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# Session 34PD
# PBGC and the Current Economic Environment

**Track:** Pension

**Moderator:** RONALD GEBHARDTSBAUER
**Panelists:** C. DAVID GUSTAFSON
THOMAS B. LOWMAN
DONALD J. SEGAL

*Summary: The attendees are updated on the impact of the current economic environment on the PBGC and the plans it insures. Issues discussed include PBGC's current financial status and its outlook for the future. Areas such as shutdown benefits, 4010 filings, floor-offset plans and PBGC variable premiums that have been impacted by current economic conditions are discussed. Attendees gain a better understanding of the impact that the current economic conditions have had on the PBGC and the plans it insures.*

**MR. RONALD GEBHARDTSBAUER:** Our first speaker is Dave Gustafson. He's the chief policy actuary at the PBGC. He's going to talk about some PBGC annual report issues and updates on recent trusteeships. Tom Lowman is going to talk next. He's the chief actuary with Bolton Partners. During his talk we're going to encourage a lot of audience participation. We're going to have you all voting, so get ready to vote. Finally, the third speaker is Don Segal. Don, like myself, is just going to be providing color commentary

**MR. C. DAVID GUSTAFSON:** First we'll do a macro view of the PBGC, in terms of financial condition. That's what I'll be doing. The more hands-on aspects of the PBGC, the micro view, will be the second half of the session.

The PBGC's financial position is probably not something that's a surprise to most of you. We had a peak year in 2000 when we had almost a $10 billion surplus, followed by an $8 billion surplus in 2001. There were a lot of calls for us to stop



**Note:** The chart(s) referred to in the text can be found at the end of the manuscript.

charging premiums. Premium holidays were on the agenda. Then we had 2002. During 2002, we had claims of more than $9 billion. That's more than we had had in our entire history up to that point. Of course, it proves that we truly are a catastrophic insurance program with that type of claims activity—lots of periods of small claims followed by some very large claim instances, which we've seen in this last year.

The amounts of claims we're seeing may be just a precursor to things to come. We've updated this $3.6 billion deficit that we had at the end of September 2002 to reflect our more recent estimate, which is now a $5.4 billion deficit.

The sources of the claims that have given rise to this deficit are well known. It's been primarily the steel industry, and, more recently, the airlines that have contributed to the claims. Together they make up almost 75 percent of the total claims in the agency's history and yet, they represent a relatively small percentage of the participants that we've covered, in total less than 5 percent. That shows you the nature of the cross-subsidy that our insurance program has in it. It's a cross-subsidy that some would suggest can't be sustained forever. We can talk about that later.

**MR. SEGAL:** Does this also represent that the average benefits for airlines and steel are significantly larger than basically everybody else is because of the liability versus the number of lives?

**MR. GUSTAFSON:** I don't now that this directly represents that. But that is the case. The guaranteed benefits, relative to the rest of the universe, are about four or five times larger than everybody else's.

**FROM THE FLOOR:** Are these liabilities minus assets?

**MR. GUSTAFSON:** It's liabilities minus assets minus recoveries in bankruptcy, so it is the net claim to the system. Bethlehem, LTV and National Steel are the top three claims. They're all funded around 50 percent for termination liability purposes. They had huge numbers of participants. One thing that strikes you about this is that the order of magnitude of the claims has grown so rapidly relative to the largest claims we had previously, which were the Pan Am and the Eastern claims back in the early 1990s. These dwarf them by size. Yet as you'll see later on, our premium income has not grown in any substantial amount to keep up with the size of these growing claims.

We did have a peak in 1996 when we uncapped the variable-rate premium under the Retirement Protection Act (RPA), but the total premium income that we received in fiscal 2002 was less than we received for any year after 1991. It's a decreasing function. A good deal of that is that the variable-rate premium is being paid by a very small percentage of plans, primarily due to the full-funding limit exemption. I think that for the last couple of years the percentage of participants in plans paying the variable-rate premium has been a very small percentage, about 6 percent or 7 percent. This is something, of course, that we need to look at quite seriously. It will change if interest rates revert.

**MR. SEGAL:** From a practical standpoint it's also becoming much more difficult to avoid the variable-rate premium through the full-funding limitation exemption.

**MR. LOWMAN:** We're doing our evaluations now and we're telling clients what it will be next year and the year after with variable-rate premiums. We know that they are not going to be avoiding them, whereas they have avoided them in the last few years.

**MR. SEGAL:** For the last few years, you put in $2 million and escape a $200,000 variable-rate premium. You're getting an immediate 10 percent return on that. But then you look for 2003, and you need to put in $16 million to avoid a $200,000 premium and there's no return on that.

**MR. GUSTAFSON:** Even with the anticipated increase in the variable-rate premium, the premium itself—using our projection models—will not be sufficient to eliminate the deficit we now have. Your clients complain about the variable-rate premiums; some even complain more about the variable-rate premiums than the funding requirements. There's a limit as to what some clients are willing to pay for a variable-rate premium, or any other premium, to sustain the system.

What is it that we're looking forward to? In fiscal 2003, we're going to reach a crossover point where there are a greater percentage of retirees and term vesteds than there is of actives. That's an aging system. It's a system that's concentrated in mature industries. It's a system that you question whether over time that can be sustained. There are too many beneficiaries and too few contributors over time.

**MR. GEBHARDTSBAUER:** When I was testifying recently, we were talking about plans either terminating or freezing. There is more thinking about freezing now. Then they asked if they could get an indication of how many plans are freezing. Is there a way of getting that information from what you have here?

**MR. GUSTAFSON:** You really can't. We sent a letter to Congressman Earl Pomeroy (D-ND), who asked that question, both in the House Ways and Means Committee testimony in April and again in the House Labor Committee testimony. There is a question that you may know in the Form 5500 that was just added with regard to freezing, but it's sort of a narrowly drawn question. It couldn't distinguish for instance, between hard freezes and soft freezes. It will be a while before the results of that Form 5500 are available to the public.

