COMPTROLLER GENERAL'S

FORUM

HIGHLIGHTS OF A GAO FORUM

The Future of the Defined Benefit System and the Pension Benefit Guaranty Corporation

June 2005

GAO

Accountability * Integrity * Reliability

GAO-05-578SP

GAO Accountability·Integrity·Reliability
Highlights

Highlights of GAO-05-578SP.

Why GAO Convened This Forum

Employer-sponsored defined benefit pension plans face unprecedented challenges in the midst of significant changes in our nation's retirement landscape. Many defined benefit plans and the federal agency that insures them, the Pension Benefit Guaranty Corporation (PBGC), have accumulated large and growing deficits that threaten their survival. Meanwhile, the percentage of American workers covered by defined benefit plans has been declining for about 30 years, reflecting a movement toward defined contribution plans (e.g., 401(k) plans) and perhaps fundamental changes in how our society thinks about who should bear responsibility and risk for the retirement income security of American workers. It is imperative that policymakers address not only the challenges facing the defined benefit system and the PBGC, but also consider broader questions about overall retirement income policy.

To address these issues, GAO convened a diverse group of knowledgeable individuals who have been influential in shaping the defined benefit pensions debate over the years. Participants included government officials, researchers, accounting experts, actuaries, plan sponsor and employee group representatives, and members of the investment community.

www.gao.gov/cgi-bin/getrpt?GAO-05-578SP.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovbjergb@gao.gov.

June 2005

HIGHLIGHTS OF A GAO FORUM

The Future of the Defined Benefit System and the Pension Benefit Guaranty Corporation

What Participants Said

Forum participants debated both the specifics of potential changes to the regulations governing America's defined benefit pension system and broader ideas about how policymakers should address retirement income security. There were varying levels of agreement on the following statements:

- Current pension funding rules do not adequately ensure sound funding in plans that are at the greatest risk of termination, and the federal government needs to do more to hold employers accountable for the benefit promises they make.
- Addressing deficiencies in the pension funding rules would be more effective and more important than reforming the PBGC premium structure, since policymakers should focus on getting employers to fulfill the promises they make to employees.
- Greater pension funding flexibility could help maintain adequate pension funding and remove disincentives that have stopped plan sponsors from contributing more to their plans in the past.
- PBGC's premium structure should better reflect the risk that a pension plan presents to the solvency of PBGC's pension insurance program.
- Improvements should be made to the transparency and timeliness of pension plan financial information that is reported to plan participants, regulators, and those who invest in the plan sponsor's stocks and bonds.
- Any reforms of pension funding rules and premium structures would be easier to achieve by separately addressing "legacy costs"—the costs from terminated and currently underfunded defined benefit plans.
- Although the traditional defined benefit system has been in retreat for about 30 years, this trend might be halted if policymakers would clarify the legal ambiguities surrounding cash balance and other hybrid plans.
- Rather than focusing on promoting certain types of pension plans, policymakers should identify and encourage those features of pension plans (both defined benefit and defined contribution) that are most likely to provide sufficient income security for American retirees.

Contents

Introduction from the Comptroller General of the United States

Employer-sponsored defined benefit pension plans, which have served as a cornerstone of private sector retirement income security for several decades, face unprecedented challenges in the midst of significant changes in our nation's retirement landscape. Many defined benefit plans and the federal agency that insures them, the Pension Benefit Guaranty Corporation (PBGC), have accumulated large and growing deficits that threaten their future survival. At the end of fiscal year 2004, PBGC reported a $23.3 billion accumulated deficit in its primary pension insurance program, the single-employer program, and estimates that it is exposed to an additional $96 billion in potential losses from underfunded plans sponsored by non-investment-grade companies.[1] While these deficits have surged in the last 3 years, the percentage of American workers covered by defined benefit plans has been declining for about 30 years, reflecting a movement toward defined contribution plans (e.g., 401(k) plans) and perhaps fundamental changes in how our society thinks about who should bear responsibility and risk for the retirement income security of American workers. The recent public debate over the merits of including individual accounts as part of a more comprehensive Social Security reform proposal should lead us to consider fundamental questions about overall retirement income policy. As part of this effort, it is imperative that policy makers address the challenges facing the defined benefit system and the PBGC.

Policymakers need to confront these challenges now because over 40 million Americans are counting on the private sector defined benefit system for at least part of their retirement income. The sooner action is taken, the more flexibility there will be to strengthen the financial condition of poorly funded defined benefit plans and the PBGC. Much of PBGC's exposure stems from large, underfunded pension plans in certain industries with structural weaknesses, which may be attributed, at least in part, to certain macroeconomic forces such as deregulation and globalization. These and other terminated and underfunded plans have increased both the costs of the pension insurance program and PBGC's exposure to risk. Because current law requires PBGC to finance itself through the collection of insurance premiums, the assets of failed plans, and related investment earnings, companies with healthier pension plans have borne increased premium costs over the years to help cover PBGC's deficits. It is unclear how much longer companies with well-funded

[1]PBGC also manages an insurance program for multiemployer plans, which covers approximately 10 million participants. This insurance program had an accumulated deficit of $236 million at the end of fiscal year 2004.

pension plans will be willing to pay higher premiums and remain within the defined benefit system. The nature of any related legislative reforms will likely have a bearing on this issue.

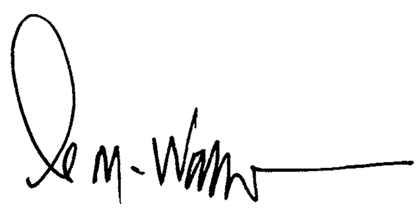
In two important ways, the current condition of the PBGC is a microcosm of the larger federal government and our Social Security system. First, PBGC has a large and growing deficit, which should be addressed sooner rather than later. And second, PBGC's pension insurance program is emblematic of a large number of federal government programs that must be reexamined because of fundamental changes in the world since they were enacted. The Employee Retirement Income Security Act of 1974 (ERISA), which among other things established the PBGC, was passed in response to trends and challenges that existed at a time when defined benefit plans were growing and most pension plan participants in the private sector were enrolled in defined benefit plans. At that time, Congress and the American people may well have expected continued growth of defined benefit plans in the decades to come.

In light of changes in the retirement landscape that have taken place over the last 30 years and the immediate financial and structural challenges facing the defined benefit system and the PBGC, GAO convened this forum to address problems with the existing defined benefit system, and to discuss broader issues of retirement income security. The forum brought together a diverse group of knowledgeable individuals who have been influential in shaping the defined benefit pensions debate over the years. Participants included government officials, researchers, accounting experts, actuaries, plan sponsor and employee group representatives, and members of the investment community (See app. I for the forum's agenda and app. II for a list of forum participants). All brought a commitment to forward thinking and an eagerness to move beyond defining and measuring the problem to discussing how to broaden understanding and public dialogue so that action could be both more immediate and more informed.

The forum was designed to create a space where a rich, meaningful, and unattributed discussion could take place and a mutual understanding among the various stakeholders involved could be achieved. In particular, the forum sought to identify some possible approaches and strategies that could address the underlying structural problems and long-term challenges facing the defined benefit pension system and the PBGC. In smaller discussion groups, participants talked about pension funding rules, PBGC's premium structure, and transparency and disclosure of pension plan financial information. In these discussions and in plenary sessions, participants also considered a number of other issues, including attributes of retirement savings plans that government should promote and whether “legacy costs”—costs from terminated and currently underfunded defined benefit plans—should be addressed separately in any proposals to reform pension funding and premium rules. Also, participants debated whether PBGC should primarily serve as a social insurance program, a market-based insurer, or a hybrid.

This report summarizes the ideas and themes that surfaced at the forum and the collective discussion of the forum participants as well as subsequent comments received from participants based on a draft of this report.

I want to thank all the forum participants for taking the time to share their knowledge, insights, and perspectives. These will be of value to the American people and to their representatives in Congress as they communicate with their constituents about the need for change in the defined benefit system and the PBGC. We at GAO will also benefit from these insights as we carry out our mission to help Congress examine the ways to ensure the sustainability of the system and the solvency of the PBGC while ensuring the pension benefits earned by millions of Americans. I look forward to working with the forum's participants on this and other issues of mutual interest and concern in the future.



David M. Walker
Comptroller General
of the United States

Background

Before the enactment of the Employee Retirement Income Security Act of 1974, companies had been sponsoring pension plans for almost 100 years.[1] During the mid-20th century, private pension plans gained in popularity and grew from covering 19 percent of the workforce in 1945 to 40 percent in 1960.[2] However, few rules governed the funding of these plans, and participants had no guarantees that they would receive the benefits promised. When Studebaker's pension plan failed in the 1960s, thousands of plan participants lost most or all of their pensions. Such experiences captured national attention and prompted the passage of ERISA to better protect the retirement income of Americans covered by private sector pension plans. Among other things, ERISA created the PBGC to protect the benefits of plan participants, subject to certain limits, in the event that plan sponsors could not meet the benefit obligations under their plans. ERISA also established rules for funding defined benefit pension plans, instituted pension insurance premiums, promulgated certain fiduciary rules, and developed annual reporting requirements. Now, when a plan is terminated with insufficient assets to pay promised benefits, PBGC assumes responsibility for the plan and for paying benefits to participants. Although PBGC provides insurance protection for over 29,000 single-employer pension plans, covering 34.6 million people, the percentage of private sector workers covered by a defined benefit plan has dropped from 39 percent in 1975 to 21 percent in 2004.

To try to ensure that plans have sufficient assets to pay for their benefit obligations, ERISA created minimum funding standards. Under current law, if a plan becomes sufficiently underfunded, the plan sponsor is required to make an additional contribution, known as a deficit reduction contribution. The funding rules also set maximum levels for tax-deductible contributions. However, prior GAO work has shown that the pension funding rules were not designed to ensure that plans have the means to meet their benefit obligations in the event that plan sponsors run into financial distress.[3]

[1]Wooten, James A., *The Employee Retirement Income Security Act of 1974, A Political History,* (2004), Berkeley: University of California Press, p.17.

[2]Wooten, p.34.

[3]GAO, *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks*, GAO-04-90 (Washington, D.C.: Oct. 29, 2003) and *Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules*, GAO-05-294 (Washington, D.C.: May 31, 2005).

PBGC receives no direct federal tax dollars to support the single-employer pension insurance program.[4] Instead, the program receives the assets of terminated underfunded plans and any of the sponsor's assets that PBGC recovers during bankruptcy proceedings.[5] PBGC finances the unfunded accrued liabilities of terminated plans with premiums paid by plan sponsors and income earned from the investment of program assets. Since its inception, PBGC's single-employer program has received most of its premium income from flat-rate premiums, which companies pay each year for every participant in a defined benefit plan they sponsor. Initially, the flat-rate premium was set at $1 per participant per year. This rate was raised several times and since 1991 has been set at $19. In 1987, a variable-rate premium was added to provide an incentive for sponsors to better fund their plans. For each $1,000 of unfunded vested benefits, plan sponsors pay a premium of $9. In fiscal year 2004, PBGC received nearly $1.5 billion in premiums, including more than $800 million in variable rate premiums, but paid out more than $3 billion in benefits to plan participants or their beneficiaries.

