American Academy of Actuaries

Academy ANALYSIS

Analysis of Congressional Pension Funding Reform Proposals: Multiemployer Plan Provisions

The American Academy of Actuaries'[1] Multiemployer Plans Task Force provides this analysis to address a number of issues related to multiemployer plans present in current pension funding reform legislation, specifically the *Pension Protection Act of 2005* (H.R. 2830) as passed by the House Education and the Workforce Committee[2] and the *Pension Security and Transparency Act of 2005* (PSTA, S.1783), which was passed by the full Senate on November 16, 2005.

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Plans in Critical Status (Red Zone) Issues

The Senate bill, PSTA, provides for a minimum maintenance level of accruals during operation of a rehabilitation plan while in critical status. The minimum level is defined as a monthly benefit commencing at the plan's normal retirement age (NRA) of "1 percent of contributions... or the equivalent" (for plans that do not state benefit accruals in that fashion). The 1 percent accrual is actuarially adjusted for benefits commencing before NRA.

We applaud the effort to provide continuing accruals for active participants, because it is more likely to result in a plan's continuance. However, the minimum accrual provision has two flaws for which we suggest the following corrections:

- The parties may agree that a plan needs a more affordable schedule — with lower contribution rates and benefit accruals — to be able to emerge from critical status and make it possible for some groups to continue in the plan. We suggest that as long as the "default schedule" contains the minimum 1 percent benefit level, the trustees and bargaining parties should have the ability to offer and choose other schedules. For instance, if the bargaining parties feel it is necessary, the trustees may want to offer a schedule that effectively freezes accruals for groups of employees.

- Some plans provide for NRA at 65, while others may define that age much earlier — for example, age 50 (typically with specific service requirements) or age 55. The value of the minimum unit ("career average") accrual of a flat 1 percent level is significantly higher (more than double) if first payable at 55 than for NRA of 65. A plan with an NRA of 55 may find it quite expensive to support a 1 percent accrual. To provide a more equitable benefit floor for all plans, we suggest that the 1 percent level should be actuarially adjusted for early commencement from the greater of NRA or age 62.

Emergence from Critical Status

In PSTA, emergence from critical status requires an actuarial determination and certification that there is a 10-year horizon with no projected deficiency at the point of emergence. While we endorse the continuation of critical status until the plan would also no longer be classified as endangered (yellow zone), this is inconsistent with emergence from endangered status, which requires only a seven-year horizon. We recommend that the 10-year critical status emergence rule

[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. The Academy is nonpartisan and assists the public policy process through the presentation of clear, objective analysis, and serves as the public information organization for the profession. The Academy regularly prepares testimony for Congress, provides information to federal officials and congressional staff, comments on proposed federal regulations, and works closely with state officials on issues related to insurance. The Academy also supports the development and enforcement of actuarial standards of conduct, qualification and practice and the Code of Professional Conduct for all actuaries practicing in the United States.

[2] On November 9, House Ways and Means approved a version of H.R. 2830. There are differences between the House Ways and Means and the Education and the Workforce versions that will need to be reconciled. For more information, please contact Heather Jerbi (Jerbi@actuary.org).

be rolled back to seven years. If there is concern about a plan immediately sliding into endangered status, then an eight-year rule might be appropriate.

Withdrawal Liability

The Senate bill provides that for purposes of determining withdrawal liability for a plan in critical status (red zone), any benefit reductions shall be disregarded in determining the plan's unfunded vested benefits. This provision leads to significant record keeping and actuarial calculations (two sets of records), which could go on for years. For example, this could mean that for participants who retire or die during this period, withdrawal liability calculations may need to take into account those benefits not previously paid to them as retirees or to their beneficiaries as a result of the benefit reductions adopted in accordance with the rehabilitation plan. Every employer can ask for this calculation once a year, leading to very significant administrative and actuarial costs to a plan in critical status that can least afford the expenditure of assets.

This provision would be appropriate if the Senate bill also provided for the ability to remove certain subsidies for early commencement and optional payment forms as well as recent benefit increases for non-retired participants as provided in H.R. 2830. H.R. 2830 requires preservation of only those specific reduced benefits in determining withdrawal liability rather than requiring reconstruction of benefit reductions that applied to future service. This more limited approach by H.R. 2830 makes sense.

With the passage of time, the calculations required to disregard certain benefit reductions can get extremely complex: e.g., What about benefit payments that would have been made if there had been no reductions? What if some, but not all, of the reductions are subsequently restored? We suggest that the Pension Benefit Guaranty Corporation (PBGC) be given authority to develop regulations allowing for simplified approximations to comply with these provisions if enacted.

Non-Core Benefit Reductions

H.R. 2830 contains a provision that would allow reductions in certain benefits that would otherwise be protected from cutback, but the Senate legislation does not include a similar provision. While the reluctance to allow for such reductions is understandable, members of the task force suggest that limiting a board of trustees' ability to be as fair as possible in matching the defined benefit promise with the ability to finance that promise, creates obstacles to fulfilling the purposes of the rehabilitation plan. Many plans have such heavy legacy costs that reducing all future accruals will not be enough to keep a plan solvent.

