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Report to the Chairman, Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce, House of Representatives

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PENSION BENEFIT GUARANTY CORPORATION

Financial Condition Improving, but Long-Term Risks Remain

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The Honorable Harris W. Fawell
Chairman, Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
House of Representatives

Dear Mr. Chairman:

Employer-provided pensions are an important source of income for many retirees. The Pension Benefit Guaranty Corporation (PBGC) helps protect this income by insuring the pensions of 42 million participants in about 45,000 private defined benefit pension plans.[1] During 1997, PBGC paid $824 million in guaranteed benefits to 213,000 retirees and other beneficiaries who had participated in plans that had terminated with insufficient assets to pay promised benefits. Moreover, it will pay guaranteed benefits to another 260,000 people once covered by these terminated plans when they reach their plans' normal retirement age.

PBGC administers two separate programs—one for single-employer plans, the other for multiemployer plans. Single-employer plans provide benefits to (1) employees of one firm (the terms of these plans may be collectively bargained) or (2) employees of several related firms (the terms of these plans may not be collectively bargained).[2] Multiemployer plans are maintained under collectively bargained agreements involving more than one unrelated firm, generally in a common industry, such as construction, trucking, or textiles. PBGC pays benefits to participants in single-employer plans that terminate without sufficient assets to pay all promised benefits; PBGC provides loans to multiemployer plans that are insolvent.

Historically, PBGC's single-employer program has had a deficit: its liabilities, the present value of future benefits PBGC is or will be obligated to pay for terminated plans or plans that are likely to terminate in a future year, exceeded its assets.[3] In 1992, we placed PBGC on our list of federal

[1]These plans pay specific retirement benefits, generally based on years of service, earnings, or both; the sponsoring company ensures plan assets are sufficient to pay all plan liabilities. In contrast, under defined contribution plans, employers, employees, or both make periodic contributions to workers' accounts. Retirement benefits are based on the contributions to and investment returns on these accounts, and employees bear the risk of poor investment performance. Pension plans are provided voluntarily by employers.

[2]Employers can, however, sponsor more than one plan.

[3]Conversely, the term "surplus" as used in this report represents a positive financial net position in which PBGC's assets exceed its liabilities.

programs at high risk because of problems in its operations as well as the large and growing deficit that threatened its long-term financial viability.[4] To address these problems, the Congress passed the Retirement Protection Act (RPA) in 1994, which strengthened minimum funding requirements for plans and increased premiums paid to PBGC by underfunded plans. In addition, PBGC improved administration of both insurance programs. Consequently, we removed PBGC from our high-risk list in 1995.[5]

The Congress, however, remains concerned about the long-term financial viability of the pension insurance programs. Because of this concern, you asked us to (1) provide information on the financial condition of the insurance programs and trends in the plans they insure, (2) determine the impact the 1994 legislation has had on the financial condition of PBGC and insured plans, (3) describe risks to PBGC's solvency, (4) review PBGC's efforts to forecast its future financial condition, and (5) discuss PBGC's efforts to improve administration of the programs.

To provide information on the financial status of PBGC's insurance programs, trends in insured plans, and the impact of recent pension reform legislation, we analyzed PBGC annual reports and statements of financial condition. We also analyzed annual plan data and studies on insured plans. To describe risks to PBGC, we analyzed trends in plan terminations and resulting PBGC claims. To report on its forecasting methodologies, we reviewed PBGC's techniques and assumptions used for forecasting the financial condition of the insurance programs. We reviewed our previous work as well as that of the PBGC Office of Inspector General (OIG) and others and examined PBGC efforts to address weaknesses in its administration of the insurance programs. Finally, we interviewed officials from PBGC, pension experts, and actuaries in the private pension community. We conducted our work between October 1997 and September 1998 in accordance with generally accepted government auditing standards.

Results in Brief

PBGC's financial condition has improved significantly over the past few years. The agency has had a surplus for the past 2 fiscal years, after having had a deficit for over 20 years. The single-employer program improved from a deficit of $2.9 billion in 1993 to a surplus of nearly $3.5 billion in 1997. The multiemployer program has maintained a surplus since the early

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

[5]High-Risk Series: An Overview (GAO/HR-95-1, Feb. 1995).

1980s. Like that of PBGC, the financial condition of most insured, underfunded plans has also improved, but underfunding among some large plans continues to pose a risk to the agency. The improved financial condition of both PBGC and the plans it insures has resulted from better funding of underfunded plans and economic improvements, such as the extended national economic expansion and growth in the stock market. Over the past decade, the number of insured single-employer plans has fallen by more than one-half, to about 43,000, because of the termination of many small plans. However, the number of participants (active workers, retirees, beneficiaries, and vested former employees[6]), about 33 million, has increased slightly because of an increase in the number of large plans. The number of multiemployer plans and participants has remained relatively stable since the early 1980s: about 2,000 plans covering between 8.3 million and 8.8 million participants. However, the declining number of active workers participating in multiemployer plans could increase the level of unfunded liabilities and place increased financial burdens on the multiemployer program.

At this time, it is difficult to isolate the effects of 1994 pension reform legislation on plan funding from other influential factors, such as the dramatic growth in the stock market or continued economic expansion. However, PBGC experienced an increase in premium revenue immediately following passage of the legislation that contributed to its improved financial condition. Also, to avoid paying higher premiums and having to notify participants about the level of plan underfunding, some plan sponsors increased plan contributions, improving overall plan funding levels.

Despite improvements in PBGC's financial condition, risks to the agency's long-term financial viability remain. Factors beyond PBGC's control, such as downturns in the economy, a significant decline in the stock market, or a substantial drop in interest rates, could increase plan underfunding and PBGC's liabilities by reducing the future returns on assets. Given the number of factors affecting PBGC's financial condition, PBGC's current methodology for forecasting the financial condition of the single-employer program is of limited use because it does not take into account the range of possible future economic conditions. PBGC is developing a new single-employer program forecasting model designed to estimate the probability of bankruptcies and terminations of underfunded plans under various economic conditions. In addition, PBGC has already improved its

[6]Participants generally earn a nonforfeitable and irrevocable right to benefits after meeting the plan's years-of-service or age and years-of-service requirements.

methodology for forecasting the financial status of the multiemployer program.

Beyond its efforts to improve forecasting, PBGC has also improved its techniques for estimating its liability for plans that are likely to require future financial assistance and is now more closely monitoring the companies with underfunded plans that represent its biggest risks. Furthermore, PBGC is strengthening its oversight efforts through increased audits of premium payments and audits of fully funded terminated plans and is working closely with plan sponsors to decrease plan regulatory and administrative burdens. While PBGC has made progress, it is important that it continue its efforts to reduce the time it takes to assume control of terminated plans, improve the timeliness of final determinations of participants' benefits, and monitor the performance of contractors that assist PBGC in administering the insurance programs.

Background

The Employee Retirement Income Security Act of 1974 (ERISA) was enacted to better protect participants in private pension plans. Among other things, it established an insurance program, administered by PBGC, to protect the benefits of participants in most private defined benefit pension plans.[7] PBGC was created as a government corporation under title IV of ERISA to encourage the continuation and maintenance of private pension plans, insure the pensions of participants in defined benefit plans, and maintain pension insurance premiums at the lowest level necessary to carry out PBGC's obligations. PBGC is financed through premiums paid annually by employers that sponsor plans, investment returns on PBGC assets, assets acquired from terminated plans, and recoveries from employers responsible for underfunded terminated plans.

Employers that sponsor plans control how much they contribute to their pension plans (subject to ERISA's funding standards). These sponsors estimate plan liabilities on the basis of the characteristics of plan participants and assumptions about the anticipated experience of the plan, such as the expected retirement age and anticipated investment return. Each plan is required to file with the Internal Revenue Service (IRS) an annual report (form 5500) that lists, among other items, the value of the assets in the plan's portfolio and an estimate of the plan's accrued liabilities (the present value of future pension benefits that have been earned to date). Subtracting the estimated liabilities from assets indicates

[7]ERISA excludes certain defined benefit plans from coverage. Excluded are professional service plans that cover fewer than 26 participants, plans of fraternal societies financed solely by member contributions, and plans maintained exclusively for substantial owners of a business.

whether the plan is fully funded or has unfunded liabilities under ERISA's funding standards.

PBGC may terminate a plan with unfunded liabilities if the plan has not met ERISA's minimum funding standards; if it will be unable to pay benefits when they are due; if it has made a lump sum distribution of $10,000 or more to a participant who is a substantial owner of the sponsoring firm, leaving the plan with unfunded nonforfeitable benefits; or if the possible long-run loss to PBGC is expected to increase unreasonably if the plan is not terminated. PBGC must terminate a plan when it determines a plan is unable to pay current benefits. Generally, a company in financial distress may voluntarily terminate an underfunded plan only if the employer is being liquidated or if the termination is necessary for the company's survival.

