S. HRG. 102-1069

# FINANCIAL STRENGTH OF PENSIONS AND THE PENSION BENEFIT GUARANTY CORPORATION

## HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

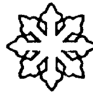
ONE HUNDRED SECOND CONGRESS

SECOND SESSION

ON

**S. 3162**

SEPTEMBER 25, 1992



Printed for the use of the Committee on Finance

U.S. GOVERNMENT PRINTING OFFICE

65-775—CC WASHINGTON : 1993

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-040736-2

5361-29

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# FINANCIAL STRENGTH OF PENSIONS AND THE PENSION BENEFIT GUARANTY CORPORATION

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**FRIDAY, SEPTEMBER 25, 1992**

U.S. SENATE,
SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS
AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE,
COMMITTEE ON FINANCE,
*Washington, DC.*

The hearing was convened, pursuant to notice, at 10:04 a.m., in room SD–215, Dirksen Senate Office Building, Hon. David Pryor (chairman of the subcommittee) presiding.

Present: Senators Durenberger and Grassley.

[The press release announcing the hearing follows:]

[Press Release No. H–34, June 8, 1992]

PRYOR ANNOUNCES HEARING TO EXAMINE FINANCIAL STRENGTH OF PENSIONS, SENATOR SAYS FEDERAL AGENCY SHOWING EARLY SIGNS OF TROUBLE

WASHINGTON, DC.—Senator David Pryor, Chairman of the Senate Finance Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service, Tuesday announced a hearing to examine the financial strength of the federal agency that insures retirement benefits for over 40 million American workers.

The hearing will be at *10 a.m. Friday, July 31, 1992* in SD–215 of the Dirksen Senate Office Building.

Pryor said the federal agency, known as the Pension Benefit Guaranty Corporation (PBGC), is showing the early signs of serious trouble.

"In this hearing we will take a look at the current status of the PBGC and explore possible solutions to the problems now on our doorstep," Pryor said.

"If the government learned anything from the collapse of the S&L industry, it should have been that we must take early action to prevent problems, rather than reacting to the full fledged crisis,"Pryor said.

"The promise of a pension to the American worker must be kept, and the PBGC must secure that promise," Pryor said.

## OPENING STATEMENT OF HON. DAVID PRYOR, A U.S. SENATOR FROM ARKANSAS, CHAIRMAN OF THE SUBCOMMITTEE

Senator PRYOR. Ladies and gentlemen, good morning. Our subcommittee will come to order at this time. The purpose of this morning's hearing is to review the financial condition of the PBGC, and to examine whether the PBGC's financial condition poses a risk to its mission to furnish security and confidence to workers participating in our private pension system.

The subcommittee expects this to be the first of a series of hearings on this very complex subject. We look forward to listening to and working with all of those interested in the matter.

At the outset, for the record, I believe it would be very useful to remember and restate, in very simple terms, the purpose of the PBGC.

Title IV of the Employee Retirement Security Act of 1974, ERISA, expressly states that the purpose of the PBGC is, one, to encourage the continuation and maintenance of private pension plans; two, to provide for the timely and uninterrupted payment of pensions; and three, to maintain premiums at the lowest level consistent with its obligations.

Now, to the extent PBGC's financial condition adversely impacts its ability to carry out these three objectives, some say that we have a real problem.

There seems to be some debate over whether or not we have a real problem, or whether it is imagined or real. This morning we are trying to find facts. We hope to get to the bottom of this debate, and, once again, this is a first in a series of hearings on the matter.

We have a sea of financial data—statistics, assumptions—which portray the financial picture of the PBGC. One cannot help being confused; all of us are a little bit, especially me. That is why we have invited to testify this morning some of the most notable experts in this field.

However, I do feel compelled to express a concern that I have when we talk about this becoming a crisis situation facing our private pension system.

As I stated before, the mission of the PBGC is to furnish security and confidence to workers for the pension plans. If the government prematurely questions the adequacy of those plans to meet the obligations, these workers understandably get scared. And instead of providing security and confidence for them, the government creates fear and confusion.

The PBGC's response to this perceived crisis is to require troubled companies to pay more of their cash into their pension plans. Many of these companies naturally feel these resources are vitally needed for investment in plant, equipment, and research and development, in order for them to recover from these recessionary times. Without recovery by a particular company, the worker ultimately has no job.

It would, indeed, be a travesty if, in protecting a worker's pension plan the government cost the worker his or her job.

Now, I certainly would not hesitate to call on the carpet any company that is irresponsible in funding its workers' pension. We must maintain a vigilant watch over the security of our private pension system, but we must do so in a thoughtful and in a prudent, responsible manner.

In summary, the government created the PBGC to ensure that companies keep their pension promises to their workers. That is the basic commitment that they have. We must guard those promises; and we will guard those promises. In doing so, we must not unnecessarily shake the confidence of those workers and their pension plans, we must not drive their employers out of business, we must be responsible, and whatever action we need to take, we must take it. Before I recognize our panelists today, I would like to state that we will have two of our colleagues testifying. One, is Senator David Durenberger, who is a member of this committee, and also

our colleague, Senator Grassley, who will also be sitting here and chairing the meeting with me this morning. I believe, also, we will have Senator Jeffords, who will be coming shortly. I hope he will be here soon.

We are going to try this morning to limit our statements. I am not going to impose a limit on our colleagues, but I am sure that they realize we have a large number of witnesses, and I am sure that they will be prudent with their remarks and that they will understand the time limitations we have.

It is my understanding we have a vote on the Senate floor at 11:00. That is 50 minutes from now. We will begin our hearing. Senator Durenberger, we recognize you and appreciate very much your attendance this morning.

## OPENING STATEMENT OF HON. DAVE DURENBERGER, A U.S. SENATOR FROM MINNESOTA

Senator DURENBERGER. Mr. Chairman, I am grateful to you. I did come prepared with a shorter statement, but I am not sure whether my colleague from Vermont is going to be here. So, you may get the longer one in case he does not come. He spent a lot of time on the Floor last night, as you know, reaching a wider audience with the urgency of doing this.

This is a pretty boring subject, I suppose, to a lot of people, until it actually affects their lives. It is to your credit, Mr. Chairman, that 2 days in succession now you are willing to take on the task of dealing with the things that affect individual people, as well as the collective security of a pension financing system.

I am here because it has been a pleasure for me to join my distinguished colleague from Vermont, Jim Jeffords, in co-sponsoring S. 3162, the Pension Funding Improvement Act. In the bill, we seek to control the Pension Benefit Guaranty Corporation's financial exposure, about which you will hear more during the course of this hearing.

If we are to secure the financial integrity of the PBGC, if we are not going to have a repeat of the S&L bail-out, I encourage my colleagues from the Senate to act quickly to maintain the viability of PBGC, which is, as we know, the ultimate guarantor of our private pension system.

First, Mr. Chairman, I would like to extend my appreciation to my colleague for his leadership in the employee benefits field. He and his staff have worked tirelessly with the Department of Labor and the PBGC in order to assure the continued vitality of our private pension system, and I know he is working also on pension portability. He played a leadership role in the Butz legislation two years ago, and I congratulate him for his leadership in this area.

Let me begin with a little background on the problem that we face as a Nation. America's retirement security system is built on three pillars: Social Security, individual savings, and private pensions. Nine years ago when the Social Security system was so close to insolvency that it was borrowing money from the Medicare trust funds, we had the bipartisan courage to shore up the trust fund and ensure that the Social Security would be there for our children and our grandchildren.

There is a lesson that we should have learned from the S&L debacle that threatened the individual savings of millions of Americans, and that lesson is, when we first see a government-guaranteed financial liability problem, we ought to act as fast as possible to solve it.

Had we provided adequate financing to close down all of the bankrupt S&Ls in 1986, the cost to the American taxpayer for S&Ls would have been less than $50 billion. But the longer we waited, the more it cost. And we, as a country, are paying the price for that delay, and we are going to for many years to come.

Mr. Chairman, the third pillar of our Nation's retirement security system is based on the private pension system. When working men and women retire after a life of service to one or more companies, they often receive a pension from their employer's Defined Benefit Plan.

In the late 1960's and early 1970's, this third pillar was in serious jeopardy. Employees who worked for 25 years were dismissed by their employers without receiving a single penny of their promised pension.

After the failure of several well-known companies in my State of Minnesota and elsewhere, including Studebaker Corporation, Minneapolis Moline, White Motor Freight, and others, this Congress finally adopted, in 1974, enforceable investing and fiduciary responsibilities for company pension plans.

I would note, by the way, that our distinguished chairman of this committee, the Senior Senator from Texas, Lloyd Bentsen, played a vital role in the adoption of the law regulating the ERISA law. He was a conferee on ERISA back in 1974.

To guarantee the promise of a pension, Congress created, through ERISA, the Pension Benefit Guaranty Corporation, whose purpose has been and is to provide financial security for plan participants if their company and their plans fail.

The PBCG collects premiums from viable, defined benefit plans, and it takes over and administers plans that terminate when employers go out of business. Thus, in a real sense, all working men and women who are participants in defined benefit plans rely on PBGC to guarantee the future existence of their pension benefits.

Mr. Chairman, the warning signals that PBGC is in trouble are everywhere. The red warning lights and the buzzers are going off, and the Senate should be paying closer attention. PBGC currently has a $2.5 billion deficit. That is up from $1 billion just a year ago. The Department of Labor expects the deficit to grow to $18 billion by 1997 if we do nothing.

The two largest losses in PBGC history occurred recently. Pan American World Airways' terminated plan was underfunded by $900 million, and Eastern, by $700 million. But what worries me the most is that the pension underfunding associated with readily identifiable troubled companies grew last year by an estimated $8 billion, to a total of $13 billion.

This constitutes an incredibly large potential liability for PBGC, and it threatens our entire private pension system. The Jeffords-Durenberger bill is a step that Congress can take to stem the further undermining of our private pension system.

One of the problems is that, under current law, companies may grant pension benefit increases, even though the pension plan is underfunded. If a plan terminates in an underfunded state, PBGC is responsible for providing the benefits, including the benefit increases. I need to repeat that. Employers may grant pension benefit increases without adequate funding of the plan, and PBGC then has to deliver on their promises.

Do you know, Mr. Chairman, America's corporate executives are very smart. They know about this rule, and I believe they have taken advantage of it to the detriment of the American public. Employers, especially in troubled industries, know that they cannot afford significant wage increases, and many have underfunded their pension plan. So, what do they do? They provide pension benefit increases without funding them. If the company turns itself around, it ends up paying the benefits. But, if it goes out of business, PBGC picks up the tab.

This amounts to nothing more than a risk-free loan from PBGC to ailing companies. Congress did not establish PBGC for this purpose, and, in the opinion of the authors of this legislation, it is just plain wrong.

According to the PBGC, benefit increases under the collective bargaining agreements in auto, steel, tire and rubber industries added a total of $7–$9 billion in underfunding to already underfunded plans in these industries. Household names in American companies are doing this. I am going to provide you now with some examples. This is from PBGC.

The 1991 labor contract for Uniroyal, Bridgestone, Firestone and Goodyear increased benefits for active employees by almost 30 percent. The 1990 labor contracts for General Motors, Chrysler and Ford increased the basic monthly retirement benefit 16–17 percent. In total, Chrysler pension benefit plan increases were 21–22 percent for actives, and 11 percent for retirees over the next 3 years.

The 1989 labor contracts for Bethlehem Steel and Armco Steel increased benefits for active employees by approximately 15 percent. Uniroyal-Goodrich Tire Company pension plan, which is currently underfunded by over $400 million and has assets equal to about 1 year's benefit payments, increased benefits for hourly actives by 50 to 80 percent from 1988 to 1991. Mr. Chairman, that is shocking. Companies are not acting responsibly. They are saddling the PBGC with huge potential liabilities, all of which threaten our entire private pension system.

The Jeffords-Durenberger bill addresses this problem. The bill amends Section 401A 29 of the Internal Revenue Code to require plans that grant benefit increases to provide security in the form of cash, bonds, or other such forms of security that the Secretary finds acceptable if the plan is less than 90 percent funded.

In other words, if employers have underfunded plans and those plans are significantly underfunded—we used 90 percent as the criteria—and the employers want to grant benefit increases, they have to pay for them. I do not think that that is too much to ask employers to pay for the benefits that they have promised their workers.

If they cannot pay for the increased benefits, then they ought to be honest and let the workers know that. The PBGC, as a Federal

guaranty agency, should not be the dumping ground for irresponsible employer promises.

Mr. Chairman, our Secretary of Labor, Lynn Martin, urges us to act quickly to address this problem. She made the following statement: "Congress has the opportunity to show it has learned the painful lesson taught us by the S&L fiasco by taking the necessary steps now to fix the Pension Benefit Guaranty Corporation. The time to act is now, before another crisis occurs like the S&L situation. This situation becomes more costly the longer we wait."

Mr. Chairman, I agree with the Secretary of Labor. Our colleague, Jim Jeffords, said as much and illustrated it last night on the floor of the U.S. Senate. We did not have an opportunity to attach this legislation to H.R. 11, which we would like to have taken advantage of.

In part, because of the assurance that there would be a hearing today and that there would be a commitment from the Finance Committee to do its part in dealing with this issue in the coming months, we believed that, even though we could not attach it to H.R. 11, we are going to get a response from this committee as quickly as possible.

So, let me just conclude by saying I agree with the Secretary of Labor. I agree with all who know that we ought to deal with PBGC financial difficulties now. And I urge that, during the rest of this morning, you listen closely and carefully, as I know you will, to those who are more expert than I, or either of us, on the details of this, and that when we return in January we take this issue up as quickly as we can.

Senator PRYOR. Senator Durenberger, thank you. Thank you for your contribution to this issue. All of your statement, by the way, if you did not complete it, will be placed in the record. And we really appreciate you attending this morning. We hope that our colleague, Senator Jeffords, will be here soon so that he may make his statement. Once again, we thank you, Senator Durenberger.

[The prepared statement of Senator Durenberger appears in the appendix.]

Senator PRYOR. We have our next witness, Mr. James Lockhart, III, the Executive Director of the Pension Benefit Guaranty Corporation. We look forward to Mr. Lockhart's statement.

Mr. Lockhart, once again, we are going to ask all of our witnesses this morning to realize some of our time problems, and also to realize that this is just first in a series of hearings that we are going to be holding the next several months.

If we could, we would like to ask you if you would hold your remarks to approximately 10 minutes. We are going to ask the other panelists to hold their remarks to about 5 minutes. So, we look forward to your statement. We will place your full statement in the record.

## STATEMENT OF JAMES B. LOCKHART, III, EXECUTIVE DIRECTOR, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, DC, ACCOMPANIED BY CAROL FLOWE, GENERAL COUNSEL, PENSION BENEFIT GUARANTY CORPORATION, WASHINGTON, DC

Mr. LOCKHART. Thank you. Mr. Chairman and Senator Durenberger, I am pleased to be here to discuss the future of the PBGC. With me today is Carol Flowe, our General Counsel. I appreciate the subcommittee's interest in this program that is critical to the retirement security of 40 million Americans. I also appreciate the strong support of Senator Jeffords and Senator Durenberger in their recently introduced legislation.

The past year has been very challenging for us. Internally, we continue to make changes to improve our financial management and internal controls. We are making good progress toward our goal of auditable financial statements.

Externally, we face a growing problem from poorly-funded pension plans of troubled companies. Despite our aggressive efforts to prevent losses to retirees and the insurance program, they continue to skyrocket.

It took us 11 years to accumulate our first $1 billion in losses. In each of the last 2 years, we had $1 billion in losses. The two largest claims in our history, Eastern Airline and PanAm, were the primary causes. Our deficit is now $2.5 billion.

As the chart shows, our fiscal 1991 budget forecast shows that our deficit will grow to $18 billion by 1997 without reforms. Our 1991 annual report estimates underfunding at $40 billion, up from $30 billion the previous year.

Well over $30 billion of this underfunding is in the single-employer program and is concentrated in relatively few firms: primarily in the steel, auto, tire, and airline industries. These underfunded plans cover about 5 million people.

As our guarantee has limits, many of these people are at risk of losing their promised benefits. $13 billion of this underfunding is associated with financially troubled companies that present a near-term, serious risk to these participants and the PBGC.

The President's budget, using a model that incorporates a long view of the future, forecasts net claims of $30–$45 billion over the next 30 years. The financial problems in the single employer program are a consequence of fundamental weaknesses in the insurance principles supporting the program. The moral hazards of inadequate premium, weak minimum funding rules, liberal guarantees, and the probability of low recovery from employers in bankruptcy still encourage financially weak companies to underfund their pension plans.

Because of these moral hazards, companies in financial difficulty view pension increases as cheap compensation, and their workers agree to these empty promises because of our pension insurance. Some companies have stopped making required contributions in bankruptcy because the judg[illegible]e allowed it.

Some companies have allowed their plans to even run out of money without violating the minimum funding rules. Lenders rarely put pressure on those companies to fund their plans, believing

in optimistic funding assumptions and expecting pension plans will have no priorities in bankruptcy.

Creditors sometimes pressure distressed companies to terminate plans rather than fund them. Companies have failed to accumulate a rainy day reserve for subsidized benefits triggered by plant closings and early retirements. One of our largest present cases illustrates many of these hazards. Using TWA's assumptions, their plans were only underfunded by $190 million on our top 50 list, but, on a termination basis, the plans are underfunded by $1.2 billion. Yet, TWA has complied with all of the minimum funding requirements. Despite the underfunding, they increased benefits, while in bankruptcy this year, by over $50 million.

Until recently, creditors, and Carl Icahn, who owns 90 percent of TWA, downplayed the underfunding and our claims in bankruptcy. Mr. Icahn is trying to extract his group of affiliated companies, also known as the controlled group, from joint and several responsibility under the law for those pension plans. We will not allow him to do that.

Our goal is to protect the pensions and to have a viable, ongoing TWA, but the situation is extremely serious. As Mr. Icahn is attempting to break up the controlled group, it may leave us with little alternative except to terminate the plans to protect participants, TWA, and our premium payers.

Many have asked why plans continue to be underfunded 18 years after ERISA's minimum funding standards were enacted and 4 years after the funding reforms of 1987. Despite the extremely strong equity and bond returns of the 1980's, underfunding is stuck at the mid-1980's level. Some companies are even backsliding.

The unsettled legal status of our bankruptcy claims and the absence of sufficient co-insurance in the program lessen the interest that creditors or workers have in plan funding. Also, the funding rules themselves continue to fall short.

In flat benefit plans, which represent about 25 percent of the universe, benefits are often increased at 3- or 5-year intervals in contract negotiations. Amortization of such increases under current law is not fast enough to prevent funding deterioration, especially in plans with a high percentage of retirees and older workers.

These plans are only about 75 percent funded, on average. Although funding rules do not allow these plans to anticipate future benefit increases, there is nothing preventing them from being 100 percent funded, and, in fact, some are over-funded.

In contrast, the other type of plan, final-pay plans, are funded at about 140 percent of termination liability. The funding rules also allow a company, regardless of funding levels, to reduce contributions immediately if they have better than expected investment or actuarial experience. Consequently, companies whose plans are billions of dollars underfunded can and have taken multi-year funding holidays.

Despite our deficit of $2.5 billion, problems like TWA, and the projected losses of up to $45 billion, there are some who say there is no reason to be alarmed. I disagree. The time to act is now, before there is an S&L-type crisis. Without action, the Congress will have to raise premiums yet again, which will drive the well-funded plans out of this voluntary defined benefit plan system.

Even some of the opponents of reform admit that this type of en masse withdrawal could cause a crisis. Make no mistake, the overall defined benefit pension system is healthy in terms of funding. But there are some problems. Every year, almost 10 percent of the plans we are insuring are terminating and dropping out of the system. PBGC is troubled.

I would be derelict in my duties if I told you today, as one witness will, that PBGC is a stronger agency today than at any time in its history, both financially and in its legal authority. We are much larger because of the many terminations, but certainly not stronger financially or legally. That is the truth, and not fear-mongering.

These opponents have been fooled by the current accounting for the PBGC in the Federal budget. Changing the accounting from a cash basis to an accrual basis, as proposed by the administration, shows on this chart the long-term contingent liability which is now hidden. If it was on the chart, you would see a small surplus under accrual accounting. That is the way the government looks at the PBGC, instead of that big red line.

Current cash budgeting ignores future benefit payments for existing and future terminations and instead shows a misleading, growing surplus. Cash flow budgeting helped obscure the S&L security crisis for many years. Both GAO, and CBO have recognized the desirability of changing to accrual accounting. The administration has also proposed the Pension Security Act of 1992 that addresses these moral hazards in three key areas: minimum funding rules, our guarantee, and bankruptcy rules.

They will contain the growing deficit in the single employer program. These reforms have received strong editorial support from many newspapers, including, just 2 weeks ago, the Wall Street Journal, and just today, the Washington Post said, in an editorial, that, the PBGC is in serious financial trouble and "these reforms are sensible."

In the interest of time, I will only summarize these proposals. In the funding area, we are proposing to strengthen the 1987 change by making it a stand-alone rule and creating a new, alternate funding rule targeted at mature companies with large numbers of participants.

Logically, it says company contributions should match the benefits paid, plus interest on the underfunding. Second, we want to restrict the growth of our hidden liabilities by only guaranteeing future benefit increases if a plan is fully funded.

Lastly, we want to put in the Bankruptcy Code the priorities that you have already given us in ERISA and the Tax Code, and then gradually increase them. The impact on our deficit of these three reforms on an accrual basis is quite dramatic, as this chart shows. It produces a small surplus over the period rather than the $18 billion deficit.

In summary, PBGC needs legislative change to reduce the threat that growing pension underfunding poses to the insurance program and to the defined benefit system, which is a major component of American savings.

We need greater incentives to better fund existing and new pension promises, not higher premiums. Ever-escalating premiums are

counterproductive, driving out the well-funded plans from this voluntary system. They could leave us, and ultimately the taxpayer, holding the bag for the underfunded plans.

I can only echo the quote that Senator Durenberger had from my boss, Secretary of Labor, Lynn Martin, who is also the Chairperson of the PBGC Board. She said, "The time to act is now, before another crisis occurs." Thank you for the opportunity to speak.

Senator PRYOR. Mr. Lockhart, thank you very much.

[The prepared statement of Mr. Lockhart appears in the appendix.]

Senator PRYOR. I noticed the arrival of our colleague, Senator Jeffords. I wonder if Senator Jeffords wants to make his statement from there, or come up here?

Senator JEFFORDS. I would just as soon make it from here, Mr. Chairman.

Senator PRYOR. All right, sir. Why don't you do that, please, sir? Senator Durenberger made his statement just a few moments ago, Senator Jeffords.

## STATEMENT OF HON. JAMES M. JEFFORDS, A U.S. SENATOR FROM THE STATE OF VERMONT

Senator JEFFORDS. First of all, I want to thank my colleague for his help in this area. I rely upon him to assist me because he has the background and the knowledge which I know is very helpful to the committee and certainly helpful to me.

Since I stated in detail my concerns yesterday on the Senate floor when Senator Durenberger and I offered my amendment, I am not going to go through with any great detail what I went through last night. I would make that part of the record here, however.

[The information appears in the appendix.]

Senator JEFFORDS. I also want to thank the committee for the work they did on the Unemployment Compensation Bill with respect to portable pensions. Finally, after many years, we have taken a very excellent step forward in that important area.

Now, I would like to talk today about PBGC problems in the Durenberger-Jeffords bill in that respect. You have heard about the problems and the fact that we have to do something, so I will not go through that. But I would like to talk about the options and what our bill tries to do, very briefly.

The reality is that we only have a limited number of options available to us in dealing with the PBGC's many problems. Furthermore, it is in the best interests of the 40 million workers that currently have PBGC insurance protection that we resolve these deficit problems and maintain a solid defined benefit plan system.

What are the options? Well, we could raise the PBGC premiums that employers pay into the system. This may be inevitable, given the PBGC's current deficit. PBGC estimates that it would have to significantly increase premiums, even if it takes only $500 million a year in underfunded liabilities and pay-outs, which is business as usual for them.

If the economy gets worse and distressed companies start to terminate at greater frequency, premiums paid by all single-employer plan sponsors are expected to rise to about $58 per person for well-

funded plans, and as much as $219 per participants in poorly-funded plans. As you know, we have already raised premiums considerably since 1974, where it was $1 a head.

How much is too much? When will responsible employers with well-funded plans say, we have had enough of premium increases to pay for obligations promised by other companies, and terminate their defined benefit plans, and, instead, offer to make contributions to a defined contribution plan, under which employer liabilities are limited and employees have no insurance protection? I am not sure. Even at present premium levels, the trend is away from the defined benefit plans, and this is very disturbing to me.

The number of defined benefit plan terminations is already on the rise, and fewer and fewer new plans are being created. Another option Congress has would be to stabilize the premium so as not to deter plan sponsors away from the system, and, instead, let the Federal Government absorb the loss. PBGC projects that it is already at risk for $13 billion in underfunding in the short-term.

If current pension trends continue, the fact that government could need to absorb that loss becomes a very real reality. In fact, in the President's budget for fiscal year 1993, the administration has already introduced the idea of budgeting for fixed and expected future PBGC liabilities.

Unfortunately, in their proposal they did not accurately assess how much would be obtained from premium income and collections of plan assets. Therefore, the likely long-term impact on the budget cannot be realistically assessed. But one thing is certain. Adding billions to the $4 trillion national debt is no way to help balance the budget.

Our third option is to encourage plan sponsors in ailing industries to limit benefit increases or put up money as collateral for payment of such increases. It might seem cruel to some to force companies to promise within their means, but it is far more cruel for workers to expect a certain level of benefits when they retire, only to find out later that the money they expected to have for their retirement is not there.

Keep in mind that the PBGC only guarantees, on an average, about 80 percent of what is currently promised. Often, when early retirement benefits are involved, this number is significantly, if not substantially, less. In my mind, the third option seems the wisest, and it is why we have adopted that option in our legislation.

Senator Durenberger's bill, and mine, S. 3162, has three titles. I have spent time discussing the second title, which would require that plans with less than 90 percent funding to provide security if they wish to increase benefits. Title I outlines stricter funding rules for pension plans. Title III provides PBGC the authority to obtain financial information on companies with underfunded plans.

It also directs CBO and PBGC to study and report to Congress on the premium increases necessary to put the program on a sound basis. Similar to the administration's proposal, our bill revises a funding concept added in 1987. It expands it reach so that pre-1987 funding liabilities must now be funded over a shorter period of time.

A new solvency maintenance requirement is also added to assure that a plan puts at least as much in as it pays out in a given year.

Unlike the administration's proposal, we would specify a new interest rate that underfunded plans would have to use in valuing current liability. Based on the weighted average of the 30-year Treasury bonds over a 4-year period, we narrow the permissible range that underfunded plans can use so that it cannot be greater than 100 percent.

These are our principle proposals. No doubt, they can be improved upon. I look forward to working with the members of the committee and other interested parties to accomplish our joint goal.

Time and time again, we, as legislators, need to be reminded that there is no such thing as a free lunch. Retirement benefits need to be paid with real money, not empty promises. As workers live longer, they will need a sufficient amount of money to be assured some quality of life, and it is our job to see that that happens.

Thank you very much, Mr. Chairman. I, again, want to show my deep appreciation for your interest in this very difficult area, one which is very politically difficult, as well. And I know that you and your committee have the courage to face up to the problems and come up with the solutions. Thank you, Mr. Chairman.

[The prepared statement of Senator Jeffords appears in the appendix.]

Senator PRYOR. Senator Jeffords, thank you very much. There is not much pleasant about this hearing this morning, I might say. I have already mentioned to our panelists and our colleagues that this is a first in a series of meetings and hearings that we will be holding on the PBGC.

We very much appreciate your contribution to this, and I will be following very closely the legislation that you, together with Senator Durenberger, have introduced. We will certainly look at that legislation. We are also going to try this morning to really get the facts.

We are trying to find what the facts are; how much trouble there is, if there is trouble. Then we are going to look at some solutions in some subsequent hearings that we are going to be holding. We do appreciate your attendance and thank you for your very keen interest in this subject.

Senator JEFFORDS. Thank you very much, Mr. Chairman.

Senator PRYOR. Mr. Lockhart, if I might ask a question or two. First, I notice the charts have been taken away, but that is all right. Let me just mention, you took, on the first chart that you had before us, the worst case scenario. And that is an $18 billion deficit by, I think, the year 2000, or 2001. You did not use other forecasts that do not look quite so bad. This was in your annual report of 1991.

Forecast A, for example, would have been a $2.7 billion deficit, I believe, rather than $18 billion. Forecast B would have been approximately a $5.5 billion deficit by the year 2001. Here are those two lines, if you can see those. This, once again, is in your own report, but you chose, this morning, to bring us the bleakest of all scenarios, and I am just wondering why.

Mr. LOCKHART. First of all, the numbers that you saw this morning are not from those charts at all, they are from a model that OMB developed that is modeling the whole pension system in the

United States and is much more sophisticated than the charts you have there. And, in fact, those are the numbers that were presented in the President's budget. In fact, that is not the worst case in that model, that is the expected case in the model that OMB created.

Those numbers there are using an old and somewhat simplistic methodology in our annual report where they say on the top line, if we had losses that averaged only at the level that we had for our whole history, which is obviously an impossibility at this point. We are having losses, as I said earlier, at 10 times the levels that we had in our early days at this point. So, those two top lines, unfortunately, are not the expectations in a more sophisticated modeling.

Senator PRYOR. Once again, I am using your publication. I am not using OMB's, I am using yours. Are you saying that the forecasts that you have been using in the past were outdated, or are they outdated now?

Mr. LOCKHART. Well, I am saying that they were not based on a very sophisticated model. We do not have, until OMB built this model, with our help, the capability to really model out into the future.

So, on the bottom line, we simply said that the $13 billion of troubled companies now would terminate over that period. What it ignores is the future dynamics of stock markets, bond markets, bankruptcies, which the OMB model picks up.

Senator PRYOR. Mr. Lockhart, let me read, if I might, from the GAO report of November 1991. That is just probably about 10 or so months old. "Serious financial system deficiencies and internal control weaknesses prevent the corporation from preparing reliable financial statements. These conditions also seriously affect the Congress' ability to assess whether the corporation's premium levels are adequate to make it meet its long-term obligation."

On the next page, just a sentence from this paragraph. This is from GAO. "Since our first attempt to audit the corporation for fiscal year 1977, weaknesses in internal controls and financial systems have prevented us from expressing an opinion on its financial statements." One more quote, and we will put the GAO report aside. I want you to respond to this, too.

We are on page nine of the report, November 1991. "There was no operating general ledger system for the corporation's trust accounting through the first 6 months of 1990, nor were there accounting procedures to govern and control the processing of all accounting information throughout the year." Now, what is going on?

Mr. LOCKHART. I, myself, was very concerned when I arrived at the PBGC. In fact, I invited——

Senator PRYOR. By the way. For the record, how long have you been at PBGC?

Mr. LOCKHART. I arrived in June of 1989; a little over 3 years.

Senator PRYOR. Thank you.

Mr. LOCKHART. I was very concerned. I asked GAO in to audit us because they had not been able to do that. I am pleased to say we have made significant progress since that report. First of all, we made some very major personnel changes—hired a CFO, Chief Financial Officer—and we are addressing all of those issues. The key

issue that GAO pointed out was the liability numbers, our future liabilities.

We have had a 2-year project with a major accounting firm which we have just completed and done a closing, and that project is in the process of being audited right now for our 1992 accounts. But it does show that the liabilities we owe pensioners, which is basically 95 percent of our total liabilities, is materially accurate. So, I am pleased to report that that is behind us.

Some of the other issues you mentioned, the trust accounting system, is up and running. Another issue that they mentioned was a problem was the premium system. We made a great deal of progress there. We are now billing everybody. We have a serious collection effort up and we are collecting money. And the last area was internal controls and financial systems, and we have a major effort going there.

We have done internal control reviews of the whole agency; we have new accounting policies. So, we have taken a very serious effort. It is something, coming from a financial background, that I felt very seriously about, and I think we have done a very good job. It is going to take awhile, but we still hope to have auditable accounts for 1992.

Senator PRYOR. All right. Mr. Lockhart, a final question. Let us go back to your chart again. I am sorry it is taken away. That is all right. We do not need it, I will just make reference to it. Let us talk about the $18 billion deficit scenario by 2001.

Now, is there a built-in assumption that if all of the companies that are participants, or the 50 major companies that you say might be underfunding their systems right now, that if they all went bankrupt today and closed their doors, would that be the $18 billion figure you are talking about? Is that how you arrive and project the $18 billion?

Mr. LOCKHART. No. The $18 billion figure is based on a financial model built by OMB that takes all of the pension plans of publicly held companies, all that report to the SEC, takes that underfunding, projects out the investment returns in those plans, and projects out whether the company will have financial difficulties or not. Then it discounts those numbers to a present value. So, it is not directly related to the top 50 list. It is using the same companies, but many other companies as well. It also projects that companies that are well-funded now may, in the future, have some difficulties. So, it goes beyond the top 50 list.

And the other thing about that chart, is that it is not 2002 that the $18 billion hits in that chart, it is 5 years out, in 1997, under accrual accounting.

Senator PRYOR. Thank you. Senator Grassley.

Senator GRASSLEY. Thank you. I am sorry I could not be here.

Senator PRYOR. I want you to do whatever you need; make a statement, ask questions. I am glad you are here.

Senator GRASSLEY. I think my first question would be just maybe asking you to rehash a little what has been said. But, you know, whether it is at the grass roots of Iowa or whether it is here in Washington, we always are talking in terms of the savings and loan crisis.

Give us some sort of a statement, if you can, it might be summary in form, of how you see the problem of PBGC compared to that, as an example? And I do not say that to put you on the defensive, but that is how everything is measured at the grass roots. You do not have a town meeting without the savings and loan crisis coming up, or the bail out of the savings and loan.

Mr. LOCKHART. PBGC does have a very serious problem. We have a $2.5 billion deficit, this potential exposure of $40 billion of underfunded plans. But the good news, compared to the S&L situation, is that we can fix it, and we have time to fix it, if Congress can act and the proposals of the Bush administration are put forward, the ones that Senators Durenberger and Jeffords have put forward, the ones that you have put forward, Senator Grassley, in the bankruptcy proposals last year. Those are the kinds of reforms that will make sure that we do not have an S&L crisis. The magnitude of the numbers are less than the S&L crisis, obviously, and that is good news.

The overall system is very healthy, but we do have this big problem of these underfunded plans and we do have a lot of the same kinds of moral hazards: Companies give their workers benefit increases that they cannot afford.

Senator GRASSLEY. Dallas Salisbury, of the Employee Benefit Research, is going to make a statement later in this hearing, in which he will say: "In fact, current exposure is approximately 40 percent of the historic average of $59.9 billion. PBGC is a stronger agency today than at any time in history, both financially and in its legal authority." Before that he quoted some figures that I am sure are commonly understood. Now, I suppose that gives me reason to ask, because I think we would be asking you to square what you just told us with what is said here. How could you have such diametrically opposed views on the condition of this agency?

Mr. LOCKHART. It is a good question, Senator. First of all, I think later in his testimony he does admit that there is some need to reform the PBGC. I cannot, in good conscience, say that we are stronger than we have ever been before. We are bigger—much bigger—unfortunately, as we take over all these plans.

The underfunding, as I said, is stuck at the mid-1980's level, despite the extremely strong stock and bond markets over the last 10 years. We have some examples of companies. There is one in the paper today, the major company in the United States, said that its plans were underfunded by several billion more than it admitted in its financial statements until now. There are problems out in the system, and I cannot say that we are stronger.

Again, I also point out that we are losing very rapidly the number of plans we insure every year. We are losing 8,000 plans a year. That is not a sign of strength in the insurance system. The $40 billion of underfunding is a real number, and, in fact, it is probably grossly understated, because one of the things we see in a termination is sort of a death spiral. Companies' pension underfunding grow dramatically before they terminate, and, instead of being at the top 50 list level, which is now about 75 percent funded, when they terminate they are more like 40 percent funded. So, we have some major financial problems.

On the legal side, we have had a major setback in a District Court in New York which has basically gutted our bankruptcy recoveries. That is one of the key reasons why you, Senator Grassley, did introduce our bankruptcy bill to try to restore our legal position to where it was.

Senator GRASSLEY. You noted from a major accounting firm just completing their work with you that the numbers in your most recent annual report are materially accurate. What does "materially accurate" mean, and that follows on the statement by the General Accounting Office that your books were unauditable.

Mr. LOCKHART. Right. The liability that we reflected last year in our balance sheet was about $8.2 billion. Using the same assumptions as last year, the work we have done so far, we are within one or 2 percent of that number. That is what we mean by materially accurate. GAO is in right now doing the audit for the 1992 accounts. We are very hopeful that they will say that we are auditable this year. They are being assisted by our Inspector General and an outside accounting firm.

Again, the key number on our balance sheet that overwhelms everything else is the liability for future benefits. And we have made a very major effort this year to clean up the data, develop a new software program, and to audit that internally.

Senator GRASSLEY. Well, Mr. Chairman, what is your desire? You do not use the light, so I cannot keep track of whether I am abusing my privileges or not.

Senator PRYOR. I do not use the light against Senators. [Laughter.]

I know it would be of no use to do it. [Laughter]

No. Go ahead, Senator Grassley.

Senator GRASSLEY. Well, let me ask one last question then. Before I ask the question, just a little bit of background. There are those who think that there are ample resources in the overall defined benefit pension system to take care of the PBGC's potential underfunding. I have in mind specifically the paper that the Employee Benefit Research Institute published in May of this year.

In that paper, they said, as I understand it that many of these defined benefit plans pay considerably more for consulting and management fees than they do for their benefit guaranty through premiums that go into the PBGC's funds.

Again, if I understand them correctly, they implied that the premium increases or a one-time lump-sum payment of some amount per participant could solve your deficit problem without diminishing employer willingness to participate in the system.

In fairness, I need to add that they point out that there are no data to prove that PBGC premiums are close to the level at which the increases in it would cause plan terminations. In any case, I would like to have your comment on that point.

Mr. LOCKHART. Premiums are high. They have gone up 19-fold, from $1 per participant to $19 per participant since we were created, for well-funded plans, and 72-fold to a maximum of $72 per participant for an underfunded plan. We estimate, to handle this $18 billion deficit problem—the number you saw there—we need to more than triple the premium for well-funded plans. That would be a 70-fold increase.

At what point do the well-funded plans drop out? We are already seeing a lot of plans drop out. Thankfully, they are the small and the medium-sized plans. If the big plans start to drop out, we have a serious problem.

I can tell you, at the kind of premium levels that we have to charge, that, according to a study we did, over half the administrative cost of a large defined benefit plan would be the premium. It will outweigh the cost of the actuarial consultants, the lawyers, all the administrative costs to the plan.

So, it is not a trivial number. It is a big number, and I think that, if you keep raising the premiums and there is no ceiling in sight, companies will drop out. It is a voluntary system. They can create their own defined contribution plan and we will lose our premium base.

Of course, the underfunded plans cannot drop out, so we will be left with just underfunded plans. And I am sure you will hear that from some of the other speakers this afternoon that represent the premium-payers.

Senator PRYOR. Once again, looking back on the history of ERISA, PBGC, et cetera, it is my understanding that in one of the debates back in 1974 when this legislation was moving through the Congress, the original idea was to have a premium, I believe, of 50 cents, a half a dollar, per worker, per year.

And someone—I believe Senator Bentsen, in his wisdom—said, maybe we better double that to a dollar a year per worker. So, I think when we talk about today's premiums of $19 per worker, per year with some variable rates of up to $72 per worker per year. I think we just need to put this in perspective. I was very shocked to realize that we started off with a dollar per year, per worker. And I think the record should reflect that.

Mr. LOCKHART. I agree. It was probably under-priced, to begin with. At the moment, the premium, I think, is well-priced for the well-funded plans, and grossly under-priced for the underfunded plans.

But, I think over the long term, the important issue is that the reforms that the Bush administration has proposed will make sure that the premiums do not have to skyrocket in the future. In fact, we can control the premium growth and keep the system healthy.

Senator PRYOR. In this area, if I may get my colleague to yield to me for a moment, what about the 8,000 plans per year that you are losing? I think that is the first time I have heard this figure. We just have 85,000 plans. Is that right? You are not saying we are losing 10 percent drop-outs per year, are we?

Mr. LOCKHART. Ten percent for the last 2 or 3 years, per year. Yes, Mr. Chairman. And it is happening in the small- and medium-sized plans, primarily. They have just been driven out by the administrative expenses of sponsoring a defined benefit plan.

Senator PRYOR. All right. Let us say a company has, say, 100 employees. What are we talking about, administrative expenses?

Mr. LOCKHART. We did a study at the PBGC 2 or 3 years ago to look at this very issue. I think the administrative expenses might be a couple of hundred dollars per person, per year for that size plan, which can represent maybe a quarter of the benefit that is provided in the plan in a year.

It becomes extremely expensive. In smaller plans, we saw something like $400 a year per person. For those plans, it has become uneconomical, unfortunately, for defined benefit plans, and they are dropping out like flies.

Senator PRYOR. If you are putting in, say, under some of the plans, $19 a year per employee, the administrative costs per employee are $200?

Mr. LOCKHART. No. The $19 a year is the premium to us. In addition, the company is putting something in, a contribution for the individual, into their plans. That may be, say, $500 a year, or maybe even $1,000 a year, depending on the plan.

But they are also having to pay $200–$400 just to administer the plan, and, at some point—especially because defined contribution plans, 401(k)s are simple to administer, a lot of these companies are either dropping out of the pension plans entirely, or going to the simpler 401(k)s.

Senator PRYOR. Mr. Lockhart, I am going to do this. It is not quite on our program. I am going to ask our next witness to come forward. Senator Grassley has been called to the phone. He may have another couple of questions. So, before you step aside or step down, if you would remain there. We will call Mr. Joe Delfico, from the General Accounting Office. If he would please come forward. Once again, please do not——

Mr. LOCKHART. I will not run.

Senator PRYOR [continuing]. Do like your chart; do not disappear. Perhaps Senator Grassley will have another question or two for you before you are released. You could stay right there, if you would like. Mr. Delfico, we appreciate you being with us this morning. We look forward to your statement.

## STATEMENT OF JOSEPH F. DELFICO, DIRECTOR, INCOME SECURITY ISSUES, U.S. GENERAL ACCOUNTING OFFICE, WASHINGTON, DC

Mr. DELFICO. Thank you, Mr. Chairman. Thank you for inviting me here today to discuss the Pension Benefit Guaranty Corporation's financial condition. Today I would like to highlight five points that we hope will be helpful in congressional policy formulation in the pension area.

We believe such policies should focus on reducing unfunded liabilities in PBGC-insured pension plans because such actions are the key to reducing future PBGC liabilities and protecting the benefits of plan participants.

We also note our concern about PBGC's longstanding operational problems. PBGC's deficit is large: it is $2.3 billion, as you have heard this morning. This was at the end of fiscal year 1991. It has grown significantly in recent years.

The major threat to the agency is the large, unfunded liabilities in the ongoing plans it currently insures. In its 1991 annual report, PBGC states that some plans—especially in the steel, tire, automobile and airline industries—are unfunded by a total of about $40 billion, with $13 billion in plans sponsored by financially troubled sponsors.

PBGC's pessimistic estimate indicates that its deficit may grow to $17.9 billion in the year 2001. I would like to point out that the

$17.9 billion was included in their 1991 annual report that you looked at this morning. Unless proper steps are taken to improve plan funding, this pessimistic estimate may become a reality.

At present, PBGC's cash flow is sufficient to meet its current benefit obligations. Premium and investment income exceeds expenditures for benefits and other expenses by $452 million in fiscal year 1991.

Nonetheless, the Congress should address the threat to the agency from underfunded plans. If the Congress acts now while PBGC still has a positive cash flow, it should not be necessary to legislate in haste at some future date, or to seriously erode the protections afforded workers in the process of solving PBGC's problems.

We are encouraged by your subcommittee's efforts to begin focusing on this issue at this time. Legislative proposals for improving funding in underfunded plans could have a significant positive effect in reducing PBGC's deficit over the long run. However, it is important to analyze the potential impacts of the specific programs on plan participants, plan sponsors, and the Federal revenues before they are enacted.

We have long supported strong and effective funding standards for the Nation's defined benefit pension plans. We believe that improving the funding for underfunded plans is the best approach to solving PBGC's current and potential deficits.

Proposals to limit PBGC's guarantees concern us because they could adversely affect plan participants. We would prefer that the threat to PBGC from underfunded plans be addressed by better plan funding rather than by limiting benefit guarantees.

PBGC has requested that its priority in bankruptcy be clarified and improved. We recognize that improving PBGC's priority position and bankruptcy would improve its recoveries. However, we are concerned what impact this will have on others, including creditors and the Federal Government. Nonetheless, we believe that plan sponsors should be required to continue making contributions to their plans while they are in bankruptcy.

In addition to these approaches, other avenues of addressing PBGC's potential claims and existing deficit should be analyzed, such as: Improving funding for flat benefit plans; making greater use of PBGC's existing authority to terminate financially troubled plans; and, to address the current deficit by increasing premiums, structuring these premiums to better reflect the plans' risk to PBGC.

Underfunded plans not only put PBGC at risk, they also pose a risk for plan participants. PBGC insures many, but not all of the benefits provided by defined benefit plans. If an underfunded plan terminates, some of the plan participants are at risk of losing promised benefits. Thus, improved funding of underfunded plans will be beneficial to participants, as well as PBGC.

In addition to PBGC's current deficit and looming potential claims, the agency has had significant internal operational problems. Because of significant internal control and system weaknesses, we have been unable to express an opinion on PBGC's financial statement.

In addition to continuing problems with PBGC's premium collection system, these problems have prevented PBGC from preparing

an accurate accounting of premium revenues. PBGC has recently moved to address these problems.

Mr. Chairman, underfunded plans pose a risk to PBGC, and, because PBGC does not guarantee all benefits to the participants of those plans, we feel that the best way to protect PBGC and plan participants is to ensure that all underfunded plans become fully funded.

Improved funding standards may impose a financial hardship on sponsors of some underfunded plans, however. A balance needs to be struck between protecting the interests of PBGC plan participants on one hand, and those of plan sponsors on the other. Striking this balance is the challenge facing the Congress, as it begins debating pension reform.

Mr. Chairman, this concludes my statement. I will be happy to answer any questions you may have.

[The prepared statement of Mr. Delfico appears in the appendix.]

Senator PRYOR. Mr. Delfico, thank you very much. Thank you very much for your statement. Something that jumps off the pages of your report from November of 1991 to me is this description, "unaudited reports." Some have used the word, "unauditable," today. That not only scares me, I imagine it would scare a lot of workers out there who have their funds under the control and under the auspices of the PBGC.

Could we talk about that for just a minute? I do not want to allay the fears of our people if this is, in fact, a very dangerous thing. What are we talking about here? Maybe Mr. Lockhart could address this, too.

Mr. DELFICO. Yes. Mr. Chairman we have not been able to audit PBGC since its inception. However, we have noticed a positive change in the way they have been working with their financial situation. Over the years, PBGC has had an unauditable financial statement. Now, what that means is we were unable to account for, or say that there was available, reliable data—as in the case that Mr. Lockhart brought up—to verifiy all liabilities of terminated plans.

It is a very difficult process to determine what PBGC's true liabilities are. It takes a long time to do that. When we audit these plans, we find that there is a soft area there; we cannot say for sure what the liabilities are. And that is one of the key points that PBGC has been trying to work on.

To put it in perspective, what troubles us the most is that, when you find a company or government agency with an unauditable financial statement, it is an indication that its financial management may not be up to snuff, and we become concerned about that.

In the case of PBGC, we have been concerned for years about how they manage their operations. This is outside of the policy area that we are discussing today. So, we are continuing to audit their financial statements, and, I must say, we are encouraged about the progress they have been making the past year, year and a half in that area.

Senator PRYOR. All right. Now, Mr. Lockhart, I am a layman in this. Explain what you think it means to be "unauditable."

Mr. LOCKHART. Effectively, it means the numbers in our financial statements cannot be verified by the auditors. It does not nec-

essarily mean that the numbers on our financial statements are wrong. In fact, as I said, we have just finished a 2-year project on looking at our liabilities, these pension plans we have taken over. We have taken over 1,700 pension plans in our existence, and we have to measure the liabilities for each one of those plans. We have just finished that process.

In comparison to last year's numbers, we are only a couple percent different after we have gone through the whole process of recomputing all of those liabilities. And now we are hopeful, as GAO reviews this year's audit, that they will say that we do have the right financial systems in place, that they are auditable, and that these numbers are materially correct.

Senator PRYOR. I am learning a lot this morning. In another life, when I was in my early 20's, I had a short—and, I must say, unsuccessful—tenure as a journalist. I thought I was going to save the world and I started my own little weekly newspaper. Still, today, because of that, I kind of think in terms of headlines and what might be the story the next day, or the headline of a particular story. Somehow or another, this word, "unauditable," leaps out at me, and I think it is going to scare people to death when they see this.

I am just hoping we can communicate properly with the people who are involved with this system and sort of make sure that we are not being overly castigating of the whole system, but certainly concerned about the condition of it.

Mr. LOCKHART. Mr. Chairman, obviously, when I arrived at the agency, it concerned me an awful lot. And we have done, I think, a tremendous effort and I am very pleased with my team on this.

