EBRI

T-85

Statement

Before the Subcommittee on Oversight
Committee on Ways and Means
U.S. House of Representatives

on

The Financial Condition of the Pension Benefit Guaranty Corporation

by

Dallas L. Salisbury, Paul Yakoboski, and
Celia Silverman

Employee Benefit Research Institute

Washington, D.C.

26 August 1992

EMPLOYEE BENEFIT RESEARCH INSTITUTE
2121 K Street, NW / Suite 600 / Washington, DC 20037-2121
Telephone 202-659-0670 FAX 202-775-6312

**SUBMISSION OF DALLAS SALISBURY,
PAUL YAKOBOSKI, AND, CELIA SILVERMAN
EMPLOYEE BENEFIT RESEARCH INSTITUTE
FOR THE SUBCOMMITTEE ON OVERSIGHT
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES**

Wednesday, August 26, 1992

Since the enactment of the Employee Retirement Income Security Act (ERISA) in 1974, employer-sponsored pension plans have assumed an increasingly important role in providing retirement income security. The Pension Benefit Guaranty Corporation (PBGC) was created under ERISA to strengthen retirement security by guaranteeing benefits for employer-sponsored defined benefit pension plan participants. Under ERISA, PBGC has three principal missions: to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants,[1] to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under covered plans, and to maintain premiums at the lowest level consistent with carrying out its obligations.

While PBGC has always operated with a net deficit, large plan terminations in fiscal 1991 and 1992 have increased its net deficit to $2.5 billion as of year-end 1991. (Table 1 reports the historical trend in assets, liabilities for future benefits, and net deficit of the single-employer fund.) PBGC's increasing deficit has caused some to question its ability to continue insuring pension benefits in the long term. PBGC believes that incorporating traditional casualty insurance principles into the current insurance scheme would minimize its exposure and reduce incentives inherent in the current system for sponsors to transfer pension debt to PBGC. Some argue that unless the system is altered, PBGC's deficit could ultimately lead to a general taxpayer bailout reminiscent of the Federal Savings and Loan Insurance Corporation (FSLIC) episode. Proponents of a social insurance perspective, represented by ERISA, argue that worker

[1]While ERISA refers to "voluntary private pension plans," the House Committee on Education and Labor in its Single-Employer Pension Plan Amendments Act Committee Report cites the "original purpose" of the title as "to encourage the establishment and maintenance of defined benefit plans while providing for the security of promised pension benefits."

What is PBGC's Current Financial Status?

Concern has been voiced regarding PBGC's financial viability. Such concern arises from PBGC's net worth deficit of $2.5 billion in its single-employer fund and the estimated $31 billion in underfunding within individual pension plans, $13 billion of which is considered by PBGC to pose a "serious risk" because of sponsor financial trouble.

The $2.5 billion deficit does not imply that PBGC has inadequate assets to cover payment obligations due in the immediate future. When a plan terminates, PBGC inherits an obligation to make a stream of payments to plan retirees over a period of years into the future (20, 40, even more than 60 years) as opposed to one large lump-sum payment on termination. The present value of these future payments, currently $7.8 billion, is booked today as a liability. However, it is not necessary for PBGC to have assets adequate to cover these liabilities now because payments are not currently due. A deficit does not necessarily indicate danger of imminent insolvency, but it does indicate that assets must eventually be increased to meet future obligations that are known today.

In addition, PBGC is likely to incur liabilities not shown on current financial statements resulting from future distress terminations. PBGC keeps track of underfunded plans where it considers distress terminations to be a reasonable possibility, but it does not include the net underfunding in these plans on current financial statements as it does with probable terminations.[2] PBGC currently estimates that there exists $13 billion of underfunding in the single-employer defined benefit system that poses a reasonably possible risk to the corporation. This is not a liability from past terminations or probable terminations but rather a potential liability for terminations PBGC believes may happen in the future.

