PENSION BENEFIT GUARANTY CORPORATION

TESTIMONY OF STEVEN A. KANDARIAN
Executive Director
PENSION BENEFIT GUARANTY CORPORATION
Before the
SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

October 14, 2003

Mr. Chairman, Ranking Member Breaux, 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 the financial health of PBGC and the future of defined benefit pension plans, 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 nearly 1 million people in over 3,200 terminated defined benefit plans. Benefit payments totaled $2.5 billion dollars in FY 2003. We expect benefit payments to grow to nearly $3 billion in FY 2004.

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 its 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.

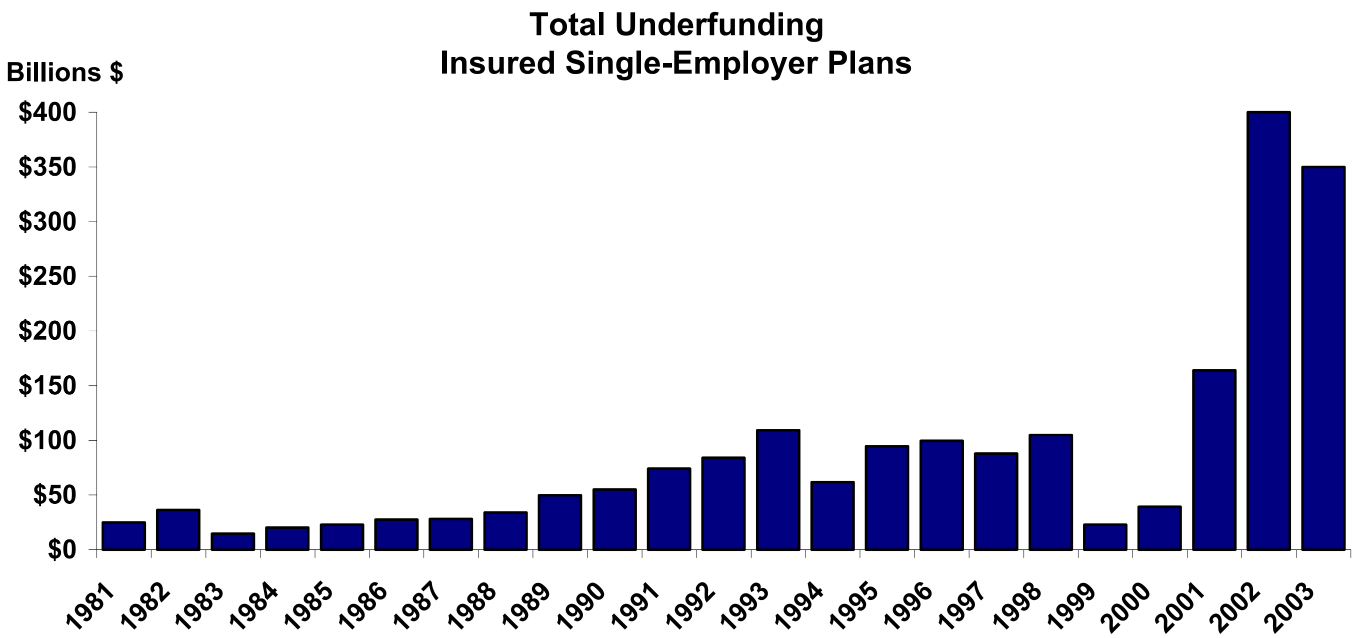
- Second, it requires better disclosure to workers, retirees, investors and creditors about the funded status of pension plans, which will improve incentives for adequate funding.

- 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 ratings.

- And fourth, it calls for additional reforms to protect workers' retirement security by improving the funded status of defined benefit plans.

Labor Assistant Secretary Ann Combs and then Treasury Under Secretary Peter Fisher testified on July 15 before a joint hearing of subcommittees of the House Committee on Education and the Workforce and the House Committee on Ways and Means about these proposals. In my testimony today I would like to focus on plan underfunding, PBGC's financial condition, and the structural challenges facing the defined benefit system that need to be addressed with additional reforms.

