



Health, Education and Human Services Division

B-281686

December 18, 1998

The Honorable Harris W. Fawell
Chairman, Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
House of Representatives

Subject: Improving Financial Condition of the Pension Benefit Guaranty Corporation and Insured Pension Plans

Dear Mr. Chairman:

The Pension Benefit Guaranty Corporation (PBGC) is a federal agency whose operation is similar to that of both a guaranty insurance company and a pension plan. It insures the pensions of 42 million participants in about 45,000 private defined benefit pension plans.¹ If an employer sponsoring an underfunded plan becomes insolvent, PBGC takes over the plan and is responsible for investing them and paying guaranteed benefits to the participants. PBGC's financial condition has been affected by the financial failure of only a small number of large firms. Historically, PBGC has had a deficit: Its liabilities, the present value of future benefits PBGC is or will be obligated to pay for terminated plans or plans that are likely to terminate in a future year, have exceeded its assets. The agency, however, had a surplus in fiscal years 1996 and 1997, after having had a deficit for more than 20 years.² PBGC's improved financial condition has resulted from factors such as continued economic growth and the lack of large claims from terminated underfunded plans over the past few years, as well as unprecedented returns on its investments. Despite improvements in PBGC's financial condition, it remains vulnerable to factors beyond its control, such as underfunding among some large plans, any future downturns in the economy,

¹These plans pay specific retirement benefits, generally based on years of service, earnings, or both; the sponsoring company ensures that plan assets are sufficient to pay all plan liabilities.

²"Surplus" represents a positive financial net position in which PBGC's assets exceed its liabilities.

and declines in interest rates. We recently issued a report to you on these issues.³

After reviewing our earlier report, you asked us to provide additional information on (1) PBGC's projections of its financial condition and assumptions used to prepare these projections, (2) the funding status of the plans it insures, and (3) its strategy for investing its assets. To provide this information, we reviewed PBGC's financial forecasts as well as detailed projected financial data, and we interviewed PBGC officials. We did not independently verify the reliability of the underlying computer-based data, however; we relied primarily on data supplementing PBGC's audited 1997 financial statements. We conducted our work between October and December 1998 in accordance with generally accepted government auditing standards.

In summary, we found that PBGC uses different methodologies to forecast the financial condition of its single-employer and multiemployer insurance programs. PBGC relies on extrapolations of its past claims experience and past economic conditions to develop forecasts for the single-employer program. The optimistic and intermediate forecasts project surpluses at the end of fiscal year 2007 of \$8 billion and \$6.9 billion, respectively, while the pessimistic forecast projects a deficit of \$17.1 billion. PBGC uses plan-specific historical data in projecting whether multiemployer plans will become insolvent and require its assistance. PBGC projects that the multiemployer program should remain financially strong and that the program's surplus, \$219 million in fiscal year 1997, should continue to grow. The funding status of many single-employer plans has improved. Between 1980 and 1995, the proportion of fully funded single-employer plans (plans with assets equal to or exceeding benefits earned by participants) increased from 58 percent to 65 percent. Overall, funding among multiemployer plans has improved since 1980, and in 1995 about 60 percent of multiemployer plans were fully funded. Finally, at the end of fiscal year 1997, PBGC reported having about \$15.6 billion in assets available for investment. In accordance with its investment policy, these assets are invested primarily in equities and fixed income securities.

BACKGROUND

PBGC administers two separate programs—one for single-employer plans, the other for multiemployer plans. Single-employer plans provide benefits to

³Pension Benefit Guaranty Corporation: Financial Condition Improving, but Long-Term Risks Remain (GAO/HEHS-99-5, Oct. 16, 1998).

employees of one firm only or to employees of several firms; the terms of these plans may not be collectively bargained.⁴ Multiemployer plans are maintained under collectively bargained agreements involving more than one unrelated firm, generally in a common industry such as construction, trucking, and textiles.