When a plan is terminated with insufficient assets to pay guaranteed benefits, PBGC takes over the plan: it assumes the plan's assets and becomes responsible for paying a guaranteed benefit to participants. To do this, PBGC evaluates the plan's assets and estimates the liabilities it will be responsible for paying. The unfunded liability calculated by PBGC may exceed the unfunded liability reported by the plan because PBGC uses different actuarial assumptions to value plan liabilities.[8] The plan's unfunded liability for guaranteed benefits then represents a claim against PBGC's insurance program.

The single-employer premium has two parts: an annual flat-rate premium of $19 per participant and an additional annual variable rate charge of $9 for each $1,000 of unfunded vested benefits. Before 1994, the variable rate premium was capped at $53 per participant. The RPA of 1994 phased out the cap, increasing premiums for many underfunded single-employer plans, and instituted changes to both improve plan funding and to require that more information be provided to plan participants. For single-employer plans terminating in 1998, the maximum guaranteed benefit for participants aged 65 is about $34,570 per year.

The Multiemployer Pension Plan Amendments Act of 1980 reformed the multiemployer insurance program. Among the reforms under the 1980 act is the requirement that a firm that withdraws from a plan may be liable for a proportional share of the plan's unfunded vested benefits—a withdrawal liability. Further, in the event of the bankruptcy of a participating firm, the

[8]The plan's actuarial assumptions used to calculate accrued liabilities are based on the assumption that the plan will be in existence for the foreseeable future. The plan's assumptions are not the same ones PBGC uses to calculate liabilities at plan termination.

remaining firms are required to assume the additional funding responsibility. According to PBGC officials, because the remaining employers have this funding responsibility, PBGC rarely takes over a multiemployer plan. Instead, if a multiemployer plan is unable to pay benefits, PBGC's multiemployer insurance program provides financial assistance in the form of a loan to the plan to pay participants their guaranteed benefits. PBGC does not necessarily expect such a plan to be able to repay the loan. PBGC guarantees a portion of multiemployer plan pensions—up to $16.25 per month times the years of credited service up to a maximum of about $5,850 per year. The multiemployer premium is a flat $2.60 per participant per year. The multiemployer program's maximum benefit guarantee has remained unchanged since 1980.

An increase in the premium rates for either program would require congressional approval. PBGC receives no funds from federal tax revenues, but it is authorized under ERISA to borrow up to $100 million from the federal treasury.

ERISA requires that PBGC annually provide an actuarial evaluation of its expected operations and financial status over the next 5 years. In its evaluation, PBGC actually presents three 10-year forecasts for its single-employer program to provide a longer-term view of the financial condition of the program under different scenarios. In addition, ERISA requires PBGC to develop, every 5 years, projections of the potential liabilities the multiemployer insurance program could incur to inform policymakers whether changes in the program's benefit guarantee or premium might be necessary.

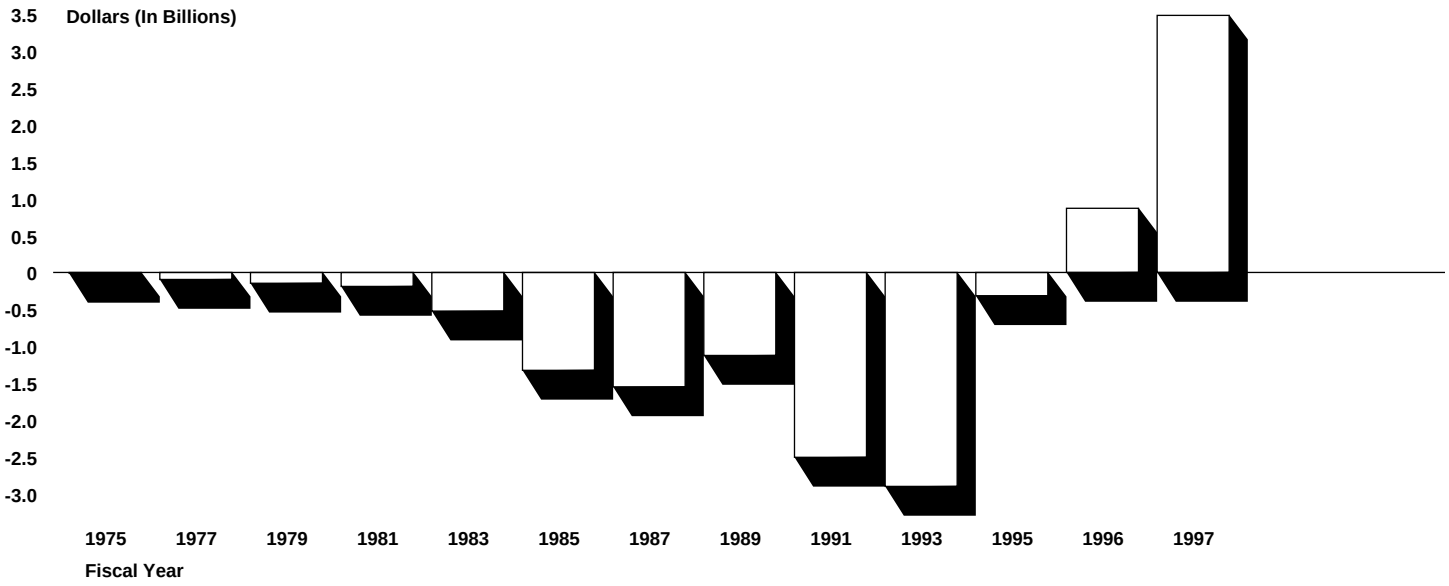
Financial Condition of PBGC's Single-Employer and Multiemployer Programs Has Improved, but Some Concerns Remain

PBGC's financial condition has improved greatly over the past few years, and both of its insurance programs currently have a surplus. However, despite this improvement and increased funding levels among the plans PBGC insures, continued underfunding in some large plans remains a concern. Although the number of single-employer plans has declined, the number of participants has increased slightly. The number of multiemployer participants and plans has remained relatively stable despite a decline in the number of active workers in these plans.

Single-Employer Program and Insured Plans Have Improved, but Underfunding Continues

The single-employer program's financial condition has improved significantly since 1993, and PBGC reported that the program achieved its first surplus in 1996. As shown in figure 1, the single-employer program moved from a deficit of $2.9 billion in 1993 to a surplus of $3.5 billion in 1997.

Figure 1: Single-Employer Program's Net Financial Position, 1975-97



Note: Fiscal year 1975 data are for the 10-month period 9/2/74 to 6/30/75.

Source: PBGC Annual Reports.

Unprecedented returns on investments are a key factor contributing to PBGC's improved financial condition. As of September 30, 1997, PBGC's combined insurance programs had about $15.6 billion in assets available for investment—$9 billion from premiums and $6.6 billion in assets from terminated plans.[9] Investment income, primarily from stocks and fixed-income investments, increased from $927 million in 1996 to almost $2.8 billion in 1997. PBGC's annual rate of return on investments was

[9]Under the law, premium receipts are required to be invested in fixed-income securities. Current PBGC policy is to invest these funds only in Treasury securities.

21.9 percent for fiscal year 1997 and averaged 14.4 percent over the past 5 years.

The financial condition of the single-employer program has also been helped by continued economic growth and the lack of large claims over the past few years. Historically, PBGC's financial condition has been affected by the financial failure of only a small number of relatively large firms. Claims from terminated underfunded plans and the growth in PBGC's net liabilities have been concentrated over short periods of time and in specific industries. The largest claims came from 10 firms that terminated 46 plans in the mid-1980s and early 1990s. Claims from these 10 firms accounted for more than half the dollar amount of all PBGC claims from 1975 to 1997.

The number of single-employer plans insured by PBGC has declined significantly since the mid-1980s; however, the number of participants has increased slightly. The number of plans fell by more than 50 percent, from about 112,000 in 1986 to about 43,000 in 1997. The decline in single-employer plans resulted mostly from terminations of small plans—those with fewer than 100 participants—and mergers of larger plans. Offsetting the decline in the number of small plans has been growth in the number of plans with 10,000 or more participants. As a result, the number of participants in single-employer plans increased slightly, from about 30 million in 1986 to about 33 million in 1997, despite the decline in the number of plans.

