Excess Pension Asset Transfers and Retirement Income Security

by

Sylvester J. Schieber
Vice President
Watson Wyatt Worldwide

and

Marjorie M. Kulash
Senior Associate
Watson Wyatt Worldwide

October 1995
FOREWORD

The proposal of the U.S. House of Representatives Ways & Means Committee to permit sponsors of defined benefit pension plans to transfer excess assets from those plans has generated a great deal of controversy. Essentially the criticism has focused on claims that such transfers will, in some fashion, jeopardize the funded status of pension plans and, by extension, will jeopardize plan participants and the Pension Benefit Guaranty Corporation.

The fact that many of these claims, which are intended to cause concern and opposition on the part of retirees and the general public, has come from the executive branch itself is especially disquieting.

Since so many claims are not supported by adequate data or analysis, the APPWP has sought to bring to light the facts. Accordingly, we have asked Dr. Sylvester J. Schieber and Marjorie M. Kulash at the highly-regarded employee benefits consulting firm, Watson Wyatt Worldwide, to analyze the impact of excess pension asset transfers on retirement income security.

The public no longer needs to rely on unfounded concerns: the facts are now available. This study demonstrates that the premise of the claims about the impact of the House Ways & Means proposal is fatally flawed.

The simple and uncontroverted fact remains that even following the transfer of excess assets, the pension plans would remain so fully or overfunded that plan sponsors would be prohibited from making any further contributions to the plans.

We hope that the analysis of the study will assuage the concerns about the asset transfer proposal and allow lawmakers to decide this important issue armed with facts that ensure that the pension system will remain strong following asset transfers.

Association of Private Pension and Welfare Plans -- October 1995
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SUMMARY

Section 420 of the Internal Revenue Code currently permits transfers of excess pension assets to fund certain retiree health benefits, subject to a number of restrictions designed to ensure the benefit security of pension plan participants. Section 420 was reauthorized by Congress last year, with the support of the Clinton Administration, as part of the General Agreement on Tariffs and Trade (GATT) legislation.

Recently, the House Ways and Means Committee voted to amend section 420 to permit plan sponsors to transfer excess pension assets for any purpose as part of its budget reconciliation bill. Under the Committee's proposal, plan sponsors must retain assets equal to the greater of the plan's full funding limit or 125 percent of current liabilities. This means, under the proposal, that even after a transfer of assets the pension plan will remain so overfunded that the tax code penalizes further contributions. In addition, all employee pension benefits must be vested. It is crucial to note that this much criticized limit of 125 percent of current liability already exists in law. The House Ways and Means Committee proposal would merely allow transfers for purposes other than financing retiree health care for which current law makes provision.

The proposal would raise a substantial amount of tax revenue. Under the Committee's plan, amounts withdrawn by an employer would be subject to ordinary income tax in all cases. No excise taxes would apply to amounts transferred before July 1, 1996, but for transfers occurring after July 1, 1996, a 6.5 percent excise tax would be assessed. The proposal is estimated to raise $9.4 billion over the next five years and, as such, is the largest revenue raising provision in the Ways and Means bill.

Following the Ways and Means Committee action, the proposal has been criticized in the press and by the Clinton Administration. The federal Pension Benefit Guaranty Corporation, and the three cabinet secretaries on PBGC's board of directors -- Labor, Treasury and Commerce -- have issued a report criticizing the proposal. Key criticisms of the proposal include:

- The transfer provision will reduce the security of pension benefits and jeopardize the financial integrity of the PBGC. Specifically, PBGC has posited scenarios that plans funded at 125 percent of current liability are at risk for simultaneous declines in their asset values and reductions in interest rates. PBGC also argues that when "termination actuarial assumptions" are applied to measure plan liabilities, plans that are 125 percent funded on an "ongoing basis" are really underfunded.
• Allowing asset transfers under the Committee amendment invites a replay of the asset reversion activity that occurred in the 1980s.

This paper examines the likely effects of the transfer of excess pension assets on the benefit security of pension plan participants and whether the legislation would put the PBGC at risk. These questions are especially timely now when the baby boom generation is within a decade of beginning its retirement. With Social Security under pressure and personal savings at historically low levels, the employer-sponsored retirement system must remain strong and employees must be assured that their pension promises are secure.

Our analysis reaches several important conclusions relevant to the criticisms leveled against the proposal. Specifically, we conclude the following:

• The Committee proposal is substantially different from the rules governing the asset reversions that occurred in the 1980s. The proposal prohibits employers from drawing down assets below the level at which federal law penalizes them for making additional contributions. Plans would not need to be terminated under the proposal and the amounts withdrawn would be required to be repaid if the plan were to subsequently fall under the full funding limit.

• Although PBGC has targeted its criticism at the 125 percent of current liability floor on asset transfers, fewer than 30 percent of fully funded plans would be able to recover assets down to this level. This is because the 125 percent level is a floor for transfers and the large majority of transfers would be constrained by a higher full funding limit.

• Allowing the transfers of excess assets under the amendment is consistent with the policy judgment made by Congress as to the appropriate maximum full funding limit. Because in no case could assets be withdrawn below a plan's applicable full funding limit, any criticisms of the limits placed by section 420 are really criticisms of the appropriateness of current full funding limitations.

• PBGC's scenarios of simultaneous drops in interest rates and asset values has never happened over the past 70 years and are highly unlikely to happen in the future. Indeed, historical data shows that whenever interest rates have declined during a year by 1 percent or more, bonds and stocks have increased in value between 18 and 40 percent in the same year.

• PBGC's use of actuarial assumptions based on plan "termination liability" are inappropriate and overstate plan liabilities given that the assets of plans subject to a transfer will be invested in higher yielding securities consistent with prudent management of ongoing plans, plans will in no event transfer assets
below the maximum allowable funding limits, and the employer will continue to be responsible for funding and paying benefits.

- Based on our stochastic modeling process, the potential risk that plans that transfer assets will later become underfunded is very small and, in fact, the plans are much more likely to be overfunded. For plans that are funded at 150 percent of current liability, and many plan transfers will be subject to this limit, there is less than a 5 percent chance that the funding level will decline below 107 percent of current liability over a ten year forecast period. There is an equal chance that the funding levels for such plans will reach funding levels in excess of 400 percent of current liability over the 10-year simulation period analyzed in the study. For plans that are funded at 125 percent of current liability, there is less than a 5 percent chance that funding levels will decline below 90 percent of current liability. In this case, there is an equal chance that funding levels for such plans will reach funding levels in excess of 300 percent over the 10-year simulation period developed.

Based on our analysis, and given the policy choices that Congress has made as to the appropriate full funding limits for pension plans, we do not understand why the PBGC or any other government agency would conclude that this proposal would threaten the continued retirement security of plan participants given the positions they have taken on pension funding policy in the past. We believe the proposal would encourage employers to sponsor and generously fund their pension plans because it would not entrap employer contributions in plans in cases where they become significantly overfunded.

**ANALYSIS**

**Pension Plan Funding**

One source of confusion over proposals for withdrawing excess assets is that there are a number of different ways a pension plan’s liability is measured against which assets are compared in order to judge whether or not the plan is adequately funded. Federal law relies on these alternative ways of measuring liabilities to both assure sufficient funding of pension promises and to limit funding at the same time. One measure of pension liability considers that the plan sponsor intends to continue to maintain the plan on an ongoing basis and allows the sponsor to consider future developments, such as anticipated wage increases, that will affect benefits provided under the plan. Another measure, current liability, considers the obligations of the plan as though it were going to be shut down immediately. In this latter
case, future developments cannot be considered because the plan would not continue to accrue liabilities if it were shut down.

Federal rules for funding pension plans are intended to strike a balance between underfunding and overfunding. On the one hand, the needs of participants to be assured that retirees will receive their benefits and the PBGC’s institutional interest in limiting its exposure to underfunded pension promises argues for high funding levels. On the other hand, competing uses of the money and governmental concerns over revenues exert downward pressures on the amounts of money plan sponsors can put into the funds. Full funding limits were changed in 1987 to restrict plan funding not only to a plan’s actuarial accrued liability or ongoing plan obligations, but also, if lower, 150 percent of current liability. For many plans this change uncoupled their pension contributions from their ongoing liability.

In a series of 5 hypothetical examples with different combinations of retirees and active employees, this paper shows the different ways the full funding limits apply. For plans that are identical except for the mix of active and retired participants, we show that the full funding limit ranges from 49 percent of actuarial accrued liability to 100 percent of accrued liability. More mature plans have a higher full funding limit relative to ongoing plan liability than more immature plans. Said another way, current law discriminates between plans in terms of letting sponsors with more mature populations more fully fund them than sponsors with less mature plans.

Asset Reversions

PBGC arguments against the Ways and Means proposal seem to stem largely from a claim that employers will engage in asset reversions, like the period of the 1980s. While there were a number of terminations during the 1980s, even when they peaked in mid-decade, only a minuscule fraction of defined benefit plans were subjected to large reversions. That point notwithstanding, comparing the current proposal to the 1980s is without basis.

As a preliminary matter, PBGC has introduced no data that shows that asset reversions increased their exposure to losses. And, even if this were the case, the proposal adopted by the Committee is substantially different and more protective of plan participants. During the 1980s employers were prohibited from taking a reversion unless they terminated a plan. Under the current proposal, by contrast, plans will be ongoing and employers would not be allowed to draw down their assets below the level at which federal law penalizes them for making additional contributions. Plans would not have to be terminated, and amounts withdrawn would be repaid over 10 years, if the plan were to subsequently fall under the full funding limit.
The Transfer Provisions in Operation

Using Watson Wyatt's *1994 Survey of Funding and Actuarial Assumptions*, we have evaluated the asset transfer proposal for the 418 final average pay plans for which we have complete survey information on their liability and funding levels. First we looked at four plans in the study and show the relationship between actuarial accrued liability and current liability. Through the examples, it is clear that the relationship between the funding limits and the new proposal is complex. Even so, the simple fact is that if the plan sponsor were to take the full transfer allowed, no further deductible contributions would be allowed for any of the plans because the plans will still be at their full funding limit, if not higher. In addition, the examples suggest that many sponsors eligible to take transfers out of their plans under the proposal might not be able to reduce the assets in the plans to the level of 125 percent of current liability that the PBGC appears to be so concerned about.