PBGC is financed through premiums paid annually by employers that sponsor plans, investment returns on PBGC's assets, assets from terminated plans, and recoveries from employers responsible for underfunded terminated plans. PBGC pays benefits to participants in single-employer plans that terminate without sufficient assets to pay all promised benefits, and in the case of multiemployer plans, it provides loans to plans that are unable to pay all benefits. During 1997, PBGC paid \$824 million in guaranteed benefits to 213,000 people in plans that had terminated with insufficient assets to pay promised benefits. It will pay guaranteed benefits to another 260,000 people in terminated plans once they reach their plans' normal retirement age.

The Employee Retirement Income Security Act of 1974 (ERISA) requires that PBGC annually provide an actuarial evaluation of its expected operations and financial status over the next 5 years.⁵ ERISA also requires PBGC to develop, every 5 years, projections of the potential liabilities the multiemployer insurance program could incur in order to inform policymakers whether changes in the program might be necessary.

THE PROJECTED FINANCIAL CONDITION OF PBGC'S SINGLE-EMPLOYER AND MULTIEMPLOYER INSURANCE PROGRAMS

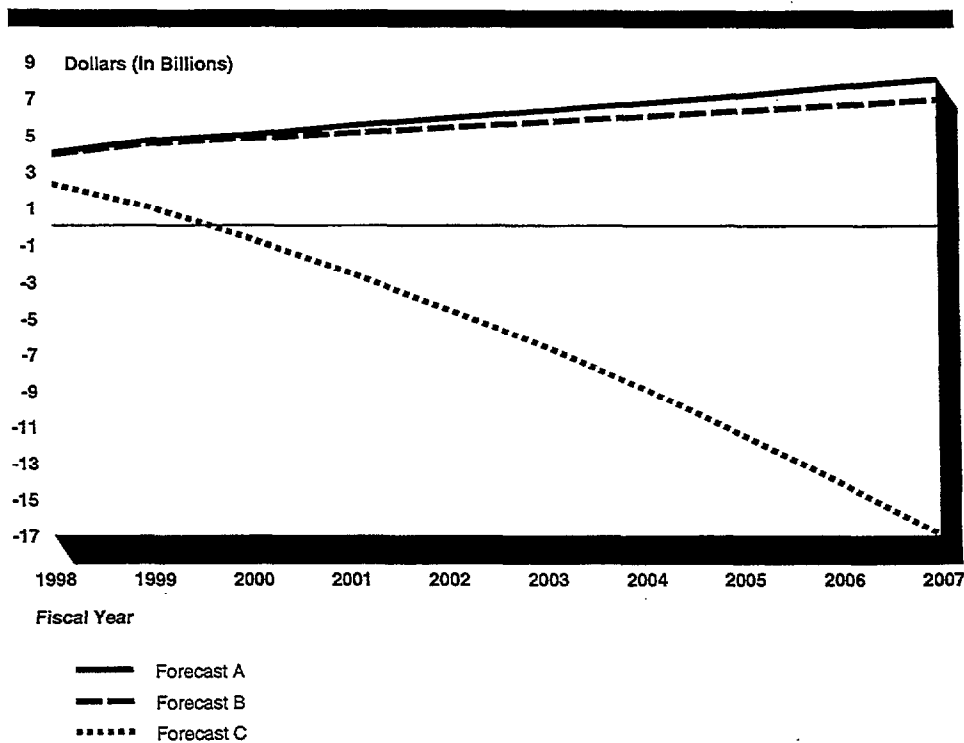
Historically, PBGC has used its claims experience and the economic conditions of the past two decades to forecast the financial condition of the single-employer program. PBGC prepares three 10-year forecasts of its single-employer program to provide a long-term view of the financial condition of the program under different scenarios. Forecast A is a projection based on the average annual net claims over PBGC's entire history and assumes the lowest level of future claims. For 1997, forecast A projected a continuation of PBGC's financial improvement, resulting in a surplus of \$8 billion at the end of fiscal year 2007. Forecast B assumes a moderate level of future claims and is based on the average annual

⁴Employers can sponsor more than one plan.