On the other side of the ledger, PBGC will be receiving revenue in the future from premiums and investment earnings. While such receipts may not result in adequate assets to cover all PBGC liabilities for unfunded pension benefits, they are nonetheless likely to be significant and should be included in any

---

[2]A probable termination is one that PBGC considers highly likely to occur; this judgment is based on criteria given in FASB Statement No. 5—Accounting for Contingencies. The plans involved have not begun the termination process, but rather the sponsor is in such dire financial straits that PBGC considers the termination likely, although not necessarily imminent. PBGC books the net liability for these probable terminations on current financial statements because these are obligations for which they are likely to be responsible in the future, and thus they want to recognize them now. Some actually move off the probable list and others remain on it for years. The reported claims figure is net because it is the present value of future benefits for which PBGC is liable less estimated plan assets available and recoveries from employers.

discussion of PBGC solvency. According to PBGC, current premium receipts[3] total $790 million per year, while interest and dividend receipts currently approximate $305 million per year. Future income is difficult to predict; premium income depends on the size and funding status of the defined benefit system as well as the regulations governing premium rates, while investment earnings depend on the net flow of assets each period as well as the rate of return earned. To get some idea of the funds involved, consider that the present value of receiving $790 million each year for the next 20 years (valued with a discount rate of 6.25 percent[4]) is $8.9 billion. Such receipts are likely to be available to help cover future pension liability payments from today's terminated plans and also to cover payments for obligations that may arise in the future (the potential $13 billion in unfunded benefits discussed above and/ or other future liabilities that may arise.) Consideration of future income receipts in addition to future liabilities provides additional insight into PBGC's solvency.

On a pure cash flow basis PBGC actually ran a surplus in 1991 as receipts from operating activities exceeded disbursements from operating activities. Premium receipts of $786 million plus interest and dividends of $305 million resulted in $1.1 billion in total receipts. Operating activity disbursements totaled $660 million and were composed primarily of benefit payments at $514 million, administrative expenses at $63 million, and interest purchased at $81 million. This resulted in a net cash flow surplus from operating activities of $431 million in 1991. PBGC anticipates positive cash flows again in 1992 and does not foresee any near term problems in meeting its obligations. According to PBGC, "Although cash-flow could turn negative as early as three years in the pessimistic forecast,[5] the fund has ample assets to pay its liabilities (benefit payments) for a considerable period of time."[6]

---

[3]PBGC's premiums were raised most recently in 1991. The flat rate was increased from $16 to $19 per plan participant, and the overall cap on premiums for underfunded plans was increased to $72 from $50. It can be argued that this latest increase has not been in effect long enough to have had a noticable effect on the deficit, so that things may improve with the passage of time.

[4]In the 1991 PBGC annual report, the present value of future benefits is valued at 6.75 percent for immediate annuities, and with lower rates for deferred annuities, giving a composite rate of 6.25 percent that was also used for projected investment results.

[5]PBGC developed three 10-year forecasts of its expected status under different loss scenarios. The pessimistic scenario assumes that termination of the plans with the $13 billion of underfunding that pose a reasonably possible risk occurs over the next 10 years in addition to a modest number of lesser terminations each year.

[6]See Pension Benefit Guaranty Corporation, *Pension Benefit Guaranty Corporation Annual Report: Strengthening the Pension Saftey Net, 1991* (Washington, DC: Pension Benefit Guaranty Corporation, 1992).

How Well Funded Are Defined Benefit Pension Plans?

PBGC's ability to meet its future obligations is also dependent on the health of the private defined benefit system as a whole. PBGC reports that, in the aggregate, defined benefit plans have $1.3 trillion in assets to back $900 billion in benefit liabilities. Available evidence suggests that approximately 85 percent of pension plans have assets equal to or exceeding 100 percent of liabilities, up from 45 percent in 1981, and 38 percent have assets in excess of 150 percent of liability for accrued benefits (table 2).[7] The percentage of plans that were fully funded on a termination basis increased every year between 1981 and 1987 and leveled off between 1987 and 1991.

From 1977 to 1987, the funding status of single-employer defined benefit plans significantly improved, rising from an average of 85 percent funded to 129 percent funded on a termination basis (table 3). Since 1980, defined benefit plans, on average, have been overfunded. The increase in funding ratios most likely reflects a combination of factors, including higher contribution rates needed to meet minimum funding standards, favorable investment returns on equity, and the use of higher interest rate assumptions to discount future benefits.

