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Improving the Financial Condition of the Pension Benefit Guaranty Corporation

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SUMMARY

The Pension Benefit Guaranty Corporation's (PBGC's) deficit is large, has grown significantly in recent years, and is expected to continue to grow. The growth in its deficit will come from underfunded plans that terminate in the future. At present, PBGC has sufficient cash flow to pay its current benefit obligations, but this may not continue. Now is the time for serious deliberations on developing solutions to improve funding in underfunded plans so as to reduce the risk to PBGC from future terminations. Legislative proposals for improving funding in underfunded plans could have a significant positive effect in reducing PBGC's deficit over the long run.

Underfunded plans not only put PBGC at risk, they also pose a risk to plan participants. Because PBGC does not guarantee all pension benefits, some participants may lose some benefits upon plan termination. Thus, improved funding of underfunded pension plans will be beneficial to participants as well as PBGC.

PBGC has been burdened not only by its current deficit and looming potential claims, but also by significant internal operations problems. Because of significant internal control and systems weaknesses, GAO has never been able to express an opinion on PBGC's financial statements. These problems indicate that PBGC needs to put more emphasis on its operations.

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me here today to discuss the Pension Benefit Guaranty Corporation's (PBGC's) financial condition. Few public deficits have received more attention in recent months than the deficit in PBGC's single-employer insurance fund. Several years ago GAO placed the private pension insurance system on its "high-risk" list because of the potential for material losses to American taxpayers and long-standing control weaknesses at PBGC. Since then, we have devoted significant attention to problems with regulation of pension plans in general and PBGC in particular.

PBGC was created by the Employee Retirement Income Security Act of 1974 (ERISA) to administer the insurance program that protects the benefits of participants in defined benefit pension plans. These plans pay specific retirement benefits, generally based on years of service or earnings. PBGC insures many of the benefits of such plans that terminate with assets insufficient to cover future benefit liabilities.

In my statement today I would like to highlight five points that we hope will be helpful in congressional policy formulation.[1] We believe that such policy should focus on reducing unfunded liabilities in PBGC-insured pension plans because such actions are the key to reducing future PBGC liabilities and better protecting the benefits of plan participants. We are also concerned about PBGC's long-standing operational problems.

1. PBGC's deficit is large--$2.3 billion at the end of fiscal year 1991--and has grown significantly in recent years. The major threat to the agency is the large unfunded liabilities in the ongoing plans it currently insures. PBGC's most pessimistic estimate indicates that its deficit may grow to $17.9 billion by the year 2001. Unless proper steps are taken to improve plan funding, this pessimistic estimate may become a reality.

2. At present, PBGC's cash flow is sufficient to meet its current benefit obligations. Nonetheless, the Congress should address the threat to the agency from underfunded plans. If the Congress now begins the process of developing solutions, it should not be necessary to legislate in haste at some future date or to seriously erode the protections afforded workers in the process of solving PBGC's problems. We are encouraged by

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[1]We conveyed these points in two testimonies before the House Subcommittee on Oversight, Committee on Ways and Means (<u>Financial Condition of the Pension Benefit Guaranty Corporation</u> (GAO/T-HRD-92-52) and <u>Pension Plans: Benefits Lost When Plans Terminate</u> (GAO/T-HRD-92-58)).

this Subcommittee's efforts to begin focusing on this issue at this time.

3. Legislative proposals for improving funding in underfunded plans could have a significant positive effect in reducing PBGC's deficit over the long run. However, it is also important to analyze the potential impacts of specific proposals on plan participants, plan sponsors, and federal revenues.

4. Underfunded plans not only put PBGC at risk, they also pose a risk for plan participants. PBGC insures many, but not all, of the benefits provided by defined benefit pension plans. If an underfunded plan terminates, some plan participants are at risk of losing some of their promised benefits.

5. In addition to PBGC's current deficit and looming potential claims, the agency has experienced significant internal operations problems. Because of significant internal control and systems weaknesses, we have never been able to express an opinion on PBGC's financial statements. Unaudited financial statements cannot be relied upon to accurately portray PBGC's financial health. However, PBGC has recently moved to address these problems.

