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# PENSION PLANS

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# Underfunded Plans Threaten PBGC


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SUMMARY

GAO placed the private pension system on its "high-risk" list because of the potential for large losses to taxpayers and long-standing control weaknesses at the Pension Benefit Guaranty Corporation (PBGC). Successfully addressing these problems involves management reforms at PBGC, modifications to the requirements for funding pension plans, and, possibly, revising the premiums charged for insuring pension benefits.

Management deficiencies have undermined PBGC's ability to administer the pension insurance program. Its financial statements have been unauditable, and its insurance premium reporting and collection system has had serious problems. While much remains to be done, PBGC has made progress in the last 2 years on its management problems. Unfortunately it lacks the tools needed to control its exposure to losses from underfunded plans.

PBGC currently has a positive cash flow but its single-employer fund deficit has grown in recent years to a reported $2.5 billion at the end of 1991. Terminations of large underfunded pension plans sponsored by financially weak companies would significantly increase that deficit. PBGC recently estimated that, as of December 31, 1991, the pension plans that it insures were underfunded by about $51 billion, including about $12 billion owed by financially troubled companies that constituted reasonably possible losses to PBGC. The underfunding figures may be understated for termination purposes. In December 1992, GAO reported that the unfunded liabilities calculated by PBGC for terminated plans were 58 percent higher than the plans reported on their last pretermination annual filings with IRS.

Plan sponsors in financial difficulties sometimes take actions that increase PBGC's risk. PBGC's only means of restricting its losses in these cases are to persuade the sponsor to better fund the plan or to terminate the plan--an onerous action for all concerned. Two features of the pension program--the premium structure and the funding standards--limit PBGC's ability to control risks. While underfunded plans pay a higher premium than well-funded plans, the additional premium is too low for the higher risk they pose to PBGC. The minimum funding standards for pensions do not require that plan sponsors make sufficient plan contributions to pay promised benefits upon termination. In an ongoing study of eight companies included on PBGC's list of the 50 companies with the largest underfunded pension plans, GAO found that significantly underfunded plans increased their benefits which contributed to their increased underfunding. In addition, overfunded plans are not as well funded in 1991 as they were in 1990.

GAO believes that the minimum funding standards need to be strengthened, even though they would increase the federal deficit in the short run by increasing tax-deductible contributions. In addition, the Congress should consider making the premium more risk related.

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me here to discuss the problems facing the Pension Benefit Guaranty Corporation (PBGC). Several years ago GAO placed PBGC on its "high-risk" list of federal programs because of the potential for large losses to taxpayers and long-standing internal control weaknesses. Since then, we have devoted significant attention to problems with pension plans and PBGC. In December 1992, as part of a series of reports dealing with high-risk areas, we reported our concerns about PBGC.[1]

In our view, successfully addressing the problems confronting PBGC involves management reforms, modification of the pension funding rules, and, possibly, changes in the insurance premium structure.

## MANAGEMENT DEFICIENCIES WEAKEN PROGRAM ADMINISTRATION

The first challenge is better management of PBGC. Weaknesses in internal controls and financial systems have undermined PBGC's ability to administer the pension insurance program. We have been unable to audit PBGC's financial statements, primarily because we were unable to determine the reliability of its estimated liability for future benefits, which makes up more than 95 percent of its reported liabilities. Nobody can effectively monitor PBGC's financial condition without reliable financial statements.

PBGC also has serious problems with its premium accounting and collection processes. PBGC's efforts to identify and collect delinquent (unpaid) premiums, underpaid premiums, and related interest and penalties have been inadequate. PBGC has not made adequate attempts to collect delinquent premiums from large plans, and had not even attempted to identify or collect delinquent premiums from small plans. Moreover, PBGC normally had not used civil action to collect delinquent premiums.

A breakdown in PBGC's computerized premium accounting system was a major factor in some of these problems. PBGC's computerized system has not been fully operational since 1988, after PBGC attempted unsuccessfully to modify the system to handle variable premiums. Until recently, PBGC management had not paid sufficient attention to premium system improvement initiatives to modify the current system and procure a replacement system. As a result, PBGC has only partially restored premium accounting system operations.

PBGC management has developed a series of interim and long-term financial management initiatives and provided added resources to address these weaknesses. PBGC established a comprehensive

[1] High Risk Series: Pension Benefit Guaranty Corporation (GAO/HR-93-5, Dec. 1992).

management control review program that is designed to alert its managers to their responsibility for (1) establishing and maintaining internal controls and financial systems, (2) assessing their operating effectiveness, and (3) addressing weaknesses that are identified.

