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Chairman McCain, Ranking Member Hollings, Members of the Committee, I welcome this opportunity to appear before you to discuss the financial and policy challenges facing the private defined benefit pension system and federal pension insurance program. Before turning to those challenges I want to emphasize that while the pension insurance fund is under increasing pressure and plan sponsors have been buffeted by a variety of forces, what is steadfast is the Administration's position that pension promises made by businesses to America's workers and retirees must be honored.

I also want to assure you and the participants in defined benefit plans that the PBGC stands ready to carry out its mission and pay benefits to participants when a pension plan is surrendered by a sponsoring company, as the agency has done since the enactment of ERISA 30 years ago last month. We currently pay monthly benefits to nearly half a million beneficiaries, and both retirees and participants with deferred benefits should know that the PBGC has sufficient resources to pay these benefits for a number of years. At the same time, the longer-term solvency of the pension insurance program, which we are here to talk about today, is at risk.

Considerable attention has been—and must be—paid to the PBGC's financial position. The Corporation's single-employer insurance fund had a record deficit at the end of the 2003 fiscal year of $11.2 billion, and we will be reporting a significantly increased deficit for the 2004 fiscal year. As you know, United Airlines has said publicly that it will not make any further contributions to its pension plans during bankruptcy and that it "likely" will have to terminate them. Those plans are now underfunded by an estimated $8.3 billion on a termination basis, $6.4 billion of which is guaranteed by the PBGC.

Likewise, US Airways, which recently re-entered bankruptcy, announced that it is suspending contributions to pension plans that are already underfunded by an estimated $2.3 billion on a termination basis, almost all of which—$2.1 billion—would be guaranteed by the PBGC. In addition, Delta has publicly indicated that the company may have to file under Chapter 11 in the near future. We estimate that the total exposure of plan participants and the pension insurance program to the airline industry was $31 billion on a termination basis as of the end of 2003.

While developments in the airline industry are cause for concern, they are symptomatic of a broader and deeper set of problems confronting the pension insurance program, plan sponsors, and beneficiaries. I believe these issues can be distilled to two central themes—corporate responsibility and retirement security. Simply put, companies should be held accountable to make good on the pension promises they have made to their workers and retirees. The consequences of not honoring these commitments are unacceptable—the retirement security of millions of current and future retirees is put at risk.

When underfunded pension plans terminate, three groups can lose: workers face the prospect of benefit reductions; other companies, including those that are healthy and have well funded plans, may face higher PBGC premiums; and, ultimately, taxpayers may be called upon by Congress to bail out the pension insurance fund, just as was the case more than a decade ago with the savings and loan bailout. (It should be noted, however, that under current law the PBGC does not have the full faith and credit backing of the U.S. government.) Of the three groups at risk, only financially robust plan sponsors have the ability to protect themselves from losses by ending their plans and exiting the system. This is the unfortunate but all too predictable result of a system that allows—and, one might even argue, sometimes encourages—companies to avoid paying for the promises they have made.

Structural Flaws in the Pension Insurance Program

I would group the structural flaws in the pension insurance program into three general categories.

The first is a Byzantine and often ineffectual set of funding rules. They are needlessly complex and fail to ensure that many pension plans are and remain adequately funded. Among the features that are impossible to square with the goal of simplicity and prudent funding: multiple liability measures, multiple discount rates, smoothing mechanisms, reclassification of contributions from one year to the prior year, credit balances, excessive discretion over actuarial assumptions, and varying amortization periods. As a result, companies can say they are fully funded when in fact they are substantially underfunded. Worse, the funding rules allow companies to avoid making contributions when they are substantially underfunded. And in some circumstances, they actually prevent companies from making contributions during good economic times. The bottom line is that we wouldn't be here today if the funding rules worked properly.

One flaw worth highlighting is that the funding targets are set too low. Employers can stop making contributions 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. As a result, employers can stop making contributions before a plan is sufficiently funded to protect participants. 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. No wonder the US Airways pilots were shocked to learn just how much of their promised benefits would be lost. Similarly, the funding rules allow contribution holidays even for seriously underfunded plans. Bethlehem Steel made no cash contributions to its plan for three years prior to plan termination, and US Airways made no cash contributions to its pilots' plan for four years before termination.