INCREASING PLAN UNDERFUNDING THREATENS PBGC

PBGC has had a deficit since its inception in 1974, and the deficit is growing. Its 1991 annual report listed assets of $5.9 billion and liabilities of $8.2 billion, an accumulated deficit of $2.3 billion--up from $1.8 billion in 1990.

PBGC's financial condition looks worse when potential terminations of underfunded plans are considered. In its 1991 Annual Report, Strengthening the Pension Safety Net, PBGC said that some plans, especially in the steel, tire, automobile, and airline industries, are underfunded by a total of about $40 billion (almost 20 times PBGC's current deficit), with over half this amount in a few large plans. Of the $40 billion, PBGC reported that $13 billion is in plans sponsored by financially troubled companies, the companies most at risk of going bankrupt and terminating their underfunded plans. Moreover, plans' funding levels could deteriorate even more if the current economic downturn continues or worsens. PBGC's most pessimistic 10-year forecast shows that its potential deficit by the end of fiscal year 2001 could be $17.9 billion.[2]

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[2]This estimate assumes that the plans with $13 billion in underfunding plus some smaller ones will terminate during the 10-year period; it is not a worst-case scenario.

The levels of unfunded liabilities cited above are PBGC estimates--the best data available. Plans, themselves, are not required to report their liabilities on a termination basis. When an underfunded plan terminates, PBGC often takes on a larger claim (unfunded plan liabilities for guaranteed benefits) than the unfunded liabilities last reported by the plan. In 44 large plans we studied that terminated in 1986-88, the aggregate claim, as measured by PBGC, was 58 percent greater than the underfunding previously reported by the plans. PBGC attempts to adjust for these hidden liabilities in describing its own financial status, but it is hindered by a lack of appropriate data.

THIS IS AN OPPORTUNE TIME TO ADDRESS PBGC'S THREAT

PBGC continues to have a positive cash flow. For fiscal year 1991, PBGC reported that its premium and investment income exceeded expenditures for benefits and other expenses by $452 million. Reported premium and investment income were $809 million and $309 million, respectively, while disbursements were $666 million. However, predicting whether and how long PBGC will be able to meet its current benefit obligations out of its cash flow is difficult. Therefore, this is the time--while PBGC still has a positive cash flow--to develop solutions to better fund pension promises. Improved funding in underfunded plans will reduce the size of potential claims against PBGC.

IMPROVING PBGC'S FINANCIAL CONDITION

A number of methods are available for improving PBGC's financial condition. We believe that the most productive approach is to focus on methods that will reduce the sizable underfunding in ongoing plans. This will limit the amount of liabilities PBGC will be asked to assume in the future. However, before implementation, any proposal to improve PBGC's financial condition should be analyzed to determine the likely effects on plan participants, plan sponsors, and federal revenues.

In January 1992, the administration proposed budgeting for PBGC's potential costs on an accrual basis so that policymakers can fully assess the costs of the pension insurance program and adequately monitor and plan for the program's future. Though we did not support that specific proposal due to certain implementation concerns, we believe that the concept of reporting appropriate accruals in the federal budget is sound.

To address PBGC's current deficit, the Congress also may want to consider raising premiums by making them more risk related. The Congress may want to consider whether the existing variable premium rate ($9 per $1,000 of underfunding) and/or overall ceiling on premiums ($72 per person) best reflects the risk to PBGC. To enhance PBGC's revenues, we believe the Congress should first focus on the premiums paid by underfunded plans because they pose the greatest threat to the program. Concerns have been raised that increasing the fixed portion of the premium will prompt sponsors of well-funded plans to drop their defined benefit plans, reducing PBGC's revenue base.

We have long supported strong and effective funding standards for the nation's defined benefit pension plans. ERISA established funding standards to help ensure that plan sponsors would fund their pension promises. The 1987 Omnibus Budget Reconciliation Act established additional funding standards aimed specifically at underfunded plans. We are currently evaluating the 1987 standards to determine whether they are working as intended.

We note that strengthening funding standards will lead to larger contribution requirements for some plans. This will increase the federal deficit in the short run because contributions are tax-deductible business expenses. Also, some financially troubled sponsors may have difficulty meeting the new standards.