In order to assess the extent to which sponsors would be able to transfer assets out of their plans, we looked at the plans in the survey that reported that they were at or above their full funding limit: 139 of the 418 plans. We found that among these 139 plans, 25.2 percent would be in the situation where the plan sponsors would not be able to transfer any assets out of these plans because the full funding limit (actuarial accrued liability) is less than 125 percent of current liability. We found that only 27.3 percent of the plans would be able to take transfers that would reduce asset levels in their plans to 125 percent of current liability; 25.2 percent would only be able to take transfers that would reduce asset levels to between 126 and 149 percent of current liability; and that 22.3 percent would only be able to transfer assets down to a level equivalent of 150 percent of current liability. The scenario that PBGC paints of fully funded plan sponsors being able to take assets from their plans down to a level of 125 percent of current liability applies in less than 30 percent of the cases of fully funded plans. **Furthermore, of the plans that could take transfers leaving assets of only 125 percent of current liability, we calculated that if all these plans made maximum transfers, they would still hold assets equal to 111 percent of their full funding limits.**

We find the criticism of the adequacy of the cushion following a transfer curious. In no case under the proposal will assets be depleted below a plan's full funding limit above which further contributions are barred. It seems that PBGC's argument that the transfer provision creates less benefit security is misplaced. To the extent there is a problem, PBGC should be arguing that the full funding limits -- which affect all plans -- should be revised.

Risk Exposure After Transfers

PBGC analysis raises the possibility that well-funded plans could quickly become underfunded--and hence a threat to their solvency--if interest rates and asset values fall
simultaneously. They argue that a pension plan funded at a level of 125 percent of current liability could become underfunded if interest rates fall one percent and the value of assets falls 10 percent at the same time. The data shows that PBGC has posited an unlikely scenario. Since 1926, in every case where long-term government bond rates dropped 1 percent or more in a year, asset values surged. The total return on large company stocks and on long-term government bonds in those years rose a minimum of 18 percent. In other words, the PBGC scenario has not occurred generally in the U.S. investment markets over the past 70 years.

Another misunderstanding regarding interest rates appears in the PBGC's calculation of termination liabilities in 10 large plans. PBGC uses a 5.65 percent interest rate—roughly 150 basis points below the current four-year weighted average of the 30-year constant maturity Treasury bond rates—along with other conservative assumptions to show that "in the aggregate, the plans' termination liability funded ratio would be less than 90%." There is no reason to believe that these assumptions, which make the funding situation seem significantly worse than reported in plan funding disclosure to the government, are more appropriate for an ongoing plan than assumptions used to value plans on an ongoing basis. The calculations seem especially irrelevant because no plan could transfer assets below the full funding limit prescribed in law.

**Stochastic Modeling of Scenarios**

One of the more puzzling aspects of the PBGC analysis of the Ways and Means proposal is that a significant portion of their analysis is spent raising the specter that a plan whose funding is reduced to 125 percent of current liability is in grave danger of becoming underfunded but they do not attempt to estimate any probabilities that such plans will become underfunded if this proposal were to be implemented. Today, many plan sponsors use stochastic models in order to understand the ramifications of alternative investment policies and funding strategies on their funding obligations over time. The PBGC has been developing its own stochastic modeling capability over the past several years to estimate just such probabilities. Their 1992 Report indicates that they themselves feel stochastic modeling of these kinds of scenarios is superior to the simpler trend modeling that they have traditionally done.

To get a better view of the potential risks created if plans were allowed to make asset transfers, we developed a set of stochastic projections to illustrate the expected variations in the funding status of a sample plan that is currently funded at 125 or 150 percent of current liability. The actual plan in the projection reflects the characteristics of the types of plan under

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terminated and retired participants. Its assets are invested 40 percent in large capital domestic stocks, 10 percent in small capital domestic stocks, 10 percent in international equities, and 40 percent in medium-term government and corporate bonds.

Using our stochastic modeling process, we simulated contribution levels and funding status over a 10-year period for a plan that began the simulation period alternatively funded at 125 and 150 percent of current liability. We assumed that the plan sponsor would consistently contribute at the minimum rate prescribed by current law, including not making any contribution at all in years when the plan held assets equal to the full funding limit liability.

On the basis of 500 simulations of the plan's funded status, we found that there was less than a 5 percent chance that the plan funded at the 125 percent of current liability level at the outset of the simulation would become less than 90 percent funded in any year. There was less than a 25 percent probability that the funding level would drop below 115 percent of the current liability limit. The analysis suggests that there is only a remote probability of dropping into underfunding status as PBGC suggests. There is also a 5 percent chance that funding levels for such plans will reach funding levels in excess of 300 percent over the 10-year simulation period developed in the analysis.

If the plan sponsor does realize the kinds of adverse investment returns that the 5 percent scenario suggests on the lower end, however, it does not necessarily indicate the disaster of broken promises and dumping of liabilities onto PBGC that have been implied in some of the colorful rhetoric analyzing the transfer proposal. It merely shows that the plan sponsor--the vast majority of whom enjoy high ratings by the credit markets--would have to make larger contributions than those assumed for the simulations. This is the special protection that participants in defined benefit plans enjoy--the employer sponsor carries the investment risk. Moreover, because of changes made to the minimum funding rules last year, plans would be required to fund liabilities very quickly if they were to become less than 100 percent funded following a transfer.

Conclusion

For all of the foregoing reasons, described in greater detail in the full report which follows, the claims of the PBGC and others that transfers of excess assets pose a risk to the PBGC or to plan participants is simply not supported by the facts.
Introduction

In approving its budget reconciliation legislation, the House Ways and Means Committee surprised the pension community by voting to allow employers with well-funded pension plans to transfer certain assets out of the ongoing plan during the next five years. These “excess assets”—amounts above the full funding limit, or 125 percent of current liability, if higher—could be used for any purpose. The provision, section 13607 of the budget reconciliation bill, would operate by expanding today’s Internal Revenue Code section 420, under which excess pension assets in ongoing plans can be used for retiree health benefits, to allow unrestricted transfers until December 31, 2000.

The measure is estimated to raise nearly $10 billion during that period, because employers withdrawing assets would pay corporate income tax on the transferred amounts and because a 6.5 percent excise tax would apply to withdrawals after June 30, 1996. In contrast, when pension plans terminate with more assets than liabilities—the only other way to take a direct asset reversion—employers who recoup the surplus pay not only ordinary income taxes but also an excise tax of up to 50 percent of the surplus.

For pension funding purposes, the proposal would treat a withdrawal as an “experience loss” to be repaid to the fund over a 10 year period, but only plans that at some point after the transfer fall below their full funding limit would make such repayments. Those that remain above their full funding limit liability are precluded from making further contributions for any reason without significant penalties.
Issues Raised by the Proposal to Allow Asset Transfers from Pension Plans

As soon as the proposal surfaced, the startled reactions began. *USA Today* (October 3, 1995) headed their graphic depiction of the issue “Your retirement under siege.” Their Money Section cover story featured claims by opponents that surplus assets should be used for cost of living raises for retirees or to increase workers’ future benefits. Further, it quotes Labor Secretary Robert Reich as saying “A plan that is overfunded today can quickly become underfunded tomorrow.” Treasury Secretary Robert Rubin predicts the proposal would once again make pensions a factor in buyouts, according to the article. The feature also raises questions of whether the proposed asset “cushion” would leave promised benefits secure after a withdrawal and whether pressure from stockholders would force companies to take the pension surpluses. Only Ways and Means Committee Chairman Bill Archer is quoted in favor of the legislation, saying it would strengthen pensions because companies will be more likely to put money into their plans if they know they can get it out.¹

*Pensions and Investments* criticized the proposal in a lead editorial in its October 2, 1995 edition. While posing the question of whether corporations with large pension surpluses would become targets of “asset-stripping corporate raiders,” the editors also raise the specter of pension funds dumping $15 to $20 billion in securities on the financial markets in a short period, possibly triggering a bear market. Further, if companies need access to capital, they can now borrow at relatively low rates, so there should be no need for recouping pension

assets, and if there is, it can be done over time with contribution holidays. Calling the idea a "$10 billion quick-fix of revenue for the government," the publication goes on to propose that at a minimum, companies be required to spread out the recapture over three years to lessen the impact on capital markets and reduce the attractiveness to raiders. Like other criticisms of the proposal, the article questions the adequacy of the cushion and calls the proposal flawed and half-baked. But it concedes nevertheless that "as a general rule, companies ought [to] be allowed to withdraw true excess pension assets, after a prudent reserve has been established."  

The most extreme and confused attack on the legislation has come from the government's own Pension Benefit Guaranty Corporation, the agency charged with insuring payment of pensions to retirees of insolvent companies whose underfunded pension plan terminates. PBGC, on September 27, 1995, published a critique of the proposal that, according to the cover letter accompanying the critique "shows that removal of these funds would leave many pension plans with insufficient resources to protect retirees and the PBGC. These pension plans would not be adequately funded to pay all benefits should they fail."  

PBGC's arguments against the proposal are briefly as follows. Reversions in the past have been associated with subsequent pension plan underfunding. The proposal encourages corporate take-overs and buyouts, and the legislation does not ensure that enough money will

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be left in the pension funds to protect against an economy characterized by simultaneously falling interest rates and falling asset values.