The second problem is what economists refer to as "moral hazard." A properly designed insurance system has various mechanisms for encouraging responsible behavior that will lessen the likelihood of incurring a loss and discouraging risky behavior that heightens the prospects of claims. That is why banks have risk-based capital standards, why drivers with poor driving records face higher premiums, why smokers pay more for life insurance than non-smokers, and why homeowners with smoke detectors get lower rates than those without.

However, a poorly designed system can be gamed. A weak company will have incentives to make generous pension promises rather than increase wages. Employees may go along because of PBGC's limited guarantee of pension benefits. If the company recovers, it may be able to afford the

increased benefits. If not, the costs of the insured portion of the increased benefits are shifted to other companies through the insurance fund. Similarly, a company with an underfunded plan may increase asset risk to try to make up the gap, with much of the upside gain benefiting shareholders and much of the downside risk being shifted to other premium payers.

Unfortunately, the pension insurance program lacks basic checks and balances. There are no risk-based underwriting standards. Plan sponsors face no penalties regardless of the risk they impose on the system. And there is relatively little consequence to acting irresponsibly and not funding pension promises. As a result, there has been a tremendous amount of cost-shifting from financially troubled companies with underfunded plans to healthy companies with well-funded plans.

Bethlehem Steel presented a claim of $3.7 billion after having paid a little over $60 million in premiums, despite the fact that the company was a deteriorating credit risk and its plans were substantially underfunded for several years prior to the time the PBGC had to step in. (See Chart 1.) Similarly, while United's credit rating has been junk bond status and its pensions underfunded by more than $5 billion on a termination basis since at least 2000, it has paid just $50 million in premiums to the insurance program. Yet the termination of United's plans would result in a loss to the fund of more than $6 billion. (See Chart 2.) This subsidization extends across industry sectors—to date, the steel and airline industries have accounted for more than 70% of PBGC's claims by dollar amount while covering less than 5% of the insured base.

The third category of structural flaws is the lack of transparency in the system. The funding and disclosure rules seem intended to obfuscate economic reality. That is certainly their effect—to shield relevant information regarding the funding status of plans from participants, investors and even regulators. This results from the combination of stale, contradictory and often misleading information under ERISA and the accounting standards. For example, the principal governmental source of information about the 31,000 private sector defined benefit plans is the Form 5500. Because ERISA provides for a significant lapse of time between the end of a plan year and the time when the Form 5500 must be filed, when PBGC receives the complete documents the information is typically two and a half years old. It is exceedingly difficult to make informed business and policy decisions based on such dated information, given the dynamic and volatile nature of markets.

The PBGC does receive more timely information regarding a limited number of underfunded plans that pose the greatest threat to the system, but the statute requires that this information not be made publicly available. This makes no sense. Basic data regarding the funded status of a pension plan, changes in assets and liabilities, and the amount that participants would stand to lose at termination are vitally important to participants. Investors in companies that sponsor the plans also need relevant and timely information about the funded status of its pensions on a firm's earnings capacity and capital structure. While recent accounting changes are a step in the right direction, more can and should be done to provide better information to regulatory bodies and the other stakeholders in the defined benefit system.

<u>Trends in the Defined Benefit System</u>

These structural flaws not only threaten the solvency and undermine the integrity of the pension insurance program but are part of a broader set of forces that must be addressed to ensure the viability of the defined benefit system.

The trend lines paint a disturbing picture. Traditional defined benefit pension plans, based on years of service and either final salary or a specified benefit formula, at one time covered a significant portion of the workforce, providing a stable source of income to supplement Social Security. The number of private sector defined benefit plans grew through the 1960s and '70s before reaching a peak of 112,000 in the mid-1980s. At that time, some 40 percent of Americans workers were covered by defined benefit plans. (See Chart 3.)

