Statement of
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NOTICE

This statement is not available for public release until it is delivered at 10:30 a.m. (EDT), on Tuesday, April 7, 1987.

In 1974, as part of a broader effort to protect participants in private pension plans, the Congress created a federal program of pension insurance to be operated by the Pension Benefit Guaranty Corporation (PBGC). The purpose of this agency is to ensure that workers receive certain retirement benefits promised by their employer, if their pension plan is terminated with insufficient assets to pay for these benefits.

Almost from the start, the pension insurance program for single-employer plans has had financial difficulties, and the PBGC itself has accumulated a large and growing deficit. Last year, the Congress responded to these and related issues by making changes in pension policies generally and by modifying the pension insurance program in particular. With the near tripling of the program's accumulated deficit during 1986 to $3.8 billion, however, concern has been expressed that additional changes are needed to assure the financial viability of the program.

My remarks today will focus on three topics:

o Information on the operation and financial status of the federal pension insurance program;

o Issues raised by the rapid growth in the accumulated deficit of the PBGC; and

- A range of specific options to address the PBGC's problems, most of which would improve its financial situation.

FEDERAL INSURANCE OF PRIVATE PENSION BENEFITS

Employers need not provide pensions for their workers, but if they do, the federal government requires them to follow rules relating to most major aspects of the plan's operation. In particular, an employer who sponsors a so-called defined-benefit pension plan--one that promises a specified annual pension benefit in retirement rather than simply providing contributions to workers' retirement accounts—is required to contribute at least a minimum annual amount to that plan as benefit commitments accrue. Annual payments must be sufficient to cover the normal cost of benefits accrued by workers in that year, as well as a portion of any other so-called supplemental pension liability that usually can be amortized over periods of 15 years or 30 years.

Even if they satisfy all legal funding obligations, pension plans can be underfunded if they terminate, largely because of the time involved in paying for amortized supplemental pension costs. These supplemental costs include benefit obligations, such as those resulting from granting pension benefits for service before the plan began and from amending the plan to increase or extend benefits. Supplemental costs can also arise from

unexpected changes in other factors, such as the early retirement of large numbers of workers or the poor investment performance of the plan's assets.

While the federal government does not restrict the termination of sufficiently funded pensions, those with funding shortfalls can only be terminated if the sponsor of the plan is in bankruptcy proceedings or generally would be unable to pay its debts without the termination. Once an underfunded plan is terminated, the PBGC takes over all of its assets, assumes liability for all guaranteed benefits, and attempts to recover any remaining liability of the sponsor. 1/ Since 1975, of the over 70,000 single-employer pensions that have terminated, about 1,350--or less than 2 percent--contained some unfunded benefits that were then taken over by the PBGC. Funds to pay for this insurance protection are derived from an annual premium of $8.50 for each pension participant, plus resources from terminated underfunded plans and their sponsors.

Because guaranteed benefits are limited in a number of ways, benefits paid by the PBGC to participants in terminated underfunded plans can be less than the amount they would have received had their plan not terminated. Only benefits vested before the plan is terminated are

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1. Sponsors of terminated underfunded plans are liable to the PBGC for up to 30 percent of their net worth for unfunded guaranteed benefits, plus 75 percent of the difference, if any, between the unfunded guaranteed benefits and 30 percent of net worth.

guaranteed by the PBGC, for example, and those benefits are not fully guaranteed unless they have been a part of the pension agreement for at least five years. Maximum guaranteed monthly benefits are limited to an indexed amount that is currently $1,858 for a life annuity beginning at the normal retirement age. In addition, the guarantee applies to the nominal dollar benefit of the plan. Benefits are not protected against inflation that occurs either before or after a worker retires.

The Financial Status of the PBGC.

