Why the PBGC Termination Insurance Program Should Be Ended

Larry Pollack

1. Introduction

The Pension Benefit Guaranty Corporation (PBGC) exists "to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants" (ERISA, Section 4002(a)(1)). The PBGC's sole source of funding, by law, is premiums paid by sponsors of private defined benefit (DB) plans.

But what if the ongoing health of the PBGC and the health of the DB plan system are fundamentally incompatible? From a plan sponsor's point of view, termination insurance premiums are equivalent to a tax on DB plans. Thus, there is an inherent contradiction in the PBGC's nature: it exists to support the DB plan system by taxing it. Like anything else, the more DB plans are taxed, the fewer will exist.

As the PBGC's deficit has grown, "saving" the PBGC as an entity funded only by DB plan sponsors has moved front and center in the pension reform debate. Private pension plans now exist to support the PBGC, a complete reversal of originally intended roles. The problem is that plan sponsors don't want to fund the PBGC, but to provide retirement benefits for their employees.

Further, for the PBGC to be funded otherwise—for example, with general tax revenue—would not be good policy. Funding from outside the DB system would mean that those without DB plan coverage would be subsidizing a privileged few.

Eliminating termination insurance would be generally salutary for the DB system. By removing a large and growing tax on DB plans, their relative attractiveness would increase relative to defined contribution (DC) plans. Each employer could decide how to provide and fund retirement benefits based more on its own business and workforce needs, and less on the fear of becoming indirectly responsible for funding the benefits of other companies. The focus of pension reform could migrate back to providing retirement benefits, versus the current obsession with avoiding a PBGC train wreck.

This paper is organized into the following sections:

- Why is there a PBGC? (historical background and implications for today's debate)
- Why the PBGC shouldn't be "fixed"
- What the DB world would look like without the PBGC
- Conclusion.

2. Why Is There a PBGC?

The PBGC was created to protect workers against the risk of default—the risk that pension plans will not have enough money to pay promised benefits.[1] Minimum funding rules, enacted at the same time, were created both for default protection and to minimize the impact of "moral hazard." (Without funding rules, termination insurance would result in incentives not to fund.)[2]

Termination insurance puts DB pensions in a special category of employee compensation. There is no other form of current or deferred compensation for which a federal agency exists to ensure that promises to employees by employers will be paid in the event of employer default.

Why the special treatment? Legend has it that "It was the collapse of the UAW negotiated pension plan at the Studebaker auto company that shocked the conscience of the nation and led to a 10-year campaign to pass ERISA and to include termination insurance."[3] As with most legends, the reality is more complex. As the history summarized below shows, several of the most contentious issues that are being debated today in respect to pension reform were recognized and debated decades ago.

The failure of all Studebaker plan participants to receive the full value of their vested benefits was not unforeseeable,[4] but rather the unfortunate consequence of a conscious choice to accept underfunding in return for higher benefits. Termination insurance was pushed by unions (primarily the UAW and USW) so that the defaults that would inevitably occur would not cause the loss of their members' vested benefits.

Before ERISA, it was perfectly legal for an employer that was not bankrupt to terminate a plan without funding all vested benefits. Studebaker-Packard did not go

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[1] The historical information is taken from James A. Wooten, *The Employee Retirement Income Security Act of 1974: A Political History* (Berkeley: University of California Press, 2004).

[2] As ERISA was being debated, the Commerce Department argued that minimum funding would make termination insurance unnecessary. The Labor Department agreed with unions that termination insurance made minimum funding rules unnecessary. See Wooten, p. 109.

[3] Remarks of Alan Reuther, Legislative Director, UAW, at a Policy Forum sponsored by the Center on Federal Financial Institutions (COFFI), "PBGC Financial Woes: Structural Crisis or Passing Problem?" Policy Forum Proceedings, November 19, 2004.

[4] When the plan terminated on October 15, 1964, current retirees and retirement-eligible employees over age 60 received their full pension; vested employees under age 60 received about 15 percent of the value of their benefits; and nonvested employees, including everyone under 40, received nothing.

bankrupt.[5] The Studebaker plan termination took place under an agreement between the company and the UAW.

