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ECONOMIC COMMENTARY

Is the U.S. Pension-Insurance System Going Broke?

by Thomas M. Buynak

Forty million Americans—about one-third of the work force—have private, employer-sponsored pensions that are insured by the Pension Benefit Guaranty Corporation (PBGC).

The PBGC is a federally chartered agency that is required by law to pay guaranteed retirement benefits to insured workers who would normally lose their pensions as a result of the failure or inability of an employer to meet its pension-fund obligations.

As of 1985, the PBGC's safety net protected private pension assets reaching $1.3 trillion. Recent developments, however, centering on corporate bankruptcy actions, have raised storm clouds over the PBGC, resulting in questions about its ability to continue to meet its pension-fund obligations.

In this *Economic Commentary,* we examine the present and prospective financial condition of the PBGC fund. The fund is on thin ice. As of the end of 1986, the PBGC's accumulated deficit, plus impending terminations, approached $4 billion.

The critical public policy issue resulting from the fund's worsening financial condition centers on how Congress will choose to fix the problem. For example, will the ultimate burden to make pension payments for defunct plans be shifted from private companies to the taxpayer? Will the PBGC system continue to be self-funded by increasing the pension-fund premium paid by participating employers? Or will new legislation reform the entire pension-insurance process?

Thomas M. Buynak is an economist at the Federal Reserve Bank of Cleveland. *The author would like to thank Mark Sniderman, Walker Todd, John B. Carlson, and James B. Thomson for helpful comments.*

Providing a Safety Net

The PBGC was established in 1974 under the Employee Retirement Income Security Act (ERISA) to guarantee the benefits of employees who participate in certain types of pension plans.

The idea was to design a government-sponsored insurance system in which employees of defined-benefit plans would be assured that they would receive their promised benefits. A *defined-benefit* plan requires a corporation to contribute to a pension fund on the basis of the benefits that eventually are scheduled to be paid to pension holders.[1] Almost three-fourths of private pension assets today are held by defined-benefit plans.

ERISA establishes, among other things, minimum funding and fiduciary standards for defined-benefit pension plans. These plans must operate on a "funded" basis, which means that a corporation must fund its defined benefit plan at the same time that it promises the benefits.

Under PBGC rules, if a firm terminates a defined-benefit pension plan that has insufficient assets, the agency becomes the trustee of the plan, assuming its assets and liabilities.

Under ERISA, the PBGC must insure *all* defined-benefit pension plans, regardless of how poorly they are funded or how weak the financial condition of the pension plan sponsor might be. The PBGC levies a flat-rate premium per participant and cannot charge higher premiums for underfunded plans. Congressional approval is required to raise PBGC's premium. The agency's one-premium pricing mechanism, coupled with the legal proviso that it must insure all defined-benefit plans, is one reason why it differs from other types of private insurance companies.

Although the PBGC is a wholly owned, independent government agency, it also differs in important ways from other federal regulatory agencies, like the Federal Deposit Insurance Corporation (FDIC). The FDIC, for example, has the power to regulate FDIC-insured banks. The PBGC, in contrast, has no regulatory powers; it *passively* insures all defined-benefit plans.

The current maximum level for individual PBGC-guaranteed payments is $1,857.95 per month. The PBGC guarantee, which was originally set at $750 in 1974, is adjusted each year in accordance with increases in the Social Security wage base. The guaranteed ceiling affects very few participants, however. In fact, the average monthly benefit check issued by the PBGC today is less than $250. The guarantee covers only "basic" benefits that, by PBGC regulation, include vested retirement benefits, plus any cost-of-living adjustments, and any death, survivor, or disability benefits if a participant is on payroll status on the date of the plan termination. Although authorized to insure nonbasic benefits, such as special supplementary benefits that are offered to encourage early retirement, the agency has opted not to do so.

1. For a thorough discussion of the basics of pension plans, see James F. Siekmeier, "Can We Count on Private Pensions?," *Economic Commentary,* Federal Reserve Bank of Cleveland, February 15, 1986.

