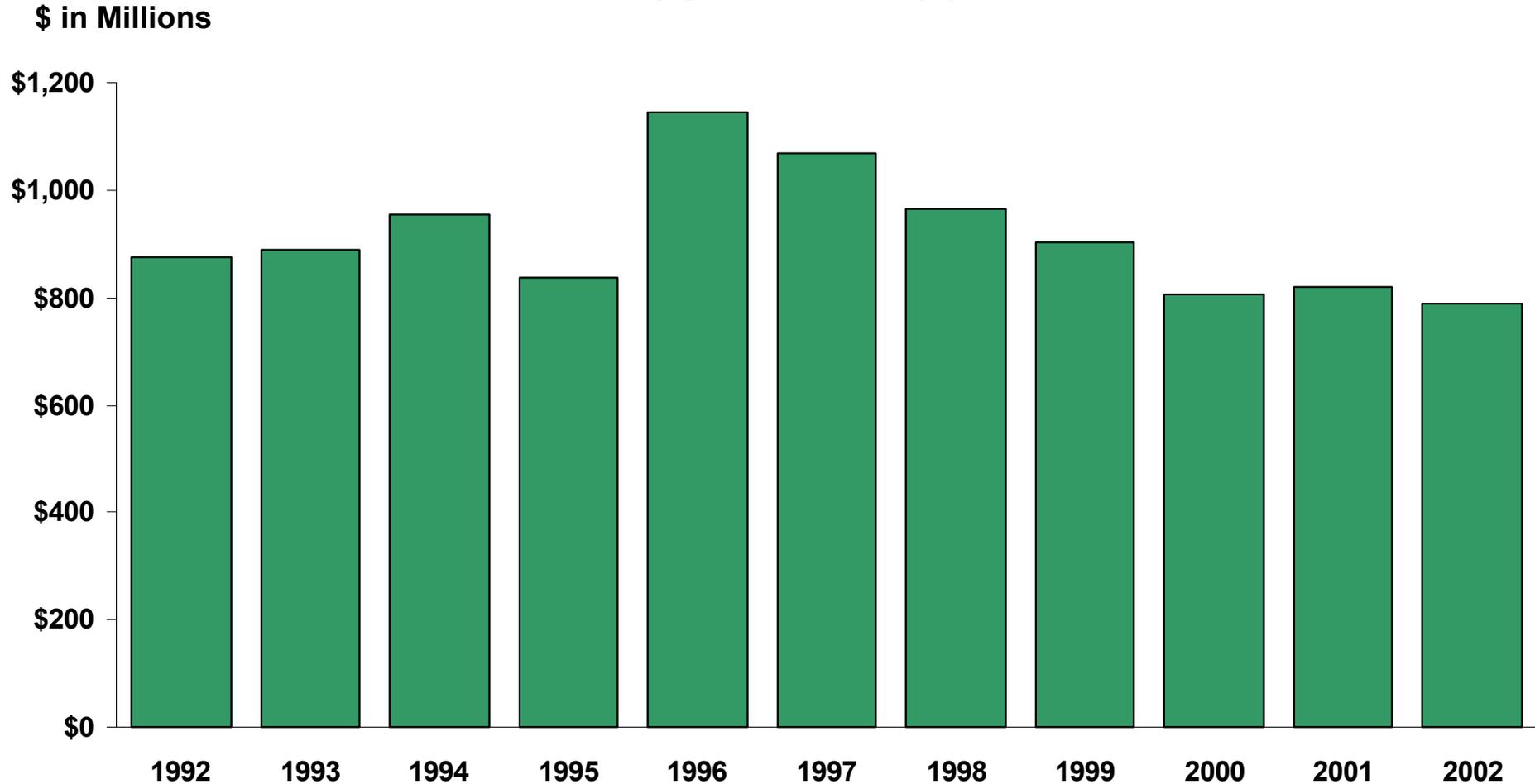
(including Bethlehem, National Steel and US Airways Pilots)



