



United States  
General Accounting Office  
Washington, D.C. 20548

Health, Education, and  
Human Services Division

B-270216

October 24, 1995

The Honorable Gerald D. Kleczka  
House of Representatives

Dear Mr. Kleczka:

Companies that sponsor defined benefit pension plans have set aside over \$900 billion to pay promised benefits. These companies are not allowed to withdraw any of these funds except in special circumstances, such as paying for their retirees' health liabilities. The House of Representatives, however, plans to consider a provision in the upcoming budget reconciliation legislation that would allow companies to transfer excess assets out of defined benefit pension plans they sponsor for any use.

You asked us to provide you with information on pension funding and other issues related to the transfer of assets that would assist you in analyzing this provision. The enclosed information responds to specific questions you raised. The information provided is based on reports and testimonies we have issued and on information we have gathered from other sources.

This correspondence was prepared under the direction of Donald C. Snyder, Assistant Director, Income Security Issues, who may be reached at 202-512-7204 if you or your staff have any questions. Michael D. Packard, Kenneth J. Bombara, Kenneth C. Stockbridge, Susan A. Poling, and Roger J. Thomas also contributed to this correspondence.

Sincerely yours,

Jane L. Ross  
Director, Income Security Issues

Enclosure

RESPONSES TO QUESTIONS ABOUT  
THE CORPORATE PENSION REVERSION PROVISION IN THE  
UPCOMING BUDGET RECONCILIATION LEGISLATION

**Question 1:** (a) What is the difference between "current liability" and "termination liability"? What kinds of costs or liabilities are not included in the measure of "current liability"? (b) Which is the better measure of participants' expectations?

(a) As we reported in Pension Plans: Hidden Liabilities Increase Claims Against Government Insurance Program (GAO/HRD-93-7, Dec. 30, 1992), current liability and termination liability are both measures of the liabilities a pension plan has accrued as of the plan's valuation date. The measures are similar but can yield very different estimates of a plan's accrued liabilities. The primary cause of the difference is the use of different actuarial assumptions--specifically the use of different interest rates, mortality tables, and retirement age assumptions--when calculating the specific liability.

Plan actuaries have some flexibility in their choice of assumptions. The Pension Benefit Guaranty Corporation's (PBGC) assumptions are set by regulation. Thus, for example, interest rates that PBGC uses will generally be lower than the interest rate plan actuaries use. This would cause PBGC's termination liability to be larger than a plan actuary's calculation of the plan's current liability, other factors being constant. A similar pattern holds for the mortality table and retirement age assumptions--PBGC's estimates are often more conservative (resulting in larger calculated liabilities) than the assumptions used by plan actuaries.

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(b) Participant expectations are that they will be paid the benefits promised by the plan. The best guarantee that these benefits will be paid is to fund the plan so that termination liabilities are met. This would allow all insured benefits to be paid if the plan terminates.

**Question 2:** How is it possible that a plan can be funded at current liability plus 25 percent and still pose a risk of loss to participants and PBGC? If a plan is funded at 125 percent of current liability, what kinds of factors can cause a significant drop in the plans funded status? Can you provide examples?

As we reported in Pension Plans (GAO/HRD-93-7, Dec. 30, 1992) and in subsequent testimonies, when companies with pensions enter into the downward financial spiral leading to bankruptcy, their pension assets diminish and their liabilities burgeon. In the sample of 44 plans trusted by PBGC that we studied, unfunded liabilities grew by an average of 58 percent during the period between the last valuation and companies' bankruptcy and PBGC trusteeship of the underfunded plans. Several reasons for the divergence of assets and liabilities in such a short time are that companies enhance benefits to induce earlier retirements, pay shutdown benefits if plants are closed, and sometimes skip contributions due the plan.

Even in companies not entering bankruptcy, a number of factors can quickly reduce plan funding. These include retirements at an earlier age than actuarial expectations, causing more years of benefit payments and fewer years of contributions; lump-sum payouts that drain cash assets from a plan; a decline in the interest rate, which can cause an average 15-percent increase in liabilities for every percentage point decline in the interest rate used to value plan liabilities; and poor investments, which can lower asset levels.

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**Question 3:** If a plan was funded at 125 percent of current liability at the most recent plan valuation date, how certain is it that the plan remains at or above 125 percent of current liability at the time an asset withdrawal is proposed? In other words, how much time can elapse before another valuation is required? How dramatically can the plan's funded status change during that time period?

A plan's underfunding can change dramatically between its valuation date (plans are generally valued once per year, as of the beginning of the plan year) and the date it is decided to withdraw assets from the plan. The degree of change will depend on several factors including the time lapse between the valuation date and the date a company intends to take a reversion of pension assets and what has happened to interest rates, retirement rates, employment rates, the stock market, and asset expenditures (all relative to expectations) in the interim.

**Question 4:** If a plan becomes underfunded and is terminated and trusted by PBGC, how is it that participants are not fully protected against benefit loss?

