STATEMENT OF STEVEN A. KANDARIAN
Executive Director
PENSION BENEFIT GUARANTY CORPORATION
Before the
COMMITTEE ON FINANCE
UNITED STATES SENATE
MARCH 11, 2003

Mr. Chairman, Ranking Member Baucus, and Members of the Committee:

Good morning. I am Steven A. Kandarian, Executive Director of the Pension Benefit Guaranty Corporation (PBGC). I want to thank you for holding this hearing and for the interest you have in the retirement security of America's workers.

This hearing is especially timely. During FY 2002 PBGC's single-employer insurance program went from a surplus of $7.7 billion to a deficit of $3.6 billion – a loss of $11.3 billion in just one year. This loss is more than five times larger than any previous one-year loss in the agency's 28-year history. In addition, we estimate that the total underfunding in the single-employer defined benefit system now exceeds $300 billion, the largest number ever recorded. I appreciate the opportunity to appear before you today to speak about these important issues.

State of the PBGC

PBGC was created as a federal corporation by the Employee Retirement Income Security Act of 1974 (ERISA). PBGC protects the pensions of nearly 44 million workers and retirees in more than 32,000 private defined benefit pension plans. PBGC's Board of Directors consists of the Secretary of Labor, who is the chair, and the Secretaries of the Treasury and Commerce.

PBGC insures pension benefits worth $1.5 trillion and is responsible for paying current and future benefits to 783,000 people in over 3,000 terminated defined benefit plans. As a result of the recent terminations of several very large plans, PBGC will be responsible for paying benefits to nearly 1 million people in FY 2003. Similarly, benefit payments that exceeded $1.5 billion dollars in FY 2002 will rise to nearly $2.5 billion in FY 2003.

No Full Faith and Credit; No Federal Tax Dollars

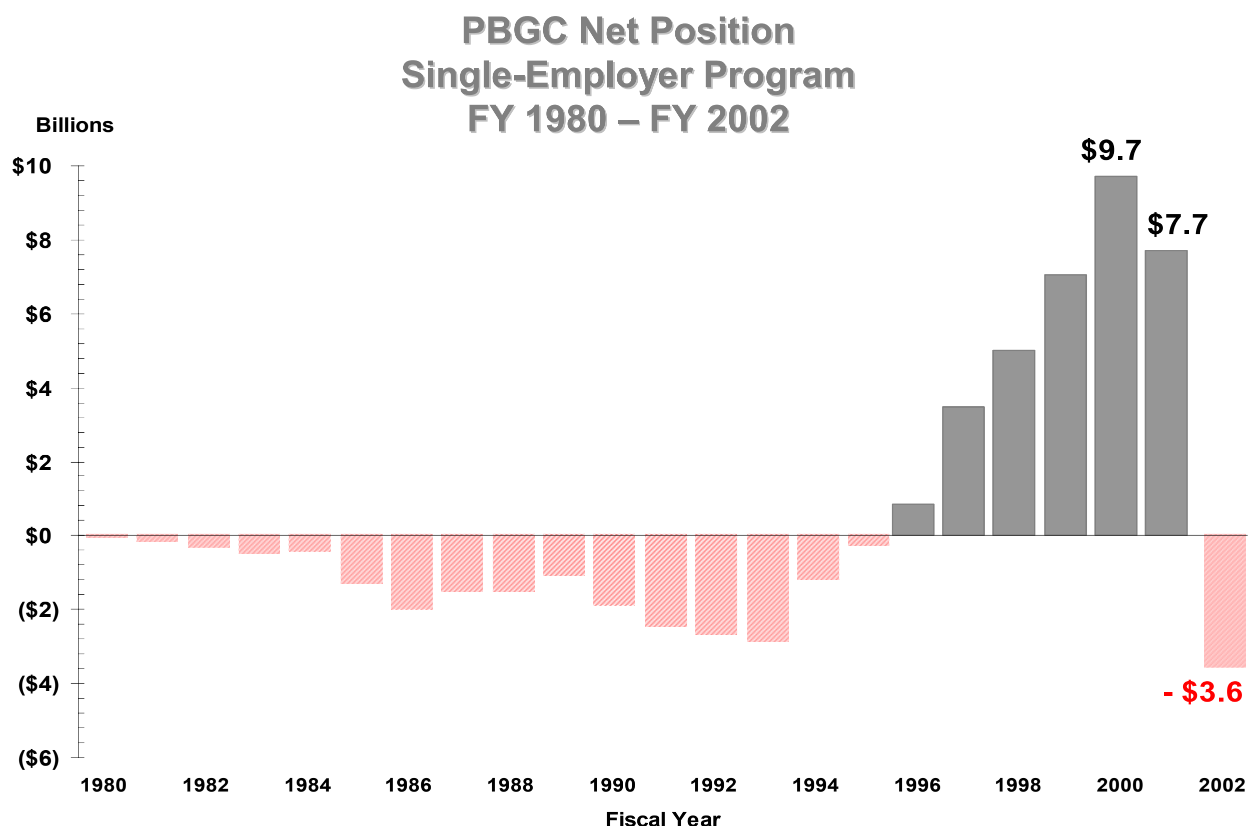
While PBGC is a government corporation under ERISA, it is not backed by the full faith and credit of the federal government. Moreover, PBGC receives no federal tax dollars. Instead, PBGC is funded by four sources: the insurance premiums paid to PBGC by defined benefit pension sponsors, the assets of pension plans that PBGC has trusteed, recoveries in bankruptcy from former plan sponsors (generally only cents on the dollar), and earnings on invested assets.

