Understanding the Financial Condition of the Pension Insurance Program

The Pension Benefit Guaranty Corporation (PBGC) is a federal corporation created under the Employee Retirement Income Security Act of 1974 (ERISA). It insures the pensions of more than 34 million workers and retirees in nearly 29,000 private-sector defined benefit pension plans under its single-employer insurance program.[1] PBGC insurance funds pay guaranteed benefits that are not funded by plan assets or recoveries from employers at plan termination.

Recent termination of a number of large, severely underfunded pension plans (e.g., LTV Steel, Bethlehem Steel, US Airways, United Airlines, Polaroid, and Kemper Insurance) has focused attention on the financial condition of the PBGC's insurance program. As of September 30, 2005, the end of the 2005 fiscal year, PBGC reported a $22.8 billion deficit in the financial statements for its single-employer pension insurance program.

This fact sheet addresses questions that have been raised about what the deficit means, how it is calculated, and the true cost of the PBGC insurance program. It also answers questions about measures of pension underfunding in the defined benefit system.

I. Measuring the Pension Insurance Program Deficit

1. How is PBGC's financial condition calculated?

PBGC's financial statements are prepared in conformance with Generally Accepted Accounting Principles, the same standards that apply to publicly traded companies across the United States . The financial statements are reviewed by the PBGC's Inspector General and subjected to a complete independent audit by a private-sector auditing firm. For fiscal year 2005, the PBGC received its 13th consecutive clean (i.e., unqualified) audit opinion from its independent auditors. A clean audit opinion requires consistent and accurate valuations and estimates.

PBGC's financial condition is determined by comparing the values of its assets and its liabilities. PBGC's assets consist primarily of accumulated premiums paid by covered plans (invested in Treasury securities) and plan assets that PBGC has taken over when it becomes trustee of terminated underfunded plans. PBGC's liabilities consist primarily of future benefit payment obligations both for trusteed plans and for those deemed likely to default. PBGC values both its assets and liabilities at market value.

Group annuity prices are the most objective measure of the cost of defeasing a plan's liabilities in the marketplace. PBGC uses group annuity prices to value its liabilities. This assures parity between the valuation of liabilities in plans taken over by PBGC and the cost of providing annuities when a company voluntarily terminates a plan and, by law, provides annuities through the purchase of annuities in the marketplace. The annuity-price methodology upholds the important principle that it should not be cheaper to terminate a pension plan with the PBGC than with a private insurance company. Moreover, it is the basis that has been used more than 160,000 times since 1974 whenever companies have terminated plans, including fully funded plans that close out without the use of PBGC insurance funds.

2. What plans are included in the PBGC's deficit?

The deficit includes losses incurred from plans that have already terminated and estimated losses incurred from "probable" terminations. A plan is classified as a probable termination if the PBGC determines that it is likely the plan will terminate. Generally, a plan is classified as a probable termination if the employer is in liquidation and there are no related companies that could fund the plan; the employer has filed for a distress termination; or the PBGC is seeking involuntary plan termination. Other criteria, such as a bankruptcy filing or the sponsor's default on a credit agreement in combination with other factors, also may be used to classify a plan as a probable termination. Once a plan is classified as a probable termination, it remains a probable until it either terminates or is no longer expected to terminate with a loss to the insurance program.

3. Why does the PBGC include probables in its deficit?

Generally Accepted Accounting Principles (GAAP) and the Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, require the PBGC to include probables in its liability for future pension benefits that the PBGC will be obligated to pay participants. Specifically, expected losses must be included if the loss is likely to occur and the amount of the loss can be estimated. The PBGC's balance sheet and deficit as of September 30, 2005, included $10.4 billion in net losses from probable terminations.[2]

The accounting standards require probables to be reported in PBGC's balance sheet on a net basis. That is, the estimated present value of plan assets and employer recoveries is subtracted from the estimated present value of benefits and the resulting net figure is reported on PBGC's balance sheet, rather than reporting plan assets as PBGC assets and plan benefits as PBGC liabilities. Accounting rules do not permit plan assets to be booked as PBGC assets until the PBGC takes over the plan assets.[3]