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



PBGC estimates from Form 5500 and Section 4010 Filings

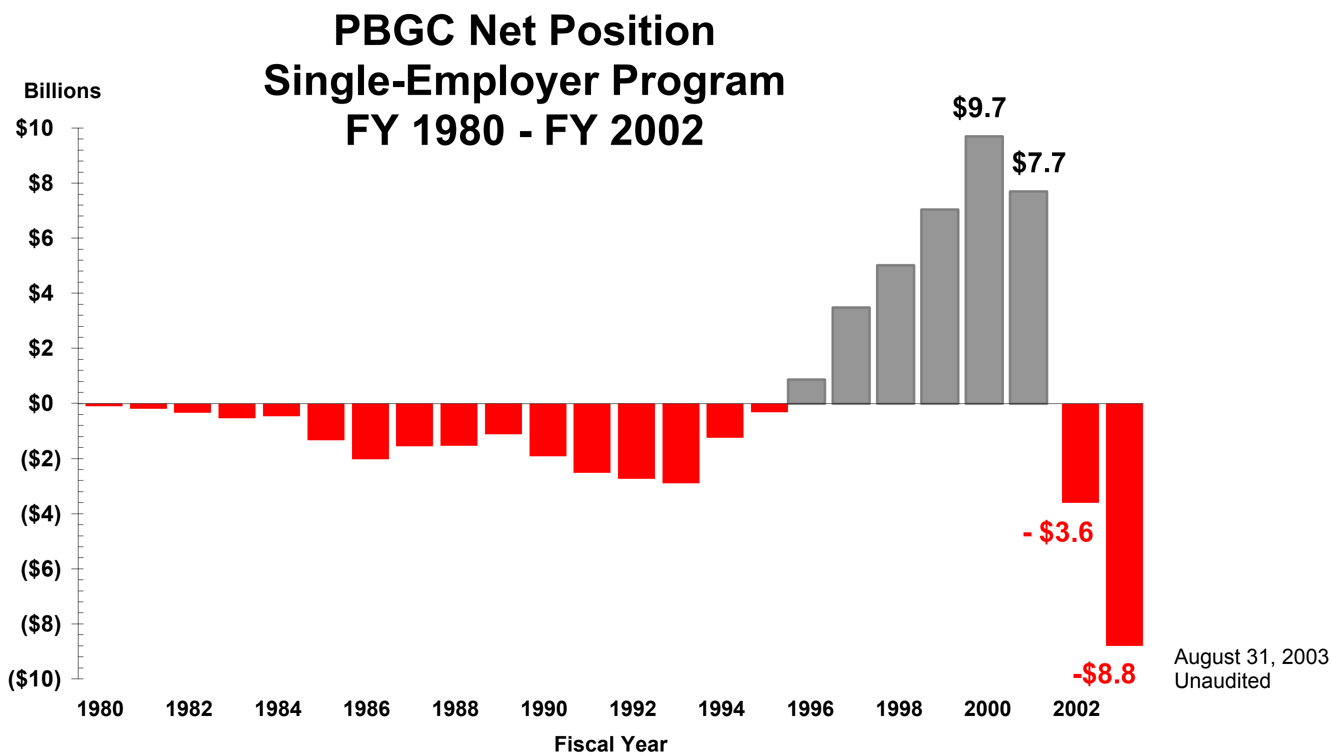
When the PBGC is forced to take over underfunded pension plans, the burden often falls heavily on workers and retirees. In some cases, participants lose benefits that were earned but not guaranteed by the pension insurance system. In all cases, workers lose the opportunity to earn additional benefits 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 currently 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 29-year history. Moreover, based on our latest unaudited financial report, the deficit had grown to $8.8 billion as of August 31, 2003.



Changes in PBGC's deficit result from a number of factors including changes in interest rates, asset values, and probable terminations, as well as new claims.

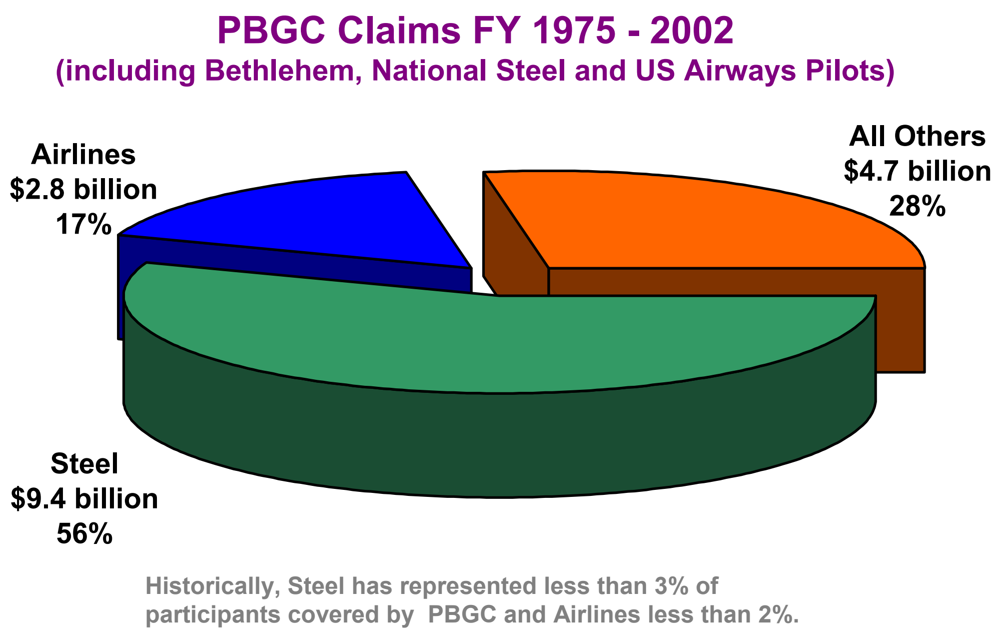
The title of this hearing asks whether America's pensions will be the next savings and loan crisis. PBGC has sufficient assets on hand to pay benefits for a number of years in the future. But, there are serious structural issues that require fundamental reform to the defined benefit system now. In addition, PBGC's deficit is the largest in its history and is still growing. Some have suggested that these issues should be addressed "at some point." It is our view, however, that the best time to address these matters is before a crisis point. Current pension funding rules have acted to delay needed pension funding. Employers find that they are hit with substantial funding requirements when they can least afford them. Deferring action until a crisis point would risk subjecting the entire pension system to similar but much more serious strains in the future.

The General Accounting Office (GAO) has found that the health of PBGC's single-employer insurance program requires the attention of policy makers. Because of PBGC's extraordinary one-year loss, the dramatic increase in pension underfunding, and the risk of additional large claims on the insurance program, GAO recently placed the single-employer insurance program on its "high risk" list. 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 insured participants in 1980 to only 53% in 2000. In addition, GAO 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 primary 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.