⁵ERISA was enacted to protect participants in private pension plans. Among other things, it established an insurance program, administered by PBGC, to protect the benefits of most participants in defined benefit plans.

net claims over the most recent 11 fiscal years. Forecast B projected net income levels that will lead to a surplus of \$6.9 billion at the end of 2007. Finally, forecast C assumes that the plans representing PBGC's "reasonably possible exposure" will terminate uniformly, resulting in \$2.1 billion in net claims each year over the next 10 years in addition to terminations of a modest number of underfunded plans with small claims.⁶ This approach resulted in a projected \$17.1 billion deficit at the end of the 10-year period. (See fig. 1 for the single-employer program's projected net financial position for fiscal years 1998 to 2007.)

Figure 1: PBGC's Single-Employer Program's Projected Net Financial Position, 1998-2007



Source: PBGC.

⁶PBGC categorizes claims it expects in the near future from underfunded plans sponsored by firms with weakening creditworthiness, including firms with below-investment grade bond ratings, as "reasonably possible exposure." PBGC reported \$21 billion to \$23 billion in reasonably possible exposure in its 1997 financial statements.

The assumptions used in making these projections are consistent with the assumptions used to estimate the present value of future benefits (PVFB) in PBGC's fiscal year 1997 financial statements. The average annual net claims and projected claims are in 1997 dollars. PBGC's rate of return on invested assets is assumed to be 6.18 percent, equal to the discount rate used to calculate PVFB. Assumed administrative expenses are consistent with PBGC's fiscal year 1999 budget. PBGC also included updated mortality assumptions in its projections. PBGC's 1997 financial statements received an unqualified opinion from its auditors, Price Waterhouse, LLP. The assumptions and data underlying the calculation of the PVFB are covered by this opinion.

PBGC used its Multiemployer Insolvency Projection Model (MIP) in its most recent 5-year examination of the multiemployer insurance program. According to PBGC officials, they do not prepare consolidated projected financial statements for the multiemployer program. Instead, MIP uses plan-specific historical data to determine whether a plan will become insolvent under a set of economic assumptions over a 15-year period based on 1992 data. For plans projected to become insolvent, it calculates the present value of the future financial assistance that would be required from PBGC. The model includes plans with the largest unfunded liabilities (which account for approximately 80 percent of total multiemployer plan underfunding), the largest plans in terms of total liability, and all plans identified in PBGC's 1994 financial statements as "reasonably possible" future insolvencies. For each plan, MIP projects such factors as the number of participants, contributions and other income, benefit payments, actuarial liabilities, assets, and funding requirements.⁷

PBGC's projections indicate that the multiemployer insurance program should remain financially strong and that the program's surplus, \$219 million in fiscal year 1997, should continue to grow under a wide range of economic scenarios and actuarial assumptions.⁸ Under the model's base scenario, the multiemployer

⁷The projections use one or more of 12 sets of assumptions such as expected retirement age, annual benefit rate increase, rate of return on assets, and whether there is a decrease in assets and an influx of new workers into a plan. Other scenarios change one or more of the model's 12 sets of assumptions to determine the effect of more conservative or pessimistic conditions.

⁸This approach differs from the unsophisticated forecasting methodology PBGC currently uses to generate the three forecasts for the single-employer program. In fiscal year 1999, PBGC intends to use a new approach to forecast the single-employer program's exposure to future claims under a wide range of future economic conditions.

program surplus will grow to \$566 million in 2007.⁹ Most plans in the model did not become insolvent during the projection period, and only six plans required PBGC's financial assistance under all scenarios. Under the most pessimistic scenarios, the multiemployer insurance program is projected to have a deficit in 2007. For example, a 20-percent annual decline in the number of multiemployer plan active participants would result in an insurance program deficit of about \$108 million in 2007.¹⁰ The largest projected deficits for the multiemployer program occur when declines in the number of active participants and the return on plans' assets are combined with large declines in the value of plan assets. However, in its 1996 report on the multiemployer program, PBGC reported that if such severe economic and demographic changes were to occur, both it and multiemployer plans would have sufficient lead time to address the changes.