4. How often do probables become actual terminations?

Historically, the vast majority of plans booked as probable losses subsequently terminate. At the end of fiscal year 2005, of the $28.7 billion in probable net claims booked by the PBGC in Fiscal years 1987 through 2004, $21.8 billion (76%) had terminated, $1.1 billion (4%) were removed from the probables category, and $5.8 billion (20%) were unresolved. Thus 95% of the $22.9 billion of resolved probable claims had terminated. Moreover, of the $17 billion of probable net claims that were reported in the financial statements as of the end of fiscal 2004, more than $10 billion became terminations during fiscal year 2005.

5. When a plan terminates that was already included on the PBGC's books as a probable, what is the effect on the PBGC's deficit?

The loss that the PBGC reports from a completed termination is the present value of future benefits assumed by the PBGC, less the present value of plan assets and expected recoveries, all measured as of the actual date of plan termination. Generally there is no significant effect on the PBGC's deficit when a plan that is classified as a probable termination actually terminates, because probables are already included in the deficit. However, there can be modest changes in the amount of the reported loss, partly because any re-measurements after the original date often are able to take into account updated information and assumptions not available when the original estimate was made.

6. What are "reasonably possible" termination claims? Are they included in the PBGC's deficit?

Generally, plans are classified as "reasonably possible" to terminate if they are sponsored by companies with a higher default risk - *e.g.*, companies whose bonds are rated below investment grade. As of September 30, 2005, there was $108 billion of underfunding in plans that were classified as reasonably possible terminations. In accordance with Generally Accepted Accounting Principles and the Financial Accounting Standards Board Statement No. 5, *Accounting for Contingencies*, the PBGC is required to disclose its exposure to losses from reasonably possible terminations in footnotes to the PBGC's financial statements. Unlike losses from completed and probable terminations, these potential losses are not included in the PBGC's balance sheet or deficit.[4]

7. What would PBGC's deficit be if measured differently?

As noted above, the PBGC's reported single-employer deficit was $22.8 billion as of September 30, 2005. The deficit was computed using a market-based interest factor reflected in private-sector annuity prices. Even if higher discount rate assumptions were used, there still would have been a dramatic swing in the PBGC's financial position from a surplus to a very large deficit over the last four years. For example, valuing the liabilities using a "spot" composite corporate bond rate**,** the deficit would have been lower, but still significant, at about $19 billion. It would have been $28 billion using a 30-year Treasury spot rate. Some have argued that higher rates reflecting the earning ability of plan assets should be used, but these methods do not reflect the risk that the assets may not generate returns at the assumed rate. The risk-adjusted rate will be lower. The discount rate reflected in annuity market pricing is the one that the PBGC believes is most applicable.

8. Do the additional assets from new terminations improve the PBGC's financial situation?

Every time the PBGC takes on more assets from an underfunded terminated plan, it also takes on new benefit liabilities that exceed the amount of the new assets. While the PBGC has enough assets to cover benefits for a number of years, taking on more terminated plans makes the long-term problem worse, not better.

II. Measuring the Long-Term Cost of the Insurance Program

1. Does the PBGC deficit represent the true long-term economic cost of the insurance program?

The deficit reported in PBGC's financial statements is not intended to be a representation of the insurance program's long-term economic cost. Rather, it is calculated as required under Generally Accepted Accounting Principles, which mandate taking into account claims from probable terminations in the near term but not future claims over the long term. The deficit, therefore, is not a measure of the program's long-term economic cost.