The UAW recognized the importance of funding, and it was a subject of negotiations. For example, the "main issue" in the UAW's strike against Chrysler in 1950 was whether a trust would be established and the plan funded. In November 1958, a national UAW official wrote a memo warning negotiators about the risks of benefit increases in poorly funded plans (Wooten, pp. 58, 69).[6]

However, unions generally preferred long amortization periods for the funding of benefits because the longer the period, the higher the "affordable" benefits. Higher benefit levels facilitated earlier retirements, avoiding the need for unpopular mandatory retirements and ensuring opportunities for younger union members, who had less seniority and therefore less job security. As described by UAW actuary Max Bloch, "The primary purpose of a retirement plan is not only to provide pensions, but to provide them *now*" (quoted in Wooten, p. 57).

The Studebaker pension termination on October 15, 1964, was merely a convenient poster child for a private pension reform movement that was already afoot by the early 1960s. Early in 1962 (more than a year before the Studebaker plant closure was announced), in recognition of the consequences of plan default, the UAW drafted a legislative proposal for termination insurance entitled "Public Reinsurance for Private Pension Plans" (Wooten, pp. 72–73). (Willard Solenberger, a pension specialist with the International UAW, noted in 1964 the desirability "to retain the already catchy tag of 'reinsurance'"; see Wooten, p. 78.)

This proposal included employer premiums that intentionally did not reflect the risk of employer bankruptcy. The UAW recognized that not accounting for this risk would implicitly subsidize high-risk firms, which increased the likelihood that low-risk firms would not utilize reinsurance if participation in the program were voluntary. Therefore, their proposal would have required low-risk firms to participate in return for favorable tax treatment. Premiums under the proposal did reflect funded status and the risk of asset depreciation. The latter risk was deemed to be "very slight," and so the relevant premium to cover this risk was anticipated to be small.

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[5] Remnants of the company still exist. See www.answers.com/main/ntquery;jsessionid=35ouch7squl69?method=4&dsid=2222&dekey=Studebaker&gwp=8&curtab=2222_1&sbid=lc04a.

[6] The memo is identified in footnote 136 as "Brindle to Regional Directors and Department Heads, November 6, 1958."

2.1 Enactment of ERISA

Even after Studebaker, termination insurance was not inevitable, and it was in fact among the more controversial provisions of pension reform proposals. Opponents noted the moral hazard, that its existence "could have the effect of subsidizing imprudent procedures and inadequate funding" (U.S. Secretary of Labor Willard Wirtz, quoted in Wooten, p. 133). Robert Royes of AT&T argued that Studebaker illustrated the inequity of termination insurance, since in that case the union had knowingly accepted the risk.

In 1972, as termination insurance was still being debated, a joint study of plan terminations by the Departments of Labor and Treasury indicated that "5,000–9,000 workers each year lose a total of $20–$30 million in benefits because of plan terminations" (Wooten, p. 199). The Commerce Department argued that this level of losses was too small to be worth the cost of setting up a termination insurance program. The Labor Department had a different view: the "modest size of the problem … makes it possible to deal with without substantial new costs to the government or the private sector. … [Termination insurance is] arguably both good policy and good politics" (Wooten, p.199).

In 1973 Murray Latimer, the United Steelworkers (USW) actuary, wrote a memo arguing against higher premiums for weak firms. According to Latimer, premiums should be "as nearly uniform … as possible" because higher premiums would result in the failure of weak firms, the very "event against which the insurance is aimed to afford protection" (Wooten, p. 229).[7]

2.2 Implications for Today's Debate

The UAW and USW pushed for termination insurance because it allowed them to negotiate high benefits (including for past service) in exchange for allowing their employers to defer payment for decades, with no fear that significant benefits would be lost upon default. The termination insurance system was designed with the understanding that healthy companies would subsidize the less healthy. Politically, termination insurance was sold in part based on the belief that claims would be minimal.

[7] This was in the context of arguing against the proposal that termination insurance be private.

Today pension reform proposals, in an attempt to "save" the PBGC, generally include one or more of the following elements:

- More rapid required funding
- Attempts at "actuarially fair" premiums reflecting the risk that a particular plan will become the responsibility of the PBGC
- Limiting of benefit improvements in poorly funded plans.

These questions thus arise:

- Why save an institution if saving it requires disallowing the very behavior it was designed to facilitate?
- Why save it if, had legislators foreseen the extent of claims, the PBGC likely never would have existed in the first place?
- What exactly are we trying to accomplish with termination insurance?

