[JOINT COMMITTEE PRINT]

ISSUES AND PROPOSALS RELATING TO THE FINANCIAL CONDITION OF THE PENSION BENEFIT GUARANTY CORPORATION (PBGC)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT

OF THE

HOUSE COMMITTEE ON WAYS AND MEANS

ON FEBRUARY 4, 1993

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of issues and proposals relating to the financial condition of the Pension Benefit Guaranty Corporation (PBGC). The Subcommittee on Oversight of the House Committee on Ways and Means has scheduled a public hearing on February 4, 1993, to review the impact of underfunded defined benefit plans on the PBGC, plan retirees, and plan sponsors.

Part I of the pamphlet is an overview. Part II discusses present law and background of the Federal pension insurance program and the financial condition of the PBGC. Part III describes present-law defined benefit plan funding requirements. Part IV describes certain proposals, including H.R. 298 ("Pension Funding Improvement Act of 1993"). Part V discusses issues relating to defined benefit plan funding and the financial condition of the PBGC.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Issues and Proposals Relating to the Financial Condition of the Pension Benefit Guaranty Corporation (PBGC).* (JCS-3-93), February 3, 1993.

I. OVERVIEW

A defined benefit pension plan is a type of employer-sponsored retirement plan that provides benefits to participants based on a formula specified in the plan. To provide benefit security to plan participants, the Internal Revenue Code and title I of the Employee Retirement Income Security Act of 1974 impose minimum funding requirements on the sponsor of a defined benefit pension plan.

The minimum funding requirements provide employers considerable flexibility in determining the minimum required contribution, and permit benefits to be funded over a long period of time. Thus, it is possible that a defined benefit plan may be terminated at a time when plan assets are insufficient to pay promised benefits.

The Pension Benefit Guaranty Corporation (PBGC) was created in 1974 to protect plan participants in the event a defined benefit pension plan terminates with insufficient assets. The PBGC guarantees basic retirement benefits, up to a current dollar maximum benefit of $2,437.50 per month (for 1993).

In its most recent annual report (for fiscal year 1991), the PBGC reported a deficit of $2.5 billion. The PBGC finds that the defined benefit system as a whole is relatively healthy, but that certain single-employer pension plans, primarily in the steel, airline, tire, and automobile industries, are underfunded by about $40 billion, about $13 billion of which is in plans sponsored by financially troubled companies. The PBGC forecasts that, depending on the level of future losses, its deficit could increase to between $2.7 billion and $17.9 billion by the end of fiscal year 2001.

Despite recent changes in plan funding rules designed to increase the level of plan funding, there is concern that the risk of loss upon plan termination has increased. There is growing concern that funding rates may be too low and that current PBGC premiums may be insufficient to cover future liabilities. To deal with these concerns, policymakers are considering a number of changes to present law.

II. THE FEDERAL PENSION INSURANCE PROGRAM

A. Present Law and Background

Defined benefit pension plans

A defined benefit pension plan is a type of employer-sponsored retirement plan that provides benefits to participants based upon a formula specified in the plan. For example, a defined benefit plan could provide a benefit equal to a percentage of an employee's average compensation multiplied by the number of years of service with the employer. A defined benefit plan could also provide a flat dollar benefit based on years of service, or a specified percentage of final or average compensation. The key feature of such a plan is that the benefit promised is based on the plan formula, not on the investment experience of the plan.

In order to help ensure that the promised benefits are paid to plan participants, defined benefit plans are subject to minimum funding requirements under both the Internal Revenue Code (the Code) and title I of the Employee Retirement Income Security Act of 1974, as amended, (ERISA) which require the employer sponsoring the plan to make certain contributions to fund the plan. These requirements are discussed in detail below.

The PBGC

As enacted in ERISA, as well as under present law, the minimum funding requirements permit an employer to fund defined benefit plan benefits over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan. In order to protect plan participants from losing retirement benefits in such circumstances, the Pension Benefit Guaranty Corporation (PBGC), a corporation within the Department of Labor, was created in 1974 by ERISA to provide an insurance program for benefits under most defined benefit pension plans maintained by private employers. According to the PBGC's latest annual report (for fiscal year 1991), the single-employer insurance program currently covers more than 32 million participants in more than 83,000 defined benefit pension plans.

Termination of underfunded pension plans

Prior to 1986, an employer generally could, subject to contractual obligations, terminate a single-employer plan at any time without regard to the financial health of the employer and without regard to the level of assets in the plan. If a single-employer plan was terminated with assets insufficient to pay benefits at the level guaranteed by the PBGC, the employer was liable to the PBGC for the

lesser of the insufficiency or an amount equal to 30 percent of the employer's net worth.

Under these rules, employers that wanted to rid themselves of underfunded liabilities could simply terminate the plan, and the PBGC would be liable for benefits. The PBGC was in some cases prevented from recouping its liability from the employer, even if the employer was financially sound. The plan termination rules were amended to prevent such transferring of liabilities to the PBGC by the Single Employer Pension Plan Amendments Act (SEPPAA) and were modified further by the Pension Protection Act of 1987.

Under present law, a defined benefit plan with assets insufficient to provide for benefit liabilities can be terminated voluntarily by the employer only if the employer and members of the controlled group of the employer are in financial distress. In general, benefit liabilities are all fixed and contingent liabilities to plan participants and beneficiaries.

Following a distress termination, the PBGC pays out all benefits under the plan, including guaranteed benefits and those not guaranteed. The amount of benefits in excess of guaranteed benefits that are paid to plan participants depends on the level of plan funding and the amount the PBGC is able to recover from the employer. The employer is liable to the PBGC for the full amount of unfunded benefit liabilities.

Guaranteed benefits

The PBGC guarantees vested retirement benefits (other than those that vest solely on account of the plan termination), up to a maximum benefit of $2,437.50 per month in 1993. The dollar limit is indexed annually for inflation. The guarantee is reduced for benefits starting before age 65, and does not apply to certain types of ancillary benefits. In the case of a plan or a plan amendment that has been in effect for less than 5 years before a plan termination, the amount guaranteed is phased in by 20 percent a year.

Sources of PBGC funding

The PBGC is funded by assets in terminated plans, amounts recovered from employers who terminate underfunded plans, premiums paid with respect to covered plans, and investment earnings. All covered plans are required to pay a flat per-participant premium and underfunded plans are subject to an additional variable premium based on the level of underfunding.

As initially enacted in ERISA, covered plans were required to pay a flat premium to the PBGC of $1.00 per plan participant. The flat-rate per-participant premium has been increased several times since the enactment of ERISA, and is currently $19 per participant in 1993.

