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Assessing PBGC's Short-Run and Long-Run Conditions

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SUMMARY

1974, the Congress passed the Employee Retirement Income curity Act (ERISA) to correct weaknesses in the private pension stem. Among its provisions, ERISA set minimum funding standards r defined benefit pension plans in an attempt to ensure that ans would accumulate sufficient funds to pay promised benefits. ISA also established the Pension Benefit Guaranty Corporation BGC) to insure a basic level of benefits for participants of ans that terminate without being fully funded.

GC has been burdened by significant internal operations problems. rious financial system and internal control weaknesses have evented us from determining the reliability of PBGC's financial atements. The lack of reliable financial data limits GAO's and e Congress's ability to assess whether PBGC's income will be equate to meet its long-term benefit obligation to pay timely and interrupted benefits. The agency's financial accounting aknesses undermine its ability to administer the pension surance program and provide basic accountability of its programs d resources. PBGC's current management has made substantial forts to improve operations, but the persisting problems indicate at more work is needed.

e Pension Benefit Guaranty Corporation's (PBGC's) deficit is rge, has grown significantly in recent years, and is expected to ntinue to grow. The growth in its deficit will come primarily om underfunded plans that terminate in the future, but premium come that is insufficient to cover losses as they occur will also a contributing factor. At present, PBGC has sufficient cash ow to pay its current benefit obligations, but this may not ntinue.

derfunded plans not only put PBGC at risk, they also pose a risk plan participants. Because PBGC does not guarantee all pension nefits, participants may lose some benefits upon plan rmination.

proving funding requirements to ensure currently underfunded ans become fully funded and currently fully funded plans remain at way will protect both the PBGC and plan participants. Making e premiums plans pay to PBGC more risk-related will help reduce GC losses as they are incurred and could help reduce the agency's rrent deficit.

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me here today to discuss some of the 'urrent and anticipated issues involving the Pension Benefit iuaranty Corporation.

In 1974, the Congress passed the Employee Retirement Income ecurity Act (ERISA) to correct weaknesses in the private pension ystem. One impetus behind ERISA was the Congress' intent to rotect pension plan participants from losing promised benefits if nderfunded plans should terminate. ERISA set minimum funding tandards for defined-benefit pension plans in an attempt to ensure hat plans would accumulate sufficient funds to pay promised enefits. ERISA also established the Pension Benefit Guaranty 'orporation (PBGC) to insure a basic level of benefits in the event hat a defined-benefit plan terminated while underfunded.[1]

Several years ago, GAO placed the private pension insurance ystem on its high-risk list because of financial management system eaknesses and long-standing internal control weaknesses at PBGC. he risks to PBGC, as well as pension plan participants, from nderfunded plans have become more apparent with the termination of number of large pension plans sponsored by companies in declining ndustries. PBGC's administrative and accounting problems add to ur concern about the pension insurance agency. For example, these roblems have prevented us from auditing the agency's financial ondition.

In my statement today I would like to highlight three areas--he operational and administrative problems at PBGC, the financial tatus of PBGC's single-employer insurance fund and the threat to t from currently underfunded private sector plans, and the risks till faced by plan participants.

ANAGEMENT DEFICIENCIES WEAKEN PROGRAM ADMINISTRATION

Serious weaknesses--both of the financial system and internal ontrols--have prevented GAO from determining the reliability of BGC's financial statements. Thus, we cannot assure that the eported financial condition of the agency's funds is reliable. he agency's financial accounting weaknesses limit its ability to ssess the adequacy of PBGC's income flow and its need for dditional funds to pay benefits for future terminated plans. This imits the agency's ability to effectively administer the pension nsurance program and to provide basic accountability for its rograms and resources. The future financial condition of the und, which is discussed later, cannot be judged by the financial

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In a defined-benefit pension plan, benefits are generally based on 'ears of service or earnings.

statements because of the uncertainty of the demands large underfunded plans terminating in the future will place on the fu

Accounting Operations

Our attempts to audit PBGC's fiscal year 1990 and 1991 financial statements were unsuccessful, in part, because neither its general accounting operations nor its financial reporting process had documented the accounting policies or major operatio procedures in place. We found that PBGC did not have an operational general ledger system for its trust accounts during t first 6 months of fiscal year 1990. Effective and continuous operation of both a general ledger system and related accounting policies and procedures are essential to ensuring that accountin information is accurately and consistently processed and summarized.

Liability Estimation

In our fiscal year 1991 audit, we were unable to evaluate t reliability of the PBGC's estimated $7.8 billion liability for future benefits because the PBGC had not (1) developed the documentation and support for its estimating techniques and assumptions, (2) assessed the completeness of the data used in t estimates, and (3) corrected weaknesses in its estimating system software. This liability, which makes up more than 95 percent o PBGC's reported liabilities, represents the discounted value of future benefit payments PBGC is obligated to pay. Without assurances that PBGC's estimate of future benefit obligations is reliable, GAO and the Congress face a difficult task in assessin the adequacy of premium levels to support the pension guaranty program.

