



# NAVAL POSTGRADUATE SCHOOL

MONTEREY, CALIFORNIA

## THESIS

**THE DEFINED BENEFIT PENSION PLAN SYSTEM:  
FINANCIAL PROBLEMS AND POLICY RESPONSES**

by

Joel B. Lang

June 2004

Thesis Advisor:  
Associate Advisor:

Richard Doyle  
Ira Lewis

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AND POLICY RESPONSES**

Joel B. Lang  
Lieutenant, United States Navy  
B.A., University of Colorado, Boulder, 1998

Submitted in partial fulfillment of the  
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from the

**NAVAL POSTGRADUATE SCHOOL  
June 2004**

Author:

---

Joel B. Lang

Approved by:

---

Dr. Richard Doyle  
Thesis Advisor

---

Dr. Ira Lewis  
Associate Advisor

---

Douglas A. Brook  
Dean, Graduate School of Business and Public Policy

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# **THE DEFINED BENEFIT PENSION PLAN SYSTEM: FINANCIAL PROBLEMS AND POLICY RESPONSES**

## **ABSTRACT**

The defined benefit (DB) pension system that provides retirement security to 44.5 million Americans faces significant challenges. At the end of 2003, the system was underfunded by \$350 billion, there were 82,696 fewer plans than during the system peak (in 1985), and the Pension Benefit Guaranty Corporation (PBGC) responsible for ensuring retirees receive their retirement benefits even after a plan terminates, reported a deficit of \$11.49 billion. This thesis examines the challenges facing the DB pension plan system, beginning with an overview of the DB plan system, a review of the different plan types, the benefits received, and funding rules. Next, examining the PBGC, its purpose, its organization, and the role that it plays in the DB pension system. Followed by an identification of the challenges facing the pension plan system, and corporate America's frustrations with the system. Finally, the thesis presents some recent reform proposals, and provides corporate America's response to them. A changing workforce demanding leaner retirement options, plans that allow multiple career changes, provide beneficiaries with lump sum benefits, provide early vesting characteristics, and are easily understood, is challenging the future of the DB plan system. To survive the DB plan system must continue to change.

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## I. INTRODUCTION

### A. OVERVIEW

Approximately 75 percent of Fortune 500 companies offer Defined Benefit (DB) Pension plans to their employees and more than 35 million Americans rely on such pensions.<sup>1</sup> However, America's corporate DB system was under-funded by \$350 billion in 2003.<sup>2</sup> When a large company such as Bethlehem Steel (95,000 plan participants) fails, the Pension Benefit Guaranty Corporation (PBGC), a federally funded corporation, assumes responsibility for the company's DB plans, and takes control of its assets, in order to ensure that retirees receive the guaranteed portion of their earned benefits. In the case of Bethlehem Steel, the PBGC assumed a \$3.6 billion liability.<sup>3</sup> Failures such as this, and nearly 300 others in the last two years, have caused the PBGC to incur an accumulated deficit of approximately \$11.49 billion.<sup>4</sup>

The PBGC receives no funding from general tax revenues. Rather, it is financed by insurance premiums, investment income, DB plan assets and recoveries from companies formerly responsible for DB plans. If the current trend continues, the PBGC could exhaust its \$35 billion in assets, and the responsibility for funding failed corporate DB plans will ultimately fall on the taxpayer. Congress recently passed the Pension Funding Equity Act of 2004, legislation providing among other things, an extension of a temporary interest rate (expiring in 2006), allowing firms to use conservative high-grade corporate bond rates instead of the 30-year Treasury rate when calculating plan liabilities.<sup>5</sup> The legislation also reduced approximately 80 percent of the required deficit

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<sup>1</sup> Committee on Investment of Employee Benefit Assets. (2004, March). *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*. Retrieved March 30, 2004, from [www.AFPonline.org](http://www.AFPonline.org), 9.

<sup>2</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 30, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 1.

<sup>3</sup> Ibid., 2.

<sup>4</sup> Ibid.

<sup>5</sup> Pension Funding Equity Act of 2004, H.R. 3108 Conference Report, 108<sup>th</sup> Cong., (2004, April 1). Retrieved March 24, 2004, from <http://edworkforce.hoU.S.e.gov/issues/108th/workforce/pension/pension.htm>. Section 101.a.

reduction contribution (DRC) payments for a limited number of firms facing an increased threat of plan termination since 2000.<sup>6</sup>

Some speculate that the “perfect storm” of 2000-2002 (poor stock market performance, historically low interest rates and a stagnant economy), resulted in nearly 300 DB plan terminations in the last two years. Whatever the cause, several agencies within the federal government (Treasury Department/Department of Labor (DOL)/PBGC) as well as the Financial Accounting Standards Board (FASB) have simultaneously proposed solutions to strengthen the DB pension plan system and reduce the number of annually terminated plans, thus alleviating the PBGC of a growing financial burden. This thesis will evaluate the current DB plan system, the problems it has encountered in the recent past, and some of the proposed solutions.

## **B. SCOPE OF THESIS**

This thesis will include analysis of: (1) the DB plan system; (2) the purpose, function and current status of the PBGC; (3) current challenges facing the private DB pension system, including demographic shifts affecting the system, the views of corporate America, the problems stemming from costly and complex accounting and funding rules, and current challenges facing the PBGC; (4) recent Bush Administration proposals and corporate America's response, including elimination of smoothing (FASB), use of a conservative corporate bond rate versus a 30-year Treasury rate (Treasury Department), and adjusting how risk premiums are assigned (PBGC); (5) legislation introduced and passed during the 108<sup>th</sup> Congress; and (6) summary, conclusions, and recommendations for further research.

## **C. RESEARCH QUESTIONS**

### **1. Primary Question**

What are the principle problems affecting the private DB pension plan system and the policy solutions being proposed by the federal government?

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<sup>6</sup> Ibid.

## **2.      Subsidiary Questions**

In support of the primary research question, the chapters following will address these questions:

1. Is there a problem with the DB pension plan system?
2. What are DB plan terminations?
3. What are the causes of plan terminations?
4. What happens when a corporation terminates a DB pension plan?
5. What is causing a shift from defined benefit (DB) to defined contribution (DC) plans?
6. What effects have the stock market, falling interest rates and a stagnant economy had on the DB pension plan system (2000-2002)?
7. What oversight does the government have over corporate sponsored DB plans?
8. What are the current proposed government and private sector solutions (FASB/PBGC/Treasury Department)?
9. Why is the 30-year Treasury bond rate causing problems for the DB plan system?
10. What are the proposed changes the 108th Congress is addressing?
11. What are the implications of plan failures for the taxpayer?
12. Why is corporate America opposed to the proposed changes?

## **D.      METHODOLOGY**

The methodology for this research consists of the following:

### **1.      Literature Reviews**

Conduct pertinent literature review of books, journal and newspaper articles, web sites, academic databases, and other library information resources, to identify the critical issues facing the private DB system.

### **2.      Government Reports**

Analyze government-sponsored reports from the General Accounting Office (GAO), Department of Labor (DOL), Treasury Department, Internal Revenue Service (IRS), Pension Benefit Guaranty Corporation (PBGC), and congressional reports from various committees and their subcommittees, to ascertain the federal government's position regarding policy issues, and recommendations for policy changes.

### **3.      Congressional Hearings**

Analyze congressional testimony given by professionals representing private organizations and federal agencies, on private pensions, retirement, and taxes to gain insight into the issues as presented to Congress.

#### **4. Private Sector Reports and Issue Papers**

Analyze private sector reports and issue papers from, but not limited to, the following organizations: American Academy of Actuaries (AAA), American Benefits Council (ABC), Association for Financial Professionals (AFP), Bridgewater Associates, Committee on Investment of Employee Benefit Assets (CIEBA), Deloitte & Touche, Employee Benefit Research Institute (EBRI), Goldman Sachs & Co., Hewitt Associates LLC, Morgan Stanley, and Society of Actuaries (SOA), to gain a better understanding of the pension related challenges that the private sector is most concerned with.

#### **5. Legislation**

Review federal legislation pertinent to the operation and administration of the private DB pension plan system, including the Employee Retirement Income Security Act (ERISA) of 1974, Single-Employer Pension Plan Amendments Act of 1986, Internal Revenue Code (IRC) of 1986, Pension Protection Act/Omnibus Budget Reconciliation Act of 1987, Retirement Protection Act of 1994, The Economic Growth and Tax Relief Reconciliation Act of 2001, The Job Creation and Worker Assistance Act of 2002, and the Pension Funding Equity Act of 2004.

### **E. CHAPTER CONTENTS**

Chapter II provides an overview of the private DB system. The chapter begins with a brief description of qualified retirement plans, both DB and DC, followed by a detailed description of DB plans, the different types, alternatives to benefits, and funding rules. The chapter closes with a snapshot of the private DB system today.

Chapter III presents an in depth look at the Pension Benefit Guaranty Corporation (PBGC), from its beginning until now, how the corporation is organization and its role in the private pension system.

Chapter IV focuses on the challenges facing the private DB pension system in 2004: the demographic changes, an overview of corporate America's frustration with the system, the complexities of current funding and administration rules, and the challenges facing the PBGC.

Chapter V addresses recent proposals from the Bush Administration and the 108<sup>th</sup> Congress designed to improve plan funding and reduce future terminations, followed by a summary of corporate America's response to the proposals.

Chapter VI presents a brief summary, conclusions and recommendations for further study.

#### **F. BENEFIT OF STUDY**

The primary benefit of the research is to provide insight into the financial structure and problems affecting the private pension system within the U.S., and the policy responses to those problems.

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## II. OVERVIEW OF DEFINED BENEFIT PENSION PLANS

### A. QUALIFIED RETIREMENT PLANS

#### 1. Defined

To encourage employers to offer retirement plans to their employees, the federal government offers tax preferential treatment as defined by section 401 of the Internal Revenue Code of 1986 (IRC) to employers who offer "qualified retirement plans." This preferential treatment provides an incentive for employers to voluntarily offer and maintain retirement plans for their employees, thereby attracting and retaining a work force while also receiving tax benefits for ensuring employee retirement security.

A qualified employee plan is an employer's stock bonus, pension, or profit-sharing plan that is for the exclusive benefit of employees or their beneficiaries and that meets Internal Revenue Code requirements. It qualifies for special tax benefits, such as tax deferral for employer contributions and capital gain treatment or the 10-year tax option for lump-sum distributions.<sup>7</sup>

An employer that maintains a qualified plan receives tax deductions for contributions to the plan. Contributions (including earnings and gains) are generally tax-free until distributed to the employee.<sup>8</sup> These contributions, held in tax-exempt trusts, provide a source of income to the employer in addition to accruing employee benefits.

In order to qualify for preferential tax treatment, employers are required to satisfy minimum participation, coverage and non-discrimination rules set forth in the IRC, as well as standards governing the conduct of plan sponsors (fiduciaries) set forth in the Employee Retirement Act of 1974 (ERISA).<sup>9</sup> Employers failing to satisfy these minimum rules can either be penalized financially or lose their preferential tax treatment.

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<sup>7</sup> Internal Revenue Service. (2003). *Pension and Annuity Income* (Publication No. 575). Retrieved April 07, 2004, from <http://www.irs.gov/publications/p575/index.html>. 3.

<sup>8</sup> Ibid., 7.

<sup>9</sup> General Accounting Office. (2002). *Answers to Key Questions about Private Pension Plans* (Report No. GAO-02-745SP). Retrieved April 01, 2004, from <http://www.gao.gov/>. 6.

## 2. Types

There are two basic types of qualified retirement plans, defined contribution (DC) and defined benefit (DB).

### *a. Defined Contribution*

A defined contribution plan provides an individual account for each participant in the plan. It provides benefits to a participant largely based on the amount contributed to that participant's account. Any income, expenses, gains, losses, and forfeitures of other accounts that may be allocated to an account also affect benefits. A defined contribution plan can be either a profit-sharing plan or a money purchase pension plan.<sup>10</sup>

In traditional DC plans, contributions (pretax or after tax) are made by an employee, his employer or both, to an individual account (similar to a mutual fund) under the plan, and generally capped at a set rate, such as 5 percent of annual earnings.<sup>11</sup> Employer contributions are contingent on employee contributions.<sup>12</sup> The benefits provided by a DC plan are the gains and losses (investment return) of these contributions. Types of DC plans include 401(k) plans, 403(b) plans, employee stock ownership plans, and profit sharing plans.

An example of a traditional 401(k) plan is as follows: an employee contributes 5 percent of his or her pretax wages into a designated account under the plan; the employer then "matches" these funds by contributing \$0.50 for every \$1, for a total annual contribution of 2.5 percent of wages.

DC plans afford the employee limited control over how account assets are invested, yet the employee bears all investment risk. DC plans do not promise a fixed amount at retirement; rather, employees receive their individual account balance. This balance may fluctuate because of stock market performance. DC plans expose employees to the risk of outliving their retirement investments because of poor

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<sup>10</sup> Internal Revenue Service. (2003). *Retirement Plans for Small Business* (Publication No. 560). Retrieved April 07, 2004, from <http://www.irs.gov/publications/p560/index.html>. 16, 19.

<sup>11</sup> U.S. Department of Labor. (October 2003). *What You Should Know About Your Retirement Plan* (Employee Benefits Security Administration Report). Retrieved March 30, 2004, from <http://www.dol.gov/ebsa/publications/wyskapr.html>. 9.

<sup>12</sup> General Accounting Office. (2002). *Answers to Key Questions about Private Pension Plans* (Report No. 02-745SP). Retrieved April 01, 2004, from <http://www.gao.gov/>. 9.

investment performance, poor stock market performance, or both. Upon retirement, employees usually take delivery of their account balances in a lump sum.

The benefits of DC plans include the "portability" of plan assets, control of the retirement assets, and pre-retirement access to their account balance.

***b. Defined Benefit***

A defined benefit plan is any plan that is not a defined contribution plan. Contributions to a defined benefit plan are based on what is needed to provide definitely determinable benefits to plan participants. Actuarial assumptions and computations are required to figure these contributions.<sup>13</sup>

Traditional DB plans are employer sponsored and provide benefits to employees in one of two forms: a lifetime annuity or a lump sum payment. Benefits are commonly determined using a formula based on an employee's average pay and years of service. By design, DB plans are most rewarding to those employees with the longest service.

DB plans are considered a "secure retirement" and are attractive for several reasons: (1) benefits are for the most part fixed (increasing due to cost of living adjustments) and not subject to stock market performance; (2) DB pension plans are "guaranteed." The employer has promised either a lump sum or a lifetime annuity based on the employee's accrued benefits. If promised an annuity, employees will not outlive their retirement; (3) plan sponsors (employers) are responsible for contributions to a pension trust fund on the employee's behalf, and are responsible for investing and managing plan assets, and bear all of the investment risk; (4) an employee's benefits are insured by the Pension Benefit Guaranty Corporation, a federal agency, against losses due to company insolvency.<sup>14</sup>

***c. Hybrid***

Hybrid plans are retirement plans that incorporate aspects of both DB and DC plans. Traditional hybrid plans are DB plans, designed to mimic DC plans, often

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<sup>13</sup> Internal Revenue Service. (2003). *Retirement Plans for Small Business* (Publication No. 560). Retrieved April 07, 2004, from <http://www.irs.gov/publications/p560/index.html>. 16, 19.

<sup>14</sup> Sutkowski & Rhoads LTD. (n.d.). *FAQ about Overview of Employee Benefit Plans*. Retrieved April 07, 2004 from [http://www.erisalawfirm.com/faq/q/defined\\_benefit\\_plans\\_and\\_defined\\_contribution\\_plans\\_purposes\\_for\\_each.asp](http://www.erisalawfirm.com/faq/q/defined_benefit_plans_and_defined_contribution_plans_purposes_for_each.asp).

called notional defined contribution (NDC) plans. Generally, hybrid plans are employer sponsored, and imitate DC plans in several ways: (1) benefits are offered in lump sum payments upon retirement or termination of employment; (2) benefits are expressed in the form of an account balance; (3) benefits accrue more quickly earlier in the life of the plan, thereby benefiting employees who terminate employment after only several years, (unlike DB plans, which benefit long-term employees).

Similar to traditional DB plans, hybrid plan sponsors make all contributions, maintain control of account assets, are responsible for account risk, and guarantee accrued benefits. Most common hybrid plans include Cash Balance and Pension Equity Plans.<sup>15</sup>

In addition to traditional hybrid plans, a Floor-Offset arrangement includes two separate but associated DB and DC plans. The DB plan provides the minimum benefit (or floor) while the DC plan offsets the benefits received. Simply put, the employee receives whichever amount is greater of the two at retirement.<sup>16</sup>

Hybrid plans are attractive to employees today because they are transparent, portable and secure.

### **3. Investment**

#### ***a. Employer versus Employee Risk***

The location of the risk of investment loss for qualified pensions depends on whether or not the plan is DB or DC. Sponsors of DB plans contribute to a plan's trust fund on behalf each employee. The plan sponsor, known as the fiduciary, invests plan assets. Since the accrued benefits are guaranteed to the employee, the risk of investment loss falls to the employer.

ERISA established protection for DB plans, including minimum funding rules and a requirement for additional funding if plan assets fall below a certain level. Additionally ERISA established the PBGC, which protects DB plans against loss due to insolvency (ERISA will be discussed further in Chapter III).

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<sup>15</sup> Pension Benefit Guaranty Corporation. (Winter 2003). *Pension Insurance Data Book 2002*. Retrieved 19 April 2004, from <http://www.pbgc.gov/publications/databook/databook02.pdf>. 5.

<sup>16</sup> General Accounting Office. (2002). *Answers to Key Questions about Private Pension Plans* (Report No. GAO-02-745SP). Retrieved April 01, 2004, from <http://www.gao.gov/>. 22-23.

In a DC plan, the benefit received by the employee is the account balance of invested contributions. Risk of plan investment loss falls on the employee regardless of who makes plan investment decisions. DC plans are not guaranteed by the PBGC because benefits received at retirement are based on plan assets rather than accrued benefits, as are DB plans.

DC and DB plans offering lump sum distributions pose the additional risk of a retiree outliving his or her benefits. This comes as an increased probability due to one or more of the following: poor investment decisions, poor stock market performance, or rapid consumption of account assets upon retirement.

In traditional hybrid plans such as Cash Balance plans, employers contribute on behalf of employees and are responsible for investment risk.

## **B. DEFINED BENEFIT PLANS**

### **1. Plan types**

#### ***a. Single-Employer Plans***

An employer may sponsor a single-employer plan for employees either unilaterally, or in conjunction with a labor union.<sup>17</sup> The IRC sets minimum funding and participation rules for this type of plan. Today there are approximately 34.5 million Americans covered by 29,500 single-employer plans.<sup>18</sup>

#### ***b. Multiemployer Plans***

Multiemployer plans consist of at least two or more employers who jointly sponsor a DB plan, in conjunction with a collective bargaining agreement, and are often confused with multi-employer plans.<sup>19</sup> Multiemployer plans often cover a group of workers in a particular unionized sector of industry such as steel, construction, and

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<sup>17</sup> Ibid., 2.

