AMERICAN ACADEMY *of* ACTUARIES

# Keeping Employers Responsible for Their (and Only Their) Pension Promises
## May 2006

One of the underlying principles behind pension funding legislation is to ensure employers remain responsible for their own pension promises. Thus, the pension reform legislation currently in a congressional conference committee requires sponsors to quickly fund their plans up to at least 100 percent of accrued liabilities and restrict benefits if the plans are not well funded. If the funding rules had been tighter and bankrupt employers had kept their pension promises, then the remaining healthy employers would not have been called on to pay increasing amounts to the Pension Benefit Guaranty Corporation (PBGC). The American Academy of Actuaries'[1] Pension Committee therefore offers the following discussion of possible means by which responsible employers who sponsor defined benefit plans, their employees, and the PBGC may avoid further harm.

Because current funding rules did not ensure adequate funding, the PBGC has amassed a $23 billion deficit, which could increase substantially if additional airline or auto companies fail. The Deficit Reduction Omnibus Reconciliation Act, passed in February, increases PBGC premiums dramatically in 2006, but analysis suggests that the additional premiums will not be enough to eliminate PBGC's deficit. So how can the remainder of PBGC's deficit be eliminated? This question requires an examination of who should assume responsibility for that deficit.

- Should it be the remaining pension sponsors who followed the funding rules and have not transferred their plans to the PBGC? If so, that could further harm the defined benefit system as healthy sponsors leave it, even though these plans are important to America's retirement security.[2]
- Should it be the customers of the airline and steel industries (i.e., the industries that created most of PBGC's liabilities[3])? They received their flights and steel products at a price that was not enough to cover the costs of the pension plans.[4]
- Should it be paid for through an increase in taxes? If so, taxes would have to increase by about 0.1 percent to pay off PBGC's deficit in 10 years.

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[1] The American Academy of Actuaries is a national organization formed in 1965 to bring together, in a single entity, actuaries of all specializations within the United States. A major purpose of the Academy is to act as a public information organization for the profession. Academy committees, task forces and work groups regularly prepare testimony and provide information to Congress and senior federal policy-makers, comment on proposed federal and state regulations, and work closely with the National Association of Insurance Commissioners and state officials on issues related to insurance, pensions and other forms of risk financing. The Academy establishes qualification standards for the actuarial profession in the United States and supports two independent boards. The Actuarial Standards Board promulgates standards of practice for the profession, and the Actuarial Board for Counseling and Discipline helps to ensure high standards of professional conduct are met. The Academy also supports the Joint Committee for the Code of Professional Conduct, which develops standards of conduct for the U.S. actuarial profession.

[2] If premiums are increased enough to eliminate PBGC's deficit in five to 10 years, then:

1. the variable premium rate of 0.9 percent would have to be increased to a level that would push many healthy employers to fund their plans enough to avoid the variable premium, and
2. the per participant premium would have to be increased to levels that could push healthy employers to terminate their plans to avoid the premiums.

[3] Per Figure 3 of PBGC's 2004 Fact Book http://www.pbgc.gov/docs/2004databook.pdf

[4] A 2005 paper titled "Saving Private Pension Insurance: An Evaluation of Current Proposals to Shore up the PBGC" by Coronado and Schieber of Watson Wyatt determined that a dollar per flight arriving or departing from the US plus a small levy per ton of steel bought in the US would pay off this deficit in about 10 years.

While the Academy does not take a specific position on the appropriate solution, we do recognize that there are significant costs associated with any of the above methods.

