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Budget, House of Representatives

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PRIVATE PENSIONS:

The Pension Benefit Guaranty Corporation and Long-Term Budgetary Challenges

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Comptroller General of the United States



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Highlights of [GAO-05-772T](#), testimony before the Committee on the Budget, House of Representatives

Why GAO Did This Study

More than 34 million workers and retirees in over 29,000 single-employer defined benefit plans rely on a federal insurance program managed by the Pension Benefit Guaranty Corporation (PBGC) to protect their pension benefits. However, the single-employer insurance program's long-term viability is in doubt, and this may have significant implications for the federal budget. In fiscal year 2004, PBGC's single-employer pension insurance program incurred a net loss of \$12.1 billion, and the program's accumulated deficit increased to \$23.3 billion. Further, PBGC has estimated that it is exposed to almost \$100 billion of underfunding in plans sponsored by companies with credit ratings below investment grade.

This testimony provides GAO's observations on the nature of the challenges facing PBGC and why it is preferable for Congress to act sooner rather than later. This testimony also notes the broader context in which reform proposals should be considered and the criteria that GAO has suggested for reform.

www.gao.gov/cgi-bin/getrpt?GAO-05-772T.

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PRIVATE PENSIONS

The Pension Benefit Guaranty Corporation and Long-Term Budgetary Challenges

What GAO Found

A combination of recent events, long-term structural problems, and weaknesses in the legal framework governing the defined benefit system has left PBGC with a significant long-term deficit and many large plans badly underfunded. Lower interest rates and equity prices since 2000 have increased the present value of pension liabilities and lowered the value of significant portions of pension plan assets. Meanwhile, PBGC is exposed to significant risk from underfunded plans in key industries at the same time that its revenue base is threatened by the long-term decline in defined benefit plan participation. In addition, the basic legal framework governing pension insurance and plan funding has failed to help ensure that plan sponsors deliver on their pension promises and safeguard the PBGC's financial condition. PBGC's current premium structure does not properly reflect the risks to its insurance program and facilitates moral hazard behavior by plan sponsors. Further, current pension funding rules have not provided sufficient incentives for plan sponsors to properly fund their benefit obligations. As a result, bankrupt plan sponsors, acting rationally and within the rules, have transferred the obligations of their large and significantly underfunded plans to PBGC. These weaknesses contribute to and are exacerbated by a lack of timely, accurate and transparent information that make it difficult for participants, investors, and others to have a clear understanding of the true financial condition of pension plans.

Comprehensive reform is required to ensure that workers and retirees receive the benefits promised to them. Ideally, effective reform would

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

Pension reform is only part of a broader fiscal, economic and retirement security challenge. Looking ahead in the federal budget, Social Security, together with Medicare and Medicaid, will dominate the federal government's future fiscal outlook. Reform should also be considered in the context of the problems currently facing our nation's Social Security system. Importantly, as is the case with Social Security, acting sooner rather than later will make comprehensive pension reform less costly and more feasible.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the problems and long-term challenges facing the defined benefit (DB) pension system, the Pension Benefit Guaranty Corporation (PBGC), the retirement security of workers and retirees covered by DB plans, and American taxpayers. In particular, I will discuss the factors contributing to those problems and suggest elements of the comprehensive reform necessary to address them.¹ As I have noted before, these problems are a subset of the broader challenges facing the federal government and our nation's retirement income system.² These programs, which include Social Security, Medicare, and Medicaid, represent large, growing, and unsustainable claims on the federal budget because America's population is aging, life expectancies are increasing, workforce growth is slowing, and health care costs are rising.