To meet the information needs of the federal agencies that administer federal pension laws, the PBGC, the Department of Labor, and the Internal Revenue Service jointly develop the Form 5500, to be used by pension plan administrators to meet their annual reporting requirements under ERISA and the Internal Revenue Code (IRC). This form and its attached statements and schedules are used to collect detailed plan information about assets, liabilities, insurance, and financial transactions, plus financial statements audited by an independent qualified public accountant, and for defined benefit plans, an actuarial statement. We have reported in prior work that Form 5500 information may often be of limited value because, when it becomes available, its information is generally at least 2 years old.[6] In addition to requiring the Form 5500, if a company's pension plans reach a certain level of underfunding, ERISA requires the company to provide

[4]If funds generated are insufficient to meet operating cash needs in any period, PBGC has available a $100 million line of credit from the U.S. Treasury for liquidity purposes.

[5]According to PBGC officials, PBGC files a claim for all unfunded benefits in bankruptcy proceedings. However, PBGC generally recovers only a small portion of the total unfunded benefit amount in bankruptcy proceedings, and the recovered amount must be split between PBGC (for unfunded guaranteed benefits) and participants (for unfunded nonguaranteed benefits).

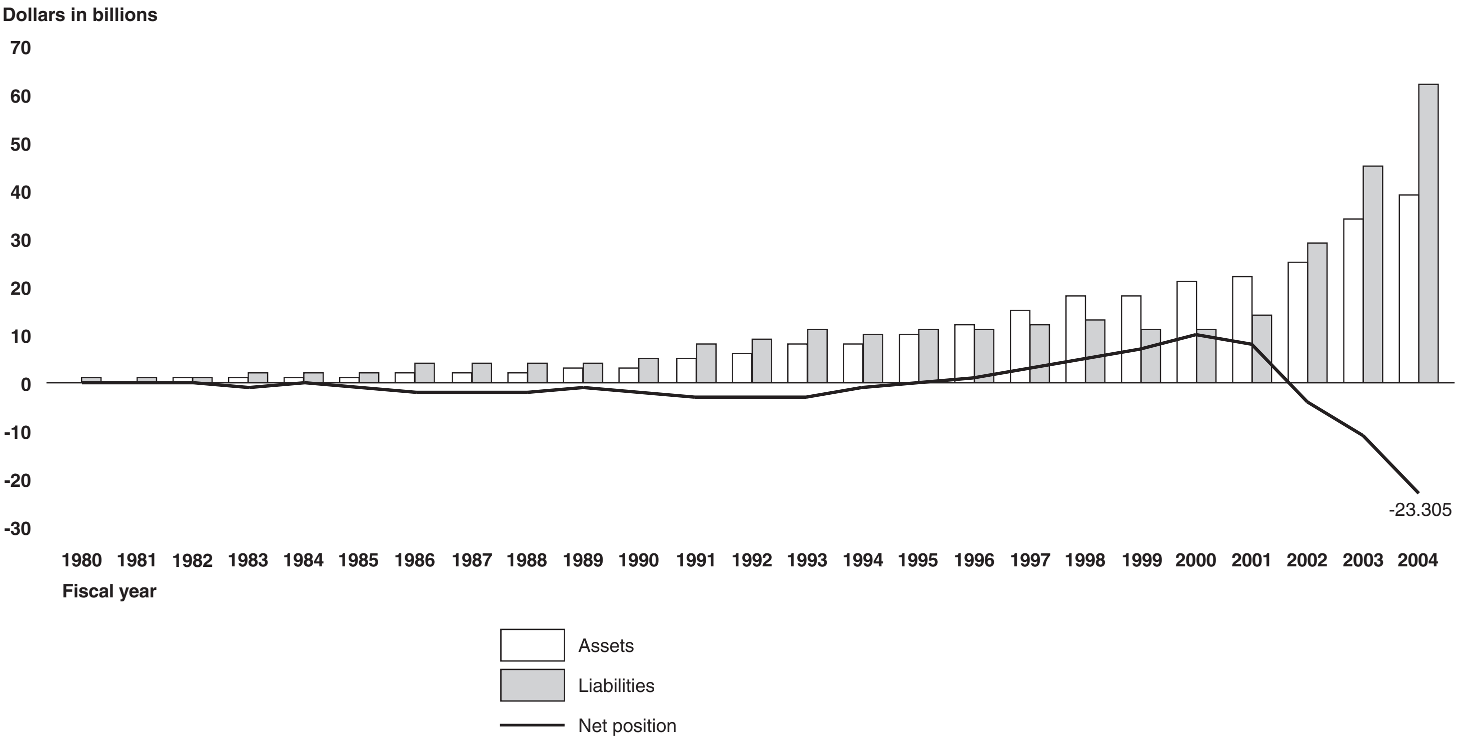
[6]See GAO, *Private Pensions: Publicly Available Reports Provide Useful but Limited Information on Plans' Financial Condition*, GAO-04-395 (Washington, D.C., Mar. 31, 2004).

detailed financial information to PBGC in what is called a 4010 filing. The 4010 filing includes proprietary information about the plan sponsor, its total pension assets, and its total benefit obligations were the company to terminate its pension plans immediately. Under current law, PBGC is not permitted to disclose this information to the public. Last, publicly traded corporations whose defined benefit plans are material to their financial statements must provide information about the effect of their pensions on their balance sheet and operations in a footnote to their 10-K filings to the Securities and Exchange Commission.

The single-employer program has had an accumulated deficit—that is, the value of program assets has been less than the present value of benefits and other obligations—for much of its existence. (See fig. 1.) In fiscal year 1996, the program had its first accumulated surplus, and by fiscal year 2000, the accumulated surplus had increased to about $10 billion, in 2002 dollars. However, the program's finances reversed direction in 2001, and at the end of fiscal year 2002, its accumulated deficit was about $3.6 billion. In July 2003, we designated PBGC's single-employer insurance program as high risk, given its deteriorating financial condition and long-term vulnerabilities.[7] In fiscal year 2004, the single-employer program incurred a net loss of $12.1 billion, and its accumulated deficit increased to a record $23.3 billion, up from $11.2 billion a year earlier. Furthermore, PBGC estimated that total underfunding in single-employer plans exceeded $450 billion, as of the end of fiscal year 2004.

[7]See GAO, *Pension Benefit Guaranty Corporation Single-Employer Insurance Program: Long-Term Vulnerabilities Warrant "High Risk" Designation*, GAO-03-1050SP (Washington, DC: July 23, 2003).

Figure 1: Assets, Liabilities, and Net Financial Position of PBGC's Single-Employer Insurance Program, 1980-2004



Source: Pension Benefit Guaranty Corporation.

Recently, the Administration has proposed wide-ranging reform for defined benefit pension plans and PBGC's single-employer insurance program. Specifically, the proposal's objectives are to (1) reform the funding rules to ensure sponsors keep pension promises; (2) reform premiums to better reflect a plan's risk and restore PBGC to financial health; and (3) improve disclosure to workers, investors, and regulators about pension plan status. Similarly, in previous reports dating back to 1992, we have emphasized that reforming these three areas is critical to restoring financial health to PBGC's pension insurance program and ensuring retirement security for millions of American workers.

Funding Rules

Participants generally agreed that current pension funding rules do not adequately ensure sound funding in plans that are at the greatest risk of termination and the federal government needs to do more to hold employers accountable for the benefit promises they make. Many said that successfully reworking the funding rules would be the best way to bring about stability in the defined benefit system and PBGC's finances. Some participants suggested that the funding rules provide more flexibility to allow for larger contributions to plans during favorable economic conditions, thus improving plans' chances of surviving difficult economic conditions. Forum participants also addressed the importance of properly measuring pension plan assets and liabilities in order for funding rules to function properly. Participants generally agreed that the timing of expected benefit payments should affect measurement of liabilities, but they disagreed on the merits of utilizing a yield curve to measure these liabilities.

Funding Rules Need Strengthening to Prevent Severe Plan Underfunding

Participants generally agreed that strengthening the funding rules is vital to alleviating the defined benefit system's finances. They suggested some changes to the funding rules that they thought would better ensure adequate plan funding and reduce PBGC's exposure to underfunded plans.

Minimum Funding Requirements

Generally speaking, defined benefit pension plans insured by the PBGC are subject to minimum funding requirements that are determined by ERISA and the Internal Revenue Code. Essentially, plan liabilities are measured in two ways:

(1) according to an actuarial valuation method that relies on a number of demographic and economic assumptions and (2) according to a more uniform measure that is prescribed by law, though still subject to some discretion by the plan sponsor. In general, the required contribution is the expected increase in the liability during the year, plus an amount to amortize any unfunded liabilities from past years. If the value of plan assets falls below 90 percent of the liability on the more uniform measure, the plan sponsor must generally make a deficit reduction contribution to the plan. Plan assets can be measured at either their market value or their actuarial value, which smoothes out volatility in market valuations, though actuarial asset values cannot deviate more than 20 percent from the market value of assets.

- *Minimum funding and deficit reduction contribution rules could be tightened.* Some participants expressed concern that the threshold for requiring a deficit reduction contribution is not sufficiently stringent. Some suggested that the minimum required funding ratio of a plan's assets to its current liability should be raised from the current level of 90 percent. One participant noted that the funding rules allow companies considerable latitude in deciding how much to contribute to their pension plans in any given year.[8] Many participants also agreed that addressing deficiencies in the pension funding rules would be more effective and more important than reforming the PBGC premium structure, since policymakers should focus on getting employers to fulfill the promises they make to employees.

- P*articipants suggested ways to limit PBGC's exposure to plan underfunding.* Participants suggested that policymakers act to limit both underfunding in pension plans and PBGC's exposure to pension underfunding by (1) curbing distribution of lump sum payments, (2) limiting federal guarantees of shutdown benefits,[9] and (3) restricting plans from increasing benefits when they are severely underfunded.

  - Participants generally agreed that lump sum distributions from plans should be eliminated or at least discouraged because, on a large scale, they can increase the probability of insolvency in underfunded plans. For example, where participants in an underfunded plan believe that the PBGC guarantee may not cover their full benefits in the event of a plan termination, many may elect to receive their benefits in a lump sum rather than risk reduced annuity payments from PBGC if the plan terminates. This may create a "run on the bank," exacerbating the possibility of the plan's insolvency as assets

[8]Sponsors of underfunded plans may sometimes avoid or reduce cash contributions if they have earned funding credits as a result of favorable experience, such as contributing more than the minimum in the past. For example, contributions beyond the minimum may be recognized as a funding credit. These credits are not measured at their market value and accrue interest each year at the plan's long-term expected rate of return on assets, which is called the valuation interest rate.