Historic PBGC Claims

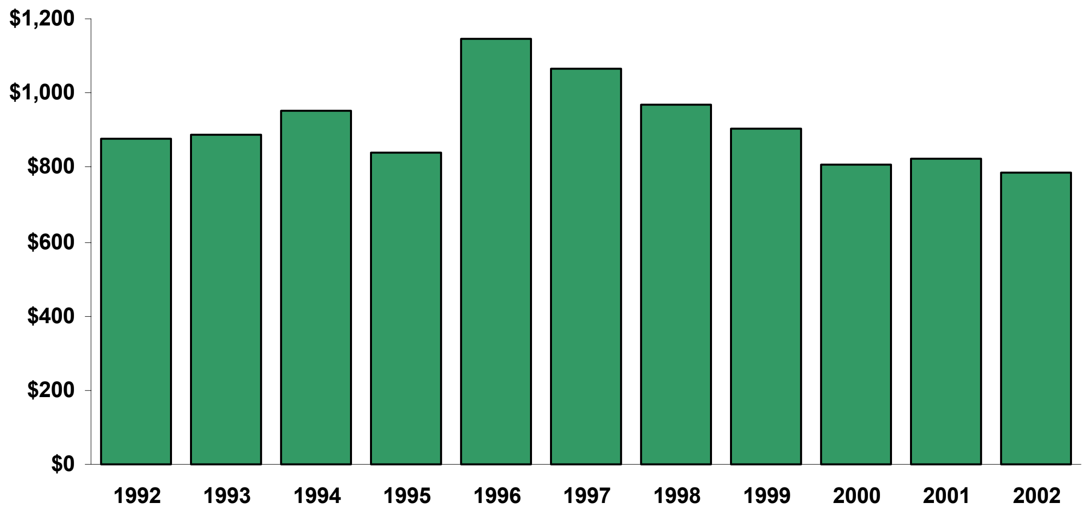


These include the plans of retailers Bradlees, Caldor, Grand Union, and Payless Cashways; steel makers including Bethlehem, LTV, National, Acme, Empire, Geneva, and RTI; other manufacturers such as Singer, Polaroid, Harvard Industries, and Durango; and airlines such as TWA. In addition, PBGC has taken over the failed US Airways pilots' plan. 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 as of December 31, 2002.

PBGC premiums have not kept pace with the growth in pension claims or in pension underfunding.

Single-Employer Premium Income
FY 1992 – FY 2002



NOTE: The variable rate premium was capped until 1996.

Premium income has fallen since 1996 to about $800 million per year, 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, despite being drastically underfunded on a termination basis.

Some have argued that PBGC overstates its deficit because it values its liabilities based on private annuity purchase rates compiled from information provided by insurance companies, even though PBGC does not buy annuities in the private market. We disagree. For an explanation of how PBGC measures its liabilities, see Appendix A.

Disclosure of Termination Liability

Some have also argued that it makes no sense to disclose the funded status of an ongoing plan in terms of its termination liability, as has been proposed by the Administration. They believe that publishing termination liability will lead workers to believe that their plans will terminate.

Since ERISA's beginning in 1974, more than 160,000 defined benefit plans insured by PBGC have voluntarily terminated in standard terminations. The number of plans peaked in 1985 at about 112,000. Since then, there has been a sharp decline, primarily among small plans, to about 32,000 plans in 2002. In the last seventeen years alone, employers have voluntarily terminated more than 95,000 plans covering about 6.5 million participants. In contrast, during the same period, only 1,800 plans were trusteed by PBGC.

Some also argue that disclosing termination liability will force companies to make contributions beyond what is necessary to meet future liabilities. The Administration strongly disagrees with any suggestion that pensions will only be funded at appropriate levels if information about the cost of paying off a plan's benefit obligations is withheld from workers. Workers have a right to know whether their benefits will be funded if there is a change in the status of the firm they work for.

This is not a hypothetical concern. It is clear that the current liability disclosure methods are inadequate to inform workers about the funded status of their benefits. For example, 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 35 percent funded on a termination basis -- with total underfunding of $2.2 billion. As a result, the US Airways pilots were shocked to learn just how much of their promised benefits would be lost.

For these reasons, the Administration has proposed increasing the transparency of information about pension plan funding. Under current law, most workers and investors are not provided with timely information about the funding of corporate pension plans, and this uncertainty can have a negative impact on the stock prices of plan sponsors. The Administration proposes to increase the timeliness and accuracy of this disclosure by requiring that all plan sponsors disclose each year the value of their plan's assets and liabilities measured on both an ongoing and a termination basis.

PBGC's Reasonably Possible and Probable Terminations

In addition to actual claims from terminated underfunded plans, PBGC reports two other kinds of claims in its financial statements – "reasonably possible" claims from underfunded plans that might terminate over the next several years, and "probable" claims from plans that are likely to terminate. Some have questioned whether it is appropriate for PBGC to report claims for plans that have not yet terminated, and argue that the criteria for classifying underfunded plans as "probable" or "reasonably possible" claims are not transparent. As detailed in Appendix C, the criteria for classifying plans as "probable" or "reasonably possible" are described in the notes to PBGC's financial statements. Furthermore, PBGC follows generally accepted accounting principles (GAAP) in reporting "probable" and "reasonably possible" claims in the financial statements. PricewaterhouseCoopers LLP, through PBGC's Inspector General, performed an independent audit of the financial statements and issued an unqualified opinion.