When PBGC takes over pension plans that are underfunded by billions of dollars, it is the premium payers – employers that sponsor defined benefit plans – who bear the cost. Financially healthy companies with well-funded pension plans end up subsidizing financially weak companies with chronically underfunded pension plans. As a result, over time, strong companies with well-funded plans may elect to leave the system. This potential for "adverse selection" could pose a real problem for the insurance program.

Health of PBGC's Programs

PBGC operates two financially independent insurance programs, the larger single-employer program and a smaller program for multiemployer plans (i.e., plans set up between a union and two or more employers). The multiemployer program has been in surplus since 1980. The single-employer program, however, was in deficit for 21 years from 1974 until 1995.

For six years, from 1996 until 2001, the single-employer program was in surplus, reaching a surplus of almost $10 billion in FY 2000. The surplus grew substantially during these years because of PBGC's investment gains during the stock market boom and because PBGC did not have to trustee any plans with large amounts of underfunding.



Data does not include restored LTV plans in 1986

During FY 2001 and FY 2002, however, PBGC's surplus rapidly deteriorated and has now disappeared altogether, leaving PBGC with a deficit of $3.6 billion. Our deficit was caused by the failure of a significant number of large companies with highly underfunded plans. These include the plans of the retailers Bradlees, Caldor, Grand Union, and Payless Cashways; steelmakers including LTV, Acme, Empire, Geneva, and RTI; other manufacturers such as Singer, Polaroid, Harvard Industries, and Durango; and Trans World Airlines. Mr. Chairman, pension claims for 2002 alone were greater than the total claims for all previous years combined. At current premium levels, it would take about 12 years of premiums to cover just the claims from 2002.

In December 2002, PBGC terminated the plans of two other major steel companies with extremely large underfunding: National Steel and Bethlehem Steel, both of which are included in the $3.6 billion deficit figure. In addition, in our most recent annual report, PBGC reported exposure to additional claims totaling $35 billion, which we categorize as "reasonably possible." Of this $35 billion, about half represents underfunding in airline and steel plans.

Over the longer term, exposure and expected claims are more difficult to quantify. However, we expect that our deficit may increase dramatically.

Large plan terminations with low funding levels drove PBGC into deficit, and additional large claims may increase that deficit. However, the current $3.6 billion dollar deficit, even though it is the largest in history, does not create an immediate liquidity problem for PBGC – we will be able to continue paying benefits for a number of years. But with $29 billion in benefit liabilities and only $25 billion in assets, we should not wait to put the insurance program on a sound financial basis. We should not pass off the cost of today's problems to future generations.

