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REPAIRING THE PENSION SAFETY NET

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We're pleased to have Jim Lockhart with us. He is the Executive Director of the Pension Benefit Guaranty Corporation. The PBGC, as you know, has two insurance programs that they're responsible for administering, covering over 40 million workers and currently 85,000 pension plans. That's the rough guess of the number of plans that are at least covered by PBGC insurance these days.

One of the concerns we all have is that that number may be diminishing rather than growing. The PBGC currently has revenues of about $800 million a year and assets of nearly $6 billion. And its benefit obligations cover roughly 370,000 individuals. That's a big plan. Jim received his BA degree from Yale University and his MBA from Harvard. And in response to my question, he says he always roots for Yale.

MR. JAMES B. LOCKHART: Actually, to answer your question about the number of plans, we are definitely losing plans, or we know that we're losing about 10% of the plans we insure per year. And so, unfortunately, we're well below the 85,000 base at the moment. Obviously, that is one of the problems we have at the agency, and that's one of the reasons we really think that we need to start fixing the program.

When I appear before a group like this, I always feel a little nervous speaking. Here is really a group of experts who certainly know much more than I do about being an actuary and the calculations of pension plans. I feel a bit like an old man I once heard about whose proudest experience was that he was one of the few survivors of the Johnstown flood. He really loved to talk about his experience any place, anywhere. Even when he died and found his way to heaven, he wanted to talk about it. So he asked St. Peter if he could talk about his experience at the Johnstown flood and St. Peter said, "Well, let me think about it." He returned a few hours later and said, it was all arranged. "You can go over to the cloud 'C' and speak about the Johnstown flood. "But," then cautioned St. Peter, "there's one thing you should know. One of those attending will be Noah." Now maybe I shouldn't joke about floods in Chicago, but the PBGC, in a way, also is trying to survive a flood -- a flood of underfunded, terminated pension plans.

Our flood of underfunded pensions hopefully has not reached the proportions of either the Chicago flood, or the flood that Noah had to face, but without reforms, there is the risk that we will continue to be overwhelmed by these terminating plans. In an ideal world, all the pensions we insure would be fully funded. We would all benefit. Without fears, retirees could enjoy their retirement and workers could concentrate on their jobs. A financially healthy pension system, as you all know, is the lifeblood of American savings, and it really does provide the fuel to keep the American economy going.

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Unfortunately, we don't live in that ideal world. As a result, we face some serious problems: Back to back, there are annual termination losses of $1 billion, a deficit of $2.5 billion and an estimated growth in that deficit that could reach $18 billion by the end of 1997. Although, I hasten to point out, and I think you all know, that the overall defined-benefit system is very healthy. We estimate that we now insure about $900 billion of liabilities, but those liabilities are backed by $1.3 trillion. The problem, the key issue, is that there are underfunded plans. We estimate that there's about $40 billion in underfunded plans, and of that $40 billion about $13 billion is in financially troubled companies, companies that really could cause a potential loss in the not-to-distant future. And, unfortunately, that underfunding is growing. Total underfunding grew about 25% last year, and the financially troubled amount, what we call reasonably possible risks, grew by about 75%.

While my main concern, obviously, is the better funding of pension plans, I am not insensitive to economic reality. The question is, how can we protect pensions without upsetting the delicate balance of some companies with underfunded pension plans? Certainly the answer is not to allow the underfunding to go unchecked. Nor is the answer to let the PBGC absorb all the losses. The ideal solution is to keep the plans ongoing and get them funded. My effort to draw attention to this serious problem we face has drawn some criticism. Among other things, I am often accused of crying wolf. But, as I like to say, we have plenty of dead sheep to prove that there is a real wolf out there. And our dead sheep are those underfunded pension plans. We had to terminate, take over, 1,700 pension plans in our 17-year history. And just in the last few months, we've taken over some medium- to large-sized plans. Two more were added last month. CF&I Steel, which is a Colorado steel company that most people never heard of, was underfunded by almost $300 million. Blaw-Knox Steel, another very small company, was underfunded by about $80 million. Those two plans added about 7,000 participants. And last year we had the Pan Ams and the Easterns of the world, where there was $700 and $900 million in underfunding, respectively. The problem is we can expect more dead sheep because there are many badly mauled, if you will, underfunded plans out there. We can expect, as I've already said, a deficit of almost $18 billion within five years unless there are reforms in the program.

