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DEFINED BENEFIT PENSIONS: Hidden Liabilities From Underfunded Plans and Potential New Obligations Confront PBGC

Statement of
Joseph F. Delfico, Director
Income Security Issues
Human Resources Division

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Committee on Government Operations
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SUMMARY OF GAO TESTIMONY GIVEN BY JOSEPH F. DELFICO

**DEFINED BENEFIT PENSIONS:
HIDDEN LIABILITIES FROM UNDERFUNDED PLANS
AND POTENTIAL NEW OBLIGATIONS CONFRONT PBGC**

The Pension Benefit Guaranty Corporation (PBGC) currently insures benefits of almost 40 million participants in about 95,000 defined benefit pension plans. The PBGC currently has a deficit of about $2 billion but is facing another $14 billion in claims from plans of financially troubled sponsors. The PBGC should have sufficient assets to cover its benefit obligation in the short-term. This testimony makes the following points.

-- The largest source of future liabilities to the PBGC comes primarily from a few seriously underfunded plans. Most of these are flat benefit plans that provide a specified monthly dollar benefit per year of service.

-- It is difficult to accurately estimate the PBGC's future liability. A plan's liability to terminate is often greater than reported to the Internal Revenue Service in annual filings because

  - actuarial assumptions used by the PBGC to value liabilities differ from those used by the plan
  - the incidence of early retirement can be greater in a terminated plan than the plan anticipated for an ongoing plan or
  - benefit increases.

  Plan assets may be lower at termination than reported because

  - the plan sponsor paid benefits to retirees but failed to make contributions to the plan or
  - the value of assets held by the plan fell.

  In addition, PBGC's future liabilities are difficult to estimate because it is hard to determine which underfunded plans will terminate.

-- Recent bankruptcy court rulings and legislative proposals to extend the PBGC coverage to new classes of beneficiaries may raise PBGC's future deficit.

-- The PBGC should be able to pay its benefit obligations in the short run without assistance from the federal government.

-- Several options are available to lessen the size and impact of future claims against the PBGC, but these options are not cost-free. One group or another will have to bear the costs.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss some of the financial problems facing the Pension Benefit Guaranty Corporation (PBGC). My discussion is based in part on preliminary results from our work for this Subcommittee on how hidden liabilities affect the PBGC. We expect to issue our final report on this work early next year.

My testimony conveys four ideas. First, the current threat to the PBGC comes primarily from a few seriously underfunded plans in industries experiencing financial troubles. These plans often contain hidden liabilities when they terminate. Second, it is very difficult to estimate PBGC's future liabilities because of difficulties in predicting if or when underfunded plans will terminate and what a plan's financial position might be at termination. Third, recent bankruptcy court decisions on PBGC's recovery claims and proposed legislation to extend PBGC's coverage to new classes of beneficiaries raise the prospect of increased obligations for the PBGC to pay in the future. And finally, despite these potential problems and its current deficit, the PBGC should have sufficient assets to cover its benefit payments.

If the Congress wants to stabilize PBGC's financial condition, legislative action may be required. I identify several general policy options affording such protection that the Congress might want to pursue.

BACKGROUND

The Employee Retirement Income Security Act of 1974 (ERISA) established vesting and funding standards for private sector pension plans.[1] Because many plans were underfunded at that time, some by hundreds of millions of dollars, they were allowed to amortize the then current underfunding over 40 years. This 40-year period is not yet half over, and much of this initial underfunding remains.

ERISA also established an insurance program, administered by the PBGC, to pay benefits to participants of underfunded defined benefit plans that terminated.[2] Today, the insurance program covers almost 40 million participants in about 95,000 ongoing plans. The PBGC guarantees benefit payments up to a maximum level ($2,250 per month in 1991).

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[1]ERISA established minimum periods of service and requirements that plan participants need to meet to have a nonforfeitable right to benefits earned while enrolled in the plan. These requirements are known as vesting standards. Funding standards define the minimum (and maximum) contributions that must be (may be) made to the plan by the plan sponsor to ensure that pension promises will be honored.

