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Health, Education and Human Services Division

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June 24, 1994

The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

After our April 19, 1994, testimony before the Committee on Ways and Means,[1] you asked that we provide you with a more detailed description of our suggestion to strengthen H.R. 3396 and with any comments the Pension Benefit Guaranty Corporation (PBGC) might have about this suggestion. This letter contains your requested information.

In summary, our position is that H.R. 3396 should improve funding in many underfunded plans as it is intended to do. In our view, the redesign of the offset is the most important funding provision in the bill and should be retained. However, not all underfunded plans will receive additional contributions under the bill.

In our testimony, we expressed concern that sponsors of only about half the plans in our sample with funding ratios of between 50 and 80 percent (16 of 31 sponsors) would make additional contributions under H.R. 3396.[2] Sponsors of all plans in our sample with funding ratios below 50 percent would have made additional contributions in 1990 had the bill been in effect. Sponsors of 9 of the 25 plans with funding ratios above 80 percent would also have made additional contributions.

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

[2]We define a plan's funding ratio as the amount on line 13c of the Form 5500 Schedule B. In this ratio, plan assets (line 8b of the Schedule B) are reduced by the plan's prior year credit balance (line 9h) and then divided by the plan's current liability (line 6d).

In our view, sponsors of poorly funded plans should be contributing more than the minimum required under the Employee Retirement Income Security Act of 1974 (ERISA) to improve the funding in their plans. The question is, what is the threshold that defines a poorly funded plan? Is it a funding ratio below 100 percent, 80 percent, or perhaps 60 percent?

Our report on hidden pension liabilities showed that plan funding can deteriorate quite rapidly.[3] A mechanism is needed to ensure that a plan's funding ratio will not fall too low. At the same time, we do not want to penalize firms whose funding ratio temporarily falls slightly below 100 percent because of plan improvements or a slowdown in their sector of the economy. In our view, a threshold defining poorly funded plans reasonably falls within the 75- to 85-percent funded range.

Our Option to Increase Plan Contributions

There are a number of ways to ensure that sponsors of more underfunded plans make additional contributions than would be the case if H.R. 3396 is enacted in its present form. We have highlighted one that would fit easily within the current 412(l) additional contribution framework.[4] Our suggestion has two parts: First, sponsors of all plans with funding ratios below a specified threshold would be required to make a contribution in addition to the minimum ERISA requirement. Sponsors of plans with funding ratios above this threshold would be required to make additional contributions only if their deficit reduction contribution (DRC) plus any unpredictable contingent event amount (lines 13j plus 13l of the Schedule B) exceeded their offset (line 13k). Second, sponsors whose plans had funding ratios below the threshold would have their offsets limited to a specified percentage of the DRC.

The threshold would determine which underfunded plans would be subject to the strengthened provision (the higher the

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

[4]This option is also discussed in our forthcoming report to you, Private Pensions: Funding Rule Changes Needed to Further Reduce PBGC's Multibillion Dollar Exposure (GAO/HEHS-94-103, forthcoming).

threshold, the greater the number of affected plans). For example, if the threshold is 80 percent, then sponsors of all plans with funding ratios below 80 percent would be required to make an additional contribution. If the threshold is 100 percent, then sponsors of all underfunded plans would make additional contributions.

The specified limitation of the offset would determine how large the additional contribution for affected sponsors would be (the lower the specified percentage, the greater the additional contribution). For example, if the offset were limited to 90 percent of the DRC, then sponsors of all plans with funding ratios below the threshold would have to make a minimum additional contribution of at least 10 percent of the DRC. The additional contribution could be higher if the plan's offset were less than 90 percent of the DRC. If the offset were limited to 60 percent of the DRC, then affected plan sponsors would make a minimum additional contribution of at least 40 percent of the DRC.

This approach or indeed any approach that would increase contributions beyond those contained in H.R. 3396 would result in an increase in tax expenditures that would not be offset by the revenue provisions in the bill. The Congress would have to balance PBGC's reduced exposure and plan participants' reduced risk of benefit loss against the budget's pay-as-you-go (PAYGO) requirements.

PBGC Views on Our Option

We met with PBGC officials to get their reaction to our suggested approach. Their opinion is that our proposal to strengthen H.R. 3396 is unnecessary. They believe that in those cases in which the minimum ERISA contribution excluding the 412(l) contribution exceeds the DRC, the minimum ERISA contribution should be sufficient to move the plan to full funding. In brief, PBGC believes it has structured a sound bill and does not agree that we have shown that our proposed additional contribution is necessary.