Yet there are those, primarily in Washington, who argue there's no need to address this problem, because it has not reached what Washington considers a crisis proportion. Obviously, their definition of crisis is quite different than mine. Coming from the corporate world, I would say any company that has a net-worth deficit of $2.5 billion qualifies as a crisis. Some argue that's okay because Congress set us up as sort of a social welfare transfer agency system. I'm not sure that Congress really had that in mind when it set us up. But even if they did, I know Congress would never have expected us after 17 years, to be facing the $2.5 billion deficit and the potential of much larger losses, a $40 billion exposure to underfunding, almost 1,700 terminated plans and owe benefits to 400,000, be facing skyrocketing premiums, and, lastly, to be facing a shrinking defined-benefit base as more and more plans terminate.

The reason we're facing this problem, in my mind, is because the PBGC was not set up as a sound insurance program. It shares many of the same moral hazards of the other government insurance agencies. It is my belief, however, that we can serve this very important social purpose and still be a sound insurance program. The alarm

has been sounded. President Bush's budgets for 1991, 1992, and 1993 all called for reforms of the pension system.

In January, my boss, Secretary of Labor Lynn Martin, also sounded the alarm by pointing out, "that PBGC remains vulnerable to substantial losses. Steps must be taken now to make sure pension promises made to American workers are kept and American taxpayers are not faced with having to foot the bill for pension promises made but not kept by corporations." At the same time, the Comptroller General, Charles Bowsher, who runs the General Accounting Office, added his concern. "If any of the plans which make up the $13 billion in underfunding terminate in the near future, there would be concern as to whether the Corporation's premium structure could be adjusted to meet their resulting funding needs. . . . Such events could result in a call for the federal government to assist the guaranty fund directly or to provide some form of assistance to the financially troubled companies." In March, Senate Minority Leader Bob Dole looked at the projection for our losses, the $18 billion plus that we may incur within five years, and said, "Even in terms of the savings and loan fiasco, these deficit figures are staggering. . . . If there is one thing we learned from the thrift crisis, it is that early action is necessary to stop the problem in its tracks and stem the exposure of the American taxpayer."

It's unfortunate, but most of the underfunding occurs because it's permissible under current law. Some companies take advantage of the system. They contribute the lowest amount that they can get away with. Rather than make contributions to their underfunded plans, they use their resources for other purposes. Pension funds become a form of cheap, unsecured credit. Since PBGC provides a subsidized safety net, companies can spend their resources on things other than their pension plans, without pressure from their workers.

It reminds me of an incident I observed on the beach in the wake of Hurricane Bob last summer. A little girl asked her mother if she could go into the ocean. The mother replied, "Of course not, it's much, much too rough to go into that sea." "But," pointed out the little girl, "Daddy is swimming." The mother's response was, "Yes, but he's insured." And that's really the crux of our problem at the PBGC. Companies, workers, and unions do not worry about pension underfunding, because they are insured. That sort of thinking helped cause the S&L crisis.

In their union negotiations, companies often give benefit increases that they cannot afford in lieu of wage increases. Unions accept them because benefits are insured, even with a phase-in. The practice reached the ultimate perverseness when, just recently in the Continental and the TWA bankruptcies, the bankruptcy judge approved benefit increases totalling over $100 million each that they couldn't afford. And the reason they were allowed benefit increases is because the creditors said that they wouldn't allow any salary increases, so plan participants instead were given benefit increases. That's the kind of perverseness that can really get PBGC and the whole insurance program into trouble.

Underfunded plans do represent a real risk to us, but they also represent a real risk to the five million people in those underfunded plans since we don't insure every benefit. And on average, about 10-20% of the individuals in terminated plans lose some benefits, and oftentimes it can be a very significant amount. We've seen examples of

people losing well over 50% of their benefits when a plan terminates. And if we use a 20% figure of the five million people in those underfunded plans, we're talking about a million people who are in high risk.