Some have proposed limiting PBGC's benefit guarantees. ERISA was enacted to protect plan participants from abuses in the pension system. We are concerned that proposals to limit benefit guarantees will adversely affect plan participants. We would prefer that the threat to PBGC from underfunded plans be addressed by better plan funding rather than by limiting benefit guarantees.

We are also concerned that such proposals may lead to inequitable treatment of participants in different types of plans. The proposals we have seen suspend PBGC's guaranty for benefit increases in new plans and plans whose benefit increases result from plan amendments. Because of the focus on plan amendments rather than underfunding per se, these proposals effectively apply primarily to one type of existing plan--referred to by PBGC as flat benefit plans--which usually are collectively bargained and serve primarily unionized, blue collar workers.

In general, we prefer that the threat to PBGC from underfunded plans be addressed through improved funding. One measure to improve funding in flat benefit plans might be to require their sponsors to anticipate future benefit increases when calculating the plan's liabilities.

PBGC has requested that its priority in bankruptcy be clarified and improved. We have not seen any studies of the dynamics of its proposals or their effects on other parties, including creditors and the federal government. Therefore, we currently do not have a position on them. We do, however, support the proposal that plan sponsors continue making contributions to their plans while in bankruptcy.

There are other measures that PBGC could take. PBGC has the authority to terminate pension plans under certain conditions. Perhaps it should use this authority in a more proactive manner with companies in, or headed for, bankruptcy. This would allow PBGC to freeze benefit accruals and minimize its potential losses. We recognize that this is a highly sensitive approach because such actions could destabilize a failing company and hurt plan participants. In the final analysis, however, someone has to decide where and when to limit PBGC's exposure, before or after bankruptcy.

In addition, PBGC should benefit from implementation of the recommendations in our April 9, 1992, report to the Subcommittee on Oversight, House Committee on Ways and Means.[3] We recommended that the Congress amend ERISA to require full scope audits of pension plans and to require plan administrators and independent public accountants to report on how effective a plan's internal controls are in protecting plan assets. Strong internal controls can help to ensure that plans more accurately report their assets and liabilities, including the amount of any unfunded liabilities, and that plans pay accurate premiums to PBGC.

SOME BENEFITS ARE NOT GUARANTEED BY PBGC

Underfunded plans not only put PBGC at risk, they also pose a risk for plan participants. PBGC insures many, but not all, of the benefits provided by defined benefit pension plans. If an underfunded plan terminates, some plan participants are at risk of losing some of their promised benefits. Generally, PBGC guarantees "basic" monthly benefits that provide income when participants retire, but it does not guarantee many other benefits. Nonguaranteed benefits include benefits that exceed the maximum specified in ERISA and a portion of benefit increases in effect less than 5 years before plan termination.

We are not advocating that PBGC coverage should be expanded to cover nonguaranteed benefits. Our intent is to show that, when plan sponsors do not adequately fund their pension plans, participants can and do lose benefits when plans terminate, even with PBGC pension insurance.

PBGC'S OPERATIONAL WEAKNESSES

PBGC has had long-standing operational problems. GAO has never been able to express an opinion on PBGC's financial statements because of internal control weaknesses and financial systems

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[3] Employee Benefits: Improved Plan Reporting and CPA Audits Can Increase Protection Under ERISA (GAO/AFMD-92-14).

deficiencies. Moreover, in our March 2, 1992, report,[4] we said that we could not evaluate the reliability of PBGC's liability estimate because PBGC had not developed documentation and support for its estimating techniques, assessed data used for estimating, or corrected weaknesses in its estimating software. In addition, we found that PBGC's efforts to identify and collect delinquent (unpaid) premiums, underpaid premiums, and related interest and penalties have been inadequate.[5]

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Mr. Chairman, underfunded pension plans pose a risk to the PBGC and, because PBGC does not guarantee all benefits, to the participants of those plans. The best way to protect PBGC and plan participants, in our opinion, is to ensure that all underfunded plans become fully funded.

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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[4]Financial Audit: Pension Benefit Guaranty Corporation's 1991 and 1990 Financial Statements (GAO/AFMD-92-35).

[5]Pension Plans: Pension Benefit Guaranty Corporation Needs to Improve Premium Collections (GAO/HRD-92-103).