**MR. LOWMAN:** If you want to do some sort of estimate, you probably could look at the current liability normal cost to see if it's zero, although you may have an expense load in there.

**MR. GEBHARDTSBAUER:** I was also wondering if you file with Department of Labor (DOL) and tell them when you amend the plan that you are freezing the plan? I don't know if they're keeping track of that, or if you still file your summary plan documents.

**MR. GUSTAFSON:** That's really labor intensive to survey something like that. We were thinking that probably the better source, and we recommended this to Congressman Pomeroy when we replied to him, would be to go to the consulting firms. Consulting firms often do surveys of this nature, in terms of what the benefit structures look like.

**MR. SEGAL:** Am I the only one in the room who doesn't know the difference between a hard freeze and a soft freeze?

**MR. LOWMAN:** A hard freeze freezes service and average pay. A soft freeze usually freezes just benefit accrual service, but not average pay.

**FROM THE FLOOR:** Do you have a category for plans that are shut down to new participants but are not freezing benefit accruals, either service or pay, for the current people that are in the plan? I don't have a name for it. That could be called a legacy plan, maybe.

**MR. GUSTAFSON:** That is, in one sense, another form of benefit freezes if you are, as many as the British plans are, closed to new entrants.

**MR. GEBHARDTSBAUER:** I think 75 percent of large defined benefit (DB) plans in the UK are frozen to new entrants.

**MR. GUSTAFSON:** The other aspect of this is that you don't know whether it's a temporary freeze or a permanent freeze. Freezes are looked upon in such negative terms, except if you're getting to a point where you're saying, "Wow, look at this huge contribution coming up here. Is there any way I can reduce it? Maybe I should temporarily back off on accruals. Maybe I promised too much relative to what I can afford." Not many folks are looking at it that way. But that's always a possibility.

From 1980 forward, the total under-funding in the PBGC's insured universe was relatively well behaved through 2000. Then in 2001 it jumped up to about $165 billion. This is primarily taken from 4010 filings that we get. For 2002, and this is calendar year end numbers, it is at least $300 billion and climbing right now. We don't have all the 4010 numbers in so we can't give you a final; this is still a projection. But this is a big, big shift and a very large increase in our exposure. As some will observe in the next couple of days, this is in part because of the asset-liability mismatch situation.

As far as the key areas of exposure, we talked a little bit about the steel industry. The steel industry actually has shrunk, because we've taken over all the plans. The airline industry is made up of about six major carriers, all of whom are junk-bond rated and several of who are either in bankruptcy or recently out of bankruptcy. They're going through some very difficult times right now. They amount to more than $26 billion in under-funding.

We include the auto and related industries, not because we anticipate that they're going to be troubled industries, but more so because it's the largest single standard industrial classification (SIC) that we've got, by far. This may be a problem in the future; we hope that it's not.

I should have said these total under-funding benefit liabilities are based upon 4010 filings. The 4010 filings are not complete right now. We hope to have them complete within the next couple of weeks. But we know from those who have filed that these are solid numbers. All of the airlines have filed, and most of the auto and related industries have filed.

Even though people are celebrating the fact that the market seems to be bouncing back, the S&P 500 has been going up since the beginning of the year and assets, according to a Ryan Labs projection, have gone up 8 percent since the beginning of the year. These are assets on sort of a stylized portfolio that Ron Ryan has maintained during the last 10 years or so of, I believe, 60 percent equities, 30 percent bonds, 5 percent international equities and 5 percent cash, if I recall correctly. But liabilities have also gone up, in this case by 11 percent, because of the drop in interest rates. From the beginning of 2000, the combined impact has really been a 71 percent drop in that asset minus liability comparison. This gives rise to $300 billion under-funding numbers.

Folks say that things will turn around. We are not entirely convinced of that. If you look at the real equity returns by decade, you find that the 1980s and 1990s were pretty good. In fact, they were above average. I think the average real rate of return in the Ibbotson data is about 7.4 percent over this period of time.

To anticipate that you're going to get those same 12 percent and 15 percent real returns for the 2000s, or whatever we call them, may be a bit overly optimistic. Surely we're off to a not-very-good start for the first couple of years. We calculated that to get back to the returns of the 1990s, for instance, you'd have to earn annually 25 percent real rate of return for each year for the remainder of the decade. That is not likely to happen even in the rosiest of projections.

We don't think it's all just asset-liability mismatch. We think that there are some significant weaknesses in the funding rules. For the last six months we've been doing a lot of analysis within the administration as to ways to improve, not necessarily strengthen, but to improve the funding rules. We've identified a number of weaknesses in the funding rules, from our perspective anyway, that we've been testing and trying to come up with alternative approaches. The first and the very largest of which are inadequate funding targets. A funding target of 90 percent of current liability just leaves plans permanently under-funded, particularly when they get into trouble. The funding target is too low. The funding rules stop too soon.

Also, we have a concern about the smoothing of assets and liabilities. That smoothing sometimes camouflages the true under-funding of a plan, whether it's the four-year weighted averaging of current liability interest rates, or whether it's the smoothing methods that you apply to the assets and the way that they are reflected in the funding rules. Again, it's a delayed recognition of the true status of the situation.

The rules also ignore company financial health. This is a controversial one. You can develop a theory that some plans should be contributing more than others can. If you are a junk-bond status plan, maybe your funding target should be different than a company that's an AAA-rated company. Maybe the AAA-rated company shouldn't have to fund as much as the current rules require them to. Maybe there should be a sort of relief for some of the stronger companies. Not that the weaker companies should pay more necessarily, but they should not stop paying at such an early point in time.