Recently, some have argued that, because PBGC is not in any immediate danger of running out of cash, there is no need to address the issue of pension underfunding. We believe this view is misguided.

Mr. Chairman, Congress heard the same argument in 1987 and again in 1994 when Congress strengthened pension security for workers. Without those reforms, workers and the PBGC would be in even worse shape today.

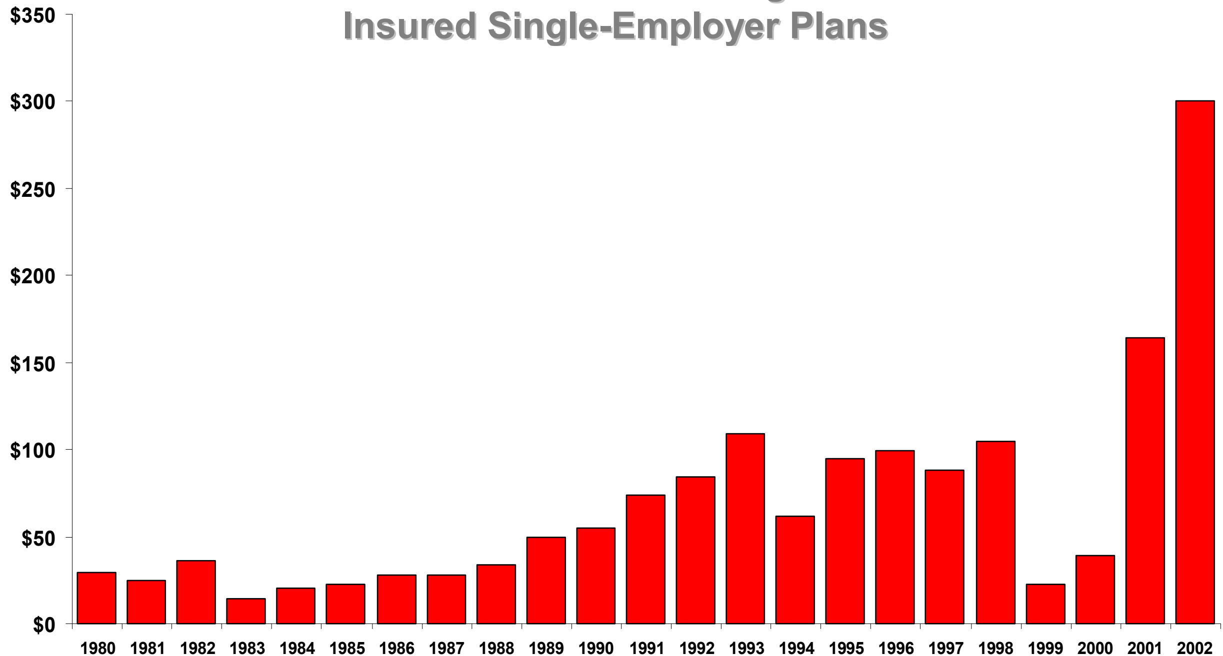
<u>State of the Defined Benefit Pension System</u>

Defined benefit plans are an important source of retirement income security for rank-and-file American workers. The defined benefit system is not in crisis, but there are structural problems that need to be addressed.

As you know, Mr. Chairman, our pension system is voluntary. In recent years, many employers have chosen not to adopt defined benefit plans, and other employers have chosen to terminate their existing defined benefit plans. Since 1986, 97,000 plans with 7 million participants have terminated. In 95,000 of these terminations the plans had enough assets to purchase annuities in the private sector to cover all benefits earned by workers and retirees. The remaining 1,800 were PBGC terminations where companies with underfunded plans shifted their unfunded pension liabilities to the insurance program, resulting in benefit reductions for some participants since ERISA doesn't guarantee all employer-promised pension benefits.

Of the 32,000 defined benefit plans that remain ongoing, many are in our oldest, most mature industries. These industries face growing benefit costs due to an increasing number of retired workers, a problem compounded by increased competition.

