# CBO TESTIMONY

Statement of
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before the
Subcommittee on Oversight
Committee on Ways and Means
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Mr. Chairman and Members of the Subcommittee, I appreciate this opportunity to discuss the structure and effects of the insurance premiums charged by the Pension Benefit Guaranty Corporation (PBGC).

My statement focuses on four points:

- The PBGC premium has significant effects on the behavior of insured firms. Yet the current premium does not effectively discourage firms from engaging in actions--such as underfunding--that increase claims on PBGC.

- The PBGC premium also has significant effects on PBGC income. The Congressional Budget Office (CBO) estimates that PBGC's collections over five years could be raised by $240 million to $2,230 million under the increases in the premium that the Subcommittee asked us to review.

- Because of the cash treatment used to account for PBGC in the budget, some policy reforms that would enhance the financial stability of PBGC lead to a pay-as-you-go (PAYGO) charge. To avoid this outcome, the Congress could remove PBGC from the PAYGO scorecard, as has been done for deposit insurance.

- The Congress could improve PBGC pricing policy so that premiums are more likely to be adjusted and maintained at an appropriate rate in the future.

## EFFECTS OF PREMIUMS ON THE INSURED AND THE INSURER

PBGC's premium is important for two related reasons: it affects the behavior of insured firms as well as the income of PBGC. These two aspects of the premium are closely related because how the premium affects firms will help determine the ability of the premium to fund the program. Moreover, the type of premium charged will determine the ability of the program to meet the objectives laid out for it by the Congress.

### Relating Premiums to Expected Claims

PBGC can follow two strategies in attempting to set premiums to pay for future claims. First, it can set premiums for groups of insured plans based on risk (the probability that a claim will be made) and exposure (the potential severity of a claim). The greater the probability that the insured will make a claim and the larger the potential claim, the bigger the expected loss and the higher the

premium. If insured firms pay premiums commensurate with the likelihood and size of potential claims, some firms with substantial underfunding and in weak financial condition will have to pay premiums that are much higher than they are paying now.

A disadvantage of that policy is that risk-based premiums may hasten or contribute to the failure of some firms that are now financially troubled. However, some analysts believe it is an advantage that risk- and exposure-related premiums force firms to pay the costs of the risks they impose on PBGC. They also limit the extent to which healthy firms that have funded their pension plan must subsidize others, including competitors, that have not done so. Perhaps most important, properly set premiums provide some assurance that premium income will pay for future claims.

PBGC can also use a second strategy for setting premiums: it can charge all insured plans the same premium, or premiums that would vary only slightly with risk and exposure. Such a strategy would underprice the insurance for some highly risky firms and would overprice it for less risky sponsors. Firms paying the overpriced premiums would subsidize the labor costs of firms paying the underpriced premiums. According to some analysts, this form of subsidization is the intended and appropriate goal of federal pension insurance. Such pricing

strategy has the potential advantage of deferring and, possibly, avoiding the failure of some troubled firms.

A disadvantage, however, is that the strategy provides overcharged, low-risk firms with an incentive to terminate their defined-benefit plan and leave the insurance pool. If they do, it may lead to an insurance system in which only those firms with the greatest risk remain in the insured pool. In addition, by not charging firms for the risks they take, this pricing policy could have the unintended result of encouraging firms to take too much risk with their pension plans.

Departures from the insurance pool and increased risk-taking in response to a flat premium make it more likely that future costs will not be covered. This result would conflict with PBGC's legislative mandate for financing by premiums and could put enormous pressure on the Congress to provide PBGC with general fund revenues.

Historically, PBGC has followed a pricing policy much closer to the flat premium than to the risk-adjusted approach. It has always charged a flat premium; it never explicitly charged premiums based on risk and only recently added a premium component for underfunding (that is, exposure). From 1974 to 1987, PBGC charged firms only on a per-participant basis with the premium

increasing from $1.00 to $8.50 during that period. Until 1988, firms that underfunded their plans paid no more in premiums than firms that fully funded their plans.