Despite the sound aggregate funding status of the defined benefit system, the net deficit of the single-employer insurance system can be significantly increased by single occurrences of distress terminations of large pension plans. Underfunded plans sponsored by companies that are having financial difficulties represent the greatest risk to PBGC. The stock market's assessment of plan sponsors' financial health can be measured by examining their equity rates. An analysis of rates of return on common stock of New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) firms with underfunded plans reveals that companies having the largest underfunding relative to the market value of their common stock also experienced the lowest rates of return on equity. Equity rates of return are shown over three holding periods for common stocks purchased in the beginning of 1986, 1981, and 1976 and held through the end of 1990. Plan sponsors were ranked into quintiles by their standardized underfunding on a termination basis. The common stock of the quintile of plans with the smallest

---

[7]Throughout this discussion "termination basis" refers to basing funding ratios on benefits accrued and assets accumulated at the end of the plan year, the assumptions plans would use to calculate liabilities for standard terminations. Termination basis funding does not refer to PBGC's calculation of liabilities for underfunded terminations, using termination mortality and retirement age assumptions.

underfunding ratio experienced a rate of return of 16.2 percent over a holding period from 1976 to 1990, while the return on equity of the most underfunded plans was 0.6 percent. The value weighted index for stocks traded on the NYSE and AMEX was 14.3 percent over the same period (table 4).

The market's relative perception of the financial health of firms traded on AMEX and NYSE that had underfunded plans in 1990 is declining over time. The common stock of each quintile of underfunded plans experienced a lower rate of return net of the value weighted index for NYSE and AMEX if the stock was purchased later. The common stock of the three quintiles of plans with the smallest underfunding ratios experienced positive net rates of return for the holding period from 1976 to 1990. However, the net rate of return on common stock experienced by these three quintiles of plan sponsors decreased to negative values for the holding period from 1986 to 1990. The net rate of return on common stock for the two quintiles of plans with the largest underfunding ratios was negative in each holding period. The net rate of return on common stock of plan sponsors in the fourth quintile reached a low of -12.7 percent, and the rate of return on common stock of plan sponsors in the fifth quintile reached a low of -25.6 percent for the holding period from 1986 to 1990.

Is It Valid to Compare PBGC and Savings and Loan Problems?

Given the manner in which the federal government's guarantees to pension participants have been implemented, it is not surprising that PBGC is inevitably compared with other incentive-incompatible guarantee funds, including the now defunct Federal Savings and Loan Insurance Corporation (FSLIC). However, several important distinctions should be drawn.

As of the end of 1988, FSLIC-insured savings institutions were much more concentrated in securities sensitive to downturns in the real estate market than defined benefit pension plans are today (charts 1 and 2). In fact, defined benefit pension plan assets are invested in a variety of investments, which means that even if PBGC cash flow problems deteriorated to the point where there was a need to sell off a large percentage of the defined benefit plans' assets, there would be less need for realizing depressed asset values through liquidation than in the case of S&L insurance.

S&Ls were given new investment powers in 1980, and many marginally capitalized institutions believed they could grow their way out of their problems. The rapid growth of agency-guaranteed liabilities does not appear to be the case with PBGC. In fact, the Omnibus Budget Reconciliation Act of 1987 introduced a potentially chilling effect on the future growth of uninsured benefits by requiring that if a plan adopts an amendment that increases current liability and the funded current liability percentage of the plan is less than 60 percent in the year in which the amendment takes effect, the contributing sponsor and members of the controlled group must provide security (e.g., a bond) to the plan.

Best judgments are that fraud and mismanagement existed in about 60 percent of the S&L failures and that they contributed to the failure or insolvency of the S&L in perhaps about 25 percent of the cases. Evidence of such activity among single-employer pension plans is almost nonexistent.

Another problem that arose in the S&L sector that has no comparable equivalent in the PBGC exposure base is that of loan participation. As S&Ls found themselves constrained by limits on the amount they could lend to a single borrower, they began to sell off pieces of the loan to other institutions. Unfortunately, many of these secondary lenders relied on the underwriting capacities of the originating S&L. Although a large proportion of defined benefit plan assets are placed in bank pooled funds and similar investments where there is a sharing of investment results, this strategy is fundamentally different from loan participations that have been characterized as "a transfer of risk from a party who lacks courage to one who lacks knowledge."[8]

From 1981 to 1987, S&Ls insured by FSLIC were permitted to use accounting options that were not in agreement with generally accepted accounting principles (GAAP) and have been described as "self-deceptive accounting procedures" by the executive director of PBGC. In contrast, pension plans must adhere to very conservative accounting measures under FAS 35, while the vast majority of the large plan sponsors follow GAAP procedures, at least for those events defining their solvency and net worth determinations.