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

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

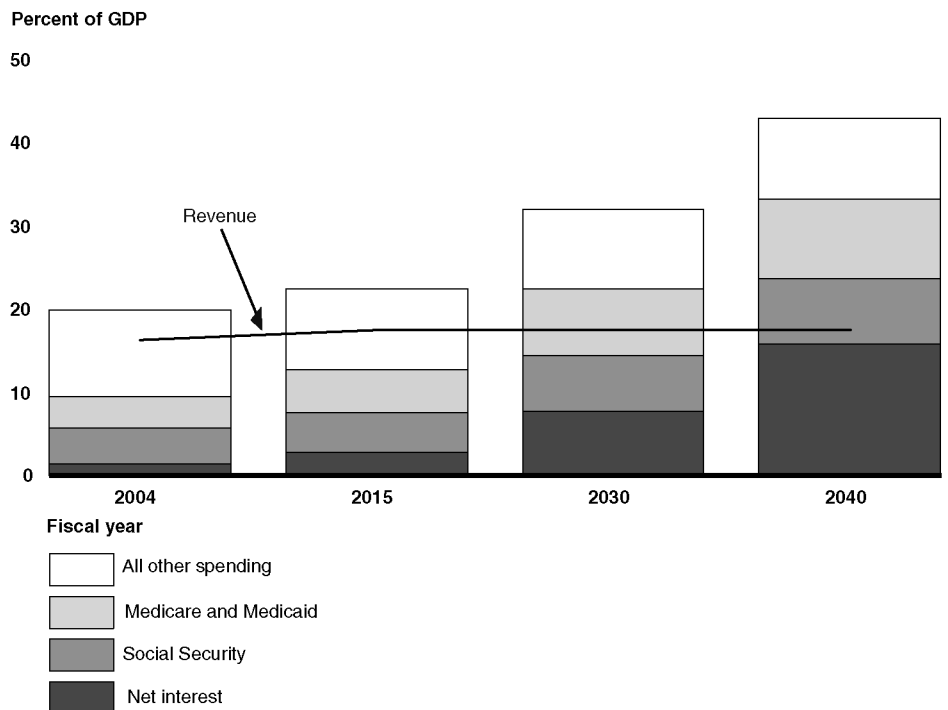
¹Many of these elements are explored in greater detail in a report that GAO is releasing today. GAO, *Comptroller General's Forum: The Future of the Defined Benefit System and the Pension Benefit Guaranty Corporation*, [GAO-05-578SP](#) (Washington, D.C.: June 9, 2005).

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

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

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

Figure 1: Composition of Spending as a Share of GDP Assuming Discretionary Spending Grows with GDP after 2005 and All Expiring Tax Provisions Are Extended



Source: GAO's March 2005 analysis.

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

PBGC is an excellent example of the need for Congress to reconsider the role of government programs, in general, and federal retirement programs, in particular, in light of past changes and 21st century challenges. In 1974, Congress passed the Employee Retirement Income Security Act (ERISA)

to respond to trends and challenges that existed at that time.⁴ Among other things, ERISA established PBGC to pay the pension benefits of defined benefit plan participants, subject to certain limits, in the event that an employer could not.⁵ When ERISA was enacted, defined benefit pension plans were the most common form of employer-sponsored private pension and were growing both in number of plans and in number of participants. Today, defined benefit pensions cover an ever-decreasing percentage of the U.S. labor force, a fact that raises questions about federal policy on pensions in general, and defined benefit plans and the PBGC, in particular.

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

PBGC's current premium structure does not properly reflect the risks to its insurance program and facilitates moral hazard by plan sponsors.

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

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

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

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

The termination of United Airlines' defined benefit pension plans is just the latest in a recent series of large, underfunded plans taken over by PBGC, and will not be the last. In July 2003, GAO designated PBGC's single-employer insurance program as "high-risk," given its deteriorating financial condition and long-term vulnerabilities.⁷ At the end of fiscal year 2004, PBGC estimated that it was exposed to almost \$100 billion of underfunding in plans sponsored by companies with credit ratings below investment grade. Though smaller in scale than Social Security, Medicare, and Medicaid, PBGC's deficit threatens to worsen our government's long-term fiscal position.⁸ While PBGC is not explicitly backed by the full faith

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

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

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

and credit of the U.S. government,⁹ policymakers would undoubtedly face intense pressure to provide PBGC the resources to continue paying earned pension benefits to millions of retirees if PBGC were to become insolvent.