Under current law, the PBGC mandates benefit reductions when insolvency is determined. Ultimately, the low monthly benefit guarantee level is no more than $35.75 for up to 30 years of service, based on up to $11 per year of service, plus 75 percent of the next $44 of accrual per year of service, for a maximum guarantee of $1,072.50 per month. Relative to that approach, the proposed reductions in H.R. 2830 would generally:

- Provide more protection for pension plan beneficiaries;
- Allow many more plans a chance to restructure and continue providing promised benefits into the future, though perhaps paid starting at a later date and in a different form from originally anticipated;
- Avoid the need for PBGC intervention and support; and
- Result in a far more rational allocation of benefit reduction among different generations and participant classes.

Reductions should be allowed *only for plans categorized as being in critical status* in the following limited areas:

- Reductions in, or complete rescission of, benefit increases adopted within the prior five years.

- Reductions in early retirement subsidies. Benefits greater than the actuarial equivalent of the accrued benefit payable at the plan's normal retirement age would be deemed, for this purpose, an early retirement subsidy.

- Reductions in subsidies for optional forms of payment. This should include the ability to eliminate the lump sum form of payment, as mandated in PSTA.

- Reduction in, or complete rescission of, other benefit increases adopted after Jan. 1, 1999 (including post-retirement benefit increases), but only if reduced or rescinded within one year of the legislation's effective date.

- For plans that define normal retirement age as less than 62, reductions in benefits greater than the actuarial equivalent of the accrued benefit payable at age 62. For example, this would put plans with a normal retirement benefit of "30 and out" on an equal footing with a plan that has the same "30 and out" provision, but is characterized as an early retirement benefit in the plan document.

We note that half the trustees are employee representatives, so employees have a strong voice in any decision to reduce benefits and will be reluctant to make any reductions unless they are necessary to ensure the plan's continuance.

The process of trustees deciding to reduce these non-core benefits in critical-status plans could include an additional feature in which such reductions could be made subject to approval by the PBGC.

IRC Sec. 412(e) Extensions Automatic

Changes by the proposed legislation would significantly reduce the amount of relief available under Internal Revenue Code (IRC) Sec. 412(e).[3] Therefore, there is less need for IRS oversight of plans seeking amortization extensions. Other provisions of the proposed legislation have the effect of requiring trustees to take prompt and decisive action to avoid a funding deficiency. The amortization extension can often play an important role in allowing time for more fundamental improvement mechanisms to take effect. Further, the current process for obtaining IRS approval to extend amortization periods has been found to be time-consuming, expensive, and fraught with uncertainty. For plans making Sec. 412(e) amortization extensions part of a funding improvement or rehabilitation plan, an automatic process is required. Both the Senate and House bills change the rules for extension of certain amortization periods, but only PSTA allows for an automatic five-year extension — in limited circumstances upon actuarial certification — that will be most useful for plans.

Funding Improvement Period (FIP)

In PSTA, the funding improvement period appears to be viewed as a fixed period, at the end of which the plan and contributing employers face severe sanctions if the targets have not been met. This could occur if, for example, investments under-perform in the last few months of the 10-year period. Under H.R. 2830, however, a plan that goes off track during the 10-year period would typically trigger a new determination of endangered status and would force the trustees to revise the funding improvement plan. This would presumably replace the earlier funding improvement plan. We believe the H.R. 2830 approach of periodic corrections is an appropriate and practical method for bringing benefits and contributions into alignment.

We also have serious concerns with the PSTA approach of imposing an excise tax penalty for failure to meet the funded ratio targets during the FIP. This excise tax would apply to plans that have met the minimum funding requirement but fail to meet the funded ratio, thereby treating endangered plans more harshly than critical plans. It would tend to fall on plans almost randomly, penalizing some plans that are on a track toward

[3] This is the result of eliminating the (currently) low amortization interest rate prescribed by Sec. 412(e).

full funding, while other plans with more severe funding problems escape penalties. H.R. 2830 imposes no excise tax penalties. The regular operation of minimum funding requirements and the danger of falling into red-zone status are sufficient incentives to meet the funding improvement plan targets, and the imposition of excise tax penalties are excessive and unnecessary.

Yellow Zone — Interim Steps
For plans that are endangered ("seriously endangered" in the Senate bill), certain interim steps would be required pending adoption of a funding improvement plan. These steps must be "reasonable" and include amortization extensions, benefit reductions, use of shortfall, etc. They must also be designed to improve the funded percentage and postpone by one year the projected funding deficiency. We point out the following:

- The only action available to the trustees that has a true economic impact would be benefit reductions. The use of the term “reasonable” is subject to interpretation and could lead to dispute among trustees. Is it "unreasonable" to reduce future benefit accruals to $0? Clarification or safe harbor steps would be helpful. Note that permitted reductions to future benefit accruals will not change the current funded percentage.