The variable rate premium was enacted by the Pension Protection Act of 1987. It was believed that underfunded plans should bear a greater burden than well-funded plans because they pose a greater risk of exposure to the PBGC. The amount of the variable rate premium is $9.00 per each $1,000 of unfunded vested benefits, up to a maximum of $53 per participant. Thus, the maximum total per-participant premium for an underfunded plan is $72 in 1993.

B. Financial Status of the PBGC

In general

As of September 30, 1991, the PBGC reported a deficit of $2.5 billion. This is an increase over the $1.9 billion deficit reported as of the end of the prior fiscal year. The PBGC experienced its largest losses in the history of the termination insurance program in the fiscal year ending September 30, 1991. The PBGC attributes these losses primarily to lower expected recoveries from employers in bankruptcy for plans added to PBGC's liabilities in 1990. The PBGC reports that the defined benefit plan system is healthy as a whole, but that some pension plans, primarily in the steel, automobile, tire, and airline industries, are underfunded by about $40 billion. Of this, the PBGC reports that about $13 billion is in plans sponsored by financially troubled companies.

The PBGC has estimated its future financial status under a variety of assumptions. The deficit could range from about $2.7 billion by the end of 2001 if losses are relatively low, to about $17.9 billion by the end of 2001 if losses are high. According to the PBGC, the estimate of a potential deficit of $17.9 is not a worst-case scenario.

Hidden liabilities reflected

In a study released by the U.S. General Accounting Office (GAO) in December 1992,[2] GAO reported that the 44 plans with the largest claims against the PBGC for calendar years 1986–88 had aggregate unfunded liabilities at termination of $2.7 billion. These unfunded liabilities were $990 million, or 58 percent, higher than the $1.7 billion in unfunded liabilities reported by the 44 plans on their last, pretermination annual filing with the IRS. GAO termed this additional unfunded liability as a "hidden liability" to the PBGC because it was not reported by plans before termination.

Hidden liabilities can result from several causes. Most of the $990 million in hidden liability reported in the GAO study was due to PBGC's higher estimate of plan liabilities as a result of PBGC's use of actuarial assumptions that were different than the assumptions used by plan sponsors. Hidden liabilities also can result because of the payment of shutdown [3] or special early retirement benefits, earlier-than-anticipated retirements, and PBGC's receipt of fewer assets than reported by the plans.

The PBGC takes its exposure to hidden liabilities into account in its financial statements.

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[2] U.S. General Accounting Office, *Hidden Liabilities Increase Claims Against Government Insurance Program* (GAO/HRD-93-7), December 30, 1992.

[3] Shutdown benefits are benefits payable only upon termination of the plan sponsor's business operations. Since this is generally assumed by plan actuaries to have a very small probability of occurring, shutdown benefits are only partially funded, at best.

III. PRESENT-LAW PENSION PLAN FUNDING REQUIREMENTS

In general

ERISA and the Code impose both minimum and maximum defined benefit plan funding requirements. The minimum funding requirements are designed to provide at least a certain level of benefit security by requiring the employer to make certain minimum contributions to a defined benefit plan. The requirements recognize that, in an on-going plan, pension liabilities are generally a long-term liability. Thus, benefits are not required to be immediately funded, but can be funded over a long period of time.

The maximum funding limitations are designed to limit and allocate efficiently the loss of Federal tax revenue associated with the special tax treatment afforded qualified retirement plans. Thus, annual deductible contributions to a defined benefit plan are limited to an amount that is not significantly greater than the amount that would normally be necessary under the employer's long-term actuarial funding method.

The minimum and maximum funding requirements provide the employer considerable flexibility in determining the amount of the contribution that must, or can, be made in any given year. The minimum required or maximum permitted contribution that can be made depends on the funding method used by the plan and the actuarial assumptions used by the plan actuary.

In response to concerns about the financial status of underfunded pension plans, the minimum funding standards were modified, and special additional funding requirements were added for underfunded pension plans, by the Pension Protection Act of 1987.

The minimum and maximum funding requirements, and the special rules for underfunded pension plans, are discussed in detail below.

Minimum funding standard

In general

Under the Code and ERISA, certain defined benefit pension plans are required to meet a minimum funding standard for each plan year. As an administrative aid in the application of the funding standard, each defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (including credits for contributions to the plan) are to be made for each plan year. If, as of the close of a plan year, the account reflects credits equal to or in excess of charges, the plan is treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by

which the charges to the account would exceed credits to the account if no contribution were made to the plan.

Accumulated funding deficiencies

If, as of the close of any plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Unless a minimum funding waiver is obtained, an employer who is responsible for contributing to a plan with an accumulated funding deficiency is subject to a 10-percent nondeductible excise tax (5 percent in the case of a multiemployer plan) on the amount of the deficiency. If the deficiency is not corrected within the "taxable period", then an employer who is responsible for contributing to the plan is also subject to a nondeductible excise tax equal to 100 percent of the deficiency. The taxable period is the period beginning with the end of the plan year in which there is a deficiency and ending on the earlier of (1) the date of a mailing of a notice of deficiency with respect to the 10-percent tax or (2) the date on which the 10-percent tax is assessed by the Internal Revenue Service (IRS). If the employer responsible for contributing to the plan is a member of a controlled group, each member of the group is jointly and severally liable for the excise tax.

For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution in that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If the total contribution is not made, then the employer would be subject to an excise tax equal to 10 percent of the deficiency for the year. If the deficiency were not corrected within the specified period, then the 100-percent excise tax would be imposed on such employer (or employers).

Funding methods

In general.—A defined benefit plan is required to use an acceptable actuarial cost method to determine the balance in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as (1) normal cost, and (2) supplemental cost.

Normal cost.—The normal cost for a plan for a year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer to maintain the plan if the plan had been in effect from the beginning of service of then included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. The normal cost will be funded by future contributions to the plan (1) in level dollar amounts, (2) as a uniform percentage of payroll, (3) as a uniform amount per unit of service (e.g., $1 per hour), or (4) on the basis of the actuarial present values of benefits accruing under the plan in particular plan years.

Supplemental cost.—The supplemental cost for a plan year is the cost of future benefits allocated to the year that would not be met by normal costs and employee contributions. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan (1) on the date the plan is first effective, or (2) on the date a plan amendment increasing plan benefits is first effective. Under some funding methods, there is no past service liability component.

Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized over a range of years specified under the Code and ERISA, which may be shorter or longer than the period over which normal costs are amortized under the plan's funding method.

