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UNDERFUNDED PENSION PLANS

Stronger Funding Rules Needed to Reduce Federal Government's Growing Exposure

Statement for the record by Joseph F. Delfico
Director, Income Security Issues
Health, Education, and Human Services Division

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Mr. Chairman and Members of the Committee:

Thank you for inviting me to submit this statement for the record pertaining to the administration's proposed pension reform legislation, S. 1780, the Retirement Protection Act of 1993. The majority of pension plans insured by the Pension Benefit Guaranty Corporation (PBGC) are well funded. However, a significant minority are underfunded, and the level of underfunding in these plans has been growing in recent years. This growth increases PBGC's exposure (the size of its potential claims).

Because of PBGC's large and growing deficit,[1] the size of the exposure it faced from underfunded plans, and its financial system and internal control weaknesses, we placed PBGC on GAO's list of "high-risk" government programs in 1990. It remains there today. We believe PBGC will continue to be at risk until its deficit is reduced and the funding in underfunded plans is significantly improved, and we believe stronger funding requirements are needed for such an improvement to occur.

At the request of the Chairman of the Subcommittee on Oversight, House Committee on Ways and Means, we have been studying funding issues for underfunded defined benefit pension plans and will be issuing a report to him in the near future.[2] Our study looks at the effectiveness of current funding rules and at the impact on plan funding of the administration's proposal. This statement is based on our results to date.

I would like to make three main points. First, current rules designed to ensure that sponsors of underfunded plans make additional contributions to better fund their plans are not working well. Second, S. 1780 should lead to substantial improvements over current law. And third, S. 1780 could and should be strengthened.

HISTORY OF PENSION PLAN FUNDING REGULATIONS

Before the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), only minimal funding rules existed. As a result, participants lost promised benefits if their underfunded plans terminated. Among other provisions, ERISA established firm minimum funding rules and established PBGC to insure the pension benefits of participants in most defined benefit plans. The ERISA funding rules worked as intended for many plans, but by the mid-1980s it became apparent that they did not work well for some plans.

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[1]The deficit in PBGC's Single-Employer Program was $2.9 billion on September 30, 1993.

[2]In a defined benefit pension plan, benefits are generally based on a formula that takes into consideration job tenure and/or earnings.

To further protect PBGC and bolster funding levels in underfunded plans, the Congress enacted the Pension Protection Act (PPA), a part of the Omnibus Budget Reconciliation Act of 1987. Among the act's provisions was an additional funding requirement for large (101 or more participants) underfunded plans. Sponsors of these underfunded plans not only had to make the contribution dictated by ERISA's minimum funding rules (specified in sec. 412(b) of the Internal Revenue Code (IRC), they had to determine if they were required to make additional contributions (specified in sec. 412(l) of the IRC), which are contingent upon both the level of plan underfunding and when it was incurred.

Plans subject to the additional funding requirement first determine their deficit reduction contribution (DRC), the additional contribution before any adjustments are made.[3] The DRC is reduced by subtracting selected components of the plan's minimum required contribution under ERISA. This reduction amount is called an offset.[4,5]

The expectation was that this additional funding requirement would help to accelerate the movement of underfunded plans toward full funding. The Congress's expectation has not been realized. PBGC reports that underfunding in the single-employer plans it insures increased from $31 billion in 1990 to over $50 billion at the end of 1992. Although this increase is due in part to declining interest rates, the trend is cause for concern.

SHORTCOMINGS IN THE CURRENT LAW

To determine the effectiveness of the Pension Protection Act's additional funding requirement, we randomly selected a sample of 93 plans from the approximately 5,000 large plans that were making

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[3]The DRC comprises a payment for the plan's underfunding at the beginning of the 1988 plan year, amortized over 18 years, and a payment for any new underfunding amortized over a shorter period that depends on the ratio of plan assets to plan liabilities (the plan's funding ratio). We estimate that between 2,500 and 3,600 plans were subject to the additional funding provision in 1990.

[4]Components of the offset (for example, the amortization payment to reduce unfunded past service liabilities arising from plan amendments) are listed in sec. 412(l)(1)(A)(ii) of the IRC.

