

## PBGC Single-Employer Premiums and Their Impact on Plan Sponsorship

OCTOBER 2020

### Key Points

- One of the PBGC's missions is to encourage the continuation and maintenance of voluntary private-sector pension plans for the benefit of their participants.
- PBGC premiums have increased substantially over the past decade, especially for those plans subject to variable premiums, causing some employers to fully or partially exit the system by terminating their plan, purchasing annuities for some of their participants, or offering lump sum programs.
- Consideration should be given to changes to both the PBGC single-employer premium structure and to how PBGC premiums are set.

### Background

The Pension Benefit Guaranty Corporation (PBGC) is a federal government agency that insures the pension benefits of participants and beneficiaries covered by private-sector defined benefit plans in the event plans terminate with insufficient funds. The PBGC was established to:

- Encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants;
- Provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under covered plans; and
- Maintain premiums at the lowest level consistent with carrying out its obligations.<sup>1</sup>

Generally, private-employer pension plan stakeholders—including employees, employers, and retirement policy experts—regard recent actions taken by Congress to dramatically increase PBGC premiums as having been contrary to the purposes as stated above.

The PBGC has two separate pension insurance programs: one that covers single-employer plans and one that covers multiemployer plans. The two programs differ significantly in the level of benefits guaranteed, the premium structure, and the events that trigger benefit guarantees. The assets of the two programs are separate and may not be used to pay the obligations of the other program.



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<sup>1</sup> PBGC mission statement: <https://www.pbgc.gov/about/who-we-are>.

PBGC premium structures have changed over time along with the premium amounts. Currently, there are two types of single-employer premiums: one based upon the number of covered participants and the other on the unfunded liability of the plan. The second type of premium only partially reflects the risk that the plan poses to the program.

The PBGC's single-employer program receives its income from several sources:

- Annual premiums paid by the employers sponsoring defined benefit plans covered by the PBGC;
- The assets of single-employer plans that the PBGC trustees and the investment earnings on these assets;
- Recoveries in bankruptcy related to PBGC's claims for plan underfunding and missed contributions; and
- Premium surcharges for some plans that terminate underfunded (negligible).

During the past several decades, many private-sector employers have discontinued their defined benefit plans for a variety of reasons. The financial burden of the annual premiums paid by employers participating in the PBGC program has been identified as one of the reasons. Employers that believe that their plans will never require financial assistance from the PBGC consider premiums wasted money, and many employers have taken plan downsizing steps to reduce them. Decisions made by employers to discontinue a plan, reduce the size of their plan, or decide not to adopt a plan due to the large premiums can be attributed in part to lawmakers' failure to recognize the PBGC's mission, which was written into the law creating the PBGC (The Employee Retirement Income Security Act of 1974 [ERISA] §4002). Consequently, changes to the premium structure are advisable.

This issue brief addresses this complex subject by raising some issues in a question-and-answer format. It focuses exclusively on the PBGC's single-employer program.

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# Current PBGC Single-Employer Program

## 1. What are the premium levels, and how much have they increased?

- The per-participant flat rate premium for plan years beginning in 2020 is \$83 (up from a 2012 rate of \$35)
- The 2020 variable rate premium (VRP) is 4.5% of the value of unfunded vested benefits (UVB), up from a 2012 rate of 0.9%. The VRP is subject to a per-participant cap, which is \$561 per participant in 2020.<sup>2</sup> The initial cap in 2013 was \$400 per participant.<sup>3</sup>

From 2012 to 2020, the flat rate premium has more than doubled and the variable rate premium has increased by a factor of 5 (though the cap has limited this increase for the most poorly funded plans). These increases have significantly outpaced wage inflation, and they are much greater than the increases in other plan expenses such as actuarial, audit, and investment advisory fees over the same period. Both the fixed rate premium and the variable rate premium are indexed to wage inflation and thus will continue to increase barring any changes.

## 2. Why have premiums increased so rapidly?

There have been several fairly recent laws enacted by the Congress in which PBGC premium increases have offset the cost of legislation unrelated to PBGC.<sup>4</sup> An increase in PBGC premiums is categorized as an increase in general revenue and can be used to offset the cost associated with other governmental expenditures in order to achieve budget neutrality. Thus, even if an increase in premiums is not requested by the PBGC to sustain the system, and even though the assets of PBGC programs are available only to pay the obligations of PBGC, legislative scoring rules permit PBGC premium income to be treated as if it were available to pay for other costs in a legislative measure. Having said that, while these significant increases in premium levels were not requested by PBGC, they have improved the financial condition of the PBGC's single-employer program.