Since then, there has been steady erosion in the number of defined benefit plans offered. Over the past two decades, the number of defined benefit plans has fallen by 75 percent to just over 31,000 plans today. Moreover, just 1 in 5 workers—20 percent of the workforce—now participates in a private sector defined benefit plan. Notably, no new plans of significant size have been established in recent years. (An exception is the United Methodist Church, which in May created a traditional DB plan for its 25,000 American pastors and lay employees. The plan, though, does not fall under the insurance coverage of PBGC.)

But the decline in the number of plans offered and workers covered doesn't tell the whole story of how changes in the defined benefit system have impacted retirement income. There are other significant factors that can undermine the goal of a stable income stream for aging workers.

For example, in lieu of outright termination, companies are increasingly "freezing" plans. Surveys by pension consulting firms show that a significant number of their clients have or are considering instituting some form of plan freeze. PBGC is also conducting its own survey on plan freezes to obtain more comprehensive data on the phenomenon. Freezes not only eliminate workers' ability to earn additional pension benefits but often serve as a precursor to plan termination, which further erodes the premium base of the pension insurance program. Workers and retirees deserve the opportunity to have a number of options for retirement security, which is why the Administration is committed to making defined benefit plans a legally and regulatorily viable option for employers.

Mr. Chairman, given the serious challenges facing the pension insurance program, no amount of tinkering will achieve the lasting solution we need to put the PBGC on a sound footing and to restore the confidence of workers and retirees who rely on our pension protection. On the contrary, we need a considered and comprehensive approach that will improve the financial health of the defined benefit pension system, protect participants' benefits, and return the pension insurance program to financial strength.

The PBGC and others in the Administration have been hard at work identifying the challenges facing the defined benefit pension system and proposing responsible solutions for more than two years. As far back as June of 2002, my predecessor testified before Congress that PBGC was facing a big financial challenge. His warning, considered dire at the time, seems prescient today:

> "I'm concerned that our surplus may decline even further … [W]e still face over $9 billion in underfunding in the steel industry, nearly half of which is in companies that are in bankruptcy proceedings. We also face large amounts of underfunding in troubled companies in the airline and retail sectors."

PBGC went on to absorb most of that $9 billion in steel industry underfunding and now runs the risk of inheriting much of the airline industry's underfunding as well.

Since June of 2002, PBGC has testified seven additional times before Congress, issuing increasingly strong warnings about the dangers facing the defined benefit pension system and mapping out the major elements of reform. Moreover, in July of 2003, Assistant Labor Secretary Ann L. Combs and Treasury Undersecretary Peter R. Fisher gave testimony in which the first three elements of pension reform were detailed for Congress. The proposal is even more relevant today than it was 15 months ago.

First, as the necessary initial step toward comprehensive reform of the funding rules, the proposal would improve the accuracy of the pension liability measurement to reflect the time structure of each pension plan's benefit payments. This would be accomplished by measuring a plan's liabilities using a yield curve of highly rated corporate bonds to calculate the present value of those future payments. Second, the proposal would require better disclosure to workers, retirees, investors and creditors about the funded status of pension plans, which will improve incentives for adequate funding. Third, the proposal provides new safeguards against underfunding by requiring financially troubled companies with highly underfunded plans to immediately fund or secure backing for additional benefits, benefit improvements, and lump sum payments.

Unfortunately, no action has yet occurred on these proposals. In fact, last fall and into the early part of this year, much of the debate centered on how much funding forbearance plan sponsors should be allowed. In the end, plan sponsors received two years of a single, smoothed corporate-bond interest rate to discount their pension liabilities, which the Administration supported as a transition to use of the corporate-bond yield curve. But an extra provision exempted companies in the steel and airline industries from the special catch-up contributions designed to get plans better funded before they can terminate. As the PBGC warned last November:

> "Giving a special break to weak companies with the worst-funded plans is a dangerous gamble. The risk is that these plans will terminate down the road even more underfunded than they are today. If that happens, workers will lose promised benefits and the pension insurance program will suffer additional multibillion-dollar losses."

The members of PBGC's Board of Directors—the Secretaries of Labor, Treasury and Commerce—also issued strong warnings in November 2003 and again in January 2004 against extra funding holidays. What the Administration warned would happen is now coming to pass. Two of the airlines given a break on their required pension contributions are now in Chapter 11 and threatening to terminate their underfunded pension plans.