[5]If the plan has an unpredictable contingent event payment (usually caused by a plant shutdown), an additional payment is added to the net amount computed. The net DRC is then tested to ensure that it does not exceed the beginning-of-year underfunding in the plan. Finally, it is reduced for plans with not more than 150 participants.

variable rate premium payments to PBGC in 1990.[6] Fifty-seven of these 93 plans had unfunded current liabilities and, therefore, were subject to the additional funding requirement. We focused our analysis on three factors that can influence the size of additional contributions--the offset, splitting plan underfunding into old and new components, and interest rates.

We found that the current law offset completely eliminated additional contributions for sponsors of 34 plans in our sample that were subject to the additional funding requirement (60 percent) and reduced them substantially for 16 others (28 percent). Sponsors of only 22 plans in our sample made additional contributions in 1990,[7] and these additional contributions equaled only 2.6 percent of the underfunding in those 22 plans.

This suggests, in our view, that the design of the offset is flawed. Under current law, the offset can be much larger than the DRC because, for most underfunded plans in our sample, the offset contains most of the amortization charges included in the ERISA minimum contribution but few of the counteracting amortization credits. The offset should, at a minimum, include all amortization charges and all amortization credits in the ERISA minimum contribution.

Also, splitting a plan's liability into old and new components reduced both the size of additional contributions and the number of sponsors who would make them. Because this provision is transitional and is designed to phase out, we do not believe it needs to be modified.

Finally, in 1990 plans were not using high interest rates to avoid making additional contributions. Only about 25 percent of the plans in our sample used an interest rate in the top half of the allowable range, and only two plans used the highest permitted rate.

PROPOSED LEGISLATION TO IMPROVE FUNDING

The bill before the Congress, S. 1780, the Retirement Protection Act, addresses the shortcomings in the current law. Our analysis indicates that S. 1780 would increase the number of sponsors of underfunded plans making additional contributions

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[6]The variable rate premium, which depends on the per participant level of plan underfunding, is an additional premium paid to PBGC by underfunded plans. The measure of underfunding differs from that used to determine if additional contributions should be made.

[7]Another sponsor should have made additional contributions, but did not because the instructions were misinterpreted.

compared with current law and would substantially increase the amount of additional contributions affected sponsors would pay (see table 1).

Table 1: Comparative Effects of Additional Funding Requirements Under Current Law and S. 1780, Based on a Sample of 93 Plans in 1990

	Provision	
	Current Law	S. 1780
Number of plans subject to additional funding requirement	57	65
Total underfunding (all plans)	$201.6 M	$255.6 M
Number of plans receiving additional contributions	22	34
Total underfunding in plans receiving additional contributions	$106.5 M	$221.6 M
Total additional contributions	$2.8 M	$28.0 M
Additional contribution as a percent of underfunding (in plans receiving them)	2.6%	12.6%

Our analysis suggests that the administration's bill, S. 1780, moves in the right direction in addressing the underfunding problem for many underfunded plans. Indeed, most funding provisions in the bill will affect only underfunded plans. Another advantage of the bill is that its funding proposals only modify the structure of current law, so practitioners will not have to learn a new system.

Most importantly, the bill corrects the current law offset's design flaw. In our view, the redesign of the offset is the single most important funding provision in the bill and is needed, as is, to maintain the integrity of the proposal.

The bill also contains several other provisions that can increase contributions to underfunded plans. These include a solvency rule, restrictions on actuarial assumptions, an increase in the deficit reduction contribution for many plans, and the immediate recognition of benefit increases.

The solvency rule would require that plans' liquid assets equal at least 3 years' disbursements. Our earlier work on hidden liabilities in pension plans demonstrated that underfunding can increase rapidly in many plans immediately before termination.[8] The solvency rule would provide that a cushion of assets be maintained to protect plan participants and the PBGC. Only one plan in our sample would have received a solvency rule contribution under this provision in 1990.

The restrictions on actuarial assumptions would dictate that plans determine their current liabilities using a specified mortality table and the lower half of the current allowable interest rate range. These restrictions would increase current liabilities for most plans in our sample and would increase the number of plans subject to the additional contribution provision.

