PRIVATE PENSIONS

Changing Funding Rules and Enhancing Incentives Can Improve Plan Funding

Why GAO Did This Study

Over the last few years, the total underfunding in the defined-benefit pension system has deteriorated to the point where the Pension Benefit Guaranty Corporation (PBGC), the federal agency responsible for protecting private sector defined benefit plan benefits, estimates that total plan underfunding grew to more than $400 billion as of December 31, 2002, and still exceeded $350 billion as of September 4, 2003. PBGC itself faced an estimated $8.8 billion accumulated deficit as of August 31, 2003. Deficiencies in current funding and related regulations have contributed to several large plans recently terminating with severely underfunded pension plans.

This testimony provides GAO's observations on a variety of regulatory and legislative reforms that aim to improve plan funding and better protect the benefits of millions of American workers and retirees while minimizing the burden to plan sponsors of maintaining defined-benefit plans.

What GAO Found

Recent terminations of severely underfunded pension plans suggest that current funding rules do not provide adequate mechanisms for maintaining adequate funding of pension plans. Funding inadequacies place the retirement security of millions of American workers and retirees, along with PBGC, at risk. While external factors, such as falling stock prices, low interest rates, and slow economic growth, have contributed to widespread pension underfunding, the defined-benefit system also faces structural problems that extend beyond cyclical economic conditions. Stagnant growth of the defined-benefit system, along with several large recent terminations of underfunded pension plans, has left PBGC in a precarious financial condition as the insurer of pension benefits.

There are two general approaches to funding reform that may improve the funding of defined-benefit pension plans. The first approach would change the funding requirements directly. These measures could address reforms to the use of termination liability instead of current liability, additional funding requirements, and lump-sum distributions. The second, more indirect approach would seek to improve plan funding by providing better incentives for sponsors to keep their plans better funded. Options in this category could include requirements broadening the disclosure of plan investments and termination liability information to plan participants and their representatives. These reforms, as part of a comprehensive package, could increase the likelihood that workers and retirees receive promised benefits, while not creating an undue regulatory or financial burden on sponsors.

Recent unfavorable economic conditions have contributed to widespread underfunding and conspired to place well-meaning plan sponsors in difficult positions. Although comprehensive reform should include improving plan funding as the key vehicle to stabilize the long-term health of the defined-benefit system, Congress may seek to balance improvements in funding and accountability against the short-term needs of some sponsors who may have difficulty making plan contributions.

Figure 2: Total Underfunding in PBGC-Insured Single-Employer Plans, 1980-2003

Dollars in billions

<table>
<thead>
<tr>
<th>Year</th>
<th>Underfunding</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>400</td>
</tr>
<tr>
<td>1981</td>
<td>350</td>
</tr>
<tr>
<td>1982</td>
<td>300</td>
</tr>
<tr>
<td>1983</td>
<td>250</td>
</tr>
<tr>
<td>1984</td>
<td>200</td>
</tr>
<tr>
<td>1985</td>
<td>150</td>
</tr>
<tr>
<td>1986</td>
<td>100</td>
</tr>
<tr>
<td>1987</td>
<td>50</td>
</tr>
<tr>
<td>1988</td>
<td>0</td>
</tr>
<tr>
<td>1989</td>
<td>0</td>
</tr>
<tr>
<td>1990</td>
<td>0</td>
</tr>
<tr>
<td>1991</td>
<td>0</td>
</tr>
<tr>
<td>1992</td>
<td>0</td>
</tr>
<tr>
<td>1993</td>
<td>0</td>
</tr>
<tr>
<td>1994</td>
<td>0</td>
</tr>
<tr>
<td>1995</td>
<td>0</td>
</tr>
<tr>
<td>1996</td>
<td>0</td>
</tr>
<tr>
<td>1997</td>
<td>0</td>
</tr>
<tr>
<td>1998</td>
<td>0</td>
</tr>
<tr>
<td>1999</td>
<td>0</td>
</tr>
<tr>
<td>2000</td>
<td>0</td>
</tr>
<tr>
<td>2001</td>
<td>0</td>
</tr>
<tr>
<td>2002</td>
<td>0</td>
</tr>
<tr>
<td>2003</td>
<td>350</td>
</tr>
</tbody>
</table>

Note: Figure for 2003 is an estimate, as of September 4, 2003.
Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss improving the funding of single-employer defined-benefit plans.1 As all of you are aware, this is a crucial issue threatening the retirement security of millions of America’s workers and retirees. Underfunded plans sponsored by weak or bankrupt employers have drained the financial resources of the Pension Benefit Guaranty Corporation (PBGC), the backstop federal agency that insures the benefits promised by these plan. PBGC’s single-employer insurance program currently faces an estimated deficit of $8.8 billion as of August 31, 2003, following the largest 1-year loss in the agency’s history. This deficit could likely increase during the next few years, with PBGC estimating that by the end of fiscal year 2003, total underfunding in financially troubled firms could exceed $80 billion.2 We believe that an appropriate comprehensive policy response can stabilize the funding of these pension plans, thereby protecting workers’ benefits for the foreseeable future. Reforming the rules that regulate how sponsors fund their pension plans is an essential part of this response. I hope my testimony will help clarify some of the key issues as the Congress and the relevant agencies choose how to respond to these serious financial challenges. As you requested, I will discuss some options to improve the funding status of defined-benefit plans.

