Statement

by

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Submitted to the

U.S. House of Representatives

Joint Hearing on Pension Plan Underfunding

Committee on Ways and Means

Subcommittees on Oversight and Social Security

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Chairman Pickle and Chairman Jones, we wish to commend you for your continued pursuit of the policy issues surrounding the nation's retirement income system, and we are honored to provide the committee with our analysis of the funding issues associated with private pension plans in the United States.

In particular, we are restricting our remarks to the question of underfunding of pension plans. In keeping with EBRI's standard policy, we will not be making recommendations or advocating any particular policy position. Rather, we will strive to provide the Committee with an analytical framework for making its own evaluation of this important question.

Is Underfunding of Private Pensions a Serious Problem?

Whether you believe the private pension system is underfunded or not will depend to a very large extent on the manner in which you choose to view the liabilities associated with pension plans. Overall, the private pension system has accumulated well over $1 trillion in assets that stand behind the claims to benefits made by active participants and beneficiaries. This constitutes the largest single funding source of pensions in the world, and adds considerable security to the benefit promise under private plans.

Mechanics of Funding

How does ERISA allow underfunding to occur? As you know, ERISA established rules for minimum and maximum funding standards for defined benefit plans, requiring employers to satisfy the minimum required plan contribution each year.

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.

If the employer does not satisfy the necessary contribution because he would incur substantial business hardship, and if enforcement of the minimum funding requirements would be adverse to the interests of plan participants in the aggregate, the employer may seek a funding waiver from the Internal Revenue Service for all or part of the minimum funding requirements. 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. Without an approved waiver, employers not meeting the minimum contribution standard are subject to a tax on the unpaid amount.

The Pension Benefit Guaranty Corporation (PBGC) has no formal role in the waiver process. Prior to passage of recent PBGC reforms, PBGC Executive Director Kathleen Utgoff attributed 20% of the PBGC's deficit to waivers granted in just 22 large termination cases. Corrective measures are now being taken. The Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) permits 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 applications. Despite the new law, the PBGC is still left at risk by the waiver process.

In practice, pension funding rules allow considerable flexibility, in part to accomodate the very diverse situations of the employers sponsoring plans. The actual amount of an employer's contributions will depend upon the actuarial cost method it chooses to use and, in certain circumstances, the funding instrument employed. Even the minimum and maximum constraints are generally expressed in terms of the actuarial cost method used by the employer. Any of several actuarial methods may be selected if the actuary certifies that the method and the assumptions are reasonable in the aggregate. ERISA lists six acceptable actuarial methods. Since funding is tied to the actuarial cost method used, funding and actuarial methods are closely interrelated.

For example, because an employer who maintains a qualified defined benefit pension plan is required to fund the cost of projected benefits on a level basis, it is necessary to make certain assumptions with respect to the level of benefits that actually will be provided by the plan. These involve economic conditions and future events. These assumptions, in particular, the assumption of future interest rates, can have a significant effect on estimates of the cost of a plan and on deduction limits with respect to employer contributions to plans.

But the adequacy of that funding can be measured in two ways: (1) against the liabilities present if the plan were to be terminated and (2) against the additional liabilities that will accumulate if the plan is maintained on an ongoing basis.

Termination-Basis Funding

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 "overfunded" on a termination basis. If such an overfunded plan is terminated, the excess assets can be recovered by the employer. The recent controversy surrounding the number of plans terminating to recapture excess assets suggests that many pension plans are overfunded.

Termination basis measurement is appropriate to, and reflective of, the legal obligations of an employer sponsoring a pension. As you well know, the decision to sponsor a pension plan in the United States is a totally voluntary one on the part of the employer. Legally, employers have no obligations to continue the pension plans. In practice, terminations of pension plans happen infrequently. Whether a pension plan is treated as terminating or continuing makes a difference in the amount of the pension liabilities, because the benefit formula usually includes wage and service factors.

