

# **CBO TESTIMONY**

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**Statement of  
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## **Defined-Benefit Pension Plans: Current Problems and Future Challenges**

**before the  
Committee on Finance  
United States Senate**

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Chairman Grassley, Senator Baucus, and Members of the Committee, I appreciate the opportunity to appear before you today to discuss questions that the termination of United Airlines' pension plans raises about private defined-benefit pensions in the United States and the issues confronting the Pension Benefit Guaranty Corporation (PBGC). Defined-benefit pensions are an important aspect of labor compensation for millions of people in the United States today, as they will continue to be for decades to come. Recent experience suggests three key observations:

- In structuring future policy, it is important to distinguish between the portion of pension underfunding and resultant PBGC liabilities that is an unchangeable legacy of the past and the portion of underfunding—and the attendant claims to be assumed by PBGC in the future—that may be reduced over time by changes in policy.
- With regard to legacy underfunding, the essential policy question is how to distribute the costs of the shortfall among shareholders, workers, and, perhaps ultimately, taxpayers.
- With regard to the future of the defined-benefit pension system, the key challenge is to design the appropriate mix of incentives for self-insurance (such as appropriate standards for funding) and for purchased insurance (such as that provided by PBGC) to ensure that workers will receive the portion of their compensation promised in the form of a defined-benefit pension—despite changes in a firm's fortunes, the growth or decline of an industry, and the overall performance of the economy.

For workers employed by a company that provides a defined-benefit plan, the promised annuity is often a substantial part of their compensation and an important aspect of their planned retirement income. However, the long period between when the compensation is earned and when the annuity is paid increases the potential for adverse economic events in the interim. Therefore, in the absence of a system of insurance, the availability of benefits from defined-benefit plans depends on the adequate funding of those benefits.

Lawmakers initially became concerned about workers' receipt of promised pension benefits after the failure of several large plans in the 1960s, which eventually led to the enactment in 1974 of the Employee Retirement Income Security Act (ERISA). That law specified minimum standards that pension plans must meet regarding participation, accrual of benefits, vesting, and funding. Along with those standards, PBGC was created to insure pension beneficiaries against the loss of promised benefits as a result of a plan's inadequate funding. At the end of 2004, PBGC insured the pension benefits of more than 44 million workers and retirees. It had assumed responsibility for paying the benefits of about

a million workers and retirees whose plans had terminated without sufficient funds to pay all insured benefits.

Since the enactment of ERISA, the percentage of active workers covered by defined-benefit plans has declined substantially, whereas coverage under defined-contribution plans has risen.<sup>1</sup> On the basis of forms filed each year by employers, the Department of Labor estimated that in 1980, about 40 percent of all private wage and salary workers participated in a defined-benefit plan, 19 percent were in some type of defined-contribution plan, and 11 percent participated in both kinds of plans.<sup>2</sup> By 2004, the Bureau of Labor Statistics reports, 21 percent of all workers in private industry were participating in a defined-benefit plan, 42 percent were participating in defined-contribution plans, and 13 percent were participating in both.<sup>3</sup>

Despite the decline in the share of workers that defined-benefit plans now cover, such plans are likely to remain a major source of income for many retired workers and their families well into the future. A study based on the Social Security Administration's Model of Income in the Near Term estimated that 53 percent of current retirees (those born between 1926 and 1935) were members of families that received income from defined-benefit pensions, whereas 46 percent received income from retirement accounts (including individual retirement accounts).<sup>4</sup> As retired workers who are covered by defined-benefit plans are replaced by workers covered by defined-contribution plans, those percentages will gradually reverse, according to the study's authors. For retirees born late in the baby boom (around 1960), an estimated 40 percent will receive income from defined-benefit pensions, and 59 percent will receive income from retirement accounts.

## **The Scale of Pension Underfunding**

At present, the underfunding of defined-benefit pension plans is a pervasive and sizable phenomenon. PBGC estimates that the vast majority of plans are currently

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1. A defined-benefit plan is an employment-based retirement plan that promises retirees a certain benefit upon retirement, regardless of the plan's investment performance. Under a defined-contribution plan, such as a 401(k) plan, benefits in retirement depend on what employers and employees have contributed and on the investment performance of those funds.
  2. Department of Labor, Employee Benefits Security Administration, "Abstract of 1999 Form 5500: Annual Reports," *Private Pension Plan Bulletin*, no. 12 (Summer 2004).
  3. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2004* (November 2004).
  4. Barbara A. Butrica, Howard M. Iams, and Karen E. Smith, "The Changing Impact of Social Security on Retirement Income in the United States," *Social Security Bulletin*, vol. 65, no. 3 (2003/2004).

underfunded to some degree. The agency's best estimate of total underfunding (on a termination basis) among all insured plans is \$600 billion—\$450 billion for single-employer plans and \$150 billion for multiemployer plans.<sup>5</sup> Of course, all estimates of underfunding are just that: estimates. As such, they are sensitive to projections about interest rates, future returns on assets, retirement ages, and life expectancies. A shift in those factors—especially in interest rates—could have a substantial effect on projections of underfunding.