1 A defined-benefit plan promises a benefit that is generally based on an employee’s salary and years of service. The employer is responsible for funding the benefit, investing and managing plan assets, and bearing the investment risk. In contrast, under a defined contribution plan, benefits are based on the contributions to and investment returns on individual accounts, and the employee bears the investment risk. There are two federal insurance programs for defined-benefit plans: one for single-employer plans and another for multiemployer plans. Our work was limited to the PBGC program to insure the benefits promised by single-employer defined-benefit pension plans. Single-employer plans provide benefits to employees of one firm or, if plan terms are not collectively bargained, employees of several unrelated firms.

2 According to PBGC, for example, companies whose credit quality is below investment grade sponsor a number of plans. PBGC classified such plans as reasonably possible terminations if the sponsors’ financial condition and other factors did not indicate that termination of their plans was likely as of year-end. See PBGC 2002 Annual Report, p. 41. The independent accountants that audited PBGC’s financial statement reported that PBGC needs to improve its controls over the identification and measurement of estimated liabilities for probable and reasonably possible plan terminations. According to an official, PBGC has implemented new procedures focused on improving these controls. See Audit of the Pension Benefit Guaranty Corporation’s Fiscal Year 2002 and 2001 Financial Statements in PBGC Office of Inspector General Audit Report, 2003-3/23168-2 (Washington, D.C.: Jan. 30, 2003).
To identify the types of reform that may improve funding for defined-benefit (DB) pension plans, we reviewed proposals for reforming the single-employer program made by the Department of the Treasury, PBGC, and pension professionals. We also discussed with PBGC officials, and examined annual reports and other available information related to the funding and termination of three pension plans: the Anchor Glass Container Corporation Service Retirement Plan, the Pension Plan of Bethlehem Steel Corporation and Subsidiary Companies, and the Polaroid Pension Plan. We selected these plans because they represented the largest losses to PBGC in their respective industries in fiscal year 2002. PBGC estimates that, collectively, the plans represented over $4 billion in losses to the program at plan termination. At the request of this committee, we will release a report at the end of this month on the financial condition of the PBGC single-employer pension program and related issues of pension plan reform.

To summarize my responses, there are two general approaches to funding reform that may improve the funding of defined-benefit pension plans. The first approach would change the funding requirements directly. These measures could encompass reforms to the use of current and termination liability in plan funding calculations, additional funding requirements, credit balances, unfunded benefits or benefit increases, and lump-sum distributions. The second, more indirect approach would seek to improve plan funding by providing better incentives for sponsors to keep their plans better funded. Options in this category could include requirements broadening the disclosure of plan investments and termination liability information to plan participants and their representatives, the restructuring of PBGC’s variable-rate premium to incorporate risk factors other than the level of underfunding, and making modifications to certain guaranteed benefits that could decrease losses incurred from underfunded plans. Reforms adopted to directly change the funding requirements or improve plan funding through providing incentives for sponsors are not mutually exclusive, and several variations exist within each reform option. These reforms, taken separately or in coordination, could increase the likelihood of plans receiving adequate funding to ensure that workers and retirees receive promised benefits.

A plan’s termination liability measures the value of accrued benefits using assumptions appropriate for a terminating plan, while its current liability measures the value of accrued benefits using assumptions specified in applicable laws and regulations.
Before enactment of the Employee Retirement and Income Security Act (ERISA) of 1974, few rules governed the funding of defined-benefit pension plans, and participants had no guarantees that they would receive the benefits promised. When Studebaker’s pension plan failed in the 1960s, for example, many plan participants lost their pensions. Such experiences prompted the passage of ERISA to better protect the retirement savings of Americans covered by private pension plans. Along with other changes, ERISA established PBGC to pay the pension benefits of participants, subject to certain limits, in the event that an employer could not. ERISA also required PBGC to encourage the continuation and maintenance of voluntary private pension plans and to maintain premiums set by the corporation at the lowest level consistent with carrying out its obligations.

Under ERISA, the termination of a single-employer defined-benefit plan results in an insurance claim with the single-employer program if the plan has insufficient assets to pay all benefits accrued under the plan up to the date of plan termination. PBGC finances the unfunded liabilities of terminated plans partially through premiums paid by plan sponsors. Currently, plan sponsors pay a flat-rate premium of $19 per participant per year; in addition, some pay a variable-rate premium, which was added in

---

4The company and the union agreed to terminate the plan along the lines set out in the collective bargaining agreement: retirees and retirement-eligible employees over age 60 received full pensions, and vested employees under age 60 received a lump-sum payment worth about 15 percent of the value of their pensions. Employees whose benefit accruals had not vested, including all employees under age 40, received nothing. James A. Wooten, “The Most Glorious Story of Failure in Business: The Studebaker–Packard Corporation and the Origins of ERISA.” Buffalo Law Review, vol. 49 (Buffalo, NY: 2001): 731.

5Some defined-benefit plans are not covered by PBGC insurance; for example, plans sponsored by professional service employers, such as physicians and lawyers, with 25 or fewer employees.


7The termination of a fully funded defined-benefit pension plan is termed a standard termination. Plan sponsors may terminate fully funded plans by purchasing a group annuity contract from an insurance company under which the insurance company agrees to pay all accrued benefits or by paying lump-sum benefits to participants if permissible. Terminating an underfunded plan is termed a distress termination if the plan sponsor requests the termination or an involuntary termination if PBGC initiates the termination. PBGC may institute proceedings to terminate a plan if, among other things, the plan will be unable to pay benefits when due or the possible long-run loss to PBGC with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated. See 29 U.S.C. 1342(a). PBGC may pay only a portion of the claim because ERISA places limits on PBGC’s benefit guarantee.
1987 to provide an incentive for sponsors to better fund their plans. The variable-rate premium, which started at $6 for each $1,000 of unfunded vested benefits, was initially capped at $34 per participant. The variable rate was increased to $9 for each $1,000 of unfunded vested benefits starting in 1991, and the cap on variable-rate premiums was removed starting in 1996.

