Evaluation of defined benefit pension plan termination policy must recognize the often competing interests of involved parties. Policy addressing the concerns of one party may have unwanted repercussions on others.

PBGC and Pension Plan Termination Policy

The Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272), recently signed by President Reagan, establishes a new termination policy for defined benefit pension plans. The new law links an increase in the premium paid by single-employer plans to the Pension Benefit Guaranty Corporation (PBGC) with reforms in PBGC’s pension insurance program, and is designed to mitigate increasing underfunded plan terminations and relieve PBGC’s deficit. Some of the law's provisions are controversial, and the ultimate effects remain largely unknown.

While the new law represents the culmination of years of attempts to financially and structurally stabilize the U.S. pension insurance program, policymakers continue to study options for longer-term system improvement. Continuing debate over underfunded plan terminations is likely to address such questions as: What are the appropriate levels of benefit protection? How might the premium rate and structure be changed to more fairly distribute costs? Should employer liability upon plan termination be greater? Is funding waiver policy contributing to underfunded terminations? Is privatization of pension insurance viable?

Policymakers are also addressing options in asset reversion policy. Some argue participants can suffer losses in the value of their pension benefit because accrued benefits are locked in at their nominal value at plan termination and that the “excess” funds ethically belong to plan participants. Others contend that employers are entitled to pension funds in excess of legally promised benefits, and if the assets are used to help an employer overcome financial difficulties, participants may face less severe losses than if layoffs or plant closings occurred.

Reforms in termination policy may involve tradeoffs. A risk-related premium structure may make the system fairer to plan sponsors, but may harm participants if poorly funded plans terminate. Excessive restrictions on terminations to recover excess plan assets could discourage, rather than encourage, defined benefit plan sponsorship. Allowing excessive withdrawals, however, could undermine sound funding and imperil participants’ benefits.
Introduction

The Employee Retirement Income Security Act (ERISA) established a benefit insurance system to protect plan participants and beneficiaries in defined benefit pension plans should a plan terminate with insufficient assets to pay promised benefits.

Prior to the passage of ERISA in 1974, pension plan participants were unprotected if plan sponsors failed to meet their pension promises upon plan termination. The Studebaker pension plan, terminated in 1963, was just 60 percent funded for promised benefits, and more than 4,000 participants lost some or all of their vested pensions. A 1972 study by the departments of Labor and Treasury found that out of 42,000 participants in 1,200 terminated plans, 19,400 lost all or more than one-half the value of their pension. Clearly, pension plan terminations could be detrimental to the retirement income security of participants. Partly in response to this situation, Congress passed ERISA.

As provided under Title IV of ERISA, the single-employer insurance program, officially titled “plan termination insurance,” is administered by the Pension Benefit Guaranty Corporation (PBGC), which was created as an independent, self-financing, wholly-owned government corporation. PBGC maintains a separate insurance program covering participants in multiemployer plans—plans maintained by employers pursuant to a collective bargaining agreement and usually jointly administered. The discussion that follows in this Issue Brief will be restricted to termination policy and issues related to single-employer plans.

Although PBGC is chartered by the federal government, it receives no appropriations from Congress. The termination insurance program is financed primarily through premiums paid by defined benefit plan sponsors.

In the last several years, the single-employer benefit insurance program has come under close scrutiny. The number and size of claims against PBGC have surpassed projected levels, and PBGC’s accumulated deficit now equals $1.3 billion. Most observers agree that a large portion of PBGC’s financial predicament has been the result of the ability of employers to “dump” their pension plan liabilities onto PBGC and thereby escape the responsibility of paying benefits.

Until recently, employers could terminate a pension plan at their own discretion. If the plan lacked sufficient assets to pay promised benefits, PBGC became responsible for paying a level of benefits guaranteed by the insurance program. Although PBGC was entitled to collect a certain amount from the employer to help pay benefit obligations, the employer’s liability was limited, and PBGC often recovered little. Although the premium rate more than doubled in 1977 (to $2.60) from the original 1974 level, the income has not been sufficient to finance increasing insurance claims.

PBGC has petitioned Congress every year since 1982 for a premium increase and for concurrent program reforms to end dumping and other structural weaknesses that many argue have burdened the system, but each year legislation has failed. Controversy surrounding the appropriate way to correct the problems in the insurance system have, until now, made resolution of PBGC’s fiscal problems politically unachievable.

The Consolidated Omnibus Budget Reconciliation Act of 1985 (P.L. 99-272), recently signed by the president, seeks to respond to structural flaws in the single-employer insurance program and relieve PBGC’s fiscal problems. This Issue Brief describes single-employer plan termination policy as set forth in the new law and describes trends in underfunded terminations since the passage of ERISA in 1974. Areas of continuing debate in underfunded plan termination policy are also examined, including alternative premium schedules, the extent of employer liability, and privatization of pension insurance.

In addition, this Issue Brief examines pension plan terminations in which plan assets in excess of those required to pay benefits are recovered by the employer—commonly referred to as asset reversions—and describes the legal provisions of these “overfunded” terminations, discusses recent trends in these terminations, and examines continuing issues in reversion policy.

Finally, because pension plan funding is an integral part of any analysis of plan termination policy, this Issue Brief highlights current legal funding obligations and analyzes recent trends in funding levels.

PBGC Provision of Benefit Insurance

Plans Covered

In general, PBGC benefit insurance covers private defined benefit plans that are tax-qualified or that have, in practice, met IRS qualification standards for the preceding five years. Pension plans not covered include plans sponsored by governments, churches, and certain fraternal societies; plans maintained outside the United States for non-U.S. citizens; and unfunded, non-tax-qualified plans.

PBGC’s insurance coverage does not extend to defined contribution plans. The obligations of these plans, by their nature, are not suitable for insurance. Defined contribution plans resemble individual savings accounts. Employers contribute a specified amount of money to each participant’s account. The final benefit depends on the contribution amount and the rate of return on the investment. In defined contribution plans, legal obligations are fulfilled on a current basis, as required contributions are made. Should a defined contribution plan terminate, the employer incurs no future benefit.

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1 PBGC, unpublished.
obligation.

Under a defined benefit plan, the employer promises a specified benefit to plan participants at retirement. Typically, the amount of the benefit is based on the participant's pay, years of service, and age at retirement. After a specified number of years of service, the participant becomes "vested," or obtains nonforfeitable rights to the pension benefit. To meet these pension promises, the employer contributes money to a pension fund, which will then pay out future benefits.

Should a defined benefit plan terminate, the employer must fulfill those future promised benefits. If investment returns are lower than expected or the plan was underfunded for future benefits, the fund may have insufficient assets to pay the obligations. ERISA's plan termination program insures the ultimate payment of benefits regardless of these circumstances.

**PBGC Premiums**

PBGC is funded primarily by mandatory premiums paid by all sponsors of covered plans. The premium is a flat rate per participant per year. Therefore, the total premium amount due from a plan sponsor equals the premium rate times the number of participants in the plan. The original premium rate set by ERISA for single-employer plans was $1.00 per participant per year. Under ERISA, PBGC must obtain congressional approval to raise the premium rate. In response to increases in claims against PBGC, Congress raised the rate to $2.60 in 1977. Despite increases in claims and requests by PBGC to raise the premium rate further, Congress did not approve another increase until the 1985 Budget Reconciliation Act raised the premium to $8.50 per participant for plan years beginning after December 31, 1985. By that time, PBGC had accumulated a deficit of $1.3 billion. Current law continues to require congressional action to raise the premium rate.

**Benefits Insured**

Generally, ERISA requires PBGC to insure "basic" vested benefits up to a maximum (benefits that vest solely due to plan termination are not insured). PBGC is also authorized to insure "nonbasic" benefits but has not opted to do so.

ERISA does not define "basic" benefits. Under PBGC regulations, basic benefits include any vested retirement benefits including cost-of-living adjustments (COLAs) that became effective prior to plan termination and any death, survivor, or disability benefit that was owed or was in payment status at the date of plan termination. Nonbasic benefits include retiree medical insurance, death, and disability benefits not owed at the date of plan termination; lump-sum and special supplemental monthly benefits designed to encourage early retirement or ease the retirement transition; and COLAs becoming effective after the date of termination.

**Maximum Benefit**—The maximum monthly benefit payable by PBGC is the lesser of (1) a participant's average monthly earnings during the highest-paid five consecutive years or (2) a dollar limit, $1,789.77 in 1986, which is adjusted annually. ERISA established the following formula to determine the dollar limit for year Y:

\[
\text{Social Security taxable wage base for year } Y \times 1974 \text{ limit ($750)}
\]

When the 1977 Social Security Amendments mandated an increase in the Social Security taxable wage base for 1979 beyond that stipulated under the automatic increase schedule, the PBGC maximum benefit formula was adjusted to reflect what would have been the Social Security taxable wage base under pre-1977 law. The formula has not been changed since then. Table 1 shows historical PBGC maximum benefit amounts.

