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NO GUARANTEES: AS PENSION PLANS CRUMBLE, CAN PBGC DELIVER?

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UNITED STATES SENATE

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NO GUARANTEES: AS PENSION PLANS CRUMBLE, CAN PBGC DELIVER?

WEDNESDAY, MAY 20, 2009

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The Committee met, pursuant to notice, at 2:10 p.m. in room SR–428A, Russell Senate Office Building, Hon. Herb Kohl (chairman of the committee) presiding.

Present: Senators Kohl [presiding], Specter, Martinez, Bennett, and McCaskill.

OPENING STATEMENT OF SENATOR HERB KOHL, CHAIRMAN

The CHAIRMAN. Good afternoon, and thank you all for being here today. Today we are going to take a hard look at the Pension Benefit Guaranty Corporation, which is responsible for insuring the pensions of nearly 44 million Americans. The Committee has grave concerns about PBGC's viability and whether this agency currently has effective financial oversight.

Given the state of the economy, the question of PBGC's viability is more urgent than ever. One in seven Americans count on this agency to pay out their pension in the event that their employer is unable to due to bankruptcy. As General Motors teeters on the edge of insolvency, hundreds of thousands of workers' pensions could soon become the responsibility of PBGC, and though Chrysler has managed to maintain its pension plan despite filing for bankruptcy, it may only be a matter of time before PBGC will have to accept responsibility for that pension plan as well.

PBGC is currently underfunded by over $33 billion, while their duty to manage and pay out benefits is expanding. Decisions made by PBGC management and a lack of oversight and governance by previous PBGC boards have contributed to the agency's financial condition. The Government Accountability Office has indicated for years that the PBGC board members do not have enough time or resources to provide the necessary policy direction and oversight.

In 28 years, the full board has met only 20 times. The fact that we could not get a representative of the PBGC board to come to this hearing is a prime example of this. But the role of PBGC is too crucial to allow its governance to slip through the cracks.

The PBGC Inspector General released a report last week detailing allegations that former PBGC Director Charles Millard was improperly involved in the awarding of $100 million contract to Wall Street firms. But the allegations against Mr. Millard are merely a symptom of the bigger problem. I will soon be introducing legisla-

tion to significantly improve the PBGC board's governance oversight structure.

In the meantime, PBGC should reopen the bidding process for the controversial $100 million contract, a process which appears to have been improperly influenced the first time around. Yesterday, I received a letter from Secretary of Labor Hilda Solis, indicating that they are lucky to do so, which I will enter into this hearing's record.

If the contract is not rebid, we will ask GAO Special Investigations Unit to assist us in reviewing copies of PBGC-related communication the committee has obtained from the Wall Street firms that won the first contract. Finance Chairman Max Baucus and Health Chairman Ted Kennedy, along with Ranking Members Chuck Grassley and Mike Enzi, have also noted this issue closely and will keep a close watch to ensure that PBGC carries out the recommendations of its Inspector General. They also have requested a further investigation into Millard's involvement with these companies.

The role of the PBGC is a vital one, now more than ever. For 44 million Americans with defined benefit pension plans, PBGC is the only thing that stands between the secure retirement they have worked so hard for and the prospect of living without retirement security. So we must get the PBGC back on track or face the possibility of absorbing these obligations on behalf of taxpayers all over our country.

So we thank you all for being here today. We look forward to your testimony. I will at this point introduce the witnesses for this panel.

Our first witness will be Charles Millard, the former Director of the PBGC. Prior to being appointed as PBGC's Director, Mr. Millard held executive positions at investment firms, such as Lehman Brothers and Broadway Partners. He was also a member of the New York City Council, representing the Upper East Side of Manhattan.

Our next witness will be Dallas Salisbury, the CEO and President of the Employee Benefit Research Institute. He's considered an expert on economic security and has served on the ERISA Advisory Council, the PBGC Advisory Committee, the U.S. Advisory Panel on Medicare Education, and the Board of Directors of the National Academy of Social Insurance.

Next we'll be hearing from Barbara Bovbjerg of the U.S. Government Accountability Office. Ms. Bovbjerg is a Director of the Education Workforce and Income Security team, where she oversees evaluative studies on aging and retirement income policy, as well as the operators of the Social Security Administration, the PBGC, and the Employee Benefit Security Administration of the Department of Labor.

Then we'll hear from Rebecca Anne Batts, the Inspector General for the Pension Benefit Guaranty Corporation. As Inspector General, she directs the office charged with overseeing PBGC's operations. Prior to her appointment, Ms. Batts held various senior executive positions at the U.S. Department of Transportation's Officer of Inspector General.

Our witness finally will be Vincent Snowbarger. Mr. Snowbarger is the Acting Director of the Pension Benefit Guaranty Corporation. Since joining the PBGC in 2002, he has served in several executive positions, including Deputy Director for Policy, and is currently the Deputy Director for Operations.

Because we're taking testimony with regard to matters of fact in this controversy, I'll be asking each of our witnesses to take the oath, and so I ask you please to stand and raise your right hand.

[Whereupon, the witnesses were duly sworn.]

The CHAIRMAN. Do you all swear that the testimony you're about to give is the truth, the whole truth, and nothing but the truth, so help you God? Thank you.

Mr. Millard, I'll turn to you first. I want to recognize that you are here today with your attorneys, and we welcome them here also with you. You have an opening statement, Mr. Millard.

TESTIMONY OF CHARLES E.F. MILLARD, FORMER DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, DC

Mr. MILLARD. I do not have an opening statement, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Millard, what was your role at PBGC, and how long were you employed there?

Mr. MILLARD. I've been advised by my counsel that I should invoke my constitutional rights and decline to answer any and all questions from the committee on this matter, Mr. Chairman.

The CHAIRMAN. Mr. Millard, it has been said that the investment strategy you spearheaded at PBGC is overly risky. What steps did you take to mitigate the risk associated with the strategy?

Mr. MILLARD. I've been advised by my counsel, Mr. Chairman, that I should invoke my constitutional rights and decline to answer any and all questions from the committee on this matter.

The CHAIRMAN. Mr. Millard, the Inspector General has reported that you were inappropriately involved in the contracting process at PBGC. Would you respond to these assertions?

Mr. MILLARD. I've been advised by my counsel, Mr. Chairman, that I should invoke my constitutional rights and decline to answer any and all questions from the committee on this matter.

The CHAIRMAN. We need to be sure that you, and not your counsel, are asserting the right, and that you're clear that you're invoking your right under the Fifth Amendment against self-incrimination, being a witness against yourself, and you're not using a formulation that leaves that overly vague. You do understand that. I'm sure you do. So we do understand from your responses that you will invoke your Fifth Amendment right in response to all questions from this committee on this subject.

Mr. MILLARD. Yes, sir.

The CHAIRMAN. Thank you, Mr. Millard. Let the record reflect that you have availed yourself of the privilege afforded you under the Fifth Amendment of the Constitution not to give testimony that might incriminate you, and you certainly have that right. The invocation of that right by every American citizen should not and does not impose any guilt.

The committee respects your constitutional right to decline and answer questions on that ground, although we certainly would have liked to have been able to hear from you today. You are correspondingly excused at this time.

Mr. MILLARD. Thank you.

The CHAIRMAN. Thank you, Mr. Millard. Before we move on to our next witness, I would like to welcome Mel Martinez, the Ranking Member on this committee, and ask him for his statement.

STATEMENT OF SENATOR MEL MARTINEZ, RANKING MEMBER

Senator MARTINEZ. Thank you very much, Mr. Chairman. Thank you very much. I apologize for being a little tardy. The Commerce Committee was also meeting. We appreciate your calling this hearing today. One of the biggest concerns among seniors today is a need to protect their pensions, especially given the state of our economy. Every senior has a right to know whether they will receive the benefits they were promised. Current economic uncertainties has highlighted a need to address the risk posed by several large firms teetering on the brink of insolvency.

As lawmakers, we cannot stand by as the fate of the pensions of many Americans remains uncertain. Fortunately, most pensions are protected by the Pension Benefit Guaranty Corporation. The PBGC is the pension manager of last resort and has the unenviable task of cleaning up where others have failed. Insolvent pensions that are turned over to the PBGC are significantly underfunded, leaving the future benefit levels at risk.

What I would like to see is fewer pensions being underfunded and fewer pensions taken over by the PBGC. These underfunded pensions have resulted in a $409 billion funding shortfall in the U.S. pension system. The pensions of those working for the Big 3 in Detroit, for instance, which include auto manufacturers and the 46 largest suppliers, are underfunded by $65 billion, with 2.1 million Americans relying on these plans.

Seniors in Florida are at risk as well. Florida's the home to more than 2 million seniors with pensions that could be impacted by factors beyond their control, including a depressed stock market and relaxed corporate governance.

How we got here and what led to these pensions being underfunded is an open question that is being addressed by other committees today. I look forward to hearing from the PBGC acting director about what contingency plans are in place in the event of further economic collapse. If one or more of the Big 3 pensions winds up being taken over by the PBGC, what plans are in place to ensure continued solvency and minimal disruption to the pensioners?

The systems we've seen is not healthy in its current form of legislation, such as—were to pass, the resulting increase in pensions would only perpetuate these underfunded multiemployer plans. The issue is only one of many concerns I have with the bill.

Peripheral, but significant, and relevant to the hearing today is the controversy involving the Director of PBGC, and we have just seen his testimony today, or his inability to testify today. While we face uncertainty in the near term, I applaud the efforts by the PBGC in the wake of the previous challenges, including the col-

lapse of the steel industry. Collectively, we can find solutions to these problems without placing a greater burden on the taxpayers whose pensions remain insolvent or who have no pension at all. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Martinez. We'll now turn to our first witness, Dallas Salisbury, who I said is the CEO and President of the Employee Benefit Research Institute. We would appreciate if you would keep your remarks to 5 minutes. If you have more to enter into the record, we'd be happy to do that. Mr. Salisbury.

STATEMENT OF DALLAS SALISBURY, PRESIDENT & CEO, EMPLOYEE BENEFITS RESEARCH INSTITUTE, WASHINGTON, DC

Mr. SALISBURY. Chairman Kohl, Senator Martinez, it's a pleasure to be here. I appreciate the invitation and the opportunity to speak on a topic that is very important. As you have noted, I started my career in Washington at the Department of Labor in the Pension Benefit Guaranty Corporation.

The CHAIRMAN. Is your mic on?

Mr. SALISBURY. It is on. I'll pull it closer. As you well know, the PBGC is a guaranty program in its name, and I only stress that point because unlike the FDIC and unlike most insurers, the PBGC is not in a position on its own to create underwriting standards to put funding requirements on plans and other things.

In fact, when I was early at PBGC, we took a study under advisement from the Congress called the Contingent Employer Liability Insurance Program Study. We went to 102 insurance companies around the world, including Lloyd's of London, and all of them said that the program designed by the U.S. Congress could not be underwritten by any insurer without very significant changes, and as a result, that program was repealed by the Congress.

In the early 1980's, as part of a privatization taskforce of the advisory council of the PBGC, appointed by then-President Reagan and chaired by two private sector insurance executives, an effort was made to, in fact, privatize PBGC, eliminate it as a governmental program, and move it into the private market.

Again, over 100 insurance companies were invited to describe to this group the underwriting standards that would be necessary to, in essence, insure pension failures and to insure essentially the solvency of American corporations. The two insurance executives asked the White House to end the taskforce efforts once they saw the underwriting standards, because it became clear that this program could not be a workable insurance program, as traditionally defined. It could be a guarantee program, and the title underlines that.

I note that also, because of one point I make in my testimony, which is that one of the primary causes of pension unfunded liabilities, and as the PBGC testimony underlines, a reason for a $7 billion increase that they've now announced in the PBGC deficit is the actions by the Federal Reserve Board. The holding down to near zero the interest rates available to pension funds and available to the market created hundreds of billions of dollars of total system liability.

So if the government and the Federal Reserve wanted pension liabilities to go away, frankly, they would only need to raise interest rates, and that would eliminate the $7 billion, plus many billions more.

Thus it is the inability of pension fund sponsors, both to control interest rates they use to value liabilities and to command the equity markets to go up that led to the issues faced today.

The PBGC, as noted, is responsible for a total system that has unfunded liabilities that, by various estimates, ranged between $400 and $500 billion. That underlines the future challenges that will be faced by the PBGC. But the ultimate and most important challenge is whether private employers will continue to sponsor defined benefit retirement plans.

You ask in your question list whether strong employers were likely to continue those programs, and I've underlined in the testimony that numerous private sector surveys of employers suggest that the movement that began 30 years ago away from defined benefit plans, toward defined contribution plans, is likely to continue in this country, as it is continuing in nations around the world.

Ultimately, those surveys underline that even with the Pension Protection Act of 2006's new funding standards, that with interest rate fluctuations being managed by the Fed and the government and held down, today's papers suggest the Fed may hold interest rates to near zero for another two years. Should they do that, you can anticipate and project in advance there will be significant additional increases in the deficit of the PBGC and in the unfunded status of private defined benefit pension plans. Those will turn around if and when the government changes interest rate policies.

So, in conclusion, defined benefit plans currently as noted provide income to 23 percent of those over age 65. For those 65 to 69, 19 percent report such income. Average payments are $2,500 per year. Medium payments are $9,000 per year. These are an important and critical supplement to Social Security and must be maintained.

There is a great deal of discussion about whether the pension system can be maintained. The challenge for the government is to manage interest rates and the economy while recognizing they're intertwining with both PBGC liability and pension liability. Thank you, sir.

[The prepared statement of Mr. Salisbury follows:]

T-159

Statement
for the

United States Senate Special Committee on Aging

Hearing on the

May 20, 2009

"The Pension Benefit Guaranty Corporation"

By

Dallas Salisbury

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The views expressed in this statement are solely those of Dallas L. Salisbury and should not be attributed to the Employee Benefit Research Institute (EBRI), the EBRI Education and Research Fund, any of its programs, officers, trustees, sponsors, other staff, or any other individual or organization. The Employee Benefit Research Institute is a nonprofit, nonpartisan, education and research organization established in Washington, DC in 1978. The testimony draw from research publications of the Employee Benefit Research Institute, and other organizations, but any errors or misinterpretations are those of the witness.

Written Testimony of Dallas Salisbury

Chairman Kohl, Senator Martinez, and members of the committee: My name is Dallas Salisbury. I am president and chief executive officer of the Employee Benefit Research Institute (EBRI). I am pleased to appear before you today. All views expressed are my own, and should not be attributed to EBRI, or any other individual or organization. Established in 1978, EBRI is committed exclusively to data dissemination, policy research, and education on financial security and employee benefits. EBRI does not lobby or advocate specific policy recommendations; the mission is to provide objective and reliable research and information. All of our research is available on the Internet at www.ebri.org and our savings and financial education material is at www.choosetosave.org

I have personally worked on retirement and pension issues since joining the Labor Department in 1975 as it was organizing to fulfill its responsibilities under the Employee Retirement Income Security Act of 1974 (ERISA). I was later on the staff of the Pension Benefit Guaranty Corporation, before joining EBRI in 1978 as its first employee. While at the PBGC I served as a special assistant to the Executive Director, as Acting Director of Communications, and as Director of the Congressionally mandated study of he Multiemployer Insurance System, the results of which led to drafting and enactment of the Multiemployer Pension Plan Amendments Act. While at PBGC I participated in many meetings with the "Board reps", the individuals designated by the Secretaries of Labor, Treasury and Commerce to work with PBGC executives on an ongoing basis. These individuals had most of the direct dealings on behalf of the PBGC with these cabinet members who make up the Board of Directors of the PBGC.

After leaving the PBGC I was appointed to a special PBGC task force by President Reagan to study a proposal to "privatize" the PBGC. The group concluded that privatization of the PBGC was infeasible as corporate insolvency was not seen as an insurable event under terms that would be acceptable to Congress.

A decade after leaving the PBGC, I was appointed by President George H. W. Bush to represent the general public on the PBGC Advisory Committee, and participated in that groups interviews of many investment managers during quarterly reviews, and meetings with those applying to become investment managers. That Advisory

Committee also worked with the then Executive Director James Lockhart, now the head of the agency overseeing Fannie Mae and Freddie Mac, on reform proposals that ultimately became law in 1986, 1987 and 1994, which changed the PBGC premium structure and the circumstances under which a plan sponsor could terminate a plan and pass the liabilities to the PBGC. These changes took steps towards relating premiums to the level of unfunded exposure a plan presented to the PBGC, and towards making voluntary termination contingent upon the insolvency of the plan sponsor, unless the PBGC determined that it was in the interest of PBGC to approve a termination based upon terms negotiated to protect the agency (and thus the defined benefit system and its participants and beneficiaries).

Under Title IV of the Employee Retirement Income Security Act of 1974 (ERISA) PBGC insures, subject to statutory limits, pension benefits of participants in covered private defined benefit pension plans in the United States. The Corporation's goals include safeguarding the federal pension insurance system for the benefit of participants, plan sponsors, and other stakeholders, providing exceptional service to customers and stakeholders, and exercising effective and efficient stewardship of PBGC resources. (PBGC 2008 Annual Report)

Given limited time I will respond the three sets of specific questions provided to me and then would be pleased to respond to any additional questions.

First: What are the current obligations facing the PBGC?

PBGC estimates that, measured on a termination basis, total underfunding in single-employer defined benefit plans that PBGC insures was approximately $225 billion as of December 31, 2006. A April 2009 report from Milliman estimated that the largest 100 plans were slightly overfunded as a group at year end 2006, while a total system estimate from Ryan Labs Asset Management found the total system to be 88 percent funded at year end 2006. By April of 2009 Milliman estimated that the 100 largest funds were 80 percent funded, and Ryan estimated that the entire system was just over 70 percent funded, suggesting total system underfunding of as much as $500 billion.

The PBGC protects the benefits of most private single and multi-employer pension plans in the event that the plans are terminated without sufficient assets to pay all

benefits. The total obligation represented for the PBGC is highly volatile from month to month and year to year. For example, the PBGC 2008 actuarial report stated:

For the single-employer program, the liability as of September 30, 2008 consisted of:

(1) $57.32 billion for the 3,850 plans that have terminated; and

(2) $12.61 billion for 27 probable terminations.

For the multiemployer program, the liability as of September 30, 2008 consisted of:

(1) $1 million for 10 pension plans that terminated before the passage of the Multiemployer Pension Plan Amendments Act (MPPAA) and of which PBGC is trustee; and

(2) $1.768 billion for probable and estimable post-MPPAA losses due to financial assistance to 90 multiemployer pension plans that were, or were expected to become, insolvent.

Today's testimony by PBGC suggests that the $12.61 billion has now increased to $23.61 billion, and the $57.32 billion to about $67 billion due to interest rate changes ($7 billion) and investment losses ($3 billion). These changes underline the volatility experienced by all defined benefit pension plans tied to both interest rates (liability swings) and investments (asset swings), and the reason plan sponsors have generally argued against mark to market accounting and for smoothing both interest rate and investment return volatility in order to smooth contributions.

How many pensions is it insuring?

The Pension Benefit Guaranty Corporation (PBGC) insures the pensions of about 33.8 million workers and retirees in about 28,000 private-sector defined benefit pension plans under its single-employer insurance program, and 10.1 million participants under its multiemployer program in about 1500 plans.

What are the basic demographics of this group?

Looking at workers with a defined benefit plan, they are predominately union, and older. About 13 percent of all private workers are in a single employer defined benefit plan and 4 percent in a multiemployer plan. About half the insured participants are active, about one quarter retired, and about one quarter separated and vested but not yet retired.

Second: How prepared is the PBGC in paying out existing pensions and what

limitations does PBGC face in securing revenue for this (i.e. inability to raise premiums, etc.).

The current assets of PBGC exceeded the liabilities attributable to plans that had already terminated at the end of FY 2007, but today's testimony suggests that is no longer the case. However, annual net negative cash flow is about $2.5 billion, providing for nearly two decades of payments at current asset levels.

The longer term issue relates to what one expects for the future in terms of terminations and net liabilities related to them.

The PBGC has the ability to return to the Congress at any time with a request to raise premiums on insured defined benefit plans. The issue is not the ability to do so, but rather the implications in the longer term future of defined benefit plans and their ability to pay premiums. The total number of participants has continued to increase slowly on whom premiums are paid, even as the number of plans decreases.

Third: What are the future challenges facing the PBGC?

The major future issue for PBGC is what happens to defined benefit plans. As long as an employer or group of employers maintains the plan until it is pays its last benefit, PBGC is fine. The risk is underfunded terminations due to business failures or reorganizations. The revised figures discussed today by PBGC suggest that this is a major challenge should the current economic crisis continue for some time, including their estimate of potential auto industry net exposure of $42 billion dollars were all plans to end up with the PBGC.

Fourth: What does the current DB pension system environment look like?

The current system environment is mixed to bad. Plan terminations have accelerated. Plan freezes have accelerated. And, the current economic crisis holds the potential for more plans to shift liabilities to the PBGC.

Fifth: What plans may default to the PBGC in the future (i.e. auto companies)?

The PBGC provides estimates of probable terminations in multiple industries. Their 2008 reports suggested significant exposure in transportation, retail, financial services and health care. Their testimony today underlines the dramatic erosion in the economy since the end of September, and the possible consequences for PBGC. The longer the economic recession continues, the higher unemployment goes, and the longer the Federal

Reserve holds down interest rates, the worse the situation for defined benefit plans and the PBGC will become. Low interest rates cause pension liabilities to rise, and that in turn requires much larger pension contributions when rates are smoothed over 3 to 5 years instead of 20, 30 or 40. Provisions in the Pension Protection Act of 2006, combined with current interest rate policy, will likely combine to cause harm to the defined benefit system and the PBGC in the years immediately ahead. That does not speak to the merits of the policies, just the results.

Sixth: What are the future liabilities (unhealthy DB plans) for the PBGC?

PBGC annually reports numbers on a broader set of possible terminations by industry, without naming firms. At year-end 2008, PBGC estimated its exposure from underfunding by plan sponsors whose credit ratings were below investment grade or who met one or more financial distress criteria at approximately $47 billion in 2008, down from $66 billion in 2007. Given current conditions, as reported by PBGC today, this number is moving back up. As they note, dropping interest rates added an estimated $7 billion to PBGC liabilities since the end of September.

Seventh: How will this affect the PBGC moving forward?

Were both Chrysler and GM plans to move to the PBGC, which may not happen, total assets of the agency would move towards 200 billion dollars. Liabilities would grow large as well, but cash flow on those plans would be easily covered for many years. The ongoing risk for PBGC also relates to premium payments, as terminations move participants onto the books of the PBGC. Thus, the PBGC has strong motivation to have firms that survive bankruptcy to keep their pension plans, even if then frozen.

Eight: Are companies with healthy DB plans likely to retain their plans and remain paying premiums into the future?

Companies and unions that continue to believe that the plan helps them achieve workforce and retirement objectives at a justifiable cost will do so. But, recent years have seen many companies that are healthy and have healthy DB plans make the decision to freeze them, and in some cases terminate them. The level of volatility that mark to market accounting / funding introduces, particularly in recent years when market volatility has been significant, serves to decrease the incentives for many sponsors to continue their defined benefit plans. Recent consulting firm surveys suggest that the

movement away from open defined benefit plans by strong companies will continue. And, the affect that the rules of the Pension Protection Act of 2006 are already having on many seemingly health DB plans is not encouraging, as committed plan sponsors have taken action to freeze their plans at least temporarily due to large contributions being required due to extraordinary investment and interest rate volatility.

Conclusion

Defined benefit plans in the private sector currently provide annuity income to about 23 percent of those over age 65. For those between 65 and 69, 18.8 percent report such income, with average payments of $2,491 and median payments of $9,180. These are important additions to Social Security.

The average pension paid by PBGC in 2006 was $6,372. While there is much focus on the fact that PBGC pays a maximum benefit of about $54,000, it is important to note that for most defined benefit plan participants that limit represents a dream, not a problem.

There has been a great deal of discussion about the advent of 401(k) plans and what that may mean for workers. Data on current IRA and 401(k) account balances from the Federal Reserve that individuals near retirement age have sufficient balances to provide median annual income of between $7,000 and $9,000 for married individuals, and $3,000 and $5,000 for single individuals.

Defined benefit plans are important for many, as they were to my father throughout his 93 years, as well as to my sister in law since my brother passed away at the age of 64 and left a joint and survivor pension. Defined contribution plans are as well, as individuals like me depend only on a 401(k) account balance and 30 years of contributions and investment earnings.

In all cases, the objective should be to keep all promises that are kept, and to help individuals spend and save and invest on an informed basis. Or as we say so often, choose to save if you do not want to work forever!

Thank you for the invitation to be with you today.

The CHAIRMAN. Thank you very much, Mr. Salisbury. Next, we'll hear from Barbara Bovbjerg of the U.S. Government Accountability Office. Ms. Bovbjerg.

STATEMENT OF BARBARA BOVBJERG, DIRECTOR, EDUCATION, WORKFORCE AND INCOME SECURITY, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, WASHINGTON, DC

Ms. Bovbjerg. Thank you, Mr. Chairman. Good afternoon, Senator Martinez, Senator Bennett. I'm pleased you invited me here today to speak about the PBGC's financial challenges and issues regarding its governance.

Created in ERISA in 1974, PBGC today insures the retirement benefits of about 40 million Americans. My statement today is based on reports that we've prepared over the last several years on these topics, updated for new information. But first, let me speak about the financial challenges.

Starting in 2002, PBGC's largest insurance program, the single-employer program, was beset by claims resulting from employer bankruptcies and the associated terminations of large underfunded plans. Indeed, we put this program on our high-risk list in 2003 and by 2004, the deficit exceeded $23 billion.

Since then, and until recently, economic conditions favorable to employers and plans helped to reduce the PBGC net deficit, and the 2006 passage of the Pension Protection Act had the potential to strengthen plan funding in the future. Indeed, as of September 2008, PBGC reported its deficit had shrunk to around $11 billion. However, this lower deficit figure reflects conditions that no longer exist. The financial market meltdown and economic recession have increased the exposure PBGC faces from financially distressed sponsors with large underfunded plans, whereas in 2008, PBGC anticipated relatively few new distress terminations.

By now, the picture is significantly worse. For example, the pension plans of Chrysler and GM today pose considerable financial uncertainty for PBGC. In the event that these automakers cannot continue to maintain their plans—as in, say, a bankruptcy scenario—PBGC may be required to take both the plans and the responsibility for paying the benefits they owe.

The plans are thought to be underfunded by roughly $30 billion, which would increase PBGC's deficit substantially. Further, absorbing these plans would almost double the number of participants PBGC must serve and the assets that PBGC must manage.

These aren't the only underfunded plans PBGC faces in the next year or so. Plan sponsors are reeling from the economic downturn, and their plan funding has doubtlessly weakened as the value of financial assets has fallen. As Dallas points out, liabilities have risen.

Further, although the Pension Protection Act was designed to improve plan funding levels, legislation passed last December delayed the implementation of the stricter funding requirements. Although the change was intended to help companies weather the current economic storm, still, plan funding will be lower than it would otherwise have been, and this too increases PBGC's exposure.

Also, PBGC recently altered its investment policy to improve returns, but our work suggests that the higher risk associated with such a policy needs more attention. For all these reasons, we believe PBGC's financial challenges are growing.

Let me now turn to PBGC's governance. Although PBGC has taken some actions in response to our management recommendations in the contracting and human capital areas, the remaining unaddressed management issues will complicate the corporation's ability to grapple effectively with the financial difficulties ahead.

This makes governance all the more important, yet PBGC's board, which is comprised of three Cabinet Secretaries, has limited time and resources to devote to providing the policy direction and oversight needed for this growing and increasingly challenged corporation.

Although the board last year approved a new set of bylaws, some critical decisions and processes go undocumented, including approval and oversight of the various changes in investment policies made over the years. Further, the composition of the board means that the entire board turns over, along with the PBGC director, when a new administration takes office, which, of course, happened in January.

It's now May 2009. The last board meeting was in February 2008, meaning the new board has yet to meet. In 2007, we recommended that the Congress restructure the board to expand membership, stagger terms, and diversify expertise, and this action continues to be urgently needed.

In conclusion, PBGC acts as crucial support for Americans' retirement income security. The corporation will be challenged as never before as it faces a deepening financial hole, combined with an overwhelming administrative burden that will doubtlessly require more PBGC staff and more contractors.

Yet, PBGC still has not made some of the strategic improvements needed in its human capital management or its contracting program, and its board is not yet positioned to provide the attentive and sustained policy guidance that is needed. So although improving PBGC governance will not by itself solve the corporation's financial problems, such actions could be critical to helping PBGC manage them. We urge Congress to consider legislating these needed improvements as, indeed, I understand you will be.

That concludes my statement, Mr. Chairman.

[The prepared statement of Ms. Bovbjerg follows:]

United States Government Accountability Office

GAO

Testimony
Before the Special Committee on Aging, U.S. Senate

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PENSION BENEFIT GUARANTY CORPORATION

Financial Challenges Highlight Need for Improved Governance and Management

Statement of Barbara D. Bovbjerg, Director
Education, Workforce, and Income Security

GAO
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GAO-09-702T

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Highlights

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Why GAO Did This Study

[illegible]

May 20, 2008

PENSION BENEFIT GUARANTY CORPORATION

Financial Challenges Highlight Need for Improved Governance and Management

What GAO Found

Financial and economic conditions have deteriorated since we last reported on PBGC's finances. While PBGC's deficit improved for fiscal year 2008, the fiscal year ended just prior to the severe market downturn, and this lower deficit may be a product of conditions that no longer exist. As a result, it is likely that PBGC's net position looks different today. Other recent events have also added to PBGC's financial challenges. These events include: recent legislation that grants funding relief to certain sponsors, developments with PBGC's investment policy, and a concern that a wide array of industry sectors—including the automotive sector—are under financial distress and may expose PBGC to future claims. As a result, the potential for automaker pension plan terminations could dramatically increase not only PBGC's deficit, but also its administrative workload.

With mounting financial challenges and the potential for PBGC's workload to dramatically increase, our concerns about PBGC governance and strategic management have become acute, and improvements are needed, now more than ever. PBGC's board has limited time and resources to provide policy direction and oversight. The three-member board includes the Secretary of Labor, as the Chair of the Board, and the Secretaries of Commerce and Treasury. These board members have numerous other responsibilities and are unable to dedicate consistent and comprehensive attention to PBGC. With only 3 members, PBGC's board may not be large enough to include the knowledge needed to direct and oversee PBGC. In fact, the new board members have yet to meet, and there has not been a face-to-face board meeting in the last 15 months. In addition, without an appointed director, PBGC's governance structure is further exposed to challenges. Further, PBGC continues to lack a fully-adopted strategic approach to its acquisition and human capital management needs. Although contract employees comprise two-thirds of PBGC's workforce, PBGC's strategic planning generally does not recognize contracting as a major aspect of PBGC activities.

Number of PBGC Board Meetings 1974 to May 2009

Teleconference
Meeting (with no quorum)
Meeting (with quorum)

Source: GAO analysis of PBGC documents and board meeting minutes.

Note: 2009 board meeting data is as of May 7, 2009.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the financial and operational challenges facing the Pension Benefit Guaranty Corporation (PBGC). PBGC operates two pension insurance programs that protect the retirement income of nearly 44 million American workers in over 29,000 private-sector defined benefit (DB) pension plans. We last testified on the challenges facing PBGC in September. At that time we noted that many of the challenges, particularly the financial challenges, facing PBGC are long-term and structural in nature. In fact, we designated PBGC's single-employer pension insurance program, its largest insurance program, as "high risk" in 2003 because of these financial challenges.[1] The program remains on the list today with a projected deficit of just over $11 billion, as of September 2008. However, recent events, particularly the steep downturn in the financial markets and worsening economic conditions, have likely further eroded PBGC's financial position and have also likely increased the risk that PBGC will have to assume responsibility for the underfunded plans of large, financially-weak employers.

My statement will discuss the (1) PBGC's financial vulnerabilities, and (2) the governance, oversight, and management challenges also facing PBGC. My statement is based on our prior work assessing PBGC's long-term financial challenges, and several reports we have published over the past two years on PBGC governance and management. We conducted our work in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In summary, financial and economic conditions have likely only worsened since we last reported on PBGC's finances. While PBGC's deficit improved for fiscal year 2008, the fiscal year ended just prior to the severe market downturn, and it is likely that their net position looks different today. Other events have occurred that also added to PBGC's financial challenges. These events include: recent legislation that grants funding

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

relief to certain sponsors, developments with PBGC's investment policy, and a concern that a wide array of industry sectors—including the highly visible automotive sector—are under financial distress and may expose PBGC to future claims. As a result, the potential for automaker pension plan terminations could dramatically increase PBGC's deficit, as well as its administrative workload.

With mounting financial challenges and the potential for PBGC's workload to dramatically increase, our concerns about PBGC governance and strategic management have become acute, and improvements are needed, now more than ever. PBGC's board has limited time and resources to provide policy direction and oversight. The board includes the Secretary of Labor, as the Chair of the Board, and the Secretaries of Commerce and Treasury. These board members have numerous other responsibilities, and are unable to dedicate consistent and comprehensive attention to PBGC. With only 3 members, PBGC's board may not be large enough to include the knowledge needed to direct and oversee PBGC. In fact, the new board members have yet to meet, and there has not been a face-to-face board meeting in the last 15 months. PBGC's governance structure is further exposed to challenges as it does not yet have an appointed director. Further, although contract employees comprise two-thirds of PBGC's workforce, PBGC's strategic planning generally does not recognize contracting as a major aspect of PBGC activities. PBGC still lacks a fully-adopted strategic approach to its acquisition and human capital management needs.

Background

PBGC was created by the Employee Retirement Income Security Act of 1974 (ERISA)[2] to pay benefits to participants in private DB plans in the event that an employer could not. PBGC may pay benefits, up to specified limits, if a plan does not have sufficient assets itself to pay promised benefits and the sponsoring company is in financial distress. PBGC's single-employer insurance program guarantees benefits up to $4,500 per month for age-65 retirees of plans terminating in 2009, with lower guarantees for those who retire before age 65. Currently, PBGC insurance covers 44 million participants, including retirees, in over 29,000 DB plans. PBGC pays monthly retirement benefits to more than 640,000 retirees in 3,860 pension plans that have ended, and is responsible for the current and future pensions of about 1.3 million people. ERISA also requires PBGC to

[2]Pub. L. No. 93-406, 88 Stat. 829 (codified, as amended, at 29 U.S.C. §§ 1001-1461).

encourage the continuation and maintenance of voluntary private pension plans.

PBGC receives no funds from general tax revenues. Operations are financed by insurance premiums set by Congress and paid by sponsors of DB plans, recoveries from the companies formerly responsible for the plans, and investment income of assets from pension plans taken over, or "trusteed," by PBGC. Under current law, other than statutory authority to borrow up to $100 million from the Treasury Department,[3] no substantial source of funds is available to PBGC if it runs out of money. In the event that PBGC were to exhaust all of its holdings, benefit payments would have to be drastically cut unless Congress were to take action to provide support.[4]

The assets and liabilities that PBGC accumulates from trusteeing plans has increased rapidly over the last 6 years or so. This is largely due to the termination, typically through bankruptcies, of a number of very large, underfunded plan sponsors.[5] In fact, 8 of the top 10 firms presenting claims against PBGC did so from 2003 to 2007. These top 10 claims alone currently account for over 60 percent of all of PBGC's claims and are concentrated among firms representing the steel and airline industries. Overall, these industries accounted for about three-quarters of PBGC's total claims and single-employer benefit payments in 2007.

In 2003, GAO designated PBGC's single-employer program as high-risk, meaning that the program needs urgent Congressional attention and agency action. We specifically noted PBGC's prior-year net deficit, as well

[3]29 U.S.C. § 1305(c).

[4]29 U.S.C. § 1302(g)(2).

[5]The termination of a fully funded DB plan is called a standard termination. 29 U.S.C. § 1341(b). Plan sponsors may terminate fully funded plans by purchasing a group annuity contract from an insurance company, under which the insurance company agrees to pay all accrued benefits, or by paying lump-sum benefits to participants if permissible. The termination of an underfunded plan, termed a distress termination, is allowed if the plan sponsor requests the termination and the sponsor satisfies other criteria. 29 U.S.C. § 1341(c). Alternatively, PBGC may initiate an "involuntary" termination. PBGC may institute proceedings to terminate a plan if the plan has not met the minimum funding standard, the plan will be unable to pay benefits when due, a reportable event has occurred, or the possible long-run loss to PBGC with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated. 29 U.S.C. § 1342(a).

as the risk of the termination among large, underfunded pension plans, as reasons for the program's high-risk designation.

As part of our monitoring of PBGC as a high-risk agency we have highlighted additional challenges faced by the single-employer program. Among these concerns were the serious weaknesses that existed with respect to plan funding rules[6] and that PBGC's premium structure and guarantees needed to be re-examined to better reflect the risk posed by various plans.[7] Additionally, the number of single-employer insured DB plans has been rapidly declining, and, among the plans still in operation, many have frozen benefits to some or all participants.[8] Further, the prevalence of plans that are closed to new participants seems to imply that PBGC is likely to see a decline in insured participants, especially as insured participants seem increasingly likely to be retired (as opposed to active or current) workers.