The funding level of many single-employer plans has increased but underfunding, especially among a few large plans, continues. Using PBGC termination assumptions, about 45 percent of all plans were overfunded while 55 percent were underfunded as of the end of 1995. However, 70 percent of covered participants and 80 percent of vested liabilities were in plans that were at least 90-percent funded, according to PBGC assumptions. For underfunded plans, the average funding ratio (percentage of assets accumulated to pay vested benefits) increased from 74 percent in 1986 to 87 percent in 1996.

Plans with funding ratios under 50 percent have accounted for 76 percent of PBGC's claims since 1975, while plans with funding ratios of 75 percent or better have accounted for only 3 percent of PBGC claims. The amount of underfunding increased from about $15 billion in 1986 to about $64 billion in 1996, largely because of the decline in discount rates (over 3 percent)

used by PBGC.[10] Some plans that had previously been fully funded became slightly underfunded as a result of the decline in interest rates. The strong financial condition of these plans, however, improved the average funding ratio for all underfunded plans.

The amount of overfunding in plans declined from $228 billion in 1986 to about $103 billion in 1996. Similarly, the average funding ratio of overfunded plans declined during this period from 165 percent to 117 percent, primarily because of the fall in interest rates and increases in plan liabilities. The enactment of more restrictive full funding limits in 1987 resulted in lower employer contributions to fully funded plans and contributed to the decline in funding ratios.[11]

Underfunding remains a concern because the underfunding of a few large plans or underfunding in several plans in certain industries poses a long-term risk to PBGC solvency. Most of the claims against PBGC's single-employer program have come from "flat-benefit" plans that cover hourly workers in unionized companies.[12] Unlike most other defined benefit plans, flat-benefit plans do not fully anticipate future benefit increases in their funding calculations. Because benefits are often increased at regular intervals as part of contract negotiations, new liabilities are added to the plan before old ones are fully funded, thereby leaving the plans chronically underfunded.[13]

Two features in the design of the pension insurance program have made it hard for PBGC to control the exposure it faces from underfunded pension plans. First, ERISA's minimum funding standards do not ensure that plan sponsors will contribute enough so that if the plans terminate, they will have sufficient assets to cover all the promised benefits. Second, the premiums that PBGC charges pension plans do not fully cover the risks that

[10]PBGC discounts its liability for future benefits to an estimated present value using long-term discount rates. Discounting takes into account that money paid in the future is worth less than money paid today. The higher the discount rate, the less valuable the money paid in the future. Conversely, lower discount rates raise the present value of future benefits.

[11]The Pension Protection Act (PPA), as part of the Omnibus Budget Reconciliation Act of 1987, introduced certain reforms to ERISA to bolster funding levels in underfunded plans. However, PPA also further restricted the maximum funding limits on tax-deductible contributions. Generally, employers do not contribute more than they can currently deduct. Under RPA, the full funding limit is the greater of the limit under prior law or 150 percent of the plan's current liability divided by the value of plan assets. The limit cannot be less than the excess of 90 percent of the plan's current liability divided by plan assets.

[12]These plans pay a flat dollar amount for each year of service recognized under the plan.

[13]The funding rules, which require funding based on current legal obligations, do not allow flat-benefit plans to anticipate yet-to-be bargained future benefit increases.

PBGC assumes. These premiums do not insure plans against a specified and limited shortfall in assets but rather against any underfunding, up to the maximum benefit guarantee per participant, no matter how large. Thus, premiums are only partially exposure-related, which enables a sponsoring company to engage in practices that reduce the level of plan assets knowing that if the plans terminate before benefits are fully funded, the responsibility for paying guaranteed benefits will fall on PBGC.

Despite PBGC's improved financial condition, its current federal budgetary treatment may not adequately reflect the potential cost of the insurance programs. Previously, we reported that under the cash-based federal budget, PBGC's annual net cash flows help reduce the annual federal budget deficit.[14] However, PBGC's growing liabilities (funded and unfunded) from the plans it insures increase the amount of its long-term commitment to pay pension benefits. Liabilities from plans taken over by PBGC and its exposure to future claims from insuring currently healthy firms—that is, the risk assumed by the government in general—are not recognized in the budget. If budget amounts were reported on an accrual basis, the long-term cost of the insurance commitment would be apparent at the time the insurance was extended. The Office of Management and Budget's (OMB) risk-assumed estimate for future PBGC costs—that is, the portion of a full risk-based premium not charged to PBGC-insured plans—was approximately $30 billion at the end of fiscal year 1997. This estimate contrasts with the $21 billion to $23 billion of "reasonably possible exposure"[15] that PBGC reported in note 9 of its 1997 financial statements.[16] We have recommended that PBGC (and other agencies operating insurance programs) develop and provide cost information in the budget document on a risk-assumed basis, in addition to the cash-based budget information it currently provides.[17]

[14]Budget Issues: Budgeting for Federal Insurance Programs (GAO/AIMD-97-16, Sept. 30, 1997).

[15]At the end of its fiscal year, PBGC categorizes claims it expects in the near future from underfunded plans sponsored by firms with weakening creditworthiness, including firms with below-investment-grade bond ratings, as reasonably possible exposure.

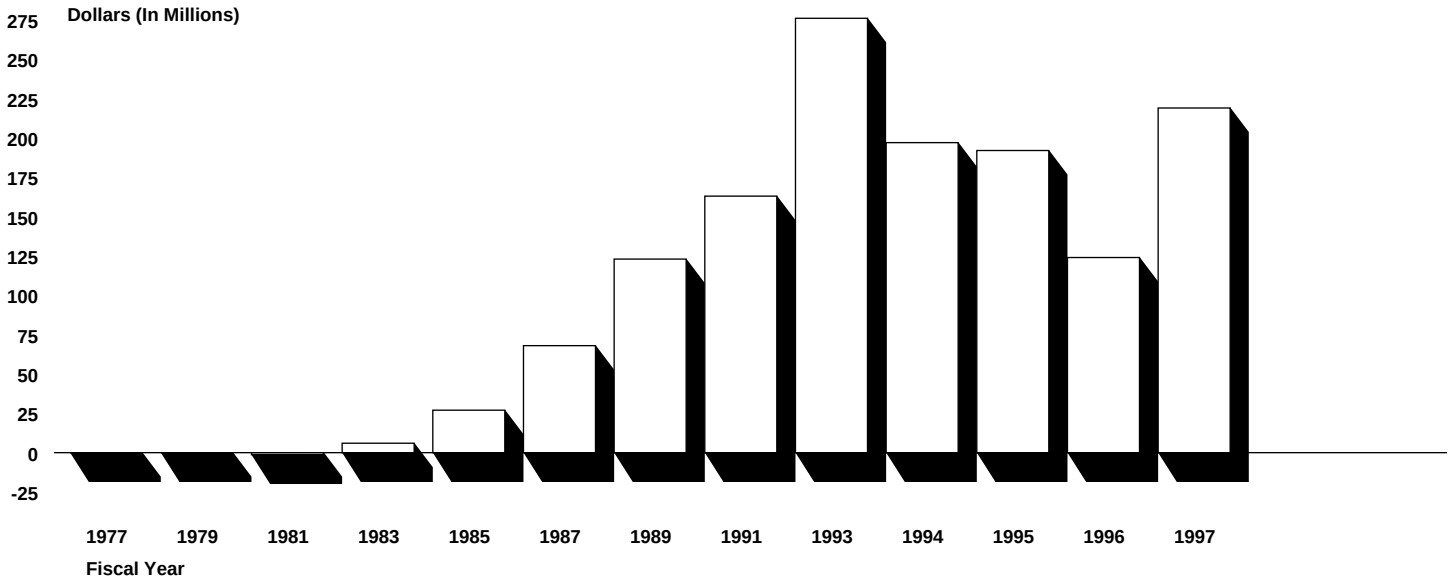
[16]Unlike PBGC's financial statements liability, OMB's estimate includes costs resulting from expected future terminations of underfunded plans sponsored by currently healthy firms.

[17]See GAO/AIMD-97-16, Sept. 30, 1997.

Multiemployer Program Remains Financially Stable, but Trends in Plans Are Cause for Concern

PBGC's multiemployer program has been in surplus almost since the program was reformed in 1980 (see fig. 2). With assets of $596 million and liabilities of $377 million, the multiemployer program had a surplus of $219 million in fiscal year 1997, up from $124 million in 1996. The surplus had declined in recent fiscal years as the program incurred losses of $79 million in 1994, $5 million in 1995, and $68 million in 1996. The losses resulted primarily from the increase in PBGC's allowance for uncollectible future loans for two plans.[18]

Figure 2: Multiemployer Program's Net Financial Position, 1977-97



Source: PBGC Annual Reports.