The administration's bill would also increase the DRC for plans whose funding ratios exceed 35 percent and would require immediate recognition of all bargained benefit increases, even if part of the increase does not take effect for several years. The first provision would increase additional contributions for most sponsors making them. The second would accelerate funding in negotiated plans, which generally are flat benefit plans,[9] a type of plan particularly susceptible to underfunding. We used our sample of plans to estimate the impact of the administration's bill had it been in effect in 1990. The actuarial assumption restrictions would have increased the number of plans subject to the additional contribution provision from 57 to 65. Sponsors of 34 of these 65 plans (52 percent) would have made additional contributions equal to about 12.6 percent of the plans' underfunding. Sponsors of all plans in our sample with funding ratios of less than 50 percent would make additional contributions, while sponsors of about half the plans with funding ratios between 50 and 80 percent and about 36 percent of those whose plans had

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

[9]Flat benefit plans generally pay a specified dollar amount per year of service.

funding ratios above 80 percent would make additional contributions.

Further Strengthening of Funding Rules Desirable

Despite the funding improvements that S. 1780 would bring, sponsors of some marginally funded plans would still not make additional contributions. These sponsors may make additional contributions at some point in the future under S. 1780, but we are concerned that some plans may never become fully funded unless they do.

Sponsors of only about 40 percent of the 57 underfunded plans in our sample make additional contributions under current law. The administration's proposal would, we estimate, increase both the number of plans subject to the additional contribution provision and the percentage making additional contributions. Based on our sample, the number of plans subject to the provisions will increase by about 15 percent, and between 50 and 60 percent of this higher number will make additional contributions.[10] With time, this percentage could increase further (because of the elimination of the unfunded old liability component of the DRC, for example).

Nevertheless, sponsors of some plans with relatively low funding ratios will not make additional contributions because their offsets will continue to exceed their DRCs. For example, one plan in our sample, that did not receive additional contributions in 1989 or 1990 and would not receive additional contributions under S. 1780, had a funding ratio that declined from 58 percent in 1988 to 55 percent in 1990. The ERISA minimum contribution did not improve funding in this plan from 1988 to 1990, and we have no reason to believe that this contribution alone will improve the plan's funding in the future. In our opinion, this plan should be receiving additional contributions to bolster its funding.

The most direct way to rectify this problem is to require that sponsors of all plans with funding ratios below a specified threshold, say 80 percent, make an additional contribution to improve their plans' funding. This could be accomplished by capping the offset at a certain percentage of the DRC. This modification would cause sponsors of all plans with funding ratios below 80 percent to make an additional contribution.

[10]Sponsors of 52 percent of the underfunded plans in our sample would make additional contributions with the bill's proposed transitional limitations in place. These limitations would restrict the level of additional contributions through the 2001 plan year. Without these restrictions, sponsors of 38 of the 65 underfunded plans (58 percent) would make additional contributions.

In our sample, sponsors of 75 percent of the underfunded plans would make additional contributions if this modification were in effect (see fig. 1). Those that would not make additional contributions have plans that are at least 80 percent funded. Figure 2 shows additional contributions as a percent of underfunding (for plans receiving additional contributions) under current law, the S. 1780 proposal, and an example of a strengthened proposal with the offset cap set at 50 percent of DRC.

While this approach will increase additional contributions by sponsors that might not make them otherwise, it will also reduce federal revenues because these contributions are tax deductible. The lower the level of the cap on the offset, the higher the additional contributions and revenue loss. To address this issue, the Congress would ultimately have to balance the budget's PAYGO (pay-as-you-go) considerations against improved protections for PBGC and participants in underfunded plans.[11]

The administration's bill contains a number of proposals that do not impinge on plan funding. Although we have not evaluated all of these other provisions, on the basis of our previous work, we see value in the provisions that would (1) require notification of participants of their plan's funding status and the limitations of PBGC's guarantee, (2) require disclosure to PBGC of information necessary to determine current liabilities and assets for certain plans, and (3) remove the cap on the variable rate premium.