3. Why the PBGC Shouldn't Be "Fixed"

The problem that has triggered the recent flurry of reform proposals is that current PBGC premiums are not sufficient to cover its losses (even just its future losses, according to several models). The PBGC thus fails as a self-funded insurance program. Fixing the PBGC would have to entail either changing the current self-funding model or looking to outside sources for funding.

Generally speaking, there are two approaches with respect to self-funding:

- "Actuarially fair" premiums reflecting each individual sponsor's risk, including the risk of bankruptcy, or
- Subsidization of high-risk sponsors by low-risk sponsors (a form of "social insurance").

Outside sources for funding that have been suggested include general tax revenue and industry surtaxes. Finally, it has been suggested that perhaps the PBGC could be privatized. This section of the paper addresses some of these proposals.

3.1 Actuarially Fair Premiums Are Not Practical

For the PBGC to be a compulsory self-funded insurance program that requires each sponsor to cover its own risk is a practical impossibility, just as it is a practical impossibility to have a life insurance system that compulsorily covers the terminally ill.

The actuarially fair premium for a terminally ill person's life insurance is equal to the amount of the death benefit. Similarly, as a firm heads toward bankruptcy, its actuarially fair PBGC premium approaches its unfunded benefit liabilities measured on a termination basis.

DB plans are generally prevalent in mature industries. Many of these industries have undergone, or are undergoing, significant restructuring as a result of deregulation and/or international competition. Plans in mature industries commonly have the majority of actuarial liabilities from retirees and terminated vested participants. (In 2002 active participants dropped below 50 percent of covered participants in PBGC-covered single-employer plans, down from almost 78 percent in 1980.)[8] In such industries, sponsors often are struggling to pay off past service liabilities with the proceeds from a business that has lower revenue and/or is less profitable than when the liabilities were incurred.

For these sponsors, bringing premiums and risk into line would require some combination of (1) raising premiums to reflect actual risk and (2) lowering risk. The latter could be accomplished by controls on any or all of funding policy (i.e., higher required contributions), benefit policy, and investment policy.

Although it may be tempting to view these firms' situations as their comeuppance from overly aggressive investment and funding policies, perhaps combined with overly generous benefits, the reality is that significantly higher immediate funding and PBGC premiums could push these firms into bankruptcy, exacerbating the PBGC's current problems. In addition to being a last resort, the use of Chapter 11 bankruptcy has grown significantly as a business tool for attaining a competitive advantage, often including the shedding of onerous pension liabilities.[9]

It is easy to see, and is well documented, how such a trend could snowball within an industry. If one company in an increasingly competitive industry enters Chapter 11, there will be increasing pressure on others in the industry to do the same. Indeed, we are currently witnessing this phenomenon within the airline industry.

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[8] *Pension Insurance Data Book 2004*, PBGC, Table S-32, available at www.pbgc.gov/publications/databook/databook04.pdf.

[9] See, for example, Micheline Maynard, "How to Succeed in Business without Really Succeeding," *New York Times*, May 15, 2005. This article described how United Airlines was attaining a competitive advantage under Chapter 11. "No matter that other airlines may ultimately be forced to copy United's methods—even to the point of filing for bankruptcy and terminating their pension plans—so that they can pull equal to it in costs."

Significantly increasing near-term funding requirements and/or PBGC premiums will only accelerate and spread this process.

Even among sponsors of plans that are currently out of harm's way, or sponsors that can currently afford higher premiums and contributions, actuarially fair premiums would increase exits from DB plan sponsorship. Prudent managers would surely recognize that, at some point in the future, difficult economic times will be encountered. Under a system of "actuarially fair" premiums, avoiding a spike in those premiums or large immediate contributions during difficult times would require very rigid benefit, funding, and investment policies. The rigidity of these policies would limit the usefulness to employers of DB plans such that the rational policy would be not to have a DB plan.

In summary, because the most at-risk firms would be unable to fully fund their plans quickly or pay true actuarial premiums, it is unlikely that the PBGC can be sustained as a self-funded termination insurance program in which sponsors pay actuarially fair premiums. For many such firms, the increase in funding requirements and/or PBGC premiums would make bankruptcy the most attractive option, maybe the only one. Even for firms currently able to financially maintain their DB plans, there would be an added impetus to exit the DB system in anticipation of the inevitable economic challenges that will be faced at some future time.