Since 1980, PBGC's multiemployer program has provided approximately $35 million in loans to 19 plans. In 1997, the program provided about $4 million in loans to 14 plans. For about the next 10 or 20 years, PBGC estimates that about $361 million will be needed to cover future loans to the 14 plans currently receiving assistance as well as loans to other plans expected to require assistance in the future. Generally, PBGC does not

[18]An allowance is set up when repayment of loans is not expected.

expect that multiemployer plans receiving financial assistance will necessarily be able to repay the loans. In January 1998, however, the Anthracite Fund repaid $3.2 million in loans it received from PBGC during the 1980s.[19] This plan became the first to repay a PBGC financial assistance loan.

Overall, funding among multiemployer plans has improved since enactment of the 1980 reforms. In 1980, multiemployer plans as a group reported a funding ratio (ratio of accumulated assets of all plans to the sum of their estimated liabilities) of 77 percent. By 1994, the overall funding ratio had increased to 105 percent, and overfunding among multiemployer plans totaled about $12.6 billion. Similarly, the funding ratio of underfunded plans has also improved since 1980. The recent high rates of return on plan investments have reduced the level of underfunding in some plans despite lower interest rates. The average funding ratio in underfunded plans increased from 58 percent in 1980 to 80 percent in 1994. The amount of underfunding decreased from about $35 billion to $27.4 billion during the same period.

The number of multiemployer plans and participants has remained relatively stable since the early 1980s. In 1980, approximately 2,000 plans covered about 8.3 million participants; in 1997, about 2,000 plans covered about 8.8 million participants. The distribution of multiemployer plan participants by industry also remained relatively unchanged. In 1980, the construction, manufacturing, and transportation industries had about 5.9 million participants, or 71 percent of plan participants. In 1994, these industries had about 5.3 million participants, or 65 percent of plan participants. The construction industry alone had 2.8 million participants.

There has been, however, a substantial decline in the number of active workers in multiemployer plans because many of these plans are in declining industries that are hiring few new workers. But because many workers are retiring or are vested and moving to other employment, the number of covered participants has remained relatively stable. Multiemployer plan contributions are based primarily on two factors: (1) administrative expenses and "normal costs" (costs to fund retirement benefits that active workers accrue each year) and (2) costs of plan modifications or deviation of plan experience from expectations. Payments or credits for these latter costs are amortized over a period of between 15 and 30 years. However, as active workers retire, contributions

[19]The Anthracite Fund of Hazelton, Pennsylvania, provides pension benefits to about 4,500 coal miners and their beneficiaries. The plan first required PBGC financial assistance in 1981, when employer contributions to the plan were suspended as a result of an industry strike.

for normal costs fall and payments for retirees' benefits increase. If such retirements occurred unexpectedly or in large numbers, the plan's financial condition could deteriorate.

For an adequate contribution base (ratio of active workers to other participants), the plans primarily depend on new employers joining or existing employers staying in and hiring new workers. The rate of growth in active workers provides a measure of the ability of the plan to fund its liabilities. Further, this growth tends to be correlated with the health of the industry covered by the plan.

Despite the improvement in multiemployer plan funding since 1980, some large plans remain underfunded and could pose a risk to the multiemployer program. In 1986, we reported that the multiemployer program was jeopardized by an eroding contribution base.[20] The number of active workers in multiemployer plans declined from about 6.4 million in 1980 (almost 76 percent of all participants) to about 4.4 million in 1994 (just 54 percent of participants). A continued erosion in contribution bases could eventually cause some plans to be unable to generate sufficient income under current funding rules to pay benefits, thereby increasing the number of plans requiring loans from the multiemployer insurance program. However, in its 1996 report on the financial condition of the multiemployer program, PBGC reported that it expected the multiemployer insurance program to remain financially strong, even with the decline in the contribution base.

Many of the multiemployer plans with sizable underfunding are in industries such as manufacturing and transportation, which may continue to experience further decline in the number of active workers. On the basis of 1993-94 form 5500 data, PBGC identified 50 multiemployer plans (about 3 percent of all insured multiemployer plans) with underfunding of about $21 billion. Underfunding is worsened by benefit increases obtained through collective bargaining. Given the declining contribution bases and continuing benefit increases, it could be difficult for the underfunded plans to substantially improve their funding levels.

Pending legislation in the 105th Congress (S. 1501) would, among other things, increase funding and reporting requirements for multiemployer plans and prohibit benefit increases if a plan was less than 95-percent funded. Recognizing that less than 1 percent of participants in

[20]Pension Plans: 1980 Multiemployer Pension Amendments: Overview of Effects and Issues (GAO/HRD-86-4, Feb. 13, 1986).

multiemployer plans projected to become insolvent have their benefits fully guaranteed, the legislation also would increase the annual maximum guaranteed benefit.

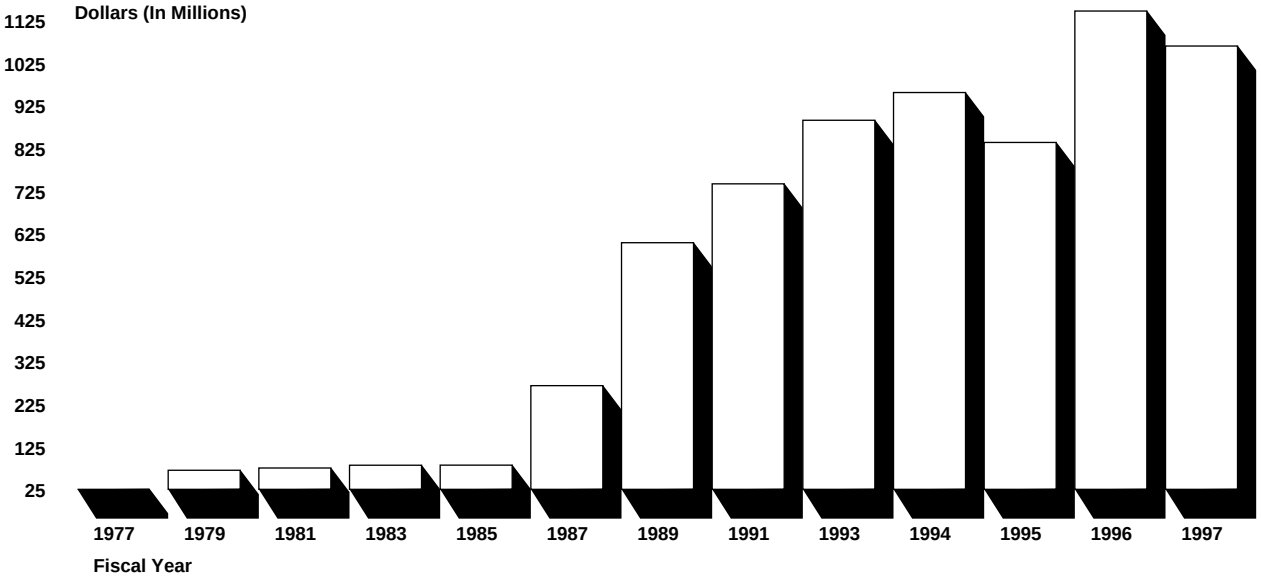
Effects of Recent Legislation on PBGC and Plan Funding Are Currently Difficult to Determine

It is difficult to isolate the effects of RPA, the 1994 pension legislation, on PBGC's financial condition and plan funding levels from other important factors, such as the growth in the stock market or economic expansion. In addition to enhancing PBGC's regulatory authority and increasing participant protection through broadened reporting requirements, RPA strengthened funding requirements for single-employer plans. For plans that are less than 90-percent funded, RPA increased funding in three ways: accelerating the funding formula for certain benefit increases, constraining the assumptions used for calculating minimum contributions, and adding a new solvency rule to ensure that plans can pay current benefits.

A comprehensive analysis of the effects of RPA requires more recent plan data than are currently available because of the time lag in filing plan annual reports. Plans are not required to file form 5500 reports until 210 days after the close of the plan year, and IRS processing time requirements further delay data availability. Even when the necessary data become available, it will be difficult to determine the extent to which RPA alone contributed to the improved financial condition of PBGC and insured plans.

However, an increase in PBGC's premium income suggests that the legislation probably had a positive impact on PBGC's financial condition. As figure 3 shows, premium income from single employers rose from $890 million in 1993 to $1.1 billion in 1996 and fell slightly in 1997. PBGC expects that premium income may further decline as the statutory interest rate under RPA, the interest rate used to calculate the underfunding on which premiums are based, increases. Also, around the year 2000, the measure of plan assets may change from an actuarial value to a generally higher fair market value. The expected increase in the ratio of plan assets to liabilities may reduce both the reported amount of plan underfunding and the variable premiums based on this underfunding.

