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PENSION BENEFIT GUARANTY CORPORATION

Structural Problems Limit Agency's Ability to Protect Itself from Risk

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Highlights

Highlights of GAO-05-360T, a report to Subcommittee on Government Management, Finance, and Accountability, Committee on Government Reform, House of Representatives

PENSION BENEFIT GUARANTY CORPORATION

Structural Problems Limit Agency's Ability to Protect Itself from Risk

Why GAO Did This Study

More than 34 million workers and retirees in about 30,000 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 insurance program's long-term viability is in doubt and in July 2003 we placed the single-employer insurance program on our high-risk list of agencies with significant vulnerabilities for the federal government. In fiscal year 2004, PBGC's single-employer pension insurance program incurred a net loss of $12.1 billion for fiscal year 2004, and the program's accumulated deficit increased to $23.3 billion from $11.2 billion a year earlier. Further, PBGC estimated that underfunding in single-employer plans exceeded $450 billion as of the end of fiscal year 2004.

This testimony provides GAO's observations on (1) some of the structural problems that limit PBGC's ability to protect itself from risk and (2) steps PBGC has taken to forecast and manage the risks that it faces.

www.gao.gov/cgi-bin/getrpt?GAO-05-360T.

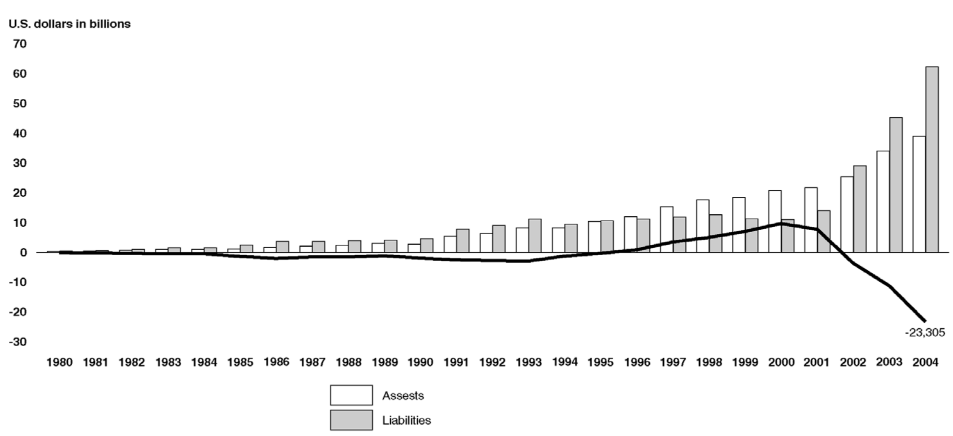
To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg, (202) 512-7215, bovbjergb@gao.gov.

What GAO Found

Existing laws governing pension funding and premiums have not protected PBGC from accumulating a significant long-term deficit and have exposed PBGC to "moral hazard" from the companies whose pension plans it insures. The pension funding rules, under the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC), were not designed to ensure that plans have the means to meet their benefit obligations in the event that plan sponsors run into financial distress. Meanwhile, in the aggregate, premiums paid by plan sponsors under the pension insurance system have not adequately reflected the financial risk to which PBGC is exposed. Accordingly, PBGC faces moral hazard, and defined benefit plan sponsors, acting rationally and within the rules, have been able to turn significantly underfunded plans over to PBGC, thus creating PBGC's current deficit.

Despite the challenges it faces, PBGC has proactively attempted to forecast and mitigate its risks. The Pension Insurance Modeling System, created by the PBGC to forecast claim risk, has projected a high probability of future deficits for the agency. However, the accuracy of the projections produced by the model is unclear. Through its Early Warning Program, PBGC negotiates with companies that have underfunded pension plans and that engage in business transactions that could adversely affect their pensions. Over the years, these negotiations have directly led to billions of dollars of pension plan contributions and other protections by the plan sponsors. Moreover, PBGC has changed its investment strategy and decreased its equity exposure to better shield itself from market risks. However, despite these efforts, the agency ultimately lacks the authority, unlike other federal insurance programs, to effectively protect itself.