Following the enactment of ERISA, however, concerns were raised about the potential losses that PBGC might face from the termination of underfunded plans. To protect PBGC, ERISA was amended in 1986 to require that plan sponsors meet certain additional conditions before terminating an underfunded plan. For example, sponsors could voluntarily terminate their underfunded plans only if they were bankrupt or generally unable to pay their debts without the termination.

The single-employer program has had an accumulated deficit—that is, program assets have been less than the present value of benefits and other liabilities—for much of its existence. (See fig. 1.) In fiscal year 1996, the program had its first accumulated surplus, and by fiscal year 2000, the accumulated surplus had increased to about $10 billion, in 2002 dollars. However, the program’s finances reversed direction in 2001, and at the end of fiscal year 2002, its accumulated deficit was about $3.6 billion. PBGC estimates that this deficit grew to $8.8 billion by August 31, 2003, its largest deficit in the program’s history both in real and nominal terms. From less than $50 billion as of December 31, 2000, the total underfunding in single-employer plans grew to more than $400 billion as of December 31, 2002, and still exceeds $350 billion according to recent estimates by PBGC. (See fig. 2.) Despite the program’s large deficit, according to a PBGC analysis, the single-employer program was estimated to have enough assets to pay benefits through 2019, given the program’s conditions and PBGC assumptions as of the end of fiscal year 2002. However, losses since that time may have shortened the period over which the program will be able to cover promised benefits. In July of this year, because of serious risks to

---

8The estimate assumes: (1) a rate of return on all PBGC assets of 5.8 percent and a discount rate on future benefits of 5.67 percent; (2) no premium income and no future claims beyond all plans with terminations that were deemed “probable” as of September 30, 2002; (3) administrative expenses of $225 million in fiscal year 2003, $229 million per year for fiscal years 2004-2014, and $0 thereafter; (4) mid-year termination for “probables”; and (5) that PBGC does not assume control of “probable” assets and future benefits until the date of plan termination.
the single-employer program’s viability, we placed the PBGC on our high-risk list.9

Figure 1: Assets, Liabilities, and Net Position of the Single-Employer Pension Insurance Program, Fiscal Years 1976-2002

2002 Dollars in billions

Source: PBGC annual reports.

Note: Amounts for 1986 do not include plans subsequently returned to a reorganized LTV Corporation. We adjusted PBGC data using the Consumer Price Index for All Urban Consumers: All Items.

For the most part, liabilities of the single-employer pension insurance program are comprised of the present value of insured participant benefits. PBGC calculates present values using interest rate factors that, along with a specified mortality table, reflect annuity prices, net of administrative expenses, obtained from surveys of insurance companies conducted by the American Council of Life Insurers.\(^\text{10}\) In addition to the estimated total liabilities of underfunded plans that have actually terminated, PBGC includes in program liabilities the estimated unfunded liabilities of underfunded plans that it believes will probably terminate in the near future.\(^\text{11}\) PBGC may classify an underfunded plan as a probable termination when, among other things, the plan’s sponsor is in liquidation under federal or state bankruptcy laws.

---

\(^{10}\)In 2002, PBGC used an interest rate factor of 5.70 percent for benefit payments through 2027 and a factor of 4.75 percent for benefit payments in the remaining years.

\(^{11}\)Under Statement of Financial Accounting Standard Number 5, loss contingencies are classified as probable if the future event or events are likely to occur.
Several Factors Have Contributed to PBGC’s Current Financial Difficulties

As we reported to this committee in September of this year, several factors have contributed to PBGC’s and plans’ current financial difficulties. The financial condition of the single-employer pension insurance program returned to an accumulated deficit in 2002 largely due to the termination, or expected termination, of several severely underfunded pension plans. In 1992, we reported that many factors contributed to the degree plans were underfunded at termination, including the payment at termination of additional benefits, such as subsidized early retirement benefits, which have been promised to plan participants if plants or companies ceased operations. These factors likely contributed to the degree that plans terminated in 2002 were underfunded. Factors that increased the severity of the plans’ unfunded liability in 2002 were the recent sharp decline in the stock market and a general decline in interest rates.

In many cases, sponsors did not make the contributions necessary to adequately fund the plans before they were terminated. For example, according to annual reports (Annual Return/Report of Employee Benefit Plan, Form 5500) submitted by Bethlehem Steel Corporation, in the 7 years from 1992 to 1999, the Bethlehem Steel pension plan went from 86 percent funded to 97 percent funded. (See fig. 3.) From 1999 to plan termination in December 2002, however, plan funding fell to 45 percent as assets decreased and liabilities increased, and sponsor contributions were not sufficient to offset the changes. According to a survey, the Bethlehem Steel defined-benefit plan had about 73 percent of its assets (about $4.3 billion of $6.1 billion) invested in domestic and foreign stocks on September 30, 2000. One year later, assets had decreased $1.5 billion, or 25 percent, and when the plan was terminated in December 2002, its assets had been reduced another 23 percent to about $3.5 billion—far less than needed to finance an estimated $7.2 billion in PBGC-guaranteed liabilities. Surveys of plan investments by Greenwich Associates


indicated that defined-benefit plans in general had about 62.8 percent of their assets invested in U.S. and international stocks in 1999.\footnote{2002 U.S. Investment Management Study, Greenwich Associates, Greenwich, Conn.}

These recent events and their consequences for PBGC’s finances have occurred in the context of the long-term stagnation of the defined-benefit system. The number of PBGC-insured plans has decreased steadily from approximately 110,000 in 1987 to around 30,000 in 2002.\footnote{In contrast, defined-contribution plans have grown significantly over a similar period—from 462,000 plans in 1985 to 674,000 plans in 1998.} While the number of total participants in PBGC-insured single-employer plans has grown approximately 25 percent since 1980, participation has declined as...
a percentage of the private sector labor force. Further, the percentage of participants who are active workers has declined from 78 percent in 1980 to 53 percent in 2000. Manufacturing, a sector with virtually no job growth in the last half-century, accounted for almost half of PBGC’s single-employer program participants in 2001, suggesting that the program needs to rely on other sectors for any growth in premium income. Unless something reverses these trends, PBGC may have a shrinking plan and participant base to support the program in the future as well as the likelihood of a participant base concentrated in certain, potentially more vulnerable industries.