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

Background

Before enactment of the Employee Retirement Income Security Act of 1974 (ERISA), few rules governed the funding of defined benefit pension plans, and participants had no guarantees that they would receive their promised benefits. Among other things, ERISA created the PBGC to protect the benefits of plan participants in the event that plan sponsors could not meet the benefit obligations under their plans. ERISA also established rules for funding defined benefit pension plans, instituted pension insurance premiums, promulgated certain fiduciary rules, and developed annual reporting requirements. When a plan is terminated with insufficient assets to pay its guaranteed benefits, PBGC takes over the plan and assumes responsibility for paying benefits to participants. According to PBGC's 2004 annual report, PBGC provides insurance protection for over 29,000 single-employer pension plans, which cover 34.6 million workers, retirees, and their beneficiaries.¹⁰

PBGC receives no direct federal tax dollars to support the single-employer pension insurance program. Instead, the program receives the assets of terminated underfunded plans and any of the sponsor's assets that PBGC

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

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

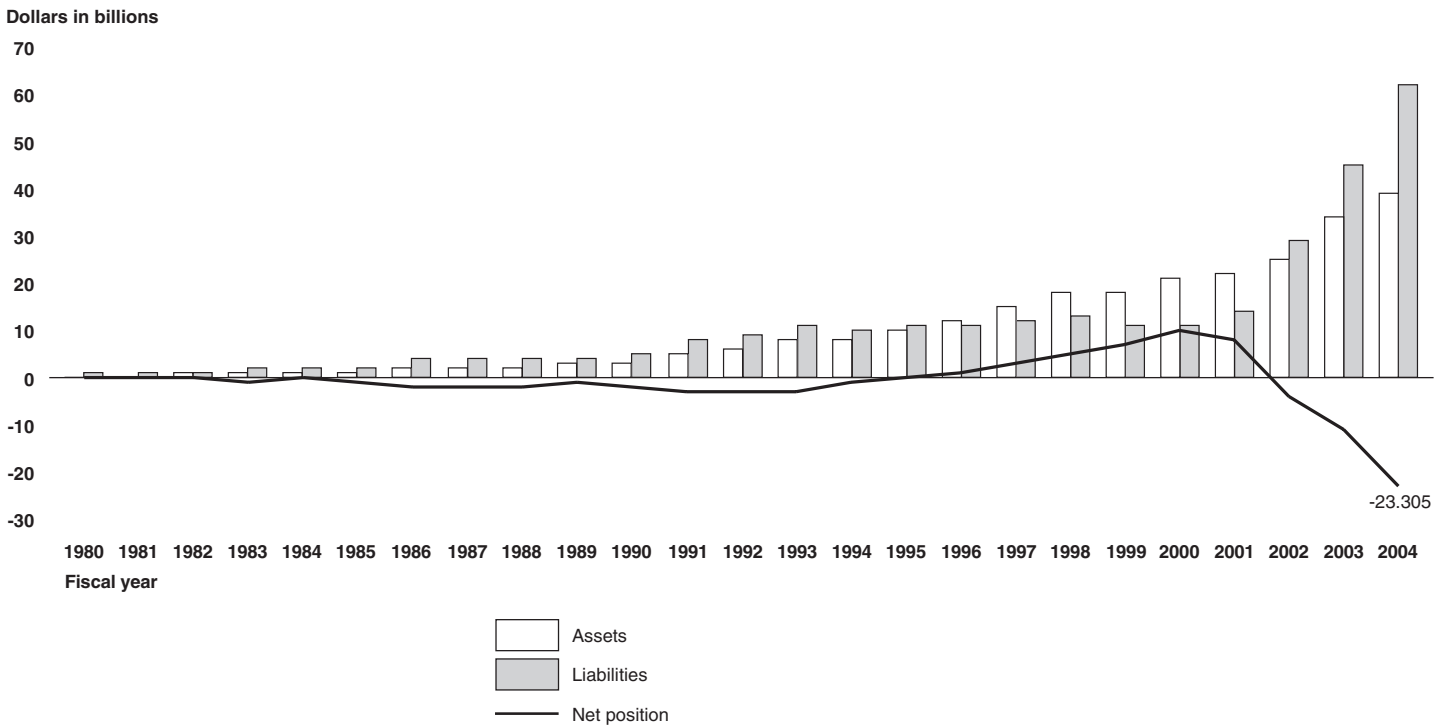
recovers during bankruptcy proceedings.¹¹ PBGC finances the unfunded liabilities of terminated plans with premiums paid by plan sponsors and income earned from the investment of program assets. Premiums have two components: a per participant charge paid by all sponsors (currently \$19 per participant), and a variable-rate premium that some underfunded plans pay based on the level of unfunded benefits.¹²