After deregulation, S&Ls turned to areas in which they had little expertise (commercial real estate). It has been alleged that auditors did not properly supervise the industry. Although similar types of

---

[8]Jeffrey Koeppel, "The Insolvency Looking Glass," *Best's Review* (September 1991): 37ff.

allegations have surfaced regarding pension plans, this only concerns the exposure of a potential claim and does not deal with the more important issue of whether a claim will arise in the first place (i.e., will the plan sponsor enter into bankruptcy).

Even if attention is focused on the exposure issue, one finds a tremendous difference in two regards. First, the thrift industry regulation was decentralized; pensions are not. Second, the matter of regulatory forbearance has often been cited as adding to the eventual cost of the S&L bailout. In comparison, the recent action of shutting down the pension plan for Pan Am reveals no such hesitation on the part of the current PBGC decision makers.

Perhaps the most important distinction between the two programs is that funds are not generally available to the customer on demand in a defined benefit pension plan prior to a termination. Although there is some potential for lump-sum distributions to negatively impact a pension plan's cash flow, this could be controlled (at least theoretically) by ERISA section 4045, which allows PBGC to recapture part of any distributions that start within the three year period immediately preceding the plan's failure. Certainly, there is only limited evidence of catastrophic "runs on the bank" from the standpoint of defined benefit plan sponsors or PBGC.

Moreover, after a termination, the cash flow position of the two programs is markedly different. S&L depositors are typically paid immediately, while PBGC spreads out payments over a long period of time.

Although most of the discussion above dealt with the similarities (or lack thereof) between the *exposures* of S&Ls and PBGC, the most important difference between the two guarantee funds is that the *likelihood* that a plan insured by PBGC will fail is diversified across several key industries, whereas S&L guarantee funds were exposed exclusively to the risks of a single industry that was extremely vulnerable to fraud and events beyond its control.

Social Insurance Perspective versus Casualty Insurance Perspective

The urgency surrounding PBGC's current financial condition and what, if any, changes are necessary depends on whether the corporation is viewed from a social insurance or a casualty insurance

perspective. The social insurance perspective views PBGC as a transfer agency in a social insurance arrangement, while the casualty insurance perspective maintains that PBGC should function like a traditional commercial insurer.

The social insurance perspective is the foundation of Title IV of ERISA. This perspective relies on appeals to justice and collective responsibility. The existence of pension plans was held to serve a legitimate public interest, and therefore it argues for insuring of all reasonable benefits that a sponsor is willing to provide for its employees and honoring the nature of defined benefit plans, i.e., realizing that benefit increases create unfunded liabilities to be funded in the future. Social insurers maintain that the system was designed to involve cross-subsidization of plans when necessary to protect participants.

Some argue that the social insurance aspects of PBGC's insurance system are responsible for its net deficit. However, from the social insurance perspective, PBGC's net deficit is not a measure of performance or ability to meet obligations but rather an indication of whether the premiums are sufficient or claims are unusually high. Because PBGC is a government agency, its net deficit is inconsequential to its ability to meet its obligations when due. A more relevant measure is its cash flow, which is positive. Furthermore, the creators of ERISA recognized the possibility of systematic abuse and therefore required that pension plans meet minimum contribution requirements, or minimum funding standards. However, even with the tightening of minimum funding standards, it is still possible to minimize contributions within legal guidelines, causing further plan underfunding.

On the other hand, the casualty insurance perspective would argue that there is no overriding public interest in having defined benefit pensions. Therefore, insurance should not be provided for benefits that increase PBGC's exposure, such as benefit increases in already underfunded plans and benefits contingent on unpredictable events (plant shutdowns, for example) that are typically not prefunded. Casualty insurance proponents also argue that premiums should be structured so that plans posing the greatest risk pay correspondingly higher premiums, without limit.