## 3. To what extent is the premium structure risk-based?

The PBGC's exposure to future plan terminations is related to both the probability of a plan terminating without sufficient assets and the value of benefits that the PBGC will be responsible for paying in the event that the plan terminates. This value is the amount that cannot be funded by the plan assets plus the amount the PBGC recovers from the plan sponsor in bankruptcy. The current premium structure does attempt to capture the amount of funds needed by PBGC to pay the plan termination benefits. However, the premium cap substantially limits the structure's ability to differentiate among plans based

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<sup>2</sup> Plans sponsored by small employers (generally fewer than 25 employees) may be subject to a lower cap.

<sup>3</sup> The cap limits premiums required by plans that are significantly underfunded.

<sup>4</sup> The Bipartisan Budget Acts of 2013 (Public Law No: 113-67) and 2015 (Public Law No: 114-74) and MAP-21 (Public Law No: 112-141).

on the amount PBGC needs to pay the termination benefits. Additionally, the current structure does not incorporate the probability of a particular plan terminating; the ability of the plan sponsor to fund the plan's benefits is not a part of the premium structure. Thus, the premium structure does not capture the total risk.

#### **4. Are there concerns about the per-participant flat rate portion of the premium structure?**

While the number of participants in a plan is not a very good measure of risk, the number of plan participants does impact the cost to the PBGC for administering the termination of a plan. For this reason, a small flat rate premium can be justified. However, the relatively recent substantial increases in the flat rate premium and the application of the premium cap for many sponsors have created a strong incentive for plan sponsors to reduce participant headcount (e.g., through annuity purchases and lump sum cash-outs) in order to reduce premiums. The current premium structure is also a disincentive to those plan sponsors that may want to add some payout options (e.g., a partial lump sum, as an alternative to a full lump sum) that might provide more flexibility to retirees interested in managing lifetime income needs.

#### **5. How does the PBGC measure its exposure to possible future plan terminations?**

The [PBGC's 2019 Annual Report](#) includes a section titled "Single-Employer and Multiemployer Program Exposure" that reports its exposure to Reasonably Possible Terminations using credit ratings to identify companies that are below investment grade and estimating underfunding in their plans. This section is required by PBGC's financial accounting standards and is reviewed each year by its external auditors. (See Note 9 beginning on page 90 [here](#). See also "[Recent Single-Employer Plan Trends](#)" on page 25 of FY2019 PBGC Projections Report.)

#### **6. Is there evidence that the premium structure is becoming a deterrent to maintaining plans?**

In a 2018 Mercer Pension De-Risking Study on PBGC's website [here](#), a plan sponsor focus group explored reasons employers are looking to reduce plan risk. Plan sponsors commonly reduce risk by paying lumps sums to participants and purchasing annuities for some of the plan's liabilities. The most extreme action to reduce risk is a plan termination. Among the major reasons cited for de-risking is the increasing burden of PBGC premiums. According to a [MetLife survey](#), 52% of surveyed plan sponsors said PBGC premiums were a factor in their de-risking decisions.

## **7. What assumptions are currently used for measuring a plan's UVB for variable premium calculations?**

Liabilities are determined based upon the return on high-grade corporate bond yields, mortality rates set by statute, and other demographic assumptions selected by the Enrolled Actuary. These assumptions do not reflect what the plan liabilities would be should the plan terminate and settle its accrued benefits through lump sums or annuity purchases from an insurer. Nevertheless, the current structure does meaningfully differentiate among plans by funding level and, setting aside questions about the premium rates and caps, serves as an appropriate basis for setting the VRP under the current premium structure.

## **8. Is there potential for moral hazard in the current PBGC premium structure?**

The current level and structure of premiums provides a strong incentive for plan sponsors to take actions to reduce premiums without necessarily reducing the risk inherent in the single-employer defined benefit system. Under the current premium structure, one commonly used approach to reducing premiums is to reduce headcount, which runs counter to PBGC's mission. The proliferation of lump sum programs and annuity purchases are reflective of this approach.

## **9. Have de-risking actions such as plan freezes, lump sum cash-outs, annuity purchases, and plan terminations by healthy employers weakened the PBGC insurance program?**

All things being equal, having healthier employers leave the system will weaken the PBGC's financial health. While it is possible that the dramatic increase in premium rates could continue to make up for lost revenue as a result of de-risking actions, the reduction in premium payments by healthy employers does shift the future burden of any future PBGC shortfalls to the remaining employers.

## Possible Changes to the Current Program

### 10. What would be the implications if the PBGC were given more responsibility in setting premiums?

On several prior occasions, the administration has taken the position that PBGC, through legislation, should have the authority to set its premium structure and rates. Such a legislative change could also eliminate the federal legislative scoring issue described above. It might then enable the PBGC to review the premium structure and adjust it (a) to be more timely when needed, (b) to more appropriately reflect its risks, (c) to reduce moral hazards and anti-selection, and (d) to discourage termination of plans and lump sums. This would better reflect the PBGC's mission to "to encourage the continuation and maintenance of private-sector defined benefit pension plans," and the premium-setting process could be subject to independent oversight.