## **The Financial Condition of the PBGC**

Part of the challenge presented by efforts to reform the defined-benefit pension system are the different terms used to describe the system's problems and the various methods used to measure them. As a federal agency, PBGC's finances are part of the federal budget, which is presented and tracked largely on a cash basis; however, the financial condition of pension plans is usually stated in accrual terms.<sup>6</sup> Both methods use such terms as liabilities and assets, obligations, and deficits, although cash and accrual accounting approach those measurements in different ways. The two methods can and, in fact, do produce different and often conflicting measures of PBGC's financial condition.

### **Cash Accounting**

PBGC's resources are divided between two funds: an on-budget fund for receipts of premiums and outlays for benefits and administrative costs, whose transactions since 1980 have been included in federal budget totals; and a nonbudgetary trust fund, in which the assets of terminated plans are held until used to help pay benefits. According to the government's cash accounting, PBGC ran a cumulative on-budget surplus of more than \$12 billion from 1981 through 2004. (The only year in which PBGC incurred a cash deficit, amounting to \$229 million, was in 2003.) An observer looking only at PBGC's on-budget accounts, as the federal budget does, might conclude that the agency was on a firm financial footing. That conclusion would be misleading, however, because it ignores the agency's long-term financial picture.

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5. By law, the funding rules and insurance system treat pension plans sponsored by a single employer differently than those sponsored by more than one firm, which are referred to as multiemployer plans. Although both types of plans are experiencing similar problems, PBGC underwrites much more liability for single-employer plans. As a result, most pension reform efforts concentrate on such plans.
  6. Cash accounting recognizes, or takes account of, transactions when cash inflows or outflows occur. Accrual measures recognize costs in the period in which they are incurred, even though the cash flows do not occur until some time in the future.

### **Accrual Accounting and Exposure to Underfunding**

PBGC's overall fiscal health is better measured by looking at the agency's net financial position—the difference between the actuarial value of its assets and the present value of its liabilities.<sup>7</sup> Under accrual accounting, the value of PBGC's assets is based on the current fair market value of all cash, bonds, equities, and other holdings of its budgetary and nonbudgetary funds. Its liabilities are calculated as the estimated present value of all future benefits that PBGC is obligated to pay on behalf of plans that have already been terminated, plans whose termination is pending, and plans that PBGC has identified as likely to be terminated.

From the time it began operations in 1975 through 1995, PBGC's net financial position—on an accrual basis—was in deficit. In other words, the total value of the assets it had on hand was not sufficient to cover its projected future benefit payments. (Use of the term “deficit” here should not be confused with annual cash-flow deficits or surpluses.) Starting in 1996, however, PBGC's net financial position moved into positive territory, reaching a peak of \$10 billion in 2000. The agency's financial position moved back to one of deficits in 2002, reaching a record shortfall of \$23.5 billion by the end of 2004.

PBGC's net financial position essentially measures how the resources available to the agency at a given point in time compare with the pension obligations already on its books as well as additional claims from plans whose termination in the near future it considers “probable.” Included in the net deficit figure of \$23.5 billion is \$17 billion in claims from plans that the agency has classified as likely to be terminated.

Another measure of PBGC's financial situation is the amount of underfunding among plans for which the agency considers default “reasonably possible.” In 2004, PBGC's exposure to claims from such plans stood at \$96 billion. (That “reasonably possible” termination category primarily includes plans sponsored by firms that the financial markets consider to be experiencing some financial distress—indicated by credit ratings below investment-grade—but that are not already included in the “probable” category.) According to PBGC, exposure to claims from plans in the “reasonably possible” termination category has risen dramatically, from about \$5 billion in 2000 to more than \$96 billion today.

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7. The present value is a single number that expresses a flow of current and future income (or payments) in terms of an equivalent lump sum received (or paid) today. Market interest rates are the basis of the discount rate used to calculate the net present value of plans' liabilities. Interest rates and the present-value calculation of liabilities are inversely related (lower interest rates lead to higher valuations of pension liabilities and vice versa).