**Recent Benefit Provisions**—PBGC does not fully insure benefits promised by plans or plan amendments that have been in effect less than five years at termination. Benefits attributable to amendments include ad hoc COLAs provided by plan amendment, benefits arising from liberalization of vesting standards by amendment, and outright benefit increases by amendment.

Such recently promised benefits are insured only up to the greater of (1) 20 percent of the benefit for each year the plan or amendment has been in effect or (2) a $20 monthly benefit for each such year. In the case of a recently promised benefit that exceeds the overall PBGC maximum monthly benefit, insurance is limited to 20 percent of the new benefit covered by the guarantee, equal to $357.95 per month in 1986, for each year.

The law provides more stringent benefit limitations for sub-

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2 Ibid.
stantial owners of recently amended or adopted plans. Their benefit insurance is simply limited to one-thirtieth of benefits for each year those benefits have been in effect. Thus, full insurance is provided only for those benefits promised by plan provisions that predate the termination by 30 or more years. This policy is designed to prevent possible abuse of the benefit insurance system by employers anticipating a distress termination.

New Termination Policy

Prior to the passage of the 1985 Budget Reconciliation Act, plan sponsors could terminate a plan voluntarily at any time, regardless of the funded status of the plan. If the plan lacked sufficient assets to pay promised benefits, PBGC took over both the assets and liabilities of the plan. The sponsoring employer was then liable to PBGC for the lesser of unfunded liability or 30 percent of the employer's net worth. (Unfunded liability was defined as the difference between the fair market value of the plan's assets and the actuarial value of the guaranteed benefits.)

Many employers believed this provision of the law to be counterproductive. In cases where a plan's unfunded pension liability exceeded 30 percent of the employer's net worth, plan termination could be financially attractive. The employer could then shift, or "dump," a sizable portion of pension liability to PBGC and continue to operate as a profitable employer. The insured event, termination of an insufficiently funded plan, was under the control of the employer. The 1985 Budget Reconciliation Act seeks to alleviate this situation by prohibiting the termination of insufficiently funded single-employer plans, except when the employer is in financial distress, and by increasing the amount of liability placed on the sponsor of an insufficiently funded terminated plan.

Under the new law, only two types of voluntary terminations of single-employer plans are permitted: standard and distress terminations. A standard termination is permitted only if the plan holds sufficient assets to pay all "benefit commitments" under the plan. Benefit commitments are defined as all PBGC guaranteed benefits, all benefits that would be guaranteed if not for maximum benefit limits or phase-in rules, and early retirement supplements and plant-closing benefits that were vested before termination. Thus, benefit commitments include virtually all accrued basic benefits vested before termination and some accrued nonbasic benefits vested prior to termination. Although under ERISA all accrued benefits become vested at termination, benefit commitments do not include benefits that become vested solely due to plan termination.

Standard Termination

When a plan sponsor wishes to terminate a plan under a standard termination, the sponsor must notify PBGC at least 10 days prior to the date of termination. PBGC then determines whether the plan has sufficient assets to meet benefit commitments. If so, PBGC authorizes and oversees the distribution of those assets to participants and beneficiaries in accordance with priorities established by ERISA. Generally, those priorities are (1) benefit commitments, (2) other benefits vested prior to termination, and (3) accrued nonvested benefits (which under ERISA become vested at termination and must be paid if assets are available). If the plan holds assets in excess of those required to pay all accrued benefits, those assets may be recovered by the employer for discretionary use. Standard terminations in which excess assets are recovered are commonly called "terminations with asset reversion, or "asset reversions."

Termination with Asset Reversion—Under ERISA, employers cannot withdraw assets from an ongoing plan, even if the plan holds assets in excess of its current legal obligations. Because of this, employers have developed strategies by which they can terminate a plan containing excess assets, recover that excess, and continue coverage of their employees under a similar replacement plan.

In some instances, known as "spin-off" terminations, the plan would be divided into two plans—typically with one covering active participants and the other covering retirees and other beneficiaries. The excess assets would be placed in the beneficiary plan, which would then be terminated. Once annuities had been purchased to cover payments to beneficiaries, the remaining assets would revert to the employer.

In other instances, known as "termination/reestablishment" transactions, a plan is simply terminated with asset reversion and replaced immediately with an identical or similar plan. Use of these strategies to recover excess assets has spawned disagreement over what conditions constitute an actual plan termination. Some contend that such terminations with asset reversion are equivalent to withdrawal of assets from an ongoing plan, and as such are prohibited by law. This ambiguity was addressed by the joint issuance of guidelines on asset reversions by PBGC and the departments of Labor and Treasury in May 1984.

Reversion Guidelines—Under the administration guidelines, such terminations are recognized, and reversions are permitted if (1) annuities are purchased to pay all accrued benefits, (2) appropriate discount rates are used to calculate lump-sum distributions, (3) no similar termination has occurred within the preceding 15 years, and (4) certain funding methods are used in the ongoing (in the case of a spin-off) or replacement (in the case of a termination/reestablishment) plan. Approval of many terminations was held pending immediately prior to the issuance of the guidelines. When the guidelines were issued, PBGC began to process these cases.

Distress Termination

With the passage of the 1985 Budget Reconciliation Act, a plan that lacks sufficient assets to pay benefit commitments (as defined above) may be terminated only when the em-
ployer is in financial “distress.” To terminate a plan in a distress situation, the plan administrator must show that (1) a petition has been filed in bankruptcy or other state insolvency proceedings seeking liquidation of the employer, (2) a similar petition has been filed seeking reorganization of the employer and the bankruptcy court has approved the termination, (3) the employer will be unable to pay its debts when due, or (4) pension costs have become unreasonably burdensome due to a declining work force. The establishment of these requirements effectively changed the insured event for single-employer plans from termination of an insufficiently funded plan to insolvency of the employer sponsoring that plan.

Employer Liability—In a distress termination, the terminating employer is liable to PBGC and to plan participants for unfunded benefit commitments up to a maximum limit. The 1985 Budget Reconciliation Act increased the amount of this liability from original ERISA levels.

Under the law, an employer is liable to PBGC for the sum of (1) the full amount of unfunded PBGC guaranteed benefits up to 30 percent of net worth, (2) 75 percent of unfunded PBGC guaranteed benefits in excess of 30 percent of net worth, and (3) interest on the amount due calculated from the termination date. The full amount of employer liability is generally payable immediately, but liability in excess of 30 percent of net worth can be paid under “reasonable” terms determined by mutual agreement of the employer and PBGC.

The employer is additionally liable to plan participants for a portion of unfunded, nonguaranteed benefit commitments. That liability is limited to the lesser of (1) 75 percent of the unfunded, nonguaranteed vested benefit commitments or (2) 15 percent of total vested benefit commitments. Payments are made by the employer to a termination trust, which is administered by a PBGC-appointed fiduciary, under “reasonable” terms prescribed by the fiduciary. Benefits are paid to beneficiaries from the termination trust.

The new law also stipulates that if any party transferred benefit liabilities (through the sale of a company or spin-off of a division or subsidiary) to another party for the principal purpose of evading employer liability upon termination, and transfer occurred within five years of plan termination, then the original transferor is subject to employer liability.

◆ Who Is Affected by Pension Plan Terminations?

Three parties are directly affected by a plan termination: the active and retired participants, the employer, and PBGC. The effect of a plan termination on plan participants varies according to a number of factors, including the following.

Funding Level of Plan—If the terminating plan is sufficiently funded, all accrued benefits must be paid. However, if the plan does not have sufficient assets available to cover benefits, some accrued benefits may be lost.

Participant Expectations—Even if all accrued benefits are paid in full, plan participants may have counted on future benefit accruals. Such participant losses could be mitigated by generous offsetting provisions of a successor plan.

Replacement Plans—Terminated plans are often replaced by “successor plans.” A successor plan may be considered more generous by some participants and less generous by others. Generally, with no replacement plan, all employees are worse off, unless wages or other benefits are increased to offset the loss of pensions.

Financial Solvency of Employer—If an employer terminates a plan because the firm is about to go bankrupt, harm to active participants may be offset if the termination saves their jobs. Termination presumably always economically beneficial to the sponsoring employer, who otherwise would not terminate the plan and continue to accrue liabilities. The economic benefit to the employer varies according to the following factors.