Congress has provided premium-setting authority to the Federal Deposit Insurance Corporation (FDIC). The FDIC, the National Flood Insurance Program (NFIP), and the Federal Crop Insurance Program all have premium structures that include risk-based elements. For example, the FDIC is required by law to set deposit insurance assessments based on risk with the goal of making assessments fairer and more accurate. Its risk-based assessment system reduces the subsidy that lower-risk banks provide higher-risk banks and provides incentives for banks to monitor and reduce risks (see [here](#) for details.)

### 11. What incentives does the current premium structure provide for employers to improve plan funding?

Although the potential of lower premiums for underfunded plans should act as an incentive for funding, the relationship between the premium rate and the premium cap limits the incentive for many plans. The amount of contributions required to bring a plan below the cap, and actually achieve any premium reduction, can be substantial for the most significantly underfunded plans. Under the current structure (premium rate of 4.5% and per-participant cap of \$561 for 2020), once the per-participant level of underfunding exceeds \$12,467, the premium does not increase any further. A large number of plans have per-participant underfunding well in excess of this amount; thus it could take a substantial contribution before the plan sees any reduction in the variable rate premium.

Changing the relationship between the premium cap and the premium rate (by raising the cap and/or lowering the rate) would increase the number of plans that would experience a reduction in premiums for a given level of contributions.

Consider an illustrative plan with 6,000 participants and unfunded vested benefits of \$100,000,000. The uncapped variable rate premium is \$4,500,000 (4.5% of \$100,000,000). The cap limits the premium to \$3,366,000 ( $\$561 \times 6,000$ ). An additional contribution of at least \$25,200,000 ( $\$4,500,000 - \$3,366,000 / 0.045$ ) would be required to bring the underfunding down to the point where the premium cap would no longer apply, and any reduction in the premium is achieved. If the sponsor can currently only afford a contribution of \$10,000,000, such a contribution would produce no reduction in the variable rate premium; therefore the sponsor could decide to invest the \$10,000,000 elsewhere.

If the premium cap were doubled, the VRP would be the full \$4,500,000, and a \$10,000,000 contribution would reduce the premium by \$450,000, which could be a strong incentive to contribute. Similarly, if the variable premium rate were cut in half, to 2.25%, while the premium cap remained unchanged, the variable rate premium would drop to \$2,250,000. In that case, an additional \$10,000,000 contribution would lower the premium by \$225,000, which again may constitute a strong incentive for funding the plan.

While simply raising the premium cap might improve the incentive to fund the plan, some would argue that the overall effect on pension funding would be somewhat limited. This is because plans with the highest relative levels of underfunding are often sponsored by financially weaker employers with limited ability to make significant pension contributions. Significant increases in premiums for these plans could simply reduce the amount available to fund the plan above the minimum requirement rather than acting as an incentive for improved funding.

## 12. Should the premium structure require that participants pay premiums?

Having participants pay premiums would allow reduction in the premiums paid by employers. A justification for participants paying some premiums is that they are the ultimate beneficiaries of the program.<sup>5</sup> A counterargument is that a pension plan constitutes a form of deferred compensation for services previously rendered. The employer that benefited from those services should bear the full responsibility for assuring that the compensation is ultimately paid, including the cost of insuring that promise.

In addition, charging retirees for this insurance could encourage, where available, more lump sum elections, which may not be in the best interest of retirees. However, theoretically, lump sum elections could also be assessed an additional charge to reduce this behavior.

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<sup>5</sup> Recent congressional deliberations related to reform of the multiemployer program have included consideration of a participant-paid premium.

### **13. Should the budget scoring rules that allow the counting of PBGC premium increases toward the scoring of unrelated legislation be changed?**

In 2017, the Academy's Pension Practice Council wrote a [letter in support of changing the budget scoring rules](#). The letter argues that recent premium changes passed by Congress could be construed as being made solely to provide support for unrelated items included in the legislation. The letter points out that premium revenue cannot, in fact, be diverted to these other purposes and therefore the beneficial effect on the budget is illusory.

### **14. What might a premium structure revised to reflect plan sponsor financial strength look like?**

Many believe that the current premium structure places too heavy a reliance on the number of plan participants. It is the plan underfunding and the plan sponsor's inability to fund the plan (if the plan is underfunded) that pose the risk. The current premium structure does not take into account the financial strength of the employer to fund the plan should it terminate with insufficient assets. A premium structure that reflects the financial strength of the plan sponsor in addition to the plan underfunding should be seriously considered.

As an example, the UK Pension Protection Fund (PPF) uses the following allocation formula:

- 20% based on the plan's covered liabilities (referred to as "Scheme Levy")
- 80% based on the plan sponsor's underfunding and likelihood of the company's insolvency (referred to as "Risk Levy")

More detail can be found regarding the PPF [here](#).