We also have concerns about the retirement age assumption. We've seen some strange results from terminated plans, in terms of what a couple of actuaries have assumed in terms of when people retire. Also, the rules right now don't yet adequately address benefit increases, although that was what the deficit reduction contribution (DRC) was permanently designed to do back in 1987.

Let me give you an example as some indication of what we're facing, in particular with regard to the use of current liability as a measure for funding purposes. One of our top ten claims is the US Air pilots' case. The pilots were surprised. They were being told that they were more than 90 percent funded by and large for every year on a current liability basis and didn't have to pay these additional contributions. Then all of a sudden, when push comes to shove, they are drastically under-funded and they're up on the Hill going to Congress. They feel betrayed because the funding rules aren't based on something that really matters for a company that's in trouble.

Bethlehem Steel didn't have to pay a contribution until July 2003. They went for a number of years without paying a contribution. They had credit balances, which is another issue. We are looking at whether or not, for troubled plans in particular; there should be any mechanism to permit contribution holidays. They were out of the DRC for many years. Only in 1996 did they have a deficit reduction contribution. They didn't have to tell participants that from 1998 forward they were under-funded since they weren't under 90 percent funded. They paid a little bit of the variable-rate premium, but something went wrong. They were under-funded on a benefit liability basis by $4.3 billion, and $3.9 billion on a guaranteed basis. There's something wrong with the funding rules.

**MR. LOWMAN:** Dave, do you explain which particular roles are causing this, like the smoothing or the retirement age assumption?

**MR. GUSTAFSON:** It is a combination of all of the above that we were just going through, particularly with Bethlehem.

**MR. SEGAL:** I'll just make the comment without intending to open up a firestorm. Part of it is derived from the assumptions upon which you are measuring the liabilities. It's obvious that the current liability is measured using a higher interest rate than the termination benefit liability. A question we actuaries face that's realistic is if we were to use PBGC termination liability interest rates as our valuation assumption, would the IRS challenge us? This is an unfortunate reality that we may be guilty of dealing with.

**MR. LOWMAN:** You're saying we could be using a lower interest rate because it's somewhere in the range, but we're using the top. Are you saying we should be using something lower?

**MR. SEGAL:** PBGC rates today are, I think, 4.3 percent for the first 20 years and 5.25 percent thereafter. That's the current termination liability annuity rate. I would be surprised if the IRS audited that and didn't make a comment, despite everything that has been happening.

**MR. GUSTAFSON:** I think we're talking about 412(l). The IRS isn't going to criticize you if you use 90 percent of the corridor rates.

**MR. SEGAL:** But PBGC is even lower than that.

**MR. GUSTAFSOSON:** Yes, but that would get you a lot closer. I don't know of any of these plans that were using anything *except* the top of the corridor.

US Airways pilots, as we were talking about a little bit earlier, have some of the same issues. During this period they never paid a DRC and never notified their participants. They paid a total of $6 million of variable-rate premium, and they ended up with unfunded benefit liabilities of $2.5 billion and 33 percent funded on the benefit liability basis. Again, I don't know how you can say that the funding rules are working properly even if you challenge the notion, and I'm sure many will, that termination liability overstates the liability. Termination liability is what it would cost, or at least our proxy for what it would cost based upon our surveys of annuity prices, to go out and purchase an annuity in the private market.

I have a couple of real examples of more technical types of problems. In the US Air pilots' case, they were paying some substantial lump sums, in the millions of dollars, when pilots would get to age 60. Right now, as you know, you cannot include the value of lump sums in determining current liability because of a notice in the 1990s from the IRS the plan is not funding toward, the current liability value of say $548,000 for a particular pilot. It's funding toward 90 percent of that. It's funding for something less than the $500,000. Yet, what's being paid out is something that's almost 50 percent larger than that.

I think the proper solution would be to value these in the form that you'd expect. If you're expecting, as you naturally would in a cash-balance plan, that the same 90 percent or more taking lump sums while the plan is ongoing is the way you would measure its value for current liability purposes.

**MR. GEBHARDTSBAUER:** The Academy wrote a paper and said that we should be able to value the lump sum as it is in current liability. But I guess if you wanted you could at least use the bottom of the corridor for people who you expect to get lump sums.

**MR. GUSTAFSON:** I think the real issue is, why do you have to go to some sort of indirect measure if you can do it directly? That underlies a lot of what we're talking about now and what we're going to be talking about for the next two days.

**MR. SEGAL:** That's right. In good actuarial practice in the basic valuation we're assuming what certain percentage is taking a lump sum, but when it comes to current liability we're prohibited from recognizing that.

**MR. GUSTAFSON:** Right. I have a real-life illustration of one of the steel plans that we took over. The assumed retirement age was age 62 for a plan where the steelworker had qualified for a 30-and-out benefit. It's a troubled company and this person could retire at any moment. He could retire without 30-and-out at age 60. Normal retirement age was 62 and 15. However, this participant was being valued as if he would retire at age 62. When the plan terminated and he was age 54, the value shot up to $256,000. They were funding toward 90 percent of $118,000. It's another problem we've got.

**MR. LOWMAN:** Has anyone ever asked for an experience study? Was one done that shows if you work eight years beyond being eligible for an unreduced benefit?

**MR. GUSTAFSON:** When you look at experience studies, yes, you'll find that the 30-and-out participants don't retire immediately because many of them say they're making more in compensation than they would get under their pension. They do stay beyond age 30. But that's on an ongoing basis. What we're talking about here is a very troubled company that's been junk-bond rated and close to bankruptcy for 10 years in a row. But that's never reflected in this assumption.

The Academy actually did a study a couple of years ago of actual purchases of annuities for relatively small plans, not very large ones. When they compared the actual purchase prices with what it would have been if you had valued the liability using PBGC assumptions, they were within 3 or 4 percent. This study has not yet been superseded by anything else.

