RECORD OF SOCIETY OF ACTUARIES
1992 VOL. 18 NO. 1A

PBGC ISSUES

Moderator: GERALD D. FACCIANI
Panelist: DAVID C. LINDEMAN*
Recorder: RONALD GEBHARDTSBAUER

- What issues is the PBGC focusing on currently?
- LTV update
- Insured annuities

MR. DAVID C. LINDEMAN: The PBGC covers about 40 million participants in about 85,000 plans; 83,000 of the 85,000 are in the single-employer world. Only about 2,100 are multiemployer plans. The PBGC is set up to deal with what you might call the problem of a plan being funded in the company sponsor's assets. We have, over the years, tried to collateralize the promise to workers in a defined-benefit plan by forcing the sponsor to, in effect, buy assets in other companies to back the promise. But to the extent that that doesn't happen, we say the plan is underfunded, or economists would say that the plan is, in effect, being financed by the sponsor's own assets. And to the extent that there's simultaneous failure of the plan and the sponsor in bankruptcy, the PBGC exists to insure against that risk.

In our 17-year history, we've taken responsibility for about 372,000 participants and about 1,600-1,700 plans. And in the multiemployer program, because of the institution of withdrawal liability, which was enacted in 1980 -- because of that mechanism and how well it's worked over time -- we are in better shape. The multiemployer program is currently in surplus, and according to our latest five-year study, does not look like it's going to have any severe problems although people do worry about the 15- to 20-year horizon in that program.

Now, with the single-employer program, we've had problems, and we believe we will continue to have even more severe problems into the 1990s, and beyond, absent reform. In 1991, we had our two largest losses to date, which were both from the airline industry. One was Pan Am, and the other one was Eastern. We have, consequently, a $2.5 billion deficit. Government agencies can run deficits that other people can't. You might wonder how we stay in business. It's because we run a Ponzi game. We essentially do not satisfy or pay out the liability at the time we take the claim, but rather we are our own annuity issuer, so we, in effect, can finance the claims or the benefit payments from plans that we've taken over in the past by essentially using assets in plans that we're now taking over, plus, of course, the premium dollars. So, even though on an accrual basis we're $2.5 billion in the hole, we're in moderate surplus on a cash basis. I'm going to go into that issue a little bit further when I talk about the accounting changes that are being discussed in the administration's budget.

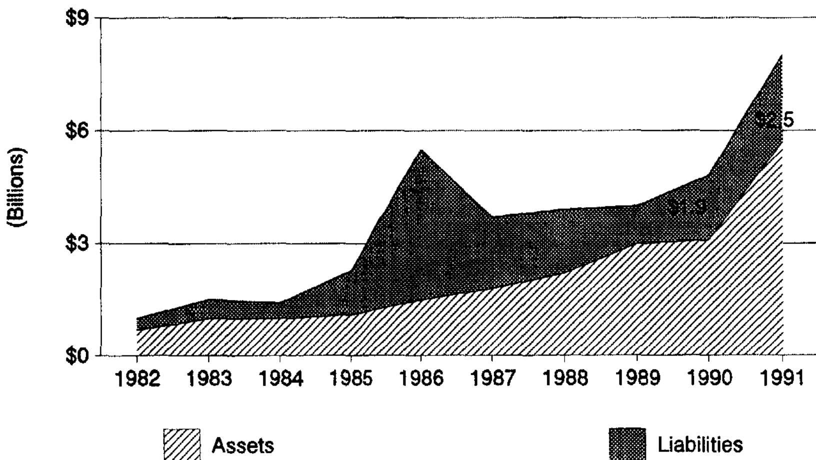
* Mr. Lindeman, not a member of the sponsoring organizations, is Director of Corporate Policy and Research at the Pension Benefits Guaranty Corporation in Washington, District of Columbia.

The plan underfunding in troubled companies is up since the last time we measured it. About half of that increase is changes in the assets, particularly in a couple of plans. Half of it can be traced back to benefit improvements negotiated by the automobile companies with the United Auto Workers (UAW) in the last bargaining round.

I'll try to distinguish the two different ways we have been forecasting losses as we go along, but if I'm needlessly confusing on this subject, please catch me, and try to get me to clarify it. Under a new model of the Office of Management and Budget (OMB), using an options pricing model, it forecasts, over the indefinite future of the PBGC, that we would have a $30-45 billion loss. The $30-45 billion range comes because there are, in effect, two variants of the model. With a 30-year claims model, there is something in the neighborhood of a $33-35 billion loss scenario. If, on the other hand, you take, literally, an infinite time horizon, and you look at the inventory of possible losses in the 30th year of your forecast, there's potentially another $15 billion of losses in expected present value. Now, let me emphasize, that's expected present value; that's literally today's dollars.

Chart 1 tells our unhappy history. As you can see, since 1982, when the claims began to really pick up, our liabilities have increased more substantially than our assets. And consequently, as I said before, we have the $2.5 billion deficit, up from $1.9 billion the previous year. This is, by the way, the single-employer program, not the multiemployer program. Our deficit is about $200 million less if you add in the multiemployer program. The spike there in the liabilities in 1986 was due to the taking of Long Temco Vought (LTV), and then giving it back, so it's more of a historical anomaly than anything else. But you can see how much the slope has gone up on both the asset and the liability side in the last two to three years, and that again is, of course due to the airline plans that I mentioned before, Pan Am and Eastern.