Funding Level of Plan—If assets under a terminated plan are sufficient to pay all accrued benefits, any plan assets beyond that point can be recovered by the employer. The greater the excess assets, the more the employer benefits from termination. If the plan assets are not sufficient to pay benefit commitments, the sponsor of a terminating plan is faced with considerable liability both to PBGC and to plan participants.

Business Environment—If excess assets from a terminated plan are recovered, termination may provide the company with immediate cash flow, commonly used for capital investment or debt payment. Furthermore, if ongoing pension costs are reduced substantially, the financial position of the firm may be enhanced.

Successor Plans and Work-Force Reaction—If a successor plan is well-received by participants, morale and productivity may improve; if poorly received, they may decline.

The federal government is also affected by plan terminations. The Internal Revenue Code provides favorable tax status to pension funds, so the recovery of excess assets from those funds by employers may have tax implications. When terminating employers are unable to pay certain benefits, PBGC must pay guaranteed benefits, although these benefits are financed by all plan sponsors through mandatory premium payments.

Plan terminations may have indirect effects. Terminations may erode confidence in the pension system, thereby weakening the system. If terminations improve the financial condition of the terminating employer, other employers in the industry may be placed at a competitive disadvantage. If ter-
minations are necessary to remain competitive in the world market, however, they may preserve jobs and bolster the economy to the overall benefit of participants, employers, and the government.

◆ An Analysis of Funding Issues

What Is "Sufficient" Funding?

Prior to ERISA, pension plans were permitted to operate on a “pay-as-you-go” basis. Under such an arrangement, retirement benefits are paid directly from current operating revenues, as are wages and salaries. This type of arrangement works as long as the company’s revenues are sufficient to pay benefits (in addition to other costs) as they become due. A young or growing company typically has a small number of retirees relative to the number of active participants. In such a company, retirement payments would represent a small fraction of total operating costs. But if growth of the company slows, the number of retirees could grow relative to the number of active participants, and retirement payments could represent an increasingly large share of the total operating cost. Since payments to retirees add nothing to current productivity, these payments could become burdensome. If the company liquidates, benefit payments could cease.

When ERISA was drafted, legislators were concerned that pay-as-you-go pension plans jeopardized the retirement income security of participants. To ensure that pension promises could be fulfilled, ERISA required that defined benefit pension plans operate on a “funded” basis. This means that funds must be set aside for the exclusive purpose of paying benefits as they become due. The funds are set aside as the promises are made. The amounts set aside should be sufficient to provide for benefit payments. But what is meant by “sufficient” funding?

Termination Basis Funding—Until now in this Issue Brief, a plan has been called “sufficiently” funded if it meets the criteria for a standard termination, i.e., if the plan’s assets are sufficient to meet benefit commitments as defined by law. But legal benefit commitments do not include benefits that become vested solely due to plan termination. An employer is not permitted to recover excess assets from a terminated pension plan, however, until annuities are purchased to pay all accrued benefits, including those vesting solely due to termination.

A plan that holds sufficient assets to provide for the payment of all accrued benefits (through the purchase of annuities) is said to be sufficiently funded on a “termination basis.” Hence, the termination-basis sufficient funding level of a plan is simply the present value of all accrued benefits. A plan that holds assets in excess of that level is said to be “...erfunded” on a termination basis. If such an overfunded plan is terminated, the excess assets can be recovered by the employer.

The present value of accrued benefits (or the cost of annuities to pay them) depends on the benefit formula(s) of the plan and two actuarial factors: the expected future rate of return and the life expectancy of beneficiaries.

Ongoing Funding—It is important to distinguish between termination-basis sufficiency and a more general concept of appropriate funding in an ongoing plan. The termination-basis sufficiency level is mainly pertinent to actual plan terminations under current law.

Funding in an ongoing plan is geared to expected future liabilities. These liabilities, like those of a terminated plan, are determined by plan provisions and actuarial factors. But while termination liabilities depend on only two actuarial factors, ongoing future liabilities depend on many, including

- expected future rate of return on plan assets;
- life expectancy of beneficiaries;
- work force characteristics, present and future, including number of employees, age distribution, and rate of turnover;
- retirement ages; and
- wage and salary growth.

Both termination liability and ongoing future liability are affected by benefit formulas; ongoing future liability is also affected by vesting standards, retirement age provisions, and other plan provisions.

A Simplified Example—The level of funding appropriate for an ongoing plan may not be the same as the termination-basis sufficiency level. To illustrate this difference, consider an employer wishing to fund benefits for one typical employee. For simplicity, assume a benefit formula of 1.5 percent of final pay times years of service and assume a starting pay of $10,000 with 5.6 percent annual pay growth. Assume also that the typical employee is hired at age 35 in year 1, and that it is now year 10. Let the expected future rate of return be 6.8 percent and the employee’s life expectancy be 77 years. Finally, assume that the typical employee will retire at age 65.

4 This is the average annual percent increase in earnings forecast for the 30-year period 1986–2015 by the Social Security Administration under Alternative II-B assumptions.  
5 This is the average annual interest rate forecast for the 30-year period 1986–2015 by the Social Security Administration under Alternative II-B.  
6 This is the life expectancy for a 35-year-old (in 1982), according to the National Center for Health Statistics.
At the end of year 10, the employee's pay will be $17,244. Suppose that the plan is exactly sufficiently funded on a termination basis. Plan assets associated with the typical employee's benefit then equal $5,726. (Retirement benefits accrued are $2,587 annually, or $216 monthly. At a discount rate of 6.8 percent, the present value of this benefit payable at age 65 until death at 77 is $5,726.) If the plan is maintained another year, the benefit will have grown to $250 monthly, with a present value (at the end of year 11) of $7,078. If the employer wishes to make one contribution at the end of year 10 to remain at the termination-sufficiency level for that typical employee's benefit in year 11, that contribution would be $901.

In terms of the ongoing future liability, the typical employee would retire at age 65 at the end of year 30 with a benefit of $23,074 annually, or $1,923 monthly. To pay this benefit, assets of $190,017 would be needed at the end of year 30. Equal annual contributions from the end of year 10 until retirement would be $3,937, much larger than the $901 required to remain at the termination-basis sufficient level for another year.

Of course, the employer might opt for a funding schedule other than flat yearly contributions. But if smaller contributions are made now, larger ones must be made later. If the employer geared funding to remain at the termination-basis sufficient funding level, increasingly large contributions will have to be made each year that the plan is maintained, because increasing pay and tenure raises benefits while the time remaining to fund those benefits decreases.

Ongoing Liability and Funding Choices

Once actuarial estimates of ongoing liability have been made, a contribution schedule must be chosen by which ongoing liabilities can be funded. A contribution schedule allows a plan sponsor to spread pension costs more evenly over the life of a plan.

If left unregulated by law, the choice of a contribution schedule would depend mainly on two considerations. The first is simply the convenience or business plans of the plan sponsor. How should costs be distributed over time so the burden of these costs is minimized? The answer to this question will depend on the employer's business circumstances, plans, and expectations. This is a technical rather than a judgmental question; the employer presumably wishes to do what is most efficient.

The second consideration is a judgmental question: How much risk of failing to sufficiently fund liabilities is acceptable? Actuarial assumptions are, of course, only educated guesses of future events. The funding level outcome of any contribution schedule can only be estimated. Likewise, future liabilities may not evolve as expected. Given this uncertainty, an employer unwilling to accept any risk of failing to meet funding sufficiency would make contributions significantly in excess of the actuarially sound equal annual contributions mentioned in the example. One willing to accept more risk might make smaller contributions. This question complicates the first consideration of the employer's business circumstances and plans, in that an employer whose business convenience would suggest making small contributions now and larger ones later must consider the increased risk inherent in such a schedule.

While the consideration of business convenience is one of maximizing efficiency whose solution should be objective, the consideration of risk is a trade-off whose solution is subjective. An employer can make smaller contributions, have more funds available for other uses, and run a higher risk of future funding insufficiency, or make larger contributions, have less funds available for other uses, and run a lower risk of future funding deficiency. In other words, funding sufficiency can be viewed as a matter of degree of assurance that all future liabilities can be paid.

Funding Regulation

To ensure that employers will make reasonable choices regarding pension contribution schedules, the law imposes certain funding requirements. Congress has long imposed upper limits on the amount of plan contributions an employer can claim as a federal income tax deduction (IRC section 404). Not until ERISA, however, were minimum plan contributions required. To ensure that plans have the money necessary to pay pension benefits and to protect PBGC from undue liability, ERISA established new guidelines for minimum contributions, called minimum-funding standards. (ERISA also set new maximum contribution standards, but are less significant to the discussion here.)