I think we are very close to achieving auditability, and I think we will show, as part of that process, that our financial statements had been materially correct, that our assets are being properly controlled, which they are, and there is no material financial problem with the PBGC.

Senator PRYOR. All right. Let me move again back to the General Accounting Office, Mr. Delfico. Here is what we have here. We have a situation where we are very nervous, very nervous about the PBGC. I am nervous.

I think the members of the House, the Senate, the committees, are nervous; a lot of people whose pensions are in the system are nervous. We keep hearing stories that come out that make us queasy; make us want to know the facts. That is what this hearing is about, trying to find the facts and put the facts on the table.

Advise us. What questions do we need to be asking from the Congress, and what answers do we need to have before we start coming forward with the solutions?

Mr. DELFICO. Those are good questions. I think you need to be asking questions that go along the lines of—what impact is this legislation going to have on the plan sponsors, the plan participants, and the Federal Government. Those three components have to be analyzed.

We are in favor of strengthening underfunded plans. We have said so. We were involved in 1987 with major legislative changes to ERISA along those lines. But, we are quite aware that it may

be difficult for financially stressed companies to adequately fund their plans.

So, there is a delicate balance you have to strike between making sure sponsers fund their pension plans, and ensuring that participants do not get hurt because of some of the rules you may change. So, I would say those questions need to be answered. You need to study those issues.

We are now in the process of looking at the impact of the 1987 changes. The questions we are asking are—did the changes do any good, if they did, what worked, and what did not work? So, those are some of the questions we are trying to answer to inform the debate.

Senator PRYOR. I think at the proper time and in the proper sequence I may request that study. I know the information gathered from it would be of great benefit to this committee and to all of us involved in this. I noticed in the paper—actually, I did not get a chance to read it all; I just saw the headline, walking over here—Raleigh's is going out of business.

Mr. DELFICO. Yes.

Senator PRYOR. All right. I read that in the paper. So, I am a shoe salesman. I have been there 30 years at Raleigh's. I pick up the Post this morning. My goodness, we are going out of business. I am not going to have a job any longer. I have been here 30 years; I am 62 years old.

Then the next day, I pick up the paper and I see all of the problems with the PBGC. I do not know if Raleigh's is a participant in this, I am just using them as an example. What are we saying to those employees? Are we saying, you are in good shape, do not worry, or you better watch out?

Mr. LOCKHART. There are two issues there. What we say to plans when we terminate them because their sponsor has financial distress—like Eastern and PanAm in the last couple of years, CFI Steel; a whole series of these companies—we tell the workers that we are there and we are going to make sure that they get their guaranteed benefits. And we do. We deliver the monthly checks, we make sure they keep coming; we protect them.

But the problem is, there is a long-term issue here that we do have these looming problems that could create a major problem out in the future. So, what we are saying now is if Congress acts now, we can ensure that these checks will continue to keep coming forever, and that is what we want.

Senator PRYOR. I hope the two of you will not mind if I do this; I am going to do it a little bit differently than we had planned. I was going to have each individual testify. I wonder if we could bring Dallas Salisbury up right now. Would that be possible? But please do not leave. I would like to have a three-way discussion. I think this might be good.

Sir, you are certainly no stranger to this committee. We appreciate the contributions you have made to this issue in the past. I wonder if you would like to make your statement now. We are going to put your full statement in the record.

We are about to have a vote, by the way. We were supposed to have it at 11:00; it has been postponed a little bit. If you would just give your statement. If you do not mind summarizing it, we would

appreciate it. We might want to get you in this discussion. Thank you.

**STATEMENT OF DALLAS L. SALISBURY, PRESIDENT, EMPLOYEE BENEFIT RESEARCH INSTITUTE, WASHINGTON, DC**

Mr. SALISBURY. Senator Pryor, thank you. It is a pleasure to be here—at least I felt that when I walked into the room. I am not quite as sure now. But, for those who are professional researchers at the institute who have worked long and hard on analyses of the PBGC, I would have to say that the discussion today must at least please them to know that the work they are doing is being read.

Senator PRYOR. Let the record state, by the way, you are the president of the Employee Benefit Research Institute here in Washington. I want the record to indicate that.

Mr. SALISBURY. Thank you, sir. Per the question Senator Grassley asked, and since you said that the entire statement will be put in the record, frankly, I will not even read my summary. I do request that our issue brief that was submitted be also included, in its entirety, in the record of this hearing.

Senator PRYOR. We will print it in its entirety.

[The brief appears in the appendix.]

Mr. SALISBURY. I will reference back to a point in history, which is January of 1992, in California, where a non-public meeting of the advisory committee of the PBGC, on which I serve, was being held.

In a discussion at that meeting, the point I stressed then, and, thus, frankly, take offense now at the characterization of my "admitting" that there might be needs for change in the PBGC program, was a statement that, throughout my involvement with the agency since 1976, the agency has made a continuous effort, along with the Congress, and along with the General Accounting Office, and others, to perfect a statute that was put together very quickly, with most everyone saying, this statute is a shot in the dark with a very worthy purpose and we hope it will work.

Your statement of throwing out a 50 cent premium which became a $1 premium, if one looks at the hearing records from that point in history, one finds that they could readily have set it at one penny, or $20, or $50 a head, and it would have been equal precision, vis-a-vis the type of analysis that was even possible at that point in history. The PBGC needs to be strong. Changes need to be continuously considered. But ERISA has been an extraordinarily successful statute vis-a-vis the pension system and vis-a-vis the PBGC. The system is far more funded today than at any point in our history. The PBGC's exposure, Jim carefully noted in his statement, has, if you will, leveled since the mid-1980's.

But leveled by the mid-1980's, as shown in the table attached to my testimony as Table II, in constant 1986 dollars, if that chart had been up here then, the underfunding and exposure of the agency would have been $126 billion, compared to the adjusted $25.6 billion talked about by the PBGC today.

At the same time today, by their own numbers, the program's premium paying organizations are $400 billion overfunded, whereas, in 1979, they were over $100 billion underfunded. The statute has been amended by you and your colleagues numerous times

since 1974 and PBGC has far greater rights today legally, legislatively, as a matter of law, than at any point in its previous history.

The agency is rightfully concerned about issues such as the decisions of certain judges and what that might have done. But, even with those decisions, they can take pride in having a better recovery record than at previous points in history.

In that California meeting I added a second statement, that, while many might rightfully be embarrassed by what they did or did not do in the savings and loan situation, it should not be used as a reaction to then use it and to try and make up for mistakes made in the past by undermining the confidence of tens of millions of Americans and causing them to needlessly worry about their pension promise.

It would be my regret if the continued theme was that this was another S&L situation, causing me to have to focus, in response to questions, to that issue rather than to the issue of, are changes necessary in the PBGC.

As my statement documents numerically with numbers from government organizations and the PBGC, numerically, the system of defined benefit plans is irrefutably stronger today as an entity and as a total system than at any time in their existence.

The PBGC's own numbers against total exposure clearly document that the PBGC's exposure is no greater today than at any time in its history, and, in fact, is potentially stronger. In terms of the debate over premiums, I am the first to say that raising premiums is only one of many options.

It may well not be the best option. It may, in fact, be the worst option. But, if one looks at the numbers against the system, it is an option that is there. And there is $400 billion in surplus termination assets and defined benefit pension plans, some portion of which could be "commandeered," if you will, to assure that the taxpayer would not face the bail-out situation of the S&L crisis.

So, I commend you, Senator, for attempting to dig into the facts. I would urge you, the Senate, and the House to step back from the rhetoric, to step back from fear, and to basically look at the agency, look at the system, and make changes in the law that will strengthen the program, strengthen the system, and assure that benefit promises are made.

But, if anything, what we should want as individuals in the grass roots of Senator Grassley's State or anywhere else, is to be able to have a clear picture of who should be afraid and when we can have confidence.

And it is our conclusion, based on our analysis, as well as every bit of data that has ever been made available publicly by the Pension Benefit Guaranty Corporation that there is no justification to cause the individuals who call my office from Kansas, from California, and from elsewhere, after reading an editorial that raises the specter of the S&L, of, do I have to lose sleep at night; is this another failure on the horizon.

I think, in all fairness, one has to conclude that, during the decade of the 1990's, unless the current recession were to continue and into a depression such that numerous companies in the near term would find themselves in dire straits, then, at that point I would add one additional item. To the GAO list of concerns, I would add

the economy, and that the effect of many changes on the economy also needs to be looked at. Thank you.

[The prepared statement of Mr. Salisbury appears in the appendix.]

Senator PRYOR. Mr. Salisbury, thank you. Now, we know the history of PBGC. We know the history of the General Accounting Office. Just for the record, tell us in a paragraph or two about your institute, if you would.

Mr. SALISBURY. In 1978, after completing 2 years of service at the Pension Benefit Guaranty Corporation where I had the pleasure of directing the study that led to the Multi-employer Pension Plan Amendment acts and the changes in that program, I was approached as to whether or not, in preparation for research tied to the Carter-appointed Presidential Commission on Pension Policy, I would like to create a private sector research organization that would be aimed at documentation of health and employee security data and research, to provide education to the media, assistance to the government and others.

So, we began in December of 1978 and have been functioning as a non-partisan, non-lobbying research and education organization since that point in time.

Senator PRYOR. All right. Now, Mr. Delfico, would you like to respond to anything Mr. Salisbury has said? I am going to also give Mr. Lockhart an opportunity.

Mr. DELFICO. Well, there are two points I would like to respond to. One, I would like to agree in part with Mr. Salisbury on one issue, and that is the savings and loan issue. Second, I would like to expand on one of the comments he made about the total exposure of PBGC.

Senator PRYOR. All right.

Mr. DELFICO. There are differences between what we see at PBGC and a savings and loan situation. I'd like to make a couple of key points here. I do not want to infer that the problem at PBGC is not serious. It is, but the differences, obviously, are in magnitude. The size of the savings and loan problem may be an order of magnitude greater than at PBGC as it sits right now. Second, if there was a crisis, PBGC's payout would be made over a series of years. It would not be as immediate as the savings and loan situation.

Third—and I think more importantly—is that the Congress has been focusing on regulating pension plans for quite some time now. The work done in 1987 focused on tightening ERISA making it stronger, whereas, if I recall, the savings and loan situation was different.

So, those three points, I think, make it a different kind of crisis. I would not compare it to the savings and loan crisis directly, but I also would not dismiss it.

Another point I would like to make is there should be concern for people who are in underfunded plans. There should be concern for people out there who are in underfunded plans sponsored by companies that are distressed and financially unstable and that are continuing to grant benefit increases.

I think participants really should be concerned and get information from either their unions or from their management about what

benefits they are bargaining for—you heard some examples that Mr. Lockhart gave today—and what the chances are of losing benefits if the plans terminate. I think there is a problem in that area. I do not think people know. I do not think people are being informed about the potential loss of benefits.

So, I would be worried if I were in one of those plans. Clearly, if I were in a fully-funded plan or an overfunded plan, I probably would not be as concerned. But that could change. We have seen, over the years, fully-funded plans become underfunded as their sponsors become distressed. I would be vigilant, if I were a participant.

Senator PRYOR. Thank you. Mr. Lockhart, do you have a response?

Mr. LOCKHART. PBGC does have extremely serious problems. We have a $2.5 billion deficit; we face $40 billion of underfunding out there. We have some of the same moral hazards as the late, lamented Savings and Loan Insurance Corporation did. The magnitude certainly is not as big, and the system is certainly healthier than the S&L system was. But we do have a serious problem now that could turn into a crisis under some scenarios. What we are suggesting is, it is time for Congress to re-look at the program and to look really thoroughly at the program and look at the alternatives.

There are three alternatives suggested by the Bush administration: better funding; limiting guarantees; and improving our bankruptcy priorities. The fourth one is premiums. Those are the alternatives. I think it would be very helpful if Congress looked at it now to prevent a crisis.

The other point is, to back up something Mr. Delfico said, when we take over a plan, we have guarantee limits. People are hurt when a plan terminates. They are hurt because they do not get all of the benefits they were getting previously; if they are well-paid, if they retired early or if they have special pension benefits.

On average, we see, say, 10 to 20 percent of the people in plans that terminate take cutbacks in their pension benefits. Sometimes they can be very material. We have seen examples where there are 50 percent cut-backs. For people that have planned that money for retirement, that is very serious. So, there is a problem here. In addition to the guarantee level, people are also being hurt because they are losing their future benefit accruals. So, I think it is a serious problem that should be resolved.

Senator PRYOR. Senator Grassley has returned.

Senator GRASSLEY. Now, Mr. Salisbury, you heard my comment to Mr. Lockhart before. I hope I understood your position adequately. That is, that you believe that any funding deficit of the PBGC's trust fund could relatively easily be handled by premium increases, or lump-sum, or employee levy. And I understand your point to have been also that the termination of insurance is relatively cheap. Is that correct?

Mr. SALISBURY. That is not covered in my testimony, though. I did not write the issue brief or analysis to which you refer. Professor Jack Vanderhigh, of Temple University, along with two individuals who are permanent members of the Employee Benefit Research Institute staff, wrote the analysis to which you refer.

Senator GRASSLEY. Do you associate yourself with it, though?

Mr. SALISBURY. I should then go the next step. You have, in fact, mischaracterized what the analysis says. What the analysis says, is that it goes through in great detail all of the different types of alternative approaches, including all of those suggested by the PBGC. It provides balanced analysis of all of those alternatives.

And, in the premium area, it simply attempts, in great detail, to put into perspective the level of premium, vis-a-vis the system and other plan expenses, the type of burden or non-burden relative to other expenses that, if the Congress found itself in a situation that Mr. Lockhart might deem to be a crisis and the agency needed the money, what would be the magnitude of the burden being represented if the Congress, instead of saying we are going to go to the general taxpayer, said, we are going to do this through the premium payers in order to assure the security of the PBGC, what would the magnitude of that premium be, and what would its relative effect be?

It in no way advocates that that is what should be done; it in no way suggests that it is no big deal; it in no way suggests that that is the approach that should be taken.

An overriding focus of that analysis and an overriding focus of what I have submitted for the record today is simply to say, is it fair to suggest that even at the maximum exposure suggested by the PBGC, that it would be necessary for the two of you and your colleagues to go to the American taxpayer directly for a bail-out of the PBGC?

And our conclusion is that, in any immediate timeframe—let us define it as between now and the year 2000—that, other than under extraordinary circumstances which no forecast of this administration or this Congressional Budget Office, even in the pessimistic case, contemplates, that the defined benefit pension system is strong enough, and, if you will, its pockets deep enough that even in a crisis it would not be necessary to go to the taxpayer for a bail-out.

That analysis was done. And I make the statement because of the frequency with which many commentators in this debate have chosen to attempt to put this into context by raising the specter of a taxpayer bail-out.

I then go the next step, that, in no way, shape or form was meant, or has ever been characterized by me in any setting, as in any way saying that there are not serious issues to be dealt with, and that the Congress should not continue to be vigilant with regard to the PBGC, and that significant additional legislative changes may, in fact, be necessary.

But it is to say, sir, that to hold the people of this country to the specter of a taxpayer bail-out is, at best, disingenuous, and, at worst, grossly dishonest and misleading.

And, as one who has dedicated my life since 1975 to government policy surrounding ERISA and the pension system, and my entire career to the concept of economic security being sacred, and promises being made, but believing that the trust in this system is essential, that anything done in the effort to get something passed that wrongfully undermines public confidence, is, in the long-term, very ill-advised.

And I have attempted—through our work and setting my own people aside—in my dealings with the media, with the government, and others on these issues, in response to requests and inquiry, have attempted to say there may well be many things that need to be done. There, indeed, are problems. The system would be better off to be fully-funded, but to put it into context. So, no. We do not advocate it, sir. We do not suggest that it is the alternative of choice by any stretch of the imagination.

Senator GRASSLEY. I would only close by saying that I understand that none of your papers advocate that. I guess, Mr. Chairman, we do not want to put him on the undecided list.

Senator PRYOR. That is right. Not at this point.

Senator GRASSLEY. Thank you.

Senator PRYOR. I would like to put him on one list, as I would with Mr. Lockhart and Mr. Delfico. I would like to put all these gentlemen on the same list of trying to help us in seeking solutions. We are going to see what solutions we need to seek, and I very much appreciate your statement, Mr. Salisbury. I appreciate the statement of all of you this morning.

I appreciate all of you coming and cooperating with the committee. There may be some questions that we would like to forward to you to be answered in writing, and I hope you will cooperate with the committee in that regard. We want to thank you very much. We are going to keep the record open for about 10 days for that purpose.

Senator PRYOR. Senator Grassley and I are going to the floor to vote. We will have about a 10 minute recess, and then we will resume with our final panel of three. Thank you very much.

[Whereupon, the hearing was recessed at 11:40 a.m.]

AFTER RECESS

Senator PRYOR. Ladies and gentlemen, we will reconvene our hearing. It is now 12:00 o'clock. We are going to have another vote very shortly and throughout the afternoon, and probably all day Saturday, the way things are looking.

We have a panel now. Mr. James A. Klein, executive director of the Association of Private Pensions and Welfare Plans, from Washington, DC; Mr. Chester Labedz, Jr., the director of the Benefit Compliance and Welfare Plan, Textron, Incorporated, Providence, RI. He is also the chairman of the Title IV Task Force, The ERISA Industry Committee. And then we have Mr. Richard A. Damsel, the chairman of the Multi-Employer Pension Plan Amendment Act Solvency Coalition, from Alexandria, VA.

Gentlemen, we appreciate you being here today, and we appreciate your patience sitting here this morning throughout the hearing. We hope that you have learned a lot; I can assure you that I have learned a lot.

We would like to, please, respectfully request that you keep your statements to 5 minutes each. Your full statements will be placed in the record, and then we will follow with a few questions. We will, first, call on Mr. Klein.

## STATEMENT OF JAMES A. KLEIN, EXECUTIVE DIRECTOR, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, WASHINGTON, DC, ACCOMPANIED BY JOHN B. BLOUNT, DIRECTOR OF CONGRESSIONAL AND FEDERAL AFFAIRS, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS, WASHINGTON, DC

Mr. KLEIN. Thank you, Mr. Chairman. I am James Klein, the executive director of the Association of Private Pension and Welfare Plans. I am accompanied today by Mr. John Blount, our director of Congressional and Federal Affairs, and we are pleased to be here.

The APPWP's members are companies, both large and small, that either directly sponsor or provide services to pension and health care plans that cover more than 100 million Americans. Our members are concerned about the well-being of the pension system and the PBGC for fundamentally two reasons.

First, because it is important to the workers and retirees of our member companies, and, secondly, because, as sponsors of predominantly well-funded plans, and as premium-payers who support the PBGC termination insurance system, the APPWP's members pay the price for other firms that are not as responsible about funding their obligations.

Since the full text of my remarks will be in the record, I would just like to briefly note a few points from my written statement.

First, the PBGC has real problems. Those problems should not be ignored. There are plans, frankly, that are imposing a risk to the fiscal integrity of the PBGC, and appropriate and prudent steps along the lines outlined in the administration's proposal and in the bipartisan legislation that was discussed earlier this morning should be taken to address those problems.

But, having noted that the PBGC is exposed to financial risk, this problem should be put in the proper context. The vast majority of defined benefit plans in the country are well-funded and pose no risk to the system. Moreover, even among many plans that are not fully funded, the sponsors of those plans do have sufficient corporate assets to fulfill the obligations to participants should those plans terminate.

In addition, many of the problems of currently underfunded plans are, in fact, historical problems which are being corrected as the funding changes enacted in 1987 begin to take effect.

The challenge, then, for Congress, is to, frankly, strike the proper balance in any changes to the funding rules that you enact. On the one hand, your focus must be on those plans that pose the greatest financial risk to the PBGC. On the other hand, the companies that will most be affected by new funding standards are the very firms that can least afford the new burden.

The PBGC has correctly pointed out that a serious problem can be created when underfunded plans are amended to increase benefits. Benefit improvements by a financially troubled company with a badly underfunded plan give a false sense of security to participants, since the plan could terminate before the guarantee of the benefit is phased in.

Moreover, such benefit improvements allow the employer and the employee representatives to trade current wage or benefit increases

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for a future pension promise that the employer may not be able to afford.

The PBGC's proposed solution to this problem would be to freeze benefit guarantees. One unintended consequence of that approach, however, could be that an innocent participant may find his or her benefit is not guaranteed in the case of a plan termination.

We think the better approach is outlined in the bipartisan legislation introduced by Senators Jeffords and Durenberger, and Congressman Pickle, which would require an employer to either fund the benefit increase or post a bond to securitize it if the plan is less than 90 percent funded.

Finally, Mr. Chairman—and most importantly—the APPWP urges Congress to recognize that the greatest threat to the PBGC is the erosion of the defined benefit system itself. And I think that you recognized that in your questioning earlier of Mr. Lockhart when you asked questions about the level of administrative burden.

As a result of extensive and continual legislation and regulations, more and more firms are terminating their plans and fewer and fewer companies are establishing new ones. In the 18 years since the passage of ERISA, there have been no fewer than 14 major legislative measures changing either the Internal Revenue Code or ERISA with respect to retirement plans.

I would like to just briefly read to you one paragraph from my written statement that directly responds to a question that you asked earlier about the magnitude of that administrative burden.

On page three of my statement I mention the recent PBGC study that reported, for the typical defined benefit plan with 75 participants, that administrative costs relative to the costs of providing benefits rose from 8 percent of total plan cost in 1981 to 33 percent of plan costs in 1990.

Senator PRYOR. Is that per employee?

Mr. KLEIN. Yes. Right. The average over the period was 19 percent. That same study found that administrative costs shifted erratically from year to year due to frequent legislative and regulatory changes. For example, in 1990, again, that typical 75-participant plan, incurred a one-time additional cost of $162 per participant for administrative cost, bringing the total average cost per participant to $464.

What this all means is that the issue of pension simplification that you have been the champion of and that you have successfully incorporated in the pending tax bill is not really a disconnected issue from the kinds of inquiries that you are making today.

Faced with the prospect of more and more plan terminations and fewer and fewer plan creations, if we simply focus on such issues as funding without recognizing the broader threats to the system, we would be making just a short-term fix. So, we pledge the efforts and assistance of the APPWP to you, Mr. Chairman, in your efforts.

Senator PRYOR. Thank you very much, Mr. Klein.

[The prepared statement of Mr. Klein appears in the appendix.]

Senator PRYOR. Now we will call on Mr. Labedz. Am I pronouncing that correctly?

Mr. LABEDZ. Yes.

Senator PRYOR. Thank you, sir. We are proud that you are here today, and look forward to your statement.

STATEMENT OF CHESTER S. LABEDZ, JR., DIRECTOR, BENEFIT COMPLIANCE AND WELFARE PLAN, TEXTRON, INC., PROVIDENCE, RI, AND CHAIRMAN OF TITLE IV TASK FORCE, THE ERISA INDUSTRY COMMITTEE

Mr. LABEDZ. Mr. Chairman, thank you. Good afternoon. I am pleased to appear today on behalf of The ERISA Industry Committee. I serve as chairman of its Title IV Task Force. In that capacity, I have actively participated in the formulation and presentation of ERIC's positions on these subjects for many years. I also serve as director of Benefits Compliance and Welfare Plans in Textron, Inc.

As you know, ERIC represents the employee benefit interests of the Nation's largest companies. Nearly all of ERIC's members employ more than 10,000 employees, and a number of them have hundreds of thousands of employees. Virtually all of ERIC's members sponsored defined benefit pension plans.

These plans have been remarkable successful in addressing the retirement security needs of millions of employees. ERIC is committed to a regulatory and economic climate that encourages these plans to continue and flourish. ERIC has vigorously supported in the past, and continues to support, strong pension funding standards and a sound termination insurance program.

As the Chairman and many members of the committee will recall, ERIC participated constructively in formulating the improvements in the funding standards and the termination insurance program that were enacted in 1986 and 1987. ERIC looks forward to working constructively with the committee and its staff on additional improvements in these areas.

As I mentioned, ERIC strongly supports a vibrant defined benefit plan system and a sound termination insurance program. We support a regulatory environment that encourages the formation and continuation of defined benefit plans on a voluntary basis, that causes responsible pension agreements to be made, and to be satisfied, and to protect employees.

The private pension system is a voluntary system. While strong funding standards are essential, any revisions to the funding standards or to the termination insurance program that make unreasonable demands on employers will discourage the formation and expansion of pension plans. Any change must strike a balance between the need for funding and the need to preserve and expand the system.

The premium rates under the termination insurance program raise a similar issue. If an employer objects to the high cost of insurance, it may terminate its existing plans, refuse to expand them, and decline to establish new plans for its employees. In our judgment, the availability of this alternative poses a very real risk to the termination insurance system.

ERIC believes strongly that a premium increase should not be one of the remedies for the ills of the termination insurance program. In recent years the premiums have skyrocketed from $2.60 per participant to as much as $72 per participant. These premium increases are already driving employers out of the system, thereby

narrowing the PBGC's premium base and weakening the system as a whole.

For the same reasons, ERIC members have a strong interest in curtailing the making of pension promises that plan sponsors cannot keep, but that will be guaranteed by the termination insurance program. The system cannot survive if employers and employees continue to have virtually a blank check for pension increases that are guaranteed by the PBGC and financed by other employers.

ERIC is gratified that both the Pension Funding Improvement Act and the Pension Security Act of 1992 address a number of its principal concerns. Measures of this kind will strengthen the system in general, and the termination insurance program in particular. They will also reduce the need for further premium increases and set the stage for reductions in the years to come.

Although ERIC supports the basic objectives of the proposed legislation, it has serious concerns about specific features. The proposals subject plans' existing benefit structures to new and more stringent funding requirements.

When employers agreed to amend their plans to increase benefits, they did so on the basis of the estimated cost of the benefits in reliance upon then-existing law. It would be inequitable for Congress now to make dramatic retroactive changes in employers' funding obligations. Such changes may be counterproductive, as well, given the fragile state of the economy, the precarious condition of many major industries, and the increasing pressure of global competition.

We do, however, support increasing the funding standards for benefits attributable to future amendments. Likewise, we support special funding rules for less than fully funded plans that are amended to provide for lump-sum pay-outs.

On the guaranty side, we support, in concept, the linking of the PBGC's guaranty to the plans' funded status. The Pension Security Act, however, proposes a cliff rule, under which the guaranty will not become effective until the plan is fully funded.

The all-or-nothing consequences of the proposed rule could have inequitable consequences for employees whose plans are just short of being fully funded. We suggest that consideration be given to the possibility of coordinating the phase-in of the guaranty with the funding standards. This approach will avoid the cliff effect that the Pension Security Act will create.

In closing, the PBGC has, since 1988, published a list of the 50 plan sponsors, with what it considers to be the greatest total unfunded pension liabilities. We believe that this list is misleading, unfair, and inappropriate.

The fact that a company's name appears in the top 50 list does not mean that the company's plans are necessarily in any danger. The risk to participants depends primarily on the company's financial condition. The PBGC's list does not take this factor into account.

We strongly urge the PBGC to discontinue publication of its list, and we oppose legislative or other proposals and efforts to develop similar lists.

Mr. Chairman, this concludes my statement. I wish to thank you and members of the committee, and I would be happy to answer any questions.

Senator PRYOR. Thank you very much for your statement.

[The prepared statement of Mr. Labedz appears in the appendix.]

Senator PRYOR. Mr. Damsel, we are proud that you are here, and we look forward to your statement.

**STATEMENT OF RICHARD A. DAMSEL, CHAIRMAN, MULTI-EMPLOYER PENSION PLAN AMENDMENTS ACT SOLVENCY COALITION, ALEXANDRIA, VA, ACCOMPANIED BY ROBERT M. SPIRA, DIRECTOR OF GOVERNMENTAL RELATIONS AND SENIOR CORPORATE COUNSEL, LEASEWAY TRANSPORTATION CORPORATION AND HERVEY H. AITKEN, JR., EXECUTIVE DIRECTOR, MULTI-EMPLOYER PENSION PLAN AMENDMENTS ACT SOLVENCY COALITION AND PARTNER WITH THE LAW FIRM OF TAYLOR, THIEMANN & AITKEN**

Mr. DAMSEL. Thank you, Mr. Chairman. As stated, I am Dick Damsel, the chairman and chief executive officer of Leaseway Transportation Corporation, and the chairman of the MPPAA Solvency Coalition. On my right is Robert Spira. He is director of Government Relations and senior corporate counsel at Leaseway. And, on his right, is Mr. Hervey Aitken, who is our executive director of the MPPAA Solvency Coalition, and a partner with the law firm of Taylor, Thiemann & Aitken.

The MPPAA Solvency Coalition consists of employers who contribute to multi-employer plans and associations with members in the trucking industry, the construction industry, the stevedoring industries, and others. In August of 1991, and, again, in August of this year, we testified before the House Ways and Means Subcommittee on Oversight regarding the chronic underfunding in multi-employer pension plans.

We are here again today to affirm our obligations to our employees and to advocate a multi-employer pension system which is based on sound financial principles which enables these plans to meet their obligations. Business as usual, which has been advocated by certain multi-employer plan managers and their representatives, will not work. Deteriorating financial conditions in some of the underfunded plans indicate that, absent corrective legislation, the plans will be unable to meet their future obligations.

Our testimony demonstrated that there should be a concern about the potential financial exposure to the American taxpayer arising from underfunded multi-employer plans. The PBGC has been unable to obtain critical information from plan sponsors, has been unable to retain necessary historical data, and to evaluate and quantify potential underfunded liabilities which, at best guess, approximate $40 billion for all pension plans, including $10 billion which relates to the multi-employer plans.

Three trends in a balanced solution, all described in greater detail in our written testimony, are keys to understanding and solving the problem. The trends are: (1) increases in unfunded vested benefit liabilities, (2) declines in the number of active participants, and (3) increases in benefits.

Unfunded vested benefit liabilities, the amounts by which a pension fund's promised benefits exceed its net assets, are growing. As stated earlier, today's estimate for multi-employer plans approaches $10 billion. We have no desire to single out any one of many multi-employer funds. However, for example—and this is just an example—according to the 1990 form 5500 filed by the Central States Fund, the Central States Fund had unfunded vested benefit liabilities of $1.7 billion.

Based on financial information disclosed in its 1991 form 5500, unfunded vested benefit liabilities of this fund grew another $558 million in 1990 alone, thus resulting in aggregate unfunded vested benefit liabilities of approximately $2.2 billion.

In addition to the increase in underfunding, many multi-employer pension plans have also experienced dramatic declines in the number of active participants. Active participants are the number of ongoing employees for whom contributions are made.

The decline in the number of ongoing employee participants is a critical factor in assessing a plan's ability to eliminate unfunded vested benefit liabilities since employer contributions on behalf of active participants are one of the principal sources for funding of a pension plan.

Another example—and, again, this is just an example—a small multi-employer fund, the Chicago Truck Drivers, Helpers and Warehouse Workers Union also demonstrates the trend. In 1990, there were approximately 6,200 employees for whom contributions were made. By 1990, only 2,600 active participants remained. This is a reduction of 58 percent.

In the Central States Fund, the active participants decreased from 427,000 employees in 1979 to 238,000 employees in 1991, a reduction of 44 percent.

Notwithstanding the unfavorable trends, fund trustees continue to increase benefits. For example, the Central States Fund tripled its monthly benefits payable to retirees with 30 years of service at age 65 from $757 in 1983, to $1,000 in 1985, and, again, to $2,500 in 1991.

In our view, present law, which provides very few restrictions on the right of fund trustees to increase benefits, must be changed in order to control this underfunding. The law should require balance among: (1) the contribution levels established through collective bargaining; (2) the financial conditions of the fund; (3) the benefit increases implemented by the fund trustees; and, (4) the imposition of withdrawal liability on employers.

Mr. Chairman, absent legislation that achieves such a balance, there will be no end to increases in underfunding. Although the vast majority of multi-employer plans have remained responsible, those chronically underfunded plans have not.

They will not solve their funding problems without a clear message from Congress. Concern regarding underfunded multi-employer plans has been growing, as stated by Mr. Lockhart. However, we must look to the numbers.

Finally, the PBGC, in its 1991 annual report, established a more realistic assessment of the level of underfunding in multi-employer plans. The new estimate is $8–$10 billion, double the estimate used only a year ago.

We understand and are supportive of what Congress is doing, both here in the Senate, and also in the House with H.R. 5800, but we believe that these bills only encourage a gradual reduction of a portion of the underfunding, and we believe that total funding is what is required. Thank you very much.

[The prepared statement of Mr. Damsel appears in the appendix.]

Senator PRYOR. Thank you, Mr. Damsel. A couple of questions here, if I might. In fact, I will just ask you this question. I have heard the figure today for the first time that we are losing in the PBGC some 8,000 plans a year. We are losing those. Did this come as a surprise to you, or any of the other panelists we have this morning? It did to me, I must say. Did it to you, Mr. Damsel?

Mr. DAMSEL. It came as a surprise to me. There is no doubt that this is just another indication of the trends that are occurring that are negative that will cause the problem that we are facing to become much more significant and larger in the future.

Senator PRYOR. All right. Now, I have a question that I will just ask for the full panel, and maybe each of you could just make a comment. How are we going to deal with all of these financially strapped companies out here who say, we are a financially troubled company, we want to pay more into our pension fund; however, if we do, we are going to have to lay off the employees or ultimately close down that plant? Where is that balance; how does the Congress respond to this plight; what do we do about it? Mr. Klein, do you want to try that?

Mr. KLEIN. Yes. I think that the answer lies in really determining which plans out there are posing the greatest financial risk to the PBGC termination insurance program and looking at how they determine their assumptions and how they are applying the funding rules, and really do it much more surgically to recognize that you have to strike that right balance. You cannot require them to fund so quickly that they have the adverse consequences that you just mentioned. Yet, on the other hand, those are the very companies who really need to improve their situation.

So, the answer, I think, lies in calling in the experts who are actuaries and others who can answer the tough questions about the way those plans got to be the way they are. In addition, both the administration's proposal, as well as the bipartisan legislation which has been discussed earlier, at least would address the problem of future benefit increases.

As Mr. Lockhart indicated, one of the biggest problems are the benefit increases that are granted, often in the period of time shortly before a plan terminates, that exacerbates that problem. That can certainly be limited, if not completely curtailed, through the measures in that legislation.

Senator PRYOR. Well, The ERISA Industry Committee might have a comment on that. Mr. Labedz, what do you think of that? How do we find that balance?

Mr. LABEDZ. Mr. Chairman, the big knot that is choking a large number of these underfunded plans is the liabilities that they have accumulated to date. And, in striking the balance, as we have recommended, one thing that you can do is to make sure that the problem gets no worse; that is really the key.

That is, we should move forward in terms of the funding standards and the guarantee of the PBGC's rights in bankruptcy. Then the problem would get no worse. Thereafter, it becomes a question—perhaps surgically—of balancing the interest of getting more dollars in for the existing underfunding against a particular company's survival, and weighing that. But I think the committee would at least be remiss if it did not report out legislation that spoke to fixing the problem going forward so it did not get worse.

Senator PRYOR. All right. Let us move to the other end of the spectrum. Let us say we have a company that is fully funding the plans and its commitments to the employees. Now we are trying to figure out a way to keep them happy.

If they are fully funding their program, there are other industries who are not fully funding theirs. Does the Congress increase their funding and their liability and responsibility, or just those who are not paying their share? How do we keep the fund safe, and how do we keep it viable?

Mr. LABEDZ. I think most of the reforms should be fixed and targeted on those plans that are underfunded. The reforms that you enacted in 1986 and 1987, together with the status of overfunded plans, should be adequate to ensure that they do not become problems for you.

Senator PRYOR. Any comments, Mr. Damsel, on that question?

Mr. DAMSEL. Yes. I believe that there has to be, again, a balance. If a fund is in a situation where it is financially unsound, you have to look at what you can spend versus the assets that you have in the funds. And if you do not have the assets, you should not be permitted to increase benefits.

So, there has to be a focus on benefit increases and a balance between assets available. So, you have to step back and look at that fund and the health and viability of that fund and make sure that there is a balance between contributions made into the fund, benefit increases allowed by the fund, and what the overall financial stability of that fund is.

Senator PRYOR. Mr. Klein, do you desire to tackle that one?

Mr. KLEIN. I would only add that one of our member companies is a very large company that operates, in fact, in your State, Mr. Chairman, Southwestern Bell.

Senator PRYOR. Yes.

Mr. KLEIN. And they have a very well-funded plan; about 100,000 participants in that plan; 65,000, roughly speaking, active employees, and another 35,000 retirees. And they have said to me on more than one occasion, I think with a great deal of justification, that nothing concerns them more than to see that, for every dollar increase in the PBGC premium it costs them another $100,000, notwithstanding the fact that they have a very well-funded plan.

There are restrictions, in fact, on how much they can fund, and they are essentially putting money into this system in order to potentially bail out the employees of other companies that are not as responsible in their obligations.

Therefore, I concur with my fellow panelists that the approach to the funding has to be very surgical, very well pointed at those companies that are posing the risk so that the other responsible

players, like the Southwestern Bells, are not continually paying more money to guarantee other people's promises.

Senator PRYOR. A question I should know, and I do not know the answer to it. Just educate me for a moment. If we increase, say, from $19 to $25 the amount the employer is paying in for a particular plan, does this increase or decrease the administrative costs, or are the administrative costs tied to the amount of the pay-in for the employees, or is it unrelated?

Mr. LABEDZ. They are really unrelated. After the earlier line of questioning, I took a look at my company's numbers. We spend about $133 a year on administration in general of our pension plans per active employee. A little bit more than half of that is the PBGC premium; the rest is accounting, actuarial, administration.

Senator PRYOR. Well, as I said earlier this morning, we are going to hold a series of these hearings. We have heard a lot of facts, figures, statistics talking about billions of dollars, numbers, graphs, charts, tables. I want to have at least one hearing and maybe more about real human beings, how they are being affected by all of this. We want to put some human faces with some of the concerns that we have and ask them to come before the committee and express their concerns. Maybe we can get some good suggestions there, too. I am going to keep you all on our list of people who are going to help us solve all the concerns we have about it. I, at this point, do not call it a crisis. I am not one who does. We are going to avert a crisis, and we are going to make sure that these are sound and that the commitments are made, not only from the companies, but also from the Federal Government. It has been a good hearing this morning, and I hope to be working with all of you in the future. And, on behalf of the committee, we thank you.

Mr. DAMSEL. May we ask, Mr. Chairman, that our written statement be made part of the record?

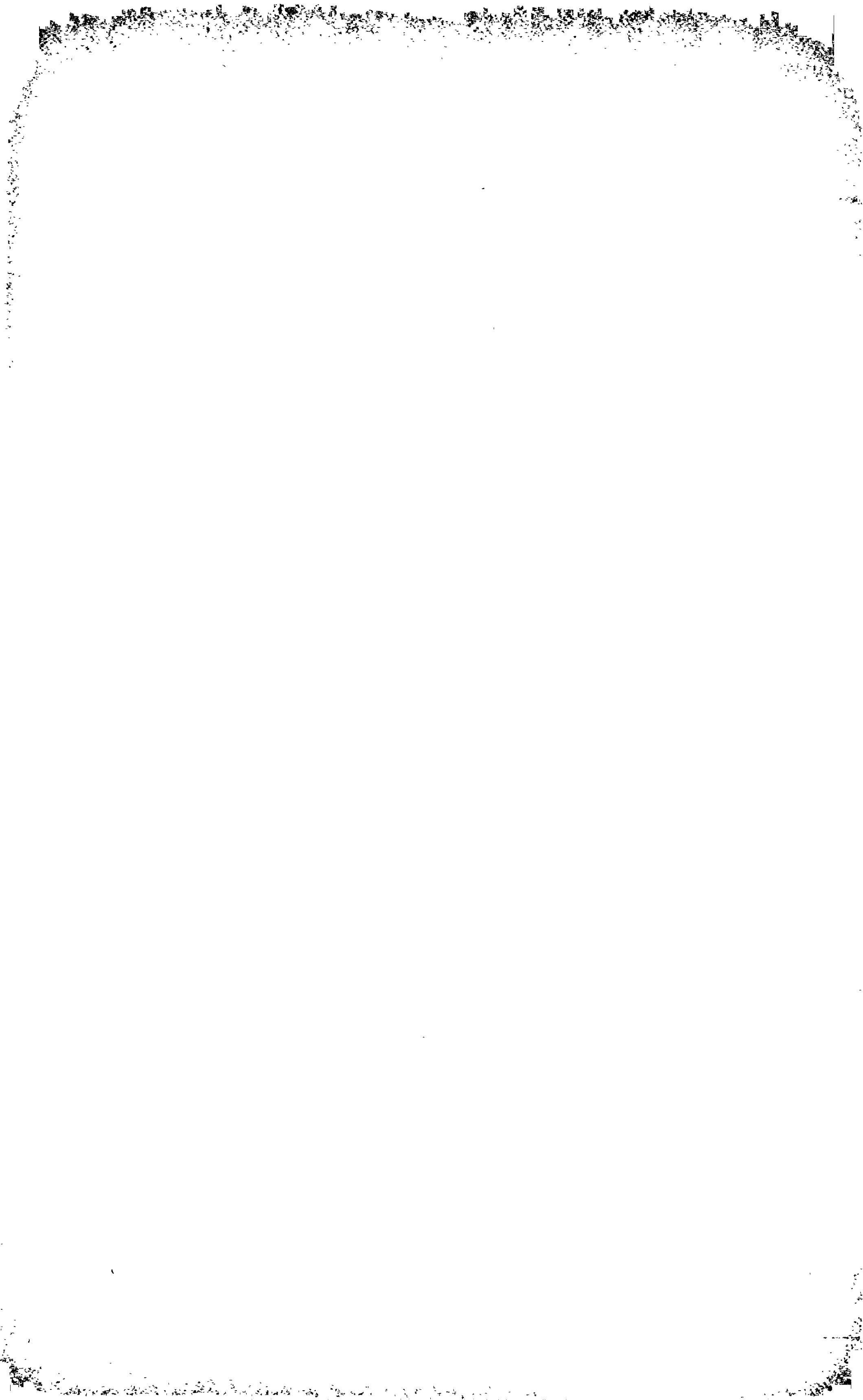
Senator PRYOR. Oh, certainly. I do apologize. I meant to cover that. They will be placed in the record. We are going to keep our hearing record open for 10 days. There may be further questions that we desire to propound to you.

Mr. DAMSEL. Thank you.

Senator PRYOR. The hearing is adjourned. Thank you.

[Whereupon, at 12:30 p.m., the hearing was adjourned.]

[The prepared statements of Senator Grassley and Paul Jackson appear in the appendix.]



# APPENDIX

## Additional Material Submitted

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### Prepared Statement of Richard A. Damsel

Good morning Mr. Chairman and members of the Senate Finance Subcommittee on Private Retirement Plans. I am Dick Damsel, the Chairman and Chief Executive Officer of Leaseway Transportation Corp. and the Chairman of the MPPAA Solvency Coalition. The MPPAA Solvency Coalition consists of employers who contribute to multiemployer pension plans and associations with members in the trucking industry, the construction industry, the stevedoring industry and others.

In multiemployer pension plans, the employer's contribution rate is usually set through the collective bargaining process. However, the benefits payable to retirees are determined by independent pension plan trustees. Plans become underfunded when trustees increase benefits to retirees without fully considering all the plan's financial requirements, including realistic funding levels. The current rules which permit trustees to increase benefits without regard to a plan's ability to pay, when coupled with industry trends, are ingredients that could lead to a crisis situation. The Coalition is alarmed that chronic underfunding exists in some multiemployer pension plans and that nothing is being done about it.

In August, 1991, and again in August, 1992, we testified before the House Ways and Means Subcommittee on Oversight regarding the inability of the Pension Benefit Guaranty Corporation ("PBGC") to determine the total amount of underfunding in multiemployer pension plans. Our testimony demonstrated that the PBGC has shown little concern for the exposures arising from weaknesses in these underfunded plans. Information on Form 5500's intended to be recorded on electronic tapes has not been recorded. The files which are intended to be maintained for public inspection are not complete. The information which is available is woefully out of date.

Our testimony also demonstrated the chronic underfunding in multiemployer pension plans, and described the impact of that underfunding on the employers contributing to those plans, on the PBGC and on the U.S. Treasury.

We are here today to demonstrate to this Subcommittee the weaknesses in the multiemployer program. We also want to affirm our obligations to our employees, and to advocate a system under which these obligations can be met based on sound financial principles. "Business as usual," which has been advocated by certain multiemployer plan managers and their representatives, will not work. The developing financial crisis must be prevented.

We believe that the existing system has created unreason able and unnecessary exposures for contributing employers, their employees and the PBGC. Participation in an underfunded multiemployer pension plan can be extremely damaging to a contributing employer. The substantial contingent liabilities which are generated from participation in these plans can negatively impact the ability of many employers to finance their businesses at competitive rates. The owners of the businesses contributing to underfunded multiemployer pension plans can find it to be extremely difficult to sell their businesses because qualified buyers are unwilling to accept the risks associated with a business with substantial and uncontrollable contingent liabilities. The PBGC has ignored the risk of potential claims on its multiemployer fund. The relatively few dollars reserved by the PBGC could easily be wiped out by a claim from even one large multiemployer pension fund.

Our concerns regarding multiemployer pension plans do not extend to all such plans. The vast majority of the multiemployer pension funds are in sound financial condition. PBGC has reported that as of the beginning of 1991, 86 percent of multiemployer plans, covering 73 percent of all multiemployer plan participants, were

fully funded. However, as we will demonstrate in our testimony today, the financial condition of some of the remaining multiemployer funds is indeed seriously impaired. Deteriorating financial conditions in these funds, and in some companies which contribute to these funds, indicate that, absent corrective legislation, the funds will be unable to meet their future financial obligations.

Over the past two years, our Coalition has devoted a substantial amount of time and effort toward generating information regarding the financial condition of underfunded multiemployer pension funds. Although existing information systems do not permit an in depth analysis of all multiemployer funds, the Form 5500's which are on file clearly reveal trends in the financial condition of certain funds. These trends are:

I. Increases in unfunded vested benefits liabilities.
II. Declines in the number of active participants.
III. Increases in benefits.

## I. INCREASES IN UNFUNDED VESTED BENEFITS LIABILITIES

Unfunded vested benefit liabilities—the amount by which a pension fund's nonforefeitable promised benefits exceed its net assets—are growing.[1] We have no desire to single out any one of the many multiemployer funds. However, for example, and this is just an example, according to the Form 5500 filed by the Central States Southeast and Southwest Areas Pension Fund ("Central States Fund"), as of January 1, 1990, the Central States Fund had unfunded vested benefit liabilities of $1.7 billion. Based on more recent financial information disclosed by the Central States Fund in its most recent Form 5500, unfunded vested benefit liabilities in the Central States Fund grew another $558 Million in 1990 alone, thus resulting in aggregate unfunded vested benefit liabilities of approximately $2.2 Billion.

Increases in the underfunding of smaller pension funds can be equally dramatic. For example, and, again this is just an example, between 1986 and 1989, unfunded vested benefit liabilities in the pension fund of the Chicago Truck Drivers, Helpers and Warehouse Workers Union ("CTDU") increased from $67 Million to $92 Million. This is a fund which, as of 1989, reported total vested benefit liabilities of $206,000,000. Unfortunately, the fund maintained an asset value of only $114,000,000 or 56% of the assets that would be required in order for the plan to be fully funded.[2] Other examples of underfunding in multiemployer plans are attached as Exhibit A to this testimony.

## II. DECLINES IN THE NUMBER OF ACTIVE PARTICIPANTS

In addition to increases in underfunding, many multiemployer pension funds have also experienced dramatic declines in the number of active participants—the number of ongoing employee participants for whom contributions are made. Declines in the number of ongoing employee participants are a critical factor in assessing a plan's ability to eliminate unfunded vested benefit liabilities since employer contributions on behalf of a ve icipants are one of the principal sources of funding of a pension plan. In 79, mployers made contributions to the Central States Fund on behalf of 427,19 mployees.[3] The 1991 Form 5500 of the Central States Fund reported that there ere only 238,354 employees for whom contributions were being made to the Cent States Fund. This is a reduction of 44.2 percent.

Declines in the contribution base of the CTDU fund are even more dramatic. In 1980, there were 6,281 employees for whom contributions were made. By 1990, only 2,564 active participants remained. This is a reduction of 59.2 percent. These trends support the Coalition's position that employers are reluctant to participate in an underfunded multiemployer plan. Other examples of declines in the number of active participants in multiemployer pension funds are attached as Exhibit B to this testimony.

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[1] Our calculations of unfunded vested benefit liabilities are based on information contained in the Form 5500's and Annual Reports filed by the various funds. These calculations are based on the difference between net assets and vested benefits as reported by the funds. The Central States Fund, in its 1990 Annual Report (page 5), indicates that it determines unfunded vested benefit liabilities based on the excess of vested benefit liabilities over "the actuarial value of net assets." However, the Central States Fund does not disclose its "actuarial value of net assets" either in its Form 5500's or in its Annual Reports. Therefore, unfunded vested benefit liabilities, as reported by the Central States Fund, will be somewhat different from the unfunded vested benefit liabilities described in this testimony. We do not believe that the differences in the method of calculation of unfunded vested benefit liabilities are material.

