

# CRS Report for Congress

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## **Can the Pension Benefit Guaranty Corporation Be Restored to Financial Health?**

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# Can the Pension Benefit Guaranty Corporation Be Restored to Financial Health?

## Summary

The Pension Benefit Guaranty Corporation (PBGC) is a federal government agency created by the Employee Retirement Income Security Act of 1974 (ERISA) to protect the pensions of participants covered by most private sector, defined benefit pension plans. The primary source of revenues offsetting PBGC's claims is premiums paid by the sponsors of covered pension plans. These premiums are established by Congress. The PBGC receives no appropriated funds. The PBGC's single-employer program has posted growing deficits for the last three years. The deficit on September 30, 2004 was at an all-time high of \$23 billion. Currently, the pension plans of major airlines present an enormous threat to the financial condition of the PBGC. Underfunded pension plans of sponsors with below-investment-grade-bond ratings represented *reasonably possible exposure* of another \$96.0 billion as of September 30, 2004 according to the PBGC.

An independent organization has projected that without reform, the PBGC's single-employer program will run out of cash in 2020 or 2021. Because of the risks to its long-term financial viability, the Government Accountability Office (GAO) has placed the PBGC single-employer program on its high-risk list of agencies with significant vulnerabilities to the federal government. PBGC failure could require a tax-payer funded bailout. Major systemic issues include the PBGC's premium structure, funding requirements for defined benefit pension plans and PBGC's access to a bankrupt company's assets.

Current PBGC premiums may be too low for the risks that PBGC underwrites. Furthermore, premiums do not vary based on the credit risk for the company, asset-liability mismatch for the pension plan, participant demographics, or benefit design features such as whether or not the plan allows lump sum payouts. Sponsors that have made pension plan contributions in excess of the minimum required in the past may not be required to make contributions to the pension in the current year even when the pension plan is underfunded in the current year. Cyclical companies that wish to make higher contributions during profitable periods may find that maximum deductibility rules prevent them from making such contributions. Under current bankruptcy law, the PBGC cannot perfect a lien to force a company that has filed for bankruptcy to make minimum required pension plan contributions.

In 2003, the Bush administration made a proposal for reform to strengthen pension plan funding and the financial condition of the PBGC. Various bills with the goal of reforming the PBGC were proposed in the 108<sup>th</sup> Congress but none were enacted into law. The doubling of the PBGC deficit from fiscal 2003 to fiscal 2004, has heightened awareness about the PBGC deficit situation. Congressional leaders from both parties have announced their intention to move aggressively on legislative solutions in the 109<sup>th</sup> Congress.

This report will be updated upon major developments affecting the PBGC's financial condition.

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# Can the Pension Benefit Guaranty Corporation Be Restored to Financial Health?

## Background

The Pension Benefit Guaranty Corporation (PBGC) is a federal government agency created by the Employee Retirement Income Security Act (ERISA) of 1974 to protect the pensions of participants covered by most private sector, defined benefit pension plans. The primary source of revenues offsetting PBGC's claims is premiums paid by the sponsors of covered pension plans. These premiums are established by Congress. The PBGC receives no appropriated funds.<sup>1</sup> In the last three years, the combination of a slow economy, low stock market returns and low interest rates have left the PBGC in a steadily worsening financial position. Currently, the pension plans of older airlines present an enormous threat to the financial condition of the PBGC. United Airlines and US Airways have indicated that they may need to terminate their pension plans in the near future on account of financial problems.<sup>2</sup> Delta Air Lines has been able to avert bankruptcy by reducing costs, including *freezing* its pilots' pension plan.<sup>3</sup> But it too has warned that if it is unable to reduce operating expenses and if it continues to experience significant losses, it will have to file for bankruptcy.<sup>4</sup> PBGC's problems may not be confined to the airline industry. Systemic issues related to PBGC's premium structure, funding requirements for defined benefit pension plans and PBGC's limited access to a bankrupt company's assets may contribute to a repeat of the airline scenario with some other industry.

## Funded Status of the PBGC Single Employer Program

The PBGC covers both single-employer and multiemployer pension plans. Multiemployer plans are collectively bargained plans to which more than one company makes contributions. As of September 30, 2004, the single-employer

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<sup>1</sup> See CRS Report 95-118 EPW, *Pension Benefit Guaranty Corporation: A Fact Sheet*, by Paul J. Graney for further information.

<sup>2</sup> UAL Corporation's (parent of United Airlines) 10-Q filing with the Securities and Exchange Commission for the quarterly period ended September 30, 2004; "US Air Asks Court to End Labor Contracts," *The New York Times*, Nov. 13, 2004

<sup>3</sup> When a pension plan is frozen, participants do not earn any additional pension accruals on account of increased service. Also, no new entrants are admitted into the plan.

<sup>4</sup> Delta Airlines 10-Q filing with the Securities and Exchange Commission for the quarterly period ended Sept. 30, 2004

program accounted for virtually all of the PBGC's deficit. This report will focus on the single-employer program.

The PBGC's single-employer program posted a deficit of \$23.3 billion as of September 30, 2004, the largest deficit in its history. **Table 1** illustrates how quickly the funded status of this program has deteriorated. Definitions for the terms used in **Table 1** are provided in the "Glossary of Terms — Table 1" at the end of this report.

