

FURTHER PBGC PREMIUM INCREASES POSE GREATEST THREAT TO PENSION SYSTEM

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American Benefits Council

By

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EXECUTIVE SUMMARY

Despite the current soundness of the Pension Benefit Guaranty Corporation (PBGC) single employer program, proposals to increase PBGC premiums are under consideration. These increases are not only unnecessary, but they also threaten the long-term viability of both the defined benefit (or DB) pension system and the PBGC's plan termination insurance program by further driving away employers that present no risk to the system. PBGC premium are effectively tax increases and increases create perverse incentives that ultimately will reduce the premium amounts collected by the PBGC.

These incentives pose a significant risk to the PBGC's ability to cover future obligations by driving away those employers most important to the viability of the single-employer insurance program. In addition to the premium increases, unrealistic funding requirements, low interest rates, and mortality table changes create incentives for employers to avoid the looming costs, by exiting the system. Considered collectively, evidence suggests that employers are using 'de-risking' strategies and other exit strategies that will ultimately reduce PBGC premium income.

Double counting of PBGC premium increases perpetuates long-term deficit spending.

Policymakers use PBGC premium increases to justify unrelated federal spending, which perpetuates long-term deficit spending by, in effect, "double counting" premium increases for revenue purposes. An inherent budget scorekeeping bias records PBGC premium increases as general revenues even though these premiums must be used to pay benefits to plan participants. PBGC premium increases look like pure revenue gains for the federal government even though they cannot, by law, be used for anything other than the PBGC program.

PBGC can pay benefits for many years into the future. The PBGC holds enough assets to pay all benefits to participants in terminated single-employer defined benefit pension plans for many years into the future. In fiscal year 2013, the PBGC's net financial position *improved by \$1.8 billion*. Interest rate assumptions drive PBGC's deficit estimates, so that the historically low interest rates are responsible for the PBGC deficit reports.

The mandatory nature of the PBGC program gives employers only one choice to avoid burdensome premiums: exit the system by de-risking. The PBGC is referred to as a mandatory insurance program. Plan sponsors with defined benefit pension plans must pay premiums to the PBGC set by law to purchase "insurance" against the possibility that the employer's plan will terminate with insufficient assets to pay all liabilities. When a service provider has a captive market, the service recipient is unable to influence pricing. In a true insurance model, the customer (in this case the sponsor of a defined benefit pension plan) could "shop" for the best premiums for its insurance coverage. This mandatory program creates a problem for employers when PBGC premiums increase; employers lack a competitive market for the service provided by the PBGC. The only options available to plan sponsors to reduce the burden of PBGC premiums are to reduce risk through buyouts and other measures or exit from the defined benefit plan system completely.

Exiting the system is a logical response for employers being forced to pay billions for other employers' losses. PBGC premiums are at such a disproportionately high level that they are forcing employers out of the defined benefit plan system, thus eroding PBGC's premium base.

Since 2005, Congress has adopted legislation that by 2016 will have *more than tripled* PBGC premiums (both flat rate and variable rate) and scheduled premium increases will add billions of dollars a year to the plan termination insurance program. At the same time, *more than 96 percent of PBGC's reported deficit estimates relate to plans that have already exited the defined benefit plan system*. The PBGC uses costs attributable to employers that have already exited the system to justify premium increases, making the cost of PBGC termination insurance prohibitively expensive for the vast majority of employers who are still in the system and who pose little or no risk to the defined benefit system. The PBGC estimates that the *total estimated liability for probable future plan terminations totals only \$352 million, while premium income will approach \$5 billion per year*.

PBGC premiums represent taxes on employees. While employers face the statutory incidence of these taxes, the taxes ultimately pass through to employees. Employees further bear the burden of these premiums when employers exit the defined benefit plan system due to higher premiums; when an employer terminates or freezes a defined benefit plan, all employees face a loss of potential retirement income; the problem can be particularly acute for employees who are older and nearer retirement.