[2] Information on the CTDU Fund was taken from Form 5500's filed by the CTDU Fund.

[3] References to active participant data are based upon the information reported by the Central States Fund in its Forms 5500 for the years indicated.

III. INCREASES IN BENEFITS

Notwithstanding the unfavorable trends described above, fund trustees continue to increase benefits. For example, the Central States Fund tripled its monthly benefit payable to individuals with 30 years of service at age 65 from $775 in 1983, to $1,000 in 1985 and again to $2500 in 1991.

Form 5500's filed by the CTDU Fund disclosed increases in its maximum monthly pension benefit of twenty-five (25) percent from 1986 to 1989.

The current management philosophy of the Central States Fund illustrates the problem. As recently as 1986, the Annual Report of the Central States Fund, at page 10, stated "[t]he trustees have concluded that for the 1990's and beyond, moving the Fund more strongly in the direction of full funding is the necessary and proper course to ensure the security of the participants' benefits." If the Central States Fund still believes what it wrote in 1986, then they should not be opposing legislation which encourages full funding.

In its recent comments to the House Ways and Means Subcommittee on Oversight, the Central States Fund suggested that it is the *fiduciary obligation* of its fund trustees to their beneficiaries to increase benefits if the employer contribution rates are increased through collective bargaining. Such an obligation, if it exists, leaves little room for trustees to consider the impact of an increase in unfunded vested benefit liabilities on the fund's ability to meet future obligations. The dramatic increase in the unfunded vested benefit liabilities of the Central States Fund during the past year demonstrates the problem. Where will the money come from to pay today's employees when they retire?

A balance needs to be struck among (1) contribution levels established through collective bargaining; (2) the financial condition of the fund; and (3) benefit increases adopted by fund trustees.

Mr. Chairman, absent legislation that achieves such a balance, we know of no end to increases in underfunding. Although the vast majority of multiemployer funds have been, and remain, responsible, these chronically underfunded plans will not solve their funding problems without a clear message from the Congress that they are required to do so. Unfunded vested benefit liabilities in chronically underfunded plans will not be eliminated so long as trustees continue to be permitted to increase benefits at every possible opportunity without regard for the plan's financial condition, current contributions, participation levels and future obligations.

Our concern is not only with the potential exposure of the members of our Coalition to withdrawal liability claims from underfunded multiemployer pension plans. Legislative proposals advocated by the Coalition do not address withdrawal liability claims. Our concerns extend to the risks to beneficiaries of these plans and to the risks to participants in currently healthy plans. Although the PBGC insures benefits provided by multiemployer pension plans and remains the ultimate guarantor of benefits that cannot be paid when a multiemployer plan becomes insolvent,[4] the PBGC's guaranty is substantially lower than the benefit levels promised by the plans.[5]

Moreover, if certain funds continue to decline to the point where financial support from the PBGC is required, fully funded plans may be required to pay increased premiums to the PBGC to support the PBGC's multiemployer insurance program. The additional premium payments would be an unnecessary financial burden on those plans that have kept their financial house in order.

We know that the PBGC has reported that its multiemployer program is in sound financial condition and that PBGC does not think that a premium increase is necessary at this time. We also know that certain managers of underfunded multiemployer funds are confident that no help from PBGC will be necessary. We can only point out the trends in these funds and hope that the Congress will be as alarmed as we are. The numbers speak for themselves.

Concern regarding those underfunded multiemployer plans has been growing. The PBGC is now beginning to confront the need to analyze the Form 5500's filed by

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[4] In a report to Congress as required by Section 4022A(f) of the Employee Retirement Income Security Act of 1974, as amended entitled: "The Financial Condition of PBGC's Multiemployer Insurance Program," by James B. Lockhart III, Executive Director, PBGC, May 1991, Mr. Lockhart states:

"The PBGC's current multiemployer pension plan insurance program was established in 1980 under the provisions of MPPAA, replacing an earlier program, which had been established by the Employee Retirement Income Security Act (ERISA) in 1974. The existing program insures plans to which more than one employer is required to contribute, and which is maintained pursuant to collective bargaining agreements between one or more employee organizations and more than one employer (ERISA Sec. 4001(a)(3)."

[5] U.S.C. 1322(a).

the multiemployer funds to determine the identity of those funds with the greatest deficits. The PBGC, in its 1991 annual report, established a more realistic assessment of underfunding in multiemployer pension plans. Their new estimate—$8 to $10 billion—is approximately double the estimate used only one year earlier.

The Congress is also beginning to show concern. Title II of the Pension Funding Improvement Act of 1992 (S. 3162), which is the bill sponsored by Senators Jeffords and Durenberger in the Senate and its counterpart in the House (H.R. 5800), sponsored by Congressman Pickle, addresses the need to control underfunding in multiemployer pension plans by placing some restrictions on benefit increases that can be given by trustees of certain underfunded plans. We congratulate Senators Jeffords and Durenberger, and Congressman Pickle, for having the foresight and leadership to address this important issue. This is a step in the right direction. However, as drafted, the Bill only encourages a gradual reduction of a portion of the underfunding in multiemployer plans. Since 86% of multiemployer plans are now fully funded, the MPPAA Solvency Coalition recommends that the provisions of Title II of the Pension Funding Improvement Act of 1992 be strengthened to encourage the remaining 14% of multiemployer plans to become fully funded.

Mr. Chairman, we are cognizant of the enormous problems faced by the PBGC in connection with its internal management systems and the enormous problems which are reflected by the under funding in single employer funds. However, the weaknesses in the multiemployer program are also great, and growing. The Congress should no longer overlook or dismiss these weaknesses.

EXHIBIT A

| PLAN | UVBL | YEAR |
|---|---|---|
| Central States Southeast and Southwest Areas Pension Fund | $2,274,642,000 | 1991 |
| Construction Laborers Pension Trust for Southern California | 402,992,900 | 1990 |
| NYSA-ILA Pension Trust Fund and Plan Board of Trustees | 328,455,400 | 1990 |
| Teamsters Pension Trust of Philadelphia & Vicinity | 222,221,874 | 1990 |
| New England Teamsters & Trucking Industry Pension Fund | 95,106,000 | 1989 |
| Trucking Employees of North Jersey Pension Fund | 130,294,000 | 1988 |
| New York State Teamsters Conference Pension & Retirement Fund | 61,658,601 | 1990 |
| Pension Plan of the Chicago Truck Drivers | 82,612,400 | 1990 |
| Trustees of ILWU-PMA Pension Fund | 92,557,667 | 1989 |
| Alaska Teamster Employer Pension Trust | 89,281,251 | 1989 |
| Western Pennsylvania Teamsters Pension Fund | 38,350,535 | 1990 |
| UFCW Union and Participating Food Industry Employers Tri-State Pension Fund | 73,019,174 | 1989 |
| The Board of Trustees Bricklayers & Trowel Trades International | 67,944,300 | 1989 |
| Joint Board of Trustees, Plumbing, Heating & Piping Industry of Southern California Retirement | 72,484,100 | 1989 |

## Exhibit B—ACTIVE PARTICIPANTS

[Examples of declining contribution bases]

| | 1979 | 1980 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 | Percent Reduction During Relevant Period[1] |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Central States SE & SW Areas Pension Fund | 427,319 | ............ | 302,548 | 293,928 | 281,204 | 269,299 | 268,385 | 264,603 | ............ | 249,235 | 238,354 | 44% |
| NYSA-LA Pension Trust Fund & Plan Board of Trustees | ............ | ............ | ............ | 9,174 | ............ | 7,657 | ............ | ............ | 4,529 | 4,529 | ............ | 51% |
| Teamsters Pension Trust of Philadelphia & Vicinity | 31,196 | ............ | ............ | 20,584 | 19,710 | 20,203 | 17,025 | 16,874 | 15,899 | 14,911 | 52% | |
| New England Teamsters & Trucking Industry Pension Fund | 48,282 | ............ | ............ | ............ | ............ | ............ | ............ | 39,823 | 38,785 | ............ | ............ | 20% |
| Trucking Employees of North Jersey Pension Fund | ............ | ............ | ............ | ............ | 5,724 | 5,811 | 4,744 | 4,800 | ............ | ............ | ............ | 16% |
| Chicago Truck Drivers, Helpers & Warehouse Workers Union | ............ | 6,281 | ............ | 4,232 | 3,918 | 3,508 | 3,250 | 2,724 | 2,637 | 2,564 | ............ | 59% |
| Alaska Teamsters Employer Pension Trust | ............ | ............ | 9,056 | ............ | 7,007 | ............ | 5,509 | 5,253 | 4,384 | ............ | ............ | 52% |
| Western Pennsylvania Teamsters Pension Fund | 19,664 | ............ | ............ | ............ | 11,643 | 10,343 | 10,227 | ............ | ............ | 9,824 | 50% | |
| Joint Board of Trustees, Plumbing, Heating & Piping | ............ | ............ | ............ | ............ | ............ | ............ | ............ | ............ | ............ | ............ | ............ | ............ |
| Industry of So. California Retirement | ............ | ............ | 7,890 | ............ | ............ | 6,846 | 6,101 | 5,640 | 5,523 | 5,461 | 31% | |
| Teamster #557 Baltimore | 4,401 | ............ | ............ | ............ | ............ | ............ | ............ | ............ | 3,052 | ............ | ............ | 31% |

[1] Relevant period is the earliest and most recent data available for each plan from 1979–1990.

## PREPARED STATEMENT OF JOSEPH F. DELFICO

Mr. Chairman and Members of the Subcommittee: Thank you for inviting me here today to discuss the Pension Benefit Guaranty Corporation's (PBGC's) financial condition. Few public deficits have received more attention in recent months than the deficit in PBGC's single-employer insurance fund. Several years ago GAO placed the private pension insurance system on its "high-risk" list because of the potential for material losses to American taxpayers and long-standing control weaknesses at PBGC. Since then, we have devoted significant attention to problems with regulation of pension plans in general and PBGC in particular.

PBGC was created by the Employee Retirement Income Security Act of 1974 (ERISA) to administer the insurance program that protects the benefits of participants in defined benefit pension plans. These plans pay specific retirement benefits, generally based on years of service or earnings. PBGC insures many of the benefits of such plans that terminate with assets insufficient to cover future benefit liabilities.

In my statement today I would like to highlight five points that we hope will be helpful in congressional policy formulation.[1] We believe that such policy should focus on reducing unfunded liabilities in PBGC-insured pension plans because such actions are the key to reducing future PBGC liabilities and better protecting the benefits of plan participants. We are also concerned about PBGC's long-standing operational problems.

1. PBGC's deficit is large—$2.3 billion at the end of fiscal year 1991—and has grown significantly in recent years. The major threat to the agency is the large unfunded liabilities in the ongoing plans it currently insures. PBGC's most pessimistic estimate indicates that its deficit may grow to $17.9 billion by the year 2001. Unless proper steps are taken to improve plan funding, this pessimistic estimate may become a reality.
2. At present, PBGC's cash flow is sufficient to meet its current benefit obligations. Nonetheless, the Congress should address the threat to the agency from underfunded plans. If the Congress now begins the process of developing solutions, it should not be necessary to legislate in haste at some future date or to seriously erode the protections afforded workers in the process of solving PBGC's problems. We are encouraged by this Subcommittee's efforts to begin focusing on this issue at this time.
3. Legislative proposals for improving funding in underfunded plans could have a significant positive effect in reducing PBGC's deficit over the long run. However, it is also important to analyze the potential impacts of specific proposals on plan participants, plan sponsors, and federal revenues.
4. Underfunded plans not only put PBGC at risk, they also pose a risk for plan participants. PBGC insures many, but not all, of the benefits provided by defined benefit pension plans. If an underfunded plan terminates, some plan participants are at risk of losing some of their promised benefits.
5. In addition to PBGC's current deficit and looming potential claims, the agency has experienced significant internal operations problems. Because of significant internal control and systems weaknesses, we have never been able to express an opinion on PBGC's financial statements. Unaudited financial statements cannot be relied upon to accurately portray PBGC's financial health. However, PBGC has recently moved to address these problems.

### INCREASING PLAN UNDERFUNDING THREATENS PBGC

PBGC has had a deficit since its inception in 1974, and the deficit is growing. Its 1991 annual report listed assets of $5.9 billion and liabilities of $8.2 billion, an accumulated deficit of $2.3 billion—up from $1.8 billion in 1990.

PBGC's financial condition looks worse when potential terminations of underfunded plans are considered. In its 1991 Annual Report, *Strengthening the Pension Safety Net,* PBGC said that some plans, especially in the steel, tire, automobile, and airline industries, are underfunded by a total of about $40 billion (almost 20 times PBGC's current deficit), with over half this amount in a few large plans. Of the $40 billion, PBGC reported that $13 billion is in plans sponsored by financially troubled companies, the companies most at risk of going bankrupt and terminating their underfunded plans. Moreover, plans' funding levels could deteriorate even more if the

[1] We conveyed these points in two testimonies before the House Subcommittee on Oversight, Committee on Ways and Means (*Financial Condition of the Pension Benefit Guaranty Corporation* (GAO/T-HRD-92-52) and *Pension Plans: Benefits Lost When Plans Terminate (GAO/T-HRD-92-58)*).

current economic downturn continues or worsens. PBGC's most pessimistic 10-year forecast shows that its potential deficit by the end of fiscal year 2001 could be $17.9 billion.[2]

The levels of unfunded liabilities cited above are PBGC estimates—the best data available. Plans, themselves, are not required to report their liabilities on a termination basis. When an underfunded plan terminates, PBGC often takes on a larger claim (unfunded plan liabilities for guaranteed benefits) than the unfunded liabilities last reported by the plan. In 44 large plans we studied that terminated in 1986–88, the aggregate claim, as measured by PBGC, was 58 percent greater than the underfunding previously reported by the plans. PBGC attempts to adjust for these hidden liabilities in describing its own financial status, but it is hindered by a lack of appropriate data.

THIS IS AN OPPORTUNE TIME TO ADDRESS PBGC'S THREAT

PBGC continues to have a positive cash flow. For fiscal year 1991, PBGC reported that its premium and investment income exceeded expenditures for benefits and other expenses by $452 million. Reported premium and investment income were $809 million and $309 million, respectively, while disbursements were $666 million. However, predicting whether and how long PBGC will be able to meet its current benefit obligations out of its cash flow is difficult. Therefore, this is the time—while PBGC still has a positive cash flow—to develop solutions to better fund pension promises. Improved funding in underfunded plans will reduce the size of potential claims against PBGC.

IMPROVING PBGC'S FINANCIAL CONDITION

A number of methods are available for improving PBGC's financial condition. We believe that the most productive approach is to focus on methods that will reduce the sizable underfunding in ongoing plans. This will limit the amount of liabilities PBGC will be asked to assume in the future. However, before implementation, any proposal to improve PBGC's financial condition should be analyzed to determine the likely effects on plan participants, plan sponsors, and federal revenues.

In January 1992, the administration proposed budgeting for PBGC's potential costs on an accrual basis so that policymakers can fully assess the costs of the pension insurance program and adequately monitor and plan for the program's future. Though we did not support that specific proposal due to certain implementation concerns, we believe that the concept of reporting appropriate accruals in the federal budget is sound.

To address PBGC's current deficit, the Congress also may want to consider raising premiums by making them more risk related. The Congress may want to consider whether the existing variable premium rate ($9 per $1,000 of underfunding) and/or overall ceiling on premiums ($72 per person) best reflects the risk to PBGC. To enhance PBGC's revenues, we believe the Congress should first focus on the premiums paid by underfunded plans because they pose the greatest threat to the program. Concerns have been raised that increasing the fixed portion of the premium will prompt sponsors of well-funded plans to drop their defined benefit plans, reducing PBGC's revenue base.

We have long supported strong and effective funding standards for the nation's defined benefit pension plans. ERISA established funding standards to help ensure that plan sponsors would fund their pension promises. The 1987 Omnibus Budget Reconciliation Act established additional funding standards aimed specifically at underfunded plans. We are currently evaluating the 1987 standards to determine whether they are working as intended.

We note that strengthening funding standards will lead to larger contribution requirements for some plans. This will increase the federal deficit in the short run because contributions are tax-deductible business expenses. Also, some financially troubled sponsors may have difficulty meeting the new standards.

Some have proposed limiting PBGC's benefit guarantees. ERISA was enacted to protect plan participants from abuses in the pension system. We are concerned that proposals to limit benefit guarantees will adversely affect plan participants. We would prefer that the threat to PBGC from underfunded plans be addressed by better plan funding rather than by limiting benefit guarantees.

We are also concerned that such proposals may lead to inequitable treatment of participants in different types of plans. The proposals we have seen suspend PBGC's guaranty for benefit increases in new plans and plans whose benefit increases result

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[2] This estimate assumes that the plans with $13 billion in underfunding plus some smaller ones will terminate during the 10-year period; it is not a worst-case scenario.

from plan amendments. Because of the focus on plan amendments rather than underfunding per se, these proposals effectively apply primarily to one type of existing plan—referred to by PBGC as flat benefit plans—which usually are collectively bargained and serve primarily unionized, blue collar workers.

In general, we prefer that the threat to PBGC from underfunded plans be addressed through improved funding. One measure to improve funding in flat benefit plans might be to require their sponsors to anticipate future benefit increases when calculating the plan's liabilities.

PBGC has requested that its priority in bankruptcy be clarified and improved. We have not seen any studies of the dynamics of its proposals or their effects on other parties, including creditors and the federal government. Therefore, we currently do not have a position on them. We do, however, support the proposal that plan sponsors continue making contributions to their plans while in bankruptcy.

There are other measures that PBGC could take. PBGC has the authority to terminate pension plans under certain conditions. Perhaps it should use this authority in a more proactive manner with companies in, or headed for, bankruptcy. This would allow PBGC to freeze benefit accruals and minimize its potential losses. We recognize that this is a highly sensitive approach because such actions could destabilize a failing company and hurt plan participants. In the final analysis, however, someone has to decide where and when to limit PBGC's exposure, before or after bankruptcy.

In addition, PBGC should benefit from implementation of the recommendations in our April 9, 1992, report to the Subcommittee on Oversight, House Committee on Ways and Means.[3] We recommended that the Congress amend ERISA to require full scope audits of pension plans and to require plan administrators and independent public accountants to report on how effective a plan's internal controls are in protecting plan assets. Strong internal controls can help to ensure that plans more accurately report their assets and liabilities, including the amount of any unfunded liabilities, and that plans pay accurate premiums to PBGC.

SOME BENEFITS ARE NOT GUARANTEED BY PBGC

Underfunded plans not only put PBGC at risk, they also pose a risk for plan participants. PBGC insures many, but not all, of the benefits provided by defined benefit pension plans. If an underfunded plan terminates, some plan participants are at risk of losing some of their promised benefits. Generally, PBGC guarantees "basic" monthly benefits that provide income when participants retire, but it does not guarantee many other benefits. Nonguaranteed benefits include benefits that exceed the maximum specified in ERISA and a portion of benefit increases in effect less than 5 years before plan termination.

We are not advocating that PBGC coverage should be expanded to cover nonguaranteed benefits. Our intent is to show that, when plan sponsors do not adequately fund their pension plans, participants can and do lose benefits when plans terminate, even with PBGC pension insurance.

PBGC'S OPERATIONAL WEAKNESSES

PBGC has had long-standing operational problems. GAO has never been able to express an opinion on PBGC's financial statements because of internal control weaknesses and financial systems deficiencies. Moreover, in our March 2, 1992, report,[4] we said that we could not evaluate the reliability of PBGC's liability estimate because PBGC had not developed documentation and support for its estimating techniques, assessed data used for estimating, or corrected weaknesses in its estimating software. In addition, we found that PBGC's efforts to identify and collect delinquent (unpaid) premiums, underpaid premiums, and related interest and penalties have been inadequate.[5]

Mr. Chairman, underfunded pension plans pose a risk to the PBGC and, because PBGC does not guarantee all benefits, to the participants of those plans. The best way to protect PBGC and plan participants, in our opinion, is to ensure that all underfunded plans become fully funded.

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[3] *Employee Benefits: Improved Plan Reporting and CPA Audits Can Increase Protection Under ERISA* (GAO/AFMD-92-14).

[4] *Financial Audit: Pension Benefit Guaranty Corporation's 1991 and 1990 Financial Statements* (GAO/AFMD-92-35).

[5] *Pension Plans: Pension Benefit Guaranty Corporation Needs to Improve Premium Collections* (GAO/HRD-92-103).

PREPARED STATEMENT OF SENATOR DAVE DURENBERGER

Mr. Chairman, I am pleased to join my distinguished colleague from Vermont (Senator Jeffords) in co-sponsoring S. 3162, the Pension Funding Improvement Act. By this bill, we seek to control the Pension Benefit Guaranty Corporation's (PBGC) financial exposure.

If we are to secure the financial integrity of the PBGC, if we are not going to have a repeat of the S&L bailout, I encourage the Senate to act quickly to maintain the viability of PBGC, which is the ultimate guarantor of our private pension system.

There is a lesson we should have learned from the S&L debacle that threatened the individual savings of millions of Americans. And that lesson is: When we first see a government-guaranteed financial liability problem, we should act as fast as possible to shore up the system and not let it get out of hand.

Had we provided adequate financing to close down all of the bankrupt S&Ls in 1986, the cost to the American taxpayer for S&Ls would have been less than $50 billion. But the longer we waited, the more it cost. And we, as a country, are paying the price for that delay today and for many years to come.

I would note that our distinguished Chairman of the Finance Committee, the Senior Senator from Texas, Lloyd Bentsen, played a vital role in the adoption of the law regulating pension plans (ERISA); indeed, Senator Bentsen was a conferee on ERISA back in 1974.

To guarantee the promise of a pension, Congress created the Pension Benefit Guaranty Corporation (PBGC). PBGC's purpose has been, and is, to provide financial security for plan participants if their company and their plans fail. The PBGC collects premiums from viable defined benefit plans and takes over and administers plans that terminate when employers go out of business. Thus, in a very real sense, all working men and women who are participants in defined benefit plans rely on PBGC to guarantee the future existence of their pension benefits.

Mr. Chairman, the warning signals that the PBGC is in trouble are everywhere. The red warning lights and buzzers are going off, and the United States Senate should be paying close attention. PBGC currently has a $2.5 billion deficit, which is up from $1 billion just two years ago; the Department of Labor expects this deficit to grow to $18 billion by 1997 if nothing is done.

Mr. Chairman, the Jeffords-Durenberger bill is a step that Congress can take to stem the further undermining of our private pension system. One of the problems is that under current law, companies may grant pension benefit increases, even though the pension plan is underfunded. And if the plan terminates in an underfunded state, PBGC is responsible for providing the benefits, including the benefit increases.

Let me repeat that. Employers may grant pension benefit increases without adequately funding the plan, and PBGC is responsible for the promised benefits.

Well, this amounts to nothing more than a risk-free loan from PBGC to ailing companies. Congress did not establish PBGC for this purpose, and I think it is just plain wrong.

Mr. Chairman, according to the PBGC, benefit increases under the collective bargaining agreements in the auto, steel, and tire and rubber industries added a total of $7–9 billion in underfunding to already underfunded plans in these industries. House-hold name companies are doing this. Let me provide some examples. According to the PBGC:

- *The 1991 labor contract for Uniroyal, Bridgestone Firestone, and Goodyear increased benefits for active employees by almost 30%.*
- *The 1990 labor contracts for General Motors, Chrysler, and Ford increased the basic monthly retirement benefit 16–17%.* In total, Chrysler pension plan benefit increases were 21–22% for actives and 11% for retirees, over the next three years.
- *The 1989 labor contracts for Bethlehem and Armco Steel Increased benefits for active employees by approximately 15%.*
- *Uniroyal Goodrich Tire Company Pension Plan, which is currently underfunded by over $400 million and has assets equal to about one year's benefit payments, increased benefits for hourly actives by 50–80% from 1988 to May 1991.*

The Jeffords-Durenberger bill addresses this problem that our country faces. The bill amends section 401 (a)(29) of the Internal Revenue Code to require plans that grant benefit increases to provide security, in the form of cash, bond, or other such forms of security that the Secretary finds acceptable, if the plan is less than 90% funded. In other words, if employers have underfunded plans, and those plans are significantly underfunded, and the employers want to grant benefit increases, then they have to pay for them.

Mr. Chairman, our Secretary of Labor, Lynn Martin, urged us to act quickly to address this problem. She made the following statement:

> Congress has the opportunity to show it has learned the painful lesson taught us by the S&L fiasco by taking the necessary steps now to fix the Pension Benefit Guaranty Corporation. The time to act is now before another crisis occurs . . . . Like the S&L situation, the solution becomes more costly the longer we wait.

Statement of Secretary of Labor Lynn Martin, Tuesday, July 28, 1992.

Mr. Chairman, I agree with the Secretary of Labor that we should act now to deal with PBGC's financial difficulties. I urge my colleagues to support the Jeffords Durenberger bill.

Thank you.

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PREPARED STATEMENT OF SENATOR CHARLES E. GRASSLEY

Thank you, Mr. Chairman. I congratulate you for calling this hearing on a very important topic.

Although the Pension Benefit Guaranty Corporation is probably not very well known by most workers or most retirees, it is clearly, by virtue of its responsibility for protecting the pension benefits of nearly 40 million people, one of the most important federal agencies for millions of retired persons.

Therefore, the financial status of this agency—its ability now and in the future to meet its potential obligations—is very important.

And, given that there has been considerable, and growing, concern in the last several years about the financial condition of the agency, it is important for this committee to review that condition, and, if we decide that these problems are indeed serious, to try to identify what steps should be taken to fix them.

As far as I can tell, there does not appear to be complete agreement as to whether the PBGC really faces a problem, or, if it does, just how serious it is.

Some think we could be looking at a mini-S&L crisis. PBGC has a current deficit of around 2.3 billion dollars. Under pessimistic assumptions, this deficit could grow 18 billion dollars by the turn of the century, as financially weak companies seek bankruptcy and saddle the PBGC with the responsibility to pay their pension benefits.

Others note that there really isn't enough hard data to say that PBGC is in financial trouble. They note that the PBGC is well able to meet its current obligations. They note that the assets of sponsored pension plans total 2 trillion and the liabilities are only 1.6 trillion. They note also that only 40 billion of the liabilities are unfunded.

It is also the case the general accounting office has been unable to audit the agency's books. This raises the obvious question as to how we really know just what the financial status of the agency really is.

In any case, Mr. Chairman, I hope that our witnesses today will be able to enlighten us further as to the situation faced by the PBGC, and whether they believe that this committee needs to take steps to deal with it.

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PREPARED STATEMENT OF SENATOR JAMES M. JEFFORDS

Mr. Chairman and members of the committee, I appreciate the opportunity to join you this morning on this critical topic.

As you know, employee benefits are as important to workers as the money they earn. An employee who works in manufacturing today typically receives as much as 32% of his or her pay in benefits.

Workers understand only too well how crucial pension, health insurance and other employee benefits are to their peace of mind and general well being. Just as benefits have become important to employees and more widely available by employers, benefits issues have become prominent in congressional debates as well.

Hardly a day goes by without a discussion of these benefits. Last week, on the Labor HHS Appropriations bill, we unanimously voted in favor of Senator Bentsen's proposal to establish a National Commission on Private Pension Plans. This Commission will be charged with reviewing existing federal incentives and programs that encourage and protect private retirement savings.

I want to applaud the Administration, and Secretary Martin in particular, for focusing attention on pension issues, especially the Secretary's recent efforts in sup-

port of changes in law to help the PBGC. So, too, do I want to commend this committee for its interest as evidenced by this hearing.

With less than half of the nation's workforce participating in a private pension plan, we certainly need to look at ways to improve upon our current pension policy. Over the past few years, we have heard from numerous employers that one major reason why more employers don't offer a pension plan is they are complex and costly to administer. The pension simplification provisions contained in H.R. 11 are designed to eliminate many of problems in current law that have caused unnecessary complexity.

Unfortunately, we know of another reason why companies don't want to be involved with defined benefit pension plans. Current law permits corporate gaming of our defined benefit plan system. It allows companies to fail to put hard cash behind their pension promises, and dump their liabilities on others.

Currently, some companies promise big pensions to their workers, while making the most minimal contributions permitted under the law. The troubled companies then terminate their pension plans, and pass along their pension debt to the Pension Benefit Guaranty Corporation (PBGC).

A debt ridden PBGC is a true threat to the retirement benefit security of the 40 million Americans currently in defined benefit pension plans. Make no mistake about it, billions of dollars of pension benefits are at risk.

While this problem isn't new, it has gotten considerably worse. This is in spite of past congressional efforts to rectify the situation. In 1987, Congress passed into law stronger minimum contribution rules in order to eliminate pension plan underfunding.

However, when this stronger floor of protection for pension plans was added, no ceiling on benefit promises for underfunded plans was included in the 1987 bill. Lack of a ceiling on what underfunded plans can promise, in combination with corporate strategies to minimize plan contributions, have resulted in startling pension plan deficits.

As a result of these irresponsible practices, we in Congress must ask ourselves several important questions. (1) Should companies in declining industries continue to promise benefit increases without the reserves necessary to make good on their commitment? (2) Should other employers with defined benefit plans be taxed to cover the cost of failed pension promises for workers in declining industries? Or (3) Should taxpayers finance yet another bailout of a government insurance program? These are the issues we in Congress must address.

Over the past few years billions of dollars in unfunded liabilities have been dumped on the PBGC and this trend is expected to increase. And I might add that I think the baseline projections provided by the PBGC are really very optimistic, in that they estimate that the PBGC will assume losses of about $500 million a year.

Just a few weeks ago, the *Wall Street Journal* and others reported that as TWA emerges from bankruptcy and begins to settle with its creditors, the PBGC will be lucky if it gets TWA to pay only $500 million of its current $1.2 billion dollar pension debt. And who is going to pay for the other $700 million in promised benefits the company hasn't funded?

For some time now, companies with underfunded pension plans have been promising significant amounts of new benefits in lieu of wage increases. Only about 80% of these benefits are guaranteed by the PBGC. Often workers get even less when early retirement benefits are involved. The trend is occurring primarily in the airline, steel, rubber and automobile industries.

Amazingly enough, in each industry we do manage to find a small minority of companies that are struggling to maintain the integrity of their promises at the same time their competitors are trying to game the pension system. A recent study for the House Ways and Means Committee revealed GM currently has a plan that has deteriorated to the point where it is only 55% funded. Chrysler has a plan which is only 40% funded.

How much lower will we permit the funding to go? While these plans sink lower and lower, Ford seems to be trying to increase funding. While they have a plan that is 65% funded, at least funding has been going up over the last few years, unlike the funding habits of its competitors.

Most of us involved with pension issues initially became aware of the corporate practices I am speaking to you about from the PBGC's annual release of the 50 companies with the largest unfunded liabilities. This has been published every year for the past three years. What many people haven't realized is that when one compares lists, one can see that the situation is getting worse. Underfunding for the top 50 companies is up by $7 billion since 1990, to a total of $21.5 billion in 1991. Thirteen

billion of this underfunding is in companies who have serious financially difficulties and therefore are likely to terminate their pension plan.

More importantly, the situation is getting worse. Companies already in bankruptcy are agreeing to *retroactive benefit increases.*

Some people will argue that strapped companies should not fund their plans, so this money can instead be put into the company, to increase productivity and competitiveness. I would argue that it is precisely because a company is financially vulnerable, that an extra effort should be made to be sure that the pension plan is financially sound. Thus, if workers need to take early retirement due to downsizing, at least that money will be there.

Others will argue that the PBGC was deliberately designed to subsidize companies in ailing industries. They are, however, at direct odds with the many who believe the PBGC should operate like a private sector insurer and set premiums more precisely related to the risk that a company would have of defaulting on its pension promises.

I come before you today to say that regardless of what one thinks about the purpose of the PBGC, the reality is that we have only a limited number of options available to us in dealing with the PBGC's many problems. Furthermore, it is in the best interest of the 40 million workers that currently have PBGC insurance protection that we resolve these deficit problems and maintain a solvent defined benefit plan system.

What are our options? Well, we could raise PBGC premiums that employers pay into the system. This may be inevitable, given the PBGC's current deficit. The PBGC estimates that it would have to significantly increase premiums even if it takes only $500 million a year in underfunded liabilities, which is business as usual for them. If the economy gets worse, and distressed companies start to terminate at greater frequency, premiums paid by all single employer plan sponsors will rise to $58 per person for well funded plans, and to as much as $219 per participants for poorly funded plans. As you know, we have already raised premiums considerably from those days in 1974 when all employers paid a dollar a head.

How much is too much? When will responsible employers with well funded plans say they've had enough of premium increases to pay for obligations promised by other companies, terminate their defined benefit plans and instead offer to make contributions to a defined contribution plan under which employer liabilities are limited and employees have no insurance protection. I'm not sure. Even at present premium levels, the trend is away from defined benefit plans. The number of defined benefit plan terminations is already on the rise and fewer and fewer new plans are entering into the system.

Another option Congress has would be to try to stabilize the premium, so as not to deter plan sponsors away from the system, and instead let the federal government absorb the loss. PBGC projects that it is already at risk in the short term for $13 billion in underfunding. If current pension trends continue, the fact that government could need to absorb the loss, becomes a very real reality. In fact, in the President's budget for fiscal year 1993, the Administration has already introduced the idea of budgeting for fixed and expected future PBGC liabilities. Unfortunately, in their proposal they did not accurately assess how much would be obtained from premium income and collections of plan assets. Therefore, the likely long term impact on the budget could not be realistically assessed. But one thing is certain, adding billions to our $4 trillion national debt is no way to help balance the budget.

Our third option is to encourage plan sponsors in ailing industries to limit benefit increases or put up money as collateral for payment for such increases. It might seem cruel to some to force companies to promise within their means. But it is far more cruel for workers to expect a certain level of benefits when they retire only to find out later that the money they expected to have for their retirement isn't there. Keep in mind that the PBGC only guarantees, on average, about 80% of what is currently promised. Often when early retirement benefits are involved, this number is significantly less. In my mind the third option seems the wisest, and this is why we adopted it in our legislation.

Senator Durenberger's and my bill, S. 3162, has three titles. I have spent time discussing the second title, which would require that plans with less than 90 percent funding provide security if they wish to increase benefits. Title I outlines stricter funding rules for pension plans. Title III provides PBGC the authority to obtain financial information on companies with underfunded plans. It also directs CBO and PBGC to study and report to Congress on the premium increases necessary to put the program on a sound basis.

Similar to the Administration's proposal, our bill revises a funding concept added in 1987. It expands its reach so that pre-1987 unfunded liabilities must now be funded over a shorter period of time. A new solvency maintenance requirement is

also added to assure that a plan puts at least as much in as it pays out in a given year.

Unlike the Administration's proposal, we would specify a new interest rate that underfunded plans would have to use in valuing current liability. Based on the weighted average of 30-year treasury bonds over a four year period, we narrow the permissible range that underfunded plans can use so that it cannot be greater than 100 percent.

These are our principal proposals, and no doubt they can be improved upon. I look forward to working with the members of this committee and other interested parties.

Time and time again we as legislators need to be reminded that there is no such thing as a free lunch. Retirement benefits need to be paid for with real money, not empty promises. As workers live longer they will need a sufficient amount of money to be assured some quality of life. It's our job to see that it happens.

FLOOR STATEMENT OF SENATOR JAMES M. JEFFORDS ON THE PENSION AMENDMENT TO H.R. 11

Mr. President, as my colleagues know it is difficult to give enough attention to the multitude of issues we face. This is particularly true when the subject is a complex one, be it banking regulations or the rules that govern our private pension system.

Be as we learned all too well over the past few years, inattention can have a terrible price. That price will be hundreds of billions in the savings and loan industry, and some argue there will be a price to pay in the banking industry as well.

Fortunately, the private pension system is not nearly in the straits of the savings and loan industry. But unfortunately, its complexity has shielded it from the scrutiny it deserves.

On the positive side, pension assets are diversified and, for the most part, invested fairly conservatively compared to the high-flying S&L's of the 1980's.

But in some respects, there are troubling similarities. Some pension plans are terribly underfunded. We passed rules to toughen funding standards in 1987, but in some plans, funding has fallen.

A contributing factor may be the "moral hazard" of the pension system. To the lay person, moral hazard may sound like the temptations of sin. I suppose it is in way, for all it amounts to is playing with somebody else's money.

As we know, lifting deposit insurance to $100,000 contributed to some of our problems with the S&L's. For pensions, there really is no limit to the ultimate payout of the federal government except the lifespan of the retiree.

It works this way. Suppose you are a company in trouble. Your employees have foregone wage increases for some time, and it's time to renew their contract. You don't have the cash for a wage increase, so why not promise greater pension benefits? The outlay or funding required is minimal, and if you go belly up the government will pick up much of the tab. From both sides of the bargaining table, it's a good deal. It's such a good deal, one company is trying to do it while in bankruptcy!

But Uncle Sam, who may wind up paying the tab, doesn't have a seat at the table. The federal government will in all likelihood pay the tab, and that tab is getting bigger and bigger every year.

The Pension Benefit Guaranty Corporation, or PBGC, collects premiums on the 40 million workers in defined benefit pension plans. It pays out those premiums to retirees whose companies have defaulted on their pension promise.

Right now, the PBGC has a deficit of $2.5 billion. Under pessimistic assumptions, which given PBGC's track record probably should be our baseline, that deficit will grow seven-fold over the next decade, to nearly $18 billion.

This may not seem like much money to some, but it's real money for the defined benefit pension system and the workers who rely upon it for their retirement security.

Already, the number of plan sponsors has stagnated, and the headaches of those still in the system have multiplied. Over the 18 years of ERISA, the basic premium has climbed 19-fold, with the top premium going from a buck a head to 72 dollars per participant.

What should we do? The Administration, to its credit, has put forward a number of proposals to strengthen the system; strengthening the minimum funding standards, improving PBGC's position in bankruptcy and denying the PBGC's guarantee to new benefits adopted by a troubled plan.

Along with Congressman Pickle in the House and Senator Durenberger in this body, I have introduced a bill along the lines proposed by the Administration. I hope

we can adopt something like that bill in the next Congress, but I would be the first to admit that the bill requires some reflection and no doubt improvement.

The amendment I am offering today is just the simplest part of that bill, the part that I hope everyone can agree on.

Quite simply, our amendment states that if your pension plan is underfunded, you can't make things worse by promising new benefits and not funding them. Any new benefits must be backed by real assets rather than faint hopes.

This is a bit different than what was proposed by the Administration. But I think it is better from a retiree's standpoint to know the government stands behind his or her retirement security rather than assuming there is a guarantee where there is none.

This amendment won't solve the problems of the PBGC or the pension system, but it will help to contain them until we can do more.

And I hope, Mr. President, that next year we can do more, in the areas of minimum funding, bankruptcy, and in the problems faced by flat benefit plans.

But for right now, I hope my colleagues will join me in the modest step that Senator Durenberger and I have proposed. While the problems are complex, you need not be an actuary to know that a poorly funded plan should not be making new promises without collateral.

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## PREPARED STATEMENT OF JAMES A. KLEIN

Good morning. I am James A. Klein Executive Director of the Association of Private Pension and Welfare Plans ("APPWP"). The APPWP is a nonprofit organization whose members include large and small plan sponsors and organizations providing support services to plans, such as banks, insurance companies, consulting and actuarial firms, investment firms and other professional benefit organizations. APPWP members sponsor or provide services to retirement and health plans covering over 100 million participants. We commend the Committee for holding this hearing to better understand the issues of concern to the Pension Benefit Guaranty Corporation (PBGC) and the nation's pension system.

### CHALLENGES FACING THE PBGC AND THE DEFINED BENEFIT PENSION SYSTEM

The Bush Administration has proposed a legislative package aimed at reducing the financial liabilities of the PBGC and providing greater security to the participants of the nation's defined benefit plans. The legislative proposal includes essentially three components:

- Granting the PBGC priority status for claims arising in connection with a plan sponsor's bankruptcy;
- Stricter funding standards;
- Limitations of the PBGC's guarantees for underfunded plans that are amended to improve benefits.

The merit of this proposal and Senator Jeffords' and Senator Durenberger's approach to the funding and the benefit increase issues, as prescribed in S. 3162, the "Pension Funding Improvement Act of 1992," are discussed in this testimony. But the APPWP would like to use the opportunity of this hearing to also address more broadly the challenges facing the defined benefit system and, in turn, the PBGC.

While legislation to shore-up the funded status of existing underfunded pension plans and limit the financial exposure of the PBGC has a great deal of merit, the Congress would be remiss if it did not recognize and address the fact that it has become increasingly difficult and expensive for employers to sponsor defined benefit plans. If Congress does not address the far more significant challenges to the sponsorship of defined benefit plans, then the revision of funding standards and curtailment of promises by underfunded plans to better protect the financial integrity of the PBGC will have limited success.

A few statistics make a compelling case:

Internal Revenue Service data show that establishment of new defined benefit plans has fallen each year since Fiscal Year 1988. Since Fiscal Year 1989, there have been more plans terminated than new plans created. In fact, since FY 1989 plan terminations occurred at more than double the average rate since the Employee Retirement Income Security Act (ERISA) became fully effective in 1976.

The resulting loss of retirement income security for current and future retirees is evident. But this erosion of the defined benefit system also poses a significant problem for the PBGC. Plainly put, the PBGC insurance system is being supported by a shrinking universe of plan sponsors. This puts greater pressure on those re-

maining plans (increasingly larger plans) to support the termination insurance system with potentially higher premiums.

Frustration with more expense and complexity in plan administration and the threat or reality of higher premiums, especially when imposed on sponsors of well-funded plans, encourages employers to reevaluate the economic wisdom of continuing to sponsor plans. It becomes a vicious cycle as more and more plans are terminated and fewer new plans are created.

The administrative cost and complexity burden for plan sponsors is tangible and well-documented. In the 16 years since ERISA became fully effective, there have been no fewer than 14 major pieces of legislation altering the private pension system. In addition, literally hundreds of pages of regulations have been issued by regulatory agencies to implement the legislative changes. This has not only caused confusion and frustration for plan sponsors; but, as the PBGC's own data shows, it has led to skyrocketing administrative costs as well.

A recent PBGC study reported that for the typical defined benefit plan with 75 participants, administrative costs relative to the cost of providing benefits rose from 8 percent of total plan costs in 1981 to 33 percent of plan costs in 1990. The average over the period was 19 percent of plan costs. The same study found that administrative costs shifted erratically from year to year due to frequent legislative and regulatory changes which required large one time costs to implement. For example, in 1990 a typical 75 participant plan incurred a one time additional cost of $162 per participant for administrative costs, bringing the average total annual administrative costs to $464 per participant that year.

Certainly the administrative cost and complexity burden is felt most seriously by small and medium sized firms which are, therefore, most likely to terminate or decline to establish plans. But the effect is also felt by the nation's major employers, like those who comprise the principal membership of the APPWP. Major employers must also cope with added complexity and expense, often resulting from rules designed to address perceived problems common among smaller plans. But, in addition, as fewer small and medium size firms sponsor plans, major employers increasingly find themselves to be a more significant source of financial support for the PBGC's termination insurance system.

Thus, while the APPWP commends the need to ensure that underfunded pension plans improve their funded status, we strongly urge the Congress to recognize that a far more serious threat to the plan termination insurance program is the lack of growth in the defined benefit system itself. Congress must consider the impact of all of its actions and the activities of the regulatory agencies on the overall viability of the defined benefit system to ensure a financially secure PBGC insurance system.

Mr. Chairman, you have recognized the scope of the burden facing the pension system and have positively addressed it with your legislative package of pension simplification initiatives, now contained in the pending "Urban Aid" tax measure, H.R. 11. These kinds of initiatives, while not enough by themselves to make the pension system simple, will certainly help make it simpler and signal a willingness by Congress to reduce the complexity of the pension system. We applaud your efforts. These kinds of simplifications not only will permit more employers to sponsor pension plans for their workers and retirees but, in the process, will strengthen the system upon which a financially sound PBGC is based.

## EVALUATING THE NEED FOR PBGC REFORM LEGISLATION

The APPWP strongly supports defined benefit plans as the most secure and reliable retirement vehicle available to employees. As premium payers, and as an association of principally well-funded plans, we share the interest of the PBGC and the Congress in the responsible funding of defined benefit plans. We are concerned about the unfunded liabilities faced by the PBGC ($2.5 billion at the end of fiscal year 1991).

On the other hand, policy makers must recognize that the vast majority of private pension plans are well-funded and pose no risk to the PBGC insurance program. Moreover, most of those plans that are underfunded are meeting the minimum funding requirements, are improving their funded status, and are sponsored by employers that can afford to meet their obligations. While we must not ignore the problem of underfunded plans, neither should we overstate the problem because the only result of that would be the creation of further disincentives to the establishment and maintenance of defined benefit plans and the increased concern of American workers and retirees. Those can hardly be our goals.

The funding rules in ERISA and the Internal Revenue Code were strengthened just five years ago, shortening from 30 to 18 years the period over which unfunded liabilities must be funded. The Congress needs to evaluate carefully the effort of

those relatively recent legislative changes before determining what, if any, new rules should be enacted. Moreover, we need to make sure that any new change is made with a scalpel, not a sledge hammer. The very companies who will be most affected by these changes are the companies that can least afford any new funding burden. That is not, in our view, a reason to resist change; it is simply a reason to move carefully and place priorities on the problems and on the solutions.

LEGISLATIVE PROPOSALS TO BETTER SECURE THE PBGC

The APPWP has spent a great deal of time over the past several months meeting with the PBGC, Congressional representatives and other interested groups and commenting on the pension funding rules contained in the PBGC's legislative proposals. We are currently undertaking a thorough review of Senator Jeffords' and Senator Durenberger's proposal as well, S. 3162. We commend both the Bush Administration and the Congressional sponsors of reform legislation for the serious and thoughtful reflection given to improving the retirement security of plan participants and the fiscal integrity of the PBGC.

One legislative change advocated by the PBGC would give the agency priority status over other creditors when the sponsor of an underfunded plan is in bankruptcy. Although the legislative modifications necessary to accomplish this objective are not directly within the purview of this Committee, we wish to express the APPWP's general support for this legislative effort. PBGC claims have been disadvantaged by court decisions that have impeded PBGC recoveries and that have allowed companies in bankruptcy to avoid funding plan obligations. This should be corrected.

A second change advocated both by the PBGC and contained in S. 3162 involves the strengthening of plan funding standards. The business community, in general, and the APPWP, in particular, has always supported strong funding standards to ensure that plans are not posing a risk to the termination insurance system. It is in the determination of funding standards that Congress must carefully balance the need to encourage underfunded plans to improve their funded status, with the recognition that rules that require improved funding too quickly will be difficult, if not impossible, to be complied with by certain plans. We have numerous technical comments on the funding rules recommended by both PBGC and Congressional sponsors which we would be pleased to provide at the appropriate time. On one issue, we particularly commend the fact that S. 3162 would eliminate the double counting of gains and losses, which creates serious actuarial difficulties.

The PBGC has correctly drawn attention to the problem of underfunded plans that are amended to increase benefits without taking the necessary steps to fund those benefit enhancements. The PBGC's response to this very real problem would be to freeze the guarantee of such unfunded benefit improvements. While we commend the PBGC for its attention to this issue, its suggested correction could potentially expose plan participants to the risk of nonguaranteed benefits through no fault of their own. In our view, the solution suggested by S. 3162, strengthening Internal Revenue Code (IRC) Section 401(a)(29), is preferable.

IRC Section 401(a)(29) currently requires security for benefit amendments adopted when a plan is less than 60% funded. The amount of security required under current law is the lesser of the amount necessary to bring the plan up to a 60% funded level, or the value of plan amendments adopted since December 22, 1987, that is in excess of $10,000,000 with an additional exclusion for pre-1988 underfunding that is phased out over 18 years. The practical effect of current law is that virtually no plans have been required to post security for benefit amendments, rendering the provision meaningless. S. 3162 would preclude amendments increasing plan liabilities without security whenever a plan is less than 90% funded. The security that would be required is equal to the amount of underfunding below the 90% level. The security requirement would be triggered whenever the benefit improvement exceeds $1 million.

We are encouraged by this change. In the APPWP's view, one of the most frustrating continuing risks to the termination insurance system is the adoption of benefit improvements that the sponsor cannot fund, and that, with the passage of time, PBGC will be required to guarantee. Benefit improvements by a financially troubled employer in an already badly underfunded plan give a false sense of security to participants, since many plans are terminated before the guarantee of the benefit improvement is phased in. In addition, such benefit improvements allow the employer and participant representatives to trade current wage or other benefit improvements for a future pension improvement that the sponsor may have no reasonable expectation of being able to afford. The participant should not be misled, and the rest of the premium payers should not be required to pay for this promise. Accordingly, we are pleased to see the tightening of IRC section 401(a)(29).

**CONCLUSION**

**We look forward to working with you, Mr. Chairman, in weaving together Congressional and Administration proposals that will improve the financial security of the PBGC and serve the needs of the sponsors and participants in the nation's defined benefit system. We are pleased to be able to have the valuable opportunity to give you our input and will continue to work closely with the Committee and the PBGC to achieve a meaningful, and well-tailored legislative effort in this area.**

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PREPARED STATEMENT OF CHESTER S. LABEDZ, JR.

Chairman Bentsen and members of the Committee, good morning. My name is Chester S. Labedz, Jr. I am pleased to appear before you today on behalf of The ERISA Industry Committee, generally known as "ERIC."

