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Financial Condition of the
Single Employer Pension
Plan Insurance Program

Statement of
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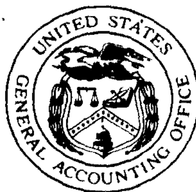
Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives



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SUMMARY

- The single employer pension plan insurance program is in serious financial trouble.

  - The reported deficit is $3.8 billion at September 30, 1986 and could reach an estimated $8 billion by 1990.

  - Program benefit payments are expected to cause an asset drain that could render the program insolvent within 15 years.

- Despite many positive effects, the Single Employer Pension Plan Amendments Act may not be enough to ensure the program's long term financial viability.

- GAO found that 70 percent of the program's large claims in 1983-85 resulted primarily because employers were not required to make sufficient contributions in time to pay for rising unfunded guaranteed benefits.

- GAO endorses the intent of the administration's proposals to reduce the program's claims by tightening the funding standards and better finance program costs through a variable premium.

  - Adequate transition rules are essential to ensure that the proposals'immediate effect on poorly funded plans' total costs is not unreasonably burdensome for certain employers.

  - The administration's previous goal of retiring the program's deficit in 15 years should be maintained because the proposed extension to 30 years increases the transfer of past program costs to future premium payers.

- To limit the financial burden on employers, consideration should be given to reducing program costs by lowering the benefit guarantees.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the financial condition of the single employer pension insurance program and changes that the Congress may wish to consider to improve it--two subjects covered in a recent report we prepared for this Subcommittee.[1]

The insurance program, which is administered by the Pension Benefit Guaranty Corporation, generally guarantees workers' vested benefits when a plan terminates. Guaranteed benefits that exceed plan assets become program claims which are to be financed by collections from the plans' sponsoring employers. To the extent not collectible, claims are to be financed from premiums paid annually by ongoing plans. The program covers over 110,000 plans with over 30 million participants.

PROGRAM'S FINANCIAL CONDITION

The single employer insurance program is in serious financial trouble. As of September 30, 1986, the program's reported deficit was $3.8 billion,[2] and the Corporation estimates that it could reach about $8 billion by 1990. Moreover, annual

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[1]PENSION PLANS: Government Insurance Program Threatened by Its Growing Deficit (GAO/HRD-87-42, Mar. 19, 1987).

[2]We have not been able to express an opinion on whether the program's financial statements are presented fairly because of accounting and internal control weaknesses. Therefore, the program's deficit may be more or less than reported.

program benefit payments, about $260 million in fiscal year 1986, are expected to be $650 million in 2 years, causing an asset drain that could render the program insolvent within 15 years.

The deficit has grown dramatically in recent years due primarily to large claims from the termination of underfunded plans of a relatively few employers. The deficit grew from $333 million to $1.3 billion during fiscal years 1983-85. It almost tripled to $3.8 billion in fiscal year 1986 primarily because plans of the bankrupt LTV Corporation were terminated with unfunded benefits of about $2 billion.

We reviewed 33 plans that accounted for 90 percent of the claims dollars incurred during fiscal years 1983-85 to identify the major causes of their underfunding at termination. We found that about 70 percent of the plans' claims resulted primarily because federal funding standards did not require sufficient contributions to pay for rising unfunded guaranteed benefits, in part due to numerous benefit increases in the years just before termination--27 of the 33 plans increased benefits during the 5 years before termination.

The remaining 30 percent of the claims resulted from employers not having made required contributions before the plans were terminated. Almost half represented contributions (generally covering all or part of a plan's last year of operations) that were not yet due because the payment deadline (8-1/2 months after the end of a plan year) came after plan termination. Also, significant percentages of the unpaid

contributions either were overdue (32 percent) or had been waived (23 percent) by the Internal Revenue Service, the agency responsible for enforcing the funding standards.

POTENTIAL EFFECTS OF 1986 AMENDMENTS

The Single Employer Pension Plan Amendments Act, enacted in April 1986, should (1) prevent program claims from employers who are not financially distressed by prohibiting them from terminating their underfunded plans, (2) increase claims recovery by raising employers' liability for unfunded benefits, and (3) increase program revenue by raising the annual premium from $2.60 to $8.50 per participant.

Despite these positive effects, the 1986 amendments may not be enough to ensure the program's long-term financial viability. The majority of the claims dollars have resulted from plans terminated by bankrupt employers. A significant increase in the recovery of such claims is not likely because the Corporation's claims in bankruptcy proceedings continue to have a low priority.

Further, the amendments' premium rate of $8.50 is projected to generate $273 million in revenue in fiscal year 1987. However, about $424 million a year would be required if the program's current deficit of $3.8 billion is to be retired over 15 years, the period used by the Corporation to determine the $8.50 rate. The Corporation estimates that about $650 million

would be needed in fiscal year 1987 to finance other program costs, primarily new claims, and expects these costs to increase in future years.