The single-employer program has had an accumulated deficit—that is, program assets have been less than the present value of benefits and other obligations—for much of its existence. (See fig. 2.) In fiscal year 1996, the program had its first accumulated surplus, and by fiscal year 2000, the accumulated surplus had increased to about \$10 billion, in 2002 dollars. However, the program's finances reversed direction in 2001, and at the end of fiscal year 2002, its accumulated deficit was about \$3.6 billion. In fiscal year 2004, the single-employer program incurred a net loss of \$12.1 billion, and its accumulated deficit increased to \$23.3 billion, up from \$11.2 billion a year earlier. Furthermore, PBGC estimated that total underfunding in single-employer plans exceeded \$450 billion, as of the end of fiscal year 2004.

¹¹According to PBGC officials, PBGC files a claim for all unfunded benefits in bankruptcy proceedings. However, PBGC generally recovers only a small portion of the total unfunded benefit amount in bankruptcy proceedings, and the recovered amount is split between PBGC (for unfunded guaranteed benefits) and participants (for unfunded nonguaranteed benefits).

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

Figure 2: Assets, Liabilities, and Net Financial Position of PBGC's Single-Employer Insurance Program



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

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

benefits calculated using mandated assumptions is known as a plan's current liability. Current liability provides an estimate of the amount of assets a plan needs today to pay for accrued benefits.

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

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

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

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

PBGC'S Problems Stem from Recent Events, Long-Term Structural Trends, and Weaknesses in the Legal Framework Governing DB Pensions

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

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

Recent Economic Factors Exacerbated the Underfunding of Large Terminated Plans by Bankrupt Sponsors

Over the last 5 years, many large pension plans have been adversely affected by simultaneous declines in broad equity indexes and long-term interest rates, as well as by the financial difficulties of their plan sponsors.¹⁶ Poor investment returns from stock market declines affected the asset values of pension plans to the extent that plans invested in stocks. According to the ERISA Industry Committee, assets in private

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

sector defined benefit plans totaled \$2.056 trillion at the end of 1999, dropped to \$1.531 trillion at the end of 2002, and climbed back to \$1.8 trillion by the end of 2004.¹⁷ Lower equity values since the end of 1999 have been particularly problematic because interest rates have also declined and thus increased the present value of plan liabilities.¹⁸ Some sponsors of large pension plans that were terminated were not in sufficiently strong financial condition to meet their pension funding requirements because of weaknesses in their primary business activities. Bankruptcies and pension plan terminations increased around the U.S. economic recession of 2001 and around prior recessions.¹⁹

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

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

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

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

Long-Term Declines of Key Industries and in Defined Benefit Pension Coverage Have Contributed to PBGC's Weakening Financial Condition

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

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

A related factor eroding PBGC's premium base is the growth of lump-sum pension distributions. More and more plan participants are exiting the defined benefit system by taking lump-sum distributions from their plans. After a lump-sum distribution is paid, the participant is out of the defined benefit system and the plan sponsor no longer has to contribute to the pension insurance system on the participant's behalf. In addition, lump-sum distributions to participants in underfunded plans can create the effect of a "run on the bank" and worsen a plan's underfunding. In such

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

cases, the plan may terminate without enough assets to pay full benefits to other participants and PBGC may incur losses.

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

Legal Framework Has Not Encouraged Adequate Plan Funding, Contributing to PBGC's Financial Difficulties

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

²¹ A major factor contributing to the increase in lump-sum distributions from defined benefit plans is the growing prevalence of hybrid plans, such as cash balance plans, which typically offer lump sums. Hybrid plans are a form of DB plan that determines benefits on the basis of hypothetical individual accounts.