I serve as the Chairman of ERIC's Title IV Task Force. In that capacity, I have actively participated in the formulation and presentation of ERIC's positions on pension funding and termination insurance issues for many years. I also serve as Director, Benefits Compliance, Welfare Plans at Textron Inc. in Providence, Rhode Island, where I am responsible for both legal and policy issues affecting Textron's employee benefit plans.

THE ERISA INDUSTRY COMMITTEE ("ERIC")

ERIC represents the employee benefits interests of the nation's largest employers. Nearly all of ERIC's members employ more than 10,000 employees, and a number of them have hundreds of thousands of employees. As sponsors of pension and savings plans covering millions of participants and beneficiaries, ERIC's members share with the members of this Committee a strong interest in the success, expansion, and security of the private-sector employee benefit plan system.

Virtually all of ERIC's members sponsor one or more defined benefit pension plans. These plans have been remarkably successful in addressing the retirement security needs of millions of employees and their beneficiaries. ERIC is committed to a regulatory and economic climate that encourages these plans to continue, to flourish, and to continue to provide retirement security to millions of employees and their beneficiaries.

ERIC has vigorously supported in the past, and continues to support, strong pension funding standards and a sound termination insurance program. Over the years, ERIC has devoted thousands of hours and committed a substantial portion of its resources to supporting legislation that will improve pension funding and strengthen the single-employer termination insurance program.

As the Chairman and many members of the Committee will recall, ERIC participated constructively in formulating the improved funding standards and the improvements in the termination insurance program that were made by the Single-Employer Pension Plan Amendments Act of 1986 ("SEPPA") and the Omnibus Budget Reconciliation Act of 1987 ("OBRA '87"). ERIC looks forward to working constructively with the Committee and its staff on additional improvements in the funding standards and the termination insurance program.

ERIC'S POSITION ON PENSION FUNDING AND TERMINATION INSURANCE

ERIC strongly supports a vibrant defined benefit plan system and a sound termination insurance program. This includes a regulatory environment that --

- encourages the formation and continuation of voluntary pension plans,

- encourages employers to make only the pension promises they can keep and to keep the promises they make,

- does not give employers a blank check on which they can make pension promises that they cannot keep, but that will be guaranteed by the Government and other employers, and

- protects employees where protection is necessary and affordable.

The formation and continuation of voluntary pension plans are essential to the health and success of the defined benefit plan system. As employers cease forming new plans, and begin terminating existing plans, retirement security is diminished: the termination insurance premium base is eroded, and the retirement security of all workers is weakened.

The private pension system is a voluntary system. While strong funding standards are essential to the success of the private pension system, any revisions to the funding standards or to the termination insurance program that make unreasonable demands on employers will discourage the formation and expansion of pension plans. Any change in the funding standards or the termination insurance program must strike a balance between the need for funding, on the one hand, and the need to preserve and expand the private pension system, on the other.

The premium rates under the termination insurance program raise a similar issue. While the PBGC requires premium payments in order to meet its obligations, we are gravely concerned that escalating termination insurance premiums are inflicting severe long-run damage on the pension system.

Unlike conventional insurance premiums, termination insurance premiums are not voluntary payments; they must be paid by defined benefit plans and the employers that sponsor them. If an employer objects to the high cost of termination insurance, it cannot simply decide to purchase insurance elsewhere or choose to go without insurance. However, the employer does have another alternative: it can terminate its existing plans (or refuse to expand them) and decline to establish new plans for its employees. In our judgment, the availability of this alternative poses a very real risk to the termination insurance system.

We are keenly aware that to the extent that PBGC insurance applies, the PBGC must cover the cost of unfunded benefits by attempting to collect employer liability payments from the employer that sponsored the plan and by collecting mandatory annual premium payments from other plan sponsors. In consequence, as the sponsors of on-going pension plans, ERIC's members have a strong interest in the sound funding of both their own plans and the plans of other employers.

ERIC believes strongly that a premium increase should not be one of the remedies for the ills of the termination insurance program. In recent years, the premium rate has skyrocketed from $2.60 per participant (as recently as 1985) to the current rate of $19 per participant plus a variable premium of as much as $53 per participant -- an aggregate premium of as much as $72 per participant. These substantial premium increases are already driving employers out of the defined benefit system, thereby narrowing the PBGC's premium base and weakening the program that the premiums are intended to support.

In ERIC's view, any legislation in this area should be designed to avoid the need for future premium increases and to set the stage for premium reductions in the future.

For the same reasons, ERIC's members have a strong interest in curtailing an employer's ability to make pension promises that it cannot keep, but that will be guaranteed by the termination insurance program. This practice is incompatible with the basic objective of a defined benefit plan: to provide a predictable retirement income. As the termination insurance program's premium payers, and as those who bear the cost of the unfunded guaranteed benefits promised by terminated plans, ERIC's members support measures to assure that employers keep their pension promises and to limit the pension benefits that the PBGC guarantees.

The termination insurance system cannot survive if every employer continues to have virtually a blank check that it can use to make pension promises that are guaranteed by the PBGC and financed by other employers. These blank checks must be prohibited.

Although ERIC supports the termination insurance program, ERIC believes that the program's guarantees must not be extended irresponsibly. Employers that sponsor less than fully funded plans should not be given a free hand to increase the benefits for which the PBGC and the employers who pay PBGC premiums are financially responsible.

## ERIC SUPPORTS THE OBJECTIVES OF THE PROPOSED LEGISLATION

ERIC is gratified that both the Pension Funding Improvement Act (S. 3162 and H R. 5800) and the Pension Security Act of 1992 (S. 2485 and H.R. 4545) are designed to address a number of ERIC's principal concerns. In particular,

- Both bills are designed to strengthen the pension funding standards;
- Both bills are designed to restrict the blank check that the current system gives to sponsors of less than fully funded pension plans; and
- Both bills are designed to avoid further increases in the termination insurance premium.

In addition, the Pension Security Act is designed to strengthen the termination insurance program by clarifying and improving the PBGC's status in bankruptcy.

Measures of this kind will strengthen the private pension system in general and the termination insurance program in particular. They also will reduce the need for further premium increases and set the stage for premium reductions in the f tu e, as the reforms take hold.

## ERIC HAS SERIOUS CONCERNS ABOUT SPECIFIC FEATURES OF THE PROPOSED LEGISLATION

Although ERIC supports the basic objectives of the proposed legislation, ERIC has serious concerns about specific features of the proposals.

New Funding Standards. The proposals subject plans' existing benefit structures to new and more stringent funding requirements. Employers have amended their plans to increase benefits in the past on the basis of the then-existing funding standards. Many of those benefits were negotiated in collective bargaining.

When employers agreed to amend their plans to increase benefits, they did so on the basis of the estimated costs of the benefits in reliance upon the law's existing funding standards. It would be inequitable for Congress now to make dramatic changes in employers' funding obligations, long after the employers became obligated to provide the additional benefits and before the employers had any knowledge of the additional costs that the proposed funding standards would impose.

The impact of imposing new funding standards can be dramatic. One of ERIC's largest members estimates that if the new funding standards proposed by the Pension Security Act are enacted, its cash contributions will be required to increase by approximately $1 billion annually over the 5-year phase-in period following enactment and $2 billion annually after the 5-year phase-in period until full funding is reached over approximately the next 5 years.

A radical change in the funding requirements for existing benefits may be counterproductive as well as unfair. Given the fragile state of the economy, the precarious condition of many major industries, and the increasing pressures of global competition, dramatic increases in funding obligations might well have major adverse effects on many employers, leading to further deterioration of the economy and risking additional plan terminations and further losses for the PBGC -- contrary to the purposes of the legislation.

We emphasize, however, that we do support increasing the funding standards for benefits attributable to future plan amendments. Faced with higher funding standards for future plan amendments, an employer will be able to determine the cost of a given benefit increase and then to decide whether the increase is one that it can afford. Likewise, we support special funding rules for less than fully funded plans that are amended to provide for lump sum payouts; the funding rules should be revised to prevent these plans from being depleted by lump sum payouts.

PBGC Guarantees. In concept, we support the approach of linking the extent of the PBGC's guarantee to the plan's funded status. As we have explained, we oppose continuation of the current blank check approach under which employers that sponsor less than fully funded plans can increase benefits and have those benefits guaranteed long before the benefits are funded.

The Pension Security Act, however, proposes a rule that will create a "cliff" effect under which the guarantee will not become effective until the plan is fully funded. We have reservations about the proposed rule. The all-or-nothing consequences of the proposed rule could have inequitable consequences for employees who participate in plans that are just short of being fully funded; in addition, because of the funding rules that apply to flat-benefit plans, flat-benefit plans that are regularly amended to provide benefit increases may never be fully funded, and in consequence, their benefits may never be guaranteed.

We suggest that consideration be given to the possibility of coordinating the phase-in of the guarantee with the funding standards, so that benefits will be guaranteed gradually as they are funded and not before.[1] This approach will avoid the "cliff" effect that the Pension Security Act would create, and will allow benefits to become guaranteed as they are funded.

PBGC's Status In Bankruptcy. ERIC supports efforts to clarify the PBGC's bankruptcy status by conforming the Bankruptcy Code with the provisions of ERISA that protect the PBGC's interests. However, ERIC has serious concerns about proposals to amend ERISA to increase the PBGC's lien above 30% of the employer's net worth.

The most important long-term security for a pension plan is a financially strong plan sponsor. Expansion of the PBGC's lien will jeopardize that security and weaken the pension system.

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[1] In order to reach this objective, it also will be necessary to repeal the $20 de minimis rule that now appears in § 4022(b)(7) of ERISA.

**Expansion of the PBGC's lien could make it significantly more difficult for employers to borrow and severely limit employers' access to the credit markets. When confronted with an expanded PBGC lien, prospective lenders may be unwilling to lend to some employers at all or willing to lend only on extraordinarily costly and restrictive terms.**

The health of the pension system in general, and the termination insurance program in particular, will be severely jeopardized if Congress enacts legislation that makes it impossible or substantially more difficult or costly for employers to borrow. Depriving employers of access to the credit markets on reasonable terms will make it more difficult for them to fund their plans and increase the number of plan terminations as more and more employers are suffering under the country's current economic conditions.

In sum, ERIC is concerned that expansion of the PBGC's lien will be counterproductive, that it will actually impede pension funding, and that it will increase the number of plan terminations and the size of the PBGC's deficit.

## THE PBGC MUST CURE THE DEFICIENCIES IN ITS ADMINISTRATION OF THE TERMINATION INSURANCE PROGRAM

The Government Accounting Office ("GAO") has made it clear that many of the problems of the termination insurance program stem from deficiencies in the PBGC's administration of the program:

- The GAO has found that the PBGC is burdened by "significant internal operations problems," and that because of "significant internal control and systems weaknesses, GAO has never been able to express an opinion on PBGC's financial statements."[3]

- The GAO has found that the PBGC's efforts to identify and collect unpaid premiums, underpaid premiums, interest, and penalties are inadequate; that attempts to collect unpaid premiums from large plans have been infrequent, and follow-up has been sporadic; and that the PBGC does not even attempt to identify or collect unpaid premiums from small plans.[4]

- The GAO also has found that the PBGC has been unable to succeed in implementing the requirements of its premium accounting system.[5]

These deficiencies are serious. Although we appreciate the recent efforts by the PBGC to address the deficiencies, more needs to be done.

In addition, since 1988 the PBGC has published a list of the 50 plan sponsors with what the PBGC considers to be the greatest total unfunded pension liabilities. ERIC believes that the list is misleading, unfair, and inappropriate. The list creates the unfair and unwarranted impression that all of the plans sponsored by the companies on the list are in financial jeopardy and that employees need to be fearful for their pension benefits.

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[3] GAO, Financial Condition of the Pension Benefit Guaranty Corporation (Testimony before the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, August 11, 1992).

[4] GAO, Pension Plans: Pension Benefit Guaranty Corporation Needs to Improve Premium Collections (June 1992).

[5] GAO, Premium Accounting System: Pension Benefit Guaranty Corporation System Must Be An Ongoing Priority (August 1992).

The fact that a company's name appears in the PBGC's top 50 list does not mean that the company's plans are in danger of a distress termination or even that all of the company's plans are underfunded. The risk to plan participants depends primarily on the company's financial condition. The PBGC's list does not take this factor into account. Nor does the list take into account the fact that some of the companies on the list sponsor pension plans that are fully funded.

Although we applaud efforts to encourage faster funding, the PBGC's top 50 list is a misleading and inappropriate means of trying to achieve that objective. Mr. Chairman ve also note that H.R.3837, concerned with Title IV and PBGC reform, would au' orize a similar list. We believe that the experience of the PBGC list makes it clear that publication of the information contained in the list does not work, that it creates unwarranted fear and concern among many more plan participants than is warranted, and that such lists are inherently misleading. We strongly urge the PBGC to discontinue publication of its list and we oppose legislative proposals to develop similar lists.

Mr. Chairman, this concludes my prepared statement. I wish to thank you and the other members of the Committee for the opportunity to appear before you today. I will be happy to answer any questions that you or the other members of the Committee might have.

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## PREPARED STATEMENT OF JAMES B. LOCKHART III

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here to discuss the PBGC and its future. With me today is Diane Burkley, our Deputy Executive Director and Chief Negotiator and Carol Flowe, our General Counsel. I would like to say I appreciate your support of this program that is critical to the retirement security of 40 million Americans and American savings.

The past year has been very challenging for PBGC. Internally, we have made changes to improve our financial management and internal controls. At the same time, because of large underfunded terminations, our workload increased tremendously. Growing underfunding in some ongoing plans has made the future of the PBGC single-employer pension safety net very uncertain. To keep this vital insurance program viable, the Administration proposed major reforms that are now before the Congress.

### Overview of the PBGC and its Role

The Pension Benefit Guaranty Corporation protects the retirement benefits of over 40 million Americans in about 85,000 private defined benefit pension plans. Defined benefit plans provide a specified benefit related to the participant's age, years of service, salary, or some combination of these. Defined benefit plans are backed by dedicated assets in separate trust funds as well as the equity of the employers.

If a pension plan's trust assets are insufficient and the sponsoring employer can demonstrate financial distress so severe that the business cannot otherwise continue to operate, PBGC steps in to pay the pensions of workers and retirees. We pay for these claims with statutory premiums collected from all employers who sponsor covered plans, recoveries from sponsors terminating underfunded plans, and investment earnings. In our 18-year history, we have assumed responsibility for the retirement benefits of 372,000 participants in 1,700 pension plans.

While a vast majority of the nation's defined benefit pension plans remain strong and well-funded, the insurance program is facing growing problems from poorly-funded pension plans of troubled companies. Despite aggressive efforts to prevent loss to retirees and the insurance program, claims against the PBGC have grown steadily. It took us 11 years to accumulate $1 billion in losses. In each of the last two years we have had a billion dollars of losses. The two largest claims in PBGC's history -- Eastern Airlines with $700 million and Pan Am Airlines with over $900 million in plan underfunding -- were the primary causes. PBGC's deficit for the single-employer program more than doubled over the past two years from $1.1 billion to $2.5 billion.

In addition to these losses, the Corporation is facing total underfunding of at least $40 billion, of which approximately $13 billion is in plans that are termed "reasonably possible" losses in accounting parlance. For the longer-run, modelling by OMB of the PBGC program suggests upward to $45 billion in future claims. I discuss these estimates in more detail below.

## Financial Management

When I arrived at PBGC three years ago I established the goal of making PBGC a service-oriented, well managed and financially strong insurance program supporting a healthy defined benefit system. To succeed, we needed strong financial management and the ability to limit our future losses.

There were significant problems with PBGC's financial management systems and I wanted the assistance of the General Accounting Office (GAO) in identifying them. To help me identify these problems, I asked the GAO to examine our fiscal year 1990 financial accounts, and the GAO found them unauditable. Our goal remains to begin annual audits and to work toward achieving auditable financial statements for fiscal year 1992.

GAO's fiscal year 1990 audit, as did their 1980 audit, found serious concerns with PBGC's premium systems, accounting and internal controls, and the methodology for evaluating our liabilities for future benefit payments. Their 1991 audit report confirmed these problems, but noted that we have made a major commitment to correcting them. We have focused tremendous attention and resources on correcting our problems and we have made substantial progress in addressing the weaknesses identified by the GAO and our Inspector General.

There has been concern that the lack of auditability means that our liabilities may be overstated. I can tell you the work that we have just completed with a major accounting firm shows that the numbers in our annual report are materially accurate.

## Need for Legislation

Underfunding in ongoing pension plans has grown from an estimated $20 billion to $30 billion as stated in PBGC's 1990 Annual Report to an estimated $40 billion as stated in the 1991 Annual Report. Eighty percent of the increase is in single-employer plans.

Well over $30 billion of the unfunded liabilities are concentrated in the plans of relatively few firms, primarily in the steel, auto, tire, and airline industries. These underfunded plans cover about 5 million people. About half of these plans are associated with financially troubled companies and present a near-term, serious risk to PBGC of about $13 billion. The President's Budget, using a model that incorporates a long view of the future, forecasts net claims to PBGC of $30 billion to $45 billion in today's dollars over the next 30 years.

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Our financial problems are a consequence of fundamental weaknesses in the insurance principles supporting the program. Some of these weaknesses were addressed by Congress in 1986 and 1987. Nonetheless, the "moral hazard" of inadequate minimum funding rules, liberal guarantees, and the probability of low recoveries from employers in bankruptcy still encourages financially weak companies to underfund their pension plans.

Our largest present case illustrates many of these hazards. TWA's pension plans are underfunded by over $1.2 billion, even though the company has complied with all the funding requirements. Despite the underfunding the company increased benefits while in bankruptcy by over $100 million in lieu of wage increases. Until recently, creditors and Carl Icahn, who owns 90 percent of TWA, have tried to downplay the significance of the underfunding and PBGC's claims in bankruptcy. Mr. Icahn is trying to extract his group of affiliated companies--also known as the controlled group--from joint and several responsibility under the law for those pension plans. We will not allow him to do that. Our goal is to protect the pensions and to have a viable, ongoing TWA; but the situation is extremely serious. As Mr. Icahn is attempting to break up the controlled group, it may leave PBGC with little alternative except to terminate the plans to protect participants, TWA and the insurance fund.

Despite PBGC's deficit of $2.5 billion, short term large potential problems like TWA, and the $30 billion to $45 billion in projected losses over the long term, some say that there is no reason to be alarmed. I disagree. The time to act is now before there is a S&L type crisis. Without action higher premiums could eventually be needed. These would drive the well funded plans out of this voluntary defined benefit plan system that contains a large portion of American savings. Even some of the opponents of reform admit that this type of "en masse" withdrawal could cause a crisis.

I think I can group our financial risks under two different time frames -- ones that we face immediately and ones that we will face in the future. In the immediate term, we are encountering the following:

- o Companies in financial difficulty look at pension increases as cheap compensation, and their workers agree to these empty promises because they are at least partially insured.

- o Plans can actually run out of money even though they have met the funding requirements. This problem has now been aggravated by recent court decisions in the LTV case that allow companies in bankruptcy to forgo contributing all but a small sliver of the normal funding requirements.

- o In this environment, lenders to distressed companies rarely put pressure on those companies to fund their plans, preferring to believe in optimistic funding assumptions and knowing that, if the worst happens, pension claims will have no priorities under the LTV decision. Indeed, sometimes the creditors will even pressure companies not to fund plans, but rather to terminate them.

- o Underfunding frequently increases dramatically just prior to termination because benefits triggered by plant closings and early retirements were not anticipated in funding assumptions. Failure of companies to accumulate a "rainy day reserve" has been costly to participants, the PBGC insurance fund, and the premium payers that support that fund.

In the longer run, the unsettled legal status of our bankruptcy claims and the absence of sufficient co-insurance in the program lessen the interest that a firm's creditors or its workers have in the funding status of the pensions. Further, the funding rules themselves continue to fall short despite the 1987 reforms. In particular:

- Flat-benefit negotiated plans add new past service benefit increases without funding old ones. Amortization of such increases under current law is not fast enough to prevent funding deterioration.

- Under the minimum funding rules, a company receives credits against future contribution requirements when it has better than expected experience, such as stronger than expected investment performance, as occurred during the 1980's, or when actuarial assumptions are liberalized. Because these credits may be used immediately, regardless of plan funding levels, companies whose plans are billions of dollars underfunded can and have taken multi-year funding holidays.

## Administration's Proposals

In the Pension Security Act of 1992, the Administration has proposed reforms in the minimum funding rules, PBGC's guarantee, and bankruptcy rules. They would improve plan funding through targeted new requirements and economic incentives - by enhancing the reforms Congress enacted in the 1980s. These reforms have received strong editorial support from many newspapers including just 2 weeks ago the Wall Street Journal. In a recent survey of pension officers by the Institutional Investor magazine only 17 percent objected to PBGC's proposals.

Before discussing these reforms in detail, I would like to also mention another important Administration initiative dealing with PBGC, and that is to change the Federal Budget treatment of PBGC from a cash basis to an accrual basis. It would increase awareness of the real cost of the insurance program.

## Federal Budget Accounting

Under the current cash flow treatment of the PBGC in the Federal Budget, the premiums paid by covered plans and investment earnings on them are offsets to Federal outlays. Benefit payments and administrative expenses paid from PBGC's revolving funds are treated as Federal outlays. Because PBGC generally pays benefits on a monthly basis over the lifetime of the recipient, payments typically run for decades, so that payments in a given year typically represent only a small fraction of PBGC's total liabilities for a terminated plan. Under cash flow Federal budgeting, PBGC now has a positive cash flow annually. This does not account for the fact that, on a present value basis, PBGC's liabilities for single-employer plans already terminated (and those PBGC books as "probable terminations" under generally accepted accounting principles), exceed PBGC's assets by $2.5 billion.

In the year that Pan Am's plans terminated, Pan Am's plans caused an outlay increase of only $10 million in the federal budget while our losses exceeded well over half a billion dollars. Cash flow budgeting is the same budgeting that helped obscure the S&L problem for so many years.

The cash approach simply ignores our growing future liabilities. The Administration is proposing to shift the budgetary treatment of PBGC (along with the other Federal insurance programs) from cash budgeting to accrual budgeting in order to reflect the long-run risk to the insurance program. Under accrual budgeting, PBGC's outlay costs will reflect both its accrued liability outstanding at the time of conversion to accrual accounting for already-terminated plans and its accruing liabilities with respect to expected future losses. This will show the real financial position of PBGC, whose deficit we estimate will grow to $18.4 billion by the end of fiscal year 1997 unless proposed reforms are enacted.

Both the Congressional Budget Office (CBO) and the General Accounting Office (GAO) have recognized that the federal budget treatment of PBGC needs to be changed. CBO Director Robert Reischauer testified last month that, "In the case of PBGC, the current budgetary treatment fails on all counts: it does not accurately characterize the use of, motivate the control of, or provide for future resources. Joseph Delfico, Director of Income Security Issues at GAO, testified at the same time that "the concept of reporting of accruals in the federal budget is sound."

I will now describe the Administration's proposal to contain this growing deficit by enacting reforms to the funding, guarantee and bankruptcy rules.

Minimum Funding Rules

The current minimum funding requirements have proven inadequate in a number of respects and, if left unchanged, will not significantly reduce the "funding gap" in chronically underfunded plans. Subject to certain limits, this funding gap is the difference between termination liability (the benefits owed by the plan in the event the plan terminates) and plan assets.

In the vast majority of so-called final pay plans, there is no funding gap. This is because final pay plans, which are about 75 percent of the universe, compute their obligations in a way that anticipates the worker's final pay. Consequently, these plans are usually overfunded on a termination basis, with funding ratios typically about 145 percent.

In so-called "flat benefit" or "flat dollar" plans, which represent about 25 percent of the universe, the funding gap can be considerable. These plans provide a flat benefit per year of credited service. Benefits do not increase automatically as in a salary-based plan, but instead are increased by plan amendment. We estimate that the latest round of negotiations in the auto, steel and rubber industries may have increased benefits by $8 to $9 billion.

Most flat benefit plans are the product of collective bargaining. Because benefits are often increased at three- or five-year intervals in contract negotiations, new liabilities can be added before old ones are funded, leaving the plan chronically underfunded. Typically, these plans are only about 75 percent funded. Although funding rules do not allow these plans to anticipate future benefit increases, there is nothing preventing them from being 100 percent funded.

While helpful, the "deficit reduction contribution" that was enacted in 1987 does not adequately address the problems posed by these flat benefit plans. In flat benefit plans of the type I have just discussed, it is possible to be in full compliance with existing minimum funding rules even when annual benefit payments far exceed annual contributions to the plan. In short, firms with large amounts of underfunding can continue to take contribution holidays provided that the plan's investment returns exceed expectations or funding assumptions are changed. Most of the largest underfunded plans have taken such holidays since 1987.

The Administration is proposing legislation to increase minimum funding for plans presenting the greatest exposure and risk to PBGC. The rules for fully-funded plans, which make up the vast majority of defined benefit plans, and for small plans with under 100 participants, would not be changed.

Under the Administration's proposal, the required minimum funding contribution would be the greatest of: (1) the amount of any funding deficiency according to the regular funding standard account; (2) the amount required by the "underfunding reduction requirement", which is a stronger version of the "deficit reduction contribution " enacted in 1987; or (3) the amount required by the new "solvency maintenance requirement."

The underfunding reduction requirement is a stronger version of the 1987 deficit reduction contribution. As before, this rule, which is a function of the amount of underfunding, requires higher contributions to the worst funded plans. Existing law requires faster amortization of unfunded liabilities added to plans after 1987, but permits significantly slower funding of older liabilities in most underfunded plans. The proposal would apply the faster amortization requirements to old as well as new liabilities. The solvency maintenance requirement would require sponsors to contribute at least an amount equal to benefit payments made during the year plus interest on the plan's unfunded liability. This rule will primarily reduce existing underfunding in the near term but over time will reduce underfunding from future benefit increases.

Underfunded plans with a heavy concentration of retirees and high amounts of benefit payments would be most affected by this rule. To ease the transition to the new rules and to provide sponsors an opportunity to adjust their future pension contribution expectations, the solvency maintenance requirement would be phased in over a five-year period. Some sponsors have stated that they will have large increases in contributions, but that is because of their recent cutback in real contributions.

These minimum funding proposals have been crafted to improve funding in chronically underfunded plans. Further, they are structured to assure that a greater portion of investment gains will result in improved plan funding ratios rather than inuring to the benefit of the sponsor through reduced contributions.

Based on our actuarial analysis, these proposals, had they been enacted in the early 1980s, would have substantially reduced underfunding in most of the major underfunded plans that constitute our current exposure. If we assume that we continue to have strong investment returns over the next decade or so, enacting these proposals should, on average, reduce the time span for full funding of plans from 30 years to 15 years.

This proposal is scored as producing a $2.1 billion revenue loss through 1997 even though, over the long term, it will save PBGC many times that amount. That again shows the perversity of cash flow budgeting, which will be corrected by the accrual budgeting proposal.

## Restrictions on PBGC's Guarantee

To further improve funding incentives and limit PBGC's exposure, the Administration is also proposing to restrict the future growth in PBGC's guarantee for benefits promised in underfunded plans. Recently $100 million in pension benefit increases were approved by the bankruptcy court not only in the TWA bankruptcy but also the Continental bankruptcy, despite PBGC's protests.

Under the proposals, PBGC would not guarantee new benefits or benefit increases due to plan amendments adopted or effective after December 31, 1991 for plans that are not fully funded for vested benefits. However, once the plan becomes fully funded for vested benefits, the benefit or benefit increase would be guaranteed, subject to the existing statutory maximum and phase-in requirements. Future increases in unpredictable contingent event benefits, such as shutdown benefits -- which have cost PBGC's premium payers over half a billion dollars to date -- would not be guaranteed at all.

Sponsors of underfunded plans and their employees would continue to be free to agree to future benefit increases, but they would do so knowing that they will not be guaranteed until the plan is fully funded. This should encourage better funding and more realistic benefit promises. Furthermore, the proposal will curb the practice of accumulating unfunded benefit increases over many years for which PBGC's premium payers then have to foot the bill when the plan terminates.

Bankruptcy

The third major area of proposed program reforms would improve PBGC's recoveries from bankrupt sponsors of terminated plans. PBGC generally has both priority and non-priority unsecured claims in bankruptcy proceedings. PBGC has long asserted that unpaid contributions due during bankruptcy proceedings and a certain portion of PBGC's claims for pre-bankruptcy unpaid contributions and employer liability for unfunded benefits are priority claims. It should be remembered that any recoveries PBGC receives in a bankruptcy are shared with participants who have non-guaranteed benefits.

A 1991 district court decision in the LTV case, if allowed to stand, effectively precludes payment of pension contributions during bankruptcy, strips PBGC's claims of their priority status, and denies PBGC the right to specify the actuarial assumptions used to determine the amount of our claims. This decision, which relies solely on interpreting the Bankruptcy Code and ignores related provisions of ERISA and the Internal Revenue Code, will lead in a number of ways to more and larger terminations of underfunded plans. In particular, the decision removes one of our key coinsurance features, which is the incentive for creditors to encourage better funding in order to limit PBGC's priority claims when an underfunded plan terminates.

On average, less than 20 percent of our claims in bankruptcy are entitled to priority treatment. Although small, these priority claims result in PBGC's claims being treated seriously before and during bankruptcy. Clearly, without priority, PBGC's recoveries in bankruptcy would be drastically reduced and the coinsurance principles will be eviscerated.

Therefore, the Administration is proposing to clarify PBGC's existing priorities in the Bankruptcy Code and, in a few cases, improve its priorities in bankruptcy. These proposals would:

- Clarify that PBGC has priority claims for most unpaid pension contributions and for underfunding up to 30 percent of the net worth of the controlled group;

- Change the priority claim for underfunding to the greater of 30 percent of net worth (as under current law) or a small, but gradually-increasing percentage of underfunding. Of course, over time underfunding should be decreasing, due to the other reforms and therefore the size of the recoveries may not change;

- Give tax priority to claims for underfunding due to shutdown benefits triggered within three years of termination because these heavily subsidized retirement benefits are not generally prefunded and are very costly to the insurance fund; and

- Give PBGC the option to be a member of creditors' committees so that we can have access to information routinely available to other creditors and help speed-up reorganizations.

Bankruptcy protections obviously help reduce PBGC's losses once an underfunded termination occurs, but also encourage better funding before bankruptcy. Companies would have less incentive to terminate underfunded plans if PBGC could recover significant amounts when plans terminate. Creditors would treat underfunded pension plans as real debt, creating a market-based incentive for better plan funding.

## Conclusion

We need legislative change to reduce the threat that growing pension underfunding poses to the insurance program and to the defined benefit system that we insure. If we do not make legislative reforms, premiums might again need to increase, which would be counterproductive. We estimate that they would need to more than triple again - a seventy-fold increase from the original premium of 18 years ago.

As this is a voluntary system, that high a premium might drive out the well funded plans leaving PBGC and potentially the taxpayer holding a bag of empty promises. A recent Economic Report published by the Federal Reserve Bank of Atlanta points out that if deposit insurance makes banking institutions unprofitable, their only option is to relinquish their banking charters. Companies facing unacceptably high PBGC premiums may find it a less difficult choice to switch from defined benefit to defined contribution plans. A recent study by Professors Zvi Bodie of Boston University and Robert Merton of Harvard concluded that overcharging sponsors of well-funded plans in order to subsidize the underfunded plans of financially distressed companies could cause a flight of healthy sponsors from the defined benefit system that could leave the United States "with bankrupt defined benefit plans financed directly by taxpayers."

To avoid this result, we need the support of the Congress to enact program reforms to improve pension plan funding, limit growth in insurance exposure and clarify the status of PBGC's claims in bankruptcy. As Secretary of Labor Lynn Martin said in July, "Congress has the opportunity to show it has learned the painful lesson taught us by the S&L fiasco by taking the necessary steps now to fix the Pension Benefit Guaranty Corporation. The time to act is now before another crisis occurs."

Thank you for the opportunity to testify before the Subcommittee. I welcome any questions you may have.

[Submitted by Senator Pryor]

[JOINT COMMITTEE PRINT]

# PROPOSALS AND ISSUES RELATING TO THE FINANCIAL CONDITION OF THE PENSION BENEFIT GUARANTY CORPORATION (PBGC)

SCHEDULED FOR A HEARING

BEFORE THE

## SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

## SENATE COMMITTEE ON FINANCE

ON SEPTEMBER 25, 1992

PREPARED BY THE STAFF

OF THE

## JOINT COMMITTEE ON TAXATION

SEPTEMBER 24, 1992

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1992

JCS-15-92

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## INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of proposals and issues relating to the financial condition of the Pension Benefit Guaranty Corporation (PBGC). The Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a public hearing on September 25, 1992, on the PBGC, Federal contingent liabilities under the defined benefit pension plan program, and PBGC's information system.

Part I of the pamphlet is an overview. Part II discusses present law and background of the Federal pension insurance program and the financial condition of the PBGC. Part III describes present-law minimum funding standards and deductions. Part IV discusses the Administration proposals and related issues.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Proposals and Issues Relating to the Financial Condition of the Pension Benefit Guaranty Corporation (PBGC)* (JCS-15-92), September 24, 1992.

## I. OVERVIEW

A defined benefit pension plan is a type of employer-sponsored retirement plan which provides benefits to employees covered by the plan based on a formula specified in the plan. In order to provide benefit security to plan participants, the Internal Revenue Code and title I of the Employee Retirement Income Security Act of 1974 (ERISA) impose minimum funding requirements on the sponsor of a defined benefit pension plan.

The minimum funding requirements provide employers considerable flexibility in determining the minimum required contribution, and also permit benefits to be funded over a long period of time. Thus, it is possible that a defined benefit plan may be terminated at a time when plan assets are insufficient to pay promised benefits.

ERISA created the Pension Benefit Guaranty Corporation (PBGC) in order to protect plan participants in the event a defined benefit pension plan terminates with insufficient assets to pay promised benefits. The PBGC guarantees basic retirement benefits, up to a current dollar maximum benefit of $2,352.57 per month.

In its most recent annual report, the PBGC reported a deficit of $2.5 billion. The PBGC reports that the defined benefit system as a whole is relatively healthy, but that certain pension plans, primarily in certain industries, are underfunded by about $40 billion, about $13 billion of which is in plans sponsored by financially troubled companies. The PBGC forecasts that, depending on the level of future losses, its deficit could increase to between $2.7 billion and $17.9 billion by the end of fiscal year 2001.

Despite recent changes in plan funding rules designed to increase the level of plan funding, the risk of loss upon plan termination has increased. To deal with this loss of pension security and increased risk to the PBGC, the Administration has proposed a number of changes to present law, including increasing minimum funding contributions for underfunded plans, and eliminating the PBGC guarantee for certain benefits and benefit increases.

## II. THE FEDERAL PENSION INSURANCE PROGRAM

### A. Present Law and Background

*Defined benefit pension plans*

A defined benefit pension plan is a type of employer-sponsored retirement plan which provides benefits to employees covered by the plan based upon a formula specified in the plan. For example, a defined benefit plan could provide a benefit equal to a percentage of an employee's average compensation multiplied by the number of years of service with the employer. A defined benefit plan could also, for example, provide a flat dollar benefit based on years of service, or a specified percentage of compensation or final average. The key feature of such a plan is that the benefit promised is based on the plan formula, not on the investment experience of the plan.

In order to help ensure that the promised benefits are paid to plan participants, defined benefit plans are subject to minimum funding requirements under both the Internal Revenue Code and title I of the Employee Retirement Income Security Act of 1974 (ERISA) which require the employer sponsoring the plan to make certain contributions to fund the plan. These requirements are discussed in detail below.

*The PBGC*

The minimum funding requirements permit an employer to fund benefits over a period of time. Thus, it is possible that the plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan. In order to protect plan participants from losing retirement benefits in such circumstances, the Pension Benefit Guaranty Corporation (PBGC), a corporation within the Department of Labor, was created in 1974 by ERISA to provide an insurance program for benefits under most defined benefit pension plans maintained by private employers. According to the PBGC's latest annual report, the single-employer insurance program currently covers more than 32 million participants in more than 83,000 defined benefit pension plans.

*Termination of underfunded pension plans*

Prior to 1986, an employer generally could, subject to contractual obligations, terminate a single-employer plan at any time without regard to the financial health of the employer and without regard to the level of assets in the plan. If a single-employer plan was terminated with assets insufficient to pay benefits at the level guaranteed by the PBGC, the employer was liable to the PBGC for the lesser of the insufficiency or an amount equal to 30 percent of the employer's net worth.

Under these rules, employers that wanted to rid themselves of underfunded liabilities could simply terminate the plan, and the PBGC would be liable for benefits. The PBGC was in some cases prevented from recouping its liability from the employer, even if the employer was financially sound. The plan termination rules were amended to prevent such shifting of liabilities to the PBGC by the Single Employer Pension Plan Amendments Act (SEPPAA) and were modified further by the Pension Protection Act of 1987.

Under present law, a plan with assets insufficient to provide for benefit liabilities can be terminated voluntarily by the employer only if the employer and members of the controlled group of the employer are in financial distress. In general, benefit liabilities are all fixed and contingent liabilities to plan participants and beneficiaries.

Following a distress termination, the PBGC pays out all benefits under the plan, including guaranteed benefits and those not guaranteed. The amount of benefits in excess of guaranteed benefits that are paid to plan participants depends on the level of plan funding and the amount the PBGC is able to recover from the employer. The employer is liable to the PBGC for the full amount of unfunded benefit liabilities.

*Guaranteed benefits*

The PBGC guarantees vested retirement benefits (other than those that vest solely on account of the plan termination), up to a maximum benefit of $2,352.57 per month in 1992. The dollar limit is indexed annually for inflation. The guarantee is reduced for benefits starting before age 65, and does not apply to certain types of ancillary benefits. In the case of a plan or a plan amendment that has been in effect for less than 5 years before a plan termination, the amount guaranteed is phased in at a rate of 20 percent per year.

*Sources of PBGC funding*

The PBGC is funded by assets in terminated underfunded plans, amounts recovered from employers who terminate underfunded plans, and by premiums paid with respect to covered plans. All covered plans are required to pay a flat per participant premium and underfunded plans are subject to an additional variable premium based on the degree of underfunding.

As initially enacted in ERISA, covered plans were required to pay a flat annual premium to the PBGC of $1.00 per plan participant. The annual flat-rate per participant premium has been increased several times since the enactment of ERISA, and is currently $19 per participant.

The variable rate premium was enacted in the Pension Protection Act of 1987. It was believed that underfunded plans should bear a greater burden than well-funded plans because they pose a greater risk of exposure to the PBGC. The amount of the variable rate premium is $9.00 per each $1,000 of unfunded vested benefits, up to a maximum of $53 per participant. Thus, the maximum total per participant premium for an underfunded plan is $72 (a $19 flat-rate premium plus a maximum $53 variable-rate premium).

## B. Financial Status of the PBGC

As of September 30, 1991, the PBGC reported a deficit of $2.5 billion. This is an increase over the $1.9 billion deficit reported as of the end of the prior year. The PBGC experienced its largest losses in the history of the termination insurance program in the year ending September 30, 1991. The PBGC attributes these losses primarily to lower expected recoveries from employers in bankruptcy for plans added to PBGC's liabilities in 1990. The PBGC reports that the defined benefit plan system is healthy as a whole, but that some pension plans, primarily in the steel, automobile, tire, and airline industries, are underfunded by about $40 billion. Of this, the PBGC reports that about $13 billion is in plans sponsored by financially troubled companies.

The PBGC has estimated its future financial status under a variety of assumptions. Based on various assumptions as to the future level of PBGC's losses, it has estimated that the deficit could range from about $2.7 billion by the end of 2001, if losses are relatively low, to about $17.9 billion by the end of 2001, if losses are high. According to the PBGC, the estimate of a potential deficit of $17.9 is not a worst-case scenario.

# III. MINIMUM FUNDING STANDARD AND DEDUCTIONS

## *Present Law*

### *In general*

The minimum funding requirements are designed to provide at least a certain level of benefit security by requiring an employer to make certain minimum contributions to a defined benefit plan. The requirements recognize that, in an on-going plan, pension liabilities are generally a long-term liability. Thus, benefits are not required to be immediately funded, but can be funded over a long period of time.

The minimum funding requirements provide an employer considerable flexibility in determining the amount of the contribution that must be or can be made in any given year. The minimum required or maximum permitted contribution that can be made depends on the funding or actuarial cost method used by the plan and the actuarial assumptions used by the plan actuary.

In response to concerns about the financial status of underfunded pension plans, the minimum funding standards were modified, and special additional funding requirements were added for underfunded pension plans by the Pension Protection Act of 1987.

The minimum funding standards and the special rules for underfunded pension plans are discussed in detail below.

### *Minimum funding standard*

#### *In general*

Under the Code and ERISA, certain defined benefit pension plans are required to meet a minimum funding standard for each plan year. As an administrative aid in the application of the funding standard, each defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (including credits for contributions to the plan) are to be made for each plan year. If, as of the close of a plan year, the account reflects credits equal to or in excess of charges, the plan is treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan.

#### *Accumulated funding deficiencies*

If, as of the close of any plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Unless a minimum funding waiver is obtained, an employer who is responsible for contributing to a plan with an accumulated funding deficiency

is subject to a 10-percent nondeductible excise tax (5 percent in the case of a multiemployer plan) on the amount of the deficiency (sec. 4971). If the deficiency is not corrected within the "taxable period," then an employer who is responsible for contributing to the plan is also subject to a nondeductible excise tax equal to 100 percent of the deficiency. The taxable period is the period beginning with the end of the plan year in which there is a deficiency and ending on the earlier of (1) the date of a mailing of a notice of deficiency with respect to the 10-percent tax or (2) the date on which the 10-percent tax is assessed by the Internal Revenue Service (IRS).

For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution in that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If the total contribution is not made, then the employer (or employers) responsible for contributing to the plan would be subject to an excise tax equal to 10 percent of the deficiency for the year. If the deficiency were not corrected within the specified period, then the 100-percent excise tax would be imposed on such employer (or employers).

*Actuarial cost methods*

*In general.*—A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the balance in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as (1) normal cost, and (2) past service liability.

*Normal cost.*—The normal cost of a plan for a year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. The normal cost will be funded by future contributions to the plan (1) in level dollar amounts, (2) as a uniform percentage of payroll, (3) as a uniform amount per unit of service (e.g., $X per hour), or (4) on the basis of the actuarial present values of benefits accruing under the plan in particular plan years.

*Past service liability.*—The past service liability element represents the cost of future benefits under the plan that will not be funded by future plan contributions to meet normal cost (1) on the date the plan is first effective, or (2) on the date a plan amendment increasing plan benefits is first effective. Under some funding methods, there is no past service liability component.

*Acceptable methods.*—Normal cost and past service liability are key elements in computations under the minimum funding standard. Although these costs may differ substantially, depending upon the actuarial cost method used to value a plan's assets and liabilities, they must be determined under an actuarial cost method permitted by ERISA. ERISA enumerates six acceptable actuarial cost methods and provides that additional methods may be permitted under Treasury regulations. Normal costs and past service liabilities under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. Generally, an actuarial

valuation is required at least once every 3 plan years. More frequent valuations may be required by the IRS.

*Charges and credits to the funding standard account*

*In general.*—Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular year depends upon the nature of the cost. For example, the normal cost for a year is generally required to be funded currently. On the other hand, costs with respect to past service (for example, the cost of retroactive benefit increases), experience losses, and changes in actuarial assumptions, are spread over a period of years.

*Normal cost.*—Each plan year, a plan's funding standard account is charged with the normal cost assigned to that year under the particular acceptable actuarial cost method adopted by the plan. The charge for normal cost will require an offsetting credit in the funding standard account. Usually, an employer contribution is required to create the credit.

For example, if the normal cost for a plan year is $150,000, the funding standard account would be charged with that amount for the year. Assuming that there are no other credits in the account to offset the charge for normal cost, an employer contribution of $150,000 will be required for the year to avoid an accumulated funding deficiency.

*Past service liability.*—There are 3 separate charges to the funding standard account that may arise as the result of past service liabilities. The first applies to a plan under which past service liability has increased due to a plan amendment made after January 1, 1974; the second applies only to a plan that came into existence after January 1, 1974; and the third applies only to a plan in existence on January 1, 1974. Past service liabilities result in annual charges to the funding standard account for a specified period of years. Assuming that there are no other credits in the account to offset a charge for past service liability, and employer contribution will be required for the year to avoid and accumulated funding deficiency.

In the case of a plan that was in existence on January 1, 1974, the funding standard account is charged annually with a portion of the past service liability determined as of the first day of the plan year of which the funding standard applied to the plan (generally the plan year beginning in 1976). In the case of a single-employer plan, the amount of the liability with which the account is charged for a year is based on amortization of the past service liability over a period of 40 plan years. The liability is required to be amortized (in much the same manner as a 40-year mortgage) in equal annual installments over the 40-year funding period unless the plan becomes fully funded.

A plan that was not in existence on January 1, 1974, is generally required to determine past service liability as of the first day of its first plan year beginning after September 2, 1974 (the date ERISA was enacted). This liability is required to be amortized by a single-employer plan in equal annual installments over a period of 30 plan years. Accordingly, if there are no other credits in the account to offset the charge for this past service liability, and if the plan does not become fully funded, annual employer contributions will

be required for 30 plan years to offset charges for this past service liability.

With respect to all plans (whether or not in existence on January 1, 1974), if a net benefit increase takes place as the result of a plan amendment, then the unfunded past service liability attributable to the net increase is determined that year and amortized over a period of 30 years.

For example, assume that a plan uses the calendar year as the plan year. Further, assume that, during 1987, the plan is amended to increase benefits and that the net result of plan amendments for 1987 is that the past service liability under the plan is increased by $500,000. In addition, the plan's actuary uses an interest rate of 8 percent in determining plan costs. The 30-year schedule requires that $44,414 be charged to the funding standard account each year to amortize the past service liability.

Accordingly, for each year in the 30-year period beginning with 1987, the plan's funding standard account is charged with the amount of $44,414. If there are no other credits in the account to offset the charge for past service liability, an employer contribution of $44,414 would be required for each of the 30 years to avoid an accumulated funding deficiency unless the plan becomes fully funded.

*Gains and losses from changes in assumptions.*—If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from charges in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 10 plan years (30 plan years in the case of a multiemployer plan), resulting in credits or charges to the funding standard account.

*Experience gains and losses.*—In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. The actuarial assumptions are required to be reasonable in the aggregate. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. For a single-employer plan, experience gains and losses for a year are amortized over a 5-year period (15 plan years in the case of a multiemployer plan).

*Waived funding deficiencies.*—Under the funding standard, the amount of a waived funding deficiency is amortized over a period of 5 plan years, beginning with the year in which the waiver is granted. Each year, the funding standard account is charged with

the amount amortized for that year unless the plan becomes fully funded. The interest rate used for purposes of determining the amortization on the waived amount is the greater of (1) the rate used in computing costs under the plan, or (2) 150 percent of the mid-term applicable Federal interest rate (AFR) in effect for the first month of the plan year.

With respect to applications for waivers submitted after April 7, 1986, SEPPAA provides that the IRS is authorized to require security to be granted as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $2 million.

*Switchback liability.*—ERISA provides that certain plans may elect to use an alternative minimum funding standard account for any year in lieu of the funding standard account. ERISA prescribes specified annual charges and credits to the alternative account. No accumulated funding deficiency is considered to exist for the year if a contribution meeting the requirements of the alternative account is made, even if a smaller contribution is required to balance charges and credits in the alternative account than would be required to balance the funding standard account for a plan year.

During years for which contributions are made under the alternative account, an employer must also maintain a record of the charges and credits to the funding standard account. If the plan later switches back from the alternative account to the funding standard account, the excess, if any, of charges over credits at the time of the change ("the switchback liability") must be amortized over a period of 5 plan years.

*Reasonableness of actuarial assumptions.*—All costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods (1) each of which is reasonable individually or (2) which result, in the aggregate, in a total plan contribution equivalent to a contribution that would be obtained if each assumption were reasonable. In addition, the assumptions are required to reflect the actuary's best estimate of experience under the plan.

### *Special rules for underfunded plans*

#### *In general*

A special funding rule applies to underfunded single-employer defined benefit pension plans (other than plans with no more than 100 participants on any day in the preceding plan year). This special funding rule was adopted due to Congressional concerns regarding the solvency of the defined benefit pension plan system and that the generally applicable funding rules were not in all cases sufficient to ensure that plans would be adequately funded.

#### *Calculation of deficit reduction contribution*

With respect to plans subject to the special rule, the minimum required contribution is, in general, the greater of (1) the amount determined under the normal funding rules, or (2) the sum of (i) normal cost, (ii) the amount necessary to amortize experience gains and losses over 5 years and gains and losses resulting from changes

in actuarial assumptions over 10 years, and (iii) the deficit reduction contribution. In addition, a special funding rule applies with respect to benefits that are contingent on unpredictable events. In no event is the amount of the contribution to exceed the amount necessary to increase the funded ratio of the plan to 100 percent.

The deficit reduction contribution is the sum of (1) the unfunded old liability amount, and (2) the unfunded new liability amount. Calculation of these amounts is based on the plan's current liability.