Now when you're talking about a steel case, those are the wild cards as to how insurance companies price these. They don't usually see the subsidies that are in steel plans. That's our experience in talking with pricing actuaries at insurance companies. They are not accustomed to dealing with the 30-and-outs and even shutdown benefits, if they are still in the plan. I don't know how they would have valued shutdown benefits on a contingent basis.

If you can go to the market and you can find an annuity carrier to take care of your guaranteed benefits, which will issue you an annuity contract, then the PBGC says more power to you and goodbye. If you're $2 million short of what the market is charging you, then you're $2 million short of what the market is charging you.

**FROM THE FLOOR:** It seems to me that if they were in bankruptcy court, and creditors and everybody were knowledgeable and active in the process, that creditors would be happy to forego $2 million of credit to save $5 million. Unless they were convinced that the PBGC claim of $25 million would be ultimately valued at less than $22 million by the bankruptcy court.

**MR. GUSTAFSON:** Historically we have gotten five cents to seven cents on the dollar on our claims in bankruptcy. In terms of the weaknesses in the rules, one factor is a controversial one. It's the possible use of financial health in the funding rules, or possibly in the premium rules. We went back and we took a look at 27 very large claims that constitute more than half of our historic claims and found the history of their credit ratings. In terms of dollars, almost 90 percent of our claims had been junk for 10 years. This is not something where companies are jumping in and out of a junk-bond status. They don't just fall out of the sky all at once; they've been there for a long time. We have other historic studies that indicate that's where all of our claims are coming from. I am trying to build a case that maybe it does make sense to include some reference to financial health of a company or the plan sponsor in setting up these rules.

**MR. GEBHARDTSBAUER:** I guess the law would allow you to terminate them 10 years ago because they just added lots of accruals and you probably didn't get that much additional money.

**MR. GUSTAFSON:** Maybe so. We have several models that we use in assessing what the future might look like. Starting in 2004, we looked at what would happen under a few interest rate regimes, including reversion to the 105 percent in plan years beginning after January 1, 2004; staying at the 120 percent of current liability level after 2003 and the rate being based upon the composite bond index which I believe is the ERISA's Industry Committee's (ERIC) bond rate of a quarter of four different indices.

The models show you that the current funding rules build in, for a very large plan, some substantial under-funding. Some folks think this is a problem for PBGC. It's not a problem for PBGC. We're just moneychangers. We're taking money in from premium payers. Those are the stakeholders in our program. We're paying benefits out to plan participants. When you see a plan that's substantially under-funded, you know that plan participants are not going to get everything that they were promised. There are losers there. It's not just about getting less than the accrued benefit. It's about losing all those contingent benefits. It's those people in the 30-and-out plans who have 27 years of service and will never get that 30th year of service because the plan terminates that contingent benefit.

But somebody has to pick up the cost of this over time. Ultimately the premium payers may ask why they are subsidizing that level of under-funding?

**Mr. GEBHARDTSBAUER:** You talked about the company that's been in junk status for 10 years. Besides raising their contribution or terminating them 10 years ago, another possibility would be to tell the company that it has to freeze its benefits while it's in junk status. I don't know what people will think about that idea. Maybe that would get its funding ratios back up quicker if it had to freeze benefits until a certain funding level was reached.

That means the company doesn't have to contribute a lot more. But then you're hitting participants. That would be a hard freeze. It would be Congress saying that the employees of companies with junk-bond status can't have benefit accruals. Is that what that means?

**FROM THE FLOOR:** Are you saying that you're going to be able to supersede a collective bargaining agreement?

**MR. GEBHARDTSBAUER:** I don't know.

**MR. GUSTAFSON:** We've done this for a whole host of companies and the numbers look similar. Where does that leave us? Right now we could do nothing. We could just wish this away. We could say that those interest rates are going to go up and the stock market is going to go up and everything is going to be rosy. It's got to get really rosy to get us out of this hole. We could consider significantly higher premiums, clearly some multiple of what we'd be charging today, or we can try to get plans better funded. Frankly, in the absence of these three, it may be a taxpayer bailout. That's the reality of this situation. There are a lot of forces that would suggest that these higher premiums and better funding rules—not higher contributions but better and more-targeted funding rules—are going to be very difficult to sell. We have no plans right now. There's no administration proposal, but we certainly are looking at all of the options and all of the reasons why we got to where we are today.

**MR. LOWMAN:** The next topic is 4010 filings, starting with what they are, understanding the obligation of filers and how life has changed a lot—we have a lot more filers then we ever did. I want to talk about what actuaries do when they do these numbers.

The 4010 filing is something you have to know about. Basically, if you're under-funded by more than $50 million, you've got to do this filing. It's on a controlled group basis. The $50 million number is a number based on the liabilities you calculate through your PBGC variable premiums. Once you reach that size of unfunded liability, then your real work starts. You're required to calculate the benefit liabilities, which is the PBGC term for roughly all accrued benefits. You need to do it on a PBGC basis, meaning your threshold is determined on some easily defined number you're used to dealing with, but now you've got to use PBGC assumptions. Those PBGC assumptions include the PBGC valuation interest rates and the PBGC assumed retirement ages. Please include the PBGC expense load in that calculation. It's part of the liability number. A lot of people were doing it for the first time a year or so ago or maybe a few years before that. They didn't quite know what it was and PBGC had a lot of calls asking how to do this. If you disclose what you're doing, it helps a lot. If you need some help, call PBGC actuaries and they'll give you some clues on what to do. The same goes with expense loads. Did they include it, or did they not? Expense loads are written up in the law as something like $200 per person and a certain percentage of your liabilities.