Chart 1A PBGC's Financial Operations, Single-Employer Fund

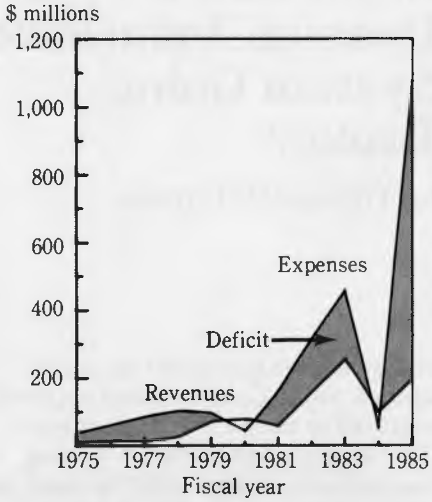
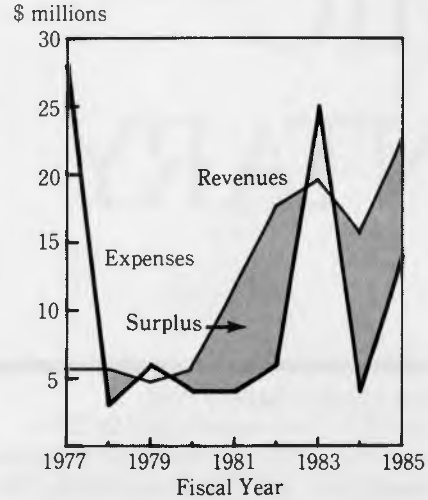


Chart 1B PBGC's Financial Operations, Multi-Employer Fund



SOURCE: 1975-1985 PBGC Annual Reports.

The PBGC is *self-financed;* it does not receive any regular government funding. The pension-guarantee fund is financed from several sources: (1) from annual premiums per participant from insured pension plans; (2) from assets acquired from terminated plans; (3) from investment income, including appreciation of investment assets; and (4) from employer-liability payments. The flat-rate premium charged by the PBGC is its primary source of revenue.

Under the employer-liability provisions of ERISA and recent legislation, the PBGC has a legal claim of 100 percent of its insurance loss, up to 30 percent of the sponsor's net worth and its controlled group. The PBGC also can claim the difference between 75 percent of the insurance loss and the recoverable proceeds under its first claim.

To illustrate: assume that company A, which has net worth of $500 million, terminates a PBGC-insured pension plan that is underfunded by $1 billion. The PGBC has a claim against 30 percent of the $500 million net worth, or $150 million. The PBGC also has a claim of 75 percent of $1 billion minus the recovered proceeds of $150 million, or $600 million.

In our example, the PBGC thus has total legal claims of $750 million against the underfunding of $1 billion. The agency's first claim has priority status in bankruptcy, and thus may have some value if the reorganization value is considered as net worth of the bankrupt company. The PBGC's second claim has lower status in bankruptcy than its net-worth claim, and is subject to various limitations that further reduce its value.

Finally, PBGC's assets include a $100-million line of credit with the U.S. Treasury, which is small compared to the FDIC's $3 billion credit line. Moreover, unlike the FDIC, the PBGC does not have the full faith and credit of the federal government behind its obligations.

PBGC's Financial Condition: Pre-LTV

Since its beginning in 1974, the PBGC has had negative net worth; its actuarial liabilities exceed its assets. This accumulating deficit was largely inconsequential until 1982, when it began to escalate, except for brief pauses in fiscal year (FY) 1980 and FY1984, when PBGC posted positive net operating results—which slightly reduced its deficit. Despite having negative net worth since its inception, however, the PBGC generally has had a positive cash flow; current income has been sufficient to meet current expenses.

Most of the agency's cumulative deficit is attributed to rising liabilities incurred in its single-employer fund, which represents 95 percent of its total assets (see chart 1A). In contrast, PBGC's multi-employer fund, which insures private pension plans covering employees of more than one employer, usually has reported surpluses, which have mitigated what otherwise would have been an even larger deficit (see chart 1B).