PBGC disagrees with our methodology for determining how underfunded a plan is. (We use the methodology currently used in Sec. 412(l) and that will be used under H.R. 3396.) PBGC agrees that the funding ratio for Sec. 412(l) should continue to be calculated using a net asset value that

subtracts prior-year credit balances from plan assets. However, it stated that credit balances should not be subtracted from assets when measuring PBGC's exposure to claims. PBGC points out that on this latter basis, only 8 plans in our sample would have a funding ratio below 80 percent and receive no additional contributions and argues that sponsors of virtually all of these 8 plans made an ERISA minimum contribution in 1990 that was a substantial portion of their underfunding.

We disagree with PBGC's perspective. In our view, a consistent funding ratio definition should be used for all calculations related to additional contributions, and that definition should be the one currently used in the Sec. 412(l) calculations. Because our intent is to increase additional contributions for some sponsors, the Sec. 412(l) definition should also be used for our suggested strengthening of H.R. 3396.

The PBGC statement that most of the eight sponsors not making additional contributions were making ERISA minimum contributions equal to a large portion of underfunding is not correct. PBGC included normal costs in its measure of contributions. Normal costs are intended to offset new liabilities being attributed to the current year and are not payments to reduce unamortized past service credits.

When we subtracted the normal costs from the ERISA minimum contributions for the eight plans in question and compared this net amount with the plans' pure unfunded current liability (calculated when credit balances are not subtracted from assets), we found that two of the eight sponsors made essentially no contribution to reduce their plans' underfunding and a third did not contribute enough to even pay interest on its plan's underfunding. Two sponsors made substantial underfunding reduction payments (15 to 20 percent of the plan's pure underfunding after accounting for interest on the underfunding).[5] The other three sponsors made smaller underfunding reduction payments.

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[5]We note that the underfunding in these plans will not necessarily fall by 15 to 20 percent because of this contribution. Other factors, such as benefit increases, changes in actuarial assumptions, and experience gains or losses, can augment or offset the funding improvement resulting from these contributions.

The effect of our proposal on these eight plans points out the difficulty of targeting legislation to solve a specific problem. One size legislation does not fit all very well. Sometimes, either some sponsors escape the legislation designed to require them to improve plan funding, or other sponsors, who can be deemed to be making adequate progress toward full funding, are required to reach full funding more quickly than they might desire. In our view, requiring plans to reach a desired goal (full funding) more quickly than they desire is much less a problem than allowing other plans to never reach that goal.

PBGC remained opposed to our proposal even when we pointed out that several of these underfunded plans, which would make no additional contribution under H.R. 3396, made only the minimum ERISA contribution in 1988, 1989, and 1990 and their funding ratios remained the same or worsened. In our opinion, these plans are not making satisfactory progress toward full funding and would probably not under the proposed legislation. The sponsors of these plans need additional requirements to improve funding, and the suggested approach would accomplish this.

PBGC expressed concern that we support our proposal on the basis of a 2-year snapshot of the data rather than on a long-term projection. In our view, our shorter-term analysis is satisfactory. We accounted for the gradual elimination of the transitional offsets and found that 4 additional plans would receive additional contributions because of this elimination (from 34 to 38 plans). We also determined that 8 additional plans (to 42 plans) would receive additional contributions if there were no old unfunded liabilities. These liabilities are scheduled to phase out by 2006. We did not determine how the year-by-year elimination of the 1990 amortization charges and credits from experience gains and losses and from changes in actuarial assumptions would affect the probability and amount of additional contributions. This would depend upon the values of new charges and credits. Because we had no _a priori_ knowledge of what these values should be, we made no projections based on these variables.

In closing, H.R. 3396 will improve funding for many underfunded plans if it is enacted. However, as it currently stands, sponsors of many underfunded plans would not be required to make additional contributions to their plans. We believe the bill should be strengthened so that a greater portion of underfunded plan sponsors are required

to improve their plans' funding. We would be glad to assist the Subcommittee to this end.

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As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution of this letter for 10 days. At that time, it will be made available on request. If you have any questions, please call me on (202) 512-7215.

Sincerely yours,

Joseph F. Delfico, Director
Income Security Issues

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