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United States General Accounting Office
Washington, DC 20548

December 17, 2003

The Honorable Earl Pomeroy
Ranking Minority Member
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Subject: *Private Pensions: Timely and Accurate Information Is Needed to Identify and Track Frozen Defined Benefit Plans*

Dear Mr. Pomeroy:

While private-sector pensions help millions of Americans achieve retirement income security, the number of private defined benefit (DB) plans[1] has declined substantially over the past two decades. Recently, those concerned with the viability of the private defined benefit pension system point to significant increases in pension contributions plan sponsors must make and to the fact that most plans are currently underfunded. The underfunding of plans, due in large part to the sharp decline in the stock market combined with a general decline in interest rates, has increased substantially. The Pension Benefit Guaranty Corporation (PBGC), whose single-employer insurance program insures the benefits of over 34 million workers and retirees in private defined benefit plans,[2] estimated that the total underfunding exceeded $350 billion as of September 4, 2003.

Between 1999 and 2002, roughly 7,000 DB plans participating in the PBGC single-employer insurance program were terminated. PBGC trusteed, or took over, about 5 percent of these plans because they did not have enough assets to pay benefits due to participants. When PBGC takes over a plan, participants may receive a reduction in expected retirement benefits.[3]

According to employer groups, plan sponsors face inflated and unpredictable pension contributions that have greatly diminished the attractiveness of maintaining DB plans. As a result, employer groups have suggested that plan sponsors may consider

[1]Employers may sponsor DB and/or defined contribution (DC) plans for their employees. DB plans promise to provide a benefit that is generally based on an employee's salary and years of service. DB plans use a formula to determine the ultimate pension benefit participants are entitled to receive. Under a DC plan, employees have individual accounts to which the employee, employer, or both make contributions, and benefits are based on contributions to and investment returns (gains and losses) on the accounts.
[2]There are two federal insurance programs for defined benefit plans: one for single-employer plans and another for multiemployer plans. Single-employer plans provide benefits to employees of one firm or, if plan terms are not collectively bargained, to employees of several unrelated firms.
[3]The benefit PBGC pays to a participant whose plan has been terminated and taken over by PBGC depends on the provisions of the terminated plan and certain statutory limits that specify maximum benefit payments among other factors.

freezing their plans rather than confronting the possibility of increased pension contributions. A plan "freeze" could have adverse consequences for the retirement income security of participants because new employees are precluded from participating in the plan, and current participants might not receive additional benefit accruals.

DB plan sponsors may vary the extent to which they freeze their plan. One type of DB plan freeze, called a "hard freeze," stops all benefit accruals. In this instance, all current employees who participate in the plan receive no additional benefit accruals after the effective date of the freeze. Also, employees hired after the freeze are prevented from participating in the plan. Another type of plan freeze, called a "soft freeze," stops benefit accruals based on years of service only. In such cases, no additional years of participant's service with the sponsor are included in participants' retirement benefit determinations after the effective date of the freeze, but benefits still grow with increases in an employee's compensation. Additionally, a plan sponsor may freeze the plan for certain groups of workers only or close the plan to new participants.

While data are published annually on terminations of DB plans covered by PBGC's insurance program, little is known regarding the occurrence of DB plan freezes. The *Form 5500 Annual Return* is a primary source of public information on tax-qualified private pensions.[4] We previously reported that while Form 5500 Annual Returns provide aggregate information, there are concerns about the availability and quality of information reported on these forms.[5] Because timely and accurate information on plan freezes could be important in assessing the overall health of the private DB plan system, you asked us to determine how many DB plans have been frozen since 2000.

To determine how many DB plans have been frozen since 2000, we interviewed officials at the Department of Labor (DOL), the Internal Revenue Service (IRS), and PBGC regarding work the agencies have done in this area as well as the usefulness of currently available information in identifying and tracking frozen DB plans. In addition, we reviewed selected reporting requirements and examined forms that plan sponsors must submit to DOL, IRS, and PBGC. We also interviewed pension plan consultants with DB plan sponsor clients and reviewed information they provided to us. We conducted our work from August to November 2003 in accordance with generally accepted government auditing standards.

