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PBGC'S UNFUNDED PENSION LIABILITIES: WILL TAXPAYERS HAVE TO PAY THE BILL?

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED NINTH CONGRESS

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PBGC'S UNFUNDED PENSION LIABILITIES: WILL TAXPAYERS HAVE TO PAY THE BILL?

THURSDAY, JUNE 9, 2005

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 9:31, in room 210, Cannon House Office Building, Hon. Jim Nussle (chairman of the committee), presiding.

Members present: Representatives Nussle, Ryan, Conaway, Chocola, Spratt, Moore, Neal, Edwards, Cooper, Davis, Case, and Schwartz.

Chairman NUSSLE. The budget hearing will come to order.

I understand that there are members who are still trying to get to the Hill as a result of the early morning fire at the Rayburn Building, but we will begin the hearing.

Our witnesses have time constraints. I know members will have time constraints as a result of votes on the floor being done today, approximately 1 o'clock.

This is a full committee hearing on PBGC's [Pension Benefit Guaranty Corporation] unfunded pension liabilities, and we have an opportunity today to hear from two expert witnesses who have testified often before our committee. We welcome back: David Walker, the Comptroller General, and Douglas Holtz-Eakin, the Director of the Congressional Budget Office [CBO].

Good morning, and welcome to this hearing.

I understand that you, General Walker, have a plane to catch, I believe at 11:30 a.m. So we will try and get into this as quickly as possible. And I ask members to be as succinct as possible.

The focus of today's hearing is really three-fold.

First, to look at the magnitude of the problems facing our Nation's system of pension benefits and the implications of those problems, not only for future pensioners, but also for taxpayers as a whole.

Second, to discuss how the Federal budget might better account for unfunded obligations or the enormous projected shortfalls of our Nation's pension guarantee system.

Third, to review some of the areas likely in need of reform. And I am not talking about any specific proposal today that I am offering or that I would assume any other members are offering, but rather what key areas we need to look at or address if we are going to try and tackle this.

I think most people of working age have a pretty good grasp of what the pension plans are all about. And while maybe not to the

extent of my father's generation, many of us in their 40's and 50's who are planning for or getting ready, near retirement, are counting on at least pensions to be a portion of that retirement.

So I don't have to tell anybody why the guarantee of promised pension benefits is a very critical issue, for not only our Nation's workers and retirees, but we will find out today, as well for our taxpayers.

The subject has been gaining quite a bit of steam in the press in the last few weeks. I am not sure that there is a clear understanding of why pension benefits are facing such a large shortfall in the future as I read the press accounts. So I will just give a quick overview from the way I see it, and this is in part why we have a hearing today.

For about the last 30 years, the Employee Retirement Income Security Act mandated companies that offered employee defined benefit pension plans to obtain insurance for these plans through the PBGC Corporation, or the Pension Benefit Guaranty Corporation.

The intent was to ensure that the promised retirement benefits of U.S. workers would be maintained, even if the company became insolvent or for some reason the pension plan failed.

So in a nutshell, if the pension plan collapsed, the PBGC would take over, pool its current assets with those of other failed plans, then use the resources, coupled with premiums from other participating companies that are purchasing the insurance, to pay for benefits.

Now in theory, the PBGC was supposed to be completely self-financing. The assets it assumed when it took over the failed pension plan, combined with the insurance premiums that were paid to the corporation by the participating companies, were supposed to be adequate to supply the resources to satisfy the pension promises.

But as we are discovering, and as most of us here know, that is not what has been happening. According to PBGC, its current total assets fall short about $23 billion of the amount needed to pay all of the benefits currently promised to pension beneficiaries.

As equity values declined during the recession of the 2000-2001 time period, several major pension benefit plans were terminated and turned over to PBGC with substantial underfunding, including the LTV Corporation, Bethlehem Steel and the now-terminated United Airlines plan.

Because these plans are large and also substantially underfunded, they have created a significant shortfall for the PBGC. And according to the Congressional Budget Office, that is not even half the story we are going to hear today from their soon-to-be-released report that I think is going to be part of the testimony today. Just to peek at that a moment, we understand that CBO is going to estimate that it could rise another $75 billion, or the difference between projected future obligations of the PBGC and the agency's projected resources.

All told, PBGC is expected to run about $100 billion short of the resources needed to pay promised benefits from failed private pension plans, according to the report, as I understand it. To make matters worse, the Center on Federal Financial Institutions, which tracks pensions, tells us that on the current path, all PBGC assets

will be exhausted, completely gone, by 2021, just 15 years from now.

So where does that leave us? Well, under the current scenario, if and when PBGC's assets fall short, the choice is really one of two right now. Either for pension holders to lose about $100 billion in promised retired benefits, or for the taxpayers to get slapped with about a $100 billion bill for failed private pension plans.

In the realm of fairness, I don't think either one of those choices is going to be very palatable, and in the realm of politics, probably very difficult. So I think we need to talk about how we are going to solve this problem, and if you look at how the budget fails to recognize the problem, it even gets worse.

First, we have a problem accounting for the balances in PBGC. The current budget figures do not reflect the true cost to the Government of taking over failed plans. It only reflects the agency's annual cash flow, which in 2004 showed that the agency had a net surplus of $247 million, even though it was carrying $23 billion in unfunded liabilities from pension plans it had already taken over. And that doesn't include the unfunded liabilities from pension plans it will likely take over, which again, according to CBO, would be as much as about $75 billion.

The PBGC's so-called unfunded obligations are a prime example of similar problems in other large government programs, especially insurance programs.

Most of us recall the enormous tax burden that came to us in the 1980s when the savings and loan debacle occurred, and when savings and loans collapsed. Due in large part to insufficient accounting, we missed the warning signs on that one, and it led to a major fiscal crisis. Policy experts have long advocated finding ways to report these obligations regularly, and if possible, to budget for them.

Back in 1997, Congressman Cardin and I began an effort to have the budget reflect actual costs of government liabilities, including likely risks. So I am especially looking forward to the discussion today, particularly in light of the warnings that we have received, looking at the shortfalls for PBGC. We need to talk about accrual accounting. There are many members who are leaders in that regard and have bills and legislation and ideas.

One final note: I am sure that this is a good area for finger pointing. If that is the case, not only today and in coming months, as to who is to blame for the state of the Nation's pension systems, but I think we need to keep a couple of things in mind.

One is that defined benefit plans and the PBGC were created in a different time, really for a different economy. American companies were competing with other American companies, who were also figuring pension benefits into their bottom line.

Today, companies are competing in a global marketplace, which is much different than when these plans and PBGC were developed. As of today, many newly industrialized nations have little or no employee benefits to add to their bottom line.

These same companies are also competing with new American companies, who don't offer defined benefit pensions, but rather defined contribution plans, which are less expensive and don't burden the company with the risk of those plans. So while defined benefit pension plans are becoming less and less common in newer compa-

nies and nearly nonexistent overseas, companies who still offer these plans can find themselves at a substantial financial disadvantage to those companies who don't.

The second point I would make is that the same demographic changes that are putting enormous stress on Social Security, such as the static workpool, the aging population, the longer life expectancies and significantly higher wages and thus higher benefits are causing some of the imbalances in the pension system.

Point three, and perhaps most important, would be that PBGC was set to be self-financing, yet it cannot achieve that goal if a number of large, severely underfunded pension plans fail. A plan underfunding destabilizes the whole system, and yet the rules we have created to prevent it are complicated, ineffective, and too often easily evaded.

All of that said, for the loyal workers who were promised benefits and are counting on those benefits to help fund their retirement, that explanation provides exactly no relief. They expect, and rightly so, that the benefits that are the ones they were promised are received. And the American taxpayers are the ones who stand to be the biggest losers in all of this, simply through default, I will guess that bailing out private pension plans is not high on their priority list of how they would like to have their tax dollars spent.

So no question, I can't imagine anyone that can find an easy answer to correct this problem. It is going to be a difficult balancing act, but nevertheless, we have to start understanding this problem and its fiscal consequences for our economy and for our budget immediately.

I would like to thank the leadership of my friend and colleague Mr. Spratt, who requested this hearing. I was eager to join him in holding the hearing, but he requested it. I appreciate his leadership in coming forward and asking that we hold this very important hearing today. And with that, I would turn to him for any comments he would like to make.

Mr. SPRATT. Mr. Chairman, thank you very much, first of all for holding the hearing as I requested and also for your opening statement, because I think you have stated the problems squarely that we have to confront.

I also want to thank our two witnesses, Comptroller General David Walker and CBO Director Douglas Holtz-Eakin. They are regulars at our hearings, but we always are the beneficiaries for their wisdom and advice and their analytical input to the decisions we have to make.

Rather than repeat or plow over ground that the chairman just covered, let me simply say that we clearly have more things to do on the Budget Committee than just priorities about spending and revenues. We need to be one of the committees in Congress that looks forward to problems that are not yet fully fleshed out and try to bring timely attention to them so that they can be resolved earlier, at a lesser cost and with better solutions than we do typically when we leave things to the crisis stage to be addressed.

And PBGC, the Pension Benefit Guaranty Corporation, falls squarely in that realm.

We have the largest cash budget in the world, the Federal budget. As a consequence, there are a number of accrual that we simply

don't recognize, don't accommodate, don't even include, except in appendices nobody ever reads, to our budget.

So one of the questions that we have to ask ourselves today and in future hearings of this kind is with our cash budget, our non-accrual budget, how do we nevertheless make budget issues like the accumulation of accrued liabilities for the pensions of the United States, the defined benefit pensions, something that is annually considered, particularly when the system is not adequately assessing the risk, underfunding, the health of corporate sponsors.

One of the problems clearly we have here that you can discern just from a superficial reading of the testimony of the two witnesses that is about to be presented, is that there are so many factors that we don't yet have a good handle for.

The statement of the shortfall in the Pension Guaranty trust fund may relate to the fact that a financially healthy and very able corporation has simply not funded adequately its pension plan, but nevertheless, it is a corporate parent or sponsor of that plan, stands liable for the assets it may not reflect any kind of necessary liability to the Government.

Secondly, the plan may be invested in gilt-edge assets, or it may be invested in assets whose net realizable value cannot be achieved with the liquidation of those assets.

There are a whole host of problems like this what we simply haven't resolved. We have coasted along with this program for a long time, and now we have some hard questions to ask:

How do you adjust the premiums to reflect the financial and economic reality? How do you baseline those premiums so that when we do the budget every year, we can tell the policy changes actually affect or improve or worsen the baseline, which the CBO is trying to develop now.

But Dr. Holtz-Eakin, as I read your testimony, I think you would describe it as a work in progress. You aren't really through with it, which is an illustration of how difficult it is to get your hands around this problem.

As difficult as it may be, politically and simply institutionally, to address the proper response to is, we need to be paying close attention to it and bending every effort to get this done, not only to get it done, but done right, so that we can put this plan on a firm basis for the future.

With that, let me end, and I will welcome again our two witnesses and say we look forward to your testimony today and your help in the future as we address this problem.

Chairman NUSSLE. Thank you, Mr. Spratt.

And my understanding is that, General Walker, you will go first with your testimony.

Welcome back to the committee. Thank you for your leadership in not only bringing this problem to our attention, but also in giving us ideas of solutions. We are pleased to receive your testimony.

Your written testimony will be made part of the record. And I would also ask unanimous consent that all members have the opportunity to place an opening statement in the record.

Mr. Walker.

STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES

Mr. WALKER. Thank you, Mr. Chairman, Ranking Member Spratt, and other members of the House Budget Committee. It is a pleasure to be back before you, this time to talk about the Pension Benefit Guaranty Corporation and related issues.

In the interest of full and fair disclosure, let me remind the members that in a prior life, before I was Comptroller General of the United States, I was a head of the PBGC, Assistant Secretary of Labor for Pensions and Health, and a Trustee of Social Security and Medicare. I think that all of those are relevant to today's topic.

I would respectfully suggest that what we have before us is a subset of a much greater challenge, namely the Pension Benefit Guaranty Corporation is a subset of a broader challenge, which is the state of retirement security in the United States, which includes Social Security, Medicare, private pensions, retiree health, long-term care, and that that is a subset of the broader fiscal challenge that the United States faces because of known demographic trends, rising health care costs and revenues that mismatch promises that have made.

So it is very appropriate and important for this committee to have this hearing to understand how this issue fits within the broader context.

Unfortunately, while this is a significant challenge, it is one of the less material challenges, as you will see. With the aid of your technology, I would like to just show you a few graphics to make several points that I think might be helpful.

I would note that each member should have received this morning this report on a forum that we recently held at GAO (Government Accountability Office) on PBGC and the defined benefit pension system. This report is being released this morning and has been posted to our website.

The first slide, please.

You have seen this before. This is the disembodiment chart. This is the U.S. budget in the long term. Due to known demographic trends, rising health care costs and lower revenues as a percentage of the economy, depending upon what assumptions you use—in this particular case, that discretionary spending grows by the rate of the economy, that all tax cuts are made permanent and that the Social Security and Medicare trustees' estimates of the costs of those programs under the intermediate assumptions are realistic—you can see this is a very sour outlook and an unacceptable path for the only superpower on Earth.

Next, please.

This represents the PBGC. The left bar is assets. The right bar is liabilities. The line represents their accumulated deficit.

They have gone from a $9.7 billion surplus in 2000 to a $23.3 billion accumulated deficit in 2004. I could show you another graphic which would look very similar, which is the Federal budget.

Next.

This represents the state of defined benefit pension plans, based upon GAO's recently issued report. The bottom line is that the most recent data that was available to the Government was 2002.

This is 2005; 2003 data is just now becoming available. That is a problem in and of itself.

Based upon the trends from 1995 to 2002, the bottom line with this chart is that the overall state of funding in the defined benefit system deteriorated during that period of time.

Next, please.

This chart shows that very few cash contributions were made by the 100 largest plans in the system during the period 1995–2002, in part because of flaws in the current funding rules.

There are fundamental flaws in the current funding rules. People are not required to deliver on their promises. People are making promises that they realistically cannot keep. People are doing what the law minimally requires, versus what is the right thing to do.

As we all know, the law represents the minimum standard of acceptable behavior. Hopefully, people should do what is right. Unfortunately in this case, many are not.

Next, please.

This represents how the state of underfunding in the entire defined benefit system has deteriorated dramatically since 2000. The purple represents the possible losses to the PBGC, in other words, entities that are deemed to be high risk as it relates to PBGC.

You can see that the PBGC's exposure has increased significantly. At the end of 2004, it represented about $100 billion. That is in addition to the $23.3 billion accumulated deficit.

Next, please.

This is an example of the problem with the funding rules. Two of the largest losses in PBGC's history, Bethlehem Steel and LTV, and I am going through the period 2002, because that is the data that we had. These represented two of the largest losses in the history of the PBGC insurance system. These companies made no cash contributions in the last years of their life.

And guess what: They weren't required to, based upon the law. In fact, they had significant credits available to them, such that at least one of these plans wouldn't have had to make contributions the next year and possibly thereafter. At the same time, on termination they were only funded at about 50 percent of the level of accrued benefits.

If that doesn't illustrate that the system is broken, I don't know what would.

I think that is it, I believe, with regard to the graphics.

Thank you very much, and I appreciate the opportunity to be with you. I look forward to having the opportunity to answer any questions that you may have.

[The prepared statement of David Walker follows:]

PREPARED STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER GENERAL OF THE UNITED STATES

Mr. Chairman and members of the committee, I am pleased to be here today to discuss the problems and long-term challenges facing the defined benefit (DB) pension system, the Pension Benefit Guaranty Corporation (PBGC), the retirement security of workers and retirees covered by DB plans, and American taxpayers. In particular, I will discuss the factors contributing to those problems and suggest elements of the comprehensive reform necessary to address them.[1] As I have noted before, these problems are a subset of the broader challenges facing the Federal Government and our nation's retirement income system.[2] These programs, which include Social Security, Medicare, and Medicaid, represent large, growing, and

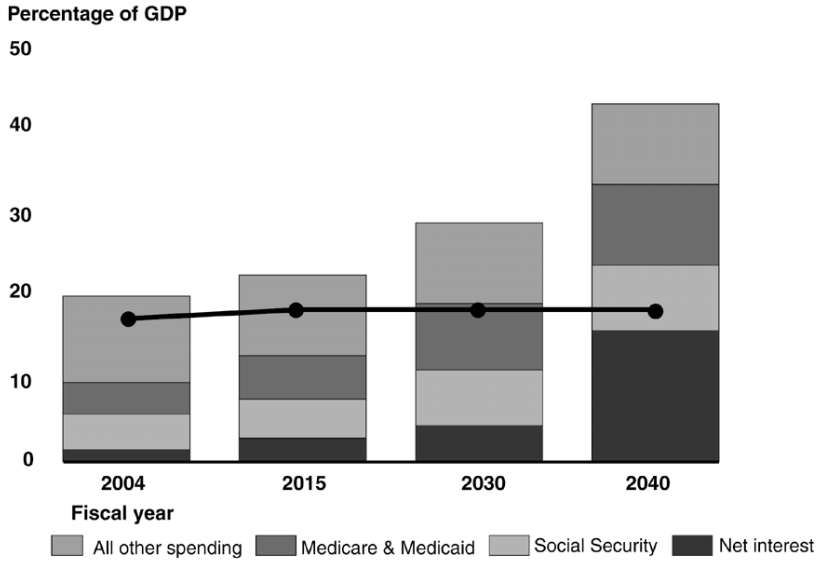
unsustainable claims on the Federal budget because America's population is aging, life expectancies are increasing, workforce growth is slowing, and health care costs are rising.

The long-term effect of Federal retirement programs on the budget is so significant that neither slowing the growth of discretionary spending nor allowing tax cuts to expire—nor both options combined—would by themselves eliminate our long-term fiscal imbalance (see fig. 1). Therefore, as we discussed in our 21st Century Challenges report,[3] tough choices need to be made about the appropriate role and size of the Federal Government—and how to finance that government—and how to bring the panoply of Federal policies, programs, functions and activities into line with the realities of today's world and tomorrow's challenges. More specifically to Federal retirement policy, we need to make choices about how to promote current and long-term economic security in retirement. In that latter context, comprehensively considering our citizens' needs for income, health care, and long-term care is important.

From our nation's overall fiscal perspective, continuing on our current unsustainable fiscal path will gradually erode, if not suddenly damage, our economy, our standard of living, and ultimately our national security.

Therefore, we must fundamentally reexamine major spending and tax policies and priorities in an effort to recapture our fiscal flexibility and ensure that our programs and priorities respond to emerging security, social, economic and environmental changes and challenges.

FIGURE 1: COMPOSITION OF SPENDING AS A SHARE OF GDP ASSUMING DISCRETIONARY SPENDING GROWS WITH GDP AFTER 2005 AND ALL EXPIRING TAX PROVISIONS ARE EXTENDED



Notes: Although expiring tax provisions are extended, revenue as a share of gross domestic product (GDP) increases through 2015 due to (1) real bracket creep, (2) more taxpayers becoming subject to the alternative minimum tax, and (3) increased revenue from tax-deferred retirement accounts. After 2015, revenue as a share of GDP is held constant.

PBGC is an excellent example of the need for Congress to reconsider the role of government programs, in general, and Federal retirement programs, in particular, in light of past changes and 21st century challenges. In 1974, Congress passed the Employee Retirement Income Security Act (ERISA) to respond to trends and challenges that existed at that time.[4] Among other things, ERISA established PBGC to pay the pension benefits of defined benefit plan participants, subject to certain limits, in the event that an employer could not.[5] When ERISA was enacted, defined benefit pension plans were the most common form of employer-sponsored private pension and were growing both in number of plans and in number of participants. Today, defined benefit pensions cover an ever-decreasing percentage of the U.S.

labor force, a fact that raises questions about Federal policy on pensions in general, and defined benefit plans and the PBGC, in particular.