Assets, Liabilities, and Net Financial Position of PBGC's Single-Employer Insurance Program, 1980-2004



Source: Pension Benefit Guaranty Corporation.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the underlying structural problems and long-term challenges facing the defined benefit pension system and the Pension benefit Guaranty Corporation (PBGC). Before addressing these matters specifically, I would like to place these challenges in the context of the larger challenges facing the federal government today, which we discuss in our recently issued 21st Century Challenges report.[1] There is a need to bring the federal government and its programs into line with 21st century realities. This challenge has many related pieces: addressing our nation's large and growing long-term fiscal gap; deciding on the appropriate role and size of the federal government—and how to finance that government—and bringing the panoply of federal activities into line with today's world. 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. We therefore 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.

The PBGC is an excellent example of the need for Congress to reconsider the role of government organizations, programs, and policies. The Employee Retirement Income Security Act (ERISA) was enacted in 1974 to respond to trends and challenges that existed at that time.[2] One impetus for the passage of ERISA was the failure of Studebaker's defined benefit pension plan in the 1960s, in which many plan participants lost their pensions.[3] Along with other changes, ERISA established PBGC to pay the

[1]See GAO, *21st Century Challenges: Reexamining the Base of the Federal Government*, GAO-05-325SP. (Washington, DC: February, 2005)

[2]ERISA has been amended a few times, notably in 1987 (Public Law 100-203) and again in 1994 (Public Law 103-465), to respond to challenges facing the defined benefit pension system and PBGC.

[3]The company and the union agreed to terminate the plan along the lines set out in the collective bargaining agreement; retirees and retirement eligible employees over the age of 60 received full pensions, and vested employees under age 60 received a lump-sum payment worth about 15 percent of the value of their pensions. Employees, whose benefit accruals had not vested, including all employees under age 40, received nothing. James A. Wooten, "The Most Glorious Story of Failure in Business: The Studebaker-Packard Corporation and the Origins of ERISA." *Buffalo Law Review*, vol. 49 (Buffalo, NY: 2001):731.

pension benefits of defined benefit plan participants, subject to certain limits, in the event that an employer could not.[4] ERISA also required PBGC to encourage the continuation and maintenance of voluntary private pension plans and to maintain premiums set by the corporation at the lowest level consistent with carrying out its obligations.[5] PBGC was thus mandated to serve a social purpose and remain financially self-sufficient.[6] 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 number of participants. In 1974, Congress may well have expected continued growth of defined benefit plans in the years and decades to come. Today, defined benefit pensions cover an ever decreasing percentage of the U.S. labor force, a fact that raises several questions about federal policy on pensions in general, and defined benefit plans and the PBGC, in particular.

In light of past trends and future challenges, some of the fundamental questions that need to be addressed as we move forward include these:

- Should the federal government continue to promote defined benefit pension plans?
- What features of various pension plans should the government promote to meet retirement income security needs of increasingly mobile American workers?
- What changes should be made to enhance the retirement income security of workers while protecting the fiscal integrity of the PBGC insurance program?
- Should PBGC act as self-sustaining insurer, according to market-based principles, should it be a social insurance program, or should it be a hybrid entity? As defined benefit pension coverage declines, there is an

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

[5]See section 4002(a) of P.L. 93-406, Sept. 2, 1974.

[6]ERISA authorized PBGC to borrow up to $100 million from the U.S. Treasury to cover temporary cash shortfalls.

inherent tension between these two approaches that Congress presumably did not foresee when ERISA was enacted.

- What legislative changes are necessary to allow the pension insurance program and the PBGC to succeed in their missions? And how much authority and flexibility should be provided to PBGC to manage its risk and respond to the fiscal challenges it faces?

- Should the government's pension insurance program be used as a tool to provide restructuring assistance to industries that have been negatively affected by certain macroeconomic forces such as globalization and deregulation? Should such costs be handled differently than other pension insurance losses?

- What portion of the PBGC's premium revenue should be fixed versus variable rate premiums and for what purposes? Should variable rate premiums be more risk-related? If so, how can they be adjusted to accomplish this objective?

- What should PBGC's investment strategy be and what impact, if any, should that have on pension funding, recovery, premium, and other calculations?

It is critical that we address these fundamental issues as soon as possible so that we take actions consistent with our broader policy objectives. Furthermore, failure to enact the proper reforms could expedite the demise of the defined benefit pension system. As part of GAO's efforts to help Congress and other policymakers address such issues, I recently convened a group of pension experts at a Comptroller General's Forum entitled "The Future of the Defined Benefit System and the PBGC." We will convey the observations of the forum participants in a forthcoming GAO report.