PBGC has remained high-risk with each subsequent report in 2005, 2007, and, most recently, 2009. In our 2007 high risk update we noted that major pension legislation had been enacted which addressed many of the concerns articulated in our previous reports and testimonies on PBGC's financial condition. The Deficit Reduction Act of 2005 (DRA) was signed into law on February 8, 2006 and included provisions to raise flat-rate premiums and create a new, temporary premium for certain terminated

[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 Pension Insurance Program Faces Significant Long-Term Risks*, GAO-04-90 (Washington, D.C.: Oct. 29, 2003).

[8]A plan freeze is an amendment to the plan to limit some or all future pension accruals for some or all plan participants. See GAO, *Defined Benefit Pensions: Plan Freezes Affect Millions of Participants and Pose Retirement Income Challenges*, GAO-08-817 (Washington, D.C.: July 21, 2008) and GAO, *Private Pensions: Timely and Accurate Information Is Needed to Identify and Track Frozen Defined Benefit Plans*, GAO-04-200R (Washington, D.C.: Dec. 17, 2003).

single-employer plans.[9] Later that year the Pension Protection Act of 2006 (PPA) was enacted; it included a number of provisions aimed at improving plan funding and PBGC finances.[10] The provisions aimed at improving plan funding included such measures as raising the funding targets DB plans must meet, reducing the period over which sponsors can "smooth" reported plan assets and liabilities, and restricting sponsors' ability to substitute "credit balances" for cash contributions. Reforms aimed at shoring up PBGC revenues included a termination premium for some bankrupt sponsors, and limiting PBGC's guarantee to pay certain benefits. However, the overall impact of PPA remains unclear; PPA did not fully close potential plan funding gaps, and provided special relief to plan sponsors in troubled industries. PBGC's net financial position improved from 2005 to 2006 because some very large plans that were previously classified as probable terminations were reclassified to a reasonably possible designation as a result of the relief granted to troubled industries such as the airlines.

PBGC's Financial Condition Has Likely Worsened Since September 2008

While PBGC's deficit improved for fiscal year 2008, the fiscal year ended just prior to the severe market downturn, and it is likely that their net position looks different today. Since we last reported to Congress on PBGC,[11] PBGC issued its fiscal year 2008 financials and reported that the net deficit for its insurance programs was $11.2 billion.[12] In some ways, this was good news. PBGC's net deficit reached a peak of $23.5 billion in 2004 largely as a result of a number of realized and probable claims that

[9]Pub. L. No. 109-171, § 8101, 120 Stat. 4, 180-83 (codified, as amended, at 29 U.S.C. § 1306). The flat-rate premium is a per-participant premium that plans pay to PBGC each year. In 2009, the rate for the flat premium is $34 per participant in insured single-employer plans. For multiemployer plans the flat rate premium is $9 per participant. These rates are adjusted annually by an average-national-wage index. The legislation created a new premium for sponsors of plans that are terminated on an involuntary or distressed termination basis. The required payment is $1,250 per plan participant, per year, for three years after the termination. For sponsors whose plans were terminated while the program was being reorganized under chapter 11 of the bankruptcy code, the premium would be levied after the sponsor emerges from bankruptcy. Under DRA the premium would not apply to firms that are liquidated by a bankruptcy court or to terminations after December 2010.

[10]Pub. L. No. 109-280, 120 Stat. 780.

[11]GAO, *Pension Benefit Guaranty Corporation: Improvements Needed to Address Financial and Management Challenges*. GAO-08-1162T (Washington, D.C.: Sept. 24, 2008).

[12]Pension Benefit Guaranty Corporation, *Annual Management Report Fiscal Year 2008*, (Wash. D.C.: Nov. 17, 2008).

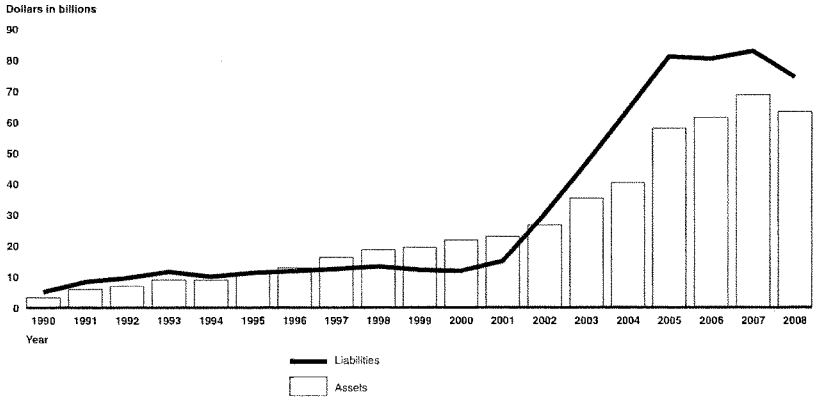
occurred during that year.[13] However, the lower 2008 deficit may be a product of conditions that no longer exist. For example, PBGC's net deficit is a resulting difference between its assets and its liabilities.[14] (See figure 1 for the difference between PBGC assets and liabilities for both insurance programs from 1990 to 2008.) As of PBGC's September 30, 2008 financial statement—even before the severe market downturn in October—PBGC saw an investment return of -6.5 percent over the year, which contributed to diminishing its assets from the prior year by about $5.5 billion. The net deficit improved, despite the performance of its assets, because of the decrease in its liabilities. According to PBGC, the improvement was due largely to successful negotiations in bankruptcy proceedings, a favorable change in interest factors used to value PBGC's liabilities, and the fact that PBGC saw significant reductions to its liabilities for probable terminations. PBGC has likely seen its net financial condition hurt by increased exposure due to declines in funding levels of many large plans, from the termination of underfunded plans, and by an increase in its liabilities due to a likely decrease in the interest rates used to value its liabilities.[15]

[13]Claims are the net cost of terminating a pension plan—the gap between its assets and its liabilities.

[14]PBGCs assets are composed of insurance income from sponsors (largely from premiums), income from its investments, and the assets it assumes from failed plans. PBGCs liabilities include the benefit obligations in the form of monthly payments to participants and beneficiaries in terminated defined benefit plans, financial assistance to multiemployer plans, as well as PBGCs operating expenses.

[15]Liability valuations 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 lower interest rate will increase the present value of a stream of payments because it implies that, as a smaller amount of investment income will be received, a higher level of assets today will be needed to fund those future payments.

Figure 1: PBGC Assets and Liabilities, Fiscal Year 1990 to 2008



Source: GAO's analysis of PBGC annual report data.

Note: Figure includes assets and liabilities of single-employer program and multi-employer program. The single-employer program accounts for over 94 percent of all assets and liabilities within each year over this period.

The current economic environment has likely increased the exposure PBGC faces from financially distressed sponsors with large, underfunded plans. The funding of many large plans has likely eroded as a result of the lowered financial health of many sponsors, thereby potentially increasing PBGC's exposure to probable terminations,[16] developments that the most recent estimates may not reflect. Estimating PBGC's future claims has always been difficult to predict over the long-term due to the significant volatility in plan underfunding and sponsor credit quality over time. However, the current economic environment seems to have put sponsors under particular stress.

[16]Probable terminations represent PBGC's best estimate of claims for plans that are likely to terminate in a future year.

There is likely a wide range of industry sectors that have been affected by the current economic environment, and particularly the automotive sector. For example, the pension plans of Chrysler and General Motors (GM) today pose considerable financial uncertainty to PBGC. In the event that Chrysler or GM cannot continue to maintain their pension plans—such as in the case of liquidation or an asset sale—PBGC may be required to take responsibility for paying the benefits for the plans, which, as of the most current publicly available information, are underfunded by a total of about $29 billion.[17,18]

Although it is impossible to know what the exact claims to PBGC would be if it took over Chrysler's and GM's pension plans, doing so would likely strain PBGC's resources, because the automakers' plans represent a significant portion of the benefits it insures. Further, from an administrative standpoint, PBGC would be presented with an unprecedented number of assets to manage as well as benefit liabilities to administer. For example, GM's and Chrysler's plans include roughly 900,000 participants, both those receiving benefits now and those who have earned benefits payable in the future, which would increase the total number of PBGC's current or future beneficiaries by nearly 80 percent.[19] Even with Chrysler's bankruptcy and concern about GM's viability, it is not certain that PBGC would take over responsibility for either plan. For example, a number of auto parts suppliers in Chapter 11 with collectively

[17]Chrysler LLC is currently undergoing reorganization under Chapter 11 of the Bankruptcy Code and will receive financial assistance from the federal government to fund its operations during bankruptcy. According to the Administration, Chrysler's pension plans will be preserved. The Department of Treasury is also providing financial assistance to GM to assist its restructuring efforts, and has given the company until June 1 to develop a credible strategy for achieving viability.

[18]Estimates of pension funding levels vary based on the methods and assumptions used. According to PBGC, GM's plans were underfunded by $20 billion and Chrysler's by $9.3 billion on a termination basis as of November 30, 2008, for GM and January 1, 2009, for Chrysler. Termination liability reflects the cost to a company of paying an insurer to meet its pension obligations should the plan terminate. This is calculated by using actuarial assumptions PBGC makes including interest and mortality. Termination liability is often higher than liability calculated for other purposes. According to GM's financial statements, its U.S. pension plans were underfunded by $13.6 billion as of December 31, 2008; according to information provided by Chrysler, its U.S. pension plans were underfunded by $3.6 billion as of December 31, 2008.

[19]Additionally, PBGC would pay all the plans' benefit promises, up to certain limits set by statute. These limits mean that some individuals, typically younger retirees, would see reduced benefits.

bargained pension plans have emerged from reorganization without terminating their pension plans.

While the events surrounding the automakers and their pension plans are clearly an area of concern for the PBGC, the recession has likely affected many industry sectors. Although, PBGC's past claims have been concentrated to industries like steel and airlines, there is cause for concern that future claims will come from a much broader array of industries.

PBGC's insurance programs held $63 billion in assets as of September 30, 2008, and the Corporation has stated it has sufficient liquidity to meet its obligations for a number of years. However, to the extent additional claims from vulnerable industries markedly increase PBGC's accumulated deficit and decrease its long-run liquidity, there could be pressure for the federal government to provide PBGC financial assistance to avoid reductions in guaranteed payments to retirees or unsustainable increases in the premium burden on sponsors of ongoing plans.

PBGC's overall exposure has increased for additional reasons. The Worker, Retiree, and Employer Recovery Act of 2008 (WRERA),[20] passed in December, grants funding relief to certain sponsors and delays the implementation of certain aspects of the PPA. WRERA makes several technical corrections to PPA and contains provisions designed to help pension plans and plan participants weather the current economic downturn. For a number of sponsors, this legislation may mean lower plan contributions than they would otherwise have had to pay under the phase-in of PPA and, at least temporarily, potentially increase levels of plan underfunding. As we noted in our 2009 high-risk update on PBGC, this legislation is likely to increase PBGC's risk exposure, perhaps significantly.

Finally, PBGC's newly-adopted investment policy may expose the Corporation to additional risk. The new policy reduces the proportion of PBGC assets allocated to fixed-income investments, such as Treasury and corporate bonds; increases its proportional holdings in international equities; and introduces new asset classes, such as private equity, emerging market debt and equities, high-yield fixed income, and private real estate. While the investment policy adopted in 2008 aimed to reduce

[20]Pub. L. No 110-455, 122. Stat. 5036.

PBGC's deficit by investing in assets with a greater expected return, in a report last summer, we found that the new allocation will likely carry more risk than acknowledged by PBGC's analysis.[21]

Our assessment found that, although returns are indeed likely to grow with the new allocation, the risks are likely higher as well. Although it is important that the PBGC consider ways to optimize its portfolio, including higher return and diversification strategies, the agency faces unique challenges, such as PBGC's need for access to cash in the short-term to pay benefits, which could further increase the risks it faces with any investment strategy that allocates significant portions of the portfolio to volatile or illiquid assets. According to PBGC the new allocation will be sufficiently diversified to mitigate the expected risks associated with the higher expected return. PBGC also asserted that it should involve less risk than the previous policy. The Congressional Budget Office has also pointed out such risks, saying that "the new strategy...increases the risk that PBGC will not have sufficient assets to cover retirees' benefit payments when the economy and financial markets are weak."[22]

PBGC has only implemented portions of the policy. PBGC told us that it has begun the process of reducing the percentage of its assets in fixed-income investments, but it has not yet begun to increase its portfolio of certain asset classes, specifically private equity and real estate. PBGC also told us that the process it follows for its current implementation of the investment policy follows industry best practices for large transactions.[23] However, PBGC officials also told us that the intended asset allocation targets set by the current implementation of this policy could easily be derailed if PBGC is required to assume the assets of very large and severely underfunded sponsors.

[21]GAO, *PBGC Assets: Implementation of New Investment Policy Will Need Stronger Board Oversight*, GAO-08-667 (Washington, D.C.: July 17, 2008).

[22]Congressional Budget Office, "A Review of the Pension Benefit Guaranty Corporation's New Investment Strategy," Letter to the Honorable George Miller (Wash. D.C.: April 24, 2008).

[23]These best practices include Chartered Financial Analyst Institute's Global Investment Performance Standards.

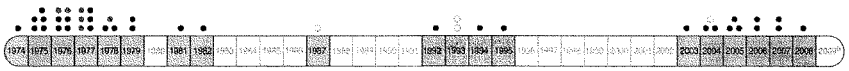
Improvements Needed to PBGC's Governance and Management

PBGC's Governance Structure Needs Improvement

PBGC's board has limited time and resources to provide policy direction and oversight.[24] PBGC's three-member board, established by ERISA, includes only the Secretary of Labor, as the Chair of the Board, and the Secretaries of Commerce and Treasury. We noted that the board members have designated officials and staff within their respective agencies to conduct much of the work on their behalf and relied mostly on PBGC's management to inform these board members' representatives of pending issues. PBGC's board members have numerous other responsibilities in their roles as cabinet secretaries and have been unable to dedicate consistent and comprehensive attention to PBGC.

Since PBGC's inception, the board has met infrequently. In 2003, after several high-profile pension plan terminations, PBGC's board began meeting twice a year (see figure 2). PBGC officials told us that it is a challenge to find a time when all three cabinet secretaries are able to meet, and in several instances the board members' representatives officially met in their place. Currently, the PBGC board has not met face-to-face in over one year—since February 2008.

Figure 2: Number of PBGC Board Meetings 1974 to May 2009



Teleconference

Meeting (with no quorum)

Meeting (with quorum)

Source: GAO analysis of PBGC documents and board meeting minutes.

Note: 2009 board meeting data is as of May 7,2009.

[24]GAO, *Pension Benefit Guaranty Corporation: Governance Structure Needs Improvements to Ensure Policy Direction and Oversight*, GAO-07-808 (Washington, D.C.: July 6, 2007).

While the PBGC board has met more frequently since 2003, very little time is spent on addressing strategic and operational issues. According to corporate governance guidelines, boards should meet regularly and focus principally on broader issues, such as corporate philosophy and mission, broad policy, strategic management, oversight and monitoring of management, and company performance against business plans.[25] However, our review of the board's recorded minutes found that although some meetings devoted a portion of time to certain strategic and operational issues, such as investment policy, the financial status of PBGC's insurance programs, and outside audit reviews, the board meetings generally only lasted about an hour.

The size and composition of PBGC's board does not meet corporate governance guidelines. According to corporate governance guidelines published by The Conference Board,[26] corporate boards should be structured so that the composition and skill set of a board is linked to the corporation's particular challenges and strategic vision, and should include a mix of knowledge and expertise targeted to the needs of the corporation. We did not identify any other government corporations with boards as small as at PBGC. Government corporations' boards averaged about 7 members, with one having as many as 15. In addition, PBGC is also exposed to challenges as the board, board members' representatives, and the director have changed with the recent presidential transition, limiting the board's institutional knowledge of the Corporation.

The revision of PBGC's investment policy provides an example of the need for an active board to help oversee the Corporation's challenges and strategic vision.[27] We found that PBGC board's 2004 and 2006 investment policy was not fully implemented. While the board assigned responsibility to PBGC for reducing equity holdings to a range of 15 to 25 percent of total investment, by 2008 the policy goal had not been met. Although the PBGC director and staff kept the board apprised of investment performance and asset allocation, we found no indication that the board had approved the

[25]Matteo Tonello and Carolyn K. Brancato, *Corporate Governance Handbook, 2007: Legal Standards and Board Practices*, Research Report R-1405-07-RR, The Conference Board (New York, New York: 2007).

[26]*Corporate Governance Handbook, 2007*, Research Report R-1405-07-RR. The Conference Board is a global business membership and research organization that creates and disseminates knowledge about management and the marketplace.

[27]See GAO-08-667.

deviation from its established policy or expected PBGC to continue to meet policy objectives. While PBGC's Board revised the investment policy in February 2008, the board has not held a meeting to discuss the new policy's implementation even though there has been a serious downturn in investment markets. In May 2009, PBGC officials told us that they have kept the new Board members—the Secretary of Labor, along with officials from the Departments of Commerce and Treasury—apprised of the progress in implementing the new investment policy.

In our July 2007 report on PBGC's governance structure, we asked Congress to consider expanding PBGC's board of directors, to appoint additional members who possess knowledge and expertise useful to PBGC's responsibilities and can provide needed attention.[28] Further, dedicating staff that are independent of PBGC's executive management and have relevant pension and financial expertise to solely support the board's policy and oversight activities may be warranted. In response to our finding, PBGC contracted with a consulting firm to identify and review governance models and provide a background report to assist the board in its review of alternative corporate governance structures. The consulting firm's final report describes the advantages and disadvantages of the corporate board structures and governance practices of other government corporations and select private sector companies, and concludes that there are several viable alternatives for PBGC's governance structure and practices.

As PBGC Relies Heavily on Its' Contractor and Federal Workforce, A More Strategic Approach Is Needed

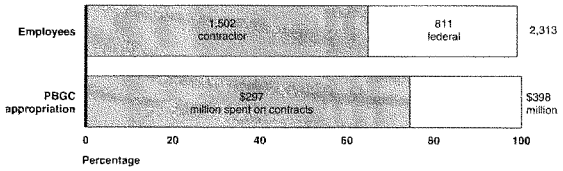
Although two-thirds of PBGC's workforce includes contractor employees, PBGC's strategic planning generally does not recognize contracting as a major aspect of PBGC activities (see figure 3).[29] Since the mid-1980s, PBGC has had contracts covering a wide range of services, including the administration of terminated plans, payment of benefits, customer communication, legal assistance, document management, and information technology. As PBGC's workload grew due to the significant number of large pension plan terminations, PBGC relied on contractors to

[28]See GAO-07-808.

[29] GAO, *Pension Benefit Guaranty Corporation: Some Steps Have Been Taken to Improve Contracting, but a More Strategic Approach Is Needed,* GAO-08-871 (Washington, D.C.: Aug. 18, 2008) and GAO, *Pension Benefit Guaranty Corporation: A More Strategic Approach Could Improve Human Capital Management,* GAO-08-624 (Washington, D.C.: June 12, 2008).

supplement its workforce, acknowledging that it has difficulty anticipating workloads due to unpredictable economic conditions.

Figure 3: PBGC Overall Versus Contractor Spending and Personnel, Fiscal Year 2007



Source: PBGC.

Last summer we reported that PBGC had begun to improve some of its contracting practices by to updating contracting policies and processes, upgrading the skills of Procurement Department staff, and better tracking contracting data. While we reported that PBGC had begun to implement performance-based contracting that offers the potential for better contract outcomes, PBGC officials recently told us that the new field benefit administration contracts will not be performance-based.

PBGC lacks a strategic approach to its acquisition and human capital management needs. PBGC's strategic plan does not document how the acquisition function supports the agency's missions and goals. Further, although contracting is essential to PBGC's mission, we fonnd that the Procurement Department is not included in corporate-level strategic planning. Based on these findings, we recommended that PBGC revise its strategic plan to reflect the importance of contracting and to project its vision of future contract use, and ensure that PBGC's procurement department is included in agency-wide strategic planning. (Appendix I includes selected GAO recommendations on PBGC Governance and Management). PBGC disagreed with our recommendation to reflect the importance of contracting and incorporate its vision for future contractor use in its strategic planning documents, as it believes its recently issued strategic plan is sufficiently comprehensive. However, PBGC's strategic plan only briefly mentions performance-based contracting, flexible staffing, and metrics for specific contracts, and therefore we believe that it does not reflect the important role contracting is playing in achieving PBGC's mission.

PBGC also needs a more strategic approach for improving human capital management. We found that PBGC's draft strategic human capital plan does not provide detailed plans for obtaining contract support or managing the workload fluctuations. While PBGC has made progress in its human capital management approach by taking steps to improve its human capital planning and practices—such as drafting a succession management plan—the Corporation lacked a formal, comprehensive human capital strategy, articulated in a formal human capital plan that includes human capital policies, programs, and practices. PBGC is generally able to hire staff in its key occupations—such as accountants, actuaries, and attorneys—and retain them at rates similar to those of the rest of the federal government. However, PBGC has had some difficulty hiring and retaining staff for specific occupations and positions, including executives and senior financial analysts. Since our report, PBGC officials told us that they have provided a human capital plan to the Office of Personnel Management (OPM) and are awaiting OPM feedback.

The need for a strategic approach to acquisition and human capital management is essential to ensure that PBGC is able to manage the administrative fluctuations of a pension insurance corporation. As noted earlier, General Motor's and Chrysler's plans include roughly 900,000 participants, both those receiving benefits now and those who have earned benefits payable in the future. These participants, if brought under PBGC administration, would raise the number of PBGC's current or future beneficiary population by roughly 80 percent. While it is uncertain whether an automaker plan would ever be assumed by PBGC, the concentration of large numbers of plan beneficiaries among just two sponsors illustrates the potential for a sudden and unprecedented administrative workload at PBGC.

Conclusions

While PBGC has been on our High Risk list since 2003—and many of its challenges are long-term in nature—the recession and market down-turn has magnified the challenges it faces. When we last reported on PBGC's financial challenges in September, we specifically mentioned the change in investment policy as a key challenge going forward. This is still the case, but even more recent events, such as legislative changes and the plight of the automakers and other financially weak sponsors in other industries, have the potential to expose PBGC to claims of a potentially unprecedented magnitude.

While many of the financial challenges are a result of long-term weaknesses that are in many ways structural, PBGC does have some degree of control over challenges it faces with respect to governance, oversight, and management. GAO has made many recommendations in these areas, but given the potentially immense financial challenges the Corporation faces, the need to act is only growing. It is unfortunate that, during a time of financial crisis, the PBGC board has not met in 15 months. However, PBGC not only needs a board that meets regularly, but also a board that can be active and commit the time to understanding the weight and urgency of the issues facing the Corporation. Ideally, a more robust board structure would be in place as soon as possible so that the board can address current challenges and anticipate new ones. The current situation has important implications for all PBGC stakeholders: plan sponsors, insured participants, insured beneficiaries, as well as the government and, ultimately, the taxpayers. PBGC should not have to take on significant, additional claims from severely underfunded pension plans before situation is recognized.

Chairman Kohl, Senator Martinez, and Members of the Committee, this concludes my prepared statement. I would be happy to respond to any questions you may have.

Appendix I: Selected GAO Recommendations on PBGC Governance and Strategic Management

Table 1: GAO Goveranance Recommendations and PBGC's Actions Taken

GAO Observation	GAO Recommendation to PBGC	PBGC Actions
PBGC has heavy use of contractors—with three-quarters of its operational budget currently being spent on contracting. While PBGC has made efforts to improve its acquisition infrastructure, it has not developed a strategic approach to its contracting process.	The Director of PBGC revise its strategic plan to reflect PBGC's use of contractors, project its vision of future contractor use, and better link staffing and contracting decisions at the corporate level.	• PBGC believes its current strategic plan is sufficiently comprehensive to address the recommendation. In response, GAO stated that the strategic plan only briefly mentions performance-based contracting, flexible staffing and metrics for specific contracts, and therefore it does not reflect the important role contracting is playing in achieving PBGC's mission.
The degree of the risk associated with PBGC's new investment policy is unclear. Implementing PBGC's new investment policy requires that the board have useful accountability measures to conduct careful oversight and to ensure that PBGC achieves its policy goals, such as protecting the pension benefits of retirees.	• The PBGC board should require PBGC director to formally submit an implementation plan that outlines accountability measure for carrying out the new investment policy.	• The PBGC director has submitted the implementation plan to the PBGC board.
	• Document the board's agreement or disagreement with any deviations from the policy implementation plan.	• The Board has not met since the new policy was approved.
	• The PBGC board should require the PBGC director to report periodically on the progress towards meeting the objectives, milestones, and time frames in the plan.	• PGBC officials told us they are keeping the Secretary of Labor, as well as officials at the Departments of Treasury and Commerce, apprised of their progress.
	• PBGC should conduct sensitivity analyses before implementing the new policy. These analyses should use a variety of assumptions of the risks and returns of the new allocation that incorporates assets, liabilities, and funded position.	• PBGC officials report they are implementing a risk management system and plan to stress-test once it is in place.
PBGC may face workforce challenges regarding key staff experience, retirement eligibility, and compensation limitations. It has has taken some steps to strategically manage its workforce, but has not prepared for possible workforce and compensation challenges.	• Integrate formal workforce and succession planning components as part of the Corporation's efforts in developing a formal strategic planning approach to managing its workforce.	• PBGC officials report that a human capital plan and student-loan certification are with the Office of Personnel Management and the agency is waiting for feedback.
	• Systematically collect and analyze workforce data and integrate the results of such analyses into its workforce planning efforts.	
	• Fully explore with the Office of Personnel Management and Office of Management and Budget all compensation options currently available to determine and document what options are appropriate and applicable within its statutory authority.	

GAO Observation	GAO Recommendation to PBGC	PBGC Actions
PBGC is directed and overseen by one of the smallest and least diverse boards of directors, even though it is financially one of the largest Corporations within the federal government.	• Establish policies, procedures, and mechanisms for providing oversight of PBGC that are consistent with corporate governance guidelines.	• PBGC contracted with a firm to identify and review governance models and provide a background report to assist the board in its review of alternative government structures.
	• Establish formal guidelines that articulate the authorities of the Board Chair and the Department of Labor, the other board members and their respective departments, and PBGC's Director.	• PBGC revised the Corporation's bylaws, specifically delineating the roles and responsibilities of board members, representatives, director, and senior management.

Appendix II: Selected GAO Reports and Testimonies Related to the Pension Benefit Guaranty Corporation

High Risk Series: An Update. GAO-09-271. Washington, D.C.: January 2009.

Pension Benefit Guaranty Corporation: Improvements Needed to Address Financial and Management Challenges. GAO-08-1162T. Washington, D.C.: September 24, 2008.

Pension Benefit Guaranty Corporation: Need for Improved Oversight Persists. GAO-08-1062. Washington, D.C.: September 10, 2008.

Pension Benefit Guaranty Corporation: Some Steps Have Been Taken to Improve Contracting, but a More Strategic Approach Is Needed. GAO-08-871. Washington, D.C.: August 18, 2008.

PBGC Assets: Implementation of New Investment Policy Will Need Stronger Board Oversight. GAO-08-667. Washington, D.C.: July 17, 2008.

Pension Benefit Guaranty Corporation: A More Strategic Approach Could Improve Human Capital Management. GAO-08-624. Washington, D.C.: June 12, 2008.

High Risk Series: An Update. GAO-07-310. Washington, D.C.: January 2007.

Pension Benefit Guaranty Corporation: Governance Structure Needs Improvements to Ensure Policy Direction and Oversight. GAO-07-808 Washington, D.C.: July 6, 2007.

PBGC's Legal Support: Improvement Needed to Eliminate Confusion and Ensure Provision of Consistent Advice. GAO-07-757R. Washington, D.C.: May 18, 2007.

Private Pensions: Questions Concerning the Pension Benefit Guaranty Corporation's Practices Regarding Single-Employer Probable Claims. GAO-05-991R. Washington, D.C.: September 9, 2005.

Private Pensions: The Pension Benefit Guaranty Corporation and Long-Term Budgetary Challenges. GAO-05-772T. Washington, D.C.: June 9, 2005.

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

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

Pension Benefit Guaranty Corporation Single-Employer Insurance Program: Long-Term Vulnerabilities Warrant 'High Risk' Designation. GAO-03-1050SP. Washington, D.C.: July 23, 2003.

Pension Benefit Guaranty Corporation: Statutory Limitation on Administrative Expenses Does Not Provide Meaningful Control. GAO-03-301. Washington, D.C.: February 28, 2003.

GAO Forum on Governance and Accountability: Challenges to Restore Public Confidence in U.S. Corporate Governance and Accountability Systems. GAO-03-419SP. Washington, D.C.: January 2003.

Appendix III: Contacts and Staff Acknowledgments

For further questions about this statement, please contact Barbara D. Bovbjerg at (202) 512-7215. Individuals making key contributions to this statement include Blake Ainsworth, Charles Ford, Jennifer Gregory, Craig Winslow, and Susannah Compton.

The CHAIRMAN. Thank you very much, Ms. Bovbjerg. Now we'll hear from Rebecca Ann Batts, who is the Inspector General for the Pension Benefit Guaranty Corporation. Ms. Batts.

STATEMENT OF REBECCA ANNE BATTS, INSPECTOR GENERAL, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, DC

Ms. BATTS. Good afternoon, Chairman Kohl, Ranking Member Martinez, and Senator Bennett. My name's Rebecca Ann Batts, and I'm the Inspector General of the Pension Benefit Guaranty Corporation, Office of Inspector General. Thank you for the opportunity to testify today about the work being done by our office.

PBGC is facing many challenges, including the need to address a potentially unprecedented influx of large defined benefit pension plans. In my full written statement, I acknowledgement PBGC's senior leadership for its engagement in planning for the potential wave of new pension plan trusteeships.

We appreciate your interest in this issue, as well as your request that we monitor and report on PBGC's preparedness strategy. We've initiated an audit in response to your request, and plan to fast-track the most time-sensitive results of our work to ensure that we provide PBGC, the PBGC board, and Congress with timely and relevant information.

Last week, my office issued an audit report addressing the serious misconduct of the former PBGC Director, Charles Millard, in contracting for lucrative strategic partnerships. The PBGC board reacted quickly and appropriately to our report, and we concur in the corrective actions proposed by the board. As requested by the committee, I'm providing the following information to inform your committee and others about the issues we identified in our audit.

Beginning with planning for the development of a new investment policy, former PBGC Director Charles Millard became intimately involved in the day-to-day details of the contracts through which the new investment policy would be developed and implemented.

Against the advice of senior leadership, Mr. Millard served on evaluation panels with subordinate employees. Against the advice of senior leadership, he participated directly in developing the criteria for picking the winners of the strategic partnership contracts. These three strategic partnership contracts for the management of $2.5 billion in assets went to three firms: Black Rock, Goldman Sachs, and JPMorgan.

At the same time, he continued to represent PBGC before the investment community and engaged in extensive phoning and emailing with various Wall Street firms, including hundreds of calls logged with the successful bidders for the strategic partnership contracts.

Mr. Millard wanted big Wall Street firms for PBGC's strategic partners. As part of his effort to establish the criteria to be a successful bidder, he consulted with a Black Rock managing directory about establishing a floor on the number of employees that a firm needed to have in order to compete for a strategic partnership. Mr. Millard explained that he needed a cutoff figure so that he could wittle the field.

In response, the Black Rock executive proposed a specific number and strategized about a way to eliminate certain types of firms from consideration. Establishing standards specifically to eliminate some firms from competition is inconsistent with the former director's responsibility established in regulation to conduct business with complete impartiality.

Even though Mr. Millard should not have been talking to bidders at the same time he was evaluating their proposals, he communicated with some of them by phone and email. Mr. Millard said these contacts were OK because these were his friends, but that creates another problem and raises questions about impartiality. The PBGC Ethics Handbook specifically notes evaluating the bid of a friend as an example of behavior that raises an ethical concern.

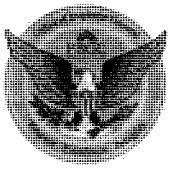
After the award of the strategic partnership contracts, a Goldman Sachs executive provided extensive assistance to the former director in his search for post-PBGC employment. The assistance, which is documented in at least 29 emails, tracks the Goldman Sachs executive's efforts to aid Mr. Millard through personal meetings, strategic advice, introductions to potential employers, and help with meeting arrangements.

Our audit results are largely based on documentary evidence, primarily in the form of phone records and email traffic. However, the impetus for our review of many of the specific issues I've discussed today was a whistleblower complaint. Reporting concerns about fraud, waste, or abuse to the Inspector General requires a lot of courage. The task is even more difficult when the issues of concern are subjective, involving questions of fairness, if impartiality, or of appearance.

I am grateful to the whistleblower who first reported the questionable actions of the former director to my office. This person made a choice that will help the PBGC board and PBGC leadership make the changes needed to maintain the public's trust. This person deserves our gratitude and thanks.

That concludes my statement, Mr. Chairman. I will be happy to answer any questions you or the other members have.

[The prepared statement of Ms. Batts follows:]



Testimony for the
Special Committee on Aging
U.S. Senate

For Release at 2:00 PM EST
Wednesday May 20, 2009

No Guarantees: As Pension Plans Crumble, can PBGC Deliver?

Testimony of

Rebecca Anne Batts

Inspector General
Pension Benefit Guaranty Corporation

May 20, 2009

Testimony of Rebecca Anne Batts
Inspector General
Pension Benefit Guaranty Corporation – Office of Inspector General
Special Committee on Aging
United States Senate
May 20, 2009

Good afternoon Chairman Kohl, Ranking Member Martinez, and other Committee Members. My name is Rebecca Anne Batts and I am the Inspector General of the Pension Benefit Guaranty Corporation (PBGC), Office of Inspector General (OIG).

Thank you for the opportunity to testify today about the challenges that the Pension Benefit Guaranty Corporation (PBGC) is facing. These challenges affect important functions of the Corporation. On one hand, PBGC and its Board must deal with the need to make decisions about how to implement PBGC's investment policy, to include the possibility that certain decisions may need to be reconsidered. Additionally, PBGC may be called to address an unprecedented influx of large defined benefit pension plans, if companies can no longer afford to maintain the plans. We appreciate your interest in these issues and your request that we monitor PBGC's preparedness strategy. We have been working with PBGC officials to support and oversee their efforts and are in the process of assembling a team to review the steps that PBGC management is taking to prepare for the coming months and years.

Both the President and Congress have noted that the current economic crisis is the result of many years of irresponsibility, both in government and in the private sector. As the guarantor of pensions for many of the Nation's workers, PBGC will certainly be affected by the trends and events that shape our economic future. We appreciate this Committee's strong interest in vigilant oversight of the PBGC's investment activities and in its readiness to face the consequences of defined benefit plans on the brink of financial distress, with this hearing as just one of the many indicators of that support.

We realize that PBGC faces enormous challenges and note the commitment of the Acting Director, PBGC's senior leadership, and the PBGC Board to the success of PBGC's investment program and preparedness initiatives. PBGC's leadership has been proactive on several fronts. For example, PBGC's senior leadership has been engaged in contingency planning for a potential wave of pension plan trusteeships in the near future. The focus is on ensuring that PBGC's core functions -- insurance programs and benefits administration -- have the necessary resources (including staff, budget, and information technology) to address the incoming workload. PBGC staff has briefed us on initial assessments of the potential impact on PBGC if pension plans of various sizes terminate without sufficient assets to pay future benefits and PBGC becomes responsible for those benefits. Additionally, PBGC consistently monitors the conditions of multiple high-profile industrial sectors including retail, newspaper, pharmaceutical and auto.

Our statement today focuses on the specific challenges PBGC faces as it prepares for the future in a turbulent financial environment and on our strategy to promote integrity and support PBGC in its readiness efforts. Specifically:

- **PBGC must continue to work with its Board to determine how to ensure integrity as it contracts for investment services**. Earlier this month, we reported on serious questions relating to the integrity of the procurement process for Strategic Partnership contracts to manage $2.5 billion in PBGC assets. We identified actions that PBGC and its Board should take to foster impartiality in future procurement activities and compliance with existing contracting laws and regulations (see attachment for full report.)[1] This interim report was issued as part of our ongoing monitoring of PBGC's plans for implementing the new investment policy and included our assessment of allegations brought to our attention by a whistleblower. Based on our analysis, we concluded that the former PBGC Director, Charles E.F. Mr. Millard, had inappropriate contacts with bidders for the Strategic Partnership contracts and took actions incompatible with his role as Director. We recommended a Board-level decision as to whether the actions of the former Director cast enough doubt about the fairness, integrity, and openness of the procurement to warrant cancellation of the contracts. We also recommended the establishment of a Board-imposed requirement that future PBGC Directors maintain appropriate separation of duties, with special care given to situations that are likely to create the appearance of improper influence or bias. The Board responded quickly and appropriately to our recommendations.

