



**TESTIMONY OF BRADLEY D. BELT
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**Before the Subcommittee on Government Management,
Finance, and Accountability
Committee on Government Reform
United States House of Representatives
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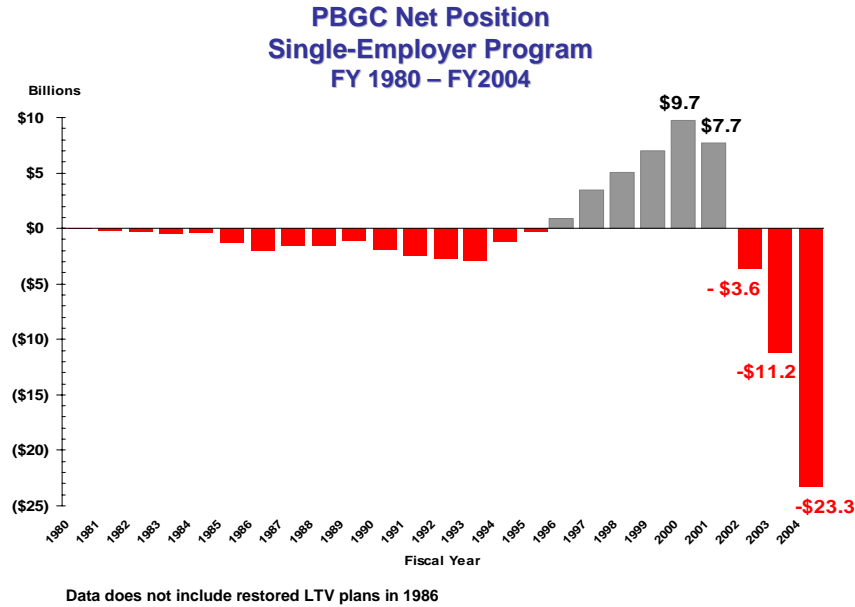
Mr. Chairman, Ranking Member Towns, and Members of the Committee: Good afternoon. I want to thank you for holding this timely and important hearing, and I appreciate the opportunity to discuss the challenges facing the defined benefit pension system and the pension insurance program, and the Administration's proposals for meeting these challenges.

The PBGC is the nation's guarantor of private-sector, defined benefit pension plans. The Corporation's pension insurance programs protect the retirement benefits of more than 44 million Americans. Indeed, these programs are the lone backstop for hundreds of billions of dollars in promised but unfunded pension benefits. The PBGC is also the trustee of nearly 3,500 failed defined benefit plans. In this role, it is a vital source of retirement income and security for more than 1 million Americans whose benefits would have been lost without the PBGC's protection.

Financial Challenges

Today's hearing is especially timely. The pension insurance program administered by the PBGC has come under severe pressure in recent years due to an unprecedented wave of pension plan terminations. This was starkly evident in 2004, as the PBGC's single-employer insurance program posted its largest year-end shortfall in the agency's 30-year history. Losses from completed and probable pension plan terminations totaled \$14.7 billion for the year, and the program ended the fiscal year with a deficit of \$23 billion. That is why the Government Accountability Office (GAO) has once again placed the PBGC's

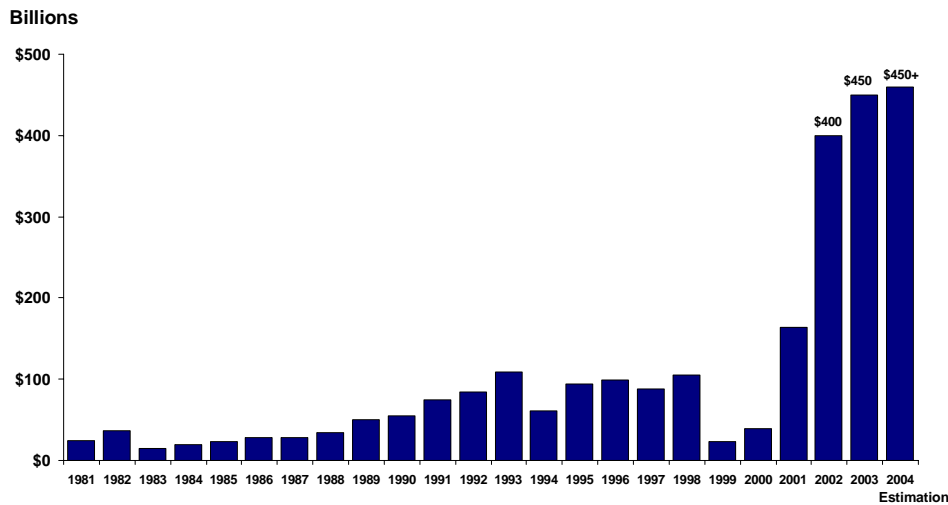
single-employer insurance program on its list of “high risk” government programs in need of urgent attention.