Figure 3: Premium Income for the Single-Employer Program, 1977-97



Source: PBGC Annual Reports.

RPA also resulted in increased plan contributions. A PBGC official told us that some sponsors with large underfunded plans made more than the minimum required contributions to lower the amount of premiums they would have to pay. Also, some sponsors increased their plans' funding ratios instead of having to report to plan participants that the plans were underfunded.

Despite PBGC's Improved Financial Condition, Long-Term Risks Remain

Although PBGC's financial condition has significantly improved over the past few years, risks remain from the possibility of an overall economic downturn or a decline in certain sectors of the economy, substantial drops in interest rates, and actions by sponsors that reduce plan assets. These risks could threaten the long-term viability of the insurance programs. Further, PBGC has only a limited ability to protect itself from risks to the insurance programs.

An Economic Downturn Could Negatively Affect PBGC

An economic downturn could adversely affect PBGC's financial condition. If such a downturn were to occur either nationwide or in those industries with mature underfunded plans (plans in which many workers are less than 15 years from retirement) and several large underfunded plans terminated, PBGC could be obligated to take on additional benefit obligations, which could drastically reduce its net financial position. For example, bankruptcies in the airline and steel industries during the past 15 years resulted in large claims against PBGC. Terminations of 10 underfunded pension plans by Eastern Air Lines and Pan American Airways resulted in about $1.3 billion in PBGC claims. Similarly, terminations of underfunded plans in the steel industry, including plans from Wheeling Pitt Steel, Sharon Steel, and LTV Republic Steel, resulted in almost $1.4 billion in claims. Terminations from these two industries alone account for almost half of PBGC's total claims. PBGC estimates that its reasonably possible future loss exposure is primarily from single-employer plans in the steel, airline, industrial and commercial equipment, and transportation equipment industries.

An overall economic downturn could have three effects on PBGC's financial condition. First, more financially troubled companies might terminate their underfunded plans, resulting in increased claims against PBGC. Second, as plan terminations rose, PBGC's premium base could erode, lowering premium income. Finally, a recession or a substantial decline in the stock market could adversely affect the value of and income from PBGC's assets.[21] (This could also occur for individual pension plans.) The value of PBGC's assets and income from them could decline at the same time that claims from the increased number of plans taken over by PBGC raised benefit payments.[22] The combination of lower premium income and greater benefit payments could limit PBGC's ability to set aside investment assets to help meet its new obligations to pay future benefits and could require PBGC to liquidate some assets to pay expenses. If PBGC continued to draw down its asset base, it could eventually run out of assets. At that point, congressional action would be required if benefit payments were to continue.

[21]As recently as fiscal year 1994, PBGC experienced a 6.4-percent investment loss totaling $426 million. The following year, however, PBGC's investment income rose to about $2 billion. Such fluctuations demonstrate the extent to which PBGC's recent improved financial condition and long-term viability are linked to the health of the economy and the stock market.

[22]However, PBGC would receive the assets of any plans it took over, which would tend to counteract losses on its stock portfolio.

Declining Interest Rates Could Increase PBGC's Liabilities

Interest rates play a major role in calculating the liabilities of pension plans and of PBGC. If the interest rates used in the calculations of liabilities were reduced, the value of plan liabilities would rise. If these rates were increased, liabilities would decrease. A lower interest rate would reduce the future returns on a given level of assets and require that the amount of assets be increased to ensure that all benefit liabilities could be paid.[23] Lower interest rates increase (1) the calculated liabilities from plans administered by PBGC, (2) the number of ongoing underfunded plans, and (3) PBGC's potential liabilities from ongoing underfunded plans. Over the past few years, lower interest rates have increased PBGC's liabilities, but this increase has been offset by PBGC's higher premium and investment income.

Actions of Plan Sponsors Can Increase PBGC's Exposure

Plan sponsors can shift unfunded liabilities onto PBGC in several ways. When negotiating with employees over compensation, sponsors having financial difficulty can increase pension benefits or relax early retirement penalties in lieu of increasing wages. Sponsors can then spread the payment for these actions over a period of up to 30 years.[24] If the plan terminated after one or a series of benefit increases, PBGC could end up paying part or all of the unamortized liability.[25] Other methods a plan sponsor can use to shift its pension liabilities onto PBGC are to (1) forgo making its required contribution to the pension plan either legally through IRS waivers or illegally, (2) sell a subsidiary with an underfunded plan to a financially troubled buyer, or (3) use the plan's assets to pay business expenses.[26] In each instance, PBGC would continue to insure the pensions of plan participants. PBGC would also insure these pensions if the sponsor failed to pay its premiums for PBGC coverage.

PBGC's inability to restrict claims, coupled with a premium structure that is only partially exposure-related, makes it subject to "moral hazard." Moral hazard surfaces when the insured parties—in this case, plan

[23]Plan sponsors' actuarially determined liabilities and related annual contributions are sensitive to changes in the underlying assumptions, particularly interest rates. For example, a small change in the assumed rate of return on plan investments could produce a large change in calculated pension liabilities and, in turn, in the annual contribution needed from an employer. A 1-percentage-point increase in the assumed investment return rate, with other assumptions remaining the same, could result in a 20- to 25-percent reduction in the required annual contribution.

[24]The 1987 PPA reduces this funding period if the benefit improvement increases plan underfunding.

[25]PBGC phases in guarantees for new benefits over a period of up to 5 years.

[26]PBGC officials indicate that improper use of plan assets is more likely to be a problem in small plans, where the sponsor has more personal control of the assets, than in large plans, where the plan administrator is often an independent fiduciary.

sponsors—engage in risky behavior knowing that the guarantor will assume a substantial portion of the risk. Although legislative reforms have increased PBGC's ability to monitor and take action against underfunded plans, and uncapped the risk-related component of its premium, plan sponsors experiencing financial difficulties are still able to shift some of their plans' liabilities onto PBGC.

PBGC Has Limited Ability to Protect Itself From Exposure

PBGC has only limited ability to protect itself from exposure from underfunded pension liabilities. PBGC does not have the regulatory authority available to other federal insurance programs, such as the Federal Deposit Insurance Corporation (FDIC), to help protect itself from risks.[27] Instead, PBGC uses moral suasion and negotiation to encourage improved funding. In fiscal year 1991, PBGC created a Corporate Finance and Negotiations Department to identify and work with sponsors whose plans posed a risk to the agency. Through this department, PBGC targets companies that represent the biggest risks to its insurance programs and negotiates additional plan protections when it identifies problems. For example, PBGC had published its Top 50 list of companies with the largest amount of pension plan underfunding, hoping that public identification of large underfunded plans and discussions with troubled sponsors would persuade them to take corrective action to better fund their pension plans.[28]

If negotiating with the companies that pose the greatest risk fails to improve their funding, PBGC can terminate these plans. In such cases, PBGC assumes responsibility for the plans' liabilities either through agreement with the plans' sponsors or through a court order. Even when PBGC can terminate a plan, it tries to avoid doing so because such action is onerous to all involved. For example, in terminating a plan, PBGC would incur a claim that it would have to pay; participants still working under the plan would stop accruing benefits, resulting in lower future benefits; and retirees whose benefits exceeded the maximum guarantee level, whose benefits were recently increased, or who were receiving supplemental

[27]An unprecedented number of bank failures and insurance losses in the late 1980s and early 1990s drained the Bank Insurance Fund, a fund that insures bank deposits of up to $100,000, of more than $25 billion over a 4-year period and depleted its reserves. The Congress responded by enacting legislation that removed caps on premium increases; gave the FDIC increased flexibility to set premium rates through risk-based semiannual rate increases; and made other regulatory, accounting, and funding reforms. These actions should reduce the impact of future economic downturns on bank failures and, thus, on the Fund.

[28]In 1997, PBGC suspended publication of the Top 50 list as a result of funding and reporting reforms in the 1994 pension legislation, including additional reporting requirements for most plans that are less than 90-percent funded.

benefits might have their benefits reduced. Further, the plan sponsor might spend time and money to try to protect its own assets from court claims filed by PBGC on behalf of the plan for missed contributions and on behalf of itself for the recovery of the unfunded benefit liability. In addition, the sponsor, if not already bankrupt, could become bankrupt.