Over the last 2 years, PBGC has made substantial progress with its financial management initiatives and its management control program. Many of the initiatives are still underway and will require additional time and resources to fully address the weaknesses. One indication of PBGC's progress is reflected in our ongoing audit of PBGC's fiscal year 1992 financial statements. While we still have substantial audit work to perform, we currently believe that PBGC has made sufficient improvements to allow us to complete a full audit of its balance sheet. However, even with improved management, PBGC has limited ability to control its exposure to losses from underfunded plans.

## PBGC THREATENED BY LARGE LOSSES

PBGC's single-employer insurance fund[2] has had a deficit since its inception in 1974, and the deficit is growing. This deficit, which threatens PBGC's long-term viability, has resulted primarily from (1) the plans of bankrupt companies terminating without sufficient funds to pay guaranteed benefits and (2) a premium structure that does not provide enough revenue to cover losses.

PBGC currently has a positive cash flow--annual premium and asset incomes exceed its annual benefit obligations and administrative costs. However, longer-term prospects are unclear when considering PBGC's unfunded deficit.[3] This deficit was $2.5 billion in the single-employer fund at the end of fiscal year 1991.

When potential terminations of underfunded plans are considered, PBGC's financial condition looks worse. In December 1992, PBGC estimated that, as of December 31, 1991, $51 billion in underfunding existed in the ongoing plans it insures--a 28-percent increase from the previous year. About $40 billion of that underfunding was in single-employer plans, especially those in the automobile, steel, airline, and tire industries. PBGC estimated that about 30 percent of the single-employer underfunding, owed by

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[2]PBGC administers two separate programs--one for single-employer plans, the other for multiemployer plans. The multiemployer plan insurance program had an accumulated surplus of $187 million as of 1991, according to PBGC.

[3]PBGC's deficit measures its assets against the present value of guaranteed benefits to participants in underfunded plans that have terminated or are expected to terminate in the near future.

financially troubled companies, constituted reasonably possible losses to PBGC.

In estimating underfunding, PBGC made adjustments to financial data reported for the plans because, in PBGC's view, plans' financial reports --prepared on the basis that plans are ongoing operations--do not reflect the financial conditions of plans when they terminate. Recent work by us supports PBGC's view.

Hidden liabilities increase claims

When PBGC takes over a plan, it calculates the value of the assets and liabilities it receives. The unfunded liability calculated by PBGC often exceeds that reported by the plan in its most recent annual filing with the Internal Revenue Service (IRS). GAO defines this difference as a hidden liability.

In a December 1992 report,[4] we studied 44 plans that terminated from 1986 to 1988, which accounted for 96 percent of the claims against PBGC for that period. PBGC determined that these plans had aggregate unfunded liabilities of $2.7 billion at termination. This was 58 percent higher than the $1.7 billion in unfunded liabilities reported by the 44 plans on their last, pretermination annual filings with IRS. Eighty percent of the nearly $1 billion in hidden liabilities was due to PBGC's higher estimate of plan liabilities caused by PBGC's use of different actuarial assumptions to value plan liabilities and the payment of shutdown or special early retirement benefits. Twenty percent of the hidden liabilities was due to PBGC's receipt of fewer assets than the plans reported. The lower asset levels were caused by the continued payment of benefits and the failure of plan sponsors to make required contributions.

PBGC uses three actuarial assumptions--interest rates, mortality rates, and retirement age--when calculating a plan's liabilities. The interest rate assumption had the greatest impact on liabilities. When GAO adjusted reported plan liabilities in the 44 plans to the generally lower interest rates used by PBGC at the plans' terminations, unfunded liabilities increased 31 percent.[5]

One reason for a difference in rates is that PBGC regularly adjusts its interest rates to reflect changes in the market price of private insurance companies' annuity contracts. Plan rates tend to

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[4]Pension Plans: Hidden Liabilities Increase Claims Against Government Insurance Program (GAO/HRD-93-7, Dec. 30, 1992).

[5]Calculated plan liabilities rise when interest rate assumptions decline and fall when interest rates rise.

be more stable over time because they represent the expected rate of return on plan assets over the long term.

Shutdown benefits, paid by some plans when companies close plants or downsize, are not prefunded and are not fully valued in the estimate of plan liabilities until they commence. If a plan terminates shortly after shutdown benefits originate, the sponsor will not have had time to fund them. Shutdown benefits cause a sudden increase in plan liabilities and drain plan assets. PBGC estimates that more than 25 percent of its current deficit may be attributable to shutdown benefits from steel industry plans. Shutdown benefits continue to pose a threat to PBGC because a large portion of its current exposure is from plans with shutdown-type benefit provisions in the steel, automobile, and tire and rubber industries.