I want to spend some time talking about cash-balance plans because cash-balance plans are a little tricky. It's more than just an assumed retirement age and making sure you value things as an annuity because PBGC values annuities and they don't generally pay lump sums. The other issues, therefore, are interest credit rates assumption and annuity conversion rates. If you have a cash-balance plan, the PBGC operating manual is going to tell you two things, one of which is very important if you're a 4010 filer. The first thing that's not as important to you is that it covers how PBGC pays benefits for cash-balance plans. It takes over. A simple way of explaining it is that they're going to go ahead and keep track of people's account balances. They're going to credit rates pretty much the way a plan is crediting rates. I know we have a lot of unusual forms, but for the standard cash-balance plan, that's what they are going to do. They're going to issue cash-balance statements. There will be no new pay credits obviously, but extra interest credits eventually every year once it gets into their system. People are going to see what their account balances are going to look like. They're going to pay it out, generally as an annuity, when they hit retirement age.

You'll see comments in there about not paying out annuities before age 55, even though maybe the ongoing plan would have paid an annuity when a person terminated employment. Those are the general rules.

The important thing for you is that it tells you not only what the PBGC will pay for a cash-balance plan under their current thought process, which can change, but it will tell you how they will value it. Therefore, it will tell you how they set their interest credit assumptions and how they set their annuity conversion assumptions. It's variable on plan design, depending on what your interest credit basis is and what your annuity conversion basis is. But for the most part, it covers a wide variety of cash-balance plans. I don't think people were aware of this document because it's not that old. But again, the first thing you can do if you're a 4010 filer with a cash-balance plan is disclose those two assumptions that will help PBGC understand what you did. Then they convert it to their own. Ideally what you would do is understand how they actually make those two assumptions and try to follow those assumptions.

By the way, 4010 information is not Freedom of Information Act recoverable; it's very confidential information. I asked Dave to comment on the number of plan filings because it has indeed increased a lot.

**MR. GUSTAFSON:** The 4010 requirement came into existence for plan years beginning in 1996. The first filing was due April 15, 1996, for calendar-year information years. During that seven-year period of time, we've had a pretty steady flow of numbers of controlled groups. We measure these by controlled groups who file. Beginning in 1996, which of course was reporting 1995 results, there were 77 filers. There were 64 filers in 1997, 53 filers in 1998, 99 filers in 1999, 50 filers in 2000, 81 filers in 2001 and then 261 filers in 2002. The actual under-funding totals, the unfunded benefit liability (UBL) totals that we got for those respective filings were $36 billion, $35 billion, $31 billion, $52 billion, $18 billion, $20 billion and $111 billion. The tally is still out for this year.

Tom mentioned that you can't access this information. That is not PBGC policy. The statute specifically says that this is confidential actuarial and financial information. That was a quid pro quo in the legislative process for having this information filed with the PBGC.

**MR. LOWMAN:** There's another thing I want you to understand. You know when your Schedule Bs are due and you know when your 5500 forms are due, but no one is going to be knocking on your door saying that you're the plan administrator and you owe this information. But it is owed. Just be aware that if you hit this threshold, it's required. I don't know what the penalties are if you forget to file.

**MR. GUSTAFSON:** This year, as there were last year, a number of first-time filers asked for extensions. When we first put out the regulations on 4010, we gave an automatic extension beyond the April 15 date to the end of May, I think. By and large, people who are first-time filers who have asked for extensions have gotten them.

**MR. SEGAL:** But the trick was that you had to ask for your extension before April 15.

**MR. GUSTAFSON:** That was a good idea.

We asked the Congress to give us this 4010 information because, as we all know, the 5500 information is dated when we get it. It may be two or three years old, from the "as of" date for the information. So here we are, an insurance company, not getting critical current information on what our exposure is. That was the way it was pitched to the Congress when we asked for this ability.

We also felt we needed more financial information than was publicly available on the 10Ks and the 10Qs, or what we could glean from information services. Congress thought that that was appropriate as well, in our capacity as an insurer. We have an early-warning program that's been in existence for more than 10 years now, where we monitor companies that might present problems. They might have a deteriorating financial situation and might be anticipating a spin-off that would be detrimental to the plan's interest in the event of a plan termination. This greatly aids the folks who are monitoring the financial health of these companies, as well as the financial health of their plans. One benefit of this whole process has been to make the Top 50 list that we had been doing since 1989 a lot less necessary and would enable us to get rid of that, which a lot of employers thought was a great idea.

**MR. SEGAL:** When talking about risk and the PBGC's watch list, it seems that the PBGC also takes an interest in transactions where a portion of a company is being sold to another company. The PBGC somehow finds out before the transaction is consummated and sometimes raises questions before the transaction is completed. Perhaps this happens when, in somebody's eyes, a less credit-worthy company is buying an operation from a more credit-worthy company.

**MR. GUSTAFSON:** Everything you said is true.

**MR. LOWMAN:** Some of those cases are actually in their annual report.

**MR. GUSTAFSON:** We take a look at trying to protect the interests of the plan participants and the premium payers, in this case the insurance program. Is something happening here with this company, or is this some business transaction that would diminish PBGC's claim in bankruptcy if this plan were to come in the door? The only threat that we have is to involuntarily terminate, which is not a very good one to use because you have to have strong evidence that that's essential to avoid long-run loss for the program. I know that there's a lot of negative feeling about PBGC's involvement in mergers and spin-offs, in terms of bringing it to a halt or thrusting the government into some private transaction. But we feel it is part of our congressional charge to protect the program against transactions that first of all, we often never hear about and secondly, would put us at a disadvantage.

**MR. SEGAL:** Is this only in cases where there is an under-funding in the plan?

**MR. GUSTAFSON:** We put out some guidelines about two years ago as to when our early-warning program can contact people for additional information. One of the requirements is that there would be under-funding.

**MR. GEBHARDTSBAUER:** Is the level of involvement in transactions still happening as much as in the prior administration?

**MR. GUSTAFSON:** Pretty much. It was reduced substantially when we put out that technical update two or three years ago, in terms of the number of letters and inquiries that went out. It has stayed at that level.