Results in Brief

We could not determine the number of defined benefit plans frozen since 2000. Currently available public information cannot be used to readily identify and track frozen DB plans. Officials at PBGC and DOL we interviewed considered potential approaches to using Form 5500 filings to determine how many DB plans have been frozen, and we found that such approaches have limitations with respect to the accuracy and completeness of the results. Consequently, PBGC requested that the

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[4]The Department of Labor, in conjunction with the Internal Revenue Service and PBGC publishes the Form 5500 to be used by plan administrators and employers in order to satisfy their annual reporting obligations under the Employee Retirement Income Security Act and the Internal Revenue Code. Plan administrators must also submit certain schedules, depending on the features of the plan that accompany the Form 5500.

[5]U.S. General Accounting Office, *Retirement Income Data: Improvements Could Better Support Analysis of Future Retirees' Prospects*, GAO-03-337 (Washington, D.C.: Mar. 21, 2003).

2002 *Form 5500 Annual Return* collect information on DB frozen plans. This information, however, is limited and will not be available until 2004. We reviewed other reports and disclosures that DB plans must provide to the government or participants, but determined that these are not useful in identifying frozen plans. Publicly available information is of limited use in identifying and tracking frozen plans in part because there is no statutory definition of a DB plan freeze. Private surveys from benefits consulting firms seek to estimate the incidence of DB plan freezes in recent years, but the results reflect information from their clients only and do not provide a clear and complete picture of plan freezes among all DB plans. More complete and timely information on frozen defined benefit plans could help assess the potential risks plan freezes pose to participants' retirement income security and the viability of PBGC's single-employer insurance program.

Because it is uncertain to what extent DB plan freezes pose risks to participants' retirement income security and PBGC's single-employer insurance program, we believe that additional steps are needed to collect information on such plans and evaluate their potential consequences. Accordingly, we are recommending that PBGC's Executive Director direct the agency to identify, track, and analyze frozen DB plans on a pilot basis.

Background

The U.S. pension system is voluntary; employers decide whether to establish a retirement plan and determine the design, terms, and features of the plan or plans they choose to sponsor. To encourage employers to establish and maintain pension plans for their employees, the federal government provides preferential tax treatment under the Internal Revenue Code (IRC) for plans that meet certain requirements.

The IRS, DOL's Employee Benefits Security Administration (EBSA), and PBGC are primarily responsible for enforcing laws that govern private pension plans. IRS enforces provisions of IRC that apply to tax-qualified pension plans. EBSA enforces the Employee Retirement Income Security Act's (ERISA) reporting and disclosure provisions and fiduciary responsibility standards, which among other things concern the type and extent of information provided to the federal government and plan participants. PBGC insures the benefits of participants in certain tax-qualified private-sector defined benefit plans. Insurance protection is provided for certain DB plan participants in the event that a plan terminates with insufficient assets.

DB plan administrators are required to file information annually with IRS, DOL, and PBGC on the financial condition and operation of their plans. This information is provided on the *Form 5500 Annual Return* and accompanying schedules. The Form 5500 was intended, in part, to measure employers' compliance with ERISA's fiduciary and funding provisions. The Form 5500 provides information about the financial condition of the plan, annual amounts contributed by participants, and the plan's income on investments. The form also provides information on plan characteristics, such as plan type (defined benefit or defined contribution), method of funding, and numbers of employees, participants, and employees who are excluded from the plan for various reasons.

The IRS also requires that plan administrators file information in certain instances. For example, plan administrators must file certain forms that disclose changes to the plan that the sponsor wants to make. These changes include combining plans after a company merger or consolidation, or in some cases when terminating a plan. PBGC requires that plan administrators file forms that are used to report and pay their premiums to PBGC. Sponsors of PBGC-insured single-employer plans generally must submit information when certain reportable events occur, such as when there is a reduction in the number of active participants or failure to make required contributions to meet pension obligations.