**Minimum Funding Rules Did Not Prevent Plans from Being Severely Underfunded**

Internal Revenue Code (IRC) minimum funding rules, which are designed to ensure plan sponsors adequately fund their plans, did not have the desired effect for the terminated plans that were added to the single-employer program in 2002. The amount of contributions required under IRC minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year’s portion of other liabilities that are amortized over a period of years.\(^\text{18}\) Also, the rules require the sponsor to make an additional contribution if the plan is underfunded to the extent defined in the law. Under the additional funding requirement rule, a single-employer plan sponsored by an employer with more than 100 employees in defined-benefit plans is subject to a deficit reduction contribution for a plan year if the value of plan assets is less than 90 percent of its current liability. However, a plan is not subject to the deficit reduction contribution if the value of plan assets (1) is at least 80 percent of current liability and (2) was at least 90 percent of current liability for each of the 2 immediately preceding years or each of the second and third immediately preceding years. To determine whether the additional funding rule applies to a plan, the IRC requires sponsors to calculate current liability using the highest interest rate allowable for the plan year.\(^\text{19}\)

In 1987, the minimum funding rules incorporated by ERISA in the IRC were amended to require that plan sponsors calculate each plan’s current

\(^{18}\)Minimum funding rules permit certain plan liabilities, such as past service liabilities, to be amortized over specified time periods. See 26 U.S.C. 412(b)(2)(B). Past service liabilities occur when benefits are granted for service before the plan was set up or when benefit increases after the set up date are made retroactive.

\(^{19}\)See 26 U.S.C. 412(l)(9)(C).
liability, using a discount rate based on the 30-year Treasury bond rate, and to use that calculation to assess the plan’s funding level.\textsuperscript{20} If plans are funded below certain thresholds as defined in the IRC, employers are to determine minimum contribution amounts on the basis of those assessments. Employers must make additional contributions to the plan if it is underfunded to extent defined in the law.\textsuperscript{21} If a plan is fully funded as defined in the law, employers are precluded from making additional tax-deductible contributions to the plan. In 2002, the Congress acted to provide temporary relief to DB plan sponsors by raising the top of the permissible range of the mandatory interest rate.\textsuperscript{22} As discussed in a report we issued earlier this year,\textsuperscript{23} concerns that the 30-year Treasury bond rate no longer resulted in reasonable current liability calculations has led both

\textsuperscript{20}Under the IRC, current liability means all liabilities to employees and their beneficiaries under the plan. See 26 U.S.C. 412(1)(7)(A). In calculating current liabilities, the IRC requires plans to use an interest rate from within a permissible range of rates. See 26 U.S.C. 412(b)(5)(B). In 1987, the permissible range was not more than 10 percent above, and not more than 10 percent below, the weighted average of the rates of interest on 30-year Treasury bond securities during the 4-year period ending on the last day before the beginning of the plan year. The top of the permissible range was gradually reduced by 1 percent per year beginning with the 1995 plan year to not more than 5 percent above the weighted average rate effective for plan years beginning in 1999. The weighted average rate is calculated as the average yield over 48 months with rates for the most recent 12 months weighted by 4, the second most recent 12 months weighted by 3, the third most recent 12 months weighted by 2, and the fourth weighted by 1.

\textsuperscript{21}Under the additional funding requirement rule, a single-employer plan sponsored by an employer with more than 100 employees in defined-benefit plans is subject to a deficit reduction contribution for a plan year if the value of plan assets is less than 90 percent of its current liability. However, a plan is not subject to the deficit reduction contribution if the value of plan assets (1) is at least 80 percent of current liability and (2) was at least 90 percent of current liability for each of the 2 immediately preceding years or each of the second and third immediately preceding years. To determine whether the additional funding rule applies to a plan, the IRC requires sponsors to calculate current liability using the highest interest rate allowable for the plan year. See 26 U.S.C. 412(I)(9)(C).

\textsuperscript{22}The top of the permissible range of the 30-year Treasury rate for determining a plan’s current liability was temporarily increased to 20 percent above the weighted average rate for 2002 and 2003. This temporary measure expires at the end of 2003.

Congress and the administration to propose alternative rates for these calculations.  

While minimum-funding rules may encourage sponsors to better fund their plans, plans can earn funding credits, which can be used to offset minimum funding contributions in later years, by contributing more than required according to minimum funding rules. Therefore, sponsors of underfunded plans may avoid or reduce minimum funding contributions to the extent their plan has a credit balance in the account, referred to as the funding standard account, used by plans to track minimum funding contributions.