CHART 1
Liabilities Are Growing More Rapidly Than Assets

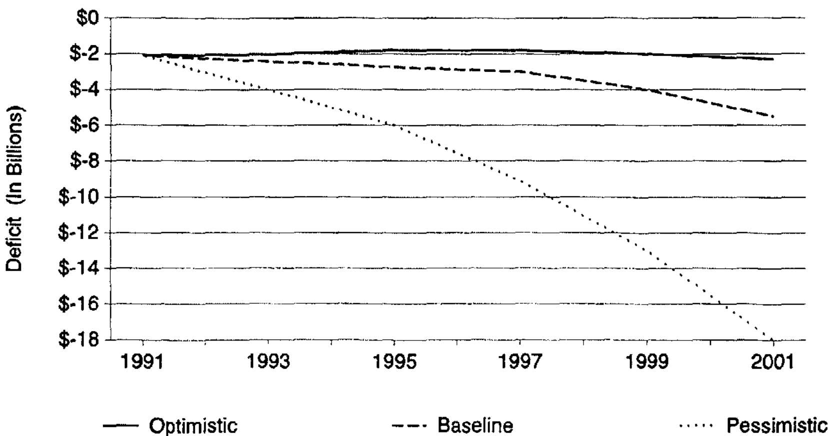


Now, in the area of exposure of the PBGC, I think it's probably worth going back to some basics. Overall, defined-benefit plans are well funded. We assume that there are several hundred billion dollars of assets exceeding liabilities in defined-benefit plans as a whole. Most of the excess, or surplus assets, or reserve for future costs, are in the final-pay salary plans, which are about 76% of the universe, and the funding ratio there is about 145%. That may actually be a little high. It may be closer to 135%-140% now, because of the influence of the full-funding limit. On the other hand, within the universe of defined-benefit plans, there's a subset, union plans, virtually all of which are flat-benefit plans, as far as we can tell anecdotally. These flat-benefit union plans, unlike the final-pay plans, which are almost axiomatically overfunded on a termination basis, are structurally underfunded. It's very difficult for them to be funded on a termination basis, much less overfunded on a termination basis. And, indeed, that's mostly where our losses have come from. If you go back and you look at our history, and you look at all the major claims we have taken, with the exception of the Republic salary plan, all of our major hits have been in the flat-benefit plans.

I'm going to remind you all of something you, I'm sure, know quite well. The reason why these flat-benefit plans are systematically underfunded is that, essentially, even if they were to catch up on the last round of funding, the next time there's a collective bargaining increase, a new layer of underfunding is added. And so they're always in a catch-up mode. They're rarely caught up, even with past increases, although, theoretically, under the new funding standards enacted in 1987, that should be less of a problem.

We now do a forecast by extrapolating past experience, which is similar to what Social Security has been doing for 40 years. Our baseline forecast (see Chart 2) assumes that we take claims over the next 10 years at approximately the level that we have since 1982, when our claims began to pick up.

CHART 2
10-Year Forecast Shows Troubled Future



You can think of that as basically taking plans with a $1 billion or more in liabilities every year, with plans having a funding ratio of 50%-60%, and very low recoveries from the employers in bankruptcy proceedings. The optimistic scenario, which once upon a time actually crossed the positive line, but no longer does, merely goes back to our full history, and puts into the extrapolation base the good years from the 1970s. And, the pessimistic case adds to the base line all the plans that we now rate as reasonably possible. Now, *reasonably possible* is a financial accounting term. It means exactly what it says: reasonably possible. It doesn't mean probable, it doesn't mean remote. It just means that the future termination occurring is more than remote but less than likely. We have started to footnote that in our financials rather more comprehensively than we had before, and we basically do this by looking at the companies, the plans that have serious underfunding, and looking at the bond ratings of those firms. So, you can think of this as all the companies out there with large, underfunded pension plans that have below-investment-grade bond ratings. That number continues to go up, unfortunately.

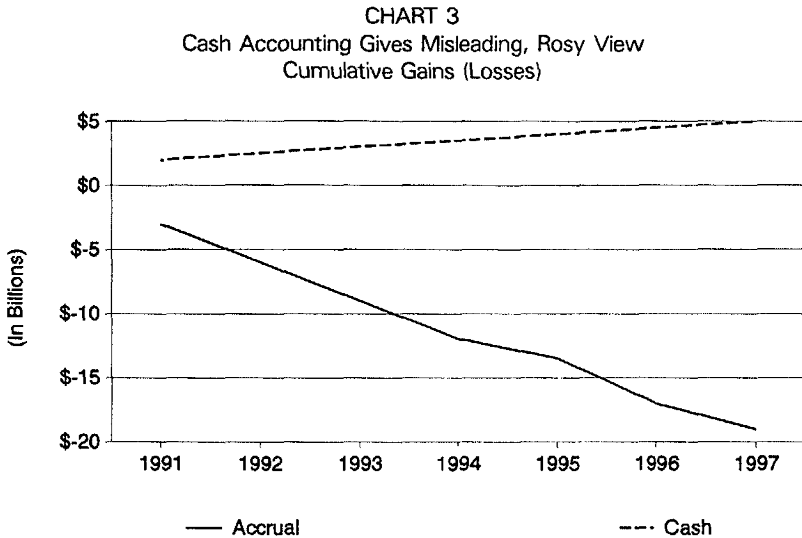
Now, let me dwell on this for a moment, because I want to make, maybe even a philosophical point here. I think when the PBGC was set up, it was set up to insure two things. One thing was the occasional circumstance in which the plan becomes underfunded and the company goes belly up. The plan assets might have dipped below full-funding because of sudden bad market performance, or just because they were never particularly profitably invested to begin with. And I would associate that with a lot of small-company plans. The other reason I think we were set up was to insure against what I think was thought to be the very unlikely circumstances of one of the major actors in American enterprise, one of the industrial giants of America, going bankrupt with what I think everybody must have thought was a structurally underfunded pension plan. I can't believe they really thought 30-year amortization was going to take care of the problem. These plans could be systematically underfunded, but it didn't matter, you know, because these giants weren't going to go bankrupt. Well, I think the 1980s have taught us to the contrary. Now, you can trace it to leveraged buyouts. You can trace it to global competition. You can trace it to just more inefficiency, in some sense, in the industrial sector relative to the service sector. There are a whole number of things you can trace it to. But you can no longer assume, as you did before, that the major industrial giants of American enterprise that sponsor the structurally underfunded pension plans are not going to go bankrupt. Some of them have, and certainly some of them will, in the future. So then the question really is, do you ask Congress to rethink the nature of the insurance contract, and narrow it? And that's what our proposals are designed to do.