**MR. LOWMAN:** I'm going to skip ahead now because there are a lot of little votes I'd like to take. I want to cover at least one issue on PBGC premiums. We're going to talk about what PBGC's funding levels should be and their current financial health. This touches on a question that somebody else asked before. PBGC has all these assets as well as liabilities. The question is how do they invest their assets? The PBGC is really just a financial intermediary, as someone else said before. The PBGC is not just the person that we're trying to have our clients pay as few premiums to as possible. In the long term, if we let plans stay poorly funded, the premium has got to go up. That's just a question of when and how.

One of the related issues is how does PBGC act as an insurer? What should their current investment mix be? I'm told that the current equity mix is around 30 percent. The question is, should it be zero percent? Should it be 50 percent? What should it be? We could take a vote.

**MR. GUSTAFSON:** It might be helpful to know that by statute we cannot invest our premium funds in anything other than debt securities. By board resolution, that means Treasury securities. Over the last decade or so, that would mean that 60 percent of our assets have to be in Treasury securities. It's the remaining 40 percent, which are the assets that come in when we trustee plans that are terminated—where we just take over the portfolio that was in that trust— where the question comes, do you maximize or minimize the equity holdings in that 40 percent? Executive directors over time have had very different opinions as to the appropriate approach.

**MR. LOWMAN:** If they do go 100 percent into fixed, then what should their valuation rate be? Should it be what the annuity rates are in the market? Or if they are going to hold the money themselves, should it be the fixed income returns they can earn themselves on the money they are going to get?

I'll give three choices. Option one is the maximum amount is 40 percent in stocks. Option two is status quo, which is 30 percent. Option three is zero percent; everything is in bonds.

Raise your hand for 40 percent. There's a smattering of votes, maybe less than 10. Raise your hand for the current 30 percent. I think some people voted twice, but a few more than the first. Raise your hand for zero percent. That has probably the fewest votes, but they're all kind of close.

**MR. SEGAL:** The 40 percent option won, but not with a majority.

**MR. LOWMAN:** I'm going to go on to a different question. Should we abolish PBGC, yes or no? Should we just get rid of PBGC and not have anyone out there guaranteeing benefits? Who should pay the premium for the $5.4 billion that's already out there? Should the current people pay for it? If they don't, who's going to pay for it?

**UNIDENTIFIED SPEAKER:** In the UK they're talking about a PBGC, and they asked us if maybe the participants should pay premiums.

**MR. GUSTAFSON:** They thought about that. But no, the program that they are looking at now does not.

**MR. LOWMAN:** The first question is going to be, are you for or against abolishing PBGC and not having a guarantor out there beyond the plan sponsor and the assets in the fund? For those who vote yes, they want to get rid of PBGC, I'll have a follow-up question. Those who vote no, they want to keep PBGC, can't vote for the follow-up question. The follow-up question will be: what happens? Are we just going to cover to the extent funded? Do the current asset allocation rules still apply? But again, who wants to get rid of the PBGC and not have any guarantor out there?

**MR. SEGAL:** We are saying they abolish the PBGC tomorrow and no benefits that have not already been trusteed by the PBGC would be guaranteed. The insurance company disappears.

**MR. LOWMAN:** Right. Maybe the federal government takes over the $5.3 billion currently out there and that's it.

So who wants to get rid of it, even on that basis? Who wants to keep it? It's pretty evenly split.

Who thinks this would be privately insured? Who thinks it can't be privately insured? We have more that think it can't be privately insured.

**MR. GUSTAFSON:** Let me ask one question of those folks who want to abolish the PBGC. If you abolish the PBGC, don't you think that the funding requirements should be strengthened?

**FROM THE FLOOR:** I think they should be strengthened in any case.

**MR. SEGAL:** We're abolishing the PBGC and we are strengthening the funding requirements. I'm not commenting on the valid point that they should be strengthened in any event. How many plan sponsors do you think would then continue their defined benefit plans? Someone said zero.

**FROM THE FLOOR:** As actuaries, we should be looking at things from the perspective of plan participants and employers. If defined benefit plans don't work for many employers, then there will be fewer. I have a couple of clients who are still not under-funded. They still have more assets than their current liability. They would like to contribute more. The IRS rules have prevented them from making contributions for a while now. The limit is going up next year, and they are looking at that as something that they want to do. Now, I agree that that's not most employers. There are other clients who don't belong in defined benefit plans because they want to provide less of their assets than they need to.

**FROM THE FLOOR:** As an alternative to the PBGC, we would make the system more transparent and we would have a better sense of the price of the risks that are being taken under the following admittedly impractical approach. We assign to every employer's DB plan the responsibility for its share of all of the pension failures by others, and we securitize that obligation. As a plan that represents 1 percent of the population, I am responsible for 1 percent of any losses. I now have a new liability that's 1 percent of everybody else. I want to pay somebody to take that off my hands. That's what I mean by securitizing. I want to make a trade to them. I would be quite interested in the price discovery process that would ensue as the pension plans traded among themselves the obligations to make good on other pension plans.

**MR. GUSTAFSON:** When we had such a huge surplus, we looked at a whole range of risk-management approaches. One approach was to issue catastrophic bonds that securitize that surplus level, whatever it is, or a deficit. It would be beyond just the DB universe. Anybody could invest in something like that.

**FROM THE FLOOR:** I see no practical way to do it. There are lots of problems. If I am not a secure promise-maker, then it's easy for me to take money to take on all these promises. That's part of why the PBGC is as important as it is. It's hard to manufacture a free marketplace. A number of people, who voted a few minutes ago, said it could not be done. It's certainly difficult. I raise the abstraction because I think it would inform the marketplace as to what kind of value is being placed on these things. As you point out, we don't have to restrict the participants. People willing to take this on could be anyone of financial substance who could make good on the promises that they took on.

