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FUNDING STABILIZATION: STABILIZING THE INPUT VERSUS STABILIZING THE OUTPUT

This paper explores an issue that has been raised during the public policy discussions on funding stabilization. The issue is whether stabilization is best achieved through stabilizing the "input" (e.g., interest rates), as explained below, or through stabilizing the "output" by capping increases or decreases in funding obligations, also as explained below.

The Council supports any approach that effectively achieves meaningful stabilization. However, as discussed in detail below, stabilizing the output through caps on increases or decreases in funding obligations is extremely hard to do effectively. It was tried in the context of the Pension Protection Act of 2006 ("PPA"), fully analyzed, and unfortunately could not be made to work. Moreover, stabilizing the input, such as was done in the Senate-passed highway bill, produces the most accurate and effective form of stabilization.

BACKGROUND

Over the last few years, the government has made a concerted effort to keep interest rates artificially low in order to stimulate the economy. Unintentionally, this effort is having an extremely adverse effect on pension plan sponsors by inflating pension plan liabilities and funding obligations. For example, funding obligations for 2012 are projected to be almost four times the level of 2010, and 2013-2017 will be far worse, peaking at almost seven times 2010 levels in 2016. These enormous liabilities will severely affect jobs and economic recovery by diverting many billions of dollars away from business investment. The unjustified funding obligations will also undermine employers' ability to continue to provide benefits under the voluntary private pension system.

One issue that has arisen is: what is the most appropriate way to stabilize the funding rules to prevent these very adverse consequences? Conceptually, there are two basic approaches: stabilizing the "input" or stabilizing the "output." For this purpose,

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the "input" is the measurement of funded status and includes the determination of the value of plan assets and liabilities. The proposal to adjust today's artificially low interest rates to fall within a reasonable range around an historical normal interest rate is a form of input stabilization.

The "output" includes all the funding-related rules that are based on funded status, including the amount of required contributions and the application of the benefit restrictions. For example, our proposal to modify the amortization rules is a form of stabilizing the output. That proposal makes contribution obligations less volatile, thus stabilizing the output.

The Council supports both forms of stabilization, as reflected by the fact that the proposal supported by the Council would provide both interest rate and amortization stabilization. However, there are current discussions among some policymakers to only stabilize the output through a cap on the amount that contribution obligations can increase or decrease from year to year. ***We are more than happy to explore any stabilization approach that works, but, as discussed in detail below, the efforts of the government in the context of the PPA to establish this type of output stabilization indicate somewhat clearly that it would be very difficult to achieve true funding stabilization in this manner***. It is certainly possible, but it is very difficult.

SENATE BILL: STABILIZING THE INPUT

The Senate highway bill addresses the funding crisis effectively in the short-term by basing pension plan interest rates on historical averages. Specifically, in 2012, the interest rates determined under current law, which are based on the two-year average of interest rates, would be adjusted so that they are within 10% of the 25-year average of interest rates. This stabilizes the input by stabilizing the measurement of funded status.

For example, assume that under current law, a pension interest rate for a year is 5.5%, based on an average of interest rates for the prior two years. Assume further that the 25-year average for that interest rate is 7%. In that case, the 10% corridor around the 25-year average would be from 6.3% to 7.7%. Since 5.5% is not within that corridor, the pension interest rate would be deemed to be 6.3%, the closest number within the corridor. This process adjusts aberrational interest rates so that they better reflect historical norms.

Under the Senate bill, the 10% corridor is increased by 5% each year until it hits 30% for 2016 and subsequent years. At least in 2012 and 2013, this proposal effectively helps compensate for the artificiality of today's low rates. This proposal was estimated to raise almost $9.5 billion over 10 years.

STABILIZING THE INPUT PROVIDES A MUCH MORE ACCURATE MEASUREMENT OF PLAN LIABILITIES

The main concern regarding stabilizing the input, as the Senate has done, is as follows: pension liabilities should be measured accurately, and using historical interest rate averages, instead of more current rates, is less accurate. We disagree with this point for the reasons set forth below.