I will now turn to the specific issues before this subcommittee today. In particular, I will discuss some of the structural problems that limit PBGC's ability to protect itself from risk and steps PBGC has taken to forecast and manage the risks that it faces. In summary, existing laws governing pension funding and premiums have not protected PBGC from accumulating a significant long-term deficit and have not limited PBGC's exposure to "moral hazard" from the companies whose pension plans it insures.[7] The pension funding rules, under ERISA and the Internal Revenue Code (IRC), were not designed to ensure that plans have the means to meet their benefit obligations in the event that plan sponsors run into financial distress. Meanwhile, in the aggregate, premiums paid by plan sponsors under the pension insurance system have not adequately reflected the financial risk to which PBGC is exposed. Accordingly, defined benefit plan sponsors, acting rationally and within the rules, have been able to turn significantly underfunded plans over to PBGC, thus creating PBGC's current deficit.

Despite the challenges it faces, PBGC has proactively attempted to forecast and mitigate its risks. The Pension Insurance Modeling System, created by PBGC to forecast claim risk, has projected a high probability of future deficits for the agency. However, the accuracy of the projections produced by the model is unclear. Through its Early Warning Program, PBGC negotiates with companies that have underfunded pension plans and that engage in business transactions that could adversely affect their pensions. Over the years, these negotiations have directly led to billions of dollars of pension plan contributions and other protections by the plan sponsors. Moreover, PBGC has changed its investment strategy and decreased its equity exposure to better shield itself from market risks. However, despite these efforts, the agency, unlike other federal insurance programs, ultimately lacks adequate authority to effectively protect itself.

Background

Before enactment of the Employee Retirement Income Security Act of 1974, few rules governed the funding of defined benefit pension plans, and participants had no guarantees that they would receive the benefits promised. Among other things, ERISA established rules for funding defined benefit pension plans and 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. More than 34 million workers and retirees in about 30,000 single-employer defined benefit plans rely on PBGC to protect their pension benefits.

[7] Moral hazard surfaces when the insured parties—in this case, plan sponsors—engage in risky behavior knowing that the guarantor will assume a substantial portion of the risk. In the case of the pension insurance system, this might include the willingness of parties to enter into agreements that increase pension liabilities, rather than taking wage increases.

PBGC finances the liabilities of underfunded terminated plans partially through premiums paid by plan sponsors.[8] Currently, plan sponsors pay a flat-rate premium of $19 per participant per year; in addition, some plan sponsors pay a variable-rate premium, which was added in 1987, to provide an incentive for sponsors to better fund their plans. For each $1,000 of unfunded vested benefits, plan sponsors pay a premium of $9. In fiscal year 2004, PBGC received nearly $1.5 billion in premiums, including more than $800 million in variable rate premiums, but paid out more than $3 billion in benefits to plan participants or their beneficiaries.[9]

