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STATEMENT OF

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BEFORE THE

HOUSE COMMITTEE ON WAYS AND MEANS

SUBCOMMITTEE ON OVERSIGHT

ON THE

PREMIUM REQUIREMENTS OF THE

SINGLE EMPLOYER PENSION PLAN

INSURANCE PROGRAM

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Mr. Chairman and Members of the Subcommittee, we are pleased to be here today to discuss the Pension Benefit Guaranty Corporation's present request for a $7.00 premium rate for its single employer pension plan insurance program. As you know, the Employee Retirement Income Security Act of 1974 established the Corporation to administer a self-financing program which insures the benefits of about 29 million participants in 106,000 private pension plans. When a plan terminates with insufficient assets, the Corporation assumes responsibility for paying participants guaranteed benefits. Shortfalls in a terminating plan's assets are financed primarily from premiums paid annually by ongoing plans. The premium rate was originally set in 1974 at $1.00 per plan participant and was raised to $2.60 in 1978. In May 1982, the Corporation, to reduce its growing deficit, requested congressional approval to increase the premium rate to $6.00, effective January 1, 1983, which has not been granted.

On November 14, 1983, we issued a report to the Congress which addressed legislative changes needed to financially strengthen the single employer insurance program. The report provided the Congress with several options relating to the level of benefits insured, plan funding standards, and employers' liability at termination which could be used to reduce the program's exposure to unfunded pension liabilities of terminating plans. However, we concluded that such changes alone would not eliminate the program's deficit.

The report also assessed the Corporation's May 1982 request for a $6.00 premium rate which it said would retire its deficit in

5 years. We observed in our report, however, that because of increased claims against the program since the premium increase was requested, a premium of about $7.50 would be needed to retire the program's deficit within 5 years. Based on our assessment of the $6.00 premium request, we concluded that (1) the Corporation's methodology for developing the premium rate was reasonable, (2) a premium increase to not less than $6.00 was needed, and (3) procedures to assure timely future adjustment of the program's premium rate should be considered.

I would now like to discuss several issues relating to the insurance program's premium needs in a little more depth and provide you with our views on the Corporation's current premium rate request. In preparing for these hearings, we used information provided by the Corporation to assess the Corporation's $7.00 request in addition to updating our work on the $6.00 premium request.

## PREMIUM RATE INCREASE IS NEEDED TO REDUCE PROGRAM'S DEFICIT

Since its inception, the single employer insurance program has operated at a deficit because claims from terminating insufficient plans have exceeded premium collections. Although the deficit is growing, the program's liquidity is not jeopardized in the short term. However, the present $2.60 premium rate is not expected to produce sufficient revenue to fund benefits of insufficient plans over the long term. As a result, the program's financial condition will continue to weaken. If the premium is not increased soon, plans established in the future could be adversely affected because they would have to pay a rate substantially higher than $7.00. In the private sector, such deficits are avoided because state insurance departments require insurance companies to maintain assets at least equal to their liabilities.

In general, the program incurs a claim when a plan terminates with insufficient assets to pay guaranteed benefits. The Corporation uses data available from the plan to compute the estimated future benefits payable to the plan's participants. The Corporation's deficit reflects the difference between the total of such estimated future benefits for all terminated plans with insufficient assets and the Corporation's total assets--including assets of such terminated plans, premium collections, and investment income.

Despite an increase in the premium rate from $1.00 to $2.60 on January 1, 1978, the Corporation estimates that the program's current deficit exceeds $400 million and could exceed $600 million by the end of 1985. To date, investment earnings and premium collections have exceeded annual benefit payments and administrative costs. However, these disbursements are expected to exceed premium revenue and investment earnings for the first time during this fiscal year.

The funding of the program contrasts with general insurance industry standards which do not permit private insurers to operate at a deficit. In order to comply with state regulatory standards, private insurers must report their financial condition annually to state insurance departments. If a private insurer's financial condition does not meet state statutory requirements, a state may take action to protect policyholders, including possible revocation of the insurer's operating rights.