Now, I'm going to talk first about one of the four proposals that are in the President's budget, regarding the PBGC, because from an analytic point of view, it may be the most important in terms of how you think about the program. Right now, when we go into the budget of the United States, what gets treated as an outlay or an expenditure of the government is what we pay out in benefit payments or administrative costs from that portion of our liabilities that are financed by premiums. On the other hand, incoming premiums are treated as income. Well, premium income in a given year is currently exceeding the amount of benefits and administrative expenses charged to the premium account, so we're in modest surplus and we're a little cash cow, in the United States budget. On the other hand, if you were to treat us, in the budget, merely in a retrospective basis, on an accrual-accounting basis, with the same

standards the SEC imposes on all corporations in the United States, we would be $2.5 billion in the red. There's another problem with cash accounting, from our perspective, which is that in the government, lost revenues are treated as a hit, a bad thing, from a budget-accounting point of view, and so if we want to increase required minimum funding, that increases certain corporations' deductions, and that's a hit on the revenue basis. And yet, at the same time, there's no way to offset that in the here and now with the benefits to the insurance program. So, cash accounting doesn't allow us to recognize the costs, and it certainly gives us a conundrum with respect to how to deal with the reform proposals.

The proposal in the budget is awfully complicated with respect to accrual accounting, or, accrual budgeting, and I'm not going to go into detail. But Chart 3 will give you a picture of what it looks like.

CHART 3
Cash Accounting Gives Misleading, Rosy View
Cumulative Gains (Losses)



The easiest way to think about this, I think, is to take that $30-40 billion forecast of our expected present value of losses and think of it as a bond that you're going to amortize over time. The cash line $2-3 billion a year, shows how much should be reserved every year for the PBGC, how much the government should be budgeting every year so that it will have enough money put aside in the PBGC account, to handle all the claims that are coming in. Economists would say, $2-3 billion a year is the real economic cost of the program. That's not a large number, necessarily, compared to a lot of things in the government. But it is a number that is nontrivial, and it is a number that ought to be paid attention to, and it ought to be weighed against the alternative uses of that money. There are alternative uses of that money. And that's basically what that accrual-accounting or accrual-budgeting line gives you. On the other hand, the cash-accounting line, as I said before, gives you a misleading impression that we're getting better over time.

Well, the question is, given our problems, where do we go from here? We have some legislative proposals. I think this time around we've put everything on the table, but not always artfully, in the opinion of many. (At the enrolled actuaries meeting, one speaker got up and described the funding proposals as not only the son of 412(l), but the demon seed.) The first set of proposals is on bankruptcy, the second is on funding, and the third is restricting the growth in the guarantees. And, the last is, as I mentioned before, to shift our budget accounting from a cash basis to an accrual basis.

In the bankruptcy area, what we're going to try to do is clarify some things that we think we've always had in the law. We've always felt that sponsors had an obligation to make contributions to their pension plan in the full amount that the tax law normally requires, whether they're in bankruptcy or not. Unfortunately, Judges Liflind and Duffy disagree with that, and believe that if you can go into bankruptcy, you can essentially extinguish your obligation to make a contribution to the extent any of it can be traced to past-service liability, which, of course, is most of it. We also have believed, at least since 1987, that if the plan terminates in bankruptcy, any missed contributions are a priority claim against the bankrupt estate. We've always believed that we have, for the employer liability claim, a priority up to 30% of net worth. There's been disagreement on that, with respect to the language in ERISA. But even more important, there is the ultimate objection you always get from the bankruptcy bar: if it isn't in the bankruptcy code, it doesn't exist. We don't care what the tax law says, we don't care what ERISA says. It has to be explicit, open, and notorious in the bankruptcy code; otherwise we don't believe Congress gave you a priority.

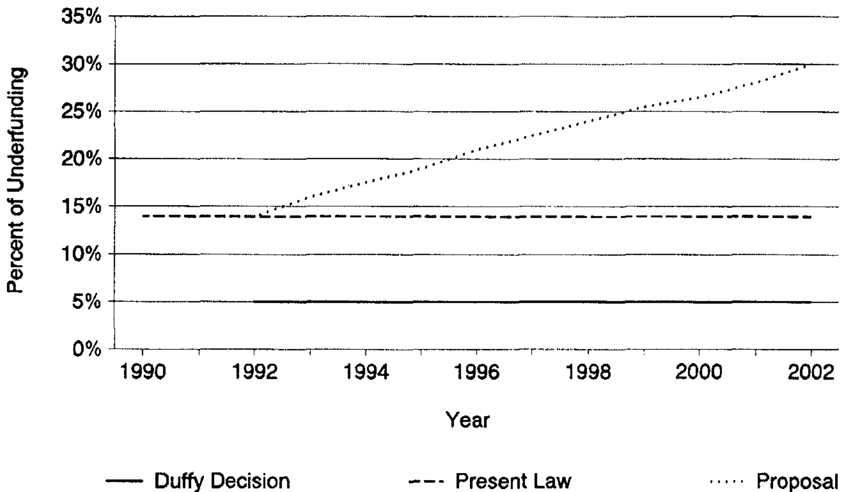
We're also asking for something new in the way of changing that employer liability claim from 30% of net worth to about 10% of plan underfunding, because over time, people are going to increasingly learn how to game the 30% net worth claim. And it's not all that difficult. So, eventually, the employer liability claim is going to become, increasingly, 30% of zero. So, we'd like to switch the employer liability claim to 10% of underfunding, and then we'd like to increase it to 50%, at 2% a year, which we think is a very gradual approach, even though we've been told that it will destroy American capitalism as we know and love it.

We'd also like to deal with shutdown benefits, which as you know are early retirement benefits, that are essentially never prefunded until the plant closes down. We would like to have a priority claim for the amount of extra liability traceable to shutdown benefits for any shutdown that occurs within three years prior to termination. And we would like the option to be a member of the creditors' committees. And on this point, that may seem trivial, but we're the largest claimant in many of these reorganizations, and we're not always allowed to be a member of the creditors' committee. This delays the process. We don't get the information, we sulk around corridors, calling people, trying to get information, trying to find out what's going on, reacting to things that we read about in the newspaper, instead of being part of the process up front. We think that if we're part of the process up front, people will have to deal with us, and we will have to deal with them. That'll expedite these bankruptcies, perhaps even reducing the cost of investment bankers.

Chart 4 is a little picture of what we think our proposal would do over time. We think we're getting about 14% of the underfunding now. Let me say that is a very

optimistic number. It's loaded with estimates of what we think we're going to get in some pending cases. If you looked at our recoveries based on actual cash or signed agreements, the number's a lot lower. The Liflind-Duffy decision, would knock us down, for a variety of reasons, to 5% of the underfunding. The proposal would raise it up over time.