In our testimony Pension Plans: Benefits Lost When Plans Terminate (GAO/T-HRD-92-58, Sept. 1992), we identified two ways that participants can lose benefits when a plan terminates and PBGC trustees it. First, PBGC guarantees only "basic" monthly retirement benefits that are vested, as well as certain disability, survivor, and early retirement benefits. Also, PBGC calculates early retirement (before age 65) benefits by actuarially reducing early retirement benefits by more than the reduction factor used by the plans it insures. Among the nonbasic benefits that PBGC does not insure are special early retirement benefits, shutdown benefits, and other benefits provided by a plan. In addition,

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benefit increases in the 5 prior years are insured on a phased-in basis of 20 percent per year. Second, PBGC does not insure all benefit amounts, just those up to a set annual amount (\$30,886 in 1995), which is indexed each year.

**Question 5:** In debating this provision, some have suggested that if a plan becomes underfunded, an employer can simply transfer to that plan assets from another plan it sponsors that may be overfunded. Is this permissible under current law? If an employer sponsors both overfunded and underfunded plans, are assets from overfunded plans freely available to reduce the risk posed to participants and PBGC by underfunded plans?

Our review of current law indicates that an overfunded defined benefit plan of a employer may not transfer its excess or surplus assets from that plan to another underfunded plan of that employer, prior to the termination of the plan and the satisfaction of all plan liabilities. Section 403(c)(1) of Title I of the Employee Retirement Income Security Act (ERISA) and section 401(a)(2) of the Internal Revenue Code (IRC) generally provide that the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries. These proscriptions prevent an employer from transferring assets from an ongoing overfunded plan to an underfunded plan.

However, section 208 of Title I of ERISA and section 414(1) of IRC provide for a limited transfer of assets when an employer seeks to merge, consolidate, or transfer plans only if each participant in the plans would receive a benefit to which he or she would have been entitled to before the merger, consolidation, or transfer. Moreover, both Title I of ERISA and IRC provide other limited exceptions to transferring assets, such as for defraying employer

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expenses for retiree health or for repaying a mistaken contribution (for example, one that exceeds the amount needed). Thus, on a limited basis some transfers may be accommodated if the plans merge and participants' benefits are not diminished at the time of that transaction. Generally, however, an employer may not transfer or obtain excess assets from a defined benefit plan under current law.

**Question 6:** (a) It has been suggested that permitting reversions out of pension plans will "free up money" and put it to work for job creation and the benefit of the reverting corporation. Is it not true that pension trust money is already invested in stocks and bonds issued by other companies? In other words, is not most pension money already placed in investments that support economic growth and job creation? Consequently, when for example, Company A takes a reversion from one of its plans, will it not be forced to liquidate stock it has purchased in Companies B, C, and D? (b) Has any attempt been made to quantify the effect on the supply of capital for corporate investment? What would this effect be?

(a) Our analysis shows that most pension money is placed in investments, such as stocks and bonds, that yield a financial return and provide capital to other companies. Plan fiduciaries are required by law to invest plan assets for the exclusive benefit of participants and to seek the highest rate of return for a given level of risk. On this basis, pension assets generally support economic growth and the resulting gains in productivity, wages, and jobs.

If the reverted assets are liquidated and then simply reinvested in other stocks and bonds, the amount of the reinvestment would equal the amount of the reversion and there is no change in the overall supply of capital. However, other effects could reduce the supply of capital as a result of the reversion. One effect is that taxes

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would be paid as a result of the reversion--primarily corporate income taxes. If the resulting government revenue is used to reduce the deficit, then the funds might find their way back into capital investment, as reduced government borrowing "frees up" private capital for other uses. If the increased government revenue is not accompanied by deficit reduction (that is, it is consumed) then the overall supply of capital could be reduced. Another effect could occur in the private sector, for example, if the reversion is paid to stockholders as dividends. As income, some of this could be used for consumption and some for investment.

Other effects are possible. For example, a situation may exist where the reverted pension assets are reinvested in a much higher yielding (or more productive) investment, even adjusting for risk. In this case, there would not be an increase in the supply of capital, but there could be gains in overall productivity and economic growth.

Also, there could be economic effects arising from changes in yields due to shifts in the relative supplies of securities. However, available research and studies suggest that the possibility of economically significant impacts from this factor is remote.

(b) We are not aware of any study that quantifies the supply effect of the reversion proposal.

**Question 7:** It has been suggested that this provision will strengthen the pension system. Is such an assertion accurate?

Our review shows that if excess assets could revert to the employer, defined benefit plans might be more attractive to

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companies, thereby inducing them to offer more defined benefit plans. At the same time, however, reverting excess assets might also weaken the pension system by allowing companies to estimate the minimum allowable liability level and remove the maximum amount of assets from a plan. The more a company needs ready cash or money for alternative purposes, the more tempting a target pension assets will be. However, reducing assets can increase the risk to participants, and could require larger pension contributions from the sponsor in the future than would otherwise be the case.

This asset reversion provision, if used by companies, would shrink the cushion of overfunding that could cover termination liabilities in the event of financial failure of the sponsor. The result would be to increase PBGC's exposure to additional risks of financial loss over what the sponsors of the plans reported on the most recent financial statement (IRS/DoL Form 5500).