<sup>18</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 30, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. Inside cover.

<sup>19</sup> Multi-employer plans consist of a group of single-employer plans under "common control." Employers choose to sponsor multi-employer plans to benefit from increased investment returns resulting from pooling plan assets with other plans. ERISA classifies plans under "common control" of a group of sponsors as single-employer plans and labels them as a "controlled group." Employers sponsoring plans of this type will typically maintain separate plans so that their contributions only benefit the employees covered under their plan. Further, these plans do not include a collective bargaining agreement unlike other single or multiemployer plans.

textiles. Generally, management and union officials determine plan details and together oversee plan coverage. Multiemployer plans facilitate the changing of jobs within an industry while also maintaining an individual worker's accrued benefits.<sup>20</sup> Today there are approximately 9.7 million people covered by 1,600 multiemployer plans.<sup>21</sup>

## **2. Benefits Received**

### **a. Common Designs**

As noted above, most DB plans provide benefits in the form of a lifetime annuity, or if offered, as a lump sum. By design, DB plans usually reward employees with the longest service.

Employers determine employee benefits in one of several ways. The first method uses a formula, which includes a percentage of annual salary, average salary, and years of service (see example below). Assuming an employee's wages are highest at retirement, DB plans by design are most rewarding to those employees with the longest service.

Percentage of annual wages \* number of years served \* average of last  
three years' wages

e.g.,

$$1.25\% * 25 \text{ years} * \$50,000 = \$15,625$$

Employers whose workforce is comprised of predominantly hourly employees typically offer flat benefit plans. Benefits are calculated using a predetermined dollar amount (per month), multiplied by the years of service. Employees participating in flat benefit plans, regardless of wage rate, receive the same base benefit. Flat benefit plans will typically increase every three to five years, or when the union and the sponsor renegotiate the collective bargaining or labor contract.<sup>22</sup>

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<sup>20</sup> General Accounting Office. (2002). *Answers to Key Questions about Private Pension Plans* (Report No. GAO-02-745SP). Retrieved April 01, 2004, from <http://www.gao.gov/>. 22-23.

<sup>21</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 30, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. Inside cover.

<sup>22</sup> *Hearing before the Committee on Education and the Workforce, U.S. House of Representatives*, 108<sup>th</sup> Cong., (2003, October 29) (Mark J. Iwry). Retrieved March 24, 2004, from <http://www.brookings.edu/dybdocroot/views/testimony/iwry/20031029.pdf>.

Generally, distribution begins at retirement age as specified by the plan or age 65. By law, benefit distribution must begin by the calendar year in which the employee reaches the age of 70½.<sup>23</sup>

***b. Annuities***

DB annuity payments differ depending on the plan and may be distributed as either fixed or variable, and at different periods, i.e., monthly, quarterly, or annually. Payment usually continues for the rest of the retiree's life. Different annuity forms include fixed-period annuities, annuities for a single life, joint and survivor annuities, and variable annuities.<sup>24</sup>

***c. Lump Sum***

Depending on the plan, employees may opt for a lump sum distribution instead of a lifetime annuity. In order to accurately determine the benefit amount "actuarially" equivalent to the total lifetime annuity, plan sponsors use assumptions consisting of an applicable interest rate (i.e., 30-year Treasury bond rate or corporate bond rate) and IRS-provided mortality tables.<sup>25</sup>

***d. Spousal Coverage***

DB plans are required to provide married couples with qualified joint and survivor annuities. Qualified joint and survivor annuities guarantee the spouse payment of accrued benefits after the plan participant dies. Additionally, DB plans are required to provide a qualified pre-retirement annuity to spouses of vested plan participants who die before they are eligible to receive retirement benefits.<sup>26</sup>

***e. Limits***

The IRC established maximum benefits that an individual may receive in a single year. This limit increases as the cost of living goes up. For 2004, the maximum annual benefit must not exceed the lesser of:

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<sup>23</sup> Internal Revenue Service. (2003). *Retirement Plans for Small Business* (Publication No. 560). Retrieved April 07, 2004, from <http://www.irs.gov/publications/p560/index.html>. 16, 19.

<sup>24</sup> Internal Revenue Service. (2003). *Pension and Annuity Income* (Publication No. 575). Retrieved April 07, 2004, from <http://www.irs.gov/publications/p575/index.html>. 3.

<sup>25</sup> U.S. Congress. (March 10, 2003). *Present Law and Background Relating to Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation* (Joint Committee on Taxation Report No. JCX-16-03). Retrieved April 09, 2004, from <http://www.house.gov/jct/x-16-03.pdf>. 17-18.

<sup>26</sup> Internal Revenue Code of 1986, 26 U.S.C. Section 401(a)(11).

(1) 100 percent of average compensation for the employee's highest three consecutive years or

(2) \$165,000.<sup>27</sup>

### **3. Funding Rules**

#### ***a. In General***

Prior to passage of ERISA, few laws governed fiduciaries of DB plans and often employees had little guarantee of receiving their promised benefits upon retirement. ERISA and the IRC established rules to protect DB plan participants.

#### ***b. Minimum Funding***

DB plans are subject to minimum funding rules in order to ensure that employer contributions are sufficient to pay all plan participant benefits upon distribution. The annually required contribution is equal to the amount needed to fund benefits earned during the year (known as the normal cost of the plan) plus an amortized portion of all other plan liabilities (known as supplemental cost). Plan sponsors (employers with more than 100 employees) failing to fund plans to the minimum required levels during a plan year are required to make additional contributions. These additional contributions (known as deficit reduction contributions) require plan funding to 90 percent of current liability (all liabilities to employees and their beneficiaries under the plan), with certain exceptions.<sup>28</sup>

#### ***c. Deduction Rules***

As noted above, employer contributions to DB plans are tax deductible, subject to maximum limits. Generally, the maximum amount deducted is not less than the plan's unfunded current liability.<sup>29</sup>

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<sup>27</sup> Internal Revenue Code of 1986, 26 U.S.C. Section 414 (b)(1), and Internal Revenue Service. (2003). *Retirement Plans for Small Business* (Publication No. 560). Retrieved April 07, 2004, from <http://www.irs.gov/publications/p560/index.html>. 13.

<sup>28</sup> Internal Revenue Code of 1986, 26 U.S.C. Section 412(b) and (l)(7)(A), and General Accounting Office. (2002). *Answers to Key Questions about Private Pension Plans* (Report No. GAO-02-745SP). Retrieved April 01, 2004, from <http://www.gao.gov/>. 21-23.

<sup>29</sup> Internal Revenue Code of 1986, 26 U.S.C. Section 404(a)(1)(D)(i), and Internal Revenue Service. (2003). *Retirement Plans for Small Business* (Publication No. 560). Retrieved April 07, 2004, from <http://www.irs.gov/publications/p560/index.html>. 13.

***d. Required Interest Rate***

The rate used in interest calculation must be within a permissible range (+/- 10 percent) of the weighted average of the interest rate on 30-year Treasury securities, based on the four-year period prior to the first day of the plan year.<sup>30</sup>

***e. Penalties***

Plan sponsors failing to meet the minimum, or exceed the maximum funding limits, or who fail to distribute accrued benefits as required, are subject to excise tax penalties.

A plan sponsor failing to meet minimum funding requirements during a plan year is subject to an excise tax of 10 percent on the amount of the accumulated funding deficiency, and if not corrected within a taxable "period," employers are subject to a tax equal to 100 percent of the unfunded amount.<sup>31</sup>

There are restrictions in place limiting the tax deductions employers may receive on contributions made to fully funded plans. Employers funding in excess of maximum funding limits are subject to an excise tax of 10 percent applied to all contributions over the maximum funding limit as described above.<sup>32</sup>

If a sponsor fails to make the minimum required distribution to plan participants during a plan year, the employer is subject to an excise tax of 50 percent of the amount which was not distributed.<sup>33</sup>

***f. Insurance***

If a company fails, freezes a plan, or terminates a plan or plans, the PBGC assumes responsibility for the company's plan assets and assumes administrative control of the plan. However, employers that are capable of fully funding a plan upon termination are required to do so. The PBGC guarantees vested employees and retirees a specified dollar amount, which changes annually. Thus, when PBGC assumes control of a plan, participants receive benefits, even though these benefits may not equal their accrued amount.

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<sup>30</sup> Internal Revenue Code of 1986, 26 U.S.C. Section 412(b)(5)(B)(ii)(I).

<sup>31</sup> Internal Revenue Code of 1986, 26 U.S.C. Section 4971.

<sup>32</sup> Internal Revenue Code of 1986, 26 U.S.C. Section 4972.

<sup>33</sup> Internal Revenue Code of 1986, 26 U.S.C. Section 4974.

## C. THE QUALIFIED RETIREMENT PLAN SYSTEM IN 2004

### 1. In General

The most current Department of Labor statistics regarding pensions, based on information compiled from the individual employer-filed IRS *Form 5500*, date back to 1998. Because of the important economic developments of 2000-2002, this information has been used sparingly. In its place, unofficial survey and statistical data have been employed to better illustrate the status of the retirement system in the US today.

In 2001, less than half (43 percent) of the US labor force (~151 million) participated in retirement plans. In slightly different terms, the number of family heads participating in an employer-offered plan was 41.6 percent (see Table 1). Analysis conducted by the Employee Benefits Research Institute, narrows the focus down further, estimating that of those workers who participated in retirement plans in 2001, 21.3 percent participated in DB plans, 61.5 percent participated in DC plans, and 17.1 percent participated in both DC and DB plans.<sup>34</sup>

|                                         | All Workers | Wage and Salary Workers Age 21-64 | Private Wage and Salary Workers Age 21-64 | Public Wage and Salary Workers Age 21-64 | Full-Time, Full-Year Wage and Salary Workers Age 21-64 |
|-----------------------------------------|-------------|-----------------------------------|-------------------------------------------|------------------------------------------|--------------------------------------------------------|
|                                         |             | (millions)                        |                                           |                                          |                                                        |
| Worker Category Total                   | 151.3       | 125.4                             | 105.3                                     | 20                                       | 90                                                     |
| Works for an employer sponsoring a plan | 80.7        | 74.6                              | 57.8                                      | 16.8                                     | 58.6                                                   |
| Participating in a Plan                 | 63.2        | 60.4                              | 45.4                                      | 15                                       | 51.1                                                   |
|                                         |             | (percentage)                      |                                           |                                          |                                                        |
| Worker Category Total                   | 100%        | 100%                              | 100%                                      | 100%                                     | 100%                                                   |
| Works for an employer sponsoring a plan | 53.4        | 59.5                              | 54.9                                      | 83.7                                     | 65.1                                                   |
| Participates in a Plan                  | 41.8        | 48.2                              | 43.1                                      | 74.8                                     | 56.7                                                   |

Table 1. Workers Participating in Employer Sponsored Retirement Plans 2002 [After Ref. 30]

A significant amount of US capital is invested in retirement plans. In 2000, the Federal Reserve estimated that 25 percent of America's assets were held in pension funds

<sup>34</sup> Employee Benefit Research Institute. (2004, January). *Notes* Vol. 25 No. 1. Available from <http://www.ebri.org/store/notes.htm>. 2., and Employee Benefit Research Institute. (2003, October). *Employment-Based Retirement and Pension Plan Participation: Declining Levels and Geographic Differences* (EBRI Issue Brief No. 262). Available from <http://www.ebri.org/store/ebriib.htm>. 1.

(\$11.57 trillion).<sup>35</sup> At the end of 2002, the amount had decreased to approximately \$9.98 trillion (see Figure 1). Of this amount, 16 percent or \$1.6 trillion was held in private DB pension plans and 19 percent or \$2.1 was held in private DC plans (see Figure 2).<sup>36</sup>

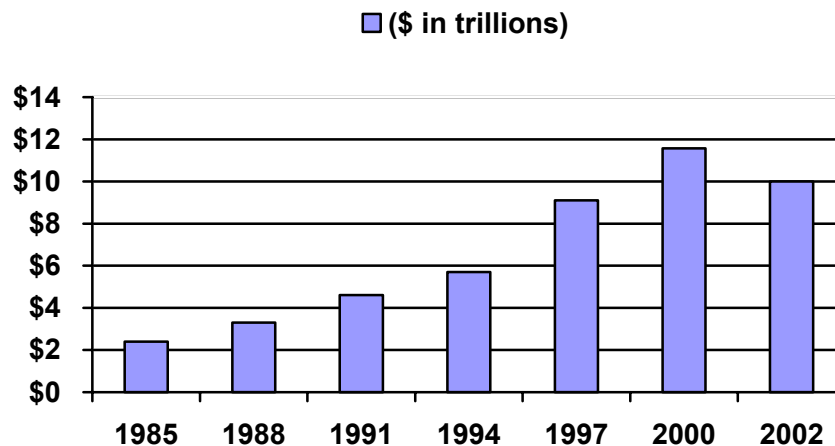


Figure 1. Total Retirement Plan Assets, 1985-2002 [After Ref. 14]

According to analysis conducted by the Employee Benefit Research Institute (EBRI), the larger the employer, the greater the probability they are participating in a retirement plan. In 2002, for example, only 16.5 percent of employees working for employers with fewer than 10 employees participated in a retirement plan, while 59.5 percent of employees working for an employer with greater than 1000 employees participated in retirement plans.

## 2. The Defined Benefit Plan System

In 1991, 90 percent of the Fortune 500 companies offered DB plans, which included approximately 26 million active participants. By 2002, this ratio declined to approximately 75 percent, or 23 million active participants in.<sup>37</sup> In 1985, 30.5 percent of

<sup>35</sup> *ERISA at 25: Has the Law Kept Pace with the Evolving Pension and Investment World?*, Hearing before the Subcommittee on Employer-Employee Relations Committee on Education and the Workforce, U.S. House of Representatives, 106<sup>th</sup> Cong. (2000, February 15) (John B. Shoven, Director, Stanford Institute for Economic Policy Research, Stanford University). Retrieved April 30, 2004, from [http://www.house.gov/ed\\_workforce/hearings/106th/eeer/erisa21500/shoven.htm](http://www.house.gov/ed_workforce/hearings/106th/eeer/erisa21500/shoven.htm), and Employee Benefit Research Institute. (2003, December). *Facts from EBRI*. Retrieved April 09, 2004, from <http://www.ebri.org/facts/1203fact.pdf>. 1.

<sup>36</sup> Employee Benefit Research Institute. (2003, December). *Facts from EBRI*. Retrieved April 09, 2004, from <http://www.ebri.org/facts/1203fact.pdf>. 1.

<sup>37</sup> Committee on Investment of Employee Benefit Assets. (2004, March 30). *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*. Retrieved March 30, 2004, from [http://www.afponline.org/pub/pr/pr\\_20040318\\_ciebamissiles.html](http://www.afponline.org/pub/pr/pr_20040318_ciebamissiles.html). 7.

private sector wage and salary employees participated in a DB plan; in 2004, after a continual decline, only 20 percent participant in DB plans.<sup>38</sup>

The DB system peaked in 1985 when it included 112,208 single-employer, and 2,188 multiemployer plans. In 2004, there are 29,512 single-employer and 1,623 multiemployer plans. Over this period, the significant decline in single-employer plans can largely be attributed to the termination of small-employer plans (<25 participants).<sup>39</sup> The period of greatest loss came during the early 1990s when small employer plans were declining at a rate of 12 percent per year.<sup>40</sup>

The opposite is true for the number of Americans participating in DB plans. The number of participants, which includes both retired and active, is on the rise. Today, the DB system includes 34.5 million participants in single-employer and 9.7 million in multiemployer plans. In 1985, there were 29.8 million in single-employer, and 8.2 million in multiemployer plans.<sup>41</sup> This growth is partly due to the increase in the number of inactive participants (retirees) from 11 million in 1985 to nearly 21 million in 2000 (latest available numbers).

In 1985 when the DB plan system was at its peak, DB plan assets accounted for 34 percent of all retirement assets. In 2002, DB plans accounted for approximately 16 percent of all retirement assets, representing 6 percent of all US stock equity holdings, and were valued at \$1.6 trillion (see Figure 2).<sup>42</sup>

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<sup>38</sup> Pension Benefit Guaranty Corporation. (2004, Spring). *Pension Insurance Data Book 2003*. Retrieved June 01, 2004, from <http://www.pbgc.gov/publications/databook/databook03.pdf>. Table S-33.

<sup>39</sup> Ibid., Tables S-31 and M-6.

<sup>40</sup> Pension Benefit Guaranty Corporation. (n.d.). Trends in Defined Benefit Pension Plan. Retrieved May 03, 2004, from <http://www.pbgc.gov/publications/annrpt/2002txt/2002plantrends.htm>.

<sup>41</sup> Pension Benefit Guaranty Corporation. (2004, Spring). *Pension Insurance Data Book 2003*. Retrieved June 01, 2004, from <http://www.pbgc.gov/publications/databook/databook03.pdf>. Table S-30 and M-5.

<sup>42</sup> Employee Benefit Research Institute. (2003, December). *Facts from EBRI*. Retrieved April 09, 2004, from <http://www.ebri.org/facts/1203fact.pdf>. 1.

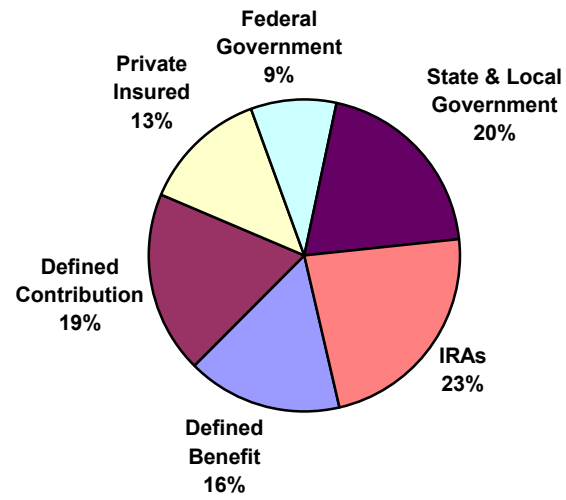


Figure 2. Total Us Retirement Plan Assets 2002 [After Ref. 14]

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### **III. PENSION BENEFIT GUARANTY CORPORATION (PBGC)**

#### **A. EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 (ERISA) AND SUBSEQUENT ESTABLISHMENT OF THE PBGC**

##### **1. Background**

Prior to the passing of ERISA, DB plan sponsors were governed by few regulations and as a result, thousands of employees lost their promised pensions due to plan terminations. In an effort to curb the loss to employees, Senator Vance Hartke, backed by the United Auto Workers, introduced "The Federal Reinsurance of Private Pensions Act" in Congress in 1964.<sup>43</sup> This legislation, riding on the bow wave of a recent termination, focused congressional attention on the unregulated private pension system.