2. What is the true long-term economic cost of the program estimated to be?

Various independent estimates have been made of the single-employer insurance program's long-term economic cost. In late September 2005, the Congressional Budget Office issued a report projecting that the ten year losses to the PBGC could grow significantly based on the underfunded status of many plan sponsors whose defined benefit plans the PBGC guarantees and exposures they have taken on in their portfolios. Using a cash-flow model, a private-sector think tank found that an amount far in excess of PBGC's current deficit would be needed to restore the program to solvency under current law. Further, a number of academic and financial institution studies have found that premiums have historically been under-priced by as much as six times the amount necessary to cover actual and expected claims.

PBGC evaluates future claims and the financial condition for the single-employer insurance program using a stochastic model, the Pension Insurance Modeling System (PIMS), to simulate thousands of combinations of economic parameters and bankruptcy rates. As stated in PBGC's 2004 Annual Report, PIMS shows that the probability of a financial statement surplus of any amount by 2014 is only 2 percent.

3. What is total underfunding in the defined benefit system?

The PBGC estimates that, measured on a termination basis, total underfunding in the single-employer defined benefit plans it insures exceeded $450 billion as of September 30, 2005. This is a measure of total underfunding exposure in the defined benefit system; this measure does not assume that all plan sponsors are going to fail. All of this underfunding is in excess of what is shown on the PBGC's balance sheet or included in its deficit.

4. How much of the $450 billion of total underfunding poses risk to plan participants, premium payers, and taxpayers?

Most of the $450 billion of total underfunding is in pension plans sponsored by healthy companies that should be able to fund promised benefits over time. However, $108 billion of underfunding for vested benefits is in plans sponsored by companies whose bonds are rated below investment grade or who met one or more of the other criteria.[5] According to rating-agency data, below-investment-grade companies are 20 times more likely to default on their debt obligations than investment-grade companies.

The PBGC's experience shows that plans of financially weak employers have been a source of substantial claims. Of the approximately $111 billion of total unfunded vested benefit liability of plans classified as reasonably possible terminations at any time during fiscal years 2001 through 2004, more than $30 billion was in plans that have subsequently been reclassified as probable terminations or did terminate by September 2005.

A recent GAO report also identified the financial strength of a plan sponsor as a key determinant of risk to the PBGC.[6] According to the report, of the PBGC's 41 largest claims since 1975 in which the sponsor's credit rating was known, 39 have involved plan sponsors that were rated as below-investment-grade three years prior to termination. These 39 claims account for 67% of the value of total gross claims on the single-employer program from 1975 to 2004. About 80% of the plan sponsors involved in these claims were rated as below-investment-grade 10 years prior to plan termination.

5. How does PBGC measure pension underfunding?

PBGC measures underfunding as if a plan were terminating today, by valuing assets and liabilities on a market basis. PBGC's value of benefits is based on the market cost of annuities (net of benefit administration expenses) that a private insurance company would charge to pay the plan's promised benefits in annuity form. This market-based measurement gives an objective snapshot of a plan's funded status at a particular point in time.

The PBGC gathers annuity pricing data from private insurance companies through a quarterly survey, which is conducted for the PBGC by the American Council of Life Insurers. The survey asks insurers to provide the price, net of administrative expenses,[7] for annuity contracts for terminating plans. The survey methodology assures that the PBGC's termination values reflect the market price of termination. The PBGC has used the same methodology for many years, ensuring that termination values are consistently determined.

PBGC's termination-basis measure also takes into account the fact that when a plan of a financially weak company terminates, more individuals tend to retire early with subsidized benefits. These early retirements often substantially increase plan liabilities and, consequently, plan underfunding.

6. How does PBGC's method for measuring underfunding differ from what companies report?

Companies typically do not use a termination basis to calculate the plan funding status they report to participants. The main differences are in the discount rate used to calculate the present value of benefits, the expected retirement age used to estimate when benefits will commence and the amount of early retirement benefits that will become payable. Companies tend to use a higher discount rate that reflects expected investment returns or perhaps an average of past investment returns, and later expected retirement ages that do not assume increased rates of early retirement.