*Current liability*

The term "current liability" generally means all liabilities to employees and their beneficiaries under the plan determined as if the plan terminated. However, the value of any "unpredictable contingent event benefit" is not taken into account in determining current liability until the event on which the benefit is contingent occurs.

The interest rate used in determining the current liability of a plan, as well as the contribution required under the special rule, is required to be within a specified range. The permissible range is defined as a rate of interest that is not more than 10 percent above or below the average mid-term applicable Federal rate (AFR) for the 4-year period ending on the last day before the beginning of the plan year for which the interest rate is being used (or, if shorter, the period that the AFR has been computed). The Secretary may, where appropriate, allow a lower rate of interest except that such rate may not be less than 80 percent of the average rate discussed above.

Within the permissible range, the interest rate is required to be reasonable. The determination of whether an interest rate is reasonable depends on the cost of purchasing an annuity sufficient to satisfy current liability. The interest rate is to be a reasonable estimate of the interest rate used to determine the cost of such annuity, assuming that the cost only reflected the present value of the payments under the annuity (and did not reflect the seller's profit, administrative expenses, etc.).

Unfunded current liability means, with respect to any plan year, the excess of (1) the current liability under the plan over (2) the value of the plan's assets reduced by any credit balance in the funding standard account. The funded current liability percentage of a plan for a plan year is the percentage that (1) the value of the plan's assets reduced by any credit balance in the funding standard account is of (2) the current liability under the plan.

*Unfunded old liability amount*

The unfunded old liability amount is, in general, the amount necessary to amortize the unfunded old liability under the plan in equal annual installments (until fully amortized) over a fixed period of 18 plan years (beginning with the first plan year beginning after December 31, 1988). The "unfunded old liability" with respect to a plan is the unfunded current liability of the plan as of the beginning of the first plan year beginning after December 31, 1987, determined without regard to any plan amendment adopted after October 16, 1987, that increases plan liabilities (other than

amendments adopted pursuant to certain collective bargaining agreements).

*Unfunded new liability amount*

The unfunded new liability amount for a plan year is the applicable percentage of the plan's "unfunded new liability." Unfunded new liability means the unfunded current liability of the plan for the plan year, determined without regard to (1) the unamortized portion of the unfunded old liability (and the unamortized portion of certain unfunded liability from certain benefit increases) and (2) the liability with respect to any unpredictable contingent event benefits, without regard to whether or not the event has occurred. Thus, in calculating the unfunded new liability, all unpredictable contingent event benefits are disregarded, even if the event on which that benefit is contingent has occurred.

If the funded current liability percentage is less than 35 percent, then the applicable percentage is 30 percent. The applicable percentage decreases by .25 of one percentage point for each 1 percentage point by which the plan's funded current liability percentage exceeds 35 percent.

*Unpredictable contingent event benefits*

The value of any unpredictable contingent event benefit is not considered in determining current liability until the event has occurred. If the event on which an unpredictable contingent event benefit is contingent occurs during the plan year and the assets of the plan are less than current liability (calculated after the event has occurred), then an additional funding contribution (over and above the minimum funding contribution otherwise due) is required.

Unpredictable contingent event benefits include benefits that depend on contingencies that, like facility shutdowns or reductions or contractions in workforce, are not reliably and reasonably predictable. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

The amount of the additional contribution is generally equal to the greater of (1) the unfunded portion of the benefits paid during the plan year (regardless of the form in which paid), including (except as provided by the Secretary) any payment for the purchase of an annuity contract with respect to a participant with respect to unpredictable contingent event benefits, and (2) the amount that would be determined for the year if the unpredictable contingent event benefit liabilities were amortized in equal annual installments over 7 years, beginning with the plan year in which the event occurs.

The rule relating to unpredictable contingent event benefits is phased in for plan years beginning in 1989 through 2001.

*Small plan rule*

In the case of a plan with more than 100 but no more than 150 participants during the preceding year, the amount of the additional deficit reduction contribution is determined by multiplying the

otherwise required additional contribution by 2 percent for each participant in excess of 100.

*Full funding limitation*

No contribution is required or permitted under the minimum funding rules to the extent the plan is at the full funding limitation. In addition, under present law, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)).

*Funding waivers*

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year. A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship. A waiver may be granted only if the business hardship is temporary and if the entire controlled group of which the employer is a member, as well as the employer itself, is experiencing the hardship. No more than 3 waivers may be granted within any period of 15 consecutive plan years. The IRS may require an employer to provide security as a condition of granting a waiver.

The IRS is authorized to require security to be granted as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $1 million.

*Controlled group liability*

The funding requirements applicable to a plan are imposed on all employers that are members of the same controlled group of corporations as the employer who is responsible for making the contributions.

*Deductions for employer contributions*

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (sec. 404). No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employee covered by the plan is also covered by another plan of the employer. However, no deduction is allowed with respect to contributions or benefits in excess of the overall limits on contributions or benefits.

Under the Internal Revenue Code, a 10-percent nondeductible excise tax is imposed on nondeductible contributions to a qualified plan. The purpose of the excise tax is to discourage employers from making excessive contributions to a plan in order to obtain the benefit of tax-free earnings on the contributions.

A special deduction rule applies to underfunded defined benefit pension plans. In the case of a single-employer defined benefit pension plan which has more than 100 participants, the maximum amount deductible is not less than the plan's unfunded current liability as determined under the minimum funding rules.

# IV. PROPOSALS AND ISSUES

## *Administration Proposals*

The Administration has proposed a number of reforms relating to the PBGC termination insurance system, including increasing the minimum funding rules for certain plans and modifying the PBGC guarantee with respect to plan amendments.[2]

### *Minimum funding requirements*

In general, the Administration's minimum funding proposal would build on the changes made by the Pension Protection Act of 1987 by requiring sponsors of underfunded plans to fund pension liabilities more rapidly than under present-law rules. Alternatively, underfunded plans with high levels of payments to pension recipients would be required each year to make contributions to the plan equal to disbursements plus interest on the plan's unfunded liability. The proposed rules would require underfunded plans to increase their funding levels over a period of time.

To accomplish these goals, the proposal would replace the current deficit reduction contribution with two new rules: (1) the "underfunding reduction requirement," and (2) the "solvency maintenance requirement". The required minimum funding contribution would be the greatest of (a) the amount of any funding deficiency according to the regular funding standard account, (b) the amount required by the underfunding reduction rule, or (c) the amount required by the solvency maintenance rule. The two new rules would only apply to underfunded pension plans with more than 100 participants, and would only have a limited effect on plans with more than 100, but no more than 150 participants.

The underfunding reduction requirement (revised Code sec. 412(l)) would apply the formula for the unfunded new liability amount from the deficit reduction contribution to the entire underfunding, thereby eliminating the grandfathering of pre-1987 liabilities over an 18-year period. As under present law, the rule would require larger contributions with respect to the most underfunded plans. To this amount would be added normal cost, the repayment of waived contributions, and charges for experience losses and losses from changes in actuarial assumptions. Credit for experience gains, gains from changes in actuarial assumptions and greater than required minimum contributions (per sec. 412(b)) would be allowed as offsets, but only to the extent of the charges for experience losses and the losses from changes in actuarial assumptions.

The solvency maintenance requirement (new sec. 412(o)) has two main components: (1) disbursements from the plan (i.e., benefit pay-

[2] These and other proposals were included in the President's fiscal year 1993 budget, and are in H.R. 4545, introduced by Mr. Michel (by request) on March 24, 1992.

ments, including annuity purchases, administrative expenses and other disbursements), and (2) the plan's initial unfunded liability multiplied by the interest rate used for purposes of the funding standard account under section 412(b). Normal cost and other charges are added to this amount, and credits are allowed, in the same manner as under the underfunding reduction requirement.

To protect firms against possibly large and unplanned increases in their required contributions on account of this rule, the solvency maintenance requirement would be phased in over a 5-year transition period. In addition, with respect to both requirements, any positive credit balances that antedate 1992 would be allowed as full offsets under both the new requirements.

Discipline in actuarial assumptions would be maintained by use of the funding standard account concepts of experience losses and losses from changes in actuarial assumptions. Limiting credit for experience gains, gains from changes in actuarial assumptions, and for greater-than-required minimum contributions in past years buttresses that discipline and assures that underfunded pension plans always make a contribution in each year that they are underfunded.

*PBGC guarantee*

The proposal would provide that the PBGC guarantee does not apply to benefits under a new plan or an increase in benefits resulting from a plan amendment unless the plan is fully funded. In addition, the proposal would provide that the PBGC guarantee does not apply to any new unpredictable contingent event benefits or any increases in such benefits. An unpredictable contingent event benefit is any benefit contingent on an event other than age, service, compensation, death, or disability or an event which is reasonably and reliably predicable.

### *Bankruptcy Reforms*

The National Bankruptcy Review Commission Act (S. 1985) ("Bankruptcy Act"), as amended on the Senate floor,[3] includes pension-related bankruptcy reforms. The stated intent of the provisions is to protect the pension insurance program by preventing the use of the bankruptcy laws to evade current pension obligations.

The Bankruptcy Act generally requires employers, after they have filed for bankruptcy, to continue to make the annual minimum funding contribution required by the Internal Revenue Code. An employer can delay the minimum contribution until the employer emerges from bankruptcy if the employer provides a security interest to the plan equal to the amount of the delayed contributions. This provision is designed to permit a financially troubled company to organize its affairs before any cash contributions are required to be paid to the pension plan.

The Bankruptcy Act treats these changes as a clarification of present law and therefore applicable to any missed pension plan

[3] Senators Packwood, Graham, and Metzenbaum offered a floor amendment (No. 2425) to the Bankruptcy Act, S. 1985, that included the pension-related bankruptcy reforms described below. The floor amendment was agreed to by unanimous consent on June 16, 1992.

contributions, before or after the date of enactment of the Bankruptcy Act, that occurred after an employer filed for bankruptcy.

### *Analysis of Issues*

#### *Increased funding rate*

Those in favor of increasing the minimum funding standards argue that the rate of funding required under the present-law minimum funding standard exposes plan participants and the PBGC to excessive risk. Under present law, the funded status of a plan could deteriorate even if the minimum funding requirements are fully satisfied. Thus, it is argued that, given the existence of a plan termination insurance program, the present-law rules providing long-term financing of increases in unfunded liabilities create an incentive for employers to provide benefit increases that might otherwise not be affordable. In addition, the existence of benefit guarantees makes it less likely that employees will express concern about the security of their promised benefits.

As a result, supporters of increases in the minimum funding rules believe that more rapid funding would more appropriately limit the ability of employers to delay or avoid funding obligations. They argue that an employer should not have the opportunity to make pension promises that exceed its financial capacity. They suggest that the purpose of sound funding is to protect employee benefits by insulating them from business risk of the employer, as well as to protect the PBGC from systematic loss. Further, they argue that if the risk of loss to the PBGC is not minimized, taxpayers may ultimately have to pay for unfunded benefit promises.

Concerns have been expressed that the rate of funding proposed by the Administration is unnecessarily high, and that an employer who otherwise would have been able to fully fund plan liabilities may, instead, choose bankruptcy as a means of avoiding the faster funding of its unfunded liability. Sharply higher contribution requirements, particularly requirements imposed with respect to existing unfunded liabilities, could prove burdensome for employers in cyclical businesses. For employers who incur net operating losses, the increased contributions may not be fully deductible when paid.

Others argue that the rapid rates mandated by the Administration proposal would unduly restrict funding flexibility under defined benefit pension plans and may cause termination of plans by employers that are unwilling to bear the increased current costs of funding. They argue that the objective of greater benefit security can be obtained with a less extensive increase in the rate of funding that is less likely to cause the termination of defined benefit pension plans.

Some who oppose faster funding believe that the requirements will interfere with collective bargaining. They suggest that the extent to which amounts earned by employees should be divided between pension plan contributions and other forms of compensation is more appropriately left to employee representatives and to employers. On the other hand, it can be argued that constraints on the collective bargaining process are appropriate in light of the PBGC's unique role as guarantor of an employer's benefit promises

to employees. Because employees are assured of receipt of their benefits from the PBGC if the employer is unable to meet its benefit commitments, some argue that the normal arm's-length nature of the collective bargaining process is weakened and that employees have less incentive to bargain for adequate funding by the employer.

Some argue that a more extensive evaluation of the present-law funding requirements is appropriate. For example, the flexibility provided to employers in selecting the method of funding to be used for a particular plan could be reexamined. The particular characteristics of employers in various industries could be studied to determine whether certain funding methods are more appropriate or desirable from a benefit security perspective. The flexibility in choosing actuarial assumptions could also be reexamined.

The PBGC reports that most of its exposure is from collectively bargained plans that provide a flat benefit (e.g., $20 per month times number of years of service). Under such plans, the flat benefit amount is increased periodically. The present-law funding rules do not permit increases in the flat benefit to be anticipated. In contrast, in plans based on compensation, increases in compensation can be anticipated. Thus, some argue that increases in flat benefits should be permitted to be anticipated in projecting plan liabilities so that the benefits can be funded in advance.

Some argue that such a proposal should not be adopted, or should be adopted only with appropriate restrictions to prevent employers who want to increase deductions from anticipating increases in benefits that may never take place. On the other hand, proponents of the proposal argue that the employer does not have an incentive to overestimate benefit increases because there is limited ability to recoup any overfunding. First, in most collectively bargained plans, the employer has no incentive to overfund, because any excess pension assets revert to employees on plan termination. Second, even if the employer has a right to any reversion, the present-law excise tax on reversions substantially reduces the amount of excess assets an employer can claim.

Others doubt that permitting increases in flat benefits will have any real impact on plan funding. Such plans typically are underfunded before any increases are granted. If the employer does not fund existing benefits, then the employer is unlikely to take advantage of the opportunity to fund benefit increases that have not been granted.

Some have suggested that an alternative way to protect against pension losses would be to increase the PBGC premiums for all plans. They argue that the PBGC program is an insurance program, so that risk of loss should be spread among all premium payers.

Opponents of increasing the PBGC premium argue that, while risk spreading is appropriate, there is an underlying moral hazard in the PBGC system that needs to be addressed — the incentive to underfund knowing the PBGC will pay benefits. Further, they argue that because the defined benefit system in voluntary, if premiums on low-risk plans are too high they will simply exit the system, leaving only plans that represent significant exposure to the PBGC. The best way to deal with systematic underfunding,

they argue, is to require employers to fund their own benefit promises.

*PBGC guarantee*

The Administration proposal to eliminate the PBGC guarantee in certain circumstances is designed to limit the PBGC's exposure to chronically underfunded plans and to provide an incentive to employers to fund benefit increases. The general theory behind the proposal is that employers will not provide and employees will not want benefit increases that are not guaranteed.

Opponents of the Administration proposal argue that the proposal is simply a way to limit PBGC exposure, and undermines the whole purpose of the PBGC—which is to guarantee benefits. They argue that the proposal will do nothing to help benefit security, but will make it worse by weakening the guarantee. Further, they argue that participants may be misled, because they may not know that the particular benefit or benefit increase is not guaranteed.

Some opponents of the Administration proposal agree that the goal of limiting unfunded benefit increases in chronically underfunded plans is appropriate, but would address it in a different way. For example, benefit increases in underfunded plans could be prohibited unless the plan is funded to a certain level, or security is provided. Such a proposal could build on the present-law requirement that sponsors of plans which are less than 60 percent funded provide security in the case of plan amendments.

**PREPARED STATEMENT OF DALLAS SALISBURY**

I am pleased to appear before you this morning to discuss the financial condition of the Pension Benefit Guaranty Corporation (PBGC). My name is Dallas Salisbury. I am president of the Employee Benefit Research Institute (EBRI), a nonprofit, nonpartisan, public policy research organization based in Washington, DC.

EBRI has been committed, since its founding in 1978, to the accurate statistical analysis of economic security issues. Through our research, we strive to contribute to the formulation of effective and responsible health, welfare, and retirement policies. Consistent with our mission, we do not lobby or advocate specific policy solutions.

Introduction

The Employee Retirement Income Security Act of 1974 (ERISA) was a landmark piece of legislation. Among its major provisions was the creation of PBGC. ERISA in general, and the provisions related to PBGC in particular, have been amended many times since 1974 in an effort to better achieve the original purposes of the Act. PBGC has consistently undertaken analysis to identify areas where further change would improve the system.

Most recently, additional proposals for change were discussed in the 1991 PBGC Annual Report to Congress. Changes to the Bankruptcy Act were proposed in November 1991 in separate pieces of legislation (S. 1985 and H.R. 3837); amended versions of these bills have been passed by their respective chambers. The President's FY 1993 Budget proposed extensive changes for PBGC that were introduced in legislative form by Senator Majority Leader Robert Dole (S. 2485) and House Minority Leader Robert Michel (H.R. 4545) last March. Most recently, Senator James Jeffords and Representative J.J. Pickle introduced legislation proposing further reforms for the PBGC (S. 3162 and H.R. 5800). The House Ways and Means Subcommittee on Oversight held a hearing on these proposals on August 11.

The descriptions of the PBGC situation have revolved around the word "crisis," amid comparison to the "S&L fiasco." (Martin, 7/28/92). Most recently it has been turned into an election issue, with statements being made that can only be said to stretch the facts.

I was at PBGC during 1977 and 1978. I had the privilege of working with Senators Jacob Javits and Harrison Williams on early revisions of the PBGC statute. I had the honor of directing the study effort that led to "reform" of the PBGC Multi-employer program and the present stability of that program. I have participated in ongoing reviews of PBGC, including a PBGC Advisory Committee Privatization Task Force in 1982-83, and presently serve by appointment of President Bush on the PBGC Advisory Committee.

Concerned by developments in 1991, EBRI undertook its own review of PBGC and in May 1992 published *EBRI Issue Brief* No. 126: "PBGC Solvency: Balancing Social and Casualty Insurance Perspectives." I ask that the full text of that review be included in the record of this hearing. The PBGC and its underlying statute still have room to evolve, but both have grown progressively stronger since 1974.

Employer-sponsored pension plans represent an important source of retirement income for Americans. In 1990, private pension retirement benefits of $141 billion accounted for 31 percent of the $457 billion in total retirement benefit payments (U.S. Department of Commerce). By comparison, private pension benefits totaled $7.4 billion in 1970. Factoring contributions and earnings, along with benefit payments, private sector defined benefit pensions had an estimated tax expenditure (using government methodology) of $8.2 billion in fiscal 1993; total tax expenditures for public and private sector employer-provided pensions was $56.5 billion.[1]

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[1] The breakdown for the estimated tax expenditure of $56.5 billion for employer-provided pensions is as follows: private defined benefit, $8.2 billion; private defined contribution, $19.3 billion; public defined benefit, $27.9 billion, and public defined contribution, $1.1 billion. Keough plans had a tax expenditure of $2.7 billion and Individual retirement plans, $7.1 billion. (EBRI compilation from Joint Committee on Taxation data and EBRI estimates by plan type.)

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PBGC Financial History and Current Financial Status

Concern regarding PBGC's financial viability arises from a current agency deficit of $2.5 billion in the single employer fund and the estimated $31 billion in underfunding within individual single-employer plans, $13 billion of which is considered by PBGC to pose a serious risk because of sponsor's financial trouble. Table 1 presents a time trend of financial information for PBGC and the insured system.

Table 1 demonstrates the willingness of Congress to adjust premiums to maintain the cash flow solvency of the agency. Premium income is currently at an all time high and the cash flow is quite positive. According to PBGC, "Although cash flow could turn negative as early as three years in the pessimistic forecast, the fund has ample assets to pay its liabilities (benefit payments) for a considerable period of time" (Pension Benefit Guaranty Corporation, 1991)

The agency's deficit, while trending upward over time, has exhibited a great deal of volatility, particularly in the mid-to-late 1980s. The 1986 PBGC Annual Report placed the deficit at $4 billion due to LTV. The present deficit of $2.5 billion is higher than at any time other than 1986 While the reported deficit includes the present value of liabilities for future benefit payments, it makes no attempt to include future revenue receipts that will be available to at least partially cover these liabilities. According to PBGC, current premium receipts total $[illegible]90 million per year, while interest and dividend receipts currently approximate $305 million per year (PBGC, 1991).

Table 2 compares PBGC's current reported exposure level with available figures of past exposure [2](Ippolito, 1989). 1990 exposure ($25.6 billion) is lower than at anytime between 1978 ($116 9 billion) and 1986 ($49.2 billion). In fact, current exposure is approximately 40 percent of the historic average of $59.9 billion. PBGC is a stronger agency today than at any time in its history, both financially and in its legal authority

Status of the Defined Benefit System

The PBGC's ability to meet its future obligations depends also upon the health of the private defined benefit system as a whole. PBGC reports that in the aggregate defined benefit plans have $1.3 trillion in assets to back $900 billion in benefit liabilities Available evidence suggests that approximately 85 percent of pension plans have assets equal to or exceeding 100 percent of liabilities, up from 45 percent in 1981, and 38 percent of plans have assets in excess of 150 percent of liability for accrued benefits (table 3) [3] The percentage of plans that were fully funded on a termination basis increased every year between 1981 and 1987 and leveled off between 1987 and 1991.

From 1977 to 1987, the funding status of single-employer defined benefit plans has significantly improved, rising from an average of 85 percent funded to 129 percent funded on a termination basis (table 4). Since 1980, defined benefit plans on average have been overfunded. The increase in funding ratios most likely reflects a combination of factors, including higher contribution rates needed to meet minimum funding standards, favorable investment returns on equity, and the use of higher interest rate assumptions to discount future benefits.

Despite the sound aggregate funding status of the defined benefit system, the net deficit of the single-employer insurance system can be significantly increased by single occurrences of distress terminations of large pension plans. PBGC publishes an annual list of the top 50 underfunded pension plans. Underfunding by plans on this list increased from $14 2 billion in 1989 to $21.5 billion in 1990.[4] Three firms, General Motors, Chrysler, and LTV are responsible for 97 percent of the increase in

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[2] All figures are in 1986 dollars

[3] Throughout this discussion termination basis refers to basing funding ratios on benefits accrued and assets accumulated at the end of the plan year—the assumptions plans would use to calculate liabilities for standard terminations Termination basis funding does not refer to PBGC's calculation of liabilities for underfunded terminations, using termination mortality and retirement age assumptions

[4] PBGC derived its top 50 list using a computerized data base created by Standard & Poor's Compustat Service, Inc., which contains corporate annual reports for fiscal years ending in 1990. PBGC supplemented the database with data from corporate annual reports for fiscal years ending in 1989 and earlier fiscal years, and where available, 1987 and 1988 5500 forms. PBGC also sent letters to plan sponsors containing their plans' funding information for comment prior to publication.

underfunding ($7.1 billion). (PBGC has reached tentative agreements with LTV to limit exposure. General Motors is the agency's largest premium payer.) The same three companies are also responsible for 64 percent of the top 50 companies' unfunded liabilities. Funding ratios of plan sponsors listed ranged from 6 percent for LTV, to 94 percent for National Steel, with an aggregate overall funding ratio of 75.5 percent. The underfunding of plans on the "Top 50" list is defined as unfunded guaranteed benefit liabilities (liabilities for non-guaranteed benefits are not included). Being on the "Top 50" list does not mean the plan is in danger of a distress termination. PBGC estimates that companies experiencing financial troubles accounted for $13 billion of pension plan underfunding in 1991, an increase from $8 billion in 1990.

Seventy-five percent of the listed plans' underfunding is attributable to plan sponsors in the airline, steel, auto, and tire industries, most of which sponsor flat benefit plans. Pension plan underfunding for an individual plan sponsor on the top 50 list ranged from $47 million to $7.1 billion. It should be noted that some plan sponsors listed have pension plans that are overfunded, but since the PBGC does not have legal recourse to the excess assets of overfunded plans these assets are not included on the list.

PBGC and the "S&L Fiasco"

Public confidence is something to be guarded. It should only be threatened if there is a real reason to do so. Comparison of PBGC to the "S&L fiasco" serves to imply that a large number of pension plans that no one thinks are in trouble are on the verge of failure, that a taxpayer bailout is imminent, and that PBGC is in historically bad condition. None of these conditions exist. The unfortunate terminations of Eastern and Pan Am, which increased PBGC liabilities in 1991, were anything but unexpected. The prospect of liabilities from LTV were well known nearly a decade ago. In 1986 the PBGC deficit was reported at $4.0 billion (compared to $2.5 billion in 1991) due to the short term holding of the LTV plans by PBGC.

Congress has a long history of careful monitoring of PBGC and legislative action when needed to avoid any type of situation even resembling the "S&L fiasco." And, ERISA has been extremely successful in strengthening the overall insured defined benefit system.

Furthermore, it should be emphasized that the "S&L fiasco" had other features not found in the pension system. These features are:

- As of year-end 1988, FSLIC-insured savings institutions were much more concentrated in securities sensitive to downturns in the real estate market than defined benefit pension plans are today (charts 1 and 2). Defined benefit pension plan assets are highly diversified.
- S&Ls were given new investment powers in 1980 and many marginally capitalized institutions believed they could grow their way out of their problems. The rapid growth of agency-guaranteed liabilities does not appear to be the case with PBGC.
- Best judgments are that fraud and mismanagement existed in about 60 percent of the S&L failures and that it contributed to the failure or the insolvency in perhaps about 25 percent of the cases. Evidence of such activity among single-employer pension plans is almost non-existent.
- As S&Ls found themselves constrained by limits on the amount they could lend to a single borrower they began to sell off pieces of the loan to other institutions (loan participation). Many of these secondary lenders relied on the underwriting capacities of the originating S&L. Although a large proportion of defined benefit plan assets are placed in bank pooled funds and similar investments where there is a sharing of investment results, it is fundamentally different than loan participations that have been characterized as "a transfer of risk from a party who lacks courage to one who lacks knowledge."[5]
- From 1981 to 1987, S&Ls insured by FSLIC were permitted to use accounting options that were not in agreement with Generally Accepted Accounting Principles (GAAP) and have been described as "self-deceptive accounting procedures" by the Executive Director of PBGC. In contrast, pension plans must

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[5] Kwerpel, Jeffrey. "The Insolvency Looking Glass." *Best's Review* (September 1991). 37ff

adhere to very conservative accounting measures under FAS 35 while the vast majority of the large defined benefit plan sponsors follow GAAP procedures, at least for those events defining their solvency and net worth determinations.

Perhaps the most important distinctions between the two programs is that funds are not generally available to the participant on demand in a defined benefit pension plan prior to termination of employment. At that point approximately 40 percent of plans offer a lump-sum option. Although there is some potential for lump-sum distributions to negatively impact the cash flow of a pension plan, this could be controlled (at least theoretically) by ERISA Section 4045, which allows PBGC to recapture part of any distributions that start within the three-year period immediately preceding the failure of the plan. Certainly, there is only limited evidence of catastrophic "runs on the bank" from the standpoint of defined benefit plan sponsors or PBGC.

Moreover, after a termination the cash flow position is also markedly different between the two programs. Depositors in S&Ls were typically paid immediately, while PBGC can spread payments over a long period of time.

Although most of the discussion here has dealt with the similarities (or lack thereof) between the exposures of S&Ls and PBGC, the most important difference between the two guarantee funds is that the likelihood that a plan insured by PBGC will fail is diversified across several key industries whereas S&L guarantee funds were exposed exclusively to the risks of a single industry that was extremely vulnerable to fraud and events beyond its control.

The Long History of PBGC Reform

A review of PBGC Annual Reports to Congress finds that recognition of the "imperfection" of the original statute came early. The 1976 report raised the potential need for higher premiums, which were in turn increased in 1977 from $1 to $2.60. The 1978 report stated: "PBGC studies and research reflect both a growing awareness of fundamental defects in that program and possible solutions that will add to the long-term strength of the private pension system." That year PBGC told Congress that the Contingent Employer Liability Program called for by ERISA was "unworkable and undesirable."

The 1979 report outlined planned legislative proposals for the single employer program and reviewed proposed changes in the Multiemployer program, while the 1980 report contained further discussion of desired change and reported that the Multiemployer changes had been enacted (MEPPA).

The 1981 report outlined single employer program changes that were introduced in Congress. The 1982 report highlighted a request for higher premiums and more legislative proposals. The 1983 report revised the premium request and the proposals. The 1984 report found a positive income year and a positive claims year with a higher premium request but a spreading of the deficit being funded from 10 years to 15 years

The 1985 report pushed for legislative change that was enacted and reported upon in the 1986 report (SEPPAA) along with a premium increase to $8.50. This legislation fundamentally restricted the circumstances under which employers could terminate an underfunded plan and "dump" liabilities on PBGC. The 1985 report also stated, however: "Unfortunately, the legislation is not sufficient to secure the program's future. The PBGC now faces a financial crisis that poses a serious threat to the future of its single-employer insurance program. Payments to current retirees are not at risk in the immediate future, and there is sufficient time to make the necessary changes. But the need for changes must not be ignored." The report highlighted the fact that the "underfunding of a small percentage of private pension plans threatens the PBGC's future."

The 1987 report highlighted an extraordinarily successful legislative effort by the agency: significant change in the single-employer program and movement to a variable rate premium structure. The changes in the Pension Protection Act of 1987 again tightened the minimum funding standards, with new minimum contributions, quarterly contributions, a lien for missed contributions, and new restrictions on funding waivers. Also, PBGC's position in bankruptcy was improved and even tighter requirements for allowing a plan termination were enacted. PBGC handed the plans

terminated by LTV back to the company. The number of plan terminations increased to 11,865, but terminations with asset reversions declined. The theme of the report was "Keeping Promises", and it again highlighted the strength of the overall system.

The 1988 report stated: "Serious problems do remain, in part due to the uncertain status of the contested LTV plans. Unpredictable catastrophic claims and economic downturns could still threaten the agency's financial stability. But with the FY 1988 pension reforms, the pension insurance system now is considerably more stable and equitable. The reforms have provided greater security for the system and the benefits it protects. The program is better funded and many of the opportunities for abuse have either been eliminated or reduced. As a result, employers, workers, and retirees can all look to a brighter future, confident that defined benefit pension plans will continue to pay benefits as promised -- and that the PBGC will continue to protect them."

The 1989 annual report (the first to be signed by PBGC Executive Director James Lockhart) noted that "defined benefit plans are healthier than ever before. PBGC, however, remains exposed to the risk of some large underfunded pension plans ..and is determined to encourage better funding of pension plans and to make it more difficult for employers to terminate these underfunded plans ...As we continue to protect the pensions of workers and retirees, we look to the future with great confidence. This confidence is based on the soundness of the defined benefit pension plans, the recent legislative changes that reinforced the program, and the quality and dedication of the PBGC staff."

The 1990 report highlighted that the variable rate premium was increased to $19 per $1000 of unfunded vested benefits with a maximum per participant charge of $72 from $16 per $1000 of unfunded vested benefits with a maximum of $50 per participant for the new fiscal year. The year brought a significant increase in the PBGC deficit to $1.8 billion, with total liabilities of $5.1 billion and assets of $3.3 billion. The report pointed out for the first time that PBGC is exposed to about $20 billion to $30 billion in unfunded pensions. The annual report letter noted: "Our long-term goal is to operate as a service-oriented, financially solvent and professionally managed insurance company that serves as a safety net for a healthy, growing defined benefit pension system."

PBGC adopted a revised investment policy in 1990 that immediately reduced equity exposure from 50 percent to 33 percent, with subsequent decreases to 25 percent in 1991, and increased bond exposure from 43 percent to 59 percent, with further increases to 70 percent in 1991. This represented a significant shift from the investment policy urged upon the agency in the 1970's by ERISA author Senator Jacob Javits, who argued that an equity oriented emphasis would allow lower premiums over the long term. The new policy has the virtue of limiting swings in the PBGC deficit when interest rates change, but the negative of lowering the long term rate of return that might be achieved by a higher exposure to equities.

By the end of fiscal year 1990, the agency had not proposed any specific legislative language. The annual report noted: "PBGC could encourage better funding and reduce its exposure by seeking tougher funding rules, better pricing the cost of insuring underfunded plans, reducing insurance coverage by limiting guarantees, or increasing coinsurance by sharing losses. ..the keystone to a sound insurance program is legislative changes to strengthen the insurance fund."

The 1991 annual report carried the cover theme: "Strengthening the Pension Safety Net". The report stated: "It is becoming clear that we cannot achieve the goal of financially sound pension insurance without legislative changes." The year brought adverse court decisions and major terminations. The report states: "without further changes in the program the deficit could approach $18 billion by the end of the decade."

The 1991 report notes that insured single-employer plans have $1.3 trillion in assets and $900 billion in liabilities. It states that troubled plans, concentrated in steel, auto, tire and airline industries, are underfunded by $40 billion, with $13 billion in financially troubled companies. The report notes a $31 billion single employer plan liability with the following breakdown: "probable, $776 million; reasonably possible, $13 billion; remote, $18 billion."

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The report states: "PBGC represents a major portion of the government's hidden liabilities. The defined benefit pension plans insured by the PBGC comprise more than 20 percent of the nearly $4.5 trillion in federal insurance. Fortunately, the assets of the pension plans exceed liabilities by several hundred billion dollars. The worth of the sponsoring companies provides further security. Nevertheless, within a generally healthy defined benefit system, pockets of underfunded pensions can be found, primarily in unionized manufacturing and transportation sectors of the economy."

The report noted the bankruptcy reform legislation set forth in November 1991, and promised funding and guarantee reform proposals as well (included in the 1992 budget and introduced in legislative language in mid-1992). The annual report letter from PBGC Executive Director James Lockhart concludes: "Bankruptcy, funding, and guarantee reforms will ensure that PBGC can continue to support the defined benefit pension system."

This review of PBGC history, from the perspective of the 1976-1991 PBGC Annual Reports to Congress, suggests that the agency and the Congress have acted on a consistent basis to improve the program and the underlying statute. The reports make clear that the overall status of the system has remained strong, and due to past reforms has gotten stronger over time. The reports also state clearly that the vast majority of participants in defined benefit pension plans face no risk of accrued benefit loss. Reports from the General Accounting Office, the Congressional Budget Office, and the Joint Committee on Taxation, as well as others, make clear that there is not agreement yet among analysts upon the specific changes that should be made to the PBGC program. The history noted above indicates that the Congress will enact reforms to assure that crisis will not occur, and will enact additional reforms in the future if needed to insure stability of PBGC.

PBGC Premiums in Perspective

Some argue that significant increases in the minimum per participant premium that all plans must pay could lead well-funded plans to terminate their plans in exchange for a defined contribution plan or other possible employee benefits. There is no data to prove or disprove the hypothesis that the PBGC premium is close to the level where it would cause plans to terminate. However, examining the fees pension funds pay investment managers provides a reference point for the magnitude of the amount pension plans are willing to pay for outside services.

A recent survey shows the average annual fee paid by corporate plans to investment managers, relative to assets managed, was 44.0 basis points, or 0.44 percent (a basis point is equal to 0.01 percent) in 1990 (Greenwich Associates, 1991). According to EBRI tabulations, pension plans paying the minimum premium to PBGC pay a premium rate in the range of 1 basis point to 9 basis points for benefits at the annual guaranty maximum of $28,227 per participant (table 5). Underfunded pension plans paying the maximum premium pay from 3 basis points to 34 basis points for the same level of guarantee. Pension plans currently pay significantly less for their benefit guarantee than they pay to outside managers for pension fund investment services (from 40 basis points to 53 basis points). Only underfunded pension plans pay premiums close to average investment management fees for participants retiring at age 65, 40 years after plan termination.

Conclusion

Does a general taxpayer bailout reminiscent of the "S&L fiasco" loom on PBGC's horizon? There are currently sufficient liquid assets within the aggregate defined benefit system itself to cover the existing pockets of underfunding within individual plans. As shown in table 2, PBGC's current exposure represents a significant improvement for the agency; it currently stands at 40 percent of the average over 1978-1986. Therefore, unless legislative changes are made that cause employers to terminate well-funded defined benefit plans en-masse, thus denying PBGC a base of premium payers, a general taxpayer bailout would not be necessary.

This does not mean that the PBGC program does not have problems or that changes are not needed. Changes may be needed in order to reduce "abuse" and maintain participants' retirement security. As currently structured, the pension insurance system creates a financial incentive for employers to underfund their defined benefit plans. The vast majority of sponsors maintain well-funded plans despite this incentive, but some do not. Without changes, underfunding within the defined benefit system is likely to slowly improve if historical trends continue. Were more firms to begin taking advantage of the system, the financial picture could deteriorate.

It must be realized that general taxpayer interests lie as well in policymakers giving attention to the long-term tax consequences of public pension and retiree medical benefit promises that have not been advance funded. Private defined benefit plans are approximately $400 billion overfunded in the aggregate. PBGC has been the focus of attention during the past two years because of a present deficit of $2.5 billion and a potential shortfall of $30 billion–$40 billion in today's dollars over the next 30 years. This situation has been compared to the savings and loan crisis by some, yet during fiscal 1991 alone, combined unfunded liabilities of civilian and military pension plans increased by $52 billion. Actuarial deficiencies of federal retirement annuity programs consist of $864 billion in the Civil Service Retirement and Disability Fund and $702 billion in the Military Retirement System that future taxpayers will have to pay.

When considering any retirement income policy proposal, its potential effect on PBGC should be considered. For example, legislation, like OBRA '87, which limited the ability of well-funded plans to receive further deductible contributions, served to reduce the "PBGC safety net." In addition, the Revenue Act of 1978, which created 401(k) plans and allowed tax deductible employee contributions to profit-sharing and stock-bonus defined contribution plans but not to defined benefit plans, may well have indirectly harmed PBGC. Finally, the Senate version of the pending energy bill (H.R. 776) includes a provision that could have the United Mine Workers pension fund reallocate $210 million to pay retiree medical benefits and would create significant new liabilities for employers who had previously employed mine workers. This policy proposal has a direct impact on the affected employers and their ability to fund their own pension plans, and could therefore ultimately harm PBGC. This does not mean that it should not become law, but the decision to affect PBGC should be understood and explicit.

Clearly, if we are concerned about insuring the fiscal viability of PBGC, we should carefully think through the potential implications for PBGC of all policy proposals related to pensions and retiree health benefit plans. We should guard public trust, and we should continue to take actions that assure that promises made are promises kept. We should "tell the people" the truth; we should not "fear-monger."

## Table 1
## PBGC Financial Figures

($ in millions)

| | 1975 | 1976 | 1977 | 1978 | 1979 | 1980 | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Premium Income | $19 | $30 | $25 | $47 | $70 | $71 | $75 | $80 | $81 | $81 | $82 | $216 | $284 | $482 | $624 | $681 | $764 |
| Benefit Payments | 2 | 10 | 13 | 28 | 32 | 37 | 57 | 94 | 137 | 169 | 170 | 261 | 303 | 325 | 356 | 372 | 516 |
| Cash Flow (Premiums less Benefits) | 17 | 20 | 12 | 19 | 38 | 34 | 18 | -14 | -56 | -88 | -88 | -45 | -19 | 157 | 268 | 309 | 248 |
| Accumulated Deficit | n/a | n/a | 95 | 138 | 146 | 95 | 188 | 333 | 523 | 462 | 1,299 | 4,000 | 1,480 | 1,451 | 1,000 | 1,913 | 2,510 |
| Single-Employer Defined Benefit Assets[a] | 164 | 190 | 205 | 240 | 280 | 354 | 389 | 484 | 566 | 609 | 716 | 772 | 751 | 772 | n/a | n/a | n/a |

Source: Pension Benefit Guaranty Corporation, *Pension Benefit Guaranty Corporation Annual Report*, 1975–1991 (Washington, DC: Pension Benefit Guaranty Corporation, 1976-1992), and Department of Labor, Pension and Welfare Benefits Administration, *Trends in Pensions 1992*, John A. Turner and Daniel J. Beller, eds. (Washington, DC: U.S. Department of Labor, 1992).

[a]Includes single employer plans, plans of controlled groups of corporations and multiple-employer noncollectively bargained plans.

**Table 2**
**Exposure Levels Facing PBGC**
**(billions)**

| | Exposure ($ 1986) |
|---|---|
| 1978 | 116.7 |
| 1979 | 126.0 |
| 1980 | 73.0 |
| 1981 | 42.1 |
| 1982 | 39.5 |
| 1983 | 35.8 |
| 1984 | 25.9 |
| 1985 | 31.8 |
| 1986 | 49.2 |
| Average | 59.9 |
| 1990 | 25.6[a] |

Source Ippolito, Richard A. *The Economics of Pension Insurance*, Pension Research Council, Wharton School, University of Pennsylvania, 1989.

[a]In its 1991 Annual Report, PBGC reports exposure in the single employer system of $31 billion. This figure is discounted to 1986 price levels using the Consumer Price Index for All Urban Consumers (CPI-U).

Table 3
**Surveyed Firms' Funded Ratios, by Percentage of All Surveyed Pension Plans**

| Ratio of Accrued Benefits over Assets | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 0.00–0.49 | 17% | 8% | 6% | 4% | 3% | 2% | 3% | 2% | 3% | 2% | 1% |
| 0.50–0.74 | 17 | 13 | 13 | 8 | 6 | 5 | 3 | 4 | 4 | 2 | 4 |
| 0.75–0.99 | 21 | 24 | 17 | 15 | 13 | 14 | 10 | 11 | 11 | 11 | 10 |
| 1.00–1.24 | 23 | 26 | 25 | 20 | 21 | 17 | 16 | 16 | 18 | 20 | 25 |
| 1.25–1.49 | 11 | 12 | 18 | 21 | 19 | 21 | 20 | 20 | 19 | 20 | 22 |
| 1.50 or more | 11 | 17 | 21 | 32 | 38 | 41 | 48 | 47 | 45 | 45 | 38 |
| Number of Plans | 575 | 813 | 700 | 919 | 846 | 799 | 720 | 786 | 787 | 781 | 801 |

Source The Wyatt Company, *1991, 1990 and 1989 Survey of Actuarial Assumptions and Funding: Detailed Survey Results Pension Plans with 1,000 or More Active Participants* (Washington, DC: The Wyatt Company, 1989, 1990, and 1991).

Note Data from The Wyatt Company are based on a survey of pension plans covering 1,000 or more active employees. The 1990 survey contained single employer plans (90 percent) and multiemployer plans (10 percent).

**Table 4**
**Funding Ratios of Single Employer Defined Benefit Plans, 1977-1987**

| | **Funding Ratio** |
|---|---|
| 1977 | 85.0% |
| 1978 | 84.2 |
| 1979 | 91.0 |
| 1980 | 107.0 |
| 1981 | 106.9 |
| 1982 | 115.4 |
| 1983 | 124.7 |
| 1984 | 128.8 |
| 1985 | 136.3 |
| 1986 | 132.4 |
| 1987 | 128 6 |

Source U S Department of Labor, Pension and Welfare Benefits Administration, *Trends in Pensions*, John A. Turner and Daniel J. Beller, eds. (Washington, DC: U.S. Department of Labor, 1989).

Table 5
**Comparison of PBGC Premium and Investment Management Fee Basis Points**

| | Premium paid for PBGC Guarantee (expressed in basis points)[a] | |
|---|---|---|
| | Participant Retires in 1992 at age 65 | Participant Retires in 2032 at age 65[b] |
| Maximum premium | 2.73 | 33.85 |
| Minimum premium | 0.72 | 8.93 |

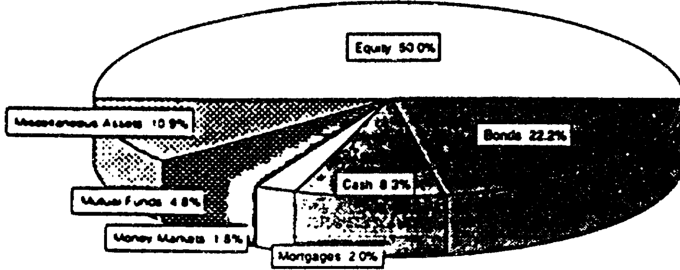
| | Average Annual Fees Paid to Outside Managers (expressed in basis points) |
|---|---|
| | 1990 |
| All Corporate Funds | 44.0 |
| Over $1 billion | 40.7 |
| $501-1,000 million | 40.6 |
| $251-500 million | 52.5 |
| $101-250 million | 43.2 |
| $50-100 million | 44.9 |
| Under $50 million | 43.7 |

Source Employee Benefit Research Institute tabulations; and Greenwich Associates, *Going Global, Good Going, Investment Management, 1991* (Greenwich, CT: Greenwich Associates, 1991).

[a]Based on the annuity purchase price of $9.36 per dollar of annual income starting at age 65, and the 1992 maximum monthly per participant benefit of $2352.27.

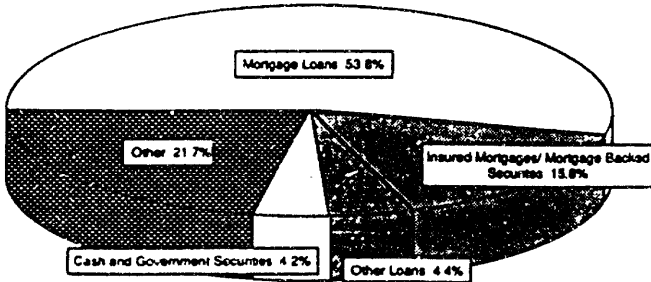
[b]Annuity prices for participants retiring at age 65 in 2032 are discounted at 6.50 percent, the immediate annuity interest rate for January, 1992. Annuity price is expressed in 1992 dollars.

**Chart 1**
**Asset Distribution in Private Trusteed Pension Plans, 1991**




[illegible] compilation from Board of Governors of the Federal Reserve System, *Flow of Funds Accounts, Financial Assets and* [illegible] *Fourth Quarter 1991* (Washington, DC: Board of Governors of the Federal Reserve System, 1992).
[illegible] The Department of Labor published asset allocation of single-employer defined benefit plans with 100 or more participants based on [illegible] forms. Asset allocation in 1987 was equity, 22.9 percent; bonds, 16.7 percent; cash, 11.3 percent; real estate, 0.8 percent; [illegible] insurance contracts, 22.4 percent; pooled funds, 20.4 percent; and other, 5.5 percent (John A. Turner and Daniel J. Beller, eds., [illegible] Washington, DC: U.S. Department of Labor, 1992).

**Chart 2**
**Asset Distribution of FSLIC Insured Savings Institutions**
**(as of December 31, 1988)**




Source: EBRI compilation from United States League of Savings Institutions, *Savings Institutions Sourcebook* (Washington, DC: [illegible] League of Savings Institutions, 1989).

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# PBGC Solvency: Balancing Social and Casualty Insurance Perspective

- Concern has been voiced regarding the financial viability of the Pension Benefit Guaranty Corporation (PBGC) and whether, as with the savings and loan episode, a general taxpayer bailout will be necessary. The focus is on PBGC's net worth deficit of $2.5 billion in the single-employer fund; an estimated $31 billion in underfunding within individual insured plans; and $13 billion which PBGC classifies as a "serious risk" because of financial problems of the sponsor company. The overall defined benefit pension system, however, presently has $1.3 trillion in assets to cover $900 billion in liabilities. Therefore, while there is $31 billion in underfunding within individual plans, there are also sufficient resources available within the defined benefit system itself—the payers of PBGC premiums—to cover this underfunding, making a general taxpayer bailout unnecessary.

- The urgency surrounding PBGC's current financial condition and what, if any, legislative changes are necessary varies with whether the corporation is viewed from a pure social insurance or a pure casualty insurance perspective, or a mix of the two. The social insurance perspective was the foundation of Title IV of ERISA, but legislative changes since 1974 have introduced casualty insurance provisions.

- The social insurance perspective maintains that PBGC should encourage the maintenance of defined benefit pension plans and function as a transfer agency in a social insurance system where the insured cross-subsidize one another in the event that a definable loss should occur. It argues for the insurance of all reasonable benefits that a sponsor is willing to provide for its employees.

- The casualty insurance perspective argues that the PBGC insurance scheme is flawed in its design and that these flaws are the cause of any existing deficit problems. The system is not designed on sound insurance principles even though it is supposed to be an insurance system protecting participants' pension benefits. The design creates financial incentives for undesirable sponsor behavior and allows the opportunity for underfunding of defined benefit pension plans.

- Four proposals have been introduced to change PBGC's current operation. The proposals, while maintaining PBGC's social insurance tradition, represent a further movement toward casualty insurance concepts. The proposals minimize PBGC's exposure by increasing recoveries and minimizing claims. The proposals maintain a social insurance program's objectives by attempting to alter the behavior of the participating plans and plan sponsors while maintaining cross subsidies and the present premium structure.

- A balance between social insurance and casualty insurance principles is most likely to sustain an overall strong and continuing defined benefit pension system, providing a continuing base of premium payers for the PBGC.

A monthly periodical from the EBRI Education and Research Fund devoted to expert evaluations of a single employee benefit issue

## ◆ Introduction

Since the enactment of the Employee Retirement Income Security Act (ERISA) in 1974, employer-sponsored pension plans have assumed an increasingly important role in providing retirement income security. The Pension Benefit Guaranty Corporation (PBGC) was created under ERISA to strengthen retirement security by guaranteeing some benefits for employer-sponsored defined benefit pension plan participants. **PBGC was designed according to social insurance principles to function primarily as a transfer agency. It was intended to transfer assets among plan sponsors to the extent necessary to provide pension benefits to participants of plans that terminate with insufficient assets to cover promised benefits.** The law has been amended several times since 1974 to improve the functioning of the program. While PBGC has always operated with a net deficit, large plan terminations in fiscal years 1991 and 1992 have increased PBGC's net deficit to $2.5 billion as of year-end 1991. Eastern Air Lines' pension plans terminated with an estimated $700 million in underfunding, and Pan American World Airways' plans terminated with about $900 million in underfunding.