**Table 1. PBGC Funded Status**  
(amounts in billions)

	Sept. 30, 2004	Sept. 30, 2003	Sept. 30, 2002	Sept. 30, 2001
Assets	\$39.0	\$34.0	\$25.4	\$21.8
Liabilities	\$62.3	\$45.3	\$29.1	\$14.0
Net position	\$(23.3)	\$(11.2)	\$(3.6)	\$7.7
Benefit payments for prior fiscal year	\$3.0	\$2.5	\$1.5	\$1.0
Reasonably possible exposure	\$96.0	\$83.9	\$35.4	\$10.9

**Sources:** PBGC 2004 Performance and Accountability Report, PBGC 2003 and 2002 Annual Reports.

**Note:** On account of rounding, Assets minus Liabilities may not exactly equal Net position.

According to **Table 1**, while PBGC's assets grew by 79% from 2001 to 2004, its liabilities grew by a far larger 345%. The liabilities shown in **Table 1** include both claims for plans that have already terminated as well as claims for probable terminations. Under Statement of Federal Financial Accounting Standard No. 5 — *Accounting for Contingencies*, when an economic event that is likely to lead to plan termination has occurred on or before the date of the financial statement, the estimated amount of the "probable" claim (net of estimated recoveries and plan assets) must be accrued.

Although the decline in interest rates from 2001 to 2004 contributed to the increase in liabilities, the predominant factor was the termination of a number of plans with large claims during this period. Notable among these were pension plan terminations for Bethlehem Steel, LTV Steel, National Steel, and US Airways Pilots' Pension Plan that accounted for total claims of \$ 7.5 billion.<sup>5</sup> In addition, net claims for probable pension plan terminations for United Airlines and US Airways (for its

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<sup>5</sup> Termination of the US Airways Pilots' Pension Plan in 2003 resulted in a net PBGC claim of \$0.75 billion. The first bankruptcy filing did not solve US Airways' financial problems, which had to file for bankruptcy again in 2004. US Airways has announced its desire to terminate some of its remaining pension plans as part of the new bankruptcy filing.

non-pilot pension plans), estimated by the PBGC at \$8.5 billion, are presumably included in the September 30, 2004 liability figure of \$62.3 billion. By way of comparison, total claims for all single employer pension plan terminations for the 29 years between 1975 and 2003 were \$ 17.59 billion.<sup>6</sup>

**Table 1** shows that the “Reasonably Possible Exposure” as of September 30, 2004 was at an all time high of \$96 billion.<sup>7</sup> Reasonably possible contingent claims generally represent underfunding in plans sponsored by companies with below-investment-grade bond ratings.<sup>8</sup> While losses from “reasonably possible” plans are not yet “probable terminations” and are not accrued for financial statement purposes, under generally accepted accounting principles, this financial exposure must be disclosed in the footnotes to the PBGC’s financial statements. Some of the plans included in the exposure for reasonably possible terminations can be expected to end up under PBGC trusteeship in the next few years. Therefore the large reasonably possible exposure in 2004 is a sign of possible escalating problems in coming years.

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<sup>6</sup> Claim figures are from Table S-5 of *Pension Insurance Data Book 2003*. Claims are defined as liabilities on a termination basis for benefits guaranteed by the PBGC less plan assets.

<sup>7</sup> The “Reasonably Possible Exposure” as of Sept. 30, 2004 was determined by the PBGC based on the estimated unfunded vested benefits as of Dec. 31, 2003 for those plans considered to be reasonably possible but not probable terminations. The PBGC adjusted the unfunded vested benefits reported by these companies to the Dec. 31, 2003 PBGC select interest rate of 4.0%. The underfunding associated with these plans would generally tend to be greater at Sept. 30, 2004 because of the economic conditions (e.g., lower interest rates and/or low investment returns) that existed between Dec. 31, 2003 and Sept. 30, 2004. The PBGC did not reflect the events that occurred between Dec. 31, 2003 and Sept. 30, 2004 in the “Reasonably Possible Exposure” of \$96 billion.

<sup>8</sup> Below-investment-grade bonds are also called junk bonds or speculative bonds.

### Measurement of Liability

The PBGC liability is measured as the *actuarial present value* of estimated future benefits to be paid by the PBGC less the *present value* of estimated recoveries from plan sponsors and the assets of pension plans. Both plans already terminated as well as plans that will probably terminate in the near future are taken into account in measuring the liability. To measure the actuarial present value, PBGC adjusts the value of future benefits to reflect the time value of money by discounting with the appropriate interest rate. The present value of estimated recoveries is determined by adjusting estimated future recoveries to reflect the time value of money by discounting with the appropriate interest rate. The actuarial present value and the liability are highly sensitive to the interest rate used for discounting. The lower the interest rate, the greater is the liability. The interest rate is chosen such that, along with the mortality assumption, it produces an actuarial present value that reflects the price of single-premium nonparticipating group annuities in the market.

Interest rates declined between 2001 and 2004. The interest rate used to value PBGC's liabilities as of September 30, 2004 was a 25-year select rate of 4.80% followed by an ultimate rate of 5.00% for the remaining years. The interest rate used to value PBGC's liabilities as of Sept. 30, 2001 was a 20-year select rate of 6.70% followed by an ultimate rate of 5.25% for the remaining years.