I. FURTHER PBGC PREMIUM INCREASES UNNECESSARY AND HARMFUL

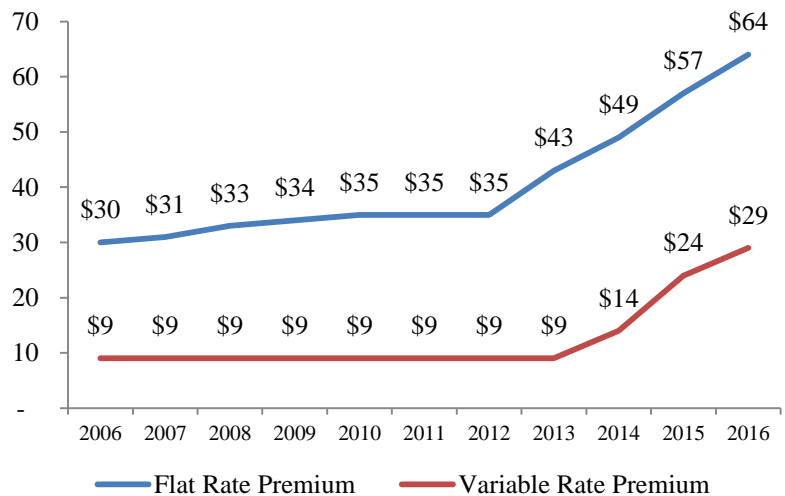
Since 1974, the PBGC plan termination insurance program has provided a backstop to ensure that employees of defined benefit pension plans will receive benefits even when a plan terminates with insufficient assets to pay promised benefits.¹ In the history of the PBGC, all payments due to participants of terminated plans have been made; in every instance in which the PBGC owed a payment to a plan participant, that payment has been made.

Funding for the single-employer plan termination insurance program consists of premium payments made by all employers who maintain defined benefit plans, assets of terminated plans, investment earnings, and recoveries from employers of failed plans. Since 2002, PBGC estimates suggest that liabilities for terminated plans (and probable plan terminations) exceed assets available to pay benefits.² At the same time, PBGC consistently states that “the Corporation has sufficient liquidity to meet its obligations (liabilities) for a significant number of years.”³ Thus, PBGC cash flow projections demonstrate that the PBGC will continue to meet benefit payments for many years into the future. In fiscal year 2013, the PBGC’s net position in the single employer defined benefit plan system *improved* by \$1.8 billion.⁴

Lawmakers justify PBGC premium increases on the basis of PBGC’s deficit estimates even though PBGC states that it faces no short-run liquidity problem. But these premiums translate to real and significant liabilities for employers and, ultimately, employees. Since 2005, Congress has enacted substantial increases in PBGC premiums for single-employer defined benefit plans. Over the 11-year period from 2005 to 2016, the flat rate (per participant) premium will more than triple (from \$19 to \$64 per participant). The variable rate premium will also more than

Graph 1 PBGC Flat Rate and Variable Rate Premiums, 2006 through 2016

Source: Pension Benefit Guaranty Corporation, *PBGC 2010 Pension Data at a Glance, Table S-39, PBGC’s Historic Premium Rates Single Employer Program, PBGC Premium Rates*, accessed at www.pbgc.gov.



¹ The PBGC plan termination program is divided into two separate programs – the single employer program and the multiemployer program. This paper focuses only on the single employer program.

² Estimates of the size of PBGC’s deficit tend to be very sensitive to interest rate assumptions. This is discussed in more detail in section B., below.

³ See, for example, Pension Benefit Guaranty Corporation, *Helping Secure Retirements. PBGC Annual Report 2013*, p. 57.

⁴ Pension Benefit Guaranty Corporation, *FY 2013 Annual Report*, p. 26.

triple (from \$9 per participant per \$1,000 of unfunded vested benefits to at least \$29 per participant per \$1,000 of unfunded vested benefits) over the 4-year period from 2012 to 2016.⁵ Graph 1 displays the dramatic increases in both the variable and flat rate premiums.

Congress passed PBGC premium increases for single-employer plans in 2012 and 2013. The Congressional Budget Office (CBO) estimated the 2012 premium increases would raise an additional \$1 billion per year in premium revenue. CBO also estimated that the 2013 increase would raise approximately \$1 billion per year.

At the end of fiscal year 2013, the inventory of *probable* single-employer plan terminations for which the PBGC would be required to pay benefits totaled only \$352 million. This represents the PBGC's total estimated liability for *probable future* plan terminations. As a result, employers will be paying an estimated \$5 billion per year in PBGC premiums after all the premium increases are fully phased in, but these employers represent a *probable* total projected liability to the PBGC of only \$352 million.

The President's budget proposal for fiscal year 2015 includes a PBGC proposal for another round of premium increases, which CBO estimates would add another \$1.5-\$2 billion per year in premiums.⁶

A. Premium Increases Used to Offset Unrelated Federal Spending

Lawmakers use increases in PBGC premiums to offset unrelated federal spending. Congress often enacts these premium increases in legislative vehicles that are unrelated to pension policies (e.g., provisions contained in the Moving Ahead for Progress in the 21st Century (MAP-21) legislation).

Lawmakers use these increases as a method of financing other federal spending, even though the premium revenues do not enter the general Treasury, but rather are dedicated to the PBGC plan termination insurance program.