Right here in Illinois there are a number of underfunded plans. Our statistics show there are about 300 underfunded plans here with over 350,000 participants. And, of course, there statistics come from corporate headquarters, so they don't include the plans of companies that may be head-quartered elsewhere, including auto and other industries. Obviously, if they were included, there would be a higher number for Illinois. We are working with some of these companies right now to encourage them to better fund their plans and to work at protecting those against future losses. In fact, we put out, as you probably all know, a list every year of the top 50 underfunded plans, and five of the plans on that list are from Illinois. Underfunding just the guaranteed benefits in those plans is about $1.3 billion. And, obviously, if you include nonguaranteed benefits, which we hope to do this year, the numbers will be much higher.

The best way to protect the workers and shore up the pension safety net is to eliminate the conditions that encourage underfunded plans. To this end, the Bush administration has proposed major reforms that were first introduced as part of the President's economic growth package. For partisan reasons, unfortunately, Congress rejected the reforms in the overall growth package. Greater economic growth will help defined-benefit pensions, obviously, and certainly the sponsors of these plans.

The reforms have been reintroduced in the Pension Security Act of 1992. We expect to have hearings next month in both the Senate Finance and the House Ways and Means Committees on these proposals. There are three major reforms as part of the Pension Security Act. The first of the reforms is to clarify our position in bankruptcy. Most of our bankruptcy claims, as you all know, fall in the general unsecured category, with only a small portion receiving priority treatment. Yet we face challenges to even these small priority claims. The latest challenge was last fall in a district court decision in the Long Temco Vought (LTV) case. The district court judge, Judge Duffy, ruled that we had absolutely no priorities in bankruptcy, and to compound the agony, he said that he could set the interest rates to discount the liabilities at a rate of 11% plus. So all of a sudden our claims shrank to about half of where they were, and even at that amount they were all unsecured, so it was a major blow to the agency. The reason for these challenges is that our priorities are expressed in ERISA and the tax code, but Congress never put them into the bankruptcy code. And, as a result, the bankruptcy judges only look at the bankruptcy code; that's why we want these priorities put into the bankruptcy code.

The U.S. Chamber of Commerce recently announced support for the clarification of the priority of our claims. The Chamber believes that we should be able to insist on continued plan contributions to avoid further deterioration of a plan's funding in bankruptcy. We want to make clear that bankrupt companies have to make payments to ongoing plans as administrative expenses. And, if a plan is terminated, we want to make it clear that we have a priority for any missed contributions and for a portion of the total underfunding. The priority for underfunding would gradually increase over time, which would allow companies and the creditors plenty of time to adjust.

Let me emphasize, we would prefer not to terminate a pension plan. It does no one any good. We lose, companies lose, creditors lose, and workers lose. We always stand ready to work with companies and creditors to keep pensions ongoing. We are not unreasonable, but we want companies' and the creditors' to take their pension debts seriously. Real unquestioned priorities will ensure that they do that. A good example of working with a company is the case of Sharon Steel, which was in bankruptcy a few years ago. The company and its creditors did take our claims seriously. They agreed to make up all past funding deficiencies and collateralize future payments for the next nine years. As a result, the company has been able to complete its reorganization and avoided a loss to it and a loss to us of several hundred million dollars.

Just recently, we've been working with a company here in Chicago, Farley Industries, to better fund and protect its pension plans. And, as some of you know, we are moving close to a final settlement with LTV with its $3 billion in underfunded plans. We want companies to reorganize successfully. Our purpose is not to stand in the way of transactions that make operational and financial success and sense. But we expect companies and their creditors to treat pension debt as real debt. In our bankruptcy reform, some of the other proposals we're seeking include a priority claim for shutdown benefits that arise within three years of termination. These retirement benefits are generally not refunded, as you all know, and have cost us about a half billion dollars to date. So they represent about 20% of our deficit. I might add that we also think, as I testified before the Actuarial Standards Board, these benefits should be fully disclosed in actuarial reports. Finally, we'd like the option of becoming a member of the creditor's committee in bankruptcy proceedings. With clarification of our priorities and active membership on the creditor's committees, the bankruptcy process should be quicker and much less expensive. The thrust of our bankruptcy forms is really to keep our place in line. It's not to go to the head of the line, as some people have accused us. Without clarification, the courts may very well push us to the back of the line, and that's what's happening right now in these major bankruptcies.