- **Our audit and investigative initiatives must continue to examine areas that present the greatest risks and promptly notify PBGC, the Board, and Congress of actions needed to ensure effective governance and readiness for whatever the future brings.** We have begun working aggressively to position our office to handle the potential increase in oversight workload associated with current economic conditions. We initiated a three-phase approach to conducting this work. Earlier this month, in anticipation of changes that may come if companies can no longer afford their defined benefit plans and in response to a request from your committee, we initiated a review to assess PBGC actions to prepare for possible influx of defined pension plans with large numbers of participants in the near future. To meet this objective we will examine: (1) the steps PBGC management is taking to prepare for a possible increase in the number of terminated plans; (2) the extent to which an increase in the number of terminated plans presents challenges for PBGC management in both termination and benefit delivery processes; (3) the effectiveness of PBGC processes for identifying, prioritizing and obtaining needed resources, such as human capital; and (4) the steps PBGC management is taking to ensure continued customer service and effective Field Benefit Administration offices in the event of

[1] OIG Report No. AUD-2009-5/PA-08-63-1, "Former Director's Involvement in Contracting for Investment Services Blurs Roles and Raises Fairness Issues," May 15, 2009. OIG reports and testimonies are available on our website: www.oig.pbgc.gov.

termination increases. We plan to fast-track the most time-sensitive results of our work to ensure we provide PBGC, the Board, and Congress with timely and relevant information.

Phase 2 of our strategy is already underway and involves a systematic review of the strengths and weaknesses of PBGC's approach for executing the new investment policy and an assessment of the effectiveness of PBGC's plan to identify and manage key risks. We plan to begin reporting the results of this effort this summer through a series of advisories to PBGC. Phase 3 is a longer-term initiative in which we will drill down on high-risk areas that emerge as a result of our ongoing review.

I will now discuss these issues in further detail.

PBGC MUST CONTINUE TO WORK WITH ITS BOARD TO ENSURE INTEGRITY IN CONTRACTING FOR INVESTMENT SERVICES

Earlier this month, we issued an interim report (attached) as part of our ongoing review of the PBGC's implementation of its new Investment Policy. Our report discussed our findings and recommendations to ensure PBGC develops and implements internal controls to foster impartiality in future procurement activities and compliance with existing contracting laws and regulations. Further, our report recommended that the Board consider whether the inappropriate actions taken by the former PBGC Director had caused so much doubt about the fairness, integrity, and openness of the Strategic Partnership that the contracts should be cancelled.

The PBGC Board provided a positive response to our report and has committed to take appropriate corrective actions.

The actions taken by the former Director constitute a serious challenge to contracting integrity at PBGC. The former Director:

1. Assumed de facto responsibility for key procurement actions, violating the principle of separation of duties and rendering PBGC vulnerable to allegations of bias, improper influence, or conflict of interest.

2. Consulted with potential bidders about the impact of certain mandatory requirements on them and on others, as well as about proposed questions for PBGC procurement officials to ask during the bidders' oral presentations.

3. Had inappropriate contact with bidders during the "blackout" period when such contact was forbidden.

4. Sought employment assistance from an executive employed by one the winning bidders for a Strategic Partnership contract to manage $700 million in private equity.

To address the serious issues discussed in this report, we recommended that the PBGC Board require future Directors to ensure appropriate separation of duties, to include refraining from service on technical evaluation panels and other de facto procurement activities, giving special attention to situations that are likely to create the appearance of improper influence or bias. The Board agreed with our recommendation and advised that it will be working with the PBGC to develop appropriate guidelines.

Today, I will highlight a few of the key areas that led to the need for action.

1. The Former Director Assumed De Facto Responsibility for Key Procurement Actions.

As part of his job, the former PBGC Director represented the Corporation before the investment community in person, traveling frequently to New York and maintaining continual telephone contact with major investment firms. However, at the same time, he inappropriately assumed de facto responsibility for key procurement activities necessary to implement the new investment policy, including evaluating many of the same investment firms with which he routinely dealt. The former Director's contact with bidders allowed some, but not all, to have frequent and in-depth access to a key procurement decision-maker. Further, the continuing contact provided an opportunity for some, but not all, bidders to enhance the former Director's level of confidence in their firms' knowledge and skills.

Federal Regulations Establish High Standards for Procurement actions .

Government-wide ethics rules are founded on fourteen principles, one of which requires all federal employees "to avoid any actions creating the appearance that they are violating the law."[2] In its own ethics handbook "*Public Service is a Public Trust*," PBGC sets forth these guiding principles of ethical conduct. The discussion about "Impartiality Issues" is written simply and lists examples of circumstances that could call impartiality into question; specifically noted is the evaluation of bids submitted by friends.

PBGC's procurement process is also subject to a variety of implementing guidance, including the Federal Acquisition Regulation (FAR), intended to ensure impartiality in contracting decisions. Examples include:

- "An essential consideration in every aspect of the System is maintaining the public's trust. Not only must the System have integrity, but the actions of each member of the Team must reflect integrity, fairness, and openness ..."[3]

- "Government business shall be conducted in a manner above reproach and, except as authorized by statute or regulation, with complete impartiality and with

[2] 5 C.F.R. § 2635.101(b)(14).

[3] FAR § 1.102-2(c)(1).

> preferential treatment for none. Transactions relating to the expenditure of public funds require the highest degree of public trust and an impeccable standard of conduct. The general rule is to avoid strictly any conflict of interest or even the appearance of a conflict of interest in Government-contractor relationships. While many Federal laws and regulations place restrictions on the actions of Government personnel, their official conduct must, in addition, be such that they would have no reluctance to make a full public disclosure of their actions."[4]

The former Director was intimately involved in the day-to-day details of contracts used to develop and implement the new investment policy.

Despite warnings from his own advisors about the wisdom of doing so, the former Director actively participated in PBGC's procurement of investment services contracts. Throughout his tenure, he enmeshed himself in the evaluative process. Examples include:

- Serving on a three-member evaluation panel, with two subordinate employees, to select **Rocaton** to assist in developing the new investment policy.
- Choosing evaluation panel members, and serving on the evaluation panel, with two subordinate employees, to select **Plexus** to provide advisory services for the development of transition management principles.
- Choosing evaluation panel members and serving on the evaluation panel, with two subordinate employees, to select **Ennis Knupp** as advisor for the upcoming strategic partnership procurement.
- Helping draft the Statement of Objectives for the Strategic Partnership contracts, including the 13 mandatory requirements; leading the bidders' conference; helping draft the evaluation factors through which the winning firms would be selected; and serving on the evaluation panel to select the winning bidders.

2. The Former Director Consulted Directly with Some Firms Prior to Issuance of the RFP.

The former Director interacted with some, but not all bidders, in a manner that failed to reflect integrity, fairness, and openness, as required by the FAR[5] and by government ethics regulations. His communications created, at a minimum, the appearance that bidders with whom he interacted would have an unfair advantage in seeking a Strategic Partnership with PBGC.

In the month preceding the issuance of the Strategic Partnership RFP, the former Director engaged in a two-day email exchange with a BlackRock Managing Director.[6] The

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[4] FAR § 3.101-1.

[5] FAR § 1.102-2(c)(1).

[6] The Managing Director was noted as a key person on the Strategic Partnership contract for the management of up to $900 million in real estate and private equity.

discussion centered on the standards to be used to evaluate bidders for the PBGC Strategic Partnerships. The emails include discussion of getting together in person and by phone.

The former Director asked the BlackRock executive about the "minimum number of employees a Strategic Partner should have globally." After the executive failed to give a definite answer, the former Director explained the reason for needing a specific number: "... I think I need a cognizable cutoff future so that we can **winnow the field** easily." [Emphasis added.]

In response the BlackRock executive wrote, "I will be self serving and say overall firm shld have at least 5,000 total employees. Getting more specific on global now, I wld suggest that at least 25 pct of total employees (and a minimum of 250 in total) shld be in non-US offices. I added the parenthetical **to eliminate the 100 person boutique firm with 30 people overseas from consideration**." [Emphasis added.]

At that point the former Director responded, "Any idea who that includes or excludes?" Clearly, the purpose of the two-day email exchange was to allow the establishment of a specific criteria that would "winnow the field" and "eliminate [certain firms] from consideration." This exchange of emails is inconsistent with the former Director's responsibility as set forth in the FAR. "Government business shall be conducted in a manner above reproach and ... with complete impartiality and with preferential treatment for none."[7]

At the August 8 bidders' conference, the potential bidders who attended were reminded of the RFP's mandatory "firm size" requirement and that no firm should submit a proposal for the Strategic Partnership work unless it had thousands of employees. To their credit, PBGC senior leaders, including the Procurement Department Director, the Procurement Deputy Director, and the PBGC Treasurer,[8] questioned the criteria for size, as established in the RFP. According to the Deputy Director of Procurement, "Requiring employees numbering in the thousands may be unsupportable. If we hide from [answering a question raised by a bidder about minimum size], it may look as if we have no rationale to support the requirement...." Mr. Millard addressed the issue in an email stating, "I don't see why we need change rfp. Says thousands, means thousands."

3. The Former Director Had Inappropriate Contact with Bidders During the "Blackout" Period.

Although he was aware that he was prohibited from speaking with representatives of the firms that were attempting to become PBGC's Strategic Partners, the former Director communicated with winning bidders by phone and by email during the time when proposals were being evaluated.[9] Ordinarily, communications between the PBGC

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[7] FAR § 1.102-2(e)(1)

[8] The Treasurer also served as Depurty Director of the Financial Operations Division.

[9] Of the 16 firms submitting bids, calls were logged from the former Director's phones with 8 firms during the "blackout" period, including calls with each of the successful bidders.

Director and executives of financial management firms would not be prohibited. However, in this case, because the former Director had been so involved in the details of the procurement process and was serving with subordinate employees on the technical evaluation panel, such contact violated regulations intended to ensure the integrity of the procurement process.

As an example of the communications during the blackout period, we found ten phone calls and at least five emails between the former Director and a managing director of JPMorgan. The emails show that the former Director was attempting to reach the JPMorgan executive by phone. The subject line of the emails was "Can I reac" [reach]. The JPMorgan executive replied with details of his hotel room number and telephone, his mobile phone number, and the phone number of his apartment, as well as times when he would be available. We were unable to determine conclusively whether the former Director and the JPMorgan executive ever actually spoke by phone and we do not have specific information about the topics the former Director planned to discuss. However, the day that winners of the Strategic Partnerships were selected, the email string continued. The subject line was changed from "Can I reac" [reach] to "Strat partnerships" and the message sent by the former Director was "U guys get 900 m. 600 real estate 300 private equity." We concluded that the email message and the subject line provide a strong indication that the strategic partnerships were to be the topic of the phone conversation between the former Director and the JPMorgan executive.

During January 2009, as part of our audit, we interviewed the former Director about communications with bidders during the "blackout" period. Initially, he stated that he had been careful not to talk to any of the potential bidders during the period that the Strategic Partnership was "on the street" for bid. He also stated that he did not recall having any conversations with offerors during the procurement. OIG professional staff then showed the former Director his own telephone logs. At that time, he amended his prior statement and commented that, if he had spoken with an offeror, he definitely would not have discussed the Strategic Partnership procurement.

The former Director's explanation about the phone calls continued to evolve throughout our audit. For example, he later provided the explanation that the phone calls to the JPMorgan executive were made to discuss a particular news article. We were unable to corroborate this explanation, as the news article to which he referred was dated after the first of the emails and phone calls – an indication that some other topic was under consideration. Subsequently, in a written statement addressing the issues in our report, the former Director asserted that he made the phone calls and emails to the JPMorgan executive as part of his work with the McCain transition team. He provided documentation to show that the JPMorgan executive had been under consideration for a cabinet level post, along with a number of other candidates. We attempted to corroborate the former Director's explanation through an interview with the leader of the McCain transition team, who advised that named candidates were not called as part of the process in which the former Director was involved. In a further attempt to corroborate the former Director's explanation, we identified the person or company associated with each phone number called from the former Director's cell phone and from his direct line during the

relevant time period. Except for the calls to the JPMorgan executive, there were no phone calls to either the homes or the businesses of any of the individuals identified by the former Director as potential candidates for political appointment, based on the listing he provided us.

4. **The Former Director Sought Employment Assistance from an Executive of One of the Winning Bidders.**

Our review of the former Director's voluminous email records disclosed extensive communication with a Goldman Sachs executive, occurring after the award of the $700 million Strategic Partnership contract. While we did not identify any evidence that the former Director was attempting to obtain employment directly with Goldman Sachs (or with any of the winning firms), we did find 29 emails between a senior Goldman Sachs official and Mr. Millard to assist him in his search for employment. For example, the former Director provided his resume, bio, and six news articles to the Goldman Sachs executive, who in turn forwarded the materials to others in the financial community. Employment assistance provided by the Goldman Sachs executive to the former Director included personal meetings, strategic advice, introductions to potential employers, and help with meeting arrangements. In one email the executive wrote:

> ... It was great to see you this afternoon. I spoke with [the CEO of a financial services firm] after our mtg. He would love to meet with you in NY. I told him I would forward your info when I receive it and then you can feel free to coordinate with his assistant at any time after that. Separately, I spoke with [--] and he confirmed for tomorrow morning. I will keep you posted on the others that we discussed.

The evidence of the 29 emails tends to contradict the written statement of the former Director, in which he asserted, " ... around the time I became aware of this audit, I became aware of a rumor that I was pursuing the Strategic Partnerships in order to increase my chances at post-PBGC employment with large financial services firms. This was ridiculous, as I already had numerous contacts at such firms and had worked in senior roles at two of them in the past."

The former Director advised us that the assistance was provided due to a "deep personal relationship" between him and the executive. He had also previously asserted that the executive was not actually involved in bidding for the Strategic Partnership contract. While the executive was not listed as "key personnel" in the Goldman Sachs bid, the former Director had requested, via email, that a subordinate provide the RFP to the executive. Further, on the day that Strategic Partnership contracts were awarded, the former Director sent the Goldman Sachs executive an email with the subject "Strat partner" stating, "U guys got 700 m in private equity." We concluded that the receipt of employment assistance from a winning bidder raises serious ethical concerns.

A Special "Thank You" to the Whistleblower

Reporting concerns about fraud, waste, or abuse to the Inspector General requires a lot of courage. The task is even more difficult when the issues of concern are subjective, involving questions of fairness, of impartiality, or of "appearance." I am grateful to the PBGC employee who first reported the questionable actions of the former Director to my office. Disregarding concern about how well the Whistleblower Protection Act could protect his/her identity, this loyal employee made a choice to put PBGC's interests above the employee's own interest to be free from possible retaliation. That choice will help the PBGC Board and PBGC leadership make the changes needed to maintain the public's trust. This employee deserves our gratitude and thanks.

THE OFFICE OF INSPECTOR GENERAL WILL CONTINUE TO EXAMINE AREAS THAT PRESENT THE GREATEST RISKS AND PROMPTLY NOTIFY PBGC, THE BOARD, AND CONGRESS OF ACTIONS NEEDED TO IMPROVE EFFECTIVENESS AND MINIMIZE FRAUD, WASTE, AND ABUSE

Our office supports PBGC in its various initiatives. We are in the process of developing a risk-based strategy that will target the highest risk areas and emphasize timely reporting of results. To that end, we are evaluating PBGC's implementation of its investment policy and providing oversight for PBGC's preparations for the potential influx of new large defined benefit pension plans. Our work is being coordinated with the Government Accountability Office to avoid duplication of effort and maximize accountability coverage. In addition, we have a number of ongoing audits and reviews that directly relate to the challenges of operating a government corporation such as PBGC. We have also begun several actions to enhance our capacity to assist PBGC in ensuring accountability; these actions include the recent hiring of an experienced audit manager and high-performing criminal investigator from other Offices of Inspector General to help us handle our increased audit and investigations workload.

The Office Of Inspector General Is Working With PBGC To Ensure Implementation Of Outstanding Audit Recommendations.

Audit recommendations are the heart of any audit report. No matter how interesting the findings may be, a report is not effective unless the recommendations are implemented and the problems reported fully addressed. Last month, my office undertook a comprehensive review of the status of outstanding audit recommendations and we identified 130 outstanding recommendations for corrective action that have not yet been implemented by PBGC. We noted the following:

- Some recommendations were quite old; for example, the need to implement an integrated financial management system was first reported twelve years ago, in 1997. The issue has been included in each subsequent year's financial statement audit, including the audit for FY 2008.

- As another example of a corrective action that is long overdue, recommendations from an audit report issued in 2003 relate to PBGC's Premium Accounting System and are not scheduled to be completed until June 2010.
- Progress is being made on some old recommendations, however. For example, our FY 2004 financial statement audit included a recommendation for the development of a comprehensive procedures manual for processing and estimating premiums – an action that is scheduled to be complete sometime this summer.
- As good news, we noted that 50 of the 130 open recommendations were issued within the last year – most of these are in the process of being implemented as we speak.
- Our recommendations focus on helping PBGC do its work better. About three-fourths of the recommendations are intended to improve PBGC's internal controls or governance.

The Office of Inspector General Is Conducting a Review to Identify Vulnerabilities and Any Needed Changes in PBGC's Approach to Executing its Investment Policy.

Ongoing audit work is examining the strengths and weaknesses of PBCG's approach for executing its investment policy. As part of that review, we are also evaluating the effectiveness of PBGC's plan to identify and manage key risks that could affect investment performance or limit anticipated benefits. We have already issued one report, the interim report discussed above. That report addressed PBGC's vulnerability to one of those risks and raised serious questions about the integrity of the procurement process for the Strategic Partnership contracts.

PBGC has committed to working with the Board to make important decisions, including whether Strategic Partnerships fit into the investment approach going forward. We plan to expedite our reporting to ensure that PBGC, the Board, and Congress have real-time information related to our work, as decisions are being made about potential changes to PBGC's approach to implementation. That is, if we identify any issues that warrant immediate attention, we will issue advisories to highlight those issues.

The final phase of our strategy involves using the results of the work mentioned above to identify areas that warrant additional effort and reporting, based on potential risks. We will use this information to develop a long-term plan outlining our investment-related audit and investigative initiatives. We remain committed to protecting PBGC's investment portfolio over the long term.

Other Ongoing Audit and Investigative Initiatives

Our investigators have been proactive in their deterrence efforts, recognizing that the risk of fraud or other criminal behavior increases at times of stress and change. Ongoing activities include:

- Investigation into post-award contacts between the former Director and executives at companies that were awarded Strategic Partnership contracts. As described earlier in my testimony, our audit determined that the former Director had sought placement assistance in the weeks following the contract announcements; in part, our investigation will address the extent to which these conversations took place in personal emails and telephone calls. We are doing this work at the bipartisan request of Senators Kennedy, Baucus, Enzi, and Grassley.
- Fraud Awareness briefings to several Pension Benefit Guaranty Corporation (PBGC) departments and Field Benefit Administration Offices throughout the country. We conducted these fraud briefings to educate employees and contractors about the roles and responsibilities of the Office of Inspector General. Specifically, the Office of Investigations focused on raising awareness to potential indications of fraud, and discussed mechanisms for reporting allegations to the Office of Inspector General.
- Non-voting participation on PBGC's Internal Control Committee. The Assistant Inspector General for Investigations provides insight gained through his experience as criminal investigator to the committee responsible for oversight and accountability of PBGC internal controls. Effective control systems may detect fraud or deliberate non-compliance with policies, regulations, or laws.
- Distributing materials, such as our newly designed Hotline posters and periodic electronic Fraud Alerts, to PBGC employees and contractors and to retirees receiving their pensions through PBGC.

Our strategy also involves emphasizing the investigation of allegations of fraud in any of the pension plans that PBGC takes on as a result of the potential influx of new plans. We will be vigilant in presenting cases to the Department of Justice (DOJ) for prosecution and participating in resulting prosecutions. We will also focus on ensuring that PBGC officials do not inadvertently take actions that compromise potential prosecutions. For example, we have already established a regular periodic meeting between the Office of Inspector General and the PBGC General Counsel at which we will discuss coordination of efforts to ensure effective deterrence. As needed, our efforts are coordinated with the Department of Labor Office of Inspector General and the Employee Benefits Security Administration. Further, we are reaching out to our investigative counterparts in other federal agencies and in state and local governments.

The Office of Inspector General is Taking Action to Best Position Itself for Future Change.

The issues under discussion today have presented our office with resource challenges. We are a small Inspector General office, especially when considered in relation to the large dollar amounts at stake and the sophistication of the businesses (including Wall Street investment firms) with whom PBGC deals. Accordingly, we are making the most of the resources provided to our office.

- We contract for assistance when we do not have enough staff or the necessary technical background to address important questions. For example, last week we issued a discussion draft report on PBGC's management of its securities lending program, a complex issue. To meet our objectives in this review, we obtained contract assistance from a well-respected financial services advisor to perform the detailed and substantive review.

- We are in the process of hiring up to three new audit managers. Bringing high-caliber leaders on board is critical so we can deploy them to track the potential influx of defined benefit plans and deal with the increased workload of complaints that is likely to occur as we continue to publicize our Hotline.

- In the very near future, we will begin conducting systematic outreach with Congressional and other stakeholders, including the staff of the Special Committee on Aging and the staffs of our authorization and appropriations committees in the House and Senate. We have been pleased with the support shown to our office by the committees and we intend to keep the lines of communication open. We know that PBGC has many other stakeholders -- beneficiaries in terminated pension plans, participants in ongoing plans that PBGC insures, the employers who pay premiums, and the policymakers who oversee the federal insurance programs. We plan to reach out to these important stakeholders, as well.

- In response to upcoming challenges, our office is updating its comprehensive strategic plan so that our audits and investigations are more clearly tied to an overarching strategy. This strategy will reflect and support PBGC's strategic goals of safeguarding the federal pension insurance system, providing exceptional service to customers and stakeholders, and exercising effective and efficient stewardship of PBGC resources.

- Finally, we are developing new reporting formats that will allow us to expeditiously issue the results of our work so that action can be taken in a timely manner. We are also focused on presenting our work in user-friendly, understandable manner to maximize the impact of our findings and recommendations. Additionally, we are making it simple to learn about our new reports and written products as they are issued. Subscribers to our New Reports Notification feature, displayed on our website at www.oig.pbgc.gov can be alerted, via email, whenever we post a new report.

CONCLUSION

The coming months will bring tremendous challenges and opportunities to PBGC as it manages its investment portfolio and works with the Board to make important decisions, including whether Strategic Partnerships fit into the investment approach going forward. Further challenges are posed by the current economic situation and concerns that some large defined benefit plans may be on the brink of financial distress. We are in complete

alignment with the Committee's commitment to ensure that PBGC management is taking steps to strategically prepare the Corporation for the possible influx of such plans and their participants.

PBGC will need sustained efforts to ensure that integrity, accountability, efficiency, and effectiveness are maintained as it moves forward. To that end, we acknowledge current PBGC leadership, including the acting Director, for their ongoing contingency planning and the focus on ensuring that PBGC core functions - insurance programs and benefits administration - have the necessary resources including staff, budget and information technology to address workload associated with the potential wave of pension plan trusteeships in the near future. We are focused on assisting PBGC officials in their efforts by identifying vulnerabilities and making recommendations for improvements, where needed.

It is important that we ensure accountability to help restore the trust that may have been damaged through the misconduct of the former Director. As PBGC moves forward, it has a unique opportunity to reconsider its approach to implementing the investment policy and make any needed adjustments. Further, if it can meet the challenge of its increased workload with efficiency, transparency, and integrity, PBGC has an opportunity to reassure the American people about the basic soundness of our Nation's economy. We are committed to helping PBGC do just that.

That concludes my statement, Mr. Chairman. Once again, I thank the Committee for its support of our efforts. I will be happy to answer any questions you or other Members of the Committee may have.

A copy of the audit report, "Former Director's Involvement in Contracting for Investment Services Blurs Roles and Raises Fairness Issues, AUD-2009-5 / PA-08063-1, is attached.

Pension Benefit Guaranty Corporation

Office of Inspector General

Audit Report

Former Director's Involvement in Contracting for Investment Services Blurs Roles and Raises Fairness Issues

May 15, 2009

AUD-2009-5 / PA-08-63-1

Pension Benefit Guaranty Corporation
Office of Inspector General
1200 K Street, N.W., Washington, D.C. 20005-4026

May 15, 2009

MEMORANDUM AUDIT REPORT

TO: The Honorable Hilda L. Solis, Secretary of Labor
Chair of the PBGC Board of Directors

The Honorable Timothy F. Geithner, Secretary of Treasury
Member of the PBGC Board of Directors

The Honorable Gary Locke, Secretary of Commerce
Member of the PBGC Board of Directors

FROM: Rebecca Anne Batts
Inspector General

SUBJECT: Former Director's Involvement in Contracting for Investment Services Blurs Roles and Raises Fairness Issues

This report describes findings identified during our ongoing audit of the Pension Benefit Guaranty Corporation's (PBGC) implementation of its new Investment Policy. While conducting this audit, we became aware of serious allegations about former PBGC Director Charles E.F. Millard's involvement in the procurement process used to select the investment managers responsible for executing aspects of the new policy. The objectives of this report include:

- Determining whether the Director's[1] direct involvement in the procurement process compromised the perception of impartiality in contracting for strategic investment partners;
- Determining whether the Director and other procurement officials made improper contacts with offerors during investment management source selections; and
- Determining whether Procurement Department standard operating procedures were inappropriately modified during investment management procurement.

The report discusses our findings and recommendations to ensure PBGC develops and implements internal controls to foster impartiality in future procurement activities and compliance with existing contracting laws and regulations. Our recommendations are made to the PBGC Board of Directors, as the actions that are needed will require implementation at a level higher than the PBGC Director.

[1] At that time we began this audit, Charles E.F. Millard was the PBGC Director. He resigned his position effective January 20, 2009.

RESULTS IN BRIEF

Serious questions about the integrity of the procurement process for the Strategic Partnership contracts were raised when the former PBGC Director inappropriately communicated with bidders during the time when such contact was forbidden by PBGC policy and the Federal Acquisition Regulation (FAR). Phone records and emails show that the former Director was communicating directly with some bidders at the same time that he was actively evaluating their Strategic Partnership proposals, a clear violation of the prohibition of contact with potential offerors. Further, the former Director took an unprecedented role in the procurement process, to include serving on Technical Evaluation Panels (TEP) to formally assess some of the same Wall Street firms with whom he was in frequent contact; at a minimum, this violated the principle of separation of duties. However, it should be noted that our audit did not identify evidence of criminal activity on the part of any bidders.

The former Director was advised that his actions could cast doubt on the integrity of the procurement process, but he did not heed these warnings. Because the former Director's subordinates were unable to prevent the activities described in this report and because internal guidance could be changed by a future Director, it is unlikely that PBGC employees can take effective action to prevent similar abuses by future Directors. Therefore, our recommendations were made to the PBGC Board of Directors (Board), in recognition of their important oversight role of PBGC and the PBGC Director. The Board is the final accountability authority for PBGC activities.

The PBGC Board provided a written response to our report. That response, which is included in its entirety as Appendix C to this report, notes that the Board will take appropriate action in response to the recommendations. We agree with the actions proposed by the Board and appreciate their commitment to ensuring that PBGC has the internal controls it needs to meet its critical mission.

BACKGROUND

PBGC is a wholly-owned Federal government corporation, established under Title IV of the Employee Retirement Income Security Act of 1974 (ERISA), with a three-member Board of Directors comprising the Secretaries of Labor, Commerce, and Treasury. The Secretary of Labor serves as the Board Chair. The Board establishes policy and provides oversight to PBGC and its Director. The Pension Protection Act of 2006 (PPA 2006) established a Presidentially-appointed and Senate-confirmed Director to administer the Corporation in accordance with policies established by the Board. PBGC also has an advisory committee appointed by the President to, among other things, advise on investments.

PBGC's By-Laws require the Board to review the Investment Policy Statement every two years and approve the Investment Policy Statement every four years. The purpose of the Board review is to ensure that the objectives of the Investment Policy continue to be

aligned with PBGC operational objectives, that PBGC is implementing investment strategies that are consistent with the investment objectives, and that PBGC's Investment Policy is implemented in a manner consistent with the principles of ERISA.

In February 2008, PBGC executives presented to the Board a proposed revised investment policy. PBGC's Board unanimously approved the policy, which is less conservative than the prior policy and involves transferring billions of dollars from fixed income treasury securities to marketable equities, real estate, and private equity. Our conclusions about the implementation of the investment policy will be presented in another audit report to be issued in the near future.

PBGC has begun the process of reallocating its $48.4 billion[2] investment portfolio. While the Corporation continues to evaluate implementation options, planned actions include the use of strategic partners to manage portions of PBGC's alternative portfolios and the interim use of passive index managers. Strategic partnership contracts awarded in October 2008 called for the purchase of nearly $2.5 billion in real estate and private equity. Total fees for the three strategic partnership contracts, over the ten year period, could exceed $100 million.

PBGC's procurement process incorporates a number of internal controls designed to ensure that business is conducted in a manner that is impartial, non-preferential, and avoids conflict of interest or even the appearance of a conflict of interest in the Government/contractor relationship. Steps in the procurement process include identification of the procurement requirements by the program office, performance of market research, preparation of a requirements package, solicitation of offers, establishment of a TEP to evaluate and report on solicitations, negotiation by the contracting officer, legal review, and awarding of the contract.

The TEP is part of the procurement process for selection of investment managers and advisers. This step in the procurement process is intended to ensure that impartial, independent and knowledgeable subject matter experts at PBGC evaluate offerors' proposals against PBGC's stated requirements and determine which proposal represents the best value. A TEP normally consists of three voting members, one of whom is designated as the Chair. TEP members are generally nominated by the program office and appointed by the Contracting Officer.

AUDIT RESULTS

Finding 1: The Former Director had Inappropriate Contacts with Bidders

The former Director violated the FAR and PBGC policy by communicating directly with bidders during the source selection period, also known as the "blackout period." He was aware of the prohibition against speaking with representatives of the firms that were

[2] As of September 30, 2008.

attempting to become PBGC's strategic partners – an opportunity that could lead to more than $100 million in fees and management of up to $2.5 billion in PBGC assets. As a result, the former Director's improper actions raise serious questions about the integrity of the process by which the winners of the strategic partnership contracts were selected.

To maintain the integrity of the procurement, the FAR establishes certain controls over contacts between agency personnel and offerors during the procurement process.[3] In essence, all contact between agency personnel involved in the procurement and bidders is to go through the contracting officer; individual conversations or communications with bidders are strictly prohibited.

The former Director was aware that he should not be in contact with bidders during the procurement process. Prior to each TEP on which he served, he was provided a verbal briefing. Procurement officials stated that in these verbal briefings they made clear the rules prohibiting contact between the TEP members and potential offerors. Further, a written memorandum which described the prohibition on contact with offerors was provided to each member of the TEP, including the former Director. The Director of Procurement stated that she asked each member of the TEP to read the memorandum in front of her, so that she could be certain that each person understood the importance of following the rules. Finally, the Director of Procurement stated that she had advised the former Director multiple times that he should not have contact with potential vendors and that he should cut off any ongoing contact once a Request for Proposal (RFP) was released.

The source selection period for the strategic partnership procurement began when the RFP was issued on July 31, 2008 and ended on October 31, 2008, when three contracts were awarded. During this 3-month communications blackout period, we identified the following contacts:

- Nine phone calls were made between the former Director's phones and **Goldman Sachs**, a firm that was awarded a strategic partnership contract to invest up to $700 million in private equity. Three calls were incoming calls and six were outgoing. Six of the nine calls were with the phone of a manager who was noted as a key person in the strategic partnership contract and whose involvement in bidding for the strategic partnership included making presentations at PBGC and in New York, and conducting the final price negotiations.

- Six phone calls were made between the former Director's phones and **BlackRock,** a firm that was awarded a strategic partnership contract to invest up to $600 million in real estate and up to $300 million in private equity. The calls included one incoming call and one outgoing call with an unknown party at BlackRock and four

[3] FAR Part 15.303 states that agency heads are responsible for source selection. The contracting officer is designated as the source selection authority unless the agency head appoints another individual for a particular acquisition or group of acquisitions. FAR 15.303(c) requires the contracting officer to: (1) serve as the focal point for inquiries from actual or prospective offerors after release of the solicitation, and (2) control exchanges with offerors after receipt of proposals.

outgoing calls to the phone of a Managing Director, who was also noted as a key person on the strategic partnership contract.

- Ten phone calls – five outgoing from the former Director's PBGC phone lines, three outgoing from the former Director's cell phone, and two incoming – were made during the blackout period between the former Director's phones and a managing director of **JP Morgan**, a firm that was awarded a strategic partnership contract to invest up to $600 million in real estate and up to $300 million in private equity.

Of the 16 firms submitting bids, calls were logged from the former Director's phones with 8 of the firms during the blackout period, including the four firms deemed to be "finalists" from which the three successful bidders were selected. He communicated via e-mail with one of the eliminated firms only to say, "The rules of ethics prevent me from having our lunch meeting."

During January 2009 as part of the audit, we interviewed the former Director about communications with bidders during the blackout period. Initially, he stated that he was careful not to talk to any of the potential bidders during the period that the Strategic Partnership was "on the street" for bid. He also stated that he did not recall having any conversations with offerors during the procurement. We then showed the former Director his telephone logs. At that time, he amended his prior statements and commented that, if he had spoken with an offeror, he definitely would not have discussed the procurement on which he was a TEP member. He advised us that he did not keep records, notes, or other documentation of his phone calls or other contacts.

As an example of the contacts, at least five emails document communications during the blackout period between the former Director and the JP Morgan executive referenced above. Our review of the email string showed that, beginning on October 24, 2008 (during the blackout period), the former Director was attempting to contact the JP Morgan executive by phone. The subject line of the emails was, "Can I reac" [reach]. The JP Morgan executive replied with details of his hotel room number and telephone, his mobile phone number, and the phone number of his apartment, as well as times when he would be available. It is unclear from the emails whether the former Director and the JP Morgan executive ever actually spoke by phone and we do not have specific information about what topics the former Director planned to discuss. However, on the day that winners of the strategic partnerships were selected, the email string continued. The subject line was changed from "Can I reac" [reach] to "Strat partnerships" and the message sent by the former Director was, "U guys got 900m. 600 real estate 300 private equity." We concluded that the email message and subject line provide a strong indication that the strategic partnerships were to be the topic of the phone conversations between the former Director and the JP Morgan executive.

During March 2009 we discussed the details of these phone calls and emails with the former Director, at his request. He asserted that the JP Morgan executive has been his friend since the mid- 90's and the discussions did not involve PBGC business or the

strategic partnerships. Nevertheless, we noted that the former Director sent an email to a subordinate, instructing the subordinate to provide the Strategic Partnership RFP directly to this JP Morgan executive, an act that further links the executive with the Strategic Partnership process.

The former Director's explanations about these particular contacts during the blackout period evolved during the course of our audit. For example, in his April 28 written statement[4] addressing the issues included in this report, he provided a new explanation for certain contacts during the blackout period for communication with bidders for the Strategic Partnerships.[5] That statement, which is included in its entirety as Appendix B, contained the following explanation for 5 phone calls and 5 emails with a JP Morgan executive that occurred between October 24 and October 29, 2008 According to the statement, "I was working at that time on the McCain presidential team's potential transition. I had responsibility for developing lists of names of individuals to be Secretaries and Under Secretaries at various agencies including Treasury, Commerce, Labor, Education and HUD. The person I was reaching via these emails was someone I wanted to put on one of these lists and whose advice I sought about other possible individuals."[6]

We attempted to corroborate the former Director's explanation for his calls and emails to the JP Morgan executive. We confirmed that the executive was listed as a potential candidate for cabinet level office on the document titled, "Top Tier Presidential Appointment Process Overview" as provided to us by the former Director. We spoke with the leader of the McCain Transition Planning Team to understand the process used by the former Director in developing the list of names. According to the team leader, the list was developed through a highly confidential process using public information; any necessary phone calls were made from the legal offices of the Republican Transition Team headquarters in Washington DC. The team leader advised that named candidates were not called as part of the process. This tended to conflict with the former Director's assertions about phone calls to the JP Morgan executive.

In a further attempt to corroborate the former Director's explanation, we identified the person or company associated with each phone number called on the former Director's cell phone and on his direct line during the relevant time period. Except for the calls to the JP Morgan executive, there were no phone calls to either the homes or businesses of any of the individuals identified by Mr. Millard as potential candidates for political appointment, based on the listing he provided us. When we told Mr. Millard the results of our corroboration efforts, he confirmed he had not contacted any other potential candidate.

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[4] We note the former Director's April 28 statement is unsigned, however, when his attorney forwarded the statement to the OIG via email he stated: "attached please find a PDF of Mr. Millard's statement. ..., we submit this statement as final and without restriction as to circulation." To date, we have not received a signed copy.

[5] The former Director had previously provided different explanations for these phone calls, including the wish to discuss a particular news article and a discussion of New York politics; we were also unable to corroborate those explanations.

[6] Page 5 of Appendix B, Statement of Former PBGC Director Charles E.F. Millard (page 20 of this report).

We advised the current Acting Director and PBGC's General Counsel about the former Director's improper contacts with bidders, as well as the post-award assistance with his job search that he received from an executive of at least one of the awardees, as noted in the following finding. The General Counsel advised that these facts, taken together, raised serious ethical concerns of which she would apprise the Board.

Also, according to the General Counsel, the career Board staff requested that PBGC slow down the implementation of the private equity and real estate allocations of the strategic partnerships because political appointees are not yet in place to serve as PBGC's Board Representatives. The General Counsel reports that PBGC is continuing with planning and training activities contemplated by the contracts.