Current federal budget scoring conventions create an inherent bias in favor of increasing PBGC premiums over other possible deficit reduction measures. The federal budget process treats increases in PBGC premiums as receipts for budget scoring purposes. However, these increased premiums are not general revenues. These premiums finance the single-employer insurance program that provides benefits to participants of defined benefit plans that terminate with insufficient assets.⁷ Under the budget scoring rules, the potential liabilities do not cancel the

⁵ Beginning in 2013, the variable rate premiums are subject to a per participant cap starting at \$400 and increasing to \$500 in 2016 (indexed after 2016).

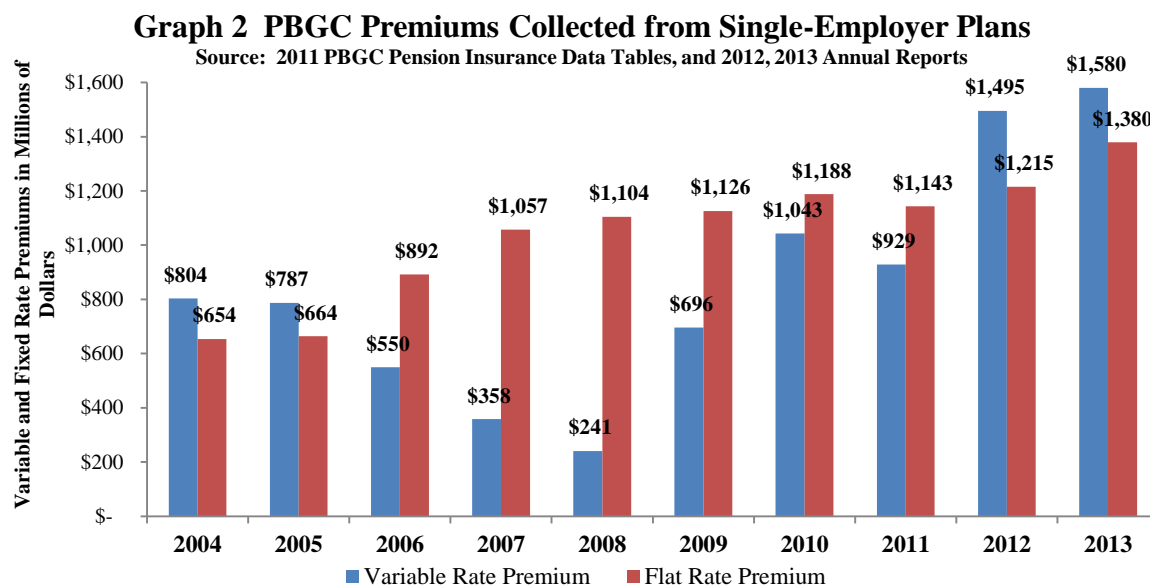
⁶ See Office of Management and Budget, *Opportunity for All. President's Fiscal Year 2015 Budget Proposal*. While the President's proposal indicates intent to raise \$20 billion in additional premium revenue, the CBO's estimates of the proposal do not total to \$20 billion; no explanation is provided for this discrepancy.

⁷ Under normal budget scoring conventions, the deduction that employers can claim for the additional premium payments will offset partially the amount of additional estimated PBGC premiums raised by a premium increases.

premium increases as offsetting outlays, so PBGC premium increases look like pure revenue gains for the federal government.⁸

The Center on Federal Financial Institutions (COFFI) raised this issue in a 2005 paper discussing possible PBGC premium increases.⁹ As COFFI noted: “A billion dollars a year of revenue could be squeezed out of other programs, . . .but the path of least resistance is likely to be implementation of the assumed rise in PBGC premiums. . .it would very likely be politically easier to impose these [PBGC premium] hikes than to find the money in another program.”¹⁰

This budget scoring bias creates a false impression that PBGC premium increases are reducing the federal deficit or paying for federal spending in other areas. PBGC premium increases have the effect of rationalizing spending on other federal programs even though these receipts will never offset this spending. In effect, this budget scorekeeping bias provides a powerful incentive to increase PBGC premiums and perpetuates long-term deficit spending.



Between 2005 and 2013, PBGC premium revenue from single-employer defined benefit plans more than doubled, from \$1.45 billion to \$2.96 billion (refer to Graph 2). Estimates of recent premium increases indicate that employers will pay approximately \$18 billion in additional PBGC single-employer plan premiums over the next 10 years, suggesting an average annual increase of approximately \$1.8 billion.¹¹ In addition, the President’s budget proposal for fiscal

⁸ Even if the scoring process recognized these potential liabilities, the liabilities would occur well outside the budget-scoring window. Thus, since analysts score federal budget proposals on a cash-flow basis, PBGC premiums present an attractive source of revenue because the receipts can offset other federal spending during the budget-scoring period.

⁹ *PBGC: Budget Process May Shape Pension Bill*. Center on Federal Financial Institutions, March 23, 2005.