**Question 8:** It has been suggested that this provision is necessary because it will release capital for investment. Is such an assertion accurate?

As discussed in Question 6, in our review we found there is no definitive answer to this question. In general, reversions will not increase the supply of capital. If the reverted assets are reinvested in other investments that are more productive (that is, earn a higher return) then there could be greater economic growth. It could be argued that the reversion provision will increase the supply of capital in the long run because plan sponsors may be more willing to contribute to pension plans given the increased flexibility to recover tax-sheltered excess assets. We are not aware of any studies or research that confirms this effect, however.

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**Question 9:** Currently, ERISA requires that pension funds be used for the exclusive benefit of plan participants. Doesn't a proposal that allows employer withdrawals for any purpose violate that requirement?

As noted in response to Question 5, our review of section 403(c)(1) of Title I of ERISA and section 401(a)(2) of IRC indicates that plan assets may not inure to the benefit of an employer and must be held for the exclusive purpose of providing benefits to plan participants and beneficiaries. Employers are prohibited from extracting or transferring a plan's assets. However, under the pertinent language contained in the proposed budget reconciliation legislation, the withdrawal of overfunded assets would be permitted and would no longer be a violation of these provisions.

**Question 10:** What are the minimum funding requirements under ERISA and how does the House proposal interact with those requirements?

ERISA's minimum funding requirements (Sec. 302(b)(2) of ERISA and of sec. 412(b)(2) of IRC) are the sum of (1) a plan's normal cost (the annual cost of future pension benefits and administrative costs assigned, under an actuarial cost method, for the current plan year) and (2) the amounts needed to amortize (a) the past service credits in existence when the plan became covered by ERISA, (b) the unfunded liabilities arising from plan amendments, (c) the net experience loss under the plan, (d) the net loss resulting from changes in actuarial assumptions, and (e) any waiver for past funding deficiencies. As a result, this funding requirement can be met by (1) employer contributions, (2) prior year credit balances, (3) a waiver for funding deficiency, or (4) a combination of these factors. Plans are also credited with amortization credits for (1) reductions in liabilities from plan amendments, (2) experience

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gains, and (3) gains resulting from changes in actuarial assumptions.

The reversion provision, in our view, will not change these funding requirements. However, the asset reversion provisions in the bill can result in plan sponsors being required to make larger cash contributions in the future than they might have otherwise been required to make.

**Question 11:** (a) Have there been any plans that were funded at or above 125 percent of current liability which subsequently were terminated and trusted by PBGC? What was the magnitude of the underfunding in those plans? (b) What was the dollar amount and percentage of their promised benefits that participants in those plans lost?

(a) In our report, Private Pensions: Funding Rule Change Needed to Reduce PBGC's Multibillion Dollar Exposure (GAO/HEHS-95-5, Oct. 5, 1994), we show how wide swings in the funded status of plans can occur. In this report, we studied 88 plans for the years 1988 to 1990 and found that 19 plans had a current liability funding ratio greater than 125 percent in 1988. Eighteen of these 19 had a lower current liability funding ratio 2 years later, including one plan that was less than fully funded in 1990. An additional 4 of these 19 plans had a 1990 funding ratio of less than 110 percent. Six of 15 plans that were between 110- and 125-percent funded on a current liability basis in 1988 were less than fully funded on that basis in 1990. This analysis shows the volatility in plan funding that can occur over a short time span.

(b) We did not analyze the amounts that participants may have lost in the terminations we studied.

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**Question 12:** (a) Have there been any plans from which reversions have been taken that subsequently became underfunded? What was the magnitude of the underfunding? (b) Of these, were any terminated and trusted by PBGC? (c) What was the dollar amount and percentage of their promised benefits that participants in those plans lost?

(a) PBGC provided two examples of plans with large underfunded liabilities that represent several companies in this circumstance:

1. Enron Corp. took \$232 million from its plan in 1986; that plan is now underfunded by \$83 million.
2. ASI Holding Corp. took \$120 million from a plan that is now underfunded by \$86 million (no year provided).

(b) PBGC also provided an example of a company's plans that will become trusted after the company took reversions from them:

Wean United Corp. took reversions totaling \$9.8 million in 1984 and made a claim for \$13.4 million in underfunding on PBGC in 1994.

(c) PBGC does not calculate the benefits that participants lose when it trustees an underfunded plan.

**Question 13:** (a) Have there been any companies that have taken reversions from one plan that, subsequently, became underfunded in another plan? What was the magnitude of the underfunding? (b) What was the dollar amount and percentage of their promised benefits that participants in those plans lost?

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(a) PBGC has listed 20 companies on its "top 50" list of companies with the largest underfunded plans that took reversions from some other plans in the 1980s. Two examples provided by PBGC include:

1. United Air Lines took a \$378 million reversion in 1985.

United's pension plans are underfunded by \$1 billion.

2. Goodyear Tire and Rubber Co. took a \$400 million reversion in 1988 from its salaried plan, its hourly plan is now underfunded by \$388 million.

(b) Though these plans have become underfunded, participants have not lost any benefits because the plans have not been terminated.

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