### **PBGC's Solvency**

Although PBGC's fiscal health is best measured in accrual terms, the shortfall between liabilities and benefits will eventually affect the agency's annual bottom line, as measured on a cash basis. Thus far, PBGC has experienced an on-budget deficit only in 2003; it is too early to tell whether the agency will record a cash deficit or a surplus this year. But under its current funding rules and premium structure and the assumptions of the Congressional Budget Office's (CBO's) current economic forecast, there is little doubt that PBGC will soon start running cash deficits for the foreseeable future (see Figure 1). In CBO's projections, the combination of rising benefit obligations and level premium income causes the agency's on-budget fund to be completely exhausted in about 2013.

No precedent exists for how PBGC would proceed if its on-budget fund became insolvent. However, CBO's expectation is that the agency would cover its expenses by increasing the percentage of benefits and other expenses being paid out of its nonbudgetary trust fund. Although CBO does not formally estimate the value of the assets held by that fund, there is a significant likelihood that all of PBGC's assets will be exhausted within the next 20 years.

Under current law, no substantial source of funds is available to PBGC if the agency runs out of money. ERISA makes it clear that PBGC is not backed by the full faith and credit of the U.S. government and has no authority to call upon general revenues to pay benefits. Therefore, if PBGC exhausted all of its holdings, either benefit payments would be drastically cut—perhaps in excess of 90 percent—or lawmakers would have to provide direct assistance from the Treasury.

### **Problems and Policy Issues: Legacy Costs**

Most of the claims that PBGC has recently assumed have been concentrated in a few industries. Nine of the 10 largest claims in the agency's history have come from the airline or steel industries, which account for nearly 70 percent of the dollar value of PBGC's total claims. The most recent example is United Airlines.

In those industries, among others, the competitive position of firms that offer defined-benefit pension plans has deteriorated significantly. That deterioration is likely to prevent such companies from bringing new resources to their underfunded pensions by raising prices and garnering additional revenues from their customers. Changes in policy that require augmented pension funding would impose new costs on sponsors (and consequently losses for shareholders), probably increasing the chances of further bankruptcy filings for purposes of reorganization or liquidation.

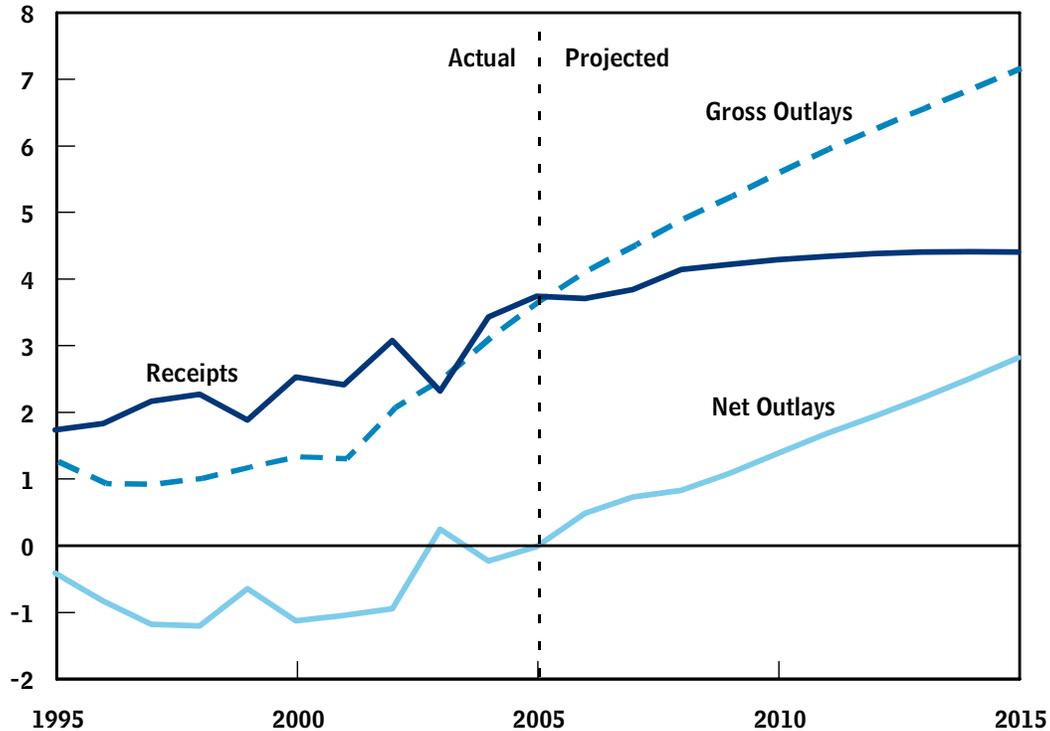
Figure 1.