At the end of 1986, the PBGC had an accumulated deficit of $3.8 billion. 2/ This shortfall is the difference between the present value of liabilities for benefit payments of about $7.4 billion and assets of about $3.6 billion. The present value of liabilities represents the amount of money that would be needed today to purchase annuities sufficient to pay when due all current and future benefits for which the PBGC has already accepted responsibility. As displayed in Figure 1, this accumulated deficit has increased during all but two years since the program began. Ignoring potential future claims, the Congressional Budget Office (CBO) estimates that the accumulated deficit could be repaid with a one-time charge of about $120 per insured participant.

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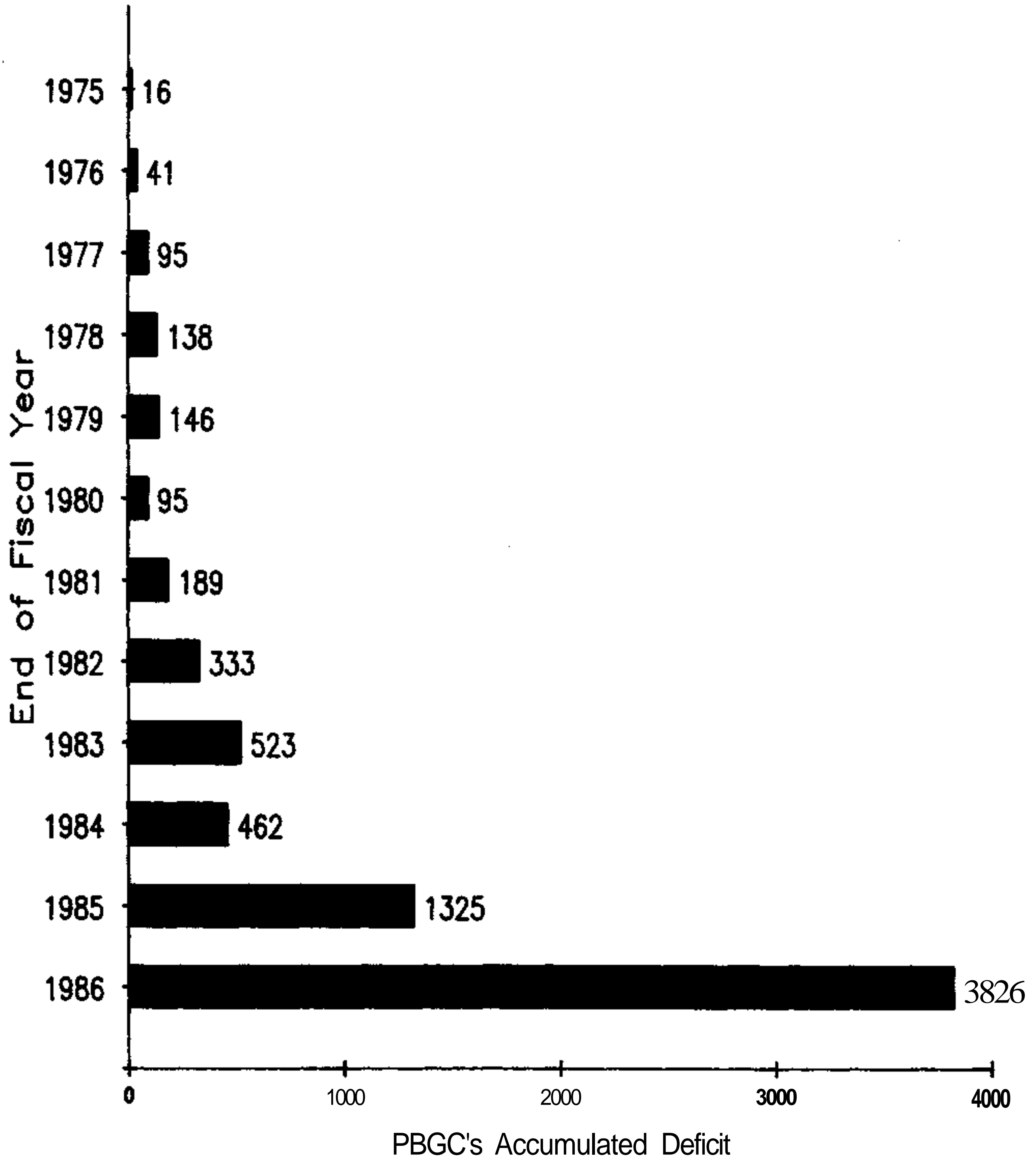
2. The term "accumulated deficit" refers to the unfunded portion of the PBGC's liabilities that have been generated since the program began in 1974, and not to the annual change in this unfunded liability.