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[11]Under the Budget Enforcement Act, PAYGO requires that all direct spending and tax legislation enacted during a session of the Congress must be deficit-neutral in the aggregate.

Figure 1: Estimated Percentage of Underfunded Plans Receiving Additional Contributions Under Current Law, S. 1780, and S. 1780 Modified So That All Plans Less Than 80 Percent Funded Receive Additional Contributions

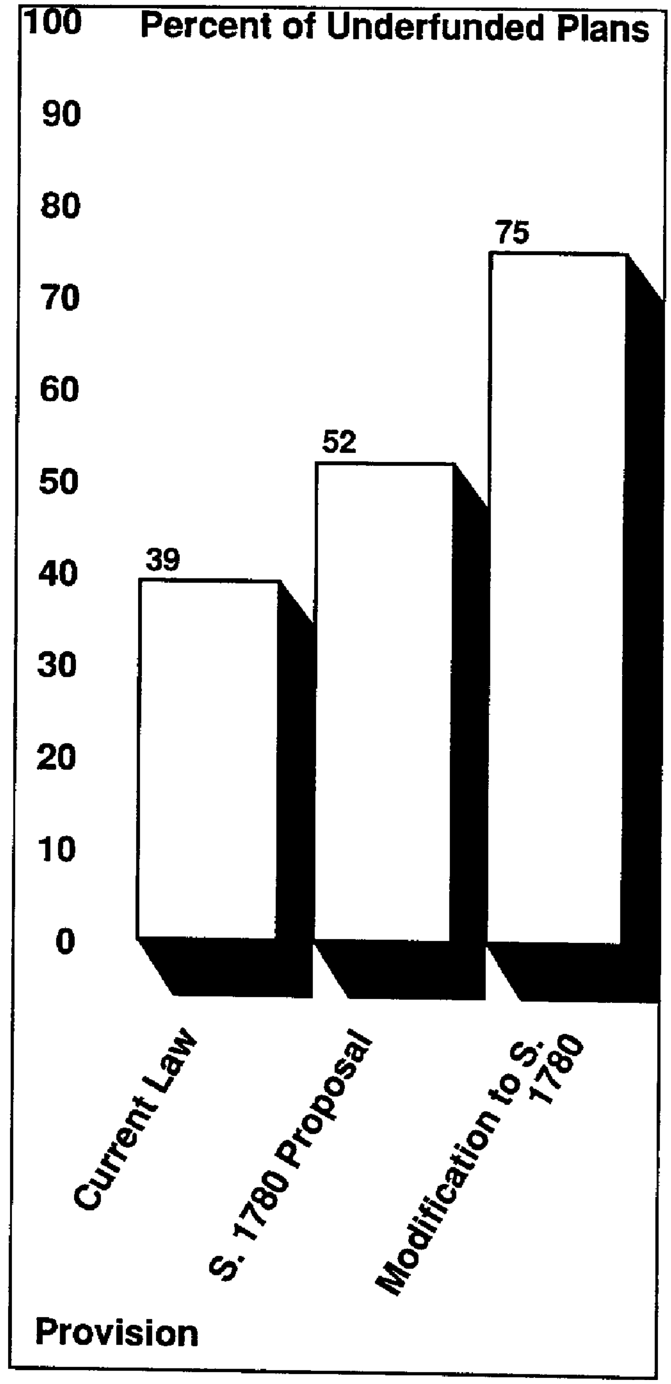
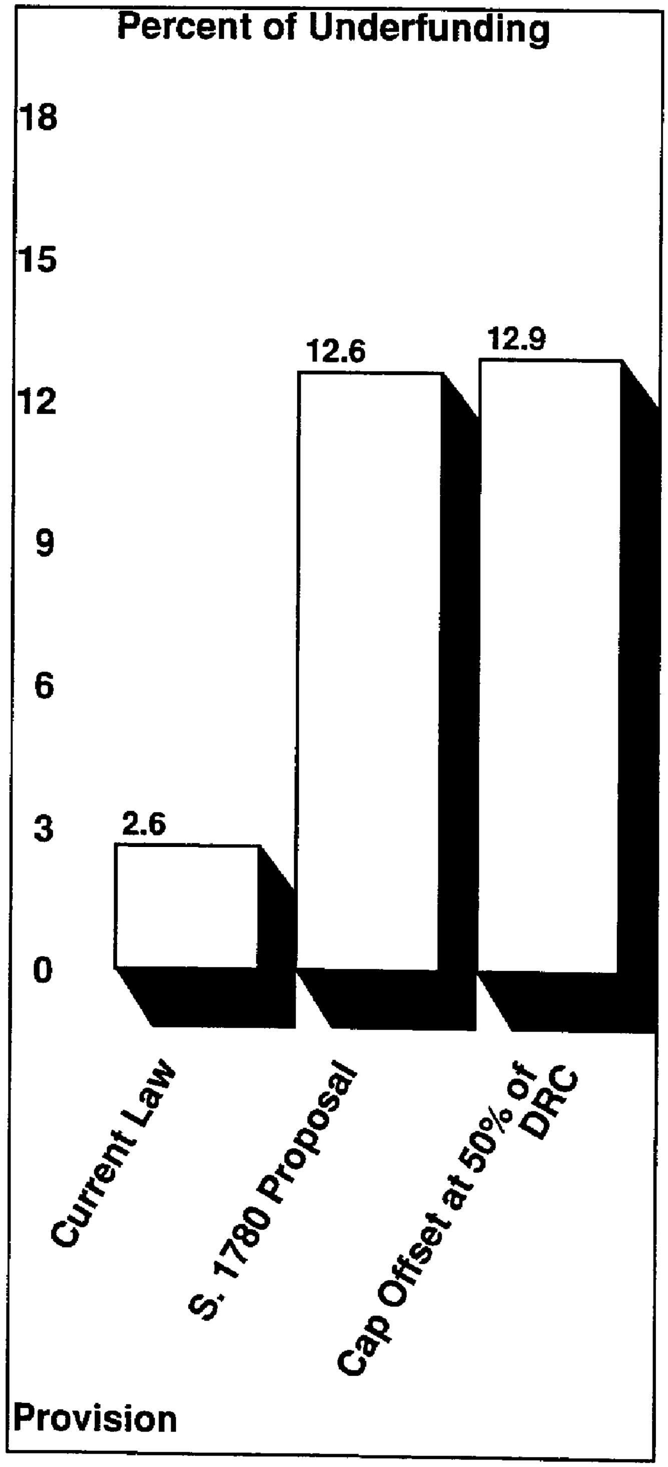