Notwithstanding our record deficit, I want to make clear that the PBGC has sufficient assets on hand to continue paying benefits for a number of years. But the numbers are trending in the wrong direction. With \$62 billion in liabilities and only \$39 billion in assets, it is clear the single-employer program lacks the resources to fully satisfy its benefit obligations over the long term.

In addition to the \$23 billion shortfall already reflected on the PBGC’s balance sheet, the insurance program remains exposed to record levels of underfunding in covered defined benefit plans. As recently as December 31, 2000, total underfunding in the single-employer defined benefit system came to less than \$50 billion. Two years later total underfunding exceeded \$400 billion due to such factors as declining interest rates (which increase the current value of liabilities), declining asset values, benefit increases, and a lack of adequate employer contributions. As of September 30, 2004, we estimate that total underfunding exceeds \$450 billion, the largest number ever recorded. (None of this underfunding is reflected in probable terminations already on our balance sheet.)

Total Underfunding Insured Single-Employer Plans



PBGC estimates from Form 5500 and Section 4010 Filings

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

The most immediate threat to the pension insurance program stems from the airline industry. Just last month, the PBGC became statutory trustee for the remaining pension plans of US Airways, after assuming the pilots' plan in March 2003. The \$3 billion total combined claim against the insurance program is the second largest in the history of the PBGC, after Bethlehem Steel at \$3.7 billion.

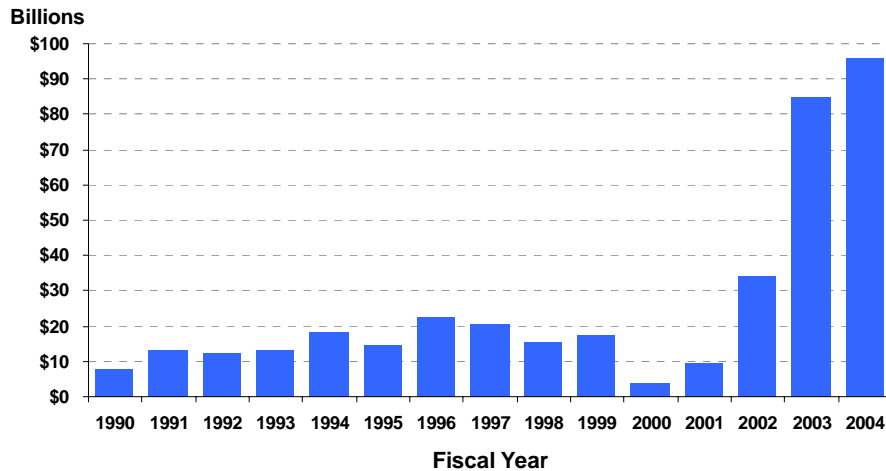
In addition, United Airlines is now in its 27th month of bankruptcy and has said repeatedly that it must shed all four of its pension plans to successfully reorganize. The PBGC estimates that United's plans are underfunded by more than \$8 billion, more than \$6 billion of which would be guaranteed by the PBGC.

If United Airlines is able to emerge from bankruptcy free of its unfunded pension liability, serious questions arise as to whether other network carriers would feel competitive pressure to follow suit. In fact, Delta Airlines and Northwest Airlines recently expressed strong concern that their pension plans are

unaffordable. According to published reports, non-bankrupt legacy carriers must contribute billions of dollars to their plans over the next several years. Additional pension plan terminations in the airline industry would put even more pressure on the PBGC at a time when the pension insurance program can least afford it.