There appears to be considerable misunderstanding about how the House Ways and Means Committee's proposal would actually work and how it relates to current funding requirements and limits within existing law. This misunderstanding has led many analysts, the news media, and some public officials to be critical of the proposal. There seems to be some conviction that this proposal will particularly jeopardize the benefit security of participants in the plans where such transfers are made. If that is indeed the case, then the benefit security of many other participants in private sector defined benefit plans that would not qualify to make such transfers are in even more jeopardy than the ones in the plans potentially affected by this proposal. The participants in these latter plans are in greater jeopardy because current law often limits the funding of their retirement plans to much lower levels than the funding level that would persist in the overfunded plans even after transfers were made under the legislation proposed by the Ways and Means Committee.

**Larger Context in which Pension Funding Should be Considered**

We are definitely sympathetic to arguments that our pension system needs to be secured. Anyone who looks at the state of our retirement system today should have some concern about the path we find ourselves on as we approach the closure of the 20th century. Today, the baby boom generation is collectively in their mid-careers, falling between the ages of 30 and 50. Over the next 10 years, the leading edge of the baby boom generation will begin to pass into retirement. Current projections by the Social Security actuaries anticipate
that under current law, benefits will exceed the resources available to pay them by 2030. In 2030, the youngest members of the baby boom generation will not yet be eligible to receive the full benefits associated with normal retirement age under the program. There are also indications that the employer-based pension system will be strained by the claims presented by the baby boomers.

If anything, the need to secure our retirement claims is even more important today than it was back in the 1960s when we were carrying on the long legislative considerations that led up to the passage of ERISA in 1974. They are more important today because we now know that we cannot anticipate the kinds of increases in Social Security benefits that current retirees were granted through significant benefit enhancements adopted in the late 1960s and early 1970s. Indeed, current law already provides that the baby boomers will be facing higher normal retirement ages than current beneficiaries faced. Their sheer numbers and the size of the cohorts of workers behind them portend further reductions in Social Security in the future. In addition, the shift toward greater dependence on individual contributory saving in recent years has been paralleled by a decline in personal savings rates in the United States, suggesting that the pension and personal savings legs of our retirement stool are no more secure for the baby boomers than is Social Security. As is often the case, however, the general rule does not necessarily have universal application. We should definitely be concerned about the future

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retirement security of workers covered by pensions today. That does not mean, however, that
some pension plans today are not significantly overfunded, in fact so overfunded that
significant resources could be removed from them with virtually no prospect they would ever
end up with “insufficient resources to protect retirees and the PBGC.”

Many of the comments about the Ways and Means Committee proposal that would
allow the transfer of assets out of pension plans play on our personal intuitions about
retirement security. The comments on the proposal have not explored the complicated
regulatory patchwork under which plans operate and how benefit security in these plans varies
widely, not because of sponsors’ willingness to fund the promises held out by their plans, but
because of the highly varied limits that pension law imposes upon them. The public comments
critical of the Ways and Means’ proposal raise a number of questions that we will address in
this paper. Some of these questions are fundamental, such as what is the appropriate measure
of secure pension funding? Or, what amount of pension plan funding is excessive, and what
rules should govern assets beyond that level? Some of the questions are clarifying, such as
how should Congress interpret PBGC’s calculations purporting to show dangerously low levels
of pension security for companies that otherwise seem well-funded? Finally, some of the
questions raised by the proposal and comments on it are conjectural, such as would the
proposal encourage another round of hostile takeovers and buyouts?

**Current Law and the Funding of Pension Plans**

Almost from the beginning of the income tax in the United States, tax law has
encouraged the funding of pension promises through incentives in the tax code. These
incentives allow plan sponsors to deduct certain contributions to their retirement plans when
the contributions are made and do not require the participants in the plans to pay taxes on
contributions or their earnings until benefits are actually paid. With the passage of ERISA in
1974, the government for the first time set contribution requirements that stipulated that
employers holding out pension promises to workers had to put aside funds to secure those
promises. Over the years since 1974, the funding requirements have undergone significant
evolution, partly because of concerns about the security of benefits being promised, partly
because of concerns about the budgetary costs of the tax preferences accorded pensions, and
partly because of concerns about the potential liability exposure of the PBGC. In order to
understand the implications of the transfer proposal put forward by the Ways and Means
Committee, we must first explore the existing bases on which pension plans are funded today.

Actuarial Concepts

To address the critical question of what pension assets are truly excessive and when
pension security is at risk, it is important to understand different ways of measuring the
adequacy of funding. Actuaries, who by law must establish correct funding requirements
within complicated legal restrictions, look at the question from at least two very different
perspectives: (1) amounts needed for appropriate funding assuming an ongoing plan and (2)
amounts needed assuming the plan were to terminate and liquidate all obligations. A third
perspective, how to treat pensions in the context of the employer’s accounting obligations,
requires still a third set of assumptions, but those are not relevant to the legislation under
discussion.
A pension plan sponsor has a fundamental obligation to provide for benefit payments to plan participants when due. The plan’s funding method is the process by which funds are collected to comply with the promises to make these payments. A funding method may be as simple as a pay-as-you-go scheme where funds are made available to pay benefits as they fall due. However, such a funding method would produce erratic and unpredictable cash flows and is a poor method of securing the promises to participants. It is also an unreasonable method for plans qualified under section 401(a) of the Internal Revenue Code and may not be used for qualified plans. For qualified pension plans, the funding method combined with the actuarial assumptions must provide for an orderly accumulation of assets to meet present and future benefit obligations.

Reasonable funding methods for ongoing plans must put in place a way to recognize liabilities for prior service under the plan for current and past participants and for expected future liabilities for current plan participants. Qualified plans must be funded with the expectation that they will continue indefinitely, that they will be ongoing. When a plan is in ongoing status, current participants are expected to accrue additional benefits through future service and through increases in compensation. If a plan terminates, only the liabilities for prior service must be recognized.

The measure of ongoing liability for benefits earned to date is called the actuarial accrued liability. A less demanding measure of the funded status is the present value of accrued benefits. This measure does not take into account the effect of future salary growth on benefits.
earned to date. With slight variation in the benefits included and the assumptions used, the present value of accrued benefits may measure the termination liabilities of a plan.

**Actuarial Accrued Liability**

In an ongoing plan valuation, one of several methods approved by the Internal Revenue Service may be used for a qualified plan to determine the liability for benefits earned to date and payable now or in the future. Although these methods differ in the specifics of how they apportion the liability between that accrued to date and that expected to accrue in future periods, they share several basic concepts. Benefits are projected to retirement or other source of decrement (e.g., disability) using a rate of salary growth and other economic assumptions to arrive at the value of benefits when they are expected to be paid. Decrement rates are applied to account for the probability of death, disability, withdrawal from service and retirement prior to the last expected retirement age. The values of benefits to be paid with respect to all resulting benefits are discounted to the present. The value obtained is the present value of all future benefit promises. This total present value is then split into two pieces: the portion attributable to past service, and the portion attributable to future service. The portion attributable to past service is the actuarial accrued liability. Note that this liability includes an allowance for future salary growth. At retirement, the actuarial accrued liability will equal the present value of future benefits.
**Current Liability**

Current liability measures the value of benefits earned to date without regard to any future growth in benefits due to salary increases. The more general description of this measure is the present value of accrued benefits. Current liability is a restricted measure of the present value of accrued benefits because the IRS imposes limits on the interest rate used to determine it. There may also be limits on the benefits that may be included under the current liability definition. For a retired participant, the current liability and the actuarial accrued liability are the same when the same interest assumption is used. If a plan terminates, the measure of liabilities for active participants no longer considers future salary increases. In a terminated plan, the actuarial accrued liability for active participants becomes the current liability when the same interest assumption is used.

**Rationale for Funding Pension Plans**

Underlying these concepts behind pension plan funding are forces pulling in opposite directions: concern that there be enough assets to fulfill benefit promises *versus* concern that too much money is being set aside outside the tax system and that too much of a company’s revenue is tied up in pension trusts rather than being used to improve the company’s operations.

ERISA, the culmination of more than a decade’s debate on how best to ensure that benefit promises be kept, expressed Congressional intention to make sure that employers set aside enough assets to secure pension obligations. Before ERISA, some retirees lost benefits when their former employer went out of business, because there was no requirement that
pensions be funded with money specially set aside for that purpose. ERISA required not only that benefit promises be funded over specified periods, but that the benefits be distributed fairly among employees and that the funds be handled with proper fiduciary responsibility.

That same law also established the Pension Benefit Guaranty Corporation, PBGC, the government agency that pays benefits to retirees whose pension plans have terminated without sufficient assets to pay benefit promises. Funds for the agency come from premiums paid by virtually all defined benefit plan sponsors, and ERISA has been amended repeatedly to raise premiums and to limit PBGC's coverage only to situations of financial distress. Obviously, adequate minimum funding standards are needed to limit the exposure of the PBGC and its premium payers. It would make no sense to guarantee benefit payments without requirements that plan sponsors fund their own plans. From the point of view of securing promises and limiting PBGC liabilities, then, it makes sense to fund plans as conservatively as possible, leaving the largest possible asset pool available as a contingency reserve against any potential adverse plan experience and as a hedge against future obligations.

