AMERICAN ACADEMY *of* ACTUARIES

Pension Funding Reform

The economic challenges of the past four years have tested U.S. pension funding rules like no other time since the funding rules were enacted. The unprecedented severe combination of declining interest rates and equity values increased liabilities and decreased asset values simultaneously — cutting funding ratios almost in half between 2000 and 2003.

Different constituencies are unhappy with the pension funding rules, and most would agree that the current rules are unnecessarily complex and lacking in transparency.

- *Employers* assert that the rules create volatile contribution requirements that are counter to their business cycles and that unpredictable results make it difficult to plan ahead.
- The *Pension Benefit Guaranty Corporation (PBGC*) is concerned about its dramatically increased deficit and the funding rules that allow sponsors of underfunded plans to completely offset contributions by a credit balance and not pay variable PBGC premiums.
- *Participants* with large benefits were surprised at how poorly funded their plans were, and how much their benefits were reduced when their employers went bankrupt and the PBGC took over their plans.

The American Academy of Actuaries'[1] Pension Committee has identified several principles that any revision of pension funding rules should meet. The primary objective of pension funding is solvency. Participants and the PBGC are benefited by well-funded pension plans. Recent proposals by both the Bush administration and Congress recognize that satisfying each of the principles the committee has defined is a balancing act. Members of the committee do not want insolvent plans, nor do they want to eliminate defined benefit (DB) plans by an over-burdensome solution. Employees could easily be hurt more by a freeze or termination of a DB pension plan than by occasions of insolvency. In addition, PBGC's deficit will be difficult to eliminate if healthy employers drop their pension plans and stop paying premiums to the PBGC. Thus, as typically happens, balance is needed when applying any principles for reform.

There are two likely approaches to reforming the funding rules: incremental or comprehensive. Both have advantages and disadvantages, and both will provide substantial challenges. Incremental change may get enacted sooner, but each change will have opponents that request exceptions and transition rules, increasing the opportunity for future problems. On the other hand, a comprehensive rewrite of the funding rules may take longer to enact and may result in unforeseeable problems that occur only when tested in future economic climates. Whether reform is incremental or comprehensive, all proposals for pension funding should be assessed to see how they meet the following principles:

- **Solvency:** The funding rules should move us to a point where assets cover accrued liabilities, particularly if and when a plan terminates. The funding rules could also encourage employers to ensure that assets cover ongoing liabilities.

- **Predictable funding:** Contributions should be more predictable so they can be budgeted in advance.
  - *Smooth contributions/less volatility:* Contributions should not change radically due to a small change in assets or interest rates.
  - *Coordinate obligation with business/economic cycle:* Employers should be able to make larger contributions in good years than under current rules, so they will not have to contribute large amounts in difficult years.
  - *Better financial risk management:* Plan sponsors should be able to hedge swings in liabilities by holding bonds, which would make contributions more predictable.

[1] The American Academy of Actuaries is the public policy organization for actuaries of all specialties within the United States. In addition to setting qualification standards and standards of actuarial practice, a major purpose of the Academy is to act as the public information organization for the profession. The Academy is nonpartisan and assists the public policy process through the presentation of clear actuarial analysis. The Academy regularly prepares testimony for Congress, provides information to federal and state elected officials, regulators and congressional staff, comments on proposed federal and state regulations and legislation, and works closely with state officials on issues related to insurance. The Academy also develops and upholds actuarial standards of conduct, qualifications and practice, and the Code of Professional Conduct for all actuaries practicing in the United States.

- **Transparency:** Users of the information should be able to understand the current financial position of the pension plan and its integration with the sponsors' disclosures.

- **Incentives to fund/flexibility:** Sponsors should be encouraged to fund their plans better by allowing them to build up margins in the plan without deduction and excise tax problems and by providing them access to "super surpluses" for other purposes, such as employee benefits, without having to pay a reversion tax.

- **Avoid moral hazards:** The rules should not encourage (nor allow) weak employers to improve benefits at the expense of someone else (e.g., the PBGC, premium payers, or US taxpayers).

- **Simplicity:** The rules should be easier to understand and comply with than the current, complex rules.

- **Smooth Transition:** Employers need smooth transitions to new rules so they are not forced into freezing or terminating their pension plans.

The Academy's Pension Committee is engaged in the development of an issue brief that expands on the way these principles can be addressed, as well as a more technical white paper that discusses how the current rules and regulations hinder achievement of these principles and alternative ways the law can be changed to realign the rules.

Why should defined benefit plans be encouraged? Defined benefit plans, in particular, can reduce the investment, inflation, interest rate, and leakage[2] risks to employees and eliminate most of the longevity risk through pooling (annuitization). Employees are much more likely to participate in the company DB plan and they are much more likely to get a lifetime income from the DB plan. (Many defined contribution (DC) plans rely on voluntary enrollment, and rarely pay out a lifetime income.) In addition, DB plans are better than DC plans at providing the country with some very important advantages, which many people (including some policymakers) will not realize are lost until many years from now, when it is too late to regain them. For example, DB plans create a more financially secure population, reduce welfare expenditures, provide a huge source of efficiently invested assets in our markets, and defer taxable income to the future when it is needed, for example, to reduce the strain on financial resources caused by retiring baby boomers. And finally, DB plans help employers with workforce management issues (and union demands) better than DC plans.

Prior law encouraged DB plans as much as DC plans. This is no longer true. DC plans have the same tax advantage, but the laws regulating them are much simpler and they allow DC plans more flexibility (e.g., pre-tax employee contributions and employer matches). Thus, any revisions to the funding rules should stop and reverse this trend, or employers will continue to switch to DC plans. Many employers have already done that (particularly ones that were intending to switch to cash balance plans but were too concerned about the current, uncertain legal environment), and many are freezing their DB plans while contemplating moving to DC plans.

We welcome the opportunity to discuss these ideas with you and to work with you in shaping a solution that will balance the needs of employees, employers, the PBGC, and other parties.

[2] "Leakage" refers to the risk that retirement assets will be withdrawn and spent before the employee retires, and will therefore not be available for retirement income.