Additionally, the rules require sponsors to assess plan funding using current liabilities, which a PBGC analysis indicates have been typically less than termination liabilities. A plan’s termination liability measures the value of accrued benefits using assumptions appropriate for a terminating plan, while its current liability measures the value of accrued benefits using assumptions specified in applicable laws and regulations. Current and termination liabilities differ because the assumptions used to calculate them differ. Interest rates are a key assumption in calculating the present value of future pension benefits: while all sponsors calculate current liabilities using a rate based on the 30-year Treasury bond rate, ERISA requires sponsors of some underfunded plans to report plan termination liability information to PBGC. These sponsors calculate termination liability using a rate published by PBGC, based on surveys of

24 Recently, the U.S. House of Representatives passed the Pension Funding Equity Act (H.R. 3108), which replaces the 30-year Treasury rate with a blend of corporate bond index rates for 2 years through 2005. In July of 2003, the Department of the Treasury unveiled The Administration Proposal to Improve the Accuracy and Transparency of Pension Information. The proposal’s stated purpose is to improve the accuracy of the pension liability discount rate, increase the transparency of pension plan information, and strengthen safeguards against pension underfunding.


26 For the analysis, PBGC used termination liabilities reported to it under 29 C.F.R. sec 4010.
insurance companies performed by the American Council of Life Insurers.\textsuperscript{27}

Other aspects of minimum funding rules may limit their ability to affect the funding of certain plans as their sponsors approach bankruptcy. According to its annual reports, for example, Bethlehem Steel contributed about $3.0 billion to its pension plan for plan years 1986 through 1996. According to the reports, the plan had a credit balance of over $800 million at the end of plan year 1996. Starting in 1997, Bethlehem Steel reduced its contributions to the plan and, according to annual reports, contributed only about $71.3 million for plan years 1997 through 2001. The plan’s 2001 actuarial report indicates that Bethlehem Steel’s minimum required contribution for the plan year ending December 31, 2001, would have been $270 million in the absence of a credit balance; however, the opening credit balance in the plan’s funding standard account as of January 1, 2001, was $711 million. Therefore, Bethlehem Steel was not required to make any contributions during the year.

Other IRC funding rules may have prevented some sponsors from making contributions to plans that in 2002 were terminated at a loss to the single-employer program. For example, on January 1, 2000, the Polaroid pension plan’s assets were about $1.3 billion compared to accrued liabilities of about $1.1 billion—the plan was more than 100 percent funded. The plan’s actuarial report for that year indicates that the plan sponsor was precluded by IRC funding rules from making a tax-deductible contribution to the plan.\textsuperscript{28} In July 2002, PBGC terminated the Polaroid pension plan, and the single-employer program assumed responsibility for $321.8 million in unfunded PBGC-guaranteed liabilities for the plan. The plan was about 67 percent funded, with assets of about $657 million to pay estimated PBGC-guaranteed liabilities of about $979 million.

\textsuperscript{27}Sponsors are required to provide PBGC with termination liability information if, among other things, the aggregate unfunded vested benefits at the time of the preceding plan year of plans maintained by the contributing sponsor and the members of its controlled group exceed $50 million, disregarding plans with no unfunded benefits. See 29 U.S.C. 1310(b). Among the information to be provided to PBGC is the value of benefit liabilities determined using the assumptions applicable to the valuation of benefits to be paid as annuities in trusted plans terminating at the end of the plan year. See 29 C.F.R. 4010.8(d)(2).

\textsuperscript{28}See 26 U.S.C. 404(a)(1) and 26 U.S.C. 412(c)(7). The sponsor might have been able to make a contribution to the plan had it selected a lower interest rate for valuing current liabilities. Polaroid used the highest interest rate permitted by law for its calculations.
Several types of reforms might be considered to improve the funding of defined-benefit pension plans. Some options for reform would directly address funding requirements and related rules. Funding rules could be revised to require increased minimum contributions to underfunded plans and to allow additional contributions to fully funded plans. This approach would improve plan funding over time and improve the security of workers’ benefits, while limiting the losses PBGC would incur when a plan is terminated. Such a change would require some sponsors to allocate additional resources to their pension plans, which may cause the plan sponsor of an underfunded plan to provide less generous wages or benefits than would otherwise be provided. Also, such funding rule changes could take years to have a meaningful effect on PBGC’s financial condition. As examples of such funding rule revisions, the IRC could be amended to:

- **Base Additional Funding Requirement and Maximum Tax-Deductible Contributions on Plan Termination Liabilities, Rather than Current Liabilities.** Since plan termination liabilities typically exceed current liabilities, such a change regarding deficit reduction contributions would likely improve plan funding and, therefore, reduce potential claims against PBGC. One potential problem with this approach is the difficulty plan sponsors would have in determining the appropriate interest rate to use in valuing termination liabilities. As we reported, selecting an appropriate interest rate for termination liability calculations is difficult because little information exists on which to base the selection.  

- **Change Requirements For Making Additional Funding Contributions.** IRC requires sponsors to make additional contributions under two circumstances: (1) if the value of plan assets is less than 80 percent of its current liability or (2) if the value of plan assets is less than 90 percent of its current liability, depending on plan funding levels for the previous 3 years. Raising the threshold would require more sponsors of underfunded plans to make the additional contributions.

- **Limit the Use of Credit Balances by Severely Underfunded Plans to Avoid Additional Contributions.** For sponsors who make contributions in any given year that exceed the minimum required contribution, the excess plus interest is credited against future required contributions. Limiting the use of credit balances to offset contribution requirements

\(^{29}\text{GAO-03-313.}\)
might also prevent sponsors of significantly underfunded plans from avoiding cash contributions. For example, in the absence of a credit balance, Bethlehem Steel would have been due to pay at least $270 million to its pension plan for the plan year ending December 31, 2001; however, because it showed a credit balance of $711 million as of January 1, 2001, Bethlehem was not required to make any cash contributions for that year. Limitations might also be applied based on the plan sponsor’s financial condition. For example, sponsors with poor cash flow or low credit ratings could be restricted from using their credit balances to reduce their contributions.