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## Outlays and Receipts of the Pension Benefit Guaranty Corporation, Fiscal Years 1995 to 2015

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(Billions of dollars)



Source: Congressional Budget Office.

Note: Data for 1995 through 2004 come from *Budget of the United States Government, Fiscal Year 2006*. Figures for 2005 through 2015 are CBO's baseline projections.

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In such circumstances, PBGC's assumption of the firm's pension liability might impose losses on workers, either through the limitations on maximum pension benefits that the law mandates or because PBGC itself might have insufficient assets to fully honor current insurance arrangements. Alternatively, plan sponsors could restrain costs by modifying their plans to reduce benefit accruals for current workers or by freezing their plans entirely. Indeed, either of those scenarios could transpire under current law.

### Problems and Policy Issues: The Future of Defined-Benefit Pensions

The recent experience of defined-benefit pension plans in the steel and airline industries provides lessons for improving policy in the future. Specifically, it is

impossible to fully anticipate the nature of shifting economic conditions at the level of the firm, the industry, or even the economy as a whole. In that case, if workers and firms wish to continue to use defined-benefit pensions as a component of compensation, it will be important to ensure that those firms either “self-insure” (adequately fund) such compensation or that external insurance (in particular, that provided by PBGC) be structured to provide suitable incentives.

### **Strengthening Pension Funding Rules**

The current rules governing pension funding were intended to ensure that firms contributed adequate resources to pay promised benefits by the time the benefits came due, while also providing firms with some flexibility as to when and how they made those contributions. However, certain features of those rules may have led to systematic underfunding among a number of defined-benefit plans. Many firms whose pension plans were recently taken over by PBGC used those features to make small or no contributions to their plans in the years leading up to the plans’ termination—at which point they presented PBGC with billions of dollars in claims.

In some cases, the funding rules discourage sponsors of plans that are considered fully funded from making additional contributions that could provide them with a greater cushion to absorb the effects of adverse market conditions. In other cases, firms that sponsor underfunded plans are sometimes allowed to reduce or suspend contributions that would serve to make those plans better funded.

For example, the law permits sponsors to make contributions in excess of those required and then to use those amounts as a credit against contributions required in the future—even if subsequent events (such as a drop in the stock market) reduce or eliminate the value of the excess contributions. In addition, some of the formulas used to determine a plan’s current liabilities—and therefore the sponsor’s contributions—are based on the assumption that the firm sponsoring the plan will stay in business indefinitely. Under such an assumption, the measure of liability will not take into account the full costs that may be incurred by plans nearing termination (such as costs related to the increased number of workers who accept early retirement benefits, the promise of shutdown benefits, or lump-sum payouts), all of which can increase the costs to PBGC in the event that it takes over the plan.<sup>8</sup>

Funding requirements that allow for the long-term smoothing of both asset values and discount rates are among the funding rules that have contributed to wide-

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8. Shutdown benefits are a form of pension benefit provided to employees when a particular plant or company closes down and ceases operation. They are not included in most calculations of a plan’s liabilities, and sponsors do not currently pay premiums for such benefits.

spread underfunding. Under the current set of rules, plans' liabilities are assessed on the basis of a four-year weighted average of interest rates; the actuarial value of assets relies on a smoothing method as well. Those rules are designed to dampen the fluctuations in contributions that sponsors would otherwise face in volatile financial markets. However, in rapidly changing markets, the reported funding ratios (assets to liabilities) might be markedly different from those that would be calculated using current market values. In recent years, that has led plans to appear better funded than they actually are. (Of course, in a different economic environment, the reverse could be true.) Some observers have suggested that using current market values of liabilities and assets would encourage plans to invest their assets in a way that better matched the liabilities' duration with the income projected to be received from assets. Such matching would help immunize plans from financial fluctuations and thus moderate the volatility of required contributions.

### **Pricing Pension Insurance**

The underpricing of PBGC's insurance—that is, the current premium structure—is a key factor in the agency's present financial difficulties. Premium revenue is the only source of income available to PBGC to cover the shortfall between the liabilities of terminated plans and the value of their assets. CBO expects that under current law, premium income will remain relatively flat—at around \$1 billion annually—whereas benefit payments resulting from both past and future claims will rise from about \$3.5 billion this year to more than \$10 billion in 2015.