[2]A defined benefit plan is one in which benefits are based on a formula that uses participant earnings and/or years of service as inputs.

The PBGC was given no permanent initial start-up assets, although it received a $100 million line of credit with the U.S. Treasury. All its assets have accumulated since its establishment. PBGC funding comes from assets of terminated plans, premiums paid by sponsors of all insured defined benefit pension plans, recoveries from the sponsors of terminated plans through bankruptcy proceedings, and earnings on PBGC assets.

Prior to ERISA, when companies would not or could not live up to their pension promises, plan participants lost the benefits to which they were entitled. ERISA has shifted the burden of underfunded terminated plans from the plan's participants to the PBGC and, through premiums, to sponsors of other insured pension plans.

From 1975 to September 30, 1990, the PBGC incurred benefit payment liabilities of $7.1 billion from 1,576 terminated plans covering 310,000 participants.[3] Three plans, with $3.4 billion in benefit payment liabilities and 101,000 participants, were subsequently returned to the plans' sponsor. PBGC's deficit on September 30, 1990 was only $1.8 billion[4] because these liabilities were offset

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[3]The GAO has been unable to audit the financial statements of the PBGC because of financial system deficiencies and internal control weaknesses. Most of the data in this testimony are, or are based on, unaudited data provided by the PBGC.

[4]This figure includes the unfunded liabilities of 34 plans the PBGC carried on its books as probable terminations.

by assets from terminated plans, recoveries from plan sponsors in bankruptcy court, earnings on assets, and income from premiums.

PBGC RISK COMES FROM A FEW LARGE PLANS

While most plans the PBGC insures report assets sufficient to cover their accrued liabilities, several thousand plans report they are underfunded. The PBGC estimates that about $40 billion of underfunding currently exists in the ongoing plans it insures. Much of this underfunding is from large flat benefit plans, the least well-funded of all types of defined benefit plans.[5]

On February 25, 1991, the PBGC made available its list of the "Top 50" corporations with underfunded defined benefit pension plans. The underfunding in the plans of these 50 corporations was $14.2 billion, more than one-third the total estimated underfunding. Indeed, the three corporations with the largest underfunding had promised their workers $6.7 billion more in benefits than they had set aside to pay these benefits. These three corporations alone are responsible for almost 17 percent of PBGC's estimated potential liabilities.

Fortunately, not all corporations with underfunded pension plans are in imminent danger of going bankrupt. The PBGC estimates that

[5]In a flat benefit plan, the participant receives a specified monthly dollar benefit for each year of service. In a salary-based plan, the monthly benefit is a percentage of final or career salary, usually multiplied by years of service in the plan.

about $14 billion of the $40 billion in underfunding is in plans sponsored by financially troubled employers. These plans pose the greatest current risk of increasing the PBGC's $1.8 billion deficit.

PROBLEMS MEASURING PBGC's POTENTIAL LIABILITY

PBGC's potential liability is difficult to estimate. The unfunded liabilities reported by plans on their annual filings with the Internal Revenue Service (IRS) are often lower than would actually arise if they terminated. We define "hidden liability" as the additional underfunding that appears when a plan terminates.

Accurately predicting which sponsors of underfunded plans will go bankrupt and leave their pension obligations with the PBGC is also a difficult task. Because of these factors, the potential liability facing the PBGC may be larger than the $40 billion it currently estimates.

Hidden Liability

Our ongoing study of hidden liabilities reviews 44 plans that terminated in 1986-88 with unfunded liabilities of $1 million or more.[6] These 44 plans were responsible for 95 percent of the

[6] Three of these plans were returned subsequently to their sponsor, but continue to pose a risk to the PBGC. The largest of these plans, with $1.6 billion in estimated unfunded liabilities, may

claims against the PBGC for this 3-year period and 42 of them had a hidden liability. Hidden liabilities accounted for 37 percent of the claims against the PBGC from these 44 plans ($991 million of $2,689 million).[7]

A hidden liability can arise both because the PBGC calculates a larger plan liability than the plan and because the PBGC receives fewer assets than reported by the plan. Thirty of the plans in our study had both higher liabilities and lower assets at termination than they reported on their final, pretermination annual filing with the IRS. Increases in plan liabilities as calculated by the PBGC accounted for 80 percent of the hidden liability and decreases in assets for the other 20 percent. Because of the numerous contributing factors, it is difficult to estimate how large a given plan's hidden liability will be. This adds to the problem of accurately estimating PBGC's potential liabilities.