## Impact of Older Airline Pension Plans

**Pension Underfunding and Credit Ratings of Older Airlines.** The older airlines<sup>9</sup> include the number one and number two airlines in the world, American and United Airlines, as well as other big names such as Delta Air Lines, Continental Airlines and US Airways. The eroded profit margins of these airlines after September 11, 2001, took a further hit with the steep increase in fuel prices in 2004. Some airlines are in worse position than others. United Airlines filed for bankruptcy in December 2002 and US Airways filed for bankruptcy for the second time in September 2004, after emerging from a previous bankruptcy filing in March 2003. Delta was able to stave off bankruptcy by negotiating benefit and salary cuts with its pilots' union. Under the agreement, Delta will freeze the airline pilot pension plan and replace it with a less expensive 401(k) plan.<sup>10</sup>

United Airlines and US Airways are both seeking approval from federal Bankruptcy Court for termination of their defined benefit pension plans. Both

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<sup>9</sup> Airlines that were in operation before the 1978 Airline Deregulation Act and whose goal is to provide service to multiple destinations by using large, complex hub-and-spoke operations are sometimes called "legacy airlines." Others define legacy airlines as those with "legacy costs," the millions of dollars paid by the airlines for the defined benefit pensions and health care costs of retirees. Most of the airlines established since deregulation do not have defined benefit pension plans.

<sup>10</sup> A 401(k) plan is a defined contribution pension plan authorized under Section 401(k) of the Internal Revenue Code. Pension benefits under a defined contribution plan are not guaranteed by the PBGC.

airlines wish to replace their traditional defined benefit pension plans with cheaper retirement benefits such as 401(k) plans. Both have suspended contributions to the defined benefit pension plans. **Table 2** shows estimated underfunding for United Airlines and US Airways.

**Table 2. Pension Underfunding by Airline**  
(amounts in billions)

Airline	Termination basis	Termination basis- PBGC guaranteed benefits only
United Airlines	\$8.3	\$6.4
US Airways	\$2.3	\$2.1

**Source:** Testimony PBGC, Bradley D. Belt, Executive Director in U.S. Congress, Senate, Commerce, Science, and Transportation, Oct. 7, 2004.

Under Section 4010 of ERISA, plans with large unfunded vested<sup>11</sup> benefits are required to file information on the plan's termination liability with the PBGC.<sup>12</sup> However, ERISA also requires the PBGC to maintain confidentiality of this information. Although the termination liability for benefits guaranteed by the PBGC is not available for Delta or the other major airlines, public data is available for another measure of liability. The Accumulated Benefit Obligation (ABO) is defined by the Statement of Financial Accounting Standard 87 as the actuarial present value of benefits (whether vested or nonvested) attributed by the pension benefit formula to employee service rendered before a specified date and based on employee service and compensation (if applicable) prior to that date. Under generally accepted accounting principles, a private sector company is required to disclose the unfunded ABO in its annual financial statements, when the ABO exceeds the market value of assets for the plan. The unfunded ABO differs from the termination liability for PBGC guaranteed benefits for several reasons. The discount rate used to determine the ABO is different (generally higher) than that used to determine the liability for PBGC guaranteed benefits. On the other hand, claims guaranteed by the PBGC are often lower than those provided under the pension plan. Overall, the liability for PBGC guaranteed benefits is often significantly greater than the unfunded ABO. In the absence of better information, the unfunded ABO can be used to provide a lower bound for the liability for PBGC guaranteed benefits.

**Table 3** shows the unfunded ABO and the Standard & Poor (S&P) credit ratings and outlook for the six older airlines at the end of fiscal 2003. The unfunded ABO

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<sup>11</sup> A vested pension benefit is a benefit that cannot be taken away from an employee even if he leaves the company prior to retirement. Typically, an employee has to serve a minimum number of years to become vested in his pension benefit.

<sup>12</sup> Section 4010 requires disclosure of the plan's termination liability when the aggregate unfunded vested benefits for all plans sponsored by the employer exceed \$50 million.

is a measure of the underfunding in a pension plan. Underfunding of a pension plan is not per se a problem for the PBGC. However, when the pension underfunding is coupled with the plan sponsor being in financial difficulty, the result can be significantly increased exposure for the PBGC.

The Standard and Poor's credit ratings, used to evaluate the quality of bonds issued by the borrowing company, are also a measure of the financial health of the company. The credit ratings are based on the issuer's financial ability to make interest payments and repay the loan in full at maturity. AAA is the highest credit rating and D is the lowest credit rating. AAA is better than AA which is better than A. Standard and Poor's also uses a plus or minus indicator. B+ is better than B and B is better than B-. Bonds rated at less than BBB are considered to be junk bonds. A rating of D indicates that the company is bankrupt or nearly so.

All of the airline credit ratings in **Table 3** are in the junk bond category. US Airways and United Airlines are currently in bankruptcy and have the D rating. Delta Airlines is ranked only slightly better with a rating of CC. Presumably the United Airlines and US Airways pension plans are considered 'Probable Plan Terminations' and included in the liability posted in PBGC's September 30, 2004 financial statement.<sup>13</sup> The rating of Delta is low enough that its pension plans would fall under either the 'Reasonably Possible Exposure' or 'Probable Plan Termination' category.