ERISA established PBGC to pay the pension benefits of participants, subject to certain limits, in the event that an employer could not. Under ERISA, the termination of a single-employer DB plan results in an insurance claim with PBGC's single-employer program if the plan does not have sufficient assets to pay all benefits accrued under the plan up to the date of termination. If a single-employer DB plan terminates without sufficient assets, PBGC takes over the plan's assets and is responsible for paying benefits up to limits set by law to participants who are entitled to receive them.[6] For example, PBGC generally does not guarantee annual benefits above a certain amount, currently about $44,000 per participant at age 65. A plan sponsor may voluntarily terminate its DB pension plan by meeting certain conditions, depending on the funded status of the plan. When a fully funded single-employer plan terminates, the benefits of participants are protected because the sponsor pays all participant benefits accrued under the plan up to the date of termination.[7]

Alternatively, DB plan sponsors may freeze their plan. A plan freeze occurs when a sponsor amends its plan to cease benefit accruals indefinitely in the future.
Plan sponsors may implement a freeze for a variety of reasons. PBGC guidelines on voluntary termination identify the cessation of benefit accruals as an alternative to termination under certain circumstances that sponsors may consider. A plan sponsor may decide to freeze its plan when it is not fully funded and can no longer afford the cost of the plan. For example, a sponsor may not be able to voluntarily terminate an underfunded plan until it has enough assets to cover benefit liabilities. Moreover, a sponsor facing financial strain may not meet conditions for PBGC to step in and trustee the plan either. However, a DB plan freeze may be temporary in some cases. For example, the sponsor cannot or chooses not to fund additional benefit accruals for the time being. Alternatively, a sponsor may freeze the plan when it anticipates terminating the plan at some later date. In some cases, this might mean that participants receive no further accruals from a DB pension plan. However, not all plan terminations mean that participants lose future pension accruals. For instance, pension sponsors might terminate a plan due to a corporate merger and move participants into an already existing DB plan. Similarly, a sponsor might terminate a DB plan to replace it with another type of plan such as a defined contribution plan.

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[6] PBGC receives no direct federal tax dollars to support the single-employer pension insurance program. The program receives the assets of terminated underfunded plans and any of the sponsor's assets that PBGC recovers during bankruptcy proceedings. PBGC finances the unfunded liabilities of terminated plans with (1) premiums paid by plan sponsors and (2) income earned from the investment of program assets.
[7] When a single-employer DB is terminated in accordance with PBGC's requirements and with enough assets to pay all of the liabilities of the plan, the termination is referred to as a standard termination. Plan sponsors typically terminate fully funded plans either by purchasing annuities from a private sector insurance company or making lump sum distributions to participants that are no smaller than the present value of accrued benefits.

We recently designated PBGC's single-employer insurance program as high risk because of its current financial weaknesses, as well as the serious, long-term risks to the program's future viability.[8] We reported that two important risks could affect the long-term financial viability of the single-employer program. First, the high level of losses experienced in 2002, due to the bankruptcy of companies with large underfunded defined-benefit pension plans, could continue or accelerate. Second, PBGC might not receive sufficient revenue from premium payments and its own investments to offset the losses experienced to date or those that may occur in subsequent years. Further, we highlighted factors that could cause premium income received by PBGC's single-employer insurance program to dwindle over the long term. For example, fixed rate premiums would decline if the number of participants covered by the program decreases, which may happen if plans leave the system and are not replaced. Moreover, a decline in the number of plans PBGC insures could weaken its ability to increase premium income in the future.

The Number of Frozen Defined Benefit Plans Is Not Currently Known

We could not determine the number of defined benefit plans that have frozen since 2000. Currently available public information cannot be used to readily identify and track frozen DB plans. PBGC officials told us that they cannot reliably track such plans with currently available public data, and DOL officials we spoke with concurred with PBGC's assessment. Both PBGC and DOL considered approaches to estimate the number of frozen DB plans using currently available Form 5500 data. However, upon review, the agencies determined that such approaches were difficult to employ and likely to yield incomplete and inconsistent results. According to the officials at DOL and PBGC we spoke with, the approaches they examined could only provide a rough estimate because such approaches are based on indicators that could suggest characteristics associated with a plan freeze. For example, DOL assessed its approach and determined that some frozen plans could be missed and some ongoing plans could be erroneously categorized as frozen. As a result, both PBGC and DOL officials we spoke with told us that they would need to contact plans directly or find supporting documentation in order to make a definitive determination regarding the status of plans identified by the approaches considered.