In 1985, PBGC's cumulative deficit nearly tripled. According to its 1985 financial statements (the latest available), the corporation had total assets of $1.44 billion and had $2.74 billion in total liabilities, leaving it with an accumulated deficit of approximately $1.3 billion as of the September end of its fiscal year. This unprecedented escalation of accumulated deficit is attributed primarily to very large claims by two companies: the Allis-Chalmers Corporation and the Wheeling-Pittsburgh Corporation, which together saddled the PBGC with claims of approximately $600 million. Although the agency's negative net worth soared in 1985, it still had a positive cash flow.

The decision of Allis-Chalmers Corporation to terminate 11 of its pension plans in a non-bankruptcy action, the bankruptcy of Wheeling-Pittsburgh Corporation, and the recent bankruptcy petition by LTV Corporation could be justified on the basis that those companies had no other financial choice.

However, it is equally plausible for companies such as LTV and Wheeling-Pittsburgh to choose bankruptcy because a court may permit a restructuring of collective bargaining agreements and a reduction of long-term pension and insurance liabilities.[2] To the extent that the courts confirm reorganization plans based on limiting long-term exposures to such outlays, bankruptcy will be an attractive alternative for debt-burdened corporations and a threat to the PBGC.

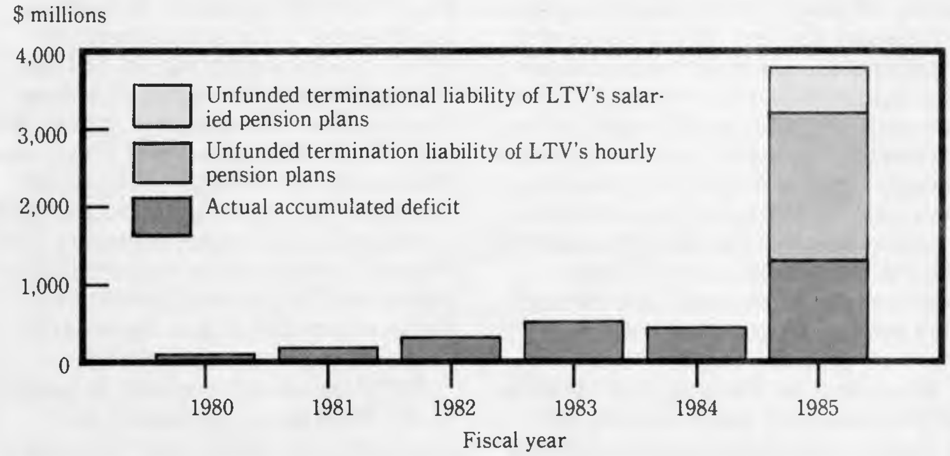
The PBGC realized that it was exposed to substantial risk of future insolvency much earlier than 1985. As early as 1982, it began to ask Congress for a premium increase for its single-

2. See Walker Todd, "Aggressive Uses of Chapter 11 of the Federal Bankruptcy Code," *Economic Review*, 1986 Quarter 3, Federal Reserve Bank of Cleveland, pp. 20-26.

3. LTV was precluded under the terms of its collective bargaining agreements from initiating the termination of the two plans covering hourly workers. Thus, the PBGC legally had to seek a court ruling to terminate LTV's hourly plans. See Cathy Trost and Cynthia F. Mitchell, "U.S. Pension Unit Set to Take Over Three LTV Plans," *Wall Street Journal*, January 13, 1987, p. 20.

employer fund. Congress last granted a premium increase for the single-employer fund, from $1.00 to $2.60, in 1978. The PBGC's repeated requests for a premium increase since then were fruitless until April 1986, when Congress finally raised the premium to $8.50. The $8.50 premium was enacted without consideration of the LTV situation, which developed in July 1986.

Chart 2 PBGC's Accumulated Deficit



SOURCE: 1980-1985 PBGC Annual Reports. Combined Employer Fund.