Accrued liability is a legal interpretation of corporate responsibility in which the firm assumes no legal obligation to continue the pension plan. One justification for this is that the accrual of additional benefit is contingent upon the worker rendering future services. ERISA considers termination of pension plans a business decision. Because of the option of plan termination, the accrued cost method emphasizes increments in accrued benefit in the current year.

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.

When a pension plan is terminated, the sponsor knows exactly the amount of liability because it has to negotiate with insurance companies to buy annuities. But few plans are terminated each year. When these nonterminating plans use termination-basis accounting, one has to make interest rate (discount rate) assumptions. Market interest rates change from year to year. Therefore, an interest rate used in one year may not be appropriate for the next year. Consequently, overfunding in one year could become underfunding in the next. For this reason most plans use an interest rate representative of long term expectations rather than current year returns. This approach "smooths" the flow of contributions and is generally termed "conservative." Some plans, however, shift from this practice when difficult economic conditions face them.

Notwithstanding the effect of interest rate assumptions, available data indicate that, on average, termination-basis funding levels of pension plans have risen over the last several years. Our analysis of various surveys conducted by the Wyatt Company, Johnson and Higgins, Greenwich Associates, and BEA Associates all points to the rising level of pension funding measured on a termination basis. (See EBRI Issue Brief #54, pp. 8-9 for details.) Charts 1 and 2, based on Wyatt's 1985 Survey of Actuarial Assumptions and Funding, illustrates the steadily increasing percentage of plans (78 percent in 1985) that are sufficiently funded on a termination basis for total accrued benefits.

As far as the magnitude of the unfunded liabilites measured on a termination basis, EBRI's tabulations from Greenwich Associates data indicate that in 1985, 1,500 of the largest corporate single-employer pension plans, when viewed as a group, had total accrued pension plan liability of $456.9 billion against total assets of $430.5 billion, or total unfunded accrued liability of $23.4 billion in 1985. This represents a substantial improvement over the year 1978, when total accrued liability of $247.7 billion measured against total assets of $172.4 billion, for a total unfunded accrued liability of $75.3 billion. The ratio of assets to accrued liability improved from a 70% ratio in 1978 to a 95% ratio in 1985.

If we look at pension liabilities of only the plans with underfunding, we find that in 1984, based on the Johnson and Higgins latest Executive Report on Large Corporate Plans, 66 plans in the sample of 453 large plans had total unfunded accrued liability on a termination basis of about $10 billion.

It must be emphasized that it is important to distinguish between termination-basis funding sufficiency and a more general concept of appropriate funding in an ongoing pension plan. Termination-basis sufficiency is mainly pertinent to actual plan termination under current law.

Ongoing Funding

Funding in an ongoing plan is based on the explicit assumption that the firm will continue the pension plan far into the future and is therefore geared to anticipating expected future liabilities.

These liabilities, like those of a terminated plan, are determined by plan provisions and actuarial factors. But whereas termination liabilities depend on only two actuarial factors, measuring ongoing future liabilities is far more complex and depends on many factors, such as:

- 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;
- wage and salary growth; and
- the prospects of business continuation.