I would now like to outline the challenges facing the defined benefit pension system and PBGC and suggest a framework for evaluating potential policy responses. In summary, a combination of recent events, long-term structural problems, and weaknesses in the legal framework governing pensions has left PBGC with a significant long-term deficit and many large plans badly underfunded. Lower interest rates and equity prices since 2000 have combined to significantly increase pension underfunding through an increase in the present value of pension liabilities, and decreases in the value of pension plan assets. Meanwhile, intense cost competition as a result of globalization and deregulation has led to bankruptcies of plan sponsors in key industries like steel and airlines, and is exposing PBGC to the risk of significant future losses in these and other industries. This competitive restructuring has occurred simultaneously with a long-term decline in defined benefit plan participation that threatens PBGC's revenue base. In addition, the basic legal framework governing pension insurance and plan funding has failed to safeguard the benefit security of American workers and retirees and the PBGC's financial condition. Too many companies are making pension promises that they are not required to deliver on, in part because of perverse incentives and "put options" created under the current pension insurance system.

PBGC's current premium structure does not properly reflect the risks to its insurance program and facilitates moral hazard by plan sponsors. Further, as we have shown in a recent report, current pension funding rules have not provided sufficient incentives, transparency, and accountability mechanisms for plan sponsors to properly fund their benefit obligations and deliver on their promises.[6] As a result, bankrupt plan sponsors, acting rationally and within the rules, have transferred the obligations of their large and significantly underfunded plans to PBGC. These weaknesses in the legal framework contribute to and are exacerbated by a lack of transparent information that makes it difficult for interested stakeholders to understand the true financial condition of and risk associated with selected pension plans.

Given pension plans' crucial significance to our nation's retirement security net, it is useful to compare the challenges facing PBGC's insurance program and Social Security. Both systems require meaningful, comprehensive reform that restores solvency, assures sustainability, and protects the benefits of participants. Similar to that of Social Security, PBGC's current condition does not represent a crisis, though delaying reform will result in serious adverse consequences for individuals, the Federal budget, and our economy. Furthermore, like Social Security, PBGC has plenty of cash on hand today to pay benefits to participants in the short term, but it faces large and growing unfunded obligations and escalating cash flow deficits in the future.

The termination of United Airlines' defined benefit pension plans is just the latest in a recent series of large, underfunded plans taken over by PBGC, and will not be the last. In July 2003, GAO designated PBGC's single-employer insurance program as "high-risk," given its deteriorating financial condition and long-term vulnerabilities.[7] At the end of fiscal year 2004, PBGC estimated that it was exposed to almost $100 billion of underfunding in plans sponsored by companies with credit ratings below investment grade. Though smaller in scale than Social Security, Medicare, and Medicaid, PBGC's deficit threatens to worsen our government's long-term fiscal position.[8] While PBGC is not explicitly backed by the full faith and credit of the U.S. Government,[9] policymakers would undoubtedly face intense pressure to provide PBGC the resources to continue paying earned pension benefits to millions of retirees if PBGC were to become insolvent.

In light of the intrinsic problems facing the defined benefit system, meaningful and comprehensive reform will be needed to ensure that workers and retirees receive the benefits promised to them and to secure PBGC's financial future. At this time, the Administration, Members of Congress, and others have proposed reforms that seek to address many of the problems facing PBGC and the defined benefit system. This is a promising development that can be a critical first step in addressing part of the long-term fiscal problems facing this country.

BACKGROUND

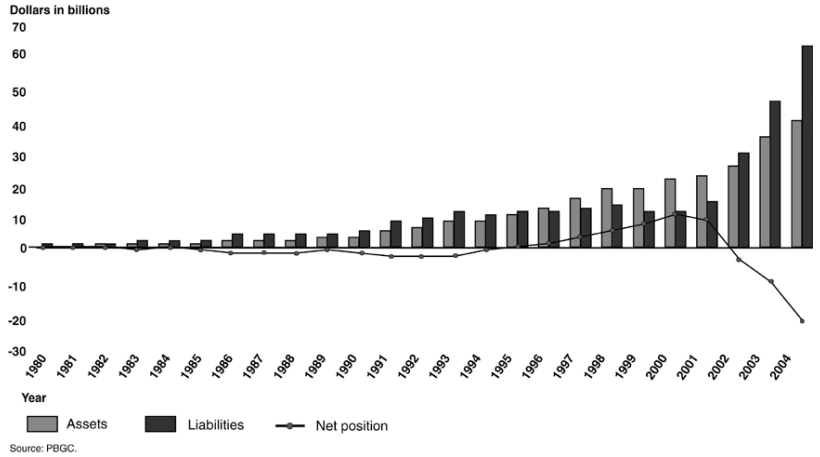
Before enactment of the Employee Retirement Income Security Act of 1974 (ERISA), few rules governed the funding of defined benefit pension plans, and participants had no guarantees that they would receive their promised benefits. Among other things, ERISA created the PBGC to protect the benefits of plan participants 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, insti-

tuted pension insurance premiums, promulgated certain fiduciary rules, and developed annual reporting requirements. When a plan is terminated with insufficient assets to pay its guaranteed benefits, PBGC takes over the plan and assumes responsibility for paying benefits to participants. According to PBGC's 2004 annual report, PBGC provides insurance protection for over 29,000 single-employer pension plans, which cover 34.6 million workers, retirees, and their beneficiaries.[10]

PBGC receives no direct Federal tax dollars to support the single-employer pension insurance program. Instead, the program receives the assets of terminated underfunded plans and any of the sponsor's assets that PBGC recovers during bankruptcy proceedings.[11] PBGC finances the unfunded liabilities of terminated plans with premiums paid by plan sponsors and income earned from the investment of program assets. Premiums have two components: a per participant charge paid by all sponsors (currently $19 per participant), and a variable-rate premium that some underfunded plans pay based on the level of unfunded benefits.[12]

The single-employer program has had an accumulated deficit—that is, program assets have been less than the present value of benefits and other obligations—for much of its existence. (See fig. 2.) 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 fiscal year 2004, the single-employer program incurred a net loss of $12.1 billion, and its accumulated deficit increased to $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.

FIGURE 2: ASSETS, LIABILITIES, AND NET FINANCIAL POSITION OF PBGC'S SINGLE-EMPLOYER INSURANCE PROGRAM



Source: PBGC.

In defined benefit plans, formulas set by the employer determine employee benefits. DB plan formulas vary widely, but benefits are frequently based on participant earnings and years of service, and traditionally paid upon retirement as a lifetime annuity, or periodic payments until death. Because DB plans promise to make payments in the future, and because tax-qualified DB plans must be funded, employers must use present value calculations to estimate the current value of promised benefits.[13] The calculations require making assumptions about factors that affect the amount and timing of benefit payments, such as an employee's retirement age and expected mortality, and about the expected return on plan assets, expressed in the form of an interest rate. The present value of accrued benefits calculated using mandated assumptions is known as a plan's current liability. Current liability provides an estimate of the amount of assets a plan needs today to pay for accrued benefits.

ERISA and the Internal Revenue Code (IRC) prescribe rules regarding the assumptions that sponsors must use to measure plan liabilities and assets. While different assumptions will change a plan's reported assets and liabilities, sponsors eventually must pay the amount of benefits promised; if the assumptions used to compute current liability differ from the plan's actual experience, current liability will differ from the amount of assets actually needed to pay benefits.[14]

Funding rules generally presume that a pension plan and its sponsor are ongoing entities, and plans do not necessarily have to maintain an asset level equal to current liabilities every year. However, the funding rules include certain mechanisms that are intended to keep plans from becoming too underfunded. One such mechanism is the additional funding charge (AFC), which applies to plans with more than 100 participants.[15] The AFC requires plan sponsors to make additional contributions to plans that fall below a prescribed funding level. With some exceptions, plans with reported asset values below 90 percent of current liabilities are affected by the AFC rules.

PBGC'S PROBLEMS STEM FROM RECENT EVENTS, LONG-TERM STRUCTURAL TRENDS, AND WEAKNESSES IN THE LEGAL FRAMEWORK GOVERNING DB PENSIONS

A combination of recent events, long-term structural problems, and weaknesses in the legal framework governing the DB system has left PBGC with a significant long-term deficit and many large plans badly underfunded. Lower interest rates and equity prices since 2000 have combined to significantly increase pension underfunding through an increase in the present value of pension liabilities, and decreases in the value of pension plan assets. Meanwhile, intense cost competition as a result of globalization and deregulation has led to bankruptcies of plan sponsors in key industries like steel and airlines, and is exposing PBGC to the risk of significant future losses in these and other industries. This competitive restructuring has occurred simultaneously with a long term decline in defined benefit plan participation that threatens PBGC's revenue base. In addition, the basic legal framework governing pension insurance and plan funding has failed to safeguard the benefit security of American workers and retirees and the PBGC's financial condition. Too many companies are making pension promises that they are not required to deliver on, in part because of perverse incentives and "put options" created under the current pension insurance system.

PBGC's current premium structure does not properly reflect the risks to its insurance program and facilitates moral hazard by plan sponsors. Further, current pension funding rules have not provided sufficient incentives, transparency, and accountability mechanisms for plan sponsors to properly fund their benefit obligations and deliver on their promises. As a result, bankrupt plan sponsors, acting rationally and within the rules, have transferred the obligations of their large and significantly underfunded plans to PBGC. These weaknesses in the legal framework contribute to and are exacerbated by a lack of transparent information that makes it difficult for interested stakeholders to understand the true financial condition of and risk associated with selected pension plans.

RECENT ECONOMIC FACTORS EXACERBATED THE UNDERFUNDING OF LARGE TERMINATED PLANS BY BANKRUPT SPONSORS

Over the last 5 years, many large pension plans have been adversely affected by simultaneous declines in broad equity indexes and long-term interest rates, as well as by the financial difficulties of their plan sponsors.[16] Poor investment returns from stock market declines affected the asset values of pension plans to the extent that plans invested in stocks. According to the ERISA Industry Committee, assets in private sector defined benefit plans totaled $2.056 trillion at the end of 1999, dropped to $1.531 trillion at the end of 2002, and climbed back to $1.8 trillion by the end of 2004.[17] Lower equity values since the end of 1999 have been particularly problematic because interest rates have also declined and thus increased the present value of plan liabilities.[18] Some sponsors of large pension plans that were terminated were not in sufficiently strong financial condition to meet their pension funding requirements because of weaknesses in their primary business activities. Bankruptcies and pension plan terminations increased around the U.S. economic recession of 2001 and around prior recessions.[19]

These conditions played a part in increasing the unfunded liabilities of plans terminated by bankrupt sponsors since 2000. For example, according to the filing of its annual regulatory report for pension plans, Bethlehem Steel's plan went from 86 percent funded in 1992 to 97 percent funded in 1999. From 1999 to its plan termination in December 2002, plan funding fell to less than 50 percent as assets decreased and liabilities increased and sponsor contributions were not sufficient to offset the changes.

LONG-TERM DECLINES OF KEY INDUSTRIES AND IN DEFINED BENEFIT PENSION COVERAGE HAVE CONTRIBUTED TO PBGC'S WEAKENING FINANCIAL CONDITION

Long-term trends in some sectors of the economy and in defined benefit pension coverage are threatening both PBGC's future solvency and the economic security in

retirement of workers and retirees. PBGC's risk of inheriting underfunded pensions largely stems from the fact that more than half of the pension participants it insures are in the manufacturing and airline sectors, which have been exposed to lower cost competition because of several factors including globalization and deregulation.[20] A potentially exacerbating risk to PBGC is the cumulative effect of bankruptcy in these industries: if a critical mass of firms go bankrupt and terminate their underfunded pension plans, their competitors may also declare bankruptcy to similarly avoid the cost of funding their plans.

PBGC also faces the possibility of long-term revenue declines from demographic changes in the population of defined benefit plan participants and a shrinking number of DB plans. Over the long term, an aging population of defined benefit plan participants threatens to reduce PBGC's ability to raise premium revenues as participants die and are not replaced by enough new participants. The percentage of participants who are active workers has declined from 78 percent in 1980 to just under 50 percent in 2002. Furthermore, PBGC cannot effectively diversify its risk from the terminations of plans in declining economic sectors because companies in other growing industries have generally not sponsored new defined benefit plans. As plan sponsors in weak industries go bankrupt and terminate their pension plans, PBGC not only faces immediate changes in its financial position from taking over underfunded plans, but also faces losses of future revenues from these terminated plans.

A related factor eroding PBGC's premium base is the growth of lump-sum pension distributions. More and more plan participants are exiting the defined benefit system by taking lump-sum distributions from their plans. After a lump-sum distribution is paid, the participant is out of the defined benefit system and the plan sponsor no longer has to contribute to the pension insurance system on the participant's behalf. In addition, lump-sum distributions to participants in underfunded plans can create the effect of a "run on the bank" and worsen a plan's underfunding. In such cases, the plan may terminate without enough assets to pay full benefits to other participants and PBGC may incur losses.

The increasing prevalence of lump-sum distributions in defined benefit plans and the growth of defined contribution plans also raise significant questions about whether many Americans will enjoy an economically secure retirement.[21] Many Americans are at risk of outliving their retirement assets as life expectancies, health care, and long-term care costs continue to increase.

LEGAL FRAMEWORK HAS NOT ENCOURAGED ADEQUATE PLAN FUNDING, CONTRIBUTING TO PBGC'S FINANCIAL DIFFICULTIES

Existing laws and regulations governing pension funding and premiums have contributed to PBGC's financial difficulties and exposed PBGC to greater risks from the companies whose pension plans it insures. PBGC's current premium structure does not properly reflect the risks to its insurance program and facilitates moral hazard by plan sponsors. Further, the pension funding rules, under ERISA and the IRC, have not ensured that plans have the means to meet their benefit obligations in the event that plan sponsors run into financial distress. First, the current rules likely allowed plans to appear better funded than they actually were, in both good years and bad years. And even these reported funding levels indicated significant levels of underfunding in our study of the 100 largest DB plans.[22] Second, plan sponsors often substituted "account credits" for cash contributions, even as the market value of plan assets may have been in decline. And third, the AFC, the primary mechanism for improving the financial condition of poorly funded plans, was ineffective in doing so. These weaknesses contribute to and are exacerbated by a lack of transparent information that makes it difficult for plan participants, investors, and others to have a clear understanding of their plan's financial condition. As a result, financially weak benefit plan sponsors, acting rationally and within the current law, have been able to avoid large contributions to underfunded plans prior to bankruptcy and plan termination, thus adding to PBGC's current deficit.

PBGC'S PREMIUM STRUCTURE DOES NOT PROPERLY REFLECT RISKS TO THE INSURANCE PROGRAM

PBGC's current premium structure does not properly reflect risks to the insurance program. The current premium structure relies heavily on flat-rate premiums, which, since they are unrelated to risk, result in large cost shifting from financially troubled companies with underfunded plans to healthy companies with well-funded plans. PBGC also charges plans a variable-rate premium based on the plan's level of underfunding. However, these premiums do not consider other relevant risk factors, such as the economic strength of the sponsor, plan asset investment strategies,

the plan's benefit structure, or the plan's demographic profile. PBGC is currently operated somewhat more on a social insurance model, since it must cover all eligible plans regardless of their financial condition or the risks they pose to the solvency of the insurance program.

In addition to facing firm-specific risk that an individual underfunded plan may terminate, PBGC faces market risk that a poor economy may lead to widespread underfunded terminations during the same period, potentially causing very large losses for PBGC. Similarly, PBGC may face risk from insuring plans concentrated in vulnerable industries affected by certain macroeconomic forces such as deregulation and globalization that have played a role in multiple bankruptcies over a short time period, as has happened recently in the airline and steel industries. One study estimates that the overall premiums collected by PBGC amount to about 50 percent of what a private insurer would charge because its premiums do not adequately account for these market risks.[23] Others note that it would be hard to determine the market-rate premium for insuring private pension plans because private insurers would probably refuse to insure poorly funded plans sponsored by weak companies.

PBGC IS SUBJECT TO MORAL HAZARD

Current pension funding and insurance laws create incentives for financially troubled firms to use PBGC in ways that Congress likely did not intend when it formed the agency in 1974. At that time, PBGC was established to pay the pension benefits of participants, subject to certain limits, in the event that an employer could not. However, since that time, some firms with underfunded pension plans may have come to view PBGC coverage as a fallback, or "put option," for financial assistance. The very presence of PBGC insurance may create certain perverse incentives that represent what economists call moral hazard—where struggling plan sponsors may place other financial priorities above funding up their pension plans because they know PBGC will pay guaranteed benefits. Firms may even have an incentive to seek Chapter 11 bankruptcy in order to escape their pension obligations. As a result, once a plan sponsor with an underfunded pension plan experiences financial difficulty, these moral hazard incentives may exacerbate the funding shortfall for PBGC.

This moral hazard effect has the potential to escalate, with the initial bankruptcy of firms with underfunded plans creating a vicious cycle of bankruptcies and terminations. Firms with onerous pension obligations and strained finances could see PBGC as a means of shedding these liabilities, thereby providing these companies with a competitive advantage over other firms that deliver on their pension commitments. This would also potentially subject PBGC to a series of terminations of underfunded plans in the same industry, as we have already seen with the steel and airlines industries in the past 20 years.

Moral hazard effects are likely amplified by current pension funding and pension accounting rules that may also encourage plans to invest in riskier assets to benefit from higher expected long-term rates of return. In determining funding requirements, a higher expected rate of return on pension assets means that the plan needs to hold fewer assets in order to meet its future benefit obligations. And under current accounting rules, the greater the expected rate of return on plan assets, the greater the plan sponsor's operating earnings and net income. However, with higher expected rates of return comes greater risk of investment volatility, which is not reflected in the pension insurance program's premium structure. Investments in riskier assets with higher expected rates of return may allow financially weak plan sponsors and their plan participants to benefit from the upside of large positive returns on pension plan assets without being truly exposed to the risk of losses. The benefits of plan participants are guaranteed by PBGC, and weak plan sponsors that enter bankruptcy can often have their plans taken over by PBGC.

CURRENT FUNDING RULES DO NOT PROVIDE SUFFICIENT INCENTIVES FOR SPONSORS TO ADEQUATELY FUND THEIR PLANS

The pension funding rules, under ERISA and the IRC, have not provided sufficient incentives for plan sponsors to properly fund their benefit obligations. The funding rules generally presume that pension plans and their sponsors are ongoing entities and therefore allow for a certain extent of plan underfunding that can be made up over time. However, the measures of plan funding used to determine contribution requirements can significantly overstate the true financial condition of a plan. And even these reported funding levels indicated significant levels of underfunding in our study of the 100 largest DB plans.[24] Furthermore, when plan sponsors make contributions to their plans, they can use account credits, rather than cash, even in cases when plans are underfunded. The funding rules include certain

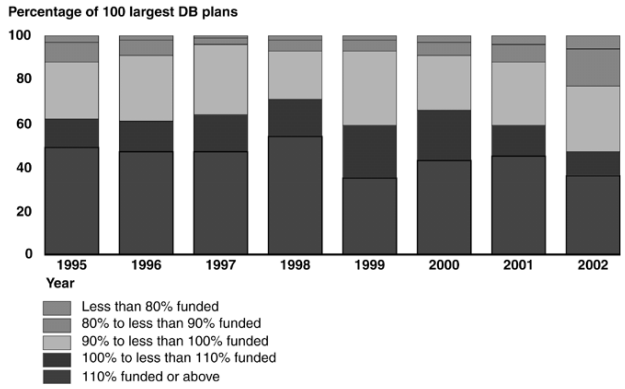
mechanisms—primarily, the AFC—that are intended to prevent plans from becoming too underfunded. However, our analysis shows that for several reasons, the AFC proved ineffective in restoring financial health to poorly funded plans.