PBGC Is Improving Efforts to Forecast Its Future Financial Condition

PBGC's limited ability to protect itself from exposure makes accurately forecasting its financial condition especially important, because it gives PBGC and the Congress time to enact policy and legislative changes to improve the long-term viability of the insurance programs. However, PBGC's current methodology for forecasting the financial status of its single-employer program is relatively unsophisticated and does not capture the high degree of uncertainty surrounding potential future claims. PBGC is already using an improved methodology for forecasting the financial condition of the multiemployer program.

Currently, PBGC relies on extrapolations of its past claims experience and past economic conditions to develop 10-year forecasts of the single-employer program's financial condition. The actuarial assumptions PBGC uses for these forecasts are consistent with assumptions used to prepare PBGC's financial statements.

Recognizing the weaknesses of its current single-employer forecasting methodology, PBGC is developing a new approach to forecast its exposure to future claims under a wide range of possible future economic conditions. The model, called the Pension Insurance Modeling System (PIMS), is designed to simulate pension funding and bankruptcy rates over a 30-year period. The model generates estimates of average expected claims and probability measures of the uncertainty surrounding the estimates under various economic and policy scenarios. PBGC, working with outside reviewers, has extensively tested PIMS over the past few years and intends to use PIMS as its forecasting tool beginning in fiscal year 1999. For its fiscal year 1998 annual report, PBGC plans to generate forecasts of its financial condition using both PIMS and its current methodology. PBGC will also continue to use PIMS for internal research.

PBGC uses a different model for forecasting the financial condition of the multiemployer program. The Multiemployer Insolvency Projection (MIP) uses plan-specific historical data to determine whether a plan would become insolvent under a set of economic assumptions over a 15-year period. For those plans projected to become insolvent, MIP calculates the

present value of the future financial assistance that would be required from PBGC.

MIP is an improvement over PBGC's earlier approach to estimating future multiemployer program liabilities. Previously, PBGC used a methodology developed for a review of the program after passage of the Multiemployer Pension Plan Amendments Act. This method relied primarily on collecting data on all multiemployer plans from 1980 to 1986, identifying plans with deteriorated financial condition that could lead to insolvency, and estimating the required PBGC financial assistance. MIP allows PBGC to examine the potential effects on the multiemployer program assuming that each plan's recent history continues and to test the program's ability to withstand a variety of economic and demographic changes. MIP is less sophisticated than PIMS and does not attempt to assign probabilities to plan insolvency. (See app. I for more detailed information on PBGC's efforts to forecast its future financial condition.)

PBGC Has Made Significant Improvements in Administering the Insurance Programs, but Concerns Remain

PBGC has made improvements in administering its insurance programs. It is continuing to address systems and control weaknesses in its operations. It is also increasing its oversight activities and working with plan sponsors to reduce the administrative burdens on plans. Despite these improvements, opportunities remain for PBGC to enhance customer service while strengthening program integrity. Two areas of concern are the continuing backlog of benefit determinations and inadequate oversight of contractors.

PBGC Has Made Progress in Addressing Past Weaknesses

PBGC's recent progress has occurred primarily in the areas of financial systems and internal control, plan monitoring, and cooperation with plan sponsors.

Financial Systems and Internal Control Problems

For many years, and as recently as 1992, we reported that PBGC had not developed and put into place the necessary documentation and support for the techniques and assumptions used to estimate its future liabilities from terminated plans and from plans expected to terminate.[29] As a result of the lack of documentation and support, PBGC could not substantiate the reasonableness of its actuarial assumptions and estimation techniques, and we were unable to evaluate the reliability of PBGC's estimated liability. Further, PBGC had significant system and control weaknesses in its

[29]Financial Audit: Pension Benefit Guaranty Corporation's 1991 and 1990 Financial Statements (GAO/AFMD-92-35, Mar. 2, 1992).

premium and accounting operations. For example, between 1988 and 1992, PBGC was unable to fully perform basic premium processing, collecting, accounting, and enforcement functions because its premium processing system was not modified in time to accommodate the variable-rate premium structure that became effective in 1988. PBGC also lacked an integrated financial system for processing financial data and preparing financial statements and instead relied on time-consuming and labor-intensive processes to support operations and financial/budgetary reporting.

PBGC has made significant progress in addressing the systems and internal control weaknesses in its operations. By 1993, PBGC had substantially improved its valuation systems and internal controls for estimating its liability for future benefits, allowing us, for the first time, to express an opinion on its 1993 financial statements.[30] PBGC has also taken steps to improve its premium processing system. In 1992, PBGC began limited manual processing to generate bills and subsequently collected almost $60 million owed for certain past-due premiums, interest, and penalties. PBGC instituted a new premium processing system in fiscal year 1996 and implemented a new automated reporting system in 1995 to generate quarterly financial information.

Plan Monitoring

PBGC has also improved its monitoring of underfunded, single-employer pension plans. Its Early Warning Program targets plans that pose the greatest risk to the agency because of underfunding. PBGC monitors over 500 companies, each with pension plan underfunding of at least $5 million. These companies represent 1 percent of all companies sponsoring insured plans but more than 80 percent of all plan underfunding. PBGC attempts to negotiate additional pension contributions and protections when it identifies transactions that could jeopardize plans. PBGC reported that in the last 6 years it negotiated more than 50 settlements that provided about $15 billion in new pension contributions and protections for about 1.6 million participants. Further, by closely monitoring significantly underfunded plans, PBGC is better able to estimate the amount of potential claims that plans represent and to act quickly to avoid additional losses before plans terminate.

Cooperating With Plan Sponsors

PBGC is expanding its cooperation with plan sponsors by improving customer service, providing regulatory relief, and negotiating rule-making. PBGC continues to audit a sample of fully funded, terminated plans to

[30]Financial Audit: Pension Benefit Guaranty Corporation's 1993 and 1992 Financial Statements (GAO/AIMD-94-109, May 4, 1994).

determine if participants received all of their guaranteed benefits under the plan. In 1997, these audits resulted in almost $4 million in additional benefits to about 4,900 participants. PBGC also has a pension search program to locate vested participants in plans it administers. In 1996, PBGC expanded the program to include a missing participant clearinghouse to help employers that are terminating fully funded plans locate all people who are owed benefits. In addition, PBGC is revising its premium compliance program and increasing the number of premium audits (to ensure firms are paying the right premium amount) while reducing the administrative burden on plans. Finally, in 1997, PBGC issued revised regulations developed in cooperation with the plan sponsor community for streamlining procedures for terminating fully funded plans. PBGC also worked with participant groups while revising its regulations for recovering PBGC benefit overpayments.

Concerns Continue About Participant Benefit Determinations and Contractor Oversight

Throughout its history, PBGC has focused primarily on paying benefits to participants of the plans it administers in a timely manner.[31] Despite recent progress in more quickly finalizing takeovers of underfunded, terminated plans and reducing the backlog of participant benefit determinations, a large backlog of final determinations remains. Further, the backlog could quickly grow if a large number of terminations occurred, as PBGC experienced during the 1980s and early 1990s. In fiscal year 1997, PBGC issued 69,000 benefit determinations but has only completed determinations for participants in certain plans that terminated during the 1970s and 1980s within the last 5 years. PBGC is now issuing participant benefit statements for plans terminated in the early 1990s. However, an average of 8 years passes from the time PBGC takes over a plan until it issues final benefit determinations to participants. During this period, estimated benefit payments are made to participants. For a number of years, some participants are underpaid, while others are overpaid and are subsequently required to repay the overpayments.

PBGC is streamlining the steps it takes when assuming responsibility for terminated plans and is implementing a new participant information system to facilitate more timely processing of determinations. PBGC has initiated these improvements in customer service, in part, because it projects that it will continue to assume responsibility for about 150 new plans with 50,000 participants each year.

[31]PBGC pays estimated benefits to retirees until it confirms necessary participant data, valued plan assets, and recoveries from the sponsor. Frequently, delays occur in obtaining these data because of inadequate plan and employer records. Once PBGC obtains the necessary records, it calculates the actual benefit payable to each participant.

Another area of concern is the adequacy of PBGC's oversight of contractors' performance and reimbursements. PBGC has about 750 employees, but it relies heavily on services from contractors for actuarial, investment management, and legal support, as well as for administration of terminated plans.[32] Of PBGC's total budget of about $150 million, an estimated $80 million to $100 million is for contracting costs. Recognizing that PBGC uses many contractors in virtually all aspects of its operations, PBGC's Inspector General has designated contractor procurement and performance as a critical audit area.

The Inspector General carries out ongoing audits of PBGC contractors and has identified problems in contractor performance and questionable reimbursements. Previously, the OIG reported finding such problems as contractor accounting records that were inadequate to support billings, contractor noncompliance with contract provisions, and excess cost reimbursements. As the OIG reported, it is important that PBGC follow its procurement controls to ensure that contractor performance and reimbursement are properly monitored.