Figure 1. Accumulated Deficit of the PBGC, 1975-1986 (In millions of dollars)



Source: CBO based on PBGC's Annual Report, various yeans.

A large part of the dollar value of claims against the PBGC has been made by an exceedingly small number of plans (see Table 1). For example, of the 1,350 underfunded pension plans terminating since 1975, the eight plans with the largest levels of unfunded benefits accounted for two-thirds of the dollar value of all claims. Fully 87 percent of claims for unfunded benefits were made by 3 percent of all terminating underfunded plans with the largest unfunded liabilities. Moreover, terminated pensions in the steel industry alone amount to about 80 percent of all claims.

TABLE 1. DISTRIBUTION OF NET CLAIMS AGAINST THE PBGC, 1975-1986

Category of Claim (In millions of dollars)	Number of Plans Making Claims	Net Claims in Category (In millions of dollars)	Net Claims in Category as Percentage of Total Net Claims
Greater than 100	8	2,636	68
50-100	1	55	1
25-50	12	416	11
10-25	19	295	8
5-10	22	159	4
1-5	107	228	6
Less than 1	1,176	111	3
Total	1,345	3,900	100

SOURCE: CBO calculations based on PBGC Annual Report, 1986.

NOTES: Data are in current dollars and reflect the amount of the claim on the date the pension plan was terminated. Details may not add to totals because of rounding.

Future Prospects

The future financial condition of the pension insurance program is highly uncertain because it will depend largely on how many private pension plans terminate and on the amount of underfunding in those plans. Both factors are hard to forecast accurately. Moreover, a few pension plans with extremely large unfunded liabilities have dominated PBGC's past claims, and its future may likewise depend significantly on the fate of a small number of large plans--making liabilities even more difficult to predict. The number of terminations is influenced by overall economic conditions, by the prosperity of particular industries, by competition from abroad, and by a variety of factors that are specific to a particular firm--such as its competitive position in the industry, its agreements with labor groups, and the assessment of its financial prospects that are necessary for it to obtain credit.

Using the historical experience of the PBGC along with available information on the status of pension funding today, CBO has made a preliminary projection of the revenue needs of the PBGC. This projection assumes that the accumulated deficit will be repaid over 15 years and that future claims will grow at the same rate as wages from a level of $650 million in 1988. On this basis, the annual premium required to pay the PBGC's costs is estimated to be roughly $30 per participant in 1988,

assuming that the insurance premium is indexed in future years to grow with average wages. Because of the large degree of uncertainty in predicting future insurance claims against the PBGC, however, reasonable estimates of its future revenue needs can vary widely.

Even if the PBGC's financial problems necessitate program changes, corrective measures may not be immediately essential. A high proportion of the agency's liabilities actually represent benefits that will not be paid for several years, so that the program does not have immediate unmet cash needs. While CBO estimates that the PBGC will have to transfer assets from its trust fund to its revolving fund to meet benefit payments beginning in 1989, the program is not expected to deplete its assets for several years. Indeed, given its current assets, future premium receipts, and assets derived from the future terminations of partially funded pensions, the PBGC could probably make benefit payments on a pay-as-you-go basis for more than a decade.

On the other hand, delay in taking corrective actions is likely to lead to continued growth in the accumulated deficit. Recent financial difficulties may be symptomatic of problems in the design of the insurance program--such as its lack of incentives for sponsors to fund their plans fully.