RULES MAY ALLOW PLANS TO OVERSTATE THEIR CURRENT FUNDING LEVELS

Current funding rules may allow plans to overstate their current funding levels to plan participants and the public. Because many plans in our sample chose legally allowable actuarial assumptions and asset valuation methods that may have altered their reported liabilities and assets relative to market levels, it is possible that funding over our sample period was actually worse than reported.

Although as a group, funding levels among the 100 largest plans were reasonably stable and strong from 1996 to 2000, by 2002, more than half of the largest plans were underfunded (see fig. 3). On average, each year 39 of these plans were less than 100 percent funded, 10 had assets below 90 percent of their current liabilities, and 3 plans were less than 80 percent funded. In 2002 there were 23 plans less than 90 percent funded.

FIGURE 3: ALMOST ONE-FOURTH OF THE LARGEST PENSION PLANS WERE LESS THAN 90 PERCENT FUNDED ON A CURRENT LIABILITY BASIS IN 2002



Source: GAO analysis of PBGC Form 5500 research data.

Reported funding levels may have been overstated for a number of reasons. These include the use of above-market interest rates, which leads to an understatement of the cost of settling benefit obligations through the purchase of group annuity contracts. Also, actuarial asset values may have differed by as much as 20 percent from current market value of plan assets. The funding rules allow for smoothing out year-to-year fluctuations in asset and liability values so that plan sponsors are gradually, and not suddenly, affected by significant changes in interest rates and the values of their assets. When current interest rates decline, the use of a 4-year weighted average interest rate lags behind, and thus measurements of the present value of plan liabilities do not accurately reflect the cost of settling a plan's benefit obligations.[25]

The terminations of the Bethlehem Steel and LTV Steel pension plans in 2002 (two of the largest plan terminations, to date) illustrate the potential discrepancies between reported and actual funding. In 2002, the Bethlehem Steel Corporation reported that its plan was 85.2 percent funded on a current liability basis, yet the plan terminated later that year with assets of less than half of the value of promised benefits. In 2001, LTV Steel reported that its plan for hourly employees was 80 percent funded, yet when the plan terminated in March 2002, it was only 52 percent funded. From these terminations PBGC's single-employer program suffered losses of $3.7 billion and $1.6 billion, respectively.[26]

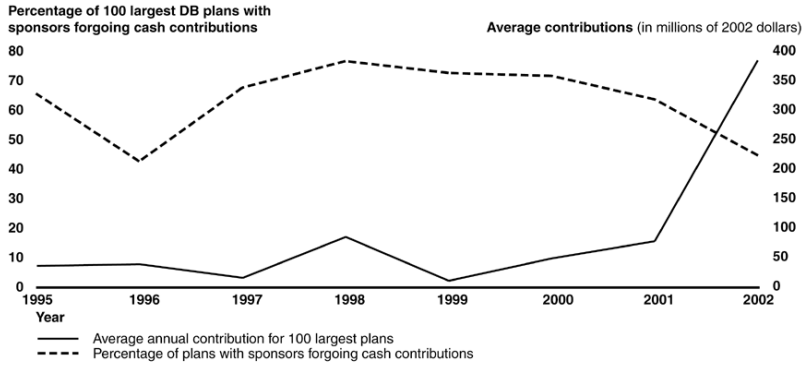
MOST SPONSORS MOST YEARS MADE NO CASH CONTRIBUTIONS TO PLANS BUT SATISFIED FUNDING REQUIREMENTS THROUGH USE OF ACCOUNTING CREDITS

The amount of contributions required under IRC minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years. This minimum contribution requirement may be met by the plan sponsor putting cash into the plan

or by applying earned funding credits. These funding credits are not measured at their market value and are credited with interest each year, according to the plan's long-term expected rate of return on assets.[27] When the market value of a plan's assets declines, the value of funding credits may be significantly overstated.

For the 1995 to 2002 period, the sponsors of the 100 largest plans each year on average made relatively small cash contributions to their plans (see fig. 4). Annual cash contributions for the 100 largest plans averaged approximately $97 million on plans averaging $5.3 billion in current liabilities (in 2002 dollars). This average contribution level masks a large difference in contributions between 1995 and 2001, during which period annual contributions averaged $62 million (in 2002 dollars), and in 2002, when contributions increased significantly to $395 million per plan. Further, in 6 of the 8 years in our sample, a majority of the largest plans made no cash contribution to their plan. On average each year, 62.5 plans received no cash contribution, including an annual average of 41 percent of plans that were less than 100 percent funded.

FIGURE 4: MOST LARGE PLANS RECEIVED NO ANNUAL CASH CONTRIBUTION, 1995-2002



Source: GAO analysis of PBGC Form 5500 research data.

Note: Average contributions for 2002 are largely driven by one sponsor's contribution to its plan. Disregarding this $15.2 billion contribution reduces the average plan contribution for 2002 from $395 million to $246 million.

As stated earlier, Bethlehem Steel and LTV Steel both had plans terminate in 2002 that were only about 50 percent funded. Yet each plan was able to forgo a cash contribution each year from 2000 to 2002, instead using credits to satisfy minimum funding obligations, primarily from large accumulated credit balances from prior years. Despite being severely underfunded, each plan reported an existing credit balance at the time of termination.

AFC, PRIMARY MECHANISM FOR IMPROVING FUNDING OF UNDERFUNDED PLANS, PROVED INEFFECTIVE

The funding rules' primary mechanism for improving the financial condition of underfunded plans, the additional funding charge proved ineffective in helping underfunded plans for four main reasons:

1. Very few plans in our sample were actually assessed an AFC because the rules, despite the statutory threshold of a 90 percent funding level for some plans to owe an AFC, in practice require a plan to be much more poorly funded to be subject to this requirement.[28] From 1995 to 2002, an average of only 2.9 of the 100 largest DB plans each year were assessed an additional funding charge, even though on average 10 percent of plans each year reported funding levels below 90 percent. Over the entire 8-year period, only 6 unique plans that were among the 100 largest plans in any year from 1995 to 2002 owed an AFC. These 6 plans owed an AFC during the period a total of 23 times in years in which they were among the 100 largest plans, meaning that plans that were assessed an AFC were likely to owe it again.

2. AFC rules also specify a current liability calculation method that may overstate actual plan funding, relative to market-value measures, thereby reducing the number of plans that might be assessed an AFC. The specified interest rate for this calculation exceeded current market rates in 98 percent of the months between 1995 and 2002.

3. The AFC rules generally call for sponsors to pay only a percentage of their unfunded liability, rather than requiring restoration of full funding. On average, by the time a plan was assessed an AFC, it was significantly underfunded and was likely to remain chronically underfunded in subsequent years. Among the 6 plans that owed the AFC, funding levels rose slightly from an average of 75 percent when the plan was first assessed an AFC to an average of 76 percent, looking collectively at all subsequent years. All of these plans were assessed an AFC more than once.

4. Plan sponsors can meet the AFC requirement by applying funding credits earned in prior years in place of cash contributions. The account value of these credits, which accumulate interest, may not reflect the underlying value of the assets in the plan. Many plans experienced significant market value losses of their assets between 2000 and 2002 while they were able to apply these funding credits. Among the 100 largest plans, just over 30 percent of the time a plan was assessed an AFC, the funding rules allowed the sponsor to forgo a cash contribution altogether that year.

The experience of two large terminated plans illustrates the ineffectiveness of the AFC. For example, Bethlehem Steel's plan was assessed an AFC of $181 million in 2002, but the company made no cash contribution that year, just as it had not in 2000 or 2001, years in which the plan was not assessed an AFC. When the plan terminated in late 2002, its assets covered less than half of the $7 billion in promised benefits. LTV Steel, which terminated its pension plan for hourly employees in 2002 with assets of $1.6 billion below the value of benefits, had its plan assessed an AFC each year from 2000 to 2002, but for only $2 million, $73 million, and $79 million, or no more than 5 percent of the eventual funding shortfall. Despite these AFC assessments, LTV Steel made no cash contributions to its plan from 2000 to 2002. Both plans were able to apply existing credits instead of cash to satisfy minimum funding requirements. In addition, both sponsors had unused funding credits at the time their plans were terminated.

WEAKNESSES IN FUNDING RULES AMPLIFIED BY LACK OF TRANSPARENCY HINDERS SOUND POLICY MAKING

Unclear measures of pension funding and a lack of timely information have made it difficult for plan participants, investors, regulators, and policy makers to accurately assess the financial condition of pension plans. Without timely and reasonably accurate data about the financial condition of pension plans, the various stakeholders cannot make timely and informed decisions on retirement savings, employment, and other key life issues. The primary regulatory filing for pension plans—the Form 5500—requires multiple measures of pension assets and liabilities, yet none of these measures tell PBGC and plan participants what share of the benefit obligations are funded in the event of plan termination. Furthermore, by the time these regulatory reports are publicly available, the information is usually at least 2 years old.[29] In a time of significant changes in interest rates and equity prices, it is possible that reported measures of pension funding will substantially differ from current measures of plan funding. PBGC does receive more current information about plans that are underfunded by at least $50 million. This more current information includes estimates of funding measures if the plan were to be terminated; however, by law this information is not disclosed to the public.

Our cash-based budgetary framework for Federal insurance programs also contributes to a lack of transparency that, at worst, may create disincentives for policy makers to enact reform measures.[30] With the current cash-based reporting, premiums for insurance programs are recorded in the budget when collected, and outlays are reported when claims are paid.[31] This focus on annual cash flows generally does not adequately reflect the government's cost for Federal insurance programs because the time between the extension of the insurance, the receipt of premiums and other collections, the occurrence of an insured event, and the payment of claims may extend over several budget periods. As a result, the government's cost may be understated in years that a program's current premium and other collections exceed current payments and overstated in years that current claim payments exceed current collections. This is especially problematic in the case of pension insurance because of the erratic occurrence of plan terminations as well as the mismatch between premium collections and benefit payments that can extend over several decades.

Cash-based budgeting also may not be a very accurate gauge of the economic impact of Federal insurance programs. Although discerning the economic impact of Federal insurance programs can be difficult, private economic behavior generally is affected when the government commits to providing insurance coverage. In the case of PBGC, the existence of pension insurance may encourage plan sponsors and em-

ployees to agree to pension benefit increases in lieu of wage increases when the plan sponsor faces economic difficulties.[32]

Cash-based budgeting for Federal insurance programs may provide neither the information nor incentives necessary to signal emerging problems, make adequate cost comparisons, control costs, or ensure the availability of resources to pay future claims. Because the cash-based budget delays recognition of emerging problems, it may not provide policy makers with information or incentives to address potential funding shortfalls before claim payments come due. Policy makers may not be alerted to the need to address programmatic design issues because, in most cases, the budget does not encourage them to consider the future costs of Federal insurance commitments. Thus, reforms aimed at reducing costs may be delayed. In most cases, by the time costs are recorded in the budget, policy makers do not have time to ensure that adequate resources are accumulated to pay for them or to take actions to control them. The late budget recognition of these costs can reduce the number of viable options available to policy makers, ultimately increasing the cost to the government.

RETIREMENT INCOME SECURITY REQUIRES MEANINGFUL AND COMPREHENSIVE REFORM

In light of the intrinsic problems facing the defined benefit system, meaningful and comprehensive pension reform is required to ensure that workers and retirees receive the benefits promised to them and to secure PBGC's financial future. While PBGC's current financial condition does not represent a crisis, delaying reform will result in serious adverse consequences for plan participants, the Federal budget, and our nation's economy. At this time, the Administration, Members of Congress, and others have proposed reforms that seek to address many of the problems facing PBGC and the defined benefit system.[33] Such comprehensive effective pension reform would likely include elements that would improve measures of pension funding and enhance transparency of plan information, strengthen funding rules (while preserving some contribution flexibility for plan sponsors, modify certain PBGC guarantees, develop an enhanced and more risk-based insurance premium structure, and resolve outstanding controversies concerning hybrid plans, such as cash balance plans.[34]

GAO HAS SUGGESTED ELEMENTS OF PENSION REFORM

Pension reform is a challenge because of the necessity of fusing together so many complex, and sometimes competing, elements into a comprehensive proposal. Ideally, effective reform would

- improve the accuracy of plan funding measures while minimizing complexity and maintaining contribution flexibility;
- revise the current funding rules to create incentives for plan sponsors to adequately finance promised benefits;
- develop a more risk-based PBGC insurance premium structure and provides incentives for sponsors to fund plans adequately;
- address the issue of underfunded plans paying lump sums and granting benefit increases;
- modify PBGC guarantees of certain plan benefits (e.g., shutdown benefits);
- resolve outstanding controversies concerning hybrid plans by safeguarding the benefits of workers regardless of age; and
- improve plan information transparency for pension plan stakeholders without overburdening plan sponsors.

Furthermore, if policy makers decide to provide measures of relief to sponsors of poorly funded pension plans, there should be mechanisms built into such laws that would prevent any undue exacerbation of PBGC's financial condition.

Developed in isolation, solutions to some of these concerns could erode the effectiveness of other reform components or introduce needless complexity. As deliberations on reform move forward, it will be important that each of these individual elements be designed so that all work in concert toward well-defined goals. Even with meaningful, carefully crafted reform, it is possible that some defined benefit plan sponsors may choose to freeze or terminate their plans. While these are serious concerns, the overarching goals of balanced pension reform should be to protect workers' benefits by providing employers the flexibility they need in managing their pension plans while also holding those employers accountable for the promises they make to their employees.

The debate over defined benefit pension reform should not take place in isolation of larger related issues. Challenges in the defined benefit system, together with 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 fun-

damental questions about how who should bear certain risks and responsibilities for economic security in retirement.

• Individual savings require greater responsibility and offer greater potential rewards and the possibility of bequeathing any unused retirement savings. However, longevity risk—the risk of outliving retirement savings—and poor investment choice are significant concerns, particularly as health care and long-term care costs and life expectancies continue to rise.

• The Federal Government is in the best position to share risk across the population, and social insurance programs, including Social Security, Medicare, and Medicaid already reflect this fact. However, the current structure of existing Federal retirement programs is unsustainable.

• Employer-sponsored pensions can alleviate longevity risk for plan participants and are generally presumed to be better placed to manage investment risk. However, poor management of plans can lead to shortfalls in funding that can damage the competitiveness of the plan sponsors. Furthermore, many employers are cutting or reducing retiree health benefits, and even employee health benefits, as growing health care costs threaten their competitiveness.

EXPERTS IDENTIFIED A VARIETY OF BROAD PENSION REFORMS

Earlier this year, GAO convened a forum on the future of the defined benefit system and the PBGC that included a diverse group of about 40 pension experts, representing various interests, to discuss various reforms to the defined benefit pension system.[35] In addition to debating changes to the funding rules and PBGC premiums, participants also talked about ways to address pension legacy costs (the costs of terminated and underfunded pension plans) and features of pension plans that government policy should encourage.

According to participants in the GAO forum, resolution of pension legacy costs and clarification of the legal status of cash balance and other hybrid pension plans could play a significant role in shoring up the defined benefit system.[36] 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. Some participants added that resolving legacy costs could be a key component of any pension reform legislation that tightened the funding rules and assessed premiums according to PBGC's risk. Also, some participants supported, and other participants opposed, the idea of separately addressing the pension legacy costs of specific industries, such as airlines and steel, which have imposed the most significant costs on PBGC. Separately addressing pension legacy costs does not necessarily imply a taxpayer bailout, as some participants suggested other ways to cover their cost, such as through an airline ticket fee to cover the airlines' share of PBGC's deficit. Others noted that resolving the uncertain legal status of cash balance and other hybrid pension plans could encourage greater participation in the defined benefit system. Expanding the universe of pension plan sponsors could lead to an increase in PBGC's premium income.

Some forum participants also suggested that the debate over Federal retirement policy needs to move beyond distinctions between defined benefit and defined contribution plans. 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 new pension plan designs be developed that explore the following features:

• allowing automatic participation of the covered population in order to expand pension coverage generally;

• improving the portability of pension benefits to accommodate workers who frequently change jobs;

• providing for professional money management and pooled investment risk;

• minimizing early withdrawals and borrowing—a problem known as leakage—from retirement savings; and

• providing incentives to receive benefits in the form of a fixed annuity, rather than a lump-sum distribution.

CONCLUSIONS

Widely reported recent large plan terminations by bankrupt sponsors and the resulting adverse consequences for plan participants and the PBGC have pushed pension reform into the spotlight of national concern. Our analysis here suggests that a variety of factors have contributed to the current state of affairs: recent declines in interest rates and financial markets, a soft economy, industry restructuring because of changes in the national and world economies, weaknesses in the legal framework governing pensions that has encouraged moral hazard by sponsors, the underfunding of plans, and a lack of timely, accurate, useful and transparent information that limits participants, unions, investors and other stakeholders from being able to make accurate and timely decisions.

In light of the intrinsic problems facing the defined benefit system, meaningful and comprehensive pension reform is required to ensure that workers and retirees receive the benefits promised to them. At this time, the Administration, Members of Congress, and others have proposed reforms that seek to address many of the problems facing PBGC and the defined benefit system. This is a promising development that can be a critical first step in addressing part of the long-term fiscal problems facing this country. Such reform will demand wisdom and patience, given the necessity of fusing together so many complex, and sometimes competing, elements into a comprehensive proposal. Ideally, effective reform would

- improve the accuracy of plan funding measures while minimizing complexity and maintaining contribution flexibility;
- revise the current funding rules to create incentives for plan sponsors to adequately finance promised benefits;
- develop a more risk-based PBGC insurance premium structure and provides incentives for sponsors to fund plans adequately;
- address the issue of underfunded plans paying lump sums and granting benefit increases;
- modify PBGC guarantees of certain plan benefits (e.g., shutdown benefits);
- resolve outstanding controversies concerning hybrid plans by safeguarding the benefits of workers regardless of age; and
- improve plan information transparency for pension plan stakeholders without overburdening plan sponsors.

However, it is also necessary to keep in mind that pension reform is only part of the broader fiscal, economic, workforce, and retirement security challenges facing our nation. If you look ahead in the Federal budget, Social Security, together with the rapidly growing health programs (Medicare and Medicaid), will dominate the Federal Government's future fiscal outlook. These are far larger and more urgent challenges, representing an unsustainable burden on future generations. Furthermore, pension reform should be considered in the context of the problems facing our nation's Social Security system. How we reform DB pensions has crucial implications for directions taken in reforming Social Security. For example, pension reforms that reduce the scope of the private pension system or change the dominant form of private pension design may have consequences for those elements of Social Security reform packages that reduce benefits or include an individual accounts feature.

This also means that acting sooner rather than later will make reform less costly and more feasible. Though smaller in scale than actuarial deficits in Social Security, Medicare, and Medicaid, PBGC's deficit threatens to worsen our government's long-term fiscal position. Finally, as with Social Security, it is also important to evaluate pension reform proposals as comprehensive packages. The elements of any reform proposal interact; every package will have pluses and minuses, and no plan will satisfy everyone on all dimensions. If we focus on the pros and cons of each element of reform by itself, we may find it impossible to build the bridges necessary to achieve consensus.

We look forward to working with Congress on these crucial issues.

Mr. Chairman, this concludes my statement. I would be happy to respond to any questions you or other members of the Committee may have.

ENDNOTES

1. Many of these elements are explored in greater detail in a report that GAO is releasing today. GAO, Comptroller General's Forum: The Future of the Defined Benefit System and the Pension Benefit Guaranty Corporation, GAO-05-578SP (Washington, D.C.: June 9, 2005).

2. GAO, Long-Term Fiscal Issues: The Need for Social Security Reform, GAO-05-318T (Washington, D.C.: Feb. 9, 2005).

3. GAO, 21st Century Challenges: Reexamining the Base of the Federal Government, GAO-05-325SP (Washington, D.C.: Feb. 2005).

4. One impetus for the passage of ERISA was the failure of Studebaker's defined benefit pension plan in the 1960s, in which thousands of plan participants lost most or all of their pensions.