A contributing factor to that pattern is that the premium rate paid by sponsors of multiemployer plans has remained constant since 1988, and rates for the two types of premiums charged for single-employer plans have not changed in more than a decade. (One of those premiums is an amount levied per plan participant; the other is calculated on the basis of a plan's underfunding.)<sup>9</sup> The rates for the premiums are set by statute, and PBGC cannot adjust them, as most insurance providers can, for the losses that past history leads it to expect. The underpricing of PBGC's insurance may also exacerbate a phenomenon known as moral hazard, by which the very existence of insurance leads firms to promise more benefits to workers or provide less funding to their pension plans than they might have in the absence of insurance.

In principle, insurance for defined-benefit pension plans could be provided either through the private sector or by the government. If private markets were used, they would charge premium rates that reflected the likelihood that the insured

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9. The premium that is levied on underfunding does not always work as intended. Because of loopholes in the premium rules, many plans that are underfunded are not actually required to pay premiums on their underfunding.

event would occur. A fully funded plan with an economically strong sponsor would represent a low potential claim to the insurer and would be charged a smaller premium than an underfunded plan with a financially struggling sponsor—which would present a higher risk and pay commensurately higher premiums.

By contrast, the current practice is to supply pension insurance through PBGC, which is not allowed to fully tailor its premiums to the risks it faces in insuring plans that vary in their likelihood of termination. Although the law specifies that significantly underfunded plans must pay a variable-rate premium based on the amount of their underfunding, the agency is not permitted to distinguish between profitable sponsors that pose little risk of termination and distressed sponsors that threaten the agency with a large-scale claim.

Another issue relevant to the pricing of pension insurance is how premiums should be changed to reflect past versus future claims against PBGC. The estimated shortfall for past claims, as well as some imminent losses, is \$23.5 billion. With estimated underfunding of \$96 billion residing in plans that are classified as having a reasonable possibility of default, it is realistic to expect that PBGC will soon be taking on billions of dollars more in claims. If premiums were set so as to lessen or eliminate the agency's accumulated deficit as well as to accurately reflect its exposure to future claims, ongoing sponsors would be charged substantially more than actuarially fair rates. That kind of system might lead some sponsors of well-funded plans to freeze or terminate their plans, thus actually worsening PBGC's finances by reducing its premium collections. In considering how to finance PBGC in coming years, it would be useful to consider the following as separate issues: (1) how to price pension insurance to cover future risks and provide the proper economic incentives to firms in managing their pension plans, and (2) how to pay for losses that have already been incurred.

The notion that premiums should reflect risk also leads to the conclusion that the measures a firm takes to reduce risk should result in the lowering of its premiums. For example, under such an approach, sponsors that had good credit ratings would face lower premium rates than less creditworthy firms. Similarly, the premium structure should take other factors into account as well, including PBGC's access to nonpension assets in bankruptcy court and contingent liabilities such as shut-down benefits.

### **Promoting Transparency in Funding and Accounting Rules**

The transparency of the risks within the defined-benefit pension system is another important consideration. Markets work best when full information is available to all of their participants. The current pension system does not do a very good job of providing the kind of information that would be helpful to investors and plans'

participants as well as to policymakers and taxpayers. Funding levels are measured in different ways for different purposes, and information about potential underfunding that is filed with PBGC and other government agencies (such as the Internal Revenue Service) often lags years behind. In some instances, PBGC receives more recent and detailed information about seriously underfunded plans but is prevented by confidentiality laws from releasing those data.

Those delays force investors and plans' participants to rely on corporate reports for timely information about a plan's funding status. However, in issuing their annual reports, firms are allowed to use a variety of interest rates to discount the cost of their pension liabilities.<sup>10</sup> In many cases, companies use a higher interest rate to calculate their plans' liabilities for corporate financial reports than they use to report liabilities to government agencies or to the plan's participants. The higher discount rate makes pension liabilities appear smaller to those who use annual reports to value companies on the basis of their assets and liabilities. The use of different discount rates combined with lack of transparency about funding levels can cause investment markets to undervalue the cost of providing pension benefits; it may also lead workers to underestimate the likelihood that their promised pensions might not be delivered in full.

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10. The discount rates used in corporate financial reports are governed by the Financial Accounting Standards Board.