**MR. LOWMAN:** What should PBGC cover? I'd like to mention a couple of plan designs. One issue is floor-offset plans. For those of you who are following the Enron situation, Enron had a floor offset tied to an employee stock ownership plan (ESOP). There was a rule many years ago saying you can't do that anymore, obviously because it's a funny risk here. If the company goes under, the DB benefit goes up. But they grandfathered certain plans. Beyond ESOP floor-offset rules, there are just regular floor-offset plans out there. I think the Academy has a floor-offset plan. It has different kinds of risk—where all of a sudden the liabilities jump up materially when the defined contribution (DC) account, balances go down. It may happen at a bad time. It may not be a bad time in the market, but a bad time for the plan sponsor. I think the good thing is there aren't a whole lot of plans out there. I don't think it's a huge risk for PBGC. But should we be charging extra premium or should something be done differently for those kinds of plans?

A different topic is prior annuity purchases. The PBGC's view is if you buy an annuity for someone from an insurance company, that's it. If that insurance company goes under, the PBGC doesn't guarantee the benefit. We could debate whether employees think that's fair or not.

Then there's the garbage stuff. If you don't work at PBGC, you don't have to worry about it. If you do work at PBGC, unfortunately you're stuck with these problems. These are plans that are what I call "materially broken" from a benefit rule perspective. I've got a little list here. One problem is that the vesting schedule is off. I myself, not PBGC, took over a plan that had 10-year cliff vesting. This is a single-employer plan a couple of years ago. What do you do? A second problem is plans that were never in writing. How do you trustee a plan that was never in writing? Is it a plan? What are you supposed to do? At least there's usually something to go by, like maybe a benefit calculation or maybe something that looks like an SPD. But it's tough.

Permitted disparity rules are tough because you get a plan formed but you know it doesn't work. But how do you fix it? Do you bring something up? Do you bring something down? What do you do? You've got a written plan, but you know something is violated.

One of my favorites is 204(h) violations. PBGC would like to think that everyone follows the rules perfectly, but sometimes you may have a fairly clear violation. Maybe it wasn't last year, maybe it was many years ago and a notice wasn't given or the amendment was signed late. The remedy to a 204(h) violation is that the amendment didn't happen. The old formula continues. It wasn't funded that way for the last 10 years. What are you supposed to do?

We're not going to deal with these particular things. Just understand that PBGC gets some garbage plans out there. The IRS has been rumbling about most valuable form of benefits in a lot of different ways, shapes or forms. Again, does the PBGC "ERISAfy" when something comes out like that, if we decide that the plan's joint and survivorship annuity (J&S) form is not the right number?

Should the PBGC always be able to tell people that all they're promising is the way the plan was written? That's all they're going to promise and no more than that.

Let me take a vote on that. I got a plan and I'm not going to tell you which of these problems occurred, whether it was vesting, 204(h), permitted disparity or what have you. Maybe you'd give me different answers depending on what the facts and circumstances were for a particular case. But as a general rule, is it reasonable for the PBGC to simply say that if I have a written plan, my guaranteed benefits should be based off of that plan? Or do I have to expand it and somehow "ERISAfy" it and make it more than it was?

Let me expand some more. Not only do I have a written plan document, but also I know it was administered this way and the valuations by the ongoing actuary were done this way. Can I follow it or do I have to fix it and pay it after it was fixed? The vote is, "all people responsible for is the written plan," or what we call "ERISAfy," fixes it somehow. Votes for "plan as written"? Votes for "ERISAfy"? There are a few more votes for "as written" than for "ERISAfy," but a lot on both sides.

**MR. GEBHARDTSBAUER:** They should "ERISAfy." Otherwise, you have people that really never got the vesting rule down to five years. Because the employer didn't change it, the participant suffers?

**MR. SEGAL:** I'll defend my vote. The law is the law is the law.

**MR. LOWMAN:** We definitely want to talk about shutdown benefits. For those of you who don't know what they are, they're very common, mostly in the steel plans but in a few other industries as well. A shutdown benefit is what it sounds like. If you shut a plant down or shut part of the operation down, extra benefits kick in. Those extra benefits usually include an unreduced early retirement age and a temporary supplement, usually until age 62. So in a steel plan, the common rules are "rule of 65" and "rule of 70/80." These are combinations of age and service. A supplement might be $400 a month or it may be bigger now. These are not pre-funded. No one recognizes them in funding until the event occurs. Once the shutdown occurs, then the funding starts from that point on. However, it may be that the shutdown occurs and the company goes under at the same time. The employer may be negotiating with the employee. The employee wants a shutdown benefit. The employer says, "Sure." The employer won't be around if they have to pay them.

Most terminations are involuntary. PBGC shuts plans down. So there's a discussion. Should we shut down the plan before the shutdown of the operation occurs, before the shutdown benefits kick in and accrue? Shutdown benefits are generally fully phased in because they're phased in from when the amendment to put them in occurred, not from when the shutdown occurred. These are big liabilities that PBGC has.

I'd like to have a vote on several options. One option is that there is no change to the law. Companies can negotiate this way with their employees and these benefits kick in. If PBGC gets stuck with billions of dollars all at once that weren't funded, so be it. Option two is to require some kind of advanced funding, which is difficult. All of a sudden you have a contingent liability that either will or will not happen, but I want you to fund for some or all of it.

Option three is a PBGC response perhaps. Start the phase-in from the date of the shutdown. This would give us a chance to get some of these things funded. If you shut down the operation, shutdown benefits kick in and then you terminate the next day, zero percent phase-in. We're going to go after you for the benefit liability. But PBGC isn't on the hook until it's been around for at least a year, which still may not be enough time to get any real funding going.

A fourth option is to eliminate shutdown benefits altogether. You can't do it anymore. The fifth choice is only cover it to the extent funded. Create a new priority category way at the end somewhere else. There are a lot of choices.