Acceptable methods.—Normal cost and supplemental cost are key elements in computations under the minimum funding standard. Although these costs may differ substantially, depending upon the actuarial cost method used to value a plan's assets and liabilities, they must be determined under an actuarial cost method permitted by ERISA. ERISA enumerates six acceptable actuarial cost methods and provides that additional methods may be permitted under Treasury regulations. Normal costs and supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is required once every plan year. More frequent valuations may be required by the IRS.

Charges and credits to the funding standard account

In general.—Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular year depends upon the nature of the cost. For example, the normal cost for a year is generally required to be funded currently. On the other hand, costs with respect to past service (for example, the cost of retroactive benefit increases), experience losses, and changes in actuarial assumptions, are spread over a period of years.

Normal cost.—Each plan year, a plan's funding standard account is charged with the normal cost assigned to that year under the particular acceptable actuarial cost method adopted by the plan. The charge for normal cost will require an offsetting credit in the funding standard account. Usually, an employer contribution is required to create the credit.

For example, if the normal cost for a plan year is $150,000, the funding standard account would be charged with that amount for the year. Assuming that there are no other credits in the account to offset the charge for normal cost, an employer contribution of $150,000 will be required for the year to avoid an accumulated funding deficiency.

Past service liability.—There are 3 separate charges to the funding standard account that may arise as the result of past service liabilities. The first applies to a plan under which past service liability has increased due to a plan amendment made after January 1, 1974; the second applies only to a plan that came into existence after January 1, 1974; and the third applies only to a plan in exist-

ence on January 1, 1974. Past service liabilities result in annual charges to the funding standard account for a specified period of years. Assuming that there are no other credits in the account to offset a charge for past service liability, an employer contribution will be required for the year to avoid and accumulated funding deficiency.

In the case of a plan that was in existence on January 1, 1974, the funding standard account is charged annually with a portion of the past service liability determined as of the first day of the plan year of which the funding standard applied to the plan (generally the plan year beginning in 1976). In the case of a single-employer plan, the amount of the liability with which the account is charged for a year is based on amortization of the past service liability over a period of 40 plan years. The liability is required to be amortized (in much the same manner as a 40-year mortgage) in equal annual installments over the 40-year funding period unless the plan becomes fully funded.

A plan that was not in existence on January 1, 1974, is generally required to determine past service liability as of the first day of its first plan year beginning after September 2, 1974 (the date ERISA was enacted). This liability is required to be amortized by a single-employer plan in equal annual installments over a period of 30 plan years. Accordingly, if there are no other credits in the account to offset the charge for this past service liability, and if the plan does not become fully funded, annual employer contributions will be required for 30 plan years to offset charges for this past service liability.

With respect to all plans (whether or not in existence on January 1, 1974), if a net benefit increase takes place as the result of a plan amendment, then the unfunded past service liability attributable to the net increase is determined that year and amortized over a period of 30 years.

For example, assume that a plan uses the calendar year as the plan year. Further, assume that, during 1987, the plan is amended to increase benefits and that the net result of plan amendments for 1987 is that the past service liability under the plan is increased by $500,000. In addition, the plan's actuary uses an interest rate of 8 percent in determining plan costs. The 30-year schedule requires that $44,414 be charged to the funding standard account each year to amortize the past service liability.

Accordingly, for each year in the 30-year period beginning with 1987, the plan's funding standard account is charged with the amount of $44,414. If there are no other credits in the account to offset the charge for past service liability, an employer contribution of $44,414 would be required for each of the 30 years to avoid and accumulated funding deficiency unless the plan becomes fully funded.

Gains and losses from changes in assumptions.—If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from charges in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued li-

ability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 10 plan years (30 plan years in the case of a multiemployer plan), resulting in credits or charges to the funding standard account.

Experience gains and losses.—In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. The actuarial assumptions are required to be reasonable, both individually and in the aggregate. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. For a single-employer plan, experience gains and losses for a year are amortized over a 5-year period (15 plan years in the case of a multiemployer plan).

Waived funding deficiencies.—Under the funding standard, the amount of a waived funding deficiency is amortized over a period of 5 plan years, beginning with the year in which the waiver is granted. Each year, the funding standard account is charged with the amount amortized for that year unless the plan becomes fully funded. The interest rate used for purposes of determining the amortization on the waived amount is the greater of (1) the rate used in computing costs under the plan, or (2) 150 percent of the midterm applicable Federal interest rate (AFR) in effect for the first month of the plan year.[4]

Switchback liability.—ERISA provides that certain plans may elect to use an alternative minimum funding standard account for any year in lieu of the funding standard account. ERISA prescribes specified annual charges and credits to the alternative account. No accumulated funding deficiency is considered to exist for the year if a contribution meeting the requirements of the alternative account is made, even if a smaller contribution is required to balance charges and credits in the alternative account than would be required to balance the funding standard account for a plan year.

During years for which contributions are made under the alternative account, an employer must also maintain a record of the charges and credits to the funding standard account. If the plan later switches back from the alternative account to the funding standard account, the excess, if any, of charges over credits at the time of the change ("the switchback liability") must be amortized over a period of 5 plan years.

Reasonableness of actuarial assumptions

All costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and meth-

[4] The standards for granting funding waivers are discussed below.

ods (1) each of which is reasonable individually or (2) which result, in the aggregate, in a total plan contribution equivalent to a contribution that would be obtained if each assumption were reasonable. In addition, the assumptions are required to reflect the actuary's best estimate of experience under the plan.

Special rules for underfunded plans

In general

A special funding rule applies to underfunded single-employer defined benefit pension plans (other than plans with no more than 100 participants on any day in the preceding plan year). This special funding rule was adopted in the Pension Protection Act of 1987 due to concerns about the solvency of the defined benefit pension plan system and that the generally applicable funding rules were not in all cases sufficient to ensure that plans would be adequately funded.

Calculation of deficit reduction contribution

With respect to plans subject to the special rule, the minimum required contribution is, in general, the greater of (1) the amount determined under the normal funding rules, or (2) the sum of (a) normal cost, (b) the amount necessary to amortize experience gains and losses over 5 years and gains and losses resulting from changes in actuarial assumptions over 10 years, and (c) the deficit reduction contribution. In addition, a special funding rule applies with respect to benefits that are contingent on unpredictable events. In no event is the amount of the contribution to exceed the amount necessary to increase the funded ratio of the plan to 100 percent.

The deficit reduction contribution is the sum of (1) the unfunded old liability amount, and (2) the unfunded new liability amount. Calculation of these amounts is based on the plan's current liability.