CHART 4
Recoveries in Bankruptcy

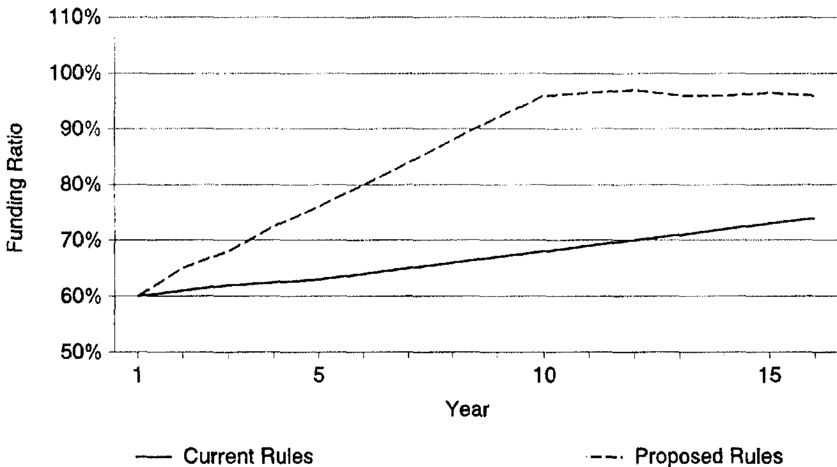


The next set of legislative proposals I'll talk about comprises the funding requirements. This is probably the part that'll be most interesting to you actuaries. Let me say at the outset that we are open to lots of suggestions and help in refining them. I'm really more interested, as we work through this process of getting a consensus, in what the results ought to be, rather than the mechanics. We would like something much closer than current law to what came from the Ways and Means Committee in 1987, when this issue was last debated, which is a set of alternative rules. Our proposal says that you have to contribute the greatest of what the 1974 funding standard account rules tell you you have to contribute; it tells what a stand-alone version of the deficit-reduction contribution would have you make, that's essentially 412(l) revisited; and then something new is what we called a solvency-maintenance contribution, and let me emphasize, that may be misnamed. It isn't really designed to deal with the plan that's about to run out of money. Basically, it's designed to deal with a problem-child-type plan, which is the industrial, unionized plan, where almost always, there's a very heavy ratio of older workers and retirees to younger workers. And what this rule does is say to a plan that you've got to put back into the plan what you took out, plus interest on the unfunded liability. You'll quickly figure out that keeps the assets of the plan constant over time, and because, as I said, these are plans that have many retirees and older workers relative to the younger workers. They are extinguishing liabilities over time at a much faster rate than they're accruing liabilities. So what happens is, the liability line is coming down over time, until

essentially it hits the assets, because the assets are being held constant. And, it's a very efficient rule. And it gets a plan funded in about 10-15 years.

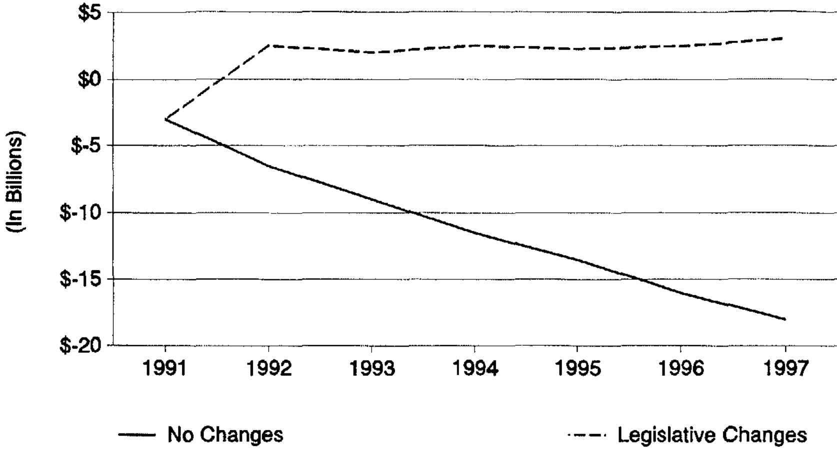
Chart 5 is a picture that gives you an example of what these rules would do. This is really a portrayal of what that solvency-maintenance rule might do. The last time we made a proposal like this, we called it a cash-flow rule, and it was rejected. So we thought that by renaming it, we might get more success this time, but we probably chose a bad name, so let's call it the banana rule for a moment. And that, as you can see, gets these plans fairly well funded in about 10 years, at least in the one we modeled there.

CHART 5
Funding Ratios With and Without Funding Reform
for Typical Plan Presenting Exposure to the PBGC



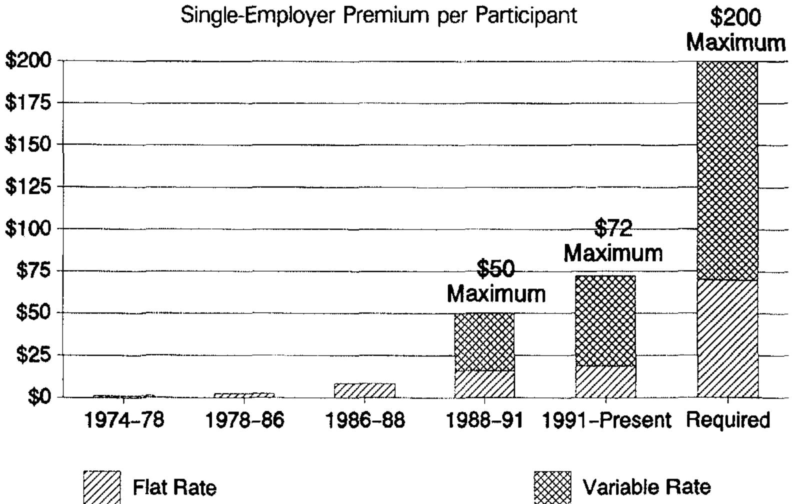
The last proposal that I will talk about is restricting the growth in the guarantees. After all, if you've got a problem in an entitlement program, one way you can address the problem is by restricting the growth in the entitlement. And that's what this proposal would do. Needless to say, this is the proposal that's the least popular on the part of organized labor. It would restrict the PBGC guarantee in cases of underfunded pension plans, and it would say that the company and the union can negotiate increases if they want to, but those increases will not be guaranteed by the PBGC until such time as the plan is fully funded, or funded on a termination basis. It's a very hard rule. I acknowledge that ahead of time. It is prospective only. It only applies to benefit increases after December 31, 1991. There would also be the rule that any increases, or any new shutdown benefits, or increases in shutdown benefits would not be guaranteed because those are inherently risky, because they're not funded in advance. Now, what does this do? Well, under the model, it takes the PBGC from the line that's shown at the bottom of Chart 6, where you're having to reserve, or should be reserving approximately $2-3 billion a year, to a situation where, after a modest jump, we're essentially in surplus, at least in the period there shown.