The casualty insurance perspective argues that the PBGC insurance scheme is flawed in its design and that these flaws are the cause of any existing deficit problems. The system is not designed on sound insurance principles, although it is supposed to be an insurance system protecting participants'

pension benefits. The design creates financial incentives for undesirable sponsor behavior and allows the opportunity for underfunding of defined benefit pension plans. Unless these flaws are corrected, PBGC may very well continue running deficits into the foreseeable future; pure casualty insurance advocates believe that the program should ideally have assets at least equal to liabilities.

Four major proposals have been introduced to change PBGC's current operation. While maintaining PBGC's social insurance program, these proposals represent a further movement toward casualty insurance concepts. They approach the benefit guarantee and plan termination issues of the defined benefit insurance system from more of a casualty insurance program perspective by aiming to minimize PBGC's exposure through increasing recoveries and minimizing claims. However, the proposals maintain a social insurance program's objectives by attempting to alter the behavior of the participating plans and plan sponsors while maintaining cross subsidies and the present premium structure. The proposals were included in President Bush's 1993 budget.

Conclusion

Does a general taxpayer bailout reminiscent of the FSLIC episode loom on PBGC's horizon? There are currently sufficient liquid assets within the aggregate defined benefit system itself to cover the existing pockets of underfunding within individual plans. Therefore, unless legislative changes are made that cause employers to terminate well funded defined benefit plans en masse, thus denying PBGC a base of premium payers, a general taxpayer bailout would be unnecessary.

Does this mean that there are no problems with the PBGC insurance system and therefore no changes are needed? No, both social insurance and casualty insurance proponents acknowledge that the system needs to change in order to reduce abuse and maintain participants' retirement security.

As currently structured, the pension insurance system creates a financial incentive for employers to underfund their defined benefit plans. The vast majority of sponsors maintain well funded plans despite this incentive, but some do not. Without changes, underfunding within the defined benefit system is likely to improve only slowly if historical trends continue. Were more firms to begin to take advantage of the system, the financial picture could deteriorate.

A balance between social insurance and casualty insurance principles is most likely to achieve an overall strong and continuing defined benefit pension system. Too substantial a movement toward either extreme could ultimately lead many businesses to abandon the defined benefit approach. Should that be deemed desirable, it should come from explicit targeted actions, not as the indirect effect of well intentioned reforms.

Table 1
Single-Employer Fund Assets, Benefit Liabilities, and Net Deficits

Year	Total Assets	Present Value of Future Benefits ($ millions)	Accumulated Deficit
1991	$ 5,664	$ 7,845	$ 2,510
1990	3,111	4,790	1,913
1989	3,059	3,984	1,124
1988	2,422	3,806	1,543
1987	2,163	3,629	1,549
1986	1,740	5,492	3,826
1985	1,155	2,447	1,325
1984	1,063	1,497	462
1983	1,085	1,570	523
1982	773	1,076	333

Source: Pension Benefit Guaranty Corporation, *Pension Benefit Guaranty Corporation Annual Report 1991: Strengthening the Pension Saftey Net* (Washington, DC: Pension Benefit Guaranty Corporation, 1992).

Table 2
Surveyed Firms' Funded Ratios, by Percentage of All Surveyed Pension Plans, 1981–1991

Ratio of Accrued Benefits over Assets	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
0.00–0.49	17%	8%	6%	4%	3%	2%	3%	2%	3%	2%	1%
0.50–0.74	17	13	13	8	6	5	3	4	4	2	4
0.75–0.99	21	24	17	15	13	14	10	11	11	11	10
1.00–1.24	23	26	25	20	21	17	16	16	18	20	25
1.25–1.49	11	12	18	21	19	21	20	20	19	20	22
1.50 or more	11	17	21	32	38	41	48	47	45	45	38
No. of Plans	575	813	700	919	846	799	720	786	787	781	801

Source: The Wyatt Company, *Survey of Actuarial Assumptions and Funding: Detailed Survey Results : Pension Plans with 1,000 or More Active Participants,* 1989, 1990, and 1991 (Washington, DC: The Wyatt Company, 1989, 1990, and 1991).
Note: Data are based on a survey of pension plans covering 1,000 or more active employees.The 1990 survey contained single-employer plans (90 percent) and multiemployer plans (10 percent).