Current liability

The term "current liability" generally means all liabilities to employees and their beneficiaries under the plan determined as if the plan terminated. However, the value of any "unpredictable contingent event benefit" is not taken into account in determining current liability until the event on which the benefit is contingent occurs.

The interest rate used in determining the current liability of a plan, as well as the contribution required under the special rule, is required to be within a specified range. The permissible range is defined as a rate of interest that is not more than 10 percent above or below the average mid-term AFR for the 4-year period ending on the last day before the beginning of the plan year for which the interest rate is being used. The Secretary may, where appropriate, allow a lower rate of interest except that such rate may not be less than 80 percent of the average rate discussed above.

Within the permissible range, the interest rate is required to be reasonable. The determination of whether an interest rate is reasonable depends on the cost of purchasing an annuity sufficient to satisfy current liability. The interest rate is to be a reasonable esti-

mate of the interest rate used to determine the cost of such annuity, assuming that the cost only reflected the present value of the payments under the annuity (i.e., and did not reflect the seller's profit, administrative expenses, etc.).

Unfunded current liability means, with respect to any plan year, the excess of (1) the current liability under the plan over (2) the value of the plan's assets reduced by any credit balance in the funding standard account. The funded current liability percentage of a plan for a plan year is the percentage that (1) the value of the plan's assets reduced by any credit balance in the funding standard account is of (2) the current liability under the plan.

Unfunded old liability amount

The unfunded old liability amount is, in general, the amount necessary to amortize the unfunded old liability under the plan in equal annual installments (until fully amortized) over a fixed period of 18 plan years (beginning with the first plan year beginning after December 31, 1988). The "unfunded old liability" with respect to a plan is the unfunded current liability of the plan as of the beginning of the first plan year beginning after December 31, 1987, determined without regard to any plan amendment adopted after October 16, 1987, that increases plan liabilities (other than amendments adopted pursuant to certain collective bargaining agreements).

Unfunded new liability amount

The unfunded new liability amount for a plan year is the applicable percentage of the plan's "unfunded new liability." Unfunded new liability means the unfunded current liability of the plan for the plan year, determined without regard to (1) the unamortized portion of the unfunded old liability (and the unamortized portion of certain unfunded liability from certain benefit increases) and (2) the liability with respect to any unpredictable contingent event benefits, without regard to whether or not the event has occurred. Thus, in calculating the unfunded new liability, all unpredictable contingent event benefits are disregarded, even if the event on which that benefit is contingent has occurred.

If the funded current liability percentage is less than 35 percent, then the applicable percentage is 30 percent. The applicable percentage decreases by .25 of one percentage point for each 1 percentage point by which the plan's funded current liability percentage exceeds 35 percent.

Unpredictable contingent event benefits

The value of any unpredictable contingent event benefit is not considered until the event has occurred. If the event on which an unpredictable contingent event benefit is contingent occurs during the plan year and the assets of the plan are less than current liability (calculated after the event has occurred), then an additional funding contribution (over and above the minimum funding contribution otherwise due) is required.

Unpredictable contingent event benefits include benefits that depend on contingencies that, like facility shutdowns or reductions or contractions in workforce, are not reliably and reasonably pre-

dictable. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

The amount of the additional contribution is generally equal to the greater of (1) the unfunded portion of the benefits paid during the plan year (regardless of the form in which paid), including (except as provided by the Secretary) any payment for the purchase of an annuity contract with respect to a participant with respect to unpredictable contingent event benefits, and (2) the amount that would be determined for the year if the unpredictable contingent event benefit liabilities were amortized in equal annual installments over 7 years, beginning with the plan year in which the event occurs.

The rule relating to unpredictable contingent event benefits is phased in for plan years beginning in 1989 through 2001.

Small plan rule

The special rules for underfunded plans do not apply to plans with 100 or fewer employees. In the case of a plan with more than 100 but no more than 150 participants during the preceding year, the amount of the additional deficit reduction and unpredictable contingent amount benefit contribution is determined by multiplying the otherwise required additional contribution by 2 percent for each participant in excess of 100.

Funding waivers

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year. A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship. A waiver may be granted only if the business hardship is temporary and if the entire controlled group of which the employer is a member, as well as the employer itself, is experiencing the hardship. No more than 3 waivers may be granted within any period of 15 consecutive plan years. The IRS may require an employer to provide security as a condition of granting a waiver.

The IRS is authorized to require security to be granted as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $1 million.

Funding limits

To limit and allocate efficiently the loss of Federal tax revenue associated with the special tax treatment afforded qualified plans, ERISA and the Code limit the amount of annual contributions that can be made to a defined benefit plan.

Full funding limit

One limitation is the full funding limit, under which no contribution is required or permitted under the minimum funding rules to the extent the plan is at the full funding limit. Before 1988, the full funding limit was 100 percent of an employer's accrued liability, as determined under the plan's funding method. However, because of

concerns that employers could manipulate the limit by changing actuarial assumptions, the Pension Protection Act of 1987 amended ERISA and the Code to create a new full funding limit. The new full funding limit is equal to the lesser of the old funding limit (accrued liability) or 150 percent of the employer's current liability. Current liability is all liabilities to participants and beneficiaries under the plan determined as if the plan terminated. It represents only benefits accrued to date, and is not dependent on actuarial funding assumptions. As a result, the new full funding limit can be lower than the old full funding limit.

If the employer contributes an amount equal to the full funding limit, the employer is not subject to the underfunding excise tax, even though the funding standard account is left with a deficit for the year. In addition, as explained below, the amount of the deduction an employer can claim for the year cannot exceed the full funding limitation.

Deductions for employer contributions

The Code also imposes a limit on the amount of deductible contributions that can be made annually to a defined benefit plan. Contributions necessary to pay normal costs (as defined under the funding rules) generally are fully deductible. Contributions necessary to fund supplemental costs generally are deductible only to the extent necessary to cover such costs amortized over 10 years. However, the deduction for any year can never exceed the full funding limitation for that year.

There is a 10-percent nondeductible excise tax imposed on contributions in excess of the deduction limit.

Security for plan amendments

Under the Code and ERISA, if a plan amendment increasing current liability is adopted, the contributing sponsor and members of the controlled group of the contributing sponsor must provide security in favor of the plan equal to the excess of (1) the lesser of (a) the amount by which the plan's assets are less than 60 percent of current liability, taking into account the benefit increase, or (b) the amount of the benefit increase and prior benefit increases after December 22, 1987, over (2) $10 million. The amendment is not effective until the security is provided.