The assets of the 44 plans GAO reviewed declined by $200 million between their last IRS filing and termination, primarily because of benefit payments. Also, sponsors, experiencing financial difficulties, often failed to make required contributions to their pension plans. The reduction in assets would have been $45 million less if sponsors had made all minimum required contributions.

Even though PBGC is aware of the hidden liability problem and attempts to estimate its exposure by adjusting reported plan liabilities to its own interest rate, it has few tools to control its exposure to plans with hidden liabilities.

## PBGC's LIMITED ABILITY TO DEAL WITH RISK

Because the pensions of plan participants are insured by PBGC, plan sponsors experiencing financial difficulties sometimes take actions that increase the exposure and risk to PBGC. They know that, if the plan terminates before these benefits are fully funded, PBGC will assume the responsibility for paying guaranteed benefits, within certain limits, including a 5-year phase-in of benefit increases.

At present, PBGC's only means of restricting its losses in these cases are to persuade the sponsor to better fund the plan or to terminate the plan, which PBGC can do only in limited circumstances. Even when PBGC can do so, it tries to avoid terminating a plan because such action is onerous to all involved. For example, PBGC incurs a claim that it will have to pay, workers stop accruing benefits, retirees may have their benefits reduced, and the sponsor may be forced into bankruptcy if not already there.

### Program Design Contributes to risk

Two design features of the Employee Retirement Income Security Act (ERISA)--the premium structure and minimum funding standards--also limit PBGC's ability to control the risks these underfunded plans pose. The premiums PBGC collects insure a plan against any shortfall, up to the maximum guarantee times the number of plan participants, no matter how large. Well-funded plans are subsidizing underfunded plans through the premium structure. For years, the single-employer plan annual premium was a fixed amount for each plan participant, regardless of the plan's funded status. To better reflect the risk PBGC faces from underfunded plans, the annual premium was restructured in 1987. Currently, each plan pays $19 per participant; underfunded plans pay an additional variable premium of $9 for each $1,000 of unfunded vested benefits per participant. The combined premium has a ceiling of $72 per person. The fixed premium probably overcharges well-funded plans for the risk PBGC assumes in insuring them; the capped variable premium undercharges underfunded plans for this risk.

Another challenge facing Congress is better funding of insured pensions. ERISA's minimum funding standards do not ensure that all plan sponsors will make sufficient plan contributions to pay promised benefits upon termination. For example, plans that had unfunded liabilities when ERISA was enacted may amortize the unfunded amount over a 40-year period; benefit increases can be amortized over a 30-year period. However, plan sponsors may increase benefits even if the existing benefits are not fully funded. As a result, many of the plans that were underfunded when ERISA was enacted remain underfunded. The Congress has enacted legislation to strengthen the minimum funding standards, most recently in 1987. However, these changes may not be enough to ensure PBGC's long-term financial viability.

We are currently assessing the impact of the 1987 changes on plan funding. In the meantime, work we are currently performing for your Subcommittee shows that some underfunded plans are increasing their benefits and becoming more underfunded. In addition, overfunded plans are becoming less well funded.

Benefit Increases by Underfunded Plans

To address the issue of benefit increases in underfunded plans, you requested that we look at 8 companies on PBGC's list of the 50 companies with the largest underfunded pension plans to determine the extent of their underfunding, whether they recently increased benefits, and how any increases were funded. The eight companies sponsoring the plans we analyzed are in the auto, airline, steel, and tire and rubber industries.

Our work is not yet completed, and we have not discussed our findings with the companies involved. We need to obtain a better understanding of the funding dynamics and the nature of the benefit increases. However, our results to date, which are based on the companies' data,[6] show that some significantly underfunded plans provided benefit increases that further increased their liability.

In plan year 1991, or 1990 for some plans not on a calendar year basis, the eight companies had 68 pension plans,[7] of which 33 were overfunded and 35 were underfunded. The overfunded plans had benefit liabilities of $21.4 billion and assets of $24.2 billion. The underfunded plans were underfunded by about $10.7 billion, with liabilities of $31.8 billion and assets of $21.1 billion. For 49 of the 68 plans, the funding ratio--the ratio of assets to liabilities--had declined from the prior year. In other words, the overfunded plans had less surplus than they had before or became underfunded, and the underfunded plans became more underfunded.

Eighteen of the 35 underfunded plans had increased benefits in 1991. While some of the increases were relatively small, others were substantial in relation to the plans' unfunded liability and the increases in their accrued liability. For example, the benefit increases for one plan were equal to 59 percent of its unfunded liability and 54 percent of its increase in accrued liability.