In another recent procurement, PBGC officials reacted strongly to a much less serious violation of the prohibition on contact with bidders during the blackout period. A PBGC employee who was serving as the Chair of a TEP contacted bidders during the blackout period to seek clarification about their pricing proposals. The employee documented all contacts and obtained supervisory concurrence with the proposed actions. However, the Procurement Department Director reported to OIG that the procurement had been compromised, noting that, "it is a violation of the FAR for any TEP member to contact any firm during the progress of a procurement regarding any matter involving that procurement. Once a procurement is on the street, only the Procurement Department may contact any vendor regarding that procurement in order to ensure that all vendors are treated fairly, equally, and without bias." When this occurred, the former Director met with the employee to reiterate the seriousness of contact with bidders during the prohibited time.

Certain senior level leaders in PBGC asserted their belief that the former Director's motivations for making contact with the bidders were inappropriate. While our audit did not identify evidence of criminal activity by any of the bidders, the former Director's improper contacts cast serious doubt on the integrity of the procurement process.

OIG RECOMMENDATION

The PBGC Board should determine whether inappropriate actions of the former Director, as described in this report, cast enough doubt about the fairness, integrity and openness of the procurement to warrant cancellation of the strategic partnership contracts. If so, the Board should instruct PBGC to cancel the contracts. **(OIG Control Number: Board-1)**

PBGC BOARD RESPONSE

The PBGC Board has asked the Acting Director of the PBGC to provide the Board with his recommendation for PBGC action in response to the draft report. The Board will review the Acting Director's recommendation and ensure that appropriate action is undertaken.

OIG EVALUATION

The Board's response meets the intent of our recommendation.

Finding 2: The Former Director's Dual Roles Raised Concerns About Impartiality

The former PBGC Director represented the Corporation before the investment community in person, traveling frequently to New York and maintaining continual telephone contact with major investment firms. The former Director recounted significantly detailed and frequent discussions with these firms over a period of time. Contemporaneously, he assumed de facto responsibility for key procurement activities necessary to implement the new investment policy, including evaluating many of the same firms with which he routinely dealt. Although PBGC has not placed a specific prohibition on the Director's participation in the procurement process, proper separation of duties would prevent his service in both roles.

Separation of duties is required for effective management control and the lack of separation leaves PBGC vulnerable to concerns of real or perceived bias. Due to the former Director's frequent contact with bidders coupled with his participation in the procurement process, senior level staff expressed doubts about the fairness of his decisions and the selection of winners for the strategic partnership contracts. The former Director's contact with bidders allowed some, but not all, to have frequent and in-depth access to a key procurement decision-maker. Further, the continuing contact provided an opportunity for some, but not all, bidders to enhance the former Director's level of confidence in their firms' knowledge and skills. Finally, the post-award assistance he received from an executive of one of the winning bidders raises serious ethical concerns.

The Controls

PBGC's procurement process is subject to the Federal Acquisition Regulation (FAR) and PBGC's implementing guidance. The FAR's specific regulations are based on guiding principles which caution that business must be conducted with integrity, fairness, and openness.

> An essential consideration in every aspect of the System is maintaining the public's trust. Not only must the System have integrity, but the actions of each member of the Team must reflect integrity, fairness, and openness.... (FAR § 1.102-2(c)(1)).

FAR § 3.101-1 states:

> Government business shall be conducted in a manner above reproach and, except as authorized by statute or regulation, with complete impartiality and with preferential treatment for none. Transactions relating to the expenditure of public funds require the highest degree of public trust and an impeccable standard of conduct. **The general rule is to avoid strictly any conflict of interest or even the appearance of a conflict of interest in Government-contractor relationships. While many Federal laws and regulations place restrictions on the actions of Government personnel, their official conduct must, in addition, be such that they would have no reluctance to make a full public disclosure of their actions.** [Emphasis added.]

OMB Circular No. A-123, *Management's Responsibility for Internal Control*, notes that appropriate separation of duties is necessary for effective management control. Key duties and responsibilities should be separated among individuals. GAO's *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1, explains that separation of duties is necessary to reduce the risk of error, waste, or wrongful acts.

De Facto Responsibility for Key Procurement Activities

The former Director was intimately involved in the day-to-day details of the contracts used to develop and implement the new investment policy. His active participation began before the first contractor was selected to help develop PBGC's new investment policy and continued throughout his tenure at PBGC, despite warnings from his own advisors about the wisdom of such involvement. Examples of his activities at each stage of the contracting process include:

- Serving on a three-member evaluation panel, with two subordinate employees, to select **Rocaton** as the contractor hired to assist in developing PBGC's new investment policy.
- Choosing the TEP members, and serving on the evaluation panel, with two subordinate employees, to select **Plexus** to provide advisory services for the development of transition management principles.
- Choosing the TEP members, and serving on the evaluation panel, with two subordinate employees, to select **Ennis Knupp** as advisor for the upcoming strategic partnership procurement.
- Helping draft the Statement of Objectives, including the 13 mandatory requirements; leading the bidders' conference; helping draft the evaluation factors through which the winning firms would be selected; choosing the TEP members and serving on the evaluation panel, with two subordinate employees, to select **BlackRock, Goldman Sachs**, and **JP Morgan** as the winning bidders for strategic partnerships to invest up to $2.5 billion of PBGC assets.

Responsibility to Represent PBGC

The former Director continued to represent PBGC before the investment community at the same time that he was serving a significant role in the procurement process, to include evaluating the contract proposals of those with whom he was in frequent contact. According to his official position description, one of the Director's major duties is serving as chief PBGC spokesperson with the presidents and chief operating officers of major corporations and heads of various associations. From February 12, 2008 when the Board approved the new investment policy, through July 31, 2008 when the RFP was issued to solicit for strategic partners, the former Director's calendar shows that he met with many firms who were potential bidders in planned procurements to implement the investment policy. In some of these meetings, PBGC staff attended with the former Director while in others the former Director met separately with the Wall Street entities.

The former Director also communicated extensively with the investment community by telephone. Records show that, between July 2007 and October 2008, hundreds of calls were logged to and from the former Director's phones with various Wall Street firms, including hundreds of calls with the successful bidders for strategic partnerships. Some of the phone calls were very short (less than a minute). The assistants to the former Director acknowledge making some calls, with the objective of scheduling visits and other routine administrative activities. Because the former Director did not keep notes or otherwise document his phone calls, we were unable to conclusively determine how many completed calls he held with bidders. However, the number of calls made (e.g., at least 172 to Goldman Sachs, 95 to JP Morgan, and 45 to BlackRock) demonstrate a persistent intention to speak with these firms rather than mere incidental or casual contact. Except for the phone calls made during the blackout period as noted in the prior finding, phone contact between the former Director and bidders would not have been inappropriate, if he had not been substantively involved in the procurement process.

We asked the former Director for notes or other details to document the nature of the telephone calls made from his phones. He initially asserted that he had made some of the calls as part of conducting market research for the various contracts related to the strategic partnerships. However, we were unable to corroborate his explanation, as he did not provide any documentation of the information he developed during the market research. FAR requires agencies to document any market research performed and the PBGC General Counsel advised the former Director of the need to document his research.

The former Director made multiple phone calls to Goldman Sachs in the three days before the strategic partnership RFP was issued. He characterized the calls as "intensive market research," but acknowledged that there was no documentation of that research. Since market research is conducted to determine whether there are firms capable of performing the work the agency requires, it is unlikely that the former Director was conducting market research, as defined in the FAR. After he left PBGC, we met again with the former Director to discuss these calls. At that time, he explained that the calls were made to two Goldman Sachs executives who he asserted were not actually involved in bidding for the strategic partnership. Neither executive was listed as "key personnel" in Goldman Sachs' bid. However, the former Director had specifically requested, via email, that the RFP be sent to one of the Goldman Sachs executives he had described as "uninvolved." This email, and others, tends to contradict the former Director's assertion and links the executive with the strategic partnership bidding process.

A whistleblower alleged that the former Director contacted certain executives in order to enhance his future employment prospects. We found that the Goldman Sachs executive noted above provided active and substantial assistance to the former Director as he searched for post-PBGC employment. However, in his written statement,[7] the former Director asserted in part "... around the time I became aware of this audit I became aware of a rumor that I was pursuing the Strategic Partnerships in order to increase my changes at post-PBGC employment with large financial services firms. This was ridiculous, as I

[7] Page 3 of Appendix B, Statement of Former PBGC Director Charles E.F. Millard (page 18 of this report).

already had numerous contacts at such firms and had worked in senior roles at two of them in the past."

Our review of the former Director's email records disclosed extensive communication with the Goldman Sachs executive, occurring after the award of the $700 million Strategic Partnership contract. While we did not identify any evidence that the former Director was attempting to obtain employment directly with Goldman Sachs (or with any of the winning firms), we did find 29 emails between a senior Goldman Sachs official and the former Director, assisting him in his search for employment. For example, the former Director provided his resume, bio, and six news articles to the Goldman Sachs executive, who in turn forwarded the materials to others in the financial community, including those with whom Goldman Sachs had a business relationship.

Employment assistance provided by the Goldman Sachs executive to the former Director included personal meetings, strategic advice, introductions to potential employers, and help with meeting arrangements. For example, in one email the executive wrote, "... It was great to see you this afternoon. I spoke with [the CEO of a financial services firm] after our mtg. He would love to meet with you in NY. I told him I would forward your info when I receive it and then you can feel free to coordinate with his assistant at any time after that. Separately, I spoke with [---] and he is confirmed for tomorrow morning. I will keep you posted on the others that we discussed. ..." The former Director advised us that the assistance was provided due to a "deep personal relationship" between him and the executive and did not have any connection with the recent contract award. However, we concluded that the receipt of employment assistance from a winning bidder raises serious ethical concerns; the PBGC General Counsel advises she shares these concerns.

As another example of questionable contact, three days before issuance of the RFP, email records show that the former Director received an email from an executive at JP Morgan on the subject "Sample Strategic Partnership RFP Questions." The email included an attachment comprising ten pages of proposed questions for PBGC procurement officials to ask bidders for the strategic partnerships during their oral presentations. When we asked the former Director about this email, he explained that he likely had discussed proposed questions with several firms, prior to issuance of the RFP. We also asked whether the file name of the attachment "JPMorgan Sample RFP Questions Strategic Partnership v5.doc" might indicate that this was the fifth version of an ongoing collaboration. He stated he did not know. However, he confirmed that he had discussed the potential strategic partnership in detail, including questions to ask, with parties external to PBGC. We concluded that allowing some bidders to propose sample questions could offer an unfair advantage to those bidders. Interacting through discussions and emails with some, but not all, bidders creates the appearance that those bidders who had prior knowledge of the questions could be better prepared and therefore more effective in delivering their oral presentations.[8]

[8] PBGC officials identified an additional instance in which a different bidder provided sample questions. According to the email, the bidder "appreciated the opportunity...to share our thoughts re additional questions you might raise in your pending RFP for Strategic Partnerships." The email contained an attachment titled "PBGC Sample RFP Questions.doc." Our subsequent review identified an additional email from the bidder regarding sample RFP questions.

Alteration of Established Review Criteria

Another example of the former Director's direct involvement with procurements occurred when he established an additional review criterion after the evaluation panel issued their final recommendation. The former Director instructed a top-level official to review the TEP evaluations of the Fixed Income Investment Manager and the Index Fund Manager solicitations after the TEP had documented their final conclusions. Senior level PBGC officials were concerned about this change; the PBGC Chief Management Officer acknowledged that there was not a specific prohibition against adding such a review, but he also noted that, "... inserting this during the end of the process rather than at the beginning brings about risk from an IG review perspective and possible bidders should they find out."

The Director of Procurement was so troubled by the change in established operating procedures that she requested a legal opinion to address the issue. In response, the PBGC General Counsel opined, in part: "... a formal source selection organization is usually established prior to proposal review. However, the FAR does not prohibit ... consulting with ... an advisor at any particular point in the procurement."

We agree with the General Counsel that the FAR does not specifically prohibit consulting an advisor. However, our concern arises from the establishment of additional review criteria that were not established until evaluations had been completed and presumptive winning bidders identified. A procurement official said that the former Director was concerned that the TEP members might not see the "big picture" or consider PBGC's needs and future direction. In addition, the former Director noted that the reviewer might have personal knowledge of a negative nature about a key individual or about the bidding firm that would not be represented in the company's proposal.

FAR § 15.203 requires that the factors and subfactors used to evaluate bids, as well as their relative importance, be included in the RFP. PBGC Standard Operating Procedures require that the factors or criteria and the methodology used to evaluate proposals be identified at the same time the requirements are defined to allow inclusion in the solicitation package. The ad hoc review process mandated by the former Director, including asking the senior official to use personal knowledge as an evaluation criteria, was not anticipated or described as part of either solicitation.

Because the reviewer was asked to consider any personal knowledge of a negative nature about a key individual or the bidding firm, the ad hoc review requested by the former Director created an additional review criterion. Changing a procurement criterion during the course of a procurement may be viewed as interference with or preference to offerors, which could result in a challenge to the procurement decision.

Proper separation of duties was not maintained between the former Director's authorized roles as spokesman for PBGC and the role he assumed of performing key procurement activities for government contracts to implement the new investment policy. The former Director's performance of incompatible duties made PBGC vulnerable to allegations of bias, improper influence, or abuse of position.

Some PBGC employees familiar with management of the investment portfolio believed that the former Director made some decisions based on his relationship with certain industry members and not on the merits themselves. In addition to frequent contacts, another factor that supported this belief was the speed with which multiple investment decisions and the subsequent procurements were made. Because the former Director did not document the reasons for his visits, calls, emails and the market research that he claimed to have performed, we could not determine whether the former Director's communications with Wall Street firms had any impact on his decisions.

The former Director strongly denies that there was anything improper in the dual roles that he fulfilled. He asserted that he set an aggressive course of action to implement the new investment policy and that he believed in talking to lots of people to understand what they have done and to discuss possibilities. He also said that he needed to be directly involved in the procurements to ensure that they actually took place; his involvement was appropriate because, in his view, he had the best knowledge of the issues and firms to be considered.

Advisors to the former Director cautioned him against serving on TEPs, explaining that his participation could create the appearance that he could dominate the panel, given that the panel members were all subordinate employees. However, the former Director was also advised that his participation did not specifically violate any provision of law or regulation. The former Director concluded that he would participate in the panels, as he did not consider that his actions would appear to be improper. During the course of this audit, he confirmed his view that he was free to participate in the evaluation panels, as long as his participation was not illegal.

RECOMMENDATION

The PBGC Board should require future Directors to ensure appropriate separation of duties, to include refraining from service on technical evaluation panels and other de facto procurement activities. Special attention should be given to situations that are likely to create the appearance of improper influence or bias. **(OIG Control Number: Board-2)**

PBGC BOARD RESPONSE

The Board agrees with the recommendation and will work with the PBGC to develop appropriate guidelines.

OIG EVALUATION

The Board's response meets the intent of our recommendation.

Appendix A

OBJECTIVES, SCOPE, AND METHODOLOGY

This interim report is issued as part of our ongoing monitoring of PBGC's plans for implementing the new investment policy. Matters came to our attention concerning possible procurement improprieties in activities to implement the new investment policy. In response, we developed the following audit objectives to guide our examination of these matters:

- Determine whether the Director's direct involvement in the procurement process compromised the perception of impartiality in contracting for strategic investment partners;
- Determine whether the Director and other procurement officials made improper contacts with offerors during investment management source selections; and
- Determine whether Procurement Department standard operating procedures were inappropriately modified during investment management procurement.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform this audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions, based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. The audit was conducted between October 2008 and May 2009. Nothing came to our attention during our field work to cause us to conclude that any procurement officials had improper contacts during the source selection blackout period, except for the instances noted in this report.

The following scope and methodology was used in conducting this review. The scope of our audit includes procurement activities related to the investment policy, from February 2008 through February 2009. We also assessed allegations made by a whistleblower regarding possible procurement improprieties related to the selection of investment consultants and managers.

We interviewed the former PBGC Director while he was still in office, certain members of the Executive Management Committee, and key management officials within the Financial Operations Department and the Procurement Department. We also met with the former Director, at his request, to allow him to provide additional comments and clarifications in relation to the issues described in this report. We agreed to receive a written statement from him and have attached that statement, in its entirety, as Appendix B of this report. The statement is unsigned, but was accompanied by a note from the former Director's attorney stating, in part, "... we submit this statement as final and without restriction as to circulation." Because the statement included certain new information, we performed additional tests intended to corroborate that information. We also evaluated available documentation related to the investment transition, with emphasis on the solicitation and selection of contractors to provide investment services, to include the strategic partnerships.

This audit did not include detailed analysis of these materials, but we did look for and resolve inconsistencies as necessary to achieve our objectives.

To address whistleblower allegations concerning improper contacts with bidders, we obtained the former Director's electronic contact list, as well as the phone records for his direct PBGC phone line, the phone lines of his two assistants, and his government-issued cell phone. After we determined that he had been in contact with bidders during the blackout period, we also obtained his PBGC email records.

Our phone record analysis included reviewing the former PBGC Director's calendar, including telephone contacts made, and comparing them to his electronic contact list to identify the contact's employer and telephone number. Additionally, we verified the employer and telephone number through internet search services.

PBGC's Office of Information Technology provided copies of the former Director's e-mail records for the May 2007 to January 2009 period. We used automated tools to sort the emails by dates, companies, and names to identify emails for further review. We reviewed the emails related to the Strategic Partnership procurement process and to post-award contact with winning bidders for Strategic Partnership contracts.

Appendix B

Statement of Former PBGC Director Charles E.F. Millard

Charles E. F. Millard
Rye, New York

April 28, 2009

VIA EMAIL AND U.S. MAIL

Inspector General
Pension Benefit Guaranty Corporation
Office Number 4823
1200 K Street NW
Washington, DC 20005

Deborah Stover Springer
Pension Benefit Guaranty Corporation
Office Number 4823
1200 K Street NW
Washington, DC 20005

Dear Becky and Deborah:

I am writing concerning the IG audit of the implementation of the PBGC's investment policy, specifically as it relates to my involvement.

The Inspector General has not permitted me to review the actual draft report. However, I will do my best to address the issues in that draft as I understand them.

There appear to be two subjects to address: first, the policy question involved in my decisions to sit on certain Technical Evaluation Panels (TEPs) involved in Requests For Proposals (RFPs) for various investment-related services to the PBGC; second, the relationships and contacts I had with firms involved in these processes. In both areas, my conduct was appropriate as a policy matter, based firmly on agency regulation and advice of agency counsel, and undertaken in good faith by me to advance the goals of the PBGC.

This letter can therefore be summarized as follows: a) I sought advice from agency counsel and from the Chief Procurement Officer at PBGC before becoming involved in the selection process; b) I *never* discussed matters pertaining to the RFP with any participant during the pendency of the RFP; and c) I acted in what I believed to be the best interests of PBGC to implement desperately needed reforms of PBGC investment policy.

Appendix B

Statement of Former PBGC Director Charles E.F. Millard

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A. THE DIRECTOR'S PARTICIPATION IN TEPs IS PERMITTED UNDER THE LAW AND IS A POLICY QUESTION

Before deciding to participate in any TEP, I made sure to consult the Chief Procurement Officer of the PBGC and/or the General Counsel. I was given clear and unequivocal guidance that there was (and to my knowledge is) no prohibition against a PBGC Director's sitting on a TEP.

Thus, the question regarding service on TEPs is a policy question. The law and regulations allow it, and I chose to take a hands-on approach to the pressing and important matters that were my responsibility as Director of the PBGC. In each instance, I added numerous hours and meetings to my own schedule, solely because I felt a need to insure the best possible stewardship of the PBGC's billions in assets that it holds in trust for the retirees it insures.

It is important to understand the situation the PBGC faced during most of the time period in question. Starting in late spring of 2008 through the conclusion of the Strategic Partnership RFP in late October 2008, three things were clear: (1) PBGC had a new investment policy to implement (which we did in a very careful and deliberate manner); (2) the capital markets were in a state of tremendous upheaval; and (3) the economy was likely to present the PBGC with corporate bankruptcies of tremendous size, possibly including companies from the automobile industry.

At the same time, the PBGC itself was dealing with over $50 billion in investible assets with a staff of approximately fifteen people. On numerous occasions, the approach I took to dealing with our challenges evoked staff resistance. But besides staff resistance, it was also quite obvious that a staff of fifteen people was insufficient to deal with problems of the order of magnitude the PBGC faced.

Moreover, the organization had developed a reputation for an inability to get things done. When the investment policy was adopted, there were two asset-manager selection RFPs in the marketplace that I believe were over a year old already. It had become an embarrassment to the corporation. When I asked senior staff for work on additional projects, I was repeatedly told that they did not have time and that anything new would mean delaying the conclusion of those RFPs which were due to be completed in late September of 2008.

It was clear to me that he PBGC needed better resources and better information flow. The staff and the existing consultant had been working together for over ten years. I came to believe on repeated occasions that the staff was resistant to or threatened by the kinds of changes that were needed to put PBGC on sounder footing to face the challenges that were coming.

I acted in the best interests of the agency. I had nothing to gain and in fact was developing resources that would principally benefit the PBGC in the future and that would be available to

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future Directors, since I fully expected that, regardless of who won the presidential election, I would be leaving PBGC in January 2009.

Around the time the IG's audit began, I began to hear about complaints from the staff. They did not like the idea of new advisors being brought in. For years the senior finance staff had a close relationship with PBGC's consultant, and I often had difficulty obtaining the information I felt a responsibility to have. I felt that the Director who bears ultimate responsibility for the organization needed more access to better advisors who were committed to more transparent information flow. I believe many of the complaints about Strategic Partnerships were the result of the staff feeling threatened. However, I knew that we needed more resources and felt my responsibility was not to please the staff but to make the right decisions for the good of the PBGC.

Also around the time I became aware of this audit I became aware of a rumor that I was pursuing the Strategic Partnerships in order to increase my chances at post-PBGC employment with large financial services firms. This was ridiculous. as I already had numerous contacts at such firms and had worked in senior roles at two of them in the past. I also fully understood that, under the ethics rules, I would not be able to work at any of the firms that we selected.

I considered recusing myself from the Strategic Partnership RFP in order to retain these employment possibilities and to avoid the criticism that I knew would come from this decision that was not supported by staff. However, I reviewed certain aspects of the ethics training I received when I arrived at PBGC, and I recalled that I was instructed that I owed a duty of "undivided loyalty" to the PBGC while I was working there.

I was the PBGC employee most knowledgeable about the firms we would be interviewing and about Strategic Partnerships. Senior staff did not have the time to carry out this assignment. I knew that my involvement would insure that we completed the task. The capital markets and the economy were presenting increasing challenges to the PBGC. Those challenges urgently required greater resources. For these reasons, I put myself on the Strategic Partnership TEP. I did not feel that I would be carrying out my duty of undivided loyalty if I left myself off the TEP in order to protect future employment possibilities or avoid unfounded criticisms.

I consulted with the Chief Procurement Officer and the General Counsel of the PBGC and was told that there was no prohibition against my sitting on the TEP, and so I decided to do so. At the conclusion of this TEP, no challenge was made to the fact that the Director had been a member of the TEP. This issue was not raised in any bidder's challenge, and the fact that the Director had been a member of the TEP was known to everyone and was not a bar to the General Counsel's determination of legal sufficiency.

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B. IN EACH OF THESE RFPs, I SCRUPULOUSLY COMPLIED WITH ALL LEGAL, REGULATORY AND ETHICAL OBLIGATIONS

I understand that the IG's report is also likely to address contacts from my office with investment firms that were participating in the RFP during the time the TEP was evaluating their proposals. Regarding my contacts with employees of firms bidding on the Strategic Partnership RFP: I was well aware of the prohibition against discussing the substance of the RFP or the RFP process outside the actual RFP process itself, and did not do so. To my knowledge, no one at PBGC, including the IG, has claimed otherwise.

The one form of communication that I have been presented in this matter that is even remotely relevant here is the requests my office made from two firms for suggested questions that might be asked during an RFP process. These requests were wholly appropriate exercises of market research. They in no way disclosed to others what we would ask or think or decide. They simply requested the kinds of suggestions that market research is designed to elicit. These requests were made before the RFP went out and were requested before the RFP was released — specifically because the RFP release date was coming shortly and the market research would have to cease.

I was also aware that it is permitted, indeed it is expected, that individuals will sometimes have contacts at bidding firms and that those contacts will continue during the pendency of an RFP. I understood clearly that such contacts are permissible but that they must not involve discussion of the RFP. I fully complied with those rules.

The IG has been informed that numerous calls made from my office were made by my assistants for scheduling purposes. I rarely placed phone calls myself; frequently calls would be placed when the person being called was not available, and in September and October, my assistants were involved in numerous calls relating to the logistics and scheduling of eight six-hour presentations at the PBGC and four seven-hour presentations at the bidders' offices in New York. The changing logistics of those situations required constant schedule and other planning changes. Moreover, I have asked the IG's office to compare these phone calls to my calendar to determine whether I was even in the building when these calls were placed. To my knowledge, such a comparison has not been made by the IG, meaning that many of the calls I supposedly made or received were in fact handled by someone else while I was out of the office.

One lengthy call in which I did participate in late October was brought to my attention at my last meeting with the IG. I explained that this call probably related to urgently finding information regarding the auto industry from senior individuals who had no involvement with the RFPs. I explained to the IG that additional time on that call was likely spent discussing politics, as the presidential election was a week away. The news article that prompted that call regarding the auto industry and the identity of the person I spoke with about the auto industry have been provided to the IG.

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In the process of writing this letter, I recalled a specific reason that I was trying to reach this party with some urgency in the "Not business" set of emails just before the GM article, and I informed the IG of this verbally today.

I was working at that time on the McCain presidential team's potential transition. I had responsibility for developing lists of names of individuals to be Secretaries and Under Secretaries at various agencies including Treasury, Commerce, Labor, Education and HUD. The person I was reaching via these emails was someone I wanted to put on one of these lists and whose advice I sought about other possible individuals. I have today provided documentary evidence of my involvement in this process as well as documentary evidence that I did in fact use the name of this individual and some of his advice in this process.

One last point about the October discussions with this individual: They all happened *after* the Strategic Partnership presentations and papers had all been made and submitted. All of the TEP on-site visits were concluded. This is not to say that RFP-related discussions would have been acceptable at that time; rather, they would have been useless. The TEP had all the information it was permitted to use. If I was coaching the firm, it could not act on my coaching; if I was seeking information to use in the TEP discussions, I would have had to bring that new information to TEP sessions and utilize it to persuade fellow TEP members in sessions that were overseen by the Chief Procurement Officer.

As an indication that I was following ethical guidelines scrupulously, I point to my email with one of the other bidders. I had a personal relationship with the chairman of the firm and he and I had spoken, before the RFP, about the idea that I might work with his firm in the future. We had arranged a lunch to discuss it. I had no idea his firm would be bidding on the Strategic Partnership RFP. As soon as I realized that his firm had bid, I consulted with the General Counsel about what to do and sent a short email that stated: "The rules of ethics prevent me from having our lunch meeting." I was aware that I needed to be clear, curt, and unequivocal, and I had no further discussions of any kind with this individual until the RFP was concluded. I stayed out of discussions with him because he *was* personally involved in the RFP process and we *had* had a discussion about employment. I shared these details with the General Counsel and followed her advice.

The part of this process that troubles me is the following: the rules state that I may have non-RFP-related contact with persons I know at the bidding firms. I had a limited amount of such contact, but that contact is now described as creating an "appearance" issue. An example: It is normal for PBGC staff to have years-long relationships with fixed-income investment managers. Yet, when a contract for fixed income management is re-bid, it is also normal for some of the same PBGC staff to have business contact one day and RFP-only contact another day. There is no appearance issue in such circumstances, and there is none here.

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Finally, it is part of job of the Director to have contact and relationships with the investment industry. I had numerous such relationships and had non-RFP-related contact with six of the eight bidders involved in the RFP during the time the RFP was pending. Additionally, one of the eight was requested to suggest possible RFP questions just before the RFP was. Yet, since only three bidders were selected, it is difficult to imagine in what way these contacts could possibly have tainted this process. I have described these contacts to the IG.

In conclusion: 1) I always acted in the best interests of the agency. I exercised my authority and judgment in ways that were sometimes counter to staff's wishes, and I took on additional work personally because I saw the need to change certain practices and to provide greater resources to an agency facing tremendous looming challenges with a limited staff. 2) I sought guidance from General Counsel and the Chief Procurement Office regarding the legal issue relating to whether I was permitted to serve on TEPs. 3) I did not discuss the RFP with anyone outside the agency who was in any way involved in the process. My non-RFP-related contacts were legal and ethical. It is my hope that the IG's report bears out these facts.

Very truly yours,

Charles E.F. Millard

Appendix C

PBGC Board of Directors' Response

Pension Benefit Guaranty Corporation
1200 K Street, N.W., Washington, D.C. 20005-4026

MAY - 8 2009

Ms. Rebecca Anne Batts
Inspector General
Pension Benefit Guaranty Corporation
Office of Inspector General
1200 K Street, N.W.
Washington, DC 20005

Dear Ms. Batts:

As the members of the Board of Directors of the Pension Benefit Guaranty Corporation (PBGC), we thank you for the opportunity to comment on the PBGC Office of Inspector General (OIG) draft report entitled, "Former Director's Involvement in Contracting for Investment Services Blurs Roles and Raises Fairness Issues."

We appreciate the work that your audit team has performed in conducting this important audit of the procurement to select contractors for the implementation of PBGC's new investment policy. We have reviewed the draft report and appreciate the information that you have provided about former PBGC Director Charles E.F. Millard's involvement in the procurement process. The Board will take the appropriate action in response to the recommendations.

OIG Recommendation 1:

The PBGC Board should determine whether inappropriate actions of the former Director, as described in this report, cast enough doubt about the fairness, integrity and openness of the procurement to warrant cancellation of the strategic partnership contracts. If so, the Board should instruct PBGC to cancel the contracts.

The PBGC Board has asked the Acting Director of the PBGC to provide the Board with his recommendation for PBGC action in response to the draft report. The Board will review the Acting Director's recommendation and ensure that appropriate action is undertaken. The OIG has advised the PBGC Board agencies that this approach meets the intent of the OIG recommendation.

Appendix C

PBGC Board of Directors' Response

OIG Recommendation 2:

The PBGC Board should require future Directors to ensure appropriate separation of duties, to include refraining from service on technical evaluation panels and other de facto procurement activities. Special attention should be given to situations that are likely to create the appearance of improper influence or bias.

The Board agrees with the recommendation and will work with the PBGC to develop appropriate guidelines.

Again, thank you for the opportunity to comment on the draft version of the OIG report. We appreciate your work in reviewing this important area. As the new Board members begin their work, we look forward to assuring that PBGC has adequate internal controls to help it meet its critical mission.

Sincerely,

HILDA L. SOLIS
Chair of the Board
Pension Benefit Guaranty Corporation

GARY LOCKE
Member of the Board
Pension Benefit Guaranty Corporation

TIMOTHY F. GEITHNER
Member of the Board
Pension Benefit Guaranty Corporation

If you want to report or discuss confidentially any instance of misconduct, fraud, waste, abuse, or mismanagement, please contact the Office of Inspector General.

Telephone:
The Inspector General's HOTLINE
1-800-303-9737

The deaf or hard of hearing, dial FRS (800) 877-8339 and give the Hotline number to the relay operator.

Web:
http://oig.pbgc.gov/investigation/details.html

Or Write:
Pension Benefit Guaranty Corporation
Office of Inspector General
PO Box 34177
Washington, DC 20043-4177

The CHAIRMAN. Thank you, Ms. Batts. Our final witness today will be Vincent Snowbarger, who is the Acting Director of the Pension Benefit Guaranty Corporation.

STATEMENT OF VINCENT SNOWBARGER, ACTING DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, DC

Mr. SNOWBARGER. Thank you, Chairman Kohl, Ranking Member Martinez, Senator McCaskill, and Senator Bennett. My name is Vince Snowbarger and I'm the Acting Director of the Pension Benefit Guaranty Corporation, or PBGC. I want to thank you for the opportunity to appear today to discuss PBGC's financial condition and its readiness to take on new challenges in these turbulent economic times.

I want to emphasize that despite the current economic slowdown and an increasing deficit, the corporation is able to meet its benefit payment obligations, and will be able to for many years to come. This is because benefits are paid in the form of annuities, and over the lifetime of retirees, not as lump sums. Nevertheless, over the long term, the deficit must be addressed.

My testimony today will focus on four issue areas: PBGC's governance structure, the agency's pension insurance program, the deficit position PBGC currently faces, and its preparedness to deal with a potential influx of plan terminations.

PBGC is a wholly owned Federal corporation with a three-member board: the Secretary of Labor, who is our Chair, the Secretaries of Commerce and the Treasury. PBGC is self-financed and receives no tax revenues. PBGC guarantees pensions when underfunded defined pension benefit plans terminate. PBGC insures 44 million workers and retirees in 30,000 pension plans. At the end of Fiscal Year 2008, PBGC was paying benefits of about $4.3 billion per year to 640,000 individuals, and another 634,000 will be eligible to receive benefits in the future.

PBGC has been in a deficit position for most of its 35-year history. At the end of Fiscal Year 1908, PBGC had an $11 billion deficit, with $75 billion in liabilities, and $64 billion in assets.

Unaudited results for the first 6 months of Fiscal Year 2009 show that our deficit has tripled to $33.5 billion. That change in the deficit is primarily due to about $11 billion in completed and probably terminations, $7 billion from a decrease in the interest factor used to value liabilities, $3 billion in investment losses, and $2 billion in actuarial charges for the passage of time.

Large plan terminations have always been and continue to be the most important factor in determining PBGC's workload as well as its financial condition. Over the years, we have adapted our processes to meet the challenges of a cyclical workload, including the ability to scale up when we experience a rapid increase in plan terminations. There were relatively terminations in Fiscal Year 2008. However, during the first half of Fiscal Year 2009, PBGC took in 75,000 new participants, over three times the number for all of last year.

Still, this workload is far less than the record influx of more than 800,000 new participants in the 4-year period from 2002 to 2005.

Those terminations included a number of large steel and airline plans. PBGC met the challenge of that increased workload.

However, to give you some idea of the potential magnitude of the future workload, if the plans of some of the troubled auto companies are terminated, the number of new participants coming to PBGC in Fiscal Year 2009 or Fiscal Year 2010 could exceed $1 million. Those terminations would almost double the number of participants PBGC serves and significantly increase the trust fund assets and PBGC deficit.

The cyclical nature of terminations and the impact of large terminations have required PBGC to develop mechanisms to handle major workload fluctuations. Contracts with our paying agent, field benefit administration offices, actuarial firms, and customer contact center allow us to adjust staffing based on workload, and historically, this has worked well.

When we take over very large plans, we often retain the services of staff for the prior plan administrator in order to ensure a smooth transition. Currently, PBGC departments are preparing for an increase in contracting activity, additional hiring, and additional space and equipment needs. PBGC's technology systems have been analyzed to verify that they're ready to handle large workload increases, and we've developed specialized team approaches to process and administer the auto plans, should that become necessary.

Finally, we are collecting and reviewing plan documents of large potential terminations to become familiar with the benefit provisions. PBGC's Fiscal Year 1909 and 1910 budgets provide for additional spending authority if we take in more than 100,000 new participants. We are working closely with OMB in anticipation that we will need to use that authority for the first time.

While PBGC has the capability to take on large plans, continuation of a plan is generally best for all stakeholders. We closely monitor troubled companies with underfunded plans and negotiate for plan protections that will limit participant and PBGC exposure and keep the pension plans going.

Companies that sponsor pension plans have a responsibility to live up to the promises they make to their workers and retirees. However, when a company can no longer keep its promises, workers and retirees need the assurance of a strong and prepared PBGC.

Thank you, Mr. Chairman, and I would be happy to answer questions.

[The prepared statement of Mr. Snowbarger follows:]

Testimony of Vincent K. Snowbarger
Acting Director
Pension Benefit Guaranty Corporation
Special Committee on Aging
United States Senate
May 20, 2009

Good afternoon Chairman Kohl, Ranking Member Martinez and other Committee Members, my name is Vince Snowbarger and I am Acting Director of the Pension Benefit Guaranty Corporation ("PBGC" or "the Corporation").

I appear before the Committee today to discuss PBGC's financial condition and its readiness to take on new challenges in these turbulent economic times. I want to emphasize that, despite the current economic slowdown and the increasing deficit, the Corporation is able to meet its benefit payment obligations and will be for many years to come.

OVERVIEW

The need for a federal pension safety net became starkly evident when, at the end of 1963, the Studebaker Corporation, then the nation's oldest major automobile manufacturer, closed its U.S. operations and terminated its pension plan. About 4,000 workers lost the bulk of their pensions, receiving only fifteen cents on the dollar of vested benefits. At an average age of 52, these Studebaker employees had worked for the company an average of 23 years.

In 1974, Congress passed the Employee Retirement Income Security Act ("ERISA") which, among other pension protections, created PBGC to insure pensions earned by American workers under private-sector defined benefit ("DB") plans. PBGC now insures almost 44 million workers, retirees, and beneficiaries in about 30,000 DB plans. When a plan terminates in an underfunded condition – because the employer responsible for the plan can no longer fund the promised benefits – PBGC takes over the plan as trustee and pays benefits to the full extent permitted by law.

Defined Benefit Pension Plans

In a DB plan, retirement benefits typically are based on a worker's earnings and years of service with the employer. DB plans insulate retirees from investment and mortality risk and are intended to be a source of stable retirement income.