Minimum-Funding Standards—For accounting purposes, pension costs are divided into two parts: normal costs and supplemental costs. Normal costs for a year are simply the amount of benefit liability accrued that year due to normal plan operation, calculated using that year's actuarial assumptions. Supplemental costs are those associated with supplemental liabilities, which include liabilities associated with changes in actuarial assumptions, liabilities arising because experience varies from actuarial expectations, liabilities resulting from retroactive benefit increases, and liabilities associated with the funding of service credit prior to plan establishment (if such credit is given).

Although many different actuarial methods of funding normal costs are permitted, each implying a somewhat different contribution schedule, employers are generally required to contribute at least the normal cost each year.

The employer must also contribute to supplemental costs. The amount of these contributions is determined by amortizing supplemental liabilities over specified periods. Gains or losses arising from differences between actuarial expectations and actual experience (calculated no more frequently than
Once every three years may be amortized over 15 years; other supplemental liabilities may be amortized over 30 years, or 40 years if incurred before ERISA's passage in 1974.

Under ERISA, every pension plan must set up a "funding standard account" to facilitate monitoring compliance with minimum-funding standards. Liabilities charged to the account are normal costs and annual payments needed to amortize supplemental liabilities. Credits to the account are employer contributions and amounts that may be used to amortize any decrease in plan liabilities. If the account balance is negative, an excise tax is imposed on the plan sponsor until the balance is corrected.

Funding Waivers—If an employer cannot meet the funding standards without incurring "substantial" financial hardship, it can request from the IRS a waiver of all or part of the minimum-funding requirement for that year. Waivers cannot be granted more than 5 out of any consecutive 15 years. If the waiver is granted, amounts waived may be amortized over 15 years. PBGC has no formal role in the waiver process.

The 1985 Budget Reconciliation Act authorizes the IRS to require "security" as a condition of granting waivers or extensions in excess of $2 million. Furthermore, the IRS must now notify PBGC of waiver applications in excess of $2 million, and employers applying for waivers must notify employee organizations. IRS must consider written opinions of all parties interested in a waiver application.

What Is the Funded Status of the Pension System?

Available evidence suggests that, on average, termination-basis funding levels of pension plans have risen over the last several years. Despite this trend, and despite ERISA's minimum-funding standards, some plans remain at funding levels well below termination-basis sufficiency. For example, in 1985, Allis-Chalmers Corporation terminated a plan that was only 3 percent funded for accrued vested liabilities. Furthermore, it appears that as overall termination-basis funding levels have risen due to high investment returns, pension plan contribution rates have fallen.

Funding Levels: Findings of National Surveys—A national survey of large single-employer pension plans by the Wyatt Company found that, in 1985, 78 percent of these plans were sufficiently funded on a termination basis. Similar surveys conducted by Wyatt for the preceding six years suggest that this percentage has increased steadily since 1979. Survey findings also show that in 1985, 84 percent of plans were sufficiently funded to qualify for a standard termination (i.e., had assets equal to or in excess of benefit commitments), also following a steady increase since 1979 (chart 1).

Survey findings actually pertain not to legal "benefit commitments," but to "accrued vested liability." Because accrued vested liability may include some nonbasic benefits not included in benefit commitments, the actual percent of plans that could qualify for a standard termination may be slightly higher than reported here. In general, accrued vested benefits not included in legal benefit commitments can be expected to account for only a small portion of total accrued vested benefits. Therefore, the level of funding for accrued vested liability can be used as a reasonable measure of level of funding for benefit commitments, and is so used throughout this Brief.

"termination-basis funding ratio," defined as the ratio of aggregate assets to total accrued liabilities in the sample, was 122 percent in 1984—up from 101 percent in 1980.10

Greenwich Associates conducts an annual study of the funded status of single-employer plans, which provides consistent time-series data.11 The study estimates termination-basis funding levels for the universe of large pension plans (defined as 1,500 of the largest corporate plans), based on a sample of those plans. According to the study, large plans held assets of $430 billion in 1985 (total private pension assets exceeded $1 trillion that year) and faced accrued liabilities of $457 billion. On average, therefore, large plans were almost 95 percent funded for termination-basis pension liabilities, and unfunded accrued liabilities totaled about $27 billion. This represents an increase in termination-basis funding levels since 1978, when plans were 70 percent funded for termination-basis liabilities, and unfunded termination-basis liabilities totaled $75 billion (table 2).

The termination-basis funding ratio reported by Greenwich (97 percent) is lower than that reported by Johnson and Higgins (122 percent), possibly because of differences in reported actuarial assumptions used to calculate liabilities. Differences in the composition of the two samples and the methods used by Greenwich to formulate universe estimates may also ac-

10 This increase may be over- or understated, due to variations in the size and composition of the sample surveyed each year.


account for part of the discrepancy. More significantly, both surveys show that funding levels have increased over the past several years.

A few very large pension plans hold a large share of all pension assets and liabilities. A BEA Associates survey12 of 40 of the nation's largest single-employer plans (which covered more than 5 million employees and held $116 billion in assets in 1984) found a median funding level for accrued vested liabilities of 121 percent in 1984. Eight of the 40 plans had insufficient assets to pay accrued vested benefit liabilities (and therefore could not have qualified for a standard termination if the new law had been in effect). Total unfunded accrued vested liabilities for these eight plans exceeded $2.5 billion. The single lowest funding ratio for accrued vested liabilities was 47 percent, and the single largest unfunded vested liability was $759 million. The other 32 plans held total assets of more than $20 billion in excess of accrued vested liabilities. The single highest funding ratio for these liabilities was 201 percent, and the largest single excess was $4.4 billion.

Unfortunately, no plan sponsor data is currently available on ongoing pension liabilities.13 As explained earlier, ongoing li-


13 Financial Accounting Standards Board (FASB) Statement 87, Employers' Accounting for Pensions, effective December (Footnote continued on page 10.)
Table 3
Median Percent Change in Pension Expense from Preceding Year in Large Single-Employer Pension Plans*

<table>
<thead>
<tr>
<th>Year</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1974</td>
<td>19.5%</td>
</tr>
<tr>
<td>1975</td>
<td>14.7%</td>
</tr>
<tr>
<td>1976</td>
<td>20.5%</td>
</tr>
<tr>
<td>1977</td>
<td>8.5%</td>
</tr>
<tr>
<td>1978</td>
<td>14.0%</td>
</tr>
<tr>
<td>1979</td>
<td>11.0%</td>
</tr>
<tr>
<td>1980</td>
<td>9.6%</td>
</tr>
<tr>
<td>1981</td>
<td>3.8%</td>
</tr>
<tr>
<td>1982</td>
<td>2.3%</td>
</tr>
<tr>
<td>1983</td>
<td>-5.5%</td>
</tr>
<tr>
<td>1984</td>
<td>-4.6%</td>
</tr>
</tbody>
</table>


*Based on a sample of 40 of the largest U.S. pension plans.

Table 4
Percent Change in Aggregate Contributions from Preceding Year in Large Single-Employer Plans*

<table>
<thead>
<tr>
<th>Year</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>-15%</td>
</tr>
<tr>
<td>1984</td>
<td>-2</td>
</tr>
<tr>
<td>1985</td>
<td>-13</td>
</tr>
</tbody>
</table>


*Estimates of aggregate pension funding in 1,500 of the largest corporate plans, based on a sample of approximately 1,000 plans.

Johnson and Higgins found that 59 percent of large pension plan sponsors reported a decrease in pension expense between 1983 and 1984. Decreases in pension expense were more acute on a per-employee basis. A full 68 percent of large plan sponsors experienced a decrease in pension expense per employee between 1983 and 1984. Average pension expense per employee in the Johnson and Higgins sample decreased by 13 percent, from $1,312 to $1,145.

Among the 40 plans included in the BEA Associates sample, growth of pension expense has decelerated quite steadily since 1978. The median change in pension expense was a 4.6 percent decline in 1984 (table 3). The median change in pension expense per employee was a sharper 7.1 percent decline. Twenty-five of the 40 plans surveyed experienced a decrease in actual pension costs; the single largest decline was 74 percent.