**Limiting the Funding of Pension Plans**

Balanced against the pressures for maximum funding are competing uses of the money and concerns over lost tax dollars. Plan sponsors--businesses--have companies to run and investments to make in their own operations, which naturally limits the amount of money any firm wants to set aside for future benefit obligations. And tax collectors, too, want to restrict the revenue losses caused by the favorable tax treatment of pension funds. Businesses deduct contributions to their pension funds, reducing taxable corporate profits. In addition workers
are not taxed on the deferred wages represented by the pension until they receive it, and the
fund earnings are not taxed until distributed, either. The most recent federal budget analysis
of so-called tax expenditures, or revenue losses due to special tax breaks, puts the pension tax
expenditure at the $59 billion mark this year.\(^6\)

Limits on the tax leakage represented by pensions take several forms. The amount a
company can deduct is limited by IRC code section 404, which caps the deduction for an
employer with both defined contribution and defined benefit plans at the greater of 25 percent
of aggregate employee compensation or the amount needed to meet ERISA minimum funding
standards for defined benefit plans.

In addition to the overall deduction limit, there are other tax code limits intended both
to ensure that the tax advantages of pension plans do not disproportionately favor highly paid
people and to limit federal revenue losses. Section 415 places both percentage and dollar caps
on the amount of contributions and benefits employers can provide under qualified plans.
Defined benefit plans cannot provide (or fund for) benefits in excess of $120,000 or 100
percent of pay, with reductions for early retirement. Compensation taken into account under
qualified plans is capped at $150,000 by section 401(a)(17). These maximum amounts affect
how much an employer can contribute to the pension plan by limiting the benefit promises and
thus the size of the plan’s liabilities.

\(^6\) We believe this number is a gross exaggeration, especially in the context of private
employer-sponsored retirement plans for reasons spelled out in detail in Schieber and Graig,
op. cit. Our reservations notwithstanding, the estimated value of the tax preference accorded
pensions takes on a significant role in virtually all deliberations over public policies affecting
privately sponsored retirement plans.
In addition to these limitations on benefits and thus liabilities, the tax code puts a cap on the degree to which those liabilities, once promised, can be funded. Beginning with ERISA, which established the first funding requirements for pension plans, once a plan reached its full funding limit further contribution would not be deductible. Only when liabilities increase or asset levels fall so that a plan is no longer at the full funding limit can contributions be deducted again.

At first, the full funding limit liability was defined in relation to the plan’s obligations as an ongoing entity. Employers could deduct up to “the excess (if any) of (A) the accrued liability (including normal cost) under the plan (determined under the entry age normal funding method if such accrued liability cannot be directly calculated under the funding method used for the plan) over (B) the lesser of the fair market value of the plan’s assets or the value of such assets determined [actuarially].” Under this definition, the limit was established according to the plan’s own funding method, chosen from approved possibilities, and using the plan actuary’s assumptions. Amounts contributed beyond the full funding limit liability would not be deductible for the company. Since the beginning of 1987, though, nondeductible contributions have also been subject to a 10 percent excise tax as a result of the Tax Reform Act of 1986.

Beginning in 1988 as a result of revenue-raising provisions in the budget reconciliation legislation for fiscal year 1988, [OBRA87, P.L. 100-203] a second limit came into play, limiting the deductible contribution to the lesser of the amount above (the “old full funding
limit") or the contribution that would bring the assets up to 150 percent of the plan's so-called current liability at the end of the year (the "new full funding limit"). Unlike the actuarial accrued liability, the "current liability" is not calculated with an eye to the ongoing liabilities of the plan, including future salary increases, for example. Instead, it represents only the present value of benefits accrued to the valuation date, based upon service and salary amounts up to that date. The enormous long-term implications of imposing a funding limit based only on a snapshot of a plan's obligations incurred to date, rather than on the expected liabilities that are being incurred on an ongoing basis will be discussed in later sections of this paper.

It was immediately clear that the new limit would halt pension contributions for many pension plan sponsors, despite the fact that their actuarial liabilities, measured on an ongoing plan basis, were not really fully funded. Watson Wyatt Worldwide's survey data based on plan valuations immediately before the OBRA87 change took effect show that 7 percent of plans were affected by the old full funding limit, but that fully 40 percent of plans in the sample had assets in excess of 150 percent of current liability and therefore would have experienced contributions reductions that year if the new limit had already been in effect.\(^7\) Indeed, the 1989 survey, conducted after OBRA87 took effect, showed that 47 percent of plans in the sample had assets exceeding 150 percent of current liability.\(^8\)

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Suddenly an enormous group of pension plan sponsors were thrown into a "contribution holiday," a period during which liabilities continued to mount, but no further funds could be added to the plan without tax penalty. Because of good investment results since that time, many companies are still not contributing to their pension plans. In our most recent survey based on the assumptions and funding reported in the valuations for the 1994 plan year, 35 percent of the final average pay plans in the survey have benefit security ratios above 150 percent, the new full funding limit.\(^9\)

We have argued elsewhere that the full funding limits set by OBRA87 are too low for many plans. When the funding limit was based solely on projected plan liability, plan sponsors could take into consideration expected pay increases for workers covered by the plan between the time of the annual valuation and their expected date of retirement. In basing the funding limit on benefits that already have been accrued under the current liability measure, anticipated pay increases could no longer be considered.

Consider the funding pattern that a plan would take for a hypothetical worker if it were using the projected pay increases, as is done in the projected unit credit funding method, in comparison to funding the benefit based on the annual increments in accrued benefits on a current liability basis (see Figure 1). In the case of a worker beginning a 40-year career job at age 25, the accrued benefit contribution rates would be less than the projected unit credit contribution rates over the first half of the career. Under OBRA87, the plan sponsor could fund

for up to 150 percent of the accrued benefit. But in many cases, for workers under age 40, 150 percent of the accrued benefit was less than 100 percent of the projected benefit.

The situation that OBRA87 created may have been worse in many cases than Figure 1 suggests. Many of the employers that had been contributing to their plans under the entry age normal funding method or the projected unit credit method were thrown into an excess funding position by OBRA87. This meant that they could not contribute to their plans until the accruing liabilities caught up with the assets that they had put into the plan under the earlier rules. So rather than continuing to contribute to their plans at the rates implied by the projected benefit contribution line in Figure 1, they enjoyed contribution “holidays” where

Figure 1

Pension Benefit Contributions: Current or Projected?
Pension Funding Perspectives under Alternative Actuarial Cost Methods, 25-Year Old Worker over a 40-Year Career

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their plans required no funding at all for some years. These contribution holidays may become habit forming and may ultimately discourage some employers from continued support of their defined benefit plans. It is one thing for a company to see its annual contributions to its pension program rising gradually over a decade as its work force ages. It is quite another to have the contribution rate jump from zero to 7 or 8 percent of payroll. That is the impact OBRA87 will have on some plans. With such precipitous changes in plan funding requirements, some sponsors simply will not continue to support their plans.

Even though we have been critical of the definition of full funding for some plans in the past, the funding limit problem illustrated in Figure 1 does not apply universally to all plans. The full funding limits still allow some plans to fund on the basis of their projected obligations. Indeed, we will show later that some plans have become significantly overfunded against this measure. The concerns being voiced about the proposal that has been put forward by the Ways and Means Committee raise an interesting question about the desirability of current policies limiting pension funding. The full-funding limit has been postulated as the maximum amount an employer can have in a pension plan and still qualify for making additional deductible contributions. This would seem to be saying that this is the maximum appropriate funding level for a plan given the fiscal cost considerations that have to be taken into account in developing public policy. It is ironic that an agency of the federal government is now arguing that plans funded at that level would have “insufficient resources to protect retirees and the PBGC.”
Asset Reversions

During the 1980s, interest rates were much higher than they are now and some employers turned to their pension funds as a source of financing. One reason was because capital had become very expensive to obtain any other way. Another reason is the interaction of pension liabilities with interest rates. As interest rates rise, the discounted value of plan liabilities falls. So in a period when asset values were high because of the rising stock market and liabilities low because of high discount rates, pension funds appeared to have greater assets relative to their liabilities than during other periods. Facing the high cost of alternative sources of funds, some corporate executives turned to pension funds for their excess assets, even though they had to pay income tax on the reversion. Although asset reversions were not commonplace, they received a good deal of attention.

At that time, prior to the authorization for asset transfers for retiree health benefits, which began in 1991, the only way to obtain funds was to terminate the pension plan. Employers who didn’t want to end their plan found ways to continue to have retirement plans. Some split their plan in two, spinning off the excess assets into a plan for retirees, and leaving the plan for active employees with the minimum needed for an ongoing plan. Then the company would buy annuities for the retirees and terminate their plan, recapturing the excess assets that had been spun off into the retiree plan. Other companies terminated their pension plan and recovered excess assets, then started up a new plan to provide benefits in addition to those secured in the terminated plan.
The IRS established guidelines in 1983 that regulated termination/reversions. They required the purchase of annuities for all plan benefits to protect employees against market fluctuations and confirmed that employers could reestablish plans after a reversion had taken place. Not surprisingly, reversions continued, even after the Tax Reform Act of 1986 applied a 10 percent excise tax to the reversions. Later the tax rose to 15 percent and the Omnibus Budget Reconciliation Act of 1990 pushed it to as much as 50 percent in addition to corporate income taxes.\textsuperscript{10} Together with dropping interest rates this punitive tax virtually ended the practice of terminating plans to gain access to surplus funds.

A central difference between the termination/reversion problem and the proposal on the table today is that employers with terminating plans in the 1980s could recoup assets in excess of what was needed to purchase annuities for the plan participants. As we will demonstrate in detail later, no plan sponsor could draw down assets below the full funding limit liability under the current proposal—and some could not even draw out that much. There is no comparison with plans in the 1980s that removed all surplus as defined for plan termination purposes and the current proposal. The linkages that have been drawn between the earlier asset reversions and the potential transfers under this proposal ignore the backstop provisions significantly limiting the extent of transfers that could be taken if this proposal becomes law.