In fact, in our view, the strongest argument for stabilizing the input is the opposite: the use of historically normal interest rates is a much more accurate measurement of plan liabilities. The current artificially low interest rates only have an economic effect if a plan terminates now. If a plan continues in operation, then today's low interest rates have no meaningful effect on the plan. In other words, a pension plan's ability to pay benefits over the next 50 or more years is unrelated to the fact that the government is temporarily keeping interest rates artificially low; the ability to pay benefits over a very long period is far more accurately measured by historically normal interest rates.

A plan that is, for example, 78% funded based on today's artificially low interest rates and 93% funded based on historically normal interest rates is really 93% funded with respect to its ability to meet its obligations over the 50 or 60 year period during which benefits will be paid. Treating it as 78% funded is inaccurate and makes the stabilization effort appear to be a request for relief. ***We are not asking for relief in any way. We are asking for stabilization, i.e., not to have plan liabilities artificially increased or decreased by artificially low or high interest rates.***

STABILIZING THE OUTPUT THROUGH CAPS ON CHANGES IN FUNDING OBLIGATIONS

Under one possible means of stabilizing the output that is being discussed, the amount that funding obligations can increase or decrease in any year would be limited. The best way to illustrate this issue is by using the output-stabilizing approach adopted by the Finance Committee during the consideration of the PPA.

Old PPA bill. In the context of the PPA, the Finance Committee bill made a very significant and laudable effort to stabilize contributions by limiting the extent to which required contributions could increase or decrease from one year to the next. But the industry reaction was not positive, in large part because the provision did not control volatility effectively, as explained below. Nor was it the fault of the Finance Committee; also as explained below, it is exceedingly difficult to effectively stabilize the output. The framers of the PPA understood this, and we should pay close attention to their experience.

Under the PPA bill referenced above, very generally, the required contribution for the current year could not increase (or decrease) with respect to the prior year by more

than the greater of (1) 30% of last year's normal cost, or (2) 2% of last year's total plan liability. One of the most problematic aspects of the rule was the reference to 2% of the prior year's total plan liability, which was included in part to deal with frozen plans. The core problem with this approach is that using total plan liability as the measure of the limit on plan volatility is that total plan liability can be completely unrelated to the size of a business, and volatility is an issue that must be controlled in a way that relates to the size of business. Otherwise, the business can have volatility that it is unable to handle.

An example illustrates the problem. Under the example, which is spelled out in detail at the end of this paper, there are two identical businesses of the exact same size with (1) the same need to make business plans, (2) the same aversion to volatility, (3) the same funded status in the prior year, and (4) the exact same workforce demographics and plan terms with only one difference -- one plan offers lump sums and one plan does not. Yet under the old PPA bill approach, the company that does not offer lump sums can experience the ***four times the volatility*** of the other, a contribution increase of $800 million compared to $200 million in the example. In other words, by offering lump sums, a company can drastically reduce its total plan liability and create a much smaller cap on the amount by which its contributions can increase.

This result makes no sense from a business perspective or from a pension policy perspective. From a business perspective, the company not offering lump sums can be in an untenable position where its contribution increase cap is enormous in the context of the size of its business. Moreover, from a competitive perspective, its ability to make business plans is hindered dramatically more than a competing company offering lump sums, despite the fact that the businesses are identical in all other ways. From a pension policy perspective, the rule would create an enormous incentive for all plans to offer lump sums to its retirees and on an ongoing basis, especially if there is any material increase in PBGC premiums.

We understand the argument that a larger volatility cap is appropriate for the plan without lump sums because it is a bigger plan. But the volatility issue is a business planning issue, and it is therefore not appropriate to base the volatility cap on a factor unrelated to the size of the business. The reason that a workable cap on contribution increases was not developed was that it was extremely hard to identify an appropriate measure for the size of a business. The 2% component of the volatility cap adopted in the old PPA bill should have been based on the total plan liability attributable to active employees. That would have worked much better and more fairly, but even that would not have accurately measured the size of a plan sponsor's business.