DB plans are funded primarily by employer contributions. The law prescribes minimum contribution requirements. Benefits under a DB plan are secure if the employer is financially healthy and can afford to make the required contributions. If an employer can no longer afford a plan, the plan is terminated and PBGC guarantees benefits, subject to legal limitations. Amounts above the statutorily-set guarantee limits can be paid only if plan assets or recoveries from employers are sufficient to allocate to these benefits. Thus, retirement income security for the workers and retirees covered by private DB plans depends on a combination of sound plan funding and a strong insurance program.

PBGC benefit payments are important, often crucial, to the retirement income security of retirees and workers in trusteed plans, many of whom worked decades for their promised benefits. At the end of FY 2008, PBGC was paying benefits to about 640,000 retirees and beneficiaries in terminated underfunded plans; another 634,000 participants in these plans will become eligible to start receiving benefits in the future.

Governance and Financial Structure

PBGC is a wholly-owned federal government corporation overseen by a three-member Board of Directors consisting of the Secretary of Labor, who is the Chair, and the Secretaries of Commerce and Treasury. Day-to-day operations are handled by a presidentially-appointed, Senate-confirmed Director, who reports to the Board. The Corporation also has a seven-member Advisory Committee appointed by the President to represent the interests of labor, employers, and the general public. The Advisory Committee provides guidance and feedback on issues, particularly investment policy.

PBGC operates two pension-insurance programs, which are financially separate. The single-employer program covers 34 million workers, retirees, and beneficiaries in about 28,000 single-employer plans. The smaller multiemployer program – which covers collectively bargained plans that are maintained by two or more unrelated employers – protects 10 million workers, retirees, and beneficiaries in about 1,500 multiemployer plans.

Although PBGC is a government corporation, it receives no funds from general tax revenues and by law its obligations are not backed by the full faith and credit of the U.S. government. Operations are financed by insurance premiums, assets received from pension plans trusteed by PBGC, investment income, and recoveries from the companies formerly responsible for underfunded trusteed plans.

ADMINISTRATION OF TERMINATED PLANS

Benefit Payments

Plan terminations and benefits administration make up the great majority of PBGC's work. It includes the ongoing work necessary to pay plan benefits to participants in trusteed plans. Each month, the Corporation pays over $350 million in benefits to individuals already in "pay status."

When PBGC takes over an underfunded DB plan, workers and retirees (and their beneficiaries) receive pension benefits earned up to the maximum amounts permitted under federal pension law. For plans that terminate in 2009, the maximum guaranteed benefit is $54,000 per year (or $4,500 per month) for benefits beginning at age 65. The maximum is adjusted for different ages or if a benefit will be payable to a surviving beneficiary.

When PBGC takes over a plan, participants are informed that their monthly benefits will continue without interruption or alteration until an initial set of calculations is made to determine any applicable ERISA guarantee limits. Reductions in benefit levels are required if benefits promised by the former plan sponsor exceed the federal guarantee, and plan assets and recoveries from employers are insufficient to cover all promised benefits. The Corporation performs these calculations as quickly as possible upon receiving the needed data (e.g., plan assets and

participant data) from the former sponsor(s). These initial calculations may result in PBGC adjusting payments to an "estimated benefit" level until a much more detailed set of calculations (sometimes taking several years) can be performed to ascertain the exact amounts due under the law for a final benefit determination.

The length of time required to determine final benefit amounts payable by PBGC is primarily the result of the different benefit structures and data components for each of the plans that the Corporation trustees, and the state of plan records. In addition, large plans typically have multiple, complex benefit formulas and retirement eligibility provisions. For example, in the case of Bethlehem Steel, there were more than 30 plan documents that PBGC was required to analyze in making final "benefit determinations" for about 95,000 participants in this plan.

In very complicated cases such as Bethlehem Steel, the time required to complete final benefit determinations can exceed three years. However, in a given fiscal year, the benefit determinations issued might generally involve a sizable percentage with faster, less complex determinations, thus lowering the average calculation time. In FY 2008, for example, the average final benefit determination time was 3.3 years.

In contrast, for FY 2010, the average time anticipated to issue final benefit determinations will be longer than in FY2008 and FY 2009. This is based on (1) issuing the remaining difficult calculations for the large airline and steel plans that were trusteed in 2004 and 2005 and (2) having a relatively low inventory of benefit determinations to issue from plans trusteed in 2006-2008, where less complex determinations would reduce the overall calculation timeframe.

Once these calculations are complete, PBGC issues a benefit determination to each participant informing them of their final monthly benefit amount and their right to appeal if they disagree with the calculation. After all appeals are resolved, PBGC continues benefit administration (e.g., placing deferred participants and survivors into pay status, income tax withholding, address changes, etc.) for every participant and beneficiary for the rest of their lives.

Historically, for 80 percent or more of participants in trusteed plans, there is no difference between estimated and final benefit payments. However, as these earlier payments are based on estimates, participants may receive more or less than they are allowed to receive under ERISA. If a participant receives more than allowed by law, future benefits are reduced accordingly. To avoid financial hardship for participants, the reduction ("recoupment") is normally no more than 10 percent of the final monthly benefit and no interest is charged. When repayment is complete, monthly payments increase to the final monthly benefit determination. If a participant (and any beneficiary) dies during repayment, further repayment is generally waived. If a participant receives less than they are entitled to by law, PBGC pays the difference to the participant in a lump sum with interest.

Benefit Limits

PBGC pays pension benefits earned by workers and retirees subject to legal limitations. For many participants, the benefits promised by their employer are paid in full by PBGC guarantees or plan funding. Unfortunately, some participants lose part of their earned benefits on which they have staked their retirement security because their benefits exceed the guarantee limitations and the plan is underfunded.

There are three principal limitations on PBGC's guarantee: (1) a maximum guarantee that is reduced for ages below 65; (2) a phase-in of the guarantee of benefit increases made within five years of plan termination or sponsor bankruptcy; and (3) a limitation on the guarantee of temporary early retirement supplements.

For example, a participant in the Bethlehem Steel plan, like many other steelworkers, might have started working in his or her early twenties and stayed employed there until eligible to retire under the plan's "30-and-out" provision with a $2,200 per month pension. When PBGC terminated the Bethlehem Steel plan in 2002, the maximum monthly guarantee was about $3,600. Because the law reduces the maximum guarantee for workers who start receiving their pension benefits before age 65, the participant would have experienced a benefit reduction by more than 40 percent to about $1,300 per month.

Participants feel a great deal of stress when their pension plan terminates, frequently at the same time they might be losing their jobs and/or health insurance. PBGC should be a source of reassurance, not another source of stress. To this end, we are both continually learning from what participants and plan sponsors tell us and proactively designing new ways of providing better information.

FINANCIAL CONDITION & TRENDS

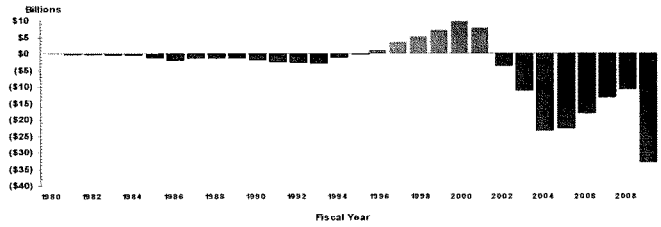
Deficit and Current Financial Condition

Since its establishment in 1974, PBGC has faced many challenges, including economic contraction in certain industries that traditionally have provided DB pensions; inadequate minimum contribution requirements which too often have resulted in unfunded promises at plan termination; premiums that often have been inadequate to meet the financial demands placed on PBGC's program; and employer shifts from DB plans to defined contribution plans, which are not insured by PBGC. Consequently, the Corporation has been in a deficit position for most of its existence.

PBGC's deficit fluctuates due to various factors, including changes in interest rates, investment performance, and losses from completed and probable terminations. While the deficit had declined from $14 billion at the end of FY 2007 to $11 billion at the end of FY 2008, unaudited financial results through the second quarter of FY 2009 show the deficit tripled to about $33.5 billion. The $22.5 billion increase in the deficit was due primarily to about $11 billion in completed and probable terminations, about $7 billion resulting from a decrease in the interest factor used to value liabilities, about $3 billion in investment losses, and about $2 billion in actuarial charges due to the passage of time. Thus, the increase in PBGC's deficit since last year is driven primarily by a drop in interest rates and by plan terminations, not by investment losses.

Despite on-going deficits (see chart below), PBGC has sufficient funds to meet its benefit obligations for many years because benefits are paid monthly spread over the lifetimes of participants and beneficiaries, not as lump sums. Nevertheless, over the long term, the deficit must be addressed. How soon depends on what happens in the next several years.

PBGC Net Position
Single-Employer Program



Data does not include restored LTV plans in 1986. Data for FY 2009 are unaudited.

Claims History

The table below shows the ten largest plan termination losses in PBGC's history. Nine of the ten have come since 2001. The top ten claims are almost entirely from firms in the steel and airlines industries.

Top 10 Firms Presenting Claims (1975-2008) PBGC Single-Employer Program

	Top 10 Firms	Number of Plans	Fiscal Year(s) of Plan Termination(s)	Claims *(by firm)*	Vested Participants	Percent of Total Claims *(1975-2008)*
1.	United Airlines	4	2005	$7,256,476,175	122,541	20.8%
2.	Bethlehem Steel	1	2003	3,654,380,116	91,312	10.5%
3.	US Airways	4	2003, 2005	2,699,936,133	55,770	7.7%
4.	LTV Steel*	6	2002, 2003, 2004	2,134,985,884	83,094	6.1%
5.	Delta Air Lines	1	2006	1,739,670,239	13,028	5.0%
6.	National Steel	7	2003	1,275,628,286	33,737	3.7%
7.	Pan American Air	3	1991, 1992	841,082,434	31,999	2.4%
8.	Trans World Air	2	2001	668,377,106	32,263	1.9%
9.	Weirton Steel	1	2004	640,480,970	9,410	1.8%
10.	Kaiser Aluminum	7	2004, 2007	597,300,477	17,727	1.7%
	Top 10 Total	36		$21,508,317,821	490,881	61.7%
	All Other Total	3,814		13,343,574,151	1,097,767	38.3%
	TOTAL	3,850		$34,851,891,972	1,588,648	100.0%

Numbers may not add due to rounding.
** Does not include 1986 termination of a Republic Steel plan sponsored by LTV.*

Total claims for FY 1975-2008 also are concentrated in those industries, with about 40 percent from the airlines industry, about 33 percent from steel and other metals, about 8 percent from other manufacturing industries, and about 19 percent from all other industries.

PBGC Claims by Industry (FY 1975-2008)

Single-Employer Program

Industry	Total Claims		Plans	Vested Participants
AGRICULTURE, MINING, AND CONSTRUCTION	**$623,083,516**	**1.8%**	**215**	**49,186**
MANUFACTURING	**17,356,914,964**	**49.8%**	**2,390**	**946,942**
Apparel and Textile Mill Products	934,639,425	2.7%	184	143,539
Fabricated Metal Products	1,245,286,028	3.6%	561	93,803
Food and Tobacco Products	307,326,928	0.9%	169	37,521
Machinery Manufacturing	1,154,728,027	3.3%	254	89,537
Primary Metals	11,586,125,841	33.2%	317	381,384
Rubber and Miscellaneous Plastics	364,083,881	1.0%	106	24,053
Other Manufacturing	1,764,724,834	5.1%	799	177,105
TRANSPORTATION AND PUBLIC UTILITIES	**14,333,663,400**	**41.1%**	**167**	**336,562**
Air Transportation	13,697,236,325	40.1%	40	308,616
Other Transportation and Utilities	366,427,076	1.1%	127	27,946
INFORMATION	**50,019,263**	**0.1%**	**45**	**6,022**
WHOLESALE TRADE	**436,323,176**	**1.3%**	**243**	**36,285**
RETAIL TRADE	**435,976,208**	**1.3%**	**283**	**96,607**
FINANCE, INSURANCE, AND REAL ESTATE	**809,496,616**	**2.3%**	**99**	**30,694**
SERVICES	**806,414,829**	**2.3%**	**408**	**86,350**
TOTAL	**$34,851,891,972**	**100.0%**	**3,850**	**1,588,648**

Sources: PBGC Fiscal Year Closing File (9/30/08) and PBGC Case Management System.

Numbers may not add due to rounding.

Current Exposure

Most companies that sponsor DB plans should be capable of meeting their pension obligations to their workers and thus are not expected to make a claim against the insurance program or put retiree and worker pensions at risk. But the amount of underfunding in pension plans sponsored by financially weaker employers is very substantial. Pension underfunding in non-investment grade companies is classified under generally accepted accounting standards as "reasonably possible" of termination and is required to be reported in the notes to PBGC's financial statements.

At the end of FY 2008, there was substantial reasonably possible exposure in plans of companies in airlines, autos, and steel, among other sectors. Subsequently, declines in the stock market have reduced the value of assets held by DB plans and have caused the unfunded liabilities of most DB pension plans to increase substantially.

PBGC is closely monitoring companies in the auto manufacturing and auto supply industries, which are in a period of significant financial distress. PBGC estimates that pension underfunding in the auto sector as a whole is $77 billion (calculated on a plan termination basis). Of this amount, PBGC estimates unfunded guaranteed benefits total approximately $42 billion. Thus, participants in auto sector pension plans and the other stakeholders of the pension insurance program are at substantial risk of loss if these plans are terminated.

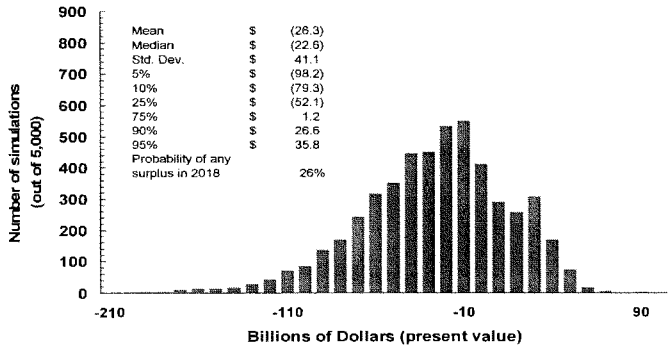
PBGC also faces increased exposure from weak companies across all sectors of the economy, including retail, financial services, and health care. While PBGC hopes that companies that enter bankruptcy will emerge from bankruptcy with their pension plans ongoing, that outcome in part depends on the overall strength of the economy.

Ten-Year Forecast

PBGC has historically made a 10-year forecast for the single-employer program. The forecast is made using a stochastic model—the Pension Insurance Modeling System ("PIMS")—to evaluate its exposure and expected claims. PIMS portrays future underfunding under current funding rules as a function of a variety of economic parameters. The model recognizes that all companies have some chance of bankruptcy and that these probabilities can change significantly over time. The model also recognizes the uncertainty in key economic parameters (particularly interest rates and stock returns).

The model simulates the flows of claims that could develop under thousands of combinations of economic parameters and bankruptcy rates. The model produces results under 5,000 different simulations. The probability of any particular outcome is determined by dividing the number of simulations with that outcome by 5,000. As shown in the chart below, at the end of FY 08, the model showed a median deficit of about $23 billion at the end of 2018 (in present value terms).

Distribution of PBGC's Potential 2018 Financial Position



Investment Policy

At the end of FY 2008, PBGC had total assets of $63 billion, of which $50 billion were investible assets. PBGC's investible assets consist of premium revenues held in the revolving fund and assets from terminated plans held in the trust funds. The revolving funds are required to be invested in Treasury securities, but PBGC has more discretion in how it invests assets held in the trust funds.

There have been several different asset allocation policies in PBGC's history. As early as 1976, trust fund assets were invested primarily in equity securities. In 1990, PBGC adopted a new investment policy, "dollar duration matching," designed to reduce the risk of an increased deficit due to interest rate fluctuations. By 1991, 70 percent of investible assets (revolving and trust fund assets combined) were held in fixed-income securities, with the remaining 30 percent invested in cash, equities, and real estate.

In 1994, PBGC's Board approved a strategic change in the investment program to maximize long-term investment return and reduce the deficit by increasing equity investments up to 50 percent of investible assets. In 2004, the Board approved a policy to decrease the percentage of assets invested in equities to a maximum range of 15 percent to 25 percent and increase investment in fixed-income securities.

Most recently, in February 2008, PBGC's Board approved a new investment policy allocating 45 percent of assets to equity investments, 45 percent to fixed income, and 10 percent to alternative investments, including private equity and real estate. The new policy was designed to take advantage of PBGC's long-term investment horizon and aims at generating better returns that provide a greater likelihood that the Corporation can meet its long-term obligations.

The Board instructed PBGC to take a deliberate and prudent approach to implement this new policy. At the end of FY 2008, the portfolio consisted of 26.7 percent equities, 70.7 percent fixed income securities, and 2.6 percent alternative investments. As of April 30, 2009, the portfolio consisted of 30.1 percent equities, 68.4 percent fixed income securities, and 1.5 percent alternative investments. Currently, PBGC's alternative investments consist solely of assets inherited from trusteed plans.

PREPAREDNESS

Workload for Terminated Plans

Not only does PBGC face financial challenges, we also face operational challenges. Large plan terminations have always been, and continue to be, the single most important factor determining PBGC's workload as well as its financial condition. Over the years, PBGC has adapted its processes to meet the challenges of its cyclical workload, including the ability to scale up when it experiences a rapid increase in plan terminations, as discussed below, in the case of large steel and airline plan terminations in 2002 through 2005.

In FY 2008, PBGC became responsible for 67 plans with 19,000 participants and $250 million in unfunded liabilities, far fewer than the record numbers of new participants between 2002 and 2005. During the first six months of FY 2009, a time when the economy was weakening, PBGC took in about the same number of plans as in all of FY 2008 and nearly four times the number of participants -- 62 pension plans with more than 75,000 participants and $480 million in unfunded liabilities.

The Corporation experienced the largest influx of participants (809,000) in its history, during the four-year period from 2002 through 2005, due primarily to terminations in the airline and steel industries. These participants represent more than half of all participants in PBGC-trusteed plans to date. The largest yearly increase was in FY 2005, when PBGC became responsible for 269,000 new participants, including about 175,000 from three US Airways plans and four United Airlines plans. PBGC successfully met the challenge of that increased workload.

In April, the Government Accountability Office (GAO) estimated that GM's and Chrysler's plans include roughly 900,000 participants, including both those currently receiving benefits and those who have earned benefits that will become payable in the future.[1] If these plans were to terminate, total new participants coming to PBGC in FY 2009 or 2010 could exceed 1,000,000, and would become by far the largest influx in PBGC's history. If PBGC were to become trustee of those auto plans, the number of participants, the trust fund assets, and the current deficit that PBGC is responsible for all would close to double compared to the end of FY 2008.

The cyclical nature of terminations and the importance of large terminations have required PBGC to develop mechanisms to handle major workload fluctuations. For example, when we take over very large plans, our field benefits administrators often retain the services of staff of the prior plan administrator in order to ensure a smooth transition.

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[1] Auto Industry: Summary of Government Efforts and Automakers' Restructuring to Date, Government Accountability Office, April 2009, Report GAO-09-553, page 21.

The Corporation has taken a number of steps to prepare for possible trusteeship of large auto industry plans:

- Contracts with our paying agent, field benefits administration offices, actuarial firms, and customer contact center, are designed to facilitate adjustments to staffing based on fluctuating workload. Historically, this has worked well.
- PBGC departments are preparing for an increased contracting activity, additional hiring, and additional space and equipment needs.
- PBGC's technology systems have been analyzed to verify their capacity to handle a large workload increase. Major hardware upgrades are planned for early FY 2010.
- Workload estimates are taking into account the possibility of increased retirement rates as a result of possible deterioration in sponsor financial conditions.
- The Corporation is reviewing plan documents of large potential terminations to become familiar with the benefit provisions, including types of benefits that may be new to PBGC.
- We have developed best practices in working with electronic records and databases associated with large plans; and
- We have formulated staffing and specialized team approaches to expand our overall capacity specifically for the auto plans, should that become necessary.

PBGC's FY 2009 budget has some flexibility to cover the expenses of an increased workload. To the extent that the number of new participants in plans terminated in FY 2009 exceeds 100,000, an additional $9.2 million is available for every 20,000 additional participants. Similar spending authority is in place for FY 2010 and beyond. Because this authority has not previously been exercised, we are working closely with OMB in anticipation that the thresholds will be met in FY 2009 or FY 2010. The 2010 Budget also includes a request for an additional $15 million for PBGC's Insurance Program Office, for actuarial and financial advisory services related to the expected increase in exposure and risk faced by the insurance program.

Risk Mitigation

While PBGC has the capability to take on large plans, even historically large plans, continuation of a plan generally is best for all stakeholders, provided adequate funding is available for the plan. PBGC closely monitors troubled companies with underfunded plans and, where possible, negotiates to obtain plan protections. The most recent example relates to protections for Chrysler's pension plans. On April 27, 2009, under a term sheet negotiated with PBGC and Chrysler, Daimler AG has agreed to contribute $600 million to its former Chrysler North American division's pension plans. Once a definitive agreement is finalized and approved by the bankruptcy court, Daimler will make the first of three payments – $200 million when the agreement is approved, and another $200 million in 2010 and again in 2011. In addition, if any of the Chrysler pensions terminate before August 2012 and are trusteed by PBGC, Daimler will pay up to $200 million to PBGC's insurance program. The new agreement replaces the $1 billion termination guarantee negotiated by PBGC at the time of Daimler's sale of Chrysler in 2007, which would have ended upon the occurrence of Chrysler's proposed ownership restructuring.

Chrysler's entry into Chapter 11 bankruptcy protection on April 30 did not change the status of its DB pension plans. The plans remain ongoing under the sponsorship of Chrysler, and are insured by PBGC. As the bankruptcy process unfolds, PBGC will work with Chrysler, its unions, and all other stakeholders to ensure continuation of the pension plans. If possible, we want to avoid plan termination without putting participants or the insurance program at risk.

Delphi's bankruptcy proceedings remain ongoing, and PBGC is continuing its efforts to protect Delphi's pension plans (67,000 participants, unfunded benefit liabilities of $6 billion) and support Delphi's goal of a successful reorganization. In September 2008, the bankruptcy court approved Delphi's agreement with General Motors to transfer up to $3.4 billion of net liabilities of the Delphi Hourly Plan to the GM Hourly Plan. Delphi transferred the first tranche of net liabilities to the GM Hourly Plan soon thereafter. The second transfer was to occur upon Delphi's emergence from bankruptcy, which has been hindered by conditions in the auto supplier industry.

In FY 2008 and 2009, as in previous years, PBGC engaged in a number of activities to safeguard the pension insurance system, including plan risk assessments, plan monitoring, and negotiation and litigation, to limit risk of termination and exposure to losses by pension plan participants and PBGC. PBGC is monitoring about 1,400 companies responsible for 3,400 plans, and is currently engaged in over 130 bankruptcy cases. PBGC takes an active role in corporate bankruptcy proceedings on behalf of workers whose pension plans are not fully funded. For example, PBGC is a member of the unsecured creditors committee in 18 ongoing bankruptcy cases. PBGC encourages plan sponsors to continue rather than terminate their pension plans. When a plan is terminated, PBGC pursues recoveries of the underfunding from the plan sponsor and other related companies that are liable.

In addition, PBGC has stepped up negotiations to protect pension plans in connection with corporate downsizing events. Under section 4062(e) of ERISA, a corporate liability arises in situations in which a company ceases operations at a facility and more than 20 percent of the active participants are separated from employment. During the past two years, PBGC has negotiated protections valued at $230 million in 11 cases covering 25,000 participants, and PBGC is currently engaged in active negotiations in over 20 additional cases covering about 29,000 participants.

The steps PBGC has taken to protect pensions that could be adversely affected by corporate transactions or bankruptcy have made a real difference to plan participants and PBGC. And the companies that cooperated in making good on their pension promises have reason to be proud. As the insurer of America 's DB pension plans, PBGC will continue to negotiate protection for workers and retirees in transactions like those described above. These safeguarding activities provide significant protection to the DB insurance system and all its stakeholders.

Currently, PBGC is working through historically high risk mitigation activities. Our ability to identify and analyze plans that pose a risk to the insurance program depends in large part on reporting of plan actuarial information and company financial information under section 4010 of ERISA. Unfortunately, the threshold for that reporting was changed in the Pension Protection Act of 2006, so that PBGC will no longer receive information on some large underfunded plans that pose a significant risk.

Customer Service

Nothing is more important to PBGC than providing the highest quality service to its customers. In recent years, a priority for PBGC has been the establishment of online services that customers could access at their convenience through the internet.

For participants, My Pension Benefit Account (My PBA), allows all participants to review and change their personal information, and retirees can use it to sign up for electronic direct deposit of their benefit payments, change banking information, change federal tax withholding, request benefit estimates, and complete and submit some of the most frequently used forms.

PBGC uses American Customer Satisfaction Index ("ACSI") surveys to measure customer satisfaction with its services and gain insight into needed improvements. In 2008, the PBGC raised the scores it received on the American Customer Satisfaction Index from retirees, future retirees, and premium payers, continuing a record that is among the very best in government. Retirees gave PBGC one of the highest scores in government for providing benefit services, noting particular satisfaction with the timeliness of correspondence. PBGC's customer contact center also received good marks.

CONCLUSION

This is a time of great challenge for all of us in the public sector who are trying to assure American working families of financial security in retirement. Economic turmoil poses issues we have never before confronted and that do not lead to easy solutions. Despite changes in the economy, DB plans will continue to play a vital role in providing retirement security.

PBGC benefit payments are important, often crucial, to the retirement income security of retirees and workers in trusteed plans, many of whom worked decades for their promised benefits. Companies that sponsor pension plans have a responsibility to live up to the promises they made to their workers and retirees. But when a company can not keep its promises, PBGC provides a dependable safety net for workers and retirees.

I would be happy to answer any questions.

The CHAIRMAN. Thank you very much, Mr. Snowbarger. We'll now hear from Senator Martinez, then Senator Bennett, and then Senator McCaskill.

Senator MARTINEZ. Thank you, Mr. Chairman. Ms. Bovbjerg, GAO made recommendations to the PBGC's Board of Directors on the appropriateness of the investment strategy and asset mix that the agency is currently employing. Is this normal in the course of what you do into your analysis of their portfolios and so forth, or are there circumstances that brought you to do that?

Ms. Bovbjerg. What we were asked to do by the Senate Help and Finance Committees was to look at the process by which the investment policies had been developed and implemented. As we were doing that work, this new policy was being developed, and so we looked at what the contractor had done in performing their estimates on risks and returns.

The concern that we had was actually not about the return side. We tested the model and felt that the return estimates were robust. It was the risk side that we felt was really not being acknowledged. So we had tried different assumptions and could see that risk might vary widely, depending on what assumptions you used.

Our concern more fundamentally was that that risk was not acknowledged. Only the return side was acknowledged. It wasn't a balanced presentation. The board then would have made a decision to go with the investment policy without having all the information on the potential impact of that investment policy.

Senator MARTINEZ. Do you think that this is just emblematic of the culture of PBGC, or was this just a moment in time, given the new guidelines, or why do you think there was that unawareness, I guess, or reticence to acknowledge risk?

Ms. Bovbjerg. The information was not provided to the board, as we understand it. I think that a more active board might perhaps have delved into that more closely. We also documented that prior boards had not really overseen the implementation of the policy, so when an investment policy changed, it wasn't always implemented for a variety of reasons, very quickly, but none of that was really documented, that the agency had gone to the board and briefed them on this and received permission to do that.

Our concern was that the board was not involved enough in this very important decision, and we do think that changes in the governance structure would help. But I do want to emphasize that our concern about the investment policy is really a long-term concern. We do think that they should reevaluate with the information about risk, as well as returns. But they should think about it as a long-term strategy and not simply something that changes every few years in response to market changes.

Senator MARTINEZ. So you think they need to have a long-term approach that is sound and in keeping with good investment practices, but not one that is temporal in terms of changing, depending on what market conditions may exist from month to month or year to year?

Ms. Bovbjerg. We think that they should make the decision that way. But I want to call to your attention that the PBGC investment policy has changed every four to six years in the past, so it has swung between a focus on equities to a focus on bonds. We

think also that if there was more stability on the board and not just political appointees from the administration, that there were staggered terms, that it would be less likely that that would happen.

Senator MARTINEZ. Good point. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Martinez. Senator Bennett.

Senator BENNETT. Mr. Chairman, thank you. I'm sorry I was late. Thank you for holding this hearing. It's of great importance to my state, Colorado. Ten percent, roughly, of the employees in our workforce are employed by companies that the PBGC insures.

Thank you all for being here today. I appreciate it. I wanted to start with Ms. Batts. I echo your expression of gratitude for the whistleblower in this case, and I—it's very hard to stick your neck out in the face of supervisors who can control your career and your livelihood. I wonder whether or not you can assure the committee that steps have been taken to protect this whistleblower in this particular situation.

Ms. BATTS. Yes, sir, we can. We're very cognizant of our responsibility to ensure protection of our whistleblowers.

Senator BENNETT. OK. This person is a hero for bringing this forward, and we need more, not less, of this. When I read your testimony, I found it particularly troubling that it appears that the prior director was trying to change the criteria for the size of the firms that could solicit—or respond to the RFP after the RFP had already been written; is that correct?

Ms. BATTS. Let me clarify. The efforts to work on the size of the firm, the communications with Black Rock about what size firm would be appropriate, were made before the mandatory criteria for the RFP were developed. These were communications that occurred before they were developed.

Senator BENNETT. OK. Thank you. I just wondered, Ms. Bovbjerg's observation about the governance structure seems almost—I think can't be disputed. I mean, having three Cabinet Secretaries be the board of the institution seems to me to be imagining a world that we don't really exist in, and I wonder whether the others here have any view on that and what we might think about, in terms of governance structure. Mr. Salisbury.

Mr. SALISBURY. Senator, I'll just speak to my time at the agency, both as an employee, and then when I was on the advisory committee. The structure in this is true today, but it's been true since 1975. Essentially, each of the Cabinet members has designated a so-called board representative who, during the early years, was generally the general counsel of the Department of Labor, Commerce, and the Assistant Secretary Financial Markets at Treasury.

That then shifted over time. In the most recent time period, for example, at the Department of Labor, it became the Assistant Secretary for the Employee Benefit Security Administration, which one could argue creates its own set of conflicts, because at that point, the person responsible for administering Titles I and II of ERISA is also essentially, one could argue, supervising the PBGC on behalf of the Secretary of Labor, who chairs the board.

But in all of the times I've been involved with the agency, the board meets, as has been pointed out, very little. Most of the activity is with these individuals. In the case of the last administration,

because it went to the Assistant Secretary level, it actually was people who had Senate confirmation. For most of the history of the agency, it was individuals who had never had Senate confirmation. It was fairly low-level staff members that were doing the coordination.

You could go back to making this a formal part of an executive branch agency, which would put it into a more normal governance structure. One of the proposals that was looked at by an advisory council about 18 years ago was to actually have it become a commission model. All of the SEC or the FTC, the FEC, which would be two or three appointed commissioners, to give it a more permanent governance structure.

If I might, the one other thing I'd comment on is the investment policy issue. Having been at the agency during the first two revisions, and having been on the advisory committee during another revision of that policy, I think the most common determination of that flipping in policy is whether the executive director of the agency has a background in insurance or has a background in active equity investment management.

When Jim Lockhart, now the head of the agency overseeing Fannie and Freddie, was the head of the agency, he had come out of an insurance background. He moved the agency toward what is termed a more bond immunization match liabilities to the asset's philosophy, which is more traditional for an insurance company and how they would function relative to life annuities, which is what PBGC is, in essence.

As opposed to the last two executive directors, the current director came straight out of the private equity active investment field; his predecessor, who had sort of a split life, is now at a large insurance company. The most extreme policy was the most recent move to a much more heavy equity strategy.

So I think the appointment of the executive director and the background of the executive director, in the time I've been involved with the agency, which is since two months after it was first created, has been heavily influenced, almost overwhelmingly by the background of the executive director. It is also influenced by the background of the individuals at the Treasury Department, which is the primary agency involved in setting investment policy, as one would argue is appropriate.

Senator BENNETT. Mr. Snowbarger, do you have a view? I know I'm putting you in a difficult position, but I—

Mr. SNOWBARGER. Thank you for recognizing that, Senator. Well, we cooperated fully with the GAO report when it came out, and actually, at the request of the Chairman of our board, we also hired a private consultant to come in and do the similar kind of study, which that report came out, I believe it was about—well, I mean, it was last summer, and it pointed out different alternatives for doing it.

I think you would find this rather unique in our structure within the Federal Government. There are a number of Federal corporations, there are a number of commissions, as was pointed out by Mr. Salisbury, but we're rather unique. When you look at the composition of our board structure, both in terms of its size and its composition, it's rather unusual.

Senator BENNETT. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Bennett. Senator McCaskill.

Senator MCCASKILL. Thank you. First let me start with the notion to our intrepid Inspector General. Congratulations on this work. This is the kind of report that makes your professional challenges worthwhile. Thank you. The rules that were broken allegedly by the former director, I assume that the people that were on the other end of those conversations were breaking rules also, correct?

Ms. BATTS. In our audit report, we make it clear that as part of the audit, we did not identify any evidence of criminal activity on the part of the bidders. One of the things that made this situation very unusual was the unusual role that Mr. Millard had taken. Normally conversations with the Director of PBGC would not be inappropriate, because normally the Director of PBGC would not have taken this intimate involvement in the procurement process. So—

Senator MCCASKILL. Well, wouldn't the person at Black Rock, if the head of PBGC is talking to them and says, "Give me a floor. I'm trying to wittle these people out," wouldn't that—I mean, people at Black Rock, I would think, knowing all of the rules and regulations surrounding—

Ms. BATTS. You would think.

Senator MCCASKILL [continuing]. These kinds of processes, wouldn't there be some kind of need on their part to blow a whistle on somebody?

Ms. BATTS. It's a good question.

Senator MCCASKILL. Well, I think we should ask that question. Can you identify who the people are at Black Rock that were part of this conversation and the people at the other firms that were having these conversations? I think we've got investments in a lot of them right now.

Ms. BATTS. Yes.

Senator MCCASKILL. We're shareholders, the American people, in some of them.

Ms. BATTS. As I mentioned in my written statement in response to a bipartisan request from Senators Kennedy and Enzi of the Health Education and Labor and Pension Committee, and Senators Baucus and Grassley from the Finance Committee, they requested that we open an investigation. We take the concerns they expressed very seriously, and we've done so. We've had discussions with the Department of Justice on the matter, and it's not appropriate for us to go forward with it.

Senator MCCASKILL. OK. Let me talk about contracting a little bit. There has been a secret growth in the size of the Federal Government through contractors. PBGC is a great example of the growth in contractors. There's hundreds—more than 130, I think, different audit recommendations that have been ignored over the years as it relates to contracting processes and procedures.

I'm looking at various charts and graphs in the GAO report that I think is over a year old now. Yeah. Well, it's not quite a year old. The excuse that's given for contracting is that your workload is unpredictable. But yet, in the same report, it acknowledges that your

workload always goes up one to two years after an economic crunch.

I assume, Mr. Snowbarger, you all are anticipating your workload going up.

Mr. SNOWBARGER. Yes.

Senator MCCASKILL. Significantly?

Mr. SNOWBARGER. Yes.

Senator MCCASKILL. So do you have plans right now to add employees as opposed to contractors?

Mr. SNOWBARGER. I wouldn't say as opposed to contractors. We'll probably add both employees and contractors.

Senator MCCASKILL. Why is it—I assume the contractors working side-by-side, like in most government agencies, are making more than the government employees?

Mr. SNOWBARGER. I really couldn't speak to that. I don't know.

Senator MCCASKILL. Who would know, if you don't?

Mr. SNOWBARGER. Our contracting officer and our personnel—

Senator MCCASKILL. Well, that would be something I think the committee should be interested in and I'm certainly interested in. Two employees doing the exact same function at nearby desks, and I'm looking at one of these. I think in your org chart, you have 933 contractors under the Chief Operating Officer, under the COO, which means your benefits, administration, and payments department, your actuarial services division, your retirement services division, your processing division, and your problem resolution office, you have four times as many contractors as you have FTEs.

I would like to know how much those contractors are making as opposed to the government employees. I think it's a notion that makes—it sounds good, but in reality, I think we don't drill down far enough to see if these contract employees are saving anybody money. Let me look specifically at your lawyers. Do you have internal counsel?

Mr. SNOWBARGER. Yes.

Senator MCCASKILL. How many do you have?

Mr. SNOWBARGER. We have two divisions of lawyers. They're primarily lawyers. We have an Office of Chief Counsel that handles all our litigation. I believe—about 45 lawyers in the Office of Chief Counsel. Chief counsel handles our litigation on cases and does our negotiation on cases, as well.

We have an Office of General Counsel that basically provides the general law advice for the firm, about 30 lawyers in that department.

Senator MCCASKILL. How much do you spend annually on outside counsel?

Mr. SNOWBARGER. We spend a considerable amount of money on outside counsel because we are facing outside counsel from the companies that are going under. In other words, you might take the Chrysler situation for example. There are all kinds of special lawyers—not just Chrysler's lawyers, but Chrysler's bankruptcy lawyers and Chrysler's merger and acquisition lawyers, et cetera. There are certain kinds of expertise that it is less expensive for us to hire through counsel than it is to maintain on staff.