Comprehensive Reform Needed

Ultimately, we need comprehensive reform of the laws governing defined benefit pension plans in order to put the system on a sustainable path. The goals of reform are straightforward—to protect the pensions of the 44 million workers and retirees who are relying on the promises made by their employers; to ensure that companies adequately fund the promises they make; and to eliminate the incentive for companies to shift to others the cost of unfunded pension obligations.

To meet these goals, we need to streamline and strengthen the ERISA funding rules. Reform must provide sounder pension plan funding. The level of underfunding in the private defined benefit system—estimated last year to be more than $350 billion—poses a substantial risk not only to beneficiaries, but also potentially to premium payers and perhaps even eventually to taxpayers if the

government is called upon to bail out the system. We need to stop the hole from getting bigger. Then, we need to make sure that the process is underway to fill the hole in a responsible and measured manner.

The current funding rules must be strengthened to ensure that accrued benefits are adequately funded. This is particularly important for those plans at the greatest risk of terminating. Various weaknesses in current law—funding holidays, so-called credit balances, unfunded benefit increases and weak liability measures—need to be fixed with a new set of rules that require sponsors falling below minimum funding levels to fund up. The rules should also be simpler and provide greater flexibility, especially for financially healthy plan sponsors. Overly prescriptive funding rules for companies that pose little or no risk of loss discourage those companies from maintaining their defined benefit plans. If we harbor any hope of keeping healthy companies in the defined benefit system we need to give them better incentives. We should allow higher tax-deductible contributions during good economic times and minimize precipitous funding increases during tough economic times.

Under existing rules, assets can be measured as multi-year averages rather than current values. Pension funding levels can only be set appropriately if both asset and liability measures are current and accurate. Failure to accurately measure assets and liabilities contributes to funding volatility. Properly structured funding rules can reduce volatility not by having the PBGC assume additional risk, but by providing better incentives for plan sponsors to adequately fund their pension promises.

We need to rationalize PBGC's premium structure. The objective is to implement a premium structure that meets the PBGC's long-term revenue needs and appropriately reflects the risks that it covers. Currently, PBGC's premium income is inadequate to cover projected claims, and the premium structure provides minimal incentives for plans to remain funded.

The heavy reliance of the premium structure on flat-rate charges leads to insurance that is underpriced for bad risks and that shifts wealth from healthy companies to unhealthy companies, as evidenced by the 70 percent of claims from the steel and airline industries. PBGC premiums can also play a useful role in encouraging sound plan funding and discouraging risky behavior. The premium structure should be reformed to provide sound incentives, to reflect the risks faced by the PBGC, including both potential claim incidence and claim severity, and to appropriately fund the federal insurance program.

We must require more timely, meaningful information on pension plans' funding levels. Too often in recent years, participants in defined benefit pension plans have mistakenly believed that their plans were well funded, only to receive a rude shock when the plan is terminated and benefits are lost. Investors are also put at risk when the true impact of a company's pension plan on its capital structure and future earnings is hidden from view. Simply put, workers, retirees, investors, and regulators need better and more timely information regarding the financial condition of pension plans.

I also believe that the PBGC needs better tools to carry out its statutory responsibilities in an effective way. While the PBGC is charged with administering the pension insurance program, recent events have demonstrated that the agency's ability to protect the interests of beneficiaries and premium payers is extremely limited. This is especially true when a plan sponsor enters bankruptcy. Currently, the agency has few tools at its disposal other than to move to terminate a plan. The PBGC should be given limited new authority to specifically respond to actions that pose a

substantial risk of loss to the beneficiaries or the pension insurance fund, particularly in the bankruptcy context.

These are clearly complex issues and inevitably require policy trade-offs and a balancing of competing considerations. We look forward to working with Congress to resolve these issues and implement comprehensive reforms consistent with this framework that will put the pension insurance program on solid footing and strengthen the defined benefit system as a whole. The Administration's goal is not only to halt the exodus from the defined benefit system, but once again to make some form of defined benefit plan an economically and regulatory viable option for employers to offer to their employees.

