

The Future of Pension Plan Funding and Disclosure: Envisioning a Better System Symposium

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I'll start by thanking the Society of Actuaries for providing this opportunity to share some thoughts and ideas with you about reforming the defined benefits (DB) retirement system from the perspective of organized labor. The best part of taking on an assignment like this is gaining access to so many thoughtful and creative papers. Reading your papers was truly educational, and I want to thank the authors for their hard work and, in many cases, ground-breaking ideas.

I've worked with actuaries for the past 27 years in my capacity as a multiemployer trustee and union negotiator. I actually employ an actuary on staff, which is somewhat unique in the labor movement. My point is I've followed your profession for many years and have much respect for what you do. My observation is that ERISA and its blizzard of regulations stifled the public voice of actuaries and prevented the profession from being forward-looking and proactive. However, the debate over financial economics, the Society's recent exposure draft on asset liability management, and the papers stimulated by this symposium suggest that intellectual spirit and theoretical rigor still thrive in the actuarial community. Your colleagues in the United Kingdom have taken an additional step with their evaluation of professional standards in the so-called Morris review. I would also strongly urge you to look beyond your experiences in the United States for new ideas—for example, the actuarial and financial work on DB funding in the Netherlands is cutting edge and relevant to our discussions.

I should also give a disclaimer on my comments. I can't speak for organized labor because organized labor is not a monolith, as the front pages of major newspapers can testify. There are sharp differences of opinion on how to reform the DB pension system in the labor movement. The United Food and Commercial Workers (UFCW) is in the camp that advocates major reform. My position could be described as more extreme—I'm an evolving convert to solvency funding standards, mark-to-market assets and liabilities, and the financial economics school. But I'm also a pragmatic practitioner, and I understand that the kinds of changes necessary in the DB world require well-planned transitions that are stakeholder-friendly and don't destroy the very system we're trying to protect.

As actuaries, you measure and manage pension funding risks, so maybe you can appreciate the risks that I'm taking today by being one of your luncheon speakers. Some of those risks include the following:

- I'm a nonactuary speaking to a room of actuaries about a subject that you are experts on.
- I represent labor unions, which some of you blame for the current pension funding crisis.
- Many of the opinions on pensions that I will express today are in direct conflict with my colleagues in the labor movement and will be subject to criticism.

It would seem that I am taking on a statistically significant level of reputation risk by appearing here today – but so be it.

One of my greatest concerns in terms of the current pension funding crisis is that the majority of pension plan decision makers are in denial and locked into the post-ERISA pension management paradigm. Few people are thinking outside the box. The recent “perfect storm” experience and the front-page coverage of the collapse of the airline industry pension system have not shocked trustees and plan sponsors into action. With few exceptions, I don’t see trustees adopting formal funding policies or investment tools to reduce funding shortfall risks. Pension governance thinking seems to be stuck in a legal vortex that prescribes to the Keynesian conundrum of failing conventionally versus succeeding unconventionally. For many plan sponsors, the simplest decision is plan termination or benefit freeze.

That’s where this symposium and your papers can make a difference. Several of your papers lay out a conceptual framework for redefining a DB pension funding model that is sustainable and transparent and meets the needs of stakeholders. Some of your ideas are a radical departure from the past: eliminating or modifying minimum funding requirements and credit balances, adopting mark-to-market interest rates, reducing or eliminating asset smoothing, and removing restrictions on asset reversions. In my opinion, these subjects are all worthy of discussion. No funding concept should be sacrosanct unless it is contrary to good solvency principles that protect retirement benefits or unless it defies transition realities.

I’ll identify several funding ideas and principles in the papers that I found most attractive:

- Klieber’s thoughts about “model-neutral” funding rules that would allow the integration of financial economics on the investment side of the equation have merit. It is critical that actuarial and investment theory and policies complement one another and create positive incentives to make good funding decisions.
- Fuerst and Kra make valuable contributions to transition thinking with their ideas on establishing volatility limits for contributions and modifying the credit balance rules to avoid abuse and unintended funding consequences. I also like their recommendation to change the terminology from “credit balance” to “prepayment balance.”
- Many of the authors, including Murphy, the Towers Perrin papers, and Fuerst and Kra contribute to a better understanding of what solvency funding should look like.

- Friedman’s introduction of “increasing dollar amortization” is another innovative funding concept that caught my attention.
- Clark’s proposal to use the aggregate funding method in a mark-to-market environment as a way to reduce contribution volatility and his criticism of unit credit adds value to the funding discussion.
- On the investment side, I like the Winklevoss, Ruloff, and Strake paper on investment strategies to manage contribution volatility in a mark-to-market world. Plan sponsors need to consider sophisticated hedging strategies as part of their investment programs in an overall effort to reduce shortfall funding risk.
- The Canadian Actuaries Statement of Principles offer important governance advice in advocating formal written funding policies for purposes of identifying and managing risks and what they describe as “provisions for adverse deviations,” which is an attempt to integrate further funding and investment policy. It still amazes me that ERISA doesn’t require pension plans to draft and follow formal detailed funding policies.