In 1987, the Congress added a premium that varies according to the underfunding of a plan. This premium was set at $6 per $1,000 of underfunding, and the flat premium was raised to $16. Because it was capped at $34 per participant, the variable premium only partially accounted for exposure. In 1991, the flat premium, the rate on the variable premium, and the cap on the variable premium were raised to $19 per participant, $9 per $1,000 of underfunding, and $53 per participant, respectively. Although PBGC may not have been able to avoid many of the claims it received, its poorly set premium contributed to its accumulated deficit of $2.7 billion. Adjusting premiums to pay for future claims does not address the difficult problem of paying for these past losses.

Because of the cap on the variable premium, firms with the greatest amounts of underfunding face no increase in costs as underfunding increases. Consequently, some firms use their available cash to fund non-pension-related activities. By giving firms that underfund a "good deal" on pension insurance, the underpriced premium could increase the exposure of PBGC and ultimately the size of PBGC claims. Estimates of a risk-related premium in a study done for PBGC

indicate that the premium is vastly underpriced for high-risk sponsors of pension plans.[1]

There are three arguments against enacting risk-related premiums. First, calculating such premiums entails a high degree of uncertainty and methodological complexity. However, PBGC is in the midst of a major effort to determine how characteristics of firms and plans affect future claims. Its findings should reduce--though not eliminate--the uncertainty associated with setting such premiums.

Second, some apprehension exists about having a government agency officially "rate" the financial health of private firms by setting premiums that vary according to the risk of bankruptcy. Setting a risk-related premium incorrectly could provide markets with false signals about a firm's financial health. The federal insurer could reduce these problems by using only public information, such as bond ratings, as indicators of risk.

Third, some analysts have suggested that PBGC was established to channel subsidies from stronger sponsors of plans to weaker firms. Moving to a purely risk- and exposure-related premium would sharply reduce such cross-subsidies. However, as I have discussed, a premium-financed system may not be possible

1. Jack VanDerhei, "An Empirical Analysis of Risk-Related Premiums for the Pension Benefit Guaranty Corporation" (report submitted to the Pension Benefit Guaranty Corporation, 1988).

over the long run if healthy firms with an option to leave the insurance pool are required to subsidize weaker firms in a significant way.

Although no definitive evidence exists that adverse selection has occurred in the PBGC insurance pool because of the current pricing, a significant movement away from defined-benefit plans has clearly taken place. For example, PBGC found that the percentage of workers with pensions, whose primary source of retirement benefits is a defined-benefit plan, declined during the 1979-1988 period from 83 percent to 66 percent. Further, because only fully funded plans can leave the insurance pool voluntarily, firms leaving the PBGC system must have a lower risk of making a claim against PBGC than the firms that remain.

Effects of Premium Increases on PBGC Income

Income raised by the PBGC premiums are treated as collections in the federal budget. In 1992, the PBGC single-employer premium brought in about $875 million. The flat premium raised about 70 percent of this total ($608 million) and the variable premium about 30 percent ($267 million). Of the income from the variable premium, about 60 percent ($160 million) came from plans at the cap and 40 percent ($107 million) is income from plans paying the variable premium but that are not at the cap (see Table 1 for additional information on the distribution

TABLE 1. DISTRIBUTION OF PREMIUM PAYERS (In percent)

| | Plans | Participants |
|---|---|---|
| Plans Paying Flat Premium Only | 68 | 73 |
| Plans Paying Variable Rate Premium but Not at Cap | 23 | 17 |
| Plans Paying Cap | 9 | 10 |
| Total | 100 | 100 |

SOURCE: CBO estimates developed using data from the 1988 filings of IRS Form 5500.

of premium payers). When the premium is increased, the federal budget deficit is lowered; reducing the premium increases the deficit.

At the request of the Subcommittee, CBO has estimated the effects on income of several specific increases to the current premium (see Table 2 for a summary of these estimates). Because these estimates must account for changes in variables such as interest rates, they are sensitive to CBO's economic assumptions.

Raise the Flat Premium

Raising the flat premium from $19 to $22 per participant would raise about $480 million over the next five years. But an increase in the flat premium does not make the premium more sensitive to exposure or risk. Firms would neither pay a higher premium if they underfund their plans nor if they pose a greater risk of making a claim against PBGC. As the flat premium raises the charge on all firms, it may increase premiums above the benefits some firms receive from pension insurance. After this increase, these low-risk firms would have more reason to exit the pension insurance system than they do today.

