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PRIVATE PENSIONS

Most Underfunded Plan Sponsors Are Not Making Additional Contributions

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SUMMARY

The Pension Protection Act (PPA) of 1987 added a new funding requirement for sponsors of underfunded defined benefit pension plans--Section 412(l) of the Internal Revenue Code. This new provision, along with PPA's other funding requirement modifications, were intended to accelerate the movement of underfunded plans toward full funding.

The available evidence indicates that pension plan funding is not improving. The percentage of plans paying the Pension Benefit Guaranty Corporation's (PBGC's) variable rate premium because they are underfunded increased from 17 percent in 1989 to 23 percent in 1991. The total underfunding in plans insured by PBGC has increased from $30 billion to over $50 billion in this same period.

GAO looked at a randomly selected sample of 93 plans paying PBGC's variable rate premium to determine how many sponsors of these underfunded plans were making additional contributions under the 412(l) provisions. Sponsors of more than one-third of these plans were not required to make additional contributions because the plans were not underfunded on the basis used for this provision. Of the 60 plans subject to the provision, only one-third received additional contributions. Sponsors of 28 of these plans did not have to make any additional contributions because of offsetting credits for amortization payments already being made. Many of the sponsors making additional contributions paid amounts that were reduced by the offsetting credits. A troubling finding is that almost 20 percent of the 60 plans had not calculated what their additional contribution requirements were.

GAO looked at the impact of the current law as well as the funding proposals for contribution requirements contained in S.105 and H.R.298. For our sample of 60 plans as a whole, the additional contributions due to current law increased total contributions by only 8 percent. The proposed funding rule changes, however, would increase contributions for an estimated 75 percent of the plans in our sample and reduce them for an estimated 10 percent. The required contributions will increase substantially under the proposals for a number of underfunded plans, however, and may be a burden to some.

Mr. Chairman and Members of the Subcommittee:

Thank you for inviting me here today to discuss our work on defined benefit pension plan funding issues. Because this work is still in progress, I wish to stress that our results are preliminary. They indicate that the current funding rules need improvement and that proposed legislation, while having shortcomings, would substantially increase contributions for many plans.

The majority of pension plans insured by the Pension Benefit Guaranty Corporation (PBGC) are well-funded. However, a significant minority of plans are underfunded and the level of underfunding in these plans is growing. This increasing underfunding raises concerns for all involved, that is:

-- PBGC faces an increase in its exposure to the risk of terminating underfunded plans.

-- Sponsors of financially sound plans may see their PBGC premiums increase to cover PBGC's growing losses.

-- Plan participants may lose some of their benefits should their underfunded plan terminate.

-- Taxpayers may have to pay should PBGC exhaust the assets it has for paying its obligations.

Improving the funding in underfunded plans should benefit each of these groups.

HISTORY OF PENSION PLAN FUNDING REGULATIONS

Before the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), only minimal funding rules existed. Many participants lost promised benefits when their underfunded plan terminated. Among other provisions, ERISA established firm minimum funding rules and created the PBGC to insure the pensions of participants in defined benefit plans. The improved funding rules worked as intended for many plans, but by the mid-1980s what became apparent was that the funding in some plans needed improvement.

The Pension Protection Act (PPA), a part of the Omnibus Budget Reconciliation Act of 1987 (OBRA 87), introduced certain reforms to ERISA aimed at bolstering funding levels in underfunded plans. PPA instituted an additional premium for underfunded plans (the variable rate premium); modified the contribution waiver process; introduced quarterly contributions and required notification to PBGC of missed contributions; reduced some amortization periods; revised guidelines for using actuarial assumptions; and, established an additional contribution funding requirement for underfunded plans.

ARE THE CURRENT RULES IMPROVING PLAN FUNDING?

In the aggregate, available evidence suggests plan funding for underfunded plans is not improving. The percentage of plans insured by PBGC that pay a variable premium because they are underfunded increased from about 17 percent in 1989 to about 23 percent in 1991. Over this same period, PBGC estimates the total underfunding in its insured plans increased from $30 billion to $51 billion. PBGC reports that the surplus of assets in the fully funded plans it insures dropped from $251 billion in 1990, to $183 billion in 1991. In part, this funding deterioration is caused by declining interest rates. The decline in the surplus of well-funded plans was also caused in part by PPA's funding limitation which precludes sponsors of very well-funded plans from making contributions to their plans.