[9]Shutdown benefits provide employees additional benefits, such as early retirement benefit subsidies in the event of a plant shutdown or permanent layoff. However, in general, plant shutdowns are inherently unpredictable, so it is difficult to recognize the costs of shutdown benefits in advance, and current law does not allow advance funding for the cost of benefits arising from future unpredictable contingent events (See 26 U.S.C. 412(m)(4)(D)). Shutdown benefits can suddenly and dramatically increase plan liabilities, and the related additional benefit payments drain plan assets.

are liquidated more quickly than expected, potentially leaving fewer assets to pay benefits for other plan participants. Forum participants said lump sum distributions could be discouraged by (1) setting minimum funding requirements according to a plan's expected lump sum distribution frequency (i.e., plans with higher lump sum distribution frequencies would have to maintain higher funding levels); (2) establishing a two-tier minimum funding requirement for lump sum distributions, which would only allow executives to receive lump sums if a certain threshold were reached, and would only allow other employees to receive lump sums if another funding level was met; or (3) linking lump sum distributions to plan funding status. For instance, if the plan were 80 percent funded, participants would not be able to receive more than 80 percent of their benefit in a lump sum and the remaining 20 percent would either be forfeited or reduced and paid out as an annuity. This would require amending existing laws that do not permit cutbacks in earned pension benefits.

- Some participants suggested ways to limit PBGC's exposure to shutdown benefits. One option would be to require plans to prefund shutdown benefits by including them in current liability measures. Alternatively, shutdown benefits could be guaranteed at a lower level than regular pension benefits earned. For example, shutdown benefits could be subject to phase-in provisions that are based on the timing of factory closures, rather than the timing of amendments to plans that introduce or increase shutdown benefits. Currently, plant shutdowns prior to plan terminations usually result in higher claims for PBGC than if these events take place concurrently.

- Most participants generally agreed that either plans should be restricted from increasing benefits in underfunded plans or the federal government should consider further limiting PBGC's guarantees of benefit increases under certain circumstances. Some participants expressed concerns that under current funding rules, plan sponsors can increase benefits for participants in underfunded plans, even if the plan sponsor may not ultimately be able to pay for these benefit increases. Thus, there are incentives for financially troubled plan sponsors and their employees to agree on pension benefit increases, in lieu of wage increases, because at least part of the benefit increases are guaranteed by PBGC. However, at least one participant said there should not be reductions in PBGC guarantees or limits to benefit increases.

Current Rules Discourage Companies from Better Funding Their Pensions

Maximum Contribution Regulations

Generally speaking, a plan sponsor may make a tax-deductible contribution to its pension plan of an amount that is at least as much as the plan's unfunded current liability. Other rules may allow for a larger deduction. Contributions beyond the deductible amount may be subject to a tax. In the 1980s and early 1990s Congress reduced employers' maximum tax-deductible contributions, imposed excise taxes on employer contributions that were not tax-deductible, and placed penalties on withdrawals of surplus assets.

Several participants said that greater pension funding flexibility could help maintain adequate pension funding and remove disincentives that have stopped plan sponsors from contributing more to their plans in the past.

- *Current funding rules do not follow the business cycle.* Some participants said that the maximum pension plan contribution levels set by law are too restrictive because they do not allow companies to make tax-qualified contributions to their plans when they can most afford it. Consequently, when the economy and equity prices decline, plan sponsors may be forced to make contributions when they can least afford them. Participants suggested raising the current limit on the amount companies can contribute to their pension plans on a tax-qualified basis during profitable times so their plans would remain in better financial condition in the event of a recession or stock market decline. Some participants said, that in recent years, the maximum funding restrictions have prohibited plan sponsors from making additional tax-qualified contributions when cash was readily available to the employer.[10] However, at least one participant noted that increasing the limits on tax-deductible contributions to pension plans would reduce federal tax revenues. Furthermore, in one participant's opinion, the companies most likely to overfund their pension plans are those in healthy financial condition that are least likely to submit a claim to PBGC.

- *Taxes on plan reversions discourage firms from making additional contributions during profitable times.* Some participants said that excise taxes present disincentives for plan sponsors to contribute more than the required minimum to their pension plans. They explained that if the rate of return on a plan's assets is greater than the growth in its

[10]Recent research shows that many employers could have contributed more to their pension plans during the 1990s by using a more conservative interest rate to measure their plans' current liabilities. One study concludes that a firm's strategic use and commitment to its pension program are the most important factors explaining contributions to defined benefit plans over time. A recent GAO study shows that in 1996, among the 100 largest plans measured by current liability, 16 of the 30 plans that had a maximum deductible contribution of zero could have increased their maximum deductible contribution by choosing a lower discount rate. See T. Ghilarducci and W. Sun, "Did ERISA Fail Us because Firms' Pension Funding Practices Are Perverse?," Paper presented at the 57th Annual Meeting of the Industrial Relations Research Association (Philadelphia, PA: January 2005); GAO, *Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules*, GAO-05-294 (Washington, D.C.: May 31, 2005); and PBGC analysis, unpublished.

liabilities, as happened during much of the 1990s, the plan sponsor would be required to pay a 50 percent reversion tax plus corporate tax on any surplus money that the employer receives when a plan is terminated with sufficient assets to satisfy the plan's liabilities. Thus, as companies consider their long-term cash needs, they might be reluctant to contribute more than the minimum as long as the reversion tax impedes them from recovering any excess plan funds. One participant asked whether the reversion tax should be reduced from its current rate of 50 percent to a rate that would better reflect the true economic value of the tax deferral that companies gain from funding their plans.

Effective Funding Rules Require Accurate Measures of Plan Assets and Liabilities

Yield Curve Approach

Current rules require all plans to measure current liability with a discount rate based on a high-quality corporate bond index. However, a single rate for all plans may not accurately estimate the present value of plan obligations since demographic factors such as the average age of plan participants can vary between plans. In theory, the present value of a plan's benefit obligations may be more accurately estimated by discounting expected future benefit payments at the market interest rate for bonds that mature when benefit payments are due (i.e., plans that cover predominantly older workers and retirees would use a shorter-term interest rate). Generally, bonds with shorter maturities have lower yields. Discounting benefit payments at a lower interest rate, assuming all other factors equal, results in a greater current liability. The Administration has proposed replacing the single corporate bond rate with a series of corporate bond rates, the so-called yield curve.

Participants discussed a number of pension funding issues related to measurement of pension assets and liabilities. There was general agreement on broad principles, but disagreement over the costs and benefits of specific proposals.

- *Measures of plan liabilities should consider the timing of benefit payments, though not necessarily using a yield curve.* Participants generally agreed that the duration (a measure related to the timing of a set of cash flows) of plan liabilities should affect their measurement and required funding levels. Some participants recommended tying liabilities to a yield curve to more accurately measure them. This could also encourage plans to adopt investment strategies, based on the yield curve, of holding bonds of the same duration as the plan's liabilities. Thus, changes in interest rates would have similar effects on both plan assets and liabilities and would not significantly change the funding status of a plan. Opponents of the yield curve approach argued that it might not improve accuracy of liability measures because an imbalance of supply and demand for bonds of certain durations could skew interest rates. It was added that the yield curve is only likely to improve the accuracy of pension measurements when short- and long-term interest rates significantly differ, and only then for plans with workers that are particularly old or young; thus, it may not be worth the significantly greater administrative expense of using a yield curve. Another participant said there are reasonable alternatives to using a yield curve that produce similar results. For example, plans could calculate the average duration of their liabilities and then use the corresponding interest rate to determine their current liability.

Rate of Return Assumptions

Pension funding rules require plan sponsors to estimate a long-term expected rate of return on plan assets. The higher this rate, the lower the value of assets a plan needs to meet minimum funding requirements, according to its actuarial funding method. However, other uniform (though still subject to some discretion) measures of pension funding may override these actuarial funding measures and result in additional contribution requirements. For further information see GAO-04-395.

- *Flexibility in rate of return assumptions may encourage riskier investments.* Some participants said that plan sponsors have incentives to invest in riskier assets so they can more readily justify assumptions of higher expected rates of return on plan assets. One participant said funding rules should not make it easier for companies to make bets using employees' pension assets. It was also noted that funding rules do not differentiate among types of plan assets and thus a fully funded plan can still present a risk to PBGC because an asset-liability mismatch would leave it exposed to market risk. Other participants, however, noted that some plan sponsors have greater tolerance for pension investment risk than others and should be allowed to invest according to their own strategy.

- *Market valuations improve transparency but may not be optimal for plan funding.* Participants generally agreed that mark-to-market valuations of plan assets and liabilities increase transparency and provide the best measure of a plan's current funding status, but opinions varied about whether the benefits of increased transparency outweighed the costs.[11] Some participants said that plan sponsors might accept mark-to-market accounting for disclosure purposes, but some participants said that plan sponsors would not support it for plan funding purposes. Opponents of mark-to-market accounting said it would increase volatility of plan funding, making it harder for firms to develop long-term funding and cash flow management strategies. One participant said plan sponsors may discontinue their pension plans if they do not believe they can predict and manage the cost of funding pension benefits. Another added that the only way to manage the uncertainty of mark-to-market accounting would be to shift most pension plan assets from equities to bonds, a change which would have significant ramifications for U.S. financial markets.[12]

  Proponents of market valuation of plan assets and liabilities said that the benefits of increased transparency and accuracy outweigh concerns over increased volatility in pension funding. One participant said incorporating mark-to-market methodology in both the pension funding and accounting rules would become increasingly harder to avoid because it is becoming standard financial accounting practice around the world as investors and regulators demand more transparency. Some participants said that mark-to-market accounting would compel plan sponsors to manage volatility by investing in bonds to match the duration of their plan assets and liabilities. This would both eliminate the market risk to which PBGC is currently exposed and lead to better-funded pension plans. Another participant said that not switching to market valuations would allow companies to continue using accounting and reporting rules to obscure the true cost of their pensions, leading to a hidden subsidy for plans.

[11]Mark-to-market accounting refers to recording the price or value of a liability, security, portfolio, or account according to its current market value rather than its book value or a notional value, such as an actuarial value.

[12]By contrast, certain actuarial funding methods aim to maintain relatively smooth contributions to plans over time on the presumption that returns on investments in a portfolio of stocks and bonds will vary from year to year, but will revert to a long-term average that can be estimated. Based on the estimated average rate of return, annual contributions may be estimated and budgeted by the plan sponsor.

PBGC Premiums

Most participants generally agreed that PBGC's premium structure should better reflect risk and that the government should more strongly emphasize variable-rate premiums. Some said that increasing the flat-rate premium is necessary for reforming the defined benefit insurance system. Others urged government regulators to look at ways to measure the risk a pension plan poses to PBGC, including the financial strength of the plan sponsor and how plan assets are invested, in addition to the plan's funding status. Pension plans invested heavily in equities expose PBGC to substantial risk, especially during volatile periods in the equity markets.

Risk and PBGC Premiums

Currently, PBGC's premium structure does not reflect many of the risks that affect the probability that a plan will terminate and impose a loss on PBGC. While plan sponsors may be subject to a variable-rate premium based on a plan's level of underfunding, premiums do not consider other relevant risk factors, such as the plan's investment strategies, benefit structure, demographic profile, or the financial strength of the plan sponsor. For further information see GAO-04-90.