Only a few months before, while experiencing financial difficulties, the Studebaker-Packard Corporation terminated its second pension plan in five years. The termination affected 6500 workers leaving a majority without promised retirement benefits. This single event became pivotal in the political process, used repeatedly to demonstrate egregious employer behavior. The termination settlement left 4400 employees with greatly reduced benefits, fully protecting only those that were retired, or those currently employed over the age of sixty. Plan participants from these two groups received 100 percent of their retirement. Vested employees less than sixty years of age received lump-sum payments worth only about 15 percent of their accrued benefits. Those without vested benefits, including all employees under age forty, received nothing.<sup>44</sup> Later, it was determined that plan underfunding equaled \$15 million, which is the equivalent of \$9.1 billion in 2004 dollars. As a reference, the combined total from the top ten largest single-employer claims since PBGC's inception in 1974 is \$10.7 billion.<sup>45</sup>

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<sup>43</sup> Wooten, James A. (2001). *The Most Glorious Story of Failure in the Business: The Studebaker-Packard Corporation and the Origins of ERISA* (Buffalo Law Review Vol. 49, 686). Retrieved May 02, 2004, from [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=290812](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=290812).

<sup>44</sup> Ibid., 730.

<sup>45</sup> Bureau of Labor Statistics. (n.d.). Inflation Calculator. Retrieved 12 May 2004, from <http://data.bls.gov/cgi-bin/cpicalc.pl>., and Pension Benefit Guaranty Corporation. (2004, Spring). *Pension Insurance Data Book 2003*. Retrieved June 01, 2004, from <http://www.pbgc.gov/publications/databook/databook03.pdf>. Table S-5.

## **2. The Passing of ERISA**

Under this law, which is entitled the Employee Retirement Income Security Act of 1974, the men and women of our labor force will have much more clearly defined rights to pension funds and greater assurances that retirement dollars will be there when they are needed. Employees will also be given greater tax incentives to provide for their own retirement if a company plan is unavailable.

President Gerald Ford<sup>46</sup>

The purpose of ERISA is to secure the benefits of plan participants in private pensions (both DB and DC) and health benefit plans (beyond the scope of this paper) through federalized funding and administration. Congress intended for this legislation to eliminate and prevent further abuses of the private pension system, thereby protecting employee benefits. ERISA rules pertaining to pensions include minimum standards for vesting periods, funding, reporting and disclosure, and participation, as well as certain standards of conduct for plan fiduciaries.<sup>47</sup> ERISA also requires all plan assets to be held in a trust, exempt from the sponsor's creditors,<sup>48</sup> and shifted administrative oversight of retirement plans from the IRS to the Department of Labor (DOL). Further, ERISA established the Pension Benefit Guaranty Corporation (PBGC), a federal corporation (previously mentioned) to establish and administer a plan termination insurance program, created to protect employees from losing their accrued benefits when an employer terminates a pension plan, either voluntarily or involuntarily.

## **3. ERISA Structure**

Since its enactment, ERISA has been amended several times, however its structure has remained the same. ERISA includes four titles, as described below.<sup>49</sup>

- Title I includes key definitions and delineates principal rules for funding, reporting and disclosure, fiduciary duties, prohibited transactions,

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<sup>46</sup> Pension Benefit Guarantee Corporation. (n.d.). *Statement by President Gerald R. Ford Upon Signing the Employee Retirement Income Security Act of 1974*. Retrieved May 04, 2004, from <http://www.pbgc.gov/about/signing.htm>.

<sup>47</sup> Department of Labor. (n.d.). *History of EBSA and ERISA*. Retrieved May 04, 2004, from <http://www.dol.gov/ebsa/aboutebsa/history.html>.

<sup>48</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. Section 1103(a).

<sup>49</sup> Department of Labor. (n.d.). *History of EBSA and ERISA*. Retrieved May 04, 2004, from <http://www.dol.gov/ebsa/aboutebsa/history.html>.

enforcement, and establishes the Employee Benefits Security Administration (EBSA) (previously the Pension Welfare Benefits Administration (PWBA)) with the DOL as its administrative authority.

- Title II establishes a set of tax standards providing employees and employers with a means to qualify for favorable tax treatment and amend three of the Title I rules in the Internal Revenue Code, specifically plan participation, vesting and funding.
- Title III defines roles in oversight, jurisdiction, administration and enforcement of regulations between the DOL and the IRS.
- Title IV establishes the PBGC, which created the single-employer and multiemployer plan termination insurance programs.

## **B. PBGC ORGANIZATION**

### **1. Overview**

The Pension Benefit Guaranty Corporation (PBGC) protects the pensions of nearly 44.3 million working men and women in more than 31,000 private defined benefit pension plans, including 34.5 million people covered by 29,500 single-employer plans and more than 9.7 million people covered by over 1,600 multiemployer plans.<sup>50</sup>

The purpose of the DB pension plan insurance program is threefold: (1) to ensure the timely and continued distribution of earned retirement benefits; (2) to support the private pension plan system, providing oversight for the administration of these plans, ensuring their continuation; and (3) to provide plan insurance while maintaining premiums at the lowest possible level.<sup>51</sup>

### **2. Leadership**

The PBGC is led by an executive director, and is subject to several governing and advisory bodies, as prescribed by Title IV of ERISA. The Board of Directors includes the Secretary of Labor (chairman), the Secretary of the Treasury, and the Secretary of Commerce. Its purpose is to oversee investment policy. The PBGC Advisory

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<sup>50</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 24, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. Inside cover.

<sup>51</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. Section 1302(a)(1)-(3).

Committee, consisting of presidentially-appointed members from corporate America, represents three groups of stakeholders: those representing the interests of the general public, those representing private employers, and those representing the interests of employee organizations.<sup>52</sup>

### 3. The PBGC Today

At 2003 year-end, the PBGC experienced a loss of \$7.6 billion in its single-employer program, a decrease from the loss recorded the previous year, expanding its deficit to \$11.2 billion. The multiemployer program experienced a loss of \$419 million, creating a \$261 million deficit, its first deficit in more than 20 years. Labor Secretary Elaine Chao attributes these discouraging numbers, in part, to the underfunding of America's private pension system (see Figure 3), estimating a lack of plan funding in excess \$350 billion, "by far the largest fiscal year-end number ever recorded."<sup>53</sup>

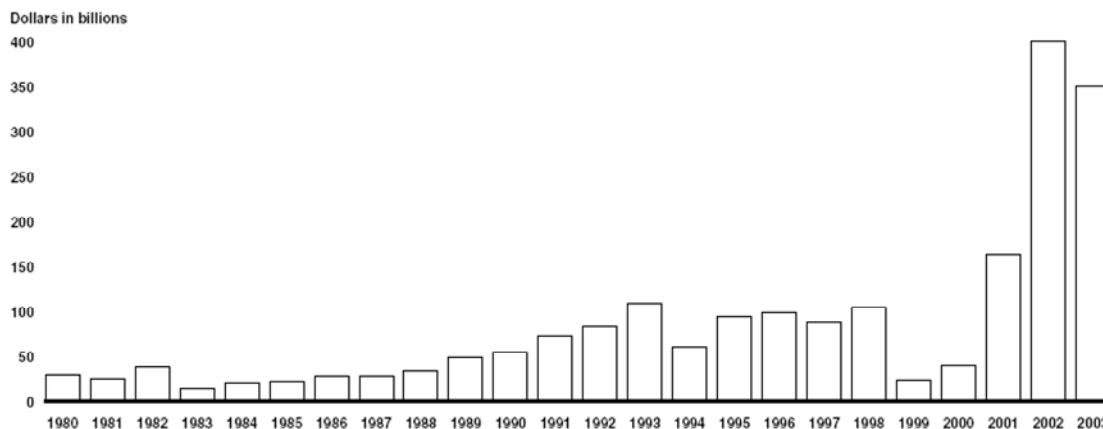


Figure 3. Total Underfunding in PBGC Insured Single-Employer Plans 1980-2003  
[After Ref. 25]

The overall performance of the insurance program has sparked significant attention, including a series of reforms proposed by the PBGC, the Financial Accounting Standards Board (FASB), and the IRS. The General Accounting Office (GAO) considers both programs at risk, placing the single-employer program in its "High Risk" category,

<sup>52</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 24, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 26, 41.

<sup>53</sup> Ibid., 1.

simultaneously citing a number of challenges facing the multiemployer program in a recent testimony before Congress.<sup>54</sup> Even though the single-employer program's future appears bleak (see Figure 4), the PBGC claims its program is "not in a crisis."<sup>55</sup>

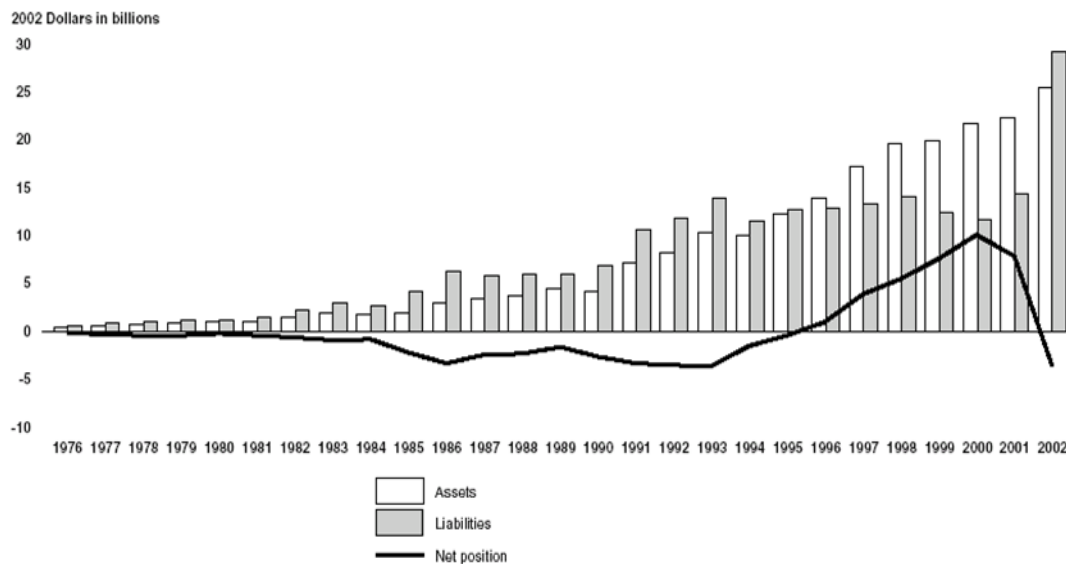


Figure 4. PBGC Single-Employer Program Assets Liabilities and Net Position 1975-2002 [After Ref. 25]

Fortunately for the more than 930,000 workers and retirees in 3,240 "trusteed" plans who rely on the PBGC to pay their retirement benefits, liabilities, as depicted above (Figure 4), are calculated on an annualized basis, representing total liabilities, both current and future. In fact, annual distributions historically require only a small percentage of the total assets to cover current liabilities. In 2003, for example, current liabilities represented only 5.5 percent of total liabilities and required only 7.3 percent of

<sup>54</sup> *Private Pensions: Multiemployer Pensions Face Key Challenges to their Long-Term Prospects*, hearing before the Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce, U.S. House of Representatives, 108<sup>th</sup> Cong., (2004, March 18) (Barbara D. Bovbjerg, Director, Education Workforce, and Income Security Measures, GAO). Retrieved March 24, 2004, from <http://www.gao.gov/>.

<sup>55</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved 24 March 30, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. Inside cover.

total assets. PBGC estimates that its \$34 billion in assets will keep the corporation solvent and able to distribute uninterrupted benefit payments until at least 2019.<sup>56</sup>

By the end of 2003, the PBGC had assumed the role of trustee for 152 plans, representing 206,000 people.<sup>57</sup> The termination of Bethlehem Steel's pension plan, also during 2003, was the single largest plan loss by one company, and added 95,000 participants (67,000 retirees) to the growing number that rely on the PBGC. This termination created a liability of approximately \$3.6 billion, over 60 percent of the liabilities entrusted to the PBGC during 2003, and nearly ten percent of total liabilities.<sup>58</sup>

At 2003 year-end, the PBGC distributed benefits totaling \$2.5 billion, yet another record, up nearly \$1 billion from the year previous. These record distributions were balanced, in part, by income generated from premium payments and improved investment performance from the previous years. Investment income equaled \$3.4 billion, with a return on investments of 10.3 percent, far exceeding 2002's return of only 2.1 percent (see Figure 5).<sup>59</sup>

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<sup>56</sup> General Accounting Office. (2003, October). *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks* (Report No. GAO-04-90). Retrieved March 24, 2004, from <http://www.gao.gov/new.items/d0490.pdf>. 15.

<sup>57</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 24, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 1, 7.

<sup>58</sup> Ibid.

<sup>59</sup> Ibid., 2.

| Single-Employer and Multiemployer Programs Combined |            |            | Investment Performance              |                    |                               |
|-----------------------------------------------------|------------|------------|-------------------------------------|--------------------|-------------------------------|
| (Dollars in millions)                               |            |            | (Annual Rates of Return)            |                    |                               |
|                                                     | 2003       | 2002       |                                     | September 30, 2003 | 5 Year Avg September 30, 2003 |
| <i>Summary of Operations</i>                        |            |            |                                     | 2002               | 2003                          |
| Premium Income                                      | \$973      | \$812      | Total Invested Funds                | 10.30%             | 5.00%                         |
| Losses from Plan Terminations                       | \$5,377    | \$9,313    | Equities                            | 25.8               | (17.0)                        |
| Investment Income                                   | \$3,386    | \$288      | Fixed-Income                        | 4.2                | 14.4                          |
| Actuarial Charges and Adjustments                   | \$6,162    | \$2,802    | Trust Fund                          | 22.9               | (15.5)                        |
|                                                     |            |            | Revolving Funds                     | 3.8                | 14.4                          |
| <i>Insurance Activity</i>                           |            |            | <i>Indices</i>                      |                    |                               |
| Benefits Paid                                       | \$2,489    | \$1,538    | Wilshire 5000                       | 26.3               | (17.5)                        |
| Retirees                                            | 459,190    | 344,770    | S&P 500 Stock Index                 | 24.4               | (20.5)                        |
| Total Participants Receiving or Owed Benefits       | 934,000    | 783,000    | Lehman Brothers Long Treasury Index | 3.7                | 14.5                          |
| New Underfunded Terminations                        | 155        | 157        |                                     |                    |                               |
| Terminated/Trusteed Plans (cumulative)              | 3,287      | 3,132      |                                     |                    |                               |
| <i>Financial Position</i>                           |            |            |                                     |                    |                               |
| <b>Single-Employer Program</b>                      |            |            |                                     |                    |                               |
| Total Assets                                        | \$34,016   | \$25,430   |                                     |                    |                               |
| Total Liabilities                                   | \$45,254   | \$29,068   |                                     |                    |                               |
| Net Loss                                            | (\$7,600)  | (\$11,370) |                                     |                    |                               |
| Net Position                                        | (\$11,238) | (\$3,638)  |                                     |                    |                               |
| <b>Multiemployer Program</b>                        |            |            |                                     |                    |                               |
| Total Assets                                        | \$1,000    | \$944      |                                     |                    |                               |
| Total Liabilities                                   | \$1,261    | \$786      |                                     |                    |                               |
| Net Income (Loss)                                   | (\$419)    | \$42       |                                     |                    |                               |
| Net Position                                        | (\$261)    | \$158      |                                     |                    |                               |

Figure 5. PBGC Financial Performance and Investment Returns in 2003 [After Ref. 50]

#### 4. Funding

The PBGC, a federal corporation, created in accordance with ERISA and the Government Corporation Control Act, receives no funding from general tax revenue.<sup>60</sup> Rather, financing comes from insurance premiums paid by sponsors of private DB plans, investment income, terminated plan assets, and recoveries from the sponsors of terminated plans.

##### a. Federal Funding

As delineated by ERISA, the PBGC self-finances its operations; however, in the event that it is required, the PBGC has a \$100 million line of credit with the US Treasury.<sup>61</sup>

##### b. Investment Income

The PBGC earned \$3.4 billion in investment income during 2003.<sup>62</sup> Investment policy, as directed by PBGC's board of directors, the advisory council, and ERISA, requires the placement of invested assets in two separate accounts for each

<sup>60</sup> Government Corporation Control Act of 1945, 31 U.S.C. Section 9101(3)(I).

<sup>61</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 30, 2004, from <http://www.pbtc.gov/publications/annrpt/default.htm> 26.

<sup>62</sup> Ibid., 2.

program. Assets generated from sponsor premium payments are placed in a revolving fund account, and assets gained from terminated plans are placed in a trust fund. Revolving fund assets (\$16.4 billion at fiscal year-end 2003), must be invested in fixed income securities. Use of revolving fund assets is intended to support the operational and administrative needs of the corporation, and to fund deficits incurred when single-employer plans terminate, or to provide financial assistance to multiemployer plans.<sup>63</sup> Receipts from active plan premium payments are accounted for in the revolving fund.

ERISA allows trust fund assets (\$18.1 billion at fiscal year-end 2003) to be invested more aggressively. Historically they have been invested in high quality equity funds. The trust fund receives its principal from trustee plans, pending plans (terminated awaiting PBGC legal authority), and premiums from probable terminations.

As of year-end 2003, the PBGC's portfolio included approximately 63 percent cash and fixed income securities and 37 percent high-grade equities, with a small percentage of real estate and other financial instruments.<sup>64</sup>

**c. Insurance Premiums**

All single-employer pension plans pay insurance premiums to the PBGC. Originally (1974), a flat rate of \$1 per participant was required. Today, after several amendments over the last 25 years, the flat rate equals \$19 per capita. Variable rate premiums, also assessed and assigned on a per capita basis, are imposed on sponsors failing to maintain plan funding at the required minimums, and are paid in addition to the flat rate premium. Currently, underfunded plans pay \$9 per \$1000 of unfunded vested benefits. Unfunded amount calculations use a variable interest rate to determine to what extent benefits are underfunded.<sup>65</sup>

There have been several changes to the premium payment system over the last decade, each time, adjusting the maximum variable rate premium that can be imposed on a sponsor. Today, there is no maximum limit. Regulations regarding the interest rates used to calculate the variable rate premiums have also seen several changes

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<sup>63</sup> Ibid., 26-27.

<sup>64</sup> Pension Benefit Guaranty Corporation. (n.d.). *Investment Program*. Retrieved May 04, 2004, from <http://www.pbgc.gov/publications/factsheets/INVFACT2.HTM>.

<sup>65</sup> Pension Benefit Guaranty Corporation. (n.d.). *Pension Insurance Premiums*. Retrieved May 04, 2004, from <http://www.pbgc.gov/publications/factsheets/PREMFAC1.HTM>.

over the past decade. As of January of 2004, the interest used is 85 percent of the spot rate for 30-year Treasury Securities. In April of that year, Congress enacted the Pension Funding Equity Act of 2004, temporarily adjusting the interest rate used in premium calculations. For plan years beginning after 31 December 2003 through 31 December 2005, interest rates will be based on high-quality corporate bonds.<sup>66</sup> The National Employee Savings and Trust Equity Guarantee Act (NESTEG) introduced in the second session of the 108<sup>th</sup> Congress (still pending at the time of writing), proposed an extension of the use of corporate bond rates for interest calculations, with an eventual implementation of a corporate yield curve.<sup>67</sup>

The handling of multiemployer plan terminations is different from single-employer plans, and so too is the handling of premiums. The PBGC flat rate premium for all multiemployer plans is \$2.60 per participant per year.<sup>68</sup>

## **C. PBGC'S ROLE IN THE PRIVATE PENSION SYSTEM**

### **1. Insurance Program**

The PBGC was established to insure private DB pensions against loss. Although single-employer and multiemployer programs differ in several ways, both promise security for accrued benefits.