**Table 3. Unfunded ABO and Credit Rating of Older Airlines at End of Fiscal 2003<sup>a</sup>**

Airline	Unfunded ABO (\$ billions)	Expected benefit payout — 2004 \$ millions	S&P credit rating	S&P outlook
United Airlines	\$5.69	\$795	D	Not applicable
Delta	\$5.04	\$779	CC	Negative
Northwest	\$3.28	\$349	B	Negative
American	\$1.98	\$410	B-	Stable
Continental	\$0.68	\$188 (Estimated <sup>b</sup> )	B	Negative
US Airways	\$0.90	\$115	D	Not applicable

**Source:** 10K filings of airlines, Standard and Poor's.

**Notes:** (a) Unfunded ABO figures are as of Dec. 31, 2003 for UAL, Northwest, American and Continental and Sept. 30, 2003 for Delta and US Airways. The Unfunded ABO and Expected Benefit Payout figures were obtained from the 10K filings of the airlines for the fiscal year ending 2003. The

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<sup>13</sup> PBGC does not name the companies included in its "Probable Plan Termination" or "Reasonably Possible Exposure" categories. However, it discloses the criteria used for inclusion in these categories. While most of the criteria are objective, PBGC judgement is also used.

S&P Credit Ratings and Outlook were obtained from Standard and Poor's website at [http://www2.standardandpoors.com] as of Nov. 5, 2004.

(b) Continental did not release its expected benefit payout for 2004. The figure shown is its actual benefit payout for 2003.

**Table 3** also shows the Standard and Poor's outlook for the credit ratings of the airlines. A negative outlook indicates that Standard and Poor's may further lower the credit rating of the company.<sup>14</sup> The negative outlook for Delta, Northwest and Continental indicates that their ratings may slip further.

**Impact on the PBGC.** If any of the airline plans were to be taken over by the PBGC, the benefit payout for claims guaranteed by the PBGC would be somewhat lower than the benefit payouts shown in **Table 3**. This is because the PBGC imposes a cap, set by statute, on the annual benefits it will pay for a participant.<sup>15</sup> In addition, PBGC does not fully guarantee the benefit increases granted by a plan sponsor in the five years prior to plan termination. Nonetheless, the benefit payouts shown in **Table 3** provide a rough idea of the magnitude of problem that PBGC faces on account of the older airlines. If United, Delta and US Airways were to terminate their pension plans, PBGC's \$3.0 billion payout would increase by roughly \$1.7 billion.

In its 2003 Annual Report, PBGC described results from the Pension Insurance Modeling System (PIMS), a model used to evaluate its exposure and expected claims. The model produces results under 5,000 different simulations. PBGC does not release the mean or median benefit payout figures between 2003 and 2013 produced by PIMS.

Congressional Research Service (CRS) estimates that termination of either the United Airlines or Delta pension plans would increase PBGC's 2004 fiscal payout of \$3.0 billion by about 0.8 billion. PBGC's 2004 Performance and Accountability Report states that expected benefit payments in 2005 are \$3.4 billion. According to the PBGC, this reflects payment of four months for probable plan terminations. Some of the probable plan terminations are assumed to occur part way through 2005.

Assumption of UAL or Delta's unfunded liability would dwarf PBGC's largest loss from one company in its history. With the trusteeship of Bethlehem Steel pension plans in 2003, PBGC absorbed a loss of \$3.6 billion. PBGC has estimated that the termination of United Airlines pension plans would result in a loss of \$6.4 billion. Based on the unfunded ABO figure in **Table 3**, CRS estimates that the termination of Delta's pension plans will result in a loss of at least \$5 billion. The

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<sup>14</sup> Moody's Investor Service and Fitch Ratings also rate bonds issued by companies and provide ratings outlook for companies. The rating scales used by these agencies are different than the scale used by Standard and Poor's. PBGC uses Standard and Poor's and Moody's ratings in evaluating whether a company's pension plan should fall in either the "Probable Plan Terminations" or "Reasonably Possible Exposure" category.

<sup>15</sup> For plans terminating in 2005, the cap is \$45,614 per year for a single-life annuity beginning at age 65. If plan assets are greater than liabilities, beneficiaries may receive benefits greater than the cap.

termination of US Airways pension plans will result in a loss of \$2.1 billion according to the PBGC.

When the sponsoring employer of an underfunded pension plan is close to bankruptcy, plan participants are likely to take steps to protect individual interests that further increase the underfunding of the plan. Delta pilots, for instance, responded to the company's financial troubles by taking lump sum early retirement benefits in large numbers. When early retirement benefits are subsidized (as for Delta), a greater number of early retirements than expected by the pension plan increases the actuarial losses for the plan. Payment of lump sums further increases the underfunding of an underfunded pension plan. Greater pension underfunding means, of course, greater potential liability for the PBGC.

If the bankruptcy court permits United to terminate its pension plans, this could set up a domino effect with other airlines seeking to reduce labor costs by filing for bankruptcy and passing unfunded pension costs on to the PBGC. While plan termination is the worst case scenario, the airlines may make other pension plan changes that could also have negative implications for the PBGC. Such changes include conversion to a cash balance plan design, freezing of the defined benefit plan to new employees or replacement of the defined benefit pension plan by a defined contribution plan. The cash balance plan design can exacerbate underfunding of a pension plan since these plans typically pay pensions as lump sums instead of monthly instalments. A steady flow of premiums is an important source of revenue for closing PBGC's current large deficit. Freezing of a defined benefit plan to new employees or replacement of a defined benefit pension plan by a defined contribution plan would drain PBGC's premium base since PBGC premiums are based partly on the number of covered participants.