- **Limit Lump-Sum Distributions by Plans That Are Significantly Underfunded.** Defined-benefit pension plans may offer participants the option of receiving their benefit in a lump-sum payment. Allowing participants to take lump-sum distributions from severely underfunded plans, especially those sponsored by financially weak companies, allows the first participants who request a distribution to drain plan assets, which might result in the remaining participants receiving reduced payments from PBGC if the plan terminates. A “tiered system” may be set up whereby a plan that does not meet a certain funding ratio threshold might be prohibited from allowing highly compensated employees from taking benefits as lump sums; below a lower funding ratio threshold, lump-sum withdrawals for all employees might be prohibited. However, the payment of lump sums by underfunded plans may not directly increase losses to the single employer program because lump sums reduce plan liabilities as well as plan assets.

- **Raise the Level of Tax-Deductible Contributions.** IRC and ERISA restrict tax-deductible contributions to prevent plan sponsors from contributing more to their plan than is necessary to cover accrued future benefits. This can prevent employers from making plan contributions during periods of strong profitability. Raising these limitations might result

---

30The administration’s proposal would require companies with below investment grade credit ratings whose plans are less than 50 percent funded on a termination basis to immediately fully fund or secure any new benefit improvements, benefit accruals, or lump sums.

31Employers are generally subject to an excise tax for failure to make required contributions or for making contributions in excess of the greater of the maximum deductible amount or the ERISA full-funding limit.
in pension plans being better funded, decreasing the likelihood that they will be underfunded should they terminate.\textsuperscript{32}

- **Expand Restrictions on Unfunded Benefit Increases.** Currently, plan sponsors must meet certain conditions before increasing the benefits of plans that are less than 60 percent funded.\textsuperscript{33} Increasing this threshold, or restricting benefit increases or accruals when plans reach the threshold, could decrease the losses incurred by PBGC from underfunded plans. One disadvantage is that it could result in lower pension benefits for affected workers. In addition, plan sponsors have said that the disadvantage of such changes is that they would limit an employer’s flexibility with regard to setting compensation, making it more difficult to respond to labor market developments. For example, a plan sponsor might prefer to offer participants increased pension payments or shutdown benefits instead of offering increased wages because pension benefits can be deferred—providing time for the plan sponsor to improve its financial condition—while wage increases have an immediate effect on the plan sponsor’s financial condition.

- **Improve Funding of Shutdown Benefits.** Shutdown benefits provide significant early retirement benefit subsidies or other benefits offered to participants affected by a plant closing or a permanent layoff. Such benefits are primarily found in the pension plans of large unionized companies in the auto, steel, and tire industries. In general, shutdown benefits cannot be adequately funded before a shutdown occurs. Rules could mandate accelerated funding of shutdown benefits after they go into effect. However, if a plant shutdown coincides with the bankruptcy of a company and the termination of the pension plan, it may be impossible for the bankrupt sponsor to fund these benefits.

In addition to funding rules, plan sponsors need an accurate funding “target” that provides enough funding to pay promised current and future benefits while not leading sponsors to “overfund” their pension plans,

\textsuperscript{32}For example, one way to do this would be to allow deductions within a corridor of up to 130 percent of current liabilities. Gebhardttsbauer, Ron. American Academy of Actuaries testimony before the Subcommittee on Employer-Employee Relations, House Committee on Education and the Workforce, Hearing on *Strengthening Pension Security: Examining the Health and Future of Defined-benefit Pension Plans*. (Washington, D.C.: June 4, 2003), 9.

\textsuperscript{33}IRC provides generally that a plan less than 60 percent funded on a current liability basis may not increase benefits without either immediately funding the increase or providing security. See 26 U.S.C. 401(a)(29).
siphoning resources from other productive firm specific activities. The interest rate sponsors use to determine plan liabilities can affect this target and, therefore, plan funding. In 1987, when the 30-year Treasury bond rate was adopted for use in certain pension calculations, the Congress intended that the interest rate used for current liability calculations would, within certain parameters, reflect the price an insurance company would charge to take responsibility for the plan’s pension payments. However, selecting a replacement rate that will provide an accurate funding target may be difficult because little information exists on which to base the selection.\textsuperscript{34} In taking action to replace the 30-year Treasury bond rate, it is important to consider the impact that any change may have on funding. If Congress mandates the use of a rate that is “too high,” plans are more likely to appear better funded, but minimum and maximum employer contributions would decrease, possibly increasing the likelihood of plan underfunding. In addition, some plans would reach full-funding limitations and avoid having to pay variable-rate premiums, and PBGC would receive less revenue. Conversely, a rate that is “too low” would make plans appear worse funded, with more plans likely to increase contributions and possibly pay variable-rate premiums. Thus, it may well be prudent for Congress to make any provision replacing the 30-year Treasury bond rate temporary to facilitate more comprehensive funding reform to take shape.