GAO's ANALYSIS OF FUNDING IN UNDERFUNDED PLANS

The PPA established an additional contribution requirement to reduce underfunding in underfunded plans, the Internal Revenue Code 412(l) provision. To test the effectiveness of the 412(l) provision, we are analyzing a randomly selected sample of 93 large underfunded plans that were paying PBGC's variable rate premium in 1990. Our results to date show that 33 plans, more than one-third of the plans in our sample, were not underfunded on a current liability basis, the basis that determines whether an additional contribution should be made.[1] The preliminary results of our study, based on the remaining 60 cases, show that (see fig. 1):

-- Sponsors of only one-third of the plans (21 plans) were making additional contributions under the 412(l) provision.

-- Almost half the plans (28 plans) did not have to make additional contributions because allowable credits for certain amortization payments already being made offset their additional contribution obligations.

-- Almost 20 percent of the plans (11 plans) did not determine if they had an additional contribution obligation.

We calculated the additional contribution obligation for the 11 plans that did not make the calculations themselves. Our analysis shows that 6 of the 11 plans should have made additional contributions. The large portion of underfunded plans in our

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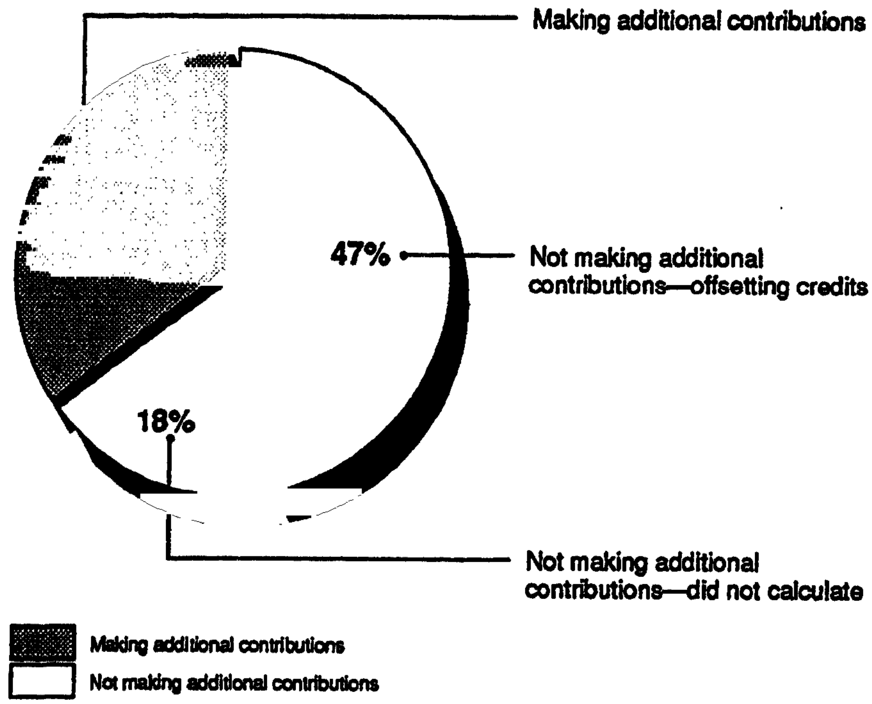
[1]See the appendix for a description of our sample, a summary of the current 412(l) provisions, and a description of the proposed funding rule changes contained in S.105 and H.R.298.

sample that did not make this calculation is troubling and suggests there may be an enforcement problem. We have not yet discussed these findings with the Internal Revenue Service (IRS), however.

Figure 1: Few Underfunded Pension Plans Make Additional Contributions (1990)



Note: Based on a sample of 60 plans paying PBGC variable rate premium

We found that the offsetting credits seriously eroded the effectiveness of the additional contribution provision. After including estimated additional contribution obligations for the 11 plans not making the calculations themselves, we found that more than half the 60 underfunded plans in our sample (33 plans) were able to avoid making any additional contributions because of the offsetting credits. In addition, the offsetting credits reduced the additional contribution payments for 15 plans that made, or would have made, such payments.