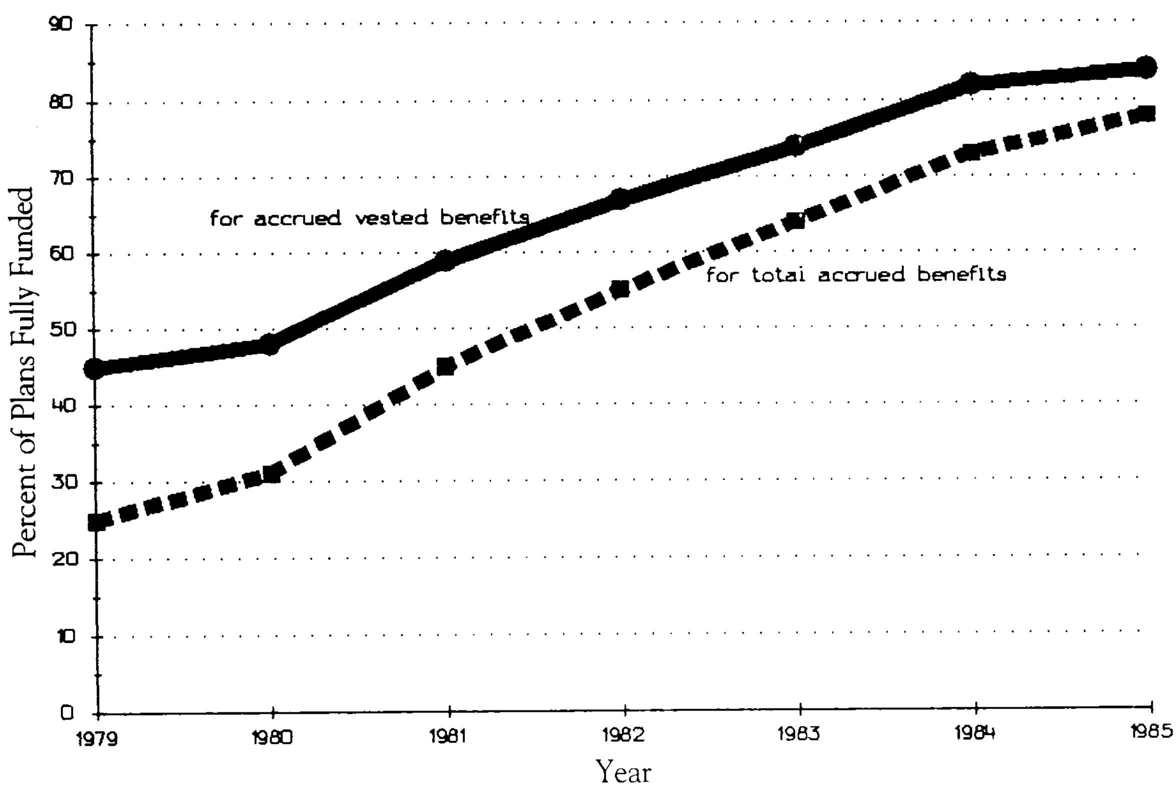
Both termination liability and ongoing future liability are affected by benefit formulas; ongoing future liability is also affected by vesting standards, retirement age provisions, and other plan provisions.

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 work-life of the participant for whom benefits are accruing.

Unfortunately, no plan sponsor data for the universe of private defined pension plans is currently available on ongoing pension liabilities, although in the next several years, some data will begin to emerge as a result of the new rules published by the Financial Accounting Standards Board (FASB), which will require sponsors to provide information on ongoing pension liabilities.