3.2 Social Insurance Model among Existing Plan Sponsors Is Not Viable

When a company defaults on its pensions, and the PBGC takes over its plans, the termination insurance system is hurt in two compounding ways: it becomes immediately liable to cover a pension shortfall, and it loses a source of funding. Keeping the PBGC a self-funded compulsory insurance system without actuarially fair premiums means that some DB plan sponsors will be funding not only their own plans, but also the plans of other industries and possibly the plans of their competitors. Whatever one thinks of the fairness of such a system, it is unsustainable.

As the cost of defaulting companies' benefits mounts, companies that can afford to fund their own benefits will have an incentive to fund their plans fully and then terminate them, exiting the system. The alternative is to be one of a shrinking number of remaining sponsors responsible for the unfunded guaranteed benefits of plans that have terminated previously. To the extent that companies remain in the system because they can't reasonably fund their own plans in a short period, they will be in no position to fund other companies' plans.

When ERISA was enacted, a social insurance model appeared possible. Strong firms subsidizing weaker firms were acceptable to many at the time. There appeared to be the critical mass of DB plans necessary to sustain a social insurance system, and new plans were being created. Mandatory participation combined with then-extensive participation in the DB plan system meant that a plan default would not result in a significantly higher financial burden on remaining sponsors. In turn, the incentive to exit would not noticeably increase.

The situation today is quite different. DB plans constitute essentially a closed group, with virtually no new significant plans being created. With existing plans concentrated to a significant degree in struggling industries, we are left with weak firms subsidizing weaker firms (or even stronger firms, after they emerge from bankruptcy without their DB plan). In addition, the rise of DC plans as an attractive alternative to DB plans, and the rise of bankruptcy as a socially acceptable business strategy, makes it likely that the universe of DB plans covered by the termination insurance system will suffer further attrition over the coming years.

For remaining sponsors to pay for plan defaults will not be cheap. The PBGC's reported deficit at the end of 2004 was approximately $23 billion. Further, the PBGC reports approximately $96 billion of "aggregate unfunded vested benefits exposure" for "reasonably possible" terminations.[10] Based on these figures, it seems reasonable to conclude that somewhere between $20 billion and $120 billion of additional one-time funding is needed over the next several years, in 2005 dollars.[11]

The PBGC reports about 34.6 million total insured participants in 2004, and, as mentioned above, fewer than 50 percent of covered participants in 2002 were active participants (and some of those are probably in frozen plans).[12] This implies that the number of active plan participants, whose productivity is available to pay for these benefits, is currently in the neighborhood of 15–17 million.

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[10] See, for example, pp. 14 and 33 of the PBGC's *Performance and Accountability Report 2004*.

[11] Looking at the situation independently, the Center on Federal Financial Institutions (COFFI) estimates that, under its "base case" scenario cash-flow projection, the PBGC would require a bailout worth $78 billion "that would have to be infused, presumably from the government, in 2005 [dollars] to avoid running out of cash [in 2021] if no other measures are taken." Douglas J. Elliott, "PBGC: Updated Cash Flow Model," Center on Federal Financial Institutions, original issue date of November 18, 2004. Available at http://coffi.org/pubs/PBGC%20Updated%20Cash%20Flow%20Model%20from%20COFFI.pdf.

[12] See Tables S-30 and S-32 in the PBGC's *Pension Insurance Data Book 2004*. All figures pertain to the PBGC single-employer program.

Therefore, it appears that an additional one-time per capita "tax" of between $1,200 ($20 billion divided by 17 million participants) and $8,000 ($120 billion divided by 15 million), on average, would be necessary to pay for current and near-term PBGC shortfalls.

It is not difficult to imagine a situation much worse than any of the numbers above: for example, if significant employers in the automotive industry default, or even one very significant employer defaults. As more companies default, there will be an increasing burden on those that remain. The total burden will increase, and the available payers (and their collective financial strength, most likely) would decrease.

In summary, a social insurance model works, if ever, only when there is a critical mass of healthy premium payers to support the less healthy ones. This condition is not satisfied in the current DB plan sponsor universe. It is therefore impossible to maintain the PBGC as a self-funded "social insurance" program among the sponsors of DB plans.

3.3 Use of General Tax Revenue

General tax revenue should not be used to fund DB plan defaults unless it is somehow justifiable as socially necessary and equitable.