\textsuperscript{10} The excise tax is reduced to 20 percent under any one of the following three conditions: \textbf{Bankruptcy}: The plan sponsor is under Chapter 7 or Chapter 11 bankruptcy proceedings. \textbf{Transfer to replacement plan}: The plan must cover at least 95 percent of the participants in the original plan. \textbf{Pro rata increase}: The employer provides a pro rata increase to participants of at least 20 percent of the reversion amount.
Current Funding Status of the System

The PBGC in its analysis of the Ways and Means proposal concludes that “Removal of substantial assets from the retirement system would impede the progress promised by the Retirement Protection Act toward improved pension funding and a stronger pension insurance system.”\(^{11}\) Its analysis ignores the fact that the current funded status of the plans that it is insuring is very uneven. Based on the 1990 valuation data, more than one-third of the plans had assets in excess of 150 percent of their current liability. Another fifth had a funding ratio between 125 and 150 percent. On the underfunded side of the ledger, 8 percent of the plans had assets that were less than 75 percent of current liabilities and another 6 percent fell between 75 and 90 percent of current liability. Locking assets in plans that are extremely overfunded, however, does not provide the PBGC any protection against the liabilities of the plans that are extremely underfunded. The PBGC has no way of leveraging overfunding in some plans against underfunding in others. The only way that PBGC’s exposure to the underfunded plans can be eliminated is by those plans becoming more funded. The Retirement Protection Act was an attempt to accomplish that end.

Proposal Allowing Asset Transfers from Pension Plans

As we pointed out earlier, the legislation that has been approved by the House Ways and Means Committee would allow pension plan sponsors with excess assets in their plans to transfer those assets out of their plans for other uses. We believe there is considerable

misunderstanding about how this proposal would actually work and how it relates to current funding requirements and limits within existing law. To understand the issues, one has to understand how excess assets are defined under the proposal, and how other aspects of pension funding is regulated.

Defining Excess Assets Under the Proposal

One of the crucial items in this proposal is the definition of excess assets which is conceptually complicated and simple at the same time. The definition of excess assets is somewhat complicated because it is based, at least in part, on the full funding limit, the level of funding for a plan beyond which an employer cannot make additional tax-deductible contributions. As pointed out earlier, the full funding limit liability is defined as the lesser of the actuarial accrued liability or 150 percent of the current liability. The transfer provision in the Ways and Means proposal would allow plan sponsors to transfer assets out of their plans to the extent they exceed the greater of the full funding limit or 125 percent of the current liability.

While the definition of excess assets in the proposal is stated in simple terms, the interaction of the definition of the greater of the full funding limit liability and current liability in defining excess assets and the use of current liability in defining the full funding limit liability seems to complicate the understanding of how the proposal actually works. The reason we conclude that the definition confuses the understanding of the proposal is because of the nature of various analyses that have raised concerns about allowing sponsors to transfer assets out of their plans down to the level of 125 percent of current liability. The general
nature of these analyses is that a plan funded at 125 percent of current liability does not have a sufficient cushion to adequately assure all of the benefits being promised under the plan. This has been widely true of the media coverage focusing on the issue, but it is equally true of the analysis published by the Pension Benefit Guaranty Corporation. For example, the transmission letter on the PBGC report to the Secretary of Labor indicates that the PBGC’s “analysis shows that removal of these funds would leave many pension plans with insufficient resources to protect retirees and the PBGC.”

The concern about a plan funded at 125 percent of current liability relates to the nature of the pension promise and the variability over time in the value of assets behind that promise. The PBGC analysis of the proposal to allow the transfer of funds out of pension plans focuses on both of these concepts. In both cases, they raise concerns that allowing some plan sponsors to transfer assets out of plans will jeopardize benefit promises without fully explaining how they derive the underlying assumptions that lead to their conclusions. In the following discussion we explore the nature of the pension liability and how it is funded within our current regulatory context. Later we look at the issues related to the potential risks that assets sufficient to fund benefits at one point in time might be insufficient subsequently.

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Understanding the Liability Concepts in Pension Funding

The current liability of a pension plan is basically the liability the plan faces if it were to shut down immediately.\textsuperscript{13} When a plan does so, it calculates the benefits for all the participants in the plan on the basis of their service in the plan up to the termination date and on the basis of pay that has been earned under the plan until that date. For many ongoing plans, however, the real liability will significantly exceed the current liability because the overwhelming majority of plans base benefits on pay toward the end of the workers' careers. They do so either explicitly, as in the case of plans with a final average salary benefit formula, or they do so implicitly by periodically updating the benefit formula, as is typically the case for career average and flat dollar plans.

The difference in pay considered under a plan that is being terminated versus one that is ongoing is the important distinguishing variable in comparing the current liability and the ongoing liability\textsuperscript{14} under the plan. For example, a worker earning $25,000 at age 40 would be earning $54,778 at age 60 if he or she gets pay raises of 4 percent per year between the two ages. Such a worker covered under a pension plan for 10 years at age 40 that bases benefits

\textsuperscript{13} Technically, the PBGC report argues that termination liability is different than current liability because of different assumptions that are used in a termination versus calculating obligations accrued to date for an ongoing plan. We will return to that distinction later. Laying aside, for the time being, the premiums required to purchase an annuity on plan termination, the two concepts are essentially equivalent.

\textsuperscript{14} The ongoing liability is essentially the equivalent of the actuarial accrued liability that is considered for funding of the plan or the projected benefit obligation that is calculated for accounting purposes. The actuarial accrued liability and the projected benefit obligation for a given plan will not necessarily be identical because different assumptions might be used in calculating them in specific cases.
on earnings toward the end of coverage under the plan would pay much higher benefits for those 10 years of coverage if the benefit was based on earnings near age 60 than on earnings near age 40. If the worker is covered by a plan that is terminated when he or she is age 40 and that worker does not change jobs until retirement, his or her benefit will still be based on wages covered during the first 10 years on the job. It will be a much smaller benefit for those years of service than it would be if it were based on the salary toward the end of his or her career.

A conceptually straightforward way to show the distinction between current liability and the actuarial accrued liability is to work through an example for a specific worker. To do so, we calculated accumulated and projected benefits that would be provided to a hypothetical worker as he or she progressed through his or her career. We developed these calculations for 431 large, traditional defined benefit plans that were included in a 1993 survey of employer-sponsored benefit plans done by Watson Wyatt Worldwide. In developing the calculations, we assumed a 4 percent inflation rate over the calculation period, a 5.5 percent rate of growth in salary levels, and an 8 percent discount rate applied backward from age 65. We developed calculations for a worker whose pay level in 1993 was one-half the Social Security wage base and beginning a job at age 25. After calculating the amounts in each year for the hypothetical worker under the 431 plans, we calculated average accumulated and projected benefits under all the plans for the hypothetical worker during each year of hypothetical coverage. In this regard, the results represent the average structure of benefit accruals under the set of plans analyzed.
Figure 2 shows the results of the projections for the hypothetical worker. The current and projected benefit values in each year are shown as a multiple of the salary that the worker would be paid in each year of his or her career. These are measures of current liability and a benefit allocation method measure of actuarial accrued liability respectively. Initially, the difference in the two values is relatively small, but by the time the worker has been in the job for 10 years, the projected benefit is four month’s earnings larger than the accumulated benefit. The difference continues to increase steadily until it reaches 11 month’s earnings just prior to early retirement eligibility at age 55, when the discrepancy between the two values diminishes to about the equivalent of two month’s earnings and continues to diminish until the two values are equivalent at age 65, the normal retirement age under most plans. For workers

Figure 2

Current Benefits and Projected Benefits as a Multiple of Current Salary for a Hypothetical Worker

with different characteristics, the differences in the accumulated and projected benefits tend to be somewhat larger for workers who have a higher wage level than those with lower wages. Also the discrepancies are smaller for workers who become covered under a plan later in their career compared to those who are covered earlier.

A pension plan’s total liability is simply the sum of the liabilities for each of the participants in the plan. Thus, the current liability for the plan is the aggregation of the liability for the current benefit shown in the figure for all of the participants in the plan. Similarly, the actuarial accrued liability is the sum of the liability for projected benefits for all participants in the plan. The substantial variation in the relative values of current and projected benefits during various stages in a worker’s career take on considerable significance in the context of consideration of adequate pension funding levels because the age structure of the workforce and retirees can vary considerably from plan to plan. For example, for a plan that covers a very young work force, there will be a significant difference between the current liability under the plan and the actuarial accumulated liability. This occurs because the projected benefits are significantly greater than the current benefits for most participants in the plan. For a plan that is much more mature, with an older work force and a large number of retirees relative to workers covered under the plan, the current liability might be nearly the equivalent of the actuarial accrued liability. In this case the two come close to approximating each other because the projected and current benefits are identical for retirees and nearly so for those workers very close to retirement under the plan.
In order to show how the maturity of a pension plan affects the relative measures of various obligations, we have developed a number of hypothetical plan populations that would each participate in a specific defined benefit plan. We have then calculated the various liability measures and measures of the plan sponsor’s ability to fund the plan for each of these hypothetical populations. The only thing that varies from each of the scenarios is the active worker and retiree populations covered under the plan. The results of the various case studies are presented in Table 1. The table includes summary statistics on the characteristics of the populations covered by the plans that are important in defining plan liabilities.

Case studies 1 and 2 are interesting because they show two relatively immature plans. Neither of them has any retirees but the plan in case study 2 is somewhat more mature than the plan in the first case study as reflected in the comparative average age and service distributions in the two cases. The item of note in comparing the first two case studies is that the more mature plan has a higher full funding limit liability relative to the ongoing plan liability than the more immature plan.