Moreover, the funding rules for pensions in general may be inadequate to ensure that plans will be sufficiently funded. If future claims against the PBGC continue to grow, the result could be higher premiums for future participants in pension plans, thus shifting program costs from current participants and limiting the future attractiveness of defined-benefit pensions. Furthermore, significant delays in taking corrective steps could lead to the use of federal general revenues to help fund an even higher accumulated deficit--thus placing some of the financial burden on future taxpayers.

CURRENT ISSUES

The accelerated decline in PBGC's financial position has focused concern on several issues, including the types of benefits that should be insured by the PBGC and who should pay for the insurance protection.

What Types of Benefits Should be Insured?

Some analysts have proposed reconsidering the nature of the insurance protection provided by the PBGC. In particular, the issue is whether or not the government should continue to insure pension benefits that have not been fully funded at least at some time in the past, usually because certain pension costs were amortized over several years.

The basic argument for denying insurance protection for underfunded benefits is that insuring them goes well beyond the traditional protection provided by government in other areas, such as in insuring bank deposits. In the case of the PBGC, insurance is provided both against market-related fluctuations in the portfolios of pension plans and against the inability of sponsors to provide sufficient future funding to meet their past pension promises. Yet the government's own rules are often the source of underfunding. Current federal rules and accepted actuarial principles allow sponsors to spread their pension costs over many years, thereby raising the likelihood that the PBGC will be called on to pay for some of these benefits.

Who Should Pay for Insurance Protection?

With recent growth in the cost of pension insurance--from $1 per participant in the original legislation in 1974, to $2.60 in 1978, and to $8.50 today--and with the prospect of considerably higher insurance premiums in the future, the issue of who should pay them becomes an increasingly important one.

Several alternative allocations of the costs of pension insurance are possible. One would be to continue distributing the costs equally among participants in all defined-benefit pension plans. This approach spreads program costs widely. But it includes--in large part--pensions that have little likelihood of making a claim. In addition, because the insurance costs

remain the same regardless of the plan's funding position, it provides no incentive for participants or sponsors to increase the funding levels in their plans.

Alternatively, insurance costs could be targeted on plans that are more likely to make claims against the PBGC. This allocation would tie premium payments more closely to anticipated costs, and would also provide an incentive for participants and sponsors to raise the funding levels in their plans. Better funding, in turn, would both reduce the probability of insurance claims and lower their insurance premiums. But charging higher premiums to less well-funded plans could itself worsen their financial condition, thereby potentially making it more likely that those plans would be terminated and that claims would be made against the PBGC.

Finally, costs could be distributed more broadly among all taxpayers by using federal general revenues to support PBGC's shortfalls. This method would insulate plans that continue in operation from any financial difficulties caused by terminated ones. It could be viewed as an inappropriate use of federal funds, however, because taxpayers in general would be supporting a relatively small number of participants, many of whom have above-average wages.

SPECIFIC ALTERNATIVES

A variety of options are available that would address the issues just discussed. Some would reallocate costs among sponsors of plans. Others would alter existing rules about the funding of pensions and the termination of underfunded plans. Most of these options would indirectly improve the financial status of the PBGC, in some cases substantially. Alternatively, or in addition, changes could be made to raise revenues or reduce outlays directly.

Options for Altering the Allocation of Program Costs

One concern is that the annual premium paid on behalf of participants in plans is the same regardless of the insurance risk posed by their plans. Instead, a so-called variable-rate premium structure could be used, in which the premium charged on behalf of pension participants would vary among plans according to some measure of the risk that each plan represents to the PBGC.

Designing a Variable-Rate Premium Structure. If a variable-rate premium structure were adopted, it would have to include a basis for assessing premiums, and might also specify maximum or minimum premiums to be charged. The assessment of the premium could be based on the level of unfunded benefits in the plan that are guaranteed by the PBGC (called the "exposure" of the PBGC for that plan), on the risk that the plan will terminate with a claim against the PBGC, or on both.