Table S-33 from PBGC's *Pension Insurance Data Book 2004* shows that in 2002 active participants covered by PBGC-insured plans constituted only 19.1 percent of private-sector wage and salary workers. This figure compares with 35 percent in 1980. As these figures presumably include active participants whose DB plan benefits are frozen, they probably overstate the "social" importance of termination insurance. Further, one can expect that not everyone insured will receive benefits from the PBGC, and those that do receive benefits will have only a portion of their total benefit actually funded by the PBGC. In addition, there are significant populations of workers *with DB plans* who are not covered by termination insurance: participants in church plans, public sector plans, and professional services businesses that employ fewer than 26 people.[13]

According to figures tabulated on the Bureau of Labor Statistics web site, in 2004, 21 percent of workers in private industry participated in DB plans (not all covered by PBGC termination insurance) versus 42 percent in DC plans. According to the Employee Benefit Research Institute (EBRI), in 2002, assets in private trusteed DC plans

[13] See Kris Maher, "Workers Whose Pensions Lack Federal Backing Face Extra Risk—Uninsured Plans Make Many Vulnerable in Health Care, Services, Small Companies," *Wall Street Journal,* May 17, 2005. The article estimates that there are 750–1,000 hospitals and 1,000 nursing homes that are exempt, and that there are 20,000 DB plans at professional services businesses that employ fewer than 26 people.

exceeded those in DB plans by over 25 percent.[14] These numbers are not intended to minimize the importance of termination insurance to those who currently or will receive benefits from the PBGC. However, the shrinking number of workers covered must be taken into account in determining "social" need.

Also, one should ask why, as a matter of public policy, workers with no employer retirement plan, or with just a DC plan, should be indirectly (through taxes) subsidizing the retirement benefits of those who were fortunate enough to have received a promise from their employer that, unfortunately, wasn't kept. It seems reasonable to speculate that those with DB plans generally had better jobs, with higher pay on average, than those without any retirement plan (and quite possibly those with just a DC plan). Having a tax subsidy for DB plans in this case would be a perverse subsidization of the "rich" by the "poor."

3.4 Industry Surtaxes

It has been argued that PBGC funding should be supplemented by a surtax levied on the products and services of industries that have resulted in substantial liabilities to the PBGC. In particular, the steel and airline industries have been mentioned. The arguments used to justify this policy include that such a surtax would spread the burden of the promised benefit across the entire industry, which would be better than the current situation, where some companies are more burdened than others. It also spreads some of the burden to companies who "caused" the problem by "forcing" the industry restructuring.

This suggestion, too, has problems from a policy point of view. Consider two otherwise identical hypothetical companies in the airline industry, one of which offered a DB plan while the other offered a DC plan of equal cost and value in total. As a result of adverse financial market performance, the first company ended up with an unfunded DB past service liability, on which they defaulted, while the second company did not. In the second company's DC plan, assets decreased by the same amount, but the cost was borne by the individual employees.

The policy question arises: Why should only the employees in the first company be subsidized by the surtax when the employees in the second company suffered the same economic loss?

[14] Taken from EBRI, September 2004. DC assets were $1.971 trillion vs. $1.542 trillion in DB plans.

In addition, it is overly simplistic to think that a surtax is borne only by the industry on whose products or services it applies. In the end, the burden ripples throughout the entire economy (first directly affected companies, then the users of the affected products and services, and so on down the line). The fact that the ultimate burden is much broader than it first appears raises the same issues as in the case of using general tax revenues.

3.5 Is Private Insurance Possible?

One alternative that has been suggested is the privatization of the termination insurance program. Richard Ippolito of the Cato Institute, the chief economist of the PBGC from 1986 to 1999, suggested a system that he described as follows:

> Congress should recognize its shortcomings, and sever its ties to pension insurance. It should make the PBGC a true insurance pool. Pension insurance can continue to be mandatory, but after five years, each pension plan should be allowed to seek coverage in the private sector. In the meantime, the ownership of the pool should be turned over to the sponsors of the defined benefit plans, run by a board of directors elected by the plans according to procedure whereby votes are proportional to covered participants. The members of the pool would be liable for any further deficits that develop and they own any surplus that they create. Congress should pay in an amount that covers the problem they created as of the transfer date, allowing the pool to start fresh.[15]

Though an attempt is made to get to a market-based approach, the inability to opt out of termination insurance coverage, and the inability of the insurer to do proper underwriting and exclude bad risks, is a significant distortion versus a private insurance system. The challenge of setting premiums under a mandatory, self-funded, closed system of financially distressed employers without hastening the demise of the DB system (see above discussion) is not solved, but rather shifted.