There is a degree of management judgement required when classifying claims as "probable" or "reasonably possible." However, from 1987 through 2002, 87 percent of the dollar amount of cumulative "probable" claims subsequently became actual claims; 6 percent continue to be considered "probable;" and only 7 percent of claims accrued during those 16 years are no longer considered "probable" and have been removed from claims for probable terminations.

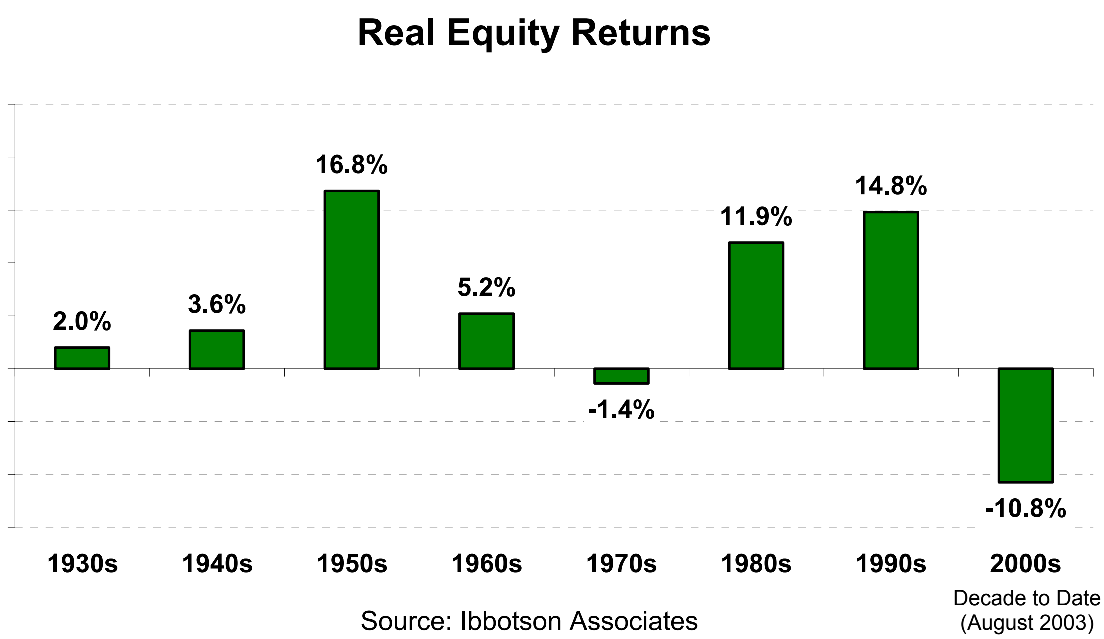
CHALLENGES FACING THE DEFINED BENEFIT PENSION SYSTEM

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.

While my testimony today focuses on single-employer defined benefit plans and PBGC's single-employer insurance program, I want to note that multiemployer plans and PBGC's multiemployer insurance program are subject to many of the same economic pressures and challenges. As a result, the Administration is concerned about proposals that would weaken multiemployer plan funding. It is likely that PBGC's multiemployer insurance program will show a deficit for the first time as of September 30, 2003.

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.



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 unprecedented 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 that impact pension liabilities. 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 the risks of this approach to PBGC.

Pension Underfunding

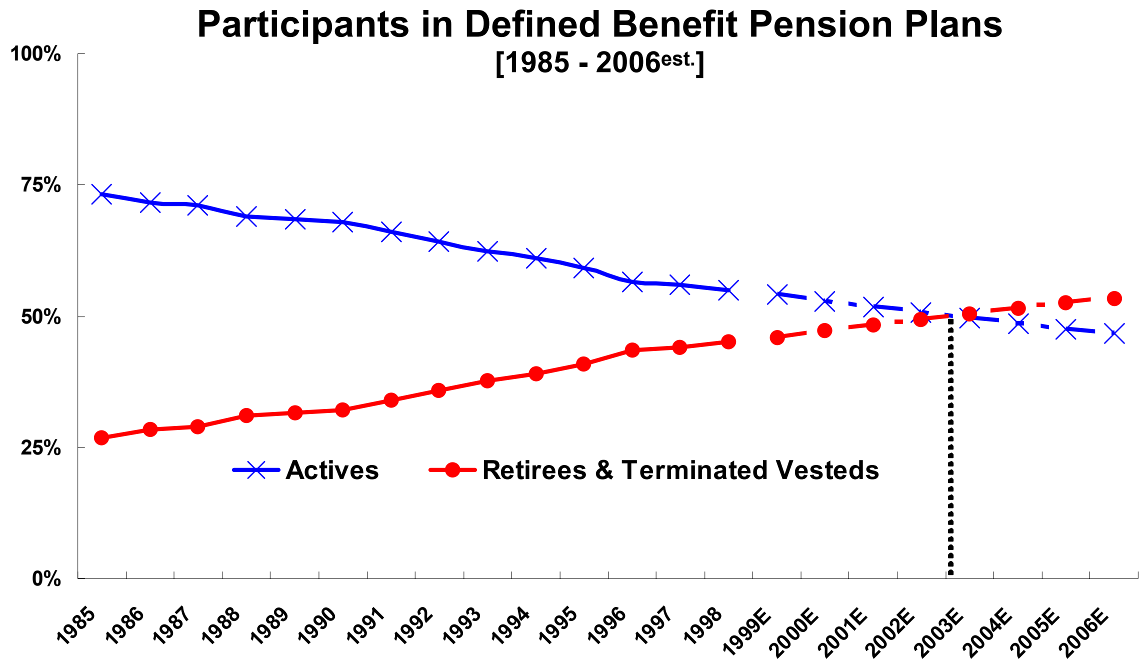
Any pension underfunding is a matter of concern and may pose risks to plan participants and the PBGC. In ongoing, healthy companies, an increase in the amount of underfunding can affect how secure workers feel about their pension benefits, even though the actual risk of loss may be low, at least in the 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. We expect underfunding in financially troubled companies to exceed $80 billion at the end of FY 2003. As I previously noted, the Administration has already made specific legislative recommendations to require financially troubled companies with highly underfunded plans to immediately fund or secure additional benefits and lump sum payments. The Administration believes that this measure will prevent companies that cannot afford to fund additional pension benefits from making new pension promises they cannot keep.