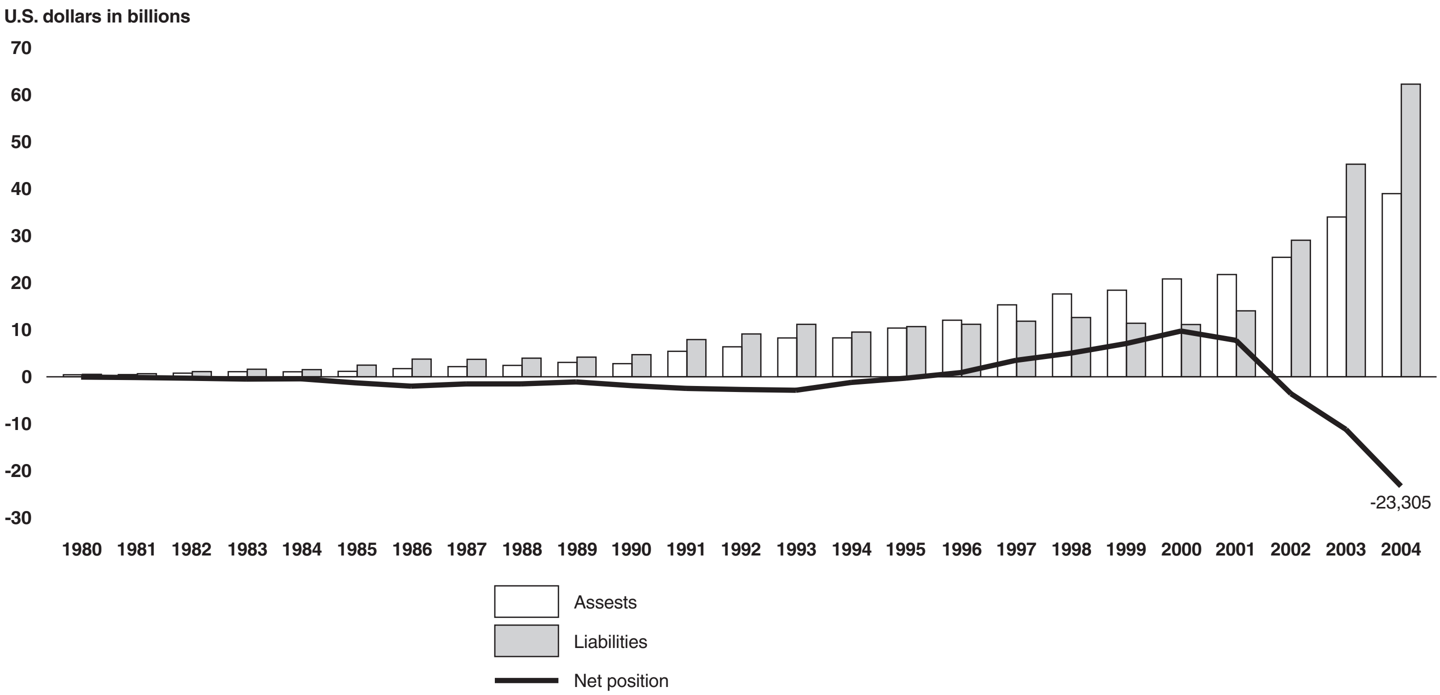
The single-employer program has had an accumulated deficit—that is, program assets have been less than the present value of benefits and other obligations—for much of its existence. (See fig. 1.) In fiscal year 1996, the program had its first accumulated surplus, and by fiscal year 2000, the accumulated 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 July 2003, we designated the single-employer insurance program as "high risk," given its deteriorating financial condition and the long-term vulnerabilities of the program.[10] In fiscal year 2004, PBGC's single-employer pension insurance 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.

[8] PBGC also assumes the assets of the plans it takes over in a plan termination and any investment income from these assets may be used to pay out benefits to participants of terminated plans.

[9] For most of its history, PBGC has received most of its premium income from flat-rate premiums.

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

Figure 1: Assets, Liabilities, and Net Financial Position of PBGC's Single-Employer Insurance Program, 1980-2004



Source: Pension Benefit Guaranty Corporation.

Structural Problems Limit PBGC's Ability to Protect Itself from Risk

Existing laws governing pension funding and premiums have not protected PBGC from accumulating a significant long-term deficit and have not limited PBGC's exposure to moral hazard from the companies whose pension plans it insures. The pension funding rules, under ERISA and the IRC, were not designed to ensure that plans have the means to meet their benefit obligations in the event that plan sponsors run into financial distress. Meanwhile, in the aggregate, premiums paid by plan sponsors under the pension insurance system have not adequately reflected the financial risk to which PBGC is exposed. Accordingly, defined benefit plan sponsors, acting rationally and within the rules, have been able to turn significantly underfunded plans over to PBGC, thus creating PBGC's current deficit. Earlier this year, the Administration released a proposal that aims to address many of the structural problems that PBGC faces by calling for changes in the funding rules and premium structure, among other things. Meanwhile, employers who responsibly manage their defined benefit pension plans are concerned about their exposure to additional funding and premium uncertainties.