Chart 1

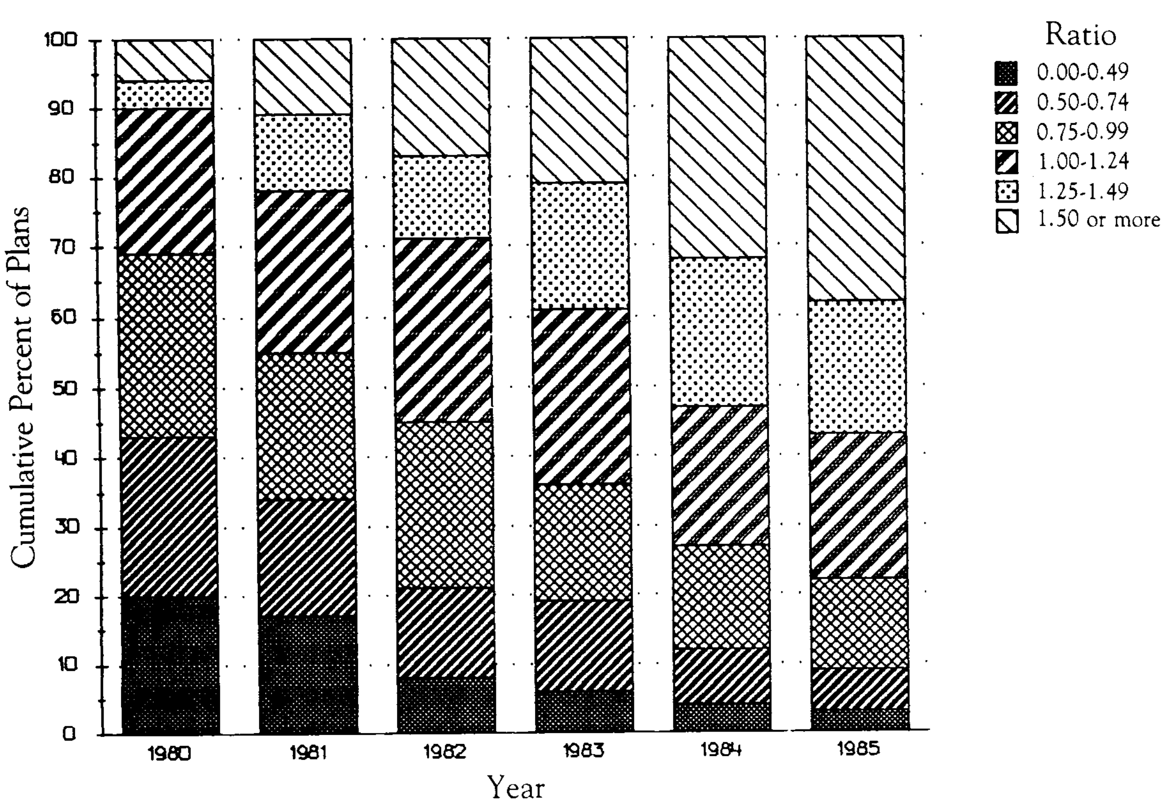
Defined Benefit Pension Plans with 1,000 or More Participants: Percent Fully Funded for Accrued Vested Benefits and Total Accrued Benefits



Source: The Wyatt Company, *1985 Survey of Actuarial Assumptions and Funding*. Sample of 948 plans.

Chart 2

Defined Benefit Pensions Plans with 1,000 or More Participants: Percent Distribution by Ratio of Assets to Total Accrued Benefit Liabilities



Source: The Wyatt Company, *1985 Survey of Actuarial Assumptions and Funding*. Sample of 948 plans.

Nevertheless, in most cases, ongoing liability will likely exceed termination-basis liability. Consequently, ongoing liability is more likely to be less than fully funded. This fact does not necessarily suggest that the pension system is in danger or that pension funding is weak. Additional employer contributions and additional investment returns will have accrued before all of the ongoing obligations fall due.

Measuring Funding Adequacy

To restate, in somewhat different terms, the differences between these two approaches to measuring funding adequacy it might be helpful to use a stock-and-flow concept. In a simplified way, termination funding is the stock of assets on hand. The question then is: Does the plan have enough assets to buy annuities to satisfy the accrued liabilities to date?

Ongoing funding adequacy refers to both the stock of assets already in the fund and the flow, or expected, annual contributions the plan sponsor is required to make to meet the present and future liabilities. Are the assets sufficient to buy annuities to satisfy all future liabilities? Generally, the answer is "no." Nor does the law require it. Funding adequacy then depends on whether the flow of annual contributions plus investment returns will be sufficient. This is a very difficult question to answer. Few researchers have examined it. Companies can and do alter their contributions and variations in key actuarial assumptions can produce dramatic differences in results. Table 1 shows the adjustment made to ongoing pension liabilities by using a different interest rate. For example, using a 7% interest rate instead of an 8% interest rate can increase liabilities by 21%.