- *PBGC's premium structure could better reflect risk.* Participants generally agreed that PBGC's premium structure should continue to consist of two parts: a flat-rate premium met by all plan sponsors and a variable-rate premium paid by those companies that create additional risks for the pension insurance system. However, some participants said that the government should make the current premium structure more risk-based by placing stronger emphasis on the variable-rate premium and requiring all underfunded plans to pay it, a condition that does not presently exist.[13] Moreover, a more expensive variable-rate premium could provide incentives for companies to adequately fund their pension plans. In addition, at least two participants said that increasing the annual flat-rate premium from $19 to $30 per person, as proposed by the Administration, would still be inexpensive for the insurance that PBGC provides. Furthermore, one participant added that flat-rate premiums should be tied to an index, such as wage growth, to ensure that premiums would rise as benefits grow. However, other participants urged caution about the extent to which the government raises premiums. They said the higher costs could hasten both the failure of unhealthy plans and the exit of healthy plans from the defined benefit system.

[13]Sponsors of underfunded plans can avoid paying the variable-rate premium if they are at the full funding limit in the year preceding the premium payment year after applying any contributions and credit balances. One of the ways plans earn credits is by contributing more than required in previous years. Credits can then be used to offset minimum funding contributions in later years. For example, Bethlehem Steel met this criterion and only contributed about $71.3 million to its pension plan during years 1997 through 2001 as compared with the approximately $3.0 billion it contributed from 1986 through 1996. PBGC terminated Bethlehem Steel's pension plan in December 2002, resulting in a total loss of nearly $3.7 billion for the agency.

- *Accurately assessing risk profiles of pension plans is necessary for developing risk-based premiums*. In order to price risk-based premiums, one participant noted that the government needs to develop a system that accurately assesses the risk that a plan poses to the pension insurance system. Presently, PBGC uses credit ratings, in part, to determine which companies' pension plans pose the greatest risk of termination.[14] However, some participants said that because credit ratings are lagging indicators, they may not sufficiently measure a company's risk to PBGC. Furthermore, credit ratings could lead to inaccurate assessments of risk for PBGC because they may not penalize investment grade companies with underfunded and unhealthy pension plans. Instead, one participant said that PBGC needs new ways to gauge its risks and discussed the idea of "stress testing" plans for weaknesses.[15] These tests, possibly performed as a mandatory service by the financial services industry, could be periodically reported to government regulators.

[14]Credit ratings are generally considered to be a useful proxy for a firm's financial health. Ratings typically take into consideration the creditworthiness of guarantors, or insurers, or other forms of credit enhancement on the obligation and take into account the currency in which the obligation is denominated. An investment grade rating implies that the debtor will probably repay its obligations when due.

[15]Stress testing is a risk management tool used to evaluate the potential impact on a firm of a specific event or movement in a set of financial variables. Stress tests help firms gauge their potential vulnerability to exceptional but plausible events. Bank for International Settlements: *Stress Testing at Major Financial Institutions: Survey Results and Practice* (January 2005); Bank for International Settlements: *A Survey of Stress Tests and Current Practice at Major Financial Institutions* (April 2001).

Rates of Return and Earnings

For corporate financial statements, the expected rate of return is used to calculate the annual expected investment return on pension assets, which factors into the measurement of pension expense. To calculate a dollar amount for the expected return, the expected rate of return is multiplied by the value of the pension assets. This expected return is used instead of the actual return in the calculation of pension expense, which has the effect of smoothing out the volatility of investment returns from year to year. If the expected return on plan assets is high enough, a company may report a negative pension expense–or pension income on its financial statements. For further information see GAO-04-395.

- *Investment strategies should factor into assessments of plan risk.* Some participants said that pension plans' investment strategies should be considered when evaluating how much risk plans pose to PBGC's insurance program. Some participants said there is a belief that investing in equities lowers a company's pension costs because the higher expected returns will result in lower cash contributions. During most of the 1990s, investments in equities produced returns that exceeded growth in plan liabilities, and in many cases, these investment gains relieved plan sponsors of the need to make any contributions to their pension plans to meet funding requirements. However, at least one participant said investments in equities, even for fully funded plans, can lead to severe plan underfunding, especially during volatile periods in the equity markets. For example, it was pointed out that negative stock market returns from 2000 to 2002 resulted in rapid deterioration in the funding status of pension plans. Others added that under the current funding rules and premium structure, PBGC will remain exposed to moral hazard as long as plan sponsors can promise benefits that they might not be able to afford because plan investment risk is not properly priced.[16] Some participants said that companies could reduce plan funding volatility by investing in bonds because plan liabilities have characteristics that are similar to bonds such as present values that are sensitive to changes in interest rates. However, plan sponsors may be reluctant to do this because it would generally have a negative effect on the corporate earnings they report in their financial statements.

  Other participants, however, said that returns on assets have surpassed expectations over the past decade, despite stock market declines since 2000. Thus, asset allocations have not been the problem, and over time, most employers can withstand the volatility of equity markets. The bigger problem, according to at least one participant, is that liabilities have increased faster than expected, particularly because of low interest rates.

[16]Moral hazard surfaces when the insured parties—in this case, plan sponsors—engage in behavior in which they would not have otherwise engaged had they not been insured against certain losses. In the case of the pension insurance system, this might include the willingness of parties to enter into agreements that increase pension liabilities, rather than taking wage increases.

Transparency of Pension Plan Information

Participants generally agreed that further steps should be taken to increase the transparency and timeliness of plan financial information to plan participants, regulators, and investors. Such steps could include requiring additional disclosures in corporate financial statements and enhancing annual reports to plan participants.

- *Corporate financial statements are an important source of up-to-date plan financial information, but additional information could help.* Forum participants generally agreed that recent changes in corporate financial statement accounting rules related to pensions had improved the transparency of pension information.[17] In particular, one person noted that investors and others now have key pieces of data, such as asset allocations, projected pension contributions, and projected benefit payments. However, several participants said that much of the information on pensions in corporate financial statements, while helpful to knowledgeable investors, would be of limited usefulness to average plan participants. While forum participants supported the Financial Accounting Standards Board's efforts to improve the transparency of pension information, they suggested additional changes that would be helpful to plan participants, investors, and regulators. Suggested changes included requiring companies to provide
    - plan cash flow projections;
    - projected minimum funding contributions;
    - statements in the Management Discussion and Analysis section on long-term trends in a company's pensions and implications for the plan sponsor; and
    - disaggregated pension plan information, such as separate plan information based on domestic versus foreign plans and tax-qualified versus non-tax-qualified plans.

[17]In December 2003 the Financial Accounting Standards Board issued a revision to its accounting standard on pension disclosures. Some of the new disclosure requirements include a description of how pension assets are invested, a narrative description of how the expected rate of return on assets was selected, and the employer's estimated contribution to plans in the following year. The revised standard does not change the general approach used in the financial statements of aggregating this information across all pension plans.

While such changes would further enhance the transparency of pension information, at least one participant noted that it is important not to burden companies with additional or overlapping reporting and disclosure requirements.

- *The 4010 filing requirement could be revised to better reflect risks to PBGC.* Some participants said that the current 4010 filing requirement should be revised to better target PBGC's risks. They agreed that the current 4010 underfunding threshold of $50 million is too low, given the relative values of assets and liabilities in most large plans. There was support for revising the threshold so that only those plans that truly represent a risk to PBGC would be required to file. One participant noted that the 4010 provision, as originally proposed, was based on a percentage of underfunding rather than a flat dollar amount. However, plan sponsors objected to the percentage measure, and the flat dollar amount was a compromise.

  Participants' opinions varied on the need to publicly disclose 4010 information. It was suggested that plan funding information in 4010 filings be made public because it is much timelier than Form 5500 data and more accurately measures the funding of a pension plan in the event of termination. However, concerns were raised about the ability of investors and plan participants to understand this information, which may cause unnecessary concern about the financial health of the plan and plan sponsor. One participant noted that there are legitimate business reasons not to disclose 4010 information to the public. For example, many plan sponsors view the detailed plan funding information as proprietary.

Summary Annual Reports

ERISA requires plans to provide participants and beneficiaries receiving benefits from the plan a Summary Annual Report each year. The Summary Annual Report summarizes the plan's financial status based on information that the plan administrator provides to the Department of Labor on its annual Form 5500.

- *Participants should receive more complete and timely information on plan financial status and PBGC-guaranteed benefits.* Many participants agreed that plan participants should be provided more meaningful and timely information on the financial condition of their pension plans as well as information about PBGC-guaranteed benefits. For example, participants may have trouble understanding the implications of funding information about a multibillion dollar pension plan. Data in the Summary Annual Reports sent to plan participants are based on Form 5500 filings. Consequently, Summary Annual Reports suffer from the same lack of timely data as does the Form 5500. Forum participants noted that the financial condition of a plan can change significantly by the time regulators receive the Form 5500 and plan participants receive their Summary Annual Report. To address this lack of timely information, participants suggested

- moving the Form 5500 from a paper-based filing to an electronic filing; and
- varying the filing deadlines for the Form 5500 according to the importance of the information provided. For example, estimated plan funding information could be filed earlier than other data. This would also allow plan sponsors to send out Summary Annual Reports earlier.

Another participant pointed out that beyond providing plan participants with plan financial information, plan participants need to be better educated about information on the Form 5500 and Summary Annual Report as well as how the U.S. pension system works overall. Thus, plan participants could better understand the information they receive about their pension benefits.

Many forum participants said plan participants and beneficiaries should receive information annually on their expected retirement benefits and the extent to which these benefits are guaranteed by PBGC. One person suggested that plan participants be provided information about their accrued benefits and the effect on their benefits of working both up to their company's normal retirement age and beyond it. Another forum participant stated that information about the limits on benefits guaranteed by PBGC is important because, as occurred with some in the airline industry, participants may face a significant reduction in benefits if their plan is taken over by PBGC.

Emerging Issues

According to participants, the debate over funding rules, premiums, and the role of the PBGC should take place amidst fundamental policy discussions about how to promote retirement income security, particularly since the traditional defined benefit pension system has weakened. In light of debates over issues such as an individual account component to Social Security, simplification of the tax code, and pension reform, policymakers should think about how to delegate responsibility for asset management and risk among individuals and entities that can pool and professionally manage risk, such as employers, insurers, and the government. However, as policymakers think about the future of retirement, the past failures of many large defined benefit plans continue to weigh on the defined benefit system. Participants suggested a few ways to address the legacy costs of terminated and presently underfunded plans, especially those in industries that have been deregulated or more affected by globalization, but noted there are not any easy options.

Policymakers Should Think Broadly about Retirement Income Security

Participants recognized the decline of defined benefit pension plans and encouraged policymakers to broadly consider how best to promote retirement income security. Among other things, participants suggested that decision makers clarify the legal status of cash balance and other hybrid pension plans.

- *The traditional defined benefit system is under threat.* Participants broadly agreed that while employer-sponsored defined benefit plans have played an important role in providing secure retirements to millions of Americans, the traditional defined benefit pension system is in a decline that is likely to continue. Reasons cited for this decline include a regulatory structure that is biased in favor of defined contribution plans, recent investment experiences that have resulted in significant plan underfunding and uncertainty over potential changes in funding rules, pension accounting standards, and PBGC premiums. Furthermore, workers often do not recognize the importance of certain features of defined benefit pensions until they approach retirement. However, some participants wondered whether adoption of individual accounts as part of Social Security would lead employees to value defined benefit plans more highly.