¹⁰ *Ibid.*

¹¹ See Joint Committee on Taxation, *Estimated General Fund and Trust Fund Effects of the Conference Agreement for the Revenue Provisions Contained in Division D of MAP-21 (The “Highway Investment, Job Creation, and Economic Growth Act of 2012”)*, JCX-58-12, June 28, 2012. This document shows an estimated increase in PBGC premiums for single-employer plans of nearly \$10 billion over the 2012 through 2022 fiscal years. In addition, see

year 2015 proposes additional PBGC premium increases of approximately \$20 billion over the 2018 through 2024 fiscal years, implying an average increase of \$2.8 billion per year of PBGC premiums imposed on single employer plans.¹² By 2024, the CBO estimates that the proposal would add an additional \$2 billion per year to PBGC premiums for the single-employer program.

PBGC premium increases impose real and substantial burdens on employers. These burdens hurt employers, employees, and ultimately, the PBGC.

B. Artificially Low Interest Rates Used to Justify Premium Increases

Interest rate assumptions play a key role in calculating important indicators for the health of the single-employer defined benefit plan system, including the size of the PBGC's deficit, the funding levels in individual defined benefit plans, and whether and the extent to which an employer must pay variable rate PBGC premiums. Low interest rate assumptions increase the amount of underfunding in defined benefit plans, making more plans subject to variable rate PBGC premiums, and increase the size of the PBGC deficit.

Since the economic recession in 2008, the Federal Reserve Board has maintained a monetary policy that has kept interest rates artificially low. The Federal Open Market Committee implemented monetary policy by adjusting the federal funds rate, and maintained that rate near zero since late 2008.¹³ This approach put downward pressure on longer-term interest rates that has created historically low interest rates for a sustained period.

While the intent of the low interest rates is to stimulate the economy and hasten the recovery, these artificially constrained interest rates overstate the problems with the single-employer defined benefit plan system. As interest rates fall, future liabilities rise. These artificially low interest rates overstate the size of the PBGC deficit.¹⁴

Congress recognized and addressed this problem with respect to the interest rate assumptions used for defined benefit plan funding purposes. The Highway Investment, Job Creation, and Economic Growth Act of 2012 (MAP-21) modified the method for calculating the interest rates used to calculate the plan's liability for minimum funding purposes to a rate derived from the 25-

Congressional Budget Office, *Congressional Budget Office Cost Estimate, Bipartisan Budget Act of 2013*, December 11, 2013, which estimated an additional increase in PBGC premiums for single-employer plans of approximately \$8 billion over the 2014 through 2023 fiscal years.

¹² The President's budget proposal would permit PBGC to set premium rates. The Congressional Budget Office estimates that approximately 75 percent of the projected premium increases would apply to the single employer program. See Congressional Budget Office, *Pension Benefit Guaranty Corporation – CBO's Reestimate of the President's FY 2015 Budget Proposal*, April 17, 2014. The President's budget proposal estimates the increases for the single employer and multiemployer plan programs at \$20 billion over the 2017 through 2024 fiscal years. See Table 13-4 of the President's Fiscal Year 2015 Budget Proposal, *User Charge Proposals in the FY 2015 Budget*.

¹³ In addition, the Fed relied on asset purchases and forward guidance to reach the goal of maximum employment and price stability. Refer to the statement by Janet Yellen, Chair, Board of Governors of the Federal Reserve System, before the Committee on Financial Services, U.S. House of Representatives, February 11, 2014.

¹⁴ Low interest rates also depress earnings on the defined benefit plan assets. As earnings decrease, the need for additional funding increases.

year average of corporate bonds.¹⁵ The intent of this change was to use more reasonable interest rate assumptions that recognize the long-term nature of defined benefit plan funding obligations.

Small changes in interest rate assumptions can have large effects. For example, the 2013 PBGC annual report states that the PBGC's single-employer program posted a *net gain of \$1.8 billion*, compared to the *\$5.9 billion net loss in 2012*.¹⁶ According to the PBGC statement, the vast majority of this nearly \$8 billion change resulted from a "decrease in actuarial charges due to change in interest factors."¹⁷

¹⁵ MAP-21 modified the rates used to calculate funding targets and target normal costs.

¹⁶ Pension Benefit Guaranty Corporation, *FY 2013 Annual Report*, p. 28.

¹⁷ *Ibid.* Actuarial charges relate to future liabilities for defined benefit plans, based on the characteristics of the plan participants. Interest factors relates to the interest rate applied to value those future liabilities.