The security must be in the form of a bond, cash, certain U.S. government obligations, or such other form as is satisfactory to the Secretary of the Treasury and the parties involved. The security is released after the funded liability of the plan reaches 60 percent.

IV. DESCRIPTION OF CERTAIN PROPOSALS

A. Pension Funding Improvement Act of 1993 (H.R. 298)

In general

H.R. 298, the Pension Funding Improvement Act of 1993,[5] would increase the minimum funding requirements for underfunded plans, modify the security requirements with respect to plan amendments to underfunded plans, modify the PBGC's reporting obligations, and authorize the PBGC to obtain additional information from plan sponsors.

Modifications to minimum funding requirements

The bill would repeal the special present-law funding rule for underfunded single-employer plans and instead impose an underfunding reduction requirement and a solvency maintenance requirement on single-employer defined benefit pension plans that have a funded current liability percentage of less than 100 (determined as of the first day of the plan year). For such a plan, the amount of the accumulated funding deficiency (if any) for a plan year is the greatest of (1) the accumulated funding deficiency for the plan year under present law (determined without regard to the special rule for underfunded plans), (2) the excess of the underfunding reduction requirement for the plan year over the amount considered contributed by the employer for the year, and (3) the excess of the solvency maintenance requirement for the plan year over the amount considered contributed by the employer for the year.

The underfunding reduction requirement is the sum of (1) an amount equal to the product of the unfunded current liability of the plan multiplied by the applicable factor, (2) the expected increase in the current liability attributable to benefits accruing during the plan year, (3) the amount necessary to amortize any waived funding deficiency, and (4) the unpredictable contingent event amount (if any) for the plan year. Like present law, if the funded current liability percentage is less than 35 percent, then the applicable factor is 30 percent. The applicable factor decreases by .25 of one percentage point for each 1 percentage point by which the plan's funded current liability percentage exceeds 35 percent. The underfunding reduction requirement is not to exceed the amount necessary to increase the funded current liability percent of the plan (determined as of the first day of the plan year) to 100 percent plus the expected increase in current liability attributable to benefits accruing during the plan year.

The bill adopts a number of rules similar to or the same as present law. For purposes of determining the underfunding reduc-

[5] H.R. 298 was introduced by Mr. Pickle on January 5, 1993.

tion requirement, the unpredictable contingent event amount is determined as under present law. Current liability is also determined as under present law, except that the interest rate must be no more than 100 percent of and no more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during the 4-year period ending on the last day before the beginning of the plan year. As under the present-law deficit reduction contribution rules, the underfunding reduction requirement and the solvency maintenance requirement do not apply to plans with 100 or fewer participants and are phased in with respect to plans with more than 100 but no more than 150 participants.

The solvency maintenance requirement for a plan year is the sum of (1) all disbursements from the plan for the plan year plus interest on the unfunded current liability of the plan (determined as of the first day of the plan year), (2) the expected increase in current liability attributable to benefits accruing during the plan year, and (3) the amount necessary to amortize any waived funding deficiency. The solvency maintenance requirement is not to exceed the amount necessary to increase the funded liability percent of the plan to 100 percent plus the expected increase in current liability attributable to benefits accruing during the plan year.

For purposes of this rule, "disbursements from the plan" means benefits payments, including purchases of annuities or payment of lump sums in satisfaction of liabilities, administrative expenditures, or any other disbursements from the plan. In determining the applicable amounts attributable to purchases of annuities or the payment of lump sums, the actual purchase price or lump sum amount paid by the plan is multiplied by the excess of one over the funding ratio of the plan. Thus, for example, if the funding ratio of the plan at the beginning of the plan year is 80 percent, then the amount of annuity purchases and lump-sum payments taken into account is 20 percent of such actual amounts.

The solvency maintenance requirement is phased in over 5 years after the effective date at a rate of 20 percent per year.

At the election of the employer, the amounts required to be contributed under either the underfunding reduction requirement or the solvency maintenance requirement may be reduced by the net of (1) credits to the funding standard account for plan years beginning on or before December 31, 1993, arising due to experience gains or changes in actuarial assumptions and amounts considered contributed by the employer to the extent necessary to avoid an accumulated funding deficiency and (2) charges to the funding standard account for such plan years arising due to experience losses and changes in actuarial assumptions.

The funding provisions would be effective for plan years beginning after December 31, 1993.

Required security

The bill would amend the Code and ERISA to require that the plan sponsor of any defined benefit pension plan is required to security to the plan if a plan amendment increases current liability of the plan and the plan is less than 90 percent funded (taking into account the increase in current liability under the amendment). The amount of required security is the excess of (1) the additional

plan assets necessary to increase the funding ratio of the plan to 90 percent over (2) $1 million.

The bill would extend the ERISA criminal penalty to failures to satisfy the security requirement. Thus, a person who willfully violates the requirement may be fined up to $5,000 or imprisoned for up to one year. In the case of a violation by a person not an individual, the fine may be up to $10,000.

The security provisions would apply to plan amendments adopted after December 31, 1993.

Miscellaneous provisions

Reports by the PBGC and CBO

The bill directs the PBGC and the Congressional Budget Office (CBO) to submit separate reports to the Congress setting forth alternative increases in premiums that would be required for the assets of the single-employer termination insurance program to equal or exceed the program's current and expected liabilities by the year 2002. The report is to be submitted no later than March 1, 1993.

The bill provides that the annual report of the PBGC is to include an actuarial evaluation of the expected operations and status of the PBGC for the next 5, 10, 20, and 30 years. Under present law, only the 5-year evaluation is required. The evaluation is to include alternative premium schedules designed to assure that the assets of the PBGC equal or exceed its liabilities during such periods.

The provision would be effective upon the date of enactment.

Information required to be provided to the PBGC

The PBGC is authorized to require the plan sponsor of a plan that is underfunded by more than $10 million, has more than 2,000 participants, or has minimum funding waivers in excess of $1 million to provide to the PBGC such records, documents or other information the PBGC deems necessary to determine the liabilities and assets of plans covered by the termination insurance program or the financial condition of sponsors of such plans.

The provision would be effective upon the date of enactment.