5. Some defined benefit plans are not covered by PBGC insurance; for example, plans sponsored by professional service employers, such as physicians and lawyers, with 25 or fewer employees.

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

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

8. For additional discussion of these broader fiscal challenges, see GAO, Our Nation's Fiscal Outlook: The Federal Government's Long-Term Budget Imbalance, at http://www.gao.gov/special.pubs/longterm/longterm.html.

9. PBGC is authorized to borrow up to $100 million from the U.S. Treasury to cover temporary cash shortfalls.

10. PBGC also guarantees a smaller pension benefit for approximately 10 million participants in multiemployer pension plans.

11. 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 is split between PBGC (for unfunded guaranteed benefits) and participants (for unfunded nonguaranteed benefits).

12. The additional premium equals $9.00 for each $1,000 (or fraction thereof) of unfunded vested benefits. A plan's sponsor may be exempt from paying the variable rate premium if the plan met a specified funding threshold in the previous plan year.

13. Present value calculations reflect the time value of money—that a dollar in the future is worth less than a dollar today, because the dollar today can be invested and earn interest. Using a higher interest rate will lower the present value of a stream of payments because it implies that a lower level of assets today will be able to fund those future payments.

14. A plan's current liability may differ from its termination liability, which measures the value of accrued benefits using assumptions appropriate for a terminating plan. For further discussion of current versus termination liability, see appendix IV of GAO, Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks, GAO-04-90, (Washington, D.C.: Oct. 29, 2003).

15. The AFC was introduced by the Omnibus Budget Reconciliation Act of 1987. See Pub. L. No. 100-203 (1987).

16. Broad equity indexes in the U.S. have risen since 2002 but remain significantly below their peak levels of 2000.

17. ERISA Industry Committee, Consensus Proposals for Pension Funding, PBGC Reform, and Hybrid Pension Plans, (Washington, D.C.: May 2005). Asset totals in 2002 and 2004 include billions of dollars in contributions by plan sponsors since 1999.

18. Falling interest rates raise the price of group annuities that a terminating plan must purchase to cover its promised benefits and increase the likelihood that a terminating plan will not have sufficient assets to make such a purchase. A potentially offsetting effect of falling interest rates is the possible increased return on fixed-income assets that plans hold. When interest rates fall, the value of existing fixed-income securities with time left to maturity rises.

19. Three of the last five annual increases in bankruptcies coincided with recessions, and the record economic expansion of the 1990s is associated with a substantial decline in bankruptcies. Annual plan terminations resulting in losses to the single-employer program rose from 83 in 1989 to 175 in 1991, and after declining to 65 in 2000, the number reached 93 in 2001. The last three recessions on record in the United States occurred during 1981, 1990-91, and 2001 (See www.bea.gov/bea/dn/gdpchg.xls).

20. The causes of restructuring are likely industry-specific. For example, the U.S. airline industry, which has many pension plans in poor financial condition, has faced profit pressures as a result of severe price competition, terrorism, the war in Iraq, and the outbreak of severe acute respiratory syndrome (SARS), creating bankruptcies and uncertainty about the future financial health of the industry.

21. A major factor contributing to the increase in lump-sum distributions from defined benefit plans is the growing prevalence of hybrid plans, such as cash balance

plans, which typically offer lump sums. Hybrid plans are a form of DB plan that determines benefits on the basis of hypothetical individual accounts.

22. GAO-05-294.

23. Boyce, Steven, and Richard A. Ippolitio, "The Cost of Pension Insurance," The Journal of Risk and Insurance, (2002) Vol. 69, No. 2, pp.121-170.

24. For further details of this study, covering 1995-2002, see GAO-05-294. These 100 plans are not a closed group. The 100 largest plans, as measured by current liability, changed from year to year for various reasons, including mergers and divestitures of plan sponsors. A total of 187 distinct plan identifiers were included in our sample, and 25 of them were in each year's sample.

25. Conversely, when interest rates rise, the opposite would be true, and the weighted average would make the cost of settling plan liabilities higher than the current market rate would indicate.

26. Several factors may explain the wide discrepancy between reported funding levels and actual funding levels at termination. Reported funding levels may use an actuarial value of assets, which may exceed the market value at termination. In addition, termination liabilities are valued using a different interest rate than that used for current liabilities. Further, current liabilities and termination liabilities may be measured at different times. Unfunded shutdown benefits may also raise termination liabilities. For more discussion of the differences between termination and current liabilities, see GAO-04-90, appendix IV.

27. See 26 U.S.C. 412(b).

28. A plan is not subject to an AFC if the value of plan assets (1) is at least 80 percent of current liability and (2) was at least 90 percent of current liability for at least 2 consecutive of the 3 immediately preceding years.

29. For further information about problems with the content and timeliness of regulatory reports on pensions, see GAO, Private Pensions: Government Actions Could Improve the Timeliness and Content of Form 5500 Pension Information, GAO-05-491 (Washington, D.C.: June 3, 2005), and Private Pensions: Publicly Available Reports Provide Useful but Limited Information on Plans' Financial Condition, GAO-04-395 (Washington, D.C.: Mar. 31, 2004).

30. GAO, Budget Issues: Budgeting for Federal Insurance Programs, GAO/T-AIMD-98-147 (Washington, D.C.: Apr. 23, 1998), and Budget Issues: Budgeting for Federal Insurance Programs, GAO/AIMD-97-16 (Washington, D.C.: Sept. 30, 1997).

31. PBGC's premium collections and benefit payments are recorded in the budget on a cash basis, regardless of when the commitments are made. The premiums paid by participants are held in a revolving fund. PBGC's budget treatment is complicated by the use of a second account for some activities which is not included in the Federal budget. This account records the assets and liabilities that PBGC acquires from terminated plans. As a result, the budget only reports PBGC's net annual cash flows between its on-budget account and all other entities, including the other PBGC account. It does not provide information on liabilities PBGC incurs when it takes over an underfunded plan or other changes in PBGC's assets and liabilities.

32. GAO-05-578SP.

33. For example, earlier this year, the Administration released a proposal that focuses on reforming the funding rules; improving disclosure to workers, investors, and regulators about pension plan status; and adjusting premiums to better reflect a plan's risk to PBGC. See U.S. Department of Labor, Employee Benefits Security Administration, Strengthen Funding for Single Employer Pension Plans, February 7, 2005.

34. For greater detail, see GAO-04-90.

35. GAO, Comptroller General's Forum: The Future of the Defined Benefit System and the Pension Benefit Guaranty Corporation, GAO-05-578SP (Washington, DC: June 2005). Participants included government officials, researchers, accounting experts, actuaries, plan sponsor and employee group representatives, and members of the investment community.

36. 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.

Chairman NUSSLE. I thank the witness.

Next we will hear from the distinguished Director of the Congressional Budget Office.

Welcome back. Your entire testimony will be made part of the record, and you may proceed.

STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. HOLTZ-EAKIN. Thank you, Mr. Chairman, Mr. Spratt and members of the committee.

The CBO is indeed pleased to be here and have a chance to testify once more. The PBGC issue is an important and timely one, and there is an enormous range of issues which we might explore, perhaps in the question-and-answer.

I am going to restrict these remarks to the work that is ongoing at the CBO at the request of the committee, which is focused on budgeting for loans, guarantees and insurance in the Federal budget.

I will make three main points. The first will be to provide a sense of the scale of the economic commitment represented by insurance for defined benefit pension plans.

The second will be to raise the question of just how much of this commitment will be picked up by the U.S. taxpayer.

And the third will be to explore effective ways to inform the Congress and other stakeholders of the budgetary resources that might be involved in these commitments.

Now I want to echo the comments of Mr. Spratt and emphasize at the outset that this is a work in progress. As we continue our work, and refine our approach, the numbers will change.

Nevertheless, we believe that our work is sufficiently mature that one can get a sense of the magnitudes involved. We are here today to talk about that.

The numbers that you will see and hear today have in front of them labels like economic costs. These are different, and deliberately different, from traditional budget estimates.

Indeed, our goal is to step back and look at cost in a different and broader context. In fact, we try to estimate the market value of the financial resources that are being transferred to or within the pension system.

So with those opening warning labels, let's take a look at the three questions.

Question No. 1: How big is the insurance problem represented by the PBGC? And here the technique is to try to estimate market values. Figuratively, we are trying to answer the question, how big a check would you need to write to the financial markets to purchase the insurance policy of the PBGC?

I will skip the financial rocket science buried in the computations and simply point out that we are going through the steps a financial analyst would go through in deciding how large an insurance premium to demand.

Step one is to estimate the probability of a sponsor's bankruptcy. Our estimates are based on the initial assets and liabilities of those firms that sponsor defined benefit plans. Using projected evolutions in the value of those assets and liabilities, we calculate the probabilities of bankruptcy, given economic conditions in the future.

Step two is to estimate the distribution of underfunding which will be present in any plan, given that bankruptcy did occur.

To do that, we need to take into account both the current funding rules and any potential changes that the Congress might wish to consider, so as to be able to project the contributions that would have been made by these firms before they arrive at bankruptcy.

Step three is to do the valuation of that particular underfunding. When a plan goes into bankruptcy and it is handed over to the PBGC, economic conditions are likely to be bad. And markets demand greater compensation for agreeing to give up valuable cash in bad times than they do in good times.

The experience of recent years is illustrative. Bad times are characterized by broad economic dips which place pressures on cash flows for firms. Revenues tend to be weak and equity market performance is typically less than stellar, which in this case would reduce the value of assets in pension plans.

Poor economic times are also typically characterized by low interest rates, which raise the valuation of the liabilities of pension plans.

So in the circumstances where markets are most unwilling to hand over valuable cash are exactly those same circumstances in which pension plans would likely end up at the PBGC. Markets will price that risk and they will charge a premium in order to come up with money in those circumstances.

Given those three broad pieces of the analysis, we can gauge the costs facing the PBGC from an economic point of view. The first slide gives you a notion of two kinds of costs.

The first is what we refer to as sunk costs. These are the costs of those plans which are in actuality or in effect already at the PBGC. This is the $23 billion number of the liabilities of the PBGC in excess of assets that they have collected already. And those cannot be avoided by prospective policy changes.

Mr. SPRATT. And that is for the duration of the plans that the government has taken over, then. There is no time limit to that, except that eventually all the employees who have an inexorable benefit get their adjusted benefit payment, and that is it.

Mr. HOLTZ-EAKIN. That is right. And that is that bottom number.

But the remaining numbers are forward-looking costs over different horizons: 10, 15, or 20 years. Those are the likely value of insurance to defined benefit plans over the next decade or two decades.

So the first number indicates that markets would require a $48 billion check to cover claims in the next 10 years at the PBGC. Clearly, as one allows time to go forward, the probability of more plans arriving at the PBGC——

Mr. SPRATT. And this is the present value of expected terminations over a 10-year period of time. Going out for 10 years.

Mr. HOLTZ-EAKIN. This is the check now——

Mr. SPRATT. Present value.

Mr. HOLTZ-EAKIN. The check now, present value, to cover terminations over the next 10 years, in market terms. Or 15 or 20.

It gives you a sense of the scale of the financial resources that will be necessary at the PBGC in order to cover the future obligations of the defined benefit pension system.

Now those estimates assume the continuation of current funding policies and premiums.

One could imagine changing policy and looking at the effects on cost.

The next slide shows 10-year effects of some illustrative policies.

Raising the flat-rate premium, currently $19, to $30 would lower prospective net costs over the next 10 years in present value from $48 billion to $45 billion, a saving of $3 billion at the PBGC.

You could also change the risk of portfolios held by pension plans.

Currently portfolios are about 70 percent invested in equities. Limiting them to a maximum of 30 percent equities would make the assets of the pension plan safer in financial terms. This change produces larger savings, $7 billion over the 10-year horizon, bringing the prospective costs to $41 billion.

Or going in the other direction, one could make permanent the temporary discount rate increase that have been in place for the past 2 years, as a result of using corporate rates to replace the rate on 30-year Treasury bonds. If that change were made permanent, it would raise the prospective costs of insurance by $5 billion, to a total of $53 billion.

Although estimates are not yet available, I would note that some other policy changes have potentially larger effects than changing premiums and discount rates. Those changes involve funding rules or definitions of liabilities.

In the former category are policies like the administration's proposal to distinguish for funding purposes between the investment-grade firms and those firms that have fallen below investment grade. Those kinds of funding changes could have a dramatic impact.

Changing funding requirements through changes in the definition of liabilities could also reduce PBGC costs. The examples of Bethlehem and LTV that Mr. Walker pointed to are situations in which shut-down benefits, lump-sum cashouts, all the things that go on close to termination, raised liabilities dramatically. Bringing those factors more fully into the funding requirements would in fact be a beneficial step.

Next slide.

The second important question is just what is the taxpayers' exposure to this potential liability? Under current law, it is in principle zero. The law requires that the PBGC be self-financing. The taxpayer has no legal liability to pick up any residual claims on the PBGC.

Nonetheless, when its assets are exhausted the PBGC will find itself in uncharted territory.

Mr. SPRATT. If I could interrupt, I think what you are assuming there is that our liability is to the extent of the trust fund and no further, are you not?

Mr. HOLTZ-EAKIN. That is right. It would be confined to the assets that the PBGC has taken from failed plans, plus any premiums that they have built up.

There is no statutory provision that would allow PBGC to automatically go to the general fund of the Treasury or to the taxpayers as a whole. That would require congressional action.

Mr. SPRATT. If the PBGC in fact guarantees the scheduled percentage of pension benefit payable, then we have a substantial cost beyond the liability of the trust fund, the resources of the trust fund.

Mr. HOLTZ-EAKIN. Absolutely. And the question then is how would that cost be picked up? Would it be borne by the workers in the form of dramatically reduced pension benefits? Or, would pressures rise to the point where the Congress would consider devoting more resources, going to the taxpayer and funding the PBGC?

There are clearly pressures of that sort.

In some industries, notably airlines at present, proposals have been made to stretch out payments to the pension plans. In fact, this would raise PBGC's cost. And if Congress goes that route, it would be hard to imagine turning around and not actually honoring that kind of a commitment to the worker.

Mr. WALKER. With your indulgence, Doug, if I can, having been head of the agency, the PBGC is not backed by the full faith and credit of the U.S. Government. The PBGC has the ability to borrow up to $100 million from the U.S. Government. That is all they have.

But from a practical standpoint, if the PBGC becomes insolvent—and I think it is only a matter of when, not a matter of if, unless there is dramatic and fundamental reform, then there would be tremendous political pressure put on you to be able to step in.

The numbers that CBO has come up with, which I think are excellent, show you the potential exposure to the budget and to the taxpayers if the Government came in to bail out the PBGC. Legally the Government is not required to do so, but practically you would so under tremendous pressure to do so.

Mr. HOLTZ-EAKIN. And that would lead you to what would happen under different policy changes. And there, the range is enormous. Literally, the sky could be the limit. You could pick up the entire economic price tag that we have tried to sketch out. Or, you could stick to current law and have zero.

It is important in thinking through any policy changes to recognize both the scale of the commitment that we have tried to lay out, but also that there will be feedback from other parts of the budget.

In particular, large increases in premiums which reduce measured profitability will have revenue effects. And the committee would be served well to think comprehensively about the impact of those proposals. And we would be happy to help you with that.

One of the issues that would arise there as well would be the degree to which it should be an explicit policy to subsidize insurance to defined benefit pension plans.

Is it a policy goal to provide resources to the defined benefit system as a whole? Or should it be the case that the insurance should not cost the taxpayer anything? If the latter, then should it be priced and regulated in a way that the firms come up with the full cost?

And then finally, let me close and turn to the question of what is the best way to present this information to the Congress and to this committee?

The next slide shows two vehicles for presenting the information. One is the standard budget documents including the appendices. And the second would be the financial statements of the U.S. Government.

Under current law, as has been noted, all that is shown in the budget are the cash flows of one part of the PBGC, the on-budget fund, which is an incomplete financial picture of the agency as a whole.

The financial statements for PBGC include a report of probable claims and a contingent liability for claims that are reasonably possible, which is disclosed in a footnote.

So the current reporting is far short of the kinds of numbers that might be available if one were to adopt the structure we have outlined.

On the budget, you could stick with the current setup. Or one could move toward the direction that the chairman proposed several years ago and actually accrue the costs, including perhaps the market risks of providing insurance in bad times.

Or you could pick a middle ground, which would be to reflect in the budget the de facto subsidy on an annual basis to the premiums that firms are paying for this valuable insurance against the risks of default on employee compensation.

So there are a variety of stylized budget options that one could go to there, and we could work out more.

And finally, in the financial statements, it would be straightforward to reflect the full market value of this insurance, the economic costs de facto being borne by the system as a whole. And that would improve the nature of the reporting as well.

So I am pleased to have a chance to present this preliminary look at our work. It is work that we have done under the leadership of the committee. We are quite pleased with the status of things and look forward to working further with you to bring it to fruition.

[The prepared statement of Douglas Holtz-Eakin follows:]

PREPARED STATEMENT OF DOUGLAS HOLTZ-EAKIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Chairman Nussle, Mr. Spratt, and Members of the Committee, I am pleased to discuss the ongoing work that the Congressional Budget Office (CBO) is doing at the request of this Committee on budgeting for loans, guarantees, and insurance. Today, I will focus on the economic costs, Federal costs, and budgetary treatment of the Pension Benefit Guaranty Corporation's (PBGC's) insurance of defined benefit pension plans.

At the outset of my statement, however, I would emphasize two important caveats. First, CBO's efforts to estimate the costs of PBGC and to identify alternative, potentially more effective budgetary treatments constitute a work in progress. With further refinements, CBO's estimates and findings are likely to change somewhat. Second, the estimates that I will be reporting today are market measures of the value of financial resources being transferred to or within the defined-benefit pension system under current law. They are not budget cost estimates, nor do the estimates of the effects of changes in policy represent the budget scoring for legislation that would effect those changes.

As economic—rather than budget cost—measures, the estimates provide an opportunity to think broadly about Federal policy toward defined-benefit pension plans. Under current policy, the full cost of those pensions is not being shouldered by the plans' sponsors. Rather, because the current rules permit plans to be underfunded and because pension insurance is underpriced for many plans, some of the costs are being borne by the plans' beneficiaries and, potentially, by taxpayers. From a budgetary perspective, the key question is, how much should taxpayers be required to contribute to the defined-benefit pension system?

Under current law, PBGC is liable for insured benefits only to the extent that it has resources from insurance premiums, investment income, the assets of terminated plans, and recoveries from sponsors. However, because PBGC is a Federal insurance agency, there is a widespread belief that its obligations have at least an implied Federal guarantee that commits the government to use general revenues to honor insured claims.

In pursuing the objective of reducing or eliminating Federal costs, policymakers have several general types of approaches available. One group consists largely of regulatory instruments, including raising premiums and adjusting them for risk, tightening the pension funding rules, improving the measurement and reporting of pension liabilities, and attempting to increase the discipline of private sponsors' funding decisions. Higher premiums—in particular, ones linked to PBGC's risk exposure—would offset losses on future claims. More accurate measurement of plans' liabilities would make the existing funding rules and premium schedule more effective.

If beneficiaries understood that they were at risk from plans' underfunding, they would have incentives to press for higher funding or perhaps another form of compensation. Accordingly, increased requirements for plans to publicly and frequently disclose sufficient information about their financial condition could be useful in reducing Federal costs. Alternatively, privatizing PBGC so that losses were absorbed by its shareholders or by private reinsurers would also bring the force of market discipline to the task of controlling PBGC's losses.

Policymakers could also use budget instruments to help move toward eliminating Federal costs for PBGC. Increasing the transparency of PBGC's own financial condition and performance could be as useful as doing so for the pension plans. For instance, the agency's budget accounts could be reconfigured to recognize the accruing cost to the government from pension insurance.

The Congress may also decide that, for various reasons, subsidizing the defined-benefit pension system is desirable. In that case, policymakers may be willing to accept some level of expected funding through general revenues. The same policy instruments could be used to limit taxpayers' exposure as would be used to eliminate it.