Table 1
PENSION PLAN LIABILITY ADJUSTMENT FACTOR

Reported Interest Rates	Liability Adjustment Factor Under Alternative Interest Rates							
	0%	2%	4%	6%	8%	10%	12%	14%
0%	1.00	0.58	0.35	0.23	0.15	0.11	0.08	0.06
1%	1.32	0.77	0.47	0.30	0.20	0.14	0.11	0.08
2%	1.73	1.00	0.61	0.39	0.26	0.19	0.14	0.11
3%	2.23	1.29	0.79	0.50	0.34	0.24	0.18	0.14
4%	2.83	1.64	1.00	0.64	0.43	0.31	0.23	0.17
5%	3.56	2.06	1.26	0.81	0.54	0.39	0.29	0.22
6%	4.41	2.55	1.56	1.00	0.68	0.48	0.35	0.27
7%	5.40	3.13	1.91	1.22	0.83	0.59	0.43	0.33
8%	6.53	3.78	2.30	1.48	1.00	0.71	0.52	0.40
9%	7.80	4.52	2.75	1.77	1.20	0.85	0.63	0.48
10%	9.22	5.34	3.25	2.09	1.41	1.00	0.74	0.57
11%	10.78	6.24	3.81	2.44	1.65	1.17	0.86	0.66
12%	12.48	7.22	4.40	2.83	1.91	1.35	1.00	0.77
13%	14.31	8.28	5.05	3.24	2.19	1.55	1.15	0.88
14%	16.27	9.42	5.74	3.69	2.49	1.76	1.30	1.00
15%	18.35	10.62	6.48	4.16	2.81	1.99	1.47	1.13

Source: Man-Bing Sze, Pension Funding Policy and Corporate Finance (Santa Monica, The Rand Corporation, P-7144-RGI, 1985), p. 49.

Actuarial Assumptions and Funding

Government and private regulatory bodies continue to take note of the importance of actuarial assumptions. Recent legislative actions -- the requirement in H.R. 3838 that key actuarial assumptions be reasonable standing alone, rather than in the aggregate (current law) -- and the new FASB rules may result in more uniform interest rates across plans in valuing pension liabilities. These changes may, however, lead to large annual assumption changes rather than "smoothing," and could actually make interpretation of the true funded status of the pension system more difficult. The results of significant changes in investment returns, for example, is shown by the pattern of declining annual contributions. This is largely due to rising investment returns and increasing actuarial assumptions. Data from Greenwich Associates (table 2) shows that aggregate contribution levels for large plans have fallen each year since 1982. From 1984 to 1985 alone, the decrease was 13 percent.

Table 2

Percent Change in Aggregate
Contributions from Preceding Year
in Large Single-Employer Plans[a]

Year	Change
1983	-15%
1984	- 2
1985	-13

Source: EBRI tabulations based on Greenwich Associates, Report to Participants on Large Corporate Pensions, 1979-1986.

[a]Estimates of aggregate pension finding in 1,500 of the largest corporate plans, based on a sample of approximately 1,000 plans.

A future concern: What will happen if the stock market reverses itself, investment returns decline overall, and lower interest rate assumptions seem more realistic for valuing returns long term? For some plans that have used high actuarial assumptions, this could result in a deterioration of funding adequacy on an ongoing basis and much higher contributions required of employers at a time when the overall level of economic activity, as measured by the stock market performance, may not be at its best. Recent actions (H.R. 3838 and FASB) may work together to push investment return assumptions up and to increase funding volatility. As a result, most plan sponsors have criticized these changes.

Economic Causes of Underfunding

We realize that the Committee has before it recent examples of large firms that have terminated their pension plans with insufficient funds to pay accrued liabilities. Without dwelling on any single firm, we would like to advance some explanations about why certain companies may underfund their pension plans.

Ironically, a valued part of ERISA, the creation of the guaranty program administered by the Pension Benefit Guaranty Corporation, creates an incentive for some employers to underfund their pension plans, knowing that any unfunded liabilities can be shifted to PBGC upon plan termination. As stated in the 1986 Economic Report of the President: "With the establishment of the PBGC, a company can make generous retirement benefit promises to employees, and pay employees lower wages than it otherwise would, because both parties know that if the company fails, the PBGC will honor the pension obligations (up to ERISA-limited amounts)."