At the same time, equity investments have suffered a large decline and pension liabilities have ballooned due to falling interest rates. As a result, underfunding in private sector defined benefit plans is now estimated to exceed a record $300 billion. Last year over 270 corporations reported to PBGC that they had pension plan underfunding greater than $50 million. This is more than three times the number of corporations that have reported to PBGC in any year in the past. In addition, about 150 major US corporations are now in bankruptcy, many of which have defined benefit plans.



PBGC estimates from Form 5500 and Section 4010 Filings

Firms Presenting the Largest Claims
FY 1975 – Present

	Fiscal Year of Plan Termination	Claims (Billions $)	Covered Participants	Funded Ratio*
Bethlehem Steel	2003	$ 3.9	95,000	45%
LTV Steel	2002	1.9	79,600	56%
National Steel	2003	1.3	35,400	47%
Pan American Air	1991, 1992	0.8	37,500	31%
Trans World Airlines	2001	0.7	34,300	39%
Eastern Air Lines	1991	0.6	51,200	65%
Wheeling Pitt Steel	1986	0.5	22,100	27%
Polaroid	2002	0.4	11,400	65%
Sharon Steel	1994	0.3	6,900	21%

* Funded ratio at termination for PBGC benefits; participants lose additional benefits not covered by PBGC

During the last economic downturn in the early 1990s, the pension insurance program absorbed what were then the largest claims in its history -- $600 million in underfunding for the Eastern Airlines plans and $800 million for the Pan American Airlines plans. Those claims seem modest in comparison to the plans we have taken in lately: $1.3 billion for National Steel, $1.9 billion for LTV Steel and $3.7 billion for Bethlehem Steel. Underfunding in some of the troubled airlines may be larger still.

With pension promises growing and with the percentage of plan underfunding remaining in the same range for a decade or more, the dollar amount of pension underfunding has skyrocketed. Meanwhile, PBGC's premium collections have remained flat at roughly $800 million a year. Raising premiums enough to cover losses of the size the PBGC endured in 2002 could prove counter-productive, driving the financially healthy companies out of the defined benefit system.

Challenges Facing the Defined Benefit System

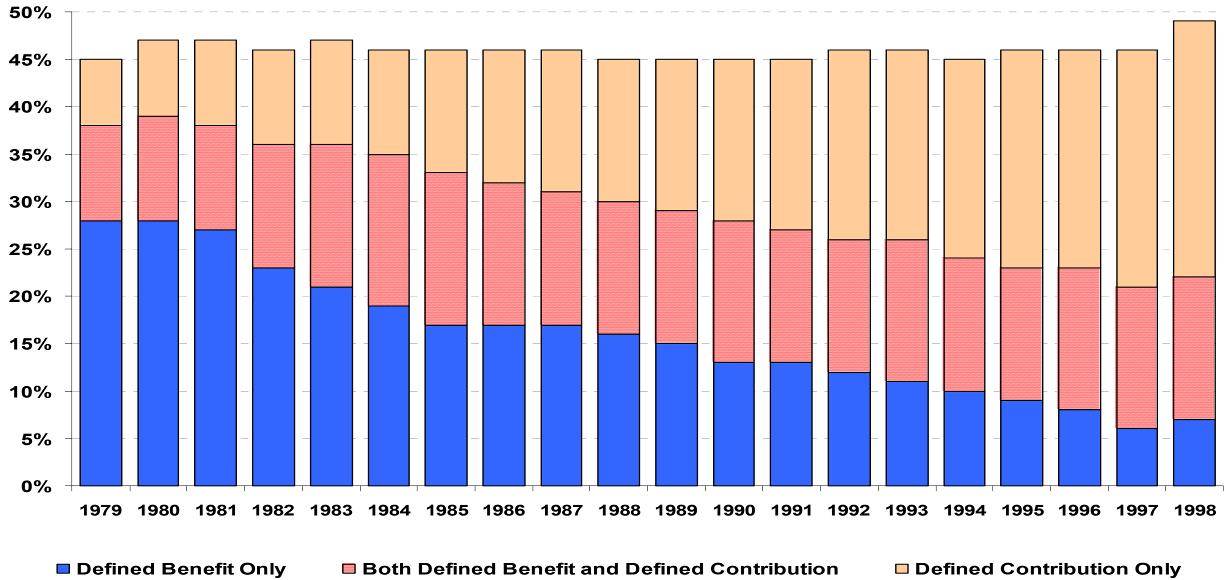
There are a number of challenges facing the defined benefit system, including the following:

The current funding rules are inadequate to ensure sufficient pension contributions for those plans that are chronically underfunded. To our knowledge, none of the defined benefit pension plans responsible for the $300 billion in underfunding is in violation of law. Companies with hugely underfunded plans have followed the funding requirements of ERISA and the Internal Revenue Code.