Overall, the benefit increases by the 18 plans were about $2.2 billion, which was about 20 percent of the amount by which these plans were underfunded for 1991 and 6.8 percent of the 1991 accrued liability. Benefit increases accounted for about 39 percent of the increase in unfunded liabilities between 1990 and 1991. Though this is significant, we are also looking into other factors that influence liability growth and will be reporting on this in the future.

We also analyzed benefit increases over a 3-year period and found that 10 additional underfunded plans had benefit increases, though benefit increases in 1991 were higher than in other recent years. In total, benefit increases averaged $1.2 billion a year for the 28 of the 35 underfunded plans that increased benefits at least once during the 3-year period 1989-91.

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[6]PBGC's top 50 list is based on company data adjusted by PBGC. Generally PBGC's adjustments, especially its use of the PBGC interest rate, rather than a plan's interest rate, would result in a significantly higher liability than a plan reports. In addition, individual plan data were often not available to PBGC, which reported underfunded plans by company using aggregate data on underfunded plans from the plan sponsors' financial statements.

[7]Some plans do not report on a calendar year basis. Our 1991 data include 1990 data, which are the most recent available for such plans. Also, we excluded four relatively small pension plans that had not been in existence during both 1990 and 1991 and three large plans that were atypical.

The attachment shows the extent of underfunding for underfunded plans and the amount of benefit increases that such plans granted in 1991. We have not identified the plans, and we have combined data from two large plans. We did this because the Single-Employer Pension Plan Amendments Act of 1986 prohibit us from disclosing the identity of any individual or employer in making any information obtained under the act available to the public. We have identified the plans and the companies sponsoring them to your office.

## CONCLUSIONS AND ACTIONS NEEDED

As long as pension plan underfunding persists, the pension insurance program and plan participants' benefits are at risk. We believe this is the time--while PBGC still has a positive cash flow--to develop solutions to better fund pension promises. We support more effective funding standards for defined benefit pension plans. Reducing underfunding would limit PBGC's future exposure and appropriately target the greatest threat confronting it--underfunded pension plans. Although strengthened funding standards would increase the federal deficit in the short run, because pension contributions are a tax-deductible business expense, it is a necessary step to avoid potentially significant future costs.

In addition, the Congress should consider whether the overall premium ceiling and existing variable premium rate best reflect the risk to PBGC. Raising premiums, by making the variable rate premium more risk-related would reduce PBGC's deficit. The Congress should first focus on the premiums paid by underfunded plans because these plans pose the greatest threat to the program.

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

UNDERFUNDED PLANS AND BENEFIT INCREASES (IN THOUSANDS)

| Plan | 1990 underfunding | Benefit increase | 1991 underfunding |
|---|---|---|---|
| 1 | $9,150 | $8,153 | $24,498 |
| 2 | 5,565 | 368 | 13,393 |
| 3 | 152,938 | 919 | 207,243 |
| 4 | 1,659 | -- | 1,409 |
| 5 | 1,211 | -- | 1,756 |
| 6 | 313,200 | 29,043 | 486,975 |
| 7 | 262,352 | 41,767 | 330,989 |
| 8 | 110,813 | 21,922 | 155,229 |
| 9 | 31,074 | 11,403 | 51,312 |
| 10 | 14,503 | 3,512 | 21,750 |
| 11 | 2,743 | 26 | 2,990 |
| 12 | 274 | 12 | 1,362 |
| 13 | 215 | 43 | 460 |
| 14 | 105 | -- | 149 |
| 15 | (596)[1] | -- | 1,961 |
| 16 | (939)[1] | -- | 1,156 |
| 17 | (1,049)[1] | 2,489 | 8,569 |
| 18 | 9,061 | -- | 8,607 |
| 19 | 1,467 | -- | 1,472 |
| 20 | 1,117 | -- | 819 |
| 21 | 853 | -- | 781 |
| 22 | 720 | -- | 632 |
| 23 | 707 | -- | 802 |
| 24 | (189)[1] | 100 | 75 |
| 25 | (1,761)[1] | -- | 204 |
| 26 | 3,363 | 4,695 | 45,871 |
| 27 | 110,481 | -- | 60,385 |
| 28 | 26,421 | 449 | 12,854 |
| 29 | 4,011 | -- | 4,177 |
| 30 | 2,789 | -- | 1,454 |
| 31 | 1,814 | -- | 1,551 |
| 32 | 67,123 | -- | 92,058 |
| 33 | (7,956)[1] | 93,746 | 158,262 |
| Two large plans | 3,999,362 | 1,933,302 | 8,966,904 |
| Totals | $5,122,601 | $2,151,949 | $10,668,109 |

[1]Plan was overfunded by this amount in 1990.

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