Case studies 2 through 5 are interesting because the current active work force covered by the plan is identical in each case but the relative share of the total covered population that is retired varies from case to case. In case 2 none of the participants are retired, in case 3, 10 percent are, in case 4 it is 20 percent, and in case 5 it is 50 percent. The current and actuarial accrued liabilities for active workers covered under the plan and for retirees are shown separately. In the case of the retirees, the current liability and the actuarial accrued liability are equivalent because there are no more anticipated pay increases that would affect benefits. In fact, the plan sponsor might provide periodic cost of living benefit increases for retirees that
<table>
<thead>
<tr>
<th></th>
<th>Case Study Number 1</th>
<th>Case Study Number 2</th>
<th>Case Study Number 3</th>
<th>Case Study Number 4</th>
<th>Case Study Number 5</th>
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</thead>
<tbody>
<tr>
<td><strong>Active workers and active worker liabilities</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of active workers</td>
<td>100</td>
<td>100</td>
<td>100</td>
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<tr>
<td>Average Age</td>
<td>39.5</td>
<td>43.2</td>
<td>43.2</td>
<td>43.2</td>
<td>43.2</td>
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<tr>
<td>Average service</td>
<td>11.0</td>
<td>14.4</td>
<td>14.4</td>
<td>14.4</td>
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<td>Average Pay</td>
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<td>35,495</td>
<td>35,495</td>
<td>35,495</td>
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<tr>
<td>Current Liability</td>
<td>690,659</td>
<td>1,109,138</td>
<td>1,109,138</td>
<td>1,109,138</td>
<td>1,109,038</td>
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<td>Actuarial Accrued Liability</td>
<td>2,128,465</td>
<td>2,925,290</td>
<td>2,925,290</td>
<td>2,925,290</td>
<td>2,925,290</td>
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<tr>
<td><strong>Retirees and retiree liabilities</strong></td>
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<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Number of retirees</td>
<td>0</td>
<td>0</td>
<td>11</td>
<td>25</td>
<td>100</td>
</tr>
<tr>
<td>Current liability and actuarial accrued liability</td>
<td>0</td>
<td>0</td>
<td>513,355</td>
<td>1,134,891</td>
<td>3,913,164</td>
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<td><strong>Total participants and liabilities</strong></td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total participants</td>
<td>100</td>
<td>100</td>
<td>111</td>
<td>125</td>
<td>200</td>
</tr>
<tr>
<td>Percent of participants retired</td>
<td>0</td>
<td>0</td>
<td>10</td>
<td>20</td>
<td>50</td>
</tr>
<tr>
<td>Total current liability</td>
<td>690,659</td>
<td>1,109,138</td>
<td>1,622,493</td>
<td>2,244,029</td>
<td>5,022,202</td>
</tr>
<tr>
<td>150 percent of current liability</td>
<td>1,035,989</td>
<td>1,663,707</td>
<td>2,433,740</td>
<td>3,366,044</td>
<td>7,533,303</td>
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<tr>
<td>Total actuarial accrued liability</td>
<td>2,128,465</td>
<td>2,925,290</td>
<td>3,438,645</td>
<td>4,060,181</td>
<td>6,838,454</td>
</tr>
<tr>
<td>Full funding limit liability</td>
<td>1,035,989</td>
<td>1,663,707</td>
<td>2,433,740</td>
<td>3,366,044</td>
<td>6,838,454</td>
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<tr>
<td>Full funding limit liability as a percent of actuarial accrued liability</td>
<td>49</td>
<td>57</td>
<td>71</td>
<td>83</td>
<td>100</td>
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</table>

would increase the actuarial accrued liability but those are not legally required, and thus are not recognized until they actually occur. Again, the phenomenon noted in the comparison of cases 1 and 2 prevails in this case. Namely, the more mature plans have a higher full funding limit liability relative to the ongoing plan liability than the more immature plans. In terms of being able to fund plans with deductible contributions, current law discriminates between plans in terms of letting sponsors with more mature populations more fully fund them than sponsors with less mature plans.

Examples of How the Transfer Provisions Would Actually Work

Having spelled out the legislative provisions defining excess assets and the background on how the various measures of liability vary given varying populations within the plans, it is important to understand how the Ways and Means transfer proposal would actually affect currently operating pension plans. In order to help clarify this matter we have taken a look at a number of plans covered in Watson Wyatt's *1994 Survey of Funding and Actuarial Assumptions*. This survey covers defined benefit pension plans with more than 1,000 active participants and reflects the assumptions used in developing the 1994 plan year actuarial valuation and the funding levels estimated in that valuation. We have evaluated the asset transfer proposal for the 418 final average pay plans for which we had complete information from the survey. Our analysis of actual plan filings was carried out at two levels. First, we developed four case studies that helped to clarify the effects of the transfer of assets on plan
funding. Second, we summarized the potential extent to which transfers might occur across plans in the sample.

The case studies utilize information from the plan filings for four plans that were at their full funding limit liability under the law based on their 1994 valuation. In other words, each of these plans held sufficient assets that current pension funding law would not allow the plan sponsors to make additional tax-deductible contributions to them. Because we commit that we will not publicly disclose information that is provided to us on the periodic surveys that we undertake, we have multiplied the actual asset information, actuarial accrued liability, and current liability information submitted on these four plans by a constant fraction. This masks the identity of the plans but in no way affects the substance of the analysis. The case studies allow the reader to systematically go through the process of defining excess assets as spelled out in the Ways and Means proposal that would allow the transfer of assets from pension plans and to understand the implications of the proposal in varying situations. They are presented in Table 2.

In case study number 1, the full funding limit liability is equal to the actuarial accrued liability (AAL) of $129,770,000 because the AAL is less than 150 percent of the current liability for the plan. Under the proposed transfer provisions, no assets could be transferred from this plan because only assets in excess of the greater of the full funding limit, $129,770,000, or 125 percent of the current liability, $159,271,000, could be transferred, but the plan only has assets of $137,610,000. In this case the plan has assets that are only 108 percent of the current liability, yet the plan sponsor can make no further contributions to the plan because it is already at the full funding limit. Indeed it holds assets equal to 106 percent
of the full funding limit, the point beyond which tax-deductible contributions can be made to the plan.

In case study number 2, the full funding limit liability for the plan is again the actuarial accrued liability of $31,313,000 because the AAL once again is less than 150 percent of the current liability for the plan. In this case, the proposed transfer provisions would allow a

Table 2

Impact of Proposal to Allow Plan Transfers on Four Fully Funded Plans

<table>
<thead>
<tr>
<th></th>
<th>Case Study Number 1</th>
<th>Case Study Number 2</th>
<th>Case Study Number 3</th>
<th>Case Study Number 4</th>
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<tbody>
<tr>
<td>Actuarial accrued liability(AAL)</td>
<td>$129,770</td>
<td>$31,313</td>
<td>$35,110</td>
<td>$5,909</td>
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<tr>
<td>Lesser of actuarial or market value of assets</td>
<td>137,610</td>
<td>54,443</td>
<td>35,856</td>
<td>6,273</td>
</tr>
<tr>
<td>Current liability (CL)</td>
<td>127,417</td>
<td>29,034</td>
<td>25,428</td>
<td>2,953</td>
</tr>
<tr>
<td>125 percent of CL</td>
<td>159,271</td>
<td>36,293</td>
<td>31,785</td>
<td>3,691</td>
</tr>
<tr>
<td>150 percent of CL</td>
<td>191,126</td>
<td>43,551</td>
<td>38,142</td>
<td>4,430</td>
</tr>
<tr>
<td>Full funding limit liability--i.e., lesser of AAL or 150% of CL</td>
<td>129,770</td>
<td>31,313</td>
<td>35,110</td>
<td>4,430</td>
</tr>
<tr>
<td>Excess asset limit</td>
<td>159,271</td>
<td>36,293</td>
<td>35,110</td>
<td>4,430</td>
</tr>
<tr>
<td>Potential transferable assets</td>
<td>---</td>
<td>18,150</td>
<td>746</td>
<td>1,843</td>
</tr>
<tr>
<td>Remaining assets as % of current liability</td>
<td>108</td>
<td>125</td>
<td>138</td>
<td>150</td>
</tr>
<tr>
<td>Remaining assets as % of full funding limit liability</td>
<td>106</td>
<td>116</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

transfer because the $54,443,000 in the plan exceeds the greater of the full funding limit liability or 125 percent of current liability, $36,293,000. In this case the plan sponsor would be eligible to transfer $18,150,000 from the plan. However, the plan would still hold $36,293,000 which would be 125 percent of current liability. It is not clear how anyone could maintain that such a transfer would be inappropriate where the plan would still hold assets exceeding its full funding limit liability by 16 percent. In other words, if the full amount eligible for transfer under the proposal were taken, the plan sponsor still could not contribute to the plan because assets remaining in the plan would significantly exceed the full funding limit. If the assets remaining in this plan are going to be “insufficient” to “protect retirees and the PBGC” it is hard to understand why public policy would prevent the plan sponsor from making additional contributions to the plan if it were only funded at this level in the first place.

In case study number 3, yet again the full funding limit liability is defined by the actuarial accrued liability of $35,110,000 which is less than 150 percent of the current liability which equals $38,142,000. As in case study number 2, this plan sponsor would be allowed to take a transfer because the $35,856,000 in the plan exceeds the greater of the full funding limit liability or 125 percent of the current liability which equals $31,785,000. In this case the sponsor would be allowed to transfer up to $746,000 from the plan. If the sponsor were to do so, it would leave assets in the plan equal to 138 percent of current liability and 100 percent of the full funding limit liability for the plan. Case study number 3 is interesting because it points out the confusion that exists about the transfer proposal allowing all plan sponsors to
take transfers down to 125 percent of current liability. For example, the PBGC’s analysis of the proposal indicates that “The only limit on the amount of the reversion would be a requirement that the transfer not be greater than the lesser of assets over 125 percent of the plan’s current liabilities as determined on January 1, 1995, or on the most recent valuation preceding the reversion.”\(^{15}\) In point of fact, the 125 percent only applies if it is higher than the plans full funding limit. In this case, the limit on the proposal that transfers not be allowed below the full funding limit liability for the plan would prevent the sponsor from transferring assets from the plan down to the 125 percent level.