#### ***a. Single-Employer Program***

The single-employer program is responsible for ensuring uninterrupted payment of retirement benefits to current and future retirees in the event a DB plan terminates. Employers, who terminate a plan due to insolvency, because a plan runs out of money, or in order to stay in business, are covered by the PBGC. Additionally, the PBGC has the authority to involuntarily terminate a plan in the interest of protecting employee benefits. When the PBGC takes over a plan, operating rules are adjusted, usually eliminating further benefit accruals and further vesting, while other plan obligations normally cease.<sup>69</sup>

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<sup>66</sup> Pension Funding Equity Act of 2004, Public Law No. 108-218. Section 101.

<sup>67</sup> National Employee Savings and Trust Equity Guarantee Act, S. 2424 (Senate Finance Committee Report No. 108-266), U.S. S., 108<sup>th</sup> Cong., (2004, May 14). Retrieved May 15, 2004, from <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:s.02424>.

<sup>68</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. Section 1306(a)(3)(A)(ii)(IV).

***b. Multiemployer Program***

Under multiemployer program rules, when a plan is unable to distribute benefits when they are due, the PBGC will finance the plan through loans. Before receiving any funding from the PBGC, all payments made by plans in excess of the guaranteed limit must cease.<sup>70</sup>

**2. Plan Termination**

The PBGC's most significant role is as trustee of terminated pension plans. In 2003, the PBGC became trustee for 152 of 155 terminations. There are two different categories of plan terminations, standard and distressed. In either case, upon termination, all benefit accruals and vesting under that particular plan cease, and the PBGC assumes responsibility for the uninterrupted payment of benefits to current and future beneficiaries.

***a. Standard Termination***

A standard termination occurs when an employer terminates a plan even though there are sufficient funds available for plan funding. When a plan goes through this process, all activities cease, all qualified benefits become fully vested, and benefits are distributed to plan participants. Upon termination, the PBGC is no longer responsible for insuring the plan.

***b. Distressed Termination***

A distressed termination occurs when an employer terminates a plan due to the inability to pay all participants current and future benefits or is unable to remain in business without so doing. In order to terminate a plan, an employer must satisfy one of four DOL distressed termination test requirements: (1) the sponsor and all members of the controlled group (if applicable) is being liquidated in bankruptcy or insolvency proceedings; (2) the sponsor and all members of the controlled group (if applicable) are going through a reorganization due to bankruptcy or insolvency proceedings; (3) the PBGC determines that termination is necessary so that the employer can pay its debts in order to remain in business; or (4) the PBGC determines that termination is necessary to

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<sup>69</sup> Pension Benefit Guaranty Corporation. (n.d.). *PBGC's Pension Guarantees*. Retrieved May 04, 2004, from <http://www.pbgc.gov/publications/factshts/GUARFACT.HTM>.

<sup>70</sup> Pension Benefit Guaranty Corporation. (n.d.). *Multiemployer Insurance Program*. Retrieved May 04, 2004, from <http://www.pbgc.gov/publications/factshts/MULTFACT.HTM>.

avoid significant pension costs as a result of a decline in the employer's workforce.<sup>71</sup> Satisfying one of these criteria, a company may voluntarily apply for a plan termination, or the PBGC, may involuntarily terminate a plan.<sup>72</sup>

The PBGC retains the right to terminate an employer's plan regardless of whether or not the employer has filed to terminate the plan voluntarily. Involuntary terminations may occur for one or more of the following reasons: (1) if the PBGC determines that a plan is unable to provide current and future benefits to participants; (2) the plan has paid a lump sum to one of its participants who is one of the "substantial owners" of the sponsoring company; or (3) if there is expected substantial future loss to the PBGC if the plan is not terminated.<sup>73</sup>

### ***c. Termination Prevention***

The PBGC monitors companies with severely underfunded plans to identify potential plan failures and step in before termination occurs. This program - the Early Warning Program - identifies companies with a bond rating below investment grade who sponsor pensions with a current liability greater than \$25 million and those sponsoring plans with a current liability greater than \$25 million with unfunded current liability in excess of \$5 million. If a company satisfies one of these two criteria, the PBGC will monitor company transactions using information shared by the company, the DOL, IRS, and the Securities and Exchange Commission.<sup>74</sup>

### **3. Expected Claim Determination**

In order to limit the effect of a significant plan termination and to forecast possible claims in the future, the PBGC employs the Pension Insurance Modeling System (PIMS). This stochastic model, using multiple variables, attempts to forecast probabilities of future underfunding and claims to which the PBGC will have to respond.<sup>75</sup> PIMS predicts that the median claim over the next ten years will equal

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<sup>71</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. Section 1341(c)(2)(B).

<sup>72</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. Section 1342.

<sup>73</sup> Ibid., and Pension Benefit Guaranty Corporation. (n.d.). *Termination Fact Sheet*. Retrieved May 04, 2004, from <http://www.pbgc.gov/publications/factshts/TERMFACT.HTM>.

<sup>74</sup> Pension Benefit Guaranty Corporation. (n.d.). *Early Warning Program*. Retrieved May 04, 2004, from [http://www.pbgc.gov/publications/factsht/early\\_warning.htm](http://www.pbgc.gov/publications/factsht/early_warning.htm).

<sup>75</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 30, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 10-11.

approximately \$2.2 billion per year, with a 10 percent chance of claims rising as high as \$4.7 billion. Half of the simulations predict PBGC's deficit will exceed \$16 billion by 2013.<sup>76</sup>

#### **4. Benefits**

In 2003, the PBGC paid approximately \$2.5 billion in benefits to retirees and vested plan participants.<sup>77</sup> The PBGC guarantees benefits to employees of terminated retirement plans based on the provisions of the plan up to a maximum limit. This maximum limit, adjusted on an annual basis, is based on changes in the Social Security contribution, the plan benefit base, and the termination date.<sup>78</sup> However, some plan participants may not receive their full retirement benefits. For example, plans terminating in 2004 may receive a maximum annual benefit of \$44,386.32 (\$3,698.86 monthly).<sup>79</sup> For those already retired or covered by plans that terminated prior to a participant reaching retirement age, plan benefit distribution amounts are based on the termination year. The PBGC does not guarantee all types of benefits. Benefits not guaranteed include health and welfare benefits, severance benefits, lump-sum death benefits and disability benefits when occurring after plan termination.<sup>80</sup>

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<sup>76</sup> Ibid., 11.

<sup>77</sup> Pension Benefit Guaranty Corporation. (n.d.). *Pension Guarantees*. Retrieved May 04, 2004, from <http://www.pbgc.gov/publications/factshts/GUARFACT.HTM>.

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> Ibid.

## IV. 21<sup>ST</sup> CENTURY CHALLENGES FACING THE DB PLAN SYSTEM

### A. OVERVIEW

A combination of poor stock market performance, historically low interest rates, significant employer shifts from DB to DC plans, demographic shifts in America's workforce, and increased scrutiny of corporate financial performance challenge the future of the private DB pension plan system in the US today. The system, backed by the PBGC, is underfunded by \$350 billion, and the PBGC itself is experiencing financial difficulties, reporting a combined deficit of \$11.49 billion at the end of 2003.<sup>81</sup>

The economic downturn of the last several years (2000-2003), a time which some have labeled the "perfect storm," has created significant challenges for previously financially healthy companies. Low interest rates (which increase plan liabilities), poor asset performance, and a stagnant economy have forced many firms to make the ultimate decision, i.e., to terminate their pension plan or risk losing the company. In the last three years, the PBGC assumed responsibility for 388 plans, three of which were the largest terminations in its history.<sup>82</sup> Further, in 2003 the PBGC estimated that there are a number of plans in danger of terminating in the near future. These potential terminations represent anywhere between \$83 and \$85 billion of additional liability.<sup>83</sup>

Other challenges facing the DB pension plan system include a significant shift from DB to DC plans, caused, according to many employers, by complex and costly DB plans and a demographic shift in today's labor force.

There will always be companies within the DB pension plan system experiencing financial difficulties, and companies will continue to offer different types of retirement

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<sup>81</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 24, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 2.

<sup>82</sup> Pension Benefit Guaranty Corporation. (2004, Spring). *Pension Insurance Data Book 2003*. Retrieved June 01, 2004, from <http://www.pbgc.gov/publications/databook/databook03.pdf>. Table S-5.

<sup>83</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 24, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 10.

plans to remain competitive. Nevertheless, the combined effects of recent events have created a strain on the entire system, which some say challenges the future existence of the DB pension plan.

## **B. DEMOGRAPHIC CHANGES IN THE DB SYSTEM**

In the US, retirees are spending more time in retirement because of earlier retirements and longer life spans. Today, according to the PBGC, the average male worker spends 18.1 years in retirement, compared to 11.5 in 1950.<sup>84</sup> As the time spent in retirement increases so do pension plan liabilities. Additionally, the US population is aging, and the ratio of active workers to retired workers is decreasing. Today, active participants equal the number of retirees (see Figure 6). These two factors combined create a scenario where employers' liabilities are growing at a faster rate than plan assets. As the shift from the number of active to inactive employees continues grow, the gap may widen.

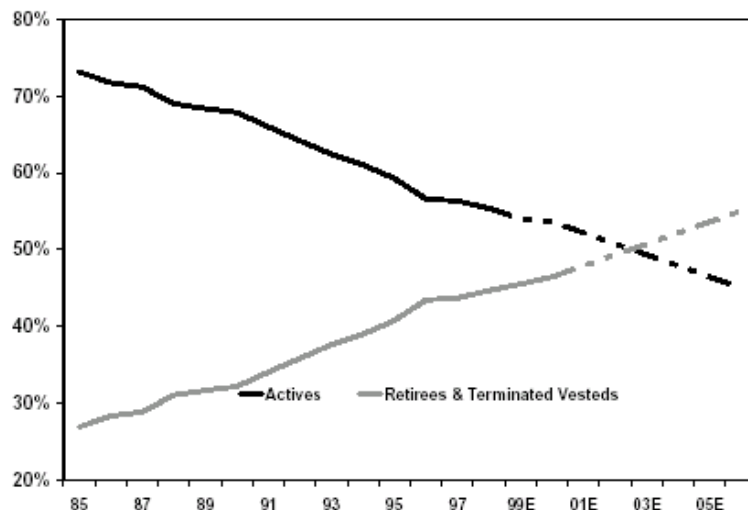


Figure 6. Active vs. Retired and Terminated Plan Participants [After Ref. 8]

## **C. SHIFT FROM DB TO DC PLANS**

Over the past twenty years, there has been a distinct shift from DB to DC plans (see Figure 7). Using data from the IRS Form 5500, David Rajnes of the Employee Benefit Research Institute (EBRI) documented an increase in DC plan participation, from

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<sup>84</sup> Ibid., 6.

4 million in 1975 to 29 million in 1998 (the most recent year for which official DOL statistics exist). During this same period, DB plans decreased from 103,000 to 56,000, while DC plans increased from 208,000 to 673,000.<sup>85</sup>

The shift over the last twenty-five years from DB to DC plans can really be attributed to the shift from DB to 401(k) plans. In 1984, 401(k) plans represented only 4 percent of DC plans. Today 401(k) plans account for 75 percent of DC plans.<sup>86</sup>

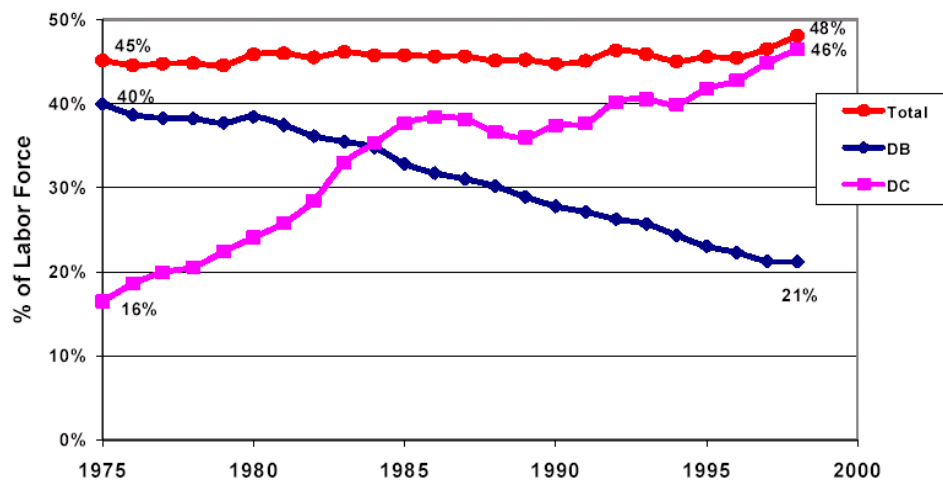


Figure 7. Participation Rates in Qualified Pension Plans [After Ref. 24]

Traditional DB pensions are often associated with the unionized sectors of American industry (e.g., steel and auto) (see Figure 8), but the trend is changing. Over the past twenty years, there has been a shift in the American economy from a primarily industrial base to a technology and service base. The shift has created a considerable challenge to the DB pension system because employers in the technology and service sectors are electing to offer DC rather than DB plans. According to the Employment Benefit Research Institute, "Roughly, 50 percent of the increase in DC Plan market share can be explained by employment shifts from unionized jobs, large firms, and industries that traditionally offer DB plans to smaller business, and the service sector offering DC

<sup>85</sup> Employee Benefit Research Institute. (2002, September). *An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans* (Issue Brief No. 249) (David Rajnes). Available from Employee Benefit Research Institute <http://www.ebri.org/store/ebriib.htm>. 5.

<sup>86</sup> Gebhardtshauer, Ron, FSA, MAAA. (March 30, 2004). *What are the Trade-Offs? Defined Benefit vs. Defined Contribution Systems*. Paper presented to the AARP / CEPS Forum. Retrieved March 30, 2004, from [http://www.actuary.org/pdf/pension/tradeoffs\\_march04.pdf](http://www.actuary.org/pdf/pension/tradeoffs_march04.pdf).

plans."<sup>87</sup> Employers are choosing 401(k) type plans over DB plans for several reasons, including ease of plan administration, lower cost, and most importantly, a shift in the locus of risk.

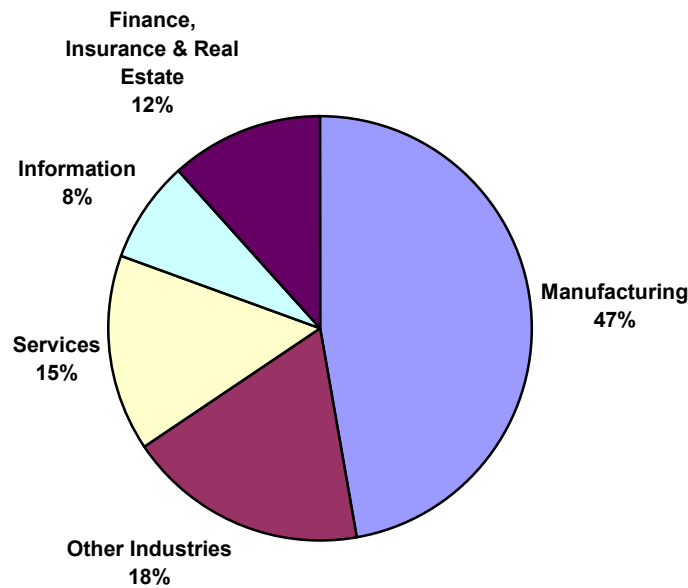


Figure 8. DB Plans By Industry [After Ref. 49]

An employer chooses to offer a retirement plan in order to attract employees and retain a quality workforce. Employers therefore are subject to market demand for their employees. As the American workforce becomes increasingly fiscally aware, employers must respond with plans that meet the needs of the ever-changing workforce. Today, the perceived value of 401(k) plans is higher than that of traditional DB plans, because the current demand is for transparent, portable plans, offering employer-matched funds, lump sum distributions, and early vesting characteristics. With the rapid growth in DC plans, it is evident that the DB system is not evolving quickly enough, and is not attractive to today's workforce. In order to remain competitive, employers must remain flexible, and

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<sup>87</sup> Employee Benefit Research Institute. (2002, September). *An Evolving Pension System: Trends in Defined Benefit and Defined Contribution Plans* (Issue Brief No. 249) (David Rajnes). Available from Employee Benefit Research Institute <http://www.ebri.org/store/ebriib.htm>. 15.

either alter current DB plans to mimic DC plans, or offer DC plans. Until DB plans offer the characteristics the workforce desires, they risk becoming less attractive to potential new workers and their numbers will continue to decline.

#### **D. CORPORATE AMERICA'S FRUSTRATION WITH THE SYSTEM**

Corporate America is frustrated with the DB pension plan system, as evidenced by the departure of companies from the system since the late 1980s (see Figure 9). The most significant decline has been in small employer plans, many attributing their departure to a system that is too complicated and costly. Small employers are therefore shifting to more easily managed DC plans. Since private DB pensions are voluntary, complicated rules and narrowly focused regulations discourage companies from participation. Government micromanagement of the system, or the appearance thereof, further undermines company support for the DB approach to pension planning.

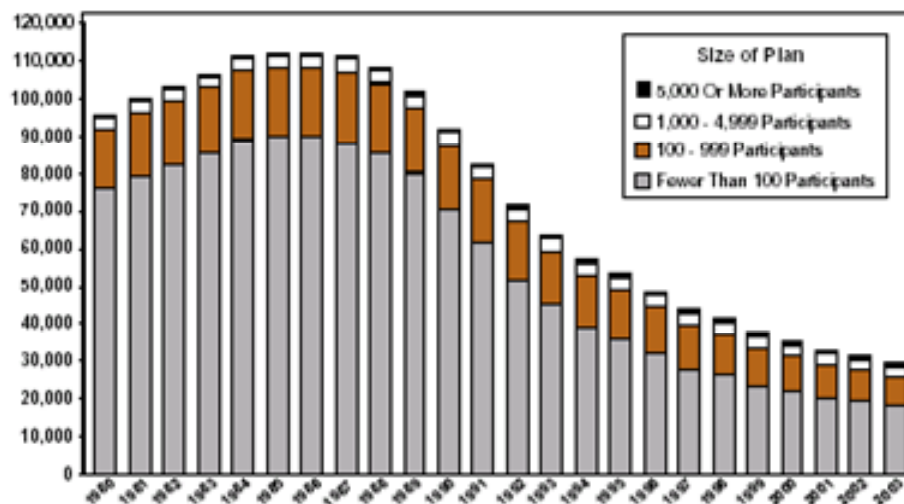


Figure 9. PBGC Insured Plans (1980-2003) Single-Employer Program [From Ref. 49]

A bull market, to some degree, is also a source of corporate frustration. Such markets free DB plan sponsors from devoting a considerable amount of time (scrutiny) and assets to their plans, as pension trust funds experience positive returns. The economic boom in the mid-to-late 1990s is a prime example. If employers contribute to

their plans above the maximum limit, funding rules will penalize employers in the form of a 10 percent excise tax applied to contributions over the limit. Therefore, while assets performed well, instead of funding pension plans near the maximum level, employers only contributed enough to meet the minimum required funding levels. That way they were not in danger of penalties if positive market performance placed their plan in an overfunded status. Thus, many employers experienced "contribution holidays." A contribution holiday refers to the period of time in which the plan is funded above 90 percent of current liability. In some cases, employers did not contribute to their plans for several years. Some of these same employers experiencing significant financial difficulties in 2004 are faced with plan terminations. If employers had been able to fund beyond maximum limits (which varied from 105 to 120 percent of current liability during this period) they would in essence have prevented much of the funding pressure they are now experiencing.