The economic costs of PBGC insurance to taxpayers (if the implicit guarantee is honored) are substantial. In thinking about reducing those costs, however, it is critical to distinguish between costs already incurred and prospective costs. PBGC had accumulated losses of $23.3 billion at fiscal year-end 2004 for single-employer plans that had been terminated or whose termination the agency regarded as probable. "Sunk" costs for plans that have been terminated (in actuality or in effect) cannot be avoided, and policy decisions can determine only who will bear those costs. However, policy changes can reduce prospective costs.

CBO estimates that the economic costs to the public of PBGC insurance for single-employer plans net of premium collections over the next 10 years is $48 billion. That figure describes the estimated net present value of the financial resources that the program will be transferring to sponsors of and participants in defined-benefit pensions. It is also the price that the government would have to pay to private insurers bidding in competitive markets to take on the obligations that PBGC will assume in that period with current premiums and funding rules. Adding sunk costs and prospective costs together results in a total of $71 billion for the upcoming decade, $83 billion for 15 years, and $91 billion for 20 years.

In terms of the particular instruments that could be used, CBO's calculations suggest the following:

- Premium collections would have to rise fivefold in order to cut net Federal costs to zero through increases in premiums alone. For well-funded plans, which do not pay a premium for underfunding, the increase would be relatively modest, but for severely underfunded plans, which do pay an underfunding premium ($9 per $1,000 of underfunding per year), the increase could constitute a large increase in costs.
- Some proposals that the Administration has made, if enacted, could measurably reduce the economic costs of the system. For example, increasing premiums from $19 to $30 per participant would reduce 10-year net economic costs by $3 billion, while the proposed tighter rules for calculating pension liabilities and the proposed requirements for increased funding by financially distressed sponsors could reduce prospective economic costs significantly.
- Other policy changes such as reducing the maximum share of a pension plan's assets that could be invested in equities (stocks) to 30 percent from the current unregulated level of about 70 percent would reduce costs by $7 billion over 10 years.
- Some changes currently being considered could increase prospective costs. For example, making permanent a legislated increase in the discount rate used to calculate the present value of pension liabilities would increase PBGC's net costs by

$5.3 billion. Increasing the average time permitted for closing a plan's funding gap by 2 years would raise net costs by $6 billion.

• Changing the budgetary treatment of PBGC or changing its ownership by paying a private entity to take it over would not directly affect net costs but could increase the visibility of those costs and contribute to improved monitoring by the Congress.

ESTIMATING THE COSTS OF PBGC

The recent takeover of several airlines' pension plans by the Pension Benefit Guaranty Corporation has focused attention on and raised concerns about this program's costs to the government, taxpayers, the plans' sponsors, and the plans' participants. However, the budgetary and financial information currently available about PBGC is not very informative about the likely costs of the takeovers or the incidence of those costs.

One reason for the absence of such information is that Federal pension insurance gives a large number of beneficiaries valuable but highly uncertain claims to future payments. A natural approach to determining the costs of such claims is to find market prices for equivalent uncertain commitments. Although no exact match is currently available in private markets, finance specialists have developed techniques for using the prices of securities that are bought and sold to price contracts that are not traded. In the case of PBGC, the value of defined-benefit pension insurance is equivalent to a type of put option. Specifically, the option held by a pension plan's beneficiaries is to sell, or put, the assets of the plan to PBGC at a price equal to the value of the insured liabilities, contingent on the financial distress of the sponsor.

CBO has used those techniques along with publicly available information to project the three key determinants of PBGC's costs: the probability of a sponsor's bankruptcy, which is necessary before the put can be exercised; the probability distribution of the plan's underfunding (the plan's liabilities minus its assets) at termination, which is the value of the put option when it is exercised (or when the plan is transferred to PBGC); and market risk (the correlation of PBGC's claims with bad economic conditions), which affects the discount rate used to calculate the present value of the option.

The resulting estimated costs are the market value of the financial resources transferred to the defined-benefit pension system by PBGC. The estimates are based on information contained in Securities and Exchange Commission filings by publicly traded sponsors of defined-benefit pension plans. (Data on privately held companies and confidential filings that sponsors of publicly traded companies with significantly underfunded plans submit to PBGC are not available to CBO.) In the data available to CBO, plans' total liabilities amount to about 88 percent of those reported by PBGC. Therefore, CBO has scaled its estimates of PBGC's costs by a factor of 1.14 to adjust them to the size of the defined-benefit pension system.

The estimates are subject to considerable uncertainty for many reasons. CBO's estimates rely on firms' reports that are based on generally accepted accounting principles of pension assets and liabilities, whereas PBGC's figures rely on firms' reports for the Internal Revenue Service and under the Employee Retirement Income Security Act, which indicate a higher initial level of underfunding. Also, CBO's estimates are based on assumptions that simplify the complexities of the defined-benefit pension system. For example, all plans are assumed to fund pensions with the same mix of assets and to exhibit the same jump in liabilities at termination.

Using those assumptions, CBO estimates that under current policy, the market price of PBGC insurance going forward for existing plans for 10 years is $48 billion (net of premiums and assets of terminated plans and recoveries). That figure conveys the present value of the commitment to take on PBGC's net obligations for existing single-employer plans for the next 10 years. With the $23.3 billion in accumulated losses reported by PBGC at year-end 2004, the combined total of historical and prospective 10-year costs is about $71 billion.

The $23.3 billion in accumulated losses are sunk costs that cannot be avoided by policy changes now and that will be difficult to recover from surviving sponsors. As a consequence, policymakers have greater latitude in focusing on the second component of costs: claims that are prospective under current policy and, therefore, may be avoided.

MEASURES TO REDUCE THE FEDERAL COSTS OF PBGC

Two general regulatory approaches may be useful in reducing the future net costs of PBGC insurance. The first is to raise insurance premiums and adjust them for risk. The second is to reduce the level of risk in the defined-benefit pension system.

RAISING PREMIUMS

Raising premiums would require sponsors to pay a larger share of costs. To cut Federal costs to zero through higher premiums alone would require a fivefold increase in PBGC's receipts from premiums. Those higher premiums might be manageable for well-funded plans, which currently pay only a flat charge of $19 per year per participant for insurance. However, for firms with plans that are significantly underfunded, their current annual premiums also include a charge of $9 per $1,000 of underfunding. A hypothetical firm with 1,000 participants and $50 million in underfunding would pay premiums of $469,000 per year, of which $450,000 is the charge for underfunding. Therefore, for some firms, the increase in premiums could be significant—perhaps to the point of causing them to adjust the form and level of compensation that they offer.

REDUCING OR CHARGING FOR RISK

An alternative to a proportionate increase in premiums for all sponsors would be to make premiums more sensitive to the risk that various plans pose for PBGC. Although the extra charge for underfunding currently provides some adjustment based on risk, increasing the variation in premiums on the basis of risk could reduce the current cross-subsidies from low-risk sponsors and plans to high-risk ones. Some risk-adjusted premiums could also strengthen incentives for sponsors to reduce risk—which could lower the premium rate required to achieve any given level of net costs.

With this approach, premiums would be higher for sponsors that were more likely to encounter financial distress and whose plans would tend to be more deeply underfunded at termination. For example, premiums could vary with the volatility of the market value of a firm and its pension assets, the ratio of the firm's liabilities to its equity (leverage), and the firm's credit rating. The resulting range of premiums could be substantially wider than it is under current policy because risk varies significantly among plans. If, for example, premiums were set so that PBGC's expected net cost for insuring an investment-grade company (which is within the top four broad ratings categories) was the same as that for a lower-rated company, they would need to be about 20 times higher per dollar of liability for the lower-rated company.

Another important correlate of plans' risk that could provide a basis for adjusting premiums is the ratio of a pension plan's assets in equities to its total assets. Sponsors appear to prefer a high proportion of equities because they expect higher average returns on stocks than on bonds. If realized, that risk premium would reduce the cash contributions a sponsor must make to its plan in order to fund the promised pension benefits. Of course, such investments entail the risk that the stock market will do poorly and the plan will become underfunded.

Plans with a high proportion of common stocks, rather than high-quality bonds or other fixed-income securities, exhibit more volatility in the value of their assets than do plans holding more debt securities. Plans with a high share of stocks are thus at greater risk of underfunding when the sponsors encounter financial distress. That increase in risk to PBGC means that fair (full-cost) premiums would be about 16 percent lower for plans with an equity share of 30 percent rather than the average of almost 70 percent currently found in defined-benefit pension plans. Such an adjustment in premiums could create incentives for firms' investment decisions that could lower costs and improve the match between the risk posed and the premiums paid. An alternative to relying on the incentive effects of risk-based premiums to reduce risk would be to limit, through law or regulation, the share of assets that plans could invest in stocks.

The current structure of premiums tends to disconnect them from risk because PBGC's costs vary more closely with plans' liabilities rather than their number of participants. The per-participant charge also tends to lower the premium per dollar of insured liabilities for firms with a high proportion of older or high-wage employees compared with firms whose workforce is predominantly younger or lower paid and therefore has few accumulated pension benefits. At the current rate of $19 per participant, those effects may be small, but if rates were raised to be fair on average, the effects on firms' behavior could be significant.

A major source of risk to PBGC is the potentially large gap between the level of pension liabilities reported under the current definitions and funding rules and the economic value of those liabilities at plans' termination. PBGC often reports that plans that appeared to be well-funded prior to termination turn out to be deeply underfunded when they are transferred to the agency. For example, Bethlehem Steel's plan was 84 percent funded on the basis of current reporting requirements but was

only 45 percent funded at termination.[1] Underfunding can increase as a sponsor approaches bankruptcy for several reasons, including the discretion that the law allows in calculating the present value of a plan's liabilities and in valuing assets at their purchase price rather than current market value. (Those same funding rules also permit many plans that are effectively underfunded to avoid paying the variable-rate premium of $9 per $1,000 of underfunding.) Changing the definition and measurement of liabilities and tightening the funding rules, especially for sponsors with a greater chance of financial distress, could lessen the risk to PBGC and to the defined-benefit pension system.

Increasing the Visibility of PBGC's Costs

The policy changes needed to reduce the costs of pension insurance might be facilitated by increasing the visibility of PBGC's costs through changes in the budgetary treatment of pension insurance or other means. The present budgetary treatment focuses on the cash inflows to PBGC's on-budget account, primarily from premiums, interest income, and transfers from an off-budget trust fund, which holds the assets of plans taken over by PBGC. The inflows are netted against Federal outlays for pension benefits in plans run by PBGC's trustees and for administrative expenses. That treatment delays the recognition of insurance claims, often for decades, from when they are realized at a plan's termination to when benefits are paid. As a consequence, and despite large losses, PBGC's budgetary position has contributed to reducing the Federal deficit in every year except for fiscal year 2003, when the on-budget account recorded net outlays of $229 million. For fiscal year 2004, net budget outlays for PBGC were once again negative, representing a net cash inflow of $247 million. Such budgetary treatment is not designed to indicate or suited to describing the expected risk and magnitude of losses in the pension insurance system.

The financial statements issued by PBGC include losses on plans that have been terminated and those whose takeover the agency can foresee. In addition, PBGC publishes financial projections based on its Pension Insurance Modeling System, which indicate that the midpoint of the agency's distribution of accumulated deficits in 10 years is about $30 billion. Although both of those indicators of PBGC's financial status provide useful information to policymakers and are good starting points for further analysis, the first focuses primarily on losses that have occurred, including losses on probable terminations (the $23.3 billion cited earlier); and the latter excludes the cost of market risk.

Information on the present market value of future transfers to the defined-benefit pension system net of future premiums might be provided to the Congress through a supplementary reporting system or through changes in budget presentation. The first approach would offer the advantage of avoiding the need for changes to the budget, which are difficult to make piecemeal; the second, the advantage of citing budget numbers, which are more frequently used for policy decisions than supplementary information is.

Budgetary treatments of pension insurance that would better indicate full costs should be the following:

- *Timely.* According to a recommendation of the President's Commission on Budget Concepts, the budget should reflect outlays when the government incurs the obligation to pay.[2] In the case of PBGC, that point suggests that costs should include losses on pension plans when they are terminated.
- *Based on Market Value.* In general, the budget uses market prices to measure the value of inputs consumed by various Federal programs. For consistency, market prices should be used in estimating insurance costs. For PBGC, the market price of risk is significant because the events that precipitate a transfer of pension liabilities to PBGC, including low investment returns, high rates of financial distress, and low interest rates, occur when the market value of all assets is down.
- *Prospective.* The costs relevant to budgeting are those to which the government is committing in the budget period. Although sunk costs need to be recorded and paid, it is those costs that are being incurred in the budget period that are the focus of decisions. Of course, the extent to which the government is committing to pay under current law is restricted to the resources available to PBGC from premiums, assets of terminated plans, and recoveries from sponsors.

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[1] Statement of Bradley D. Belt, Executive Director, Pension Benefit Guaranty Corporation, before the Senate Committee on Finance, March 1, 2005.

[2] President's Commission on Budget Concepts, Report of the President's Commission on Budget Concepts (October 1967), p. 36.

The current budgetary treatment of PBGC recognizes the inflow of premium collections during the budget period but not the value of claims arising under the insurance. It thus falls short of having the attributes outlined above. CBO is currently exploring budgetary alternatives that might attain those qualities. One possibility would be to estimate the net prospective economic costs of PBGC over a specified period and to treat those values as the budget baseline costs of the program. Future year budgets could recognize the changes in the value of the insurance due to changes in law, regulation, or variables such as insured liabilities or interest rates. In the language of credit reform, those changes in costs might be treated either as reestimates (the result of unexpected economic changes) or modifications (the result of policy changes).

Another possibility would be to structure the accounts to recognize as budget costs the unpaid fair-value premiums for PBGC insurance. That is, estimates of the annual premiums required to cut the net budget costs of insurance to zero could be compared with the premiums expected to be paid by sponsors, and the difference could be shown as the budget costs of PBGC.

A more extreme approach would be to transfer PBGC to private owners. That step would probably accelerate the recognition of past losses in the budget because the current deficit would have to be covered, presumably by Congressional appropriations, before a private entity would be willing to assume the program's obligations. In addition, a private owner might require either an annual or lump-sum payment from the government to continue to operate the insurance program under current funding rules and premiums. Because PBGC insurance is mandatory for defined-benefit pension plans, the government would probably remain involved in regulating the terms of the insurance—which raises the question of the amount of risk and responsibility the government effectively could transfer to private owners. Nevertheless, the risk to the government would most likely be less than it is under current policy.

THE ADMINISTRATION'S PROPOSALS

The Bush Administration has proposed several changes in the defined-benefit pension system intended to reduce its financial shortfall and increase transparency.[3] Generally, the Administration would raise premiums and permit further risk-adjustment of them; change the measure of plans' liabilities and funding requirements; and increase public disclosures of plans' funding status. Plans' sponsors would also be permitted to fund the liabilities at higher levels during good economic conditions (without loss of tax benefits) as a buffer against underfunding during bad economic conditions and to use a higher discount rate to calculate plans' liabilities. Most of those changes are consistent with the objective of reducing the Federal costs of pension insurance. More specifically, the major provisions being proposed would do the following:

- Raise the fixed premium per participant from $19 to $30 per year and index the premium to future wage growth. CBO estimates that this change would reduce the prospective 10-year economic costs of PBGC insurance by $3 billion.[4]
- Authorize PBGC's directors (the Secretaries of Labor, Treasury, and Commerce) to adjust the variable-rate portion of the premium so that PBGC's income would cover expected losses. The change would require more than a sixfold increase in the premiums paid by plans' sponsors.
- Require that plans' liabilities reflect the effects of early retirements, lump-sum distributions, and increased longevity. The proposal would also require sponsors with credit ratings below investment-grade to calculate pension liabilities by assuming that employees retire at the earliest opportunity, thereby increasing estimated liabilities. Such sponsors would also be required to fund completely any increases in the plans' benefits. Although it is difficult to estimate the effect of the tighter rules for calculating liabilities, they are potentially the largest source of savings among the Administration's proposals.
- For the purpose of discounting in calculating pension liabilities, funding requirements, and premiums, mandate the use of a 3-month average of interest rates on corporate bonds whose duration matches the scheduled payments to beneficiaries. The proposal would make permanent the change from a Treasury rate to a corporate rate for discounting pension liabilities. It would permit plans' sponsors to avoid making up the additional underfunding that resulted from the legislated increase in discount rates for 2004 and 2005. According to CBO's estimates, this proposal would increase PBGC's costs by $5 billion over 10 years.

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[3] Details are available at *www.dol.gov/ebsa/pdf/seppproposal2.pdf.*

[4] This estimate does not reflect the budget saving that would be credited to this provision.

The Administration's proposals incorporate many of the policy options discussed here to reduce PBGC's risk exposure and to improve the transparency of the system. However, they also omit several options that are relatively important for reducing risk exposure and cross-subsidies between sponsors. First, premiums would continue to be unrelated to the risk of how pension assets are invested. Second, no new limitations would be placed on sponsors' investment policies. Third, the proposals retain a fixed charge per worker, rather than establishing charges per dollar of coverage, which would perpetuate a transfer from plans with younger, lower-paid workers to those with a higher proportion of older workers, higher-paid workers, and retirees.

Chairman NUSSLE. Thank you to both of our witnesses for their testimony.

Let me begin by welcoming a new member to the committee, Chris Chocola, who is here from Indiana. He is filling the slot that was vacated as a result of Mr. Portman's appointment as U.S. Trade Representative. We welcome you to the committee, look forward to your tenure.

Welcome to the committee. You have a $100 billion liability to deal with. That is just today. [Laughter.]

I look forward to your answer to that. We always give those problems to the new members.

Let me begin by asking, we have a draft report that I requested on PBGC, on the liability. And as I have seen—and it is not, as I understand it, ready for public announcement, because you are going through the final analysis of the report before it is realized.

But could you give the committee an understanding of the $23 billion versus $100 billion numbers that are going to be compared, that you have talked about a little bit today, but just to punctuate that one final time. Is it $23 billion that we are looking at as a long-term liability or are we really talking about $100 billion, or near $100 billion, as a long-term liability?

Mr. HOLTZ-EAKIN. Well, $100 billion is a much more sensible estimate than $23 billion. The $23 billion is done, it has already happened. Nothing can change that. There will be more in the future. And the $100 billion number is a forward-looking estimate of what we know about already and the additional claims likely to arrive in the future.

Chairman NUSSLE. And my understanding is for those who were not here during the S&L crisis—and I was not here during it, but just coming in at the end of it, my recollection is that it was approaching a $100-billion concern or crisis as well.

So we are talking about a gigantic challenge that as you were speculating, while there may not be a legal statutory obligation, chances are there will be a political answer and a practical answer that needs to be provided.

We have put in reconciliation for—as far as I am concerned, and this is the reason I was so adamant about making sure that we had this instruction available to the Education and Workforce Committee—available to their jurisdiction, as I remember, about $12.6 billion of jurisdiction, so that they can begin to address the problem. Our thumbnail budget estimate was in the $5 billion range, although that is not a number that is obligatory to the committee to follow.

Given the opportunity to begin to address this today in a vehicle such as reconciliation, what would be your recommendations of a—and I understand there is no such thing as a quick fix, but would be your first things first if we could approach this, what would be

your recommendations to us as a committee and to the Congress of the first things first?

Given an opportunity of some jurisdiction now and a vehicle to accomplish it in reconciliation, what should we consider approaching first this year, in the next 3 or 4 months, in order to begin to address the problem?

Mr. HOLTZ-EAKIN. You go first, I will go second.

Mr. WALKER. Mr. Chairman, just a point of clarification. Are you talking about this committee and what is within your jurisdiction, or are you talking about the Congress as whole?

Chairman NUSSLE. Both, but we gave the Education and Workforce, we also obviously have jurisdiction in Ways and Means that can be used, but let's keep it to the Congress as a whole.