PBGC has taken steps to improve its oversight of contractors. In fiscal year 1994, PBGC established a contract audit group, after having had no contract audit function for most of its history. PBGC reports that this group has completed audits of 79 contracts valued at approximately $315 million, resulting in savings of about $9.8 million. PBGC has also consulted with the OIG on performance and cost reviews of some field benefit administrators. At PBGC's request, the OIG reviewed PBGC draft reports on field benefit administrators and found that the reports, especially concerning contractor performance, were a useful management tool.

Conclusions

While PBGC's financial condition has significantly improved, risks to the long-term financial viability of the insurance programs remain. Continued underfunding among some large plans poses a risk to the agency. PBGC also remains vulnerable to other risks, such as downturns in the economy, problems in certain economic sectors, and declines in interest rates. An economic downturn and the termination of a few plans with large unfunded liabilities could quickly reduce or eliminate PBGC's surplus. Therefore, a continued focus on maintaining a strong financial condition is important in anticipating and addressing these risks. In addition, PBGC's current methodology for forecasting the future financial condition of the

[32]For some terminated plans, PBGC contracts with former pension plan administrators from large sponsors and other outside parties to continue plan administration. These former plan administrators are designated by PBGC as field benefit administrators.

single-employer program does not take into account the range of economic conditions that can result in plan terminations, nor does it measure the probability that such future terminations will result in claims. Given the historic volatility of PBGC claims, it is important that PBGC continue efforts to improve its methodologies for forecasting its future financial condition. The ability to anticipate large claims and their impact on PBGC is an important step toward ensuring PBGC's long-term financial solvency.

PBGC has made significant progress in addressing the financial systems and internal control weaknesses that had plagued the agency for many years. However, continuing to reduce the backlog of benefit determinations, while improving their timeliness, and improving oversight of contractors must be ongoing agency priorities if PBGC is to improve customer service and maintain the integrity of the insurance programs.

The voluntary nature of the private pension system means that efforts to strengthen the insurance system should be properly balanced to encourage the creation and continuation of defined benefit pension plans—one of PBGC's legislative mandates. However, PBGC and the Congress should be ready to respond to economic or other changes that could jeopardize PBGC's long-term financial condition. Properly anticipating and responding to such changes in a timely manner could avoid the need for large premium increases or for general revenues from the federal government, while at the same time protecting the pensions of millions of workers.

Agency Comments

We obtained PBGC's comments on a draft of this report. PBGC agreed with our findings that the agency continues to face significant risks, many of which are beyond the agency's control, and that it must remain diligent in managing these risks. (See app. II for the full text of PBGC's comments.) PBGC also provided technical comments, which we have incorporated as appropriate.

As arranged with your office, unless you publicly announce the contents of this report earlier, we plan no further distribution until 30 days after its issue date. At that time, we will send copies of this report to relevant congressional committees; the Executive Director, PBGC; the Secretary of Labor; and other interested parties. Copies will also be made available to others on request. If you or your staff have any questions concerning this

report, please call me on (202) 512-7215. Major contributors to this report include Francis P. Mulvey, Assistant Director; Michael D. Packard, Evaluator-in-Charge; and George A. Scott, Senior Evaluator.

Sincerely yours,

Cynthia M. Fagnoni
Director, Income Security Issues

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Abbreviations

ERISA	Employee Retirement Income Security Act
FDIC	Federal Deposit Insurance Corporation
IRS	Internal Revenue Service
MIP	Multiemployer Insolvency Projection
OIG	Office of Inspector General
OMB	Office of Management and Budget
PBGC	Pension Benefit Guaranty Corporation
PIMS	Pension Insurance Modeling System
PPA	Pension Protection Act
RPA	Retirement Protection Act

PBGC Efforts to Improve Forecasting Methodologies

The Pension Benefit Guaranty Corporation (PBGC) is required to annually provide an actuarial valuation of the single-employer program's expected operations and financial status over the next 5 years. PBGC has historically exceeded this requirement, providing three 10-year forecasts. In addition, PBGC is required to examine its multiemployer insurance program every 5 years to determine whether changes in the benefit guarantee level or premium are necessary.

Current Methodology

PBGC's current unsophisticated forecasting methodology for its single-employer program is based on the agency's claims experience and the economic conditions of the past 2 decades. Forecast A is a projection based on the average annual net claims over PBGC's entire history and assumes the lowest level of future losses. For 1997, forecast A projects continuation of PBGC's financial improvement, resulting in a surplus, in 1997 dollars, of $8 billion in 2007. Forecast B assumes a moderate level of future losses and is based on the average annual net claims of the most recent 11 fiscal years. Forecast B projects net income levels that will lead to a surplus of $6.9 billion at the end of 2007. Finally, Forecast C projects $2.1 billion in net claims each year, over the next 10 years, from a modest number of plans with small claims and the largest underfunded plans. This approach results in a projected $17.1 billion deficit at the end of the 10-year period.

The assumptions used in making these projections are consistent with the assumptions used to determine the present value of future benefits in PBGC's fiscal year 1997 financial statements. Assumed administrative expenses are consistent with PBGC's submission to the President's 1999 budget.

Pension Insurance Modeling System

PBGC is developing a model, the Pension Insurance Modeling System (PIMS), to forecast its future exposure to claims under a range of future economic conditions by simulating pension funding and bankruptcy rates over a 30-year period. PBGC plans to replace its current single-employer forecasting methodology with PIMS.

PIMS simulates a series of dynamic relationships that characterize the growth of firm assets and liabilities, the number of plan participants, the assets and liabilities of the pension plan, and the normal cost associated with the plan. The pension plan and the sponsoring firm are treated as separate but related entities. The future financial condition of the firm and

plan are interdependent and also dependent on current financial conditions, legal and regulatory restrictions, and the uncertainty of future economic conditions. Stochastic variables are used to model this uncertainty.[33] The model simulates these dynamic relationships over a specified period of time. In order to forecast future expected claims, the model is run many times to produce a distribution of possible outcomes. This distribution provides an estimate of the average expected future claims and a measure of the probability that actual claims will be within a certain range around the estimate.

PIMS uses numerous attributes of individual pension plans and sponsoring firms. The model is run using a stratified sample of firms. The PIMS database currently has data on 417 plans representing approximately 50 percent of PBGC's liability and 50 percent of plan underfunding. Model results can be extrapolated to account for the entire population of plan sponsors. For each plan in PIMS, IRS funding requirements are modeled. The probability of firm bankruptcy is also modeled and depends on several factors, including firm size, industry, and firm characteristics.

The initial assumptions used in the model are those of the plans' actuaries as reported on the form 5500. In cases in which the model's initial estimated liability for a plan differs from that on the form 5500, PBGC adjusts some of the model's assumptions, data, or both so that the two liability estimates are consistent. Subsequent changes in year-to-year assumptions are determined by a subset of equations in the PIMS model.

Multiemployer Insolvency Projection Model

PBGC used its Multiemployer Insolvency Projection (MIP) model in its most recent 5-year examination of its multiemployer insurance program. The model includes plans with the largest unfunded liabilities (which account for approximately 80 percent of total multiemployer plan underfunding), the largest plans in terms of total liability, and all plans identified in PBGC's 1994 financial statements as "reasonably possible" future insolvencies. For each plan, MIP projects such factors as the number of participants, contributions and other income, benefit payments, actuarial liabilities, assets, and funding requirements. The projections are made for 15 years on the basis of 1992 data and use 1 or more of 12 sets of assumptions, such as expected retirement age (the age at which active workers are assumed to retire), annual benefit rate increase, rate of return on assets and whether there is a decrease in assets, and influx of new workers into the

[33]A stochastic variable is a variable whose value cannot be fully determined prior to observation; that is, there is a degree of randomness about the variable that is due, in some part, to chance.

plan. The model's base scenario assumes a continuation of the plan's recent experience and includes the plan actuary's assumptions. Other scenarios change 1 or more of the model's 12 sets of assumptions to determine the impact of more conservative or pessimistic conditions.

Comments From the Pension Benefit Guaranty Corporation

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SEP 1 1998

Office of the Executive Director

Ms. Cynthia M. Fagnoni
Director, Income Security Issues
Health, Education, and Human Services Division
United States General Accounting Office
Washington, DC 20548

Re: Draft Report: Pension Benefit Guaranty Corporation: Financial Condition Improving but Long Term Risks Remain (GAO/HEHS-98-225)

Dear Ms. Fagnoni:

Thank you for the opportunity to review and comment on your proposed report on PBGC's financial condition. Your report notes that PBGC's financial condition continues to improve, but that PBGC still faces significant risks that must be carefully managed.