During this same period (late 1990s), Congress and the federal agencies put into place multiple changes affecting the system. But because assets were performing well, many employers did not pay close attention to the nuances of the legislation and new regulations. It was not until 2001, when sponsors began to feel the effects of poor asset performance in the stock market and falling interest rates, that more attention was devoted to pension funding and accounting rules.

The Enron debacle created an air of distrust for corporate America, resulting in increased scrutiny of public corporation financial performance. Together with the economic downturn, these two events have generated a multitude of proposals to improve and prolong the life of the DB plan system. The Financial Accounting Standards Board (FASB), the Treasury Department (which includes the IRS), the PBGC, and Congress have all proposed changes to strengthen and protect the system. Many in corporate America believe that the increased scrutiny and new rules are creating an increasingly complex regulatory environment, which is encouraging employers to shift to the more easily managed DC system.

Corporate America is in favor of changes to the system, but the preponderance of proposed changes will, in their view, only exacerbate frustrations already felt by

employers. Many believe that now is not the time for drastic changes to improve the system. The combination of a poor performing equities market and historically low interest rates is unusual. Implementing significant changes now may produce negative results when the system as a whole normalizes. Changes, many believe, should only ease constraints on the system, improving funding and accounting rules to enable the continued existence of plans and employers during periods when the economy is performing poorly.

Probably the greatest source of frustration felt amongst employers lies in the use of an obsolete interest rate for pension calculations. The combined effects of poor equity performance and falling interest rates placed many employers in a crisis over the last several years. In 2001, the Treasury Department ceased offering 30-year bonds, and subsequently the 30-year Treasury bond rate began to fall. Until recently, employers were required to use the 30-year Treasury rate for all DB plan liability and lump sum calculations. With the 30-year Treasury rate well below that of the market, plan sponsors are opposed to the use of the obsolete rate. Since pension liabilities are calculated by taking the present value of future benefits, the lower the interest rate (discount rate), the larger the liability, thus requiring sponsors to contribute additional assets to plans in order to meet funding requirements. Use of the obsolete Treasury rate, according to industry, is costing them billions of dollars.<sup>88</sup>

Congress responded in 2002 and 2004 by providing employers with a temporary fix, enabling the use of a higher rate for present value calculations. But in both cases, the temporary rate is not applicable to all calculations, requiring the continued use of the obsolete rate. Further, the legislation is not permanent, expiring in 2006. From corporate America's perspective, the short-term fix, though helpful, has not solved all their problems, and a temporary fix prevents long-term planning, introducing volatility to the system.

Some believe only minor changes are needed to improve the system. As of the spring of 2004, the economy has experienced three quarters of economic expansion. As

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<sup>88</sup> *Discount Rate Issues, testimony Before the Working Group on Defined Benefit Plan Funding and Discount Rate Issues, The ERISA Advisory Council, U.S. Department of Labor* (2003, June 26) (Kenneth Steiner, Actuary, Watson Wyatt Worldwide,). Retrieved May 28, 2004, from <http://www.abcstaff.net/documents/steinertestimony.pdf>.

the stock market improves and interest rates rise, many of the problems seen over the last several years will normalize. Making changes now, when the system is attempting to recover from unusual pressure, may exacerbate the complexity and volatility of the system. Many believe that now is not the time to make significant changes to the system.

## **E. PROBLEMS WITH CURRENT DB PLAN STRUCTURE**

### **1. Accounting Rules**

#### ***a. Transparency***

The Bush Administration and the FASB have both proposed changes to accounting rules, in order to improve DB plan transparency. Both agree that plan participants do not receive sufficient plan financial performance information.<sup>89</sup> Those in favor of increased transparency believe that increasing public information will enable the participant to become better aware of plan funding problems earlier in their existence. There is a belief that increased awareness provides employers with an incentive to better fund financially weak plans, and solves a principal-agent problem that currently exists. Additionally, increased public information will enable employees to make better retirement, and perhaps future employment decisions, as well as prepare for impending terminations prior to instead of after the fact.

#### ***b. Current vs. Termination Liabilities***

Current law requires plan sponsors to include current liability calculations as part of the financial performance data provided to participants. Both the FASB and the Bush Administration believe employers should also provide their employees with termination liability calculations. Termination liability, many believe, is a better measure of the risks associated with plan terminations, because it accounts for "shutdown benefits" as well as "other costs" that current liability does not. These "other costs" include lump sum distribution payments, and a prediction of early and normal retirement costs. Historically speaking, when faced with a plan termination, a greater number of employees choose the option to retire early or choose the option for a lump sum benefit

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<sup>89</sup> *The Administration's Activities to Improve the Retirement Security of Defined Benefit Pension Participants: Hearing before the Senate's Special Committee on Aging, U.S. Senate*, 108<sup>th</sup> Cong., (2003, October 14) (Mark J. Warshawsky, Acting Assistant Secretary for Economic Policy, U.S. Department of the Treasury, U.S. Treasury Press Report No. JS-919). Retrieved May 20, 2004, from <http://www.U.S.treas.gov/press/releases/js919.htm>.

distribution, if available. These two options, which are not normally included in current liability calculations, require additional assets, and place an increased strain on the plan, therefore increasing plan liability.<sup>90</sup>

## 2. Funding Rules

### a. Interest Rate

The Treasury Department started to retire federal debt in 1998 through a buyback program repurchasing 30-year Treasury bonds. In October 2001, the Treasury Department ceased issuing 30 year-bonds. The yields on the 30-year bonds had already been dropping, and have continued to drop (see Figure 10). With the decrease in the supply of government-backed bonds, the interest rate on 30-year Treasury bonds has dropped below the long-term bond market, and as of the spring of 2004 was at a 50-year low.<sup>91</sup>

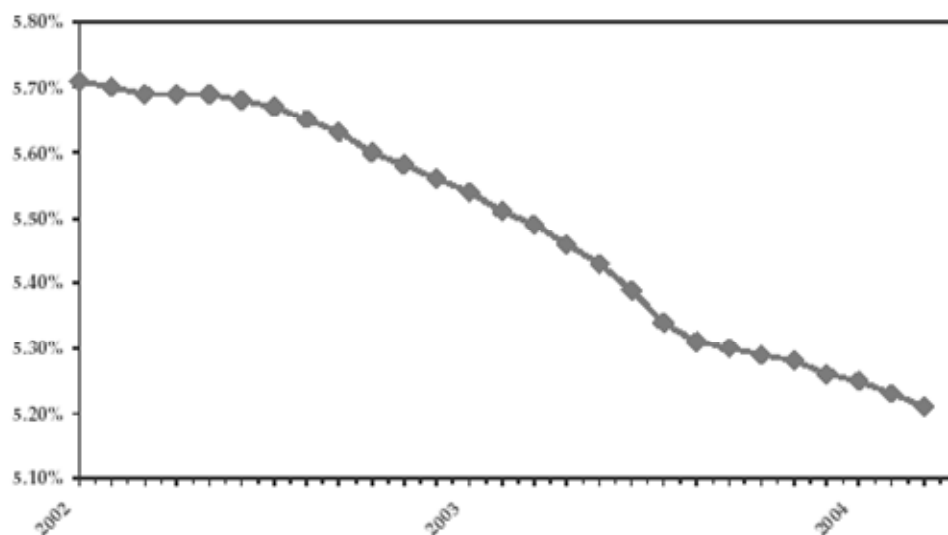


Figure 10. Weighed Average, 30-Year Treasury Bond Interest Rate, 2002-2004  
[From Ref. 4]

<sup>90</sup> Hearing before the Committee on Education and the Workforce, U.S. House of Representatives, 108<sup>th</sup> Cong., (2003, October 29) (Mark J. Iwry). Retrieved March 24, 2004, from <http://www.brookings.edu/dybdocroot/views/testimony/iwry/20031029.pdf>.

<sup>91</sup> American Benefits Council. (2004, May). *Pensions at the Precipice: The Multiple Threats Facing Our Nation's Defined Benefit Pension System*. Retrieved May 28, 2004, from [http://www.abcstaff.net/documents/definedbenefits\\_paper.pdf](http://www.abcstaff.net/documents/definedbenefits_paper.pdf). 14.

Pension funding calculations require the use of interest rates to identify plan contributions (current liability), lump sum benefit distributions, and variable rate premium payments to the PBGC. During recessions, the resulting lower interest rates generally cause higher liability, requiring increased funding requirements; and, during periods of economic expansion, rising interest rates reduce funding requirements due to reduced liabilities.<sup>92</sup> Using an interest rate that is below the market rate for calculations causes pension liabilities to be artificially high, forcing employers to contribute additional assets to their pension plans. Underfunded plans pay inflated variable rate premiums to the PBGC.

To illustrate, research conducted by the American Benefits Council concluded that contributions by Fortune 1000 companies to DB plans between 1999 and 2001 averaged \$13.7 billion. In 2002, contributions made by these same corporations totaled \$43.5 billion, and contributions in 2003 and 2004 (assuming the use of the 30-year Treasury rate) are expected to total more than \$160 billion.<sup>93</sup> In May 2004, the American Benefits Council published a subsequent report, again highlighting the negative affects of the "obsolete" 30-year rate by illustrating the monumental difference between the size of quarterly pension contributions using the 30-year Treasury and corporate bond rates. A company expecting to use the 30-year Treasury rate calculated a quarterly contribution of \$7.1 million. Upon recalculation using the corporate bond rate this same contribution equaled \$200,000.<sup>94</sup>

In 2002, Congress enacted the Job Creation and Workers Assistance Act of 2002, which included a temporary measure permitting sponsors to use an interest rate up to 120 percent of the 30-year Treasury rate for pension liability calculations.<sup>95</sup>

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<sup>92</sup> Bridgewater Associates. (2004, March 9). *Pension Fund Missiles Project: Source of Yield Data*. In Committee on Investment of Employee Benefit Assets (2004, March), *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*. Retrieved March 27, 2004 from, [www.AFPonline.org](http://www.AFPonline.org). Appendix E.

<sup>93</sup> *Discount Rate Issues, testimony Before the Working Group on Defined Benefit Plan Funding and Discount Rate Issues, The ERISA Advisory Council, U.S. Department of Labor* (2003, June 26) (Kenneth Steiner, Actuary, Watson Wyatt Worldwide,). Retrieved May 28, 2004, from <http://www.abcstaff.net/documents/steinertestimony.pdf>.

<sup>94</sup> American Benefits Council. (2004, May). *Pensions at the Precipice: The Multiple Threats Facing Our Nation's Defined Benefit Pension System*. Retrieved May 28, 2004, from [http://www.abcstaff.net/documents/definedbenefits\\_paper.pdf](http://www.abcstaff.net/documents/definedbenefits_paper.pdf). 15.

<sup>95</sup> Job Creation and Worker Assistance Act of 2002, Public Law 107-147. Section 405.

Congress noted that the 30-year Treasury rate was obsolete and that the interest rate used in pension funding calculations should match the market rate. Even the Treasury Department concluded that use of the Treasury bond rate produced inaccurate measurements of pension liabilities.<sup>96</sup> The legislative fix was temporary however, and expired in 2003.

The Pension Funding Equity Act of 2004, the second temporary measure taken by Congress to fix the interest rate problem, extends the use of the corporate bond rate for an additional two years, but does not address the requirement to use the 30-year Treasury rate for lump sum benefit calculations. Many sponsors within the DB plan system are eager to see permanent legislation enacted that will enable long term planning. Legislation in the form of the National Employee Security Trust and Equity Guarantee Act (NESTEG) is being considered by Congress in 2004, and if passed will provide the permanent interest rate adjustment that many in corporate America are seeking.

***b. Lump Sum Distributions***

Current law requires the use of the 30-year Treasury rate when calculating lump sum amounts to be paid by DB plans to vested participants. As mentioned above, the Pension Funding Equity Act replaced the 30-year Treasury rate for liability calculations; it did not, however, replace the 30-year rate for lump sum calculations. When used, the 30-year Treasury rate artificially inflates the lump sum payment (as mentioned above), requiring the employer to pay an amount that is larger than a lifetime annuity of the same economic value. The difference in amounts is due to the use of two separate interest rates for benefit calculations. The use of the Treasury rate has created an incentive for employees to opt for the lump sum. Corporate America is concerned that the continued requirement for the use of the 30-year Treasury rate for lump sum

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<sup>96</sup> *Pension Funding and Its Impact on the Pension Benefit Guaranty Corporation (PBGC): Hearings before the Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate, 108<sup>th</sup> Cong., (2003, September 15) (Testimony of Kathy Cissna, Director of Retirement Plans, R.J. Reynolds, on behalf of the American Benefits Council). Retrieved May 28, 2004, from <http://www.abcstaff.net>.*

calculations will force employers to overpay retirees and provide a perverse incentive for participants to opt for the lump sum (if offered) over the lifetime annuity until a legislative fix is signed into law.<sup>97</sup>

**c. *Maximum Funding Limits***

The IRC identifies a maximum limit affecting employer contributions to a pension plan that affects the tax treatment of the contribution. Contributions beyond this limit are not tax deductible and are subject to a 10 percent excise tax. Corporate America is lobbying for an increase in the maximum limit. Many believe that current funding rules have prevented employers from protecting themselves from a situation very much like the one they experienced from 2000 to 2002 (low interest rates, poor stock market performance, stagnant economy). By increasing the maximum funding limit, Congress would allow employers to overfund plans during periods of economic growth, protecting the employer and their plans from future economic downturns or poor investment performance. Overfunding, simply put, allows a sponsor to "save for a rainy day."

**d. *Funding Credit***

According to current law, if an employer contributes more than the minimum required contribution, the excess accumulates as a credit, which may be applied towards future contributions. The Bush Administration and the PBGC believe this rule has created significant problems within the DB plan system. In the PBGC's 2003 annual report, two examples are given of recent terminations that illustrate the failure of this rule. In both cases (United Airlines and Bethlehem Steel), neither firm had paid into their funding accounts for several years prior to termination. Funding credits permitted "contribution holidays." The problem with the current funding rules, according to the PBGC, stems from how the credits are determined and how often they are reviewed. Since credit determination is merely an accounting procedure, it fails to adjust itself to the rise and fall of asset value. The rule exempts sponsors in some cases from contributing to plans for multiple accounting periods regardless of the fair market value of assets held, due to a prior period qualification.<sup>98</sup>

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<sup>97</sup> American Benefits Council. (2004, May). *Pensions at the Precipice: The Multiple Threats Facing Our Nation's Defined Benefit Pension System*. Retrieved May 28, 2004, from [http://www.abcstaff.net/documents/definedbenefits\\_paper.pdf](http://www.abcstaff.net/documents/definedbenefits_paper.pdf). 14-15.

<sup>98</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 24, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 6.

*e. Moral Hazard*

Employers are able to adjust the amount of benefits their plan offers to employees. Employers commonly increase employee benefits instead of increasing pay. Employers prefer benefit increases instead of pay raises because the increase does not affect short-term expenditures; instead, the employer is able to defer the cost to some future period. This type of behavior by financially weak companies creates a moral hazard, i.e., it encourages benefit increases regardless of plan financial status, enabling sponsors of financially unstable plans to increase employee benefits, knowing that the PBGC insures all plans against loss due to termination or financial insolvency.

This behavior affects not only plan participants but also other employers in the system. Employers with financially healthy plans end up subsidizing the weak because all participants pay a flat premium (regardless of plan funding status) to the PBGC. During periods of poor stock market performance, applying pressure on all participants, there is an increased likelihood of the financially healthy employers exiting the system if premiums are raised. The system depends on premium payments because operations are not financed by tax-dollars; if the financially healthy plans depart the system, the future of the PBGC as well as the system will be put at risk. The challenge then, is to determine a systematic way of identifying and preventing employers with financially unstable plans from increasing benefits offered until they can improve their plan's financial standing.<sup>99</sup>

**F. PBGC INSURANCE PROGRAM CHALLENGES**

**1. Not in a Crisis**

On page 1 of PBGC's 2003 Annual Report, Labor Secretary Elaine Chao clearly stated that the PBGC "is not in a crisis." However, she did not avoid the fact that the PBGC is facing challenges: "it is clear that the financial integrity of the federal pension insurance system is at risk."<sup>100</sup> Several weeks prior, PBGC's Executive Director testified

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<sup>99</sup> *Hearing before the Governmental Affairs Committee Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate*, 108<sup>th</sup> Cong. (2003, September 15) (Steven Kandarian, Executive Director, Pension Benefit Guaranty Corporation). Retrieved May 20, 2004, from [http://www.pbgc.gov/news/speeches/testimony\\_091503.htm](http://www.pbgc.gov/news/speeches/testimony_091503.htm).

<sup>100</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 24, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 1.

before Congress, stating that if the problems facing the pension system were not corrected, the taxpayer could ultimately be required to "bailout" the PBGC.<sup>101</sup> In early 2004, Barbara Bovbjerg, Director of the GAO's Education, Workforce, and Income Security Issues committee, went on record before Congress stating that "a number of factors pose challenges to the long-term prospects of the multiemployer pension plan system."<sup>102</sup> Each of these officials is acknowledging that the PBGC faces multiple challenges.

## **2. The Single-Employer Program**

### **a. Deficit**

The PBGC's single-employer program reported an accumulated deficit for the third straight year in 2003, reaching \$11.2 billion, an increase from the year previous, and more than five times larger than any previous one-year loss in its history.<sup>103</sup> This was also a significant swing from 2000, when the federal corporation reported an accumulated surplus of \$9.7 billion.<sup>104</sup> The GAO, concerned with the PBGC's financial performance and its future, placed the single-employer program in its "high risk" category, a means of placing increased federal attention on the program.