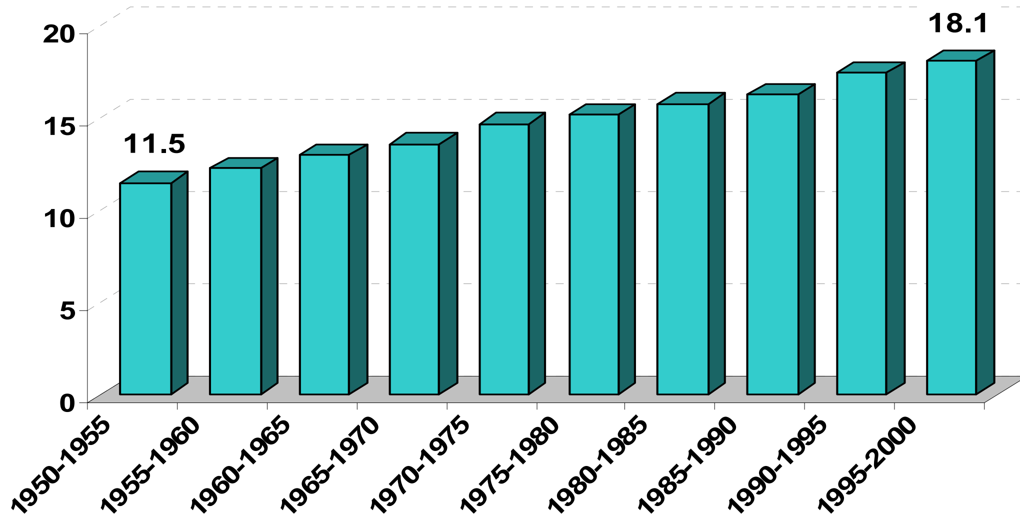
When PBGC trustees these underfunded plans, participants often complain that "there ought to be a law" requiring companies to fund their plans. Mr. Chairman, there is a law, but it is inadequate to fully protect the pensions of America's workers when their plans terminate. The funding targets are simply not high enough for the plans of companies at the greatest risk of termination. Allowing companies to compute contribution requirements based on asset and liability numbers that are averages of prior years can further defer funding. Finally, nothing in the funding rules requires companies with underfunded pensions to make annual cash contributions to the plan.

Another trend impacting the defined benefit system is increased in competitive pressures that have led companies to look at their entire cost structure. During the 1990's, some workers did not place a high value on their defined benefit plans, and the costs to plan sponsors have been volatile. As a result, many companies are increasingly unable to afford or unwilling to maintain defined benefit plans and are moving to 401(k) and other defined contribution arrangements.

In addition, demographic trends have made defined benefit plans more expensive. With workers retiring earlier and living longer, plans must pay annuities for far longer. Today, the average life expectancy of the 65-year old male has grown to 16.1 years, and the average age of retirement has dropped to 62. As a result, the number of years of retirement has increased from 11.5 in 1950 to 18.1 today, an additional seven years of retirement which must be funded.



Source: U.S. Department of Labor
Pension and Welfare Benefits Administration
Abstract of 1998 Form 5500 Annual Reports Winter 2001 - 2002