In recognition of the need to obtain more definitive information on frozen DB plans, PBGC requested the addition of an item to the 2002 *Form 5500 Annual Return*. The 2002 *Form 5500 Annual Return* includes an identifying code that allows plan sponsors or administrators to indicate whether the plan has been frozen for all benefit accruals (i.e., both service credits and salary increases). Thus, information on plan freezes that becomes available from the 2002 Form 5500 is limited to so-called "hard freezes." The data will not provide information about plan freezes that freeze only service credits for benefit accruals—so-called "soft freezes." Furthermore, plan sponsors or administrators are not able to indicate instances when the plan is frozen for certain groups of workers or closed to new participants.[9]

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[8] See U.S. General Accounting Office, *Pension Benefit Guaranty Corporation Single-Employer Insurance Program: Long-Term Vulnerabilities Warrant 'High Risk' Designation*, GAO-03-1050SP (Washington, D.C.: July 23, 2003), and *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks*, GAO-04-90 (Washington, D.C.: Oct. 29, 2003).

[9] We previously reported on the delays and other problems associated with the Form 5500. See U.S. General Accounting Office, *Retirement Income Data: Improvements Could Better Support Analysis of Future Retirees' Prospects*, GAO-03-337 (Washington, D.C.: Mar. 21, 2003).

PBGC also noted shortcomings with the timeliness of Form 5500 data for the purpose of identifying and tracking frozen DB plans. Because 2002 Form 5500 data filings are first due 7 months after the end of the plan year and because, on average, it takes over 6 months to process a Form 5500 filing at present, data from plans whose plan year began January 1, 2002 (plan year 2002) are not expected to be generally available until February 2004. At the time of this review, any approach using currently available Form 5500 data would only capture few instances of plan freezes that occurred after 2001. However, officials we interviewed suspected many of the recent DB plan freezes occurred during 2002 and 2003. In addition to being limited and delayed, the 2002 Form 5500 identifier may not result in accurate information. For example, plan sponsors may not fully adjust their reporting procedures to account for the new identifying code. Thus, the data may initially result in a miscount of so-called hard freezes because reporting errors are typically higher in the first year a new item is added to the Form 5500.

Other reports and disclosures that plans must provide to the government or participants about the plan's operation, financial status, terms, or benefits do not specifically or readily identify frozen DB plans. The reports and disclosures we reviewed include the premium forms that covered plans submit to PBGC, the notice of reportable events submitted to PBGC, Application for Determination for Employee Benefit Plan submitted to IRS, and requirements under section 204(h) of ERISA. While events related to a DB plan freeze may trigger certain reporting or disclosure requirements, plan sponsors are not explicitly required to report to the federal government or participants that they have frozen their plan in such instances. For example, while a PBGC-insured frozen DB plan would be required to submit the annual premium form, the form does not expressly require the sponsor to indicate whether or not the plan is frozen. Additionally, section 204(h) of ERISA requires plan sponsors to provide notices to participants when they amend the plan in a way that results in a significant reduction in either the rate of future benefit accruals or an early retirement benefit or retirement-type subsidy, which would include a plan freeze. However, plan sponsors are not required to furnish these notices to the government nor are they specifically required to declare the plan as frozen, even though the information contained within the notice could describe changes to future benefit accruals consistent with a plan freeze.