The assumptions companies use to measure liabilities often understate the plan's underfunding compared to its underfunding on a termination basis. As a result, participants in terminating plans often are alarmed to learn just how poorly funded their plan is. For example, Bethlehem Steel reported that its plan was 84 percent funded on an ongoing basis, but the plan turned out to be only 45 percent funded on a termination basis, with a total shortfall of $4.3 billion. US Airways' pilots' plan was 94 percent funded on an ongoing basis, but the plan was only 33 percent funded on a termination basis, with a $2.5 billion shortfall.

III. Consequences of the Deficit and Plan Underfunding

Why do PBGC's deficit and underfunding in the system matter?

Simply stated, when underfunded pension plans terminate, workers and retirees, companies that have acted responsibly in honoring their pension promises, and, potentially, U.S. taxpayers are hurt. These terminations can have particularly harsh consequences for workers and retirees. While the PBGC steps in to pay benefits to participants in terminated pension plans, some workers and retirees may lose benefits they were counting on to provide economic security in retirement if promised benefits exceed guarantee limits established by Congress.

For example, the total amount of underfunding in the four largest terminations in PBGC history was approximately $18 billion. About two-thirds of that shortfall was covered by the PBGC. The remaining one-third (about $6 billion) represents the loss to plan participants. In other words, workers and retirees in these plans forfeited $6 billion of earned pension benefits, losses that can never be recovered. This example is not intended to imply that a 2-to-1 ratio is the norm. In some terminations, the magnitude of participant losses is much less, and in others, it is more. However, in plans with more generous formulas, participants are more likely to be adversely affected.

Besides workers and retirees, the other stakeholders in the system are companies with PBGC-insured plans. By law, the PBGC is supposed to be self-financing. The principal source of revenue to pay unfunded guaranteed benefits is premiums paid by these companies. The premiums needed to pay for plan defaults might become too high for the defined benefit plan sponsors in the system, raising the prospect of either the need for general tax payer assistance or a greater loss of benefits for insured participants.

It also is important to provide investors an accurate measure of pension liabilities. They have a financial interest in knowing the cost that companies would incur to settle their pension obligations through voluntary plan termination and the claim that PBGC would have against the company in the event of a distress or involuntary termination.

ENDNOTES

[1] Under a separate program, the PBGC guarantees the pensions of 9.9 million people covered by about 1,600 multiemployer plans.

[2] This approach is detailed in Note 2 "Significant Accounting Policies" to the PBGC's FY 2004 Financial Statements and was also the subject of a recent GAO report, which states, "PBGC stated its exposure for probable claims in accordance with FAS No. 5 as required by GAAP. Directed at the accounting objective of full disclosure, this standard requires the PBGC to record a loss if it is likely to occur and the amount of the loss can be reasonably estimated. PBGC's financial statement auditors routinely review this area and its compliance with GAAP requirements as part of their annual audit. PBGC has consistently used a method of specifically identifying potential claims supplemented by estimates for additional claims that might be missed by its method for selecting probable claims." U.S. Government Accountability Office, Private Pensions: Questions Concerning the Pension Benefit Guaranty Corporation's Practices Regarding Single-Employer Probable Claims, GAO-05-991R Private Pensions, page 4, September 9, 2005.

[3] Claims from terminated plans that have not yet been taken into PBGC trusteeship similarly are reported on a net basis in PBGC's balance sheet.

[4] The PBGC's experience shows that plans of financially weak employers have been a source of substantial claims. Of the approximately $111 billion of total unfunded vested benefit liability of plans classified as reasonably possible terminations at any time during fiscal years 2001 through 2004, more than $30 billion had been reclassified as probables or terminated by September 2005.

[5] PBGC disclosed this $108 billion of underfunding for vested benefits in plans of financially weak companies as reasonably possible terminations in the footnotes to the fiscal year 2005 financial statements.

[6] United States General Accountability Office, "Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules," GAO-05-294, pp. 30-36 (May 2005).

[7] Separately, PBGC periodically surveys the administrative expense charges of annuity providers and adds an allowance for those expenses to net prices generated by the annuity price survey.