Demographic Trends

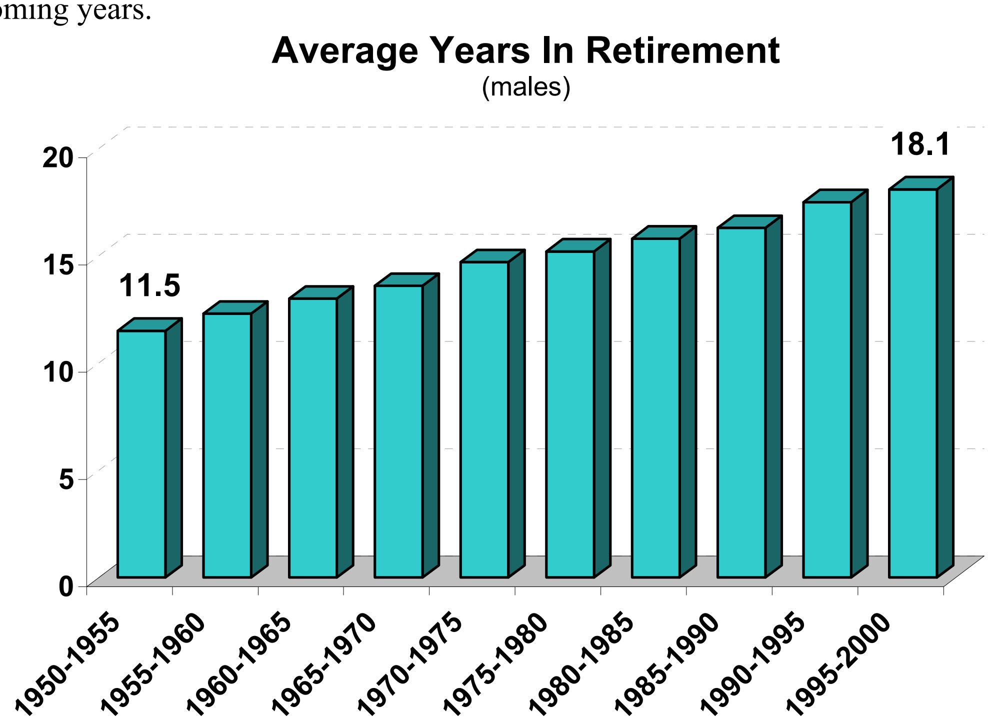
Demographic trends are another structural factor adversely affecting defined benefit plans. Many defined benefit plans are in our oldest and most capital intensive industries. These industries face growing pension and health care costs due to an increasing number of older and retired workers.

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



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

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. 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 fully 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:

Funding Targets

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 result 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.

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?	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

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 35 percent funded on a termination basis – with total underfunding of $2.2 billion. 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.

US Airways Pilots

	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?	Y	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 35%
Unfunded Benefit Liabilities $2.2 billion