[15] Richard A. Ippolito, "Is Pension Insurance the Next S&L Crisis?" Cato Institute, September 29, 2004. Available at www.cato.org/pub_display.php?pub_id=2834-5.8KB-Ippolito:2. See also Ippolito, "How to Reduce the Cost of Federal Pension Insurance," Policy Analysis No. 523, Cato Institute, August 24, 2004, available at www.cato.org/pub_display.php?pub_id=2304-4.8KB-Ippolito:2.

4. What Would the DB World Look Like without PBGC Termination Insurance?

PBGC termination insurance to this point has been a sacred cow, but it stands on wobbly legs. Increasingly extreme and onerous measures are suggested in an attempt to save it. Now is the time to seriously consider its elimination among the other pension reform proposals being discussed.

It is anathema to most people that DB plan participants be exposed to any risk whatsoever (except for benefits above the PBGC limit). Once you have accrued a benefit under your employer's plan, it should be a sure thing. Isn't that what DB plans are for? Subjecting any portion of this sure thing to risk strikes an emotional chord, conjuring up visions of poverty in our old age.

Eliminating termination insurance would result in winners and losers. Clearly, the losers would be participants in *underfunded* plans *that terminate.* But the winners would be everyone else.

And how bad would benefit losses be? The emotional nature of this issue obscures the fact that losses are not total. Even in the Studebaker termination, retirees and retirement-eligible people over age 60 received their full pension. The only people who lost everything were people under age 40.[6]

Emotions also obscure the lack of policy logic in the concept of termination insurance. Following are some questions that should be considered in thinking about whether a termination insurance program is desirable:

1. *Why does a promised of benefit of $1,000 per month funded at 50 percent warrant an insurance payment, whereas a promised benefit of $500 per month funded at 100 percent doesn't?* One might argue that the person promised $1,000 "gave up" some other compensation. But what if the person with the $500 benefit also received an equivalent value (at the time of benefit accrual) 401(k) match in employer stock, which became worthless at the same time as the pension termination? Why wouldn't that be insured? Perhaps the employer was irresponsible in promising the higher amount, and the employee was "counting" on it. But is fixing this unfortunate situation worth tying an anchor to the legs of the DB system, when, if the employer had simply promised less, there would be no discussion taking place?
2. *Why is it good policy to provide insurance to a 65-year-old with a promised DB benefit worth $100,000 that is funded at 75 percent, but it isn't good policy to*

provide insurance to a similar 65-year-old whose DC balance of $100,000 one year ago lost 25 percent of its value over the last year?

3. *Why aren't retiree medical benefits insured?* More important, perhaps: Why is a pension promise so much more sacred than retiree medical benefits under current law? An employer can unilaterally stop paying for retiree medical benefits in most cases without legal ramifications and without retirees having recourse to any sort of termination insurance. But if an employer defaults on a DB plan, other employers who sponsor DB plans are responsible for paying the shortfall versus promised benefits.

Eliminating termination insurance would change the fundamental nature of the current legal pension promise. Currently, participants' benefits are guaranteed up to the PBGC limit. In its fiscal year 2004 *Pension Insurance Data Book,* the PBGC reports that "more than 90 percent of the participants in PBGC-trusteed plans receive all the benefits they were promised by their plan."

Without termination insurance, the nature of a DB plan reverts to where the employer promises to fund a trust based on actuarial calculations, and the plan benefit formula and other plan provisions determine each participant's share of the trust. If the trust doesn't have enough money to pay everyone the formula specified, and the employer defaults, the plan (or applicable law) would define how available assets are divided.

Even without a PBGC guarantee, this benefit is still potentially very valuable to both parties of the employment contract:

- *Participants:* Participants benefit from the pooling of risk that they will outlive their retirement savings. Obviously, because of some added risk associated with employer default, this risk of outliving savings is not eliminated, but it is greatly reduced in the pooling with other participants. Participants also potentially benefit from the pooling of investments. A temporary drop in assets for any reason need not mean a drop in retirement income. Finally, for older participants, DB benefit accruals can be worth substantially more than DC accruals in plans with similar total costs.
- *Employers:* In addition to the obvious benefit of not having to pay termination insurance, employers would have a tool for workforce management that cannot be duplicated with a DC plan. The back-loaded benefit accruals and ability to offer early retirement windows, supplements, etc., might become especially valuable as the workforce ages.

