A Comprehensive Defined Benefit Pension Plan Reform Proposal

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1. Introduction

There can be no doubt that, before the passage of ERISA, pension plans—and particularly defined benefit plans—were in need of reform. As plan sponsorship spread from a few large corporations to a broad cross section of businesses, opportunities for abuse of the loosely regulated retirement system proliferated. This situation was exacerbated by the high-profile bankruptcies of a few large sponsors, with concomitant loss of the pension benefits of affected workers.

ERISA introduced a wide variety of reforms: minimum participation and vesting standards, minimum funding standards and tighter restrictions on tax-deductible contributions, and limits on benefits and plan termination insurance. Since the passage of ERISA, most restrictions from the original law have been tightened by subsequent legislation. With nearly 30 years of experience under ERISA behind us, it seems clear that, at least with respect to defined benefit plans, the cure has nearly killed the patient. The number of defined benefit plans and the percentage of U.S. workers participating in them have both decreased dramatically, many remaining sponsors are freezing or terminating their plans, and the plan termination insurance program is running a multi-billion-dollar deficit.

What went wrong? It is apparent that many of the ERISA reforms, although adopted in good faith, have had perverse unintended consequences. Minimum participation and vesting standards have extended coverage to employees who have no need for or interest in defined benefit plans, making it difficult for many employers, particularly in emerging industries with young workforces, to justify plan sponsorship. Limits on benefits have reduced interest in qualified plans among the most highly paid employees, who also make plan sponsorship decisions. Tight restrictions on contributions have forced employers to fund their plans in opposition to the economic cycle by limiting the buildup of assets during periods of economic expansion and making large demands on sponsors' resources during downturns. Limited underwriting has made the plan termination insurance program a mechanism for financially strong employers to subsidize the financially weak.

However well intended, it is clear that ERISA reforms were not merely inadequate, but misdirected. The following proposal charts a new direction in defined benefit plan regulation in the areas of plan termination insurance, minimum and maximum funding rules, and plan design restrictions.

2. Plan Termination Insurance

The bulk of ERISA rules are contained in Titles I and II, which govern the labor- and tax-related aspects, respectively, of pension law. Plan termination insurance is contained in Title IV. Failure to integrate the termination insurance program into the fabric of plan regulation has contributed to the termination insurance program's current financial problems. The following discussion outlines a multipronged approach for shoring up the program for the present and redesigning the program for the future.

2.1 Who Is Insured?

The current plan termination insurance program, administered by the Pension Benefit Guaranty Corporation (PBGC), insures, within limits set by law, plan participants' pension benefits. The program does not insure plan sponsors' pension obligations; when the PBGC becomes trustee of an underfunded terminated plan, the sponsor's liability under the plan is not extinguished but merely transferred to the PBGC, which becomes a creditor in the bankruptcy proceedings, often among the largest such creditors. Thus neither the plan sponsor—the premium payer—nor its owners and lenders obtain any benefit from the insurance coverage.

The insurance program should be changed so that the pension trust is the beneficiary of the insurance. Under this scheme, internal limits on coverage would be eliminated. When an underfunded plan terminates, the insurance program would make a sufficient payment to the trust to enable the trust to purchase annuities to cover all benefit liabilities, thus satisfying the sponsor's pension obligation. This scheme increases protection for participants while extending protection to sponsors, owners, and lenders, greatly increasing the utility of the program. The cost is a small increase in coverage due to the elimination of internal limits on coverage and the loss of recoveries in bankruptcy.

2.2 Program Administration

PBGC termination insurance premiums comprise two parts: a fixed premium based on the number of plan participants, and a variable premium based on the value of unfunded vested benefits. The PBGC has no authority to underwrite its risks based on the probability of plan termination. The inevitable result is that financially strong sponsors, with a low probability of terminating their plans in an underfunded condition, subsidize weaker companies, where the probability of termination may be far higher.