Table 5
PBGC Single-Employer Trusteeships, 1975-1985

<table>
<thead>
<tr>
<th>Fiscal Year</th>
<th>Plans in PGBC Trusteehip</th>
<th>Pending Plan Trusteeships</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>3</td>
<td>95</td>
<td>98</td>
</tr>
<tr>
<td>1976</td>
<td>48</td>
<td>222</td>
<td>270</td>
</tr>
<tr>
<td>1977</td>
<td>145</td>
<td>281</td>
<td>426</td>
</tr>
<tr>
<td>1978</td>
<td>266</td>
<td>260</td>
<td>526</td>
</tr>
<tr>
<td>1979</td>
<td>389</td>
<td>259</td>
<td>648</td>
</tr>
<tr>
<td>1980</td>
<td>514</td>
<td>267</td>
<td>781</td>
</tr>
<tr>
<td>1981</td>
<td>659</td>
<td>126</td>
<td>785</td>
</tr>
<tr>
<td>1982</td>
<td>771</td>
<td>133</td>
<td>904</td>
</tr>
<tr>
<td>1983</td>
<td>891</td>
<td>130</td>
<td>1,021</td>
</tr>
<tr>
<td>1984</td>
<td>999</td>
<td>119</td>
<td>1,118</td>
</tr>
<tr>
<td>1985</td>
<td>1,090</td>
<td>101</td>
<td>1,191</td>
</tr>
</tbody>
</table>


14 This may not be true in all cases. If an employer expects most of its employees to leave the company before becoming vested, its termination-basis liability might significantly exceed its expected ongoing liability.
Greenwich Associates estimates that aggregate contribution levels for large plans have fallen each year from 1982 to 1985 (table 4). From 1984 to 1985 the decrease was 13 percent.

**Trends in Underfunded Terminations and PBGC Liability**

By the end of fiscal year 1985, PBGC had become the trustee of 1,090 single-employer plans, and trusteeship of another 101 plans was pending (table 5). Total liability for insured benefits in these plans was nearly $2 billion. Somewhat less than one-half of this amount ($927 million) was covered by the plans' assets and employer liability. The other $1 billion represented claims paid by or pending against PBGC (table 6). By the end of FY 1985, PBGC was responsible for the payment of pension benefits with a present value of $1.9 billion to 168,600 participants.

The 39 claims paid by or pending against PBGC due to 1985 terminations totaled $187 million. This is the smallest number of claims filed in any one year since the inception of PBGC. The total amount of these claims, however, was surpassed only in 1982 and 1983 (table 6). Furthermore, the 1985 average claim size, $4.8 million, is more than double the amount of any other year. This is due to the termination of the Allis-Chalmers Corporation plan, which was only 3 percent funded for accrued vested liabilities, and resulted in a claim of $147 million—or 79 percent of total claims for the year.15 Since 1974, six terminations have resulted in claims of more than $50 million, accounting for 44 percent of all claims against PBGC.16 The pending terminations of the Wheeling-Pittsburgh Steel Corporation's underfunded plans are not included the FY 1985 claims total. PBGC estimates the claim that would result from the termination at $464 million.

Although claims growth has been uneven, total annual claims against PBGC increased dramatically between 1974 and 1985. During this time, PBGC insurance premiums remained at $2.60 per participant, and the number of participants covered by the system stayed relatively constant. Due to these circumstances, the PBGC single-employer program faced increasing deficits. During fiscal year 1985, the accumulated deficit more than doubled—from less than $500 million to $1.3 billion (table 7). (For the purpose of estimating the

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15 PBGC, unpublished.

16 Ibid.
From its inception in 1985, PBGC received termination notices for 66,443 single-employer defined benefit plans sufficiently funded for total accrued liabilities. The number of notices received each year has increased steadily since 1980. In 1985, PBGC received 8,635 notices, the most in any single year since 1976. (The surge in 1985 may be due, in part, to pending legislation that would impose a 10 percent excise tax on reversions.) By the end of fiscal year 1985, PBGC had confirmed that 49,092 of these plans held sufficient assets to pay all accrued benefits and had issued "notices of sufficiency" to these plans, thereby authorizing recovery of excess plan assets (table 8).

In a sufficient termination, the employer is entitled to recover any assets in excess of total accrued liabilities. Statistics are only available for cases in which a plan's asset reversion exceeds $1 million. Between May 31, 1980, and December 31, 1985, PBGC approved 749 terminations with asset reversions in excess of $1 million, and as of year end 1985, another 271 (involving 342,000 active participants) were awaiting approval. Total approved and pending reversions reached $11.5 billion (table 9). These 1,020 plans held $26.9 billion in assets at termination and faced accrued liabilities of $15.4 billion. The overall termination-basis funding ratio of these plans was 175 percent, while the median ratio was 185 percent.

The number of terminations involving reversions in excess of $1 million has increased each year since 1980, as has the total amount recovered by employers. In 1985 alone, 413 terminations (of which 261 still awaited approval as of December 31) involved a total of $5.7 billion in reversions. This rapid growth may have been influenced by the 1984 administration guidelines on termination. The 1985 total includes the termination of three United Airlines' plans with reversions totaling $889 million and the termination of the Union Carbide plan with an $836 million reversion. Since May 31, 1980, there have been 16 terminations with asset reversions in excess of $100 million, accounting for $4.3 billion in reversions—or 37 percent of all reversions over $1 million.

### Trends in Overfunded Terminations and Asset Reversions

From its inception in 1974 through the end of fiscal year 1985, PBGC received termination notices for 66,443 single-employer defined benefit plans sufficiently funded for total accrued liabilities. The number of notices received each year has increased steadily since 1980. In 1985, PBGC received 8,635 notices, the most in any single year since 1976. (The surge in 1985 may be due, in part, to pending legislation that would impose a 10 percent excise tax on reversions.) By the end of fiscal year 1985, PBGC had confirmed that 49,092 of these plans held sufficient assets to pay all accrued benefits and had issued "notices of sufficiency" to these plans, thereby authorizing recovery of excess plan assets (table 8).

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### Table 8

Terminations of Single-Employer Defined Benefit Plans with Sufficient Assets

<table>
<thead>
<tr>
<th>Year</th>
<th>Notices Received</th>
<th>Notices of Sufficiency Issued</th>
</tr>
</thead>
<tbody>
<tr>
<td>1975</td>
<td>2,470</td>
<td>0</td>
</tr>
<tr>
<td>1976</td>
<td>8,932</td>
<td>1,533</td>
</tr>
<tr>
<td>1977</td>
<td>7,202</td>
<td>4,510</td>
</tr>
<tr>
<td>1978</td>
<td>5,158</td>
<td>7,420</td>
</tr>
<tr>
<td>1979</td>
<td>4,810</td>
<td>5,484</td>
</tr>
<tr>
<td>1980</td>
<td>3,933</td>
<td>3,465</td>
</tr>
<tr>
<td>1981</td>
<td>4,949</td>
<td>4,195</td>
</tr>
<tr>
<td>1982</td>
<td>6,003</td>
<td>4,272</td>
</tr>
<tr>
<td>1983</td>
<td>6,730</td>
<td>4,923</td>
</tr>
<tr>
<td>1984</td>
<td>7,621</td>
<td>5,811</td>
</tr>
<tr>
<td>1985</td>
<td>8,635</td>
<td>7,479</td>
</tr>
<tr>
<td>Total</td>
<td>66,443</td>
<td>49,092</td>
</tr>
</tbody>
</table>


FY 1985 accumulated deficit, PBGC recognized the expected liability associated with the pending Wheeling-Pittsburgh claim.

Reforms enacted in the 1985 Budget Reconciliation Act are intended to mitigate or reverse the trend of increasing claims against PBGC by restricting underfunded terminations and increasing employer liability. These provisions and the premium increase could also help alleviate PBGC's deficit.

### Table 9

Pension Plan Terminations with Asset Reversion in Excess of $1 Million

<table>
<thead>
<tr>
<th>Year of Termination</th>
<th>Notice of Sufficiency Issued</th>
<th>Notice of Sufficiency Pending</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Plans</td>
<td>Reversion (millions)</td>
<td>Plans</td>
</tr>
<tr>
<td>1980</td>
<td>9</td>
<td>$18.3</td>
<td>-</td>
</tr>
<tr>
<td>1981</td>
<td>35</td>
<td>158.6</td>
<td>-</td>
</tr>
<tr>
<td>1982</td>
<td>81</td>
<td>400.4</td>
<td>-</td>
</tr>
<tr>
<td>1983</td>
<td>164</td>
<td>1,596.5</td>
<td>-</td>
</tr>
<tr>
<td>1984</td>
<td>308</td>
<td>3,545.4</td>
<td>10</td>
</tr>
<tr>
<td>1985</td>
<td>152</td>
<td>3,139.3</td>
<td>261</td>
</tr>
<tr>
<td>Total</td>
<td>749</td>
<td>$8,858.5</td>
<td>271</td>
</tr>
</tbody>
</table>

Source: EBRI tabulations of PBGC data.
PBGC data offers some, albeit inconclusive, reasons that employers terminate their plans (table 10). Forty-two percent of plans with asset reversions in excess of $1 million—42 percent of the total amount of these reversions—reported that the termination was intended to facilitate the "adoption of a new superseding plan." Another 15 percent of plans, accounting for about 9 percent of reversions, cited "change of company ownership."