Beyond the airline industry, the insurance program faces tremendous exposure from the manufacturing sector of the economy, which includes the auto and auto parts industry groups. Indeed, of the \$96 billion in pension underfunding at financially weak firms, manufacturing accounts for \$48 billion. It is alarming that so much of the insurance program’s “reasonably possible” exposure – underfunding in plans sponsored by companies with below-investment-grade bond ratings – should reside in a single industry sector.

Exposure from Plans Representing “Reasonably Possible” Claims



In the face of these unprecedented threats to the financial viability of the pension insurance program, the Corporation’s premiums have simply not proven adequate. The annual insurance premium for single-employer plans has two parts: a flat-rate charge of \$19 per participant, and a variable rate premium (VRP) of 0.9 percent of the amount of a plan’s unfunded vested benefits, measured on a current liability basis.

Congress sets the premiums for the pension insurance program, and the \$19 per-participant charge has not been increased in 14 years. In addition, as long as plans are at the “full funding limitation,” generally 90 percent of current liability,

they do not have to pay the variable-rate premium.¹ This 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.

Structural Flaws in the Defined Benefit System

The PBGC's record deficit and historic levels of pension underfunding underscore the structural flaws in the defined benefit system – flaws that must be corrected to better protect workers' benefits and strengthen the pension safety net.

The principal flaw is an overly complex and ineffectual set of funding rules that fail to achieve a necessary and appropriate level of benefit security for participants. The funding rules use multiple liability measures, multiple discount rates and varying amortization periods, imposing added complexity without achieving sound funding. Of particular concern are mechanisms such as credit balances and "smoothing" of assets and liabilities, which allow companies with underfunded plans to defer contributions for many years into the future. The bottom line is that we probably would not be here today if the funding rules worked properly.

The second flaw is "moral hazard." A properly constructed insurance system provides incentives for responsible behavior and disincentives for risky behavior. The federal pension insurance program does neither. If a financially weak company promises more than it is able to afford, it can shift the cost of the benefits to other companies – including competitors, at least indirectly – through the pension insurance program.

The third flaw is a lack of transparency. Publicly available information about pension plans is often stale and misleading. More current information about the

¹Employers are not subject to the deficit reduction contribution rules when a plan is funded at 90 percent of current liability, a measure with no obvious relationship to the amount of money needed to pay all benefit liabilities if the plan terminates. Generally, a plan's actuarial assumptions and methods can be chosen so that the plan can meet the "full-funding limitation."

In addition, in some cases employers can stop making contributions entirely because of the "full funding limitation." As a result, some companies say they are fully funded when in fact they are substantially underfunded. Bethlehem Steel said its plan was 84 percent funded on a current liability basis, but the plan turned out to be only 45 percent funded on a termination basis, with a total shortfall of \$4.3 billion. US Airways said its pilots' plan was 94 percent funded on a current liability basis, but the plan was only 33 percent funded on a termination basis, with a \$2.5 billion shortfall.

Despite substantial underfunding, in 2003 only about 17 percent of participants were in plans that paid the VRP.

funded status of plans isn't publicly available. The system's opacity discourages accountability and market discipline, and key stakeholders are prevented from responding effectively to current problems. Worst of all, workers are often the last to know of problems with their pension plans.

How the PBGC is Responding to its Challenges

Despite the structural problems inherent in the current system, the PBGC continues to do all it can to meet the challenges facing the pension insurance program. From strong financial management and robust internal controls to new system technologies and a sharper focus on risk management, the Corporation is fully prepared to meet its statutory responsibilities.

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

These mandates are not always easy to reconcile. For example, the PBGC is instructed to keep premiums as low as possible to encourage the continuation of pension plans, but also to remain self-financing. Similarly, the program should be administered to protect plan participants, but without letting the insurance fund suffer unreasonable increases in liability. The PBGC struggles daily to achieve the appropriate balance between these competing considerations.

Mr. Chairman, your staff also requested that I discuss the PBGC's financial management practices, and I am pleased to do so. The PBGC's financial reporting continues to present a clear and accurate picture of the fiscal health of the insurance programs. For fiscal year 2004, the PBGC's financial statements received their 12th consecutive unqualified opinion from the Corporation's independent auditors, PriceWaterhouse Coopers.

