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PENSION PLANS

Benefits Lost When Plans Terminate

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SUMMARY

Some pension plan participants lose benefits and the ability to qualify for potential future benefits when plans terminate, especially if the plans are underfunded. Despite federal insurance protections, participants in underfunded plans and others that terminate risk losing promised benefits.

When underfunded plans terminate, some participants lose benefits promised by the plans because certain benefits are not guaranteed by the Pension Benefit Guaranty Corporation (PBGC). Generally, PBGC guarantees "basic" monthly benefits that provide income when participants retire, but does not guarantee other benefits. In addition, PBGC does not guarantee benefits that exceed the maximum specified in the Employee Retirement Income Security Act of 1974, or 100 percent of benefit increases in effect less than 5 years before plan termination. We reviewed 71 terminated plans for which PBGC had determined the benefits payable, and found that participants in 31 of the plans lost or will lose $38.8 million, or 11.6 percent of $336 million in benefits promised by their plans. For example, participants in 17 plans lost benefits due to ERISA's restrictions on the degree to which benefit increases are guaranteed.

When a plan terminates with no successor plan, some participants and their beneficiaries lose the ability to qualify for benefits they could have received had the plan not terminated, regardless of whether the plan was underfunded. Working participants lose potential retirement benefits because benefit accruals, which are often based on salary and years of service under the plan, stop. Further, participants who have not qualified for certain benefits before their plan terminates may lose the ability to qualify for them. For example, promised early retirement benefits based on participants meeting specified tenure requirements may not be provided unless the requirements are met before plan termination.

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me here to discuss how terminating a pension plan affects plan participants. Some plan participants lose benefits and the ability to qualify for potential future benefits when plans terminate, especially if the plans are underfunded. In my testimony today I would like to discuss the types of benefits participants lose and the reasons why. The key point of my testimony is that, despite federal insurance protections, participants in underfunded plans that terminate risk losing promised benefits.

When a plan terminates, participants may lose benefits in two ways. First, they may lose benefits promised by underfunded plans--plans with assets too small to cover all benefit liabilities. Second, they may lose the ability to qualify for certain benefits that they would have received, or would have been eligible to receive, had the plan continued, regardless of the plan's funding status.

LOSING PROMISED BENEFITS

Participants in underfunded plans that terminate sometimes lose benefits promised by the plans, despite many protections provided by the Employee Retirement Income Security Act of 1974 (ERISA). ERISA established funding, participation, and vesting standards for defined benefit plans--plans that promise specific benefits based on participant earnings and/or years of service. ERISA also created the Pension Benefit Guaranty Corporation (PBGC) to administer an insurance program to protect participants in defined benefit plans.

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

PBGC does not guarantee all benefits promised by plans. It does not guarantee nonbasic benefits, such as special supplemental benefits that exceed the amount that would be paid at normal retirement and lump-sum death benefits. Nor does it guarantee basic benefits that exceed the maximum permitted by ERISA for the year in which the plan terminates--$2,352 per month for 1992. The maximum benefit must be adjusted downward for benefits paid before age 65 and for election of joint and survivor benefits. Further, PBGC does not guarantee 100 percent of benefit increases in effect for less than 5 years before plan termination. However, PBGC will pay benefits that are not guaranteed if it recovers assets from a plan's sponsor.[1]

PBGC does not have readily available information on the total number of participants who have lost (or will lose) benefits or the total present value of such benefits. We reviewed records for 71 of the 86 terminated plans for which PBGC had determined the benefits payable and lost. We reviewed PBGC's records to determine the (1) amount of promised benefits, (2) amount of lost benefits, and (3) reasons for lost benefits. Though the 86 plans do not necessarily represent the universe of all terminated plans, our analysis shows that participants lose promised benefits. Participants in 31 of the plans we reviewed lost or will lose $38.8 million, or 11.6 percent of $336 million in benefits that had been promised by the plans. Participants in the other 40 plans did not lose benefits.

Participants in the 31 plans lost benefits for several reasons.

Phased-in Coverage of Benefits

Pension benefits often are increased after plans are established. For many plans, pension levels are set as a part of periodic pay and benefit negotiations. However, under ERISA, guarantees of benefit increases, such as those produced by negotiations, must be phased in over 5 years. PBGC guarantees 20 percent (or $20 per month, if larger) of benefit increases after the increase has been in effect for one year, and 20 percent (or $20 per month) for each additional year until the benefit increase is fully covered. This limit also applies to benefit increases produced by cost-of-living provisions in effect before plan termination. (PBGC does not guarantee plan-specified cost-of-living increases after termination.) Participants in 17 of the plans we reviewed lost benefits because of the phase-in limit. For example, 13 of 68 retirees in one plan had their monthly benefits reduced by as much as 8 percent because of the phase-in limit.