We found that the effect of offsetting credits on additional contributions were concentrated in underfunded flat benefit plans.[2]

[2]"Flat benefit plans" is used to describe defined benefit plans calculating monthly benefits by multiplying years of service in the plan by a fixed dollar amount. Most flat benefit plans are

Two-thirds of the flat benefit plans, compared with less than 40 percent of the salary and other plans, made no additional contribution because of the offsetting credits. One reason for this is the splitting of plan underfunding into old and new components and amortizing the new component over a shorter period of time.[3] This results in a smaller additional contribution, before taking the offsetting credits, than if the total plan underfunding were amortized over the shorter period now applying only to the new component. We found that flat benefit plans were more than twice as likely as salary and other plans to have at least 75 percent of their 1990 underfunding in the old liability category.

Our preliminary analysis indicates that the current funding rules for underfunded plans have not produced as dramatic an increase in contributions as the framers of the rules might have anticipated. These rules allow sponsors of most underfunded plans to avoid making additional contributions. If Congress wants to further improve the funding levels in underfunded plans, then it may need to consider legislating additional improvements to the funding rules.

S.105 AND H.R.298

Two bills (S.105 and H.R.298) have been introduced recently that would improve funding in most plans with unfunded current liabilities. These bills would require sponsors of such underfunded plans to make minimum contributions equal to the highest of the contributions required under three different funding rules.

These rules are complicated but may be briefly described as (1) the ERISA Rule, which is the current contribution requirement without the additional contribution obligation, (2) the Deficit Reduction Rule, which would modify the current additional contribution rule and eliminate the offsetting credits, and (3) the Cash Flow Rule, which would be a new rule having contributions equal to plan expenditures plus other charges.

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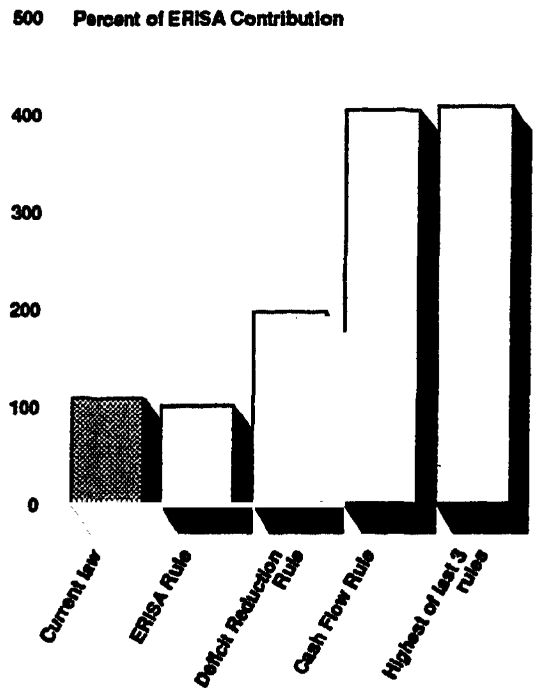
negotiated union plans. The other major type of defined benefit plan is salary-based and calculates monthly benefits by multiplying years of service in the plan by some measure of earnings. Flat benefit plans make up 60 percent of our sample of 60 underfunded plans.

[3]Old underfunding is the unamortized portion of the underfunding that existed at the beginning of the 1988 plan year. New underfunding is the difference between old underfunding and the total underfunding in the plan at the beginning of the current year.

Our preliminary analysis of the effects of these bills indicates that total contributions would increase for approximately 75 percent of the plans in our sample of 60. However, the contributions for more than 10 percent of these 60 plans would decline from current levels.

Figure 2 shows the level of contributions required for our sample of 60 plans by current law, and by the various components of the proposed legislation using the ERISA Rule as the base. The current law increased total funding in our sample of plans by about 8 percent. The proposed rules would have much larger effects.

Figure 2: Proposed Rules Will Increase Contributions In Underfunded Plans



NOTE: Based on a GAO sample of 60 underfunded pension plans (in 1990)

The Deficit Reduction Rule could be more effective than current law in accelerating plan funding improvements. This rule would almost double the total contributions for these plans. Moreover, the Cash Flow Rule would more than quadruple contributions. The proposal that plans make contributions equal to the highest of the three funding rules would require contributions of more than four times the total ERISA contribution.