- It is impossible to instantly improve the funded percentage without a large cash infusion or a reduction in accrued benefits, neither of which will take place during the applicable period pending development of the FIP. The period over which the funded percentage is to be improved needs to be clarified.

- Interim steps make sense for a plan that has been gradually approaching endangered status, for instance, a projected funding deficiency that went from eight years to seven years. Depending on what is considered reasonable, it might be difficult for a plan that is "endangered" at the time of the legislation’s enactment. We suggest deferring the effective date by a year or two to allow trustees time to take appropriate action.

Funding ratios
Both H.R. 2830 and PSTA make use of the plan’s funded ratio. H.R. 2830 appears to base the liability on the funding method adopted by the plan, while PSTA uses the unit credit funding method. We believe PSTA’s definition of the funded ratio is more appropriate. The liability determined under the unit credit method is the present value of benefits that have been earned in the past and is the appropriate liability to use for this purpose. In addition, we are concerned that use of the plan’s funding method might lead plans to change to the unit credit method simply to improve the calculated funded ratio even in situations where a change to unit credit might not be in the plan’s best interest.

Both H.R. 2830 and PSTA base the funded ratio on the actuarial assumptions used for plan funding purposes. We agree with this approach, as it would allow the trustees to create and carry out improvement plans to meet the applicable targets and provide adequate funding on a sound long-term basis.

Actuarial Certification for Status of Improvement Plans
We recommend that legislation (both H.R. 2830 and PSTA) be clarified to indicate that actuarial projections used for any certifications under the new rules should be performed on a “best estimate” standard — other than projected contribution increases and other actions anticipated in rehabilitation or improvement plans that are specifically designated by the trustees.

Potential for Challenges
The sharp lines, introduced in proposed legislation, that determine the red and yellow zones, and the potential for a plan to fall in and out of these zones, create an environment in which small differences in data and actuarial calculations and methodologies can have vastly different outcomes for participant’s benefits and employers’ contributions. We feel it is important that legislation include language that would protect the plan, trustees, and actuary by clarifying the grounds for potential challenges to actions taken by trustees or

bargaining parties take based on actuarial calculations. The language could be similar to that contained in the Multiemployer Pension Plan Amendments Act of 1980 (MPPAA):

"In the case of the determination of a plan's unfunded vested benefits for a plan year, the determination is presumed correct, and no claim for liability may be brought against the actuary, unless a party contesting the determination shows by a preponderance of evidence that

(i) the actuarial assumptions and methods used in the determination were, in the aggregate, unreasonable (taking into account the experience of the plan and reasonable expectations), or
(ii) the plan's actuary made a significant error in applying the actuarial assumptions or methods."

Actuarial Projections for Purposes of FIP and Rehabilitation Plans
For purposes of projecting the funding standard account balances and funded percentages into the future, legislation should allow the use of reasonable projections about contribution rate increases in accordance with the trustees' stated intent for purposes of the FIP and the rehabilitation plan. For purposes of determining whether the plan is in endangered or critical status, only those contributions already adopted/negotiated should be used in any actuarial projections.

Determination of Withdrawal Liability
Members of the task force wrote to the PBGC requesting that, in certain circumstances, plans be allowed to adopt a "fresh start" approach when using the presumptive method to determine withdrawal liability. In some cases, the historical data (dating back 25 years) is simply not available. We believe there would be little or no adverse impact if plans were able to start fresh with the presumptive method in any year following a year in which the plan's assets were greater than its vested benefit liability. The PBGC indicated that, while sympathetic to the request, it does not have the statutory authority to grant the request. Therefore, we would like to encourage this issue be covered in legislation. For more information, please see our letter to the PBGC.

Miscellaneous Items
Amortization of short-term benefits: Both H.R. 2830 and PSTA mandate that any adopted benefit increases involving payment of "short-term" benefits (with duration of 14 years or fewer) require amortization over the same duration. Although the intent appears to be limited to temporary benefits, we recommend that this provision be clarified to specifically exclude application to any benefit increases payable as a non-decreasing life annuity.

Timing of Contributions: A recent IRS private-letter ruling questioned the practice of treating employer contributions to a multiemployer plan as being made for a plan year if contributed within eight and one-half months after the close of that plan year, regardless of the basis on which the contribution amounts are calculated. This is the same treatment afforded single-employer plans. We support statutory clarification that multiemployer plan sponsors have the same ability as employers sponsoring single-employer plans with respect to this issue.

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Members of the Academy's Multiemployer Plans Task Force appreciate the efforts of the House Education and the Workforce, House Ways and Means, Senate Finance and Senate HELP committees in advancing pension funding reform legislation for multiemployer plans and look forward to discussing any of the issues outlined in this analysis. Please contact Heather Jerbi, the Academy's senior pension policy analyst (202.223.8196; Jerbi@actuary.org) if you have any questions or would like to additional information.