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

Single-Employer Premium Income

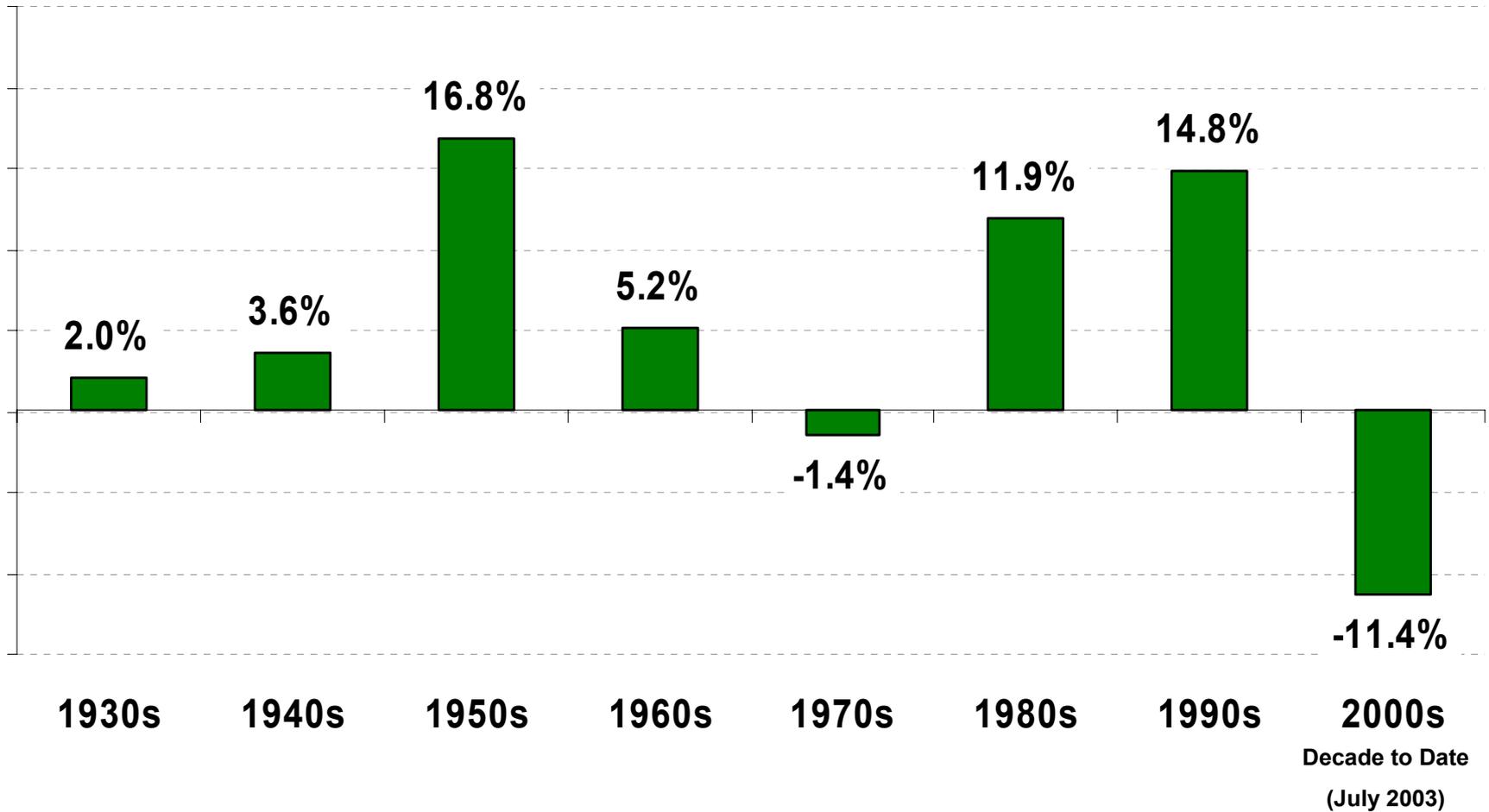
FY 1992 – FY 2002



NOTE: The variable rate