For those who bemoan the rise of DC plans and the decline of DB plans, and those who appreciate the power of unencumbered markets to determine the optimal structure of compensation arrangements, this setup should be good news. The desire to save termination insurance is driving DB rules toward ever more restrictions on benefit, funding, and investment policy. Restrictions in addition to those that have accumulated over the 30-year history of ERISA could be the final nails in the coffin of DB plans.

Eliminating termination insurance, by directly and indirectly lowering the cost of DB plans, could help reestablish DB plans as a viable option (though, of course, termination insurance isn't the whole story). Funding rules could be relaxed to allow for a flexible (but reasonable) long-term funding approach, which would enable sponsors to suspend funding during times of hardship. Difficult economic times would not precipitate fear of a PBGC crisis. Additional funding flexibility versus what is currently being proposed would reduce one very major advantage that DC plans currently have over DB plans: the ability to suspend a 401(k) match or not make profit-sharing contributions.

In general, by putting DB plans and DC plans on a more even footing, a major distortion to market forces would be removed, allowing the labor markets and employers to set up more easily the plan structure that is best in each given situation.

The rest of this paper further explores some of the ramifications of ending termination insurance.

4.1 Higher DB Plan Coverage

Proponents of termination insurance focus on current participants in DB plans, sometimes to the exclusion of people *not* covered by virtue of the non-benefit-related expenses associated with DB plans, including termination insurance. As discussed above, eliminating PBGC termination insurance, by removing a growing cost and obviating the need for more restrictions on general plan policies, will result in higher overall coverage under DB plans. Although the many factors contributing to the overall decline of DB plans might limit the forming of new plans, keeping current plans as going concerns would be facilitated.

Even after taking into account that some participants in plans that have defaulted will receive lower benefits, the additional number of people who remain covered would represent a net strengthening of the DB plan system.

4.2 Monitoring of Funded Status by Unions and Fewer Plan Defaults

The moral hazard associated with termination insurance would disappear. There is a systematic bias toward underfunding in union plans. Benefit increases for past service are usually negotiated during each negotiation cycle. In addition, there is a natural tendency for unions to request greater benefit increases if their plan is well funded, so employers have a corresponding natural tendency not to overfund.

Also, under the current regulatory regime, an employer facing near-term financial difficulties might be tempted to roll the dice and offer additional pension benefits in lieu of other types of compensation and invest aggressively, hoping that the markets will bail him or her out. Unions might accept, secure in the knowledge that the PBGC will guarantee the benefits (albeit, with a five-year phase-in).

As evidenced by the pre-ERISA historical record, the absence of termination insurance would force unions to focus on funding during negotiations. Indeed, one of the reasons that unions (primarily the UAW and USW) pushed for termination insurance was that it allowed them to bargain for higher benefits with less concern about the consequences of default. Another focus of the unions might be asset allocation. Unions concerned about benefit security likely would also be concerned with an aggressively invested portfolio.

By removing termination insurance, unions would have to face the risks associated with the higher unfunded benefits they negotiate and therefore would have incentives to monitor elements of pension policy that are ignored currently. The end result would be fewer plan defaults. Of course, even nonunion plan participants would have additional incentives to monitor their employer’s policies and apply pressure as warranted.

4.3 Monitoring of Funded Status by Financial Analysts, Lenders, Credit Rating Agencies, and the Media

ERISA was passed in the days before FAS 87 and Sarbanes-Oxley. Whatever criticisms one might have, the amount of available information on pension funding, and the extent to which senior corporate officers are being held accountable for its accuracy, have increased tremendously over the last two decades. In recent years this attention has resulted in high-profile, sizeable voluntary pension contributions by major companies. Although this public focus mitigates the moral hazard caused by the existence of the PBGC, it has made the PBGC increasingly less necessary.

4.4 Corporate Bankruptcies

As described above, companies are increasingly using Chapter 11 of the Bankruptcy Code as a business tool rather than a last resort. To the extent that they would rather avoid the employee relations issues associated with defaulting on their pensions without PBGC backup, they will be less likely to enter bankruptcy protection to reorganize, except where it is really necessary. In addition, the more flexible funding rules that could be adopted simultaneously with the elimination of termination insurance would reduce some of the pressure a plan sponsor might feel to declare bankruptcy.