LTV Spins Off Unfunded Pension Liabilities Onto the PBGC

LTV Corporation's pension plans are underfunded by $2.3 billion. Its hourly pension plans are more severely underfunded than its salaried plans (see chart 2). In September 1986, the Dallas-based corporation transferred one of its two salaried plans to the PBGC and, on January 13, 1987, a federal court allowed the agency to terminate LTV's three other pension plans.[3] Assumption of the four LTV plans will triple the agency's already burgeoning cumulative deficit.

While it is clear that the agency is already insolvent, the assumption of LTV's unfunded liabilities is pushing the cash outflows of the PBGC above its cash inflows.[4] As a consequence, the agency is now forced to reduce its reserves by selling investment assets so that it can pay its legally mandated claims. This is a no-other-choice, short-run solution that undermines the PBGC's long-term viability because, in effect, it forces the agency to accelerate recognition of future earnings in order to strengthen current earnings. The process of selling assets eventually will exhaust the PBGC's reserves.

The PBGC's Potential Future Liabilities

Alicia H. Munnell investigated the prospective financial condition of the PBGC in 1982, and she observed that the business of guaranteeing private pension plans was potentially quite expensive.[5] Munnell's investigation found that the PBGC was financially vulnerable in 1982 to the termination of major pension plans, despite the apparent financial soundness of the overall pension system.

Munnell's study revealed that the majority of terminated plans with insufficient assets were terminated because of adverse business conditions, such as poor economic conditions, business liquidations, or plant closings. Almost three-fourths of the plans with insufficient assets were terminated as a result of bankruptcy—an unpredictable event. Although most plan terminations were relatively small, she found that the worst underfunded plans are typically the larger plans. Thus, it is not surprising that the PBGC today is facing insolvency and liquidity problems in the wake of the pension-plan terminations of Allis-Chalmers, and the bankruptcy of Wheeling-Pittsburgh and of LTV, all of which Munnell identified in 1982 as companies with a high likelihood of pension-plan termination.

A second, but minor, phenomenon affecting the solvency of the PBGC is the growing number of corporations that are voluntarily terminating their overfunded plans. When a pension fund is overfunded, a corporation's management has an incentive to voluntarily terminate a defined-benefit plan and to strip the corporation's fund of surplus assets, a procedure called a *reversion.*[6] In a reversion, the pension-sponsoring corporation claims the surplus pension assets.

According to PBGC data, pension plan reversions have removed approximately $11 billion in excess assets from the private pension system since 1980. Pension-asset reversions have not yet contributed to any significant degree to the PBGC's financial plight. However, if the recapitalization of the PBGC fund imposes a disproportionate burden on overfunded pension plans, then pension-asset reversions might rise rapidly. This, in turn, would aggravate PBGC's financial troubles.

The Tax Reform Act of 1986 will partially undercut the incentive to terminate overfunded pension plans because it requires corporations to pay an additional tax of 10 percent on asset reversions. However, there are other ways in which corporations can obtain access to surplus pension assets without terminating their pension funds. For example, Cleveland-based Sherwin-Williams Company recently received approval from the U.S. Department of Labor to

4. See Laurent Belsie, "U.S. pension-insurance agency awash in steel-industry red ink," *The Christian Science Monitor,* December 15, 1986, p. 3.

5. See Alicia H. Munnell, "Guaranteeing Private Pension Benefits: A Potentially Expensive Business," *New England Economic Review,* Federal Reserve Bank of Boston, March/April 1982, pp. 33-44.

6. See Arturo Estrella, "Corporate Use of Pension Overfunding," *Quarterly Review,* Federal Reserve Bank of New York, Spring 1984, pp. 17-25.