Table 4
Rates of Return on Common Stock for New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) Firms Sponsoring Underfunded Plans in 1990

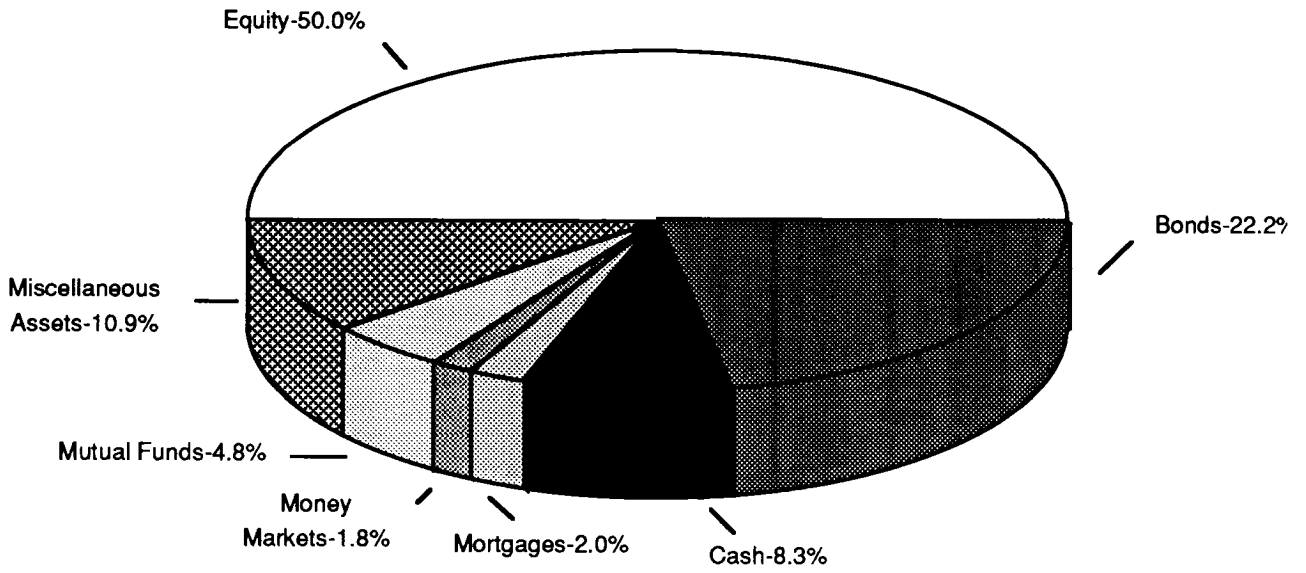
	Holding Period		
	1986–1990	1981–1990	1976–1990
Standardized Underfunding Quintile Ranking[a]			
Least Underfunded	8.55%	12.29%	16.16%
2	8.83	13.41	14.57
3	7.06	10.81	14.98
4	-0.91	4.34	10.63
Most Underfunded	-13.85	-4.24	0.59
Value Weighted Index for NYSE, AMEX	11.75%	13.01%	14.25%
Excess Rate of Return Relative to NYSE, AMEX Index			
Least Underfunded	-3.20%	-0.72%	1.91%
2	-2.92	0.40	0.32
3	-4.69	-2.20	0.73
4	-12.66	-8.67	-3.62
Most Underfunded	-25.60	-17.25	-13.66

Source: Paul Yakoboski, Celia Silverman, and Jack VanDerhei. "PBGC Solvency: Balancing Social and Casualty Insurance Perspectives." *EBRI Issue Brief* no. 126 (Employee Benefit Research Institute, May 1992).

[a]Underfunding measured by FASB '87 disclosures for underfunded plans in 1990. Standardized underfunding is equal to the accumulated benefit obligation, or termination liability, less the market value of assets divided by the market value of the sponsor's common stock in 1990.