## **Pension Funding Rules**

Section 412 of the Internal Revenue Code specifies the minimum funding requirements for a defined benefit pension plan. The minimum required contribution is the sum of the "normal cost" (present value of pension benefits earned during the year) and amortization of liabilities including past service credit and experience gains and losses.<sup>16</sup> Sponsors of plans with over 100 participants are required to make additional contributions called "deficit reduction contributions" (DRCs) when the value of plan assets is less than 90% of the "current liability."<sup>17</sup> Companies that contribute more than the minimum required amount establish a credit balance in their "Funding Standard Account." In any subsequent year when they are low on cash, the law permits the companies to make the minimum required contributions (including the DRC) out of the credit balance instead of paying cash into the pension fund. This is true even if the credit balance that existed on paper has melted away

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<sup>16</sup> Amortization of a liability means paying off the liability over a number of years in level instalments consisting of principal and interest.

<sup>17</sup> Current liability is the liability of a plan determined as though the plan is an ongoing entity. It is based on employee service and compensation to date. The interest rate used to determine the current liability must fall in a range specified by law that is based on an average of long term interest rates over several years.

on account of assets being invested in investments, such as stocks, that have dropped in value. Thus United Airlines was not required to make cash contributions to the flight attendant's pension fund in 2001 even though it had slid to 88% funding.<sup>18</sup>

The Pension Funding Equity Act of April 2004, P.L. 108-218, gave commercial airlines and steel producers breaks in the funding of pension plans on account of the adverse financial conditions faced by these industries. Under the act, these employers can elect temporary relief from required deficit reduction contributions for plan years beginning after December 27, 2003, and before December 28, 2005, provided they were not subject to the deficit reduction contribution in 2000. Companies that qualify for DRC relief still are required to make the "regular contribution" that they would have to make without regard to the DRC provision, but the required DRC is to be reduced by 80% in 2004 and 2005.<sup>19</sup> Congress legislated the targeted relief for certain employers with the belief that the action was necessary to preserve the pension plans. The older airlines in fact availed themselves of this provision thereby reducing the funding of their pension plans below what it would have been otherwise. A few months after passage of the legislation, United and US Airways announced their intent to terminate their employee pension plans.

Section 404 of the Internal Revenue Code specifies rules for determining the maximum deductible contribution to a pension plan. The Code also defines the "full funding limit" (generally 90% of the current liability). Any contributions in excess of the maximum deductible contribution are not tax deductible.

## Reporting and Disclosure

While detailed information is available on pension plan funded status to regulatory agencies, information available to plan participants and investors is fairly limited. Pension plans are required to furnish plan participants with a Summary Annual Report that contains information regarding the plan's net assets, contributions, income, and expenses. The Summary Annual Report must contain the current value of a plan's net assets as a percentage of its current liability only if the percentage is less than 70%.

In addition to the above disclosure, plans that are less than 90% funded on a current liability basis (with some significant exceptions) must distribute notices to employees that describe the plan's funding status and the limits of PBGC's guarantees.

Even when plans disclose their current liability, plan participants may be unaware of the plan's termination liability. While the current liability reflects the pension plan's liability assuming the employer's plan will continue indefinitely, the termination liability reflects the cost to a company of terminating its pension plan by paying lump-sums and purchasing annuities in the private market that reflect the

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<sup>18</sup> "For Pension Plans Like United's, a Healthy Glow That's Paper Thin," *The New York Times*, Nov. 6, 2004

<sup>19</sup> See CRS Report RS21717, *H.R. 3108: The Pension Funding Equity Act*, by Patrick Purcell and Paul Graney for further information.

benefits workers have earned. Often the termination liability is considerably higher than the current liability.

Section 4010 of ERISA does require plan sponsors with more than \$50 million in aggregate plan underfunding to furnish information on the plan's termination liability and assets to the PBGC. However, on account of the law's confidentiality requirements, this information is not available to plan participants or the public.

## **PBGC Premiums**

The primary source of PBGC revenues, other than assets of terminated pension plans under PBGC trusteeship, is the premiums set by Congress and paid by the private sector employers that sponsor defined benefit pension plans. The PBGC premium structure for the single-employer program consists of flat-rate premiums and variable-rate premiums. All covered single-employer plans are required to pay a flat annual premium of \$19 per participant. Underfunded plans are required to pay an additional variable-rate premium of \$9 per \$1,000 of unfunded vested benefits. However, the variable premium is waived if contributions to the plan for the prior year were at least equal to the Full Funding Limit. Bethlehem Steel, the largest plan termination to date in PBGC's history, paid no variable-rate premiums for five years prior to plan termination.