Under these conditions, the premium revenue generated by the amendments will not be enough to retire the program's deficit, much less pay for unrecoverable claims from future plan terminations.

REFORM ALTERNATIVES

Our recent report presented additional reforms that the Congress might consider. To help control potential claims, we suggested strengthening the funding standards and lowering benefit guarantees. To better finance claims, we proposed raising the program's premium rate and the priority of its claims in bankruptcy proceedings.

The administration proposes to strengthen plan funding and increase premium revenue using a variable rate approach. Although we have not had sufficient time to make a detailed analysis of these proposals, I would like to make some preliminary observations on their major provisions. My comments are primarily based on (1) our experience over the last 5 years with the single employer pension plan insurance program, (2) discussions with Corporation officials, and (3) the administration's February proposal to change plan funding requirements.

PREMIUM REQUIREMENTS AND VARIABLE RATE STRUCTURE

According to the Corporation, the program's premium structure should generate adequate revenue to meet the program's financing needs and, in so doing, satisfy certain criteria. The premium structure should be simple to administer and enforce, equitable to plans, and avoid placing an unreasonable financial burden on plans and employers.

The Corporation proposes a variable premium with automatic adjustment features. Specifically, the proposal presents a basic premium that includes a flat $8.50 participant charge for all plans plus an additional charge of $6 for each $1,000 of underfunding to be paid by plans with 100 or more participants. Underfunding will be determined by subtracting assets from 125 percent of estimated termination liability. Although the premium is initially capped at $100 per participant, other charges could raise the cap to $250 per participant for plans not paying contributions computed under the funding standards.

Both the $8.50 rate and the $100 cap are to be indexed annually to the Social Security wage base. In addition, the $6 underfunding charge can be adjusted, but by no more than 50 percent, every 3 years based on the program's claims experience.

The Corporation estimates that the variable premium will generate enough revenue to eliminate the program's deficit over the next 30 years, pay for new claims (estimated at $656 million in 1988), and cover administrative costs ($40 million in 1988). However, the Corporation cautions that its claims estimate is

very uncertain. Claims in recent years have been extremely volatile--ranging from $40 million in 1984 to $2 billion in 1986. Claims have come primarily from what the Corporation has called "catastrophic events"--the termination of a few employers' plans that were underfunded by large amounts. According to the Corporation, it is doubtful whether any methodology can be developed at this time to forecast the program's claims and, hence, revenue needs with precision. We agree.

Estimates of revenue under the current premium are relatively straightforward--total covered participants times $8.50. A variable premium adds uncertainty because the Corporation's revenue estimates rely primarily on the extent of plans' underfunding, which could vary over time depending on such factors as changes in interest rates and employer contributions. Moreover, current or accurate data on underfunding are not maintained by the government. As a result, the Corporation cannot reliably estimate how much revenue the proposed premium will produce.

Because of these uncertainties, we agree with the Corporation's proposal to include automatic adjustment features in the premium. We took a similar position in 1983 and believe that the situation is much more critical today. An automatic adjusting premium should help the program react to its volatile claims experience by allowing more frequent changes in the premium rate to keep revenues more in line with costs. However,

we have not had time to fully assess the impact of the proposal's premium adjustment features on the costs to plans and employers.

Although more complex than a flat $8.50 rate per participant, the variable premium is simple to calculate using available plan data and information to be provided to plans by the Corporation. The proposed approach, which is based solely on a plan's potential claim against the program (exposure), is not as equitable as also considering a plan's probability of termination. Nonetheless, we believe it is more equitable than the existing flat rate because those plans generally representing no immediate potential claim would pay the lowest premium.

The new premium structure would increase premium costs for all plans whose assets are less than 125 percent of their termination liabilities, which includes some overfunded plans. Estimates of who will be affected and by how much vary with the data used to make the estimates. Using 1984 data on 12,832 plans with about 21 million participants, we estimate that, if the variable premium had been in effect that year, 74 percent of plans with 100 or more participants would not have paid any higher premium because they were more than 125 percent funded. About 1 percent of these large plans covering 3 percent of all participants would have paid a $100 premium per participant and borne about 21 percent of the premium cost.

A determination of whether a variable premium would be burdensome to plans is a matter of judgment. To get an idea of its potential impact on a significantly underfunded plan, we

calculated the 1984 premium for the plan causing the largest claim against the program as of September 1985. We found that the plan would have had to pay about $860,000 under the variable premium rather than about $73,000 at the $8.50 rate. The additional premium cost would have represented about 5 percent of the plan's required annual contributions and less than 1 percent of its ultimate claim against the program.