Minimum Funding Rules Do Not Prevent Plans from Being Severely Underfunded

As the PBGC takeovers of severely underfunded plans suggest, the IRC minimum funding rules have not been designed to ensure that plan sponsors contribute enough to their plans to pay all the retirement benefits promised to date.[11] The amount of contributions required under IRC minimum funding rules is generally the amount needed to fund that year's "normal cost" – benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years. Also, the rules require the sponsor to make an additional contribution if the plan is underfunded to a specified extent as defined in the law.[12] However, sponsors of underfunded plans may sometimes avoid or reduce minimum funding contributions if they have earned funding credits as a result of favorable experience, such as contributing more than the minimum in the past. For example, contributions beyond the minimum may be recognized as a funding credit. These credits are not measured at their market value and accrue interest each year, according to the plan's long-term expected rate of return on assets.[13] If the market value of the assets falls below the credited amount, and the plan is terminated, the assets in the plan will not suffice to pay the plan's promised benefits. Thus, some very large and significantly underfunded plans have been able to remain in compliance with the current funding rules while making little or no contributions in the years prior to termination (e.g., Bethlehem Steel).

Further, under current funding rules, plan sponsors can increase plan benefits for underfunded plans, even in some cases where the plans are less than 60 percent funded. This may create an incentive for financially troubled sponsors to increase pension benefits, possibly in lieu of wage increases, even if their plans have insufficient funding to pay current benefit levels.[14] Thus, plan sponsors and employees that agree to benefit increases from underfunded plans as a sponsor is approaching bankruptcy

[11]Pension funding rules include minimum funding requirements for all plans and additional funding requirements for underfunded plans that set minimum contribution requirements for plan sponsors.

[12]Under one of the amendments to ERISA in 1987, an additional funding requirement rule was added. Generally speaking, large single-employer plans are subject to a deficit reduction contribution if the value of plan assets is less than 90 percent of a standardized liability measure. To determine whether the additional funding rule applies to a plan, the IRC requires sponsors to calculate this liability using the highest interest rate allowable for the plan year. See 26 U.S.C. 412(l)(9)(C).

[13]See 26 U.S.C. 412(b).

[14]Some measures exist to limit losses incurred by PBGC from benefits added to a plan within the 5-year period prior to plan termination.

can essentially transfer this additional liability to PBGC, potentially exacerbating the agency's financial condition.

In addition, many defined benefit plans offer employees "shutdown benefits," which provide employees additional benefits, such as significant early retirement benefit subsidies in the event of a plant shutdown or permanent layoff. In general, plant shutdowns are inherently unpredictable, so that it is difficult to recognize the costs of shutdown benefits in advance and current law does not include the cost of benefits arising from future unpredictable contingent events.[15] Under current law, PBGC is responsible for at least a portion of any benefit increases, including shutdown benefits, even if the benefit was added to the plan within 5 years of plan termination. However, many of these provisions were included in plans years ago. As a result, shutdown benefits pose a problem for PBGC not only because they can dramatically and suddenly increase plan liabilities without adequate funding safeguards, but also because the related additional benefit payments drain plan assets.[16]

Finally, because many plans allow lump sum distributions, plan participants in an underfunded plan may have incentives to request such distributions. For example, where participants believe that the PBGC guarantee may not cover their full benefits, many eligible participants may elect to retire and take all or part of their benefits in a lump sum rather than as lifetime annuity payments, in order to maximize the value of their accrued benefits. In some cases, this may create a "run on the bank," exacerbating the possibility of the plan's insolvency as assets are liquidated more quickly than expected, potentially leaving fewer assets to pay benefits for other participants.

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 that, 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 plan sponsors a variable-rate premium based on the plan's level of underfunding. However, these premiums do not consider other relevant

[15] See 26 U.S.C. 412(m)(4)(D).

[16] Shutdown benefit payments begin immediately after a facility closes, using assets accumulated to pay other plan benefits.

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 happened 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.[17] 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

Despite a series of reforms over the years, current pension funding and insurance laws create incentives for financially troubled firms to use PBGC in ways that Congress did not intend when it formed the agency in 1974. PBGC was established to pay the pension benefits of participants in the event that an employer could not. As pension policy has developed, however, firms with underfunded pension plans may 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 moral hazard—struggling plan sponsors may place other financial priorities above "funding up" their pension plans because they know PBGC will pay guaranteed benefits. Firms may even have an incentive to seek Chapter 11 bankruptcy in order to escape their pension obligations. As a result, once a plan sponsor with an underfunded pension plan experiences financial difficulty, existing incentives may exacerbate the funding shortfall for PBGC while also affecting the competitive

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

balance within an industry. This should not be the role for the pension insurance system.

This moral hazard 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 them with a competitive advantage over 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 airline industries in the past 20 years.