Mr. WALKER. First, I think it is absolutely critical not just for this area but for other areas within the Federal budget that we need to have more transparency over the true discounted present-value cost and exposure associated with this and other types of Federal programs.

Secondly, I think it is very important that when Congress is thinking about making changes in the law that it consider the discounted present-value dollar cost, not just the 10-year cash flow numbers, for what the potential implications are, positive or negative, with regard to the Federal budget.

Thirdly, with regard to dealing with the structural imbalance, as you saw from the excellent CBO analysis, some of the proposals that people are discussing, like increasing base premiums, making a few adjustments with regard to the guarantees, won't come close to solving the problem.

You need to have a package of reforms, just like Social Security, you need comprehensive pension reform—things like enhanced transparency with regard to underfunded plans for both plan participants as well as other key stakeholders, including the Government; much tougher funding rules for plans that really represent exposure yet additional flexibility to make tax deductible contributions in good times, especially for plans that may not be in trouble today but could be tomorrow; additional restrictions on the ability to pay lump sum benefits when a plan is underfunded, therefore having a rush on the bank potentially; additional PBGC reforms, not just premium reforms, both flat and variable rate, which should be more risk-related than it is today, but also issues associated with what types of benefits are guaranteed, and under what circumstances are they guaranteed.

You may also need to look at the interaction of the bankruptcy law and the pension rules, as well as certain other provisions.

One of the things that the Congress is going to need to consider is the fact that an overwhelming majority of PBGC's losses are concentrated in a relatively few firms in less than a handful of industries.

That is also likely to be the case going forward.

Historically, it has been steel and airlines.

Going forward, it is likely to be more steel, airlines, autos, and auto-related. Therefore, to a certain extent one of the things the Congress is going to have to debate is is the PBGC serving as a backdoor industrial policy mechanism? Should the PBGC and the

premium payers of the PBGC be funding the cost of global competition and domestic deregulation in some of these industries, and frankly poor management in others?

There are some very important issues to think about. Clearly comprehensive pension reform is absolutely essential, just as Social Security reform is essential.

Last comment, Mr. Chairman. The challenges here are strikingly similar to Social Security. The only difference is the numbers. Every day that we wait, the bigger the numbers are going to get.

Thank you.

Mr. HOLTZ-EAKIN. I think that it is important to recognize that the kinds of economic costs that are present under current law are reflective of the reporting environment, the ability to actually understand the net asset position of these plans, the regulatory environment, and then also the pricing of that insurance, that comes last.

The reality is that if one moves to a reconciliation target in the current budgetary framework, with the cash flow of the on-budget fund as the centerpiece, the focus will have to be premiums, specifically on raising premiums.

Our estimate is that it would take an enormous increase in premiums as a whole, a five-fold increase, in order to bring the net economic costs down to zero. But this is underpriced insurance. Raising the premiums would show up in reconciliation. It would be a desirable policy from this perspective.

It is also possible to affect the pace at which underfunded plans make up the shortfall, do their catch-up contributions, or their DRCs. And that would have some cost-saving implications as well?

The rest, over a 5-year horizon, is largely baked in the cake. It is servicing the benefit payments that are going out. And that is very difficult to affect with policy in the near term. It is more desirable to think longer term from that perspective.

The last thing to remember in doing both those is to remember there will be feedback to the revenue side of the budget. And you won't get everything that you might think if you just focus on the outlay side.

Chairman NUSSLE. Well, it gives us an opportunity this year, as a result of reconciliation. It is a floor, it is not a ceiling, meaning that the reconciliation process gives us an opportunity to open the door a crack, but we could, in fact, go to a much more comprehensive approach, as you are requesting or suggesting in your advice to Congress.

I would hope that the committees of jurisdiction hear your concerns today. And I will make sure that I relate them to the chairman as well, that we have a challenge here that can be addressed in the near term with some policies that similar to Social Security are easier now than they will be 5 years from now or 10 years from now, if we even get that far before the crisis manifest itself.

So thank you for your testimony.

Mr. Spratt.

Mr. SPRATT. Thank you both for your testimony. If we could go back, first to General Walker, with the last chart you showed, which related to the Bethlehem and I believe the LTV collapse and

the consequent assumption of liability by PBGC. If we could have that chart on the screen, please.

You indicated that, No. 1, I think you averted to this, when the PBGC finally took hold of the plan assets of Bethlehem and LTV, they found out that there was a lot less there than they had previously thought.

Why is that? Does it have something to do with the fact that 4010, Section 4010 of ERISA (Employee Retirement Income Security Act), provides confidentiality to these numbers and they don't get the attention they would get in full public scrutiny? How is it we can delude ourselves about the balances in a plan that we are insuring?

Mr. WALKER. That is part of the problem, Mr. Spratt. Right now, if you look in the pension area, you will find that there are a number of different numbers that are calculated, some of which are disclosed, some of which are not disclosed.

You will calculate numbers with regard to the funding status of the plan for determining what your required contributions are under the minimum funding standards. You will calculate numbers for purposes of PBGC variable rate premiums. You will calculate numbers for purposes of public reporting, especially if you are a public company and file a 10–K.

You will generally find that certain things tend to happen in connection with troubled companies. No. 1, they use very optimistic discount rates to determine what their liabilities are, so they serve to understate their liabilities.

Secondly, and when they had good times with regard to their asset increases, during times of good markets, they carried forward those credits, and they are allowed to do that under current law, even though those gains could have totally evaporated and turned into losses since then. However, under current law they are still allowed to consider them for purposes of meeting their funding requirements.

In the case of LTV Steel, there were shutdown benefits, those are benefits that arise when a plant shuts down. Therefore the degree of underfunding can increase dramatically overnight. As you can see in this graphic, it did.

The bottom line with regard to your premise is, one of the first things we have to start with is transparency. All too frequently, the information that is provided to plan participants and beneficiaries, to the Government and to other key stakeholders is outdated and misleading.

We need to provide more timely, accurate and useful information. Transparency is a powerful force in trying to encourage people to do things that they otherwise should do.

And right now, 4010 is a problem.

Mr. SPRATT. As I understand it, there is a provision in FASB 87, Financial Accounting Standard Board Rule 87, which deals with the actuarial present value of benefits. And if the plan assets are beneath the actuarial present value, then the difference has to be recorded as a liability on your balance sheet. I guess it gets booked to revenues for that time period, too.

But in any event, why is that not enough? And if it is not enough, are you saying then that we need to rescind, we need to

radically change the disclosure rules with respect to the shelter, the veil that is allowed by Section 4010 of ERISA?

Mr. WALKER. There is clearly a need for a change in the law here, Mr. Spratt. The fact of the matter is, you are correct that there is a different accounting treatment under generally accepted accounting principles for pension costs, versus what has to be provided to plan participants and beneficiaries. It is also very different than what the funding rules are.

The amounts that are provided in the 10–K, the annual report filing with the SEC (Securities and Exchange Commission) for public companies, is usually a lot more reflective of reality. It is important that more realistic information be provided in a more timely manner to plan participants and beneficiaries and other interested parties than is the case under current law.

Mr. SPRATT. Do you agree with that basically, Dr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. Yes. I think this is a two-step process. The first is to make sure there is transparency to workers, to the PBGC, and to shareholders, so they can monitor better the status of these plans. Similarly, you would like to have better transparency of the PBGC to the Congress itself, so you can monitor the status of that commitment.

And second, once you have transparency, what is it that you would like to reveal? Given that this is an insurance product and insurance products are about volatility, I think it is desirable to recognize these things as close to market value as possible so that you can know when a bad thing is happening and insurance is going to kick in.

The current reporting structure which emphasizes smoothing is at odds with providing good information about an insurance product.

Mr. SPRATT. What is the policy behind it? Is there a concern there would be a run on the stock if there were a substantial liability or unfunded actuarial value?

Mr. WALKER. I think it is important to note that PBGC does receive certain information under this section——

Mr. SPRATT. Confidentially.

Mr. WALKER (continuing). Yes, it is confidential. That is correct.

I think it is important to note that a lot of key stakeholders aren't like plan participants. Presumably, if they were very sophisticated investors and they were very familiar with FASB 87 and FASB 88, if they read the financial statements of the company closely, and if they looked at the footnotes of the financial statements, a sophisticated player might be able to understand what is going on.

However, a vast majority of workers and retirees aren't in that category. Therefore, we need to provide it in a more timely and user-friendly fashion, because ultimately this is not just about PBGC. Ultimately, it is about the retirement income security of American workers and retirees, because PBGC does not guarantee all benefits.

There are limits as to what PBGC guarantees. As a result, significant losses can be imposed on workers and retirees.

Mr. SPRATT. Dr. Holtz-Eakin, you have made reference to premium increases, but you didn't talk about the two types of pre-

miums—the fixed-rate and the variable-rate premium—and you also didn't indicate what sort of magnitude of increase would be necessary to truly mitigate this problem.

Could you address that?

Mr. HOLTZ-EAKIN. Well, our rough estimate is that overall, if you take both of them, it is about a fivefold increase. The fixed-rate increase looks far less burdensome on average than does a variable-rate increase.

The variable rate is hitting those firms which have underfunded plans. They are typically in less than stellar financial health themselves. And so imposing that kind of a premium increase is a far more problematic initial step. I mean, that is just too abrupt.

Both are appropriate policy instruments. It is important to use the variable rate to reflect the risk to the PBGC.

Whether you tie that to the kinds of assets in the plans, or whether you tie it to underfunding, there are a variety of ways you can go. I think both premiums can be used more fully to price better. The fixed rate is easier to adjust in the near term. The variable rate should be structured to provide good long-term incentives.

Mr. SPRATT. Well, just for basic clarification, the fixed rate applies to every defined benefit plan that is insured by PBGC. It is $19 per plan participant.

Mr. HOLTZ-EAKIN. Yes.

Mr. SPRATT. And one of the proposals, then, would be to increase that amount.

Obviously, to the extent that it becomes an onerous increase, you risk the possibility that healthy, financially solid and stable firms might decide to withdraw as opposed to paying and convert to defined contribution rather than defined benefit plans. Is that a concern?

Mr. HOLTZ-EAKIN. For the fixed premium, ballpark numbers—suppose you use the $19 to $30 as the canonical proposal, that looks like a couple of pennies per hour in terms of labor compensation.

Since this is about ensuring that labor compensation promised at one point in time is actually delivered at another, that doesn't strike many people as a really big increase from the point of view of making sure that, that commitment is honored.

The variable rate is very different; $9 per $1,000 of underfunding, a sixfold increase in that, or something that would be necessary to make our kinds of numbers dramatically smaller, would be a big financial burden if instituted——

Mr. SPRATT. And the downside risk is that plans would terminate and withdraw and then you lose all their contributions.

Mr. HOLTZ-EAKIN. Yes.

Mr. SPRATT. Fixed and variable.

Mr. WALKER. If I can, Mr. Spratt?

Mr. SPRATT. General Walker?

Mr. WALKER. The $19 has not changed since the early 1990s, so if you index it for inflation it goes to $30. Obviously, people would prefer for them not to go up, just like people do not like tax increases—but the relative burden is not likely to be that significant.

One has to be careful, however, because you have to decide how much money you need and then how to raise that money.

The current variable-rate premium right now does not reflect risk. The current variable-rate premium right now is based solely on the degree of underfunding.

It does not consider the assets in the plan. It does not consider the nature of the plan and potentially pop-up liabilities that can come due. It does not consider a number of important factors that really correlate with risk.

For example, 80 percent of PBGC's losses that have occurred to date for big plans have been attributable to companies that had a junk-bond status 10 years from the date that they terminated—80 percent.

Therefore, actual losses bear a very high correlation to the financial condition of the sponsor.

Yes, additional premium revenues are necessary, but there ought to be more of a risk-based variable-rate premium.

You have to be careful not to raise the base rate too much, to where you encourage the exodus that you talked about. If we are going to have a variable or so-called risk-related premium, it really ought to relate to risk—it doesn't right now.

Mr. SPRATT. Well, we have got a chart up here now which indicates how low the premium used to be.

I used to fill out a 5500 C, as I recall it, for a small firm, a bank, a small bank that we ran. And I think my time engaged in filling out the form was more expensive than the premium we had to remit with the form, particularly when you tried to understand what OMB (Office of Management and Budget) was putting in the fine print on it.

But thank you both for your testimony. I may have further questions, but I want to allow others the opportunity.

Thank you very much for your presentations.

Chairman NUSSLE. Before I turn to the next member, let me welcome a special guest that is here with Director Holtz-Eakin. I understand your son is here, welcome Colin. Your dad does a great service to our country and for our Congress, and we welcome you to the Budget Committee.

Mr. Chocola for 5 minutes.

Mr. CHOCOLA. Thank you, Mr. Chairman.

First time showing up early in Congress has been rewarded. Thank you. I appreciate the opportunity to serve on the committee with you.

And thank you both for being here today. I just quickly want to follow up on some of your comments, especially Mr. Walker.

You talked about transparency a lot. You talked about this is a subset of greater challenges.

I used to work with a publicly traded company, and we were required to follow things like accrual accounting practices. And it allowed us to plan for things. And I think in order to meet a challenge, you have to be able to define a challenge.

If we budgeted on an accrual basis, would we be able to achieve some of that transparency and be able to plan for these challenges in a better fashion?

Mr. WALKER. No question.

It would make your reconciliation process tougher, because the numbers would be a lot bigger than you are seeing right now.

But as you know, there are certain things right now that are on an accrual basis, certain kinds of credit activities. But this is not on an accrual basis.

I agree with Doug Holtz-Eakin that we not only need changes in the budget process, we need changes in the financial reporting process, and I am trying to make that a reality.

Mr. CHOCOLA. Do you agree, Mr. Holtz-Eakin?

Mr. HOLTZ-EAKIN. I am more cautious than some about moving the Federal Government full-scale to an accrual framework, for a whole variety of reasons, and I will spare you the sermon—we can talk about it later.

I think it is important that the information be entered in the policy process, that this committee and the Congress in general know the accrual status of Federal programs.

Budgeting is, in the end, a year-by-year event. The delivery of budget authority is a management tool by which you allow people to exercise policy options, and that is a cash flow operation.

And so I think there is a place for both in thinking about how the Congress does its business.

Mr. CHOCOLA. Mr. Walker, would you talk about it in the terms of the bigger challenges that you referred to earlier? There is a sense of Social Security—I mean, this is a subset of bigger challenges. The need for transparency is a much bigger issue than just this, isn't it?

Mr. WALKER. Absolutely. Let me give you some numbers.

PBGC has a $23.3 billion accumulated deficit based upon the numbers we have seen from CBO, which are very similar to the numbers that PBGC has disclosed itself.

You can easily add another $90 billion to $100 billion on top of that, so that gets you about $120 billion or so.

Social Security has a discounted present-value unfunded commitment right now of about $4 trillion. There are 12 zeros behind that. It is going up every year. That number is just for 75 years, not for perpetuity.

The U.S. Government has liabilities and unfunded commitments of $45 trillion, which went up over $13 trillion in the last year alone.

So this is a subset of a range of issues, and we need to start dealing with them.

Mr. CHOCOLA. And if the Federal Government were a publicly traded company and it reported its liabilities like the Federal Government reports its liabilities, it would be understating its liabilities, wouldn't it?

Mr. WALKER. Well, let's talk about what current rules are and what I am trying to get changed.

By the way, both GAO and CBO sit on the Federal Accounting Standards Advisory Board (FASAB), which is the body that recommends accounting and reporting changes.

Right now, there is a separate statement which contains many of the numbers that I gave you. You can go to and see the $4 trillion, for example, for Social Security; you can see the almost $30 trillion for Medicare. They are not currently deemed to be liabilities for a lot of reasons.

One of the things that we need to do is we need to provide better transparency over trust fund versus nontrust fund activity, because as we all know they are not really trust funds; they are subaccounts of the general ledger.

We need to provide more transparency with regard to the total liabilities and unfunded obligations, the related burden on a per-capita basis, and how it fits intergenerationally.

We are dedicated to further improving Federal financial reporting. In addition to that, because not enough people read the financial statements, I am not going to ask you to raise your hand. But I can tell you in the last month, I have given speeches to hundreds or thousands of people, and less than five people have read the financial statements of the U.S. Government.

One of the things we need is a user friendly and concise summary annual report, in plain English, and with charts and graphs. I am working with Treasury and OMB to make that happen.

You need to change the budget process too. You don't have to go to full accrual budgeting—there are pluses and minuses there.

My understanding is you were just talking about this area rather than overall.

I do, however, think that there needs to be more transparency with regard to these commitments and contingencies, and they need to be accrual numbers. And that would be a positive first step to help ensure that these issues are actually considered, discussed and debated.

Mr. CHOCOLA. Mr. Chairman, if I could, I have been baited into this, I cannot resist.

The PBGC, like many, in principle, private entities, is different. It was intended to be a funded system. Firms were either supposed to self insure, by putting aside sufficient funds to meet the promise of this deferred compensation, or purchase insurance against adverse economic events that allowed them to meet that commitment as well. That is standard operating procedure. And it was intended to be funded either through internal resources or purchased resources in that fashion.

Government programs are very different and in some cases, were never intended to be funded—Social Security and, in particular, Medicare.

And my reservation with full accrual accounting is best exemplified by Medicare and Medicaid, where if one takes at face value the history of the growth of health care costs and simply extrapolates that into the future, you cannot compute the present value.

And so the unfunded liability—the funded or unfunded liability is infinite.

The only way to actually make the computation work is to assume that at some point in the future health care costs grow more slowly, and that would be a technical assumption made by someone—either GAO, CBO, OMB—in consultation with committees.

It strikes me as extraordinarily arbitrary to place the budgeting framework of U.S. Government on something that capricious as an assumption that 30 years from now health care costs will grow more slowly.

That is a reservation I have about implementing that kind of thinking in the government context.

Mr. WALKER. The trustees have to do that every year, and they have been doing it for many years. Under generally accepted accounting principles for public-sector companies, as you know—you used to be involved—you have to do the same thing.

Nothing is perfect, but I think we need to see some numbers. They need to be on the radar screen. Right now, they are not.

You can't solve a problem until you agree that you have a problem. You also need to see whether or not you are making progress or making it worse.

Chairman NUSSLE. Mr. Neal.

Mr. NEAL. Thank you, Mr. Chairman.

Mr. Chairman, let me congratulate you for holding this hearing this morning. It is timely, and I think it speaks to one of the fundamental problems with this Congress. I frequently refer to this Congress, as you know, as the Stepford Congress. Whatever the administration says, the majority in this Congress goes along with.

As the war in Iraq goes badly, we insist it is going fine. Cut taxes five times with two wars, and we would say, well, the budget is fine, we don't have to worry about the deficits. And then the argument becomes, well, it would have been worse if we didn't cut taxes in terms of the temporary recession we experienced.

It seems as though that transparency reference that you made at least 25 times in your opening statement, Mr. Walker, really is something that Congress has been very slow to come to.

And the chairman indicated he came here at the end of the S&L issue. I was here in the middle of it and I remember what that was like as we deregulated the industry, we allowed people to get into businesses which they had no former experience and certainly no discipline, as they began to loan money.

And now we find ourselves here with the pension problems that we have, and in some measure it is a reflection, I think, of the lack of will by the Congress to do what they are supposed to do, and that is to ask questions.

Now, having said that, let me point out that I recall when President Clinton offered his health care plan, that was vetted from every conceivable angle. People like myself opposed it because we didn't think that the questions were being answered in the right way.

The current Congress goes along with everything the administration says. Never is there a question. We hear time and again answers from the administration that cause Members of Congress to swoon in front of them rather than to ask them about the true problems.

And now we have this issue here in front of us about pension liability.

And let me specifically speak to the issue of the multi-employer pension plans.

We have done some things here in the last few years to address the issue of single employer pension plans. But we really haven't addressed the multiple employer pension plan.