PBGC's increasing deficit has caused some to question its ability to continue insuring pension benefits in the long term. **PBGC believes that incorporating traditional casualty insurance principals into the current insurance scheme would minimize its exposure and reduce incentives inherent in the current system for sponsors to transfer pension debt to PBGC.** PBGC and other proponents of the casualty insurance perspective believe that PBGC insurance system's current structure has led to the increasing net deficit. The casualty insurance perspective holds that PBGC would ideally operate with no net deficit. Some argue that, unless the system is altered, PBGC's deficit could ultimately lead to a general taxpayer bailout reminiscent of the Federal Savings and Loan Insurance Corporation (FSLIC) episode. **Proponents of the social insurance perspective argue that worker retirement security is PBGC's primary objective, and that PBGC's operation must take into account the defined benefit system's assets and the long-term payout stream represented by pension payments.** This *Issue Brief* examines the defined benefit system's funding status; ... policy questions surrounding PBGC; the appropriateness of the FSLIC analogy; the adequacy of PBGC's current system from both social and casualty insurance perspectives, and possible solutions.

## ◆ Retirement Security

*Pension Plans and Retirement Security*

**Pension plans, along with personal savings and government programs, seek to provide economic security to workers during their retirement years. In 1990, private pension benefit payments totaled $141.2 billion, or 30.9 percent of all retirement benefit payments made to retired workers and their families.** From 1975 to 1988, the total number of tax-qualified employer-sponsored defined benefit and defined contribution plans increased from 311,000 to 730,000, and gross participation (active workers, separated vested participants, survivors, and retirees) in such plans rose from 45 million to 78 million over the same period. The assets in these plans grew from $260 billion in 1975 to $1.5 trillion in 1988 (Turner and Beller, 1992). In 1990, 55.3 percent of all civilian, nonagricultural workers had an employer who sponsored a pension plan, while 42.9 percent participated in a plan. In 1990, among the ERISA work force (i.e., civilian, nonagricultural, wage and salary workers aged 21 and over with at least one year of tenure and who reported working at least 1,000 hours in the year), 66.4 percent had an employer who sponsored a pension plan, and 58.4 percent participated in a plan. According to the Advisory Council on Social Security, the percentage of elderly families receiving income from employer-sponsored pensions is expected to increase from the current 40 percent to 76 percent by 2018 (1991 Advisory Council on Social Security, 1991).

There are two types of employer-sponsored pension plans—defined benefit and defined contribution plans.

A defined benefit plan promises the participant a specified monthly benefit on retirement, the size of which typically depends on salary and/or years of service. The plan sponsor is responsible for making contributions to the plan's fund and investing pension assets so that the fund has sufficient assets to fulfill the promised benefits when they are due.[1] With a defined contribution plan, each participant has an account to which the employer and/or employee may contribute, depending on the specifics of the plan. A participant's pension benefit consists of the contributions and investment returns of these contributions. The employee bears the risk of poor investment returns and gains the reward of good returns.

There has been a general trend toward the establishment of defined contribution plans as opposed to defined benefit plans over the last 20 years. Some employers, particularly small ones, have eliminated their defined benefit plans. Many larger businesses have supplemented the defined benefit plan with a defined contribution plan and reduced the rate of benefit growth in the former. Cash balance plans, which are essentially a defined benefit/defined contribution hybrid, have also grown in popularity recently among large employers. These plans are legally defined benefit plans but combine features of both defined benefit and defined contribution plans.[2] Probably more important, the sectors of the economy in which traditional defined benefit plan coverage is most firmly established, including heavily unionized and older industrial sectors, have generally contracted or grown more slowly than other sectors in which plan diversity is greater. In 1975, there were 103,000 defined benefit plans with 33 million gross participants[3] and $186 billion in assets. In 1988, there were 146,000 such plans, down from the peak of 175,000 in 1982 and 1983. The number of gross participants has remained in the 40 million–41 million range since 1983, and plan assets amounted to $912 billion in 1988 (Turner and Beller, 1992). More recently, Employee Benefit Research Institute (EBRI) tabulations show single-employer defined benefit assets grew to $885 billion as of September 30, 1991. Over the same time period, the number of defined contribution plans increased from 208,000 to 584,000. The number of gross participants increased from 12 million to 37 million in 1986, and remained at that level in 1988. The amount of assets in such plans increased from $74 billion to $592 billion between 1975 and 1988 (Turner and Beller, 1992). EBRI research shows assets in these plans at $486 billion as of September 30, 1991.

**While PBGC has always operated with a net deficit, large plan terminations in fiscal years 1991 and 1992 have increased PBGC's net deficit to $2.5 billion as of year-end 1991.**

When requested, the Internal Revenue Service's (IRS) Office of Employee Plans and Exempt Organizations issues determination letters regarding the tax-favored status of private plans when they are established, amended, and terminated. Since IRS first compiled determination letter statistics by plan type in 1976, favorable letters have been issued for 220,000 new defined benefit plans and 131,000 defined benefit terminations. This represents a ratio of new to termi-

[1] A defined benefit plan can have individual accounts, as is the case with deferred annuities, although this is generally not the case.

[2] Because cash balance plans are legally defined benefit plans, they are included in the PBGC insurance system. In these plans, each participant has an account that is credited with a dollar amount that resembles an employer contribution, generally determined as a percentage of pay. Each participant's account is also credited with interest. The plan provides benefits in the form of a lump-sum distribution or annuity. On termination of employment, the amount of the lump-sum distribution is equal to the participant's vested account balance.

[3] Includes active, separated, vested, survivors, and retired. Not adjusted for double counting of individuals participating in more than one plan.

**nated plans of 1.7:1. At the same time, IRS issued favorable letters for 586,000 new defined contribution plans and 176,000 defined contribution terminations, for a ratio of new to terminated plans of 3.3:1. While IRS determination letter activity is at best an imperfect measure of plan starts and terminations, the trends in this measure are striking and consistent, providing additional (if not independently conclusive) evidence of a total system shift toward defined contribution plans. Most recently, in fiscal years 1989, 1990, and 1991, the number of favorable letters issued regarding defined benefit terminations exceeded the number issued in response to initial defined benefit applications by large margins.** However, the number of favorable letters issued regarding defined contribution terminations exceeded the number issued in response to initial defined contribution applications for the first time in fiscal 1990. The two were equal in fiscal 1991. This may indicate that the growth trend in defined contribution plans is flattening. The defined benefit system is stronger than it was in 1974. There are more plans that are better funded, and the move to cash balance plans, as opposed to a total shift to defined contribution plans, maintains the premium base with a plan design that is most likely to be well funded.

The growth of defined contribution plans, which arguably was encouraged by the creation of section 401(k) plans by the Revenue Act of 1978, has implications for retirement income security in that it serves to shift the burden of responsibility for retirement income adequacy planning from the employer to the employee. Also, the increasing incidence of preretirement lump-sum distributions in both defined contribution and defined benefit plans, in which workers receive their entire pension benefit from an employer in one payment, implies a further shift to individual responsibility for retirement security. It is the individual's decision whether to roll over a lump-sum distribution into an individual retirement account (IRA) or another retirement savings vehicle on job change. In general, an individual who does not roll over the distribution into an IRA or other tax-qualified vehicle must pay both regular income tax and an additional 10 percent penalty tax on the taxable portion of the amount received. In 1988, 8.5 million workers reported that they had received more than $48 billion in lump-sum distributions from prior jobs; 11 percent rolled the entire distribution into a tax-deferred retirement account, while 34 percent consumed[4] the entire amount (Piacentini, 1990). This raises the issue of the adequacy of individual planning for future retirement security.

*Legislation and Retirement Security*

Given that the primary social objective served by employer-sponsored pension plans is to promote economic security in retirement, legislation governing minimum plan funding has been enacted over time to try to ensure that pension promises are kept. These regulations govern only defined benefit plans; defined contribution plans are by nature always fully funded because a participant's benefit is his or her retirement account balance. **ERISA set minimum funding standards for defined benefit pension plans that were subsequently tightened by the Omnibus Budget Reconciliation Act of 1987 (OBRA '87). If a plan is underfunded,[5] regulations govern how quickly this underfunding must be amortized. While these minimum funding regulations serve to create a funding floor, they may not be enough to completely insure retirement security, particularly when an industry reaches a point at which its retiree population grows rapidly while the active work force shrinks.**

On the other hand, legislation has restricted sponsor funding of some defined benefit plans. The 150 percent full funding limit, also instituted by OBRA '87, established a stricter upper limit on tax-deductible contribu-

[4]Includes purchase of a car, education expenses, expenses incurred during a period of unemployment, and other uses.

[5]Whether or not a plan is underfunded is determined on a termination basis, i.e., whether the plan fund has assets sufficient to cover the present value of accrued benefits projected to the end of the current plan year.

tions to defined benefit plans than previously existed.[6] If a plan is more than 150 percent funded on a termination basis, any additional contributions to the fund are not tax deductible at that time. As a result, some sponsors have not made contributions to their plans since the effective date.

**TRA '86 reduced the longest allowable cliff vesting schedule for most private single-employer plans from 10 years to 5 years.**

There also is a limit on the benefits that defined benefit plans can provide to individual participants on a tax-deductible basis. The Tax Reform Act of 1986 (TRA '86) set the annual benefit dollar limit for individuals retiring at age 65 at $90,000, to be adjusted annually for changes in the Consumer Price Index (CPI). Because this is the maximum allowable annual benefit, a plan cannot fund on a tax-deductible basis a greater benefit level even though projected final salary may result in a retirement benefit that is greater than the current limit, and the limit adjusted with the CPI may eventually exceed the projected final benefit. (The 1992 limit is $112,221.)

Legislation enacted to increase retirement security has also served to increase sponsors' liability. TRA '86 reduced the longest allowable cliff vesting schedule for most private single-employer plans from 10 years to 5 years. Vesting schedules determine when plan participants gain a legal right to a pension benefit attributable to employer contributions or benefit accruals. Benefits that have been accrued but not vested are forfeited if a participant separates from service. With cliff vesting, the participant becomes entitled to all accrued benefits at one point in time. Reducing the allowable time prior to cliff vesting thereby increases small lump-sum distributions to short service workers but employers may respond by reducing the retirement benefit of long service workers (benefits cannot be reduced retroactively, however). If benefits of longer service workers are not reduced, faster vesting by necessity increases employers' liability. The move to five year vesting in defined benefit plans was estimated to have increased employers' required contributions by an average of 2.4 percent (Employee Benefit Research Institute, 1980).

[6]Congress has long imposed upper limits on the amount of plan contributions an employer can claim as a federal income tax deduction (IRC section 404).

*ERISA, PBGC, and Retirement Security*

ERISA, which was signed into law on September 2, 1974, brought about significant changes in the private pension system designed to improve the security of pension promises made by employers to employees. Congress was motivated by what it saw as potential lapses in the security of these pension promises. The intent of the law was to prevent the occurrence of such events as the Studebaker case in 1963, when the underfunded pension plan terminated and more than 4,000 participants lost some or all of their vested pension benefits. In an effort to improve retirement security, ERISA established new participation, vesting, funding, reporting, fiduciary, and disclosure requirements and established PBGC to provide termination insurance.

Under ERISA, PBGC has three principal missions: to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants,[7] to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under covered plans, and to maintain premiums at the lowest level consistent with fulfilling

[7]While ERISA refers to "voluntary private pension plans," the House Committee on Education and Labor in its Single-Employer Pension Plan Amendments Act Committee Report cites the "original purpose" of the title as "to encourage the establishment and maintenance of defined benefit plans while providing for the security of promised pension benefits."

**Table 1**
**PBGC Single-Employer Insurance Activity**

| Year | Benefits Paid ($ millions) | Participants Receiving Benefits | Plans Trusteed and Pending Trusteeship |
|---|---|---|---|
| 1991 | $ 614 | 140,000 | 1,644 |
| 1990 | 369 | 110,380 | 1,558 |
| 1989 | 353 | 106,770 | 1,501 |
| 1988 | 357 | 110,300 | 1,455 |
| 1987 | 300 | 109,700 | 1,376 |
| 1986 | 261 | 90,750 | 1,315 |
| 1985 | 170 | 74,800 | 1,191 |
| 1984 | 169 | 64,700 | 1,118 |
| 1983 | 137 | 55,400 | 1,021 |
| 1982 | 94 | 50,900 | 904 |

Source: Pension Benefit Guaranty Corporation, *Pension Benefit Guaranty Corporation Annual Report 1991: Strengthening the Pension Safety Net* (Washington, DC: Pension Benefit Guaranty Corporation, 1992)

its obligations. PBGC was created as an independent, wholly owned government corporation. Under current law, PBGC insures that vested participants in covered defined benefit plans receive some pension benefits in the event that plan sponsors are unable to meet these obligations due to financial distress, i.e., the sponsor liquidates or will be forced to liquidate if the plan is not terminated. (Originally, ERISA allowed sponsors to terminate underfunded plans at will and turn liabilities over to PBGC.) Tax-qualified defined benefit pension plans are required to participate in the program.[8] PBGC insures only defined benefit pension plans. Defined contribution plans are not included in the program since they are always fully funded.[9] The program is designed to be self-financing; PBGC revenue consists of premiums paid by plans sponsors, assets acquired from terminated plans, recoveries from sponsors of terminated plans, and earnings from invested assets.

PBGC operates two separate defined benefit insurance programs, one for single-employer plans and one for multiemployer plans. Multiemployer plans are maintained by employers pursuant to collectively bargained agreements and are jointly administered by a union and two or more employers. There are approximately 8.5 million participants in 2,100 multiemployer plans (Pension Benefit Guaranty Corporation, 1991). This discussion considers only the solvency of the single-employer program, as it is generally acknowledged that the multiemployer program is on sound financial footing as a result of major changes made to the original program by the Multiemployer Pension Plan Amendments Act (1980).

*How Does the Program Work?*

Pension plan terminations can be classified as either standard or underfunded; underfunded terminations can be further classified as distress, involuntary, or mandatory. PBGC insures benefits in the event of underfunded terminations. A standard termination occurs when a plan sponsor decides to terminate a defined benefit plan and buys annuities covering the participants' benefits. These include all accrued basic benefits, including those that were not vested at the time of termination, and could include other benefits as well. PBGC currently asserts that it is not authorized to insure the benefits once annuities are purchased.[10] Plan participants and PBGC must be notified of the

[8]Plans that are exempt from ERISA include government plans; church plans for which no election has been made for coverage under the Internal Revenue Code; plans of fraternal or similar organizations that receive no contributions from the participants' employers; plans maintained solely to comply with workers' compensation, unemployment compensation, or disability insurance laws; plans maintained outside the United States primarily for nonresident aliens; and professional employer plans with fewer than 25 active participants.

[9]Also, the PBGC does not insure guaranteed investment contracts through insurance companies for defined contribution plans or insured annuities for defined contribution plans. Furthermore, PBGC asserts that it is not responsible for insuring annuities purchased to cover participant benefits in standard terminations.

[10]Interest in such coverage has been raised by the bankruptcy of the Executive Life Insurance Company. PBGC maintains that it is not currently authorized to guarantee annuity contracts, while others maintain that it is. PBGC's position is that this is a state responsibility. Every state now has a guaranty fund for annuity contracts, but the guarantee limit varies from state to state.

sponsor's desire to terminate. The plan administrator and actuary submit actuarial certification of fund sufficiency to cover benefits owed. If the plan holds assets in excess of the benefits owed, those assets may be recovered by the employer. Such recoveries are known as "asset reversions." Total reversions peaked in 1985, when $6.1 billion was recovered, and have declined since that time. This decline has occurred largely because Congress has imposed a continually increasing excise tax on asset reversions, with the current tax rate ranging from 20 percent to 50 percent.[11] PBGC estimates only $100 million in total reversions for 1991. Most terminations are standard; in 1991, PBGC allowed 7,500 standard terminations, whereas it agreed to the distress or involuntary termination of 86 underfunded plans (in many cases, the actual termination date was designated to an earlier year.)

An underfunded termination involves the closing out of a defined benefit plan with insufficient assets to buy annuities covering the participants' benefits. Such a termination can be triggered by either the sponsoring employer (distress) or PBGC (involuntary or mandatory.) The employer can initiate a distress termination only in instances of bankruptcy liquidation or when PBGC agrees termination is necessary for the employer's survival. An underfunded plan may be terminated involuntarily by PBGC to protect PBGC's interests. PBGC is required to terminate plans with no assets to pay current benefits. After an underfunded termination, PBGC becomes the plan's trustee. This means that PBGC takes over plan records, determines benefit eligibility and amounts, and then pays the benefits. (Table 1 presents historical information on the amount of benefits paid and the number of participants receiving these benefits, in addition to the number of plans trusteed and pending trusteeship.) In addition, PBGC takes over any plan assets available and recovers amounts due from the employer or the employer's controlled group (the employer's parent corporation and any corporations of which the parent owns at least 80 percent). Actual trusteeship often occurs months after plan termination.

PBGC does not insure all pension benefits; rather, ERISA requires PBGC to insure basic vested benefits up to a specified maximum (benefits that vest because of plan termination are not covered). According to PBGC regulations (ERISA does not define basic) basic includes any vested benefits, including cost-of-living adjustments (COLAs) effective prior to plan termination and any death, survivor, or disability benefits owed or in payment status at termination. The maximum benefit was $27,000 per year in 1991 and has risen to $28,227 in 1992. Coverage for new benefit promises or plan amendments is currently phased in at the greater of $20 or 20 percent per year over five years. Although it has not done so, PBGC also has the option of insuring nonbasic benefits such as retiree medical insurance, health, and disability benefits not owed at termination and COLAs becoming effective after termination.

Plan sponsors are required to pay an annual per participant premium for this coverage. Premium rates are not

**Table 2**
**Single-Employer Premium Rates per Participant**

| Years | Flat Rate | Maximum Rate |
|---|---|---|
| 1974–1978 | $ 1 00 | |
| 1978–1986 | 2 60 | |
| 1986–1988 | 8 50 | |
| 1988–1991 | 16 00 | $50 00 |
| 1991– | 19 00 | 72 00 |

Source Pension Benefit Guaranty Corporation, *Pension Benefit Guaranty Corporation Annual Report 1991: Strengthening the Pension Safety Net* (Washington, DC Pension Benefit Guaranty Corporation, 1992).

[11]The excise tax on asset reversions was increased most recently from 15 percent to 20 percent by the 1991 federal budget if the employer (1) transfers a cushion equal to 25 percent of the excess assets to a qualified replacement plan, or (2) provides pro-rata benefit increases in the accrued benefits of qualified participants equal to at least 20 percent of the maximum reversion that could be received. The excise tax was increased to 50 percent if the employer does not maintain a qualified replacement plan or provide certain pro-rata increases.

set by PBGC but rather by Congress in the form of legislation that must be signed by the President. When the program was originally established in 1974, the premium was a flat rate of $1 per participant per plan. Currently there is a flat premium of $19 per participant and an additional variable premium of $9 per $1,000 of unfunded vested benefits, with an overall premium cap of $72 per participant (table 2). Furthermore, there are IRS regulations governing plan contributions to which sponsors must adhere. These specify the minimum deductible contributions that employers must make and maximum deductible contributions that employers may make to their plans and set a time frame within which underfunding must be amortized, i.e., liquidated by installment payments. An amortization period may be extended by the Secretary of Labor for up to 10 years if the employer shows the extension would provide adequate protection for participants and their beneficiaries. Such potential extensions are advantageous for cases in which a substantial risk exists that without them a pension plan would be terminated or greatly reduced employee benefit levels or reduced employee compensation would result.

The Treasury Department can also allow some flexibility for employers in meeting the minimum funding standards of the Internal Revenue Code (IRC). In circumstances in which an employer is experiencing temporary substantial business hardship and strict enforcement of the minimum funding standards would adversely aff[illegible] plan participants, the Secretary of the Treasury may waive payment of all or part of a plan's required contributions for a particular year. The law provides that no more than three waivers may be granted a plan within a consecutive 15-year period; and the amount waived, plus interest, must be amortized within five years. Before granting such a waiver, the Secretary must notify PBGC and consider its view regarding the waiver. PBGC is allowed 30 days to comment. The Secretary must consider PBGC's view and the written view of any employee organization representing plan participants. Such employee organizations must be notified by the employer when a waiver is requested. In cases in which more than $1 million is involved, the waiver can be conditioned on the tendering of security for the amount of the waiver.

Table 3
Funding Ratios of Single-Employer Defined Benefit Plans, 1977–1987

| Year | Funding Ratio |
|---|---|
| 1977 | 85.0% |
| 1978 | 84.2 |
| 1979 | 91.0 |
| 1980 | 107.0 |
| 1981 | 106.9 |
| 1982 | 115.4 |
| 1983 | 124.7 |
| 1984 | 128.8 |
| 1985 | 136.3 |
| 1986 | 132.4 |
| 1987 | 128.6 |

Source: John A. Turner and Daniel J. Beller, eds. *Trends in Pensions* (Washington, DC: U.S. Department of Labor, 1989).

## ◆ Status of the Defined Benefit System

### *How Well Funded Are Defined Benefit Pension Plans?*

PBGC's ability to meet its future obligations is dependent on the health of the private defined benefit system as a whole. PBGC reports that, in the aggregate, single-employer defined benefit plans have $1.3 trillion in assets to back $900 billion in benefit liabilities. Available evidence suggests that approximately 85 percent of pension plans (including both single-employer and multiemployer plans) are currently fully funded on a termination basis (The Wyatt Company, 1991).[12] A pension plan's funding status can

[12]Throughout this discussion, termination basis refers to basing funding ratios on benefits and assets accrued at the end of the plan year—the assumptions plans would use to calculate liabilities for standard terminations. Termination basis funding does not refer to PBGC's calculation of liabilities for underfunded terminations, using termination mortality and retirement age assumptions.

be measured by accrued benefit security ratios that are disclosed in plans' Form 5500 Schedule B, which are filed with the Department of Labor (DOL) and the IRS. The accrued benefit security ratio is the ratio of the market value of plan assets to the current liability for accrued benefits, assuming all plan participants are vested. Plans that are fully funded, as measured by an accrued benefit security ratio of 1 or greater, are likely to be eligible for a standard termination. Plans that are underfunded could represent possible future liabilities for PBGC should they terminate under distress circumstances.

Accrued benefit security ratios calculated by plans are not perfectly comparable to funding ratios calculated by PBGC, and as such do not reflect the total liability PBGC is likely to face in the event that an underfunded plan terminates. PBGC typically uses lower interest rate assumptions, called interest factors, that are based on current market prices for group annuities at representative ages and PBGC's mortality rates. PBGC uses lower retirement age assumptions than pension plans because participants of plans that experience underfunded terminations are likely to retire earlier and collect pensions over longer time periods if they are near retirement age. Accrued benefit security ratios assume that both the plan and the sponsor are on-going entities. Therefore, PBGC calculates higher liabilities and lower funding ratios than pension plans report in their annual reports. Furthermore, PBGC has found that the funding ratios of plans sponsored by financially stressed companies deteriorate rapidly prior to plan termination. Companies experiencing financial difficulties often attempt to reduce their pension plan costs by discontinuing contributions or selecting interest rate, retirement age, and mortality assumptions that, while falling within legal guidelines, result in lower minimum contributions. Plan sponsors also may reduce their operating costs by encouraging early retirement or closing plants, which often increases pension obligations through higher early retirement benefits or shutdown benefits. Such benefits are rarely funded in advance, and employees typically elect to receive early retirement benefits as soon as they are eligible if the benefits are available for a window of time.

**From 1977 to 1987, the funding status of single-employer defined benefit plans based on form 5500 tabulations significantly improved, rising from an average of 85 percent funded to 129 percent funded** on a termination basis (table 3) (Turner and Beller, 1989). Since 1980, defined benefit plans on average have been overfunded. The increase in funding ratios

**Table 4**
**Surveyed Firms' Funded Ratios, by Percentage of All Surveyed Pension Plans**

| Ratio of Accrued Benefits over Assets | 1981 | 1982 | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 | 1989 | 1990 | 1991 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 0 00–0 49 | 17% | 8% | 6% | 4% | 3% | 2% | 3% | 2% | 3% | 2% | 1% |
| 0 50–0 74 | 17 | 13 | 13 | 8 | 6 | 5 | 3 | 4 | 4 | 2 | 4 |
| 0 75–0 99 | 21 | 24 | 17 | 15 | 13 | 14 | 10 | 11 | 11 | 11 | 10 |
| 1 00–1 24 | 23 | 26 | 25 | 20 | 21 | 17 | 16 | 16 | 18 | 20 | 25 |
| 1 25–1 49 | 11 | 12 | 18 | 21 | 19 | 21 | 20 | 20 | 19 | 20 | 22 |
| 1 50 or more | 11 | 17 | 21 | 32 | 38 | 41 | 48 | 47 | 45 | 45 | 38 |
| Number of Plans | 575 | 813 | 700 | 919 | 846 | 799 | 720 | 786 | 787 | 781 | 801 |

Source The Wyatt Company, *Survey of Actuarial Assumptions and Funding: Detailed Survey Results Pension Plans with 1,000 or More Active Participants*, 1989, 1990 and 1991 (Washington, DC. The Wyatt Company, 1989, 1990, and 1991)
Note Data are based on a survey of pension plans covering 1,000 or more active employees. The 1990 survey contained single-employer plans (90 percent) and multiemployer plans (10 percent)

most likely reflects a combination of factors, including higher contribution rates needed to meet minimum funding standards, favorable investment returns on equity, and the use of higher interest rate assumptions to discount future benefits.

Funding ratios calculated directly from 5500 forms are not available beyond 1987. However, national surveys examining accrued benefit security ratios of pension plans with 1,000 or more active participants indicated that 85 percent of plans had assets equal to or exceeding 100 percent of liabilities in 1991, up from 45 percent in 1981, and 38 percent had assets in excess of 150 percent of liability for accrued benefits in 1991, up from 11 percent in 1981 (table 4) (The Wyatt Company, 1989, 1990, and 1991). The percentage of plans that were fully funded on a termination basis increased every year between 1981 and 1987 and leveled off between 1987 and 1991. Survey findings also show that the percentage of plans funded at less than one-half of the level required for termination-basis sufficiency declined from 17 percent in 1981 to 1 percent in 1991.

The survey compares funding ratios of defined benefit plans using three formulas to determine benefit levels: final average pay, career average pay, and flat benefit pay.[13] Final average pay formula based benefits are a percentage of the participant's final average earnings multiplied by the number of years of service. Career average pay formula based benefits are a percentage of the participant's average pay over the entire period of plan participation multiplied by the number of years of service. Flat benefit pay formula based benefits are the participant's years of service to the firm multiplied by a fixed dollar amount. In 1991 plans with benefits determined by final average pay were adequately funded to meet liabilities on a termination basis more often than other plan types. Ninety-one percent of these plans have accrued benefit security ratios greater than 1, compared with 86 percent of career average pay plans and 66 percent of flat benefit plans. Furthermore, 13 percent of flat benefit plans were less than 75 percent funded, compared with only 3 percent of final average pay plans and 4 percent of career average pay plans. **Flat benefit plans are typically negotiated plans in which the benefit levels are adjusted for inflation periodically through negotiation with unions as part of a new contract. These plans are underfunded more often than career average or final pay plans because the plans are not allowed to project increases in the fixed dollar amount when calculating their deductible contributions.** The increases in the fixed dollar amount may be funded only after the benefit improvements have been negotiated. Plans with benefits determined by career average and final average formulas must account for projected salary increases.

**PBGC estimates that companies experiencing financial troubles accounted for $13 billion of pension plan underfunding in 1991.**

**Despite the sound aggregate funding status of the defined benefit system, the net deficit of the single-employer insurance system can be significantly increased by single occurrences of distress terminations of large pension plans.** PBGC publishes an annual list of the top 50 underfunded pension plans. Underfunding by plans on this list increased from $14.2 billion in 1989 to $21.5 billion in 1990.[14] Three firms, General Motors, Chrysler, and LTV, were

[13]The benefit formulas of the plans surveyed were final average pay plans (61 percent), career average pay plans (15 percent), and flat dollar pay plans (24 percent)

[14]PBGC derived its top 50 list using a computerized data base created by Standard & Poor's Compustat Service Inc., which contains corporate annual reports for fiscal years ending in 1990. PBGC supplemented the data base with data from corporate annual reports for fiscal years ending in 1989 and earlier fiscal years and 1987 and 1988 5500 forms where available. PBGC also sent letters to plan sponsors containing their plans' funding information for comment prior to publication.

responsible for 64 percent of the top 50 companies' unfunded guaranteed liabilities in 1990. Funding ratios of plan sponsors listed ranged from 6 percent for LTV to 94 percent for National Steel, with an aggregate overall funding ratio of 75.5 percent. The underfunding of plans on the top 50 list is defined as unfunded guaranteed benefit liabilities (liabilities for nonguaranteed benefits are not included). Being on the top 50 list does not mean the plan is in danger of a distress termination. PBGC estimates that companies experiencing financial troubles accounted for $13 billion of pension plan underfunding in 1991, increasing from $8 billion in 1990.

**Seventy-five percent of the listed plans' underfunding is attributable to plan sponsors in the airline, steel, auto, and tire industries, most of which sponsor flat benefit plans.** Pension plan underfunding for an individual plan sponsor on the top 50 list ranged from $47 million to $7.1 billion. Some plan sponsors listed have pension plans that are overfunded, but because PBGC does not have legal recourse to the excess assets of overfunded plans, these assets are not included on the list.

**The reliability and accuracy of these underfunding estimates must be considered when evaluating the potential exposure companies on the top 50 list represent to PBGC.** PBGC currently does not have sufficient detailed information about plans' participants and benefit provisions to enable it to use more refined valuation methods.[15] Moreover, the information is acquired on an annual basis, and funding may deteriorate or improve before the next reporting period. In August 1991, after obtaining additional information and performing refined valuations, PBGC found that TWA's pension plans were underfunded for PBGC-insured benefits by $440 million rather than the $190 million in underfunding published on the top 50 list. PBGC's latest estimate of TWA's pension plan underfunding for benefit liabilities is $1.1 billion. The list also does not necessarily reflect all the pension plan underfunding that appears when a plan terminates. A study of 44 plans that terminated between 1986 and 1988 with unfunded liabilities of at least $1 million found that 42 of these plans had a hidden liability that accounted for 37 percent of the total claims (U.S. General Accounting Office, 1991). Hidden liabilities may result from unforeseen increases in liabilities and decreases in assets. Unforeseen liabilities may be caused by PBGC's use of actuarial assumptions that differ from those used by the plan or a higher than anticipated incidence of subsidized early retirement benefits. Plans' assets may be lower than expected on plan termination because plan sponsors in Chapter 7 or Chapter 11 bankruptcy may pay nonguaranteed benefits to retirees without making contributions to the plan, or the return on plan assets may be negative.

[15] See footnote 24 on page 16

**Underfunded plans sponsored by companies that are having financial difficulties represent the greatest risk to PBGC. The stock market's assessment of plan sponsors' financial health can be measured by examining the sponsors' equity rates of return. An analysis of rates of return on common stock of New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) firms with underfunded plans reveals that companies having the largest underfunding relative to the market value of their common stock also experienced the lowest rates of return on equity** (VanDerhei, 1992). Equity rates of return are shown over three holding periods for common stocks purchased in the beginning of 1986, 1981, and 1976 and held through the end of 1990. Plan sponsors were ranked into quintiles by their standardized underfunding on a termination basis. The common stock of the quintile of plans with the smallest underfunding ratio experienced a rate of return of 16.2 percent over a holding period from 1976 to 1990, while the return on equity of the most underfunded plans was 0.6 percent. The value weighted index for stocks traded on the NYSE and AMEX was 14.3 percent over the same period (table 5).

The market's relative perception of the financial health of firms traded on AMEX and NYSE that had

Table 5
**Rates of Return on Common Stock for New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) Firms Sponsoring Underfunded Plans in 1990**

| | Holding Period | | |
|---|---|---|---|
| Standardized Underfunding Quintile Ranking[a] | 1986–1990 | 1981–1990 | 1976–1990 |
| Least Underfunded | 8.55% | 12.29% | 16.16% |
| 2 | 8.83 | 13.41 | 14.57 |
| 3 | 7.06 | 10.81 | 14.98 |
| 4 | −0.91 | 4.34 | 10.63 |
| Most Underfunded | −13.85 | −4.24 | 0.59 |
| Value Weighted Index for NYSE, AMEX | 11.75% | 13.01% | 14.25% |
| | Excess Rate of Return Relative to NYSE, AMEX Index | | |
| Least Underfunded | −3.20% | −0.72% | 1.91% |
| 2 | −2.92 | 0.40 | 0.32 |
| 3 | −4.69 | −2.20 | 0.73 |
| 4 | −12.66 | −8.67 | −3.62 |
| Most Underfunded | −25.60 | −17.25 | −13.66 |

Source: VanDerhei, Jack L., "Estimating the Magnitude of PBGC's Exposure for Single-Employer Pension Plans," Working Paper (Philadelphia, PA: Temple University, 1992).
[a]Underfunding measured by FASB '87 disclosures for underfunded plans in 1990. Standardized underfunding is equal to the accumulated benefit obligation minus the market value of assets divided by the market value of the sponsor's common stock in 1990.

underfunded plans in 1990 is declining over time.[16] The common stock of each quintile of underfunded plans experienced a lower rate of return net of the value weighted index for NYSE and AMEX if the stock was purchased later. The common stock of the three quintiles of plans with the smallest underfunding ratios experienced positive net rates of return for the holding period from 1976 to 1990. However, the net rate of return on equity experienced by these three quintiles of plan sponsors decreased to negative values for the holding period from 1986 to 1990. The net rate of return on equity for the two quintiles of plans with the largest underfunding ratios was negative in each holding period. The net rate of return on common stock of plan sponsors in the fourth quintile reached a low of −12.7 percent, and the rate of return on equity of plan sponsors in the fifth quintile reached a low of −25.6 percent for the holding period from 1986 to 1990.

[16]The net rate of return experienced by the common stock of the quintile of firms with the second smallest underfunding ratios was higher for stocks purchased in 1981 than in 1976, but was lowest for stocks purchased in 1986.

*The Nature of Defined Benefit Plans*

Defined benefit plans, by their very nature, have unfunded liabilities at plan establishment and additional unfunded liabilities with subsequent benefit increases. A newly established defined benefit plan allows benefits to be paid immediately to older workers who retire based on past service credits to be funded over time by future contributions. Furthermore, improvement in plan provisions that improve participants' retirement security also increase plan liabilities, thereby reducing a plan's funding status.

COLAs, for example, increase the benefit liabilities of pension plans. During periods of inflation, retired persons living on fixed pensions have been affected by the dollar's declining value. Employers are able to offer ad-hoc cost-of-living adjustments under their plans or provide periodic benefit increases. Similarly, each time the benefits of Social Security beneficiaries, military retirees, or other government retirees are adjusted with inflation increases, the programs' unfunded liabilities increase significantly.

Prior to ERISA, private pension plans were permitted to operate on a pay-as-you-go basis. Public pension plans can still operate in this manner under federal law. Under such an arrangement, retirement benefits are paid directly from current operating revenues, as are wages and salaries. As companies offering pension plans matured, and the number of retirees increased relative to the number of active employees, retirement payments represented an increasingly large share of companies' total operating costs, making it more difficult for these companies to maintain their pension promises. When ERISA was drafted, the creators were concerned that pay-as-you-go pension plans jeopardized participants' retirement income security and required that defined benefit pension plans operate on a funded basis. Plans are therefore required to set aside funds for the purpose of paying benefits as they become due. However, in recognition of the nature of defined benefit plans, the legislators of ERISA did not require that plans be fully funded on an ongoing basis, only that minimum funding standards be met.

**ERISA's minimum funding standards divide pension costs into two parts: normal costs and supplemental costs.** Normal costs are contributions equal to the benefit liability accrued during the plan year arising from normal plan operation, calculated using that year's actuarial assumptions and administrative expenses charged to the plan for the year. Supplemental costs are costs associated with supplemental liabilities, which include liabilities associated with changes in actuarial assumptions, experience varying from actuarial expectations, retroactive benefit increases, and granting of service credit prior to plan establishment (if such credit is given). ERISA originally allowed plan sponsors to amortize some supplemental costs over long time periods, regardless of their funding status.[17] OBRA '87 required plans that are underfunded on a termination basis to make an additional annual contribution for liabilities incurred after 1988, based on the plan's underfunding. For those liabilities already incurred at the beginning of the 1988 plan year, the amortization period was decreased from 30 years to 18 years. The additional contribution and decreased amortization period was expected to lead to the improved funding status of plans relative to ERISA requirements.

**Public plans are not subject to ERISA's minimum funding standards, and consequently have a significantly lower funding status than private pension plans.** However, the Federal Employees Retirement System (FERS) and the Military Retirement System (MRS) are required to contribute (through employee and/or employer contributions) an amount equal to the actuarially determined cost of retirement annuities. MRS has an unfunded accrued liability of $533 billion, and FERS has an unfunded accrued liability of $6 billion. The unfunded accrued liability is defined as the actuarial present value of future benefits and administrative expenses less the assets currently in the fund and the present value of future normal cost contributions.[18] Therefore, the unfunded accrued liability is a net, not gross, liability because it is net of future normal cost contributions. The Civil Service Retirement System (CSRS) has an unfunded accrued liability of $660 billion. CSRS has looser funding standards than FERS and MRS. Employer and employee contributions to CSRS fund cover only about 50 percent of the pension plan's accruing costs. The Treasury pays approximately $19 billion annually to the Civil Service Retirement and Disability Trust Fund in an effort to limit the growth of CSRS' unfunded

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[17]See page 29 for details on the amortization periods required under ERISA

[18]In the case of the CSRS and FERS, future military service deposits are also deducted.

liability. Smaller federal retirement programs that operate on a pay-as-you-go basis include the Coast Guard, the National Oceanic and Atmospheric Administration, and the Public Health Service Commissioned Officers. These programs have a combined unfunded accrued liability of $21 billion (Executive Office of the President, 1992).

**Both private and public defined benefit pension plans play a significant role in providing retirement security to U.S. workers. While there is underfunding within both systems, the federal pension system has a significantly larger unfunded liability.**

**The major federal government pension plans have a total unfunded accrued liability, net of future net contributions, of $1.22 trillion. Private defined benefit plans, according to PBGC, are overfunded in the aggregate by as much as $400 billion.** This overfunding does not account for future contributions individual plans will contribute in the future. However, PBGC still acts as a "transfer" agency as the funding of private plans varies by industry, with single-employer pension plans of steel, automobile, tire, and airline industries having an aggregate underfunding of about $31 billion, and plans sponsored by financially troubled companies having $13 billion in underfunding.

**Both private and public defined benefit pension plans play a significant role in providing retirement security to U.S. workers. While there is underfunding within both systems, the federal pension system has a significantly larger unfunded liability.** As noted above, the unfunded liability of federal government pension programs is growing nearly as much each year as the total aggregate underfunding of PBGC guaranteed plans. When considering the possibility of a general taxpayer bailout of these federal pension systems, it must be realized that they are sponsored by the U.S. government. The primary means the government has to reduce public plan underfunding is through the use of tax revenue. In contrast, PBGC must utilize the assets in the private defined benefit system by charging plan sponsors premiums. PBGC has authority to borrow up to $100 million from the Treasury,[19] but ERISA explicitly does not provide for the full faith and credit of the government to stand behind PBGC: "The United States is not liable for any obligation or liability incurred by the corporation."[20]

## ◆ Status of PBGC

### *Distress Terminations*

**Two of the largest underfunded plan terminations in PBGC's history occurred in fiscal year 1991, heightening concern over PBGC's financial solvency. In October 1990, seven Eastern Air Lines' pension plans, which were underfunded by $700 million, were terminated. PBGC terminated three of Pan American World Airways' plans with about $900 million underfunding in July and December of 1991 to prevent further losses to PBGC.**

PBGC negotiated with Eastern Air Lines' parent company, Continental Air Holdings Inc., to provide full funding to its subsidiary's seven terminated pension plans. After this settlement was agreed upon, Continental filed for bankruptcy in December 1990, nullifying the agreement. PBGC still expects to recover a portion of Eastern's pension liability. It has filed $752 million in claims against Continental for liability connected with Eastern's plans and $183 million for Continental's own underfunded plans. PBGC filed claims totaling $1.3 billion for all three plans' underfunding and missed contributions but expects recoveries will account for a very small portion of the underfunding.

[19]ERISA Sec. 4005(c).
[20]ERISA Sec. 4002(g)(2).

Table 6
Loss Experience from Single-Employer Plans

| Year of Termination | Number of Plans | Benefit Liabilities ($ millions) | Trust Plan Assets ($ millions) | Recoveries from Employers ($ millions) | Net Losses ($ millions) |
|---|---|---|---|---|---|
| 1975–1980 | 686 | $ 570 | $ 227 | $ 65 | $ 277 |
| 1981–1985 | 606 | 1,358 | 479 | 161 | 719 |
| 1986–1991 | 352 | 4,839 | 2,033 | 361 | 2,445 |
| Total | 1,644 | 6,768 | 2,739 | 587 | 3,442 |
| Probable | 15 | 1,552 | 595 | 181 | 776 |

Source: Pension Benefit Guaranty Corporation, *Pension Benefit Guaranty Corporation Annual Report 1991: Strengthening the Pension Safety Net* (Washington, DC Pension Benefit Guaranty Corporation, 1992)

PBGC's loss from completed terminations totaled $1.4 billion in 1991. PBGC reported an additional probable loss of $776 million. The Blaw Knox pension plan, which was underfunded by $81.6 million, terminated on February 29, 1992. On March 19, 1992, PBGC terminated CF&I's pension plans with $270 million in unfunded liabilities. An additional $1.8 billion of underfunded pensions are sponsored by companies in Chapter 11, including Trans World Airlines, Continental Airlines, Jesup Group, and Western Union/New Valley Corporation, which are currently in negotiation with PBGC.

PBGC reached a tentative agreement with LTV Steel for LTV to contribute an initial payment of approximately $1.5 billion to its three plans that are underfunded by an estimated $3 billion and to fund the remaining liabilities over the next 30 years. LTV Corporation filed for Chapter 11 protection in 1986 and stopped payments to three of its plans. PBGC assumed responsibility for these plans plus an additional LTV plan that is still terminated. While in bankruptcy, LTV negotiated with its employees to provide follow-on plans offering potentially the same level of benefits offered under the old plans.[21] In September 1987, PBGC returned the responsibility of funding the plans to LTV on the grounds that LTV's establishment of follow-on plans was an abuse of the pension guaranty system. LTV opposed the restoration of the pension plans and won the case in lower level courts. In June 1990, PBGC won the case in the Supreme Court, requiring LTV to fund its plans.

[21]The plans were replaced with defined contribution plans.

While the frequency of underfunded single-employer plan terminations has declined in recent years, PBGC's net losses resulting from these plans have increased. **From 1986 to 1991, 352 plans terminated with insufficient assets to cover their liabilities, compared with 606 plans terminating between 1981 and 1985 (table 6). Net losses incurred by PBGC increased by a factor of three and one-half over the same period, with net losses of $2.4 billion from 1986 to 1991, increasing from $719 million during the prior four-year period.** As of year end 1991, PBGC had trusteed 1,644 single-employer funds with total net losses of $3.4 billion. Benefit liabilities for these plans were close to $7 billion, with nearly one-half of these liabilities, or

Table 7
Trends in Losses from Single-Employer Plans

| Year of Termination | Percentage of Funding Level | Recoveries as a Percentage of Net Underfunding | Average Loss per Terminated Plan ($ millions) |
|---|---|---|---|
| 1975–1980 | 40% | 19% | $0.4 |
| 1981–1985 | 35 | 18 | 1.2 |
| 1986–1991 | 42 | 13 | 6.9 |

Source: Pension Benefit Guaranty Corporation, *Pension Benefit Guaranty Corporation Annual Report 1991. Strengthening the Pension Safety Net* (Washington, DC Pension Benefit Guaranty Corporation, 1992).

$3.3 billion, covered by plans' assets and employers' liabilities. The remaining $3.4 billion represents claims paid by or pending against PBGC. Twenty-eight plans terminated in 1991, accounting for 25 percent of losses incurred to date, yet representing only 2 percent of plan terminations.

While the funding status of plans has increased in recent years, PBGC's recoveries as a percentage of net underfunding has declined, resulting in higher net losses. Between 1986 and 1991, the average funding level of terminated plans was 42 percent, increasing from an average funding level of 35 percent between 1981 and 1985 (table 7). PBGC's recoveries as a percentage of net underfunding declined from 18 percent between 1981 and 1985 to 13 percent between 1986 and 1991. The average net losses per terminated plan subsequently increased from $1.2 million between 1981 and 1985 to $6.9 million between 1986 and 1991. The trends in underfunded plan terminations have resulted in PBGC's increasing net deficit over time. The deficit stood at $2.5 billion by the end of fiscal year-end 1991 (table 8).[22]

*What is PBGC's Current Financial Status?*

**Some concern has been voiced regarding PBGC's financial viability. Such concern arises from PBGC's net worth deficit of $2.5 billion in the single-employer fund and the estimated $31 billion in underfunding within individual pension plans, $13 billion of which is considered by PBGC to pose a serious risk because of sponsors' financial trouble. This section examines what these figures imply for PBGC solvency.**

PBGC's single-employer fund's total assets of $5.7 billion are outweighed by $8.2 billion in total liabilities, resulting in a net deficit.[23] The present value of future benefits owed,[24] at $7.8 billion, accounts for more than 95 percent of total liabilities. The remainder is the present value of nonrecoverable future financial assistance, unearned premiums, and accounts payable. Future ben... are made up of trusteed plans and plans pending trusteeship ($7.1 billion) plus net claims for probable terminations ($0.8 billion).[25]

**The $2.5 billion deficit does not imply that PBGC has inadequate assets to cover payment obligations due in the immediate future. When a plan terminates,**

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[22]The 1986 net deficit of $3.8 billion represents the historic high. This was due to the termination of LTV's pension plans.

[23]PBGC's financial statements have "limited reliability" according to the U.S. General Accounting Office (GAO). GAO has not been able to complete an audit of PBGC's financial statements mainly because of difficulty in estimating PBGC's liabilities for future benefits. PBGC plans on having this difficulty resolved so that financial statements will be auditable by the end of fiscal year 1992.

[24]To estimate future liabilities, PBGC uses one of three different techniques, depending on the stage of the termination process in which a plan is located. For terminated plans for which the PBGC has complete individual participant as well as plan data, the present value of future benefit liabilities is calculated for each participant using special software, the Individual Participant Valuation (IPV) system. Two alternative techniques are used when the detailed data required by IPV are not yet automated (a process that can take from three to five years); these techniques are considered less precise because liabilities are estimated at the plan level rather than at the individual participant level. The second technique takes a plan-level liability as of the actual termination date and brings it forward to the date of the financial statement (this method is used when the IPV data are accumulated but not yet entered in the data base.) The third, and least precise technique is used for terminated plans for which the detailed data are not yet accumulated and for plans that PBGC thinks will terminate underfunded in the future. This technique uses pretermination, plan-level data provided by the plan itself to estimate liability as of the (projected) termination date. For terminated plans, this liability is then brought forward to the date of the financial statements.

[25]A probable termination is one that the PBGC considers highly likely to occur; this judgment is based on criteria given in Financial Accounting Standards Board (FASB) Statement No. 5—Accounting for Contingencies. The plans involved have not begun the termination process, but rather the sponsor is in such dire financial straits that PBGC considers the termination likely, although not necessarily imminent. PBGC books the net liability for these probable terminations on today's financial statements since these are obligations for which it is likely to be responsible in the future, and thus it wants to recognize them now. Some actually move off the probable list and others remain on it for years. The reported claims figure is net because it is the present value of future benefits for which PBGC is liable less estimated plan assets available and recoveries from employers.

**Table 8**
**Single-Employer Fund Assets, Benefit Liabilities, and Net Deficits**

| Year | Total Assets | Present Value of Future Benefits | Accumulated Deficit |
|---|---|---|---|
| | | ($ millions) | |
| 1991 | $ 5,664 | $ 7,845 | $ 2,510 |
| 1990 | 3,111 | 4,790 | 1,913 |
| 1989 | 3,059 | 3,984 | 1,124 |
| 1988 | 2,422 | 3,806 | 1,543 |
| 1987 | 2,163 | 3,629 | 1,549 |
| 1986 | 1,740 | 5,492 | 3,826 |
| 1985 | 1,155 | 2,447 | 1,325 |
| 1984 | 1,063 | 1,497 | 462 |
| 1983 | 1,085 | 1,570 | 523 |
| 1982 | 773 | 1,076 | 333 |

Source: Pension Benefit Guaranty Corporation, *Pension Benefit Guaranty Corporation Annual Report 1991: Strengthening the Pension Safety Net* (Washington, DC: Pension Benefit Guaranty Corporation, 1992).