In preparing its financial statements, the PBGC conforms to Generally Accepted Accounting Principles (GAAP) in the United States, the same standards followed by all publicly traded companies. In certain quarters, this has drawn criticism. Because the PBGC has not yet taken over administration of plans booked as "probables," some suggest the Corporation's deficit is inflated. But under Financial Accounting Standard No. 5, the PBGC is required to reflect losses from "probable" terminations. Indeed, a failure by the PBGC to record these losses could jeopardize our clean audit opinion. If the financial history of the last five

years has taught us anything, it is that these liabilities should be reported on the balance sheet, where they belong.

Additional validation of the PBGC's financial reporting comes from the Department of the Treasury's Financial Management Service. Using its "traffic light" grading system, they awarded the PBGC scores of "green" to signify that the agency had successfully met all standards for the accuracy and timeliness of its financial reporting for the first quarter of FY 2005. Less than two-thirds of the agencies rated received a green rating for timeliness of reporting, and less than half of the agencies received a green rating for accuracy of reporting.

In further recognition of the evolving emphasis on sound financial reporting in the wake of the Sarbanes-Oxley Act, the PBGC was one of the first federal government entities to perform a comprehensive internal control assessment, even though it was not required. The PBGC contracted with KPMG to help identify, document, test, correct and report on all of the Corporation's key financial controls. Its conclusion that the PBGC has sound financial controls provides another level of assurance about the accuracy and integrity of the PBGC's financial systems and information.

The PBGC also has initiated several key changes to enable it to better manage the financial risks facing the pension insurance program. The first was adoption of a new investment policy that will reduce the Corporation's risks resulting from a mismatch between assets and liabilities. The policy calls for the Corporation to increase its investment in fixed-income securities that match the duration of its liabilities. When fully implemented, the PBGC's investment strategy will result in less volatile financial performance and a reduction in the agency's overall risk. Through this strategy, any change in the value of the PBGC's existing liabilities will be more closely offset by a corresponding change in the value of the fixed-income assets, reducing the risk of an increase in PBGC's deficit resulting from interest rate changes.

Another initiative will improve the PBGC's ability to gather, analyze and act on pension plan funding information and to respond to marketplace developments in a timely manner. As part of an overall reorganization, the Corporation is establishing a new Office of Risk Assessment to strengthen its capability to measure and manage risks to the pension insurance program. This office, which will report directly to the Executive Director, will analyze industry and economic risks to the PBGC's financial strength and the pension insurance system.

The PBGC is also taking aggressive steps to monitor the financial condition of pension plans and their sponsors more closely to limit risks and minimize losses for the insurance program. When necessary, the PBGC is prepared to move

forcefully, in negotiation or litigation, to protect the benefits of plan participants and the interests of the insurance program.

Management and Operational Challenges

The PBGC's financial losses are only one of the challenges confronting the insurance program in the current climate. In fiscal year 2004, the PBGC also faced a swelling workload as it assumed administrative responsibility for the benefits of nearly 150,000 additional participants in failed single-employer pension plans. Despite this surge of new participants, the Corporation was able to issue more than 137,000 benefit determinations to retirees in trusted plans, nearly 50 percent more than the previous record of 92,000 issued the year before.

Another top PBGC priority has been the establishment of online services that customers can access at their convenience through the Internet. In the past year, the Corporation unveiled two new self-service accounts, one for participants in PBGC-trusted plans and the other for administrators of PBGC-insured plans and the pension practitioners who assist them. These new facilities, available through the PBGC's website, enable participants and plan practitioners to interact electronically with the PBGC and conduct a range of transactions any time of day, year-round.

For participants, this service is called My Pension Benefit Account (My PBA). It allows all participants to review and change their personal information, and retirees may use it to sign up for electronic direct deposit of their benefit payments, change banking information, and change information on their federal tax withholding. Future improvements to My PBA will allow participants to electronically access, complete and submit the Corporation's most frequently used forms and to submit online requests for benefit estimates.

Plan administrators and practitioners may now use My Plan Administration Account (My PAA), the other new self-service application, to electronically create, route, sign and submit premium filings and payments to the PBGC. This system, which requires no special software, offers a number of advantages over paper submissions: improved data accuracy, easier filing preparation, shared electronic access to filings (which eliminates manual routing and mailing), e-mail notification of required actions, and confirmation that the filing and payment were received by the PBGC. The Corporation is examining ways to expand this service to allow, for example, the electronic filing of other required submissions.