In addition, current pension funding and pension accounting rules 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 loss, 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.

Administration Has Proposed Reforms to Address PBGC's Long-Term Challenges

Earlier this year, the Administration released a proposal for strengthening funding of single-employer pension plans. The Administration's proposal focuses on three areas:

- reforming the funding rules to ensure pension promises are kept by improving incentives for funding plans adequately;

- improving disclosure to workers, investors, and regulators about pension plan status; and

- adjusting premiums to better reflect a plan's risk and ensure the pension insurance system's financial solvency.

Among other things, the proposal would require all underfunded plans to pay risk-based premiums and it would empower PBGC's board to adjust the risk-based premium rate periodically so that premium revenue is sufficient to cover expected losses and to improve PBGC's financial condition.[18]

Employer groups have expressed concern about their exposure to additional funding and premium uncertainties and have claimed that the Administration's proposal may strengthen PBGC's financial condition at the expense of defined benefit plan sponsors. For example, one organization has stated that in its view, the current proposal would result in fewer defined benefit plans, lower benefits, and more pressures on troubled companies.

PBGC Has Attempted to Improve Its Ability to Forecast and Manage Risk but Ultimately Lacks Adequate Authority to Properly Do So

PBGC has proactively attempted to forecast and mitigate the risks that it faces. The Pension Insurance Modeling System (PIMS), created by PBGC to forecast claim risk, has projected a high probability of future deficits for the agency. However, the accuracy of the projections produced by the model is unclear. Also, through its Early Warning Program, PBGC negotiates with companies that have underfunded pension plans and that engage in business transactions that could adversely affect their pensions. Over the years, these negotiations have directly led to billions of dollars of pension plan contributions and other protections by the plan sponsors. Moreover, PBGC has begun an initiative called the Office of Risk Assessment that combines aspects of both PIMS and the Early Warning Program and will enable the agency to better quantitatively analyze claim risks associated with individual plan sponsors. PBGC has also changed its investment strategy and decreased its equity exposure to better shield itself from market risks. However, despite these efforts, the agency, unlike other federal insurance programs, ultimately lacks the authority to effectively protect itself, such as by adjusting premiums according to the risks it faces.

[18]PBGC's board is composed of the Secretary of Labor, the Secretary of the Treasury, and the Secretary of Commerce.

PBGC Uses Its Pension Insurance Modeling System to Forecast Its Potential Exposure to Future Claims, but Forecasting Firm Bankruptcies Is Difficult

Over the long term, many variables, such as interest rates and equity returns, affect the level of PBGC claims. Moreover, large claims from a small number of bankruptcies constitute a majority of the risk that PBGC faces. Consequently, PBGC created the Pension Insurance Modeling System—a stochastic simulation model that quantifies risk and exposure for the agency over the long run. PIMS simulates the flows of claims that could develop under thousands of combinations of various macroeconomic and company and plan-specific data. In lieu of predicting future bankruptcies, PIMS is designed to generate probabilities for future claims.

In recent annual reports, PBGC has discussed the methodologies used to develop PIMS. Furthermore, as far back as 1998, PBGC has reported PIMS results that forecast the possibility of large deficits for the agency. For example, at fiscal year end 2003—the most recent year for which PBGC has released an annual report—the model's simulations forecasted about an 80 percent probability of deficit by the year 2013. This included a 10 percent probability of the deficit reaching $49 billion within this time frame. These forecasts, made at the end of fiscal year 2003, did not include the $14.7 billion in losses that PBGC experienced from terminated plans in fiscal year 2004. Therefore, PIMS appears to have understated the extent of PBGC's long-term deficit, given that by the end of fiscal year 2004, the agency's cumulative deficit had already grown to $23.3 billion.