It is unlikely any government-run program can adequately underwrite plan termination insurance. Underwriting requires judgment, which, in the hands of government, becomes an invitation for abuse. When regulation is substituted for judgment, inflexibility in the face of changing circumstances inevitably leads to poor decision making. These difficulties arise even before considering the question of whether government ever should be placed in the role of evaluating private companies. An alternate structure would comprise three parts, covering long-term, short-term, and industry-specific risks. The program would be administered by a nonprofit corporation controlled by a board representing the plan sponsors. In addition to administering the program, the corporation would compete with commercial insurers to provide insurance coverage.

There is no guarantee that commercial insurers would enter the market, although experience with other government-mandated coverages, such as the fidelity bond required under ERISA for certain plan fiduciaries, shows that, when government creates a market, commercial insurers are likely to enter. In any case, competition from commercial insurers is not required to make the model work.

2.3 Long-Term Risk

Each year a sponsor calculates its uninsured benefit liability, equal to its total benefit liability less plan assets and any previously insured liabilities. The sponsor then obtains coverage for this liability, with premiums fixed as a percentage of the covered amount over the lifetime of the coverage. The covered amount is written down 20 percent each year, so both the amount and period of coverage are fixed. Underwriting would be based primarily on the company-specific risk of bankruptcy. Any negative uninsured benefit reduces the outstanding balances and the premiums, proportionately for all previously insured liabilities. After five years the long-term risk premium is the sum of the premiums for up to five pieces of insured benefit liability.

2.4 Short-Term Risk

In addition, each year a sponsor must obtain one-year term coverage for short-term fluctuations in its benefit liability during the year. The short-term risk would not include liability for any benefit enhancements: benefits not taken into account in the beginning-of-year benefit liability cannot become effective until the beginning of the following year. Underwriting for the short-term risk would take into account any asset-liability mismatch risk in addition to the bankruptcy risk.

2.5 Industry-Specific Risk

The entire deficit in the current system can be attributed to two industries, steel and airlines. Both industries are in the process of major restructuring. Although the reasons for these restructurings are largely unrelated to their pension plan sponsorship, old-line companies in both industries face competition from new entrants in the United States and from foreign competitors who do not sponsor defined benefit plans or whose younger workforces make plan sponsorship less expensive. There is no industry in the United States not potentially vulnerable to such restructuring. Although it can be argued that neither the PBGC nor any successor should have to help finance industry-wide restructurings, the fact is that large-scale plan terminations are often a part of such restructurings. A mechanism must be found for insuring these risks without jeopardizing the solvency of the plan termination insurance program, as has happened under the current system.

One possible mechanism is bonds whose specific purpose is to finance unfunded pension liabilities in industries undergoing restructuring. Here's how they would work. Defined benefit plan sponsors would be divided into standard industry groups. For each industry, the corporation would issue special-purpose "pension underfunding bonds" in an amount sufficient to provide stop-loss coverage against plan terminations due to industry-wide restructuring. Bond default, that is, use of all or part of the bond proceeds to shore up the plan termination insurance program, would be triggered by plan terminations in the industry (measured by total insured liabilities) exceeding the national average by some percentage, probably in the 100–200 percent range. Thus, default would be triggered not by increased terminations alone, which might occur during an economic downturn, but by terminations exceeding the national average.

Sponsors in each industry would be required to pay a supplemental premium sufficient to cover the risk premium demanded by the market (and transaction costs) on the bonds issued to cover the industry. These bonds would limit the losses for underwriters of the long- and short-term risks, thus helping to ensure the long-term solvency of the plan termination insurance program. A similar mechanism is used by casualty insurers to diversify the risk of large-scale natural disasters such as hurricanes and earthquakes.

2.5 Transition

The transition from the PBGC to a nonprofit corporation must include a means for accommodating sponsors who, on account of plan underfunding and/or a weak financial position, are unable to find plan termination insurance at a reasonable cost.

This can be handled by maintaining the current insurance program, administered by the PBGC, for a transition period up to five years for these sponsors. If, at the end of the transition period, these sponsors are still unable to find insurance at a reasonable cost, they would be required to terminate their plans.

The transition from the PBGC to a nonprofit corporation must also include a means for dealing with the PBGC's current deficit. Given that the deficit is entirely attributable to the steel and airline industries, a logical scheme is for the PBGC to retain all assets and liabilities, both current and future, attributable to these two industries, and for government to cover from its general revenue these industry-specific risks not provided for when the PBGC was established. The remaining net surplus would be used first to fund the transition insurance program described above; any remainder could provide seed capital for the new insurance program.