premium was capped until 1996

Real Equity Returns

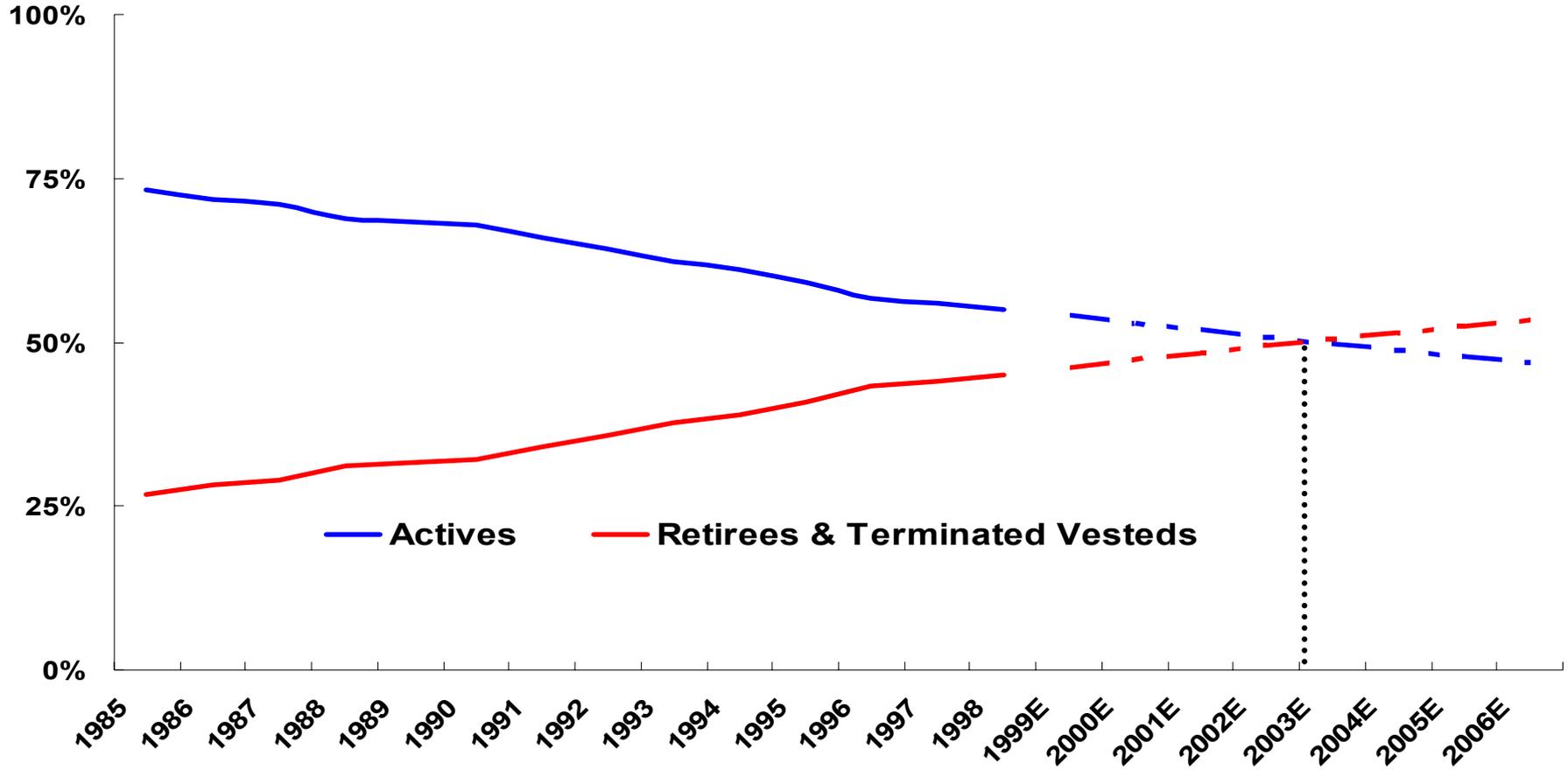
Chart 5



Source: Ibbotson Associates

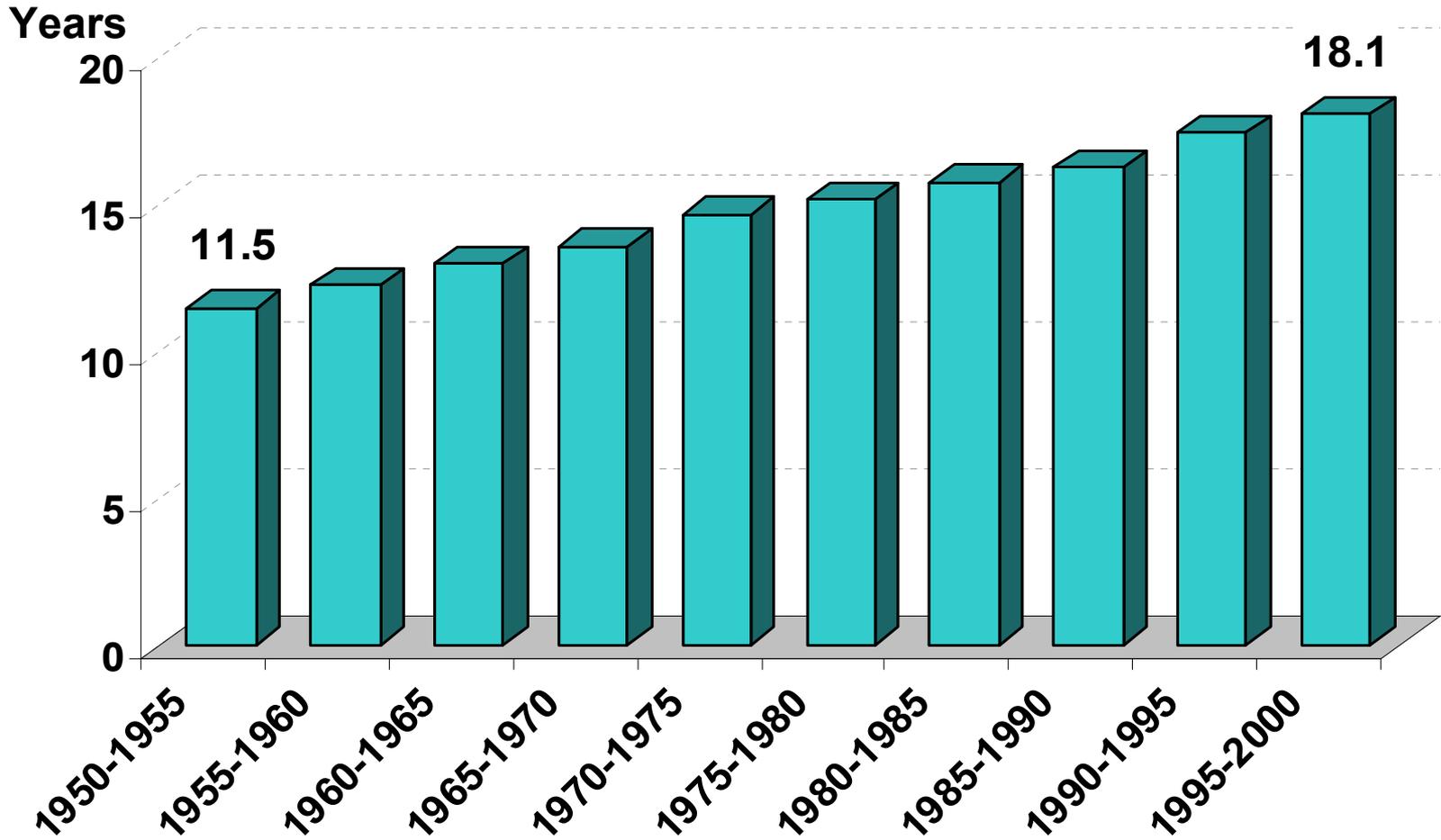
Participants in Defined Benefit Pension Plans

[1985 - 2006^{est.}]



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

Average Number of Years Spent in Retirement (Males)