\textbf{Other Reforms Might Enhance Sponsor Incentives to Maintain Plan Funding}

In addition to direct changes to the funding rules, other reforms may result in improved plan funding by improving incentives for sponsors to maintain proper funding in their plans. These measures may prevent plans from terminating with severely underfunded balances, thus better protecting workers, retirees, and PBGC. For example, improving the availability of information to plan participants and others about plan investments, termination funding status, and PBGC guarantees may give plan sponsors additional incentives to better fund their plans, making participants better able to plan for their retirement. The restructuring of PBGC’s premium

\textsuperscript{34}Other than a survey conducted for PBGC, no mechanism exists to collect information on actual group annuity purchase rates. Compared to other alternatives, the PBGC interest rate factors may have the most direct connection to the group annuity market, but PBGC factors are less transparent than market-determined alternatives. Long-term market rates may track changes in group annuity rates over time, but their proximity to group annuity rates is uncertain. For example, an interest rate based on a long-term market rate, such as corporate bond indexes, may need to be adjusted downward to better reflect the level of group annuity purchase rates. However, as we stated in our report earlier this year, establishing a process for regulatory adjustments to any rate selected may make it more suitable for pension plan liability calculations. See GAO-03-313.
rates could also provide an incentive for plan sponsors to better fund their plans. It is also possible that basing changes to premium rates on the degree of risk posed by different plans may encourage financially healthy companies to remain in or enter the defined-benefit system while discouraging riskier plan sponsors. Moreover, it may be appropriate to consider modifying certain benefit guarantees that could decrease losses incurred by PBGC from underfunded plans. ERISA could be amended to:

- **Require Greater Disclosure of Information on Plan Investments.** Some information on the allocation of plan investments among asset classes—such as equity or fixed income—may be available from Form 5500s prepared by plan sponsors, but that information is not readily accessible to participants and beneficiaries. Additionally, some plan investments may be made through common and collective trusts, master trusts, and registered investment companies, and asset allocation information for these investments might need to be obtained from Form 5500s prepared by those entities or from their prospectuses. As such, improving the availability of plan asset allocation information to participants may give plan sponsors an incentive to increase funding of underfunded plans or limit riskier investments. Moreover, only participants in plans below a certain funding threshold receive annual notices regarding the funding status of their plans, and the information plans must currently provide does not reflect how the plan’s assets are invested. One way to enhance notices provided to participants could be to include information on how much of plan assets are invested in the sponsor’s own securities.  

- **Require Greater Disclosure of Plan Termination Funding Status.** Under current law, sponsors are required to report a plan’s current liability for funding purposes, which often can be lower than termination liability.

35 Although ERISA permits plan sponsors to invest plan assets in employer stock, defined-benefit plans may not acquire any qualified employer security or real property if immediately after the acquisition the aggregate fair market value of such assets exceeds 10 percent of the fair market value of the plan’s total assets.
In addition, only participants in plans below a certain funding threshold receive annual notices of the funding status of their plans. As a result, many plan participants, including participants of the Bethlehem Steel pension plan, did not receive such notifications in the years immediately preceding the termination of their plans. Expanding the circumstances under which sponsors must notify participants of plan underfunding might give sponsors an additional incentive to increase plan funding and would enable more participants to better plan their retirement. Under the Administration’s proposal, all sponsors would be required to disclose the value of pension plan assets on a termination basis in their annual reporting. The Administration proposes that all companies disclose the value of their defined-benefit pension plan assets and liabilities on both a current liability and termination liability basis in their Summary Annual Report (SAR).

- **Increase or Restructure Variable-Rate Premium.** PBGC charges plan sponsors a variable-rate premium based on the plan’s level of underfunding, premiums, with sponsors paying $9 per $1,000 of unfunded liability. However, the recent terminations of Bethlehem Steel, Anchor Glass, and Polaroid, plans that paid no variable-rate premiums shortly before terminating with large underfunded balances, suggest that the current structure of the variable-rate premium does not provide a strong enough incentive to improve plan funding or is too easily avoidable. The rate could be adjusted so that plans with less adequate funding pay a higher rate. In addition, premium rates could be restructured based on the degree of risk posed by different plans, which could be assessed by considering the financial strength and prospects of the plan’s sponsor, the risk of the plan’s investment portfolio, participant demographics, and the plan’s benefit structure—including plans that have lump-sum, shutdown

---

36The ERISA requirement that plan sponsors notify participants and beneficiaries of the plan’s funding status and limits on the PBGC guarantee currently goes into effect when plans are required to pay variable-rate premiums and meet certain other requirements. See 29 U.S.C. 1311 and 29 C.F.R. 4011.3.

37Participants and individuals receiving benefits from their plan must receive a Summary Annual Report (SAR) from their plan’s administrator each year. The SAR summarizes the plan’s financial status based on information that the plan administrator provides to the Department of Labor on its annual Form 5500. This document must generally be provided no later than nine months after the close of the plan year.

38For example, a plan that allows a lump-sum option—as is often found in a cash-balance and other hybrid plan—may pose a different level of risk to PBGC than a plan that does not.
benefit, and floor-offset provisions.\textsuperscript{39} One advantage of a rate increase or restructuring is that it might improve accountability by providing for a more direct relationship between the amount of premium paid and the risk of underfunding. A disadvantage is that it could further burden already struggling plan sponsors at a time when they can least afford it, or it could reduce plan assets, increasing the likelihood that underfunded plans will terminate. A program with premiums that are more risk-based could also be more challenging for PBGC to administer.

- **Phase-in the Guarantee of Shutdown Benefits.** PBGC is concerned about its exposure to the level of shutdown benefits, or benefit increases that are unfunded at termination.\textsuperscript{40} PBGC could phase-in the guarantee of such benefits. Similar to benefit increases prior to termination, the agency could perhaps guarantee an additional 20 percent of shutdown benefits each year after the benefits are offered, with full benefits (up to PBGC limits) guaranteed only after 5 years. Phasing in guarantees from the date of the applicable shutdown could decrease the losses incurred by PBGC from underfunded plans.\textsuperscript{41} A phase-in might cause workers to put pressure on sponsors to fund these benefits or benefit increases, or demand alternative forms of compensation. Modifying these benefits would reduce the early retirement benefits for participants who are in plans with such provisions and are affected by a plant closing or a permanent layoff. Dislocated workers, particularly in manufacturing, may suffer additional losses from lengthy periods of unemployment or from finding reemployment only at much lower wages.