### **15. What are some implications of changing the premium structure to one that more directly addresses a plan's risk to the program?**

A program that charges premiums directly related to a plan's risk to the system would likely reduce premiums for plans where the employer is better able to fund the plan upon plan termination, thereby reducing current incentives for these employers to terminate their plans and exit the system. For less-healthy employers, premiums would presumably increase unless they could find funds to improve the plan's funded status. It is less likely that these employers would quickly exit the system, as few are in a position to reduce plan liabilities or terminate their plans. However, as noted in the answer to question 11, the resulting increase in premiums may actually divert resources from improving the funding of these plans.

There are additional questions that would need to be addressed in implementing a risk-based program, including:

- How would a transition be implemented?
- Would it include premium caps?
- How would an employer's financial ability to fund a plan be determined?

## **16. How could a transition from the current premium structure to a more risk-based structure be implemented?**

One possible approach would be through a multiyear phase-in during which premiums would be determined under both the old and new structures and would be gradually weighted more toward the new structure.

Another possible approach might be to bifurcate plans into two pieces for premium purposes—one reflecting the pre-structural change liabilities and plan assets and the other to the post-structural change liabilities and assets; the former would be subject to premiums based on the current structure and the latter, the new structure. However, the significant number of plans that have frozen benefit accruals might limit the effect of this transition approach.

The 2019 PBGC Annual Report noted the following:

“The financial status of the Single-Employer Program shows continuous improvement and maintained a positive net position at the end of FY 2019. Estimates from PBGC's FY 2018 Projections Report indicate that continued improvement in the financial status of the Single-Employer Program is likely but not guaranteed.”

The fact that the program is in a better financial condition may permit a smoother transition to a more risk-based program, though current economic events could negatively impact that financial condition.

Please note that the Academy has previously addressed the transition to a more risk-based premium structure in an issue brief, [\*Examining the PBGC Premium Structure\*](#).

### **17. How might employers be affected by a risk-based premium structure?**

A change to a risk-based structure that reflects both the PBGC's needs and a plan's risk to the system will produce winners and losers. If the risk of bankruptcy is a component of the premium structure, some privately owned companies might be concerned because the premium level information may indirectly provide otherwise confidential information regarding the company's health. However, there are several ways to keep such information confidential, which is currently done by the PBGC under certain circumstances covering non-premium issues through confidentiality letters to plan sponsors.

### **18. How would financial data on the plan sponsor's health be gathered and assessed?**

Financial health data would likely be gathered for risk-based premiums by application of credit ratings from a major rating agency that that would be translated into probabilities of plan sponsor bankruptcy for premium determination purposes. For a brief description of one risk-based structure, the UK's Pension Protection Funds' premium structure, see page 65 of the Government Accountability Office's extensive report [\*Redesigned Premium Structure Could Better Align Rates with Risk from Plan Sponsors\*](#).

### **19. Will a risk-based premium structure drive some employers to terminate their plans?**

A more risk-based program should encourage the continuation of plans sponsored by healthy employers, because their premiums would be reduced—possibly substantially. Employers sponsoring plans that would face larger premiums may want to terminate plans but might not be able to do so due to a lack of financial resources. If they are able to terminate their plans, this would result in a reduction of risk to the PBGC and the remaining premium payers.

### **20. Should a more risk-based premium structure also provide for consideration of plan investment asset allocation?**

Though investing in equities and other return-seeking assets has the potential to achieve better long-term results, it also adds investment risk when benefits are not subject to change with plan investment performance. Investing in fixed-income securities where the expected cash flow matches the expected plan benefits poses less risk to the plan. Asset-liability mismatch and risk-adjusted assets should be considered if a new premium structure is to consider all risks to the system.

### **21. How might employers reduce their premiums in a more risk-based program?**

Other than making certain that the plan is well funded, a risk-based program might permit reduced premiums for plan sponsors that post a security bond or pledge employer assets as security to the plan, as is done in the U.K.

## 22. Are there defined benefit pension guaranty programs in other countries?

Yes, there are pension guaranty programs in the U.K., Germany, Switzerland, Sweden, Finland, and the province of Ontario in Canada.

The largest of these programs is in the U.K. In 2004, the U.K. instituted a defined benefit plan insurance program called the Pension Protection Fund (PPF), which relies heavily on risk-based premiums. A description of the PPF levy components can be found on page 65 [here](#).

Its risk-based premium is based on the plan's underfunding, risk-adjusted asset values, and the risk of plan sponsor bankruptcy, as determined by a commercial credit rating agency contracted by the PPF; a plan's bankruptcy risk is confidential information and is available only to the PPF, the plan trustees, and the plan sponsor. Sweden and Finland also have risk-based premium structures.

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