Publicly available information is of limited use in identifying and tracking frozen DB plans in part because there is no statutory definition of a DB plan freeze. We found few references to DB plan freezes within existing laws and regulations applicable to private pensions. While ERISA and IRS regulations delineate characteristics indicative of a plan freeze in determining whether a partial termination has occurred, this reference only applies to a limited set of frozen plans.[10] Aside from this limited regulatory reference and the new identifying code on the 2002 Form 5500, there is no definition of a plan freeze within current law and regulations. The lack of a statutory definition constrains the capability of federal agencies in identifying and tracking such plans.

[10] A DB plan freeze that creates or increases a potential assets reversion to the employer or employers maintaining the plan is deemed a partial termination. See IRS Revenue Ruling 2003-65, IRS Bulletin 2003, and 26 C.F.R §1.401(a)(26)-2(b).

Private Surveys of Plan Sponsors Indicate Occurrence of Plan Freezes, but Results Are Limited

Surveys from benefits consulting firms indicate that plan freezes have occurred in recent years, but such surveys do not provide a clear and complete picture of plan freezes among all DB plans. Generally, practitioners we spoke with from these benefits consulting firms highlighted the role of current economic conditions on the funding status of defined benefit pensions. They also noted an increase in the number of DB plans freezing over the last few years. Some had surveyed their clients to ascertain to what extent they had frozen or intended to freeze their DB plan. For example, one consulting firm reported that 2 percent of plans it surveyed had frozen benefits prior to 2001, and 13 percent implemented a freeze since that time.[11] Another private consulting firm conducted a survey on their clients' DB plans and found that 15 percent of these plans had frozen or reduced benefits for current employees, and 19 percent had frozen or reduced benefits for new employees since 2000. While the results of these surveys suggest that some plan sponsors have frozen or are considering freezing their plans, they cannot be generalized to all DB plans because they are drawn from a limited client base. Moreover, the surveys we reviewed used different definitions of a plan freeze so their results are not directly comparable. For example, one survey asked questions broadly about actions plan sponsors had taken or intended to take, including plan freezes along with other changes such as terminating the plan.

Complete and Timely Information on Frozen DB Plans Could Help Assess the Potential Risks to Participants and the PBGC Insurance Program

More complete and timely information on frozen DB plans could help assess the potential risks that plan freezes might pose to participants' retirement income security and the viability of PBGC's single-employer insurance program. The impact on participant's retirement income is likely to vary depending on the extent to which the plan is frozen and the long-term result of the freeze. DB plan freezes may also increase risks to the long-term health of PBGC's single-employer insurance program.

Because plan sponsors can freeze their plan in various ways, the risks to participants' retirement income security can vary in part depending on the type of freeze that the sponsor implements. Depending on the extent to which benefit accruals are frozen, the number of participants whose future benefit accruals are reduced will vary, as will the extent to which a participant's future benefit accruals could be reduced. For example, a hard freeze reduces expected future defined benefit accruals to a greater degree than a soft freeze. Furthermore, a hard freeze affects all participants and new employees, while a soft freeze may leave certain participants unaffected.

The ultimate outcome of a DB plan freeze also affects the extent to which workers may receive income from private pensions. For example, a frozen DB plan may or may not be replaced with another pension plan at some later date. If a frozen plan is terminated and replaced, the new plan could be more or less generous in terms of providing future benefit accruals. Thus, it could be important to examine the reasons any individual plan sponsor might freeze. This is because they could potentially

[11] Aon Consulting Alert, October 22, 2003. Aon's survey included more than 1,000 private-sector DB plans.

indicate whether the plan sponsor is likely to continue offering that plan or a similar plan in the future, or whether the plan sponsor is likely to significantly reduce pension benefits. Knowing the reasons why DB plan freezes occur could help assess the likelihood that the affected participants may or may not experience a significant reduction in expected benefit accruals.

DB plan freezes could also increase risks to the long-term sustainability of PBGC's single-employer insurance program. PBGC officials told us that to the extent plan freezes are an early indicator of future terminations, they may also be predictive of reductions in PBGC's premium revenue stream. Furthermore, they said that anticipated problems with respect to PBGC's ability to collect premium revenue might be understated because plan freezes are not currently analyzed by PBGC. To be viable in the long term, the single-employer insurance program must receive sufficient income from premiums and investments to offset losses due to terminated underfunded plans. Fixed rate premiums will decline if the number of participants covered by the program decreases, which may happen if plans leave the system and are not replaced. Frozen plans that are ultimately terminated could lessen PBGC's ability to collect revenue premiums over the long term.