²² [GAO-05-294](#).

PBGC's Premium Structure Does Not Properly Reflect Risks to the Insurance Program

PBGC's current premium structure does not properly reflect risks to the insurance program. The current premium structure relies heavily on flat-rate premiums, which, since they are unrelated to risk, result in large cost shifting from financially troubled companies with underfunded plans to healthy companies with well-funded plans. PBGC also charges plans a variable-rate premium based on the plan's level of underfunding. However, these premiums do not consider other relevant risk factors, such as the economic strength of the sponsor, plan asset investment strategies, the plan's benefit structure, or the plan's demographic profile. PBGC is currently operated somewhat more on a social insurance model, since it must cover all eligible plans regardless of their financial condition or the risks they pose to the solvency of the insurance program.

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

PBGC Is Subject to Moral Hazard

Current pension funding and insurance laws create incentives for financially troubled firms to use PBGC in ways that Congress likely did not intend when it formed the agency in 1974. At that time, PBGC was established to pay the pension benefits of participants, subject to certain limits, in the event that an employer could not. However, since that time, some firms with underfunded pension plans may have come to view PBGC coverage as a fallback, or "put option," for financial assistance. The very presence of PBGC insurance may create certain perverse incentives that represent what economists call moral hazard—where struggling plan sponsors may place other financial priorities above funding up their

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

pension plans because they know PBGC will pay guaranteed benefits. Firms may even have an incentive to seek Chapter 11 bankruptcy in order to escape their pension obligations. As a result, once a plan sponsor with an underfunded pension plan experiences financial difficulty, these moral hazard incentives may exacerbate the funding shortfall for PBGC.

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

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

Current Funding Rules Do Not Provide Sufficient Incentives for Sponsors to Adequately Fund Their Plans

The pension funding rules, under ERISA and the IRC, have not provided sufficient incentives for plan sponsors to properly fund their benefit obligations. The funding rules generally presume that pension plans and their sponsors are ongoing entities and therefore allow for a certain extent of plan underfunding that can be made up over time. However, the measures of plan funding used to determine contribution requirements can significantly overstate the true financial condition of a plan. And even

these reported funding levels indicated significant levels of underfunding in our study of the 100 largest DB plans.²⁴ Furthermore, when plan sponsors make contributions to their plans, they can use account credits, rather than cash, even in cases when plans are underfunded. The funding rules include certain mechanisms—primarily, the AFC—that are intended to prevent plans from becoming too underfunded. However, our analysis shows that for several reasons, the AFC proved ineffective in restoring financial health to poorly funded plans.

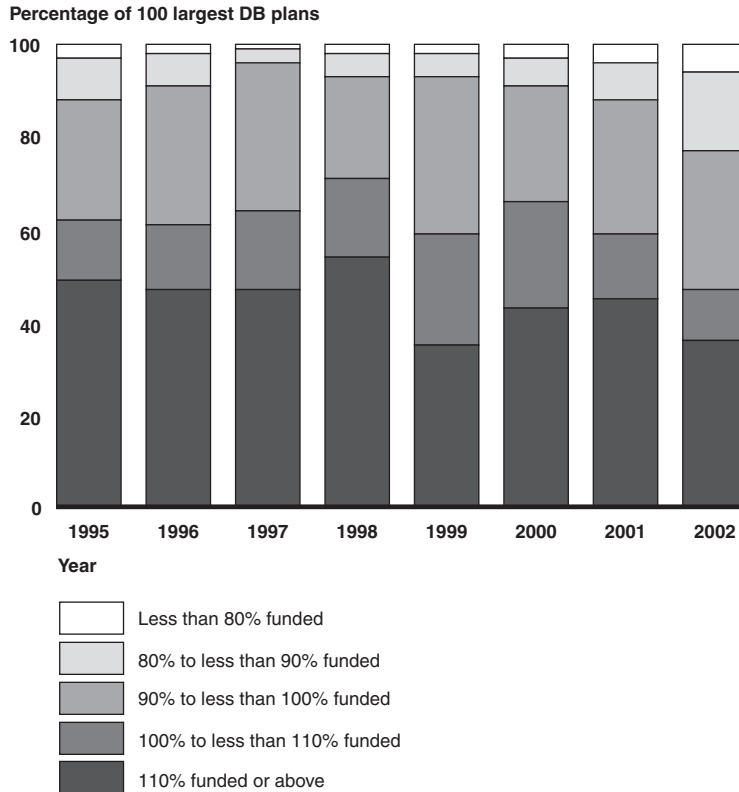
Rules May Allow Plans to Overstate Their Current Funding Levels