\textsuperscript{39}Under the floor-offset arrangement, the benefit computed under the final pay formula is “offset” by the benefit amount that the account of another plan, such as an Employee Stock Ownership Plan, could provide.

\textsuperscript{40}PBGC guarantees benefits up to certain limits. PBGC may pay only a portion of the claim because ERISA places limits on the PBGC benefit guarantee. For example, PBGC generally does not guarantee annual benefits above a certain amount, currently about $44,000 per participant at age 65. Additionally, benefit increases in the 5 years immediately preceding plan termination are not fully guaranteed, though PBGC will pay a portion of these increases. The guarantee does not generally include supplemental benefits, such as the temporary benefits that some plans pay to participants from the time they retire until they are eligible for Social Security benefits.

\textsuperscript{41}Currently, some measures exist to limit the losses incurred by PBGC from certain terminated plans. PBGC is responsible for only a portion of all benefit increases that the sponsor adds in the 5 years leading up to termination.
Conclusion

Widespread underfunding in the defined-benefit pension system potentially threatens the retirement security of millions of American workers. The termination of severely underfunded plans can significantly reduce the benefits promised to workers and retirees. It also threatens the solvency of PBGC’s single-employer insurance program, with, in the worse case, Congress facing the choice of a bailout or of letting affected workers and retirees lose the pension benefits they depend on. While the pension system does not face an immediate crisis, these serious financial challenges suggest that meaningful, if perhaps difficult, comprehensive action needs to be taken. Such action would be aimed towards the improvement of the long-term funding status of plans and the accountability of plan sponsors, especially those that represent a clear risk to PBGC, plan participants, and their beneficiaries.

Undoubtedly, unfavorable economic conditions have contributed to widespread underfunding and conspired to place well-meaning sponsors in very difficult positions to maintain their plans’ funding. Although comprehensive reform should include improving plan funding as the key vehicle to stabilize and enhance the long-term health of the defined-benefit system, Congress may seek to balance improvements in funding and accountability against the short-term needs of some sponsors who may have difficulty making contributions to their plans. Relief measures should be carefully targeted to those sponsors that may need it most urgently, with some provision for this aid to eventually lead to improved plan funding. In crafting this reform, the Congress should be wary of temporary rule changes directed exclusively to short-term problems that could increase the risk that plans terminate in even worse financial straits than they suffer today.

It is important to keep in mind that the factors contributing to the deterioration of pension plan funding go beyond the effects of the recent economic downturn. The defined-benefit system has shown signs of stagnation for the past 2 decades, with a steady decline in the number of plans and a decreasing proportion of working participants. PBGC’s participant base may also be concentrated in more vulnerable industries. Concerns about PBGC’s long-run financial viability, and not just the recent alarming jump in its accumulated deficit, prompted us to put the single-employer program on our high-risk list. While it is unlikely that any rules can guarantee that all plans are fully funded at all times, nor should that be their goal, regulations should strive to maintain the overall health of the system and prevent poor economic conditions from creating a general funding crisis.
In addition to the administration’s current proposal, the Treasury Department, Labor Department, and PBGC are considering reforms that seek to address many of these issues and include elements of the options that I have identified in my testimony, such as increased transparency for plan participants. The private defined-benefit pension system is at a crossroads, facing a threat of continued financial erosion and decline. However, we also have the opportunity and the challenge to broadly move the system back to a solid, stable financial footing that will provide needed retirement benefits to workers and retirees for decades to come.

Mr. Chairman, this concludes my statement. I would be happy to respond to any questions that you or other members of the Committee may have.

For information regarding this testimony, please contact Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues, on (202) 512-7215 or Charles A. Jeszeck on (202) 512-7036. Individuals who made key contributions to this testimony are Mark M. Glickman, Jeremy Citro, Daniel F. Alspaugh, and John M. Schaefer.
The General Accounting Office, the audit, evaluation and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

The fastest and easiest way to obtain copies of GAO documents at no cost is through the Internet. GAO's Web site (www.gao.gov) contains abstracts and full-text files of current reports and testimony and an expanding archive of older products. The Web site features a search engine to help you locate documents using key words and phrases. You can print these documents in their entirety, including charts and other graphics.

Each day, GAO issues a list of newly released reports, testimony, and correspondence. GAO posts this list, known as "Today's Reports," on its Web site daily. The list contains links to the full-text document files. To have GAO e-mail this list to you every afternoon, go to www.gao.gov and select "Subscribe to e-mail alerts" under the "Order GAO Products" heading.

The first copy of each printed report is free. Additional copies are $2 each. A check or money order should be made out to the Superintendent of Documents. GAO also accepts VISA and Mastercard. Orders for 100 or more copies mailed to a single address are discounted 25 percent. Orders should be sent to:

U.S. General Accounting Office
441 G Street NW, Room LM
Washington, D.C. 20548

To order by Phone: Voice: (202) 512-6000
TDD: (202) 512-2537
Fax: (202) 512-6061

To Report Fraud, Waste, and Abuse in Federal Programs

E-mail: fraudnet@gao.gov
Automated answering system: (800) 424-5454 or (202) 512-7470

Public Affairs

Jeff Nelligan, Managing Director, NelliganJ@gao.gov (202) 512-4800
U.S. General Accounting Office, 441 G Street NW, Room 7149
Washington, D.C. 20548