The extent to which plan freezes pose risks to the sustainability of PBGC's single-employer insurance program, and the associated PBGC liabilities are difficult to gauge because PBGC cannot identify and analyze frozen DB plans with currently available public information. PBGC officials indicated that DB plans might implement a plan freeze in a variety of ways and for a variety of reasons. Because different factors may precipitate a plan freeze, it is important to have information on the extent of and the reason for the freeze so that the risks to participants and PBGC can be adequately assessed. It is also important to track the final outcome of a plan freeze. Whether a frozen plan will eventually unfreeze, terminate, or remain frozen has different implications for the risk facing PBGC. For instance, if a plan sponsor freezes an underfunded plan, such action could help reduce or delay PBGC's exposure to termination liabilities. While plans that unfreeze or remain frozen pose no immediate risks, their eventual termination could reduce PBGC premium revenue and if underfunded result in liabilities for PBGC.

Conclusion

The extent to which DB plan freezes pose risks to participants' retirement income security and to the sustainability of PBGC's single-employer insurance program is difficult to gauge with currently available public information. Plan freezes lessen pension adequacy through the cessation of benefit accruals for current participants and by preventing new employees from participating in the plan. However, it is difficult to assess the potential long-term impact of plan freezes on participants' retirement income without information on the eventual consequences in such instances. Additionally, while plans that unfreeze or remain frozen pose no immediate risk to PBGC, their eventual termination could reduce premium revenue and if underfunded, result in claims on the single-employer insurance program.

However, the federal government cannot systematically identify and track frozen DB plans with currently available public information. Eventually, the recent addition of an identifying code to the *Form 5500 Annual Return* will provide federal agencies with data on frozen DB plans limited to so-called hard freezes. However, such initial information is likely to be of poor quality, and by the time such information becomes available on frozen DB plans, it may well be out of date. Hence, policymakers have incomplete information to formulate and evaluate policies to ensure DB plans provide adequate and secure retirement income.

Reliable and timely identification and tracking of DB plan freezes is an important first step in obtaining the information needed to make sound assessments regarding potential risks to participants and PBGC's insurance program. PBGC intends to examine the potential for obtaining more detailed and timely information on frozen plans without creating an undue burden on plan sponsors. However, simply collecting and reporting information on the incidence of plan freezes is not sufficient to gauge the associated risks. A thorough examination of the factors that precipitated and the eventual outcomes of DB plan freezes is needed to ascertain the extent to which such instances pose risks to participants and PBGC.

Recommendation for Executive Action

To enable the federal government to determine the risks DB plan freezes pose to participants and PBGC, we recommend that the Executive Director of the PBGC direct the agency to conduct a pilot study to identify frozen DB plans it insures and assess the usefulness of information on the characteristics and consequences of plan freezes. The information PBGC obtains from plan sponsors could help it assess the extent to which plans are frozen, the eventual outcomes of plan freezes, and the likely consequences on PBGC's single-employer insurance program and participants' retirement benefits. The results of a pilot study could help PBGC determine whether a regular data collection and analysis effort is warranted and if an additional reporting requirement for plan sponsors is needed.

Agency Comments

We provided PBGC with a draft of this correspondence for review and comment. PBGC provided informal technical comments, which we have incorporated where appropriate.

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We are sending copies of this correspondence to the Executive Director of PBGC, the Secretary of Labor, the Secretary of Treasury, and other interested congressional committees. Copies will also be available at GAO's Web site at www.gao.gov.

If you have any questions concerning this letter, please contact me at (202) 512-7215 or George Scott at (202) 512-5932. Jeremy Citro, Charles Ford, and Gene Kuehneman also made major contributions to this correspondence.

Sincerely yours,

Barbara D. Bovbjerg

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