Premium Collections

PBGC's premium accounting system--which was developed to account for premium receipts, its principal source of income, as well as identify and collect delinquent (that is, unpaid) and underpaid premiums, and related interest and penalty charges--ha not been fully operational since 1988. As a result, PBGC effort to identify and collect delinquent premiums, underpaid premiums, interest, and penalties were inadequate.

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One of management's basic responsibilities is ensuring that sound financial systems and internal controls are in place and operating. This responsibility is especially critical to an ent that is experiencing financial difficulties. In our judgement, nature of the problems we uncovered reflects a failure by earlie PBGC management to fulfill its obligations.

PBGC Actions to Improve Its Operations

Over the last 2 years, the management of PBGC responded to our reported weaknesses by (1) developing a series of interim and long-term financial initiatives and (2) providing added resources to address these weaknesses. The agency has made substantial progress with its financial management initiatives and its management controls program. Many of the initiatives are still under way and will require additional time and resources to correct the identified weaknesses. However, as an indication of PBGC's progress in improving its financial statements, we believe, at this time, that we will be able to complete a full audit of its 1992 balance sheet.

In its efforts to address its premium collections problems, PBGC has taken steps to collect overdue premiums, interest, and penalties. However, efforts to completely restore its premium accounting system have not yet succeeded.

The ultimate success of the financial initiatives, as well as PBGC's efforts to build a sound financial management structure, requires that the management team to be appointed by President Clinton continues with a strong and sustained commitment by providing both the time and resources to address these issues. Such a commitment will help ensure that PBGC's recent progress will not be lost.

I would like now to turn to a discussion of PBGC's short-run and long-run financial condition.

GROWING DEFICIT SIGNALS PROBLEMS FOR PENSION INSURANCE PROGRAM

PBGC's current financial condition reflects those plans it has already taken over and expects to take over in the immediate future. Its long-run financial condition will be more heavily influenced by the group of ongoing underfunded plans.

PBGC's unfunded deficit measures its current financial condition. It also measures the shortfall in resources that are needed to provide guaranteed benefits to participants in underfunded plans that have terminated or are expected to terminate in the near future. Since its inception, PBGC has had a deficit, which had increased to $2.3 billion (PBGC's unaudited figure) by the end of fiscal year 1991.[2] PBGC's deficit amount for fiscal year 1992 is not yet available for release.

ERISA specified that PBGC would collect premiums from the sponsors of all insured plans and that these premiums were intended to be sufficient for PBGC to carry out its functions under ERISA. However, the premiums PBGC collects have not been large enough to offset the losses PBGC has incurred. Neither do they fully cover the risks PBGC assumes. To better reflect the risk PBGC faces from underfunded plans, the premium was restructured in 1987. Underfunded plans are now required to pay, in addition to the fixed premium per participant, a supplemental premium that varies with the size of the plan's per participant underfunding. The fixed premiums tend to overcharge well-funded plans for the risk PBGC assumes in insuring them; while the variable premium, which has a cap, tends to undercharge underfunded plans for this risk.

The premium income PBGC has collected has not been sufficient to offset the unfunded liabilities it has incurred from plans that terminated. Nonetheless, PBGC's recent premium income has exceeded the amount needed to pay benefits and administrative expenses, but a continuation in the growth of its deficit will threaten the insurance program's long-term financial viability. Should a funding emergency arise, PBGC is authorized to draw up to $100 million from the U.S. Treasury to meet its obligations.

PBGC's existing deficit, then, 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 offset termination losses as they are incurred.

<u>Plan Underfunding Presents Greatest Risk</u>

PBGC's future financial condition will be most heavily influenced in the short-run by ongoing plans that are currently, or will become, underfunded in the future, not by the plans that have already terminated. PBGC recently estimated that it is exposed to about $51 billion in underfunding in the plans it currently insures. Of this amount, PBGC estimates that about $12 billion is in plans sponsored by financially troubled firms, primarily those in the steel, tire, automobile, and airline industries. These plans pose an immediate threat to the agency. The other $39 billion is a more remote threat.

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[2]PBGC administers two separate pension insurance programs--one for single-employer plans, the other for multiemployer plans. The funds from one program may not be used to pay obligations of the other. The single-employer plan had a deficit of $2.5 billion; the multiemployer plan had an accumulated surplus of $187 million as of 1991, according to PBGC.

Taking the immediate underfunding threat into account, PBGC's most pessimistic 10-year forecast shows that its deficit could reach $17.9 billion by 2001.[3] Even this pessimistic forecast may underestimate PBGC's future deficit because plan underfunding generally increases when the plan sponsor goes bankrupt.[4] PBGC and others commentators have referred to this phenomenon as a plan's "death spiral."