TABLE 2. PRELIMINARY CBO COST ESTIMATE OF PBGC PREMIUM OPTIONS (Outlays by fiscal year, in millions of dollars)

| | 1994 | 1995 | 1996 | 1997 | 1998 | Five-Year Total |
|---|---|---|---|---|---|---|
| Raise Flat Premium to $22 per Participant | -80 | -100 | -100 | -100 | -100 | -480 |
| Raise the Cap on the Variable Premium to $100 | -110 | -150 | -160 | -170 | -180 | -770 |
| Raise the Rate on the Variable Premium to $18 per $1,000 of Underfunding | -40 | -50 | -50 | -50 | -50 | -240 |
| Raise the Flat Premium to $22 per Participant, the Variable Rate to $18, and the Cap to $100 per Participant | -300 | -380 | -400 | -410 | -410 | -1,900 |
| Above Option with Flat Premium and Cap Indexed to Wages | -300 | -410 | -460 | -510 | -550 | -2,230 |

SOURCE: CBO estimates developed using data of the 1988 filings of IRS Form 5500.

As a result of its small size, however, a $3 per-participant increase alone would probably not drive many firms from the pool. But expected future premiums as well as current premium increases can cause adverse selection. If low-risk sponsors of fully funded pension plans believe that the Congress will continually increase their premiums to pay for the claims of other plans, they may leave the pool to avoid future increases. Some of the exiting of firms may take place in hidden ways, such as the use of temporary employees that are not covered by the firm's defined-benefit pension plan.

Increase the Cap on the Variable Premium

Increasing the cap on the variable premium from $53 to $100, while keeping the rate on the variable premium at its current amount of $9 per $1,000 of underfunding, would raise $770 million over five years. By increasing the cap, the change would target those plans with significant amounts of underfunding. Such plans, with a higher cap, would pay a higher cost for continued underfunding. Because it does not affect the flat premium, this change does not increase PBGC's vulnerability to the exit of low-risk firms. However, because the increase would target sponsors of plans that may already be in poor financial health, it could cause hardships for some affected firms--possibly even driving them out of business.

Raise the Rate on the Variable Premium

Raising the rate on the variable premium from $9 per $1,000 of underfunding to $18 per $1,000 of underfunding, while holding the cap on the variable premium at $53, would yield $240 million over five years. One reason that doubling the rate on the variable premium brings in such a relatively small amount of money is that many of the firms sponsoring plans with underfunding are already at the cap on the variable premium. Thus, raising the rate on the variable premium alone does not raise the cost of underfunding to these firms and, in general, only makes the premium slightly more sensitive to exposure. Raising the rate on the variable premium, however, is significantly more efficient than raising the flat premium since it targets those plans and the underfunding that determines the ultimate size of the PBGC claim. This targeting of the premium toward plans with underfunding may cause hardship to some pension sponsors that are already in financial difficulty.

Raise the Flat Premium, the Rate on the Variable Premium, and the Cap on the Variable Premium

The Congress can change more than one component of the premium. For example, the flat premium could be raised to $22 per participant, the rate on the

variable premium could be doubled, and the cap on the variable premium could be raised to $100 per participant. Such a change would raise $1,900 million over five years. This premium change would target underfunded plans but would also raise the fees of low-risk firms. It is impossible to link the premium to a single variable and expect it to charge the majority of insured firms correctly.

Index the Premium to Wage Growth

The Congress can index the premium, or part of it, to the growth in a firm's wages. Because benefits may partially be a function of wages, indexing the premium to wage growth would raise premiums as total insured benefits increased. Indexing the flat premium and the cap on the variable premium will raise an additional $300 million to $400 million over five years. For example, an additional $330 billion could be raised by indexing the flat premium and the cap on the variable premium while raising the flat premium to $22 per participant, doubling the rate on the variable, and raising the cap on the variable premium to $100 per participant. Indexing the cap and the rate on the variable premium could make the PBGC premium more sensitive to exposure. By itself, however, this change could not make the premium sensitive to risk and does not distinguish plans by the exposure they pose to PBGC. For example, such automatic increases would occur whether or not the new insured benefits were funded.

No premium increase is painless. Increases in the variable premium or the cap on the variable premium could put weak firms out of business. Such an outcome would result from the vulnerability of the firms to any cost increases; nonetheless, bankruptcy associated with a premium increase will strike some as undesirable and unfair. Another option would be to increase the flat premium for all sponsors of defined-benefit plans. But too high an increase in the flat premium could threaten the viability of the insurance system as low-risk plans exit the system.