Would the two witnesses care to speak to those issues?

Mr. WALKER. I can speak to it, having been head of the PBGC. There are two principal kinds of defined benefit plans that the PBGC insures. One is the single employer pension plan, which

typically is sponsored by a particular company for its employees and retirees. Another is a multi-employer pension plan, which typically is sponsored by a trade union. It could be the Teamsters, it could be other types of unions, and where the nature of the benefit promised is somewhat different, but it is a defined benefit promise.

Importantly, the insurable event is different for multi-employer plans versus single employer plans. For single employer plans, it is termination. That was the use for LTV, Bethlehem, and United.

For multi-employer, it is insolvency. In other words, when the money runs out and you can't pay benefits. There are significant exposures in the multi-employer plan universe. They are not likely to be realized as quickly, just like Social Security. When the trust fund runs to zero, that represents insolvency. In the case of Social Security today, the program already has a $4 trillion deficit.

So that is the primary difference.

Mr. HOLTZ-EAKIN. A good opportunity for me to make clear to the committee that our work focused exclusively on the single employer plans. That judgment was made because if you look at the $23 billion—sunk costs in the single employer plans—there is about a $0.2 billion comparable number for the multi-employer plans.

So we focused on the bigger problem first.

Mr. NEAL. Thank you.

Mr. Chairman, I want to reiterate what I said at the beginning. I want to thank you for holding this hearing. And I want to say that whether—the trouble we have here, I think, in the Congress, whether it is global warming or it is tobacco, it is really hard to get answers to questions.

And I want to tell you, for those of you who have an institutional memory here, we hammered witnesses on the S&L issue, of all political parties. They were dragged—I was on the Banking Committee at the time, for two painful terms. We clobbered those witnesses as they came before us regardless of their political party or their affiliation or who they were close to. During the Clinton health care plan, we hammered away at them day after day.

It is the job of the Congress to ask questions and not to accept everything the administration says. And that is why we find ourselves now trying to play catch-up with giving a lot of answers to questions.

So I do thank you sincerely, Mr. Chairman, for holding this hearing.

Chairman NUSSLE. Mr. Conaway.

Mr. CONAWAY. Thank you, gentlemen.

Thank you, Mr. Chairman, I appreciate that.

The reporting requirement that PBGC gets under law versus what FASB requires obviously are not the same. I do not know that the FASB disclosures are all that great either. There are some suggestions that additional information, more information as to the types of assets within plans and the extent that companies use their own stock to fund their annual contributions.

Could you talk to us a little bit about the nature of the assets and the fiduciary responsibilities that the plan trustees have of diversifying investments out of their portfolio?

Mr. WALKER. Having been a prior Assistant Secretary of Labor for ERISA, I had to oversee the fiduciary responsibility provisions. There are fiduciary responsibility provisions that relate to all private pension plans. Prudence is one of those. Diversification in order to minimize the possibility of large and unexpected losses is an element of this.

For defined benefit pension plans, which we are talking about here, there is a statutory limitation that employers can not invest more than 10 percent of the value of the assets in the plan in qualifying employer securities. But that 10 percent is determined as of the time that the contribution is made to the plan, so it could vary from 10 percent, depending upon market trends.

There are, however, certain types of plans called floor offset plans where you have a defined benefit plan in conjunction with the defined contribution plan. By the way, Enron had one. Under these plans, you can evade that 10 percent limit in employer stock under current law. I think this needs to be addressed. It needs to be stopped because it represents undue exposure for plan participants and beneficiaries and to the PBGC.

You are making a good point that you just can't look at the assets and you just can't look at the liabilities and the net difference. You have to understand the nature of the assets, the nature of the liabilities and that is why I am saying the current deficit——

Chairman NUSSLE. Sorry to interrupt. We are OK. It is the Senate.

Mr. WALKER. We are OK?

Chairman NUSSLE. I knew this was a hot hearing. I hope we did not catch on fire. [Laughter.]

You are in a different world.

Mr. WALKER. Thank you. OK. On the other side of the Hill, right? We will not say anymore.

The fact of the matter is, you need to get below the bottom-line numbers, because it makes a difference as to what true risk and true volatility are.

Mr. CONAWAY. As you used Bethlehem Steel and LTV, the differential between what was being reported as the unfunded, about 85 percent, versus what actually, that 60 percent.

What role did the plans holding LTV or Bethlehem Steel stock? Because once the company goes bankrupt, any exposure to that stock means that you have caused a problem. That exacerbated the problem.

Do you know off the top of your head?

Mr. WALKER. I will have to provide that for the record. The primary difference was, No. 1., the differences in the interest rates and No. 2, the fact in the case of LTV or Bethlehem, I think it was, there were significant shut-down benefits that popped up overnight that caused the funding level to decline dramatically.

So primarily interest rates and shut-down benefits. I will provide the rest for the record.

Mr. HOLTZ-EAKIN. Congressman, I want to note for the committee again, when we did our work, it was entirely off the publicly available information that we can get through the 10–K filings.

It remains an unfinished task to crosswalk our estimates to the estimates of the PBGC. The confidentiality provisions under law

preclude that quite frankly. I think a policy issue going forward is the degree to which that confidentiality is an important part of the way that PBGC should operate.

Mr. CONAWAY. Mr. Walker, you showed a chart that was updated all the way through 2002 and made some reference to the stale date. Why is that information not more readily available?

Mr. WALKER. Two reasons. Under current law, people are not required to file it until, I think, about 7½ months after the end of the year. After they file it, it takes a considerable amount of time for the information to be processed by the Government.

Historically, the Government has waited until all of the returns were processed before they provided information publicly.

So I think there are several issues here. By the way, we have issued a report on this which I am happy to make available to you and the other members.

I think you need to look at requiring accelerated reporting, at least with regard to plans that represent a risk with regard to their financial condition. I also think we need to move to electronic reporting, especially for large companies possibly requiring electronic reporting by large companies. Certain other government agencies have already done that for other required reports.

Clearly, the Department of Labor needs to improve their processes and possibly reconsider how they are processing these returns, so they don't wait until the end. They also need to analyze this information more on an installment basis rather than on a completion basis.

Mr. CONAWAY. Thank you, gentlemen.

Mr. Chairman, thank you.

Chairman NUSSLE. Mr. Moore.

Mr. MOORE. Thank you, Mr. Chairman.

And thank you, Mr. Spratt, for requesting this hearing.

Mr. Chairman, I also appreciate your convening the hearing.

Gentlemen, would it be safe and reasonable for us Members of Congress to assume that the pension benefits of employees are created basically the same as the pension benefits of corporate executives?

Mr. WALKER. No.

Mr. MOORE. Why not?

Mr. WALKER. Well, two reasons. One, there are two types of plans that typically corporate executives have. Many times they are covered under the defined benefit pension plan that would be subject to PBGC guarantee limits. Obviously, they have more exposure if they are, because the maximum benefit guarantee for PBGC is about $45,000 a year at the normal retirement age. Therefore, typically, they would have a lot more lucrative benefits based upon their salary. So they would take more of a haircut.

Secondly, typically, most corporate executives, especially for public companies, have non-qualified deferred compensation plans that are not subject to the Employee Retirement Income Security Act. They typically provide for very lucrative benefits, and typically, a vast majority of their benefits are this way. They may or may not be funded.

They may be subject to additional risk in bankruptcy, but there are ways to provide funding and security to avoid any problem in bankruptcy. That is a very controversial topic.

Mr. MOORE. And what would those ways be, if you can tell us briefly, Mr. Walker?

Mr. WALKER. Well, there are certain types of tax planning and trust vehicles that have been used in the past that have, in some cases, withstood bankruptcy. I would be happy to provide details for you if you would like.

Mr. MOORE. Well, the intent of my question was not to give further protection to the corporate executives, but to find out if maybe, if they had additional risk and the same risk that employers have, that maybe things might change. Any thoughts there, about how to make that happen?

Mr. WALKER. Well, I think there are some people that have talked about whether and to what extent there should be more of a mutuality of interest with regard to this risk. I would be happy to talk to you about that further, because there are some complicating factors.

I mean, it is one thing if the executives have been there since the beginning and maybe they were some that made the promises that they could not deliver on or they decided not to fund the pension plan and to do something else with the money.

It is another issue if you have somebody who is new management, who is coming in to try to help save the company, they weren't part of the problem, and your need to be able to attract and retain top talent.

So I would be happy to talk to you about it further. But I think it is a fact and circumstances issue.

Mr. MOORE. Thank you, Mr. Walker.

You said to us, go look at the numbers, and they are on a site or someplace. And you were talking about a $30 trillion dollar Medicare unfunded liability? Is that correct, sir?

Mr. WALKER. Close to $30 trillion.

Mr. MOORE. And $4 trillion for Social Security.

Mr. WALKER. That is correct.

Mr. MOORE. Where do we go look at those numbers?

Mr. WALKER. Well, first, they are in the Social Security and Medicare trustees reports, which come out every year.

Secondly, the number for last year, fiscal 2004, which is somewhat lower than that, but still staggering, is in the annual report of the U.S. Government, which is also available on Treasury's website and our website as well.

Mr. MOORE. You also made the statement, I believe, and this may not be an exact quote but close, I think, they are not trust funds. Did you say something like that?

Mr. WALKER. If you look at "Webster's Dictionary," these do not qualify as trust funds——

Mr. MOORE. I understand that.

Mr. WALKER. They are sub-accounts of the general ledger. In fact, if you look at the financial statements of the U.S. Government, you will not find a liability equal to the amount of bonds that are in these trust funds, because the left hand owes the right hand.

One of the things that I am pushing for is to provide more transparency over what is going on, because last year, our deficit really wasn't $412 billion, it was $567 billion, because we spent every dime of the Social Security surplus.

Mr. MOORE. I practiced law for 28 years before I came to Congress. And in Kansas and I think probably most other states, there is a requirement that attorneys who have client's funds in their possession deposit them in a true trust account. And it is an absolute no-no to touch those funds, because you can be prosecuted perhaps and disbarred for doing that.

Would there be any benefit to the U.S. Government having a true trust fund for deposit of Social Security monies that are later to be paid out for benefits?

Mr. WALKER. I think there are two issues. One, even if you had a true trust fund, if you are going to invest the same way that you are investing right now, I am not sure that would really change anything.

Mr. MOORE. Of course, we are not investing right now, we are spending, are we not, on——

Mr. WALKER. Well, we are spending it——

Mr. MOORE (continuing). A lot of other things, right?

Mr. WALKER. We are spending every dime of the Social Security surplus on other government expenses. We are replacing it with a non-readily marketable bond backed by the full faith and credit of the U.S. Government, guaranteed as to principal and interest, but it is only as good as the ability of the Government to tax, to cut other spending, or to go out and borrow, typically from foreigners, in order to be able to fund our deficits and debt.

Mr. MOORE. Thank you, sir.

Chairman NUSSLE. Mr. Ryan.

Mr. RYAN. A couple of questions I wanted to ask already were asked, such as Mr. Chocola's on accrual accounting.

Let me ask you about the difference between multi-employer pension plans and single employer pension plans. Mr. Walker, I think with multi-employer pension plans, the risk is spread to the rest of the employers in the pool, so there is another line of risk exposure away from the Government with respect to multi versus single, correct?

Mr. WALKER. That is correct.

Mr. RYAN. And so looking at the provisions we are facing within this Congress on multi-employer pension plans, do you think—and this is a question for both of you—that we can, through reforms, transparency, smoothing, all these other things—and you have seen the proposals up here—that we can reform multi-employer pension plans sufficiently in this Congress?

We are looking at reconciliation. What are the first things first that we do? It appears that we can't fully fix the single-employer problem. Can we, in your estimation, fully fix the multi-employer problem?

Mr. WALKER. Well, candidly, it is my understanding, Mr. Ryan, that the administration's proposals do not go to multi-employer plans, and I am not familiar if there are legislative proposals up here that do.

Mr. RYAN. There are, and they are from multiple sources. I think the Teamsters have one for the red zone, the food distributors for the yellow zone.

You know, there are a lot of groups that are involved in multi-employer pension plans who have come up with proposals. Ed and Labor, not a committee I serve on, is doing hearings on these things.

So you haven't had a chance to look at these various multi-employer pension proposals?

Mr. WALKER. I haven't, but I will be happy to take a look at it.

Mr. RYAN. Yes, I would love to hear your opinion as to whether or not those cover the job of fixing the plan.

Doug, have you taken a look at any of these solutions?

Mr. HOLTZ-EAKIN. We haven't looked at those. The one distinguishing difference here is the degree to which you can get additional monitoring from the other firms in a multi-employer plan.

And so if you can make that monitoring more effective, you can get a lot of bang for the buck out of things that do not have a lot of——

Mr. RYAN. Because they have an incentive to make sure—so more transparency is clearly a great starting point for the multis.

On the singles, should I take away from this testimony, from both of you, that at first blush, the premium increase is just the first no-brainer? Then we are going to have to look at transparency, other things like that. And given where we are with respect to reconciliation, that is the best place to start?

Mr. HOLTZ-EAKIN. The fixed premium is certainly the place to start. Thinking hard about what you want the variable premium to do and whether you want it to address underfunding and risk and how quickly you move that is a bit harder.

Mr. RYAN. OK, let us go to accrual quickly. I got the impression from the answer to Mr. Chocola's questioning that, Mr. Walker, you think it is right and proper that we do full accrual accounting of all the assets and liabilitieson the books.

Doug, I got from you that you think it is just a tough computation to make, especially when you are talking about health care.

Mr. HOLTZ-EAKIN. I also think it is different. I mean, it reflects an attempt to transfer private sector accounting into the Government, and government is different. It has the power to tax. In the end, government programs are funded up to the point of economic rationale. You can tax the resources and provide them for the Government budget.

There is no private entity that has a comparable power, who can print money as a government can.

So I am nervous about simply carbon-copying private sector reporting and budgeting into the government sector. They are different.

Mr. RYAN. Actually, I think that is a very good argument when applied to Social Security, which is when you price benefit guarantees, the cost of pricing a benefit guarantee would be theoretically lower for the Federal Government because it has the power to tax any given year than versus pricing, say, a benefit guarantee in the private sector. Would not the same argument apply?

Mr. HOLTZ-EAKIN. In those circumstances where the Government has the ability to pool across a greater set of risks, it will do better than the private sector. And what you want to do is look for those opportunities where the Government has a comparative advantage in risk spreading.

Mr. RYAN. So you would agree on both sides, the Social Security side of the ledger as well?

Mr. HOLTZ-EAKIN. Not necessarily on all Social Security matters. You and I have been there.

Mr. RYAN. That is why I wanted to bait you into that.

Mr. WALKER. If I can, Mr. Ryan, there are two issues. One is the issue of financial statements, and we do have accrual accounting for financial statements. However, right now the only thing that is deemed to be a liability on Social Security and Medicare is due and unpaid benefits.

We do disclose the discounted present value numbers of the difference between promised benefits and funded benefits, that is a $4 trillion number for Social Security and roughly a $30 trillion number for Medicare.

Mr. RYAN. Is the 30 a 75-year number?

Mr. WALKER. It is a 75-year number. We do disclose that. It is not deemed to be a liability. I would debate whether or not it is a liability, because of some of the fundamental differences between a pension plan and social insurance program.

The other side of the coin—but it needs more transparency.

At the same point in time, the other side of the coin is, what do you do for budget purposes? So for financial statements, we need accrual concepts. The debate is whether or not it is a liability. We need more transparency and enhanced reporting in any event.

On the budget side, it is different.

Mr. RYAN. But you both agree that accrual is appropriate when we are talking about single employer——

Mr. WALKER. Well, they already have it. They are subject to generally acceptable accounting principles. For example, PBGC's $23.3 billion deficit at September 30, 2004, include United Airlines, which did not terminate until this year.

Now, why did it include United Airlines? Because under generally accepted accounting principles, if it is identifiable, probable and estimatable, you have to book it as a liability on an accrual basis.

Interestingly, if you end up increasing PBGC's premiums, that will help the Federal budget. That will help PBGC in the short term. But they will still have a huge hole. So it might make them look like they are better off than they are, but in reality they are still in a huge whole.

Mr. RYAN. And there is some peril to that.

What is the infinite horizon number on Medicare trustees? I don't know off the top of my head.

Mr. WALKER. I remember Social Security's number is over $10 trillion. I do not remember the Medicare number.

Mr. RYAN. You don't know Medicare?

Mr. WALKER. Not off the top of my head but I will be happy to provide it for the record.

Mr. RYAN. Thanks.

Chairman NUSSLE. Mr. Edwards.

Mr. EDWARDS. Mr. Chairman, let me first thank you for holding this meeting.

Mr. Spratt, for asking for it.

I think as an institution, we are good sometimes at addressing immediate crises. We are reactive, though, as an institution. We are not very good at trying to prevent crises 10, 20 years down the line. I think it is important that you start the first process, educating Members of Congress that there is a serious problem here.

General Walker, I guess this is a request, perhaps, as you play a leadership role in addressing this problem, I hope you will address the issue of corporate responsibility and fairness.

I think our capitalist system, which is the greatest capitalist system in the history of the world, depends on trust, as you know better than I do.

And while the key issue here is protecting the pension benefits of workers and not exposing taxpayers to too much liability, the fact is that if corporate CEOs are getting golden parachutes, the very same CEOs who in many cases are responsible for making the poor management decisions that drove their corporations into bankruptcy, they are being protected with golden parachutes by boards, and workers are getting the shaft and losing their pensions altogether, a great percentage of them, you are really going to lose trust in this system.

And I hope that aspect of it, while the numbers of corporate execs may be limited, I think it is a huge issue that Mr. Moore dealt with. And I hope somehow we deal with that.

And I know you have to be careful. You don't want to punish corporate CEO and executives that were not responsible for driving a company into bankruptcy and you don't want to set up kinds of disincentives to corporate executives so that none of them would ever want to set up a defined benefit plan.

But within those limitations, I hope that issue is seen as not just a minor side issue, but an important part of the public's confidence in our system.

Let me ask this. I haven't looked carefully at the status of General Motors, but I understand their bonds are at junk bond level now. If tomorrow—let us be clear, General Motors is not going to go bankrupt tomorrow—but if General Motors would go bankrupt, what would be the implications on PBGC of that, in terms of dollar exposure? If you were to assume the Federal Government would make the benefits, pension benefits of their employees.

Mr. HOLTZ-EAKIN. I think the honest answer is: We don't know. The PBGC knows, but they can't tell us. I mean, the filings are confidential. It is a substantial pension risk. It is a very big number.

Mr. EDWARDS. We can generally—we could probably do some decent estimating. You have to do that all the time as an economist, and I respect that. I assume you could estimate the average worker's pension benefit, given an average expected life expectancy, would cost so much. And if GM went under, I mean, are we talking about $50 billion, $1 trillion, at least just to put it in perspective?

Mr. HOLTZ-EAKIN. We can produce a rough estimate.

Mr. EDWARDS. OK.

Mr. WALKER. I think that what one could do, and I will be happy to provide something for the record, is to look at the 10–K for General Motors and possibly get a sense as to what the potential magnitude is.

I don't know the number off the top of my head. It is my understanding that if that were to happen, it would be a substantial loss, possibly the largest in the history of the agency.

Mr. RYAN. Will the gentleman yield, just for a quick clarification?

Mr. EDWARDS. Be glad to.

Mr. RYAN. Is it not true that General Motors is not underfunded, and they floated $18 billion of bonds about 2 years, and they are not declared an underfunded plan? Is that not the case?

Mr. HOLTZ-EAKIN. I think that is right. That is what we are going to check.

Mr. RYAN. Yes. But Ford and Chrysler are lower than GM. GM does not have an underfunded pension plan, to my understanding.

Mr. HOLTZ-EAKIN. Yes. And I am not familiar with the nature of their investments.