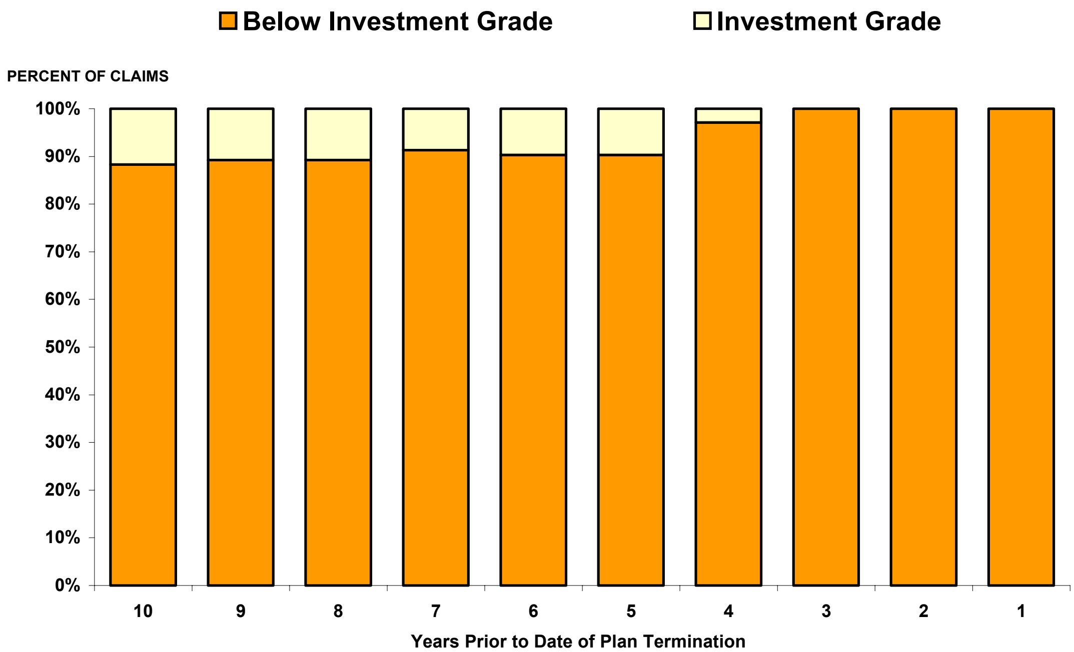
Contribution Holidays

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.

Risk of Loss

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.

Debt Ratings for Large Claims



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

Minimum/Maximum Funding Range

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.

Lump Sum Payments

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.

Contribution Volatility

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 current 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.

PENSION CONTRIBUTION RELIEF

Congress has been asked to enact legislation that replaces interest rates for the no longer issued 30-year Treasury bond to discount pension liabilities. The Administration agrees that the 30-year Treasury bond rate should be replaced.

Corporate Bond Rates

Earlier this year, the Administration proposed that pension liabilities be discounted for two years using a blend of corporate bond rates before phasing in to a methodology utilizing a corporate bond yield curve that would more accurately match pension plans' discounting methods to the duration of their liabilities. On October 8, 2003, the House passed the "Pension Funding Equity Act of 2003" (H.R. 3108), a bill that would provide a two-year replacement rate for the historic 30-year Treasury rate. This bill is consistent with the transitional portion of the Administration's proposal over the same time frame. The Administration looks forward to working further with Congress to enact a permanent method of discounting pension liabilities.

In 2002, Congress passed legislation that temporarily changed the pension discount rate from 105 percent to 120 percent of 30-year Treasury bonds to provide funding relief to plan sponsors. Replacing the 120 percent of 30-year Treasuries with a corporate rate will provide additional short-term funding relief of $26 billion over the next two years – about a 10 percent reduction in corporation pension contributions.

The Senate Finance Committee recently reported out a pension bill – the National Employee Savings and Trust Equity Guarantee Act (NESTEG). NESTEG includes a yield curve that is consistent with the position favored by the Administration. While the Administration supports using a yield curve to more accurately discount pension liabilities, it strongly opposes the provision that would eliminate, suspend, or weaken the Deficit Reduction Contribution (DRC) that was enacted in 1987 to protect workers.

The Administration understands the pressures placed on employers by funding rules that do not operate as well as they should. The DRC is a part of a system of flawed funding rules, which should be reviewed and reformed. The current funding rules often act to disguise market conditions and to permit funding holidays even as plans are in reality becoming more underfunded. When the DRC kicks in, it often hits employers with huge contribution increases when they can least afford them. The Administration is deeply concerned about volatility in funding requirements, and believes that reforms should dampen out contribution volatility. A well-structured system of funding rules would limit sudden increases in employer contribution requirements, while producing stronger pension funding over time.

The appropriate place to consider any further funding relief, however, is in the context of comprehensive reform to strengthen long-term funding. To grant funding relief with no offsetting action to address systemic underfunding would, in our view, be ill advised. Earlier this year, the Administration testified that action to reform pension discounting was needed to increase liability measurement accuracy, and thereby better inform our discussion of comprehensive funding reform. The Administration continues to believe that our proposal for accuracy and transparency is an important first step before undertaking measures that would change the funding rules.

If we eliminate the DRC without providing an effective replacement for it, workers can suffer large losses when sponsors of substantially underfunded plans promise benefits that they cannot afford to pay. The DRC requires those plan sponsors to fund the cost of new benefits over 3 to 7 years – a faster schedule designed to get plans funded before companies fail and transfer their liabilities to PBGC. If the DRC were eliminated, plan sponsors could fund new benefits over 30 years as they did before the 1987 reforms.

PBGC analyzed the effects of granting a three-year waiver from the DRC. We estimate that suspending the DRC for the next three years would increase underfunding by $40 billion. As noted earlier, PBGC estimates that overall pension underfunding in plans sponsored by financially weak companies exceeded $80 billion as of December 31, 2002. A DRC waiver would allow companies representing nearly $60 billion of this "at risk" liability to stop making accelerated pension contributions. Yet the average funded ratio of these plans, if they were to terminate, is less than 60 percent.

PBGC also examined the underfunded plans that have terminated since 2000 to see how many would have been exempt from the DRC. These were the riskiest plans of all – so risky that they terminated. Yet nearly 90 percent of them would have been off the hook under the Finance Committee's DRC provision, including Bethlehem Steel, whose plan had $4.3 billion in unfunded benefits at termination, the largest in PBGC's history.