## **The PBGC Versus Private Insurance Companies and State Insurance Guaranty Funds**

The PBGC is often thought of as an insurance company that protects the pension benefits of employees of bankrupt companies. However, there are key differences between commercial insurance companies and the PBGC. State regulations require an insurance company to hold adequate reserves to back promises behind the products they sell. When the products involve particularly unpredictable risks (variable annuities, for instance), additional reserves are required. Insurance companies develop their premiums such that after allowing for administrative expenses, enough is left over to build the required reserves. The PBGC's premiums, on the other hand, do not always reflect the true cost of insurance. In particular, PBGC premiums do not reflect the market risk that a poor economy may lead to widespread unfunded plan terminations during the same year. A 2002 article estimated that PBGC premiums were about half of the market price for the insurance.<sup>20</sup>

In an effort to attract better risks, insurance companies usually subdivide policy applicants into subgroups and base premiums for a particular subgroup on the level of risk that the subgroup presents. Applicants that are better risks are charged lower premiums. The PBGC premium is based only to a limited extent on the risk that a particular pension plan represents. The variable component of the premium is based on the unfunded vested benefit which reflects the degree of underfunding of the pension plan. However, the premium rate is not higher for a company that has a low

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<sup>20</sup> Stephen Boyce and Richard A. Ippolito, "The Cost of Pension Insurance," *The Journal of Risk and Insurance*, vol. 69, no. 2, pp. 121-170.

credit rating or a pension plan that has a marked mismatch between its assets and liabilities. The PBGC premium structure may encourage “moral hazard”.<sup>21</sup> A company could make its workforce promises for higher pensions instead of paying higher wages, then file for bankruptcy and transfer the pension obligation to the PBGC. The Boyce and Ippolito article notes that the moral hazard resulting from higher risks not being charged appropriate premiums was not taken into account in determining the underpricing of PBGC premiums. Presumably the estimate of underpricing would be even greater than 50% had moral hazard been taken into account.<sup>22</sup>

A better analogy to the PBGC might be a state insurance guaranty fund. State insurance guaranty funds are established for the protection of insurance policyholders. They are administered by the states and funded by assessments on insurers. Upon insolvency of an insurer, the insurers that are members of the state’s guaranty association assess themselves proportionate to their premium volume in the state to fund the difference between the insolvent company’s assets and the residents’ claims. Upon liquidation of a property-liability insurer, responsibility for payment of claims is transferred to the state’s guaranty association. Upon liquidation of a life insurer, the state’s guaranty association sells or transfers its insurance policies to another life insurer.<sup>23</sup>

Unlike the PBGC, a state’s guaranty fund does not actually contain monies until an insurer has become insolvent and participating insurers are assessed their share of the shortfall from the insolvent insurer. To date, state guaranty funds have not had the same financial problems as the PBGC. This is because a state’s control over an insurance company’s finances is greater than the PBGC’s control over funding of a pension plan. In addition to monitoring that adequate premiums are being charged for insurance premiums, a state can intervene when an insurance company faces financial problems. When a state’s insurance commissioner determines that the insurer is financially troubled, he can order the insurer to suspend business. If he believes that the insurer’s problems cannot be corrected, he can petition for an order of liquidation. The PBGC on the other hand cannot perfect a lien to force an employer that has filed for Chapter 11 reorganization to make pension contributions that are required under minimum funding rules. Typically, an underfunded pension

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<sup>21</sup> “Moral hazard” is a term used in the insurance industry to characterize a premium structure that does not appropriately reflect the risk presented by certain policyholders and therefore encourages disproportionate enrollment by these policyholders. The result is losses for the insurer that must be corrected by a revised premium structure. In the worst case, the result is insolvency of the insurer.

<sup>22</sup> Not everyone believes that PBGC premiums are too low for the risks that it covers. Christopher W. O’Flinn, Chairman of the ERISA Industry Committee, in his Sept. 15, 2003 testimony indicated that the use of conservative discount rates may be resulting in the overstatement of PBGC liabilities and excessive PBGC premiums. The testimony was given before the Subcommittee on Financial Management, the Budget and International Security, Committee on Governmental Affairs, United States Senate.

<sup>23</sup> See CRS Report RL32175, *Insurance Guaranty Funds*, by Carolyn Cobb for further information.

plan of a company on the verge of bankruptcy becomes far more underfunded by the time the plan terminates.

## Prognosis for the PBGC

Many of the older airline pension plans were adequately funded in 1999. Yet they are all significantly underfunded today. The airline industry can serve as an example of how fast profit conditions can deteriorate for an industry. Some say that the auto industry may be next in line.<sup>24</sup> The credit ratings of the auto companies have been worsening, with the rating for General Motors, the biggest of the autos, standing at just above junk bond status. These companies have expensive defined benefit pension plans with low funded ratios. The autos face continued pressure on their profit margins as a result of global competition as well as the prospect of expensive redesign to meet new emission controls that may be established by major states.

Because of the risks to its long-term financial viability, the GAO has placed the PBGC single-employer program on its high-risk list of agencies with significant vulnerabilities to the federal government.

The PBGC does not release cash flow projections from its stochastic PIMS model. However, estimates were recently released by an independent non-partisan organization called The Center on Federal Financial Institutions (COFFI) based on deterministic modeling of the cash flows from PBGC's single-employer program.<sup>25</sup> While results from a stochastic model are more detailed and would have been preferable, the COFFI analysis has been useful in providing rough order of magnitude numbers and furthering debate and discussion on issues facing the PBGC. Some of the major conclusions from COFFI's analysis are:

- Under COFFI's base scenario, PBGC's single-employer program will run out of cash in 2020 or 2021.<sup>26</sup> By way of comparison, the Social Security fund is expected to run out of cash in 2042. PBGC's own stochastic modeling shows a less than 10 percent chance that the program will deplete its assets by 2020. However, according to the PBGC such "tail events" can and do happen. The PBGC's large surpluses of the late 1990s and its record deficits of the early 2000s were scenarios with a less than 10 percent chance of occurring.
- In order to return PBGC to solvency, while honoring new claims from underfunded pension plans, it would be necessary to transfer \$78 billion from taxpayers to the PBGC.