The second reform, which is directly in your area, deals with pension funding. The minimum funding rules enacted in 1974 and modified in 1987 have proved inadequate. There are a number of examples that really dramatize the problem with the current funding rules. TWA has made the required contributions to its pension plans, yet its plans are underfunded by over $1 billion. The auto companies have been making their pension plan contribution and their underfunding is skyrocketing. We had to terminate LTVs Republic Steel salaried plan when it ran out of money in 1986. Again, it was making the required payments. Both Blaw-Knox and the CF&I plans that I mentioned were running out of money, and yet they were making most of their required payments.

We're now seeing companies with billion-dollar-plus underfundings able to take many multiyear pension funding holidays. What we're suggesting in the pension funding area is to speed up the funding process with a goal of having a plan funded in 10-20 years, rather than what we estimate now is more like a 30-year horizon for many plans. We're suggesting that a company pay the higher of three calculated amounts, and they would be based on either the 1974 rule, a stronger version of the 1987 rule, or a new rule that we call the solvency rule. And the latter rule to me is a

relatively straightforward rule, but in many plans it's relatively powerful. All it says is that pension contributions have to equal the amount paid out in benefits plus interest on the underfunded amount. Let me again point out that these changes will be phased in gradually to prevent undo burden on companies. They wouldn't take effect until 1994, and there would be transition rules and caps for a five-year period.

Now turning to the third reform. It calls for us to guarantee future benefit increases only in plans that are fully funded. This would apply prospectively to new plan amendments. Once a plan is fully funded, all premium increases would be guaranteed. This reform really goes right to the "why worry its insured" syndrome, and that's the syndrome that we share with many of the other government insurance agencies that have been troubled. The bulk of the recent increases in pension underfunding is due to negotiated benefit increases. New benefit liabilities are often added before old ones are funded, leaving these plans chronically underfunded. We estimate that the last round of increases in the auto, steel, and tire industries added about $7-9 billion in underfunding to the system. On average, negotiated flat benefit plans are funded at 75%, and final salary plans are funded on average at about 145%. Companies can really keep their pension plans better funded. Obviously, choices have to be made as to where limited resources go. But it's hard for me to imagine a better use of resources than increasing pension contributions, which protect workers and retirees, reduce debt, and reinvest the money in the American economy. My conviction that companies can fund their pension plans better was reinforced recently when I received a letter from one of the companies on our infamous top-50 list, informing me it had just made a contribution to its plan so that it was now fully funded. And so companies can do better.

Of course, there are opponents to the reforms. Some companies like the flexibility that the present system gives to take maximum advantage of the safety net. In effect, they are asking the companies that have well-funded plans to subsidize their empty promises. If these changes are not made, those corporations with well-funded pensions, which make up over 80% of our total insured plans, will face skyrocketing premiums. To fund our present deficit and cover our expected losses, we estimate that the premiums for well-funded plans would have to more than triple from where they are now. That would be a 70-fold increase from the original dollar that was set in 1974. And, of course, I don't have to tell you that that might have a very negative impact on the whole system, as we are in a voluntary system and it could drive even more plans out of the system.

Other critics argue that the PBGC has no problem, because it still faces a positive cash flow. This, of course, conveniently ignores the future payments it already owes participants of terminated plans and those that will terminate in the future. These critics are really being fooled by the same accounting that led to the S&L debacle. That is why the Bush administration also is proposing that all government insurance companies adopt accrual accounting for budget purposes. The American people should know the real cost of government insurance programs. At the same time I want to stress that our current cash flow is strong. It makes it possible to pay benefits to retirees in the pension plans that PBGC has already taken over and to continue to pay benefits in the future. Retirees who now depend on the PBGC, or who may need to rely on our guarantees in the near future, can be assured there is

time to take the necessary steps to keep the safety net strong. And that is the point. If we act now, while there still is time, we can prevent a crisis.