II. INCREASES IN PBGC PREMIUMS ADVERSELY AFFECT EMPLOYERS AND EMPLOYEES

A. *PBGC Not A True Insurance Program*

The PBGC is referred to as a mandatory insurance program. Plan sponsors with defined benefit pension plans must pay premiums to the PBGC set by law to purchase “insurance” against the possibility that the employer’s plan will terminate with insufficient assets to pay all liabilities.¹⁸ Employers have no alternative to purchasing plan termination “insurance” with the PBGC. When a service provider has a captive market, the service recipient is unable to influence pricing. In a true insurance model, the customer (in this case the sponsor of a defined benefit pension plan) could “shop” for the best premiums for its insurance coverage. This mandatory program creates a problem for employers when Congress decides to increase PBGC premiums; employers lack a competitive market for the service provided by the PBGC.

The PBGC single-employer insurance program is a plan termination program, but this program does not fit a true insurance model. In effect, PBGC represents a captive market for plan termination insurance because plan sponsors are required to participate and cannot shop for lower premiums.¹⁹ The only options available to plan sponsors to reduce the burden of PBGC premiums are to reduce risk through buyouts and other measures or exit from the defined benefit plan system.

PBGC premium increases are justified based on the PBGC’s total deficit, which relates to past liabilities for plans *already* terminated or that are likely to terminate in the near future.²⁰ Thus, most of the PBGC’s deficit projections relate to liabilities for plans that terminated in the past. In a 2012 report that predated the latest round of PBGC premium increases, the General Accountability Office (GAO) noted the equity concerns of requiring ongoing employers to pay premiums to cover PBGC liabilities for losses that occurred in the past.²¹

These costs arising from *prior* plan terminations are referred to as “legacy costs.” As the American Academy of Actuaries (AAA) pointed out in a recent issue brief, “legacy costs already incurred generally are not insurable future events.”²² As AAA states, the PBGC assesses premiums (for both ongoing and legacy costs) on only the group of viable, ongoing plan sponsors. As a result, plan sponsors must pay for more “insurance” than they receive because a portion of their premium payments covers PBGC’s legacy costs.

¹⁸ PBGC argues that it should have the right to set premium rates without legislative action.

¹⁹ One criticism of the PBGC’s proposal to set premium rates without legislative authorization stems from this captive market. Because plan sponsors are required to participate in the PBGC plan termination insurance program, it would be patently unfair to permit the PBGC to set premium rates when the only recourse available for plan sponsors is to exit the defined benefit system entirely.

²⁰ See the discussion later in this paper addressing problems with the way PBGC deficit estimates are calculated.

²¹ United States General Accountability Office. *Pension Benefit Guaranty Corporation. Redesigned Premium Structure Could Better Align Rates with Risk from Plan Sponsors*. GAO-13-58, November 2012.

²² American Academy of Actuaries Issue Brief, *Examining the PBGC Premium Structure*, April 2012, p. 3.

The Academy also notes “assigning more than minimal legacy costs to ongoing plan sponsors creates a financial incentive to exit the DB system and an impediment to the establishment of new plans, ultimately resulting in no one left to pay the bill. Such actions would deprive participants of a valuable pension and frustrate the PBGC’s mission to encourage the continuation and maintenance of private-sector DB pension plans.”²³

The President’s fiscal year 2015 budget proposal would allow the PBGC board to set premium rates, taking into account the risks that different sponsors pose to PBGC. If enacted, the CBO estimated that this proposal would raise approximately \$10 billion from single employer plans over the fiscal year 2018-2024 period and that, by 2024, the proposal will raise more than \$2 billion additional per year in premiums from single-employer plans.²⁴ Yet the PBGC’s fiscal year 2013 Annual Report states,

“two single-employer plans with underfunding of \$352 million were newly classified as probable terminations in FY 2013 and this represents PBGC’s *total* (emphasis added) single-employer probable inventory. Probable terminations represent PBGC’s best estimate of claims for plans that are likely to terminate in a future year.”²⁵

Thus, approximately 96 percent of the revenue for this latest proposed PBGC premium increase would apply to losses from single-employer plans that have already terminated.

Because plan sponsors *voluntarily* maintain defined benefit pension plans, large PBGC premium increases create strong incentives for plan sponsors to freeze or terminate their defined benefit plans.

B. Additional PBGC Premium Increases Could Put More Employers at Risk

Proposed PBGC premium increases would impose an estimated \$2 billion per year of additional costs on employers in the single-employer defined benefit plan system by fiscal year 2024. Over the short run, employers may absorb these costs by reducing capital investments or reducing dividends paid to shareholders.²⁶

Bauer et al. (2013) noted that defined benefit plan liabilities could have a significant impact on the ability of companies to achieve business objectives.²⁷ Bauer et al. argue that employers should evaluate pension funding strategies in light of other corporate cash uses and strategies, such as investment in productive capacity, research and development, share or debt buybacks,

²³ *Ibid*, p. 4.