The president's Economic Report goes on to explain, "The companies most likely to abuse PBGC pension insurance are those doing poorly. Companies losing money enjoy no tax benefits from fully funding pension plans and are also less likely to be able to deliver on pension promises with company assets." Other studies confirm that companies in financial difficulty are the most likely ones to underfund a pension plan and shift risk to the PBGC. But the relationship of pension funding to corporate profitability and tax liability underscores another potential economic reason for underfunding -- or overfunding -- namely the concerns of corporate finance.

Companies can control the flow of money into pension funds because of the flexibility ERISA allows in amortizing plan liabilities. Many plans continue giving benefit increases after plan funding has begun to deteriorate and, under ERISA, can fund these increases over 30 years--for a declining industry, a very long time period. Yet, this flexibility is one of the primary reasons public and private employers have been willing to sponsor defined benefit pension plans. By synchronizing the timing and amount of pension contributions, funding strategy becomes a valuable tool in financial planning. Corporate and joint-trust use of pension funding for such purposes falls within the current funding rules, and coexists along with ERISA's fiduciary rule that pension funds must be managed for the exclusive benefit of participants. The implications of new pension accounting rules published by the Financial Accounting Standards Board now make more clear what many have known for years: that pension funds may constitute a large and growing corporate asset.

Declining employment in certain industries may also lead to underfunding, since the declining ratio of participants to beneficiaries increases the employer's pension costs, particularly if the plan has not been fully funded up to that point.

Impact of Pension Underfunding on PBGC

Underfunding, itself, does not exert an immediate adverse effect on the PBGC -- although it always poses a potential risk to PBGC because the plan sponsor has had the option to terminate the plan at will. Obviously, the termination of an underfunded plan does pose financial burdens on the PBGC and eventually requires additional premium payments by nonterminating employers to finance the underfunded terminations. COBRA, in addition to the premium increase, modifies the termination rules, making it more difficult for an employer to terminate an underfunded plan and reduces PBGC's exposure somewhat. But even under the new law, PBGC has limited claims in an underfunded situation. Recently, the current executive director of the PBGC has suggested additional steps that may be needed: (1) a $13.50 premium per participant; (2) changes in bankruptcy laws to give PBGC a higher priority as creditor in bankruptcy proceedings; and (3) tighter minimum funding standards.

In addition to the financial impact on the PBGC, one must also consider the adverse effects underfunded plans have on the way the insurance program is viewed by the private sector. To the extent that underfunded terminations continue and force escalating PBGC premium increases, another negative reason exists for not establishing or maintaining a defined benefit plan. To the extent that premium increases continue to rise -- and they will have to in the future, despite the new law -- it aggravates the inequity of asking responsible employers to pay for PBGC's $1.5 billion deficit. Such inequities might eventually dispose even strong plan sponsors to terminate their plans, rather than continuing to subsidize weaker firms. And if that happens, the financial burden on the employers remaining in the PBGC will worsen in a vicious cycle.

All of these effects can be viewed as negative influences underfunded plans exert on the private sector pension system as well as on PBGC.

Impact on Federal Treasury

Since the agency that guarantees pension benefits is financed by employer-paid premiums, the termination of an underfunded pension plan has no adverse effect on the federal treasury. In the short run, underfunding can actually increase federal revenues because -- all things being equal -- an underfunded plan means less tax deferral.

In the long run, however, the federal treasury could well become involved if PBGC's deficit should worsen and if the appropriate premium increase were neither politically feasible nor desirable. In that sense, it is not inconceivable that general revenues could be tapped to help finance PBGC, just as they have been tapped for Social Security, Railroad Retirement, Civil Service Retirement, and others.

Impact of Underfunding on Pensioners and Active Participants

Generally, ERISA requires PBGC to insure "basic" vested benefits up to a maximum. PBGC is also authorized to insure nonbasic benefits but has not opted to do so.