PBGC inherits an obligation to make a stream of payments to plan retirees over a period of years into the future (20 years, 40 years, even more than 60 years) as opposed to one large lump-sum payment on termination. The present value of these future payments, currently $7.8 billion, is booked today as a liability. However, it is not necessary for PBGC to have assets adequate to cover these liabilities now because payments are not currently due. A deficit does not necessarily indicate danger of imminent insolvency, but it does indicate that assets must eventually be increased to meet future obligations that are known today.

In addition, PBGC is likely to incur liabilities not shown on current financial statements resulting from future distress terminations. PBGC keeps track of underfunded plans where it considers distress terminations to be a reasonable possibility, but it does not include the net underfunding in these plans on current financial statements as it does with probable terminations. In such plans, a distress termination is not as likely as with probable terminations, but PBGC considers such an occurrence a reasonable possibility in the future due to the sponsor's financial problems.[26] PBGC currently estimates that there exists $13 billion of underfunding in the single-employer defined benefit system that poses a reasonably possible risk to the corporation. This is not a liability from past terminations or probable terminations but rather a potential liability for terminations PBGC believes may happen in the future.

On the other side of the ledger, PBGC will be receiving revenue in future periods from premiums and investment earnings. While such receipts may not result in adequate assets to cover all PBGC liabilities for unfunded pension benefits, they are nonetheless likely to be significant and should be included in any discussion of PBGC solvency. According to PBGC, current premium receipts[27] total $790 million per year, while interest and dividend receipts currently approximate $305 million per year. Future income is difficult to predict; premium income depends on the size of the defined benefit system as well as the regulations governing premium rates, while investment earnings depend on the net flow of assets each period as well as the rate of return earned. To get some idea of the funds involved, however, consider that the present value of receiving $790 million each year for the next 20 years (valued with a discount rate of 6.25 percent[28]) is $8.9 billion. Such receipts are likely to be available to help cover future pension liability payments from today's terminated plans and also to cover payments for obligations that may arise in the future (the potential $13 billion in unfunded benefits discussed above and/or other future liabilities that may arise). Consideration of

[26]Criteria are set by FASB 5.

[27]PBGC's premiums were raised most recently in 1991. (The flat rate was increased from $16 to $19 per plan participant, and the overall cap on premiums for underfunded plans was increased to $72 from $50). It can be argued that this latest increase has not been in effect long enough to have had a noticeable effect on the deficit.

[28]In the 1991 PBGC annual report, the present value of future benefits is valued at 6.75 percent for immediate annuities, and with lower rates for deferred annuities, giving a composite rate of 6.25 percent that was also used for projected investment results.

future income receipts in addition to future liabilities provides additional insight into PBGC's solvency.

**On a pure cash flow basis, PBGC actually ran a surplus in 1991, as receipts from operating activities exceeded disbursements from operating activities. Premium receipts of $786 million in addition to interest and dividends of $305 million resulted in $1.1 billion in total receipts.** Operating activity disbursements totaled $660 million and were composed primarily of benefit payments at $514 million, administrative expenses at $63 million, and interest purchased at $81 million. This resulted in a net cash flow surplus from operating activities of $431 million in 1991. PBGC anticipates positive cash flows again in 1992 and does not foresee any near term problems in meeting its obligations. According to PBGC, "Although cash-flow could turn negative as early as three years in the pessimistic forecast,[29] the fund has ample assets to pay its liabilities (benefit payments) for a considerable period of time" (Pension Benefit Guaranty Corporation, 1991).

## ◆ Is It Valid to Compare PBGC and Savings and Loan Problems?

**Given the manner in which the federal government's guarantees to pension participants have been implemented, it is not surprising that PBGC is inevitably compared with other incentive-incompatible guarantee funds, including the now defunct Federal Savings and Loan Insurance Corporation (FSLIC).** The latter agency had insured deposits in savings and loans' (S&L) accounts up to a limit of $100,000. In September 1990, the final cost of the S&L bailout was estimated at $600 billion.

[29]PBGC developed three 10-year forecasts of [illegible] expected status under different loss scenarios. The pessimistic scenario assumes that termination of the plans with the $13 b[illegible] of underfunding that pose a reasonably possible [illegible] occurs over the next 10 years in addition to a modest number of lesser terminations each year.

The academic literature (for example, Kane, 1989) is replete with examples of how defective systems encourage voluntary risk taking by clients and by managers and politicians responsible for administering their funds. Recently, similar allegations have been directed toward PBGC (Bodie, 1992).

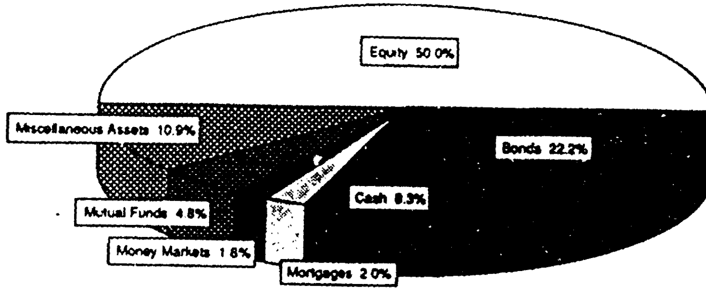
Before analyzing the propriety of these comparisons, it is useful to briefly review the history of the S&L insurance scheme to see whether the problems of an industry-specific guarantee scheme are likely to be applicable to PBGC.

### *History*

According to M. Danny Wall, former chairman of the Federal Home Loan Bank Board (the predecessor to the Resolution Trust Company), the major problems with the S&L guarantees started in 1980, when the interest rate legislation was passed deregulating the liabilities (i.e., deposits) but not the assets (Wall, 1991). This was soon followed by federal tax incentives that were put into place in 1981 and 1982 that allegedly caused real estate projects to be undertaken that were not economically viable. During this time, the federal government had tightened the money supply, causing government bond interest rates to rise, which forced S&Ls to find higher short term rates through junk bonds. In 1986, oil plunged to $10 a barrel, and the income tax incentives were taken away with no grandfather provisions. A year later the stock market plummeted, and then in 1989 the Financial Institution's Reform Recovery and Enforcement Act (FIRREA) imposed higher capital standards on the thrift industry, thereby automatically causing a situation in which more institutions had to be seized by the government than could have been projected.

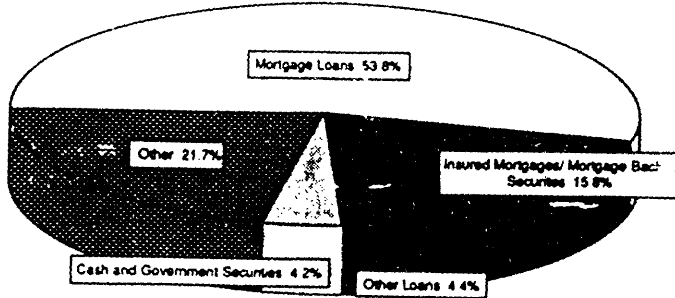
A detailed analysis of the impact of each of these events on the guarantee scheme is beyond the scope of this discussion. However, with the exception of the 1987 stock market decline, these events would not have a major impact on an insurer with exposures diversified across all industries.

Chart 1
**Asset Distribution in Private Trusteed Pension Plans, 1991**




Source: EBRI compilation from Board of Governors of the Federal Reserve System, *Flow of Funds Accounts, Financial Assets and Liabilities, Fourth Quarter 1991* (Washington, DC: Board of Governors of the Federal Reserve System, 1992).
Note. The Department of Labor published asset allocation of single-employer defined benefit plans with 100 or more participants based on 1987 5500 forms. Asset allocation in 1987 was equity, 22.9 percent, bonds, 18.7 percent; cash, 11.3 percent, real estate, 0.8 percent, unallocated insurance contracts, 22.4 percent, pooled funds, 20.4 percent; and other, 3.5 percent (John A. Turner and Daniel J. Beller, eds., *Trends in Pensions*, Washington, DC: U.S. Department of Labor, 1992).

Chart 2
**Asset Distribution of FSLIC Insured Savings Institutions (as of December 31, 1988)**




Source: EBRI compilation from United States League of Savings Institutions, *Savings Institutions Sourcebook* (Washington, DC: United States League of Savings Institutions, 1989).

### *Are Comparisons Valid?*

In addition to the marked differences in the historical evolution between the problems of the S&L guarantees described above and those of PBGC described earlier, there are several additional important distinctions that need to be drawn.

*Investments*—**Whereas the people involved with the S&L crisis are alleged to have taken excessive investment risks (Lockhart, 1990), that has not happened with pension plans.** Whether the risks were indeed excessive, it is true that as of the end of 1988, FSLIC-insured savings institutions were much more concentrated in securities sensitive to downturns in the real estate market than defined benefit pension plans are today (charts 1 and 2). In fact, defined benefit pension plan assets are invested in a variety of investments, which means that even if PBGC cash flow problems deteriorated to the point where there was a need to sell off a large percentage of the trusteed assets there would be less need for realizing depressed asset values through liquidation then in the case of S&L insurance.

*Growth of Benefit Guarantees*—As indicated earlier, **S&Ls were given new investment powers in 1980, and many marginally capitalized institutions believed they could grow their way out of their problems. The rapid growth of agency-guaranteed liabilities does not appear to be the case with PBGC.** In fact, OBRA '87 introduced a potentially chilling effect on the future growth of uninsured benefits by requiring that if a plan adopts an amendment that increases current liability and the funded current liability percentage of the plan is less than 60 percent in the year in which the amendment takes effect, the contributing sponsor and members of the controlled group must provide security (e.g., a bond) to the plan. The amount of the security required is the excess over $10 million of the lesser of:

- the amount of additional plan assets that would be necessary to increase the funded current liability percentage under the plan to 60 percent, including the amount of the unfunded current liability under the plan attributable to the plan amendment, or
- the amount of the increase in current liability under the plan attributable to the plan amendment.

It is important to note that the grandfathering of the unamortized portion of the pre-1987 plan liability substantially decreased the short-run impact of this provision.

*Alleged Fraud*—According to Wall, the best judgments are that fraud and mismanagement existed in about 60 percent of the S&L failures and that they contributed to the failure or the insolvency of the S&L in perhaps about 25 percent of the cases. Evidence of such activity among single-employer pension plans is almost nonexistent.

*Loan Participation*—**Another problem that arose in the S&L sector that has no equivalent situation in the PBGC exposure base is that of loan participation.** As S&Ls found themselves constrained by limits on the amount they could lend to a single borrower, they began to sell off pieces of the loan to other institutions. Unfortunately, many of these secondary lenders relied on the underwriting capacities of the originating S&L. Although a large proportion of defined benefit plan assets are placed in bank pooled funds and similar investments where investment results are shared, this strategy is fundamentally different from loan participations that have been characterized as "a transfer of risk from a party who lacks courage to one who lacks knowledge" (Koeppel, 1991).

*Accounting Issues*—From 1981 to 1987 S&Ls insured by FSLIC were permitted to use accounting options that were not in agreement with generally accepted accounting principles (GAAP) and have been described as "self-deceptive accounting procedures" by the executive director of PBGC (Lockhart, 1990). In contrast, **pension plans must adhere to very conservative accounting measures under FAS 35 (Allen et al., 1988) while the vast majority of the large plan sponsors follow GAAP procedures, at least for those events defining their solvency and net worth determinations.**

*Regulation*—As mentioned earlier, after deregulation S&Ls turned to areas in which they had little expertise (commercial real estate). It has been alleged that auditors did not properly supervise the industry. Although similar types of allegations have surfaced regarding pension plans, it is important to note that this only concerns the exposure of a potential claim and does not deal with the more important issue of whether a claim will arise in the first place (i.e., will the plan sponsor enter into bankruptcy).

Even if attention is focused on the exposure issue, there are two significant differences. First, the thrift industry regulation was decentralized; pensions are not. Second, the matter of regulatory forbearance has often been cited as adding to the eventual cost of the S&L bailout. In comparison, the recent action of shutting down the pension plan for Pan Am reveals no such hesitation on the part of the current PBGC decision makers.

*Cash Flow*—Perhaps the most important distinction between the two programs is that funds are not generally available to the customer on demand in a defined benefit pension plan prior to a termination. Although there is some potential for lump-sum distributions to negatively impact a pension's cash flow, this could be controlled at least theroetically by ERISA section 4045, which allows PBGC to recapture part of any distributions that start within the three-year period immediately preceding the plan's failure. Certainly, there is only limited evidence of catastrophic "runs on the bank" from the standpoint of defined benefit plan sponsors or PBGC.

Moreover, after a termination, the cash flow position of S&Ls is also markedly different. Depositors in S&Ls were typically paid immediately, while PBGC spreads out payments over a long period of time.

*Propriety of the FSLIC Analogy for PBGC*

Although most of the discussion above dealt with the similarities (or lack thereof) between the *exposures* of FSLIC and PBGC, the most important difference between the two guarantee funds is that the *likelihood that a plan insured by PBGC will fail is diversified across several key industries*, whereas S&L guarantee funds were exposed exclusively to the risks of a single industry that was extremely vulnerable to fraud and events beyond its control.

## ◆ Social Insurance Perspective versus Casualty Insurance Perspective

The urgency surrounding PBGC's current financial condition and what, if any, changes are necessary depends on whether the corporation is viewed from a social insurance or a casualty insurance perspective (or from some point along the continuum between the two). Fuchs, in reference to national health insurance describes these two views as follows: "Casualty insurance, which usually refers to automobile collision, residential fire, and similar risks, is premised on the idea that premiums should (to the extent feasible) be set according to expected loss. Other things being equal, policy holders with better driving records or with smoke detectors in their homes pay lower premiums; poorer risks pay higher premiums. Social insurance, which is the basis for national health insurance, provides for extensive cross-subsidization among different risk groups; it ignores expected loss in allocating cost."

The social insurance perspective views PBGC as a transfer agency in a social insurance arrangement, while the casualty insurance perspective maintains that PBGC should function like a traditional commercial insurer (some have advocated privatization of PBGC, based on the notion that it would be better to have no defined benefit plans than have plans that could not meet commercial insurance underwriting standards.)

The social insurance perspective, not the casualty insurance perspective, is the foundation of Title IV of ERISA. This perspective relies on appeals to justice and collective responsibility. The existence of pension plans was held to serve a legitimate public interest, and

therefore this perspective argues for the insurance of all reasonable benefits that a sponsor is willing to provide for its employees and for honoring the nature of defined benefit plans, i.e., realizing that benefit increases create unfunded liabilities to be funded in the future. Social insurers maintain that the system was designed to involve cross-subsidization of plans when necessary to protect participants.

**On the other hand, the casualty insurance perspective would argue that there is no overriding public interest in having defined benefit pensions.** Therefore, insurance should not be provided for benefits that increase PBGC's exposure, such as benefit increases in already underfunded plans and benefits contingent on unpredictable events, such as plant shutdowns, that are typically not prefunded unless a fair premium can be charged for such coverage. Casualty insurance proponents also argue that premiums should be structured so that plans posing the greatest risk pay correspondingly higher premiums, without limit.

*The Social Insurance Perspective*

**This view maintains that PBGC should continue to encourage the maintenance of defined benefit pension plans and to function as a transfer agency in a social insurance system containing limited casualty insurance aspects.** A social insurance scheme is one in which the insured cross-subsidize one another in the event that a definable loss occurs. Pension plan sponsors were represented in the lengthy negotiations that led to the creation of PBGC's program in its social insurance form. As originally established, every pension plan contributed a premium of $1 per participant in exchange for coverage of its pension plan benefits in the event the sponsor firm is unable to fulfill its pension obligations. PBGC's responsibility in this scheme was to administer the transfer of funds and act as trustee for those plans that fail. Under this perspective, PBGC is not a private insurance company and should not charge premiums adjusted for risk, nor should it limit its safety net to those benefits representing the least exposure to PBGC. Congress explicitly rejected the traditional casualty insurance model when writing Title IV of ERISA.

**Inherent in the social insurance scheme is the assumption that all parties behave in an appropriate manner that will benefit the defined benefit pension system.** It is assumed that plan sponsors will not take advantage of the social contract by continually underfunding plans and purposefully causing underfunded plans to terminate in order to escape pension obligations at the expense of other plan sponsors. While this assumption may be reasonable in the case of a small number of participants that have a common connection, it becomes less reasonable with a large group of anonymous participants. However, the social insurance perspective also holds that some level of such abuse is preferable to a regulatory structure that leads all employers to decide they do not want to sponsor defined benefit plans. They believe that strict casualty standards would lead to this result. Some use an analogy of federal pension plans: if all public pensions had to be fully funded at all times, benefit levels would have to be significantly reduced.

Some argue that the social insurance aspects of PBGC's insurance system are responsible for its net deficit. However, PBGC's net deficit is not a measure of its performance or ability to meet obligations as a social insurance program. Rather, it is an indication of whether the premiums are sufficient or claims are unusually high. Because PBGC is a government agency, its net deficit is inconsequential to its ability to meet its obligations when due. A more relevant measure is its cash flow, which is positive. Furthermore, the creators of ERISA recognized the possibility of systematic abuse, and therefore required that pension plans meet minimum contribution requirements or minimum funding standards. However, as mentioned above, even with tightened minimum funding standards, it is still possible to minimize contributions within legal guidelines, causing further plan underfunding.

**While proponents of social insurance support the existence of minimum funding standards, they believe**

**plans should be able, or required, to contribute more during profitable periods and less during economic downturns.** Instead, the reverse occurs because of the relationship between the funding of defined benefit plans and returns on plan assets. When returns are high, plan sponsors are able to make lower contributions to cover their normal cost, and when returns are low, they must make higher contributions. Furthermore, maximum funding standards limit the amount of assets plan sponsors may contribute on a tax-deductible basis.

Another solution for improving PBGC's financial situation that follows naturally from the idea of cross-subsidization would be increasing premiums. If PBGC needs more assets to effectively cross-subsidize pension plans, one solution is for each plan to contribute more in terms of premiums. Per plan participant premiums, which started at $1, are currently a minimum of $19 for well-funded plans and a maximum of $72 for underfunded plans. However, some argue that further significant increases in the minimum per participant premium that all plans must pay could lead well-funded plans to terminate their plans in exchange for a defined contribution plan or other possible employee benefits. There are no data to prove or disprove the hypothesis that the PBGC premium is close to the level at which it would cause plans to terminate. However, examining the fees pension funds pay investment managers provides a reference point for the amount pension plans are willing to pay for outside services. A recent survey shows the average annual fee paid by corporate plans to investment managers, relative to assets managed, was 44.0 basis points in 1990 (Greenwich Associates, 1991). According to Employee Benefit Research Institute calculations, pension plans paying the minimum premium to PBGC pay a premium rate in the range of 1 basis point to 9 basis points for benefits at the annual guaranty maximum of $28,227 per participant (table 9). These calculations assume that a plan terminates in 1992, with participants retiring at age 65 over a period ranging from the year of plan termination to 40 years after termination. The basis points range from the cost of purchasing annuities for participants retiring at age 65 during the year of plan termination to the cost of purchasing annuities for participants retiring 40 years after plan termination. Underfunded pension plans paying the maximum premium pay from 3 basis points to 34 basis points for the same level of guarantee. Pension plans currently pay significantly less for their benefit guarantee than they pay to outside managers for pension fund investment services (from 40 basis points to 53 basis points). Only underfunded pension plans pay premiums close to average investment management fees for participants retiring at age 65, 40 years after plan termination.

**Table 9**
**Comparison of PBGC Premium and Investment Management Fee Basis Points**

| | Annual Premium Paid for PBGC Guarantee for Plans Terminating in 1992 (expressed in basis points)[a] | |
|---|---|---|
| | Participant retires in 1992 at age 65 | Participant retires in 2032 at age 65[b] |
| Maximum Premium | 2.7 | 33 9 |
| Minimum Premium | 0 7 | 8 9 |
| | Average Annual Fees Paid in 1990 to Outside Managers (expressed in basis points) | |
| All Corporate Funds | 44 0 | |
| Over $1 Billion | 40 7 | |
| $501–$1,000 Million | 40 6 | |
| $251–$500 Million | 52.5 | |
| $101–$250 Million | 43 2 | |
| $50–$100 Million | 44 9 | |
| Under $50 Million | 43.7 | |

Source. Employee Benefit Research Institute tabulations; and Greenwich Associates, *Going Global, Good Going, Investment Management, 1991* (Greenwich, CT: Greenwich Associates, 1991)

[a]Based on the annuity purchase price of $9.36 per dollar of annual income starting at age 65 and the 1992 maximum monthly per participant benefit of $2,352 27.

[b]Annuity prices for participants retiring at age 65 in 2032 are discounted at 6 50 percent, the immediate annuity interest rate for January 1992 Annuity price is expressed in 1992 dollars

Charging each plan sponsor a one time, lump-sum per participant payment to eliminate the deficit is another option. This is similar to the system used in Germany,

where each year plan sponsors pay a current-cost premium related to the insurance system's liability. This option would eliminate any current PBGC deficit. Some might argue that charging a lump-sum payment to plan sponsors may drive well-funded pension plans to terminate, exiting the defined benefit system; however, the German insurance system has not led to an exodus of plans. PBGC insures approximately 32 million participants in 82,000 single-employer defined benefit plans. The current deficit of $2.5 billion could be eliminated if each plan sponsor contributed a one-time lump-sum payment of $78 per participant, compared with the current maximum annual premium of $72. Using the same benefit assumptions as above, the $78 lump-sum per participant charge would range from approximately 3 basis points to 37 basis points. If PBGC's estimated $13 billion in unfunded liabilities that pose a serious risk were included, the resulting net deficit would be $15.5 billion. The lump-sum charge would increase to $486 per participant, or approximately 18 basis points to 229 basis points in this case. If instead sponsors were to pay a surcharge over 10 years[30] to cover the $15.5 billion, the charge would be $66 per participant,[31] or approximately 3 basis points to 31 basis points (assuming the number of participants remains constant at 32 million) per year.

Within a social insurance framework, PBGC is financially solvent as long as there are sufficient funds to allow cross-subsidization. Although a lump-sum, per participant charge may seem prohibitive to some employers, there are more than sufficient funds in the defined benefit system to cover PBGC's current and expected liabilities. The $400 billion aggregate overfunding in the defined benefit system is ample to cover PBGC's net worth deficit of $2.5 billion, the $13 billion liability for probable distress terminations, and even the $31 billion of estimated underfunding within the single-employer system.

*The Casualty Insurance Perspective*

**The casualty insurance perspective argues that the PBGC insurance scheme is flawed in its design, and that these flaws are the cause of any existing deficit problems. The system is not designed on sound insurance principles although it is supposed to be an insurance system protecting participants' pension benefits.** The design creates financial incentives for undesirable sponsor behavior and allows the opportunity for underfunding of defined benefit pension plans. Unless these flaws are corrected, PBGC may very well continue running deficits into the foreseeable future, while pure casualty insurance advocates believe that the program should ideally have assets at least equal to liabilities.

To illustrate the problems with the system when viewed from this perspective, we first give a brief description of the classic insurance scheme and then evaluate how well PBGC compares with a textbook insurer. First, there must be an insurable event involving a loss. The insurance then covers all or part of the loss if the insured event occurs. Insurance does not cover instances where the event is the intended direct result of the insured's actions, e.g., arson and suicide. For such coverage, the insured pays a premium that is related to risk and exposure. Risk involves the probability of the event occurring, and exposure involves the level of the loss should the insured event occur.

Two classic problems arise in any insurance arrangement: adverse selection and moral hazard. Adverse selection is the term used for the phenomenon that, all else being equal, individuals who are at higher risk are more likely to seek insurance, while those whose risk is low may simply opt to go without coverage and bear any risk themselves. Moral hazard is the phenomenon whereby the insured is less careful because of the insurance coverage, and thus the probability of the insured event occurring increases with coverage.

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[30] PBGC's annual report gives three 10 year forecasts of the corporation's financial status under different loss scenarios. The pessimistic forecast assumes that termination of the plans with $13 billion of underfunding that represents reasonably possible losses occurs over the next 10 years, along with a modest number of lesser terminations.

[31] The present value of $2.1 billion each year for 10 years (discounted at 6.25 percent) is $15.5 billion.

**In PBGC's case, the insurable event is the distress termination of a pension plan in which assets are insufficient to cover participant benefits and the employer demonstrates financial distress. From the casualty insurance perspective, the premium structure for such coverage is the source of the flaws in the system—premiums are only tenuously related to risk and exposure.** Originally, there was one flat rate per participant in each plan, regardless of the plan's funding status. Now there are additional charges on top of the existing flat rate for underfunded plans. The additional charge varies with the level of underfunding but is capped, resulting in a maximum possible premium. The result of this premium structure is the cross-subsidization of high-risk, poorly funded plans by well-funded plans; there is no pure risk sharing as in a classic insurance scheme.

**Adverse selection is not an issue in the normal sense because participation by all plan sponsors is mandatory. However, if the cross-subsidization discussed above is significant, it could possibly lead the sponsors of well-funded plans to shut them down and establish defined contribution plans (or offer other benefits) instead, although there is no evidence of this occurring so far. However, were this eventually to occur, PBGC could be left with a pool of plans to insure consisting solely of high-risk, underfunded plans.**

**Moral hazard incentives—this is the ultimate source of any PBGC financial trouble—do exist and are exacerbated by the premium structure and funding regulations.** Sponsors have the financial incentive to underfund their plans because they do not bear the full cost of the resulting increase in risk. (However, this was more the case before PBGC was established in 1974.) This incentive is especially strong for companies experiencing financial difficulties and thus having a hard time covering their expenses. Minimum funding regulations allow this type of behavior. A sponsor can follow the regulations and still remain underfunded for long periods of time. An underfunded plan can amortize past liabilities over 18 years, and, in addition, plans can pay back any waived amounts of funding over 5 years. Furthermore, defunding of plans when the sponsor hits hard financial times is possible, and currently little can be done to prevent it. Since sponsors are given some limited degree of latitude in setting interest rate, retirement age, and mortality rate assumptions used to determine minimum contribution requirements, a sponsor can adjust these to minimize plan contributions. Furthermore, the costs associated with early retirements and plant shutdowns, which are common in financially distressed companies, are typically underfunded. Strict casualty insurance would allow the insurer to dictate all of these calculations while having an effective veto over adverse actions by virtue of its ability to cancel the insurance.

One course of action suggested by a casualty insurance approach is to adjust premiums to more fully reflect risk and exposure. Such a move would force sponsors to bear the full burden of their underfunding and thus lessen the financial incentives to underfund plans. It is possible that a premium structure with unlimited risk premiums could push financially troubled sponsors into bankruptcy and thus drive their plans into distress terminations, but it is also possible that some of these plans may experience a distress termination eventually even if nothing changes. Such a change should serve to keep other plans out of distress termination danger in the future by leading to better funding practices in the defined benefit system. However, a risk based premium structure may lead even strong companies with flat dollar plans to freeze benefit levels because any increases will at least initially be unfunded. Furthermore, such premiums could effectively freeze the number of defined benefit plans with past service credits, as occurred following the passage of the Multiemployer Pension Plan Amendments Act. New defined benefit plans by design of awarding past service benefit credits at the time of plan set-up are almost always initially underfunded, and a high premium might pose a significant entry barrier. Thus, in considering a move to a risk-based premium structure, short-term costs and benefits must be weighed against long-term costs and benefits.

Another casualty insurance possibility is to reduce or freeze benefit coverage; this would at least limit PBGC's exposure by reducing the level of insured benefits. This could lead to better funded pension plans; if PBGC's guarantee is minimal, workers have the incentive to exert more pressure for additional funding. However, such an increase in risk exposure to employees may not be acceptable to plan sponsors and participants and could lead to the establishment of defined contribution plans as a substitute for defined benefit plans.

## ◆ PBGC Legislative Proposals

**Four proposals have been introduced to change PBGC's current operation. The proposals maintain PBGC's social insurance program while representing a further movement toward casualty insurance concepts.** The proposals fall far short of what a full casualty insurance model would require. The proposals approach the benefit guarantee and plan termination issues of the defined benefit insurance system from more of a casualty insurance program perspective by aiming to minimize PBGC's exposure through increasing recoveries and minimizing claims. However, the proposals maintain a social insurance program's objectives by attempting to alter the behavior of the participating plans and plan sponsors while maintaining cross-subsidies and the present premium structure. Overall, the goals of these proposals are to increase bankruptcy recoveries, increase incentives for better funding and funding requirements, restrict future growth in guarantees, and cor rt PBGC's budget accounting to provide a more realistic financial picture. However, some of these revisions could increase the possibility that plan sponsors with well-funded plans will leave the defined benefit system. The proposals were included in President Bush's 1993 budget. The proposals (with the exception of the accounting proposal) were introduced as legislation (S.2485, H.R.4545) in March 1992 by Sen. Robert Dole (R-KS) and Rep. Robert Michel (R-IL), respectively. The termination in bankruptcy proposal (S.2014, H.R.3843) was introduced in November 1991 by Sen. Charles Grassley (R-IA) and Rep. Rod Chandler (R-WA), respectively.

### *Termination in Bankruptcy Proposal*

**The provisions of the bankruptcy proposal are intended to give PBGC the ability to clarify and increase its recoveries in bankruptcy from both terminated plans and plans that are not terminating but are being taken over by an affiliate.** This proposal is close to the casualty insurance perspective because it places a higher priority on preserving payment to PBGC than on the preservation of the defined benefit system. Recent court rulings, particularly the LTV ruling, have challenged PBGC's claims. Both the bankruptcy court and district court ruled against PBGC on its assertion of priority claims for both unpaid contributions and employer liability and denied that PBGC has the authority to determine the amount of its claims in bankruptcy.

The objective of the bankruptcy proposal is to clarify PBGC's major bankruptcy claims for unpaid contributions and employer liability. These claims are generally unsecured, although some have priority status. ERISA and the tax code give PBGC priority on claims for contributions and employer liability in bankruptcy; however, this is not stated in the Bankruptcy Code. The revisions to the Bankruptcy Code are intended to minimize dispute over PBGC's claims for contributions and employer liability, thereby increasing recoveries and reducing incentives to stop contributions during and prior to bankruptcy. PBGC's bankruptcy proposal would alter the Bankruptcy Code to recognize pension contributions as administrative expenses, similar to salary, that are paid during bankruptcy; increase PBGC's claim for all contributions missed more than 180 days prior to bankruptcy filing; and affirm that a portion of PBGC's claim for employer liability has tax priority. Additionally, PBGC would be allowed to assert a claim for underfunding against a liquidating sponsor even if the plan is not terminating but is being taken over by an affiliate

The proposal could decrease plan sponsors' incentives to seek termination of underfunded plans because plan sponsors and affiliates would be held directly respon-



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sible for contributions before and during bankruptcy, and PBGC would have greater enforcement capabilities because its claims would be clarified in the Bankruptcy Code. The revisions might also lead creditors to pressure plan sponsors to keep plans well funded; if creditors know that PBGC has priority status in bankruptcy, they will be less willing to lend money to companies that sponsor underfunded pension plans. However, the inability to secure loans from creditors could result in the ultimate failure of companies in dire financial condition. Plan sponsors might drop defined benefit plans and start defined contribution plans, realizing that their ability to secure loans would be limited should they incur plan underfunding in the future.

The proposal also seeks to clarify PBGC's right to determine the amount of its claim and would allow PBGC to increase the amount of the priority claim above the 30 percent of net worth calculation.[32] The priority claim would not be able to exceed the sum of: (1) the amount of benefits attributable to the occurrence of events, such as plant shutdowns, that cannot be predicted and occur within the three years prior to plan termination, and (2) the greater of 30 percent of the sponsor's and affiliate's net worth or a percentage of unfunded benefit liabilities, starting with 10 percent and increasing 2 percent each year until it reaches 50 percent. PBGC would be given the option to disregard the 30 percent of net worth calculation when it results in lower recoveries than the alternative or when the calculation is too contentious to be cost effective. PBGC argues that the 30 percent of net worth calculation for PBGC's priority claim is often inadequate when pension plan underfunding is high in relation to the net worth of a company, which is often the case in bankruptcy. The proposal is intended to provide PBGC with an option for a higher priority claim because, unlike most other creditors, PBGC is not able to establish the amount of credit it extends to plan sponsors. The priority claim for shutdown benefits within is intended to decrease the underfunding, or PBGC's liability for underfunding, that often occurs shortly before plan termination. As mentioned above, plant shutdowns often occur shortly before plan terminations and are most often not prefunded.

[32]Currently, PBGC's priority claim is equal to the full amount of unfunded benefit liabilities up to 30 percent of the plan sponsor's and its affiliate's net worth.

Finally, PBGC would have the right to be a member of a creditors' committee, and bankruptcy courts would be required to notify PBGC of proceedings and all other notices given to creditors in any case where a debtor or a debtor's affiliate maintains a PBGC-covered plan. This provision is intended to facilitate PBGC's membership on creditors' committees, increase the information PBGC has available for purposes of maximizing recoveries, and encourage creditors to pressure plan sponsors not to seek termination of their pension plans.

**Consistent with ERISA's social orientation, a pension plan's funding status is currently not considered in extending PBGC's coverage of pension plan benefits.**

*Benefit Guaranty Proposal*

**Limiting PBGC's guaranty of benefit increases and benefits that are associated with unpredictable events is intended to reduce PBGC's exposure in the event of distress terminations and prevent the growth of unfunded liabilities.** The change would eliminate PBGC's guarantee for new benefits or benefit increases made after December 31, 1991 until a plan is fully funded. Once a plan is fully funded, all previous increases would be guaranteed, subject to monthly limits. The proposal also would eliminate PBGC's guarantee of pension benefits adopted and effective after December 31, 1991 that are contingent on an unpredictable event such as a plant shutdown. **These changes are most closely related to casualty insurance concepts, as they**

**essentially take the position that guarantees should only be provided where no unfunded risk exists.**

Under ERISA, PBGC generally fully guarantees new benefits or benefit increases included in plan amendments, within a five year phase-in period. Consistent with ERISA's social orientation, a pension plan's funding status is not considered in extending PBGC's coverage of pension plan benefits. Chronically underfunded plans may increase their benefit promises, which subsequently increases their underfunding. The current minimum funding rules allow plan sponsors to amortize the cost of benefit increases over a longer period than the time in which the benefits become fully guaranteed. Negotiated pension plans, which typically increase benefits every three to five years, become underfunded or increase their underfunding because the increases cannot be prefunded before they are negotiated. The proposal would replace the five-year phase-in period for the guarantee of new pension benefits with a requirement that plans be fully funded for vested benefits in order to receive the guarantee for new benefits. **In this manner, the proposal attempts to eliminate pension plan underfunding that occurs when benefits are increased while plans are underfunded. This change utilizes casualty insurance concepts by guaranteeing only those benefits that do not have unfunded risk but thereby potentially makes flat benefit negotiated plans unworkable.** An alternative change, driven by social insurance objectives, would be to allow, or encourage, flat benefit negotiated plans to prefund benefits on a tax-deferred basis before they are negotiated. This change would encourage increased funding while maintaining the guarantee of benefits without regard to unfunded risk.

PBGC has found that benefits associated with unpredictable contingent events, such as plant shutdowns, often are not prefunded and introduce substantial costs to PBGC when the benefits are triggered shortly before a pension plan terminates. Shutdowns often occur shortly before plan termination, as companies attempt to downsize. During PBGC's 17 years of operation, shutdown benefits have cost it approximately half a billion dollars, as of year-end 1991. **By eliminating guarantees of increased or additional shutdown benefits, PBGC may reduce its exposure, encourage prefunding of these benefits, and limit further provision of these benefits where they are unlikely to be funded.** Again, this proposal is a movement away from a more social orientation that led to initial guarantees for shutdown benefits.

**During PBGC's 17 years of operation, shutdown benefits have cost it approximately half a billion dollars, as of year-end 1991.**

The most direct effect of both parts of this proposal would be to limit PBGC's guarantees for the most common sources of underfunding. The proposal is intended to prevent plan sponsors from offering new benefits before they are fully funded for their previous benefits or offering shutdown benefits without prefunding. Participants in underfunded plans would not receive their increased pension benefits should their plans terminate except through their share of PBGC's recoveries. Therefore, participants in plans that negotiate updated benefits with each new agreement may pressure employers to better fund their pension plans or replace their defined benefit plan with a defined contribution plan. This argument assumes that participants are aware and concerned that their benefits would not be guaranteed. Some might argue that participants are not likely to be aware of the changes in pension plan guarantees. Under ERISA, new pension benefits are often not fully guaranteed until five years after the benefits are increased. Participants historically have not pressured plan sponsors to provide alternate benefits because they fear that they would not receive negotiated benefits if the plan fails within the five-year period. This may be evidence that plan participants do not behave on the assumption that the plan sponsor might fail.

*Funding Requirement Proposal*

**This proposal revises the additional funding requirements for underfunded single-employer plans by replacing the deficit reduction contribution that is based on plans' unfunded liabilities with two new rules, an underfunding reduction requirement, and a solvency maintenance requirement.** Plans that are not underfunded are not subject to the deficit reduction contribution and would not be required to pay the additional contribution defined in the proposal. The two new rules would apply only to underfunded plans with more than 100 participants.[33] The required additional contribution for underfunded plans would be the greater of: (1) a stronger version of the 1987 deficit reduction contribution and (2) the new solvency maintenance requirement. PBGC estimates that the funding proposal would lead underfunded plans to reach full funding within 10 years to 20 years.

[33]There is only a limited effect on plans with between 100 participants and 150 participants.

Table 10
**Example of Minimum Required Contribution for Plans That Are Not Underfunded**

| | |
|---|---|
| Normal Cost at January 1, 1990 | $ 500,000 |
| Amortization Charges at January 1, 1990 | |
| Initial unfunded liability | 75,000 |
| Plan changes | 325,000 |
| Actuarial losses | 100,000 |
| Total | 500,000 |
| Interest to Year-End on Normal Cost and Amortization Charges at 9% | 90,000 |
| Total Charges | 1,090,000 |
| Credit Balance at January 1, 1990 | 0 |
| Amortization Credits at January 1 1990 | |
| Plan changes | 150,000 |
| Actuarial gains | 250,000 |
| Total | 400,000 |
| Interest to Year-End on Credit Balance and Amortization Credits at 9% | 36,000 |
| Total Credits | 436,000 |
| Minimum Required Contribution | 654,000 |

Source: Michael A. Archer, "Minimum Funding Requirements," in Martin Wald and David E. Kenty, eds., *ERISA: A Comprehensive Guide* (New York: John Wiley & Sons, Inc., 1991).

*Minimum Funding Requirements for Plans That Are Not Underfunded*—Since 1974, the basic minimum funding standard under the IRC requires that a pension plan having supplemental liabilities must amortize such liabilities over a specified period of time, in addition to the funding of normal cost. For plans in existence on January 1, 1974, the maximum amortization period for supplemental liability is 40 years; for single-employer plans established after January 1, 1974, the maximum amortization period is 30 years. Moreover, experience gains and losses for single-employer plans must be amortized over a five-year period. Changes in supplemental liabilities associated with changes in actuarial assumptions must be amortized over a period not longer than 10 years.

**All pension plans subject to the minimum funding requirements must establish a funding standard account that provides a comparison between actual contributions and those required under the minimum funding requirements.** The main purpose served by the funding standard account is to provide some flexibility in funding by allowing contributions greater than the required minimum, accumulated with interest, to reduce the minimum contributions required in future years. (See table 10 for an example of a funding standard account.)

A determination of experience gains and losses and a valuation of a plan's liability must be conducted at least once every year. For each plan year, the funding standard account is charged with the normal cost for the year and with the minimum amortization payment required for the initial unfunded liabilities,[34] increases in plan liabilities, experience losses, the net loss resulting from changes in actuarial assumptions, and waived contributions for each year. These amortized charges

[34]The initial unfunded accrued liability is the liability incurred when a plan is started. The initial underfunding is primarily due to credit given toward service prior to plan establishment.

are listed in the example on table 10 as initial unfunded liabilities, plan changes, and actuarial losses. Adjustments are made for interest on the amortized charges and normal cost charges to the end of the plan year. The account is credited in each plan year for employer contributions made for that year, with amortized portions of decreases in plan liabilities, experience gains, the net gain resulting from changes in actuarial assumptions, amounts of any waived contributions, and adjustments for interest on the preceding items to the end of the plan year.[35] If the contributions to the plan, adjusted as indicated above, meet the minimum funding standards, the funding standard account will show a zero balance, as is the case in the example. If the funding standard account has a positive balance at the end of the year, such balance will be credited with interest in future years (at the rate used to determine plan costs). Therefore, the need for future contributions to meet the minimum funding standards will be reduced to the extent of the positive balance plus the interest credited.

[35]In certain situations, the account will also be credited with a full funding limitation credit. See Prop Reg. Sec. 1.412(c)(6)-1(g).

*OBRA '87 Minimum Funding Requirements for Underfunded Plans*—Partly as a result of PBGC's exposure to the increasing incidence of bankruptcies

**Table 11**
**Example of Development of Deficit Reduction Contribution**

| | | |
|---|---|---|
| Calculation of Unfunded Old Liability Amount | | |
| (1) | Current liability as of January 1, 1989 based on October 16, 1987 plan provisions | 10,000,000 |
| (2) | Actuarial value of assets as of January 1, 1989 (less credit balance) | 8,000,000 |
| (3) | Unfunded old liability[a] | 2,000,000 |
| (4) | Unfunded old liability amount[b] | 209,564 |
| Calculation of Unfunded New Liability Amount | | |
| (5) | Current liability as of January 1, 1990 | 12,000,000 |
| (6) | Actuarial value of assets as of January 1, 1990 (less credit balance) | 9,500,000 |
| (7) | Unfunded current liability[c] | 2,500,000 |
| (8) | Unamortized unfunded old liability[d] | 1,951,575 |
| (9) | Unfunded new liability[e] | 548,425 |
| (10) | Current liability funded percentage[f] | 79.2% |
| (11) | Percentage of unfunded new liability recognized[g] | 19.0% |
| (12) | Unfunded new liability amount[h] | 104,201 |
| Calculation of Deficit Reduction Contribution | | |
| (13) | Sum of unfunded old liability amount and unfunded liability amount[i] | 313,765 |
| (14) | Amortization charges and credits for initial unfunded and plan changes[j] | 250,000 |
| (15) | Deficit reduction contribution[k] | 63,765 |

Source: Michael A. Archer, "Minimum Funding Requirements," in Martin Wald and David E. Kenty, eds., *ERISA: A Comprehensive Guide* (New York: John Wiley & Sons, Inc., 1991).
[a](1)–(2)
[b]18-year amortization of unfunded old liability at the current liability rate of 9%.
[c](5)–(6)
[d](3)–(4)*1.09
[e](7)–(8)
[f](6)/(5)
[g]30%–.25((10)–35%)
[h](11)*(9)
[i](4)+(12)
[j]The sum of the initial unfunded liability and charges for plan changes less the credits for plan changes (75,000+325,000–150,000) shown in table 10.
[k]Minimum((13)–(14),(7))

and persistent underfunding by some plans in the 1980s, OBRA '87 established additional minimum funding requirements for plans covering more than 100 participants that are not at least 100 percent funded for current liabil ·ies.[36] In general, the current liability is the plan's liability determined on a plan termination basis. Specifically, it is the present value of accrued benefits projected to the end of the current plan year, excluding the value of unpredictable contingent events that have not occurred.[37] A plan's unfunded current liability is calculated by subtracting the actuarial value of assets, minus the credit balance in the funding standard account, from the current liability. **Plans that have an unfunded current liability based on this calculation must pay an additional minimum funding contribution.**

The additional contribution is based on the deficit reduction contribution, which is the sum of the unfunded old liability amount and the unfunded new liability amount net of the amortization charges and credits for initial plan supplemental liabilities and those arising from plan changes. (See table 11 for an example of the calculation of the deficit reduction contribution.) The unfunded old liability is the unfunded liability that existed at the beginning of the 1988 plan year, based on the plan provisions in effect on October 16, 1987. The unfunded old liability amount is a portion of the unfunded old liability equal to an 18-year amortization, beginning in 1989, of the unfunded old liability. The unfunded new liability equals the excess, if any, of the unfunded current liability after subtracting the portion of the unfunded old liability that has not yet been paid (called the unamortized portion of the unfunded old liability).[38] The unfunded new liability amount is a percentage of the unfunded new liability, determined by a formula with higher payments required for more serious·· underfunded plans. The degree of underfunding is measured by the funded current liability percentage, defined as the ratio of the plan's actuarial value of assets, net of the funding standard account's credit balance, to its current liability. If this ratio is 35 percent or less, the percentage of the unfunded new liability recognized is 30 percent. For every percentage point by which the funded current liability percentage exceeds 35 percent, the percentage of unfunded new liability recognized declines by 25 percent.

Plans with an unfunded current liability pay the excess, if any, of the deficit reduction contribution over the net total of the following funding standard account amortization charges and credits—charge for the initial unfunded accrued liability, charges for plan changes, and credits for plan changes.

*Proposed Minimum Funding Requirements*—**Although the OBRA '87 modifications undoubtedly increased the minimum funding requirements for a substantial percentage of underfunded plans, there were several anomalies that allowed some underfunded plans to (legally) circumvent the law's intended objective.** In an attempt to correct these provisions, additional funding requirements for plans that are not multiemployer plans have been proposed by the Bush administration to assure that pension plans make a sufficient contribution in each year that they are underfunded.

**If enacted, the Bush administration proposal would eliminate the deficit reduction contribution introduced by OBRA '87 and replace it with a new underfunding reduction requirement.** In essence, this change would apply the formula for the unfunded new liability amount from the 1987 law to the entire

[36]The additional contributions are phased in for plans with between 100 participants and 150 participants. All defined benefit plans must be aggregated to determine the number of participants in applying this exception.

[37]The present value of this liability is calculated using the plan's valuation interest rate, provided that it is between 90 percent and 110 percent of the weighted average of rates of interest on 30-year Treasury securities during the four-year period ending on the last day of the prior plan year. Furthermore, the interest rate should be consistent with current insurance company annuity rates. The IRS may, by regulation, extend this range downward if 90 percent of the weighted average is unreasonably high, but to no lower than 80 percent of the weighted average.

[38]The unfunded new liability does not include liability for unpredictable contingent events that have occurred.

underfunding, eliminating the grandfather clause in OBRA '87 that allows the unfunded old liability to be amortized over 18 years. When viewed in isolation, this change could drastically impact the minimum funding requirement for severely underfunded plans. For example, plans with the lowest funding ratios (i.e., those whose plan assets are less than 35 percent of their termination liability), would find their marginal funding requirement on the amount OBRA '87 defines as the unfunded old liabilities almost tripled. The proposal would increase the current annual payment of approximately 10.5 percent of the unfunded old liability (assuming a 9 percent discount rate) under the 18-year amortization schedule to a formula amount requiring an initial annual payment of 30 percent of the unfunded old liability.

However, it is possible that the underfunding reduction requirement would not be relevant to a group of underfunded plans with a very mature population of plan participants. Since the implementation of the OBRA '87 modifications, it has been observed that, even with the additional funding required by the deficit reduction contribution, plans with a heavy concentration of retirees relative to the number of participants may find that benefit payments exceed the minimum required contributions to the plan.

Therefore, the proposal provides for a larger minimum required contribution for plans that fall into parameters established by a newly defined solvency maintenance rule. In general, underfunded plans will be subject to the solvency maintenance rule provisions if the rule provides for a larger minimum contribution than the underfunding reduction requirement. The solvency maintenance rule would (eventually) introduce two new components into the calculation of the minimum required contribution: disbursements from the plan and interest (as determined by the plan interest rate) on the plan's *initial*[39] unfunded liability. Disbursements from the plan are specifically defined to include benefit payments, including purchases of annuities or payment of lump sums in satisfaction of liabilities, administrative expenses, and any other disbursements from the plan or its trust. However, a special rule exists for determining the applicable amounts attributable to purchases of annuities or the payment of lump sums for this rule. Specifically, the applicable amount will be equal to the actual amount paid by the plan (or trust) multiplied by the excess of 1 over the initial funding ratio of the plan.

Since a sudden shift to either of the two new minimum funding rules may be expected to have serious cash flow consequences for sponsors already encountering serious financial difficulties, it was decided to provide a gradual transition to the new rules. With respect to both requirements, any net positive credit balances in the funding standard account for plan years beginning on or before December 31, 1993 would be available as an offset to the new requirements.[40] The solvency maintenance rule would be phased in gradually over a five-year period, further lessening its impact.

Another aspect of the OBRA '87 minimum funding requirements that in many cases minimized the impact of the deficit reduction contribution concerned the existence of funding standard account credits (typically from experience gains or changes in plan assumptions). Under the OBRA '87 calculations, it is quite possible that the deficit reduction contribution could be entirely eliminated if these credits are sufficient. The proposal attempts to correct this problem for underfunded plans by continuing to allow credit for experience gains, gains from changes in actuarial assumptions, and greater than required minimum contributions, but only to the extent of the charges for experience *losses* and *losses* from changes in actuarial assumptions.

The final modification in this proposal simultaneously treats two issues introduced by the current liability

[39]Under the proposal, the word *initial* refers to the first day of the plan year, not the effective date of the new provisions.

[40]Even though underfunded, plans may have a net positive credit balance. For many plans, this may be due to greater-than-anticipated investment returns in recent years.

concept in OBRA '87 by replacing the current liability computation with the initial termination liability. Although the details are beyond the scope of this discussion, **in many situations the assumptions mandated for the current liability calculation limited the value assigned to this liability component of the deficit reduction contribution.** With fewer plans **qualifying as underfunded, the impact of the additional funding requirement would be minimized.** Secondly, the additional regulatory burden of this additional valuation would cease to exist if the proposal were enacted.