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

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

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

Figure 3: Almost One-Fourth of the Largest Pension Plans Were Less than 90 Percent Funded on a Current Liability Basis in 2002



Source: GAO analysis of PBGC Form 5500 research data.

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

present value of plan liabilities do not accurately reflect the cost of settling a plan's benefit obligations.²⁵

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

Most Sponsors Most Years Made No Cash Contributions to Plans but Satisfied Funding Requirements through Use of Accounting Credits

The amount of contributions required under IRC minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years. This minimum contribution requirement may be met by the plan sponsor putting cash into the plan or by applying earned funding credits. These funding credits are not measured at their market value and are credited with interest each year, according to the plan's long-term expected rate of return on assets.²⁷ When the market value of a plan's assets declines, the value of funding credits may be significantly overstated.

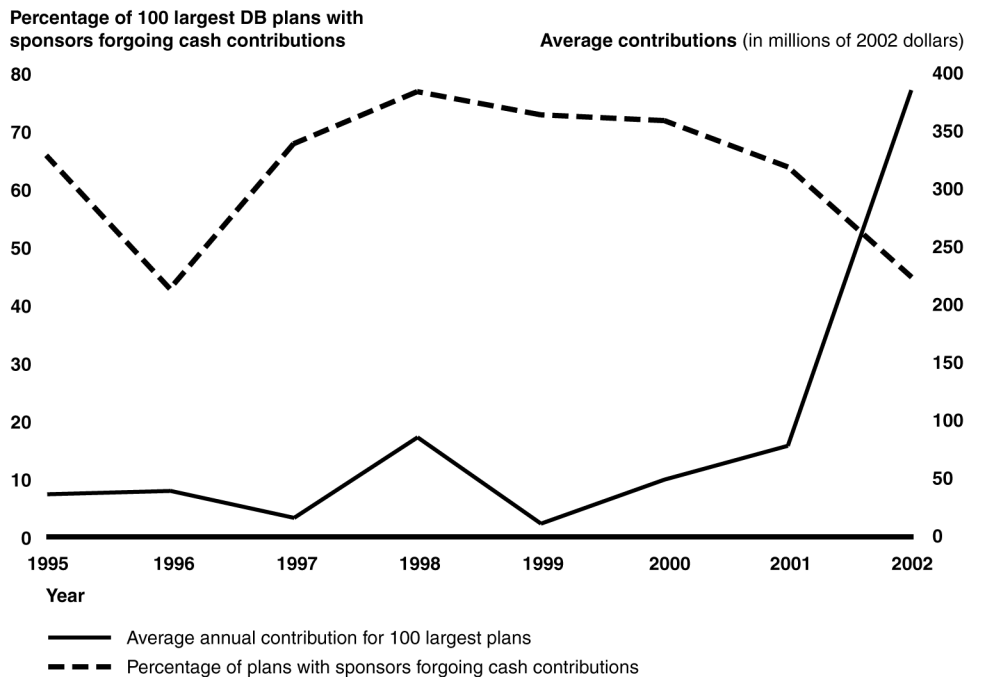
²⁵Conversely, when interest rates rise, the opposite would be true, and the weighted average would make the cost of settling plan liabilities higher than the current market rate would indicate.

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

²⁷See 26 U.S.C. 412(b).

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

Figure 4: Most Large Plans Received No Annual Cash Contribution, 1995–2002



Source: GAO analysis of PBGC Form 5500 research data.

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

As stated earlier, Bethlehem Steel and LTV Steel both had plans terminate in 2002 that were only about 50 percent funded. Yet each plan was able to forgo a cash contribution each year from 2000 to 2002, instead using credits to satisfy minimum funding obligations, primarily from large

accumulated credit balances from prior years. Despite being severely underfunded, each plan reported an existing credit balance at the time of termination.