²⁴ The \$20 billion of additional premium revenue would come from both single employer and multiemployer defined benefit pension plans. See, Office of Management and Budget, *Budget of the United States Fiscal Year 2015, Analytical Perspectives, Federal Revenues*. For the CBO estimates of the President’s Budget Proposal, see Congressional Budget Office, *Pension Benefit Guaranty Corporation – CBO’s Reestimate of the President’ FY 2015 Budget Proposal*, April 17, 2004.

²⁵ Pension Benefit Guaranty Corporation. *Helping Secure Retirements, PBGC Annual Report 2013*, p. 27.

²⁶ See the discussion below about the long-run effects of increases in compensation costs.

²⁷ Bauer, Geoff, Gordon Fletcher, Julien Halfon, and Stacy Scapino. *The Funding Debate: Optimizing Pension Risk within a Corporate Risk Budget*. The Wharton School, University of Pennsylvania, Pension Research Council Working Paper, PRC WP2013-30, October 2013.

and corporate acquisitions. They note, "...a corporate sponsor's financial health is instrumental in ensuring its pension plans' long-term capacity to meet their obligations."²⁸

While the authors do not specifically consider the costs imposed by PBGC premiums and their effect on corporate success, PBGC premiums add to overall business costs. Increasing PBGC premiums reduces cash available for productive corporate investment. For the vast majority of employers with defined benefit plans, PBGC premiums represent a pure sunk cost because these plans will never transfer liabilities to PBGC. The more PBGC premiums increase, the greater the risk that these costs cannot be rationally borne by companies with adequately funded defined benefit plans.

C. Changes in Mortality Tables Increase Risks to Defined Benefit Plan System

The Society of Actuaries (SOA) recently released draft new mortality tables for defined benefit pension plans that will, when fully implemented and adopted in some form by the Internal Revenue Service, significantly increase pension liabilities.²⁹ As a result, the funding levels of defined benefit plans will decline resulting in substantially increased funding requirements and higher PBGC variable rate premiums. Further, these changes will make the size of pension liabilities much more sensitive to changes in interest rate assumptions, increasing interest rate volatility. The amount that employers will pay for lump-sum distributions from defined benefit pension plans will increase as well.

In addition to the long-term effects of these changes, the adjustments for the new mortality tables will create a significant, one-time "shock" to the defined benefit system. This shock will take place at a time when recent PBGC premium increases have fully phased in, leading to a dramatic increase in costs for the employers who sponsor these plans.

The combination of scheduled PBGC premium increases and the increased liabilities created by the changes in mortality tables could threaten the continued viability of the single-employer defined benefit plan system. Additional PBGC premium increases would likely push employers to consider drastic actions to reduce their risk exposure with their defined benefit plans.

D. PBGC Premium Increases Threaten Long-Term Retirement Security

PBGC premiums are just one of the costs of operating a defined benefit pension plan and defined benefit plans represent one component of an employer's compensation costs. When PBGC premiums increase, the overall cost of a defined benefit plan increases. Economic theory suggests that employees will bear the full incidence of these increased costs through reduced wages or other benefits. In effect, PBGC premiums represent a tax on employers who maintain defined benefit pension plans.³⁰ While the statutory incidence of this tax is borne by the plan sponsor, ultimately the employees will bear these costs through adjustments to overall compensation costs, such as a reduction in contributions to the defined benefit plan, termination

²⁸ *Ibid.* at p. 10.

²⁹ Society of Actuaries. *Exposure Draft RP-2014 Mortality Tables*, February 2014.

³⁰ This is particularly true to the extent that the premiums collected cover prior losses of the PBGC because; the premiums bear no resemblance to actual insurance risk.

of the defined benefit pension plan, changes in other benefits offered by the employer, changes in wages and salaries, or job losses.

In addition, the scheduled increases in PBGC premiums could threaten the long-term retirement security for millions of employees. These premium increases and mortality table changes represent a looming cost increase for many employers. The vast majority of employers maintain adequately funded plans and do not present a risk to PBGC. Consequently, these increases can make defined benefit plans prohibitively expensive and increase the chances that these plans will be frozen or terminated.

Butrica et al (2009) estimated the effect on retirement incomes of Baby Boomers if all remaining private sector defined benefit plans were frozen.³¹ The authors found that, even if employers supplemented the frozen plans with new or enhanced defined contribution plans, more retirees would lose retirement benefits than would gain benefits. The losses would be particularly acute for the last wave of Boomers (those born from 1961 through 1965), because they are more likely to have their defined benefit pension frozen with relatively little job tenure. Overall, the authors found that 26 percent of the last wave of Boomers would have lower family incomes and only 11 percent would have higher family incomes. The authors point out,

“If people are to participate in DB and DC plans at different times during their working careers, the worst scenario for them is to hold a DB plan early in their career and a DC plan late in their career. When workers switch from DB to DC plans midcareer, they lose the high-accrual years in their DB plans and have fewer years to accumulate DC wealth.”³²

While the effects of freezing or terminating defined benefit pension plans might, over the long term, be offset by increases in number of and contributions to defined contribution plans, employees with relatively little job tenure who are nearing retirement age will inevitably be losers if high PBGC premiums drive employers out of the defined benefit plan system.