Information on types of replacement plans is available only for terminations awaiting approval (table 11). Just over one-half of these terminations were reported to be spin-offs or termination/restart transactions, with active participants still covered under a defined benefit plan. Another 34 percent of terminated plans were replaced with defined contribution plans. Only 16 percent of terminated plans were not replaced. (This includes the 4.1 percent of terminations due to company dissolution, subsidiary or division closing, bankruptcy, merger, or acquisition.)

## Continuing Issues—Underfunded Terminations

### Why Is There Underfunding?

This question was recently posed by PBGC Executive Director Kathleen P. Ugoff in reference to the grossly underfunded Allis-Chalmers termination. As mentioned earlier, the Allis-Chalmers plan was only 3 percent funded for accrued vested liabilities on termination.

It has been suggested that a large portion of termination-basis underfunding is due to minimum-funding waivers. Prior to the passage of the 1985 Budget Reconciliation Act, Ugoff had characterized these waivers as unsecured, low-interest loans from plan participants and PBGC (and indirectly from premium payers) to financially troubled companies, resulting in uneconomic redistribution of resources. She attributed 20 percent of the PBGC's deficit to waivers granted in just 22 large termination cases. In response to this situation, although not yet required by law, PBGC requested and obtained "security," or collateral, against the large funding waiver issued to LTV Corporation in 1985.

The 1985 Budget Reconciliation Act permits IRS to require debt security as a condition for a waiver. This provision might cause or hasten some plan terminations, however, if some financially troubled companies are unable to provide sufficient security and are denied funding waivers. Some argue that plan termination is the appropriate outcome in such situations, preferable to growth of unfunded liabilities and efficient from a market standpoint. Others contend that such an outcome is contrary to the purpose of the funding-waiver provision, which is to offer temporary relief and an opportunity for recovery to financially troubled companies.

It has also been suggested that systematic, deliberate underfunding may exist when employers negotiate with unions. Studies cited in the 1986 Economic Report of the President suggest that underfunded plans may help employers contain union wage growth by creating a common interest—the solvency of the plan—for which the union is willing to sacrifice. Evidence in support of this idea includes the association of defined benefit pension plans with unions and a historical 30 percent discrepancy between termination-basis funding ratios of union and better-funded nonunion plans.

Another force that contributes to continued underfunding (as well as to requests for funding waivers) is the decline in employment in some industries. When a company's ratio of active employees to retirees declines, pension costs become an increasingly large and burdensome portion of operating costs, particularly if accrued benefits have not been fully funded to date. Because unionization is more prevalent in declining industries, this may partially explain the association between unions and weaker funding. To the extent that continued underfunding is a result of industry decline, funding-waiver policy becomes enmeshed with the more general

---

**Table 10**

<table>
<thead>
<tr>
<th>Reported Reason</th>
<th>Percent of Plans</th>
<th>Percent of Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adoption of new plan</td>
<td>42.0%</td>
<td>42.0%</td>
</tr>
<tr>
<td>Change of company ownership</td>
<td>14.7</td>
<td>9.1</td>
</tr>
<tr>
<td>Adverse business conditions</td>
<td>11.6</td>
<td>6.4</td>
</tr>
<tr>
<td>Company liquidation</td>
<td>2.8</td>
<td>1.4</td>
</tr>
<tr>
<td>Plant or division closing</td>
<td>2.7</td>
<td>0.7</td>
</tr>
<tr>
<td>Company merger</td>
<td>2.1</td>
<td>1.0</td>
</tr>
<tr>
<td>Plan too costly, no reference to ERISA</td>
<td>2.1</td>
<td>0.7</td>
</tr>
<tr>
<td>Employer/employees dissatisfied with present plan</td>
<td>1.7</td>
<td>0.5</td>
</tr>
<tr>
<td>ERISA impact</td>
<td>1.0</td>
<td>0.3</td>
</tr>
<tr>
<td>Bankruptcy</td>
<td>0.6</td>
<td>0.3</td>
</tr>
<tr>
<td>Other reason not cited above</td>
<td>18.1</td>
<td>37.5</td>
</tr>
<tr>
<td>Reason unknown/not reported</td>
<td>0.7</td>
<td>0.2</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: EBRI tabulations of unpublished PBGC data. Includes pending cases and those with notice of insolvency issued.

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18 Ibid.

employees' perception of their total compensation. If employees believe that they are accumulating pension benefits (referred to in this interpretation as "deferred wages"), they will accept lower (current) pay. If this interpretation is accurate, then the loss of unvested benefits and the loss of vested benefits resulting from underfunded termination are both perceived and actual financial losses to participants. Most observers agree that this "deferral" situation exists in collectively bargained settings, but many contend that it does not apply in nonbargained situations.

Is More Protection Called For?——Given the losses suffered by participants in underfunded terminations, two questions arise. What benefits should be protected? And, who should pay the cost of that protection?

More benefit protection would imply higher costs. If additional protection were provided through stepped-up PBGC guarantees, the expected result would be higher PBGC premiums. But higher PBGC premiums might discourage employers from establishing and continuing defined benefit pension plans, to the overall detriment of retirement income security. Alternatively, more protection could be provided by further increasing employer liability, perhaps to include all nonguaranteed vested benefits or even to include nonvested benefits. But the specter of such large liabilities might also discourage defined benefit plan sponsorship. And increased employer lia-

20 This view has been advocated by representatives of the AFL-CIO, the American Association of Retired Persons, and the United Auto Workers in hearings before the Labor Department's termination task force.

21 These losses may be offset in some way, however, such as by implementation of a replacement plan with past service credit.

### Table 11

<table>
<thead>
<tr>
<th>Replacement Plan</th>
<th>Percent of Plans</th>
<th>Percent of Total Reversions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defined benefit (spinoff)</td>
<td>18.5%</td>
<td>40.9%</td>
</tr>
<tr>
<td>Defined benefit (termination/restart)</td>
<td>31.7%</td>
<td>31.5%</td>
</tr>
<tr>
<td>Defined contribution</td>
<td>33.6%</td>
<td>21.1%</td>
</tr>
<tr>
<td>No new plan</td>
<td>16.2%</td>
<td>6.6%</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: EBRI tabulation of unpublished PBGC data.

industrial policy.

**Benefit Insurance: How Much Protection Is Appropriate?**

In underfunded terminations, participants may lose some accrued benefits. PBGC guarantees payment of basic benefits up to an indexed maximum. Up to certain limits, the terminating employer is liable to plan participants for vested benefits not insured by PBGC. But once these limits are reached, vested benefits still unfunded are lost.

In addition, accrued benefits that are not vested prior to termination are lost. (In contrast, in a sufficient termination all accrued benefits vest upon termination, and must be paid.) In 1984, 85 percent of defined benefit pension plans used a "10-year cliff vesting" schedule. Participants with less than 10 years of service in plans with this vesting provision are not entitled to receive any of their accrued benefits. After 10 years of service, participants become entitled to 100 percent of accrued benefits. This suggests that the value of necessary pension benefits a participant becomes entitled to each year is zero until the participant's tenth year, when there is a "spike" in the value, followed by a smooth increase in value later on. This spike is more pronounced for workers hired at later ages (chart 3).

If participants expect to work 10 years or more and become entitled to accrued benefits (and do not expect the plan to terminate), then they may perceive that they are "earning" these benefits steadily over their first 10 years of employment. But if an underfunded termination occurs before the tenth year, no benefits will be paid. In the eyes of the participants, earned benefits will be lost.

Congress is presently considering amendments to ERISA that would require more rapid vesting. If enacted, these provisions would mitigate benefit losses due to failure to vest prior to underfunded termination.

Many believe that wages in the labor market are set based on
bility might lead to the liquidation of some financially troubled terminating employers. Participants might prefer to lose some benefits to preserve their jobs.

How Should the Costs of Benefit Insurance Be Distributed?

As earlier noted, PBGC premiums have risen dramatically—from $1 in 1975 to $8.50 in 1986. At $8.50, however, premiums still represent less than one-tenth of one percent of the labor cost to employers. Although the amount is small, many feel that the current premium system places an unfair burden on well-funded plans. Some characterize the premium as a tax, paid by all plans to "subsidize" protection for poorly funded plans.

Some employers and policymakers suggest that the premium schedule be modified to allow well-funded, lower-risk plans to pay lower premiums, while poorly-funded, higher-risk plans pay more. Two types of alternative premium systems have been proposed: exposure-related and risk-related.