It is inherently unfair for taxpayers at large to guarantee the pension benefits of employees in two industries. A close analogy is the savings-and-loan bailout, where taxpayers at large made whole the depositors in certain failed financial institutions. In both the PBGC and savings-and-loan situations, financial difficulties arose from hidden risks inherent in poorly designed legislation. It retrospect, the savings-and-loan bailout seems to have been the correct course of action for dealing with that situation, and the proposed PBGC bailout seems reasonable in that light.

3. Minimum Funding Standards

The purpose of minimum funding standards is to insure that a plan always has sufficient assets on hand to pay benefits. If a robust plan termination insurance program is in place to guarantee payment of benefits, all plans are always fully funded, just as a fully insured health plan is always fully funded as long as the sponsor continues paying premiums. This makes minimum funding standards redundant. Eliminating minimum funding standards (aside from the obligation to fund benefits when due) would strengthen defined benefit plans by

- Circumventing the impossible and ultimately counterproductive task of finding a single correct formula for adequate plan funding that applies to all plans.
- Allowing each sponsor to determine for itself, based on its particular circumstances, the optimal balance between contributing to the plan and paying plan termination insurance premiums.
- Providing the needed flexibility for advance funding of future benefit increases for non-salary-related plans and special termination or shutdown benefits.

4. Maximum Tax-Deductible Contributions

When ERISA was first passed, it included a special limit on tax-deductible contributions for plans that, on account of extraordinary gains, were deemed fully funded on an ongoing-plan basis. Later, a second full funding limit was added based on plan funding on a plan termination basis. The effect of these full funding limits, especially the latter, is to severely limit the sponsor's ability to make sufficient contributions when profits are high to provide a cushion that might reduce funding requirements when profits are low or nonexistent. This makes pension funding countercyclical: contributions are restricted during economic expansions and increased during downturns.

There is no natural maximum funding level. Any bright-line limit on funding, such as the full funding limit, is of necessity a compromise between the need to allow sponsors to build up an adequate funding cushion while preventing them from making contributions merely to shelter profits. Congress has failed to find an appropriate compromise, if such a compromise even exists.

During the mid-1980s, some plan sponsors recovered excess assets in their plans by terminating the plans, taking any assets in excess of the amount necessary to purchase annuities to cover accrued benefits, and setting up identical replacement plans. Congress shut down this practice by imposing increasingly onerous excise taxes on plan assets reverting to the sponsor.

Experience shows that the potential excise tax on asset reversions operates as effectively as the full funding limits to restrict plan contributions. Further, the tax can be graduated, so that a bright-line limit on contributions can be avoided. One possible scheme would allow reversions of excess assets in two situations: (1) if the assets withdrawn are used to fund other tax-favored employee benefit plans; or (2) if all assets used to fund nonqualified deferred compensation are withdrawn first, and no further funding of nonqualified deferred compensation can occur until the qualified plan's assets have been restored with interest. In either case, assets can be withdrawn without any excise tax up to 130 percent of the termination liability, with a graduated excise tax of 10 percent on overfunding from 130 to 160 percent, 25 percent from 160 to 180 percent, 40 percent from 180 to 200 percent, and 50 percent of overfunding in excess of 200 percent.

This graduated excise tax is not intended to have any economic logic; its primary purpose is to limit sponsor contributions via a mechanism that avoids a bright-line limit. Any attempt to promote economic fairness by taxing previously sheltered income is of secondary importance. A possible objection is that it potentially penalizes exceptional investment performance by placing resulting gains in higher excise tax brackets. However, such extraordinary gains are most likely in flush economic times, when the risk of triggering the excise tax by plan termination is low; and, since there is no minimum required contributions, sponsors can manage the level of plan overfunding to some extent by temporarily eliminating contributions.

5. “Model-Neutral” Funding Rules

The current funding rules were developed during the ERISA gestation period in the early 1970s and incorporate generally accepted actuarial practice of the time, which has come to be called the “traditional model.” Some actuaries strongly advocate that the funding rules be changed to reflect developments in financial economics since the current rules were established. These actuaries claim that incorporation of the traditional model into the current legislated funding rules has slowed widespread adoption of the new financial economics model, to the detriment of the profession.