³¹ Butrica, Barbara, Howard M. Iams, Karen E. Smith, and Eric J. Toder. *The Disappearing Defined Benefit Pension and Its Potential Impact on the Retirement Incomes of Baby Boomers*. Social Security Bulletin, 69(3), 2009.

³² *Ibid.* at p 19.

III. INCREASES IN PBGC PREMIUMS ADVERSELY AFFECT THE DEFINED BENEFIT PLAN SYSTEM AND THE PBGC

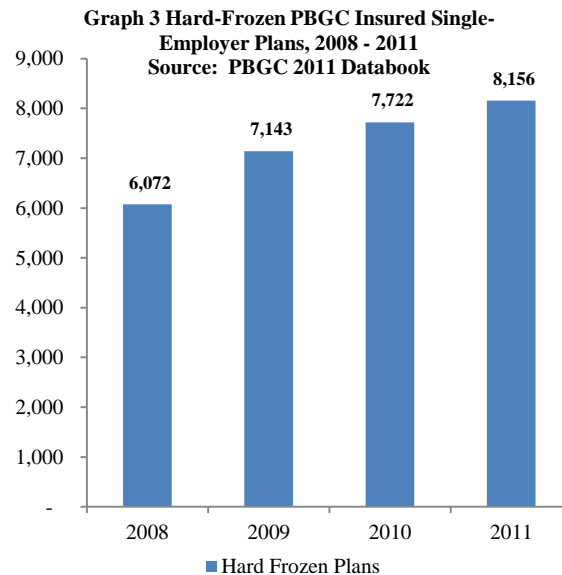
PBGC premium increases could threaten the long-term viability of both the defined benefit pension system and the PBGC's plan termination insurance program by further driving away employers that present no risk to the system.³³ Premium increases create perverse incentives that ultimately will reduce the premium amounts collected by the PBGC.

These incentives pose a significant risk to the PBGC's ability to cover future obligations by driving away those employers most important to the viability of the single-employer insurance program. In addition to the premium increases, unrealistic funding requirements, low interest rates, and mortality table changes create incentives for employers to avoid the looming costs through strategies to reduce risk. Considered collectively, evidence suggests that employers are using 'de-risking' strategies that will reduce ultimately future obligations to plan participants.³⁴

Strategies to reduce risk involve managing the plan composition. This plan management includes:

- freezing the plan completely, or closing it by allowing no new employees to join the plan;
- modifying plans to become hybrid plans by moving toward cash balance plans;
- offering lump sum distributions to plan participants to encourage classes of participants to voluntarily exit the plan; and
- satisfying liabilities through commercial annuity contracts.

Freezing the defined benefit plan offers a number of options to the plan sponsor. A plan sponsor might implement a 'hard freeze,' which would not allow any new participants or any new benefit accruals. Graph 3 displays the recent trend in the number of plans that are now hard-frozen plans. The number of hard-frozen plans in 2011 was 34.3 percent higher than in 2008.

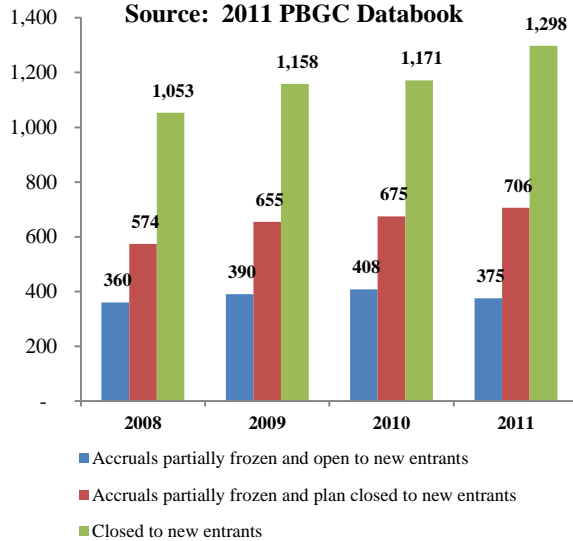


³³ Consider a single-employer defined benefit plan with 10,000 participants subject to the maximum variable rate premium. In 2016, the employer sponsoring this plan will pay at least \$5,640,000 of total PBGC premiums (\$640,000 of flat rate premiums plus \$5 million of variable rate premiums). These represent a significant financial obligation, often times diverting resources from funding the plan or other business endeavors.