Bethlehem Steel

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

Termination Benefit Liability Funded Ratio 45%

Unfunded Benefit Liabilities \$4.3 billion

US Airways Pilots

Chart 9

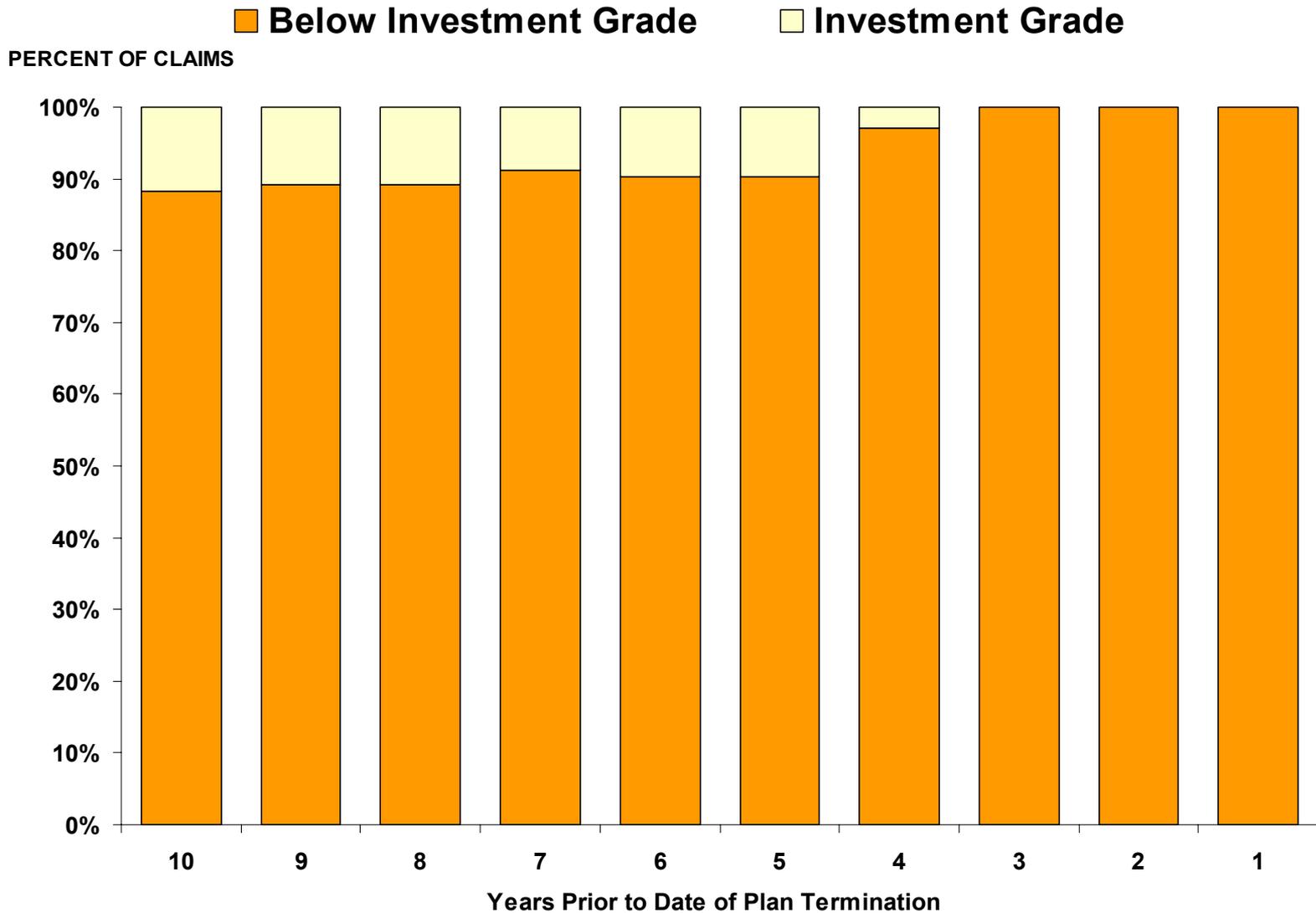
| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 |
|--|-----------------|------|--------------|------|-------------|------|------|
| Current Liability | 97% | 100% | 91% | 85% | 104% | 94% | NR |
| Was the company required to make a deficit reduction contribution? | N | N | N | N | N | N | NR |
| Was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

Termination Benefit Liability Funded Ratio 33%

Unfunded Benefit Liabilities \$2.5 billion

Debt Ratings for Large Claims

Chart 10



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