Exposure-related premiums would be geared to the amount of unfunded termination-basis liability that exists under a plan. Plans with more unfunded liability would pay higher premiums. In theory, these higher premiums would serve as incentives to sound funding. Furthermore, well-funded plans would no longer bear as large and "unfair" a proportion of the cost. But some contend that an exposure-related premium schedule would neither adequately address the fairness issue nor appropriately distribute costs, because not all similarly funded plans face similar risks of underfunded termination.

A risk-related premium schedule, similar to that used by private insurers, would be geared both to the amount of liability and the probability of termination. Such a system might provide "fairer," market-efficient distribution of costs. Two possible problems arise, however. First, the riskiest employers might often be in the poorest position to pay higher premiums. Second, risk may be difficult to measure. The 1985 Budget Reconciliation Act requires PBGC to study the feasibility of risk-related premiums and within one year report its findings to a congressionally appointed advisory group, which, in turn, must make recommendations to Congress within six months.22

Who Should Insure Pension Benefits?

Some proponents of risk-related premiums go one step further, suggesting that some or all benefit insurance should be provided by private insurers. This idea is viewed by advocates as consistent with the Reagan administration's desire to transfer many government services to the private sector. But it is not clear whether pension benefits can be efficiently and effectively insured by private carriers. Observers point out that plan termination insurance is different from freight transportation or electric power generation insurance, for example. For instance, one unique aspect of plan termination insurance is the need for the insurer to assume trusteeship of the plan and pay benefits to a large number of participants.

Privatization raises all of the issues associated with risk-related premiums, since private insurance premiums presumably would be risk-related. In addition, it is questionable whether private insurers could offer affordable insurance to the most poorly funded, highest-risk plans. One possible alternative would be for PBGC to function as an insurer of "last resort" for plans unable to obtain private coverage. But this would leave PBGC in the untenable position of bearing the highest risks without benefit of a broad base of premium payers to fund its liabilities. Another alternative would be to allow uninsurable plans to "price out" of the defined benefit system. The result would be loss of defined benefit plan coverage for participants in uninsurable plans and a smaller, but potentially better funded, defined benefit plan system.

A PBGC task force comprising representatives from private-sector corporations, public policy institutes, and labor unions, has been appointed by PBGC's private-sector advisory committee to study and make recommendations on the possibility of privatization.

How Much Employer Liability Is Appropriate?

Another area of policy debate is the degree of liability to impose on employers terminating underfunded plans. Greater employer liability could reduce PBGC liability and/or reduce benefit losses to participants. Excessive employer liability could discourage sponsorship of defined benefit plans and burden already financially troubled companies. Lower employer liability could provide firms a competitive advantage when their underfunded plans are terminated. When Wheeling-Pittsburgh transferred $475 million in termination liabilities to PBGC, other steel companies tried to block the termination because it gave Wheeling-Pittsburgh "unfair" competitive advantage.

Continuing Issues—Asset Reversions

Why Is There Overfunding?

Because ongoing pension liabilities tend to exceed termination-basis liabilities, funding designed to ensure ongoing plan solvency may result in excess termination-basis funding. This effect can be exaggerated when short-run investment returns on pension assets exceed expectations. For instance, a discrepancy of four percentage points between expected and actual rates of return can lead to funding levels 20 percent higher than expected in five years (table 12). Available evi-

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22 Alternative premium structures for the multiemployer benefit insurance program have been studied in detail by the PBGC. See PBGC, Multiemployer Study Required by P.L. 95-214, July 1, 1978 (Washington, DC: U.S. Government Printing Office), Part VII, "Multiemployer Program Premium Structure."
dence suggests that the recent increases in funding levels described earlier have been due, in large part, to favorable investment returns surpassing the expectations of plan sponsors.

Prudent ongoing funding may dictate the accumulation of termination-basis surpluses, which critics of asset reversion have cited as incentives to termination. But evidence suggests that employers rarely respond to this incentive. Total asset reversions in excess of $1 million sought and taken in 1984 and 1985 account for 10 percent of reported excess assets held by the 475 large underfunded plans surveyed by Johnson and Higgins in 1984. Furthermore, assets recovered through reversions in excess of $1 million since May 1980 account for only about one percent of all private pension assets.

Why Do Terminations for Asset Reversion Occur?

Many forces have been identified as possible factors in the decision to terminate a sufficiently funded pension plan. For example, an employer who terminates a defined benefit plan and replaces that plan with a defined contribution plan may do so to (1) achieve level and certain (and possibly lower) ongoing pension costs and/or (2) because a defined contribution plan may better serve current employees and help attract desirable workers.

Financial needs arising from perceived long-run investment requirements or immediate financial distress may lead an employer to terminate an underfunded plan. Assets recovered may be used for capital investment or debt payment. Some reversions may represent action by self-interested employers to improve short-run cash flow and boost dividend payments. It is also possible that when one employer takes a reversion, others in the same industry may feel pressure to follow suit to remain competitive.

New Financial Accounting Standards Board accounting rules may create an incentive to terminate plans for asset reversion to bolster bottom-line cash flow for one year. While earlier accounting rules generally allowed gains from an asset reversion to be amortized over 10 to 20 years, the new rules will allow immediate recognition of some or all of the reversion.

Some link asset reversions to corporate mergers and takeovers. Recently, many newly acquired companies' plans were terminated for asset reversions by the acquiring firms. The specter of acquisition may induce some employers to recover assets themselves, thereby becoming a less attractive target for a takeover. Others may use funds recovered from terminated plans to finance acquisitions of their own.

Many reasons may lead employers to terminate their plans for asset reversion; the mere presence of recoverable excess, however, does not mean that termination will necessarily occur.

Is Asset Reversion Harmful or Beneficial?

Effect on Participants—In terminations with asset reversion, all accrued benefits, both vested and unvested, must be fully funded. Some contend, however, that participants still incur substantial losses.

More than one-half of participants in medium and large pension plans receive benefits based on a "terminal earnings formula," which links participants' benefits with their pay during the last or highest-paid years of employment. Because inflation and wage growth tend to be related, this type of benefit formula provides substantial protection against erosion of the value of accrued benefits.

By contrast, when a plan terminates, accrued benefits are locked in at their current nominal value; that value can be eroded by inflation and will not reflect future real wage growth. Labor Department economist Richard A. Ippolito concludes in a recent study that, under these circumstances, the value of accrued benefits at retirement can be less than one-half what it would have been had the plan continued. The study also provides empirical evidence in support of the idea that participants do not expect plan termination and therefore accept lower wages than they would if they ex-

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Table 12: Impact of Rate of Return on Asset Levels after Five Years

<table>
<thead>
<tr>
<th>Average Annual Rate of Return Achieved</th>
<th>Ratio of Assets Held after Five Years to Assets Expected with 7% Annual Rate of Return</th>
</tr>
</thead>
<tbody>
<tr>
<td>13%</td>
<td>1.31</td>
</tr>
<tr>
<td>11%</td>
<td>1.20</td>
</tr>
<tr>
<td>9%</td>
<td>1.10</td>
</tr>
<tr>
<td>7%</td>
<td>1.00</td>
</tr>
<tr>
<td>5%</td>
<td>0.91</td>
</tr>
<tr>
<td>3%</td>
<td>0.83</td>
</tr>
</tbody>
</table>

Source: EBRI calculations.

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pected termination and the associated reduction in the future value of accrued benefits.

These potential losses, Ippolito suggests, may be offset if a defined benefit replacement plan provides past service credit or if a replacement defined contribution plan provides "grandfather clauses" to benefit participants who would otherwise lose benefits. A defined contribution plan with more liberal vesting standards may also benefit younger participants with shorter job tenure.

The effect of asset reversions on participants is one of several issues currently being studied by a task force formed by the Labor Department's Advisory Council on Employee Welfare and Pension Benefit Programs. To assist the task force, Hay/Huggins Company was commissioned to evaluate the effect on participants of actual terminations for reversion with various replacement plans. Hay/Huggins found that participants suffer no losses in spin-off terminations, since in such cases past service credit is automatically granted and benefit formulas are rarely changed. Similarly, participant losses are rare in termination/reestablishment transactions because past service credit is usually granted, and new benefit formulas are rarely less generous than those of the terminated plan. In terminations with no successor plan, participants invariably suffer significant losses, but since most such cases involve business shutdowns, these losses might be viewed as unavoidable. In terminations with defined contribution successor plans, a substantial number of participants may suffer losses, but since benefit levels under these plans are susceptible to fluctuations in investment performance, losses are difficult to predict.