Cash Balance Pension Plans

Cash balance plans are a type of defined benefit plan that look more like a defined contribution plan to participants. As with other defined benefit plans, the sponsor is responsible for managing the plan's commingled assets and complying with the minimum funding requirements. However, information about benefits is communicated to plan participants through the use of hypothetical account balances, which makes the plan appear like an individual account-based defined contribution plan. The hypothetical account balances communicated to plan participants do not necessarily bear any relationship to actual assets held by the plan.

- *Clarifying the legal status of cash balance plans may encourage some companies to remain in the defined benefit system.* Several participants stated that lawmakers need to clarify the status of cash balance and other hybrid plans as soon as possible to prevent the further demise of the defined benefit system and the PBGC. Cash balance plans constitute approximately 20 percent of large defined benefit plans, and some sponsors of cash balance plans have already exited the defined benefit system because of the legal uncertainty they face. Their exit, and the potential exit of other cash balance plan sponsors, is gradually reducing the PBGC's premium base and potentially placing even greater strain on those who remain behind in the defined benefit system.

- *Policymakers should encourage certain pension plan features rather than certain plan types.* Some participants suggested that the debate over federal retirement policy needs to move beyond distinctions between defined benefit and defined contribution plans. Participants widely agreed on the value of defined benefit pension plans but disagreed over whether the federal government should promote defined benefit plans more than other vehicles for retirement savings. Others added that discussions of retirement policy need to focus on ways to create incentives and remove barriers for employers to set up retirement plans and how to get American workers to build adequate retirement savings and security. This may be achieved by thinking about the interaction of private pensions and Social Security and by looking at hybrid pension plans, such as cash balance plans and plans that combine the best features of defined benefit and defined contribution plans. Participants suggested that pension plans include the following features:

- automatic participation;
- portability of benefits to accommodate workers who frequently change jobs;[18]
- allow participants to pass on accumulated wealth to their heirs;
- professional money management;
- pooled investment risk;
- ability for participants to work longer;
- minimal leakage (early withdrawals and borrowing) from retirement savings; and
- incentives to receive benefits in the form of a fixed annuity, rather than a lump sum distribution.

[18]One participant questioned whether employers are the proper nexus for pension plans in today's world since many of them cannot bear the risk of investing plan assets and being liable for making up investment losses.

Addressing Legacy Costs of Failed and Underfunded Pension Plans

Participants spoke about the advantages, disadvantages, and significant challenges to separating legacy costs from current and future funding and premiums rules. They also proposed several ways to pay for legacy costs.

- *Separately addressing legacy costs could encourage future participation in the defined benefit system and ease passage of reform proposals.* Separating legacy costs from the existing and future liabilities of the remaining defined benefit plans might encourage plan sponsors to remain in the defined benefit system. Many plan sponsors are concerned that, through increased PBGC premiums, they may be required to pay for the failures of other companies to responsibly fund and manage their pension plans. Presently, companies that sponsor healthy plans are subsidizing weak plans, and it is unclear how much longer companies with well-funded pension plans will be willing to remain within the defined benefit system. Some participants noted that resolving the matter of legacy costs could be a key component of any pension reform legislation that tightened the funding rules and assessed premiums according to risk. Such a proposal would essentially strike a deal between the federal government and employers that would settle PBGC's unfunded liabilities through an infusion of general revenues, while imposing stricter pension funding standards on plan sponsors to minimize the possibility of significant future underfunding in the defined benefit system. Others added that if legacy costs are addressed separately, it would be possible to establish a more functional, risk-based insurance system. And, one participant added, resolution of pension legacy costs would bring a measure of security to millions of American retirees and workers who face uncertainty about their pension benefits. While participants generally supported separating pension legacy costs from ongoing pension liabilities, many opposed limiting the scope to specific industries such as air transportation and steel, which have been affected by globalization and deregulation.

- *Separately addressing legacy costs could set a bad precedent.* Requiring taxpayers or other companies to pay for failed private sector pension plans sends a message that the government will bail out companies who poorly design and manage their benefit plans or businesses. Furthermore, according to one participant, paying for defined benefit plan legacy costs with federal tax revenues would increase the federal government's deficit, perhaps by as much as $100 billion, according to one participant.

- *Defining legacy costs is difficult.* Participants provided different definitions of legacy costs in the defined benefit system. Some noted that any underfunded terminated plan that has been trusteed by PBGC represents a legacy cost. Another proposed defining legacy costs as any unfunded current liability. And one person pointed out that we may not even be able to accurately determine the extent of the legacy costs in the defined benefit system because they will eventually include costs for events that have not yet happened.

- *Determining who pays for legacy costs is politically challenging.* Many participants said that it is not reasonable to expect the companies remaining in the defined benefit system to pay for the costs of plans that have failed. Requiring them to do so would drive the healthy plans and plan sponsors out of the defined benefit system. On the other hand, it is hard to equitably shift the costs of these benefits to the general population, especially since a large percentage of Americans do not have any form of private pension.

- *Participants suggested several ways to address pension legacy costs*:

  - **Taxpayer bailout**. Some participants said that relative to the entire federal budget, a taxpayer bailout would not cost much over a long period of time, and this would be a small price to pay for shoring up an important part of the nation's private pension system.

  - **Industry-specific fees**. Some participants said that those industries that have placed the greatest burden on the defined benefit system should be required to fund at least their share of the legacy costs. For example, the government could impose a fee on airline tickets that would cover the underfunded airline plans that have been taken over by PBGC.

  - **Consolidate plans in distressed industries.** One participant suggested that pension plans from financially distressed companies in troubled industries (e.g., airlines, steel) be grouped together into multiemployer plans that would be jointly managed by a board of trustees representing employer, employee, and goverment interests. Such a plan would be required to follow a set of investment guidelines that would limit future funding risk.

  - S**ecurity trading commissions**. One participant suggested imposing a securities trading commission on the financial services industry to help cover legacy costs, because they have benefited over the years from managing pension plan assets and have an interest in the continuance of the defined benefit system.

- **Expand universe of defined benefit plans**. Another participant suggested that the government seek to expand the defined benefit universe, primarily by resolving the legal status of cash balance plans. Having more employers in the system would distribute the costs across a wider population.

- **Wait for higher interest rates**. Others suggested that much of the underfunding problem will eventually be solved by rising interest rates, which would reduce the present value of benefit obligations. However, higher interest rates could lead to lower stock and bond prices and thus reduce the market value of pension plan assets.

PBGC's Mandate

Many participants said there is a conflict in PBGC's mandates to promote defined benefit plans and insure them all at the lowest cost while remaining self-financed. Some participants advocated for PBGC serving as a social insurance program because a market-based program would increase costs for companies and make it difficult for many to maintain their plans. Others argued that the agency should become more of a market-based insurer so as to manage the risks it faces. For example, PBGC should have both the authority to adjust premium rates and a higher standing in bankruptcy proceedings. These participants also said that the current social support system is problematic because guaranteed PBGC insurance encourages weak plan sponsors to make benefit promises they cannot keep. In addition, participants debated the optimal investment strategies for PBGC's portfolio of assets.

- *PBGC should play a social insurance role.* Some participants said PBGC should serve as part of a wider government effort to promote defined benefit plans. This may require the federal government to transfer general revenues to PBGC occasionally. At least two participants acknowledged that the federal pension insurance system is flawed because, when it was designed, nobody anticipated the collapse of entire industries along with their pension plans. Nonetheless, one participant said the legislative history shows that PBGC was not intended to be run like a commercial insurance company and that the insurance component of PBGC was drafted on a social support system model. It was emphasized that transforming PBGC into a market-based insurer would adversely affect both sponsors and participants by dramatically increasing premium rates and making it difficult for companies to maintain their defined benefit pension plans. Some participants also said that without fixing the funding rules, the defined benefit system cannot be properly insured.

- *PBGC should operate more like a commercial insurer.* Some participants said that PBGC should remain self-financing, like a commercial insurance program. A few participants pointed out that PBGC has limited ability to control and manage its risks in the way that any commercial insurer normally can. Some participants suggested that

  - PBGC should have the authority to set and adjust premiums and

  - PBGC should be able to act sooner to work with any plan sponsor entering bankruptcy and restructure a plan to try to obtain long-term refunding if the plan would otherwise be terminated.

  One participant stated that PBGC's present role as a social insurer does not encourage healthy plans and is contributing to the decline of defined benefit plans because, in effect, it provides loan guarantees of promises made by weak employers to their employees. Employers can thus promise benefits they may not be able to afford, since they can pass the cost off to PBGC.

- *PBGC would benefit from improved standing in bankruptcy, but this would create other challenges.* Participants broadly disagreed over what ought to be PBGC's standing in bankruptcy. While improving PBGC's standing in bankruptcy would help PBGC recover more money in plan terminations, a change in the rules needs to carefully consider the impact on existing creditors and the access of plan sponsors to the credit markets. Some participants noted the following:

  - Under current law, it is too easy for companies to shed their pension obligations during bankruptcy proceedings in order to emerge from bankruptcy, and

  - Improving PBGC's standing in bankruptcy would slightly increase the cost of credit for plan sponsors and would slightly increase PBGC's administrative expenses. It is not clear whether these cost increases can be accurately modeled.

- *PBGC's investment strategy may not be optimal.* Participants debated PBGC's investment strategy, and some of them felt that PBGC has not invested in an optimal portfolio of assets. It was suggested that PBGC invest more heavily in high-quality corporate bonds, since they offer a higher rate of return than Treasury bonds and are nearly as safe as investments. Furthermore, one person suggested that there is a conflict of interest in PBGC's investment policy since the Secretary of the Treasury sits on PBGC's board. Another participant said that PBGC's investments in equities multiply its exposure to market risk because most large plans it insures are heavily invested in equities. In a stock market decline, the value of PBGC's equity portfolio would fall at the same time that the assets of the plans it insures decline in value. Thus it would make more sense if PBGC were to sell short the Standard & Poor's 500 stock index. It was also suggested that PBGC invest long in bonds of well-funded companies and sell short the bonds of poorly funded companies.

Forum Agenda

The Future of the Defined Benefit System and the PBGC

Thursday, February 3, 2005

Agenda

8:30	Registration, breakfast
9:00	Welcome and Introduction David M. Walker, Comptroller General of the United States
9:15	Brief overviews of topics for breakout groups • Pension funding rules Ron Gebhardtsbauer, Senior Research Fellow, American Academy of Actuaries • PBGC premiums and guarantees Brad Belt, Executive Director, PBGC • Pension transparency/accounting David Zion, Director, Credit Suisse First Boston
9:30	Presentation of Administration's Pension Reform Proposal Ann L. Combs, Assistant Secretary, Employee Benefits Security Administration, Department of Labor
9:45	Break and move to discussion groups • Breakout group discussions • Strengthening funding rules • Enhancing transparency of plan financial information

Facilitators:

Doug Elliott, President, Center on Federal Financial Institutions
Olivia S. Mitchell, Professor of Insurance & Risk Management,
The Wharton School, University of Pennsylvania
Dallas Salisbury, President, Employee Benefits Research Institute

11:30	Break / Pick up box lunches for working lunch
11:45	Reports from breakout groups and discussion

- Presentation of points of consensus and disagreement
- Plenary discussion based on reports from groups

Moderator: David M. Walker

12:45	Plenary Discussion of Broader Defined Benefit Plan Issues

- Presentation of pre-forum survey responses
- Discussion topics:

What is likely to be the future role of DB plans in providing retirement income for private sector workers?