Without taking the side of either the traditional or the financial economics model, one can observe that, at any given time, generally accepted actuarial practice is deemed correct by most actuaries, and nobody can know what aspects of that practice will be deemed incorrect by future actuaries. Although the process can seem glacially slow to those who advocate change, generally accepted actuarial practice does change over time, and legislation based on practice at the time the legislation is enacted can retard the adoption of new practice. To avoid interfering with evolving actuarial practice, legislation must be “model-neutral,” that is, designed to accommodate a wide variety of practice. The funding rules described above are designed to be model-neutral.

Experience shows that regulatory discontinuities such as contemplated here often result in temporary periods of uncertainty and volatility as the affected parties adjust to the new environment. It would be naive not to expect such a result in this case, at least in the short term. Over the longer term, it can be expected that actuaries, economists, and investment advisors will devise models and methods that enable sponsors to finance their plans optimally through a combination of funding and insurance so as to minimize both the magnitude and volatility of cost while maintaining benefit security. The design and application of these models and methods will provide stimulating work for actuaries bored by the rote application of government-mandated funding rules.

6. Plan Design Alternatives

Funding reform is useless if there are no plans left to fund. Many reasons—administrative complexity, wide year-to-year fluctuations in funding requirements and reported expense, lack of participant appreciation, among others—have been offered for the decline in defined benefit pension plans, and no one factor can account entirely for this decline. The following plan design alternative addresses as many of these issues as possible within the context of a traditional defined benefit plan. The basic premise behind the design is that defined benefit plans, by their nature, meet the needs of employees approaching retirement, and that the most important underlying reason for the decline in defined benefit plans has been the misguided attempt to use these plans to provide benefits to a broad range of employees. Requiring an employer to provide benefits for younger, short-service employees under a defined benefit plan as a condition for providing benefits to older, long-service employees is like requiring an employer to provide childcare benefits to childless employees as a condition for providing childcare benefits to employees with children. Ultimately, chasing the will-o'-the-wisp of fairness results in the loss of benefits for everyone.

The following proposal is not meant to supplant current plan designs, but to offer an alternative. Congress has adopted a number of alternate defined contribution designs over the years, whose popularity among sponsors has varied widely. Whether this new defined benefit plan design becomes popular can be determined only by experience.

Participation Standards: This plan differs from traditional designs primarily by allowing the sponsor to set the minimum participation age as late as age 40. The sponsor would be required to cover all nonunion employees who meet the minimum participation requirements. The plan is mandatorily disaggregated for nondiscrimination testing and is deemed to meet all ERISA coverage and participation requirements.

Normal Retirement Age: The sponsor may set the normal retirement age as late as age 70.

Vesting: Full vesting is required after the later of 10 years of service, including preparticipation service, or five years of participation.

Benefit Formula: Any traditional formula—that is, one that expresses the benefit as a monthly amount—that meets the current nondiscrimination tests is permitted. Benefits must accrue uniformly over a period of years exactly equal to the number of years from the minimum participation age to the normal retirement age.

Maximum Benefits: There is no maximum benefit amount, but includable compensation is limited to the amount defined by the top 1 percent of FICA wage earners. This limit is imposed year by year without indexing.

Early Retirement: Subsidized early retirement is not permitted, with the following exceptions: (1) disabled participants may continue earning service credits while disabled until the normal retirement age, and (2) *de minimis* subsidies may be introduced to allow for linear early retirement factors.

Death Benefits: The plan must provide, free of charge, the pre-REA preretirement survivor annuity, which requires coverage only for participants eligible for immediate retirement. The plan must also provide the REA qualified preretirement survivor annuity unless the sponsor provides, through the defined benefit plan or a separate group life insurance plan, a lump-sum death benefit equal to at least participants' base salaries.

Forms of Payment: The plan must offer the same normal forms as standard plans. Lump-sum distributions, except *de minimis* amounts, are prohibited.

Transition: Transition rules would be provided for converting existing defined benefit plans into plans meeting the new design rules.