I recognize that the legislative session is waning and that there is not sufficient time to give appropriate consideration to a comprehensive reform package. Moreover, comprehensive reforms, even if enacted, will need time in order to have a beneficial effect on systemic pension underfunding. However, I would encourage Congress to consider as timely a response as possible to some of the developments we have witnessed in the past few weeks. I am particularly concerned with the temptation, and, indeed, growing tendency, to use the pension insurance fund as a means to obtain an interest-free and risk-free loan to enable companies to restructure. Unfortunately, the current calculation appears to be that shifting pension liabilities onto other premium payers or potentially taxpayers is the path of least resistance rather than a last resort.

The PBGC will do all it can to protect the interests of workers and retirees, to ensure compliance with the statutory and regulatory requirements, and to discourage irresponsible behavior. However, we have relatively few arrows in the quiver, and they are not particularly sharp. The decision by United Airlines and US Airways not to make any further payments to their pension plans while in bankruptcy—and to do so without consequence, notwithstanding the fact that such payments are required by federal law—highlights the problem. In the ordinary course, if a company misses a required pension payment, a lien arises and the PBGC is able to perfect and enforce the lien on behalf of the pension plan. However, under the bankruptcy code, perfection of a lien is automatically stayed. Providing for an exception to the automatic stay would better enable the PBGC to protect the interests of the workers and retirees that it insures and make it clear that we place a high priority on meeting pension promises made to workers and retirees. Moreover, with such a change, we could expect creditors to encourage better plan funding to counteract PBGC's strengthened claim in bankruptcy.

Another needed change in the law is to provide plan participants better and more timely information regarding the funded status of their pension plan and the amount of their promised pension benefit they risk losing should the plan terminate. Participants are often the last to know what is at stake when a company enters bankruptcy. In the United Airlines situation, workers should have known much earlier that they stand to lose nearly $2 billion in benefits if the company's plans are terminated. Congress could require companies that enter bankruptcy to promptly inform their participants of the funded status of pension plans on a termination basis and of the amount of benefits that may be lost due to legal limits on PBGC's guarantees.

Conclusion

Mr. Chairman, the defined benefit system and the federal insurance program that stands behind it are being tested more severely than at any time since the enactment of ERISA 30 years ago. At stake is the viability of one of the principal means of providing stable retirement income to millions of

American workers. The challenges are multi-faceted, defy easy answers, and demand a careful balancing of competing interests to achieve workable solutions.

I am confident that such solutions are achievable, and we look forward to working with Congress to find them as expeditiously as possible. Thank you for the opportunity to appear here today, and I would be pleased to answer any questions you may have.

Chart 1

Bethlehem Steel

When the Bethlehem Steel pension plan terminated in December 2002, it was 45 percent funded and had $4.3 billion in unfunded benefit liabilities.

PLAN YEAR	1996	1997	1998	1999	2000	2001	2002
Current Liability Funding Ratio	78%	91%	99%	96%	86%	84%	NR
Was the company required to make a deficit reduction contribution?	Y	N	N	N	N	NR	NR
Was the company obligated to send out a participant notice?	Y	Y	N	N	N	N	N
Did the company pay a Variable Rate Premium?	$15 million	$17 million	N	N	N	N	N
Actual Contributions	$354 million	$32.3 million	$30.9 million	$ 8.1 million	$0	$0	$0
Debt Rating	B+	B+	BB-	BB-	B+	D	Withdrawn
Market Capitalization	$990 million	$980 million	$1,100 million	$1,100 million	$230 million	$50 million	$14 million