Reforming the Pension Benefit Guaranty Corporation (PBGC) is a separate theme covered by a number of the papers. One paper even calls for the total abolition of the PBGC, which, not surprisingly, I totally reject. Before discussing these fixes for the PBGC, I want to make a few editorial comments. First, we need to get our priorities straight. Reforming the DB system is a holistic exercise that includes protecting the fiscal health of the PBGC. The caveat here is that reforming the PBGC guarantee system should not drive this process. As many of the authors remind us, the PBGC’s legislative mandate is to promote and protect DB plans.

I’m also concerned with the savings and loan crisis analogy often used to compare the current problems of the PBGC. Deliberately or inadvertently, this comparison may create a dangerous and false public image. The S&L crisis involved massive levels of fraud and corruption, and it required an expensive taxpayer bailout that Congress most willingly legislated. What has happen to the DB system has no resemblance to Enron and WorldCom.

Yet realistically, the PBGC cannot be allowed to operate with runaway deficits that may exhaust the agency’s assets and ability to guarantee benefits 10–15 years from now. Moreover there is no denying that the PBGC is subject to real and dangerous “moral hazard” risks. Chapter 11 bankruptcy is surely the Achilles heal of the DB system and the PBGC. I agree with Lohmann and Friedman that pension plans and the PBGC must have a

higher claim to company assets in bankruptcy. This would dramatically enhance the PBGC's financial position going forward.

Several of the papers offer creative ideas on how to fix the PBGC's finances:

- I don't necessarily agree with Klieber's privatization model for the PBGC with its commercial reinsurance component, but his three-part conceptual framework that underwrites short-term, long-term, and industry-specific risks is useful; and his idea of "pension underfunding bonds" as a financial tool to manage stop-loss coverage against plan terminations in restructuring industries is ingenious.
- Fuerst and Kra also offer some commonsense reforms involving consistent treatment of the guarantee period, requirements for funding contingent liabilities like shutdown benefits, and redefining early retirement benefits as nonguaranteed benefits. I'm also not adverse to benefit improvement restrictions based on funding ratio thresholds and similar restrictions on lump-sum payments. Fuerst and Kra also offer a simple structure for variable premium rates dependent on a progressive scale of funded status.
- I am especially impressed with the Gold paper, which proposes a financial solution to the PBGC deficit and the current funding shortfall of most DB plans by securitizing the relationships between sponsors, plans, and the PBGC. Gold proposes a bond-for-bond exchange that many corporate CFOs would understand and appreciate in terms of balance sheet symmetry, where a debt-for-debt swap would leave employers indebted to the capital markets instead of to their employees. Gold's proposal is a macromodel of what General Motors financially engineered several years ago with their successful pension bond offering.

One critical subject absent in these papers is the subject of principal-agent theory — whether the economic interests of principals and agents making decisions on their behalf are aligned. The Stonewall and Moore paper, aptly titled "What's in It for Me?," at least starts the conversation about what pension stakeholders expect. But principal-agent issues highlight governance problems and conflicts in the current DB system. Today's plan underfunding has as much to do with plan sponsor conflicts over responsible funding versus other corporate priorities as it does with poorly constructed funding rules. With the exception of multiemployer plans, key stakeholders, namely, plan participants, were excluded from the funding and investment decision-making process.

Some of you may discount the principal-agent effect, but I don't know of any multiemployer plans with 9.0 percent plus interest rate assumptions that are invested 75

percent in public equity, or who have taken decade-long contribution holidays. Regardless, I'll concede the fact that many multiemployer plans are underfunded, and a few have serious solvency issues. However, I also would point out that a large number of multiemployer plans have been proactive over the last two years in taking tough action to bring financial balance back to their plans through benefit cuts and contribution increases.

What I'm suggesting here is fundamental. If we are really going to fix the DB system, we need to redefine the rules of the pension deal," and that requires stakeholder representation. One cutting-edge thinker who articulates this concept of the pension deal best in my estimation is Canadian pension strategist Keith Ambachtsheer. Ambachtsheer defines the pension deal as a risk-sharing cooperative based on the following principles:

- A clearly stated target pension benefit
- A clearly stated expected cost of delivering the target benefit
- A clearly stated risk-bearing deal between various stakeholders groups
- A clear statement about how risk will be managed within the pension cooperative.

These critical principles currently are missing from today's pension deal. As a result, stakeholders don't necessarily understand their risk exposures until it's too late, and when those risk exposures grow too large, pension deals can be broken, as we are witnessing today. Let me be clear in what I'm suggesting—if we redefine the "pension deal" as described by Ambachtsheer, it also means that the rules on pension surpluses must change, and that surplus reversion above a specific funding level would become possible.

The Ambachtsheer pension cooperative risk-sharing model is not restricted to DB plans. In fact, let me be so bold as to reject the simple defined benefits–defined contributions debate and challenge the Society of Actuaries to organize a future symposium on creating benefit designs that meet the Ambachtsheer pension deal guidelines. If the traditional DB pension plan is not sustainable, let's create something that is within the needs of all the stakeholders and society at large. In that spirit, I urge the actuarial profession to take a leadership role in the retirement policy debate.