Timely implementation of rate changes is necessary to maintain the program's assets at a level sufficient to pay liabilities. At the time the first premium increase to $2.60 was approved, the Corporation estimated that it would provide sufficient revenue to retire the program's estimated deficit of $59.4 million on January 1, 1978 within 4 years. However, unexpectedly high claims substantially increased the program's deficit.

In December 1980, a Corporation study showed that a $4.66 premium would be needed to eliminate a then estimated deficit of $157 million within 5 years. However, the Corporation did not propose a premium increase until May 1982. Had the $4.66 premium rate been requested and made effective on January 1, 1981, about $200 million in additional assets would have been generated during the subsequent 3-year period. As a result, a lower premium would now be needed. In addition, the program's costs would be more equitably allocated between then existing plans and plans established subsequently.

## PROGRAM'S PREMIUM REQUIREMENTS DIFFICULT TO PREDICT WITH CERTAINTY

The premium rate needed to finance the program is difficult to predict with certainty because major components of the premium are based on subjective assumptions and predictions of future events. These components include projections of future claims, the amount needed to retire the program's deficit, numbers of future participants for whom premiums will be paid, and administrative expenses.

Claims from terminating plans are the program's largest annual cost and are the most difficult to predict because forecasting methodologies are based on the presumed relationship between future claims and the program's past experience or other economic variables. To illustrate how claims projections can differ, our actuaries used three assumptions about the program's future claims and calculated that the average annual claims could range between $81 million and $183 million over the next 5 years.

For example, the average annual claims would be projected to be $81 million if they were assumed to equal the average annual amount of claims experienced since the program began in 1974. Under this assumption, the strong upward growth in the program's claims is ignored--which we believe would be unreasonable--and projected claims are lower than the program's actual claims experience during the last 5 years. The average annual claims projection would be increased from $81 million to $122 million if it is assumed that claims for the next 5 years would equal the average claims level over the last 5 years. Finally, the claims projection would be increased from $122 million to $183 million if the growth in claims experienced during the program's last six years is assumed to continue for the next 5 years. If this growth should continue, claims would be even higher than those experienced during the last 5 years. Each $34 million increase or decrease in projected annual claims has a $1.00 effect on the premium.

The annual cost to retire the deficit can also vary significantly depending on the repayment period. For example, the annual cost to retire an estimated deficit of $400 million would be $104 million over 5 years compared to $64 million for 10 years and $51 million for 15 years. However, the reduction in the annual cost becomes less significant as periods longer than 15 years are used. For example, a 30-year repayment period would result in an annual cost of $41 million. As with the claims projection, each $34 million difference in the annual deficit payment leads to a $1.00 change in the premium rate.

The quality of the Corporation's data raises an additional uncertainty about the cost to retire the deficit. The accuracy of the Corporation's accounts, including the accumulated results of operations (the deficit), was not determinable for financial statement reporting purposes. However, the preliminary deficit estimate of over $400 million through the end of 1983 is the only information available for determining the premium. For each 10 percent variation in a deficit of $400 million, the required premium changes by $.31 for a 5-year deficit repayment period and $.13 for a 15-year period.

The premium requirements are based on a projection of the number of participants for whom premiums will be paid. From 1975 through 1981, the Corporation estimated that insured participants increased at an annual rate of 1.1 million. Any major change in this growth rate could have an effect on premium requirements.

For example, if the projected participant growth rate is cut in half over the next 5 years, the required premium would increase by $.43 assuming the same absolute amount of program costs.

The program's administrative expenses are another source of uncertainty in developing the required premium. Historically, the program's expenses have grown at an average of about 14 percent a year. Any change in the assumed future growth of program expenses could affect premium requirements. For example, if the growth rate over the next 5 years is cut in half, the required premium decreases by $.16.

## ANALYSIS OF THE CORPORATION'S PREMIUM REQUEST

The Corporation's $6.00 premium request in May 1982 was based on the program's experience through fiscal year 1981. The premium request has been raised to $7.00 because the program's claims in fiscal year 1982 were significantly higher than originally projected for the $6.00 rate. For its $7.00 request, the Corporation extended the period used to project claims and administrative costs and to retire the deficit from 5 years to 15 years. If this period had remained at 5 years as used in the $6.00 rate request, the Corporation estimates that an $8.50 premium would now be required.