Also, for participants who own 10 percent or more of the plan sponsor, PBGC's guarantee is phased in over 30 years. Participants in 11 plans we reviewed lost benefits due to this limit. For example, the monthly benefit of a substantial owner who was a participant in one terminated plan was reduced from $2,337 to $1,671.

[1]These guarantees apply to single-employer plans. More limited guarantees apply to multiemployer plans, which are sponsored by more than one employer under one or more collective bargaining agreements.

Maximum Guaranteed Benefit

Some plans promise high pension benefits. However, PBGC will only guarantee benefits up to the maximum benefit level established by ERISA. The maximum probably affects relatively few participants. For example, Current Population Survey data indicate that only about 5 percent of pension recipients have monthly benefits that exceed this maximum. In addition, participants in plans with generous early retirement and disability benefits sometimes receive substantially reduced benefits because of this restriction. In our review of actual pension plan terminations, we found 242 participants in 4 of the plans had their benefits reduced as a result of this limit.

Restrictions on Supplemental Benefits

PBGC does not guarantee all supplemental benefits--benefits paid in addition to normal retirement benefits. PBGC does not guarantee that portion of supplemental benefits which, when added to the retirement benefit at the participant's actual retirement age, exceeds the benefit payable at the normal retirement age specified by the plan. For example, before the plan terminated, the monthly benefit of a participant in one plan we reviewed was $824. This benefit consisted of a $424 pension benefit and a $400 supplement. PBGC determined that the participant's monthly benefit payable at normal retirement age would be $558. Therefore, PBGC paid $558, including only $134 of the $400 supplement. Participants in 3 of the plans we reviewed lost supplemental benefits.

LOSING POTENTIAL FUTURE BENEFITS

When a plan terminates with no successor plan, some participants and their beneficiaries lose the ability to qualify for benefits they could have received had the plan not terminated. These benefits may be lost regardless of whether the plan that terminates is underfunded.

Working participants lose potential retirement benefits because benefit accruals stop when the plan terminates. Monthly benefits in defined benefit plans are usually based on the participant's salary and years of service under the plan. In some cases, they may be based on a specified dollar amount. When a plan terminates, the participants can accrue no more years of service, even though the participant may continue to work for the plan sponsor. In addition, the specified dollar amount or salary level used to calculate benefits is frozen at the level in effect on the plan termination date. As a result, a participant's benefit entitlement at termination can be substantially less than it would have been if the plan had continued.

For example, in a plan that pays a monthly benefit of 1/12 of 1 percent of final salary for each year of service, a participant with a $36,000 salary and 15 years of service at plan termination would be entitled to a monthly benefit of $450 at retirement. If the plan had continued and the participant had worked for 25 years and attained a final salary of $48,000, the participant would have been entitled to a monthly benefit of $1,000 at retirement. Because benefit accruals stop upon plan termination, the participant in this example would lose benefits because of fewer years of service and a lower salary upon which to base benefits.

Inflation can erode the purchasing power of pension benefits which are frozen when a plan terminates. If the participant is young and the benefit does not begin for a number of years, inflation will reduce the purchasing power of that benefit when it is received. The higher the inflation rate and the longer the participant must wait until retirement, the greater will be the inflation loss.

Participants who do not already qualify for the following benefits when their plan terminates may lose the ability to qualify for them.

- -- Early retirement benefits based on the participant meeting specified tenure requirements may not be provided unless the requirements are met before the plan terminates. For example, in a plan that provides early retirement benefits at any age with 30 years of service, a participant with 29 years of service when the plan terminates would not be eligible to retire one year later. The participant would have to wait to the plan's earliest retirement age to receive retirement benefits.

- -- Unpredictable contingent event benefits, such as plant shutdown benefits in the steel industry, may not be paid if the contingent event occurs after plan termination.

- -- Disability benefits for participants who become disabled before they are eligible to receive retirement benefits may not be provided to workers who become disabled after plan termination. In addition, disability benefits that start within 3 years of plan termination may be reduced.

- -- Death and survivor benefits payable to beneficiaries of workers who die while employed by the plan's sponsor may not be paid if the worker dies after plan termination.

Participants in fully funded plans who are already receiving these benefits when a plan terminates generally continue to receive them. However, depending on the type of benefit, plan provisions, and length of time the participant has received the benefit, PBGC may not guarantee all these benefits being received by participants when an underfunded plan terminates. In cases where such benefits are not guaranteed and the plan's assets are insufficient to cover them, PBGC would reduce the level of the recipients' payments.

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Mr. Chairman, our intent today is not to imply that PBGC benefit coverage should be expanded to cover the situations we have described. Our intent is to show that when plan sponsors do not adequately fund their pension plans, participants can and do lose benefits when such plans terminate, even with PBGC pension insurance.

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

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