The extent to which PIMS can accurately assess future claims is unclear. There is simply too much uncertainty about the future, with respect both to the performance of the economy and of companies that sponsor defined benefit pension plans. It is difficult to accurately forecast which industries and companies will face economic pressures resulting in bankruptcies and PBGC claims. Furthermore, because PBGC's risk lies primarily in a relatively small number of large plans, the failure or survival of any single large plan may lead to significant variance between PBGC's actual claims and the projected claims reported by PBGC in its annual reports. Academic papers report varying rates of success in predicting bankruptcy with various models that measure companies' cash flows or financial ratios, such as asset-to-liability ratios. One paper we reviewed reports that one model succeeded at a rate of 96 percent in predicting bankruptcies 1 year in advance and a rate of 70 percent for predicting bankruptcies 5 years in advance.[19] However, another paper concludes that no single

[19]Altman, Edward. "Predicting Financial Distress of Companies: Revisiting the Z-Score and Zeta Models," July 2000. Retrieved from http://pages.stern.nyu.edu/~ealtman/Zscores.pdf

bankruptcy prediction model proposed in the existing literature is entirely satisfactory at differentiating between bankrupt and nonbankrupt firms and that none of the models can reliably predict bankruptcy more than 2 years in advance.[20]

PBGC's Early Warning Program Is One Tool For Managing Risk

PBGC's Early Warning Program is designed to ensure that pensions are protected by negotiating agreements with certain companies engaging in business transactions or events that could adversely affect their pension plans. Companies of particular interest to the PBGC are those that are financially troubled, have underfunded pension plans, and are engaged in transactions such as restructurings, leveraged buyouts, spin-offs, and payments of extraordinary dividends, to name a few. The Early Warning Program proactively monitors financial information services and news databases to identify these potentially risky transactions in a timely fashion.

If PBGC, after completing an extensive screening process, concludes that a transaction could result in a significant loss to the pension plan, the agency will seek to negotiate with the company to obtain protections for the plan. The Early Warning Program thus raises awareness of pension underfunding, may change corporate behavior, and may allow PBGC to prevent losses before they occur. Under the program, PBGC currently monitors about 3,200 pension plans covering about 29 million participants. Since 1992, the program has protected over 2 million pension plan participants through about 100 settlement agreements valued at over $18 billion (one settlement accounted for about $10 billion). Some recent representative cases include the 2004 settlement with Invensys that provided for over $175 million of additional cash contributions to the pension plan and the 2005 agreement with Crown Petroleum whereby the plan has been assumed by a financially sound parent company and $45 million of additional cash will be contributed to the pension plan.

[20]Mossman, Charles, et al. "An Empirical Comparison of Bankruptcy Models," *The Financial Review*, (1998) Vol 33, pp. 35-54.

PBGC Has Developed an Initiative to Better Quantitatively Assess the Risk Associated with Individual Firms

PBGC has recently undertaken an initiative to create an Office of Risk Assessment, which will focus on improving the agency's ability to quantitatively model individual firms' claim potential. According to PBGC, neither PIMS nor the Early Warning Program provides this information. For example, PIMS projects systemwide surpluses and deficits and is not designed to predict specific company results. Meanwhile, the Early Warning Program targets specific companies, but in a manner that is qualitative in nature. The Office of Risk Assessment, however, will attempt to combine the concepts of both tools and better attempt to quantitatively analyze the claim risk associated with individual companies.

PBGC has consulted with other federal agencies, such as the Federal Deposit Insurance Corporation (FDIC), that have implemented similar approaches for assessing risk. In March 2003, FDIC established a Risk Analysis Center. Guided by FDIC's National Risk Committee, which is composed of senior managers, the center is intended to "monitor and analyze economic, financial, regulatory and supervisory trends, and their potential implications for the continued financial health of the banking industry and the deposit insurance funds." The center does so by bringing together FDIC bank examiners, economists, financial analysts, resolutions and receiverships specialists, and other staff members. These members represent several FDIC organizational units and use information from a variety of sources, including bank examinations and internal and external research. According to FDIC, the center serves as a clearinghouse for information, including monitoring and analyzing economic and financial developments and informing FDIC management and staff of these developments. FDIC officials believe that the center enables them to be proactive in identifying industry trends and developing comprehensive solutions to address significant risks to the banking industry.

PBGC Has Also Taken Steps to Better Protect Its Investment Portfolio from Certain Market Risks

In early 2004, PBGC adopted a new investment strategy to better manage its approximately $40 billion in assets. Although many factors that affect PBGC's financial health are beyond the agency's control, a well-crafted investment strategy is one of the few tools PBGC has to proactively manage the financial risks facing the pension insurance program. Under the new investment policy, PBGC is decreasing its asset allocation in equities from 37 percent as of fiscal year end 2003 to within a range of 15 to 25 percent. Since many of the pension plans that PBGC insures are already heavily invested in equities, some pension and investment experts have said that the agency can create more financial stability by establishing an asset allocation that can hedge against losses in the equity markets. The equity exposure reduction ensures that PBGC's own financial condition will not deteriorate to the same degree as the assets in the pension plans it insures. However, PBGC continues to benefit when equity markets rise because the plans it insures will rise in value. In addition, PBGC claims that this strategy moves the agency closer to the asset mix typically associated with private sector annuity providers. However, it is too soon tell what effects this new investment strategy will have on PBGC's long-term financial condition.