However, the PBGC claims that they are not experiencing a financial crisis and believe their assets (\$35 billion) will last well into the future (the year 2019).<sup>105</sup> Challenges facing the PBGC are somewhat beyond their control, however. When an underfunded pension plan terminates, it potentially affects three groups: participants may

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<sup>101</sup> *Hearing before the Governmental Affairs Committee Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate, 108<sup>th</sup> Cong.* (2003, September 15) (Steven Kandarian, Executive Director, Pension Benefit Guaranty Corporation). Retrieved May 20, 2004, from [http://www.pbgc.gov/news/speeches/testimony\\_091503.htm](http://www.pbgc.gov/news/speeches/testimony_091503.htm).

<sup>102</sup> *Private Pensions: Multiemployer Pensions Face Key Challenges to their Long-Term Prospects, hearing before the Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce, U.S. House of Representatives, 108<sup>th</sup> Cong.,* (2004, March 18) (Barbara D. Bovbjerg, Director, Education Workforce, and Income Security Measures, GAO). Retrieved March 24, 2004, from <http://www.gao.gov/>.

<sup>103</sup> *Hearing before the Governmental Affairs Committee Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate, 108<sup>th</sup> Cong.* (2003, September 15) (Steven Kandarian, Executive Director, Pension Benefit Guaranty Corporation). Retrieved May 20, 2004, from [http://www.pbgc.gov/news/speeches/testimony\\_091503.htm](http://www.pbgc.gov/news/speeches/testimony_091503.htm).

<sup>104</sup> Pension Benefit Guaranty Corporation. (2001). *2000 Annual Report*. Retrieved March 24, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 1.

<sup>105</sup> General Accounting Office. (2003, October). *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks* (Report No. GAO-04-90). Retrieved March 24, 2004 from <http://www.gao.gov/new.items/d0490.pdf>. 15.

see their benefits reduced, other businesses may see their pension premiums go up, and worst case, Congress may call on taxpayers to support the PBGC, and "bailout" the pension system.<sup>106</sup> The PBGC's assets may be sufficient to cover its current annual expenditures (distributions to trustee participants), but if the economic situation worsens, causing additional terminations similar to the size and scope of Bethlehem Steel's termination (\$3.6 billion, 95,000 participants<sup>107</sup>); the PBGC may not have sufficient assets to cover even current liability payments. The Bush Administration, as well as other agencies within the federal government, have directed a significant amount of attention towards the PBGC's single-employer program in order to improve and ensure its future. Without the backing of tax dollars, the PBGC relies on the private DB system in part to fund its operations and pay benefits to trustee plan participants. As the number of terminated plans increases, and as the number of large plans terminating continues to increase, it places an ever-increasing financial burden on the PBGC.

During 2002-2003, the single-employer program saw three of its largest terminations to date. All three were from the steel industry, placing an enormous burden on the program - approximately \$6.7 billion dollars, accounting for more than 38 percent of claims to date (see Table 2). Since 2000, 334 plans have terminated, creating the largest financial draw (\$10.7 billion) on the program in a three-year period to date.<sup>108</sup> This is evidence of the fact that current challenges, however temporary, are an enormous strain on the private plan system.

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<sup>106</sup> *Hearing before the Governmental Affairs Committee Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate*, 108<sup>th</sup> Cong. (2003, September 15) (Steven Kandarian, Executive Director, Pension Benefit Guaranty Corporation). Retrieved May 20, 2004, from [http://www.pbgc.gov/news/speeches/testimony\\_091503.htm](http://www.pbgc.gov/news/speeches/testimony_091503.htm).

<sup>107</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 24, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 2.

<sup>108</sup> Pension Benefit Guaranty Corporation. (2004, Spring). *Pension Insurance Data Book 2003*. Retrieved June 01, 2004, from <http://www.pbgc.gov/publications/databook/databook03.pdf>. Table S-3.

| <i>Firm</i>     | <i>Fiscal Year of<br/>Plan<br/>Termination</i> | <i>Claim</i>    | <i>Vested<br/>Participants</i> | <i>Percent<br/>of Total<br/>Claims<br/>on PBGC</i> |
|-----------------|------------------------------------------------|-----------------|--------------------------------|----------------------------------------------------|
| Bethlehem Steel | 2003                                           | \$3,650,276,601 | 97,015                         | 20.8%                                              |
| LTV Steel       | 2002                                           | \$1,849,498,808 | 78,732                         | 10.5%                                              |
| National Steel  | 2003                                           | \$1,216,107,871 | 35,404                         | 6.9%                                               |

Table 2. Top 3 Firms Presenting Claims (1975-2003) [After Ref. 49]

When the economy takes a downturn, there has historically been an increase in the number of terminations, as one would expect. The private pension plan system and the PBGC have seen similar challenges in the past. In 1990, for instance, the GAO considered the PBGC's single-employer program high-risk due to its financial performance, placing it on its high-risk list where it remained a concern until its removal in 1995.<sup>109</sup> During this same period, the GAO reported that the PBGC's deficit was large and growing, threatening its "long-term financial viability." At the end of fiscal year 1991, the single-employer program reported a \$2.3 billion shortfall, its largest deficit since inception, primarily due to two large terminations (Eastern Airlines, \$552 million, and Pan American Airlines, \$841 million). Of note, in 1992, the PBGC deficit had been growing since its inception in 1974.<sup>110</sup>

Some have likened the PBGC deficit "crisis" to that of the Savings and Loan (S&L) crisis in the 1980s. As the American Benefits Council points out, there are significant differences, however.<sup>111</sup> Individual account holders during the S&L crisis had the right to demand their account balances at any time from their financial institution.

<sup>109</sup> General Accounting Office. (2003, October). *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks* (Report No. GAO-04-90). Retrieved March 24, 2004, from <http://www.gao.gov/new.items/d0490.pdf>. 7.

<sup>110</sup> General Accounting Office. (1993). *High-Risk Series: Pension Benefit Guaranty Corporation* (Report No. GAO/HR-93-5). Retrieved March 24, 2004, from <http://www.gao.gov>. 6., and Pension Benefit Guaranty Corporation. (2004, Spring). *Pension Insurance Data Book 2003*. Retrieved June 01, 2004, from <http://www.pbgc.gov/publications/databook/databook03.pdf>. Table S-5.

<sup>111</sup> *Pension Funding and Its Impact on the Pension Benefit Guaranty Corporation (PBGC): Hearings before the Governmental Affairs Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate, 108<sup>th</sup> Cong.,* (2003, September 15) (Testimony of Kathy Cissna, Director of Retirement Plans, R.J. Reynolds, on behalf of the American Benefits Council). Retrieved May 28, 2004, from <http://www.abcstaff.net>.

In the case of the PBGC, a participant is unable to demand the full amount at any time. When the threat of financial loss became imminent during the S&L crisis, many customers withdrew, or attempted to withdraw their account balances. This in turn caused an increased financial demand on the S&L system, forcing the federal government to step in and provide federal funds in order to meet demand. In the case of the PBGC, there will never be a time when all benefits become due at once, because the system is designed to distribute retirement benefits over a long period. True, recipients can opt for lump sum distributions, but those plans offering lump sums represent only a small percentage of the benefits guaranteed by the PBGC.

***b. Premium Payment and Risk Determination***

As previously mentioned, the Executive Director of the PBGC believes there is cause for concern. In testimony before Congress he stated that a good indicator of trouble is the fact that premium income is not increasing from year to year; rather, it has been in a decline since 1996 (at the time of his testimony there was not sufficient data to determine statistics for 2003) (see Figure 11).<sup>112</sup> There was a rise in variable rate premiums in 2003, however. If the trend of decreasing premiums continues, it could lead to a situation where the PBGC must raise premium payments. The PBGC relies on invested assets and premium payments in order to pay trustee participants relying on the PBGC for their retirement income. If the decline in premium income continues, and if PBGC liabilities increase further, premium payments ultimately will go up. The PBGC is reluctant to raise premiums because they risk losing program participants. A growing number of employers are already voluntarily terminating their plans and exiting the system, offering instead, the more easily managed and less expensive DC plans. The PBGC is understandably reluctant to raise premiums, for fear they may be left with significantly fewer participating employers and an increased financial burden. Ultimately, if the burden becomes too great, the PBGC will call on the federal government (the taxpayer) to ease the burden.

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<sup>112</sup> *Hearing before the Governmental Affairs Committee Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate, 108<sup>th</sup> Cong. (2003, September 15) (Steven Kandarian, Executive Director, Pension Benefit Guaranty Corporation). Retrieved May 20, 2004, from [http://www.pbgc.gov/news/speeches/testimony\\_091503.htm](http://www.pbgc.gov/news/speeches/testimony_091503.htm).*

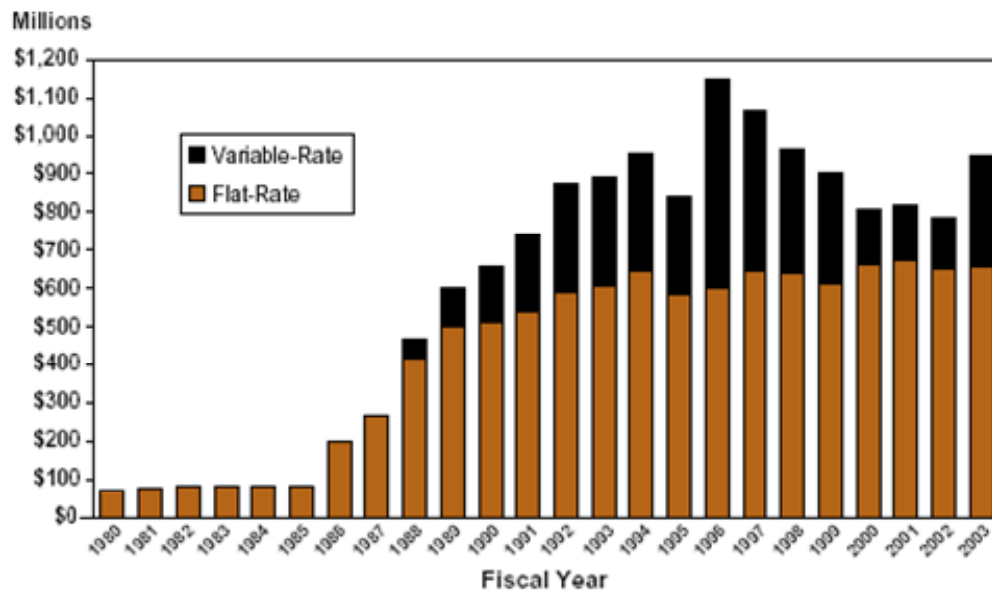


Figure 11. PBGC Premium Revenue (1980-2003) Single-Employer Program [From Ref. 49]

When premiums rise, those who sponsor healthy plans are penalized for the under performance of others (moral hazard). Instead of taxing all to support the few, the challenge is to develop a better method of identifying weaker plans, and forcing terminations earlier while sponsors still have the means to support a termination. Current law, which requires taxing a plan that is already underfunded and will most likely terminate in the near future, sounds illogical. Therefore, the challenge facing the PBGC is to better determine a means of identifying the plans that are at risk earlier in the life of the plans and reduce its deficit without raising premiums – if that is possible.

## 2. The Multiemployer Program

Many of the factors affecting multiemployer plans over the last several years are similar to those challenging single-employer plans: historically low interest rates, poor stock market performance, and a stagnant economy; a growing number of employers choosing to offer DC plans over DB; and the growing life expectancy of Americans

resulting in increased pension benefit costs.<sup>113</sup> There are however, several challenges to multiemployer plans different from those pressuring the single-employer system.

The PBGC operates the single-employer and multiemployer programs separately, each having separate insurance funds, different insurance coverage rules, and different participant guarantees. Generally, employer contributions to multiemployer plans are based on a set dollar amount per hour of covered work per active plan participant.<sup>114</sup> Faced with poor market conditions over the last several years, many employers have cut back on employment, thereby lowering contributions, which in turn has lowered plan funding. This is expected during an economic downturn, but the system has been further challenged with a decrease in the number of active participants, while at the same time experiencing an increase in the number of retirees from 1.4 to 2.8 million since 1980.<sup>115</sup> A similar trend is evident in the single-employer program, but the challenge to the multiemployer program is more pronounced, because employer contributions are tied to active employment numbers.

As of 2003-year end, the PBGC multiemployer plan system had an accumulated deficit of \$261 million, its first since 1981, which is nearly five times larger than its 2000 deficit.<sup>116</sup> Further, the program was underfunded by \$100 million at the end of 2003. These numbers represent a far less daunting financial burden than those facing the single-employer plan program, but the challenges facing the multiemployer program may prove more significant.

In 1980, there were 2,244 plans, but by 2003, the number had fallen to 1,623, a decline of 27 percent.<sup>117</sup> The multiemployer program covered 4.7 million active participants in 1980, representing about one-fifth of all active benefit plan participants. This number has since dropped to 3.3 million, covering only 4.1 percent of the workforce

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<sup>113</sup> *Private Pensions: Multiemployer Pensions Face Key Challenges to their Long-Term Prospects, hearing before the Subcommittee on Employer-Employee Relations, Committee on Education and the Workforce, U.S. House of Representatives, 108<sup>th</sup> Cong., (2004, March 18) (Barbara D. Bovbjerg, Director, Education Workforce, and Income Security Measures, GAO). Retrieved March 24, 2004, from <http://www.gao.gov/>.*

<sup>114</sup> Ibid.

<sup>115</sup> Ibid.

<sup>116</sup> Ibid

<sup>117</sup> Ibid.

as of 2001 (latest available numbers).<sup>118</sup> Further, in the last eleven years there have only been five new plans introduced to the system.

Multiemployer plans are tied to collective bargaining agreements, which means the future of the program may depend on the future existence of the labor union. In 1980, 19 percent of the national workforce belonged to unions, where today that number is less than nine percent.<sup>119</sup>

As union membership declines, the number of retirees and plan operating costs increase, and the number of multiemployer plans decrease, the future of the multiemployer plan program is increasingly challenged.

The DB pension plan system experienced multiple challenges over the last several years. These challenges included the increased cost of retirees spending longer in retirement, employers exiting the DB plan system, the use of an obsolete interest rate for pension liability calculations, complex administrative rules, system abuses by financially weak participants, and several unusually large plan terminations, were exacerbated by interest rates at a 50-year low, equities in the stock market performing poorly, and an economic downturn. Consequently, a considerable strain has been put on the PBGC, increasing its combined deficit to \$11.49 billion by the end of 2003. A number of proposed reforms have emerged to preserve and prolong the life of the DB plan system.

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<sup>118</sup> Ibid.

<sup>119</sup> Ibid.

## V. POLICY SOLUTIONS

### A. ADMINISTRATION PROPOSALS

In July 2003, the Treasury Department released "The Administration's Proposal to Improve the Accuracy and Transparency of Pension Information," proposing three measures of reform. These were: (1) to improve the accuracy of the pension liability discount rate; (2) to increase the transparency of pension plan information; and (3) to strengthen safeguards against pension underfunding.<sup>120</sup> The President addressed these proposals as follows in his fiscal year 2005 budget:

Give employers two years of relief from current pension plan contribution requirements – now tied to 30-year Treasury bond interest rates – and base requirements on more appropriate corporate bond rates.

After the two-year transition period, base pension funding requirements on a "yield curve" (commonly used in corporate finance), which would better tie funding requirements to the timing of the payout of retiree benefits.

Make additional changes to restrict promises of added benefits by severely underfunded plans and to provide better information on pension finances to workers, retirees and stockholders.<sup>121</sup>

#### 1. Improving Pension Discount Rate

In testimony before Congress, Acting Assistant Secretary of the Treasury for Economic Policy Mark Warshawsky highlighted the fact that the first step in pension reform is to address liability measurement. Warshawsky conceded that the 30-year Treasury rate is no longer accurate and therefore believed it was "imperative" to promptly enact its replacement.<sup>122</sup> He provided three reasons why an accurate interest rate is vital to pension calculations: (1) it fosters accurate determination of contribution payments,

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<sup>120</sup> U.S. Department of the Treasury. (2003, July 8). *The Administration's Proposal to Improve the Accuracy and Transparency of Pension Information* (Press Release No. JS-529). Retrieved March 20, 2004, from <http://www.treas.gov/press/releases/js529.htm>.

<sup>121</sup> President of the United States of America. (2004). *Analytical Perspectives: Budget of the United States Government Fiscal Year 2005*. Retrieved March 20, 2004, from <http://www.whitehouse.gov/omb/budget/fy2005/pdf/spec.pdf>. 94.

<sup>122</sup> *The Administration's Activities to Improve the Retirement Security of Defined Benefit Pension Participants: Hearing before the Senate's Special Committee on Aging, U.S. Senate*, 108<sup>th</sup> Cong., (2003, October 14) (Mark J. Warshawsky, Acting Assistant Secretary for Economic Policy, U.S. Department of the Treasury, U.S. Treasury Press Report No. JS-919). Retrieved May 20, 2004, from <http://www.U.S.treas.gov/press/releases/js919.htm>.

enabling sponsors to earmark the correct amount of funds in order to meet minimum funding rules and target goals; (2) it enables investors to have a better understanding of the amount of future earnings that will be dedicated to plan funding; and (3) it ensures participants have the correct financial information regarding the health of their retirement plan.

***a. Liability Calculations Based on Corporate Rates***

Because pensions are not bought and sold on the open market, Warshawsky noted, the interest rate used should be aligned with that used on a similar financial obligation.<sup>123</sup> The Administration argued that the interest rate used in pension liability calculations should be modeled after group annuity contract payments rates, since these contracts perform much like pensions. The Bush Administration proposes the use of an interest rate which is based on corporate high-quality investment grade bonds (AAA/AA). The use of an interest rate associated with "safe," high-quality bonds will ensure interest rate calculations are consistent with market-to-market performance, and support the sound investment criteria required.

***b. Unsmoothed Corporate Yield Curve***

The Administration also proposes a change to current funding rules to adopt the use of a corporate yield curve instead of a single long-term interest rate for pension calculations. In financial markets, the interest rate earned on an investment or paid on a loan typically varies with term lengths; therefore, it is prudent to use the same approach when calculating pension liabilities. The use of an unsmoothed corporate yield curve, according to the Treasury Department, will enable employers to use different interest rates to calculate benefits and liabilities of participants in different stages of their career and life.

For example, an employer with a predominantly aging workforce does not benefit in using a 30-year rate to predict pension contributions, just as an employer with a predominantly younger workforce does not profit from using a 5-year rate for all calculations. Warshawsky illustrates this point further by giving a hypothetical example of a consumer who goes to a bank to borrow money in order to buy a house. The consumer will expect to pay a higher interest rate for a 30-year mortgage than for a 15-

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<sup>123</sup> Ibid.

year mortgage.<sup>124</sup> The Administration's proposal includes the use of interest rates based on zero coupon bonds, taken from a corporate yield curve, maturing on the same date as pension benefits become due.

The proposal phases in the use of the yield curve over five years. The first two years employers would use a static corporate rate, while in the third year beginning the use of the yield curve, with all plan sponsors using it by the fifth and final year.