CHART 6
Impact of Legislative Proposals on PBGC's Financial Status
(Cumulative Gains (Losses) Under Accrual)



Eventually, that surplus gets used in later years as claims do come in. But, under the OMB model, these proposals essentially reduce future program costs to meet existing premium revenues, i.e., there would be no premium increase if you were to enact the totality of these reforms and they were to work as we have modeled them. The alternative, of course, is to increase the premium. In a very crude way what that means is that the current $19 flat-rate premium would go up to $70, and the variable-rate premium would go from the $72 max to a $200 max (see Chart 7).

CHART 7
Single-Employer Premium per Participant



Now, that assumes that the current ratio of income, which is about 83% of the flat-rate premium, 17% of the variable-rate premium, is held constant. Obviously, you could come up with a very different scenario if you were to keep the flat-rate premium at $19 and put the full incremental burden on the variable-rate premium, which some in Congress have suggested, and a lot of people in the academic world have suggested, who like risk-related, or at least exposure-related premiums.

One of the things I didn't mention about the proposal that the President set up, with respect to accrual budgeting is first of all, it's generic to all federal insurance programs. It's not just PBGC-specific. It's supposed to be a way in which the federal government begins to think about and budget for all its insurance programs.

Something like this was done in the credit programs a couple of years ago. The proposal for the insurance programs is very much modeled on the one used for credit reform. The other thing that's in the proposal is that, to the extent that Congress doesn't cut costs to meet premium revenue, or doesn't raise the premium to meet costs, or meet what the reserve should be, then Congress is supposed to appropriate the deficiency. More or less, there would be a direct subvention from the general fisc. Now, that's part of the proposal that makes the Congressional Budget Office (CBO) very leery about this whole approach. It says these programs are supposed to be self-financing. Also, the CBO and the General Accounting Office (GAO) have concerns about whether the modeling that the OMB has done so far is all that it should be. I think we all would acknowledge, including the folks at the OMB that did it, that they had to do a job in a very constrained environment, and that it would be good to refine the modeling. And we have a rather ambitious program over the next couple of years to do a more exfoliated model of the PBGC and defined-benefit plans, and I suppose the world as a whole, if you take it large enough. And so, there are some concerns as to the robustness of the numbers under some of this modeling, and that's a legitimate concern. So, there are a lot of very conceptual issues on this accrual budgeting that have to be dealt with. What is interesting, however, is that both the CBO and the GAO said that accrual budgeting is the right way for the federal government to start looking at these contingent liabilities. These things can't just be ignored. But then they'll say, "look what happened," when the event actually occurs.

Modeling forces you to think about the program and think about the world in which the program exists a lot more deliberately than you otherwise would. It gives you some sense of what the distribution of the risks are around the mean, and what the circumstances are in which you could have a real disaster, like you had in the S&L situation. After all, the S&L program went along for 30, 40, 50 years reasonably well, but it was a coincidence of all the worst possible things coming together that caused the disaster. Well, there's merit in trying to think about what that means in the context of the PBGC, and trying to figure out, what the policy responses are that you could take to avoid that kind of contingency, and whether indeed, the benefits of those proposals, or those changes, are worth the costs. For example, not only could you force plans to be fully funded on a termination basis, but if you really wanted to get rid of all interest-rate risk for the PBGC, you could essentially say that you've got to have a bond portfolio up to termination liability in your pension plan. Well, when academics suggest that, my colleagues and bosses in the bureaucracy pale visibly, because that is, of course, very interventionist and in effect tells the sponsor how to

invest its assets. But it does give you a sense of what those trade-offs are. It gives you a sense of those trade-offs and it allows you to give the congressional staff, the committees, and the expert agencies a sense of what those trade-offs are too. So, I think that this modeling process and this approach to looking at the program will produce an analytic consensus, more so than we have had in the past. And while legislation may or may not pass this year, and we certainly haven't given up hope, I would expect, over time, that you will probably see a consensus emerge, and we probably will have further remedial legislation for the PBGC.

FROM THE FLOOR: My question relates to Chart 3. What does this look like if you run it out 20 years?

MR. LINDEMAN: Under cash accounting, we would probably continue to be in a surplus, because as long as we keep taking in plans, and we can use those plans to pay for outgoing benefits, I think those cash lines go negative somewhere. It depends on how you define cash, to some extent. But if you do it the way it's defined there, I think that goes negative somewhere around 2005, or something like that. I mean, it starts to go below zero. The accrual line is how much you should be reserving every year cumulatively over time for PBGC losses. It does not take into account existing premium revenues. Now, if you think about it, the losses are projected at $30-$40 billion on a present-value basis. Premiums are about, on a comparable basis, $9-10 billion. So, you essentially have about a $20-30 billion shortfall on a present-value basis. Now, you can either make up that shortfall by, in effect, cutting program costs, cutting your liabilities, or increasing funding. Or you can raise premiums, or essentially, you can force the general fisc to support the program.

FROM THE FLOOR: So, this takes into account new plans coming in?

MR. LINDEMAN: Yes. What the model does is project the defined-benefit world into the indefinite future. And, 30-40 years is the indefinite future for all intents and purposes. And, it has existing plans increasing their liabilities. It has them increasing their funding, even under current rules. We do believe the current rules are increasing funding to some degree. And, it has firms failing. It has new firms coming into existence, substituting for the firms that failed. It has a certain assumption about how many of them started defined-benefit plans as opposed to defined-contribution plans. So, it is, like any other set of modeling exercises, filled with lots of assumptions about the future, but I think they're, by and large, reasonable assumptions. And one of the things we're going to try to do in our own modeling is get a better sense of what the different kinds of assumptions do to different kinds of scenarios and try to develop a consensus among ourselves and others as to what the reasonable set of assumptions ought to be. That, in effect, is a full-blown modeling of the program into the indefinite future.