Mr. RYAN. They are my larger——

Mr. HOLTZ-EAKIN. Right. OK. OK.

Mr. EDWARDS. Well, we will follow up on that issue.

Let me ask this.

Dr. Holtz-Eakin, when we reduced the corporate tax rate in the last several years, what was it reduced from, and to what level today?

Mr. HOLTZ-EAKIN. It is 35 percent now. It has been much higher in the past. It is now 34 percent for manufacturers.

Mr. EDWARDS. What role did the economic implications, if you were to take those companies that your own report says many of the underfunded plans are sponsored by financially healthy firms. What if we deferred that tax cut until those pension investment plans for those corporations were considered adequate enough to——

Mr. HOLTZ-EAKIN. I don't know off the top of my head. I would be happy to go through that to the best of our ability and get back to you.

Mr. EDWARDS. OK. Final question: Has anybody looked at the 270 companies that have underfunding within $50 million as of 2002, what kind of pension plan that corporate executives in those 270 companies have? Has anybody looked at that?

Mr. HOLTZ-EAKIN. We haven't.

Have you?

Mr. WALKER. We haven't looked at that.

I think one has to be careful about General Motors, because the fact of the matter is, you have to look at the nature of their plan. If their plans have shutdown benefits, which it is very possible that they could, then they could look fine from the standpoint of the 10–K, because they are not considering the shutdowns.

But there could be real problems if in fact they actually terminate and there are huge benefits that pop up overnight.

We can't take a whole lot of comfort in the 10–K numbers. You have to look below the numbers. You have to look at the nature of the assets. You have to look at the nature of the plan and the na-

ture of the benefit obligations to truly get a true sense as to what the real exposure is.

Mr. EDWARDS. My time is up, but I would just hope someone could take a look at that in a broad brush figure, just to get a sense of what the numbers would be.

Chairman NUSSLE. Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

Thank you, Mr. Spratt, for requesting this hearing.

As always, thank the witnesses. I appreciate your leadership on these issues, and even more so on the larger deficit and debt issues.

I would like to reiterate a comment made at the outset of this hearing, that as bad as these problems are with PBGC, they are relatively small set of problems in comparison with the larger deficit and debt issues that we face.

And I hope that all our colleagues will take it to heart, some of the warnings particularly David Walker has made, because the chart that you showed at the outset of the hearing, when by 2040 it will take all government revenues just to service the debt and there will be very little, if any, money left over for national defense or Social Security or Medicare or anything, clearly should illustrate we are on the wrong path.

But this Congress is not deviating from that wrong path. In fact, we are probably accelerating, because I think General Walker has said that, I think this is an exact quote: "Arguably, 2004 was the worst year in American fiscal history," because we promised $13 trillion worth of stuff that we aren't paying for.

Eight trillion dollars of that was in one bill, the Medicare drug bill. And that bill, as I recall from the last session, has almost a billion in funding to educate Americans about the bill and transition into it and things like that.

Poor General Walker has hardly any budget to tell people about the dangers posed by promising $8 trillion in one piece of legislation that is not paid for.

So if we put this hearing in perspective, these problems are grave, but not nearly as grave as the larger problems. And I would hope we could have more hearings on the larger problems.

And with the chairman's indulgence, perhaps we can do that.

Very few issues can shake a society to its foundations, but I think this is one. As we fly back and forth to Washington in airports, we are approached by dozens of airport workers, scared, because they are afraid their airline is going to declare bankruptcy, and they don't really know what PBGC will or will not do for them. Upper income folks over $45,000 are particularly concerned.

But is it not true—my understanding is that an employee who works for what they thought was a good American company, works for 20 or 30 years, has a defined benefit plan, that should that company go bankrupt, that employee, despite a lifetime of work and hard service is just an unsecured creditor in the bankruptcy proceedings. So they would come after a long line of secured creditors and others who would have a prior claim on the assets of that company.

Is that a correct understanding?

Mr. HOLTZ-EAKIN. I think the crucial issue is where does the PBGC stand in line in bankruptcy. And indeed, they don't have any preferred status in bankruptcy. And as a result, cannot claim assets and other resources to honor the benefit.

Mr. COOPER. With a woefully underfunded, underprepared PBGC, they are going to start looking to us, the U.S. Congress and to the American taxpayer almost immediately.

Because they thought they were already part of an ownership society. They thought they already owned their pension. They thought it was due them.

And these people are waking up and suddenly finding that their entire retirement plan is possibly shaken, if not destroyed.

Mr. WALKER. Mr. Cooper, Doug is correct in saying that the issue is not about the individual participants. If the plan terminates, is underfunded, and is guaranteed by PBGC, then the PBGC stands in line.

A vast majority of their claims typically are unsecured claims. There are certain circumstances in which they could have secured or priority claims, but those are generally the exception rather than the rule.

Therefore, that is why it is important not just to think about this as a PBGC issue, there are real losses imposed on participants, even if PBGC steps in and even if PBGC is adequately funded for today and tomorrow.

Mr. COOPER. If they were listening to this hearing, they would have heard already that these multi-employer plans are safer, because there at least you have multiple managements watching the store.

They would have also heard that a lot of our CEOs have made sure that they were taken care of through nonqualified plans, so they don't have to worry about PBGC or anything. Their plan is funded and safe and removed from bankruptcy and taken care of.

So the average poor worker, who all they have done is do a good job at their job their entire life would have to feel a little worried at this point.

And they realize theirs is a single employer plan, so there hasn't been that level of safeguard. The PBGC is underfunded. Their boss or bosses have taken care of themselves and really probably don't care in terms of their own financial interests. That seems to be a society in which it is more dog eat dog than the Golden Rule.

Mr. WALKER. Excuse me, I think we have to be careful, a significant majority of sponsors of single employer defined benefit plans are responsible and a majority of the plans are well-funded.

Regarding multi-employer plans, I think we have to be careful, because they are not necessarily better off. It is individual facts and circumstances.

There are troubled multi-employer plans too.

Mr. COOPER. I would agree. Most plans are properly run. But if you are in the airline industry or the steel industry or some of these other industries, you are likely to be extremely concerned.

And I worry that our government looks so out of touch. If we can't even get data that is more than 3 years old, we look clueless and hopeless in trying to protect people and their earned benefits.

So this is the situation.

I appreciate your testimony. I see my time has expired. But this should be an urgent matter, not as big as the overall debt crisis that we face, but an urgent matter for this Congress to face up to.

I thank the gentleman.

Chairman NUSSLE. Mr. Case.

Mr. CASE. Thank you.

We are all taking off on Mr. Cooper's comments about going through airports. I am married to a United Airlines flight attendant, who used to be a Pan American flight attendant. That is called a double PBGC whammy. Not only do I not want to go through airports nowadays, I don't even want to go home. [Laughter.]

Let me ask you a bigger picture question, because I think we obviously have a problem, a looming crisis. And one more large bankruptcy is going to turn it into a full-blown crisis.

I think it is important for us to understand the generational extent of the problem. Let me make a statement and get your reaction to it. In the next 25 to 50 years, are we going to have a substantial population of defined benefit plans? Because it strikes me that in the big picture, they are moving toward some form of obsolescence.

I am talking about private plans, by the way. State and county governments and the Federal Government—well, the Federal Government is pretty much out of it at this point, but State and county governments are still in the defined benefit arena, and they can figure that out, that doesn't really affect us.

But in the private sector, are we looking at getting through a bubble here, a 25-year bubble? I don't know the figures about whether new companies or old companies are creating new defined benefit plans, or whether they are primarily trying to shift the risk, the overall risk, over to the employees or come up with a different program that will somehow yield really the defined contribution model being the pension model, if we have that model at all, from a private employment perspective.

Is there any anecdotal or empirical evidence that that is happening?

Mr. HOLTZ-EAKIN. Well, there is lots of evidence on trends. The defined benefit plan used to be the preferred model. But a greater fraction of the labor force is now covered by defined contribution plans than defined benefit plans. So certainly as a fraction of workers, defined benefit plans are going down, defined contribution plans are going up.

In terms of absolute numbers, there are more workers covered than ever by defined benefit plans.

Defined benefit plans will be an important part of the landscape for quite a while to come. Even if they diminish as a fraction of the total.

Mr. WALKER. I differ somewhat on this. First, my wife is a Delta Airlines retired flight attendant, so I feel your pain.

Mr. CASE. Condolences.

Mr. WALKER. I haven't felt it yet, but we may in the future.

Defined benefit plans have been declining in number. The number of participants covered in defined benefit plans are such that more and more represent retirees, rather than actives.

Thirdly, the only types of defined benefit plans that have really showed any life, as far as creating them, are so-called hybrid plans, that look more like defined contribution plans, but they provide some type of a defined promise, like cash balance plans.

One of the reasons is because when the Congress imposed the reversion tax, in other words, when sponsors terminate their plans, take out excess money, when they are well-funded, they have to pay excise taxes on that. As a result a lot of sponsors, rather than going from a defined benefit plan to a defined contribution plan, which is clearly where the growth is in the private sector and it is likely to stay for a number of years for a variety of reasons, many went to a hybrid plan as a way that they could move toward the defined contribution world, have potentially less volatility and uncertainty with regard to their risk, and be able to obtain the economic benefit of the surplus without having to pay excise taxes.

I think it is highly unlikely that the traditional defined benefit plan will resurge any time in the near future, at least.

Mr. CASE. Let me ask you, from a perspective of foreign competition, if you know, when our companies go out there and try and compete in the world with a defined benefit plan, are they at a distinct competitive disadvantage at that point, because I assume that it is true.

I don't really know what is happening in China, for example, in terms of private pension plans. But it would seem to me that if the trend here over time is that the competition in increasingly from China, especially in classic defined benefit plan country like manufacturing, that you would see the companies of our country in manufacturing evolve away from defined benefit plans because it is just simply uncompetitive when they look overseas at a place like China.

Mr. HOLTZ-EAKIN. I think it is useful to do that in two steps. Step one is to determine the nature of overall compensation relative to the productivity of the workers? That determines fundamental competitiveness.

And pensions are part of that compensation. And the issue with the defined benefit plans and the PBGC is, in those circumstances, whether at a firm level or at an industry level or an economy level, competitiveness changes and compensation needs to be restructured, i.e., you have to change the way you do business.

How can past promises be preserved for the future? That is the nature of the insurance, because you will never be able to fully anticipate whether today's compensation bargain is the right one for tomorrow.

But given these structures, employees have done the work. You have promised the compensation. You have to somehow either put the resources aside or buy insurance to make sure that they get paid for their past labor. And so you want to break the question of competitiveness between total compensation and the competitiveness that that delivers—versus assuring that the commitments of the past are honored.

Those are two different problems.

Mr. WALKER. The biggest competitive challenge that we face is health care, by far. That is truly a competitive disadvantage.

Secondly, if you look at the nature of past losses and exposure, in the defined benefit system to the PBGC and the planned participants and beneficiaries, they are concentrated overwhelmingly in industries that have one of two characteristics—number one, increasing global competition, and number two, domestic deregulation.

Those are where a vast majority of the losses are.

Mr. CASE. Thank you.

Chairman NUSSLE. Mr. Davis.

Mr. DAVIS. Thank you, Mr. Chairman.

General, Mr. Holtz-Eakin, welcome to you today.

You were saying, General Walker, that your belief is that the overwhelming majority of corporate actors are responsible in this area and that the overwhelming majority of companies have made the appropriate decisions in terms of contributing to their pension plans.

I would contrast that a little bit with some observations that I saw in The Washington Post a few days ago, and you may or may not want to comment on the veracity of these statements.

There was an observation from the GAO that said that because of the rules and the requirements as to the contributions, that over 60 percent of the largest companies between 1995 and 2002 did not make adequate new contributions to their plans.

The Republican chairman of the Senate Finance Committee, Senator Grassley, bemoaned the fact that, as he put it, "the rules themselves were full of very serious holes."

As I listen to this argument, I have this image in my mind of the bankruptcy debate that we had just a couple of months ago. And in interest of full disclosure, I voted for the bankruptcy bill because I tend to prefer bright-line standards over no standards.

But during that debate over bankruptcy, there were a lot of people on, frankly, both sides of the aisle, on my side, on the chairman's side, who kept using the phrase "personal responsibility" over and over again.

And it sounds great, this idea of personal responsibility, this idea that people pay their bills, which is better known as another way of keeping your promises, because when you enter an arrangement with a creditor and promise to pay them, that is a promise, in effect.

And we got very outraged about the idea that, well, people making $45,000 a year were shirking their duties and they were trying to get in Chapter 7 when they didn't need to be, and we got all bent out of shape about all of these middle-class people walking around who just didn't want to pay their bills, weren't being responsible.

It seems pretty clear to me that we are talking about another kind of moral responsibility here.

When a company enters an arrangement with an employee and provides a pension, that strikes me that, that is as moral a promise as the one a creditor makes with a debtor, and that—vice versa—and that ultimately there are companies in America, some of them with the excuse of hard times, some of them without that excuse, who are simply taking advantage of fairly soft rules and not adequately funding their plan.

And I am reminded, frankly, of something that the 42d President of the United States, Bill Clinton, used to say a lot. He used to, when he was making my party one that identified with personal responsibility again, he would use the phrase that for all of our talk about personal responsibility, we shouldn't lose sight of the fact that the greatest flight from responsibility in this country in the 1980s and 1990s came at the top and not the bottom of the economic sphere.

And I would submit that, frankly, that is where we are again. Frankly, the bankruptcy bill that we passed and that I voted for should have given priority to the PBGC.

Frankly, we ought to be finding ways, across the aisle, to incentivize companies to do the right things for their employees. We ought to be doing things to incentivize them to contribute to their pension plans.

And we shouldn't just be so cavalier about this idea that when companies get in trouble the first people they ask to sacrifice are the people who are earning their profits for them every single day.

I think that this is a matter of moral responsibility. And would either of you care to comment on that proposition?

Mr. WALKER. Well, let me comment on the GAO report, because I reviewed it, and it is referenced in my testimony.

Basically, overall funding levels have deteriorated during the period 1995 to 2002, but most plans were well-funded.

Here is what happens. When companies start to get into trouble, they start using the rules such that they will do what they are minimally required to do under the law, rather than what is right.

My personal view is, is that people ought to not make promises that they can't deliver on and that the law should be structured to maximize the chance that they are held responsible and accountable to do that in the vast majority of circumstances.

But the simple fact of the matter is, history has shown that when people get in trouble, pensions are not a priority, they do the minimum, and therefore there is a put option exercised on the PBGC which ultimately represents a contingent liability to the taxpayer.

Last thing. I have been very outspoken on the need for corporate governance reform, and on the need for additional transparency and accountability in the private sector. GAO and I were very actively involved in Sarbanes-Oxley and other issues, and we will continue to be.

Mr. DAVIS. Well, I appreciate that.

If I can just wrap up, Mr. Chairman, in just 10 seconds.

I mean, frankly, all the people in my party who are sitting around looking for a big idea for us to talk about, this ought to be one of our big ideas, how we keep our commitment to employees every day and how we stop companies from shirking their responsibilities by taking advantage of loopholes.

If it is good enough for people who are filing bankruptcy—you know, sometimes I wish that we cared as much about the people who vote for us, as we do the people who write us checks.

Chairman NUSSLE. Ms. Schwartz.

Ms. SCHWARTZ. Thank you, Mr. Chairman. And thank you also for this hearing.

And I appreciate the most recent questions, and in particular I know there was a lot of discussion about, generally, transparency and knowing more about what is going on.

But I am really interested in that, because of Mr. Davis and Mr. Cooper asking very much about the employee, about the plan participants. And I know there has been a lot of discussion about personal responsibility, about individual employees being able to take on pretty important decisions about how they invest and save for the future.

I do not agree with the president's plan to privatize Social Security. But I do agree that Americans should have both flexibility and ability to make retirement investment decisions and be given more flexibility and information to do that.

We are now faced with the whole concern you have about pensions and about their not being there. And you have been calling for more information to us, Congress, to you, to just make sure we don't end up with too many underfunded pensions.

But even looking at the president's proposal and some of his ideas, which I think some of them are good ones, how much information is going to be available to employees along the way? To what degree do you think they ought to know and have access to information in an understandable way?

Everyone can say, look, stockholders, shareholders, employees, can go to annual meetings and they can look through all that information. But I think all of us who have been employees, our eyes glaze over when we have our 5-minute meeting with the human resources person when we first get hired, and we never see them again, until we retire.

And then we say, "Well what did the fine print say?" And there are a lot of years in between.

And how can we in an ongoing way provide information to employees or require companies to provide that information to employees about the status of their pension plans, changes that have been made, the degree to which they are funded or unfunded,even the concern today is, they have been funded adequately, but it has not been doing well, so that the value has gone down and maybe appropriately the company says I am going to take some money out of there, put it in there, try and invest in the company. It will do better. Employees will ultimately do better and I will be able to pay back the pension plan.

It sounds a little bit like what the Government is doing with some Social Security trust funds.

But it is maybe not an outrageous notion, except when it doesn't work. And when in fact, they are paying far too little in and it ends up in a disaster, which then the taxpayers have to pay and employees don't get all that they should.

So my question is, what can we and should we be doing to require companies to be more straightforward with their employees and provide information in a really consumer friendly way, if you could say that, and encourage employees to take all the personal responsibility they can to understand the reality that they are in? So not just dealing with the fear that everybody has about what next, but what can actually be done to help the employee be a part of the solution, if they can be at all?

Mr. WALKER. I think it is important to note that under current law, plan participants and beneficiaries are required to get a summary annual report. They have the opportunity to receive the Form 5500, which is the annual report that is filed with the Government. They obviously have an opportunity to look, if it is a public company, at the 10–K.

I think the problem is is that some of the information that they are giving is not in a very useful and usable format. It is provided as part of a tremendous amount of information and people don't really understand what is important.

I think one of the answers is, you need to give them more timely, more market-based information and in a way that they are more likely to pay attention to it, understand about it, and care about it.

I think that should be a key element of any comprehensive reform proposal.

Ms. SCHWARTZ. OK. You need to be more specific about that as we go forward, about what that would mean.

I guess the next question would be, do you think that they should be able to take any action—I am not sure what that would be. But what happens when they get all this information and they find out that it is going to be pretty tough going forward? What then do they do about it?

Mr. WALKER. Well, it depends. I mean, the fact of the matter is, if it is a collectively bargained plan, and if they knew more about it, employees could end up bringing more pressure on those who represent them to try to be able to make sure that the plan is adequately funded.

If it is not a collectively bargained plan, employees could bring more pressure on management in order to try to make sure that people are not just avoiding the problems.

Transparency and sunshine is a powerful force. A lot of bad things can happen if they are done in the dark. So I think we need to include this.

Ms. SCHWARTZ. OK. I appreciate that. And again, the information be in a really consumer-usable way is really the point. So thank you very much.

Thank you, Mr. Chairman.

Chairman NUSSLE. I thank the gentlelady.

Thank you very much, both of you, for your testimony today. This is an opportunity to be in some ways a canary in the mine shaft. And we hope that the warnings will be taken by our colleagues on other committees.

We will certainly make sure that they understand what happened on some of the testimony here today, and hopefully we can begin to use the reconciliation process this year to usher through some new proposals with regard to PBGC to help alleviate the challenges that are obviously upcoming, from your testimony.

Mr. Walker.

Mr. WALKER. One quick thing, Mr. Chairman.

I just want to refamiliarize you and the other members on the committee with our "21st Century Challenges" report. Several of the members, including yourself as chair, noted that this is a subset of a much bigger problem.

There are 202 illustrative questions that need to be asked and answered about the base of the Federal Government in here. One of them relates to PBGC.

This is an important issue, but it is a subset of a much bigger challenge. We look forward to working with you and others to try to address them in the future.

Thank you.

Chairman NUSSLE. I thank you.

And without anything further to come before the committee, we will stand adjourned.

[Whereupon, at 11:30 a.m., the committee was adjourned.]

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