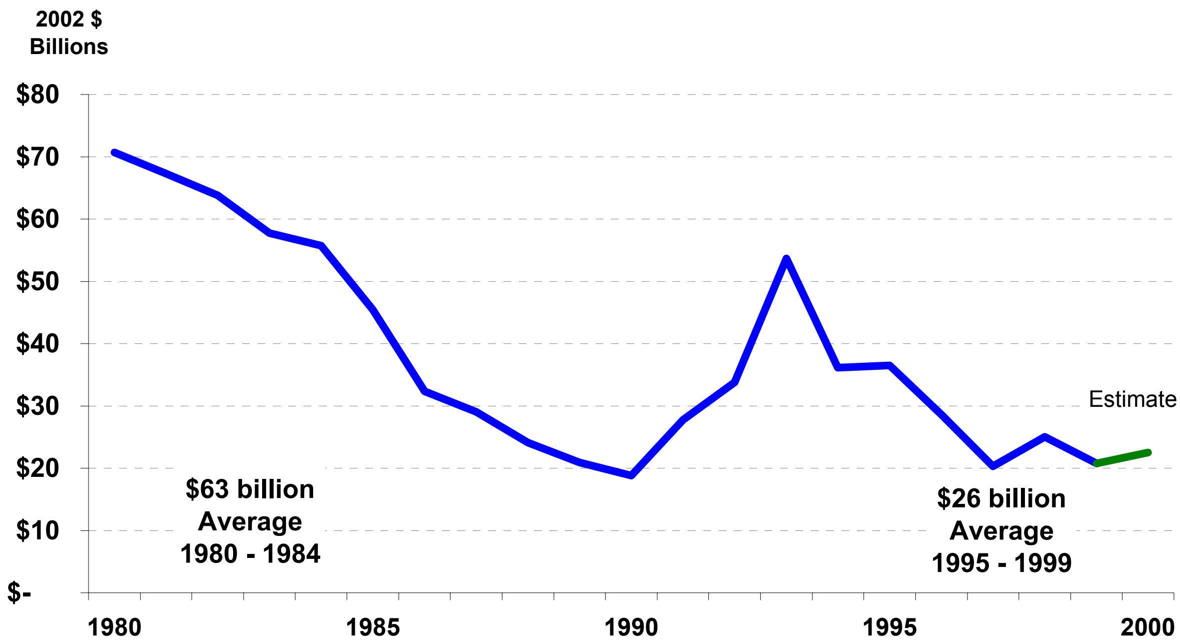
The Administration's goals are to put plans on a path toward better funding. Eliminating the DRC without an effective substitute would undercut workers' retirement security. The appropriate timing of employer pension contributions should be considered only as part of broader comprehensive reforms that strengthen pension funding over the long term.

<u>Required Pension Contributions</u>

Defined benefit pension plans have always required substantial contributions by the companies sponsoring the plans. These contributions can be funded either with cash contributions or with investment returns.

For example, because of unprecedented investment returns during the late 1990s, defined benefit plan sponsors made little or no pension contributions for many years. From 1995 to 1999, total pension contributions averaged only $26 billion per year in 2002 dollars.

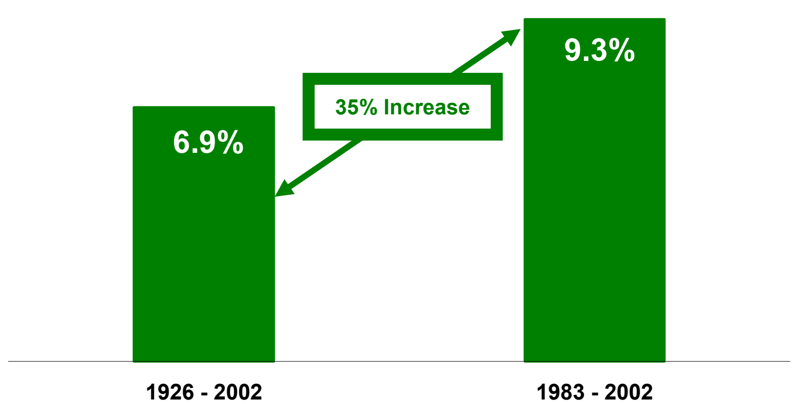
Historic Single-Employer Contributions



To put that into perspective, total contributions during the early 1980s averaged $63 billion per year in 2002 dollars. Over this period, the amount of benefits insured by PBGC has more than doubled, adjusted for inflation. As a result, current pension contributions are not inconsistent with the levels of contributions in periods with more normal equity returns.

Some have suggested that 2002 was an artificially low point in the market and that it is inappropriate to base funding decisions on PBGC's deficit and total pension underfunding during that time. It is worth noting that, even including the market declines in 2001 and 2002, real rates of return on equity investments for the 20 years ending in 2002 are significantly above the long-term historical average (1926 through 2002). It is not reasonable for plan sponsors to base pension funding on the expectation that the stock market gains of the last decade will continue indefinitely.

Real Equity Performance



Source: Ibbotson's Large Stock Returns

Some have alleged that there would be adverse macroeconomic consequences of these increased required contributions. They contend that the economy would suffer because funds that could have been used for capital improvements and jobs growth would be used for pension funding. The Administration believes that this argument is incorrect. Pension contributions go back into the economy as savings and provide a source of capital investment in our economy – investment that creates jobs and growth. The Council of Economic Advisers recently estimated the economic impact if plan sponsors fully met their pension obligations, and found that the effects on the macroeconomy would not be substantial.

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, which are essentially severance 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 PBGC. These companies are using their pension plans to unfairly shift their labor costs 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.

The Administration has already introduced proposals to more accurately measure pension liabilities, improve pension disclosure, and protect against underfunding. In addition, the Departments of Labor, Commerce, and the Treasury and PBGC are actively working on comprehensive reform, including reform of the funding rules, to improve the retirement security of American workers and retirees. 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.