One might think retirees and the PBGC would be more secure in case 3 than in case 2 because the former would still hold 138 percent of current liabilities if the full transfer were taken whereas case 2 would have only 125 percent of current liabilities after a full transfer. Yet the plan in case 2 would have assets exceeding its full funding limit liability by 16 percent whereas in case 3 the remaining assets in the plan if the full transfer were taken would only be 100 percent of the full funding limit. It is easy to see how this whole situation might be confusing for reporters and others not familiar with the patchwork of regulations and constraints imposed on employer-sponsored retirement plans. Despite the confusion, the simple fact is that if the plan sponsor were to take the full transfer allowed, no further deductible contributions would be allowed for this plan because it would still be at its full funding limit.

In case number 4, the full funding limit liability for the plan is stipulated by the plan’s current liability because 150 percent of that liability equals $4,430,000 which is less than the actuarial accrued liability of $5,909,000. In this case the sponsor would be eligible to take a transfer from the plan because the assets in the plan, $6,273,000, exceed the greater of the full funding limit liability or 125 percent of current liability which equals $3,691,000. In this case, since 150 percent of the current liability defines the full funding limit, the plan sponsor could not transfer assets below 150 percent of current liability. Again we have one of those confusing situations where participants would seemingly be better off because the assets remaining in the plan are clearly more than 125 percent of current liability, but where assets could be transferred down to the full funding limit liability for the plan. Still, if the full transfer was taken, the plan sponsor could not contribute additional money to the plan because it would still be at its full funding limit.

These four case studies give rise to a question about relative incidence of plans in the various situations that have been identified as being possible. In order to address this question we have evaluated the plans with final average pay benefit formulas covered in Watson Wyatt’s 1994 Survey of Funding and Actuarial Assumptions that focuses on larger plans, those with more than 1,000 active participants. There were 418 such plans in this survey, of which 139 reported that they were at their full funding limit. Of these, 25.2 percent would not be eligible to transfer any money out of their plans because their liability structure is such that their full funding limit liability is less than 125 percent of their current liability, and while all have assets in excess of their full funding limit, none have assets in excess of 125 percent of their current liability. Of the fully funded plans, 27.3 percent would be eligible to take
transfers under the proposal that would allow them to reduce their asset levels to 125 percent of their current liability. Not a single one of these plans could transfer assets down to their full funding limit liability and in the aggregate, if they all transferred the full amounts they would be eligible to transfer out of their plans, the plans would still hold assets equal to 111 percent of their full funding limits. Another 25.2 percent of the plans would be eligible to transfer assets from their plans down to a level where the remaining assets would be equal to 126 to 149 percent of their current liability, but not one of these plans would be able to remove assets below their full funding level. Finally, 22.3 percent would be able to transfer assets down to a level that would leave them at 150 percent of their current liability, but again none would be able to remove assets to a level where they could immediately qualify to put any additional assets in the plan.

**Practical Issues in Evaluating the Transfer Proposal**

The discussion above demonstrates two important points in assessing the proposal to allow plan sponsors to transfer assets out of their plans in certain circumstances. The first of these is that no plan sponsor would be able to take assets out of the plan below the level specified in current law as the maximum funding limit for the plan beyond which additional deductible contributions can be made to the plan. The second is that the majority of plan sponsors with plans at the full funding limits that would be eligible to take a transfer under the proposal would not be able to take assets out of their plans down to the level of 125 percent of current liabilities that PBGC seems so concerned about. On the basis of these points alone,
the PBGC's concern about the risks created by this proposal might seem facetious, but there are a number of other grounds as well.

**Potential Future Transfers and Current Law**

The Omnibus Budget Reconciliation Act of 1990 (OBRA90) added section 420 to the Internal Revenue Code to allow employers to transfer pension assets from overfunded pension plans in order to finance retiree health benefits. These transfers are allowed without the employer having to terminate the plan. As would be the case with the current proposal, transfers can be made only to the point assets are still the greater of 125 percent of the percent of current liability or the full funding limit. Certainly, the current proposal would give plan sponsors greater access to excess funds in their plans than the current section 420, but the PBGC did not publicly air the perceived threats that this earlier provision would pose to retiree cash benefits or their insurance program. If taking assets out of plans down to the limits already specified in section 420 was acceptable in 1990, what has changed so radically that it is now a threat to the retirement security of pension participants in 1995?

While the PBGC is under different management today than it was when OBRA90 was being considered, the current management has been in place for nearly three years now and has successfully pushed a significant piece of pension legislation through Congress without readdressing the existing section 420 issue. Indeed, section 420 was reauthorized as part of the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) legislation which the Clinton Administration advocated as it was considered during 1994. The Administration
raised no objections as to the appropriateness of the transfer provisions that were reauthorized by that legislation.

In addition, the fact that no plan could deplete assets below the current full funding limit liability under the proposal raises questions about the veracity of complaints by people in the policy community who have been actively involved in setting those limits in the first place. If a plan is suddenly posing a threat to participants and the PBGC by spending assets down to the full funding limit, isn’t a plan that is funded at less than the full funding limit liability even a greater threat? If plans currently at the full funding limit as well as those below are so underfunded that they are posing a threat to pension participants and PBGC, shouldn’t we have higher funding limits than we now do? Clearly, the current administration has not argued for such higher limits. Indeed, the current Administration proposed the provision of the Omnibus Budget Reconciliation Act of 1993 (OBRA93) that lowered the compensation that can be used in funding pension plans. This effectively reduced the funding of defined benefit pensions for many workers, even for workers earning as little as $30,000 per year.\(^\text{16}\)

**Risk Exposure after Transfers Are Taken**

In evaluating the potential implications of the transfer proposal, the PBGC has pointed to the earlier history of plan terminations during the 1980s as an example of problems that arise when plan sponsors take money out of their pension plans. They point to a number of

\(^{16}\) See Watson Wyatt Worldwide, “Letter to the President” *Wyatt Insider* (April 1993), vol. 3, no. 4, pp. 1-9 for a full discussion of how OBRA93 led to the reduced funding of pension benefits for many younger workers, even those earning relatively low wages.
cases where an asset reversion was taken by a plan sponsor and that same sponsor has subsequently had a pension plan that became significantly underfunded. The history of plan terminations and asset reversions in the 1980s would appear to be qualitatively very different than the implications of this proposal. The situation back in the 1980s required that the plan be terminated in order for the sponsor to gain access to the excess funds. In those cases, the asset cushions required under the current proposal were not left in the plans. Further, under the current proposal, the plan would not be terminated and the sponsor would have an ongoing responsibility to financially support the plan. Indeed, if asset levels in the plan fall below the full funding limit, the sponsor would be required to amortized over a 10-year period the transfers that had been taken from the plan.

**Concerns about Asset Levels and Interest Rates**

The PBGC in its analysis of the Ways and Means asset transfer proposal argues that pension plans that are overfunded can become underfunded quickly. In order to demonstrate their point they argued that “a reduction in the interest rate of one percentage point together with an asset reduction of 10 percent would cause a plan funded at 125 percent to become underfunded.”17 While the PBGC’s calculation may be correct, they have posited a scenario that is unlikely.

Typically, when interest rates are falling there are other things going on in the financial markets that lead to the appreciation in the value of assets. According to the Ibbotson

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17 PBGC, op.cit., p. 10.
Associates, Inc. tracking market results for the period 1926 to 1994, long-term government bond yields have only rarely dropped by 1 percent or more in a year. From 1926 to the present, long-term government bond yields have dropped by 1 percent or more only in 1982, 1985, 1986, 1989, and 1991.\textsuperscript{18} The corresponding annual returns for large company stocks and for long-term government bonds for those years are shown in Table 3.

<table>
<thead>
<tr>
<th>Year</th>
<th>Drop in Year-End Yield on Long-Term Government Bonds</th>
<th>Total Return on Large Company Stocks</th>
<th>Total Return on Long-Term Government Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1982</td>
<td>2.4</td>
<td>21.4</td>
<td>40.4</td>
</tr>
<tr>
<td>1985</td>
<td>2.1</td>
<td>32.2</td>
<td>31.0</td>
</tr>
<tr>
<td>1986</td>
<td>1.7</td>
<td>18.5</td>
<td>24.5</td>
</tr>
<tr>
<td>1989</td>
<td>1.0</td>
<td>31.5</td>
<td>18.1</td>
</tr>
<tr>
<td>1991</td>
<td>1.1</td>
<td>30.6</td>
<td>19.3</td>
</tr>
</tbody>
</table>


Over this period, declines in long-term government bond yields of one percentage point or more that would increase the value of the pension liability are associated with large positive returns for both stocks and bonds assuring concurrent large growth of pension assets. In other

words, the PBGC scenario has not occurred generally in the U.S. investment markets over the past 70 years. While it cannot be completely ruled out, it is highly unlikely to occur.

