



# AMERICAN BENEFITS COUNCIL

April 4, 2012

## QUESTIONS AND ANSWERS REGARDING FUNDING STABILIZATION LEGISLATION

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.

The Senate-passed Moving Ahead for Progress in the 21st Century Act (S. 1813) addresses this issue 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.

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 S. 1813, 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.

This paper addresses several policy questions have been raised concerning this proposal.

**Q-1: If companies are permitted to contribute less, won't that lead to greater underfunding?**

A-1: Today's "underfunding" is solely a product of today's artificially low interest rates. If historically average interest rates are used, there is very little underfunding, and the lower contributions address the real underfunding. Put a different way, 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.

**Q-2: Won't less funding jeopardize the security of participants' benefits?**

A-2: The only instance in which participants lose benefits is where the plan sponsor goes bankrupt and is forced to terminate the plan. In today's challenging economic climate, the enormous funding obligations created by artificially low interest rates will lead to more bankruptcies, more layoffs, and more frozen plans. Participants will suffer far more under current law than under S. 1813.

**Q-3: Won't less funding jeopardize the solvency of the PBGC?**

A-3: PBGC stated in a recent annual report: "[s]ince our obligations are paid out over decades, we have more than sufficient funds to pay benefits for the foreseeable future." In fact, in a November 2011 report, PBGC concluded, based on 5,000 simulations, that the chances of its single employer program running out of money by 2020 were *zero*. Furthermore, in a majority of the 5,000 simulations, PBGC's financial position *improved* over the next 10 years.

**Q-4: In light of the PBGC's deficit, shouldn't Congress also increase PBGC premiums to stabilize PBGC?**

A-4: First, like participants, PBGC only suffers losses if a plan sponsor goes bankrupt. Accordingly, since funding stabilization will clearly reduce bankruptcies, there is, *as CBO has previously concluded*, no evidence that reducing funding obligations during a recession increases claims against PBGC. In fact, the opposite may well be true.

Second, a study by a leading actuary concluded that 80% of PBGC's deficit is attributable to the Fed's actions in decreasing interest rates since 2008. The other 20% is attributable to the fact that PBGC uses an interest rate to value its liabilities that is even lower than today's artificially low interest rates. In short, using a historically representative interest rate, PBGC has no deficit. Thus, there is no reason to impose new premium burdens on plans and plan sponsors.

**Q-5: If public plans are being asked to disclose liabilities based on Treasury bond rates, why should private plans be permitted to use a higher interest rate?**

A-5: Single employer private plans are more than happy to discuss various disclosure rules. But the fact is that, *for actual funding purposes*, public plans and private multiemployer plans are permitted to use far higher rates than single employer private plans, *even under S. 1813*. With or without S. 1813, single employer private plans are subject to the lowest interest rates.

**Q-6: Why is the averaging period 25 years? That seems much too long.**

A-6: That issue was reviewed very intensely by both the private sector and the Senate. The private sector reviewed using either a 10- or 20-year average. Unfortunately, because of the current extended period of low interest rates, using a 10-year average did not include years that would counter-balance the artificially low interest rates of recent years. Even the 20-year average produced a result that was not historically representative. We also looked at 30 years, but that included the extremely high interest rates from the early 1980s, making it less representative also, though in the other direction. After a great deal of review, it was determined that a 25-year period achieved a true historical average. Since that is the objective – achieving a true historical average – 25 years is the right period.

**Q-7: Funding contributions for 2012 are not due in full until September of 2013. Why do we need to act now?**

A-7: If a company facing, for example, an additional \$400 million contribution in September of 2013 has not begun planning for it, the company is late. Many companies have already made decisions to forgo business investments and hiring because of these looming obligations. If we wait, far more harm will be done.

**Q-8: Shouldn't pension policy be discussed fully before a change like this is made?**

A-8: Ideally, yes. But we have a short-term crisis and the Senate has offered an excellent solution to that crisis, which provides us all with time to consider long-term issues.

**Q-9: If companies had moved to a liability-driven investment ("LDI") approach several years ago, they would not have encountered this funding problem. Why should Congress be helping companies whose investment strategy was not correct?**

A-9: Most importantly, it is not appropriate to "punish" any company and its employees by forcing the company to use artificially low interest rates, lay off large numbers of employees, and forgo business investments that would help the company, the employees and the economy. In addition, many companies made decisions that a full immediate LDI strategy would not be prudent, either because, for example, (1) their plan's portfolio strategy could not prudently be changed overnight, or (2) in the case of a plan that was not fully funded, a full LDI strategy can affect a plan's ability to address underfunding through reasonable appreciation in a sound equity portfolio. Finally, it goes without saying that Congress has never mandated a single investment strategy and should not do so.