PBGC is dedicated to promoting defined benefit pension plans in the private sector because they provide a predictable, secure retirement benefit for life. PBGC is also committed to providing the highest quality customer service to participants in plans taken over by PBGC. In administering our programs, we continue to work to improve our operations and to ensure that PBGC remains financially strong.

We are gratified that your report recognizes our accomplishments in improving our operations and financial condition. We also strongly concur in your finding that significant risks continue to face PBGC, many of which are beyond the agency's control, and that PBGC must remain diligent in managing these risks. We appreciate this opportunity to highlight several of the points raised in your report.

Improved Financial Condition

PBGC's financial condition has steadily improved since 1993 when our deficit approached $3 billion. In 1993, PBGC began to take a variety of actions to address the problems facing it. PBGC strengthened internal controls, reorganized its insurance operations, created an audit department reporting to the Chief Financial Officer to oversee PBGC contractors, and implemented new state-of-the-art computer systems. As a result, PBGC was removed from GAO's "high risk" list in 1995 and has received clean opinions on our financial statements since 1993.

PBGC also spearheaded the Retirement Protection Act of 1994 to address the problem of underfunded pension plans and the risks faced by plan participants and PBGC. This legislation strengthened the funding requirements for pension plans, increased PBGC's enforcement capability, and improved the information provided to participants.

As of the 1997 fiscal year, PBGC enjoyed a surplus of over $3 billion, largely due to high investment returns and low pension losses. It is important to recall that this is only the second time in our 24-year history that we have been in a surplus position.

Continuing Risks

Your report notes that PBGC remains exposed to a variety of risks, many of which are beyond the agency's control. Specifically, your report warns that an economic downturn could have a significant adverse affect on PBGC's financial condition. There would be a direct impact on PBGC because of a reduction in the value of investments. In addition, the value of assets held by plans covered by PBGC would be similarly adversely affected, posing an increased threat to plan participants and to PBGC. PBGC would be expected to take over an increasing number of pension plans sponsored by companies that failed during a downturn, and PBGC would be at risk for the possibility of the termination of unusually large plans during an economic slump.

Participant Benefit Determinations

Your report notes that, although PBGC has made many improvements to its operations, you still have concerns about the backlog of benefit determinations in PBGC's inventory, and the timeliness of completing benefit determinations for participants in plans taken over by PBGC.

PBGC issues an initial determination letter, or "IDL," once participant benefits have been determined. The benefit calculations contained in the IDLs are accurate, although we agree that issuance of IDLs should be more timely. We are working towards a corporate goal of three to five year processing by the year 2002 -- i.e., PBGC will issue IDLs within three to five years after a plan has been taken over. At this point we have improved processing time so that IDLs are issued between six and seven years after plan termination.

Some of the most significant operational improvements made in recent years to improve benefit processing are noted below.

- In 1994, PBGC reorganized and streamlined its insurance operations to implement team case processing, where auditors, actuaries and benefit administrators work together as a team to determine benefits. Team case processing replaced sequential case processing, where cases were handed-off between divisions as discrete tasks were completed.

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- PBGC has shortened the time required to terminate and trustee a plan, and has expanded its monitoring program to monitor plans maintained by financially troubled small companies.

- PBGC has also accelerated the audits of plan and participant records. This further reduces overall case processing time and improves the accuracy of estimated benefits that might have to be paid to participants prior to issuance of an IDL.

- PBGC has developed new computer systems to support team case processing. Customer service to participants has been strengthened through the creation of a dedicated Customer Service Center that is integrated with the new computer systems.

- PBGC has strengthened management oversight of its Field Benefit Administration Offices ("FBAs"). FBAs are independent contractors that are responsible for processing our largest plans.

Today PBGC issues over 60,000 IDLs each year compared to 20,000 to 25,000 per year prior to 1994. We are confident that we will continue to reduce our backlog and shorten processing time.

Multiemployer Program

The report expresses concern that continued decline in the number of active workers in multiemployer plans could jeopardize the multiemployer insurance program. In June 1996, the PBGC issued its required five-year report to Congress on the financial condition of PBGC's multiemployer insurance program. As stated in the five-year report, the "program is financially sound, and is projected to remain so" even with the continued decline in the contribution base. The PBGC's five-year report is based upon forecasts of the financial condition of the program utilizing the Multiemployer Insolvency Projection (MIP) model; the MIP is described in your report. The MIP baseline forecast assumes a continuation of the recent historic decline for each plan in the number of active workers, a decline that has averaged 4% annually. The baseline projected surplus grows from $190 million in 1995 to $570 million in 2007. If the decline assumption is increased by 4% annually (producing an average annual decline of 8%), the projected surplus decreases to $470 million in 2007.

In addition, in the years after the enactment of reforms in 1980 when, as you note, there was a decline in active employees, funding increased steadily, as you also note. For example, the average funding ratio in underfunded plans increased from 58 percent in 1980 to 80 percent in 1994.

For these reasons, we have confidence that the funding of the multiemployer system and the PBGC insurance program is not jeopardized by a decline in active employees.

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Pension Insurance Modeling System (PIMS)

Your report expresses concerns about PBGC's current methodology for forecasting its financial condition, and notes that PBGC's new forecasting tool, the Pension Insurance Modeling System (PIMS), will greatly aid PBGC in forecasting and managing long-term financial risks.

PBGC intends to use PIMS as our forecasting tool beginning in FY 1999. PIMS portrays the potential variation in PBGC's future financial status under a variety of future economic and demographic scenarios. It is a sophisticated tool that will provide a broad range of information related to the long-range risks facing PBGC.

Contractor Oversight

Your report notes that oversight of contractors is especially important because of PBGC's heavy reliance on contractors for actuarial, investment management, and legal support, as well as administration of trusteed plans.

As you note in your report, PBGC established a contract audit program which reports the Chief Financial Officer. As a result, PBGC effectively oversees the reimbursement of contractors that perform services for the Corporation. The Contract Auditors provide support to the Procurement Department in the award, administration, and settlement of PBGC contracts. This group performs pre-award audits of contractor cost proposals, performs interim reviews of invoices submitted under PBGC contracts, and completes contract close-out audits to assess compliance with contractual terms. Since the program was established, the Contract Auditors have audited 79 contracts valued at approximately $314 million, resulting in total savings of $9.8 million.

Since 1994, the Procurement Department has added three contract specialists, thereby increasing its ability to oversee contractor performance. Both departments have provided training to PBGC technical representatives and contractors.

Over the years, GAO has provided invaluable assistance to PBGC as we have worked to improve our operations and financial standing. We look forward to your continued assistance.

Sincerely,

David M. Strauss
Executive Director

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Related GAO Products

Budget Issues: Budgeting for Federal Insurance Programs (GAO/AIMD-97-16, Sept. 30, 1997).

Financial Audit: Pension Benefit Guaranty Corporation's 1994 and 1993 Financial Statements (GAO/AIMD-95-83, Mar. 8, 1995).

High-Risk Series: An Overview (GAO/HR-95-1, Feb. 1995).

Private Pensions: Funding Rule Change Needed to Reduce PBGC's Multibillion Dollar Exposure (GAO/HEHS-95-5, Oct. 5, 1994).

Underfunded Pension Plans: Stronger Funding Rules Needed to Reduce Federal Government's Growing Exposure (GAO/T-HEHS-94-191, June 15, 1994).

Financial Audit: Pension Benefit Guaranty Corporation's 1993 and 1992 Financial Statements (GAO/AIMD-94-109, May 4, 1994).

Underfunded Pension Plans: Federal Government's Growing Exposure Indicates Need for Stronger Funding Rules (GAO/T-HEHS-94-149, Apr. 19, 1994).

Financial Audit: Pension Benefit Guaranty Corporation's 1992 and 1991 Financial Statements (GAO/AIMD-93-21, Sept. 29, 1993).

Pension Plans: Underfunded Plans Threaten PBGC (GAO/T-HRD-93-2, Feb. 4, 1993).

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

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

Pension Plans: Pension Benefit Guaranty Corporation Needs to Improve Premium Collections (GAO-HRD-92-103, June 30, 1992).

Financial Audit: Pension Benefit Guaranty Corporation's 1991 and 1990 Financial Statements (GAO/AFMD-92-35, Mar. 2, 1992).

Pension Plans: 1980 Multiemployer Pension Amendments: Overview of Effects and Issues (GAO/HRD-86-4, Feb. 13, 1986).

Ordering Information

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