THE FUNDING STATUS OF MANY PLANS HAS IMPROVED

The funding status of many single-employer plans has improved but underfunding, especially among a few large plans, continues.¹¹ Plans with funding ratios (percentage of assets accumulated to pay vested benefits) below 50 percent have accounted for 76 percent of PBGC's claims since 1975, while plans with funding ratios of 75 percent or better have accounted for only 3 percent of PBGC's claims. The percentage of plans that were at least fully funded improved from 58 percent in 1980 to 65 percent in 1995. Likewise, the percentage of covered participants in plans that were at least fully funded improved from 55 percent to 73 percent during the same period. Furthermore, as shown in table 1, the percentage of single-employer plan liabilities in plans that were at least fully funded also improved. The percentage of plan liabilities

⁹The model's base scenario assumes a continuation of the plan's recent experience and includes the plan actuary's assumptions.

¹⁰For an adequate contribution base, plans primarily depend on new employers joining or existing employers staying in and hiring new workers. Continued erosion in contribution bases could eventually result in insufficient contributions to pay all benefits under current funding rules for some plans. This could increase the number of plans requiring financial assistance.

¹¹Some plans that had previously been fully funded recently became underfunded as a result of the decline in interest rates. Other plans continue to incur new benefit liabilities before old ones are fully funded, thereby leaving the plans chronically underfunded.

in fully funded plans increased from about 46 percent in 1980 to 77 percent in 1995.¹²

Table 1: Percentage Distribution of Single-Employer Plan Liabilities by Funding Ratio

	1980	1985	1995
Percent funded			
Less than 25	0.69	0.33	0.04
25 to 49	5.54	1.97	0.20
50 to 74	21.95	6.62	3.63
75 to 99	26.05	13.08	18.79
100 to 124	25.76	20.26	39.40
125 to 150	9.67	25.45	24.83
More than 150	10.33	32.31	13.13
Underfunded	54.23	21.99	22.65
Fully funded	45.77	78.01	77.35

Source: PBGC compilation of reported annual plan data.

The funding levels of multiemployer plans have also improved. In 1980, multiemployer plans as a group reported a funding ratio (ratio of accumulated assets of all plans to the sum of their estimated vested liabilities) of 77 percent. In its most recent 5-year report on the multiemployer program, PBGC reported

¹²The data in the table have several limitations and caution should be used when trying to assess trends over time. First, the data are from plans with 100 or more participants and are based on different liability definitions. Second, changes in interest rates can affect plans' liabilities. The interest rates used to value plan liabilities varied substantially over time. Third, the mortality assumption was set by the plan actuary in 1980 but standardized in 1995. Finally, legislative changes have also affected plan funding levels by restricting the range of assumptions that plans' actuaries can use when valuing plan liabilities and restricting the maximum funding limits on tax-deductible contributions to fully funded plans.

that by 1994, the overall multiemployer plan funding ratio had increased to 105 percent. As shown in table 2, in 1995, about 60 percent of multiemployer plans were fully funded while 40 percent were underfunded. Nearly 44 percent of participants and 41 percent of liabilities were in plans that were fully funded. In addition, another 41 percent of participants and liabilities were in plans that were 75-to-99 percent funded. As PBGC noted in its 1997 annual report, the financial condition of multiemployer plans will depend on future economic and demographic factors such as interest rates, investment performance, and employment levels in covered industries.

Table 2: Distribution of Multiemployer Plans by Funding Ratio

	Number of plans	Percent of plans	Number of participants	Liabilities (dollars in millions)
Percent funded				
Less than 25	1	0.06	4,030	\$39
25 to 49	16	0.94	53,674	1,436
50 to 74	103	6.07	1,260,367	33,621
75 to 99	564	33.25	3,488,068	87,001
100 to 124	722	42.57	2,561,422	64,837
125 to 150	222	13.09	991,397	16,534
More than 150	68	4.01	164,276	3,072
Total	1,696	100.00	8,523,234	\$206,541
Underfunded	684	40.33	4,806,139	\$122,098
Fully funded	1,012	59.67	3,717,095	\$84,443

Note: Data include only plans with 100 or more participants and are subject to the other limitations explained in footnote 7. Because of rounding, individual numbers may not equal totals.

Source: PBGC, as reported in 1995 plan data.