Senator MCCASKILL. I would love—have you done a cost-benefit analysis on that?

Mr. SNOWBARGER. I believe we have.

Senator MCCASKILL. I'd love to see that cost-benefit analysis. Because I know what those outside lawyers are charging you an hour, and I know how much lawyers make in government, and I have a bias there, since I've been a lawyer in government most of my legal career. There are some really smart lawyers that are in government that are great value, and you all are going to need specific expertise going forward, I think, over the next 5 to 10 years, and I would love to see what you're spending on inside counsel versus outside counsel and the cost-benefit analysis that's been done in that regard.

Mr. SNOWBARGER. Sure.

Senator MCCASKILL. Tell me what your plans are in terms of the use of contractors going forward. Have you looked at the recommendations that have been made by GAO, and do you have plans going forward that would actually begin to implement these recommendations in terms of contracting?

Mr. SNOWBARGER. Partial. There are some of the recommendations that we disagreed with. I don't know that I could go through those right now, but we can provide you with our response to the GAO's report. But yes, we've already started implementing a lot of those. We've restructured our procurement department, for instance. We have those divisions set up now so that we've got people looking solely at the policy about whether or not we hire contractors or not and on what basis, plus the side of the contracting department that would actually be doing the procurements and the administration of those procurements.

Senator MCCASKILL. OK. I'll stick around, Mr. Chairman, and ask some more questions later. Thank you.

The CHAIRMAN. Thank you very much, Senator McCaskill. Ms. Batts, on the findings in your report, do you think the investment services contract that was awarded to Goldman Sachs, JPMorgan, and Black Rock should be rebid?

Ms. BATTS. We have not done audit work specifically to assess whether the strategic partnership contracts are the best way to assist in accomplishing PBGC's investment objectives, although that is one of the objectives of ongoing work.

In a comprehensive implementation plan for its investment policy, PBGC needs to figure out whether the strategic partnerships fit in their overall strategy.

The CHAIRMAN. So you're saying they should be rebid, should not, you're not sure, you haven't recommended, what?

Ms. BATTS. OK, I'm sorry. I'm very troubled by the contracts, and our recommendation to the board was that they consider seriously whether the contracts needed to be terminated. I think that's what you're referring to by being rebid.

The CHAIRMAN. Yes.

Ms. BATTS. I was pleased to see Mr. Snowbarger's recommendation that the three contracts be terminated. In terms of rebid, I don't know whether strategic partnerships are the way to go or whether PBGC might choose some other way to move forward.

The CHAIRMAN. I'll get back to you in a second. Mr. Snowbarger, do you concur with what Ms. Batts has said?

Mr. SNOWBARGER. Well, as she indicated, I did recommend to the board that the contracts be terminated. In terms of a rebid, I think it's a little early to know whether or not that fits into the new board's investment policy strategy. They want to take time and naturally want to review what was done over the past, and once they've made that determination, strategic partnerships may or may not fit into achieving those overall goals.

I think that being the case, it's probably just better at this point to terminate them, and if the board decides that strategic partnerships are a tool for implementing a new investment policy, then we can go back out and rebid.

The CHAIRMAN. OK. Ms. Batts, PBGC has 130 pending recommendations from you. Why hasn't PBGC taken action to implement these recommendations? Have you taken steps to inform the Board of Directors of all your recommendations?

Ms. BATTS. There are many reasons as to why PBGC hasn't implemented the 130. Many will take a length of time to complete and are in process. We've recently begun a concerted effort with PBGC management to ensure that appropriate corrective action plans have been developed. For example, PBGC needs to integrate its financial systems, and this will require a number of changes in systems. I would note, however, that this recommendation was first raised in the 1997 financial statement audit.

In the interest of streamlining processes, my predecessor made a decision to rely upon PBGC to track recommendations and follow-up. Though this can and does work in many Offices of Inspector General, we found that it did not work well for us. This spring, we returned to the prior method where the Office of Inspector General controls the tracking of the recommendations, and have established our own tracking system for open recommendations.

Some of the recommendations have been briefed to the board in the past. For example, many relate to the significant deficiencies in the financial statement audit internal control report. We ordinarily would not brief many of the recommendations to the board, only those that are most significant.

The CHAIRMAN. Thank you. Mr. Salisbury, given the current economic situation, do you believe PBGC will be able to meet its financial obligations today and on into the future?

Mr. SALISBURY. Senator, I think that as even the revised numbers from the PBGC indicate, and even if you take the testimony today describing the worst case, with all of the auto industry plans coming in, and then you look at the annuity nature of the payouts, the fact is that there are participants in these programs that are, let's say, 30 years of age, who wouldn't be eligible for a benefit for 35 years, and that's when payments would come. Does PBGC, even under the most dire scenarios, have assets that will grow sufficiently to pay benefits for some number of decades, at least two decades, possibly longer?

The issue is, in the very long term, related to whether there will be other defined benefit plans that continue to exist that are able to continue paying some level of premiums. The real problem for PBGC is when the assets run out, which I see as occurring a long time in the future. That doesn't say that one should wait to look at it, but it does create that temptation.

The second issue that relates to this is why I mentioned the interest rate environment; if one were to simply revalue PBGC's liabilities and defined benefit pension liabilities, based on the assumption of moving back to more traditional market interest rates, including Federal Reserve policy, that alone would dramatically improve the funded status of many pension plans.

For lack of a better example, one large U.S. company that before the market meltdown was 137 percent funded, by January, was 98 percent funded. Based on its public statements, if you simply moved the government interest rate back up, that plan would instantly move to 114 percent funded simply because the interest rate changed.

So I think that until we know where the economy comes out after 11, 10, and 11, and where interest rates level out, there's an awful lot of uncertainty in what the status of PBGC is, and frankly, what the status of defined benefit plans, per se, is.

The CHAIRMAN. Thank you. Ms. Bovbjerg, as you said, the board has not met since February of 2008. Of course, a lot has happened in our economy since then that has an impact on PBGC. In your opinion, what steps does Congress need to take to be sure that the board is, in fact, able to discharge its obligations, which I assume you regard as essential?

Ms. Bovbjerg. Well, absolutely. I think we said in my statement, now more than ever. We really—there are two issues really with the current board structure. One is that it's not structured for members to give the kind of attention and oversight that we think the corporation needs. It's the number. There's only three. It's that they're Cabinet Secretaries, although, as Dallas points out, they do have appointees under them who represent them when there are board meetings. They have staff who work with them.

The Big 3 are really not able to give the corporation the kind of attention that it deserves and now increasingly needs. We looked at a number of other government boards. They average seven members. Also, PBGC commissioned a study from McKinsey that looked at all these different options for different types of boards. Nearly all of them have a little more horsepower on them.

The other thing is that everyone's term ends simultaneously. There's no continuity, and that's really a problem for this corporation. If the deputy position had not been made permanent about a year ago, we wouldn't have Mr. Snowbarger here to run PBGC either. So it's really important to have staggered terms.

We also think that the intent of the three Cabinet Secretaries was to provide a diversity of perspective. You have Labor there to represent workers, Commerce to represent business, Treasury to represent finance. That's a really good idea. In fact, we think that there should be more diversity on the board to include certain types of expertise from other areas—financial expertise, labor expertise, governance.

We think that it would enhance greatly the board's ability to oversee, for example, contract issues, because if there is a director who is at least giving an appearance of a not transparent fair contracting process, the board needs to be alert to that and should not have to rely solely on a whistleblower to bring that information to the floor.

The CHAIRMAN. Thank you. Senator Martinez?

Senator MARTINEZ. I've got to tell you, I agree completely with your assertion regarding the board. I don't believe that a Cabinet officer is ever going to be in a position to be hands-off enough to be an effective member of a board such as PBGC needs to have. This is not a board where it's merely policy setting. This is a board about oversight and nuts and bolts of a large investment operation.

So I really believe that that is a key element here in what, going forward, needs to occur, which is a hands-on board that is not Cabinet officers, who I know, from personal experience, are incapable of giving the kind of time and attention that a board like this would need. As you said, they'll delegate it to someone within the department who might not be senior enough to really have the stature, perhaps, to be an effective board member. Plus you leave it only on three, and that's not very many to be overseeing such a large amount of money with such an important responsibility.

But to that effort, let me just say on the audit report, it appears pretty clear that the fundamental PBGC that you uncovered was a merger of functions between being the executive director and then immersing himself in the procurement process and, in a very detailed way, impacting it. As part of his job, he would have to talk to people that, by necessity, once he became also the procurement officer, he was then prohibited from really being in contact with.

I understand that that is a policy recommendation, and I want to ask Mr. Snowbarger whether that situation has been now clearly defined, because I also saw a letter from Mr. Millard where he alleges that he consulted with the counsel at the time and was told that there was no reason why he could not do all of that. I find that hard to understand, but given that situation, I just wondered if this is now corrected and is no longer an issue. I see that the board said that it agreed with a recommendation and will work with PBGC to develop appropriate guidelines. Are those guidelines now in place?

Mr. SNOWBARGER. Since the letter just came out yesterday, the answer is no, but there is no problem. This acting director will not be involved in the contracting process.

Senator MARTINEZ. I understand.

Mr. SNOWBARGER. It's just a matter of papering up. We agree with the recommendation of the Inspector General, and we'll work with the board to paper that decision.

Ms. BATTS. To speak to the comment that you made about Mr. Millard's comment about the legal review that was performed by general counsel, it's important to remember that at the time the general counsel did that legal review, she was not aware that he was having contact with bidders. She was not aware of some of the events that had occurred before the RFP was developed. So—

Senator MARTINEZ. Well, I wasn't trying to judge Mr. Millard's actions here—

Ms. BATTS. Certainly. Certainly.

Senator MARTINEZ [continuing]. Because I think there will be other forums for that. I was just trying to make sure that we had in place policies, since there seemed to be some confusion on his part, and I saw the recommendation, and I wanted to make sure that it would be followed upon.

Ms. BATTS. Certainly.

Senator MARTINEZ. That's all. Thank you very much.

The CHAIRMAN. Thanks, Senator Martinez. Senator McCaskill?

Senator MCCASKILL. Mr. Salisbury, what worries me the most about this whole sit—and, by the way, Mr. Snowbarger, you do have a really hard job, because you took over, and there is no board, right, at the moment you took over?

Mr. SNOWBARGER. At the moment I took over, there was no board. We obviously have a board at this point in time.

Senator MCCASKILL. You have a board now. But taking over this agency with literally no board is rocky terrain, especially under the circumstances which you took over. So I am cognizant of the challenges you faced.

I'm curious, Mr. Salisbury, I think most people in business would say that defined benefit plans are going away, that we're not going to have many companies 20, 30, 40 years from now that have defined benefit plans. As more and more defined benefit plans go away, then, as you mentioned, the source of funding for this agency goes away.

Have there been—are you aware or is anyone else on the panel aware of any of the long-term studies that have been done, assuming, worst-case scenario, that we no longer have defined benefit plans in our major automobile manufacturers, and that most of that liability is shifted over to this agency? Assuming that we continue on the same track, I don't recall ever seeing statistics of what the drop-off has been over the last 5 years, but I know it's been significant.

What is—who's going to pay the premiums to keep this agency going 30, 40 years from now? Where is that revenue source going to be?

Mr. SALISBURY. You end up, Senator, with a couple of interesting statistical quirks. One is that even though the number of defined benefit pension plans which, at its high point was at about 185,000, and is now down at about 29,000, or a little less than that, in spite of that amount of decline, the total number of participants on whom PBGC has been collecting premiums has actually gone up very slightly and is now just short of 44 million.

Senator MCCASKILL. Because of mergers and acquisitions?

Mr. SALISBURY. It's a combination of mergers, of acquisitions, of premiums being paid on so-called deferred vested participants that represent about 25 percent of those on whom premiums are being paid. Another 25 percent are those in retirement on whose behalf the plan still pays. When I was at the Labor Department, it was a 95/5 rule: 95 percent of participants were in 5 percent of the plans. It's almost that pronounced today.

Second factor, in the last 20 years, many of the defined benefit plans, the Pension Benefit Guaranty Corporation, and the Internal Revenue Service made a ruling, which has since been endorsed by Congress, that so-called cash balance plans that look like a defined contribution plan to the participant, would legally be declared to be defined benefit plans. This is because of the way the benefit accrues, even though almost everyone who leaves those plans gets a single-sum distribution, not a life income annuity.

Those plans promise very low benefits. The contribution rates are very, very low. On a conference call earlier today I was told by one of the consulting firms that most of the companies sponsoring those plans have reduced the additional interest crediting they give to individual participant accounts to zero in order to hold down the PPA 2006 liabilities and costs. Some plans are being frozen, but most of them are being continued.

The interesting thing is that with about 30 percent of PBGC participants now in those types of very, very low-cost plans low cost means low benefits—there is a significant premium flow, an area where the cost of the plans can be very effectively managed by the employer. This is unlike traditional DB plans, the other 70 percent of the universe, where the employer doesn't have this ability.

In that realm, the large employer plans, we have seen enterprises like IBM freeze all of those defined benefit plans. But IBM, at least based on stock value and what the market's done, looks like it will be a secure company; it is likely to maintain those plans, as will many other companies.

They keep them for an interesting reason. They tend to keep them because they essentially have gone to insurance companies, in many cases when the plan is overfunded—there's more than enough money to pay all the benefits. They ask the insurance company, "If we simply give you money so that you take over all of the funding obligation—that would cause premium responsibilities to disappear as well—how much would you charge us?"

The insurance companies generally would charge them far more than what the companies believe it will cost them to maintain the plan themselves. So you have many companies with frozen plans that do not do that. Now, the reason I note that is because right now, interest rates are being fairly heavily managed by the Federal Reserve. One would argue they always are, but they're being managed very low right now. If the market for interest rates come back, the economy comes back, plans move back to overfunded status, and we were to have a spike in interest rates such that companies, as they have done twice before in the last 30 years, hit a so-called interest rate sweet spot, suddenly there would be a tremendous financial advantage in doing a so-called sufficient termination of the plan. Then everybody gets their pensions, the company is done with the obligation, PBGC has no liability, but they now lose the guaranteed premium flow. You could see a significant loss of plans that are currently frozen, a very significant proportion that hit that sweet spot, plans would go away.

Senator MCCASKILL. What percentage would you say are frozen right now that, if that sweet spot was attained, that—

Mr. SALISBURY. Depending on which—the government data is now about 3 years old, but the last time the government looked at it, it was about 30 percent of what would be the premium base.

Senator MCCASKILL. Mr. Snowbarger, is there—internally are there discussions about the premium flow into the future? I mean, is this something that your organization is down in the weeds, trying to figure this out?

Mr. SNOWBARGER. Well, again, because our premiums and our client base are all determined by Congress, it would be a matter of just looking at, well, what's really going to hit and when? We

don't have much control over how that occurs. We have asked Congress for higher premiums, and we got some increase in premiums in the Pension Protection Act. We've also asked for authority to set premiums so that we could adjust those premiums based on the risk that the company actually poses to us, and we've not had that authority given to us.

So, I mean, there are requests that we've made to try to manage that deficit over time. At this point, again, Congress has not responded to those in a positive way.

Senator MCCASKILL. Going—

Senator, if I could just quickly note, I mentioned in my testimony a former chief economist of the PBGC, Richard Ippolito, and he did do a book and has done a lot of work looking at what he describes is the death spiral that would occur here.

So there is work that has been done, including so-called Monte Carlo modeling, looking at these issues. The PBGC, in its PIMS model that is mentioned in their testimony, does have a reasonable capability to model for the types of scenarios you're describing, where that's something that you desire to have done, speaking on behalf of the agency.

Senator MCCASKILL. He loves it, I can tell. Mr. Snowbarger, finally, clearly according to Mr. Salisbury, we've had an investment strategy that was driven, to some extent, by the experience of the director. I'm not sure, based on my knowledge of organizations and their investment strategy, if that is the wisest course. What is your—I know that you are struggling with whether or not to cancel these contracts and reevaluate, but what is your recommendation going to be to the board about what the investment strategy should be going forward, and where should that recommendation actually come from?

Mr. SNOWBARGER. Well, again, I've—in my term at PBGC, I've had directors that have gone both ways, more fixed-income-based and more equity-based. As Mr. Salisbury pointed out, it kind of swings back and forth. It swings back and forth with particular leaders. It doesn't necessarily follow party lines. It really has more to do with the experience.

I think part of what you're getting at with board structure and part of what GAO is getting at with a continuity in a board structure would give you a little more stability, so that any new director coming in is going to have some direction from above, OK, if you want to tweak, we can go a little bit this way or a little bit that way, but you wouldn't have these 180-degree swings in the investment policy itself.

In terms of what my recommendation might be to the board, I'm going to wait for the new director to come on board. I've not had discussions with my current board about what their concerns are about this investment policy. Again, it is not that unusual, if you look back across PBGC's history, to have a more equity-based kind of investment policy.

I think the questions that were raised by the GAO when the policy first was announced, the Congressional attention that it garnered after that report, and then the economy last fall, I think it clearly brought into question, wow, is this a good economic strategy?

Well, if you take the admonition, again, of Mr. Salisbury, if you think about this over a long period of time and you make certain assumptions about PBGC's responsibility to fill that hole, and you make certain assumptions about whether or not PBGC will ever get the authority to use premiums to fill that hole, I'm not sure what other alternative you're left with. In fact, I think Peter Orszag, when he was the director of the Congressional Budget Office, in doing his analysis of PBGC's strategy, was very similar to the conclusions that GAO came up with, but he did raise the question, if you don't have premium authority and you don't have underwriting authority, and you have this hole, how do you fill it?

Senator MCCASKILL. Right. Well, I have thousands of auto workers in my state that are out of work, and it is a tragedy, what is happening to them and their families. When I see them, a lot of them grab me, physically grab me, and look in my eyes, and say, "Is my pension OK?" Not to put any pressure, but I look at them and I say, "Your pension's OK."

I think the responsibility of this agency is very intense. Over the next 24 to 48 months, you need to be a rock, because these families are looking for one to cling to. They've worked hard. They deserve what they've been promised. I hope that all of the recommendations that have been made by the IG and the GAO are taken as a priority, and that your agency moves forward through this obviously little bit of a black mark here, as we make sure we're there for these folks. It's only right.

Mr. SNOWBARGER. I'm sure.

Senator MCCASKILL. Thank you for having the hearing, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator McCaskill. I want to thank you very much for being here today, folks. The Pension Benefit Guaranty Corporation is obviously a very important, critically important government entity. We need to be certain that it's sound heading into the future, that its governance and administrative structure really does work on behalf of the American people.

You've contributed a lot today to getting us on that path, and we are going to follow through on your recommendations, along with some of our own. I'd like to hope that better days are ahead for the PBGC. Thank you so much for being here. Thank you all for coming.

[Whereupon, at 3:30 p.m., the hearing was adjourned.]

APPENDIX

Douglas J. Elliott
Center On Federal Financial Institutions
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The Brookings Institution
May 20, 2009

A Guide to the Pension Benefit Guaranty Corporation

The current financial crisis has damaged the finances of many retirees and of employees who were hoping to retire soon, but who now face the need to work for years longer or to accept a pinched life in retirement. Often, they have been relying on the value of investments accumulated in their 401(k) accounts, plus the equity built up in their homes. Unfortunately, house prices have declined by about a quarter and these losses have been multiplied by the leveraging effect of mortgage debt, which helps when house prices are rising, but adds to the harm of falling prices. At the same time stocks and bonds, which make up the great bulk of investments within 401(k) accounts, have plummeted in value.

There is a fortunate group, about a quarter of all employees and a higher percentage of retirees, that is protected by traditional, "defined benefit," pensions. These are the pensions that normally pay a fixed amount each month for as long as a retiree lives and, in many cases, for the remaining life of a spouse as well. Such pensions can provide a secure retirement, in combination with Social Security -- a government-sponsored defined benefit plan. The money to pay these pension promises is built up over time by employer contributions to a pension fund plus investment income on those contributions. Any investment losses are borne by the employer and not the employee or retiree. In return, the employer benefits from any investment gains through the ability to reduce future contributions.

However, defined benefit plans do bring one risk that 401(k)'s and other "defined contribution" plans do not: the pension fund can run out of money if its investments go bad and the employer becomes bankrupt and stops making new contributions. The bankruptcies of the automakers Packard and Studebaker in the 1960's brought home this risk by leaving a large number of employees with very substantially reduced pensions when they retired.

The current massive problems in the auto industry naturally make the public wonder how safe the pensions are for autoworkers this time around. There is good news and bad news on that score. On the positive side, the government created the Pension Benefit Guaranty Corporation (PBGC) in 1974 to ensure that workers would not suffer this way again. On the negative side, there are limits to the PBGC's pension guarantees that do put the autoworkers at some risk of losing a portion of their benefits. Given the importance of this industry, the situation in the auto industry is discussed in more detail later.

How does the PBGC work? It guarantees pension promises made by businesses, stepping in when a firm goes bankrupt and the pension fund has too little money to meet its future obligations. The PBGC primarily funds itself by collecting premiums from employers that offer defined benefit pension plans and by taking over whatever investments remain in the pension funds of failed companies. In order to keep premiums low, and to discourage employers from offering unreasonably large pensions, there are limits on how large a

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pension will be insured by the PBGC. These limits are high enough that only certain groups have had their pensions reduced, principally more senior airline pilots and the higher-paid portion of steelworkers. Members of these groups were paid relatively well and stayed with their same employer for many years, which produces large pensions. Those who retire at relatively young ages, particularly if they were relatively well-compensated, are also vulnerable to a reduction in benefits. This is the primary issue in the auto industry, where many workers retire quite young.

Unfortunately, the PBGC itself has major financial problems. It currently owes $11 billion more than it has and there are reasonable scenarios under which that deficit could balloon to $100 billion. (A GM bankruptcy alone could add over $20 billion to the deficit, if past relationships hold between what a company's accounting books say beforehand and the loss eventually experienced by the PBGC.) This is far larger than can reasonably be paid from future premiums or excess investment returns, making an eventual taxpayer-financed rescue likely. Close observers of the PBGC situation recognize that Congress is extremely unlikely to sit back and let the PBGC default on its guarantees, although it technically could. Retirees and employees have been counting on these promises for years and it could be politically suicidal to disappoint them. However, any rescue is likely to be years away, since, like Social Security, the problem is huge, but distant in time. The pension payments are spread out over decades, meaning it would be well more than a decade before the PBGC ran out of cash, even in the worst case.

This guide is intended to help employees and retirees who have been promised defined benefit pensions to understand the protection provided by the PBGC. It is also intended to help all citizens to understand the potential effect on them as taxpayers if the problems at the PBGC do worsen. The guide is divided into the following sections:

- Background on retirement plans
- Pension funding rules
- Guarantees provided by the PBGC
- How the PBGC works
- The situation in the auto industry
- The PBGC's financial crisis
- Options to fix the crisis
- Glossary of terms

The Center On Federal Financial Institutions (COFFI) is a nonprofit, non-partisan, non-ideological public policy institute which analyzes federal insurance and lending activities. Much more information about the PBGC can be found on our website, www.coffi.org, particularly the following papers:

- PBGC: A primer
- PBGC: Fundamental Questions
- PBGC: Policy Options
- PBGC: When will the cash run out?
- Pension Reform: Summary of Final 2006 Bill
- PBGC Legislation May Not Restore Solvency

There is also a great deal of useful information available on the PBGC's own website at www.pbgc.gov.

We would like to extend our deep appreciation to the Ford Foundation for suggesting this guide and for generously providing all of the funding that supported us in researching and writing it.

Background on Retirement Plans

Only about half of current employees are offered a retirement plan of any kind, a level that has been relatively stable in recent decades. Of those employees with a plan, the large majority have a "defined contribution" plan, usually in the form of a 401(k) plan. About 17% of workers at businesses are offered a defined benefit plan, which is what the PBGC protects. Companies that offer defined benefit pensions usually also offer a 401(k) plan.

Defined contribution plans

401(k)'s and other defined contribution plans are somewhat like a savings account. Contributions go into the account and investment income is earned on the balance in it. The accumulated value is available for withdrawal during retirement, or, in certain cases, beforehand. The amount received by the employee is based solely on the account balance. If the investments do well, the employee will have a better retirement. If they do badly, the employee will have a more pinched existence. This is a key point – the investment risk belongs to the employee, not the company, as does the risk of outliving his or her savings.

There is usually a mix of employer and employee contributions. Employee contributions are generally voluntary and reduce his or her taxes in the year in which contributions are made. Employer contributions are often on a matching basis to encourage maximum participation, with the company putting in a dollar or fifty cents for each dollar contributed by the worker.

Defined contribution benefits are not insured, but the accounts must be kept in trust and are not allowed to be used by the sponsoring company for any other purpose. This means that unless there is fraud, there is no need to provide insurance for the employees, since whatever is in the account is exactly what the employee is entitled to. There have been instances of fraud in the past, but not often enough to be a major concern.

Defined benefit plans

Defined benefit pensions are what we think of traditionally as pensions. The benefits are generally defined based on years of service and the employees' wage levels in their final working years, without regard to investment performance. Traditionally, the retiree would receive a monthly check at a fixed level for as long as he or she lived and a surviving spouse might receive a check at the same or reduced level until he or she passed on. More recently, there has been a trend towards allowing "lump sum" distributions. In those cases, the employee receives the value in today's dollars of what their lifetime payments would have been, based on expectations of how long they would be expected to live on average and using an interest rate defined by law. About half of all plans offer lump sum distributions and more than four out of five employees choose to take that lump sum when they can.

The use of formulas based on the pay levels in an employee's final working years ("final average pay") creates an interesting effect, since inflation generally produces substantially higher pay over time. Each year of additional work tends to increase pension benefits more than the year before, because the worker receives both the credit for the new year of work and an increase in the credit for all past years, assuming there has been a wage increase. An extreme example of this effect occurs with airline pilots, since their seniority rules place them in larger planes as they progress in their careers and the salary level of a pilot is generally tied to the type of plane they fly. Therefore, staying an additional few years to move up to the highest salary level can produce a major bump in their pension credit for prior years of service.

Defining the benefits by years of service, salary, and expected life-spans opens up the possibility that there will not be enough money to pay the retiree what they are entitled to. The first defined benefit pensions were simply promises from the company and the employee bore the entire risk that the company might be unable or unwilling to meet its commitments. Over time, it became customary to set up a separate pension trust that would hold at least some of the funds needed to make the pension payments. Eventually, this became a legal requirement.

In 1974, in part because of the Packard and Studebaker failures, the Employee Retirement Income Security Act (ERISA) was passed. This required that companies offering defined benefit pensions set funds aside in a pension trust to pay the pensions. Rules were put in place to try to ensure that companies contributed enough over time to fund all of the pension payments. However, it was recognized from the beginning that variations in investment performance might leave the promises temporarily underfunded. In addition, companies could use their flexibility to choose certain technical assumptions and methodologies to effectively defer some contributions when their financial situation made it difficult to meet the schedule, creating a second way in which underfunding could occur. In addition, explicit funding deferrals were allowed in certain cases for companies in financial trouble that appeared to be temporary.

The PBGC was established to protect employees against the possibility that a company would go bankrupt at a time when its pension fund did not have enough money to make all its future payments. Companies in bankruptcy are allowed to reduce the amount that they pay on all their promises, whether to banks that lent them money, suppliers that provided services, or employees and retirees who have been promised pensions. The pension fund and other claimants would likely receive some partial payment at the end of the bankruptcy process, but not the total amount they were owed. Sometimes the actual payments are far below the original promise.

Without the PBGC, an underfunded pension fund would not be in the position to pay everyone their full pensions. In those situations, the PBGC steps in and takes over the investments of the pension fund and takes on all of its promises, except pension payments in excess of a certain level or which violate certain conditions, as will be explained in detail later. (This applies to single-employer pension plans. The rescue methodology is different for multi-employer plans, as explained later.)

Hybrid plans

The popularity of 401(k) plans has led to a movement towards "hybrid" plans that are legally structured as defined benefit plans, but whose pension promises mimic those of a defined contribution plan. That is, an employee's pension promise grows each year as if they had their own savings account which takes in contributions from the employer and whose balance grows at a specified interest rate. In most cases, all employees receive the same interest rate, although some plans give an employee the ability to choose among a limited set of investment options. Hybrid plans virtually always offer a lump sum option, which retiring employees are highly prone to take. (This does not necessarily mean that they spend the accumulated balance. If the balance is large, there is a strong tendency to roll it over into an IRA or a 401(k) account in order to continue building value on a tax-deferred basis.)

Almost a third of all participants in defined benefit plans insured by the PBGC are now in hybrid plans, usually designed as so-called "cash balance" plans. Since these plans are legally in the form of defined benefit plans, the PBGC insures them and the sponsoring companies must obey the same funding rules as

for other defined benefit plans. However, hybrid plans do have subtle effects on the PBGC's risk level that are beyond the scope of this paper. As one example, employees in hybrid plans usually build value in their pensions more evenly than in traditional plans. There is frequently a higher crediting rate for later years, but the effect is more muted. This difference in the nature of the promise changes the risk taken on by the PBGC, although it is not always obvious whether this increases or decreases that risk.

Comparison of defined benefit and defined contribution plans

There is no clear, objective answer as to whether a defined benefit plan is better than a defined contribution plan. It depends on what one's priorities are. "PBGC: Fundamental Questions," provides an analysis of the pros and cons of defined benefit and defined contribution plans. As part of this analysis, a table was constructed ranking the different plan types on 21 different characteristics. The overall conclusions based on that table were:

Plan designs form a spectrum, with 401(k)'s at one end and traditional defined benefit plans at the other. The order of ranking is quite consistent, with the two defined contribution plan types most similar to each other and the two traditional defined benefit plan types clumping together. The hybrid plan design generally falls in the middle, consistent with its attempt to mimic defined contribution plans within a defined benefit format.

Traditional defined benefit plans protect participants better from risks related to uncertainties about savings rates, investment performance, lifespan, and other factors than 401(k)'s do.

401(k) plans provide far more participant control and flexibility to make choices than do traditional defined benefit plans, including the flexibility to change jobs without a major loss of benefits and the chance to select the level of exposure to the rewards and risks of the stock market.

Businesses find 401(k)'s more attractive than traditional defined benefit plans. There appears to be a slightly narrower range of differences here, but companies clearly are voting with their feet to move away from traditional pension plans and towards 401(k) plans.

Traditional defined benefit plans are somewhat better at meeting other public policy objectives than are 401(k) plans. However, this category is the most subjective, in terms both of which sub-objectives were chosen and the weighting placed on a wide range of criteria.

Who has defined benefit pensions?

Defined benefit plans insured by the PBGC, which covers virtually all plans offered by private businesses except for the very smallest, provide pension promises to a population that is quite different from the general population of private sector employees and retirees. Almost half are union members, compared to about one-tenth of the general population. Similarly, around half of the participants are in manufacturing industries versus approximately one-seventh of the general population. Because of the decline in manufacturing and unions, participants are also disproportionately older, including a higher percentage of retirees than in the population at large.

Although statistics are not readily available, it is almost certain that employees participating in these plans have incomes significantly above those of the overall working population. It is worth remembering that roughly half the working population has neither a defined benefit nor a defined contribution plan. Those who do have them tend to be paid more as well.

Pension Funding Rules

The role of the PBGC is to protect employees and retirees from losing pension payments due to underfunded pension plans, so it is worth explaining the funding rules in some detail. ERISA and the tax laws (the "tax code") require companies to prefund future pension payments, according to very complex rules. Essentially, the company that has made the pension promise (the plan "sponsor") is putting up collateral to ensure that the promise is kept. Originally this was voluntary and then it became a requirement, but one with a great deal of flexibility. Another change is that the collateral has become very difficult for the employer to take back through a "pension reversion," if it turns out to be more than necessary for the current level of pension promises. Finally, in recent years, the intention has become to shoot for full collateralization, so that the PBGC and participants would not be at any risk, although this is so complex to achieve that it remains a target and not a constant reality.

The core concept is that there should be funds in the pension plan equal to the value of the future pension payments, in today's dollars. This value is measured by "discounting" the payments back to a "net present value." This is done using a "discount rate," the interest rate likely to be earned by an appropriate set of investments. In intuitive terms, dollars are set aside now and assumed to grow like a savings account by earning interest. The account is drawn down each year to pay pensions. The amount needed today is the value which will cause the balance to be zero when the last pension payment is made, taking into account investment earnings and pension payments over time.

The discount rate applied to these future pension payments is controversial. Most experts agree that it depends principally on the riskiness of the investments that are considered appropriate. The funding rules for pensions now use an index of corporate bond rates to set the discount rate. However, many financial economists differ with this view. They believe that the correct rate for measurement is the "risk-free" rate. The Treasury rate, currently near 4%, is a reasonable approximation for that rate.

The discount rate choice is crucial; a one percentage point change in discount rates usually changes the net present value, the amount of funds needed now, by 10-15%. A high discount rate allows companies to put in less money and therefore create fewer of the trust assets that act as collateral to protect the PBGC. Low rates can protect the PBGC more, but do so by creating more of a burden for firms.

The legal funding rules are highly intricate. Simplifying greatly, firms must fund benefits earned during the year plus interest on the starting balance of future obligations, which are now one year closer to payment. Funding is also adjusted for the effects of changes in estimates for life expectancy and other actuarial assumptions, discount rates, and the market value of assets. These changes are recognized over a number of years rather than being applied completely in the first year. This smoothing is to give companies a chance to catch up over time, rather than facing a potentially huge cash burden in a single year if, for example, the stock market falls sharply as it has done recently. This smoothing increases the potential for significant underfunding to develop, which creates problems if a firm goes broke while the plan is still underfunded.

Required contributions can be delayed ("waived") when they would represent a temporary and substantial business "hardship," based on legal specifics and the Treasury Department's judgment, but they must be made up with interest and the Internal Revenue Service can require collateral.

Another potential cause of underfunding is that a number of plan sponsors have substantial "credit balances" created by making contributions in one or more previous years that exceeded the minimum requirements. In order not to discourage such additional contributions, rules were established to allow future year's contributions to be reduced by the remaining balance of past excess contributions. Unfortunately, until the Pension Protection Act of 2006, there was no linkage between the credit balances and the value of the assets in which the excess contributions had been invested. In some cases, very large credit balances exist, despite significant underfunding. This means that the sponsor of an underfunded plan may be able to skip making any contributions for a few years, likely aggravating the underfunding problem. This is of particular relevance to the auto industry, as discussed later.

It is important to note that accounting rules have no direct effect on legal funding requirements, and vice versa, although they are based on some similar concepts. There can be a large difference at times between what the accounting statements of a company say the pension liability is and the funding level that is required by law.

Guarantees provided by the PBGC

The pension benefits guaranteed by the PBGC vary depending on whether an employee or retiree, known as a "participant," is in a "Single-employer plan" or a "multiemployer" plan. About three-quarters of participants are in single-employer plans, meaning that there is generally only one company providing the benefits. The other quarter of participants are in industries where it is so common to move from employer to employer that the industry, working with labor, has set up pension plans that cover multiple employers. For example, it is common in the trucking industry to change employers frequently, so a multiemployer plan has been set up that allows a worker to earn pension credits for working at any of the companies participating in the plan. All of the participating companies are jointly responsible for ensuring that retirees receive their promised pensions. For completeness, it is worth noting that there are several hundred plans that are considered single-employer plans because no union is involved, but which actually include more than one employer.

Earning the benefits

Traditionally, plans for salaried workers have been set up differently than plans for unionized, hourly workers. Salaried employees generally earn pension benefits based on the number of years that they work at the firm multiplied by a fixed percentage, (often 1%), multiplied by their final salary level, usually based on the average of their last few years of work. So, if a salaried employee earned $50,000 a year in his or her final years and had 10 years of service, the pension might be $5,000 a year ($50,000 times 10 years times 1%.) Non-union hourly workers often receive pension credit in a similar manner, although some adjustment might be made for differing levels of hours worked in different years.

Unionized workers often earn a fixed monthly benefit amount for each period of service, regardless of their wage level, as negotiated between the unions and the company. For example, an employee might receive $100 per month for each year of service, so that an employee serving 30 years would receive $36,000 a year (30 years times 12 months times $100). Traditionally these benefit levels were increased for both future and past service as part of contract negotiations every three years.

Pension plans generally also have a "vesting" schedule. Workers who leave in their early years of employment with a company may lose all or part of their promised pension. ERISA limits the toughness of these vesting requirements, so that most companies have a five-year requirement for an employee to vest in their entire pension benefit. (As a separate rule, "cash balance" plans have vesting periods of three years or shorter.) The PBGC guarantee only applies to vested benefits.

Single-employer plans also generally provide an incentive for early retirement. Employees are usually allowed to retire before the standard age and years of service requirements have been fulfilled, but at a reduced pension level. One reason for the reduced benefit is that someone who retires earlier will collect benefits for more years than if they retired closer to the end of their lives. So, if the benefit were kept constant, it would unfairly pay more to early retirees over time. The early retirement incentive is that most companies reduce the benefit by less than the life expectancy table would suggest. Historically, this has often been a way for companies to encourage early retirement in order to replace expensive older workers with cheaper younger workers or to reduce their work force without firing employees.