Liability increases

Plan liabilities can be higher at termination than reported for a number of reasons. Primarily this results from PBGC's use of

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terminate again before year's end.

[7]The claim against the PBGC reflects PBGC's valuation of the liabilities and assets it receives from terminated plans.

30 years. Anticipated salary increases are often incorporated when determining the liabilities of salary-based plans, but flat benefit plans cannot anticipate increases in the specified monthly dollar benefit. Negotiated plans, which tend to be flat benefit plans, frequently increase benefits when the labor contract is renegotiated. Because these plans cannot anticipate the benefit increases, they tend to be chronically underfunded. Should they terminate, other plan sponsors, through PBGC premiums, will have to honor their increased pension promises.

Asset reductions

Plans often have less assets at termination than reported to the IRS because plan sponsors continue to pay benefits to retirees, while failing to make required contributions to the plan. In our ongoing study, we found that 20 percent of the claims against the PBGC were from unpaid contributions. Only one of the 44 plans reviewed was not in arrears in its sponsor's contributions at termination.

It is easy to understand why a financially troubled business owner might elect not to make a contribution to the pension plan if he or she feels his or her choices are making the contribution and going bankrupt or using the money for other business expenditures to try to keep the company afloat. It is especially easy to understand if one realizes that, regardless of the owner's choice, the pensions of workers are guaranteed by the PBGC. Most of the plans in our study terminated prior to the passage of the Omnibus Budget Reconciliation Act of 1987 (OBRA 87). OBRA 87 allows the PBGC to place a lien against business assets when unpaid contributions exceed $1 million. This provision may reduce the incentive of large companies to forego making contributions to their pension plans.

Further, plan assets can be less at termination than reported amounts if plans experience investment losses on their assets, plan sponsors raid the plans' assets to pay business or other expenses, or plans overstate the value of reported assets. Sponsor raiding of pension assets is illegal and does not seem to be a significant problem, especially in large plans where the pension plan is managed by an independent fiduciary. We do not know to what extent the over-reporting of asset values is a problem because plan audits, required yearly in plans with 100 or more participants, are usually of limited scope and infrequently verify the value of assets plans claim to own.

Predicting Bankruptcies

The plans the PBGC takes over usually terminate when the plan's sponsor goes bankrupt. However, the bankruptcy of a sponsor does not always lead to the termination of the sponsor's plans. It is very difficult to predict if a financially troubled company will go bankrupt (some limp along for years), even harder to predict when, and harder still to predict if the pension plan will terminate.[8] The PBGC has recently established a division whose purpose is to identify sponsors in financial difficulty, to monitor these sponsors, and to take action to avoid major financial losses.

OTHER UNCERTAINTIES MAY INCREASE PBGC's LIABILITIES

Two additional issues create uncertainty about the magnitude of the potential liability facing the PBGC. First, bankruptcy courts do not treat PBGC claims uniformly, making it difficult to estimate PBGC's recoveries and potential net claims. Second, pending legislation would require the PBGC to insure two new classes of beneficiaries. These issues increase the prospect that the PBGC will have increased funding difficulties in the future.

Bankruptcy Court Rulings

ERISA provides that the PBGC shall have a priority claim in bankruptcy court for missed premiums and contributions and for a portion of the plan's underfunding. These ERISA provisions are not written into Chapter 11 of the bankruptcy code, however. Some bankruptcy judges honor the ERISA provisions; others do not. This

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[8]The PBGC recognizes this difficulty by making three financial forecasts, which are based on different assumptions about future claims against the agency.

makes it difficult to estimate what portion of plan underfunding is likely to be recovered from the plan's sponsor in bankruptcy court. A recent decision in the U.S. District Court for the Southern District of New York is an example of this problem.[9]

PBGC would prefer to have a higher standing in bankruptcy court. One can argue that sponsors who make pension promises should be the ones to fulfill those promises. If they do not adequately fund their pension plan, then sponsor assets should be appropriated for this purpose. However, the sponsors have also made promises to their other creditors. These other creditors, being understandably more concerned about protecting their own interests, do not favor increasing PBGC's standing in bankruptcy. Also, if PBGC's standing is increased, sponsors of underfunded plans may find it more difficult to obtain credit.