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<sup>24</sup> "Pension Tension," *The New York Times*, Aug. 8, 2004

<sup>25</sup> See *PBGC: Updated Cash Flow Model from COFFI*, at [<http://www.coffi.org>].

<sup>26</sup> The base scenario assumes new claims from underfunded pension plans at \$2.7 billion each year (the level assumed in PBGC's PIMS model), incoming PBGC premiums starting at the 2004 level of \$1.5 billion and grading down to the historical average of \$900 million per year, and an annual investment return of 5.2% consistent with the predominantly bond portfolio held by the PBGC.

- The taxpayer rescue amount would rise from \$78 billion to \$95 billion if in addition to claims assumed in the base scenario, there were claims from plan terminations of all the legacy airlines. As a basis for comparison, we note that the bailout of the Savings & Loan federal insurance program (S&L) in 1989 cost taxpayers \$200 billion in today's dollars.
- Shutdown of the PBGC program without any new claims or any new premiums would still require a taxpayer transfer of \$30 billion.<sup>27</sup> While legislation could be enacted to shut the PBGC to new claims, this could be difficult since employees in firms that had paid PBGC premiums would expect to be protected with respect to vested guaranteed benefits earned to date.

COFFI's analysis also quantifies alternatives to taxpayer transfers for solving the PBGC problem. These include raising PBGC premiums or earning a higher rate of return on the assets held by the PBGC. Large increases in premiums may be untenable since they may cause the healthiest plans to drop out of the program. Earning a higher rate of return may be possible in some years by investing a larger proportion of assets in volatile investments such as stocks, but the resulting mismatch with PBGC's liabilities could ultimately result in lower returns on account of the need to liquidate assets in a down market to meet cash flow needs. During 2004, PBGC adopted a new investment policy that will increase investments in fixed income securities and reduce the percentage of assets invested in equities to 15% - 25% of total invested assets. The investment policy will reduce balance sheet volatility arising from a mismatch between assets and liabilities.

Many observers note that the prognosis for the PBGC is not good. Several leading Congressional members have announced their intention to move aggressively on legislative solutions in the 109<sup>th</sup> Congress.

## Policy Issues and Congressional Action

The GAO in its 2003 report on the PBGC's single-employer program made several suggestions for improving the long-term financial health of the program.<sup>28</sup> The Bush Administration made reform proposals in 2003 for accurate measurement of pension liabilities, increased transparency of pension plan information, and improved safeguards against deterioration of pension plan funding.

Pension underfunding in financially troubled companies is concentrated in industries subject to global competition such as the steel, airline, and auto industries. Some believe that PBGC insurance for pensions may have, in many instances, turned

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<sup>27</sup> This amount is \$7 billion greater than PBGC's fiscal 2004 deficit. According to COFFI, the difference of \$7 billion is attributable to a difference in treatment of future expenses. The COFFI model includes future expenses associated with the payment of claims, whereas under generally accepted accounting principles, the PBGC is not allowed to take all future expenses into account in determining the liability.

<sup>28</sup> GAO-04-90, *Single-Employer Pension Insurance Program Faces Significant Long-term Risks*.

out to be insurance for reorganizing in a globally competitive environment and that the solutions to strengthen PBGC's finances should be examined in this light.<sup>29</sup>

Various bills were introduced in the 108<sup>th</sup> Congress with the goal of improving the financial condition of PBGC's single-employer program. The various proposals for strengthening PBGC's single-employer program can be categorized as follows:

**Strengthen Funding Rules for Pension Plans.** GAO suggestions include restricting sponsors with low credit ratings from using their Funding Standard Account credit balances for reducing contributions, limiting lump sum distributions from severely underfunded pension plans, and raising the level of tax deductible contributions.

A key element of the Administration proposal is that pension contributions would be determined by using interest rates for discounting pension benefits taken from a corporate bond yield curve (a graph that plots the interest rates on bonds that mature at different dates in the future). This would ensure that the calculation of pension liabilities is more accurate than the current practice of using the same discount rate for all future payments regardless of when they occur. Sponsors of plans with older workforces would probably be required to increase pension contributions under this proposal. Small employers are also concerned about this proposal on account of the added complexity it would entail. The Administration also proposes that companies with below investment grade ratings whose plans are severely underfunded would have to immediately fully fund or secure any new benefit improvements, benefit accruals or lump sum distributions. The Administration has put forth several other reform principles that would also have the effect of strengthening pension funding.

The Pension Rights Center has suggested that companies not be allowed to use pension assets for payment of non-pension benefits such as retiree health benefits or to merge underfunded and overfunded pension plans.

The National Employee Savings and Trust Equity Guarantee Act of 2004, S. 2424, provided that an employer with a below-investment grade rating and plan assets valued at less than 50% of current liability would have its plan frozen and could not improve benefits or pay lump sums. It was approved by the Senate Finance Committee in September 2003 but not acted on by the Senate.