7. See "Pension loan cleared for Sherwin-Williams," *Crain's Cleveland Business,* November 3-9, 1986, page 1.

8. See *The Handbook of Pension Statistics* 1985, Commerce Clearinghouse, Inc., Chicago, Illinois, pp. 28-29.

borrow as much as $65 million from $314 million of assets in its pension plans; in return, the company agreed not to terminate its two pension plans.[7]

Although the law clearly states that a corporation rightfully owns the surplus assets of terminated pension plans, the issue of "who *ought* to own the surplus assets" is rapidly becoming controversial. Pension holders are increasingly protesting and questioning whether a corporation has the exclusive right to tap a pension fund's surplus assets. Pension holders contend that the surplus pension assets are theirs and are, in effect, deferred wages.

If we focus on the long-term viability of defined-benefit pension plans, the prospects of adequate pension funding through the next decade depend critically on the long-term financial health of the sponsoring corporations. Almost half of both the total number and total assets of defined-benefit pension plans are held by plans covering workers in manufacturing industries.[8] Thus, the viability of a large percentage of defined-benefit pension plans during the next decade is strongly linked to the long-term outlook of this industry group in particular. Due to poor performance, however, it is not unreasonable to predict future bankruptcy filings and pension fund problems in the manufacturing sector.[9]

Legislative Band-Aid

In 1986, Congress enacted the first major piece of legislation to shore up the finances of the single-employer PBGC fund since passage of ERISA.[10] This legislation, the Single Employer Pension Plan Amendments Act of 1986 (SEPPAA), contains several provisions to improve the viability of the single-employer insurance fund, including: (1) a tripling of the annual insurance premium; (2) more restrictive termination rules; and (3) additional liability for corporations choosing to terminate a single-employer pension plan.[11]

SEPPAA's most sweeping provision is the $8.50 annual premium per employee. The PBGC had requested a premium increase to $7.50 based on a projected fund deficit in 1985 of less than $600 million, but that low estimate excluded the unusually large claims that were later filed by Allis-Chalmers, Wheeling-Pittsburgh, and LTV Corporation.

The other SEPPAA provisions make it more difficult to terminate an underfunded plan and require sponsoring companies that terminate an underfunded plan to assume more liability to cover the underfunding. It is unclear at this time, however, whether SEPPAA makes any major change in bankruptcy law or in the liability of zero-net-worth corporations that terminate their underfunded pension plans.

Concluding Remarks

The PBGC clearly is in a dangerous financial condition. It is currently insolvent and may be unable to pay its legally required pension claims in as little as 10 years. Its current difficulties are primarily the result of a poorly designed pension insurance system and are not the consequence of an underfunded private pension system.

To survive, however, it is clear that the PBGC must be recapitalized. The Reagan administration and Congress are well aware that sweeping changes are necessary in our private pension insurance system. The recapitalization of the PBGC fund could conceivably utilize many elements, including enlarging the agency's credit line with the Treasury; setting more stringent standards for minimum funding and higher maximums on yearly funding; establishing risk-adjusted insurance premiums; reducing PBGC's guarantee; allowing private insurers to insure more pension dollars; setting stiffer waiver standards; or, mounting a bailout using taxpayer's money.

How long before the PBGC runs out of cash? The exact timing will depend on future plan terminations, on interest rates, and on related factors. The result ultimately will depend on the political process. If Congress waits too long before providing a solution, however, it could find itself faced with some very unpleasant and very expensive choices.

9. A financially distressed corporation may seek a funding waiver (subject to IRS approval) to defer all or part of an annual payment into the pension fund. The IRS grants a waiver if it determines an employer cannot meet the minimum funding standards without incurring substantial financial hardship. The PBGC plays no formal role in the waiver process.

10. Congress also enacted the Multi-employer Pension Plan Amendments Act of 1980 (MPPAA). MPPAA raised the annual per capita premium rate from 50 cents to $1.40, imposed increased funding requirements on employers in multi-employer funds, and made employers (subject to certain relief provisions) liable for unfunded benefits when a company withdraws from a multi-employer fund.

11. See "New Act Muddies Single-Employer Pension Water," *Legal Times,* Washington, D.C., June 16, 1986, pp. 15-17.

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