While under bankruptcy protection, both US Airways and United Airlines refused to make required pension contributions. US Air noted that to do so would be "irrational," as it would add nothing to the bankruptcy estate. Where benefits are not funded up to the PBGC guaranteed levels, making contributions would not help participants either. Removing the PBGC guarantee would make it less likely that similar actions (or inactions) will be taken in like situations.

One somewhat ironic result of PBGC termination insurance may be a lower number of total DB plans. The reason is the prohibition against creating "abusive follow-on plans," where a sponsor creates a plan that, for example, "wraps around" a plan the PBGC has previously taken over. Clearly, the PBGC has an interest in making sure a company does not act on the moral hazard of being able to shift responsibility for past-service liabilities to the PBGC under Chapter 11. But considering the PBGC's mission to encourage DB plans, it seems odd for the PBGC to be prohibiting the creation of new DB plans by willing sponsors.

Probably as a result of the prohibition against follow-on plans, US Air replaced DB pensions with DC plans. And United Airlines agreed to give its pilots $550 million in convertible notes as compensation for ending its pension plan. The United arrangement, at least, appears to have been made with the follow-on rules clearly in mind.[16] Without termination insurance, no such prohibition on starting a new DB plan upon emergence from bankruptcy after defaulting on a prior plan would be necessary.

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[16] Mary Williams Walsh, "Pilot's Union at United Makes Pension Deal," *New York Times*, December 18, 2004.

4.5 PBGC Intrusions into Non-Pension-Related General Business Operations

In recent years the PBGC, to protect itself, has started intervening in corporate transactions where it perceives a threat that insured pensions might become less secure. Under its "early warning program," the PBGC may intervene in corporate acquisitions, sales, and spin-offs.

Many current pension reform proposals would increase the regulation and monitoring of normal business operations yet further. It has even been suggested that if contributions and PBGC premiums were to depend on a company's credit rating (as under the Bush administration proposal), additional regulation of the credit rating agencies would be necessary. For nonpublic companies not rated by the rating agencies, the government would need an equivalent rating system, which would likely involve detailed assessments of normal business operations.

The current level of intrusions and the potential for significantly greater intrusions is sure to be disturbing to DB plan sponsors, and at the very least represents a significant cost of termination insurance and a corresponding deterrent to participating in the DB plan system.

Eliminating termination insurance would relieve the government of a significant burden at the same time that it would allow businesses to be run without an undue focus on pension issues to the detriment of other factors that contribute to a successful business. And a successful business is ultimately the best guarantee against DB plan default.

5. Conclusion

Eliminating termination insurance is the fairest and most practical of the available alternatives for permanently addressing the problems of the PBGC. Ending termination insurance would also likely result in a more viable DB plan system by removing a significant cost to participating. To sponsoring employers, PBGC premiums are a tax on providing DB plans—one that is likely to grow significantly in the near future absent elimination of the termination insurance program.

Certainly, transitioning to a system without termination insurance would raise several difficult and controversial issues. One contentious issue would be what to do with the benefits for which the PBGC is currently responsible. Should they be given special treatment versus plans that have not yet defaulted? If so, and future defaults will not be covered, might some companies that had been considering bankruptcy as one of many options rush to declare bankruptcy, to "beat the deadline" for the benefit of its employees? Who will pay for the benefits that the PBGC is ultimately responsible for (if any)?

Doubtless, some will argue that it would be politically impossible to end termination insurance. One hopes, however, that an issue as important as this one can be decided on the merits.

If politics is a concern, then it is appropriate to ask how effective current pension reform proposals would be. Even as pension reform is being debated that would require significant additional funding in certain cases, legislation is being considered to lengthen the funding period for unfunded benefit liabilities in the airline industry – the industry that now accounts for half of the top 10 PBGC claims in dollar amount. This is not to suggest that extending the funding period is a bad idea. But it does illustrate the political pressure that will be applied to exact exceptions to the more stringent funding requirements and higher PBGC premiums that might result from pension reform. Such exceptions would mean that pension reform would fail to accomplish its objectives (maybe not a bad thing), while potentially harming sponsors with limited political clout.

PBGC underfunding is a distorting influence on overall retirement policy. Instead of backing employers into a corner with ever more restrictions on benefit, funding, and investment policy in a vain attempt to rescue a system that is bankrupt in every sense, eliminating termination insurance could help breathe new life into a besieged DB plan system.

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