***c. Elimination of Smoothing***

Current law permits the use of interest rate "smoothing," allowing sponsors to use an interest rate that is based on a corridor above and below the weighted average of the interest rate over several plan years.<sup>125</sup> Smoothing reduces the volatility of liability calculations and aids sponsors in making future contributions more predictable. The Administration believes that smoothing also reduces the accuracy of pension calculations by using a weighted average instead of the true interest rate. Therefore, the Administration proposes to phase out the use of smoothing over the same five-year period as the implementation of the yield curve.

***d. Interest Rate Use – Annuities and Lump Sums***

The Pension Funding Equity Act of 2004 did not change current law requiring the use of the obsolete 30-year Treasury rate for lump sum calculations. Using two different interest rates when calculating the present value of a lifetime annuity and a lump sum benefit of the same economic value over-inflates the lump sum amount, encouraging plan participants to choose lump sums over lifetime annuities (if offered). Additionally, the two rates cause a mismatch in plan funding. Funding rules require the use of the temporary corporate rate for contribution calculations while the rules also require the use of the 30-year Treasury rate when calculating lump sum distribution amounts. This results in greater than planned expenditures for plan sponsors. The Administration proposes the use of the yield curve to calculate lump sums and plan contributions. Use of a yield curve for lump sum calculations will be phased in over a five-year period.<sup>126</sup>

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<sup>124</sup> Ibid.

<sup>125</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. Section 1082(b)(5)(B)(ii)(I).

<sup>126</sup> Ibid.

## **2. Increased Transparency**

The Bush Administration believes that in many cases plan participants do not receive sufficient plan financial information. Additional information is intended to protect participants from loss. By making poor plan performance public earlier in the life of the plan, participants will be able to find out that their plan is in trouble before the plan is terminated. Increasing information in the manner described below, the Administration hopes, will foster better long-term career and retirement planning.

### ***a. Current Liability vs. Termination Liability***

The Administration proposes a change to DB plan accounting rules, by requiring employers to disclose both termination and current liability in annual financial reports. Termination liability includes all costs used to determine current liability, in addition to the costs associated with plan terminations. Termination liability tends to be higher than current liability, which the Administration believes is a more realistic account of the plan's financial health.

### ***b. Public Disclosure of Plan Underfunding***

Current law requires employers to notify the PBGC if plan underfunding reaches \$50 million or greater. This notification remains confidential. The Bush Administration proposes that plans this severely underfunded should be required to make public additional plan financial information. Public information would include the assets, liabilities, and funding ratios of the underfunded plan, but would not include any confidential employer financial information. This public notification satisfies two objectives: (1) it provides plan participants with information that will enable them to better plan for their future; and (2) it provides an incentive for employers to devote additional assets to their troubled plan.

### ***c. Duration-Matched Liability Disclosure***

The Bush Administration's proposal includes the requirement for employers to disclose annual plan liabilities based on the use of the proposed yield curve before the five-year phase-in is completed. This proposal allows participants and investors to have access to more accurate accounting of pension liabilities, which is intended to facilitate future planning.

### **3. Strengthen Pension Funding**

#### ***a. Restrict Benefit Increases***

In order to prevent employers who sponsor underfunded plans from increasing employee benefits, thus placing an increased financial strain on the firm, the plan, and the pension system (creating a moral hazard), the Administration proposes to restrict benefit increases to healthy plans. The proposal prevents employers with below investment grade credit ratings and a funding ratio of less than 50 percent of termination liability from increasing employee benefits. Plans meeting these criteria would have to freeze the plan, preventing additional benefit accruals and prohibiting lump sum payments unless the employer contributes cash or is fully able to fund these added benefits.

This proposal stems from plan termination research conducted by the PBGC. Their analysis discovered that in over half of plan terminations, 90 percent of companies whose plans were taken over by the PBGC had junk bond credit ratings for a ten-year period prior to termination.<sup>127</sup> This proposal aims to prevent employers from making pension promises they cannot keep.

## **B. 108<sup>TH</sup> CONGRESS - LEGISLATIVE RESPONSES**

### **1. Pension Funding Equity Act of 2004**

In the first session of the 108<sup>th</sup> Congress, Representative Boehner introduced H.R. 3108, The Pension Funding Equity Act, "To amend the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code of 1986 to temporarily replace the 30-year Treasury rate with a rate based on long-term corporate bonds for certain pension plan funding requirements and other provisions, and for other purposes."<sup>128</sup> Backed by the Bush Administration, H.R. 3108 provides extended interest rate relief to corporate America by amending current law to use a temporary interest rate, which would replace the obsolete 30-year Treasury rate until Congress decides upon a permanent replacement.

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<sup>127</sup> *Hearing before the Governmental Affairs Committee Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate*, 108<sup>th</sup> Cong. (2003, September 15) (Steven Kandarian, Executive Director, Pension Benefit Guaranty Corporation). Retrieved May 20, 2004, from [http://www.pbgc.gov/news/speeches/testimony\\_091503.htm](http://www.pbgc.gov/news/speeches/testimony_091503.htm).

<sup>128</sup> Pension Funding Equity Act of 2003. (2003). H.R. 3108 I.H., 108<sup>th</sup> Cong., (2003, September 17). Retrieved March 24, 2004, from <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:h.r.03108>.

H.R. 3108 also includes a provision that provides a finite number of companies financial relief for several years, known as the "alternative deficit reduction contribution" (also known as DRC relief). H.R. 3108 was signed into law in April 2004, just days before the first quarterly pension payment of 2004, allowing employers to pay substantially less in premium payments due to the higher rate.

**a. *Temporary Interest Rate Fix***

The Job Creation and Worker Assistance Act of 2002 amended pension funding rules for plan years beginning after December 31, 2001 and before January 1, 2004, in order to allow employers to use a higher interest rate for liability calculations. This legislation adjusted the permissible range (smoothing effect) used in determining the applicable interest rate from 90-105 percent to 90-120 percent of the 30-year Treasury bond rate over the previous four years.<sup>129</sup>

H.R. 3108 amends the above provision in several ways. First, it replaces the 30-year Treasury rate with an interest rate based on an index of high-quality corporate bond rates, chosen by the Treasury Department. Additionally, H.R. 3108 amended the permissible range for plan years beginning after December 31 2003 and before January 1 2006. The permissible range for these years is from 90 to 100 percent.<sup>130</sup>

**b. *Deficit Reduction Contribution Relief***

H.R. 3108 gives a limited number of firms with underfunded plans a two-year waiver from paying the full deficit reduction contribution (DRC). The DRC is required of firms when plans have not met the minimum funding rules (90 percent of current liability) for the previous two years.<sup>131</sup> Instead of paying the full DRC amount, H.R. 3108 reduces the amount required for commercial passenger airlines, those involved with the manufacturing of steel mill products or the processing of iron ore pellets, and a limited number of others who were not subject to the penalty in 2000. This provision will reduce the DRC to approximately 80 percent of the required amount, for a two-year period. The congressional intent is to alleviate the fiscal burden brought on by the economic downturn from 2000 to 2002.

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<sup>129</sup> Public Law 107-147. Section 405.

<sup>130</sup> Public Law 108-218. Section 101.

<sup>131</sup> Employee Retirement Income Security Act of 1974, 29 U.S.C. Section 1082(d).

Members of the Bush Administration, including the Secretaries of Treasury, Commerce and Labor, the Director of the Office of Management and Budget, the PBGC, and several members of Congress, were opposed to the DRC relief concept. The PBGC predicts that waiving required penalties will place an additional burden on the DB system. PBGC analysis estimates that the temporary waiver will alleviate high-risk companies from paying penalties of approximately \$40 billion over the two-year period. These same high-risk underfunded companies already represent approximately 17 percent of the \$350 billion in DB system underfunding. Those opposed to the DRC relief concept believe this provision simply pushes the risk of failure into the future.<sup>132</sup>

## **2. National Employee Security Trust Equity Guarantee Act**

In the second session of the 108<sup>th</sup> Congress, Senator Grassley introduced S. 2424 the National Employee Security Trust Equity Guarantee Act (NESTEG), "An original bill to amend the Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 to protect the retirement security of American workers by ensuring that pension assets are adequately diversified and by providing workers with adequate access to, and information about, their pension plans and for other purposes."<sup>133</sup> NESTEG adopted many of the Administration's proposals for DB pension reform, including the use of a corporate yield curve for liability and lump sum calculations, reducing benefit increases to severely underfunded plans, and an increase in the number of companies eligible for DRC relief.

In May of 2004, at the conclusion of committee markup, the Senate Finance Committee reported NESTEG favorably and without amendment. NESTEG is currently awaiting full Senate action.<sup>134</sup>

### **a. Interest Rate**

NESTEG extends use of the temporary rate described in H.R. 3108, a rate based on an index of high-quality corporate bonds, for an additional two years. This

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<sup>132</sup> *Hearing before the Committee on Education and the Workforce, U.S. House of Representatives, 108<sup>th</sup> Cong.*, (2003, October 29) (Mark J. Iwry). Retrieved March 24, 2004, from <http://www.brookings.edu/dybdocroot/views/testimony/iwry/20031029.pdf>.

<sup>133</sup> National Employee Savings and Trust Equity Guarantee Act, S. 2424 (Senate Finance Committee Report No. 108-266), U.S. S., 108<sup>th</sup> Cong., (2004, May 14). Retrieved May 15, 2004, from <http://thomas.loc.gov/cgi-bin/bdquery/z?d108:s.02424>.

<sup>134</sup> Ibid.

temporary measure, in line with the Administration's proposal, applies the temporary rate to all plans beginning after December 31, 2003 and before December 31, 2006. The temporary rate will be replaced by a corporate yield curve, which will be used in lump sum and liability calculations for select plans beginning after December 31, 2006. The provision phases in the use of the yield curve over a five-year period, requiring a 20 percent adoption rate over that period, completing the phase-in by December 31, 2010.<sup>135</sup>

***b. DRC Relief***

NESTEG increases the number of plans eligible for DRC relief. Instead of applying to a limited of companies, this provision will apply to all companies that were not required to make DRC payments during plan years between December 31, 1999 and January 1, 2001. Plans qualifying will not have to make the DRC payments for plan years beginning after December 31, 2003 and before December 31, 2006.<sup>136</sup>

***c. Restrict Benefit Increases***

Similar to the Administration's proposal, this provision applies to companies whose plans have junk bond ratings in any two of the previous five years and a funded liability (accrued vested benefits) of less than 50 percent. If a plan meets these two criteria it will be prohibited from benefit increases, it will have to freeze benefit accruals, and there will be a restriction on the dollar amount which may be distributed to plan participants.<sup>137</sup>

***d. Maximum Funding Limits***

To better assist plan sponsors, NESTEG includes a provision that increases the tax-deductible limit for contributions from 100 percent to 130 percent of the plan's current liability, divided by the value of plan assets.<sup>138</sup>

***e. Reduced PBGC Premiums for Small Employers and New Plans***

In order to make DB pensions more attractive to small employers, NESTEG includes a provision reducing the premiums paid to the PBGC for the first five

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<sup>135</sup> Ibid., Title IV(A)(1).

<sup>136</sup> Ibid.

<sup>137</sup> Ibid.

<sup>138</sup> Ibid.

years of the plan. This provision applies only to small employers (less than 100 employees), reducing the required premium from a flat \$19 per participant to \$5.<sup>139</sup>

In addition to reducing the size of the flat premium, NESTEG reduces the variable-rate premium payment for small employers as well. Instead of paying the required variable-rate premium of \$9 per \$1000 of unfunded vested benefits, this provision reduces the variable-rate premium for small employers (fewer than 25 employees – different from above), to not more than \$5, multiplied by the number of employees.<sup>140</sup>

NESTEG also includes a provision under this section which applies to all new plans, reducing the variable-rate premium for the first six years of the plan's life. The provision phases in the variable-rate premium in the second plan year, requiring sponsors to pay only 20 percent of the premium (if required), then increasing the premium amount by an additional 20 percent for the next four years (reaching 100 percent by year six).<sup>141</sup>

## **C. CORPORATE AMERICA'S RESPONSE TO THE DB REFORM PROPOSALS**

### **1. Overview**

Corporate America has experienced significant financial challenges over the past several years, and a large number of DB plans have struggled because of poor asset performance, historically low interest rates and a stagnant economy. With a considerable number of plans falling below minimum funding limits within the last three years, employers sponsoring DB plans currently seek solutions that are intended to promote solvency of their plans and preserve the future of the DB plan system.

The Bush Administration and Congress have responded with multiple proposals to "fix" the DB pension system, some of which were mentioned above. However,

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<sup>139</sup> Ibid., Title IV(C)(6).

<sup>140</sup> Ibid.

<sup>141</sup> Ibid.

corporate America is not in agreement with some of these policy solutions. Some even believe that the proposed changes will worsen the decline in the DB pension system.<sup>142</sup>

Several recent surveys illustrate corporate America's response to the proposals of the Bush Administration and the 108<sup>th</sup> Congress. With 75 percent of Fortune 500 companies offering DB pensions, the views of corporate America must be taken into consideration.

## **2. Plan Funding Rules**

### ***a. Use of a Corporate Bond Rate***

Many in corporate America support the use of high-quality corporate bond rates for pension calculations. The American Benefits Council believes that the corporate rate is a suitable replacement for the obsolete 30-year Treasury rate: "High-quality corporate bond rates are known and understood in the market place and are not subject to manipulation. These rates steer the conservative middle course between the rates of return actually earned by ongoing plans and the rates earned by the insurers that underwrite the annuities of terminating plans."<sup>143</sup> This is a commonly held view throughout corporate America, with similar opinions voiced by CIEBA, the American Academy of Actuaries, Goldman Sachs, and Hewitt Associates. H.R. 3108 replaces the 30-year Treasury rate for two years only, not enough time to make a long-term difference. Corporate America supports the change, but seeks a long-term solution.

H.R. 3108 addresses the interest rate problem for pension calculations, with the exception of lump sum distributions. Lifetime annuity calculations use the corporate rate, while lump sum calculations use the obsolete 30-year Treasury rate. The disparity caused by the difference in the two rates is a source of concern, and employers within corporate America seek a solution that will enable the use of a single rate for both calculations. Additionally, the two rates create an inequality in plan funding. Contribution calculations use the corporate rate (which is currently higher), while lump

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<sup>142</sup> Goldman Sachs & Co. (2004, March 15). *Corporate Defined Benefit Plans: The Potential Consequences of Current Reform Initiatives* (Dudley, C, William, and Moran, A. Michael CFA). In *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*. Retrieved March 27, 2004, from [http://www.afponline.org/pub/pr/pr\\_20040318\\_ciebamissiles.html](http://www.afponline.org/pub/pr/pr_20040318_ciebamissiles.html). Appendix B2.

<sup>143</sup> American Benefits Council. (May 2004). *Pensions at the Precipice: The Multiple Threats Facing Our Nation's Defined Benefit Pension System*. Retrieved May 2004, from [http://www.abccstaff.net/documents/definedbenefits\\_paper.pdf](http://www.abccstaff.net/documents/definedbenefits_paper.pdf). 16.

sum distributions use the 30-year rate (which is lower). Not only does the difference in the two interest rates create an incentive for employees to opt for the lump sum, it also creates a funding mismatch within plans. Corporate America supports a permanent fix.<sup>144</sup>

***b. No Yield Curves***

Probably the single greatest disagreement between industry and government stemming from the recent Bush Administration and congressional proposals is the use of an unsmoothed corporate yield curve for pension calculations. Many in corporate America believe the use of an unsmoothed yield curve will create additional problems for the pension system. The American Benefits Council believes the proposal raises "serious technical and policy questions."<sup>145</sup> The CIEBA, takes an even harder stance, arguing that "the use of an unsmoothed corporate yield curve for funding purposes would potentially double or triple the expected volatility in annual funding, with essentially little or not intermediate-term increase in the accuracy of the actual secular estimate of the underlying pension obligation. Potentially, its use would seriously undermine other governmental efforts to manage the US economy effectively."<sup>146</sup> Corporate America does not support the proposal for several reasons: (1) it would yet again change the funding rules within the system, and increase plan complexity; (2) it would remove the smoothing affect, and therefore increase "volatility," reducing an employer's ability to predict funding; (3) it would encourage a shift in portfolio design, from primarily equities to bonds, in order to reduce the increased risk created by the use of a spot rate; and (4) it would only marginally improve liability accuracy compared to the use of a smoothed corporate rate.<sup>147</sup>

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<sup>144</sup> Ibid., 17

<sup>145</sup> Ibid., 18.

<sup>146</sup> Committee on Investment of Employee Benefit Assets. (2004, March 30). *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*. Retrieved March 30, 2004, from [http://www.afponline.org/pub/pr/pr\\_20040318\\_ciebamissiles.html](http://www.afponline.org/pub/pr/pr_20040318_ciebamissiles.html). 20.

<sup>147</sup> *America's Pension System: Hearing before the Committee on Aging, U.S. Senate*, 108<sup>th</sup> Cong., (2003, October 14) (Scott Macey, representing the American Benefits Council Business Roundtable, ERISA Industry Committee, Financial Executives International, National Association of Manufacturers and U.S. Chamber of Commerce). Retrieved June 09, 2004, from [http://www.abcstaff.net/documents/testimony\\_aging\\_101003.pdf](http://www.abcstaff.net/documents/testimony_aging_101003.pdf).

The use of an unsmoothed yield curve, according to corporate America, would change the way employers approach pension plan funding and cause a significant shift in portfolio design. Plan portfolios today usually include a 60/40 split between equities and bonds. Equities historically provide a greater return, and with the help of smoothed rate, employers are able to predict contributions for long periods. With increased risk caused by the use of an unsmoothed yield curve, employers are likely to shift to portfolios comprised primarily of bonds in order to reduce risk, and with this change come lower returns. As expected, corporate America is not in favor of the implementation of an unsmoothed yield curve.

*c. Max Funding Limit*

Corporate America believes that complicated funding rules, which penalized employers from overfunding their plans, exacerbated the financial difficulties experienced during the "perfect storm" of 2000-2002. Extending the maximum deductible limit would solve the funding problems experienced by employers over the last several years. Increasing maximum limits would allow employers to dedicate additional assets to pension funds during periods of economic growth, and alleviate significant financial pressure during periods of economic difficulty.

The Economic Growth Tax Recovery Reconciliation Act of 2002 temporarily adjusted the maximum funding limit, but according to John Parks of the American Academy of Actuaries, this temporary fix did not do enough "to prevent the current shortfall in pension funding experienced by many employers."<sup>148</sup> Parks recommends increasing the limit to 130 percent of current liability (included in NESTEG provisions), an amount that would have covered all periods in America's recent history with the exception of the Great Depression and the "perfect storm" of 2000-2002.<sup>149</sup> Fortunately for corporate America, the Bush Administration agrees with this view. Undersecretary of the Treasury for Domestic Finance Peter Fisher testified before Congress that, "Raising the limits on deductible contributions would allow sponsors to

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<sup>148</sup> *Defined Benefit Plan Funding Crisis: the Balancing Act Between the Needs of the Employer, the Participant and the PBGC: Hearing before the Committee on Governmental Affairs Subcommittee on Financial Management, The Budget, and International Security, U.S. Senate, 108<sup>th</sup> Cong.* (2003, September 13) (John Parks, Vice President, Pension Practice Council, American Academy of Actuaries). Retrieved March 01, 2004, from [http://www.actuary.org/pdf/pension/testimony\\_091503.pdf](http://www.actuary.org/pdf/pension/testimony_091503.pdf).