Any premium based on exposure or risk might also include maximum and/or minimum values for the annual charge. An upper limit, or cap, on the annual premium per participant would lessen the chances that the cost of the insurance itself would lead to financial difficulties for the sponsor or to termination of the plan. At the same time, however, it would limit the extent to which the insurance costs were allocated according to exposure or risk. A minimum premium that is greater than zero would allow certain program costs to be shared by participants in all covered plans, but would also somewhat lessen the incentive for sponsors to fund their plans fully.

The PBGC's Proposal. The PBGC's proposal would combine a variable-rate premium based on the amount by which the plan was underfunded with an increase in the average premium charged to all covered plans. This proposal would set the minimum annual charge at $8.50 per participant and the maximum charge at $100 per participant. It would raise the annual premium above the $8.50 base by $6 for each $1,000 per participant that the plan is underfunded. This underfunding is determined by the difference between plan assets and 125 percent of liabilities, which are calculated as if the plan is being terminated.

CBO is now analyzing this proposal using 1984 data about the financial status of pensions. According to our preliminary results, if the PBGC's proposal had been in effect in 1984, the minimum premium of $8.50 would have been paid on behalf of about three-quarters of covered participants.

Higher premiums would have been paid on behalf of roughly 12 percent of participants in plans that were less than 100 percent funded in that year, plus another 12 percent of participants in plans that were between 100 percent and 125 percent funded. About 3 percent of participants were in plans that would have been assigned the maximum premium of $100.

Revenue derived from this proposal in future years would depend on the overall level of funding of pension plans, the distribution of funding among plans, and their sizes. Very preliminary projections by CBO indicate that in 1987 the PBGC's proposal would generate about $700 million in revenue, or about $22 per participant.

As with many premium structures that might be explored, the incentives for increased pension funding contained in this proposal would not be likely to cause large changes in the behavior of the sponsors. Indeed, under the PBGC's proposal of charging $6 per $1,000 of underfunding per participant, it would be considerably cheaper for the sponsor to pay the $6 for several years than to make up the $1,000 funding shortfall. The proposal could speed up the funding of some underfunded plans, however, if the sponsors of those plans already intended to reduce their underfunding in the near future. Moreover, these incentives could be strengthened somewhat by charging rates that would increase according to the extent of plan underfunding.

Given the tremendous uncertainties in the magnitude of future insurance claims and in the funding levels of pensions, the PBGC's proposal also offers one mechanism for adjusting the premium in the future. CBO has not, however, had sufficient time to analyze the likely success of this option.

Options for Reducing Underfunding or the Termination of Underfunded Plans

By its very nature, insurance of private pension benefits increases the likelihood that pensions will be underfunded and that underfunded plans will be terminated. To limit these effects, some analysts have proposed changes in the methods currently used to fund pensions and in the treatment afforded certain benefits.

Increase Minimum Annual Pension Contributions by Plans Sponsors. Increasing annual pension contributions by plan sponsors would be one way to increase pension funding throughout the lives of the plans. One approach would be to reduce from 30 years the allowed amortization periods for certain supplemental pension liabilities. Alternatively, or in addition, minimum funding standards could be strengthened. The Administration has proposed, for example, requiring annual pension contributions to depend on the extent to which a plan is underfunded, or just barely funded.

To avoid the severe disruptions that would occur for some firms, both approaches could be implemented gradually. In that case, however, reductions in underfunding would occur more slowly, leaving the PBGC exposed to larger claims in the interim.

More rapid funding of pension obligations could increase the likelihood that the assets of pension plans would be available to pay promised benefits, while the added pension contributions generally would not come at a time when the sponsors were in severe financial difficulty. On the other hand, requiring higher pension contributions might lead to slower wage growth for the sponsors' employees and discourage the use of defined-benefit plans.