The attached exhibit shows the portion of the $6.00, $7.00, and $8.50 premiums needed to finance claims, repay the deficit, and pay administrative expenses. For all rates, the Corporation estimated that the number of participants for whom premiums would be paid would grow at a rate of 1.1 million a year.

The Corporation's $6.00 premium rate included about $2.00 to retire the January 1, 1983 estimated deficit of $236 million over 5 years. In contrast, the Corporation estimates that $1.50 of the $7.00 premium is needed to retire the program's estimated January 1, 1984 deficit over 15 years. The Corporation has not finalized computation of the deficit and for purposes of computing its premium needs, the Corporation has projected a deficit of $462 million as of January 1, 1984. On the basis of this deficit, extending the period from 5 years to 15 years reduced the portion of premium needed for retiring the deficit even though the total projected deficit almost doubled. If the period had remained at 5 years, about $3.50 rather than the present $1.50 would be needed to retire the $462 million projected deficit.

If the premium rate increase is not made effective on January 1, 1984, the program's deficit could increase by about $140 million by the end of 1984 because of premium revenue foregone. As a result, about $2.00 rather than $1.50 would need to be included in the premium rate to retire the higher deficit within 15 years as presently proposed.

While the $6.00 premium included about $3.00 for the claims projected over a 5-year period, the Corporation estimates that $4.50 of the $7.00 premium will be needed to pay for projected claims for the next 15 years. About $1.00 of the $1.50 increase reflects the rise in claims since the earlier request and $.50 results from the Corporation's switch from a 5-year to a 15-year projection period. As a result, $4.00 rather than $4.50 would be needed to pay projected claims over a 5-year period.

Although the Corporation estimated that $1.00 of both the $6.00 and $7.00 premiums would be needed to cover future administrative expenses, the underlying expense assumptions have been changed for the $7.00 request. In addition to extending the expense projection period from 5 to 15 years, the Corporation lowered the projected expense annual growth rate from 9 percent to just over 2 percent. If the 9 percent assumption had been maintained, about $1.50 would now be needed to cover future administrative expenses for 15 years or about $1.00 for a 5-year period.

## GAO OBSERVATIONS

In our November 1983 report, we concluded that the Corporation's methodology in its May 1982 study was reasonable. The proposed $6.00 premium was designed to cover claims, administrative expenses and retire the deficit in 5 years and was to be effective on January 1, 1983. We observed, however, that because of higher than expected claims in 1982, a premium of about $7.50 would be required to achieve the same objective. Presently, because the effective date of the requested premium increase is being extended to January 1, 1984, a premium rate of $8.50 may now be needed to cover claims, administrative expenses, and retire the deficit within 5 years.

We recognize that there are substantial uncertainties in arriving at a premium rate and believe that the $7.00 premium proposed by the Corporation is the lowest that should be provided. However, regardless of the rate that is approved, we believe that the size of future rate increases can be minimized and the insurance program placed on a sounder financial basis by timely evaluation and adjustment of the premium rate. In our 1983 report, we suggested that the Congress consider (1) requiring the Corporation to provide information in its annual report to the Congress on the adequacy of its existing premium rate, including recommended changes when warranted, or (2) providing an automatic annual adjustment to the premium rate. We continue to believe that one of these options should be implemented.

This concludes my testimony Mr. Chairman. We would be glad to answer any questions you or other Members of the Subcommittee might have.

## EXHIBIT

## PENSION BENEFIT GUARANTY CORPORATION'S

## PREMIUM ESTIMATES IF

## EFFECTIVE JANUARY 1, 1983 OR JANUARY 1, 1984

| | Premium Requested | | Premium Needed |
|---|---|---|---|
| | 5-year projection January 1, 1983 | 15-year projection January 1, 1984 | 5-year projection January 1, 1984 |
| Finance Future Claims | $3.02 | $4.50 | $4.00 |
| Retirement of Deficit | 1.95 | 1.50 | 3.50 |
| Administrative Expenses | .97 | 1.00 | 1.00 |
| Total | $5.94[a] | $7.00 | $8.50 |

[a]Rounded up to $6.00 by the Corporation.

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