To what extent should the federal government promote DB plans or should the government take a more neutral posture on private retirement plan design?

Was PBGC designed to fulfill a social insurance purpose, or act as a self-sustaining insurer?

How do we keep PBGC solvent without overburdening the employers remaining in the DB system?

Do we need a more explicit national policy to address structural weaknesses in certain industries, with large underfunded pensions?

How will/should Social Security and/or tax reform affect the DB plan system?

Moderators:

David M. Walker
Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues, GAO

2:15	Wrap-up
2:30	Adjourn

Forum Participants

The Future of the Defined Benefits System and the PBGC

Thursday, February 3, 2005

Moderator

David M. Walker
Comptroller General of the United States
U.S. Government Accountability Office

Participants

Eddie Adkins
Member, Employee Benefits Technical Resource Panel
American Institute of Certified Public Accountants

Joseph A. Applebaum
Chief Actuary, U.S. Government Accountability Office

Brad Belt
Executive Director, Pension Benefit Guaranty Corporation

Richard Berner
Managing Director, Chief U.S. Economist, Morgan Stanley

David S. Blitzstein
Director, Negotiated Benefits Department
United Food and Commercial Workers International Union

Teresa Bloom
Chief of Government Affairs
American Society of Pension Professionals and Actuaries

Bill Bortz
Associate Benefits Tax Counsel, U.S. Department of the Treasury

Phyllis Borzi
Research Professor
The George Washington University School of Public Health

Barbara D. Bovbjerg
Director, Education, Workforce, and Income Security Issues
U.S. Government Accountability Office

Ann L. Combs
Assistant Secretary, Employee Benefits Security Administration
U.S. Department of Labor

Julia Lynn Coronado
Senior Research Associate, Watson Wyatt & Company

Randy G. DeFrehn
Executive Director, National Coordinating Committee for Multiemployer Plans

John W. Ehrhardt
Principal & Consulting Actuary, Milliman, Inc.

Doug Elliott
President, Center on Federal Financial Institutions

Karen Ferguson
Director, Pension Rights Center

Peter Fisher
Managing Director, Blackrock

Ron Gebhardtsbauer
Senior Pension Fellow, American Academy of Actuaries

Gary A. Glynn
President, US Steel and Carnegie Pension Fund

Carol D. Gold
Director, Employee Plans, Tax Exempt & Government Entities
Internal Revenue Service

Jeremy Gold
Jeremy Gold Pensions

Britt Harris
Chief Executive Officer, Bridgewater Associates, Inc.

Nell Hennessy
President, Fiduciary Counselors Inc.

Robert H. Herz
Chairman, Financial Accounting Standards Board

J. Mark Iwry
Nonresident Senior Fellow, The Brookings Institution

Dennis M. Kass
Chairman and CEO, Jennison Associates

Jim Klein
President, American Benefits Council

Betty Krikorian
Principal, BLK Consulting

James B. Lockhart
Deputy Commissioner, Social Security Administration

Olivia S. Mitchell
Professor of Insurance and Risk Management
The Wharton School, University of Pennsylvania

Michael Peskin
Managing Director, Morgan Stanley

Alan Reuther
Legislative Director, United Auto Workers

Elizabeth Robinson
Deputy Director, Congressional Budget Office

Dallas Salisbury
President, Employee Benefit Research Institute

Scott Sprinzen
Managing Director, Corporate and Government Ratings
Standard & Poor's

Carol Stacey
Chief Accountant, Division of Corporation Finance
U.S. Securities and Exchange Commission

Gene Steuerle
Senior Fellow, Urban Institute

Mark J. Ugoretz
President, ERISA Industry Committee

Kim Walker
Chair, CIEBAQwest Asset Management CompanyCaptain

Duane Woerth
President, Air Line Pilots Association

David Zion
Director, Credit Suisse First Boston

Comptroller General's Presentation Slides

The Future of the

Defined Benefit System

and the *PBGC*

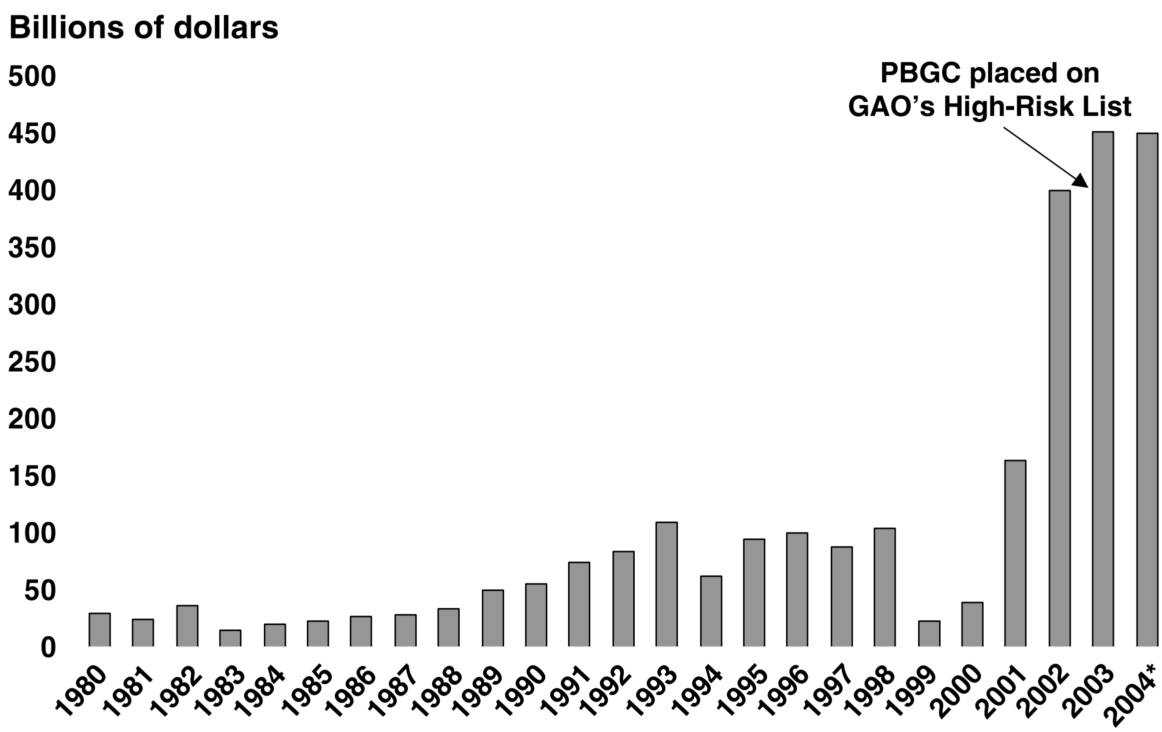
February 3, 2005

Challenges Facing the DB System

1) Large accumulated deficits for many active plans, the PBGC, and the U.S. Government
2) Structural weaknesses in certain industries with large, underfunded DB plans
3) PBGC has limited control over its risks
4) Decline in DB plans
5) Changing demographics and workforce trends
6) Legal and regulatory uncertainties
7) Social Security reform initiatives

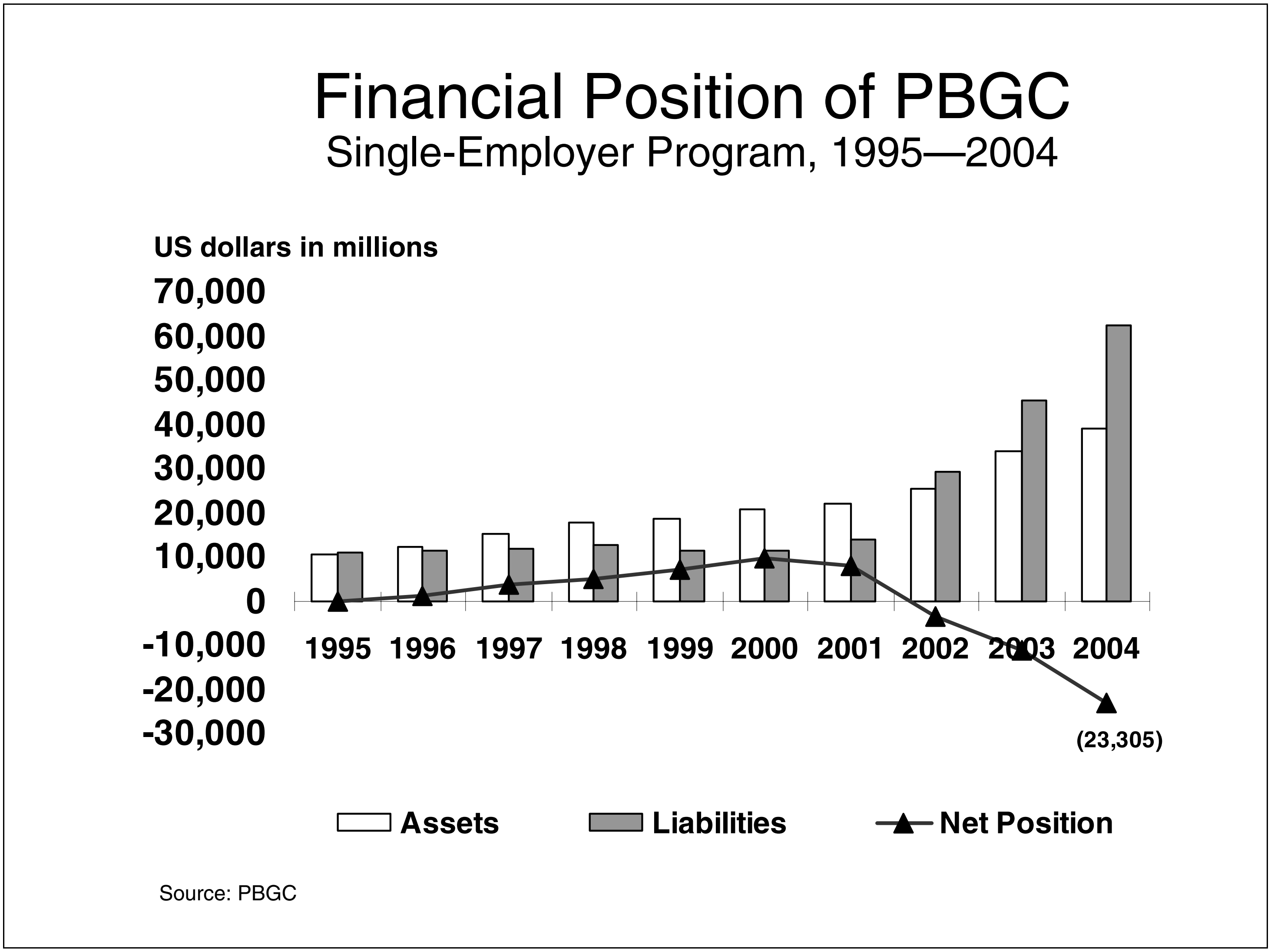
Total Underfunding Single-Employer Program Plans