In some cases, losses suffered by active participants due to termination for asset reversions may be less severe than losses that would have been suffered had the reversion not occurred. An employer facing severe financial hardship might use termination for asset reversion instead of layoffs or plant closings as a means of overcoming financial difficulties.

Many critics of terminations for asset reversion contend that retirees under terminated plans can suffer significant losses. If plan sponsors fail to grant COLAs that would have been granted had the plan continued, the value of benefits to beneficiaries could be eroded. Whether such losses occur cannot be determined with certainty because most COLAs are provided on an ad hoc basis, and there is no way to determine whether COLAs would have been granted had the plan continued. If such losses do occur, their severity would vary with the rate of inflation.

Effect on Plan Sponsors—A defined benefit plan sponsor presumably will terminate the plan for asset reversion only if the termination appears to be in the interest of the firm. If recovered assets are used to finance investment or reduce debt burden, some suggest the termination may be to the long-run benefit of participants and the economy as a whole.

Effect on Plan Funding—Some contend that because of the discrepancy between termination-basis sufficiency and sound ongoing funding levels, termination with asset reversion undermines ongoing funding of replacement defined benefit plans. Once excess assets are recovered, poor investment performance could lead to termination-basis underfunding. In this scenario, following a spin-off or termination/reestablishment transaction, participants are exposed to greater risk of distress termination and associated losses of nonvested and other benefits. Furthermore, if funding of defined benefit replacement plans is poor, an indirect consequence of the reversion may be increased PBGC liability with resulting higher PBGC premiums needed from all plan sponsors. Therefore, if ongoing funding is undermined, both plan participants and plan sponsors could suffer losses.

Dennis A. Tito, president of Wilshire Associates, points out that the reductions in pension costs and improvements in funding levels recently enjoyed by many plan sponsors are due primarily to a favorable financial market and associated high rates of return. He suggests that it is unlikely that such favorable conditions will persist. In the worst scenario, a future downturn in financial markets similar to the one that resulted from the "oil price shocks" of the 1970s could cause total unfunded (termination-basis) pension liability to rise to $900 billion, or 57 percent of pension assets, by 1994.29 If this occurs, plan sponsors who recovered "excess" assets from plans in the 1980s will face large increases in pension costs and/or very low termination-basis funding levels.

Requirements for funding of replacement defined benefit plans following termination for asset reversion specified in the administration's guidelines address this potential hazard. The Labor Department's ERISA Advisory Council has been told by the task force on terminations for reversion that, under the guidelines, funding of replacement defined benefit plans does not "present a threat to either the PBGC or to participant benefit security."

Effect on Government—Because defined benefit pension fund assets are not taxed on a current basis, terminations with asset reversions are sometimes characterized as a form of tax arbitrage. Although the recovered assets are taxable income to the employer, the tax deferral from the time the excess funds accrue until the time they are recovered may represent a revenue loss to the government.

28 In three of these cases, the plan sponsor appeared about to cease operation as an employer, implying inevitable termination, regardless of funding level.

Who Is Entitled to “Excess” Assets?

In sponsoring a defined benefit pension plan, an employer assumes the risk associated with fulfilling benefit promises. If pension fund performance is poorer than expected, the employer must make additional contributions to ensure benefit payments. Therefore, many argue, employers ought to be entitled to recover excess assets.

Assets in excess of termination-basis sufficiency may only represent prudent ongoing funding levels, however, because ongoing benefit liabilities, which include future benefit accruals and increases, are usually greater than termination-basis liabilities. Those who maintain that participants are harmed by terminations with asset reversion because they lose expected future benefit accruals and increases often contend that participants are the rightful “owners” of some or all termination-basis excesses.

Proposals for Change

Moratorium on Asset Reversions—Some critics of current asset reversion policy believe that the losses imposed on participants by terminations with reversion are so great that a moratorium should be placed on reversions in excess of $1 million. This is not a long-term policy proposal, but an interim step viewed as necessary to protect participants while new policies are formulated. Those who contend that employers are entitled to excess assets strongly oppose this proposal because it represents the freezing of assets to which the employer is legally entitled. Many feel that the proposal is too drastic and that losses to participants are small and do not warrant such action.

Excise Tax on Asset Reversions—The House-passed tax reform bill and the Senate Finance Committee draft proposal call for a 10 percent excise tax on reversions, as did the president’s May 1985 tax reform proposal. The tax is intended to address the tax arbitrage issue, although some point out that a single tax rate may not be appropriate, as the amount of untaxed earnings may vary with the rate of return and the investment period. Others contend that a tax levied against employers taking reversions would represent confirmation of the employers’ right of ownership of excess assets, already implied in current law.

Some fear that imposing a tax on reversions would discourage sound funding of defined benefit plans. Employers might be wary of accumulating excesses that they could not recover without incurring an excise tax. Some fear such a tax might discourage defined benefit plan sponsorship altogether.

Citing government revenue losses from overfunding of tax-favored pension plans, officials in the United Kingdom have proposed rules that would prohibit the build-up of pension assets above an actuarially calculated limit. The proposed limit would be actuarial sufficiency for total accrued benefits considering future salary growth, plus 5 percent. (This limit is much higher than termination-basis sufficiency under U.S. law, because termination-basis sufficiency does not consider future salary growth.) When a surplus develops, it could be alleviated without penalty to the employer through benefit increases or contribution reductions. The surplus could also be recovered by the employer, but the reversion would be taxed “at a special rate of 40 percent . . . to recover the tax relief previously given.”

Permit Excess Asset Withdrawal without Termination—Those who subscribe to the view that employers are entitled to excess assets commonly believe that withdrawal should be permitted without plan termination. Since current law permits an employer only through plan termination to recover excess assets and continue to sponsor a defined benefit plan (through a spin-off or termination/reestablishment transaction), some question whether plan termination should be required to accomplish this.

Others, citing the difference between termination-basis and ongoing funding and/or advocating participant entitlement to part of this excess, recommend that only asset withdrawals above termination-basis sufficiency plus some “buffer” amount (defined as a percent of termination-basis liability) be allowed. A buffer too high might discourage sound funding and defined benefit plan sponsorship. A buffer set too low, however, might result in unsound funding of ongoing defined benefit plans, leading to future underfunded terminations and benefit loss.

Table 13 compares the amount of money that would be recovered in reversion cases pending with PBGC as of December 31, 1985, to amounts that would be recovered by withdrawal from ongoing plans with various buffer levels. Any buffer greater than zero percent would make amounts recovered in a withdrawal less than those recovered in a termination. However, it has been suggested that plan sponsors might benefit more from withdrawal than from termination because (1) the transaction cost of withdrawal from an ongoing plan could be less than that of termination, (2) withdrawal from an ongoing plan would be less disruptive to employee morale than a termination, and (3) withdrawals could be made frequently, while terminations with reversion (and a defined benefit replacement plan) can occur only once every 15 years.

Some feel that no untaxed withdrawals should be allowed, because such a policy would be in conflict with the purpose of the tax-favored status granted to pension funds.

Continue Current Policy—Many feel that current termination policy, as set forth in the administration asset reversion guidelines, represents a compromise between conflicting interests. Permitting recovery of all excess assets avoids disincentives to sound funding and plan sponsorship. Continued

the benefit of their participants.” In considering reform of single-employer plan termination policy, it is useful to ask whether proposed changes would serve this purpose.

Continuing debate over underfunded terminations includes funding waiver policy, levels of benefit protection, premium amount and structure, levels of employer liability, and privatization of pension insurance. Resolution of the controversy may involve tradeoffs. On the one hand, steps taken in the interest of fairness may harm some participants if terminations result. For example, privatization could expel some participants from the defined benefit system if poorly funded plans cannot obtain affordable insurance and must terminate. On the other hand, measures intended to enhance benefit security may discourage defined benefit plan sponsorship. Both of these outcomes would be contrary to the purpose of Title IV. Competing interests must be carefully weighed so that hasty policy changes will not lead to unexpected and unwanted outcomes.

Similarly, asset reversion termination policy must carefully balance the forces that shape plan sponsor behavior. Excessive restrictions on reversions could discourage, rather than encourage, defined benefit plan sponsorship. Allowing excessive withdrawals could undermine sound funding and imperil the interests of participants as well as the overall health of the pension system.

In summary, evaluation of defined benefit plan termination policy must recognize the sometimes competing interests of all concerned parties (participants, plan sponsors, and government). Policy directed toward the interests of one party may have unwanted repercussions on others, or create unwanted incentives. To fulfill the purpose of Title IV, to encourage pension plan sponsorship “for the benefit of . . . participants,” policy must recognize the interests of other parties as well.

**Conclusion**

One of the purposes of ERISA’s Title IV is “to encourage the continuation and maintenance of private pension plans for
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