Figure 2: Estimated Additional Contributions as a Percent of Underfunding Under Current Law, S. 1780, and S. 1780 Modified So That the Offset Is Capped for Plans With Funding Ratios of Less Than 80 Percent



CONCLUSION

Our work to date suggests that the evidence of funding problems in some plans is sufficiently compelling to support stronger funding requirements for underfunded plans. PBGC calculations show that underfunding in the plans it insures is increasing in spite of provisions in the 1987 Pension Protection Act and is now over $50 billion. Continued and growing underfunding has several negative impacts. It (1) increases PBGC's exposure, (2) puts plan participants at risk of losing benefits not guaranteed by PBGC, (3) may result in premium increases for well-funded plans (to reduce PBGC's losses), and (4) might result in a taxpayer-assisted bailout of PBGC should the agency become unable to meet its benefit obligations. Improving the funding of underfunded plans would benefit each of these groups.

The additional contribution provision of the 1987 Pension Protection Act appears to be having less impact than envisioned on improving funding in underfunded plans. The proposed funding provisions in the administration's Retirement Protection Act, especially the revised offset design, should increase both the number of sponsors of underfunded plans that make additional contributions and the amount of these additional contributions. However, based on our sample, sponsors of about half the plans that are 50 to 80 percent funded will not make additional contributions under the proposed funding rule changes. As a result, we believe the proposed funding provisions need to be strengthened further to ensure that an even greater percentage of underfunded plans' sponsors make additional contributions.

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This concludes my statement. We would be happy to respond to any questions Committee members may have. Please address questions to Donald C. Snyder of my staff (phone, (202) 512-7204).

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