In summary, the Bush administration reforms will provide the incentives necessary for companies and their creditors to take pension funding seriously. They will create a stronger safety net upon which 40 million Americans can depend for their retirement security. We are probably in the same position that the tunnel under the Chicago River was in a while back when there was still a fixable flaw. Let's not wait until the floods come in on the PBGC. The real question we face is not whether we need reforms, but when should these needed reforms be made? Now, when there's still time to implement them gradually. Or do we wait, as in the case of the S&L mess, until it's too late and too costly? I hope companies and Congress respond correctly, both to the need for reforms and the need to take pension funding seriously.

FROM THE FLOOR: What is your expected timing on the top-50 list?

MR. LOCKHART: It will come out in the late fall. We'll send out the letters to the companies that are potentially on the list within the next month or so, and we would hope it would come out sometime in November. One thing I should add is that the top-50 list may be expanded. There's legislation in Congress that's going to require us, if it's passed, to inform it of every plan that's underfunded by more than $25 million. So it may turn out eventually to be a 100-plus-list of underfunded plans.

FROM THE FLOOR: I think you said you'd like to enhance the minimum funding rules, strengthen them; that's going to run counter to the generation of taxes. How are you going to jump that hurdle?

MR. LOCKHART: Well, that's a very big hurdle as you know. Our proposals have been priced out at about $2.1 billion over five years, and it's the five-year horizon looked to for taxes. The most logical way to jump the hurdle is to drop accrual accounting. Under accrual accounting, you see the benefits of those higher fundings because our future losses will be less, and that's the way the President's package is going to be paid for. And, in fact, the benefits from those three proposals are greatly excessive, that $2 billion. In fact, over the five-year period, they've been priced out at about $20 billion.

FROM THE FLOOR: The funding deficiencies tend to add another layer to the rules. To tighten up the rules, by implication, kind of removes judgment from actuaries. Maybe that suggests that in part actuaries are at fault in historically not applying good judgment in their advice to their clients on how to fund pension plans. Is there a solution to that if that's true?

MR. LOCKHART: Well, I think you can say that about some actuaries, yes. I wouldn't say it about all actuaries, for sure. It may be a problem. We looked as we went through there, you know, our legislative thought process used over the last year, whether we should get extremely specific and actually require specifications of mortality tables or early-retirement-age assumptions. We decided that that would be horrendous paperwork, a nightmare, and would be arbitrary. So these proposals are still relying on actuarial judgments, and we are hopeful that the profession can help clean up the area if there is a problem here.

FROM THE FLOOR: Congress, in its wisdom back in 1974, decided that defined-benefit plans should be insured and pay for the premium. Let's say that you want the insurance, and Congress wants that insurance, but there should be a different way of paying for it. Without expanding the insurance program, couldn't we get revenue from all plans or all employers as compared to just defined-benefit plans? We're driving defined-benefit plans out of the marketplace.

MR. LOCKHART: Well, certainly, that has been suggested. I personally don't favor it. I mean I look at that as just the tax, pure and simple, to employers. My solution really is to tackle the problem head-on, which are the underfunded plans and the rules that allow and the practices that give some companies the incentives to underfund plans. I did not propose a premium increase for the well-funded plans at this point. I don't think that that's the right solution here. I think the solution is to strengthen the insurance principles underlying the program.

FROM THE FLOOR: What about the OBRA 87, full-funding notation rules? Here are companies now in existence that support contributions today to look for the 150% of the current liability calculation. Seven, eight, nine years from now, they may not be in such a good position. So aren't we kind of begging additional liability down the line with some of Congress' enactments?