While the proposed legislation would help improve funding in many underfunded plans by requiring additional contributions, it is important to note that the new rules could substantially increase required contributions for many plan sponsors. This would appear especially true for sponsors who would be subject to the new Cash Flow Rule.

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

APPENDIX

This appendix contains a brief discussion of GAO's sample of underfunded plans, the current Internal Revenue Code Section 412(l) provisions, and proposed funding rule changes contained in S.105 and H.R.298.

GAO's SAMPLE

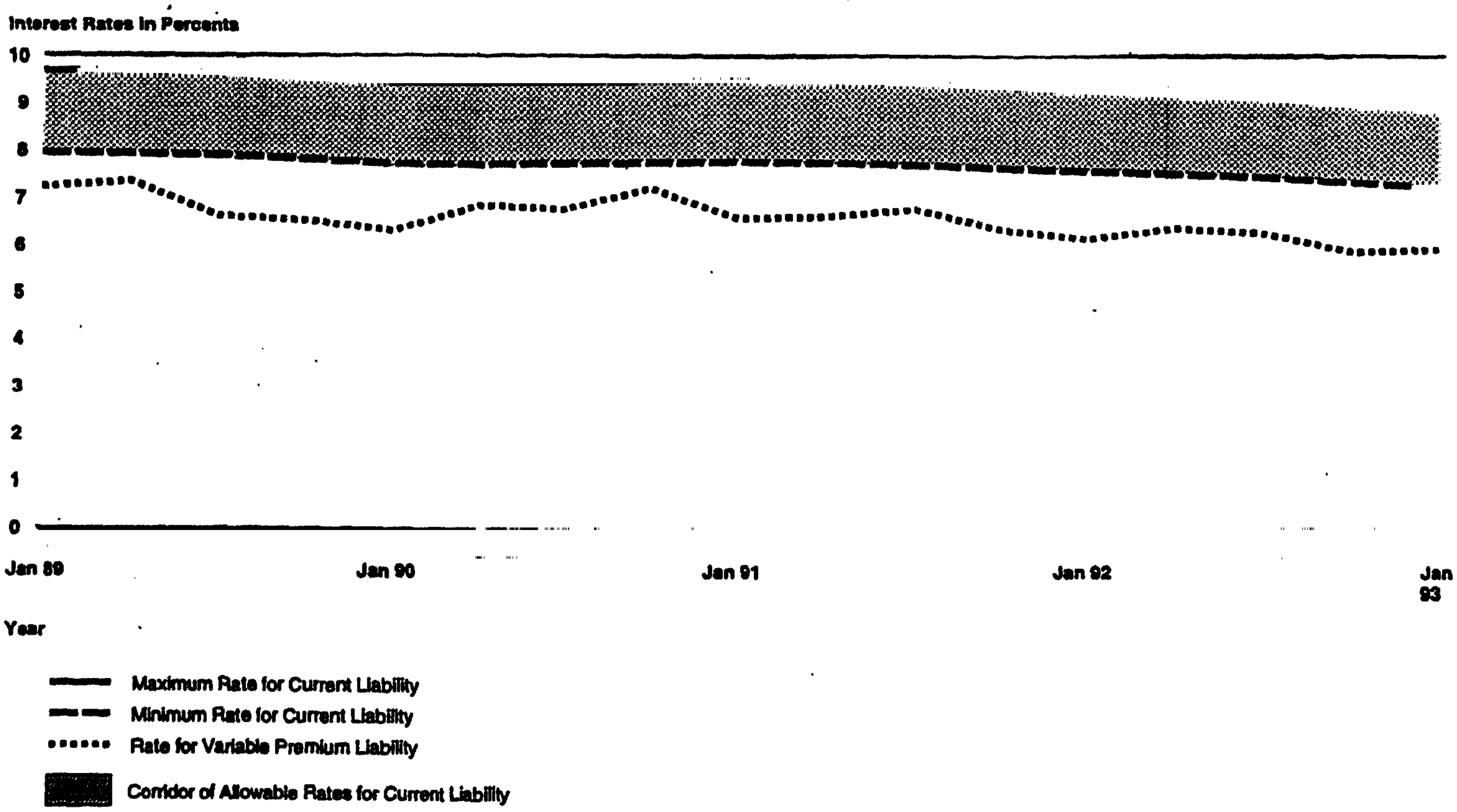
In 1990, over 15,000 of the plans PBGC insured were paying the variable rate premium. This premium is required of all plans that are underfunded when plan liabilities are calculated using an interest rate equal to 80 percent of the 30-year U.S. Treasury Bond interest rate. We used this population of underfunded plans to draw a random sample of underfunded plans for our study of the Internal Revenue Code Section 412(l) provisions requiring sponsors of underfunded plans to make additional contributions to their plans. Plans with fewer than 101 participants are not subject to the 412(l) provisions. More than 10,000 plans making variable rate premium payments to PBGC had fewer than 101 participants and were exempt from making additional contributions. We eliminated these plans from our base population before drawing our sample.