Alter the Treatment of Benefits Derived from Layoffs or Plant Closings. Altering the treatment of extra pension benefits derived solely from layoffs or plant closings could limit the extent to which these benefits result in claims against the PBGC. Although sizable portions of these benefits are not insured, they can lead to higher claims either because a portion of them are insured or because they are paid to participants--in lump sums, for example--before the plan is terminated, thereby reducing the funds that remain to pay guaranteed benefits later. The PBGC estimates that, in the steel industry, roughly $1 billion in unfunded claims have resulted from these benefits, although there is little other data on the inclusion of these benefits in pension agreements. Instead, the payment of

these benefits could be made conditional on funds being available, perhaps in a separate account that could not be used to meet minimum funding standards.

Supporters of this change maintain that it could lead to less reliance on this type of pension benefit, and reduce claims against the PBGC. On the other hand, opponents contend that these benefits are often necessary to protect the income security of workers who lose their jobs. Moreover, the benefits may make affected workers more willing to accept overall economic change--thereby potentially improving the adaptability of the economy, which would ultimately benefit everyone.

Options for Directly Raising Revenues or Reducing Outlays

If direct changes in the financial status of the PBGC are deemed appropriate, several options are available, including raising the insurance premium charged on behalf of covered participants, increasing receipts from other sources, and reducing outlays for benefits.

Increase the Premium Charged on Behalf of Pension Participants. Revenues could be raised directly by increasing the insurance premium charged on behalf of participants in covered pensions. Each $1 increase in the PBGC premium in 1988, for example, would generate about $30 million in revenue. Raising the premium could be accomplished with a one-time

increase, or by indexing the premium to changes in an indicator, such as the level of claims against the PBGC or average wages in the economy. Such an increase could be made either with or without also changing to a variable-rate structure, as proposed by the PBGC.

Raising revenues by increasing the PBGC premium would help to restore solvency to the program by using the mechanism originally designed to provide such stability. On the other hand, large increases in pension premiums could discourage the future use of defined-benefit pensions, with a possible reduction in the income security of affected workers.

Increase Other Receipts. Revenues could also be increased in other ways, including raising the priority of PBGC's claim in bankruptcy proceedings on the assets of sponsors of terminated underfunded plans, or by using federal general revenues to pay part of the PBGC's accumulated deficit.

Raising PBGC's priority in bankruptcy proceedings would increase recoveries from some terminated underfunded pension plans, but these added funds would come at the expense of those sponsors' other creditors. Moreover, sponsors with underfunded pensions might be less able to obtain credit under these rules, potentially raising the likelihood that they would become insolvent and their plans would be terminated.

Obtaining funds from federal general revenues would satisfy the need for increased revenues without discouraging the continued use of defined-benefit pensions. On the other hand, using federal funds in this way could be viewed as inappropriate, because they would support voluntary private pension plans that benefit only a portion of the population.

Reduce Outlays for Benefits. Reducing benefits for new claimants would also directly improve the financial situation of the PBGC. Expenditures could be reduced by lowering benefit protection across the board--such as by limiting PBGC's insurance payments to some fraction of their previous level--or by lowering the maximum benefit guaranteed by the program, or by reducing insurance coverage for particular types of benefits. Reducing benefit protection for new claims to 85 percent of the present guarantee could reduce insured claims against the PBGC by about $100 million in 1988. Limiting insurance protection for unfunded benefits that result from past service credits or plan liberalizations could also have a noticeable impact on PBGC's future claims, whereas reducing the maximum benefit guarantee from the current $1,858 per month would have a much smaller one, because relatively few claimants reach that cap.

Supporters of these limitations maintain that it is fair to require workers who will benefit from the program's protection to share directly in

the costs of restoring its financial stability. Opponents contend, however, that reductions in benefits are contrary to the government's promise to protect earned pension benefits, that current guarantees are not excessive, and that there is no justification for treating future claimants differently from those whose underfunded plans have already terminated.

CONCLUSION

Many options are available to respond to the growing financial problems of the PBGC. In particular, the Administration is proposing a variable-rate premium to cover the costs of pension insurance. Earlier it suggested ways to strengthen the minimum funding standards for defined-benefit plans. While it is not essential that the Congress act quickly, delaying could lead to larger accumulated deficits and harder policy choices in the future.