AFC, Primary Mechanism for Improving Funding of Underfunded Plans, Proved Ineffective

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

1. Very few plans in our sample were actually assessed an AFC because the rules, despite the statutory threshold of a 90 percent funding level for some plans to owe an AFC, in practice require a plan to be much more poorly funded to be subject to this requirement.²⁸ From 1995 to 2002, an average of only 2.9 of the 100 largest DB plans each year were assessed an additional funding charge, even though on average 10 percent of plans each year reported funding levels below 90 percent. Over the entire 8-year period, only 6 unique plans that were among the 100 largest plans in any year from 1995 to 2002 owed an AFC. These 6 plans owed an AFC during the period a total of 23 times in years in which they were among the 100 largest plans, meaning that plans that were assessed an AFC were likely to owe it again.
2. AFC rules also specify a current liability calculation method that may overstate actual plan funding, relative to market-value measures, thereby reducing the number of plans that might be assessed an AFC. The specified interest rate for this calculation exceeded current market rates in 98 percent of the months between 1995 and 2002.
3. The AFC rules generally call for sponsors to pay only a percentage of their unfunded liability, rather than requiring restoration of full funding. On average, by the time a plan was assessed an AFC, it was significantly underfunded and was likely to remain chronically underfunded in subsequent years. Among the 6 plans that owed the AFC, funding levels rose slightly from an average of 75 percent when the plan was first assessed an AFC to an average of 76 percent, looking collectively at all subsequent years. All of these plans were assessed an AFC more than once.

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

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

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

Weaknesses in Funding Rules Amplified by Lack of Transparency Hinders Sound Policy making

Unclear measures of pension funding and a lack of timely information have made it difficult for plan participants, investors, regulators, and policy makers to accurately assess the financial condition of pension plans. Without timely and reasonably accurate data about the financial condition of pension plans, the various stakeholders cannot make timely and informed decisions on retirement savings, employment, and other key life issues. The primary regulatory filing for pension plans—the Form 5500—requires multiple measures of pension assets and liabilities, yet none of these measures tell PBGC and plan participants what share of the benefit obligations are funded in the event of plan termination. Furthermore, by the time these regulatory reports are publicly available,

the information is usually at least 2 years old.²⁹ In a time of significant changes in interest rates and equity prices, it is possible that reported measures of pension funding will substantially differ from current measures of plan funding. PBGC does receive more current information about plans that are underfunded by at least \$50 million. This more current information includes estimates of funding measures if the plan were to be terminated; however, by law this information is not disclosed to the public.

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

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

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

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

mismatch between premium collections and benefit payments that can extend over several decades.

Cash-based budgeting also may not be a very accurate gauge of the economic impact of federal insurance programs. Although discerning the economic impact of federal insurance programs can be difficult, private economic behavior generally is affected when the government commits to providing insurance coverage. In the case of PBGC, the existence of pension insurance may encourage plan sponsors and employees to agree to pension benefit increases in lieu of wage increases when the plan sponsor faces economic difficulties.³²

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

Retirement Income Security Requires Meaningful and Comprehensive Reform

In light of the intrinsic problems facing the defined benefit system, meaningful and comprehensive pension reform is required to ensure that workers and retirees receive the benefits promised to them and to secure PBGC's financial future. While PBGC's current financial condition does not represent a crisis, delaying reform will result in serious adverse consequences for plan participants, the federal budget, and our nation's economy. At this time, the Administration, members of Congress, and others have proposed reforms that seek to address many of the problems

³²GAO-05-578SP.

facing PBGC and the defined benefit system.³³ Such comprehensive effective pension reform would likely include elements that would improve measures of pension funding and enhance transparency of plan information, strengthen funding rules (while preserving some contribution flexibility for plan sponsors, modify certain PBGC guarantees, develop an enhanced and more risk-based insurance premium structure, and resolve outstanding controversies concerning hybrid plans, such as cash balance plans.³⁴

GAO Has Suggested Elements of Pension Reform

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

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

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

³⁴For greater detail, see [GAO-04-90](#).