The PBGC also argues that a pension plan funded at 125 percent of current liability can be underfunded on a termination basis. The reasons for this are several but generally relate to using different assumptions for calculating liabilities for a plan that is terminating versus one that is ongoing. To make their point, the PBGC calculated the termination liabilities for 10 large pension plans to determine the value of the 125 percent of current liability cushion on a termination basis. They used a 5.65 percent interest rate, GAM-83 mortality assumptions, and their own expected retirement pattern assumptions in estimating the termination liabilities. They estimated that “in the aggregate, the plans’ termination liability funded ratio would be less than 90%.”19 It is not clear from their presentation whether these 10 plans would qualify for an asset transfer under the Ways and Means proposal or if they did, if they could transfer assets down to 125 percent of current liability if they chose to do so. It is clearly possible to use sets of assumptions different from the assumptions that are used in funding a pension plan that make the funding situation seem significantly worse than the one that seems reasonable to a sponsor of an ongoing pension plan. There is no good reason to believe that the worse set of termination assumptions is more relevant for an ongoing plan than the assumptions actually used to value the ongoing plan. Thus, the calculation exercise hardly seems relevant.

The termination liabilities that a pension plan faces take on relevance only in the context of actual termination of the plan. When a plan is being terminated, the sponsor is

19 PBGC, op.cit., p. 10.
faced with having to purchase annuities to cover the plan’s obligations. Insurance companies are naturally going to be relatively conservative in valuing the liabilities in the plan. They are going to attempt to minimize their exposure to long annuity periods by being careful in calculating expected retirement behavior and life expectancies of participants in the plans. They are also going to price the annuities to garner some profit from the transaction. While this is completely understandable from the perspective of the annuity suppliers, it also helps to explain why plan sponsors are naturally reluctant to go the plan termination route.

The original motivation for large employers to set up their own pension trusts was that they realized they could fund and self-administer their own retirement annuity programs far more efficiently than they could finance them through insurance markets. Running their own plans, sponsors could more reasonably value their own liabilities, invest their assets to capture greater returns, and avoid the profit loadings they faced when running their plans through insurance companies.20 The environment for funding a plan through a self-administered trust is essentially the same today as it was back in the 1940s and 1950s when self-trusteed plans came into vogue. The Ways and Means proposal that would permit asset transfers would not require plan termination in order to qualify to transfer assets out of plans. Thus the economic incentives to stand by existing plans would be maintained. The question then, is whether or not plan sponsors will be able to estimate the liabilities and funding status of their plans so aggressively that they will somehow jeopardize the participants in the plans and the PBGC.

The PBGC would have us believe that is the case. But that is not consistent with other positions that the agency has taken on recent pension policy developments.

The PBGC played a major role in the development of the Retirement Protection Act (RPA) that was part of the GATT legislation passed in late 1994. The RPA included provisions for calculating funding requirements for plans that are underfunded, including limitations on the assumptions that can be used in calculating liability levels and increasing the variable premium cap for PBGC insurance. In some regards, plans that are almost fully funded were given some relief by the RPA because the definition of an underfunded plan was changed from being less than 100 percent funded to being less than 90 percent funded. These plans might increase PBGC's exposure somewhat but they did not protest the provisions. In the final analysis, however, no plan that would qualify to transfer assets under the Ways and Means proposal could transfer assets below the full funding limit liability prescribed in law.

Stochastic Modeling of Asset and Liability Scenarios

One of the more puzzling aspects of the PBGC analysis of the Ways and Means proposal is the fact that they do not attempt to estimate any probabilities that plans will become underfunded if this proposal were to be implemented. Today, many plan sponsors use stochastic models in order to understand the ramifications of alternative investment policies and funding strategies on their funding obligations over time. The PBGC has been developing its own stochastic modeling capability over the past several years to estimate just such probabilities. The 1992 Annual Report clearly indicates that the agency believes that the
estimates developed from such stochastic models are superior to the simpler trend projections that it has used in the past to estimate its liabilities under alternative scenarios of the future.  

In order to analyze the potential risks created if plans were allowed to transfer assets down to 125 percent of current liability more directly than we can from the PBGC analysis, we have developed a set of projections for a sample plan in order to illustrate the expected variations in funding status if the plan is currently funded at 125 and 150 percent of current liability. The sample plan is an actual pension plan selected for purposes of this study. The plan is relatively mature; the liability for accrued benefits is split roughly 50 percent for active plan participants and 50 percent for retired and terminated vested plan participants.

In this analysis we develop a set of simulations to assess the level of contributions and funding status of the plan under a variety of investment return scenarios over a 10-year period. Because we are simulating a variety of investment scenarios based on historical returns to financial assets, the funding status over the time period will vary somewhat from simulation to simulation. The projected range of funded status was analyzed assuming the plan assets are invested to reflect a split of 40 percent of assets in large capital stocks, 10 percent in small capital stocks, 10 percent in international equities, and 40 percent in intermediate government and corporate bonds. The contributions are assumed to be equal to the minimum required amount each year.

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The purpose of this exercise is to determine the probability of a sample plan with assets equal to 150 or 125 percent of current liability becoming underfunded as the result of changes in interest rates and asset returns over a 10-year period. In developing this analysis we utilized the most recent version of an asset model developed by Watson Wyatt Worldwide that is used extensively in helping defined benefit plan sponsors develop funding and investment strategies for their plans.

The analysis for this exercise is based on a series of 500 simulations from our stochastic modeling process. In each of the simulations, the rates of return realized on the assets will vary from year to year based on actual returns realized on the same classes of assets in prior periods. The process used for this exercise adjusts the liabilities in each simulation to reflect changes in inflation and interest rates. The initial interest rate for computing the current liability is 7.1 percent. The interest rate used to compute the current liability is “smoothed” based on the four-year weighted average of simulated 30-year Treasury yield rates.

For purposes of this modeling exercise, the interest rate used to determine the actuarial accrued liability is 7.5 percent and is unadjusted for future years. This provides a “funding target” for the plan that is consistently equal to ERISA minimum contributions each year, regardless of changes in the current liability interest rate. There is no contribution if the full funding limit applies.

Figure 3 shows the distribution of the results of the 500 simulations. The various lines in the graph represent the probability of certain outcomes occurring in the future if future returns on assets bear a resemblance to historical returns on assets, a common assumption used
Figure 3

Probabilities of Alternative Funding Ratios for a Pension Plan Over a 10-Year Period with Starting Ratio of 150 Percent of Current Liability

Funding ratio as a percent of current liability


In evaluating various investment strategies. The bottom line in the graph represents outcomes in the funding of the plan relative to the current liability that would be expected to occur with no more than a 5 percent probability. In other words, 95 percent of the time we would expect the funding status to turn out better than the level reflected by the bottom line in the graph. Thus, on the basis of the 500 simulations of the funded status of the plan over time shows that there is less than a 5 percent chance that the plan will become less than 100 percent funded relative to the current liability in any year.
The top line in the graph represents outcomes in the funding of the plan relative to the current liability that would be expected to occur at the other end of the probability distribution. In other words, 95 percent of the time we would expect the funding status to turn out below the level reflected by the top line in the graph. Thus, the 500 simulations of the funded status of the plan over time show that there is roughly a 5 percent chance that the plan will become more than 400 percent funded relative to the current liability in any year in the simulation period. The middle line in the graph represents the 50 percent probability distribution, under which assets grow steadily from 150 percent of current liability to 207 percent by 2004.

Figure 4 shows the funding probability distributions for a plan funded initially at 125 percent of current liability. In this case, on the basis of the 500 simulations of the funded status of the plan over time shows that there is less than a 5 percent chance that the plan will become less than 90 percent funded relative to the current liability in any year. At the 50 percent probability level, the plan's funding status steadily increases to 157 percent of current liability. At the 95th percentile it increases to more than 300 percent of current liability in any year in the simulation period.

While a 5 percent chance of becoming less than 90 percent funded relative to the current liability is relatively small, there is still some probability of falling below this funding level given the contribution scenario that we have assumed in developing this analysis. If the plan were to fall below the funding level indicated by this very pessimistic scenario, it does not suggest that the benefits in the plan would be in jeopardy. It merely indicates that the plan sponsor would have to make larger contributions to the plan than those assumed for this
Figure 4

Probabilities of Alternative Funding Ratios for a Pension Plan Over a 10-Year Period with Starting Ratio of 125 Percent of Current Liability


analysis. Indeed, one of the special characteristics of defined benefit plans is that the sponsors do assume the investment risk in funding such plans. Furthermore, because of changes to the minimum funding rules included in the GATT legislation discussed earlier, plans would be required to fund liabilities very quickly if they become less than 100 percent funded following a transfer.
Conclusions

The funding of pension promises for participants in plans is extremely important and should be carried out judiciously. For a variety of reasons that have been spelled out in this paper, the funding of pension promises has been reviewed extensively since the passage of ERISA and has been revised on numerous occasions, especially over the past 15 years. The rules that have evolved through this regulatory process are extremely complicated and often confusing for plan sponsors as well as policy makers. We believe that the confusion over existing rules had led to much of the misunderstanding of the proposal put forward by the Ways and Means Committee that would allow the sponsors of overfunded defined benefit pension plans to transfer some of the excess assets out of their plans for other uses.

We believe that most people do not understand that this proposal is merely an extension of existing law. It does not extend current law by allowing plan sponsors with overfunded plans to tap any more of the excess funds in their plans than they can now. It merely lets them tap them for purposes other than funding retiree health insurance.

We believe that most people do not understand that this proposal would limit the transfer of excess assets so that no plan would end up with fewer assets than current law sets as the upper limit at which employers can still make tax deductible contributions to the plan. Indeed, many plans could not even transfer assets out of their plans down to this level--i.e., they would still remain in an overfunded position. If all of the plan sponsors who would be eligible to take assets out of their plans did so to the maximum extent possible, not one of
them would become eligible to make a tax deductible contribution to their plan because federal law deems their plans to be fully funded at the remaining asset levels.

We believe that most people do not understand that various critiques of this proposal have not taken into account how existing law governing funding works or have not considered relevant assumptions that can be used to fairly evaluate policy proposals of this sort. We believe that if most people understood these issues the discussions about the merits of the proposal would be significantly different than it has been thus far.