Coverage of New Classes of Beneficiaries

Legislation has been introduced in the Congress to require the PBGC to insure two classes of beneficiaries it has not insured in the past. These are insurance annuitants whose pension benefits were insured by the PBGC before the plan sponsor terminated the plan and

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[9]This decision upheld an earlier bankruptcy court ruling that PBGC's claims against a debtor employer for pension plan underfunding are not entitled to priority treatment in a Chapter 11 bankruptcy. It also ruled that the bankruptcy court, and not the PBGC, could set the interest rate used to value the pension liability.

converted benefits into annuities and participants whose plans terminated prior to the enactment of ERISA. In the first instance, the PBGC would pay benefits only if the insurance company issuing the annuity failed and a state guarantee fund or other entity did not pay the annuity. In the second, the PBGC would be required to pay participants as they are identified and proved qualified. The administrative burden to the PBGC of this second proposal would be substantial. In neither case have premiums been collected to pay for the proposed benefits.

CONCLUDING OBSERVATIONS

The PBGC is at risk of incurring additional liabilities, primarily from the potential termination of a few identified large, underfunded pension plans. Its annual premium income of some $700 million is currently sufficient to meet its benefit and administrative expenses. However, a substantial increase in PBGC's benefit obligations could overwhelm its premium income and eventually exhaust its assets. In my view, this is unlikely to occur in the short run. The PBGC should have sufficient assets to cover its benefit obligations in this decade and perhaps for several decades.

In the event the PBGC is unable to pay benefits, the federal government would not have to redeem its entire deficit at once.[10] PBGC's liabilities comprise the future benefit payments of terminated plans. Many of the participants in these plans will not reach retirement age for several decades, and then their benefits will be paid over a period of decades. Any federal assistance would only need to cover the benefits and administrative expenses that are payable in a given year.

Legislative action may be required to protect the PBGC from this. Several options are available to lessen the size or impact of future claims against the PBGC. Four options, each involving costs to some group, follow. The Congress could

-- reduce the level of benefit protection currently afforded plan participants. Such a reduction could involve a freeze on the guaranteed maximum benefit level, a minimum age requirement of 55 (or even 65) for PBGC payment of benefits, a PBGC-imposed actuarial reduction on benefits it pays before age 65, or any of numerous other possibilities. A reduction in protection will lower lifetime benefits paid to some or all PBGC payees, however.

-- strengthen pension funding requirements for underfunded plans again to increase pressure on plan sponsors to honor their

[10]Under ERISA, the PBGC has only a $100 million line of credit at the U.S. Treasury. This is the current extent of the federal government's obligations to the PBGC.

pension promises. Such action would lower federal corporate tax revenues because contributions are a tax-deductible expense. Also, some plan sponsors may be financially unable to meet the tougher funding guidelines and may be forced to terminate their plan.

-- raise premiums again. Premiums are also a tax-deductible expense. Corporate tax revenues would fall, but total federal revenues would increase because the premiums themselves are a form of federal revenue. The increased premium may lead some plan sponsors to terminate their well-funded defined benefit plans and substitute defined contribution plans because they may feel the administrative costs of maintaining defined benefit plans have become too high. Sponsors of some underfunded plans may terminate them if they cannot afford to pay the additional premiums.

-- clarify the law to give PBGC claims a better standing in bankruptcy court. This would allow the PBGC to increase recoveries from sponsors who failed to adequately fund their pension promises. This change would reduce the assets available to satisfy claims of other creditors, however, and it may have a negative impact on the sponsors' ability to obtain credit.

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

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