PBGC'S INVESTMENT STRATEGY

Significant returns on investments are a key factor contributing to PBGC's improved financial condition. At the end of fiscal year 1997, PBGC reported having about \$15.6 billion in assets available for investment—\$9 billion from premiums and \$6.6 billion in assets from terminated plans.¹³ PBGC's investment policy is "geared primarily to maximizing investment return within acceptable levels of risk." (See the enclosure for a copy of PBGC's Investment Policy Statement.) As shown in table 3, 61 percent of PBGC's assets are in fixed income investments (including cash), with the remaining assets in equities and real estate. Overall, PBGC's annual rate of return was 21.9 percent for fiscal year 1997 and averaged 14.4 percent over the past 5 fiscal years. The fixed income assets experienced an annual rate of return of 13.5 percent during fiscal year 1997 and 10.9 percent over the past 5 fiscal years, while equity investments had an annual rate of return of 37.6 for fiscal year 1997 and 20.6 percent over the past 5 fiscal years.

Table 3: PBGC's Investment Performance as of September 30, 1997

Investment type	Assets (dollars in millions)	Percent of assets	Annual rates of return		
			Fiscal year	Three years	Five years
Equities	\$6,099	39	37.6	29.2	20.6
Fixed income	9,474	61	13.5	12.4	10.9
Total	\$15,573	100	21.9	17.9	14.4

Source: PBGC.

¹³Under the law, premium receipts must be invested in fixed-income securities. Current PBGC policy is to invest these funds only in Treasury securities. The remaining assets are invested primarily in the stock market.

B-281686

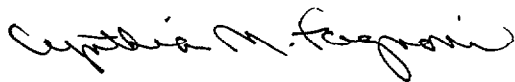
AGENCY COMMENTS

We asked PBGC's Executive Director and Chief Financial Officer to review a draft of this correspondence. They provided technical comments, which we have incorporated as appropriate.

As arranged with your office, we will make copies of this correspondence available to those who are interested.

If you have any questions about this information, please contact me on (202) 512-7215. Major contributors are Francis P. Mulvey, George A. Scott, and Michael D. Packard.

Sincerely yours,



Cynthia M. Fagnoni
Director, Income Security Issues

Enclosure

11/09/94

PENSION BENEFIT GUARANTY CORPORATION
INVESTMENT POLICY STATEMENT

Introduction

Pension Benefit Guaranty Corporation ("PBGC") is a federal agency which operates both like a financial guaranty insurance company and a pension plan. PBGC insures the pension benefits of a corporation's employees if a company sponsoring an underfunded defined benefit pension plan becomes insolvent. PBGC becomes trustee of the plan and its assets, and is then responsible for investing those assets and paying benefits to the plan's participants.

PBGC's environment is dynamic. The philosophy incorporated herein is to allow for sufficient flexibility in the management process to capture investment opportunities as they may occur, yet set forth reasonable parameters to ensure prudence and care in the execution of the investment program.

Investment Policy and Objectives

PBGC shall discharge its asset management duties so as to best provide and administer termination insurance benefits to participants and their beneficiaries and to maintain premiums at the lowest level consistent with Title IV of ERISA. Investment decisions will be geared primarily to maximizing investment return within acceptable levels of risk.

Responsibility

PBGC's Executive Director is responsible to PBGC's Board of Directors for management of PBGC's investable assets. The Chief Financial Officer is responsible for stewardship of the assets and implementing the investment policy.

Asset Allocation

Assets will be primarily invested in equities and fixed income securities in a manner consistent with all legal and program restrictions. The asset allocation decision will be based upon a desire for sound long term performance. PBGC seeks to produce a return on investment which is based upon levels of liquidity and investment risk that are prudent and reasonable, given prevailing capital market conditions. While PBGC recognizes the importance of preservation of capital, it also adheres to the theory of capital market pricing which maintains that varying degrees of investment risk should be rewarded with compensating returns. Thus, prudent risk-taking is justifiable.