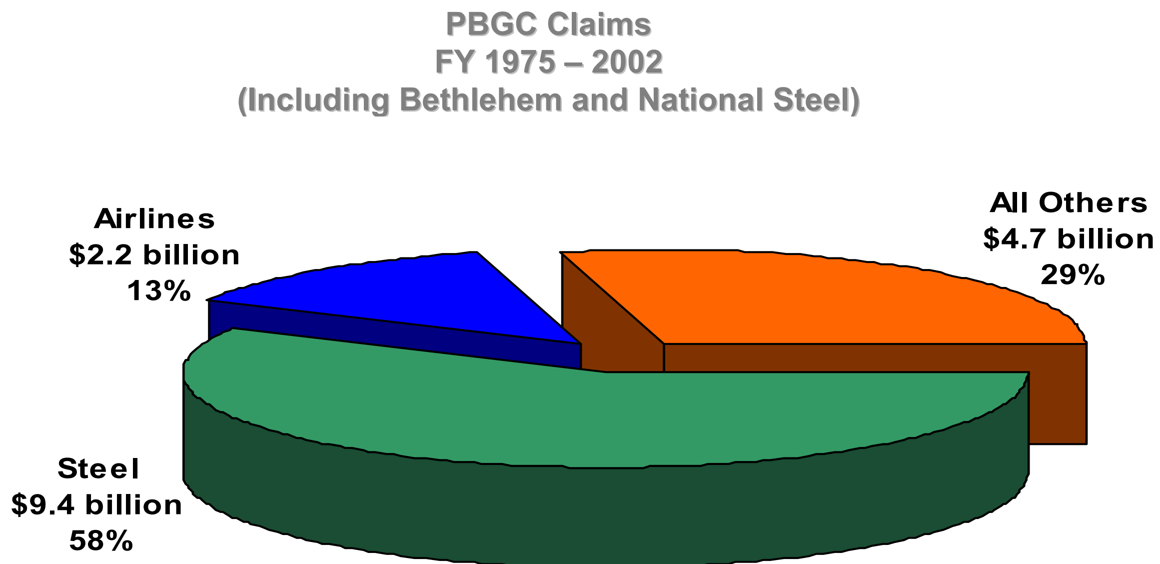


Another problem is that the current disclosure rules do not require timely data that would help participants and shareholders understand the funding status of plans and the consequence of pension underfunding. The current value of plan assets and liabilities is not transparent to workers, retirees, investors, or creditors. Timely, accurate data would allow the capital markets to inject some discipline into the system and allow participants to protect their interests.

Congress added new requirements in 1994 providing more timely data to PBGC and expanding disclosure to participants in certain limited circumstances, but our experience tells us those disclosures are not adequate. The information provided to PBGC is confidential, so its impact is limited. And the notices to participants do not provide sufficient funding information to inform workers of the consequences of plan termination. Workers in many of the plans we trustee are surprised when we have to tell them their plans are underfunded. They are also surprised to find that PBGC's guarantee does not cover certain benefits, including early retirement benefits not yet fully earned.

Problems in the Steel and Airline Industries

In addition to the issues affecting the defined benefit system as a whole, there are also challenges facing specific economic sectors, including steel and airlines. PBGC is watching these two industries closely because they have accounted for some 70 percent of the claims against PBGC but fewer than 5 percent of insured participants. Steel, with less than 3 percent of participants, has accounted for 58 percent of PBGC's claims, and the airlines, with about 2 percent of participants, have constituted 13 percent of claims.



Airline pension plans currently have about $18 billion in underfunding. Almost all carriers are losing money today. Two major carriers are currently in bankruptcy -- US Airways and United Airlines – and several others are financially troubled.

To reduce its pension costs, US Airways asked PBGC (late in 2002) to terminate the company's pension plans, immediately restore those plans, and provide 30 years to fund them. PBGC does not have the legal authority to terminate and restore the US Airways plans. Moreover, we do not believe it would have been wise to grant the request even if we had the legal authority to do so.

We understand the financial difficulties many companies are facing and we are sympathetic to those workers who would suffer significant cutbacks if their plans were terminated. However, relaxing the funding rules for plans of companies in financial distress would set a dangerous precedent for the pension insurance program and put further at risk the integrity of the overall defined benefit system.

Furthermore, providing this special relief to US Airways would give it a competitive advantage over other airlines. It would also give other financially distressed companies a blueprint for evading the statutory funding rules at the expense of the pension insurance system and the 44 million workers it protects. Mr. Chairman, this is a slippery slope.

If US Airways, why not other financially troubled airlines? If airlines, why not companies in other industries?