Caps on contribution volatility do not work if adopted when contribution obligations are abnormally high or low. If the approach in the old PPA bill were adopted today, it would, to some extent, lock in today's artificially high contribution rates. This does not provide the type of stabilization that is needed in the context of a

series of recent years with artificially low interest rates. By contrast, creating stable inputs is much simpler and more effective, and we strongly support that approach. In light of the clear recognition that interest rates are being held artificially low, this approach also makes solid policy sense.

Far more complexity in numerous ways. Even if we could solve the extremely difficult problems described above, stabilizing the output is significantly more complex than stabilizing the input, because many more rules would need to be developed. If interest rates are stabilized, all the other funding-related rules are automatically stabilized to some extent because everything works off of funded status, which is based on interest rates and asset values. If the output is stabilized, we need many more rules, each of which needs to be developed differently, including rules addressing the following: required funding contributions, each of the four different benefit restrictions, the measurement of at-risk status, application of the quarterly contribution rules, reporting, and disclosure.

For example, if interest rates have been artificially low for a few years, as is currently the case, how do we "stabilize the output" by preventing those low rates from triggering inappropriate benefit restrictions? Use of prior year data would not help in that case. In order to address that problem, one has to address the cause of the problem – the artificially low interest rates.

A host of other complex issues would also arise. For example, how do we deal with plans that have had major changes in the last 12 months, such as a major event triggering a large reduction or increase in participants?

CONCLUSION

Today's funding problems are being created primarily by artificially low interest rates and should be addressed through a proposal that is targeted directly at those problems. On the other hand, we are, of course, more than happy to work on an output stabilization proposal if that is the approach that policy makers would like to use. The most important thing is to solve the problem created by the artificially low interest rates, and we are more than happy to work on any solution. We simply offer the cautions that (1) this has been tried before and it did not work, (2) it is exceedingly difficult to do effectively, and (3) the simplest and most effective approach is to address the cause of today's problems, i.e., the artificially low interest rates.

DETAILED EXAMPLE REFERENCED ABOVE

Assume, for example, that there are two identical companies, in terms of number of employees, and gross and net revenue. Moreover, both are legacy companies that have

shrunk greatly in recent years and have frozen their plans. Assume further that they have plans with identical benefit formulas, and there is only one major difference. Plan A allows lump sums and everyone elects a lump sum (which is very close to the actual experience of most plans that offer lump sums). Plan B does not allow lump sums and accordingly 75% of its participants are retirees (not at all an unusual number). In 2011, both plans are 95% funded. Plan A has liabilities of $10 billion and assets of $9.5 billion. Because of its retiree population, Plan B is four times as large, so it has liabilities of $40 billion and assets of $38 billion. The minimum contribution owed with respect to Plan A for 2011 is approximately $85 million ($500 million amortized over seven years). Plan B's minimum contribution for 2011 is approximately $340 million.

Because of market and interest rate declines, in 2012, Plan A has $11.5 billion in liabilities, and assets of $8.55 million (a 15% increase in liabilities and a 10% decrease in assets). Plan B has the exact same experience, so that it has $46 billion in liabilities, and assets of $34.2 million. Without regard to the cap on volatility, the minimum contribution to Plan A would be very roughly $511 million, and the minimum contribution for Plan B would be very roughly $2.04 billion. (The numbers in the preceding sentences are estimates, but they are not critical to the point of the example.)

After application of the volatility cap, the minimum contribution for A would be reduced to $285 million, an increase of $200 million (2% of the total 2011 liabilities of $10 billion) over the 2011 amount. After application of the volatility cap, the minimum contribution for B would be reduced to $1.14 billion, an increase of $800 million (2% of the total 2011 liabilities of $40 billion). Thus, two otherwise identical companies have contribution increase caps of $200 million and $800 million solely because one has lump sums and one does not. The one without lump sums receives no effective protection against contribution volatility.