B. 1992 PBGC Proposals

During the 102nd Congress, the PBGC proposed a number of reforms relating to the PBGC termination insurance system, including increasing the minimum funding rules for certain plans, modifying the PBGC guarantee with respect to plan amendments, and bankruptcy reforms.[6]

Minimum funding requirements

In general, the PBGC's minimum funding proposal would build on the changes made by the Pension Protection Act of 1987 by requiring sponsors of underfunded plans to pay off pension liabilities more rapidly than under present-law rules. Alternatively, under-

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[6] These proposals were included in the President's fiscal year 1993 budget, and in H.R. 4545, introduced by Mr. Michel (by request) on March 24, 1992.

funded plans with high levels of payments would be required each year to make contributions to the plan equal to disbursements plus interest on the plan's unfunded liability. The proposed rules would require underfunded plans to increase their funding levels over a period of time.

To accomplish these goals, the proposal would replace the current deficit reduction contribution with two new rules: (1) the "underfunding reduction requirement," and (2) the "solvency maintenance requirement". The required minimum funding contribution would be the greatest of (a) the amount of any funding deficiency according to the regular funding standard account, (b) the amount required by the underfunding reduction rule, or (c) the amount required by the solvency maintenance rule. The two new rules would only apply to underfunded pension plans with more than 100 participants, and would only have a limited effect on plans with more than 100, but no more than 150 participants.

The underfunding reduction requirement would apply the formula for the unfunded new liability amount from the deficit reduction contribution to the entire underfunding, thereby eliminating the grandfathering of pre-1987 liabilities over an 18-year period. As under present law, the rule would require higher contributions from the worst funded plans. To this amount would be added normal cost, the repayment of waived contributions, and charges for experience losses and losses from changes in actuarial assumptions. Credit for experience gains, gains from changes in actuarial assumptions and greater than required minimum contributions would be allowed as offsets, but only to the extent of the charges for experience losses and the losses from changes in actuarial assumptions.

The solvency maintenance requirement has two main components: (1) disbursements from the plan (i.e., benefit payments, including annuity purchases, administrative expenses and other disbursements), and (2) the plan's initial unfunded liability multiplied by the interest rate used for purposes of the funding standard account under section 412(b). Normal cost and other charges are added to this amount, and credits are allowed, in the same manner as under the underfunding reduction requirement.

To protect firms against possibly large increases in their required contributions on account of this rule, the solvency maintenance requirement would be phased in over a 5-year transition period. In addition, with respect to both requirements, any positive credit balances that antedate 1992 would be allowed as full offsets under both the new requirements.

Discipline in actuarial assumptions would be maintained by use of the funding standard account concepts of experience losses and losses from changes in actuarial assumptions. Limiting credit for experience gains, gains from changes in actuarial assumptions, and for greater-than-required minimum contributions in past years buttresses that discipline and assures that underfunded pension plans always make a contribution in each year that they are underfunded.

PBGC guarantee

The proposal would provide that the PBGC guarantee does not apply to benefits under a new plan or an increase in benefits resulting from a plan amendment unless the plan is fully funded. In addition, the proposal would provide that the PBGC guarantee does not apply to any new unpredictable contingent event benefits or any increases in such benefits. An unpredictable contingent event benefit is any benefit contingent on an event other than age, service, compensation, death, or disability or an event which is reasonably and reliably predicable.

Bankruptcy reforms

The proposal would clarify the standing of the PBGC in bankruptcy by giving it the same priority status under the Bankruptcy Code as it has under ERISA and the Code. Thus, it would amend the Bankruptcy Code to include contributions attributable to the pre-petition period and pre-petition priority employer liability claims (that is, employer liability for termination before a bankruptcy petition has been filed) in the list of pre-petition taxes that are accorded priority under section 507(a)(7) of the Bankruptcy Code. The proposal also would amend the Bankruptcy Code to include contributions attributable to the post-petition period and post-petition priority employer liability claims (that is, employer liability for termination after a bankruptcy petition has been filed) among the post-petition taxes that are treated as allowable administrative expenses of a bankrupt company and are accorded priority under section 507(a)(1) of the Bankruptcy Code.

The proposal would give priority to claims for underfunding attributable to shutdown benefits triggered within three years of termination. It also would allow the PBGC's claims to arise without having to terminate the plan in the event the plan sponsor liquidates, and the control group assumes responsibility for the plan. Sponsors in bankruptcy with ongoing plans would have to continue to fund the plan as required under the Code and ERISA.

The proposal would amend ERISA to clarify that a portion of PBGC's claims for employer liability has priority. The proposal also would prospectively revise the amount of PBGC's priority employer liability claim to be the sum of: (a) unfunded benefits liabilities attributable to the occurrence of unpredictable contingent events arising during the three years preceding termination, plus (b) the greater of: (1) 30 percent of employer net worth; or (2) the currently applicable percentage of the remaining unfunded benefit liabilities. The percentage begins at 10 percent and increases 2 percentage points a year until it reaches 50 percent in 2012. The PBGC could disregard the 30 percent of net worth calculation where cost-effective to do so.

Lastly, the proposal would give the PBGC the option to be a member of the creditors' committee, so that it would have access to information routinely available to other creditors.

V. ISSUES AND ANALYSIS

In general

The PBGC contends that, without legislative reforms, its financial condition is likely to deteriorate to the point that it will not be able to meet its obligations under ERISA. According to its calculations, premiums and other income will be insufficient to pay guaranteed benefits for terminated underfunded plans in the future.

If the PBGC's forecast is correct,[7] there are a number of possible ways to strengthen the financial condition of the PBGC working within the present termination insurance program.[8] PBGC funding could be improved by increasing the amount of premiums collected by the corporation or by giving the PBGC higher priority status in bankruptcy proceedings. Another option is to reduce PBGC liabilities by limiting the PBGC guarantee or by improving the health of the defined benefit pension system generally, so that fewer plans will terminate with unfunded liabilities. For example, steps could be taken to increase minimum funding standards to reduce the amount of unfunded liabilities in the system. These, and other possible solutions, are discussed in detail below.

PBGC funding

One way to help ensure that the PBGC will be able to continue to meet its obligations under ERISA is to increase the amount of funds available to pay unfunded benefits guaranteed by the corporation.[9]

Premiums

Since the PBGC is required by ERISA to be self-supporting—there is no annual appropriation from general revenue—most of the corporation's revenue comes from premiums collected from employers sponsoring defined benefit plans. An increase in premiums could be achieved either by increasing premium rates or by increasing the number of plans from which premiums are collected (base broadening).

In determining the proper way to structure PBGC premiums, a major issue is risk distribution—that is, should all premium payers

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[7] Some have questioned whether the PBGC's forecast of impending financial crisis is accurate. For example, critics assert that the PBGC uses very conservative actuarial assumptions that may overstate plan liabilities and the PBGC's exposure. See Part II.B. above. Because the PBGC has never produced auditable financial statements, it is very difficult to independently verify the accuracy of the corporation's assessment. See U.S. General Accounting Office, *Labor Issues* (GAO/OCG-93-19TR), January 7, 1993.