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

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

The debate over defined benefit pension reform should not take place in isolation of larger related issues. Challenges in the defined benefit system, together with the recent public debate over the merits of including individual accounts as part of a more comprehensive Social Security reform proposal, should lead us to consider fundamental questions about how who should bear certain risks and responsibilities for economic security in retirement.

- Individual savings require greater responsibility and offer greater potential rewards and the possibility of bequeathing any unused retirement savings. However, longevity risk—the risk of outliving retirement savings—and poor investment choice are significant concerns, particularly as health care and long-term care costs and life expectancies continue to rise.
- The federal government is in the best position to share risk across the population, and social insurance programs, including Social Security, Medicare, and Medicaid already reflect this fact. However, the current structure of existing federal retirement programs is unsustainable.
- Employer-sponsored pensions can alleviate longevity risk for plan participants and are generally presumed to be better placed to manage investment risk. However, poor management of plans can lead to shortfalls in funding that can damage the competitiveness of the plan sponsors. Furthermore, many employers are cutting or reducing retiree health benefits, and even employee health benefits, as growing health care costs threaten their competitiveness.

Experts Identified a Variety of Broad Pension Reforms

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

According to participants in the GAO forum, resolution of pension legacy costs and clarification of the legal status of cash balance and other hybrid pension plans could play a significant role in shoring up the defined benefit system.³⁶ Separating legacy costs from the existing and future liabilities of the remaining defined benefit plans might encourage plan sponsors to remain in the defined benefit system. Many plan sponsors are concerned that through increased PBGC premiums, they may be required to pay for the failures of other companies to responsibly fund and manage their pension plans. Some participants added that resolving legacy costs could be a key component of any pension reform legislation that tightened the funding rules and assessed premiums according to PBGC's risk. Also, some participants supported, and other participants opposed, the idea of separately addressing the pension legacy costs of specific industries, such as airlines and steel, which have imposed the most significant costs on PBGC. Separately addressing pension legacy costs does not necessarily imply a taxpayer bailout, as some participants suggested other ways to cover their cost, such as through an airline ticket fee to cover the airlines' share of PBGC's deficit. Others noted that resolving the uncertain legal status of cash balance and other hybrid pension plans could encourage greater participation in the defined benefit system. Expanding the universe

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

³⁶Cash balance plans are a type of defined benefit plan that look more like a defined contribution plan to participants. As with other defined benefit plans, the sponsor is responsible for managing the plan's commingled assets and complying with the minimum funding requirements. However, information about benefits is communicated to plan participants through the use of hypothetical account balances, which makes the plan appear like an individual account-based defined contribution plan. The hypothetical account balances communicated to plan participants do not necessarily bear any relationship to actual assets held by the plan.

of pension plan sponsors could lead to an increase in PBGC's premium income.

Some forum participants also suggested that the debate over federal retirement policy needs to move beyond distinctions between defined benefit and defined contribution plans. Others added that discussions of retirement policy need to focus on ways to create incentives and remove barriers for employers to set up retirement plans, and how to get American workers to build adequate retirement savings and security. This may be achieved by thinking about the interaction of private pensions and Social Security and by looking at hybrid pension plans, such as cash balance plans and plans that combine the best features of defined benefit and defined contribution plans. Participants suggested new pension plan designs be developed that explore the following features:

- allowing automatic participation of the covered population in order to expand pension coverage generally;
- improving the portability of pension benefits to accommodate workers who frequently change jobs;
- providing for professional money management and pooled investment risk;
- minimizing early withdrawals and borrowing—a problem known as leakage—from retirement savings; and
- providing incentives to receive benefits in the form of a fixed annuity, rather than a lump-sum distribution.

Conclusions

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

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

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

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

consequences for those elements of Social Security reform packages that reduce benefits or include an individual accounts feature.

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

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

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

Contact and Acknowledgments

For further information, please contact Barbara Bovbjerg at (202) 512-7215. Individuals making key contributions to this testimony include David Eisenstadt and Charlie Jeszeck.

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