PBGC guarantees for single-employer plans

This section describes limitations to the benefits that the PBGC guarantees. Most retirees are not affected by these limits. A PBGC study showed that only 16% of participants in plans taken over between 1990 and 2005 suffered any reduction. Those that did lost an average of 28% of their promised benefits. Airline pilots and steelworkers were the most likely to be affected by the caps, as described earlier. (Most of the PBGC's claims have been from failed steel companies and airlines, so these groups are a significant percentage of the participants aided by the PBGC.)

The principal limitation on the PBGC guarantee is a cap on annual benefit payments. This is set by law at $54,000 per year for a retiree at age 65 in plans that the PBGC eventually takes over whose sponsors go bankrupt in 2009. The cap rises annually for *new* plan terminations based on the annual inflation adjustment in the Social Security program. Once a plan is taken over, the guarantee level is set in stone and does not increase with inflation. (Plans taken over by the PBGC in the past were subject to lower caps, since this inflation adjustment has been in place for many years.) It may be that the participants are fortunate enough that the funds in the pension trust are enough to pay benefits over and above those guaranteed by the PBGC, in which case there is a complicated formula to determine who gets the benefit of the extra funds.

By law, the PBGC makes two adjustments to the cap on annual benefit payments. Just as most pension plans do, it adjusts the maximum guarantee down for retirements commencing before age 65 and up for later retirements, to reflect the number of years the participant is likely to receive benefits. However, there is no incentive built in to encourage early retirement, so the amounts drop off significantly faster for early retirement than is usual for a pension plan. The amount is also lowered if the employee has elected to have survivor benefits paid to their spouse if the employee dies before the spouse does. This, too, is similar to how a standard pension plan works, since paying out as long as even one of the two is alive will almost always produce more pension checks than simply paying while one lives.

Improvements made to pension benefit formulas within the five years preceding the date of the sponsor's bankruptcy are phased in. This is to prevent a company near bankruptcy from promising benefits that it is unlikely to be able to afford, knowing that the PBGC will end up honoring the obligation. (There is a history of companies exhibiting this type of behavior, since unions are often willing to accept the pension benefit increase instead of demanding some cash benefit such as a hike in wages. The PBGC guarantee makes such pension promises valuable even if the employer is weak.) The Pension Protection Act of 2006 extended this benefit limitation to increases in pension benefits that were triggered as a result of plant shutdowns. Such protections have been negotiated in a few industries in the past.

Such benefits are phased in at the greater of: (a) 20% of the improvement per full year since the amendment or (b) a monthly benefit of $20 for each year since the amendment. That is, if a change was introduced slightly over three years ago, only 60% of the increase will be guaranteed, or $60 per month, if this is higher. The cutback does not apply to an automatic increase in benefits during the five year exclusion period made according to a pre-existing formula, such as increases in "final average pay" calculations based on raises. In practice, this creates a disparity between plans for salaried employees and the typical union plan. The union plan is subject to the cutback rules because benefit increases are a result of new labor

contracts which create pension plan amendments, whereas salaried employees are not subject to cutback because their increases are automatic and do not result from a plan amendment.

Finally, there is a benefit limitation sometimes referred to as "accrued at normal." This only applies to supplemental benefits that some plans provide to early retirees, often as part of a package of incentives to encourage early retirement when a company has to reduce its workforce. This limitation says that the guaranteed portion of the pension in any given year can be no larger than the amount the retiree would have received as a pension if he or she retired at the normal retirement age.

In some cases, the investments taken over by the PBGC may be enough to pay all of the guaranteed benefits with money left over. In that case, the funds are used to pay benefits in a specific order, set by law. The first category is entirely funded before anything is allocated to the second category and so on down the priority list.

The priorities are:

1. Voluntary employee contributions. (These are relatively rare.)
2. Mandatory employee contributions. (These are also relatively rare.)
3. Payments to participants who have been retired for three years or more or who became eligible for retirement at least three years before the plan sponsor went bankrupt
4. Benefits guaranteed by the PBGC.
5. Vested, non-guaranteed benefits.
6. All other benefits.

The amounts recovered by the PBGC in bankruptcy proceedings are split among the participants in a similar manner. The complexity of this process is a principal reason that "final determination" of PBGC benefits can take several years to calculate. Estimated benefits are paid until the final determination is made. If the final determination is higher than the estimate, the PBGC will pay interest, but participants are never charged interest if they were overpaid.

PBGC guarantees for multiemployer plans

Multiemployer plans are under quite different, less generous, guarantee limits. By law, the PBGC guarantees only 75% of the annual benefit over $132 per year of service and the PBGC payment is capped at $429 for each year of service. For a participant with 30 years of service, the 75% limit applies at a pension of $3,960 per year and the total cap is $12,870 in annual benefits. These levels do not automatically increase for new plan terminations as single-employer limits do and were changed only once since 1980, in 2000.

Unlike single-employer plans, multiemployer plans receiving financial assistance from the PBGC are required to suspend benefit payments that would exceed the guarantee level. This includes a requirement to reduce benefits to meet the 75% limitation described above. Thus, there are also no payments of non-guaranteed benefits, as there can be in single-employer plans, unless the plan is somehow restored to health and repays

its loan from the PBGC. (Please see later for an explanation of the mechanics of a PBGC rescue of a multiemployer plan, which differs markedly from how a single-employer plan is handled.)

For multiemployer plans, there is no phase-in of improvements made to pension benefit formulas within the five years preceding the date of plan termination. Instead, participants lose all such increases.

PBGC guarantees for multiemployer plans are therefore substantially less generous than for single-employer plans. On the positive side, participants in multiemployer plans are protected by the obligation of every company in the plan to ensure that all promised pensions are paid, whereas a single-employer plan is dependent on the fate of one company alone. The net result is that fewer multiemployer plans fail to pay their full benefits, but those that do need assistance from the PBGC cut back their pension benefits much more sharply than a single-employer plan would.

How the PBGC works

The PBGC is a federal government corporation created in 1974 when ERISA was passed. It has no outside owners besides the government. The PBGC collects insurance premiums and receives no general tax revenue, although it has a legal right to borrow up to $100 million from the Treasury Department as needed. (This figure is very small in relation to the size to which the PBGC has grown over time.)

It insures approximately 44 million participants in more than 31,000 pension plans offered by businesses. (Government plans are not insured.) The PBGC insures pensions with an estimated value of approximately $2.5 trillion as of 2008. To date, it has assumed pension obligations for approximately 1.3 million workers and retirees in about 3,900 plans.

The management team is headed by a Director, formerly called an "Executive Director," appointed by the President with Senate confirmation. A three-member Board of Directors is chaired by the Secretary of Labor and includes the Secretaries of Treasury and Commerce. In practice, they generally delegate Board attendance to an Assistant Secretary of their cabinet department. A presidentially-appointed advisory committee of employer, employee, and public representatives makes suggestions on certain matters.

Taking over underfunded single-employer pension plans

The PBGC's role is to protect participants in the event that plan sponsors are unable or unwilling to fulfill their pension obligations. The mechanism differs between single-employer plans, explained in this section, and multiemployer plans, explained next.

The PBGC takes over the investments and obligations of underfunded single-employer pension plans which are terminated. Such a plan termination can be initiated by the company sponsoring the pension plan under certain conditions ("distress termination"), usually while the company is in bankruptcy. Or, under specific circumstances, the PBGC can force a plan termination ("involuntary termination") if it believes that waiting will create greater harm.

A plan sponsor will be granted a distress termination only in three circumstances:

> The sponsor is being liquidated in bankruptcy proceedings.
>
> The sponsor is reorganizing under Chapter 11 of the bankruptcy law and the bankruptcy judge determines that the firm cannot successfully survive post-bankruptcy without a plan termination.
>
> The termination is "required to enable payment of debts [by the sponsor] while staying in business or to avoid unreasonably burdensome pension costs caused by declining workforce."

The PBGC may initiate involuntary terminations only in the following situations:

> A plan has not met the minimum funding requirements
>
> A plan "will be unable to pay benefits when due."
>
> The "possible long run loss [to the PBGC] with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated."

Under certain conditions, if there is a pension payment to a major owner of the company sponsoring the pension plan and that payment causes the plan to become underfunded. This would only ever apply to a relatively small plan.

Many employers have been "freezing" pension plans. It is important to understand that this is not a termination and does not affect the PBGC or its insurance, except in the sense that the promises it is backing will stop growing or will grow more slowly. A plan sponsor may choose to "freeze" a plan by ceasing to credit new pension benefits to its employees for additional service. A freeze is only allowed if proper procedures are followed and there are no separate contractual commitments blocking the change.

A sponsor could implement any of three types of freezes. A "soft freeze" still allows benefits to rise in "final average pay" plans to the extent that salaries increase. A "hard freeze" cuts this off as well. Finally, some view a "closed plan" as a form of freeze. This involves ceasing to allow new employees into an existing plan.

Again, a freeze is not a termination; the plan continues under the normal funding and other rules. However, employees earn fewer or no additional pension benefits.

Providing financial assistance to distressed multi-employer plans

Distressed multiemployer plans are not taken over by the PBGC, instead the PBGC provides emergency loans as necessary to ensure pension payments are made. If the plan is restored to health, which is not a frequent occurrence, the PBGC will be repaid over time. As noted above, distressed plans are required to cut back pension payments to the level actually guaranteed by the PBGC, which can be much lower than the original promises.

PBGC finances

Like any insurer dealing with a claim against it, whenever the PBGC takes over a pension plan, it expects to take a loss, since the obligations of the plan are greater than the value of the plan's investments. Therefore, the PBGC needs an additional source of funds to cover the claims and its operating expenses. This is supposed to be provided by premiums charged to the companies sponsoring pension plans that are insured by the PBGC. Premiums for single-employer plans are charged at the rate of $34 per participant, which will automatically rise with the inflation rate used for Social Security calculations. In addition, underfunded plans are required to pay another $9 per thousand dollars of underfunding of vested benefits. Finally, companies who passed pension obligations on to the PBGC in bankruptcy and then successfully reorganized under Chapter 11 of the bankruptcy code are required to pay the PBGC $1,250 a year for three years for each participant who was in the plan.

In 2008, the PBGC collected about $1.5 billion of premiums from single-employer plans, of which $1.2 billion was from the fixed premium, $241 million from the variable premium on underfunding, and $57 million from the retroactive premium on bankrupt companies.

The PBGC's multiemployer insurance premiums are simple; there is a charge of $9 per participant per year, which brought in $90 million in 2008.

The PBGC also inherits the claims of terminated single-employer pension funds against the bankrupt company that sponsored the fund. Although there are exceptional circumstances in which the PBGC has a

higher recovery priority, it generally acts as an unsecured creditor; at the bottom of the bankruptcy priority list for creditors. (It would still be ahead of common and preferred stockholders, but there is often very little left for those claimants.) As a result, it generally recovers only a small portion of the underfunding through the bankruptcy process.

Another source of funds for the PBGC is investment income. This is earned on the investments that it takes over from the terminated pension plans as well as funds from premiums and recoveries from bankrupt companies. The PBGC had about $48 billion of investments as of September 2008, generally managed by major investment management firms which have been hired for this purpose.

There is also an operational aspect to the PBGC. It is responsible for making the pension payments to all of the retirees for plans which it has taken over. Much of this work is accomplished by contract employees.

The Situation in the Auto Industry

The U.S. auto industry is undergoing very hard times which have put the existence of a number of the automakers and their suppliers in peril. Chrysler is already in bankruptcy and there is a serious possibility that General Motors (GM) will follow. Ford appears likely to survive without bankruptcy, but this happier result is by no means certain. In addition, major suppliers such as Delphi are already in bankruptcy.

Unfortunately, the gravity of the situation is made worse by substantial pension underfunding at most of these firms. Business Week reports that the PBGC recently estimated that the auto industry, including suppliers, was underfunded by about $60 billion, according to the PBGC's method of calculation. GM alone had a shortfall of about $20 billion, while Chrysler had a gap of about $9 billion. Sadly, the history of the PBGC has shown that these kind of deficits can grow substantially by the time the PBGC actually takes over a pension plan, so even these figures are hardly worst case numbers. As discussed later, most of the current pension deficit would actually fall on participants in the Chrysler and GM plans because these plans are significantly more generous than the legal guarantee limits covered by the PBGC.

On the positive side, it appears that even though Chrysler is in bankruptcy, it does not intend to terminate its pension plans. "Credit balances" from previous contributions exceeding the required minimums will apparently allow it to skip cash contributions for about two more years, buying the company time to try to repair its own finances and to hope that strong investment returns narrow the pension deficit. If the gap does not narrow, it will apparently have to begin making cash contributions to the pension plans of about $1 billion a year, starting in a couple of years. However, if the company successfully reorganizes and emerges from bankruptcy without terminating the plans, as seems very likely, the participants would not have to fear a loss of their benefits unless Chrysler went back into bankruptcy again in the future. (It is possible that a distress termination would be permitted outside of bankruptcy, but this would be highly unusual.)

A potential GM bankruptcy would likely play out the same way. GM also has large funding credits for past contributions that would allow it to avoid putting more cash into the pension plan for the next few years. Given the major roles being played by both the UAW and the government, who would like to avoid terminating the pension plans, it seems unlikely that a pension plan which is not a major cash drain in the near-term would be terminated.

If plans at either company were terminated, there would be a substantial loss of benefits for many of the participants. Participants would reportedly bear $16 billion of the $20 billion pension deficit at GM and $7 billion of the $9 billion Chrysler deficit, if these plans terminated and recent estimates proved to be correct. The main reason for the huge hit is that the automakers provide their employees with the ability to retire relatively young and they have been providing substantial pension supplements to encourage early retirement. The PBGC's treatment of early retirement, mandated by law, essentially strips away all of the subsidies and supplements that encourage early retirement, leaving a significant amount unguaranteed.

Earlier in the paper, it was speculated that the PBGC could conceivably absorb a $20 billion loss if GM were to eventually terminate its pension plans. This figure is a very rough estimate based on two key facts. First, PBGC's losses from Bethlehem Steel and many other past PBGC problems were often substantially larger than the last reported figures would have suggested. Second, GM's pension plan has about $100 billion in obligations. If the pension deficit widened out by just 20% of this amount, it would add $20 billion to the

pension deficit, the great bulk of which would fall on the PBGC rather than the participants.

The PBGC's financial crisis

The PBGC owes $11 billion more than the value of its assets, as of September of 2008, the end of its last fiscal year. Further, there is the real possibility of much higher deficits in the next few years if some of our industrial giants were to go into bankruptcy. Analyses by COFFI in 2004 showed that the deficits could easily exceed $100 billion if trends continued as they had been. Although we do not have updated numbers, the situation since 2004 has worsened in many significant ways due to the severe economic and financial crisis we are undergoing. This is at best only partially offset by changes that were put into place as a result of the Pension Protection Act of 2006.

The root causes

The PBGC is in an unusual situation for an insurer, even a government one. It controls virtually none of the key variables that determine its finances, since these are carved into law. The PBGC has no ability to decide who to offer insurance to, since all pension plans at businesses with certain characteristics qualify and indeed are required to buy the insurance, with some minor exceptions. Nor can it directly influence the behavior of pension plans, since it has no regulatory authority, including no ability, for example, to question or influence the investment strategy of a pension plan. The PBGC's premium schedule is set by Congress, with no discretion. Funding decisions by the firms sponsoring pension plans are at the firms' discretion, as long as the contributions fall within the funding rules set by Congress. Even exceptions to the funding rules, such as funding waivers, are not directly ruled upon by the PBGC, although the IRS will solicit the PBGC's opinion.

Congress has attempted over the last 35 years to keep the PBGC's premium rates low and the funding rules relatively flexible, in order to encourage companies to continue offering traditional pension plans. As a result, the premiums have been consistently too low for the level of risk borne by the PBGC as the result of funding and investment decisions taken by companies and their pension plans. An analysis by COFFI in 2006 showed that premium rates would have had to have been roughly double their actual levels over the life of the PBGC to have avoided the deficit that the PBGC then faced. Further, it concluded that rates would have to be as much as six times their 2006 level in order to clear up the existing deficit and avoid creating a new one going forward, assuming no other actions were taken.

One reason that it has not been obvious that rates were too low or funding rules too weak is that the PBGC, like other credit insurers, is heavily affected by the business cycle. A for-profit credit insurer will often make high earnings for many years in a row, but lose enough in the next year to bring the accumulated profits down to reasonable levels. This is because it takes a high level of bankruptcies to create significant losses, levels that are reached infrequently, but which do occur from time to time. When they do, the losses can be heavy.

The PBGC's situation is even more exaggerated because two things happen in severe recessions that work together to create large losses. There are many more corporate bankruptcies in recessions than in good times -- a strong economy covers most mistakes, while a deep recession exposes every weakness. This is critical, since the PBGC only takes over underfunded pension plans from bankrupt companies or those very near bankruptcy.

Further, weak economies are usually accompanied by falling stock markets (which decrease the value of plan assets) and falling interest rates (which decrease the discount rate, raising the cost in today's dollars of future payments). The combined effect is to sharply increase pension underfunding. This would not occur if pension funds were entirely invested in high-quality bonds with maturities matching the future payments, since the market value of the bonds would rise to offset the change in interest rates. However, the average corporate pension plan generally keeps about three-fifths of its assets invested in stocks. Stock prices can easily move down at the same time as interest rates do, resulting in negative effects on both sides of the balance sheet. In addition, even a pension plan's investments in bonds may only be loosely tied to the timing of expected pension payments, creating another mismatch with the potential to create or worsen pension underfunding.

The current situation

As noted, the PBGC was $11 billion in the hole as of September 2008. This is calculated according to Generally Accepted Accounting Principles (GAAP) which includes establishing a liability for "probable losses," which was $3 billion in 2008. These are claims for plans that it believes will be terminated in the future, based on information available as of the end of the PBGC's fiscal year. It bases this on applications for distress and involuntary terminations and on insolvencies where no solvent plan sponsor remains to take the pension underfunding. The PBGC also determines whether a plan is "high risk" based on a considerably larger list of risk factors, including the existence of funding waivers, junk bond ratings, and loan defaults. Each high risk plan is evaluated to see if in the PBGC's judgment it is likely to terminate, in which case it also generates a "probable loss."

Not all probable losses will materialize. Investment gains can change the funding status, a troubled firm may avoid insolvency, a buyer can materialize that is willing to take over the pension obligations, or an insolvent sponsor may choose not to terminate a plan after all. For example, 11% of probable loss amounts set up from 1987-2007 had not resulted in claims by the end of 2008, after adjusting for five airline plans which were effectively rescued by special provisions in the Pension Protection Act of 2006. Only 3% of the amounts have been deleted as unlikely to create a loss for the PBGC, the rest may yet produce a loss.

The PBGC also reports an estimate of potential losses from "reasonably possible" future claims. Firms are placed in this category if they meet any of a number of criteria, most of which revolve around a less than investment grade credit rating or equivalent shaky creditworthiness. This figure does not go into the financial statements except as a footnote, but is used by PBGC as a measure of its potential risk. Reasonably possible losses as of December 2007 were judged to be $47 billion. This figure would likely be sharply higher now, given the depth of the current recession and the continued damage to the stock market, neither of which are yet in the possible loss figure given the substantial delay in compiling the data.

How did the PBGC lose $11 billion?

Much of the damage to the PBGC's finances occurred in 2002 and 2003. Bankruptcies of PBGC-insured firms rose significantly at the same time as pension funds were becoming more underfunded, in part as a result of the bursting of the "dot com" bubble. The combination produced a record level of $15 billion of underfunding in plans taken over by the PBGC in 2002 and 2003. Bethlehem Steel alone accounted for $4 billion.

Defined benefit underfunding sharply expanded from approximately $160 billion at the end of 2001 to over $350 billion at the end of 2003, according to the PBGC, as a result of swings in the financial markets. The S&P 500 stock index fell by 1%, rather than earning the cumulative 15-20% that companies expected. Even more important, the discount rate used by the PBGC to calculate its present value cost of future benefit payments (by far its biggest liability) fell from 6.70% to 4.40% as interest rates fell in general. Declining discount rates mean a higher level of investments is needed now to pay the future obligation.

Further, the PBGC's investments were exposed to the same trend of falling stock prices and falling interest rates that affected corporate pension plans, since it held 30% of its assets in stocks at the end of fiscal year 2001. Investment income of $4 billion over the two years did not fully offset an increase in the present value of the liabilities of at least $6 billion due to lower discount rates.

2004 continued the downward spiral in the PBGC's finances, affected in large part by the United Airlines bankruptcy. The actual claim on the PBGC, the largest ever at $8 billion, came in 2005, but it was already in the "probable loss" category by 2004, which meant it fed through the numbers as if it were already a claim. The PBGC's deficit under GAAP accounting bottomed out at in 2004 at $23 billion. Since then, a stronger economy and better financial markets (until recently) led to a halving of the deficit. This fortunate movement is extremely unlikely to continue over the next several years, given the awful state of the economy and the financial markets. As discussed later, a GM bankruptcy alone could add $20 billion to the PBGC deficit.

The effects of the PBGC on the federal budget

Profits or losses at the PBGC affect the federal budget, but in a skewed way, very different from Generally Accepted Accounting Principles. The federal budget credits the PBGC with the full insurance premiums being raised to build funds to pay its massive liabilities, but only reflects a small portion of the increased liabilities themselves in the annual budget calculations. (Please see "PBGC: A Primer" for the very complicated details.) As a result, the PBGC aided the federal budget by $12 billion from when it went "on budget" in 1982 until 2003, despite losing almost that same amount in economic and GAAP accounting terms.

Future losses at the PBGC

The current deficit at the PBGC is only a taste of what we are likely to experience in the future, according to extensive analyses run by COFFI. COFFI was the first organization to publish detailed estimates of future cash inflows and outflows for the PBGC. It is still the only non-governmental body to make these estimates, since only the Congressional Budget Office (CBO) has produced any similar detailed analysis. The results of both COFFI's work and that of the CBO have been broadly consistent with the PBGC's own estimates, but the PBGC chooses not to publish the underlying details of its analyses, making it impossible to fully compare the workings of the models. Please see "PBGC: When will the cash run out?" and "PBGC Legislation May Not Restore Solvency" for an explanation of COFFI's projections in greater detail.

Although the calculations in COFFI's model are complex, the concept is simple. We estimate how much the PBGC will take in from premiums, investment income, and bankruptcy recoveries. There is some variation in these figures, but the numbers are still reasonably predictable on average. That is, investment income can move up or down quite considerably, but the average over time is much more stable, allowing us to be reasonably comfortable within a range of average returns. Part of the PBGC's cash outflows are also fairly

predictable, since they consist of pension payments for people whose plans have already been taken over by the PBGC. Actuarial analyses were available from the PBGC which showed the likely pension payments going out many years. (The PBGC has stopped providing these estimates, unfortunately, making future modeling more difficult.) PBGC expenses levels are also reasonably predictable, once one has estimated the size of the pension promises at plans that have been taken over.

The hardest part of the modeling is the projection of future losses for the PBGC from taking over additional underfunded plans. At the time of COFFI's initial modeling, the biggest risk was from the likely bankruptcies of several major airlines, as did indeed occur. In addition to specific modeling of these bankruptcies, the analysis also looked at a base case scenario for non-airline losses and more optimistic and pessimistic cases, in order to evaluate the range of reasonable possibilities. Estimating the losses is fairly complex – interested readers should look to the reports cited above for the details.

COFFI's modeling underlines three problems. First, 35 years of charging premiums that were too low has baked in losses that have only partially become evident through past bankruptcies. There are likely to be a number of bankruptcies in the next few years that will produce major losses for the PBGC, given the depth of the current recession. For example, it appears quite possible that General Motors will undergo bankruptcy. If this were to be accompanied by a plan termination, the PBGC could face a major loss on GM's pension underfunding. Please see the earlier discussion on the auto industry.

Second, the premiums collected by the PBGC appear insufficient to cover the level of risk it faces on new pension promises. This risk is imposed on it by Congressional mandates and the choices made by the businesses sponsoring pension plans. The PBGC's own estimates are that the average level of claims in today's dollars over the next ten years would be $3.6 billion a year, well above the $1.5 billion in premiums collected in 2008. (That disparity is likely to be considerably larger when the next annual report comes out, given the claims that are almost certain to result from the current severe financial crisis.) This means that the hole keeps getting dug deeper. This would not be evident every year, however, since the losses are highly concentrated in years of severe recession or weak financial markets. The PBGC's finances could improve for years in a row, as they have done for the last few, even though the structure of premiums and risks is storing up future trouble.

Third, the actual cash outflows will build for a number of years even if there are no new bankruptcies, simply because older employees will be retiring and starting to collect benefits. This will be offset to some extent by the deaths of existing retirees and their spouses, which will end their particular pension payments, but the new retirements will far outweigh the mortality effects for a number of years. As these larger payments are made, the investments of the PBGC will begin to fall, resulting in less investment income as well, compounding its problems.

COFFI's base case analysis found that the PBGC would run out of cash in 2020 unless it were rescued. Ironically, the evil day will be pushed out further if the PBGC has additional large claims, as is likely to be the case. The mechanism for this unintentionally works similarly to a Ponzi scheme. A major bankruptcy brings in substantial pension assets that help to fund payments from prior bankruptcies, even though the size of the total problem gets bigger due to the underfunding taken on from the new claim.

Apparently, the PBGC's model shows the cash running out well beyond COFFI's earlier 2020 estimate. Regardless of the actual year, the real problem is that the cashflows turn strongly negative once the cash

runs out. These payments may be many years out, but the amount of money that would need to be invested now to cover those future payments is quite large.

What are the options to fix the PBGC's finances?

For 35 years there has been a significant imbalance between the risks imposed on the PBGC and the level of premiums charged. Both the risks and premiums are determined by Congress and that body has passed several pieces of legislation intended to remedy this imbalance. Despite these reforms, no academic study found that the premiums were more than half what they would need to be to cover the risks and some concluded that the level was as little as one-sixth of that needed for self-sufficiency.

The imbalance between premiums and risk results from the inter-relationship of three factors: (1) premium levels; (2) the inherent risk in offering defined benefit pensions; and (3) structural features that encourage risky behavior. Financially weak companies have incentives to minimize pension contributions, increase their investment risk, and provide richer pension promises in place of other compensation that would require immediate cash.

The previous section of this paper explained the results of COFFI's analysis of the PBGC's future financial situation. Action is needed now, despite the absence of a liquidity problem; regulators would already have seized control of any private sector insurer in a situation similar to the PBGC. The longer we wait, the closer we get to the cliff edge where a massive taxpayer rescue would be necessary to avoid having PBGC payments of retiree pensions fall to pennies on the dollar. (Serious analysts of the PBGC do not believe Congress would let retirees lose their pensions. The real risk is that the taxpayers would have to pony up.)

Appendix I outlines 14 options to solve the PBGC's financial problems with its single-employer insurance program. (The size of the problem in the multiemployer program is far smaller and the potential solutions are more complex, so the appendix only focuses on the single-employer plans.) Any legislative solution is likely to combine a number of these alternatives, especially since every proposal inflicts pain on some party. We have dug a deep hole for the PBGC and there is no easy, painless way to climb out. The choices fall into several broad categories:

Raise premiums. All else equal, high enough premiums will provide the cash to pay future claims even under the present structure. However, an excessively large premium increase could chase out of the defined benefit system some of the strong companies whose premiums support the PBGC.

Add more risk-based premiums. One way of increasing premiums is to add extra charges for firms that pose the most risk to the PBGC, either due to their generally weak creditworthiness or to a high proportion of stock investments in their pension funds. This should encourage less risk-taking by companies and lower claims on the PBGC, but there are negatives that vary with the specific proposal.

Change funding rules. Various proposals look to encourage higher funding levels at pension plans or to make the contribution requirements less volatile. The pros and cons vary with the proposals.

Improve the PBGC's position in bankruptcy. The PBGC's net losses would be lower if it recovered more than pennies on the dollar in bankruptcy court. However, higher recoveries would come out of the hide of other creditors and could cause them to take actions in anticipation of possible bankruptcy that would be costly to companies sponsoring pension plans and to the PBGC.

Limit the PBGC's guarantee. Reducing the amount covered by the PBGC in certain circumstances would directly reduce its losses, at the expense of present and future retirees. Such proposals are generally aimed at perceived abuses, where pension increases are allegedly given in the knowledge that they are unaffordable but that the PBGC will pick up part or all of the bill.

Increase the PBGC's stockholdings. The PBGC could increase the proportion of stock that it holds in its own investment portfolio. This would increase the expected long-run return, reducing the PBGC's deficits over time, but it would expose the PBGC to the risk of even larger deficits if the stock market underperforms expectations. The PBGC started to do this in 2007, in a modest way, and had the bad luck to immediately lose a substantial amount of the money it switched into stocks.

Privatize the PBGC. Some argue that the PBGC's financial problems are inevitable with a government attempt to provide insurance of this type and therefore the task should be switched to private insurers. A privatized PBGC would require a large cash infusion up-front of tens of billions of dollars, but has at least the possibility of eliminating a future taxpayer rescue. There are many technical issues discussed in Appendix I.

Infuse taxpayer funds. There is no question as to the effectiveness of such a plan in improving the PBGC's financial condition. The arguments center around whether this is good public policy.

The Pension Protection Act of 2006

By 2006, it was clear to almost everyone that the PBGC was in deep financial trouble. Several major airline bankruptcies, and the threat of more, massively increased the PBGC's deficit and brought home the riskiness of its situation. That year, the Administration proposed a series of reform measures intended to fix the PBGC's finances. Congress then made a number of modifications to the proposal, mostly at the request of the managements and unions of companies offering defined benefit plans or their trade groups. The resulting legislation became the Pension Protection Act of 2006, which was signed into law in August of that year.

COFFI's modeling at the time suggested that the legislation would reduce an anticipated need for a $92 billion rescue to about $60 billion instead. We have done no new modeling since then, but would expect that the result would look no better now and possibly significantly worse, as a result of the current financial crisis. In addition to the onset of the financial crisis, it is not clear that the changes introduced by the law are having the intended major positive effect on the PBGC's situation.

A fuller explanation of the bill and its likely effects is contained in "Pension Reform: Summary of Final 2006 Bill." An edited version of the core of that summary is shown in the rest of this section.

- **Stricter funding requirements.** Prior to this law, a company could shoot for a level of investments equal to 90% of the value of the pension promises, rather than trying to be 100% funded. Once the provisions of the new law are fully phased-in, companies will always need to strive for 100% funding. (They will have seven years to fund any shortfalls that develop, but the target remains 100% funding.) All else equal, this would represent roughly a $200 billion increase in system-wide funding. Plans that are considered to be "at risk" of termination, because of the depth of their underfunding, will be required to fund up to a higher level that takes into account potential employee retirement choices that could increase costs, especially retiring at the earliest allowable age. "At risk" plans will also have to increase their funding to reflect likely PBGC expenses of terminating the pension plans. Moving in the other direction, "airline relief" provisions will allow airlines to fund much more slowly, if they agree to freeze their plans and accept a limitation on future PBGC guaranty levels, as many indeed chose to do.
- **Benefit restrictions.** Heavily underfunded plans will be restricted from increasing benefits. The most underfunded will be required to freeze their plans altogether until they are better funded.
- **Higher PBGC premiums.** The bill eliminates an exception that allowed most underfunded plans to avoid paying a variable premium based on the amount of their underfunding. Over time, this should lead to either or both of higher PBGC premiums or reduced underfunding in the system.

Appendix I: 15 Options to Fix the PBGC's Financial Situation

Raise the PBGC's fixed premium rate for single-employer plans

The PBGC currently charges $34 per year for each participant in a single-employer pension plan. Participants include current employees, former employees who retain a right to future benefits, and retirees. The rate rises each year at the inflation rate used for Social Security calculations. The fixed premium contributed $1.2 billion of PBGC's total premiums in 2008.

When the PBGC was established in 1974 under the Employee Retirement Income Security Act (ERISA), Congress set this fixed charge at $1 per participant. It has raised the level periodically, with the last increase occurring in 1991. The Pension Protection Act of 2006 raised the annual rate from $19 per participant to $30 each and put in place the automatic inflation adjustment. Legislation would be required to raise the level further, as the PBGC has not been given authority to set its own premium rates. Such legislation could either set a new fixed rate or could provide an automatic indexation for additional factors beyond inflation, such as PBGC deficit levels.

Pros

Higher premium revenues would directly improve the PBGC's financial position. This would be particularly useful in offsetting the existing deficit, since other options are very limited.

Arguably, insufficient premium levels were a major contributor to current PBGC deficits. As noted, there has been a large mismatch between premium levels and the risks imposed on the PBGC. Some of this mismatch presumably derived from the premium rate, although allocating responsibility between premiums and other factors is subjective.

Cons

Higher premiums would be a modest disincentive to offering defined benefit pensions. PBGC premiums currently represent about 2% of the annual cost of providing a defined benefit pension plan. A significant rate increase might theoretically cause companies that are on the fence to choose to exit their defined benefit plans. However, plan sponsors would only escape the premium increase if they terminated their plans by paying an insurer to take over the legal obligation. There are strong reasons for big companies not to do this, since most pension plans have become underfunded as a result of the current financial crisis. Many firms would need to borrow large sums to fully fund their pension plans in order to pay the insurers to take over the obligations. The credit crunch makes this difficult and expensive.

In addition, companies may be reluctant to give up the 8-9% returns they expect on their large pension investments and essentially lock in a bond-like return from the insurers, currently less than 7%. The gap between companies' return expectations and insurer pricing is currently quite narrow, as a result of the present financial crisis, which is forcing insurers to offer higher rates for all types of business in order to counteract concerns about their credit strength. The gap is likely to widen again as the crisis passes.

Large firms that do exit the defined benefit system are much more likely to do so over time by "freezing" their plans, (ceasing to provide any benefits for additional years of service or wage increases). However,

freezes have little immediate effect on the PBGC's fixed rate premiums, since they are based on the number of participants, including retirees. This figure would decline slowly over time as deaths were no longer offset by the addition of new participants to the plan.

Higher premiums could slightly increase bankruptcies and distress terminations. Firms which are on the edge of viability may not be able to afford to pay increased premiums. However, few firms are so vulnerable that an increase in an item that may represent only 2% of their pension payments is likely to push them over the line.

Arguably, an increase in the fixed rate is unfair to low-risk plans. Companies have considerable control over their riskiness to the PBGC and the vast majority of plan sponsors will never produce a claim on the PBGC. Management decisions on debt levels and operational risks have major influence on their ability to avoid a future bankruptcy. Decisions on pension contributions and the riskiness of pension investments similarly influence the risk of underfunding. Some argue that companies that minimize the PBGC's risk provide a level of subsidy to riskier firms that is at best fair and may be excessive already.

Premium increases remain a political "hot button," perhaps because of the perceived fairness issue. The strong employer reaction against premium increases cannot be adequately accounted for by the relative size of these premiums compared to other economic factors related to pensions. This may represent a negotiating tactic, it may represent a profound dislike of paying premiums to support weak companies that may be viewed as irresponsible, or there may be other factors.

Charge a one-time premium

Some have suggested that Congress charge a one-time levy on plan sponsors as a way of filling the PBGC's deficit on past insurance provision without overpricing for future insurance. This would probably need to apply to all plans in existence as of a date prior to passage of the legislation, in order to avoid encouraging a rush of plan sponsors exiting the defined benefit system.

Pros

Reduces or eliminates the PBGC's deficit.

Holds down future premium levels. Plan sponsors would not need to be overcharged for the risk of future claims in order to make up for past losses, if the level is set to eliminate the existing deficit. Even a lower one-time premium than the full amount required would still reduce the need for overcharging for future risk.

Reduces the federal budget deficit. Such a levy could potentially be of a size that would be more than a rounding error on the federal deficit. PBGC premiums are reflected as revenues in the Unified Federal Budget.

Cons

Arguably, it is unfair to plan sponsors that have stayed in the defined benefit system. If premiums were too low in the past, many of the beneficiaries were sponsors that have since exited the defined benefit system.

There are also fairness issues among remaining plan sponsors. Would a levy be based on the number of participants, size of pension obligations, underfunding levels, credit risk, or some other factor(s)? Any choice benefits some firms at the expense of others.

Some firms might exit the defined benefit system out of fear of future extraordinary premiums. The precedent could frighten many plan sponsors.

The charge might be enough to push some companies into bankruptcy. If the charge fell particularly heavily on troubled firms, it might be enough to push some over the edge.

Raise the level of variable premiums

The PBGC also collects an annual premium equal to 0.9% of the vested underfunding. However, the technical calculations mean that only a fraction of the estimated underfunding among all insured plans is treated as underfunding for this purpose. In 2007, less than 20% of the PBGC's estimate of system wide underfunding was considered underfunding for the purposes of calculating the variable premium.

Premiums could be increased by raising the 0.9% rate or by applying the rate to total underfunding.

Pros

Higher premium revenues would directly improve the PBGC's financial position.

Variable premiums encourage full funding. Companies with good access to capital at reasonable rates have an incentive to borrow and contribute to their pension funds, in order to avoid the cost of the variable premium. However, this logic fails at current rate levels for many companies, particularly those with weaker creditworthiness, which are generally the firms the PBGC must worry about. For those firms, an annual charge of 0.9% is a small price to avoid borrowing at high rates to fund the plan. For both strong and weak companies, the potential ability to avoid being in the 10-20% that actually would be required to pay such a premium also weakens the incentive to fully fund.

Arguably, variable premiums are fairer. Companies whose decisions have led to greater underfunding are required to pay more for the risk they represent to the PBGC. However, this fairness argument would not be valid to the extent that external factors created the difficulties.