Chart 1

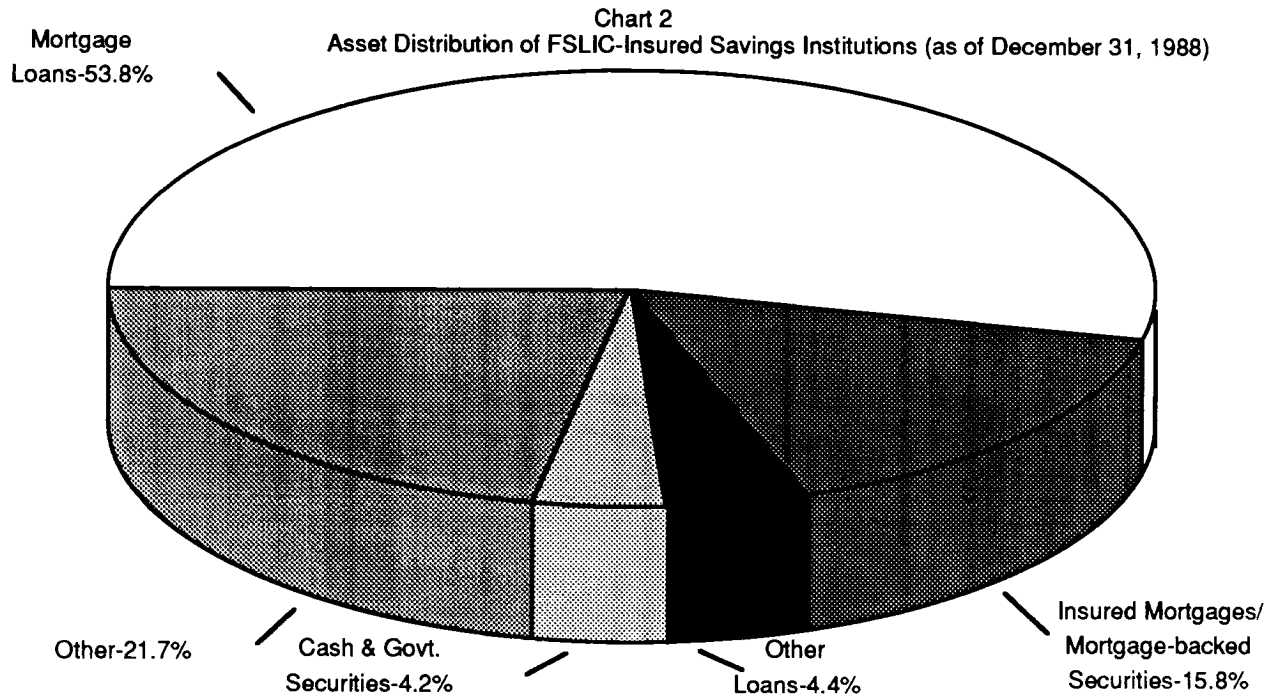
Asset Distribution in Private Trusteed Pension Plans, 1991



Source: Federal Reserve Board, *Flow of Funds Accounts, Financial Assets and Liabilities, Fourth Quarter 1991*, (Washington, DC: Federal Reserve Board, 1992).

[a]The Department of Labor published asset allocation of single-employer defined benefit plans with 100 or more participants based on 1987 5500 forms. Asset allocation in 1987 was: equity, 22.9 percent; bonds, 16.7 percent; cash, 11.3 percent; real estate, 0.8%, unallocated insurance contracts, 22.4 percent; pooled funds, 20.4 percent; and other, 5.5 percent. (U.S. Department of Labor, Pension and Welfare Benefits Administration, *Trends in Pensions*, John A. Turner and Daniel J. Beller, eds. Washington, DC: U.S. Department of Labor, 1992).

Chart 2
Asset Distribution of FSLIC-Insured Savings Institutions (as of December 31, 1988)



Source: EBRI compilation from United States League of Savings Institutions, *Savings Institutions Sourcebook,* (Washington, DC: United States League of Savings Institutions, 1989).

Table 3
Funding Ratios of Single Employer Defined Benefit Plans, 1977–987

Year	Funding Ratio
1977	85.0%
1978	84.2
1979	91.0
1980	107.0
1981	106.9
1982	115.4
1983	124.7
1984	128.8
1985	136.3
1986	132.4
1987	128.6

Source: U.S. Department of Labor, Pension and Welfare Benefits Administration, *Trends in Pensions*, John A. Turner and Daniel J. Beller, eds. (Washington, DC: U.S. Department of Labor, 1989).