FROM THE FLOOR: It needs these new plans flowing into it to meet these projections?

MR. LINDEMAN: Yes. It does not have a lot of new plans flowing in. The reality is that not a lot of defined-benefit plans are being formed, and we certainly reflected that in any modeling we're doing. We know that altogether too well.

MR. JOHN LEE BARTZ: My question regards the option to be a member of the creditors' committee. Is that secured or unsecured? And if it's both, would that present a conflict?

MR. LINDEMAN: I think in general it would be unsecured. I really don't know how we would handle the case where we are also a secured creditor. You may know more about the mechanics of bankruptcy than I. We rarely – well, I shouldn't say rarely – go into bankruptcy as a secured creditor. We are doing much better now, in terms of the waiver process. Waivers were a problem. Part of the hit that we took in Pan Am is clearly traceable back to waivers granted by the IRS in the early 1980s. But since 1987, with the new waiver rules, either waivers are not being given, or when they are given, we're given pretty good collateral. And so we're now going into bankruptcy with secured claims.

FROM THE FLOOR: Every time we deal with an underfunded plan, and we have to pay huge variable PBGC premiums, we say, "well, the plan assets can always pay those." Isn't there some flaw, if the plan assets pay the premium? So, the plan assets are depleted, and the plan becomes more underfunded. But the money goes to the PBGC.

MR. LINDEMAN: Yes, I think that is a problem. The program is in the business of having one set of people cross-subsidize another set of people. If you were to price this program differentially on the basis of risk, much less exposure, you'd have a very different kind of pricing structure than what you have now. I mean, there are limits to it. You can't charge the person who has terminal cancer in the last year of his illness the full expected cost of his illness without violating the very concepts of insurance. So, you're talking about shifting the burden relatively between the healthy and the unhealthy.

FROM THE FLOOR: Well, the PBGC seems to have a tremendous amount of assets. Where are those assets invested?

MR. LINDEMAN: We have two kinds of assets pools. One of them is the premiums. As I said before, we're running our own insurance company, our own annuity company, if you will, so we've taken in a lot of premiums which are, in effect, being held for future benefit payments. Those are held in government securities. And to that extent, you can think of us very much like the Social Security Trust Fund. The assets in the plans that we take over and any recoveries that we have from employers go into what is sometimes called an extra budget trust fund. In effect, these are assets we hold in our capacity as a trustee, rather than as a government agency. And they are invested in the private sector. Now, one of the things we've done that I didn't highlight is that we've moved those, increasingly, to a long-term, fixed-income bond-type portfolio. There's always been the question as to whether we ought to go into equities with respect to the trust fund, because the expected rate of return to equities over time is higher than it is to bonds, and the premium payer or the government is there to back us if we're wrong. That has been the philosophy of the PBGC investing, generally, up until recently. Under Jim Lockhart, the current Executive Director, we've moved to what I would typify as much more of an insurance practice. Fisher Black, the finance expert, came in as part of a consulting contract we had. He essentially said, in short, that we're long on equity whether we like it or not. After

all, we're insuring the equity risk of the failure of the firms, plus about half of the plan assets are usually in equities. So, if that's our risk, we really ought to be in bonds. So we've moved to an immunization strategy, which has worked rather well. This year, interest rates changed, and we had essentially a matching in the portfolio, and to that extent, the strategy has worked out reasonably well.

FROM THE FLOOR: Compared to equities, it's worked out.

MR. LINDEMAN: Yes.

MR. CHARLES N. VEST: One of the topics on the program was purchased annuities. And, in that area, my understanding is that, over the last year or so, there have been some proposed rules from the Department of Labor and the PBGC relating to minimum claims-payment ratings for pension plans purchasing annuities from an insurance company. Could you maybe give a brief outline of what those are, and what the status of those rules is?

MR. LINDEMAN: The program did mention that I would talk about some other PBGC topics, and I'm happy to talk about them. But let me say that there is a panel dealing with this exact issue, and Angela Arnett, from our General Counsel's office, is a member of the panel, and she'll be going into that in substantial detail.

But I will say that we have gone through the advanced notice of proposed rule-making. We've gotten a lot of comments from the public, and so has our sister agency, the Pension Welfare Benefits Administration (PWBA), because this is not just a PBGC problem. You've got to deal with it, not only in a termination context, but also in an ongoing plan context. Options are being reviewed and discussed by the PBGC and the PWBA. Now, there is also a notice that we put out that says that a plan sponsor must provide the names of possible insurers, before the contract's finalized, and that will go final fairly soon. That's in the OMB for final clearance right now. But aside from that, we're not in any final or proposed stage yet. But I'll let Angela go into more detail about it.

One other thing I should mention is that we are putting out, for proposed rule-making, fairly soon, two other regulations that folks ought to pay some attention to. One is a regulation that would simplify, in some respects, the premium process, how you determine the premium, when you pay it, what goes in early in the year versus later in the year, etc. The proposal is, to some extent, driven to just simplify the process for you. It's also driven to make it simpler for us. We will be designing a new computer collection system, so we really know where our premium dollars are coming from and where they're going. And, that's one of the things we've got to clean up in order to get a clean opinion eventually from the GAO. And what's simple for you turns out to be simple for us, so I hope you'll view these proposals with some sympathy, or at least have constructive comments. There'll be some minor shifting of the burden away from some plans to other plans.

We're also going to put out a proposed regulation on the factors that go into assessing employer liability. Now, this is important beyond the narrow confines of the PBGC, because whether we like it or not, the Congress has chosen to reference our interest rate in the tax code, for the interest rate that puts a ceiling on what you can

use for cashing out people with lump sums. There are implications for this regulation that flow into the tax code. And one of the things we will be discussing internally is whether that kind of link should be broken. Frankly, it constrains our ability to move and keep up with changes in the annuities market. All we're trying to do in our employer liability regulation is somehow match the market. It's a very narrow parochial PBGC concern, and ought not have repercussions beyond the PBGC.

MR. PAUL W. ROBBERSON: if I'm interpreting your two charts here correctly, you have four legislative proposals that give about a $20 billion swing in 1997. How much of the savings are from each one of the proposals?