## PBGC AND PAYGO

Cash accounting in the budget in conjunction with the pay-as-you-go budget rule, which requires that increases in mandatory spending or decreases in revenue be offset, "penalizes" the Congress when it legislates new policies to reduce risk to PBGC. PAYGO was part of the Budget Enforcement Act of 1990. Under its rules, legislated increases in mandatory spending or decreases in revenue collections must be offset, in total, by legislated revenue increases or spending cuts. If, in any Congressional session, the total legislated changes in mandatory spending or receipts increase the deficit for that year, a pay-as-you-go sequestration is triggered. This sequestration would make up the resulting

shortfall through automatic spending reductions in a limited number of mandatory programs.

PAYGO has an effect on PBGC reform because of proposed legislation that would reduce PBGC's future losses, in part, by tightening the funding rules for pension plans. The contributions of firms to pension funds are tax deductible, and funds in defined-benefit pension plans receive favorable tax-deferred status. The greater the funding of pension plans, the lower are PBGC's expected losses but the larger is the short-term tax loss to the federal government. If the Congress passes new funding rules that increase pension plan funding, the PAYGO system would record a charge. As a result, the PAYGO system penalizes the Congress for taking action to enhance the financial stability of pension termination insurance.

This anomalous outcome results because the cash accounting treatment of the budget recognizes the tax loss immediately but ignores lower PBGC claims in the future. To avoid this result, CBO has previously recommended that the Congress be "held harmless" in the budget for adopting policies to control the cost of pension insurance. This could be achieved by changing the budgetary treatment of PBGC or more simply by exempting PBGC from PAYGO.[2]

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2. For a full discussion of this and other budgetary reforms for PBGC, see Congressional Budget Office, *Controlling Losses of the Pension Benefit Guaranty Corporation* (January 1993).

Insured firms are constantly adjusting their behavior as economic conditions change. In turn, these shifts mean that PBGC's potential losses are subject to significant change. If PBGC is to continue to be financed through premiums, the potential changes in future claims require that premiums be modified with corresponding flexibility. Currently, only legislation can adjust PBGC's premiums. Congressional action is required even if the needed adjustment is simply to change the insurance premiums paid by a few sponsors.

At its best, the Congress is not institutionally suited to such a managerial role. However, as noted in earlier CBO testimonies before this Subcommittee, the Congress is particularly hamstrung with this program, since the budget--one of the most important instruments for informing and motivating Congressional action--misstates the financial condition of PBGC. In fact, Congressional changes in the PBGC premium have come only after PBGC has accumulated significant, irrevocable losses. For example, PBGC reports that four years elapsed between the time it requested an increase--from $2.60 to $8.50--in the insurance premium and the time Congress enacted the increase in 1986. By then, even $8.50 would not sufficiently cover PBGC's projected losses.

One option to make it more likely that premiums are adjusted in a timely fashion is to allow PBGC--because of the data it collects on pension plans and its expertise in pension insurance--to set and adjust premiums in a timely and appropriate manner. If PBGC were given the power to make such adjustments in premiums, the Congress could retain substantial control by defining the objectives for premium pricing. For example, the Congress could instruct PBGC to establish risk- and exposure-related premiums and maintain them at rates appropriate to expected losses. The Congress would also be free to subsidize firms whose premiums would increase under such a system. Moreover, given PBGC's history of managerial, accounting, and information-system problems, the Congress may wish to establish an oversight board or in some manner provide for external review of premiums.

The Congress could also index the various components of premiums to wage growth. Although indexing does not adjust for risk and exposure, it could be an effective supplement to reforming the premium. Finally, the budgetary treatment of PBGC could be modified to give the Congress more timely, action-forcing information on the financial condition of PBGC. A number of budgetary reforms for PBGC are discussed in CBO's recent study on controlling PBGC's losses.

## CONCLUSIONS

The PBGC premium is a potentially powerful device for encouraging firms to fund their plans fully and reduce PBGC losses. However, the premium as currently structured does not make much use of this potential. Several options are available to the Congress that would make the premium more sensitive to risk and exposure and make it more likely that the premium will be maintained at adequate levels.