APPENDIX A

MEASURING PBGC's LIABILITIES

Matching the Private Annuity Market

Annuity prices are what insurance companies charge to assume responsibility for a company's pension plan and make a series of future payments to its workers. When a company voluntarily terminates its pension plan, it must defease the plan liabilities by providing an annuity or a lump sum payment to its workers. Group annuity prices are the most objective measure of the cost of defeasing a plan's liabilities in the marketplace.

GAO, in its February 2003 report on interest rates for pension calculations, noted that "Congress intended that the interest rates used in current liability and lump-sum calculations should reflect the interest rate underlying group annuity prices." PBGC's interest factors were specifically developed to approximate group annuity purchase prices, as required by regulation for more than 25 years. An October 2000 study by the American Academy of Actuaries and the Conference of Consulting Actuaries compared the actual cost to terminate a plan with the cost that would have resulted if PBGC's assumptions had been used. Their results showed that PBGC's assumptions yielded a measure of termination liability within 3 to 4 percent of the actual cost.

Since ERISA was enacted in 1974, more than 160,000 defined benefit plans insured by PBGC have voluntarily terminated in standard terminations. Today, PBGC insures about 32,000 plans, down from an all-time high of 112,000 plans in 1985. The companies sponsoring each of these terminating plans were required to defease their plans' liabilities either by purchasing annuities in the private annuity market or by making lump sum distributions to their workers.

If PBGC's "price" to close out a plan in a distress or involuntary termination were lower than the market price to close out a plan in a standard termination, there would be an uneven playing field for plan sponsors. This could create an incentive for sponsors of poorly funded plans to file for distress terminations with PBGC because it would be cheaper than a standard termination.

For a discussion of PBGC's calculation of interest factors, please see Appendix B – "PBGC Procedure for Setting Interest Factors Used to Value Liabilities for PBGC Financial Statements."

APPENDIX B

PBGC Procedure for Setting Interest Factors Used to Value Liabilities for PBGC Financial Statements

PBGC has historically derived its valuation assumptions by surveying private sector annuity prices and selecting a valuation interest factor that, when combined with PBGC's mortality assumption, will match the market price of single-premium, nonparticipating group annuity contracts for terminating plans. To determine these interest factors, PBGC gathers pricing data from insurance companies that are providing annuity contracts to terminating pension plans through a quarterly "Survey of Nonparticipating Single Premium Group Annuity Rates." The survey is distributed by the American Council of Life Insurers (ACLI) and provides PBGC with "blind" data; that is, the survey is conducted in such a way that PBGC is unable to match responses with the companies that submitted them. The survey is sent to approximately 17 insurance companies.

The survey asks insurers to provide the net annuity price for annuity contracts for plan terminations. PBGC uses the information from the survey to develop interest factors, which are adjusted to the end of the year using an average of the Moody's Corporate Bond Indices for Aa and A-rated corporate bonds for the last five trading days of the month. The adjusted interest factors are published in mid-December for use in January. The interest factors are then further adjusted each month on the basis of the average of the Moody's bond indices.

The interest factors, when used along with the mortality table specified in PBGC regulations, reflect the rate at which pension sponsors could have settled their liabilities, not including administrative expenses, in the market place for single-premium nonparticipating group annuities issued by private insurers.

GAO's February 2003 report noted that, "of all the alternative rates, PBGC's interest rate factors have the most direct connection to group annuity purchase rates." However, GAO also noted that the calculation of PBGC's interest factors is not transparent and the identity of the insurance companies surveyed is not known, raising ambiguity about the extent to which PBGC's interest factors reflect the current broad market for group annuities. PBGC would not object to an independent review of the methodology for developing these interest factors that lead to the calculation of a market price. While we believe that our survey methodology replicates the market price of private group annuity contracts, PBGC is certainly open to considering alternative methods of calculating annuity purchase factors.

APPENDIX C

PBGC’s Probable and Reasonably Possible Claims

“Probable” claims are included in accrued liabilities in the financial statements. When an economic event that is likely to lead to plan termination has occurred on or before the date of the financial statements, GAAP requires that the estimated amount of the “probable” claim (net of estimated recoveries and plan assets) be accrued. This is consistent with the Financial Accounting Standards Board Statement No. 5 – *Accounting for Contingencies*, which requires that a loss contingency must be recorded if (1) it is likely (probable) that one or more future events will confirm the loss and (2) the amount can be measured (reasonably estimated).

Criteria used for classifying a claim as “probable” are listed in the footnotes to the financial statements and include:

(1) the plan sponsor is in chapter 11 liquidation or comparable insolvency proceeding with no known solvent controlled group member;

(2) the plan sponsor files for a distress plan termination; or

(3) PBGC seeks involuntary plan termination.

In addition to “probable” claims, PBGC also reports “reasonably possible” contingent claims generally represent underfunding in plans sponsored by companies with below-investment-grade bond ratings. While losses from “reasonably possible” plans are not yet “probable terminations” and are not accrued for financial statement purposes, GAAP requires this financial exposure to be disclosed in the footnotes to PBGC’s financial statements.

Other criteria used for classifying a company as “reasonably possible” are listed in the footnotes to the financial statements and include:

(1) the plan sponsor is in Chapter 11 reorganization;

(2) the plan has a funding waiver pending or outstanding with the IRS;

(3) the plan has missed minimum funding contributions; or

(4) the plan sponsor has no bond rating but the ratio of long-term debt plus unfunded benefit liability to market value of shares is 1.5 or greater.