**MR. SEGAL:** I'd like to offer a sixth option. This is the one that I will vote for. Require advanced funding, require additional PBGC premium, and to the extent funded under a PC7—all three conditions.

**MR. GUSTAFSON:** I hate to throw water on your option, Don, but back in 1987 or 1988 I participated in an ad hoc committee of the Academy that studied this issue of advanced funding of shutdown benefits. The report of that committee was actually on the Society's syllabus for a number of years. Its conclusion was that you cannot advance fund shutdown benefits. Large, catastrophic, unpredictable events are ones you cannot satisfactorily put enough money in. You either put far too much or far too little in. By its very nature it's unpredictable. Advanced funding is not an option. That's why in 1987 one of the funding rules was to try to tighten up the ex-post-funding requirements for shutdown benefits. I'm not sure that that's something we should even put on the table.

**MR. GUSTAFSON:** One of the practical problems is convincing the IRS that you should be able to deduct that.

**MR. SEGAL:** Obviously, if there were a requirement for advanced funding, it would have to be deductible. One of our major issues right now is, as a plan sponsor, am I prevented from contributing more. I would be surprised if the PBGC had a problem with a change in the law that would enable me to put some money away, even if they are saying I'm putting it away for a contingent event that is unlikely to happen. The money is still sitting there in the plan.

**MR. GUSTAFSON:** The problem is not us. We've never seen a contribution dollar that we don't like. But some will say that if you permit this to happen, every doctor's plan in the country will have a shutdown provision in it.

**MR. LOWMAN:** A few plans that we've seen do have some assumptions in place. Usually about 2 percent to 3 percent of retirements will be shutdowns. If you're a big enough organization with lots of different plants, it's fairly predictable.

**MR. LOWMAN:** I'm going to let you vote multiple times because there are too many options for you to remember which one you liked best. The first vote is for "no change, just stick it to PBGC, guarantee everything and life is good." No one voted for that.

The second vote is to require advanced funding. Eight people voted for that. The third vote is to start the phase-in from the date of shutdown. About 17 people voted for that, so that was fairly popular. The next vote is to eliminate shutdown benefits altogether. That was the most votes; that's a lot of people. The next vote is to only provide it to the extent funded. It's a new priority category and comes in very last. At least 10 of you voted for that. Now I've got Don's category, which was all of the above plus extra premiums. We lost a few.

**MR. GUSTAFSON:** I think the winner was to eliminate them. Then you get to the interesting question, what do you do about window benefits? How are they any different? The only difference is that they are phased in.

**MR. LOWMAN:** That's a big difference.

**MR. GUSTAFSON:** I know it is. But it's not a complete difference. The phase-in doesn't give us complete protection.

**MR. SEGAL:** No, but it's very simple. I'm the Terminal Steel Co., and I decide to have a window for all my employees, whom I discharge in the next three months.

**MR. GUSTAFSON:** The shutdown benefit operates exactly the same way. The employer has to declare a shutdown. It's entirely within the employer's control, just like a window is.

**MR. LOWMAN:** The three months is not the problem with the window. The problem with the window is just over a year, and you haven't funded anything for it yet.

**MR. GEBHARDTSBAUER:** On salaried plans you get automatic increases because of salary increases. They are not phased in like in an hourly plan.

**FROM THE FLOOR:** It seems to me that if you don't have assets, all these benefits are suspect. If you are trying to achieve a forward purpose by giving these benefits, to the extent that you can afford it, go ahead. By "afford it," I mean either it's pre-funded or you are able to put in funds. Windows are essentially a bribe to get people to retire. Is this in fact a pensionable benefit? Is this something that companies should be getting tax-sheltered funding for, or as a matter of societal interest, is this bribe something you should be doing as a severance benefit, outside of the qualified system?

**MR. SEGAL:** Because this window benefit is enabling you to fund over a number of years, something which perhaps you should fund immediately.

**MR. LOWMAN:** Now you're moving from your ability to provide a benefit based on the credit-worthiness of the company to how well funded the pension plan is.

**FROM THE FLOOR:** If you expect to get the PBGC to guarantee it, you're going to rearrange the relative values of more senior and junior participants by giving these kinds of benefits; if you can't afford it within the plan, you shouldn't be able to promise it.

**MR. GUSTAFSON:** There is a provision in the code, in section 401(a)(29), that says if you're funded less than 60 percent on a current liability basis, and there were some grandfathering provisions and a $10 million de minimus. Then basically you can't amend the plan, unless you fund it immediately up to 60 percent or you provide security.

**FROM THE FLOOR:** You need to raise that and you need to limit the guarantees for plans that are unfunded.

**MR. LOWMAN:** We were talking about cash-balance plans a little bit. One of the issues of the cash balance plans is this issue of leveraging. They tend to be under-funded relative to paying off their lump sum account balances, which is a problem for PBGC. As the number of plans grow, it could become more of a problem, even if PBGC doesn't pay lump sums. It has a lot of limitations on cash-balance payouts.

**FROM THE FLOOR:** There's a paper from 1993 that talks about the trade-off for guaranteed providers. You can require 100 percent funding and monitor very, very frequently. Or you can require 105 percent funding and well-matched assets and liabilities, and monitor less often. Or you can let people have more freedom in their asset-liability mismatch, but then they'd need 120 percent funding. You can use these three pedals to control this process.

The other paper is from in 1976, in which the author talked about essentially the value of what he called the "PBGC put." It's all these things we've been talking about, where sponsors are able to create a value for their shareholders, inevitably at the expense of the PBGC.

**MR. GEBHARDTSBAUER:** I guess Bethlehem Steel did that. They had a huge retiree liability. They bet on stocks beating bonds, and so, if the stocks did well, they did well. If the stocks didn't do well, then PBGC didn't do well.