Our sample contained 93 plans for which we were able to obtain complete 1990 Form 5500 data. Although all 93 plans were underfunded for premium payment purposes, only 60 were underfunded on a current liability basis, the basis used for determining the additional contribution obligation under the 412(l) provisions. The reason 33 plans were not underfunded on a current liability basis is that current liabilities are calculated using an interest rate from an allowable corridor of rates. These rates have been higher than the interest rate used to calculate premium liabilities since the 412(l) provisions became effective (see fig. A). The uses of higher interest rates to calculate plan liabilities lowers the value of the liability. Thus, many plans that are underfunded on a premium basis may not be underfunded on a current liability basis and may not be subject to the 412(l) provisions.

THE CURRENT ADDITIONAL CONTRIBUTION PROVISION

The 412(l) provisions specify that plans that are underfunded on a current liability basis should make an additional contribution in certain circumstances. These underfunded plans are allowed to separate their current level of underfunding into two components--old and new. Old unfunded liabilities are equal to the unamortized amount of the underfunding existing in the plan at the beginning of the 1988 plan year. Old unfunded liabilities are amortized over an 18-year period beginning in 1989. New unfunded liabilities are the difference between the current level of underfunding and the old unfunded liabilities. The payment for the new component varies from 14 to 30 percent of the new unfunded liabilities and depends

Figure A: Interest Rates Used to Calculate Current Liabilities (from Corridor) and Variable Premium Liabilities



on the funding ratio of the plan (old and new underfunding combined.) These two payments are combined into the deficit reduction contribution.

The deficit reduction contribution is reduced for offsetting credits--amortization payments the sponsor is making for initial plan underfunding, past benefit increases, waivers, and alternative minimum funding standard payments less amortization credits for benefit changes. A charge for any unpredictable contingent event (shutdown) payments being made is added to the new total. The final additional contribution can be no larger that the level of underfunding in the plan. Plans with fewer than 150 participants pay a reduced additional contribution--2 percent of the calculated additional contribution for each participant over 100.

NEW FUNDING PROPOSALS

Two bills (S.105 and H.R.298) have been introduced recently and would improve funding in most plans underfunded on a current liability basis. These bills would require sponsors of underfunded plans to make minimum contributions equal to the highest of the contributions required under the 412(b) rule, a modified 412(l) rule, or a proposed 412(o) rule.

The 412(b) rule requires contributions equal to the plan's normal cost plus amortization charges, less amortization credits. This is the contribution requirement under ERISA and is the current contribution requirement without the additional contribution provision. We call this the ERISA Rule.

The proposed modified 412(l) provision specifies that the current liability be calculated using a restricted corridor of allowable interest rates and that this alternative required contribution equal a payment based on the combined unfunded old and new liabilities, the plan's normal cost, amortization payments for waivers granted, and a charge for unpredictable contingent event payments. The modified 412(l) provision also eliminates the offsetting credits for certain amortization charges already being made by the plan's sponsor. We call this the Deficit Reduction Rule.

The proposed 412(o) provision would require a contribution equal to plan expenditures (including benefit payments), interest on the plan's underfunding, the plan's normal cost, and amortization payments for waivers granted. We call this the Cash Flow Rule.

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