[8] Possible options outside the termination insurance program, such as appropriations from general revenues, are not discussed here.

[9] The sources of PBGC's funds are assets of terminated plans, premiums, claim recoveries from sponsors of terminated plans, and investment earnings. Since, by definition, assets of terminated plans represent funded benefits, only the latter three sources are available to pay unfunded benefits.

pay the same premium, or should the premium be adjusted to reflect risk. Those who favor increasing the flat-rate premium charged to all covered plans focus on the social insurance aspect of the PBGC. They argue that providing retirement benefits is an important social good and that, therefore, the cost of providing benefits should be spread equally among a broad group. When the PBGC was created in 1974, this was the approach adopted—every defined benefit plan contributed a premium of $1 per participant, regardless of risk to the system.

Under a flat-rate PBGC premium, well-funded plans effectively subsidize high-risk, poorly-funded plans. Proponents of this approach argue that this subsidization is intentional, and is inherent in the concept of the PBGC as a social insurance program. Social insurance programs typically involve transfers of wealth, usually from higher-income individuals to lower-income individuals.

Proponents of an increase in the flat-rate premium express concern that increased reliance on risk-based premiums could cause employers to unnecessarily limit or delay benefit increases or, in the case of newer plans, to limit the amount of past service credit. Such changes in plan benefits increase plan liabilities, and thus could cause a plan to be underfunded in the short run, even though the plan may be fully funded over time. Proponents of a flat-rate system are also concerned that a significant increase in premiums for underfunded plans could divert assets away from plan funding (or some other business purpose like research and development or expansion), and even force some companies into bankruptcy.

Those who favor risk-adjusted premiums argue that premiums should be based, at least partially, on plan underfunding because of the moral hazard that exists under the present system. The flexibility in the minimum funding rules permits plan sponsors to minimize contributions. Thus, plan sponsors can deliberately underfund plans, knowing that if the plan is terminated, other premium payers (through the PBGC) will provide the benefits.

In private insurance companies, insurance is priced to prevent such moral hazards. Proponents of risk-adjusted premiums argue that PBGC insurance should be priced in a similar manner. Although premiums are marginally higher for underfunded plans than for fully funded plans, the difference under present law is not sufficient to reduce the incentive to abuse the system.

Proponents of risk-adjusted premiums argue that an increase in flat-rate premiums would be unfair to healthy defined benefit plans. In fact, the PBGC opposes higher premiums for all plans because it fears that there will be a mass exodus of premium payers from the defined benefit system. The more cross-subsidization that occurs between well-funded and poorly-funded plans, the more the premium structure will be perceived as unfair and the more risk there is that healthy plans will simply exit the system. A company can respond easily to the increased cost of pension insurance by switching from a defined benefit plan to a defined contribution plan (although such a switch could not be made unilaterally in the case of a collectively-bargained plan).

An increase in premium rates for underfunded plans also may result in overcharges to some plans because not all underfunded plans pose an equal risk to the PBGC. The degree of risk posed to

the PBGC also depends on other factors, such as the health of the particular plan sponsor and its industry. In a perfect insurance setting, adjustments for this type of risk may be desirable. However, determining what the appropriate premium should be for any particular plan would likely be unduly complicated. Plan underfunding may be an adequate proxy for risk.

Another way to increase the amount of premiums collected by the PBGC would be to broaden the premium base. One method of accomplishing this would be to collect "premiums" [10] from all qualified pension plans, not just defined benefit plans. Defined contribution plans benefit from the same tax-favored treatment afforded defined benefit plans, and the two types of plans generally are considered to be part of the same system established and supported by the government to help ensure that individuals have adequate retirement income to supplement Social Security benefits and private savings. A modest per-participant "premium" collected from all qualified plans could increase PBGC funding substantially without increasing the cost of defined benefit plans relative to defined contribution plans.

On the other hand, the less connection there is between the premium payers and the beneficiaries of the PBGC's insurance, the more likely the system will be perceived as unfair, particularly if the incentive to underfund plans remains. Further, the more such connection weakens, the more difficult it is to distinguish the financing method from general fund financing and the more the program is simply a wealth transfer program rather than insurance. If wealth transfer is ultimately the objective of the pension termination insurance system, then there may be better ways to accomplish the desired result than through the existing system.

Enforcement

Better enforcement of the premium requirements also would improve the financial condition of the PBGC. GAO found that the PBGC's efforts to identify and collect unpaid premiums, underpaid premiums, and penalties are inadequate.[11] GAO recommended civil actions, systematic past due filing notices, and systematic statements of account with proper follow-up.

Bankruptcy reform

Increasing the priority status of PBGC claims in bankruptcy could help to secure the financial stability of the corporation. It would enable the PBGC to claim a larger share of the assets of bankrupt companies to help pay guaranteed benefits. Elevating the status of pension claims also would provide an additional incentive for employers to fund their pension liabilities because of the potential negative effect of unfunded liabilities on the perceived financial health of the employer.

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[10] Because a defined contribution plan participant could never benefit from the PBGC guarantee, amounts collected from such plans would not technically be "premiums" for insurance. Rather, they would be more like taxes.

[11] U.S. General Accounting Office, *Pension Benefit Guarantee Corporation* (GAO/HR-93-5), January 7, 1993; *Pension Benefit Guaranty Corporation Needs to Improve Premium Collections* (GAO/HRD-92-103), June 30, 1992.

However, increasing the priority status of the PBGC would come at the expense of other creditors. Moreover, creditors may be less likely to loan money to firms with underfunded plans, hastening the ultimate failure of a company in dire financial condition.

PBGC liabilities

Another way to help ensure the continued viability of the PBGC is to limit the corporation's exposure to excessive liabilities.

PBGC guarantee

One way to limit the PBGC's exposure is to eliminate or limit the PBGC guarantee in certain circumstances. For example, the PBGC guarantee could be denied to certain benefit increases promised by underfunded plans. Structured properly this might discourage financially troubled sponsors and labor representatives from shifting compensation liabilities to the PBGC by negotiating increased pension benefits in lieu of wages as it becomes apparent that the sponsor may fail. If the increased benefits were not guaranteed by the PBGC, labor would be more likely to insist that the benefits be funded by the sponsor.