1980—2004*



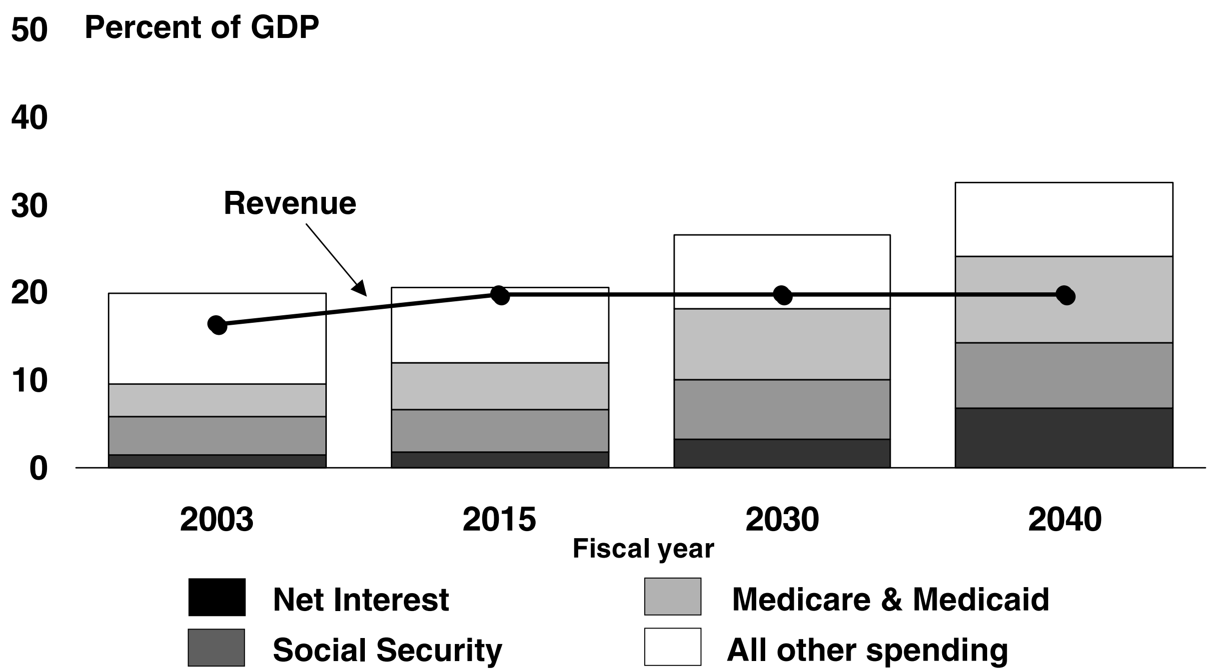
Source: PBGC.

*Note: 2004 data is an estimate as of September 30, 2004.


Financial Position of PBGC
Single-Employer Program, 1995—2004
US dollars in millions
70,000
60,000
50,000
40,000
30,000
20,000
10,000
0
-10,000
-20,000
-30,000
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
(23,305)
Assets
Liabilities
Net Position
Source: PBGC

Composition of Spending as a Share of GDP

Under Baseline Extended

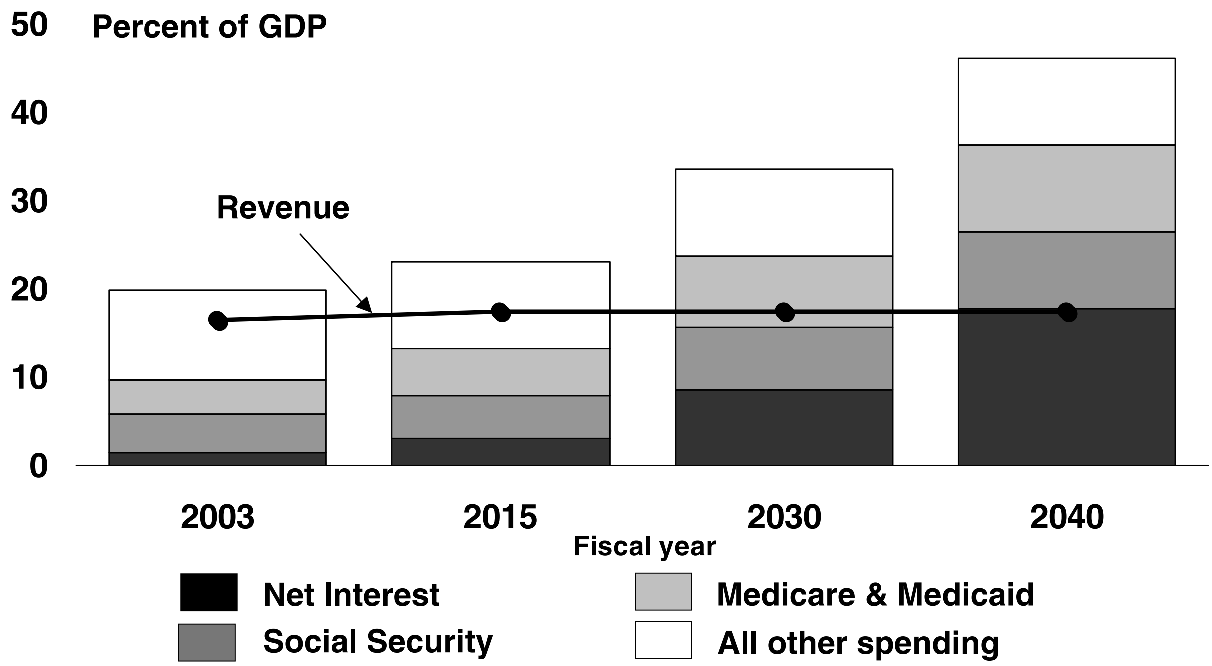


Notes: In addition to the expiration of tax cuts, revenue as a share of GDP increases through 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant. Budgetary effects due to passage of the Working Families Tax Relief Act of 2004 are not reflected in this simulation.

Source: GAO's September 2004 analysis.

Composition of Spending as a Share of GDP

Assuming Discretionary Spending Grows with GDP after 2004
and All Expiring Tax Provisions are Extended



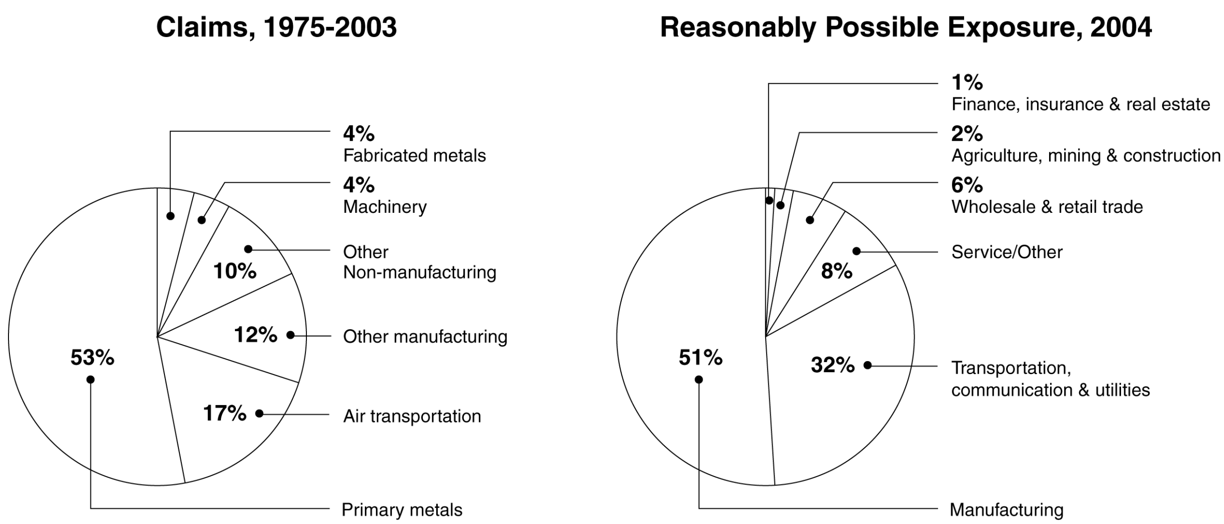
Notes: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the AMT, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant.

Source: GAO's September 2004 analysis.

PBGC's Risk is Concentrated in a Few Industries…

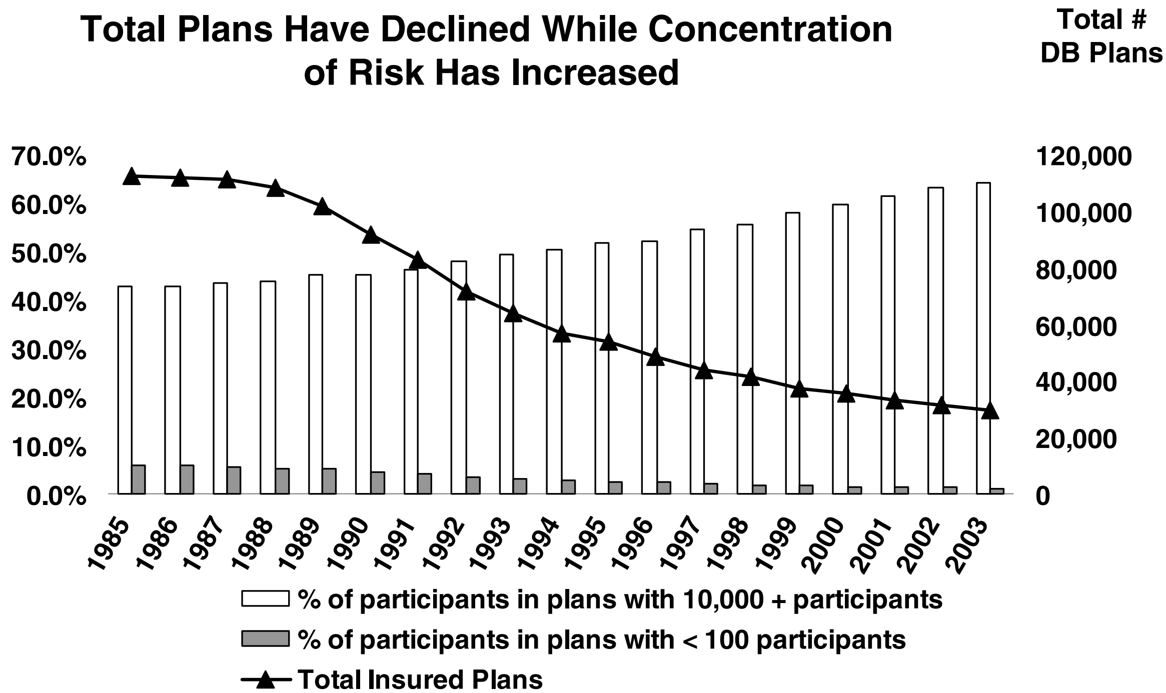
- Legacy costs in industries facing significant globalization, deregulation, and competitive and technological changes and challenges
  - e.g., steel and air transportation sectors
- Potential domino effect of plan terminations
  - Plan terminations by a few may encourage competitors to declare bankruptcy to terminate their plans, too
- Raises Question: Should financial difficulties of certain industries, including pension underfunding, be addressed separately from wider efforts to reform the DB system?