**Restructure PBGC Premiums.** The GAO has noted that the current fixed-rate premium of \$19 per participant has not been changed since 1991 and indexing it to the rate of CPI increase might be appropriate. The variable-rate premium could be restructured based on the risk posed by different plans. Different variable-rate premiums could be charged depending on the financial strength of the plan sponsor, asset-liability mismatch, participant demographics, and the plan's benefit structure, e.g., whether the plan has a lump sum option.

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<sup>29</sup> Remarks of David Walker, Comptroller General of the United States, at COFFI Policy Forum, Nov. 19, 2004

**Improve Transparency of Information.** The Administration proposes that the Summary Annual Report furnished by employers to plan participants include the plan's termination liability in addition to its current liability. The Administration also would like information collected by the PBGC under Section 4010 for the plan's termination liability to be made public.

The House version of the Appropriations bill for fiscal 2005 for Labor-Health and Human Services-Education, H.R. 5006, was approved in September 2004. The version would have repealed the ERISA provision that bars the PBGC from releasing to the public information it receives under ERISA Section 4010 (e.g., the plan and sponsor financial information that must be filed when a plan is more than \$50 million underfunded). The Senate Appropriations Committee approved its version of this bill, S. 2810, in September 2004. However, this version did not include any changes to ERISA Section 4010. The Fiscal Year 2005 Consolidated Appropriations Act (P.L. 108-447); signed by the President into law in December, 2004, did not include any changes to ERISA Section 4010 either.

The ERISA Industry Committee recommends that the PBGC disclose analyses of the long-term projections of its cash flow as well as its funded status (assets divided by liabilities) under various scenarios.<sup>30</sup>

**Change Bankruptcy Law.** Under current law, the PBGC is not allowed to perfect a lien to force a company that is in bankruptcy reorganization to make required minimum pension contributions. The PBGC would like the authority to do this so that plans do not become even more underfunded by the time they terminate.

**Reduce Disparity between Executive and Non-Executive Benefits.** H.R. 5292, introduced in October, 2004, would have prohibited employers from paying or promising nonqualified deferred compensation<sup>31</sup> to executive officers or directors for five years following a shift in pension liabilities to the PBGC during bankruptcy.

**Review Cash Balance Regulation.** The regulatory climate for cash balance plans<sup>32</sup> is highly uncertain. Employers have indicated that unless favorable

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<sup>30</sup> Testimony of Christopher W. O'Flinn, Chairman of the ERISA Industry Committee, on Sept. 15, 2003 before the Subcommittee on Financial Management, the Budget and International Security, Committee on Governmental Affairs, United States Senate.

<sup>31</sup> Nonqualified deferred compensation plans are benefit plans offered to executives that allow them to defer part of their compensation for payment at a later date, often with compounding at attractive interest rates. These plans do not have the same tax advantages as qualified pension plans offered to rank and file employees.

<sup>32</sup> Cash balance pension plans combine the characteristics of both traditional defined benefit pension plans and defined contribution pension plans. Like a traditional defined benefit pension plan, the employer has control over the investment of pension assets. Employees are provided periodic statements of amounts accumulated in their accounts, as for a defined contribution pension plan. Employees usually have the option of receiving a lump sum distribution from the plan when they leave the employer. For more information, see CRS

regulations are issued, they may be forced to terminate their cash balance plans in favor of defined contribution plans. Cash balance plans tend to be sponsored by large employers and are generally well funded. Termination of cash balance plans in large numbers would leave the PBGC in a more vulnerable position.

The doubling of the PBGC deficit from fiscal 2003 to fiscal 2004, has heightened awareness of the PBGC deficit situation. Representative Boehner, Chairman of the House Committee on Education and the Workforce, Senator Gregg, Chairman of the Senate Health, Education, Labor, and Pension Committee, Senator Grassley, Chairman of the Senate Finance Committee, and Senator Baucus, ranking Democrat on the Senate Finance Committee are among those that have announced their intention to move aggressively on legislative solutions in the 109<sup>th</sup> Congress.<sup>33</sup>

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<sup>32</sup> (...continued)

Report RL30196, *Pension Issues: Cash Balance Plans* by Patrick J. Purcell.

<sup>33</sup> "Pension Agency's Deficit Hits Record," *Washington Post*, Nov. 16, 2004; "PBGC Incurs Fiscal 2004 \$12.1 Billion Loss, Record \$23.3 Billion Deficit, Congress to Act," *Pensions & Benefits Daily*, Nov. 16, 2004; "Grassley, Baucus Say PBGC Finances Highlight Need for Pension Law Reforms," *Pensions & Benefits Daily*, Nov. 16, 2004.

## **Glossary of Terms — Table 1**

*Assets* — PBGC's investable assets for the single employer program, consisting of premium revenues, assets from terminated pension plans and assets recovered from their sponsors.

*Liabilities* — The present value of net guaranteed benefits with respect to underfunded terminated plans as well as the estimated present value of net guaranteed benefits for probable plan terminations. The interest rate used to calculate the present value is determined by the PBGC such that along with the assumed mortality table, it reflects the cost to purchase an annuity.

*Net Position* — Excess of assets over liabilities.

*Benefit Payments* — Benefits paid by the PBGC to retirees and beneficiaries in trustee plans.

*Reasonably Possible Exposure* — Potential loss to the PBGC from underfunded pension plans of sponsors experiencing financial problems. This amount excludes the potential losses from pension plans that the PBGC believes will be probably terminated in the foreseeable future.