Cons

Higher variable premiums could lead to more bankruptcies and job losses. One cause of underfunding is economic distress at the plan sponsor. In such cases, higher variable premiums would impose an additional financial burden on an already stressed company. To put this in perspective, had United Airlines paid the 0.9% variable premium on their entire $8.3 billion of underfunding as calculated by the PBGC, it would have cost approximately $75 million a year or 0.4% of its operating costs.

Higher variable premiums would encourage weak companies to freeze their pensions. Weaker firms would be more inclined to stop accruing additional pension benefits, since they would have less economic flexibility to underfund their plans in bad times. This would hasten the shrinking of the defined benefit system, although it would likely help the PBGC by lowering the size of future claims from those weak firms that collapse eventually. Note that we do not suggest that plan terminations outside of bankruptcy would rise appreciably, since weaker firms are in the worst position to pay an insurer to take over the obligation.

Base the variable premium partly on credit risk

The variable premium currently charges firms for underfunding, but not for other aspects of the risk they present to the PBGC. Some propose relating the premium to the creditworthiness of the plan sponsor. For practical purposes, firms must enter bankruptcy before they can pass their pension obligations to the PBGC. Statistics clearly show that a firm with high creditworthiness today is much less likely to enter bankruptcy in subsequent decades than is a firm that is already weaker. (There are always exceptions, of course. Railroad bonds were once viewed as the safest corporate bonds in the world, but virtually all railroads eventually went bankrupt.)

Credit ratings from Standard & Poor's, Moody's, and other rating agencies would likely be used to measure creditworthiness, although quantitative tests, such as ratios of debt to equity, could theoretically be used. Unfortunately, it is very difficult to devise ratios that fit all circumstances, which is why investors pay attention to the more nuanced analyses of rating agencies.

This proposal could be combined with the current underfunding test and/or with a test based on the composition of a pension fund's investments, discussed below.

Pros

Arguably, this approach is fairer than current law. Firms make many choices about how aggressively to borrow, and about their business plans, that substantially affect their credit. For example, aggressive borrowing can significantly raise returns to shareholders while shifting risk to creditors such as the PBGC. Most creditors, such as banks, are able to charge more for this increased risk, but the PBGC is not.

Stronger companies would be encouraged to retain their pension plans. This approach helps cover the PBGC's deficit without inflicting significant cost on stronger companies that offer pension plans.

Cons

There could be more bankruptcies and layoffs. Troubled companies would be hit the hardest and might find themselves paying higher and higher rates as their problems mounted. The extent of this effect would depend on how sharply premium rates change with credit ratings and what absolute levels were chosen.

Arguably, this approach is less fair than current law. Sometimes firms are hit by external events beyond their control, such as an oil price shock, Raising premiums in those cases is like raising auto premiums for someone who has been hit by a drunk driver.

Government involvement in evaluating corporate credit risk will make some uncomfortable. There are likely to be at least some situations where government administrators might have to make judgment calls about corporate creditworthiness. Some will view this as "industrial policy" that should be avoided.

Some technical problems exist. Rating agencies are fallible, as has become particularly obvious lately. It is true that their record is considerably better with corporate credit risk than with the complicated mortgage-backed products that have tainted their reputations recently. Nonetheless, they sometimes take too long to recognize the seriousness of an industry problem and then can over-react once they do. Also, some plan sponsors that do not have public debt would not have a pre-existing rating from one of the agencies.

Base the variable premium partly on investment allocation

As financial economists have shown, a substantial portion of the risk to the PBGC results from volatility in the investment returns of pension funds. In particular, stocks may have a higher average return, but they can experience major declines, such as after the bursting of the "dot com" bubble or the recent collapse in the market.

Some propose that incentives be put into place to encourage bond investments, which are well-matched to the underlying pension liabilities. (A promise to pay money monthly for the life of the retiree can be matched with bonds that promise an equivalent income stream from principal and interest payments. Even the uncertainty of life expectancies does not destroy this matching, since large groups have relatively predictable mortality rates.)

These proposals are more likely to be viewed as creating *disincentives* for investing in stocks, given the strong bias of most corporations to invest their pension funds heavily in stocks. One disincentive would be a higher variable premium for plans owning a high proportion of stock.

Pros

Claims on the PBGC should go down. Some firms would be likely to lower their holdings of stocks, reducing the volatility of their investment returns and the likelihood of future substantial underfunding. Additional firms might freeze or terminate their pension plans (see Cons below), which would also reduce claims on the PBGC.

Variable premium revenue might go up. Other firms would be willing to pay the penalty in order to retain the potential upside of stock investments. They would be subject to a higher premium rate. This increase would likely more than offset any loss of revenue from firms freezing their plans (which produces little immediate premium decrease) or switching to lower stock holdings. However, the details of the rate structure would determine the actual outcome.

Arguably, it is fairer to conservative pension sponsors. Companies CAN choose the investment strategies of their pension plans, so it would seem fairer for them to bear the consequences, positive or negative, of the level of risk they choose to create for the PBGC.

Cons

Selling stocks and buying bonds could substantially raise accounting costs. Accounting rules allow firms to calculate their pension expense by assuming that they are earning investment returns consistent with a long-term expected average. Thus, executives may be able to plan on the basis that their accounting results will show returns for stocks in their pension funds in the 8-10% range, while bonds only show 5-6% returns. Therefore, selling stocks and buying bonds would hurt near-term earnings. The hit could be substantial for companies with large pension funds.

Firms that do not reallocate face higher premiums, which would be particularly hard on troubled companies. Higher variable premiums would produce both a cash and an accounting hit that could be significant for firms with large pension funds.

Some firms may exit the defined benefit system due to these higher costs. One of the remaining attractions of defined benefit plans to many large companies is that they can benefit from stock returns on a large pool of pension assets under their control. If the disincentive to own stocks in the variable premium structure is too strong, many firms may find the game no longer worth the candle.

The change could hurt the stock market modestly. A reduction in demand for stocks by large pension funds should, by definition, decrease stock prices. However, that change in demand is likely to be quite small compared to the size of the financial markets and any fall in stock prices should encourage other investors to buy more stocks at the cheaper price, largely counteracting the decline by bidding stocks back up towards their original levels. Politically, however, this could be a very powerful argument against the change as long as the stock market remains depressed.

Tighten funding rules for defined benefit plans

Many people have proposed that rules on pension funding be "tightened" in one manner or another. (Existing pension funding rules are too complex to describe here, but interested readers can see "PBGC: A Primer", available at www.coffi.org.) Tightening in this context generally means either (1) requiring maintenance of a higher average level of funding or (2) requiring contributions more quickly when underfunding occurs, or both. One argument for tightening is that funding rules currently use a measure of the pension liability that has often proven to be substantially lower than the pension fund's liability as determined in bankruptcy.

The details of tightening proposals will matter greatly, but, for simplicity, we will deal here with the generic concept of "tightening."

Pros

Claims on the PBGC would be lower than under current law, all else equal. There would be lower levels of underfunding that might result in claims on the PBGC.

Lower claims on the PBGC would also mean fewer participants losing non-guaranteed benefits. When the PBGC has a claim, there are often individuals whose benefits are cut back because they exceed those guaranteed by the PBGC.

Healthy companies might benefit from slightly lower borrowing costs. As noted under "Cons," weak companies might have to divert cash away from new investment or wages and into pension contributions. The flip side is that there would be more money in pension funds looking for investment opportunities. Healthier companies might find a slight lowering of their cost of borrowing and a slight increase in their stock price. Thus, a small group of companies might be hit hard, while a large number of firms were helped a bit.

Cons

More firms would exit the defined benefit system. There would be greater cash demands placed on companies, particularly during difficult economic times. (There is some correlation between recessions and poor stock market performance.) Many firms might freeze or terminate their plans in order to minimize the potential impact of higher cash needs.

Weaker companies might need to downsize. Weaker firms with large pension plans might find that cash demands from pension contributions made it difficult to make new investments and spurred layoffs.

The most troubled companies might go bankrupt. Additional cash demands for pension contributions could drive particularly troubled firms into bankruptcy, because they no longer had enough cash to pay debt and make pension contributions. In bankruptcy they could restructure their financial debt and also eliminate the cash drain from pension contributions through a distress termination.

Change funding rules to reduce volatility of contributions

Current funding rules, in combination with pension portfolios that are heavily invested in stocks, have produced swings in required contributions that discourage companies from offering defined benefit pension plans. Many have therefore insisted that reducing the volatility of contributions must be a goal of any pension reform. This is difficult to analyze without a specific proposal, but a few general points can be made.

Pros

Companies might be more inclined to retain defined benefit plans. Executives would be able to plan further in advance and to communicate clearly to the financial markets what the cash cost of contributions would be. This would reduce a major expressed concern of managements and markets.

Cons

All else equal, claims on the PBGC would be larger. Unless other actions are taken, there will be no reduction in the underlying volatility of pension fund adequacy. Funding adequacy changes with the value of investments, changes to benefit formulas, company-specific actions such as layoffs or hirings, changes in lifespans and other demographic factors, and other variables. Reducing the risk to one party by stabilizing company contributions merely shifts the risk to other parties, principally the PBGC but also participants with benefits exceeding guaranteed levels.

For example, contribution requirements went up sharply after the stock market losses from the bursting of the "dot com" bubble. If contributions had been held more stable, then the level of underfunding would have remained higher than it has, increasing the likely size of claims on the PBGC from distress terminations from that time until such point as the stable contribution rules had caught up with the underfunding.

Raise the maximum pension funding limits

The Internal Revenue Code and ERISA place limits on the extent to which firms can make tax-deductible contributions to their pension funds. These limits are intended to reduce the loss of tax revenue while still allowing adequate funding. Some argue that the limits are based more on maximizing taxes than on ensuring sufficient funding and that the limits should therefore be raised. These arguments have become considerably less pressing since the Pension Protection Act of 2006 raised the full funding limitation to 150% of the plan's liabilities. However, we will lay out the arguments, as they remain of theoretical interest.

Pros

Claims on the PBGC might decrease modestly in number and size. Some companies would make more pension contributions during good times, giving them a greater margin for error if trouble struck. Even if they subsequently went bankrupt, funding would be higher, reducing losses to the PBGC and participants.

Sponsors might find it marginally more attractive to retain defined benefit plans. Firms that were interested in using this provision, and financially able to do so, would be able to reduce their risk of sharp increases in future contribution requirements, since they would have built up a margin for error. They would also have a larger tax break from the tax-exempt status of pension investments, as well as from deductions for their extra pension contributions.

Cons

The budget deficit would widen, at least temporarily. Higher pension contributions would reduce taxes initially. This might be offset over the long run by minimizing or avoiding a taxpayer rescue of the PBGC. The tax losses would be highest in the early years, as those companies that wanted to prefund built up their desired margin of overfunding. After that, contributions should revert roughly to the levels required to match newly accrued benefits.

The companies presenting the most risk to the PBGC are unlikely to prefund. From the point of view of the PBGC as a credit insurer, it would benefit most from additional pension funding at weaker firms. These are generally firms with high levels of debt already, the ones least likely to borrow more to increase their contributions and the ones most likely to prefer using cash flow to pay down existing debt or invest in urgently needed projects. GM's massive borrowing a few years back to pay down its pension underfunding might be cited as a counter-example, but key parts of their argument to the financial markets would not apply here. They argued that they were substituting financial market debt for an equally real liability representing pension underfunding and that eliminating underfunding also avoided the risk of paying variable premiums to the PBGC. Neither of these critical points would be true for overfunding. That said, there could be some firms in cyclical industries that chose to prudently build a margin of error during good times and that are weak enough credits that they would pose a risk to the PBGC without the overfunding.

The "wrong" companies are likeliest to increase funding. Firms with excess cash for which they do not have immediately attractive investment opportunities are the most likely to park the money in their pension funds, accelerating a tax deduction and increasing tax-free investment income. They can potentially retrieve the funds when investment opportunities arise by skipping future contributions, although there could be timing problems. Needless to say, firms strong enough, and conservative enough, to have excess cash tend not to be the ones that present claims to the PBGC down the line.

Raise the PBGC's overall priority in bankruptcy

Under current bankruptcy law, the large majority of the PBGC's claims receive no special treatment. This results in a bankruptcy recovery rate of a few cents on the dollar, while higher priority creditors, such as those with a lien on fixed assets like airplanes, may be fully paid or at least receive a much higher payout ratio. Some have proposed a super-priority status for the PBGC that would result in substantially higher average recoveries.

As explained below, such a change could have powerful effects on the PBGC's position and on the defined benefit system, assuming the change in priority were sufficient to substantially change the PBGC's recoveries. There would be less effect on the PBGC if the details of the legislation left room for other creditors to take actions that would put them back above the PBGC.

Pros

All else equal, the PBGC's finances could improve markedly. The PBGC might easily recover half or more of the underfunding from the estates of bankrupt firms, rather than the current average of a few cents on the dollar.

Weaker firms would have a strong incentive to avoid underfunding. As noted in "Cons" below, other creditors would substantially raise their rates for weak firms with large pension underfunding. Companies would therefore wish to avoid such underfunding.

Cons

Weak firms with large underfunding would have to pay substantially more to other creditors. Higher PBGC recoveries would come out of the hide of other creditors. These creditors would raise their rates significantly to compensate for the risk of receiving less if the firms do go into bankruptcy. In many ways, the financial markets would be imposing the equivalent of a credit-based variable premium. Of course, some creditors, such as people who were promised retiree health insurance benefits, might not be in a position to charge more going forward.

Some weak firms could be pushed into bankruptcy that would otherwise have survived. Higher funding costs could force some weakened companies under. In general, there would be an increase in the speed of decline of firms that are flirting with bankruptcy. Each step down in credit rating would incur a higher cost for those firms with large underfundings, as other creditors increasingly focused on the possibility of bankruptcy in an environment where the PBGC would take a larger piece of the pie.

Lenders may over-react. Pensions are complicated and not well understood by all lenders and capital markets. Some creditors may over-react and shy away altogether from lending to firms with the potential to develop large pension underfunding, or they may charge exorbitant rates. Companies will not always have the time and resources to find an alternative lender who does understand pensions.

Many companies may exit the defined benefit system. Executives at all but the strongest firms pay serious attention to their funding sources. A threat that their pension funding situation could lead to difficulties in borrowing may be enough to trigger the freezing or termination of pension plans.

Severe transition problems are possible. It would be unfair, and politically impossible, to immediately vault the PBGC ahead of other creditors who had lent on the expectation that existing bankruptcy rules would remain. However, any transition arrangement is subject to at least three potential problems. One, creditors might force firms into bankruptcy in advance of the change, even though some of these companies might have otherwise pulled through. Two, longer transition periods that minimize the first problem would fail to protect the PBGC from major claims that might arise in the next decade. Three, even a long transition period might not be long enough to be fair to existing creditors with very long-term obligations.

Bankruptcy proposals face two additional political hurdles. First, the Judiciary committees of both Houses would become involved, adding another party to already complicated negotiations. Second, financial institutions and others interested in bankruptcy legislation would add their voices.

Increase the PBGC's flexibility to negotiate with troubled firms

The PBGC has a limited arsenal of negotiating tools under current law. The biggest is one they have referred to as the "nuclear option", the right to terminate a pension plan involuntarily if they can show a reasonable probability that allowing the plan to continue will produce an unreasonable increase in the claim on the PBGC. This is a politically very unpalatable option. It puts the PBGC, rather than the company that arguably created the problem, in the position of denying employees future pension accruals and cutting back pensions to participants who have amounts above the guaranteed levels. Nonetheless, the PBGC has used the nuclear option, for example, moving at the end of 2004 to involuntarily terminate the pension plan for UAL's pilots. (The PBGC has also used this option many times with small plans, for technical reasons that are not worth detailing here.)

The PBGC also has negotiating flexibility in regard to various technical legal and actuarial issues that arise in given cases, although there they are often bound by the fear of setting an unfavorable precedent for other cases where they would not be receiving any quid pro quo for being as flexible as they might in the specific case.

Some argue that the PBGC should have more room to strike bargains with weak or bankrupt companies, as private insurers and lenders do. One proposal is to allow firms to make up their underfunding over a longer time period if they, and their unions, agree to freeze their pension plans and accept a freeze of the PBGC guarantee level. That is, if a plan were frozen today under this proposal, each participant would be subject to the current $54,000 cap on annual pension benefits paid by the PBGC, even if the plan were terminated in five years, when the cap might otherwise have risen to $60,000. Note that these companies are already able to freeze their plans, with union consent. The change is that the proposal would allow firms that freeze plans to contribute less money each year to catch up on the underfunding than is allowed under current law. In fact, a proposal of this type was incorporated in the Pension Protection Act of 2006 specifically for airlines, a number of whom have taken advantage of this feature. However, there is no ability for companies in general to do this or for the PBGC to assist them in arranging it.

Another proposal, which we will not examine in depth here, would give a bankruptcy judge the ability to modify funding obligations in exchange for freezing or lowering pension promises and limiting PBGC obligations. A bankruptcy judge theoretically has the neutrality and expertise to judge what is a reasonable balance.

Conceptual Basis

There is an underlying policy point that does not fit easily into the Pros and Cons below. This option principally makes sense from a public policy viewpoint if one accepts a key argument of the proposal's supporters. They argue that the companies that would take advantage of this option would be ones that *should* freeze their pension plans, but are unable practically to achieve this without the incentive of lower contribution rules, generally due to union opposition. This option is a non-starter from a policy viewpoint if one believes it would be a mistake to encourage these plans to be frozen. Accepting this argument is a necessary, but not sufficient, condition. Other policy hurdles remain.

Pros

Some companies might avoid bankruptcy, based on lower pension contributions. Cash demands for pension contributions would be lower, which might allow some firms to successfully navigate through hard times.

Other companies might defer bankruptcy. The change might buy time, even if it does not prevent bankruptcy. The PBGC would benefit from any contributions the company has made to pay down its underfunding, since no new benefits would have accrued to add to the claim. The wild card would be the investment performance of the pension fund in the interim, which may or may not have exceeded what the PBGC would have earned with the assets if there had been an earlier termination.

All else equal, frozen guarantee limits would reduce the PBGC claims. The PBGC would benefit, at the expense of participants, if a company terminates in a later year. The lower PBGC cap would reduce its payments, to the extent that some participants would have been entitled to benefit levels falling between the two cap levels.

The PBGC's negotiating position would improve, since it could choose whether to allow the option. Negotiations between the PBGC and the companies would allow the PBGC to determine when it felt there would be an advantage to allowing this choice. It would also have room to negotiate other changes, such as a more conservative investment policy, as a quid pro quo for approval. Political constraints might reduce the PBGC's flexibility, but it would at least be a negotiating tool that does not exist now.

Cons

As noted, this option would encourage exit from the defined benefit system. Companies would have to cease awarding new defined benefit pension benefits in order to qualify. This might be limited by constraining the option to a particular industry, although it may be politically difficult to maintain this constraint over time.

PBGC claims might be higher than without the eased contribution rules, if firms go bankrupt anyway. If lower pension contributions do not prevent bankruptcy, they would increase the underfunding and claim on the PBGC as compared to freezing the plans today without benefit of the eased contribution rules. Depending on how much easing of the rules is allowed, the PBGC might even have been better off with continuing benefit accruals, but considerably larger pension contributions.

Limit the PBGC's guarantee further

There are already limits to the level of pensions guaranteed by the PBGC, of which the principal one is a cap of $54,000 of annual benefit for employees retiring at age 65 under plans taken over by PBGC in 2009. This figure is substantially reduced for early retirees and is lower for plans taken over earlier than 2009. See the discussion earlier in this paper for details on this and other limitations.

Steps to disallow or not guarantee improvements to pension formulas in plans that are very severely underfunded were included in the Pension Protection Act of 2006. This is an attempt to deal with the specific "moral hazard" issue of troubled companies that offer pension increases as a sweetener for employees to accept less attractive cash compensation than they otherwise would. Even if employees, or their union representatives, believe there is a high probability of bankruptcy by the plan sponsor, they know that the PBGC will pick up some portion of the benefit increases. Even before the Pension Protection Act, then-current law already reduced this incentive by phasing in the full PBGC guarantee for benefit increases that occur within 5 years of a subsequent bankruptcy. However, supporters of further guarantee limits believed that this limitation was not fully successful in eliminating the moral hazard issue.

There are also questions, not addressed here, about how to treat increases in pension benefits triggered by plant closings ("shutdown benefits") and whether existing law is fair in how the 5-year phase-in works, since it effectively treats union plans less favorably than non-union plans, to the extent that non-union plans are more likely to use the "final average pay" concept. Finally, some have suggested that lower general guarantee levels in theory would increase participants' incentives to force firms to fund more fully. We are not aware of a specific policy proposal in this regard.

Pros

PBGC claims would be lower.

Arguably, the change would be fairer to "good" plan sponsors. It may be that some of the PBGC's losses come from severely underfunded companies that promise excessive benefits and pass the cost to the PBGC. Since the PBGC is, by law, supposed to be self-supporting, this cost would eventually be passed on to employers, unless there is a taxpayer rescue.

Cons

Pension increases might be constrained unnecessarily at some companies. In some cases, it may be reasonable to raise pension benefits at companies that are likely to survive, despite a short-term cash crunch that prevents bringing their pension funding to appropriate levels.

Increase PBGC investment returns

Some maintain that the PBGC's financial problems were exaggerated by an investment policy that relies heavily on bonds, rather than stocks. For a number of years, the investment policy at the PBGC was to target an allocation of 15-25% of investments in stocks. Virtually the entire remaining amount was in bonds, usually Treasury bonds. Premiums are required by law to be held in bonds, but there is no such limitation on other assets, primarily investments taken over from failed pension plans. The PBGC, under Director Millard, moved towards a somewhat higher allocation to stocks, a decision made not long before the stock market's recent major decline. Even with this move, the PBGC's actual allocation to stocks was only in the area of 30% of its investments.

Proponents believe that increasing the allocation to stocks will raise average returns and reduce the need for more premiums or a taxpayer rescue. Opponents believe that it is inappropriate to introduce the additional level of exposure to volatile stock markets. They prefer to match promises of future pension payments with known future principal and interest payments from bonds, minimizing interest rate and financial market risks.

A variant of this approach would be to own more high-quality corporate bonds, which would have nearly the certainty of the payments from Treasury bonds, but would yield perhaps a percentage point more each year over a long time period. The extra yield is higher in today's market, but is likely to come down over time. (Some of this added return would be eliminated, in practice, by defaults on these high-quality, but not riskless, bonds.) This would have a much smaller effect than increasing stock allocations, but would similarly increase expected returns at the expense of risking worse results.

Pros

Stock returns are expected to exceed those of bonds, on average. Since 1928, the U.S. stock market has returned an average of about 9% per year versus around 5% for long-term government bonds and 4% for short-term bonds. Most financial economists expect a smaller difference going forward for reasons too numerous to describe here. Our informal survey of the literature in 2005 suggested an average forecast of perhaps 3 percentage points greater return from stocks than from long-term government bonds. This difference may have risen by a percentage point or two on average for the next decade as a result of the recent collapse of the stock market. (Many believe that the market has now overshot on the downside, just as it previously overshot on the upside, and will correct over the course of the next decade.)

Cons

Investors receive a higher EXPECTED return because they risk LOWER actual returns. No matter how long the time-frame, there is a risk that stocks will underperform government bonds, or even lose money. That risk is considered to be lower for long time horizons, but it does not vanish. As an extreme example, an investor buying at the peak of the market in 1929 would have been a net loser for 25 years, through 1954. It would have been some years after that before they caught up with bond investors.

Stock market returns generally rise and fall in tandem with bankruptcies. Bankruptcies are significantly more likely to occur in bad financial times, which are also normally bad times for the stock market. The PBGC's losses are closely tied to the level of bankruptcies, so owning stocks essentially "doubles down" on that risk.

Infuse taxpayer funds

General revenues, provided by taxpayers, represent one potential source of funds to fill the PBGC's deficit.

Pros

There would be less pressure on companies to exit the defined benefit system. Every dollar of taxpayer funds that is infused is one dollar less that has to be charged to plan sponsors. As noted, filling the PBGC's current hole through premiums means significantly over-pricing future pension insurance in order to make enough profit to pay for the past.

Arguably, the government created much of the problem and should bear much of the cost. There are at least two variants of this argument. First, some contend that the deficit really represents failed government industrial policy that has helped sink a large part of the steel and airline industries. Take away these two sectors and the PBGC would likely not have a deficit. Second, Congress has set the premium rates and minimum funding rules, including allowing the steel and airline industries extra leniency in funding. Perhaps the government should bear the consequences of its decisions.

Arguably, it is not fair to remaining plan sponsors to bear the full cost of past losses. A small number of companies are responsible for the PBGC's deficit. It may not be fair to transfer that burden onto the plan sponsors that have been "good citizens" by continuing to voluntarily offer defined benefit plans. Unfortunately, the government is the only other entity that might reasonably pick up the bill.

Cons

There may be better uses for taxpayer money. Given the dramatic budget deficits already in existence, adding to those deficits is not appealing. Nor are taxpayers in the mood for another bailout.

Arguably, plan sponsors have been the beneficiaries of the underpricing and should not be bailed out. Congress is supposed to set PBGC premiums at levels sufficient to pay the bills. Industry and union lobbyists have been instrumental in persuading Congress to set the rates as low as they are; often arguing that even these levels were too high. Plan sponsors then benefited from the low premium rates and perhaps ought to bear the costs.

Arguably, taxpayers should not be asked to bail out a group more affluent than the average taxpayer. People in defined benefit plans may be better off than the average taxpayer. To the extent that they are, it magnifies the perceived unfairness of asking taxpayers who have never had a chance to be in a defined benefit plan to bail out others who have had that opportunity. On the other hand, given the progressive nature of taxation, it is not clear that the percentage of taxes coming from each segment of the income spectrum is distributed any more progressively than is the percentage of pension income going to each participant.

Privatize the PBGC

Richard Ippolito, former Chief Economist of the PBGC, has proposed that the federal government remove itself from the business of guaranteeing pensions. (His paper is available at www.cato.org.) Taxpayers would pick up the existing deficit, near-term expected claims, and future operating expenses related to existing and near-term expected claims. At the time of his proposal, he estimated this at $18.7 billion, based on runs of PBGC's PIMS financial model done as of the end of fiscal 2003. The PBGC's own recent modeling suggests this figure might now be about $26 billion. COFFI's analyses indicate that the number could be much greater than that, a concern magnified by the potential for a claim on the PBGC related to GM of $20 billion or more.

The core of the idea is that companies would be required to form a true self-insurance pool, with no possibility of further federal aid. (He believes that companies should be allowed at some point to buy private market insurance and exit the pool, but he does not address the mechanisms for this.) Ippolito postulates that under those conditions the pool members would set a variable premium that would apply to all underfunding, calculated on a true market basis. This variable premium would be at the same rate for all firms, with no gradations for creditworthiness. The rate would change from year to year, being set at the level necessary for the risk based on that year's business and financial market conditions.

Pros

Taxpayer costs would be limited to the initial rescue. If the pool is truly self-sufficient, no further funds would be forthcoming from the government. (However, see "Cons" for doubts about how this would work.)

Companies could not "game" the system. Firms that took actions which increased underfunding would soon find themselves paying substantially higher premiums to compensate other pool members for that risk.

Well-funded pension plans would draw low premium costs, encouraging the continuance of sound plans. All premiums would be based on underfunding, so firms with little underfunding would pay very little.

Cons

Taxpayers would be faced with a major up-front cost. As noted above, the cost is unlikely to be less than $30 billion and could easily be $50 billion or more, depending on near-term business conditions and actions triggered by transition considerations. Note that the proposal itself does not necessarily increase the present value of the eventual costs, but it does cause them to be borne by the taxpayers up-front.

Taxpayers would likely remain an implicit guarantor. It is difficult to envision how companies would be persuaded not to lobby for a rescue if the pool developed a large deficit, particularly in the first decade. A large deficit in the early years of operation would almost certainly be blamed on an insufficient initial payment from the government. Even if the problem occurred later, or could not reasonably be tied to the initial funding, lobbyists would likely assert that the pool was established by the government and that companies were forced to participate in a scheme that proved unsound. It is instructive to remember that the PBGC technically is already supposed to act as a self-insured pool, since premiums are intended to be set at break-even levels and federal support is limited by law to a potential $100 million loan.

Variable premium levels could prove very high, forcing some firms into bankruptcy. If the pool were to encounter again years such as 2002-4, it would need roughly $10 billion a year in variable premiums to stay

even. Spread over 2008's estimated $250 billion in underfunding this would come to a roughly 4% charge on each dollar of underfunding. However, anticipation of the possibility of high variable rates would likely lead the stronger companies to fully fund, leaving only the weaker credits still underfunded. This might leave a $10 billion charge to be spread over perhaps $100 billion of underfunding which would be a 10% charge on each dollar of underfunding. Faced with that calculation, even the strongest of the weak credits would find a way to borrow and fund, but that would leave the very weakest companies with an overwhelming premium burden that could be 20% or more of the underfunded amount.

Admittedly, the proposal would over time encourage better funding so that there would likely not be many years with $10 billion in claims, but it is hard to see how this would have been accomplished in the first years of operation, given how many weak companies have major underfunding today. It might also be possible to deal with this problem by running deficits at the pool and spreading the premium cost over time, but this could produce other severe problems, including a higher likelihood of a government bailout of the pool.

Incentives to fund would be so strong as to be equivalent to extremely tight funding rules. All of the potential disadvantages of tight funding rules would exist in great measure.

It appears politically infeasible. Even if policymakers determined that the pool concept was desirable, it would likely be opposed strongly by virtually every segment of the pension community. All firms would dislike the pressure to fully fund so quickly. Strong firms would worry about being stuck with excessive losses from weak firms, without hope of government aid. Weak firms would worry about overwhelming cash contribution requirements and high premium rates.

Other generic proposals

Other ideas have been advanced that are difficult to assess without specific details. For example, virtually everyone agrees that greater "transparency" would be helpful. Participants and financial markets could then better understand a company's situation and would have incentives to encourage sensible behavior that would protect these stakeholders. The devil, however, is in the details. Some steps in this direction were taken in the Pension Protection Act of 2006, but it is difficult to measure the effects of these changes, given everything else going on in the markets and the economy.

The idea has been raised of giving the PBGC some regulatory authority over pension funds. For example, it might be allowed to limit the level of investment risk taken by seriously underfunded plans. Again, this is difficult to judge without a specific proposal and would need to be compared to existing authority held by the Department of Labor to ensure prudent management by pension trustees.

GLOSSARY

Actuarial assumption: One of the technical assumptions that are the basis for actuarial calculations. Examples include estimated life expectancies, retirement dates, and discount rates.

Actuary: A statistician who estimates characteristics, such as lifespans and retirement ages, of individuals and groups eligible for pensions or insurance.

Asset/liability matching: The technique of choosing investments to match the expected cash inflows to a set of future cash outflows.

Benefit accrual: The additional benefit earned with the passage of time, and possibly with an increase in salary.

Cash balance plan: A defined benefit pension plan that bases benefits on hypothetical individual accounts. Contributions to the accounts are usually based on current pay levels. The balance also grows based on interest credits. It is a common type of hybrid pension plan.

Cash flow: A cash payment or receipt, now or in the future.

Deficit reduction contribution: An additional pension contribution beyond that otherwise required, due from plan sponsors of certain underfunded pension plans. Only single-employer plans with more than 100 participants are subject to the deficit reduction contribution requirement.

Defined contribution pension plan: A pension plan with individual accounts where the amount ultimately paid to the exiting employee is based on the level of contributions plus or minus actual investment returns.

Discount rate: The interest rate used to calculate a present value.

Distress termination: A company-initiated termination of an underfunded defined benefit pension plan according to rules laid out in ERISA. The plan sponsor must be in severe financial trouble and is often in bankruptcy.

Early retirement benefit: A pension benefit received by someone who retires before the retirement age defined in a pension plan as normal. In many plans, the early retirement benefit is subsidized. That is, the present value of the early retirement benefit is greater than the present value of the benefit that would be received if the employee retired at normal retirement age.

ERISA: The Employee Retirement Income Security Act of 1974. The basic federal law that, along with the Internal Revenue Code, governs employee benefits. It generally pre-empts state laws in this area.

Final average pay formula: A formula to determine benefits in many defined benefit plans. The annual benefit is equal to the employee's highest compensation averaged over a specified number of years, multiplied by both years of service and an accrual rate per year of service.

Final determination of benefits: The final determination by PBGC of the amount of benefits owed to a retiree under a plan taken over by PBGC. The complexity of rules on guarantee limits and priority of

payments forces PBGC to pay an estimated benefit for some time after taking over a plan. After the final benefit determination is made, PBGC makes up any shortfall in estimated payments in a lump sum payment that includes accumulated interest. Any overpayments are recouped (without interest) by temporarily reducing future benefit payments.

Flat-rate PBGC premium: A per participant premium charged to all insured single-employer and multi-employer pension plans. The rate for single-employer plans is currently $34 per participant and the rate for multi-employer plans is $9 per participant.

Funding waiver: A waiver granted by the IRS that allows a plan sponsor to defer a pension contribution from the present year and to spread the payments over the next five years. ERISA defines fairly restrictive conditions for granting a waiver. Interest is charged and the IRS may require collateral.

GAAP: Generally Accepted Accounting Principles, the rules under which accounts must be kept for most private sector bookkeeping. PBGC reports under GAAP, as do certain other public entities.

Hybrid pension plan: A defined benefit pension plan that attempts to mimic many aspects of a defined contribution plan, for example, a "cash balance" plan.

Involuntary termination: A PBGC-initiated termination of an underfunded defined benefit pension plan, following procedures laid out in ERISA. PBGC must involuntarily terminate a plan if it is unable to pay benefits when due and *may* terminate a plan if it determines the underfunding in the plan will increase unreasonably if the plan is not terminated.

Lump sum payment: A single payment to a departing employee in lieu of monthly pension benefits in retirement. It is calculated as the present value of the employee's entire accrued pension benefit.

Multiemployer insurance program: The PBGC insurance program for pension plans that are established pursuant to a collective bargaining agreement between employees and two or more unrelated employers.

Off budget: An account that does not directly affect the calculation of the federal government's deficit or surplus.

On budget: An account that directly affects the calculation of the federal government's deficit or surplus.

Participant: Someone who is or may become eligible to receive a benefit from a pension plan. Participants include current employees, former employees with vested benefits, retirees collecting benefits, and beneficiaries of deceased vested employees.

PBGC Put: A slang term for the historical ability of plan sponsors to shed their pension obligations in exchange for turning over 30% of their net worth to PBGC. The term is sometimes still used, although the actual rules for turning obligations over to PBGC are far more stringent now.

PBGC's maximum single-employer benefit guarantee: The maximum amount that PBGC, by law, can pay as an annual pension benefit to a retiree from an underfunded single-employer plan that has been taken over by PBGC. The effective cap is lower for those retiring prior to age 65. However, if the plan has sufficient assets, some retired participants may receive benefits higher than this guarantee level. Also, if PBGC

recovers assets from the plan's sponsor in bankruptcy proceedings, some participants may receive benefits that exceed the guarantee.

Pension trust: A trust fund set up under local trust law to receive contributions from the plan sponsor, invest plan assets, and pay pension benefits to plan retirees and beneficiaries.

Plan amendment: A legal change to the terms of a pension plan.

Plan freeze: The cessation of the crediting of new pension benefits to employees based on additional years of service, without termination of the pension plan. In a "soft freeze" benefits may still rise in final average pay plans if salaries rise. In a "hard freeze" benefits do not rise at all.

Plan sponsor: An employer who establishes or maintains a pension plan for its employees.

Plan termination: The ending of a defined benefit pension plan according to procedures prescribed by ERISA.

Prefund: To put aside money in advance of the need for payment.

Present value: The value in the present day that is economically equivalent to one or more payments in the future. The present value is determined by discounting the future payments using a specified discount rate.

Probable loss: A loss from an underfunded pension plan that PBGC determines is expected to terminate in the future.

Reasonably possible loss: A potential loss from an underfunded pension plan of a sponsor experiencing financial problems. However, this will be recorded instead as a probable loss if PBGC believes the sponsor's financial condition is so grave that it will have to terminate the plan in the foreseeable future.

Shutdown benefit: A supplemental or early retirement pension benefit in some plans that only becomes available if a plant or an entire company closes down.

Single-employer insurance program: The PBGC insurance program that covers insured defined benefit plans that do not fall into the Multi-employer program.

Standard termination: A termination of a well-funded defined benefit plan according to rules laid out in ERISA. The plan sponsor arranges for an insurer to take over all pension obligations except those where the employee or retiree chooses to take a lump sum payment from the pension plan.

Survivor benefits: Pension benefits paid to the named beneficiary of a deceased vested participant.

Termination liability: The estimated cost of terminating a pension plan and buying a group annuity from an insurance company to cover all pension obligations.

Variable rate PBGC premium: An insurance premium charged to underfunded single-employer plans by PBGC of 0.9% of pension underfunding.

Vesting period: A period of employment that must pass before a new participant in a pension plan earns a non-forfeitable right to benefits accrued under the plan.

Withdrawal liability: The obligation of a withdrawing sponsor from a multi-employer plan to pay its share of the unfunded vested benefits as of the time of its withdrawal.

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