Unlike Other Federal Insurance Programs, PBGC Has Limited Ability to Protect Itself From Risk

Although PIMS and the Early Warning Program help PBGC assess and manage risk to some extent, PBGC lacks the regulatory authority available to other federal insurance programs, such as the FDIC, to effectively protect itself from risk. Whereas PBGC's premiums are determined by statute, Congress provided FDIC the flexibility to set premiums and adjust them every 6 months based on its analysis of risk to the deposit insurance system. Furthermore, FDIC can reject applications to insure deposits at depository institutions when it determines that a depository institution carries too much risk to the Bank Insurance Fund.[21] By contrast, PBGC must insure all plans eligible for PBGC's insurance coverage. Last, FDIC may issue formal and informal enforcement actions for deposit institutions with significant weaknesses or those operating in a deteriorated financial condition. When necessary, the FDIC may oversee the re-capitalization, merger, closure, or other resolution of the institution. By contrast, PBGC is limited to taking over a plan in poor financial condition to prevent it from accruing additional liabilities. PBGC has no authority to seize assets of the plan sponsor, who is responsible for adequately funding the plan.

Conclusion

The current financial challenges facing the PBGC reflect, in part, the significant changes that have taken place in employer-sponsored pensions since the passage of ERISA in 1974. Given the decline in defined benefit plans over the last two decades, it is time to make changes in the rules governing the defined benefit system and reexamine PBGC's role as an insurer. In recent years an irreconcilable tension has arisen between PBGC's role as a social insurance program and its mandate to remain financially self-sufficient. Unless something reverses the decline in defined benefit pension coverage, PBGC may have a shrinking plan and participant

[21] Before granting access to the federal deposit insurance system, FDIC evaluates the potential risk to the funds. It assesses the adequacy of an applicant's capital, financial history and condition, and its future earnings potential, as well as the general character of its management.

base to support the program in the future and may face the likelihood of a participant base concentrated in certain potentially more vulnerable industries. In this regard, effectively addressing the uncertainties associated with cash balance and other hybrid pension plans may serve to help slow the decline in defined benefit plans.

One of the underlying assumptions of the current insurance program has been that there would be a financially stable and growing defined benefit system. However, the current financial condition of PBGC and the plans that it insures threaten the retirement security of millions of Americans because termination of severely underfunded plans can significantly reduce the benefits participants receive. It also poses risks to the general taxpaying public, who ultimately could be made responsible for paying benefits that PBGC is unable to afford.

To help PBGC manage the risks to which it is exposed, Congress may wish to grant PBGC additional authorities to set premiums or limit the guarantees on the benefits it pays to those plans it assumes. However, these changes would not be sufficient in themselves because the primary threat to PBGC and the defined benefit pension system lies in the failure of the funding rules to ensure that retirement benefit obligations are adequately funded. In any event, any legislative changes to address the challenges facing PBGC should provide plan sponsors with incentives to increase plan funding, improve the transparency of the plan's financial information, and provide a means to hold sponsors accountable for funding their plans adequately. However, policymakers must also be careful to balance the need for changes in the current funding rules and premium structure with the possibility that any changes could expedite the exit of healthy plan sponsors from the defined benefit system while contributing to the collapse of firms with significantly underfunded plans.

The long-term financial health of PBGC and its ability to protect workers' pensions is inextricably bound to the underlying change in the nature of the risk that it insures, and implicitly to the prospective health of the defined benefit system. Options that serve to revitalize the defined benefit system could stabilize PBGC's financial situation, although such options may be effective only over the long term. Our greater challenge is to fundamentally consider the manner in which the federal government protects the defined benefit pensions of workers in this increasingly risky environment. We look forward to working with Congress on this crucial subject.

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

Contacts and Acknowledgments

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