However, this approach could undermine the whole purpose of the PBGC, which is to guarantee benefits. If benefit increases are not guaranteed, participants of plans that are not fully funded upon termination could receive a reduced pension. Further, participants may be misled, because they may not know that a particular benefit increase is not guaranteed. Collectively bargained flat-dollar plans would be particularly affected, since benefit increases under such plans are always at least initially unfunded.

A better way to limit PBGC's exposure to unfunded benefit promises might be simply to prohibit, or at least limit, plan improvements that increase unfunded liabilities. For example, benefit increases in underfunded plans could be prohibited unless the plan is funded to a certain level, or unless security is provided. Such a restriction could build on the present-law requirement that sponsors of plans which are less than 60 percent funded provide security for plan amendments that increase unfunded liabilities by more than $10 million.

One drawback to this latter approach is that participants in underfunded plans could be denied benefit improvements. Also, companies and labor representatives would be restricted in their ability to negotiate freely in their own best interest (although this concern should be balanced with what is best for the defined benefit plan system as a whole). Moreover, if plan sponsors are required to provide security for benefit increases, sponsors may find it difficult to obtain the credit necessary to keep their businesses in operation. However, if pension promises are to be recognized as significant liabilities, this may be the correct result. A plan sponsor that cannot fund an increase in benefits without jeopardizing its business operations arguably should not make that increase.

Increased minimum funding rate

Another way to limit the PBGC's exposure is to strengthen the minimum funding standards in ERISA and the Code. Many pension experts argue that the rate of funding required under the

present-law minimum funding standards exposes plan participants and the PBGC to excessive risk.

Under present law, plans with unfunded liabilities are permitted to amortize the shortfall over a number of years that varies with the cause of the underfunding. This period can be as long as 40 years. As a result, the funded status of a plan can deteriorate even if the minimum funding requirements are fully satisfied. Strengthening the minimum funding rules would limit the ability of employers to delay or avoid funding obligations.

Stricter funding rules would not come without a price, however. Stricter rules would have the greatest effect on underfunded plans in declining and troubled industries, possibly forcing some companies into bankruptcy. Tighter restrictions could also affect companies that in a cyclical downturn may be unable to meet strict funding standards during an unprofitable period. (Presumably, though, IRS funding waivers could be preserved to accommodate these situations.) Even some healthy companies will object to additional restrictions on funding flexibility because of the increased costs that will sometimes result. Income tax revenues would decline because companies would be required to increase the amount of deductible contributions to their plans, and because subsequent earnings on the additional contributions would be excludable from income.

Full funding limit

In a similar vein, pension funding might be improved by easing restrictions on maximum funding levels. This way, plans might be able to contribute enough during profitable periods to make up for any shortfalls during economic downturns. Some have suggested that repeal of the limit based on 150-percent of current liability (added in 1987) [12] would be beneficial in this regard.

According to a 1991 Treasury Report,[13] however, the effect on funding levels of the current liability limit is minimal. Treasury found that the decrease in funding levels resulting from the limit does cause a small increase in the risk to plan participants and the PBGC because of lower funding rates. However, the limit affects only well-funded plans, and only by relatively small amounts. The report concludes that the current liability limit is likely to have an insignificant effect on employee benefit security.

Hidden liabilities [14]

The PBGC's exposure could be limited by reducing its hidden liabilities. In a study released in January 1993,[15] GAO reported that the PBGC's exposure to unfunded liabilities is much larger than plans have indicated on their annual reports. As a consequence, when a pension plan terminates with insufficient assets, the PBGC is likely to absorb unfunded liabilities considerably greater than the plan reported (thus the term "hidden liability"). According to

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[12] For background on this limit. See Part III, above ("Funding limits").

[13] Department of the Treasury, *Report to Congress on the Effect of the Full Funding Limit on Pension Benefit Security*, May 1991.

[14] See Part II.B., above, for a general description of hidden liabilities.

[15] U.S. General Accounting Office, *Hidden Liabilities Increase Claims Against Government Insurance Program* (GAO/HRD-93-7), December 30, 1992.

GAO, the PBGC has few tools under present law to control its exposure to these hidden liabilities.

Critics assert that the amount of its liabilities the PBGC overstates because the actuarial assumptions the corporation uses to calculate such liabilities are unrealistic. Thus, one way to reduce hidden liabilities would be for the PBGC to use more realistic assumptions. The PBGC acknowledges its use of a lower-than-market rate of interest, but defends this practice on the grounds that it is necessary to offset the effect of the relatively high mortality rates it assumes. The PBGC recently proposed [16] to revise its mortality and interest rate assumptions to reflect recent actuarial practice.

Plan sponsors also could be required to use actuarial assumptions that more accurately reflect expected future liabilities. For example, interest rate assumptions used to calculate plan liabilities could be regulated more strictly. Under present law, actuaries hired by plan sponsors are free to select, within a typical range of about 2 percentage points, the interest rate to be used by the plan. GAO found that a 1 percentage point increase in the interest rate assumption will generally lead to about a 10- to 20-percent decrease in calculated plan liabilities. Thus, a rate selected from the high end of the range can result in calculated liabilities significantly lower than a rate from the low end of the range. Plan sponsors that use a higher rate can reduce the amount of required contributions, possibly leading to underfunding and a hidden liability to the PBGC.

Better reporting and internal plan audits by independent accountants also could reduce hidden liabilities. GAO has recommended that the Congress amend ERISA to require full-scope audits of pension plans, and to require plan administrators and independent accountants to report how effectively the internal controls of a plan protect plan assets.[17] These internal controls should be a key safeguard in protecting plan participants and the PBGC.

The Congress could address the problem of hidden liabilities that arise as a result of special shutdown benefits paid when an employer ceases operations. Shutdown benefits are poorly funded because they are not fully valued by plan actuaries when calculating the plan's liabilities. Because plans often terminate shortly after shutdown benefits begin, sponsors do not have time to fund the benefits once they accrue, and the PBGC receives a hidden liability.

Many observers view shutdown benefits as a particularly egregious abuse of the pension guarantee system. Since such benefits are payable only upon termination of all or a part of the sponsor's operations, sponsors know that responsibility for making payments probably will be borne by the PBGC. Critics argue that such benefits should not be insured by the PBGC. However, even if not insured, shutdown benefits increase plan liabilities because they drain plan assets that would otherwise be used to pay regular, guaranteed, benefits. This practice would also have to be restricted in order to limit PBGC's exposure to potential excessive liabilities.

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[16] 58 Fed. Reg. 5128 (January 19, 1993).

[17] U.S. General Accounting Office, *Improved Plan Reporting and CPA Audits Can Increase Protection Under ERISA* (GAO/AFMD-92-14), April 9, 1992.

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