<sup>149</sup> Ibid.

build larger surpluses to provide a better cushion for bad times."<sup>150</sup> Increasing maximum funding limits is one of few instances where corporate America, the Bush Administration, and Congress all agree upon the proposed solution.

### **3. Accounting Rules**

#### ***a. Elimination of Smoothing***

Corporate America is actively seeking solutions to remove the volatility from pension funding and liabilities. Smoothing, to a certain degree, removes some of the effects of market-to-market changes. Both the Bush Administration and Congress have introduced proposals that remove smoothing provisions from funding rules, in order to improve pension liability accounting. Corporate America is opposed to these proposals. Christian Weller, an economist from the Economic Policy Institute, suggested in testimony before Congress that the elimination of current policy, "could increase volatility of the interest rate assumption by more than 20 percent. Since interest rates tend to fall in a recession, eliminating the smoothing provisions will result in sharper declines of the underlying interest rate and necessitate larger increases in the required contributions."<sup>151</sup> In a recent survey conducted by the Committee on Investment of Employee Benefit Assets (CIEBA), 45 percent of corporations indicated that they would shift assets out of stocks and into bonds and reduce employee benefits if the Financial Accounting Standards Board (FASB) implemented a change that eliminated the use of smoothing.<sup>152</sup> According to Goldman, Sachs & Co., "This initiative creates greater earnings volatility, mismatches the timing of assets and liabilities, and is inconsistent with the treatment of corporate bonds."<sup>153</sup> In a different survey conducted by Deloitte

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<sup>150</sup> *The Administration's Proposal for Accurately Measuring Pension Liabilities: Hearing before the Subcommittee on Financial Management, the Budget, and International Security, U.S. Senate, 108<sup>th</sup> Cong.*, (2003, September 15) (Peter R. Fisher, Under Secretary for Domestic Finance, U.S. Treasury, Treasury Press Release No. JS-732). Retrieved March 20, 2004, from <http://www.U.S.treas.gov/press/releases/js732.htm>.

<sup>151</sup> *Testimony on the Bush Administration's Proposal to Change Funding Rules for Pension Plans: Joint Hearing before the Committee on Ways and Means Subcommittee on Select Revenue Measures and the Committee on Education and the Workforce Subcommittee on Employer-Employee Relations, U.S. House of Representatives, 108<sup>th</sup> Cong.*, (2003, July 15) (Christian Weller, Economist, Economic Policy Institute). Retrieved May 28, 2004, from <http://www.epinet.org/content.cfm?id=1469>.

<sup>152</sup> Committee on Investment of Employee Benefit Assets. (March 30, 2004,). *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*. Retrieved March 30, 2004, from [http://www.afponline.org/pub/pr/pr\\_20040318\\_ciebamissiles.html](http://www.afponline.org/pub/pr/pr_20040318_ciebamissiles.html). 20.

<sup>153</sup> Ibid.

Consulting LLP a member firm, of Deloitte Touche Tohmatsu, 37 percent of respondents reported that one of the primary methods to address the pension crisis is to smooth assets over time.<sup>154</sup> Since corporate America already believes that current rules do not "smooth" current market-to-market effects enough, eliminating the use of smoothing provision from current rules would be bad policy.<sup>155</sup>

**b. Increased Transparency**

Congress and the Bush Administration propose to increase plan transparency by requiring employers to publish termination liability along with current liability figures in annual reports. This is one proposal that many in corporate America support, or at least, do not strongly oppose. CIEBA reports that employers "are relatively unconcerned" about the proposal, indicating that 92 percent of employer respondents would not alter plan design if additional transparency rules were implemented.<sup>156</sup> Morgan Stanley believes that increased transparency is one of four major areas of improvement, stating, "Realistic and appropriate pension accounting principles provide transparency about the financial health and riskiness of each plan to investors, regulators, and sponsors."<sup>157</sup> Transparency benefits both the plan participant and the investor. It comes as no surprise therefore, that employers are less vocal about increasing transparency, when finance experts like Morgan Stanley believe the issue has the ability to improve balance sheet reporting, while eliminating inflated return on asset (ROA) assumptions.<sup>158</sup>

**4. Premium Alternatives**

As mentioned previously, one cause of corporate frustration with pension policy stems from healthy companies with well-funded plans subsidizing less financially stable

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<sup>154</sup> Deloitte Development LLC. (2004, April). *Pension Crisis Survey Synopsis*. Retrieved May 27, 2004, from <http://www.deloitte.com/dtt/research/0,2310,sid%253D26555%2526cid%253D46520,00.html>.

<sup>155</sup> American Academy of Actuaries. (2004, Spring). *Pension Funding Reform (Enrolled Actuaries Report (EAR) Volume 29 No. 1)*. Retrieved March 20, 2004, from [http://www.actuary.org/ear/pdf/spring\\_2004.pdf](http://www.actuary.org/ear/pdf/spring_2004.pdf).

<sup>156</sup> Committee on Investment of Employee Benefit Assets. (March 30, 2004,). *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*. Retrieved March 30, 2004, from [http://www.afponline.org/pub/pr/pr\\_20040318\\_ciebamissiles.html](http://www.afponline.org/pub/pr/pr_20040318_ciebamissiles.html). 24.

<sup>157</sup> Morgan Stanley. (2004, January 21). *Pension Missiles: Is the Cure Worse than the Disease? (Accounting and Economics)* (Berner, Richard and Harris Trevor). In *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*. Retrieved March 27, 2004, from [http://www.afponline.org/pub/pr/pr\\_20040318\\_ciebamissiles.html](http://www.afponline.org/pub/pr/pr_20040318_ciebamissiles.html). Appendix C4.

<sup>158</sup> Ibid.

employers with weaker plans. Rising premiums tax healthy corporations in order to ensure the continued existence of pension insurance programs. Solutions to improve the system proposed by the Bush Administration and Congress include increasing public disclosure of severely underfunded plans and preventing corporations with poor credit ratings (junk bond rating) from increasing benefits. Goldman Sachs supports another approach, the use of risk-based premiums. Instead of the financially healthy and weak plans paying the same premiums, the premiums of the companies with good credit ratings would be reduced and the required payments for the weak, which have poor credit ratings increased. "Higher quality companies with adequately funded pensions," according to Goldman Sachs, "are much less likely to fail and generate liabilities that must be assumed by the PBGC."<sup>159</sup>

A different solution is to reduce the guaranteed amount provided by the PBGC. Reducing the guaranteed amount would push more of the risk onto the employer. Employees would be far more concerned with the financial health of their employer's plan if they knew that the PBGC did not guarantee the full amount of their accrued benefits, and potential new employees would be less likely to seek employment with a company that did not provide financially stable plans. Hewitt Associates supports this approach and proposes either a reduction in the guaranteed amount or a reduction in the shutdown benefits.<sup>160</sup>

The consensus amongst the financially healthy employers is that more of the risk of termination needs to shift from the PBGC to plan sponsors themselves. Until the DB pension system becomes more risk-based, employers will continue to take advantage of the PBGC and the other premium paying employers in the system.

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<sup>159</sup> Goldman Sachs & Co. (2004, March 15). *Corporate Defined Benefit Plans: The Potential Consequences of Current Reform Initiatives* (Dudley, C, William, and Moran, A. Michael CFA). In *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*. Retrieved March 27, 2004, from [http://www.afponline.org/pub/pr/pr\\_20040318\\_ciebamissiles.html](http://www.afponline.org/pub/pr/pr_20040318_ciebamissiles.html). Appendix B7.

<sup>160</sup> Hewitt Associates LLC. (2004, March 12). *Responses to CIEBA Request for Impact Analysis of Emerging Issues* (Jacobs, Ari, F.S.A., and Johnston, Mike, F.S.A.). In *The U.S. Pension Crisis: Evaluation and Analysis of Emerging Defined Benefit Pension Issues*. Retrieved March 27, 2004, from [http://www.afponline.org/pub/pr/pr\\_20040318\\_ciebamissiles.html](http://www.afponline.org/pub/pr/pr_20040318_ciebamissiles.html). Appendix D15.

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## **VI. SUMMARY, CONCLUSIONS AND SUGGESTIONS FOR FURTHER RESEARCH**

### **A. SUMMARY**

In 1985, at its peak, the DB pension plan system accounted for 34 percent of all assets invested in retirement plans in the US. In 2002, nearly 20 years later, DB assets represented 16.1 percent, less than half of its 1985 share. During this period, the cost and the complexity of sponsoring a DB plan encouraged many employers to shift to the more easily managed DC plans. This thesis provides a focused look at the DB pension plan system, its organization, its administration, the challenges it faces, and the proposals for reform.

In the US, traditional pension plans usually refer to DB plans. DB plans are employer provided, and typically offer a retiree a lifetime annuity, with some offering lump sum distributions. Since 1974, when the Employee Retirement Investment Security Act (ERISA) was enacted, the Pension Benefit Guaranty Corporation (PBGC) has guaranteed plan participants an annualized portion of their retirement benefits up to a certain amount. The PBGC, created in accordance with ERISA, operates and maintains two insurance programs that ensure the retirement security of plan participants. The single-employer program includes 29,500 plans, and covers 34.5 million Americans; the multiemployer program includes 1,620 plans, and covers 9.7 million active and retired workers.

The PBGC's sole purpose is to ensure that DB plan participants receive some portion of promised retirement benefits. Established as a federal corporation, the PBGC does not receive its funding through general tax revenues. Instead, it finances operations through premium payment receipts, investment income, and through assets acquired from terminations of single-employer plans. At the end of 2003, the PBGC had a combined accumulated deficit of \$11.49 billion, its largest ever, caused by the termination of several of its largest claims to date, exposing the corporation to liabilities in excess of \$9.5 billion in just two years. The PBGC estimated that the DB system was underfunded

by \$350 billion at the end of 2003, and that there were a number of plans whose termination was classified as "reasonably possible," representing between \$83 and \$85 billion of unfunded vested benefits.<sup>161</sup>

Poor financial conditions experienced by corporate America in the first two years of this century caused substantial plan underfunding. Faced with interest rates at a 50-year low, poorly performing equities in the stock market, and a stagnant economy, many employers underfunded their DB plans in order to remain a "going concern." Plan funding was further challenged in 2001 when the Treasury Department ceased offering 30-year Treasury bonds. As a result, the 30-year Treasury rate fell to a 50-year low in 2004. Low interest rates inflate pension liability calculations (which use the interest rate in present value calculations). Already faced with increasing financial challenges during the economic downturn, the obsolete 30-year Treasury rate forced employers to contribute more assets to pension plans than they would have if a market rate were used.

This period (2000-2002), which has since been labeled the "perfect storm," exacerbated the negative effects of several funding and administrative rules enacted during earlier periods of economic expansion. Maximum funding rules, for example, penalize employers from overfunding plans in order to limit tax-deductible contributions. Employers were therefore unable to overfund plans during growth periods, which may have reduced significantly the number of plans currently underfunded.

Since the late 1980s, there has been a considerable shift in the qualified retirement plan system. Employers by the hundreds terminated their DB pension plans for more easily managed DC plans. Frustrated with a complex and costly administrative burden, employers in the evolving technology and service sectors are opting for DC plans instead of DB, even though DB plans, by design, can offer many of the same aspects of DC plans (i.e., portability, lump sum distributions). This is a good indication that there are problems with the funding and administration of DB plans. Absent such difficulties, employers would adapt their current DB plans to meet consumer demand, instead of completely abandoning them for DC plans.

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<sup>161</sup> Pension Benefit Guaranty Corporation. (2004). *2003 Annual Report*. Retrieved March 30, 2004, from <http://www.pbgc.gov/publications/annrpt/default.htm>. 33.

The DB plan system is also faced with an aging workforce. In 2004, the number of active workers roughly equaled the number of inactive, with the ratio of retired to active expected to increase in the future. This trend is significant because employees are spending longer in retirement due to longer life spans and earlier retirements. The increasing numbers of retirees who spend longer in retirement create additional pension liability, which requires additional plan funding.

With such challenges facing the DB pension plan system, the federal government has been seeking pension policy reform. With the DB plan system severely underfunded, the PBGC under significant financial pressure, and with the Enron debacle triggering an air of corporate mistrust, the Bush Administration, Congress and agencies within the federal government (Treasury Department/DOL/PBGC) as well as the FASB have all proposed reforms to repair and prolong the life of the DB plan system. Many in corporate America are fearful that the proposed changes will increase the complexity and expense of operating a DB plan and force additional employers to exit the system.

Regardless, the Bush Administration and Congress have taken steps intended to improve the system. The Bush Administration proposes to improve the DB plan system in three ways: (1) improve the accuracy of the pension liability discount rate, by implementing the use of an unsmoothed corporate yield curve; (2) increase the transparency of pension plan information, by requiring employers to publish additional financial plan information in their financial reports; and (3) strengthen and safeguard the DB pension plan system against underfunding, through the prevention of benefit increases by severally underfunded plans.<sup>162</sup>

The 108<sup>th</sup> Congress responded to the challenges facing the DB plan system by enacting the Pension Funding Equity Act of 2004, and is considering the enactment of the National Employee Security Trust and Equity Act (NESTEG). The Pension Funding Equity Act introduced the use of a discount rate based on an index of high-quality corporate bond rates, in order to better match liability calculations with current market performance. Additionally, the Act provided relief by reducing the deficit reduction

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<sup>162</sup> U.S. Department of the Treasury. (2003, July 8). *The Administration's Proposal to Improve the Accuracy and Transparency of Pension Information* (Press Release No. JS-529). Retrieved March 20, 2004, from <http://www.treas.gov/press/releases/js529.htm>.

contribution (DRC) for a limited number of industries not subject to the DRC in 2000 by as much as 80 percent over a two-year period.

NESTEG (at the time of writing still awaiting a vote in the Senate), incorporated many of the Bush Administration proposals, including the use of the unsmoothed corporate yield curve, the prevention of benefit increases by underfunded plans, and increases in the eligibility of DRC relief to all employers not subject to the DRC in 2000.

Corporate America's response to the proposals of the Bush Administration and Congress is mixed, but for the most part is unfavorable. Corporate America approves of replacing the interest rate with a corporate rate, but is opposed to the use of an unsmoothed corporate yield curve. Smoothing provisions allow companies to reduce the volatility of market-to-market changes and facilitate long-term planning because they use a weighted average of prior year interest rates, thus minimizing fluctuation. Adopting a corporate yield curve will subject employers to the rise and fall of the market, and will therefore be much less predictable. Many in corporate America predict a significant shift in pension portfolios from equities to fixed income investments if the corporate yield curve is adopted.

Corporate America is in favor of several of the proposals which address long-term funding. NESTEG increases the maximum funding limits, enabling employers to fund beyond 100 percent of current liabilities, thus allowing them to save for a "rainy day."

Many financially healthy plan sponsors have become increasingly frustrated with financially weak plans that increase benefits without the means of meeting the increased commitment. Current law permits employers to increase benefits at their discretion, and with the assumption that the PBGC will back all terminated plans, some employers are increasing benefits without the intention of ever being able to carry through with their promises. When plans like these fail, they create an increased burden on the PBGC and the other premium paying employers in the system. NESTEG attempts to enact the Bush Administration's proposal to prevent severely underfunded plans from increasing benefits, and thus reduce the number of annual terminations.

Finally, both corporate America and the federal government have introduced proposals to alter how insurance premiums are assessed. Instead of requiring all

participants to pay a flat premium regardless of financial health, one proposal recommends that the premium rate be adjusted to match a corporation's credit rating. Another proposal recommends reducing the amount of benefits guaranteed by the PBGC. Reducing this amount will shift some of the risk of termination back to employers, as employees would be less likely to work for a firm that is unable to demonstrate its ability to fully fund its pension obligations.

## **B. CONCLUSIONS**

### **1. Do Nothing?**

Are the financial challenges facing the private DB system cyclical? Will sustained economic growth erase the effects of the "perfect storm" of 2000-2002? If so, is the best solution to do nothing? After several quarters of economic growth in 2004, the worst of the perfect storm appears to be over. The question then, is whether the regulatory bodies should do nothing and simply wait for economic recovery to heal the wounds of the last several years. The conservative answer is no. The perfect storm took its toll on the DB pension system, but the challenges facing the DB system prior to 2000 remain.

Complicated and costly DB plans have been encouraging employers to abandon their DB plans for more easily managed DC plans for approximately 20 years. Until Congress is able to implement rules that make DB plans as appealing to the consumer as DC plans currently are, the DB plan system will continue to experience a decline.

Advocates are quick to point out that DB plans can be designed to emulate DC plans, offering most if not all of the same characteristics. With this being the case, one would expect DB plan sponsors to adjust their plans in order to meet the growing demand for plans that offer lump sum distributions, are portable, and possess early vesting characteristics. Unfortunately for the DB plan system, employers are choosing to exit rather than redesign their plans, which is a clear indication of the complexities and the administrative burden associated with DB plans.

## **2. Future Risks**

It seems somewhat naive for new employees to expect their employers to still be sending them checks in 50 years. First of all, today's labor force is being told to expect to have multiple careers before they retire. Second, who can guarantee their company will still exist in 30 years? So why would a new employee sign up for a retirement plan that makes promises up to 50 years down the road? There is one consistent fact in corporate America, and that is all companies will eventually fail, but the government will not. The challenge facing the DB plan system is future risk. Currently the PBGC guarantees to pay vested participants a set dollar amount for life. If this set dollar amount is drastically reduced, sponsors will terminate plans, and choose a less risky retirement plan (DC), or, employees will demand that their employers do a better job of funding their retirement plans.

Since the government will continue to exist regardless of whether or not companies sponsoring DB plans survive or fail, it is in the PBGC's best interest to focus reform efforts on ways that will better assign premium payments, and shift funding risk to plan sponsors. The proposal in NESTEG that prevents underfunded plans from increasing benefits, is a step in the right direction. Currently, the DB plan system is not risk-based, and until it is, plans will continue to promise more than they are able to deliver.

## **C. SUGGESTIONS FOR FURTHER RESEARCH**

As Americans become increasingly aware of fiscal reality, and if the current trend of employees preferring to provide for their own retirement continues, the future of the DB pension plan system is problematic. What would be the economic implications if the \$1.6 trillion invested in the DB plan system were invested in individual retirement accounts of some kind?

Corporate America argues that the corporate yield curve would introduce increased volatility in the DB plan system and would encourage employers to shift from equities to fixed income securities. What are the long-term economic implications of a considerable asset shift from the equities market into fixed income investments?

Is it possible for the federal government to amend the law and remove the PBGC's single-employer and multiemployer insurance programs, making employers responsible as well as liable for plan terminations?

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