Exposure of Single-Employer Program



Source: PBGC

…And Increasingly in Large Plans



Source: PBGC

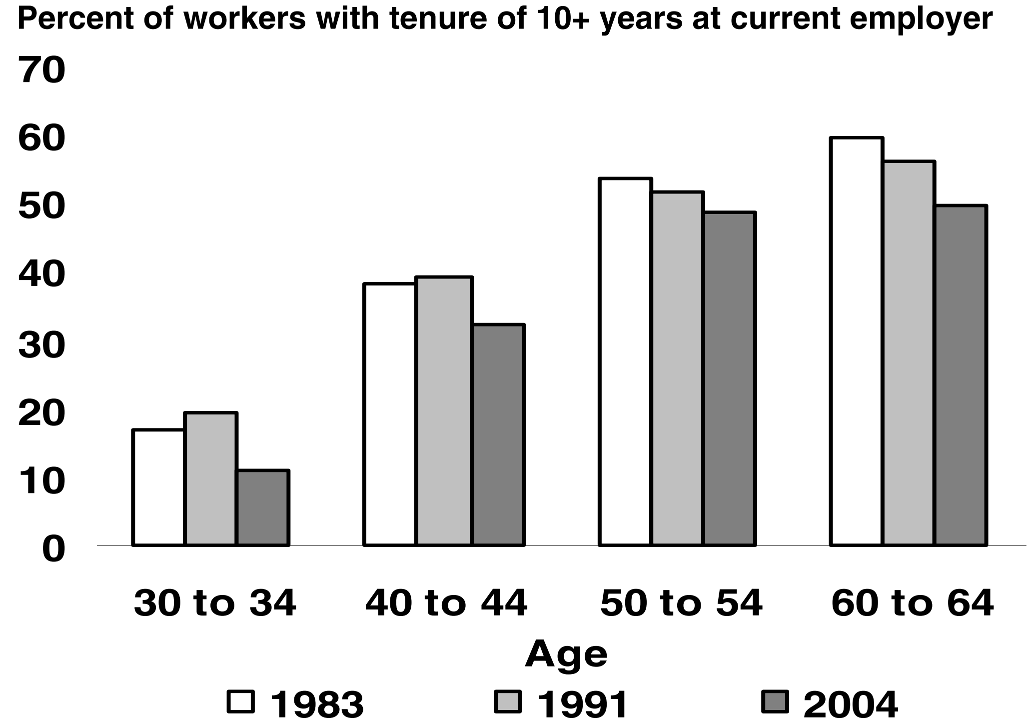
PBGC Cannot Limit Its Risk

- PBGC must insure all eligible plans, is subject to certain "put option" risks, and is exposed to market risk from plan investments
- PBGC premiums do not reflect:
  - Plan sponsor's financial position
  - Risk in plan's investment portfolio
  - Plan's benefit structure
  - Plan's demographic profile
- PBGC is insurer of last resort
- PBGC's revenue base is shrinking

Employee Preference: DC vs. DB

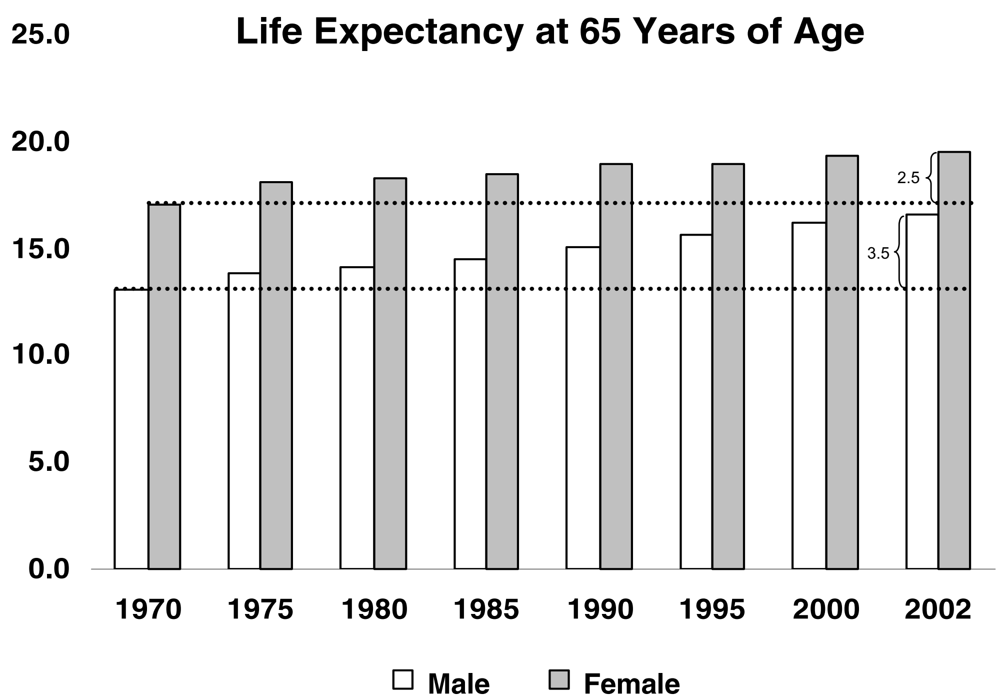
- AAA/SOA survey conclusion: People tend to prefer the type of retirement plan in which they are already enrolled (most active participants are in DC plans today)
- The traditional DB system provides a certain and secure benefit but may be ineffective for building retirement assets for those who change jobs frequently
  - Vesting provisions
  - Backloading of accruals
  - Lack of portability

Increasingly Mobile Labor Force



Source: BLS (Employee Tenure Summary, 9/21/2004)

Retirees are Living Longer



Source: National Center for Health Statistics

Legal & Regulatory Uncertainties

- Employer concern over status of cash balance plans
- Employer concern over potential changes to:
  - Pension funding rules
  - PBGC premiums and other insurance reforms
  - Pension accounting rules
- Lack of action by policymakers may drive more employers away from DB plans

Social Security Reform Initiatives

- Social Security is not adequately funded to deliver on promised benefits beginning in 2042
- Social Security reform is being debated
- Social Security reform may involve modified benefits and individual accounts
- What implications will Social Security reform have on private pensions, in general, and on DB plans, in particular?

Defined Benefit Plan Weaknesses Have Serious Implications for National Retirement Policy

- **Current Issues:**
  – Protecting the benefits of workers in terminated plans
  – Improving funding of DB plans going forward
  – Addressing the PBGC's financial exposure

- **Broader Issues: What is the future role of DB plans in ensuring retirement income security?**
  – Revitalized DB system vs. smoother transition to a DC world
  – Impact of Social Security reform on the private DB and DC system and personal savings arrangements

Role of PBGC?

Social Insurance Program	*vs*	**Financially Sound Insurer**
• Encourage growth of private pension plans • Cover all eligible plans • Ability to exercise "put options" on the system • Limited "risk-related" premiums		• No federal budget appropriations • Limited to borrowing $100M from Treasury • Limited ability to encourage funding and moderate losses

Other Broad Issues

- Is the pension insurance model still viable as the number of DB plans declines?
- Different theoretical frameworks for pension funding: actuarial vs. financial economics view
- Dealing with pension legacy costs in an open, deregulated, and dynamic economy

Broad Goals for Reform of the DB System

- Improve transparency of plan financial information
- Provide incentives and safeguards for plan sponsors to improve plan funding
- Hold plan sponsors accountable for adequately funding their plans

Potential Steps

Improve Transparency

- Disclose plan investments, funding status, and benefit guaranty limitations to plan participants and others
- Review and possibly revise pension accounting rules (FAS 87)

Potential Steps

Modify Funding Rules and Premiums

- Strengthen funding rules applicable to poorly funded plans
- Raise full funding limitations
- Adjust pension premiums to reflect risk

Potential Steps

Other Regulatory Steps

- Clarify legal status of cash balance plans
- Eliminate floor/offset arrangements with significant investment concentrations in employer securities
- Limit lump sums and benefit increases in underfunded plans
- Modify program guarantees (e.g., phase-in rules)
- Modify bankruptcy laws?

GAO Contacts and Staff Acknowledgments

Contacts

Barbara D. Bovbjerg, Director (202) 512-7215

Staff Acknowledgments

In addition to the contact above, David A. Eisenstadt, Benjamin A. Federlein, Jason S. Holsclaw, George A. Scott, and Derald L. Seid made important contributions to organizing this forum and producing this report.

Related GAO Products

Private Pensions: Government Actions Could Improve the Timeliness and Content of Form 5500 Pension Information, GAO-05-491. Washington, D.C.: June 3, 2005

Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules, GAO-05-294. Washington, D.C.: May 31, 2005.

Pension Benefit Guaranty Corporation Structural Problems Limit Agency's Ability to Protect Itself from Risk, GAO-05-360T. Washington, D.C.: March 2, 2005.

Private Pensions: Airline Plans' Underfunding Illustrates Broader Problems with the Defined Benefit Pension System. GAO-05-108T. Washington, D.C.: October 7, 2004.

Pension Plans: Additional Transparency and Other Actions Needed in Connection with Proxy Voting. GAO-04-749. Washington, D.C.: August 10, 2004.

Private Pensions: Publicly Available Reports Provide Useful but Limited Information on Plans' Financial Condition. GAO-04-395. Washington, D.C.: March 31, 2004.

Private Pensions: Timely and Accurate Information Is Needed to Identify and Track Frozen Defined Benefit Plans. GAO-04-200R. Washington, D.C.: December 17, 2003.

Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks. GAO-04-90. Washington, D.C.: October 29, 2003.

Private Pensions: Changing Funding Rules and Enhancing Incentives Can Improve Plan Funding. GAO-04-176T. Washington, D.C.: October 29, 2003.

Pension Benefit Guaranty Corporation: Long-Term Financing Risks to Single-Employer Insurance Program Highlight Need for Comprehensive Reform. GAO-04-150T. Washington, D.C.: October 14, 2003.

Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks. GAO-03-873T. Washington, D.C.: September 4, 2003.

Options to Encourage the Preservation of Pension and Retirement Savings: Phase 2. GAO-03-990SP. Washington, D.C.: July 29, 2003.

Private Pensions: Participants Need Information on Risks They Face in Managing Pension Assets at and during Retirement. GAO-03-810. Washington, D.C.: July 29, 2003.

Private Pensions: Process Needed to Monitor the Mandated Interest Rate for Pension Calculations. GAO-03-313. Washington, D.C.: February 27, 2003.

Answers to Key Questions About Private Pension Plans. GAO-02-745SP. Washington, D.C.: September 18, 2002.

GAO's Mission

The Government Accountability Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site (www.gao.gov). Each weekday, GAO posts newly released reports, testimony, and correspondence on its Web site. To have GAO e-mail you a list of newly posted products every afternoon, go to www.gao.gov and select "Subscribe to Updates."

Order by Mail or Phone

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. Government Accountability Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: www.gao.gov/fraudnet/fraudnet.htm
E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Congressional Relations

Gloria Jarmon, Managing Director, JarmonG@gao.gov (202) 512-4400
U.S. Government Accountability Office, 441 G Street NW, Room 7125
Washington, D.C. 20548

Public Affairs

Paul Anderson, Managing Director, AndersonP1@gao.gov (202) 512-4800
U.S. Government Accountability Office, 441 G Street NW, Room 7149
Washington, D.C. 20548

PRINTED ON RECYCLED PAPER