In addition to the funding rules, there are other ways to forestall the shifting of additional liabilities to the PBGC (and thus the premium payers). Sec. 402 of the Senate-passed funding bill (S. 1783) gives the PBGC authority, with the approval of the Secretary of the Treasury, to work out alternative funding arrangements with sponsors in order to keep them responsible for their pension plans. The PBGC can freeze benefits, freeze guarantees, require security, and impose other conditions necessary to protect the PBGC. This is similar to creditors working out refinancing arrangements with employers who cannot meet their original loan covenants. Sec. 403 in S.1783 does this automatically for airlines willing to freeze their benefits and have their PBGC guarantees frozen. With these freezes, the PBGC's liabilities are essentially capped, so any additional contributions that the plan receives will most likely improve its financial position.[5]

Sec. 403(h) extends the alternative funding rules to airlines that don't freeze accruals as long as they are willing to make their contributions towards normal cost based on the more conservative at-risk rules. In order to cap PBGC's liabilities, the provision would still need to freeze PBGC's guarantees and prohibit lump sums, as discussed above.[6]

## Alternative Using Loan Guarantees

An alternative approach to reducing the contributions for certain plan sponsors would be to require all companies to pay the regular minimum contribution, and offer qualifying companies a federal guarantee for a loan needed to pay it. As an outcome of this alternative, participant guarantees would not be frozen and other DB plan sponsors would not be punished for arrangements worked out between the government and the qualifying companies. The federal government's liabilities might increase, but not those of the PBGC or the premium payers.

At many weak companies, pensions are not the only financial problem. Other compensation costs (such as wages, employee and retiree medical plans, overstaffing, etc.) can also constitute reasons why they are not competitive in world markets. Because a company's future pension funding requirements are just one element of its financial problems, assisting with that funding could be viewed as just one component of any federal financial relief. Thus, the magnitude of any federal financial relief to a company in a financially distressed industry could be determined through a more comprehensive appraisal of its overall financial needs rather than solely based on its pension funding obligations.

## Improving PBGC's Priority Claim in Bankruptcy

The current deficit situation experienced by the PBGC has been exacerbated because current bankruptcy law can encourage sponsors with underfunded pension plans and a poor short-term financial outlook to resort to reorganization as a means of shedding large legacy pension, post-retirement medical, and other liabilities. The fact that sponsors have the PBGC standing behind most of their pension promises creates a moral hazard. Sec. 402 of S.1783 helps reduce this

[5] Pension payments made from the plan in excess of PBGC's guarantees (and benefits in PBGC's third priority category, PC3) in the interim would reduce the PBGC gain, but are likely to be less than the additional contributions made by the sponsor to the plan. One way to reduce that problem greatly would be to restrict lump sum payments, which both pension bills being considered by the Congressional conference committee already do. Note: Most or all of Delta and Northwest Airlines' pension liabilities are already on PBGC's books as probable claims, so additional contributions to those plans could reduce PBGC's deficit (if the accruals, guarantees, and PC3 are frozen).

[6] This can be seen by analyzing what would happen if the plan had a de minimis accrual. Under this hypothetical, the contribution would hardly be affected compared to plans that freeze accruals, but they would not have their PBGC guarantees frozen. Another alternative might be to allow the PBGC guarantees to increase by the amount of the accruals, but not for any other reason (such as phase-in, later plan year maximums, greater ages).

moral hazard by allowing the PBGC to keep employers in reorganization responsible for their plans by freezing plan benefits and PBGC guarantees, and working out a temporary financial arrangement with the sponsor.

In addition, because accrued pension benefits and wages are both owed to employees, Congress should consider modifying bankruptcy law to give unfunded pension liabilities a priority, at least to the level given to unpaid wages, and clarify PBGC's priority unsecured claim for the cost of current accruals. This would give the PBGC more leverage to negotiate indentures with the bankrupt plan sponsor that could permit it to emerge from bankruptcy without leaving the PBGC — and the DB plan system — with all of the plan's unfunded liabilities. With this change in bankruptcy law, banks would likely move to add prohibitions to loan covenants that would forbid increasing benefits if the plan is not properly funded. This would engage the banking industry in helping to monitor pension financial practices, where banks that lend money to companies that increase their pension benefits lose position in bankruptcy.

Any improvement in the status of unfunded pension liabilities might discourage companies from abusing the bankruptcy process, perhaps prevent pension promises from being made beyond what the sponsor is able to afford, and provide an incentive to plan sponsors to more vigorously improve or maintain funding levels.

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In summary, we appreciate that Congress is addressing legislation that would strengthen pension funding requirements. We believe, however, that some financial remedies, which use mechanisms outside the defined benefit system, may be needed to avoid harming the pension system.

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