PLAN FUNDING STANDARDS

The existing funding standards were designed to provide reasonable assurance that an ongoing pension plan will systematically accumulate sufficient assets to pay benefits to participants as they become due. As I pointed out earlier, however, the standards do not assure that the benefits owed to participants will be funded if the plan terminates or that a plan's unfunded benefits will not grow over time.

The administration's funding standards proposal includes several changes to help reduce potential claims. The major thrust of the proposal is to require more rapid amortization of a plan's unfunded termination liabilities. Other changes would (1) require all plans to pay contributions quarterly rather than 8-1/2 months after plan year end; and (2) reduce the number of funding waivers now allowed, while requiring quicker payment of those granted. These changes address the causes of underfunding identified in our recent report.

We believe these changes should meet the same criteria set out by the Corporation for the variable premium--simplicity, equity, and avoidance of unreasonable burden. However, information made available to us by the administration on the proposals has been primarily conceptual and not specific enough in certain key areas for us to make a detailed analysis.

In general, it appears that the proposed changes will have a limited effect on most plans because they appear sufficiently overfunded and will continue to follow the existing funding requirements. However, the changes will make already complex funding standards more complex for marginally overfunded and all underfunded plans. (Affected plans may have to compute contribution levels under three new funding requirements and compare the results to the contribution level required under the existing standard.) Further, it appears that the changes could be financially burdensome to those plans that are significantly underfunded because they could be required to pay substantially higher contributions than now required.

POLICY IMPLICATIONS

We endorse the intent of the administration's proposals to reduce the insurance program's claims exposure by tightening the funding standards and to better finance program costs through a variable premium. Furthermore, we believe that the proposals provide a useful framework for deliberating the major policy options available. Both proposals should be considered together,

rather than individually, because their cost implications are targeted toward the same general population--poorly funded plans. In this regard, we believe that the Congress needs more information on the proposals and their effects to ensure that adequate safeguards, as transition rules, are put in place so that plans' total costs do not become unreasonably burdensome for employers.

As pointed out in our recent report, changes designed to improve the program's financial condition and otherwise protect the benefits owed to participants at plan termination can directly and indirectly affect employers, plan participants, the federal government, and other private companies. For example, raising the contribution requirements by changing the funding standards could affect participants because it may encourage some employers to hold down pension costs by reducing or eliminating future benefit increases or terminating their plan. Further, because contributions are tax deductible, government tax revenue could (1) increase if plan terminations occur without an increase in other deductible expenses or (2) decrease if employers increase contributions without reducing other deductible expenses.

Funding Standards

The requirements for more rapid funding of a plan's unfunded liabilities and subsequent benefit increases represent the two most significant changes that can be made to the funding

standards. Developing the specific triggers for determining contribution levels requires establishing a delicate balance between the need to reduce a plan's underfunding and the employer's ability to pay. While some underfunded plans are sponsored by healthy employers, many are financed by employers who are experiencing financial difficulties. Imposing too high costs could force the termination of plans, reduce the granting of benefit increases designed to provide a reasonable retirement income, and discourage other employers from establishing new defined benefit plans.

In order to minimize the burden of policy changes in such instances, it will probably be necessary to establish contribution requirements that, while higher than existing standards, may not represent the highest level needed to immediately protect the program from large claims. As a result, we believe that changes to the funding standards should be viewed as long-term solutions to the program's financial problems.

Premium Requirements

Because of the present large imbalance between program costs and revenues, changes are needed in the premium structure to slow the expected erosion of program assets over the next 15 years. We support the variable premium because it provides a more equitable approach to distributing program costs than the current flat rate. Including an automatic adjustment mechanism is a critical element given the uncertainty in the program's revenue

needs and in the potential revenue that will be generated by the variable rate structure.

Certain aspects of the proposal warrant further consideration. We believe that premium payers should finance program costs as close to when they are incurred as possible and that the administration should not alter its previous goal of retiring the deficit in 15 years. Extending the retirement period to 30 years, as proposed, increases the inequitable transfer of responsibility for past program costs to future premium payers. Such potential inequities could be reduced by increasing the base premium charged to all plans above the current $8.50 rate. A base premium of $12.50 would be needed to retire the program's existing deficit over 15 years.

Benefit Guarantees

The administration's proposals, like prior reforms, are designed to resolve the program's financial crisis by raising the costs of employers sponsoring insured plans. As an effort to limit the financial burden on employers, we believe that further consideration should be given to reducing program costs by lowering the benefits guaranteed. For example, eliminating insurance program coverage of benefit increases within 5 years of plan termination would reduce claims dollars. While we support the program's primary intent to protect participants' benefits, we believe that the establishment of affordable benefit

guarantees may be an essential policy alternative to ensure the program's financial viability.

This concludes my prepared remarks. I will be happy to answer any questions you may have.