MR. LINDEMAN: It depends on how you look at them. Do you look at them individually? Do you look at them together? Which one is the marginal one? The answer is approximately one-third, one-third, one-third. On the other hand, if you take any one of them away, some of them tend to fill up the difference. For example, the limit on the guarantee, if that's all you did, not the funding, not the bankruptcy, I think it is probably 70-80%. You probably get most of the effect from that. So, it's partly a question of what you consider to be first in, second in, third in. And indeed, if nothing else happens, and there's a big drive next year to control entitlement spending, and you ask yourself, well, what does that mean in the context of the PBGC? It means something like that. It doesn't mean not indexing the maximum dollar amount on the guarantee. That's trivial. It means saying there's no growth in the insurance contract. So you may see that reemerge in that context, if there is some big drive to control entitlement spending in the government, and you all know that's much talked about.

On the other hand, I think most people would want to, at the same time that you're putting that kind of constraint on growth in the guarantee, push up the funding requirements, so that, in fact, the guarantee does become meaningful again. Eventually, when the plans become funded, the guarantee pops back up under the proposal – not only for just the last benefit increase, but all the benefit increases that go back to December 31, 1991. Now, a lot of variants have been proposed on this. People think the guarantee proposal is too harsh, that the assets sort of creep up over time, and they can fill up some of those intermediate benefit increases, and we ought to guarantee those, but not the last one or the penultimate one. The problem with that is tracing and administration. We have a hard time administering these programs, taking in these plans and making final benefit determinations anyway. Ron Gebhardtsbauer is our chief actuary, who worries about most of our posttermination activities. He can testify to that, and I would not want to administratively complicate this issue any more than we already have. So, there are a lot of administrative problems with trying to do something other than this guarantee proposal. But obviously there are many variations on this notion, of limiting the growth in the PBGC's exposure.

MR. ROBBERSON: And finally, are the details of these projections published?

MR. LINDEMAN: Yes. They're in the budget. I don't have the reference numbers.

MR. ROBBERSON: Where would a person get the details?

MR. LINDEMAN: If you give me your card, I'd be happy to send you the pages from the budget.

FROM THE FLOOR: I have two questions. One is about the projections, and to what extent that reflects the dynamics of increasing the flat and the variable rate over time, both for increases in distressed terminations as the rate rises, and also for increases in standard terminations and the drops in premium as the rate rises.

MR. LINDEMAN: You're talking about the premium projections.

FROM THE FLOOR: Right, and also, I guess, the effects of legislation 401(a)(4), etc.

MR. LINDEMAN: Let me just digress for a moment. There is this very simple mathematical solution, which is the OMB approach, that it did in its options pricing model. It's based on some literature that came out in the early 1980s on options pricing. There's another approach, which a couple of researchers at the Federal Reserve Bank of New York tried, which the PBGC is going to follow, which is to do a lot of simulations. This approach would separately simulate bankruptcies and separately simulate funding behavior, because that's more important, in some ways, than the rules. And we know sponsors put in more in good times than in bad times. So you want to model behavior as well as rules. You want to model bankruptcy. You want to model how you think people are going to react to regulatory burden, which is what you're saying, essentially, when it comes to the 401(a)(4) rules. As you know, we've put out a couple of studies. We sponsored a Hay/Huggins study on administrative cost. Dick Ippolito, who's probably one of the best pension economists in the country, has put out a fairly extensive piece of work on the defined-benefit/defined-contribution (DB/DC) drift. And it's definitely clear there's a shift away, in market share, from defined-benefit plans toward defined-contribution plans. What we're basically assuming right now is that the population in defined-benefit plans stays constant in absolute terms, sort of at around 31 million people. There are a lot of retirees in our premium base. We may be one annuitization fad away from disaster in that respect. But we're not assuming a lot of growth in defined-benefit plans. We're assuming that virtually most of the growth in qualified plans goes on in the defined-contribution world.

So, that means that the percentage covered by defined-benefit plans slowly shrinks over time. I heard someone say earlier when I attended the meeting on the nondiscrimination rules, that, essentially, for plans above four or five thousand, they can shrug off the costs of these compliance rules, which is true. And, I think if you look at the Hay/Huggins study, you'll see that reflected in the numbers, if you go back and look at earlier changes in the 1980s. Below 500 lives, the flight from defined-benefit plans is manifest to everyone, in all the statistics. It's not just regulatory burden, I think it's a change in the tax environment, too, away from high tax rates. The really critical problem is between the 1,000 to 4,000-life plan, if you don't keep that base there. Particularly as new companies mature, where once they might have set up a defined-benefit plan as part of their life cycle, perhaps they now no longer will. That's a real problem. I don't think it's a problem for the PBGC narrowly confined, because we get 80% of our premiums from the plans with 4,000 or more participants. And unless there's a real flight from defined-benefit plans from them, I don't think there is an immediate crisis in the premium base. But one wonders whether this is the best

thing for society as a whole, whether we're torquing the decision process away from defined-benefit plans in situations where, in a more neutral environment, people might have chosen them. I'm not making a pitch for defined-benefit plans, I'm not saying they're the best thing since sliced bread. I'm saying, in some settings, they are better than defined-contribution plans, and the market ought to let people be able to choose. And I'm not so sure that we'll have that.

FROM THE FLOOR: Could you go into a little more detail on the proposed regulations regarding the factors in assessment of employer liability, and how they relate to the lump sums under the 417(e) regs?

MR. LINDEMAN: Let me suggest to you that whatever I'm going to say here is very preliminary. It has not cleared my building, much less the other ERISA agencies, and/or the OMB. But as you know we have for years tried to mark to the market with our employer liability assessments. We don't want to make it any more costly or any less costly to close out with the PBGC than if you were closing out in a standard termination. That's been our attempt. Unfortunately, by regulation, we're frozen at a mortality table that no one seems to be using any more in the insurance industry. And in order to keep our total price, if you will, the same as what we're observing from the survey that the ACLI gives us every quarter, we've had to lower our interest rate to make up for the fact that we have a mortality table that doesn't really reflect the greater longevity that the insurance companies are experiencing. So, the first thing to do is to shift to a mortality table that's more coincident with what the insurance companies are using. It follows, therefore, all other things being equal, that the interest rate goes up, by somewhere from 150 to 200 basis points.