Possible Reforms

Mr. Chairman, we believe there are three basic options to deal with the problems facing the defined benefit system.

First, we could do nothing and hope that the system will self-correct. This approach risks putting off today's problems to the next generation.

Second, Congress could enact a large, across-the-board premium increase, a change that seems unfair to those well-funded plans that are already subsidizing the system.

Or third, we could look at how best to move underfunded plans to appropriate target funding levels over a reasonable period of time.

In an effort to improve pension security for workers and retirees by strengthening the financial health of the defined benefit system, PBGC and the Departments of Labor, Treasury, and Commerce are currently examining a number of possible solutions. These ideas are still in the developmental stage, but I would like to share with you some of our concerns.

Mr. Chairman, under current law benefits can be increased with little new funding as long as the plan is at least 60% funded. We are examining whether the 60% threshold should be increased. In too many cases, management and workers in financially troubled companies may agree to increase promised pensions. The cost of wage increases is immediate, while the cost of pension increases can be deferred. When plans of financially weak companies terminate, the pensions may be fully protected by PBGC's guarantee, although they have not been funded.

Another problem is that under current funding rules, a company with an underfunded plan may not be required to make an annual pension contribution. Under current law, many of the companies that had plans that were highly underfunded when trusteed by PBGC did not have to make contributions for many years prior to termination. In addition, funding and premium rules do

not take into account a company's financial health and the resulting risk to the pension protection system.

Still another concern is the need for fuller disclosure of the funded status of pension plans. For example, only participants in plans below a certain funding threshold receive annual notices of the funding status of their plans, and the information provided does not reflect what the underfunding likely would be if the plan terminated. In addition, PBGC is prohibited from publishing termination liability data.

A final concern is the financial integrity of the pension insurance program. A strong benefit guarantee program is necessary to assure the long-term stability of the defined benefit pension system. To discourage moral hazard, ERISA provides for the sharing of risk by companies and participants as well as PBGC. To fulfill this sound principle, we must work to better link guarantees to the funding of benefits. For example, current law requires that PBGC in many cases pay shutdown benefits – which are subsidized and supplemental early retirement benefits triggered by plant shutdown or permanent layoffs -- even though funding of these benefits does not begin until the shutdown or layoff has occurred. These shutdown benefits – which are similar to severance benefits not guaranteed by PBGC -- account for billions of dollars of PBGC's unfunded liability exposure.

Finally, PBGC is examining its premium structure in light of the massive increase in claims. Under the current structure, premiums are computed based solely on the number of plan participants and the dollar amount of pension underfunding. The formula does not attempt to reflect the risk of a claim from a given plan. In general, however, we continue to believe that well-funded plans represent a better solution for participants and the pension insurance program than any changes we could make on the premium side.

Conclusion

Mr. Chairman, we are working to find ways to improve pension security for workers and retirees by strengthening the financial health of the voluntary defined benefit system.

Former Representative J.J. [Jake] Pickle was one of the chief advocates of the 1987 and 1994 reforms. His comments on the floor at the time the 1994 pension reforms were enacted are something we should remember:

> "I note that I would have personally preferred to make these reforms much stronger, and I caution my colleagues that they should not expect these reforms to immediately solve all the problems caused by underfunded pension plans. In order to overcome strenuous objections by certain automobile, steel, and airline companies we have included very generous transition rules for companies which have maintained chronically underfunded pension plans. . . . I deeply regret that we have given another reprieve to companies who have shirked their pension obligations for the 20 years since the passage of [ERISA]."

Congressional Record, 103rd Cong., 2nd Sess., H11477, Nov. 29, 1994.

Mr. Chairman, the existence of the pension insurance program creates moral hazard, tempting management and labor at financially troubled companies to defer their pension obligations. This unfairly transfers the cost of underfunded pension plans to responsible companies and their workers. These financially strong companies at some point will have had enough, and will exit the defined benefit system, leaving only those which pose the greatest risk of claims. We need to make sure the incentives in the system are changed so this doesn't happen.

Again, I thank the Chairman for inviting me to testify this morning. I will be happy to answer any questions.