A corollary to the removal of the current liability computation may be troubling to some observers in that it would provide a greater degree of flexibility to the choice of actuarial assumptions for the additional funding requirement. In calculating current liability, plans were required to use the plan's valuation interest rate which must fall within specific guidelines.[41] The proposal does not introduce requirements for interest rate assumptions for calculating the initial termination liability. Professional standards and the additional discipline introduced from the limitation of credit for experience gains and gains from changes in actual assumptions and from greater-than-required minimum contributions in past years will undoubtedly minimize the use of assumptions resulting in extraordinarily low liability values. However, it appears that the substitution of the initial termination liability concept for the OBRA current liability may decrease the number of plans that are considered to be underfunded in the short run. Plans that do not have an initial unfunded liability would not be subject to either of the two new additional contribution requirements.

*Accounting Proposal*

**The accounting proposal would change the budgetary treatment of PBGC's accounting from a cash to an accrual basis in order to reflect anticipated costs and provide budgetary incentives for the adoption of other proposals.** PBGC asserts that cash accounting is misleading because it does not recognize potential long-term losses and emphasizes that accrual accounting is the standard insurance accounting methodology. The proposal would allow PBGC to accrue its losses and expected losses and reflect savings that will be incurred by the adoption of legislative changes. President Bush's budget projected that the cumulative effect of the adoption of the pension proposals would be to lower PBGC's accrued cost by $8.7 billion in the year the savings are first counted and reduce the growth of costs substantially thereafter. However, some have criticized this aspect of the proposal as "a gigantic accounting gimmick" because the savings from reforms that would occur over decades would be used as a pretext to cut taxes in the 1993 federal budget (Samuelson, 1992).

**While PBGC already calculates its liabilities and net deficits on an accrual basis in reporting its financial status, these numbers are not recognized in the federal budget.** The revision is intended to facilitate PBGC's ability to convince Congress to pass legislation that would reduce underfunding and facilitate increases in premiums to cover deficiencies if necessary. Because pension contributions are tax deferred, increasing funding standards reduces tax income, thereby increasing the federal deficit. However, by including the savings gained from funding reforms in PBGC's budget statement, its accrued deficit will decline, softening the impact of the decrease in tax income on the federal budget. On the other hand, the inclusion of expected losses in PBGC's accrued deficit may make it more difficult to pass legislation to increase benefit guarantees should this be desirable in the future.

## ◆ Conclusion

Does a general taxpayer bailout reminiscent of the FSLIC episode loom on PBGC's horizon? **There are currently sufficient liquid assets within the aggregate defined benefit system itself to cover the existing pockets of underfunding within individual plans. Therefore, unless legislative changes are made that**

[41]See footnote 35 on page 30 for details on setting plan's valuation interest rates

**cause employers to terminate well-funded defined benefit plans en masse, thus denying PBGC a base of premium payers, a general taxpayer bailout would be unnecessary.**

The overall defined benefit pension system currently has $1.3 trillion in assets to cover $900 billion in liabilities. From the social insurance perspective, this means that, while there is underfunding within some individual plans, there are also sufficient resources available within the defined benefit system itself to cover this underfunding. The $15.5 billion liability for trusteed plans and probable distress terminations represents 3.9 percent of the $400 billion dollar surplus in the defined benefit system. The needed funds can be accessed through increased premiums or by imposing an annual lump-sum premium charge on sponsors that is sufficient to eliminate any PBGC year-end deficit. The bulk of defined benefit assets are in liquid bond and equity investments and are thus easy to access; this was not the case with the assets of S&L institutions, which were concentrated heavily in mortgages. Furthermore, whereas S&Ls and banks face the prospect of depositors demanding immediate withdrawals, pension plans pay out funds only when an individual separates from service or retires. In addition, consideration of the present value of income (premiums and investment earnings) that is likely to be received during future periods when benefits are being paid substantially improves PBGC's deficit picture.

Does this mean that there are no problems with PBGC insurance system and therefore no changes are needed? No, **both social insurance and casualty insurance proponents acknowledge that the system needs to change in order to reduce abuse and maintain participants' retirement security.**

As currently structured, the pension insurance system creates a financial incentive for employers to underfund their defined benefit plans. The vast majority of sponsors maintain well-funded plans despite this incentive, but some do not. Without changes, underfunding within the defined benefit system is likely to improve only slowly, if historical trends continue. Were more firms to begin to take advantage of the system, the financial picture could deteriorate.

**A balance between social insurance and casualty insurance principles is most likely to sustain an overall strong and continuing defined benefit pension system.** Too great a movement toward either extreme could ultimately lead many businesses to abandon the defined benefit approach. Should that be deemed desirable, it should come from explicit targeted actions, not as the indirect effect of well intentioned reforms.

Finally, the private defined benefit system and PBGC's financial status should be considered in context. Private defined benefit plans are approximately $400 billion overfunded in the aggregate. Actuarial deficiencies of federal retirement annuity programs consist of Social Security-OASDI at $1.1 trillion, the CSRS at $660 billion, the FERS at $6 billion, the MRS at $533 billion, the Railroad Retirement Board at $33 billion, and other retirement programs at $21 billion. In addition, actuarial deficiencies in federal health programs consist of Medicare-HI at $402 billion, the Federal Employees Health Benefits Program at $115 billion, and Military Treatment Facilities and Civilian Health and Medical Program for the Uniformed Services (CHAMPUS) at $295 billion. Concern for PBGC premium payer may well merit changes in the laws governing private pensions and PBGC, but, in terms of underfunded liabilities, larger general taxpayer interests lie in policy makers giving attention to the long-term tax consequences of public pension and retiree medical benefit promises that have not been advance funded.

This *Issue Brief* was written by Paul Yakoboski, Celia Silverman, and Jack VanDerhei of EBRI with assistance from the Institute's research and education staffs and helpful comments from outside reviewers.

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# COMMUNICATIONS

## STATEMENT OF THE INDUSTRIAL UNION DEPARTMENT (AFL-CIO)

My name is Richard Prosten, director of bargaining and research for the Industrial Union Department, a semiautonomous part of the AFL-CIO family of unions. We represent 51 international unions, with a membership of 4½ million workers. The enactment of ERISA in 1974 was a response to an intensive educational effort by our Department. The Act was one of the top priorities of then IUD President I.W. Abel, who was also President of the United Steelworkers of America. The protections it affords workers are an important part of his legacy and a testimonial to his compassion for and concern about older Americans and their economic welfare.

No group has a greater stake in a smoothly functioning defined benefit pension system and financially sound Pension Benefit Guaranty Corporation (PBGC) than the men and women we are privileged to represent. Their retirement security is a very important part of our agenda, a concern we know the committee shares.

Title IV was ERISA's most innovative component. It established the PBGC, a model of social insurance crafted by Congress to fill a need that the private sector was unwilling or unable to address. It reinsures the benefits of workers who find their retirement security threatened should their plan fail. Sadly, much of the PBGC's recent activity has been misdirected, leading many of our members to conclude that the Agency they have supported and relied on has turned on them, in effect blaming the victims for the crime.

In the name of protecting the Agency, the PBGC is undermining the retirement security of the plan members it was established to protect. Its actions often suggest that it is ready to stray from its fundamental purpose of protecting pension benefits in defined benefit plans and ready to adopt a casualty insurance provider model—a model that is totally inconsistent with PBGC's historical mission. In its attempts to follow the casualty insurance path, the PBGC has frequently adopted anti-participant, anti-defined benefit plan, and anti-collective bargaining postures. We cannot support the abandonment of PBGC's historic role, and are concerned about scare tactics apparently intended to try to pressure the public and Congress to accept the Agency's proposals.

The centerpiece of this "campaign of fear" is a specious comparison of the PBGC to the Federal Savings and Loan Insurance Corporation (FSLIC)—a comparison that is frequently offered by Agency and other Administration officials. Rather than account for its inept handling of the Savings & Loan situation, the Bush Administration has been using the FSLIC mess as a cover for its attempts to undermine confidence in the pension reinsurance system and to dismantle worker protections that the PBGC has administered for the last eighteen years. Labor Secretary Martin recently went so far as to declare that Congress must act at once if the country is to avoid a taxpayer bailout of PBGC during her watch.

The Secretary's statement sounds alarming, but comparing PBGC to the FSLIC is quite inappropriate. Taken as a whole, private defined benefit pension plans are overfunded by $400 billion—a differential that has actually been growing in recent years. Certainly there are pockets of underfunding in some hard pressed industries, and these are problems that need to be dealt with carefully and compassionately. The Administration, however, seems to be suggesting that killing the patient is the way to cure the ailment.

In a comprehensive issue brief, the Employee Benefits Research Institute (EBRI), a non-profit, non-partisan, public policy research organization based in Washington, DC, has recently concluded that the Pension Benefit Guaranty Corporation (PBGC) insurance system is financially sound.

According to the EBRI, comparisons of the PBGC's insurance of defined benefit plans to the problems of the failed FSLIC insurance system and its bailout by taxpayers are unwarranted for a number of reasons, including the following:

- Pension plans insured by the PBGC are, as ERISA mandated, widely diversified in terms of their investments—while the risk exposure of the S&L's was almost exclusively to real estate.
- It is estimated that some 60 percent of the S&L failures involved fraud and mismanagement. Such activity among single employer plans is essentially non-existent.
- Throughout the 80's, FSLIC-insured S&L's, operating in a deregulated atmosphere, were allowed to use very loose accounting practices. Pension plans must adhere to very strict accounting rules.
- PBGC's liabilities are paid out over time, while S&L depositors were paid, in full, almost immediately.

In short, the disaster that Secretary Martin is warning us about is very unlikely to happen—but it provides a great cover for the anti-worker agenda that PBGC Director Lockhart and the Administration are pursuing legislatively.

The key supporting role in the Administration's campaign of fear goes to the numbers concocted by the PBGC to represent its current and potential future liabilities. The PBGC describes a deficit position of $2.5 billion without noting that this figure represents liabilities that will be paid out over many years. During that time, the Agency will be collecting hundreds of millions of dollars annually in premiums and hundreds of millions of dollars in interest earnings on its nest egg of more than $4 billion (as of last September 30). Nor does the Agency draw attention to the healthy status of the defined benefit pension system, which taken as a whole, has $400 billion more in assets than liabilities. The EBRI study we mentioned earlier calculates that the entire deficit of $2.5 billion could be eliminated by a one-time charge of $78 per participant—a modest two-tenths of one percent of defined pension plan assets.

Even PBGC's allegation that there is a $2.5 billion deficit is suspect. The General Accounting Office has indicated that the Agency's liability calculations are so unreliable as to be unauditable.

Another element of this campaign of fear is PBGC's periodic publication of a fist of plan sponsors that the Agency declares to be the fifty most underfunded plans in the reinsurance system at a given moment. The tortured mathematics that produce the list do not recognize a firm's other completely funded and overfunded plans and ignore any potential recovery by the Agency, should the plan sponsor fail. While troubled plans are clearly a problem that deserves attention, the Agency's listings add little to public understanding of the issue.

PBGC's list of 50 underfunded plans focuses simultaneously on very diverse cases. The latest release, for example, includes plans whose funding ratios, as calculated by the PBGC, range from 6% to 94%. A close inspection of the list reveals that over 70% of the identified plans are at least 60% funded. Twenty-one of the fifty firms on the Agency's latest list were firms whose plans were at least 80% funded, including General Motors, Westinghouse Electric & Raytheon.

Raytheon, for example, was on the list despite its pension plan being 83% funded, with assets of $428 million and liabilities of $514 million. Raytheon is no longer on the list, and the PBGC executive director would have everyone believe that this is because the company made a special contribution to get off the list—a sign that the list is working to encourage funding. In fact, the special contribution was an unnecessary diversion of corporate resources. Even if the company had not made an extra payment, its plan's investment returns alone would have been sufficient to knock it off the list.

In short, PBGC's listing invites misinterpretation and causes unnecessary concern for plan members as well as the general public. *Pension & Investment Age,* a widely read trade publication, editorialized that the PBGC was "shouting 'fire' in a crowded theater when no fire exists. It [the list] is irresponsible and fear mongering."

Having tarnished the pension system by associating it with the Savings and Loan crisis, and using misleading and suspicious numbers to argue its case, the PBGC has made a series of proposals for dealing with its self-described crisis. These proposals relate to accelerating funding, reducing benefit guarantees and increasing the Agency's clout in bankruptcy.

We believe that, taken as a whole, the need for these measures is unproven, and that they unfairly discriminate against hourly production workers and unionized workers. While these measures might indeed eliminate any possibility that the PBGC balance sheet would ever be in the red, they would accomplish this by shifting the risk to retirees.

In the mid- and late-80's, Congress responded to Administration requests for funding improvements designed to alleviate pressures on the PBGC. The effects of many of those changes will take years to work their way through the system. De-

spite a lack of experience and data as to the effectiveness of these recent changes, the Administration is coming back for "more."

And the "more" that PBGC Director Lockhart wants will almost exclusively and—needless to say—negatively, impact the plans covering workers such as those represented by our Department.

The PBGC proposes to eliminate guarantees for improvements in all except fully funded plans (rather than a five-year phase-in, as under current law). Some proposals go even further. A recently considered amendment to tax law would require companies to provide the PBGC with security for the value of any pension increases in situations where a pension plan is less than 90 percent funded. We strongly oppose such a punitive, discriminatory concept. It would strike primarily at single employer flat benefit plans, which PBGC identifies as the source of most of the underfunding in the defined benefit system.

The Agency has also proposed changes in funding that would discriminate against our members and their plans. The PBGC seems to be implying that the blame for underfunding lies with excessive union bargaining leverage or collusion between labor and management. This is exactly wrong, and stands reality on its head. Flat benefit plans tend to be underfunded more than final-pay plans because the law does not allow them to anticipate or fund for future benefit improvements. This is completely unlike the situation for the final pay plans, commonly enjoyed by salaried employees, in which pay escalation is built into the benefit formula. Law allows these salaried plans to pre-fund based on expectations of future salary and benefit levels.

The Administration proposal would also withhold coverage for shutdown benefits negotiated or otherwise added to plans in the future, no matter how well funded the sponsoring plan was.

Without a hint of embarrassment, the Agency maintains that these proposals would not interfere with collective bargaining. Ironically, the Agency has, in recent years, been attempting to insert itself into bargaining matters in a number of ways, including:

- Interference with union attempts to enforce certain pension clauses in collective bargaining agreements at distressed companies. In the case of United Engineering, for example: PBGC has petitioned the U.S. District Court for the Northern District of Ohio to dismiss a suit filed by the United Steelworkers of America against United Engineering seeking payment of supplemental retiree benefits required by collective bargaining agreements.
- PBGC asserts that recent amendments to the Employee Retirement Income Security Act (ERISA) make the pension Agency the sole authority for collection and distribution of employers' unfunded benefit liabilities under terminated pension plans. The Agency said this includes both statutorily-guaranteed pension benefits and non-guaranteed supplemental benefits that the Steelworkers are seeking in the suit.
- USWA filed the suit to collect $400 monthly pension supplements that accrued prior to the termination of the pension plan in August 1989. The Steelworkers maintain that the 1987 legislation includes nothing that would reduce the union's contractual right to require an employer to make full payment of pension supplements, rather than waiting for the PBGC, which normally is able to collect only a portion of such benefits.
- The PBGC told LTV, which was trying to emerge from bankruptcy, that in order to get the Agency off its back, it would have to negotiate a labor agreement that was "acceptable" to the PBGC. What's more, the Agency was simultaneously telling LTV that cuts in retiree health coverage would best meet that goal.

Which brings us to the third aim of the Administration's pending legislation—the PBGC's desire to increase its standing in bankruptcy. It wants first crack at any unsecured assets. However reasonable it seems that the government be allowed additional recoveries, the impact might well be to reduce the likelihood of successful reorganization, by lowering the recovery of other creditors to the point where liquidation seems desirable to them—and liquidation has inevitably lead to job loss. Bankruptcy reorganization and liquidation also hits very hard at retiree health insurance which is unfunded and not guaranteed and is increasingly a claim PBGC seems willing to sacrifice in order to increase its own recoveries. At least PBGC has the assets of a healthy defined benefit pension system to back up its guarantees; pensioners have only the continued viability of their former employer to fund their health insurance benefits after retirement.

In conclusion, we are dismayed by an Administration rhetoric that would have the public believe that corporations and unions are collusively involved in a series of

abusive schemes to strip the Agency of its assets, and that an S&L type disaster can only be avoided through the application of casualty insurance approaches to PBGC operations. We are not persuaded that there is a crisis. Rather, we believe that any long-term financial problems are best addressed with adequate data and due deliberation, and that the goal should be to minimize disruption to the participants, not to eliminate benefit guarantees.

Absurd as it may sound, the PBGC is asking that it only be responsible for insuring benefits at firms whose plans are the least likely to make a claim. This would be the application of casualty insurance principles with a vengeance.

America's pensioners deserve better.

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## STATEMENT OF PAUL H. JACKSON

My name is Paul H. Jackson. I am a Fellow of the Society of Actuaries and a Director of The Retirement Policy Institute. This statement is based on my own personal experience as a practicing actuary working with insurance companies, private pension plans and employee benefit plans for 40 years. In addition, commencing in 1970, I have testified before Congress more than a dozen times on taxes, employee benefits, pensions and the PBGC. I was the only public witness to testify before the Dent Subcommittee in its hearings on plan termination insurance in 1973. I have followed the progress of PBGC closely ever since its founding.

Before analyzing PBGC's financial results future prospects and the various legislative changes now proposed, it is necessary to keep in mind the problems that Congress perceived in pre-ERISA pension plans and why PBGC was established.

### PBGC'S MISSION

In 1973, when the details of plan termination insurance were being fleshed out, I proposed that the program should pay benefits to "all individuals who have lost benefits because of the failure of a private pension plan." I further proposed that the plan collect contributions each year sufficient to pay the estimated benefit payout in the following year. I had doubts as to whether a government agency could set realistic actuarial assumptions and make effective long term investments on a basis that would be independent of political considerations. I still have doubts.

The PBGC was established within the Department of Labor to help restore faith in our private pension system by making benefits more secure. No one in Congress ever stated that their real mission was to establish a private insurance company that would make money for the government or compete with the Aetnas and Liberty Mutuals of the world. The purpose of PBGC, as set forth in Title IV of ERISA, was to encourage the continuation and maintenance of private pension plans, to provide for the timely and uninterrupted payment of pensions, and to maintain premiums at the lowest level consistent with its obligations. Attaining a triple-A credit rating or accumulating assets sufficient to buy private sector annuities for all of its obligations were <u>not</u> considerations.

In its original design of Social Security, Congress consulted insurance experts and academics and held long discussions about the optimum balance between individual equity among premium payers and the social adequacy that should be required of a governmental program. Unfortunately, equity and sound insurance principles led to the prospective design of Social Security. You can't buy insurance on a house that is already burning. That is

the reason why contributions (taxes) were required of all workers, but workers who were over 65 when the program started were excluded from benefits permanently! It was 1950 before the "new start" amendments corrected this unpopular and unfair provision.

It was in 1973, and is now, my belief that a government program should be perceived as fair and should serve some public purpose in order to warrant the support of the public. In general, I believe a government program should meet current needs rather than collect money from the public currently in order to invest it so as to meet some future need. Moreover, if the needs are real (as they are here) and if private sector methods can meet them, then somebody would already be doing it. Not even Lloyds of London offers pension plan termination insurance.

Whatever the reasoning, ERISA only covered future plan terminations (more precisely it went back only two months and four days in covering the plan terminations of the past). Those members of the public who had testified before Congress on the need to improve vesting and funding and to provide financial backing for pensions when employers go bankrupt, were shocked to find that they were excluded. Congress had many opportunities to explain directly to those testifying to their loss (the "pension losers") that one of the fundamental features of private insurance is -- no premium, no insurance. The principle was not mentioned.

Senator Orrin Hatch expressed the insurance point of view in the recent floor debate on the "pension losers amendment" to the Older Americans Act when he said that "these people haven't paid one thin dime for this insurance." Maybe not, but most of the pre-ERISA plans contained provisions agreed to by the losers that, at plan termination, any assets would be used to provide the full benefits to the oldest pensioners first and then down as far as possible into the active group until the money ran out. Thus those who lost out did so because they and not the government, provided the plan termination insurance for the oldest among them. Many of the pension losers gave up their entire pension interest in the process and, while the loss must have been personally devastating, I never heard a single one of them say "those old retired people didn't pay one thin dime for this insurance."

Congress recently extended the benefit period under the unemployment compensation program. This program has also been called "insurance" and is supported by experience rated employer premiums. Nowhere in the debate was there any mention of sound insurance principles nor of the failure of those already unemployed to have paid "one thin dime" for the added protection.
Sound legal principles led PBGC to deny benefits in the Collins and Page cases. Here the pension plans were terminated after the effective date of ERISA but either the employers had failed to amend their plans as required by law or they had failed to pay the required premium to PBGC. Some of those employers might have had more pressing matters to worry about as they were slowly going out of business. Whatever the reason, PBGC denied benefits under all such plans until Congress passed a law making future cases of that sort eligible for benefit. A government agency should do what is right. The impact of each such decision on those who would otherwise lose their pensions should be an important consideration.

PBGC is not a profit-making private insurance company. It is a government agency supported by mandated payments (taxes) required of all who sponsor private defined benefit pension plans. While accounting, legal, investment and actuarial considerations are important (and have been effectively addressed), PBGC's mission is to shore up confidence in the private pension system. Every

claim effectively denied by a private sector insurance company means greater profit to the stockholders in the short run and lower and more competitive premiums in the long run. Every claim denied by PBGC on purely technical grounds means more dissatisfaction with bureaucratic doublespeak and less faith in the combined PBGC-private pension system.

The current review of PBGC's operations should commence with an appraisal of PBGC's mission and the extent to which its decisions and activities have carried out that mission. The program will receive failing marks on its social adequacy until benefits are provided for the "pension losers" and the Collins and Page-type plans. This government sponsored safety net was unfairly limited at the start. That failure should be corrected now.

PBGC'S CURRENT FINANCIAL CONDITION

Table A attached sets out the premiums, claims, deficit, pensions paid, administrative expenses and assets at the end of each fiscal year taken from PBGC's Annual Reports. Several facts are worth noting:

(1) claims in 1990 and 1991 are much higher than previous levels due to the recession,

(2) year by year claims are very erratic while pensions paid tend to increase steadily,

(3) deficits appear to be increasing,

(4) "probable" claims represent a significant part of the year end deficits, and

(5) year end assets are growing even faster than deficits and currently amount to almost ten times the sum of the current years pensions paid and administrative expenses.

PBGC is not required to have on hand all of the assets sufficient to buy annuities from commercial insurance companies to cover all of the benefit promises it must keep. PBGC is required to pay pensions when due and, of course, to pay the salaries of its employees, the rent on its office space, etc. Thus the test of whether PBGC can continue operating is not whether it has a deficit but whether it has assets and income sufficient to pay pensions and administrative expenses. Dividing assets by the current years cash paid out is a very crude measure of how close PBGC is coming to the point where it cannot pay its bills. This measure dropped from 11 years outgo in 1977 to 5.3 years in 1984 and has increased to 9.7 years currently. PBGC is a long way from defaulting on its benefit obligations.

Most of PBGC's financial problems can be traced to the inadequacy of premiums during its first 14 years of operation and to the current recession. In its efforts to convince Congress of the need for higher premiums, PBGC has focused public attention on its deficit and on the similarities to the saving and loan crisis. An S&L's deficit is withdrawable in cash on demand. PBGC has deferred liabilities and enough assets to meet cash demands for a decade. By publicizing its deficit, listing annually the 50 corporate plans most underfunded, and drawing a comparison with the S&L crisis, PBGC may have convinced Congress but, in the process, it has also undermined the public's faith in the combined PBGC-private pension system. Perhaps if premium adequacy were assured, PBGC would direct its press releases to the positive good that it is contributing to the working men and women of America.

THE EFFECT OF INFLATION ON PBGC'S CLAIMS

PBGC insures the accrued pension benefits under ERISA qualified pension plans up to a maximum benefit that is set by law. The maximum benefit was originally set at $9,000 annually but it is indexed for inflation by the factors used for Social Security (Sec. 4022(b)(3)(B) of ERISA) and it is currently about $28,000. Once PBGC has taken over a terminated plan, the benefits it is required to pay are frozen.

Some pension plans provide benefits based on pay and such benefits will rise with inflation to the extent that inflation results in a subsequent increase in pay. Many union negotiated pension plans provide benefits based on a specified dollar amount for each year of service and such benefits will also rise with inflation to the extent that the unions negotiate improvements.

Retiree benefits are frequently improved on an ad hoc basis but usually at the rate of about half of the cost of living. Thus even though very few private pension plans index benefits for inflation directly, as living costs rise, the benefits provided by the active pension plans that are insured by PBGC can also be expected to rise.

PBGC has expressed concern about the flat benefit pension plans in particular because, with steady substantial inflation, such plans require substantial increases to keep benefits at the real dollar level contemplated by the labor-management agreements. The newly added benefits are totally unfunded at the outset and, given high inflation, this dilutes the funded status of the plan and increases PBGC's risk. The problem here does not arise because benefits are flat but because of inflation. And it is important to note that the private pension plan is one of the few financial instruments which permits an immediate correction for a sharp loss of purchasing power. Bank accounts do not rise, life insurance policies do not self-adjust and 401(k) plan balances are not negotiated upward. Whatever other problems private pension plans may have, they deserve no criticism because some of them are improved by their sponsors after inflation has diminished their value.

PROPOSED INDEXING OF PREMIUM BASE

The maximum insured benefit is automatically indexed and the benefits under pension plans that have not yet terminated are increased by amendment whenever the cost of living increases. PBGC's administrative costs also rise. Obviously a flat dollar premium, whether $1.00, $2.60 or $19.00 per participant, cannot adequately support the PBGC indefinitely unless there is no inflation. Congress has increased PBGC premium rates sporadically in the past but by amounts which, in the aggregate, were seven times greater than the cost of living would have warranted. This is because the initial $1.00 premium has proven grossly inadequate and because bankruptcies and plan terminations have recently been running at abnormally high levels.

For these reasons I recommend that the $19.00 base premium rate should be indexed by the same factor used to index the maximum benefit amount. This change would replace sporadic large changes in the premium rate with annual moderate, predictable changes. The reference to "$19" in Sect. 4006(a)(3)(A)(i) of ERISA should be amended to read "$19 multiplied by a fraction, the numerator of which is the contribution and benefit base (determined under Section 230 of the Social Security Act [42 U.S.C. 430]) in effect for the calendar year in which the plan year commences and the denominator of which is such contribution and benefit base in effect in the calendar year 1993." Alternatively, the base in effect in 1992 could be used to the same end if greater margin in future premiums is needed.

FINANCIAL RESULTS MODIFIED FOR PAST INDEXING

The attached Table B sets out in columns (2) through (6), the experience of the single employer insurance fund since the inception of the program. Yearly loss ratios have ranged from a low of -700% to a high of +1200%. Even the cumulative ratios have ranged from 88% to 451%. The total losses through the end of 1991 have been 142% of the total premium. The losses of a given year represent the estimated single sum value of all of the future monthly benefits PBGC became obligated to pay by reason of the plans terminating (or becoming "probable") in that year. Clearly the level of past premiums has been inadequate to cover the losses.

The rest of Table B, Columns (7) through (12), shows what the results would have been if the current premium of $19.00 were considered to be the 1992 value of an indexed premium that started at $7.08 in 1975 and increased by 6% each year to 1992. (The Social Security contribution and benefit bases increased by an average of about 6% per year from 1975 to 1991). Such a modified premium basis would have developed a cumulative loss ratio of only 61%. Furthermore, instead of a deficit every year and a current deficit of $2.5 billion, PBGC would have had a

deficit at the end of only one year (1986) and would currently have a surplus of $2.9 billion.

The last several years have been unusually poor ones for business when compared with the previous ten or twenty years periods. Thus it is not appropriate to base annual indexed premiums on the loss levels of the last three or even five years. Perhaps the 61% loss ratio to date can be considered as a good estimate of the long term future loss ratio based on $19.00 indexed premiums. Except for 1986, 61% is as high as the cumulative loss ratio has been since 1975. On this assumption the $19.00 indexed premium contains a margin of roughly 30% which should be sufficient to amortize the present deficit of $2.5 billion over a 10 or 15 year period. In my judgment, what is needed is an indexing of the present $19.00 premium and not a massive increase to the $80.00 level.

"PROBABLE" CLAIMS

A "probable" termination is one that PBGC considers highly likely to occur but which has not yet begun the termination process. If PBGC considers the employer to be in such dire financial straits that termination is likely to take place sometime in the future, it can put them on the probable list and recognize the liability now. PBGC has indicated that some of these plans actually move off the probable list and others remain on it for years. (See EBRI Issue Brief #126 footnote 25).

At year end 1990 PBGC reported a deficit of $1,934 million. During the 1990 year, PBGC processed $69 million in claims and at the end of the year believed that another $1,111 million would possibly be processed sometime in the future. Thus the highly publicized deficit of $1.9 billion at September 30, 1990 was really "only" $802 million because $1.111 million were losses that had not yet happened. To put the matter in perspective, the estimated single sum liability to provide "pension losers" benefits up to $1,500 per year was $350 million on 9/30/90 ($305 million now), less than a third of the future claims PBGC decided to add in 1990's report.

PBGC's approach to "probable" claims is certainly conservative but it injects an arbitrariness into the official books that is simply inappropriate. Clearly if a claim has not yet occurred, then it is a claim of some future year, if a claim at all. I

recommend that PBGC stick to the facts in its reporting of claims in its Annual Reports. A plan termination or a bankruptcy has either occurred or it has not. The information as to "probable" losses is helpful but only as an indication of what future financial statements might look like. Some liability must be estimated for claims that have been incurred but not yet reported to PBGC or not yet processed fully. It is simply not appropriate to include a liability for claims that have not yet been incurred. I am certain that the IRS would not recognize such books as valid offsets to income.

PBGC has recommended accounting on an accrual basis and has suggested that perhaps a greater part of the $13 billion of underfunded plans with financially troubled sponsors might be included in liabilities. Following PBGC's approach James Smalhout in THE COMING PENSION BAILOUT (Wall Street Journal, 6/10/92) referred to unfunded liabilities of $21.5 billion. Professor Zvi Bodie of Boston University has been using $43 billion as the liability, citing OMB as the source (Contingencies, March/April 1992 p.37).

The $43 billion liability assumes that all private pension benefits accrued to date must be insured by PBGC whenever termination occurs as a consequence of PBGC's acceptance of past premiums! Of course, this could happen if all of the employers with underfunded plans went bankrupt immediately and if all other employers with pension plans terminated them immediately and bought annuities. The chance, however, is rather small. On the same basis, the incurred unfunded liability for Social Security is somewhere between $10 and $30 trillion, but of what practical use is that information?

PBGC'S INVESTMENT POLICY

During 1990 PBGC studied its liabilities and investment options and decided to immunize its annuity obligations by shifting to long term bonds with an average duration equal to that of the pension payments. The effect of this decision was to increase the fixed income securities from 38% of the portfolio at 9/30/89 to 70% at 9/30/91. Equity securities were reduced from 50% to 23%. This change in investment policy is likely to reduce the annual variation in PBGC's reported deficit but it is also likely to reduce the long term investment return on PBGC assets. There are very few 10 years periods in which the return on bonds has exceeded that of stocks.

PBGC has had 7 executive directors in its 18 years and the turnover of its Board members has been even greater. Thus PBGC's management has a much shorter time horizon than does PBGC's obligations. In the last 25 years very few private pension plans have invested as much as 70% in bonds. Most have 50-70% in common stocks aimed at maximizing long range returns. The shifting of roughly 30% of PBGC's invested assets from stocks to bonds will probably result in PBGC's interest assumptions (used to assess liability at plan termination) decreasing by one full percentage point. This seems like a high price for plan sponsors to pay for the stabilization of PBGC's deficit.

PROPOSED GUARANTEE FREEZE

PBGC's 1991 Annual Report states that they will propose freezing the guarantee for plan amendments that increase benefits promises for plans that are underfunded. While this will certainly limit PBGC's exposure to loss, it is basically unfair to unionized workers who must renegotiate their flat benefit plans whenever inflation strikes. Salaried employees covered under final pay

plans will receive full coverage even if massive inflation should occur because their increased pension benefits are the result of salary increases rather than pension plan amendment. This proposal should not be adopted by Congress.

## BANKRUPTCY REFORMS

PBGC's 1991 Annual Report lists a number of changes in the Bankruptcy Code that were included in a bill submitted to Congress in November 1991 (S.2014). My experience in bankruptcy is limited to the Penn Central plan. Penn Central went into bankruptcy in 1972. All pension contributions ceased but the judge permitted the continuing accrual of pension benefits throughout the three year reorganization period. The Penn Central plan was well funded and has continued to pay 100 cents on the dollar but the reorganization seriously weakened its funding.

In my judgment, no pension accruals should be granted without the appropriate contributions. If the reorganized employer must pay wages and Blue Cross premiums for the current workforce, there is no good reason why that employer should not pay their pension contributions. The fact that it is legal to do so, or easy to get away with is not a good reason.

As to the rest of the changes, Congress should be careful that, in giving advantages to PBGC, the pension sponsor's chief credit source is not disadvantaged to the extent that the availability of credit is seriously diminished. In general, if PBGC is given more power and authority, then the sponsors of private pension plans will get pushed around more and eventually there will be fewer and fewer pension plans to insure and collect premiums from.

## PUBLIC RELATIONS

PBGC now publishes an Annual Report with the heft and feel of a Fortune 100 company's report. The latest report runs 60 pages and does contain references to the safety net that Congress set up. Almost all of the PBGC's releases, speeches etc. appear to focus on the negative. For example, a front page headline in the Washington Times (July 29) declares "PRIVATE PENSION FUNDS IN PERIL AS FEDERAL BACKING RUNS IN RED. MASSIVE BAILOUT MAY BE NEEDED." PBGC should balance their presentations and emphasize the positive. The private pension funds it backs are largely well run and financially strong.

The benefits that PBGC pays are important to the recipients. Instead of proposing to make the safety net smaller and harder to get into, PBGC should be proposing new ways to add security. The fact that the economy is in recession and bankruptcies and pension plan terminations are abnormally high does increase PBGC's deficit but it also offers PBGC greater opportunities to serve the public. In short, PBGC's protection is needed more now than ever before.

## APPRAISAL

On balance, I believe PBGC has been well run. There are no scandals to be found here. If PBGC had been established as a private insurance company it would have been forced into bankruptcy the day it opened for business. PBGC is a government agency and, so long as it serves the public interest, it will be around as long as there is a U.S. Department of Labor.

**PENSION BENEFIT GUARANTY CORPORATION**
**FINANCIAL SUMMARY OF THE SINGLE EMPLOYER INSURANCE FUND**
**(ALL $ AMOUNTS IN MILLIONS)**

| YEAR ENDED 9/30 | PREMIUMS COLLECTED IN YEAR | CLAIMS REPORTED FOR YEAR | DEFICIT AT YEAR END | "PROBABLE" CLAIMS END OF YR | PERCENT NOT INCURRED | PENSIONS PAID IN YEAR | ADMIN. EXPENSES PAID | CASH PAID OUT | ASSETS AT END OF YEAR | CASH FLOW SOLVENCY RATIO |
|---|---|---|---|---|---|---|---|---|---|---|
| (1) | (2) | (3) | (4) | (5) | (6) | (7) | (8) | (9) | (10) | (11) |
| 1975 | $30 | $32 | | | | $3 | $3 | $6 | | |
| 1976 | $25 | $18 | | | | $10 | $9 | $19 | $127 | 9.5 |
| 1977 | $26 | $24 | | | | $12 | $12 | $24 | $176 | 11.0 |
| 1978 | $27 | $73 | | | | $22 | $15 | $37 | $264 | 9.2 |
| 1979 | $70 | $45 | | | | $28 | $17 | $45 | $342 | 10.4 |
| 1980 | $71 | $26 | $95 | | | $37 | $19 | $56 | $467 | 8.4 |
| 1981 | $75 | $141 | $189 | $82 | 43% | $57 | $21 | $77 | $515 | 6.7 |
| 1982 | $80 | $203 | $333 | $102 | 31% | $94 | $24 | $118 | $835 | 7.1 |
| 1983 | $82 | $167 | $523 | $93 | 18% | $137 | $27 | $164 | $1,085 | 6.6 |
| 1984 | $81 | $42 | $462 | $109 | 24% | $169 | $30 | $200 | $1,063 | 5.3 |
| 1985 | $82 | $658 | $1,325 | $585 | 44% | $170 | $33 | $203 | $1,155 | 5.7 |
| 1986 | $201 | $2,407 | $3,826 | $2,439 | 64% | $261 | $33 | $294 | $1,740 | 5.9 |
| 1987 | $268 | ($1,872) | $1,549 | $418 | 27% | $300 | $36 | $336 | $2,163 | 6.4 |
| 1988 | $465 | $58 | $1,543 | $108 | 7% | $357 | $48 | $405 | $2,422 | 6.0 |
| 1989 | $603 | $163 | $1,124 | $242 | 22% | $353 | $45 | $398 | $3,059 | 7.7 |
| 1990 | $659 | $938 | $1,913 | $1,111 | 58% | $369 | $63 | $432 | $3,111 | 7.2 |
| 1991 | $741 | $1,049 | $2,510 | $776 | 31% | $514 | $71 | $585 | $5,664 | 9.7 |

NOTE: COLUMN (6) EQUALS COLUMN (5) DIVIDED BY COLUMN (4)

COLUMN (11) EQUALS COLUMN (10) DIVIDED BY COLUMN (9)

TABLE B

PENSION BENEFIT GUARANTY CORPORATION
FINANCIAL SUMMARY OF SINGLE EMPLOYER INSURANCE FUND
ALL $ AMOUNTS IN MILLIONS EXCEPT FOR COLUMN (7)

| | | | | | | MODIFIED BASIS--BASE UNIT INCREASES 6% PER YEAR | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| YEAR END 9/30 (1) | PREMIUMS IN YEAR (2) | CLAIMS IN YEAR (3) | LOSS RATIOS YEAR (4) | LOSS RATIOS TO DATE (5) | DEFICIT END OF YEAR (6) | BASE UNIT (7) | PREMIUMS IN YEAR (8) | LOSS RATIOS YEAR (9) | LOSS RATIOS TO DATE (10) | ADDED ASSETS (11) | SURPLUS END OF YR (12) |
| 1975 | $30 | $32 | 107% | 107% | | $7.06 | $212 | 15% | 15% | $182 | |
| 1976 | 25 | 18 | 72% | 91% | | 7.48 | 187 | 10% | 13% | 355 | |
| 1977 | 26 | 24 | 92% | 91% | | 7.93 | 206 | 12% | 12% | 556 | |
| 1978 | 27 | 73 | 270% | 136% | | 8.40 | 227 | 32% | 18% | 789 | |
| 1979 | 70 | 45 | 64% | 108% | | 8.91 | 240 | 19% | 18% | 1,006 | |
| 1980 | 71 | 26 | 37% | 88% | $95 | 9.44 | 258 | 10% | 16% | 1,254 | $1,159 |
| 1981 | 75 | 141 | 188% | 111% | 189 | 10.01 | 289 | 49% | 22% | 1,543 | 1,354 |
| 1982 | 80 | 203 | 254% | 139% | 333 | 10.61 | 326 | 62% | 29% | 1,882 | 1,549 |
| 1983 | 82 | 167 | 204% | 150% | 523 | 11.25 | 355 | 47% | 32% | 2,267 | 1,744 |
| 1984 | 81 | 42 | 52% | 136% | 462 | 11.92 | 371 | 11% | 29% | 2,694 | 2,232 |
| 1985 | 82 | 658 | 802% | 220% | 1,325 | 12.64 | 399 | 165% | 47% | 3,172 | 1,847 |
| 1986 | 201 | 2,407 | 1198% | 451% | 3,826 | 13.39 | 317 | 760% | 113% | 3,478 | (348) |
| 1987 | 268 | (1,872) | -699% | 176% | 1,549 | 14.20 | 448 | -418% | 51% | 3,866 | 2,317 |
| 1988 | 465 | 58 | 12% | 128% | 1,543 | 15.05 | 623 | 7% | 43% | 4,456 | 2,913 |
| 1989 | 603 | 163 | 27% | 100% | 1,124 | 15.95 | 601 | 27% | 42% | 4,722 | 3,598 |
| 1990 | 659 | 938 | 142% | 110% | 1,913 | 16.91 | 696 | 135% | 52% | 5,043 | 3,130 |
| 1991 | 741 | 1,049 | 142% | 116% | 2,510 | 17.92 | 830 | 126% | 61% | 5,434 | 2,924 |
| 1992 | | | | | | 19.00 | | | | | |

COLUMN (4) EQUALS COLUMN (3) DIVIDED BY COLUMN (2)
COLUMN (5) EQUALS THE RATIO OF TOTALS TO DATE OF COLUMNS (3) AND (2)
COLUMN (8) EQUALS COLUMN (2) TIMES COLUMN (7) DIVIDED BY THE ACTUAL BASE UNITS
COLUMNS (10) AND (11) SUBSTITUTE COLUMN (8) FOR COLUMN (2)

## Statement of the Principal Financial Group

The Principal Financial Group is a family of insurance and financial services with assets of more than $33 billion. Its largest member company, Principal Mutual Life Insurance Company, is currently the sixth largest life insurance company in the nation ranked by premium income.

The Principal Financial Group serves 688,000 individual policy holders, 66,000 group employer clients, 23,700 pension contractholders and 62,600 mutual fund shareholder accounts. In all, 7.4 million customers (businesses, individuals, and their dependents) rely on the companies of The Principal Financial Group for their financial services needs.

The Principal believes a strong PBGC is essential to the national pension system. The PBGC must continue to step in and guarantee benefits upon a distress termination. It is important to have a "safety net" to insure the benefits of plan participants. As a result, we are deeply concerned by the PBGC's current financial difficulties. The PBGC's deficit for the single-employer fund was $2.5 billion in 1991. Forecasted future liabilities of $30–45 billion are expected to be assumed by PBGC as a result of plan terninations in the next 15–20 years, due primarily to minimal funding of some defined benefit plans and increased benefits due to plan terminations or plant shut downs. Unless action is taken soon, the PBGC will go deeper into debt and the Government (taxpayers) may be forced to bail out the PBGC.

We feel it is vital that the opinions of typical defined benefit plan sponsors also be heard by Congress. For that reason, we surveyed more than 100 of our customers that fund their plans with The Principal. On average, these plans benefit from 100–500 participants and nearly all of them are fully funded. The opinions of these plan sponsors are very enlightening. We have summarized the survey as part of our statement.

We have divided our comments into two parts: the first part covers our comments on the various legislative proposals; the second part summarizes our customer survey.

### COMMENTS ON PROPOSED LEGISLATION

We support, in general, bills introduced by Rep. Chandler (H.R. 3834), Rep. Michel (H.R. 4545) and Rep. Pickle (H.R. 5800) to reform and strengthen the PBGC. While these proposals have caused debate among the groups affected by the changes, we believe the legislation is beneficial for most employers since, in the past, Congress attempted to solve PBGC's financial difficulties primarily by raising premiums.

Raising PBGC premiums is not an acceptable solution to the problem. PBGC premiums have increased steadily since ERISA was passed in 1974 as Congress has attempted to cover this liability. Each time premiums increase, more sponsors of fully funded plans have terminated their plans, resulting in less pension coverage nationwide and further pressure on the PBGC.

In fact, a recent study conducted by the American Academy of Actuaries found that over 30,000 defined benefit plans have been terminated since 1990. Nearly 40% of those plans have not been replaced, resulting in five million workers without pension coverage. The survey also revealed that 90% of the workers whose plans *were* replaced, received less generous benefits-typically in defined contribution plans. Unless changes are made, the number of workers without pension coverage will continue to increase.

*Part I: Comments By The Principal*

The Principal offers the following comments on the three main points in the bills:

*1. Tougher Minimum Funding Rules*

The bills would strengthen the minimum funding rules for plans with more than 100 participants by:

- creating a new minimum solvency contribution based on both annual benefit payments made by the plan and its unfunded liability, and
- revising the 1989 alternative minimum contribution that requires the amount of a plan's underfunding to be taken into account in determining minimum contributions.

Both changes take aim at strengthening the funding of plans most at risk. While affected employers will see increased plan contributions, it is a good start towards attacking the problem of underfunded plans at its source. However, we believe it is critical that funding changes be aimed specifically at the plans which cause the most potential liability for the PBGC.

Typically, these are plans of larger employers (10,000+ employees) concentrated in certain industries (steel, automobile and airline) which provide flat dollar benefit formulas. We feel the funding changes should be aimed at these types of plans. The PBGC reports that $40 billion in underfunding is concentrated in the steel, automobile and airline industries—$13 billion of this in financially troubled companies.

If funding rules are changed for all plans with more than 100 employees, actuarial valuation costs for these plans will increase needlessly since the vast majority of these plans are not at risk.

In addition, the Principal feels that plans which provide "dollars times years of service" benefit formulas should be allowed to project future benefit increases in the same manner as plans that provide benefits based on compensation. Allowing such projections would significantly reduce the amount of unfunded liability in these plans.

*2. Limits on PBGC Benefit Guarantees*

The bills would reduce the amount of guarantees for future underfunded benefits by requiring plans to be fully funded before PBGC will guarantee future benefit increases.

In essence, this requires employers to pay for previously promised benefits before the PBGC will take responsibility for new ones. This could affect employees in one of two ways-either unfunded plans will not increase benefits or the PBGC will not guarantee the increased amount. The Principal supports this proposal since it will place more responsibility on employers and employees and encourage them to design affordable plans.

*3. PBGC Recoveries In Bankruptcy Proceedings*

The bills would increase PBGC recoveries in bankruptcy proceedings by moving the PBGC up in priority status and allowing the agency to recover the greater of 30% of net worth or a phased in percentage of the unfunded liability.

This proposal would have a negative impact on other creditors whose relative position in bankruptcy proceedings could be downgraded. Creditors will be forced to change lending methods. Also, employers may need to keep plans well funded in order to avoid more costly credit. Fairness suggests that this change in priority status should not affect credit extended by others before the effective date of this legislation. In the future, however, the provision could provide additional incentive to the employer to properly fund its plan in order to obtain the most inexpensive credit possible.

*Part II: Survey of Pension Plan Sponsors*

As mentioned earlier, The Principal surveyed over 100 of our defined benefit customers to get their views on the PBGC, its current financial status and the proposed legislation. The plan sponsors were amazingly supportive of the PBGC. Indeed, 98% felt it served an important function in the private pension system. They did feel that some employers were taking advantage of the PBGC and many expressed concern about the availability of the PBGC as a safety net for their plan participants. As a result, over 75% supported all or part of the proposed legislation. The plan sponsors were most supportive of the minimum funding changes.

Even the plan sponsors with well funded plans were concerned about the future of the PBGC. The overriding concern of the majority of plan sponsors was the fear of higher PBGC premiums. Almost all of the plan sponsors felt that well funded plans must not be penalized through insurance premiums. As one sponsor said, ". . . the good guys are punished for the business practices of those that don't fund their plans properly." 50% of the plan sponsors surveyed felt that PBGC premiums were too high already. 77% said if the premiums rose any higher, they would seriously consider terminating their plans.

As mentioned earlier, the majority of survey participants felt minimum funding changes should be made. Nearly 60% felt that plan underfunding should not be tolerated. These plan sponsors stated that employers have an obligation to keep their plans well funded. Many felt that plan sponsors should be required to reach full funding within a minimum number of years. Those that don't reach full funding within the required time period would face penalties.

Sponsors supported the proposal to limit guaranteed benefits for underfunded plans, as well. They felt that underfunded plans shouldn't be allowed to increase benefits. They felt that employers should be realistic and establish plans that promise affordable benefits.

It is clear from our survey that while plan sponsors are both supportive of and recognize the need for the PBGC, they feel strongly that legislative measures are needed to insure sufficient plan funding and stabilize the PBGC's financial status.

We would be pleased to provide further details of the survey upon request.

ADDITIONAL SUGGESTIONS AND COMMENTS

The Principal believes the primary problem is the minimum funding rules which allow much flexibility in determining the minimum required contribution and the assumed interest rates that may be used in the plan's actuarial valuation. Benefits at plan termination must be purchased at then-current market rates which can be lower than the plan's assumed rates. This difference can often result in plan terminations with insufficient assets.

We suggest the PBGC better coordinate the methods of determining minimum funding requirements and actual plan termination liability in order to reduce the amount of underfunding at plan termination.

SUMMARY

In summary, The Principal supports the PBGC reform packages in H.R. 3834, H.R. 4545, and H.R. 5800. We strongly support changes to the minimum funding rules in order to reduce plan underfunding and better coordinate minimum funding requirements and actual plan termination liability. We also support limiting the amount of guaranteed benefit increases in underfunded plans in order to force employers to take establish affordable plans. Finally, we support increasing the PBGC's recoveries in bankruptcy proceedings, but believe that the provisions regarding PBGC seniority over other creditors should be prospective. It is in everyone's best interests to keep the PBGC financially sound.

*For More Information*

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