MR. LOCKHART: Well, I cannot speak for all Congress' enactments, certainly. I mean it is an issue and it is one of the things that concerns us. The Office of Management and Budget (OMB) has built a model with our help, looking at the future of the agency, and it projects $30-40 billion of losses in present-value basis for the agency. And about 25% of those losses are coming from plans that are presently now well funded, or over 100% funded. So that is an issue that at some point we have to look at. I'm not sure whether the 150% limit is enough to cause a problem at this point for us.

FROM THE FLOOR: The Small Business Administration administers the loan process that might not even have been on a cash basis. It's operating to recognize the cost each year of loans that really already have come belly-up. When they actually went into the guaranteed process they didn't anticipate any losses. And they changed that in the accounting system in the early 1980s. Have you looked at that for a model?

MR. LOCKHART: Yes, that's sort of the model that's being built on; that, and then about two or three years ago, a credit reform for all the government loan programs was done and was on accrual accounting. The Bush administration is proposing that this is the next logical place to adopt it. The proposals for this year were for the PBGC and the FDIC to adopt it, and then for next year the other government insurance programs. There are some controversies about the specific proposals, but overall we have not heard many complaints or criticisms of adopting accrual accounting. People were objecting to the specific ways that it was being proposed, but the General Accounting Office and the Congressional Budget Office have both looked at accrual accounting and have been talking about it for a long time for government insurance agencies. So we're hoping that we can move it along, if not this year, next year.

FROM THE FLOOR: One of the objectives that the PBGC has stated was to foster the defined-benefit program. Obviously, one of the major problems is the exodus of healthy plans from the system. What among the administration's proposals, if anything, is addressing that side of it, while we encourage the maintenance or establishment of the new refinements?

MR. LOCKHART: Well, we certainly take that mission seriously. In fact, that's the first of the three that Congress gave us. The other two include making sure people got their benefits paid on a timely basis and keeping our premiums as low as reasonably possible. And I would say that's what we're doing here. Effectively, if we can create a strong insurance system, I think we can lessen people's fears about this system. I think one of the many reasons that companies are not looking at forming defined-benefit plans now is because they're afraid that our premiums are going to continue to skyrocket. Maybe at $19 a person that's not too high, but at $70 and climbing it may get to the point that will dry people out. So we think that our reforms will have the impact of at least slowing down the exodus. We've done some studies on this exodus, obviously, because it worries us that that's our premium base. Much of it is because of the economic shifts in the economy, and manufacturing companies are shrinking and they traditionally have defined-benefit plans. And small service sector companies are coming in and they traditionally have defined-contribution (DC) plans. But the other reasons are obvious. All the regulations that have been put out during the 1980s have cost so much that for a small plan it's too expensive.

FROM THE FLOOR: But even premiums have gone up let's say by a factor of 54 from 18 years ago. I know you're a lot smarter than the people who set up the system, but are you 50 times smarter so that you can tell us that premiums probably aren't going to at least go up tenfold in the next 10 or 20 years?

MR. LOCKHART: No. Without reforms I can say they're going to skyrocket.

FROM THE FLOOR: Where do they think that a dollar will carry us?

MR. LOCKHART: Oh, you hear many stories about the birth, and I never know which ones to believe. But apparently some studies were done and terminations were looked at over the last five years. Over a five-year period, there have been $150 million worth of losses divided by five, $30 million, and there were 30 million participants. At least that's one story I've heard about what was done. Sophisticated modeling wasn't used, that's for sure, and I certainly didn't think about the future potentials, bankruptcies, and things like that which we're really working on doing at the moment. OMB, as I said, has built a model. We're also doing many modeling activities that I think will make us smarter, but still not that smart.

FROM THE FLOOR: Could you talk about the status of the multiemployer planned program?

MR. LOCKHART: Right. The multiemployer planned programs seem to be the success story from the insurance standpoint. We do have a surplus now. I think it's about $150 million and growing. We did a five-year study a year or so ago which was required by law, and we did some projections about what could happen in the

future. In almost any economic scenario, we do not see significant problems occurring in a multiemployer plan world. But the reforms in 1980, in that case, seemed to have been very successful. They are working. From an insurance standpoint, the risks are relatively small and manageable.