For asset allocation purposes the single-employer and multi-employer funds may be treated as one fund. The Revolving Fund will be invested in U.S. Treasury securities. Trust Fund assets are discretionary and may be invested in various securities such as domestic and international equities and fixed income assets and real estate. Real estate will be limited to 5 percent of the portfolio; in the event PBGC inherits real estate in excess of 5 percent, such assets may be liquidated at a prudent pace. When practical, investment in companies representing contingent liabilities will be avoided.

Investment Manager Selection

Discretionary investments (e.g. equity, fixed income, real estate) will be managed by external professional money management organizations. PBGC will select these external managers based upon their demonstrated experience and expertise, so that their investment styles collectively will implement the planned investment strategy. Managers will invest assets within the guidelines established by PBGC. The investment management firms selected will be accountable for their implementation of the guidelines as defined and periodically refined by PBGC.

The characteristics of the asset management function will change over time. It will be necessary to plan and preserve a degree of flexibility in the asset management program in order to permit a change in its investment posture in response to changes in circumstances. Changes in managers will be made carefully to assure that each change will, in fact, be an improvement.

Performance will be judged against specified performance objectives. PBGC will be limited in achieving targeted long-term investment management performance results by the returns available in the various securities markets. Within this limitation, PBGC will seek to maximize its total return from its asset management within an acceptable level of risk. Investment management fees should be designed to fairly compensate the managers for their services as well as minimizing the cost to PBGC. Fee arrangements may be flat, asset-based and/or performance based.

Advisory Committee

PBGC's Advisory Committee advises PBGC's Executive Director on investment activities. Periodically the Advisory Committee will meet with each external investment manager. They will also advise on the selection of new managers and changes in investment policies.

Reporting Requirements

Monthly investment reports will be prepared by PBGC. Investment performance reports will be prepared for each Advisory Committee Meeting. An annual report on investment results will be submitted by the Executive Director to the Board of Directors.

Cost Management

PBGC will seek to control costs when administering the investment program without sacrificing quality and/or superior performance. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs, and other administrative costs related to the investment program.

Specific Investment Guidelines

1. Each manager will have specific investment objectives and guidelines specifying acceptable investment instruments and practices.
2. If practicable, fixed income and equity investment in contingent liability companies will be avoided.
3. Options and futures may be used, within specific guidelines, to hedge assets, liabilities or contingent liabilities.
4. Securities lending is allowed.
5. Margin buying is prohibited unless part of a specific hedging program.
6. A commission recapture program may be employed.
7. Proxy voting is the responsibility of the each investment manager. Managers will report at least annually their voting record to PBGC.
8. PBGC may purchase annuities with Trust and Revolving Funds to pay benefits.
9. Limited marketability assets received from terminating plans or the settlement of PBGC's claims will be liquidated as soon as feasible.

September 28, 1994

3

(207051)

Ordering Information

The first copy of each GAO report and testimony is free. Additional copies are \$2 each. Orders should be sent to the following address, accompanied by a check or money order made out to the Superintendent of Documents, when necessary. VISA and MasterCard credit cards are accepted, also. Orders for 100 or more copies to be mailed to a single address are discounted 25 percent.

Orders by mail:

**U.S. General Accounting Office
P.O. Box 37050
Washington, DC 20013**

or visit:

**Room 1100
700 4th St. NW (corner of 4th and G Sts. NW)
U.S. General Accounting Office
Washington, DC**

**Orders may also be placed by calling (202) 512-6000
or by using fax number (202) 512-6061, or TDD (202) 512-2537.**

Each day, GAO issues a list of newly available reports and testimony. To receive facsimile copies of the daily list or any list from the past 30 days, please call (202) 512-6000 using a touchtone phone. A recorded menu will provide information on how to obtain these lists.

**For information on how to access GAO reports on the INTERNET,
send an e-mail message with "info" in the body to:**

info@www.gao.gov

or visit GAO's World Wide Web Home Page at:

<http://www.gao.gov>

**United States
General Accounting Office
Washington, D.C. 20548-0001**

**Bulk Rate
Postage & Fees Paid
GAO
Permit No. G100**

**Official Business
Penalty for Private Use \$300**

Address Correction Requested