Under PBGC regulations, basic benefits include any vested retirement benefits including cost-of-living adjustments effective prior to termination and any death, disability or survivor benefit that was owed or in payment status at the date of plan termination.

Despite the guaranty program, both beneficiaries and active participants run the risk of losing some benefits in the event an underfunded plan terminates.

Beneficiaries in current payment status may suffer a reduction in their payments after an underfunded termination for two reasons: PBGC only insures up to a maximum indexed dollar amount ($1,789.77 monthly in 1986) and (2) benefits promised by plans or plan amendments in effect for less than five years at termination are not fully insured.

In underfunded terminations, active participants may also lose some accrued benefits. PBGC guarantees payment of basic benefits up to an indexed maximum. Under the new law, in addition to liabilities guaranteed by PBGC, the terminating employer is also, within prescribed limits, liable to plan participants for vested benefits not insured by PBGC. However, such a claim may be difficult to enforce on financially ailing firms. Moreover, for firms that can afford to pay, once legislated limits are reached, noninsured vested benefits that are still unfunded are lost.

In addition, participants in underfunded plans that terminate lose accrued benefits that are not vested prior to termination. (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 "10-year cliff vesting" schedules. If an underfunded termination occurs before the worker's tenth year of service, no benefits will be paid to the worker and earned benefits will be lost. If the House of Representatives accepts the Senate provision in H.R. 3838 for five-year vesting under private plans, fewer workers will lose all their benefits in an underfunded termination. But the same principle will still apply, i.e., workers whose service has not vested will not receive any benefits after an underfunded termination.

Conclusion

Congress imposed funding standards upon employers to improve the security of the pension benefit promise.

Overall, the standards adopted by Congress have achieved that goal. In general, private plans are far better funded than they were before ERISA, and current measures of funding on a termination basis have been improving over the past several years. Combined with the insurance provisions of ERISA, pensions are far more secure in the vast majority of cases.

Despite the generally favorable picture, the current rules still allow a minority of individual firms to underfund their plans. Basically, this is because ERISA allows considerable flexibility in choosing the period for amortizing funding of plan liabilities which is, in turn, closely related to funding levels. Funding waivers available to firms experiencing substantial business hardship also allow plans to underfund.

Termination of underfunded pension plans contributes to the PBGC's financial deficit, further aggravates inequities within the single-employer insurance program between financially weak sponsors and the financially strong sponsors who subsidize them through the PBGC premium, and exposes both beneficiaries and participants to potential benefit losses.

Recent legislation will make it more difficult for plans to terminate and raises substantial revenue for PBGC. But it doesn't cure the problem of underfunded pension plans, and another round of premium increases and further reforms may be expected.

The pending tax reform bill would make changes in the rules governing actuarial assumptions. Five-year vesting, if adopted by the House, will cut down on some of the accrued benefit losses experienced by active participants in terminating underfunded pension plans. Other recent developments warrant continued attention of Congress, such as the reaction of corporate pension funding behavior to the recently announced FASB rules for pension accounting, and the recent decline in corporate contributions to pension plans in the wake of unusually large investment gains. In particular, Congress should be aware that pension funds are a large and growing corporate financial asset, and changes in pension legislation can have a large effect on employers' willingness to fund pensions.

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Supplemental Sheet: June 24 hearing on Pension Plan Underfunding

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- Studies confirm that companies in financial difficulty are the most likely ones to underfund a pension plan and shift risk to the PBGC.

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- o Companies can control the flow of money into pension funds because of the flexibility ERISA allows in amortizing plan liabilities. Many plans continue giving benefit increases after plan funding has begun to deteriorate and, under ERISA, can fund these increases over 30 years--for a declining industry, a very long time period. Yet, this flexibility is one of the primary reasons public and private employers have been willing to sponsor defined benefit pension plans.

- o Declining employment in certain industries may also lead to underfunding, since the declining ratio of participants to beneficiaries increases the employer's pension costs, particularly if the plan has not been fully funded up to that point.

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