The population of people owed a guaranteed benefit from the PBGC includes a growing number for whom Spanish is the primary language. To improve service and the availability of understandable information to the Corporation's growing

population of Spanish-speaking customers, within the past year the PBGC created a dedicated section on its website for Spanish-language content.

All of these initiatives to improve the services we provide to our customers have led to higher customer satisfaction ratings for the PBGC. The Corporation uses the American Customer Satisfaction Index (ACSI) to measure customers' satisfaction with its services and to gain insight into needed improvements. In 2004, the PBGC's customers provided the Corporation with an overall ACSI score of 78 (on a scale of 0 to 100), exceeding the score of 72 for the federal government as a whole.

Similarly, the PBGC recently underwent its first Program Assessment Rating Tool review by the Office of Management and Budget. PART is a systematic method of assessing the performance of program activities within agencies and across the federal government with the goal of improving program performance. This review holds programs to high standards—simple adequacy or compliance with the letter of the law is not enough. Rather, a program must show it is achieving its purpose and that it is well managed. The PBGC's overall PART rating was "moderately effective," the second highest rating possible.

While the PBGC performed well in areas under the Corporation's control, OMB's official summary noted that "ERISA prevents it from following many insurance industry best practices regarding premium structure, risk management, funding rules, and benefit determinations. The Administration supports legislative reform to remove the statutory barriers to improving these areas."

The GAO also specifically exempted the PBGC's internal management practices when it put the single-employer insurance program on its "high-risk" list in 2003, pointing instead to structural challenges in the defined benefit pension system. When GAO updated its "high-risk" list last month, it put the emphasis squarely on legislative change: "Comprehensive reform will likely be needed to stabilize the long-term finances of the single-employer program. The Congress should consider revising current pension law to mitigate the financial risk posed by financially troubled sponsors with underfunded plans, perhaps by strengthening funding rules, restricting the use of credit balances and lump-sum distributions, revising the PBGC's premium structure, and increasing plan transparency. . . . The administration has recently introduced a proposal that would address many of the challenges facing the PBGC."

Administration's Reform Proposal

Mr. Chairman, we hope that Congress will take action this year to address the challenges facing the PBGC. For even as the PBGC does everything it can under current law constraints, it is not enough. No amount of tinkering will achieve

the lasting solution we need to restore the confidence of workers and retirees who rely on pension promises and to put the PBGC on a sound footing. We need a considered and comprehensive approach that will restore the financial health of the defined benefit pension system, strengthen the pension safety net, and improve pension disclosure. The Administration's comprehensive pension reform proposal, announced by Labor Secretary Elaine Chao on January 10 and elaborated in the President's Budget on February 7, would accomplish all three goals.

On pension funding, the proposal would streamline and strengthen the current rules to ensure that promises are backed by sufficient assets. Weaknesses in current law would be eliminated to ensure troubled plans are fully funded, and the rules would provide greater flexibility to all plan sponsors to encourage them to remain in the defined benefit system.

On pension insurance, the proposal would implement a rational premium structure that will gradually restore the PBGC to fiscal balance. The new structure would meet the program's long-term revenue needs, provide incentives to fully fund covered plans, and appropriately reflect the risks faced by the program.

On pension disclosure, the proposal would require more timely, meaningful information on pension plans' funding levels. This will ensure that those with a stake in the pension system – workers, retirees, investors and regulators – can make decisions based on current, accurate information. Additional detail on the Administration's proposal is available on the Web at <http://www.dol.gov/ebsa/pensionreform.html>.

Conclusion

Mr. Chairman, the proposal we have put forward represents a responsible, balanced approach that will restore the defined benefit pension system to health. Our proposal will encourage companies to offer and maintain defined benefit pension plans, while ensuring that those plans are able to honor their commitments. Enactment of the Administration's proposal will strengthen the finances of defined benefit plans, shore up the pension safety net, and improve the retirement security of America's workers. We look forward to working with Congress to make the necessary reforms in 2005, and I thank you for inviting me to testify. I will be pleased to answer any questions.