We're also currently trying to reflect the administrative costs that the insurance company imposes as part of a standard termination by, in effect, taking 50 basis points off the interest rate. We're going to propose a more plan-size dependent function. It'll be independent of the interest rate. That again raises the interest rate by 50 basis points. And we're also changing the form. As you know, now we assume a particular interest rate for everybody, once they go into pay status. And then we have this k, and n (PBGC Interest Rate Procedure) which works in a way that's counterintuitive; there are lower interest rates up front. It may produce the right result, but it just is counterintuitive. So, we'll be going to a system more like one we already have now in the multiemployer program, where we're assuming a market interest rate, if you will, for the next 20 years or so. You then assume a step down because of the reinvestment risk after that. So, four things are going on, and we're going to try to be as clear as we can, in the regulations. But we're trying to have a structure that looks a lot more like what insurance companies have when they charge somebody for a standard termination. The PBGC interest rate will no longer be counterintuitive. We'll be coming out with our proposed rule and at the same time the administration and Congress will begin to think about what the proper rate is to be in the tax code. And I think that's quite independent of the PBGC rate. They used us because we were handy in 1984, and they could come up with some function of the 30-year Treasury rate, which I think would be an effective substitute.

MR. GERALD D. FACCIANI: I have three issues to address. The first one's a minor one, a small one. It's a small-plan issue. You made some reference to the declining universe of small DB plans. That issue will be addressed in detail at an open forum at

this meeting. In the *New York Times* Sunday edition a week ago last Sunday, there were several articles dealing with PBGC underfunded plans. One dealt with some of the PBGC's proposals, which you've addressed. The Employee Benefit Research Institute (EBRI) made some remarks that it felt that maybe the PBGC was crying wolf. The reporter who did this article said that, well, maybe in Washington, one has to cry wolf -- or, fire, in this case -- before people will evacuate a building. So my question is, is the PBGC crying wolf with regard to some of these accrual accounting proposals?

And finally, with regard to the most underfunded list, there's been a lot of hue and cry about that list being very misleading. I have a neighbor here in Las Vegas who is a GM retired employee, and the poor guy's undergone open-heart surgery. Every time I see him, he asks if he is going to get his pension. Are we doing more of a disservice to some of these folks than a service?

MR. LINDEMAN: Let me try to answer your first question analytically, and see whether this satisfies or not. If you took our experience since 1982, and you just extrapolated that out for the next 30 years, and you caused the claims to grow with the real wage-growth rate that you're assuming, then, we would have something like $17 billion of claims, in a present-value sense, for the next 30 years, offset by about $9 billion of premiums. When the OMB model runs out for the same period of time, and it looks at claims, it comes up with a number of about $33-34 billion. It says, essentially, that our claims are going to be twice as bad as a straight extrapolation. Now, the 1980s, as I said before, were the decade in which I think the implicit premise of the program in 1974 was proven wrong -- that the giants of American industry who sponsored these plans were never going to go bankrupt. Or they're just going to go bankrupt very infrequently. That's not true. The risk of bankruptcy in some of these firms is high. It doesn't mean all of them are going to go bankrupt. It just means that if you look at their bond ratings, you know that there's a certain degree of risk. On the other hand, the 1980s, from a macroeconomic standpoint, were very good for the PBGC, ironically. The high interest rates in the initial period of the 1980s kept down the liability numbers.

On the other hand, there's the inventory problem. If you run through all the chronically underfunded pension plans as distressed terminations, what moves to replace them? And I'm not completely sure I understand how to model that yet. And to that extent, I would say there's a little problem in the way we've been thinking about the issue. I'm not going to agree with EBRI's sudden burst of optimism about the future. But I think it behooves the government to try to model these programs and to think about them deliberately, and to think about the conditions in which large claims could be put to the public fiscal budget. After the experience we had with the S&L industry, we ought to at least do that. Now, that doesn't necessarily mean that we're going to have the same sort of disaster. Forty billion dollars of claims over 30 years relative to a half a trillion dollars and counting in the S&L situation puts it in perspective. Forty billion dollars is, what, maybe the rate of increase in Medicare and Medicaid for one year? I mean, compared to a lot of other problems in society, maybe the PBGC doesn't loom very large. But the potential for problems is there. There are cross-subsidies in the program that may cause there to be some inefficiencies in the society. There are things to worry about, and it is probably a tractable problem. Is it a serious problem? By some measures, yes. I think two to three

billion dollars a year is a serious problem. And, I can't say, a year from now, whether that number will be double or half of what it is right now.

Well, I know the most underfunded list irritates a lot of people. But, it's been remarkably effective in changing the behavior of certain companies. Some companies have chosen to merge plans, get plans funded up in a faster schedule than they otherwise would have. It's had its effects. Positive, possibly, as well as negative. But in any event, it's now going to become the Congress's list, because the Congress wants it now, so the Congress will be putting out an underfunded pension plan list every January or February. I think it's now part of a permanent part of the landscape, whether folks like it or not.

MR. SAMUEL P. ADAMS: Is the PBGC likely to have to guarantee annuitized benefits any time in the near future? And if so, what steps will it take to protect itself against life insurance solvencies?

MR. LINDEMAN: The answer is, unless Congress chooses to pass, and the President signs such legislation, to reverse the legal position we have taken, the answer is it's not going to happen. We looked at the situation in some length, from a legal as well as a policy perspective. And I think we determined that if Congress had wanted us to insure benefits that had been annuitized, it would have been a lot clearer. There's not a lot of statutory evidence for the proposition. There's a lot of material in Title IV about how a claim is put to the PBGC in the case of a distress or involuntary termination. There's no mechanism for an insolvent insurance company to put a claim to the PBGC. And one of the things we were concerned about was being elastic in our interpretation, and taking on a new liability, which wasn't clear and present in the statute. And, we were mindful of the fact that we have very little regulatory control over that industry. That's basically been left to state regulation. Now, again, the unhappy experience of the S&L industry should teach us something here, because in fact, the federal government did, in effect, delegate S&L regulation to the states. I'm not quite sure exactly how it worked, but essentially, if the states chose to regulate, the federal government would step back. But the federal government was the insurer. And, that was one of the things that most people argue compounded the problem in the S&L disaster of the 1980s in Arizona and Florida. So, I don't think that's going to happen. There are a lot of people who have very strong policy views to the contrary. And, I suppose it's possible that Congress would choose to reverse it, but I don't see any great willingness on the part of Congress to take on new liabilities right now.