Chart 2

United Airlines

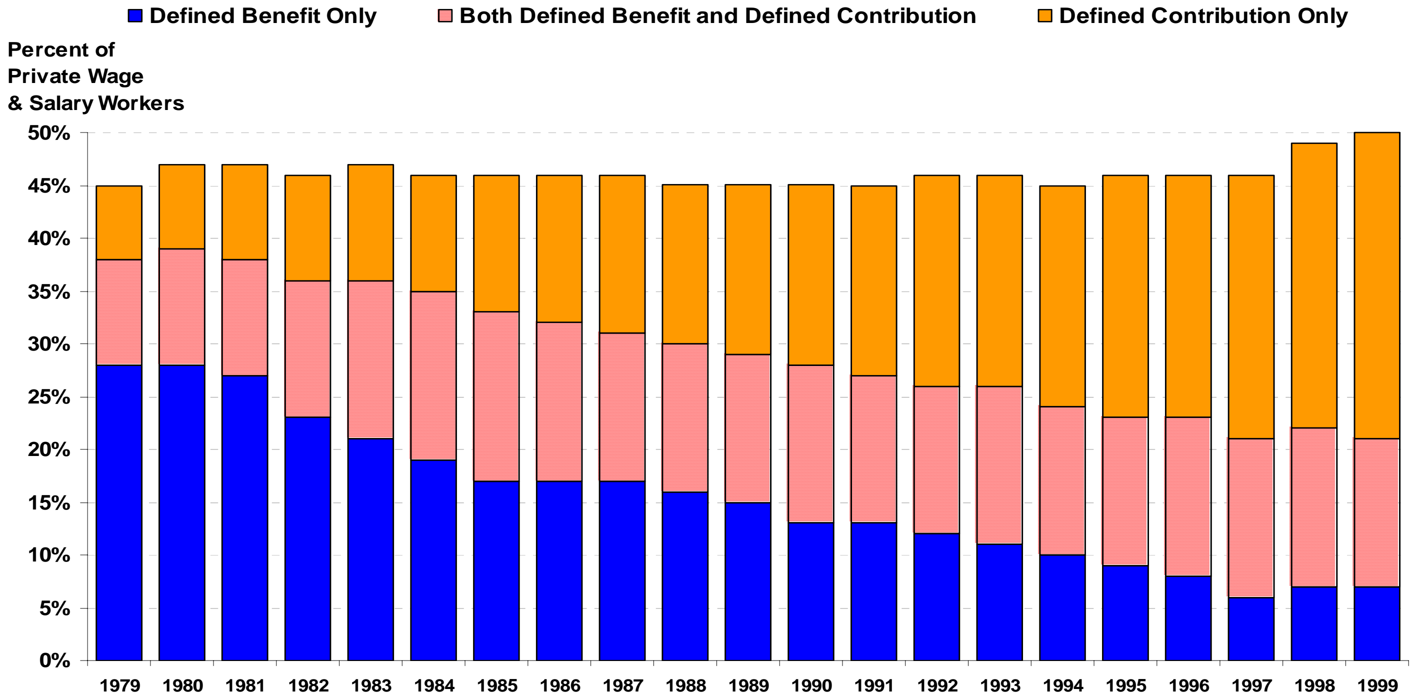
As of July 31, 2004, United Airlines' pension plans were 46 percent funded and had $8.3 billion in unfunded benefit liabilities.

PLAN YEAR	1998	1999	2000	2001	2002	2003	2004
Current Liability Funding Ratio	99%	95%	98%	95%	99%	72%	NR
Termination Liability Funding Ratio (Unfunded Benefit Liability)			Non-Public	Non-Public	Non-Public	45% ($7.5 billion)	46% ($8.3 billion)
Was the company required to make a deficit reduction contribution?	N	N	N	Y*	N	Y**	Y (projected)
Was the company obligated to send out a participant notice?	N	N	N	N	N	N	NR
Did the company pay a Variable Rate Premium?	N	N	N	N	N	Y (2 of 4 plans)	Y (projected)
Actual Contributions	$199.9 million	$199.9 million	$0	$0	$0	$ 133 million ($ 428 mil required) (estimate)	$ 0 ($ 803 mil required)***
Debt Rating	BB+	BB+	BB+	BB+	D	D	D
Market Capitalization	$3,092 million	$3,938 million	$2,046 million	$ 742 million	$ 118 million	$ 179 million	$ 134 million

* In 2001, only the Flight Attendants plan was subject to a DRC contribution ($212 million), but this amount was offset by credits.
** DRC totaling $660 million for three plans (DRC not required for Pilots plan)
*** Reflects missed contributions for Plan Year 2003

Chart 3

Defined Benefit Participation Rates



Source: U S Department of Labor
Employee Benefit Security Administration
Abstract 1999 Form 5500