I note that the $51 billion in underfunding PBGC estimates it currently faces is not an upper limit on its long-run potential deficit because some plans that are now well-funded may become underfunded in the future.[5] One reason currently well-funded plans could become underfunded in the future is the funding limitation that prohibits a sponsor from making a contribution to its plan if assets exceed 150 percent of the plan's current liability.[6] This funding limitation lowers the funding cushion plans can maintain and may leave them vulnerable to becoming underfunded in times of economic hardship.

Impact of a Severe Economic Downturn on PBGC

A severe economic downturn could overwhelm PBGC's ability to pay promised benefits. While this pessimistic scenario of terminations may not occur, it is instructive to show how such a scenario might come about and how PBGC would be affected.

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[3]This 1991 estimate assumes that the plans of financially troubled sponsors, as well as some smaller plans, will terminate during the 10-year period. PBGC's 1991 intermediate 10-year forecast estimated its deficit would grow to about $5.5 billion by 2001.

[4]See our recent report, PENSION PLANS: Hidden Liabilities Increase Claims Against Government Insurance Program (GAO/HRD-93-7, Dec. 30, 1992), for a discussion of some reasons why unfunded liabilities increase shortly before plan termination.

[5]Two recent studies indicate that a large portion of future underfunded terminations will occur in plans that are currently fully funded (Beverly Hirtle and Arturo Estrella, "Alternatives for Correcting the Funding Gap of the Pension Benefit Guaranty Corporation," Federal Reserve Bank of New York, May 1990, and Christopher M. Lewis and Richard L. Cooperstein, "Estimating the Current Exposure of the Pension Benefit Guaranty Corporation to Single-Employer Pension Plan Terminations," Office of Economic Policy, Office of Management and Budget, May 15, 1992).

[6]The 150 percent funding limitation was incorporated into ERISA in 1987 in an effort to reduce the number of plans terminating so that the plans' sponsors could recover excess plan assets.

If a severe economic downturn was to occur in those industries with mature underfunded plans and if these plans terminated in a wave of sponsor bankruptcies, PBGC would be in a position of taking on additional benefit obligations that could swamp its ability to make payments out of premium income.

Such an occurrence would have two distinct impacts on PBGC's financial condition. First, as more plans terminate, the premium base erodes, lowering future premium income from plan sponsors. Second, a severe recession could have an adverse impact on the value and income from PBGC's assets. The combination of lower premium income and greater benefit payments would severely restrict PBGC's ability to set aside investment assets to help meet its new obligations to pay future benefits. At that point, the Congress and PBGC might decide that an infusion of funds is needed to avoid PBGC liquidating assets to pay expenses. Additional funds could come either from increases in premiums (the most likely source) or from the federal treasury.

If PBGC did not receive an infusion of funds, but chose instead to stay the course, it would have to begin drawing down its asset base to pay its obligations. This pessimistic scenario, if it continued, would eventually cause the agency to run out of assets. At that point, congressional action would be required if benefit payments were to continue.

NOT ALL PROMISED BENEFITS ARE INSURED

We are concerned that underfunded pension plans not only pose a potential burden on PBGC, but also can have an adverse impact on the plan's participants. Despite ERISA's goal of protecting the pension benefits of plan participants, ERISA did not authorize PBGC to insure all of the benefits provided by defined-benefit plans. If an underfunded plan terminates, some plan participants are at risk of losing some of their promised benefits.

PBGC guarantees "basic" pension benefits--vested monthly benefits that provide income when participants retire. These benefits include benefits beginning at normal retirement age and certain disability, early retirement, and survivor benefits.

However, PBGC does not guarantee nonbasic benefits, such as lump-sum death benefits and special supplemental benefits that exceed the amount that would be paid at normal retirement.[7] Nor does it guarantee basic benefits that exceed the maximum permitted by ERISA for the year in which the plan terminates--$2,437.50 per month for 1993. The maximum benefit is adjusted downward (1) when

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[7]However, PBGC will use a portion of assets recovered from a single-employer plan's sponsor to pay benefits that it does not guarantee.

benefits begin before the age of 65 and (2) for election of joint and survivor benefits. Further, PBGC may not guarantee a portion of benefit increases that have been in effect for less than 5 years at plan termination.

CONCLUDING COMMENTS

Pension plan sponsors who do not fully fund their plans put an undue burden on others--sponsors of other, well-funded plans who may have to pay higher premiums to PBGC to cover the insured shortfall; participants in underfunded plans who can lose some of the benefits they have earned if their plans terminate; and, under the pessimistic scenario that I mentioned earlier, the federal treasury which may be called upon to pay guaranteed benefit should PBGC be overwhelmed by a rash of large terminations during a period of economic distress.

In the final analysis, Mr. Chairman, we believe that to protect PBGC and the participants of defined-benefit plans, the Congress should focus on ways to improve the funding of underfunded plans and methods that ensure fully funded plans remain that way. Reducing plan underfunding can be expected to lower PBGC's future losses by targeting the greatest threat to PBGC. We also believe the Congress should consider making the variable rate premium more risk-related in order to reduce future losses PBGC will most likely incur. Such a change could also help reduce the agency's current deficit.

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

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