

PENSION POINTERS.....

PLEASE FORWARD TO THE LA FOR PENSIONS:

In the near future your office again will be asked to take a position on pension reform. The currently pending bills are the most significant reform bills since ERISA passed in 1974. The choices made in crafting a final bill will encourage employers to establish and maintain defined benefit pension plans – or will encourage them to avoid those plans. The bills also make significant changes to rules governing defined contribution plans.

To assist you in understanding this critical legislation, we will be sending you short briefs on key issues in the bills. This brief examines concerns about the future viability of the Pension Benefit Guaranty Corporation and the role those concerns have played in the current debate. Put it in a special folder so you will have it readily available when the time comes for your office to determine whether the bill will help, or hinder, pension coverage in the future.

A FRESH LOOK AT THE PBGC

Much of the debate regarding pension funding reform been fueled by contentions that the Pension Benefit Guaranty Corporation (PBGC) has been compromised by a swing in its fortunes from a \$9.7 billion surplus in 2000 to a deficit of approximately \$23 billion in 2004 and 2005. But the PBGC itself stated recently that “the Administration’s modeling shows that there is less than a ten percent probability that the PBGC’s single-employer pension insurance fund will become insolvent on or before 2020.”¹ This means that the PBGC is unlikely to become insolvent for many years after 2020 as well. Moreover, this analysis was made before premiums paid to the PBGC were substantially increased in the Deficit Reduction Act of 2005 (P.L.109-171).

How can Congress tell whether the PBGC is in imminent danger or not? The answer to that question is an important one since concerns about the PBGC could lead Congress to enact pension reforms so harsh they drive employers away from sponsoring pension plans. That would be a tragedy that Congress must not allow to happen. This brief seeks to help you better understand the financial status of the PBGC.

WHAT IS THE PBGC & HOW IS IT FUNDED?

The PBGC is an agency of the federal government that administers defined benefit pension plans that have terminated with insufficient funds to pay promised benefits. The PBGC pays the benefits promised under the plan up to specified guarantee levels and with certain other restrictions. To pay benefits to plan participants, the PBGC receives NO general revenue financing. Instead, it (1) collects premiums from employers that voluntarily sponsor pension plans for their employees, (2) assumes control of the assets of pension plans it administers, and (3) invests and earns money on these premiums and assets.

IF THE PBGC RECEIVES NO GENERAL REVENUES, WHY DO SOME TALK ABOUT A POSSIBLE “TAXPAYER BAILOUT?”

Should the PBGC ever not have sufficient funds to continue to pay guaranteed benefits, many presume that Congress would step in and pass a law to continue those payments and that those payments would be funded from

¹ Committee on Ways and Means, Mark-up of H.R.2830, November 9, 2003. Response to questions for the record from Representative Earl Pomeroy, supplied by the Department of Labor on February 26, 2006, Question #5.

general revenues.

IS THE PBGC IN DANGER OF NOT BEING ABLE TO PAY BENEFITS ANYTIME SOON?

The answer is “NO.”

- As noted above, PBGC analysis indicates there is a greater than 90 percent probability the agency will be solvent to 2020 and beyond.
- In 2005, the PBGC paid \$3.7 billion in benefits – but received \$1.5 billion in premiums and earned \$3.9 billion on its assets.² It does not have a cash-flow problem.
- Because PBGC payouts are made gradually – typically over decades – current deficits also should be amortized over long periods. PBGC’s extended pay-out period also means that the PBGC will not be subject to a sudden run on their cash such as occurred several years ago in the savings and loan industry.

WHAT OTHER MATTERS SHOULD BE CONSIDERED IN AN ANALYSIS OF THE PBGC’S FINANCIAL STRENGTH?

- A critically important factor is the interest rate used to estimate the program’s liabilities. Many believe the rate used by the PBGC is too low – making the program’s liabilities appear larger than they in fact are. For its interest rate, the PBGC uses an approximation of annuity purchase rates – even though the PBGC does not purchase annuities and consistently earns a higher rate of return on its assets than the interest rate used to calculate its deficit.
 - Instead of purchasing annuities, the PBGC operates more like a large and ongoing pension plan, and in fact is less likely than an ongoing plan to run out of assets in the near term because it does not pay lump sums.
 - If the PBGC had used the corporate bond yield curve recommended by the Administration for pension plan funding, its \$23.3 billion 2004 deficit would instead have been about \$18.4 billion. If the PBGC used a weighted average rate based on high quality, investment-grade corporate bonds, its 2004 deficit would have been about \$14.3 billion.³
- In recent years, the PBGC has changed its investment policy to allocate more assets to bonds instead of equities. This action has “locked in” their current deficit and denied the agency and those who depend on it the advantage of higher returns available through equities.
- The PBGC’s 2005 financial report states that it faces \$108 billion in future exposure from plans of companies with a credit rating below investment grade (called “reasonably possible terminations”). This number is often cited in the government’s testimony.
 - A PBGC website shows only 27 percent of companies included in its 2001-2004 reasonably possible lists became claims or “probable” claims.⁴ Not all “probable” claims actually terminate. Thus, it is radically incorrect to assume, as many do, that the PBGC will be asked to take over all these plans.

² Pension Benefit Guaranty Corporation Performance and Accountability Report, Fiscal Year 2005.

³ *Promises to Keep: the True Nature of the Risks to the Defined Benefit Pension System*, prepared for the American Benefits Council by Optimal Benefit Strategies, LLC, September 2005, page 4.

⁴ <http://www.pbgc.gov/media/key-resources-for-the-press/content/page15247.html>

- As of September 2004, the PBGC estimated that the plans it insures were underfunded by \$450 billion. This number is still widely circulated today. This number is outdated and overstated.
 - It primarily reflects the impact of the 2000-2003 recession and does not reflect the substantial improvement in the funded status of many plans due to subsequent contributions, recent healthy asset returns, and interest rates that are approximately 75 basis points higher today.
 - The number was calculated on a “termination” basis – that is, as though every company in the study was going to fail and be forced to terminate its plans. That is not going to happen. An analysis by Goldman Sachs summed it up this way: “Quite frankly, if all of those sponsors were to fail, pension plan underfunding would be the least of the worries for the U.S. economy and the capital markets.”

WHY IS IT IMPORTANT TO FOCUS DEBATE ON ENCOURAGING EMPLOYERS TO SPONSOR PENSION PLANS?

- Private sector defined benefit pension plans paid approximately \$120 billion in benefits in 2005.⁵ The PBGC paid \$3.7 billion – or about 3 percent as much.
- 44 million Americans are now receiving or in the future will receive benefits from an employer-sponsored plan. The PBGC’s present and future beneficiary population was 1.3 million in 2005 – or about 3 percent as many.⁶
- The PBGC has trusteeed 3,469 plans since its creation in 1975 through 2004. Over the same period 194,856 single employer defined benefit plans concluded their business without the PBGC (i.e., fully funded) or are still in existence. The PBGC represents about 1.7 percent of the long-term defined benefit universe.⁷

The vast majority of pension plans are NOT a threat to the PBGC, but harsh and volatile rules are a threat to the vast majority of plans and to the businesses that sponsor them. While the PBGC’s financial status bears careful watching and in depth study, overreaction based on an incomplete picture will undermine retirement security for millions of Americans.

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⁵ Cerulli Assoc., Quantative Update, Retirement Markets.

⁶ PBGC Performance and Accountability Report Fiscal Year 2005.

⁷ PBGC Pension Insurance Data Book 2004, pp. 11 & 28.