³⁴ While this section focuses on the liabilities associated with single-employer plans, one strategy focuses on the asset side through liability driven investment (LDI). These investment strategies allow employers to select investment vehicles that provide future returns that correlate to the future liabilities. This typically means that fully funded plans will invest in fixed income assets. Many underfunded plans began strategies to borrow at low interest rates to fund the plans and then move into fixed income investments. Refer to Zorast Wadia, *Map-21 and De-risking Considerations*, The Actuarial Digest, Spring 2013.

Alternatively, employers may limit the risk associated with the plan by (1) closing the plan to new participants (while still allowing increases in accruals); (2) closing the plan to new participants and partially freezing accruals; or (3) leaving the plan open, but not allowing accrual increases. Graph 4 depicts the increased de-risking behavior through partially freezing either benefits from or entrance to the plan.

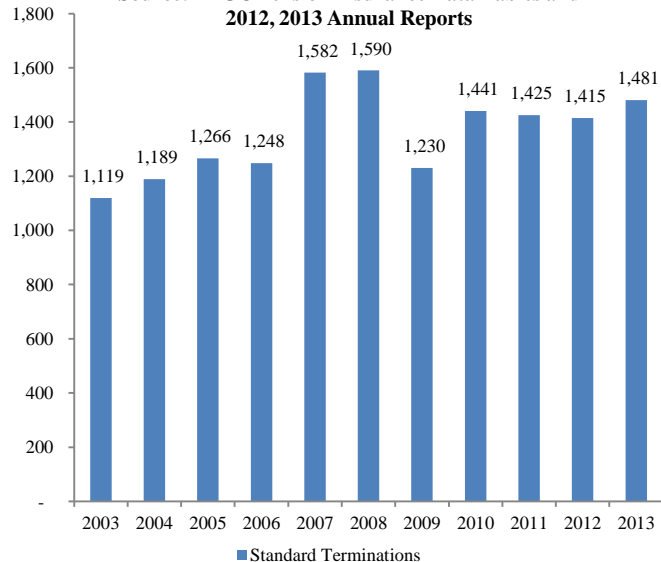
Graph 4 Partially Frozen PBGC Insured Single-Employer Plans, 2008-2011
Source: 2011 PBGC Databook



Many plans will discharge a significant portion of their obligations by purchasing annuities through insurance companies and/or paying lump sums. The use of annuity buyouts and lump sums by companies allows companies to reduce the risks associated with the future funding of their plans. Both of these actions could erode the base of plans and participants on which the PBGC premiums rely.³⁵

Standard terminations remain viable for many employers. Graph 5 displays the number of defined benefit plans that entered standard terminations over the past eleven years. While in recent years, the number of terminating plans remains below the peak in 2008, the number of standard terminations remains steady with over 1,400 plans each year. Because there are virtually no new defined benefit plans, each of these standard terminations represents a permanent loss to the plan termination insurance program.

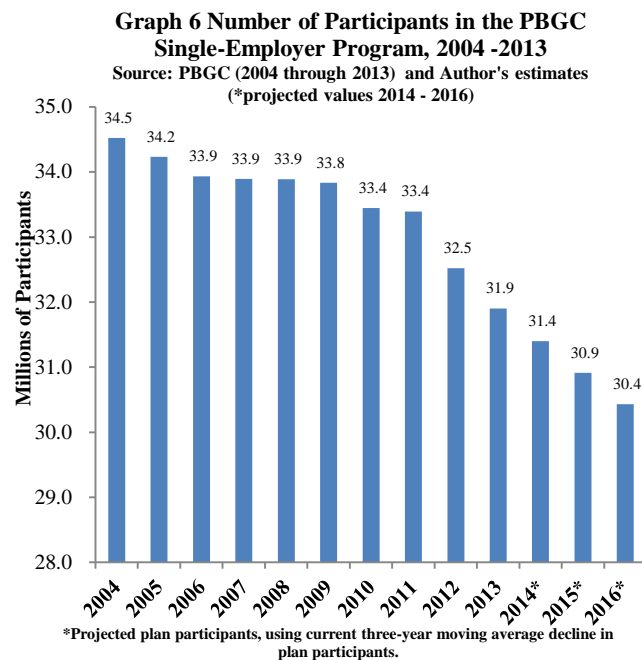
Graph 5 Number of Defined Benefit Plans that Entered Standard Terminations, 2003 through 2013
Source: PBGC Pension Insurance Data Tables and 2012, 2013 Annual Reports



Single-employer plans that elect de-risking strategies (to reduce future liabilities) or those eligible for standard termination represent to the PBGC an important base of premium revenue. The plans that reduce or eliminate their risk are those that can afford to do so – those fully-funded with adequate asset accumulation. Therefore, as the numbers of plans employing de-risking strategies and entering a standard termination continues to grow, this represents a significant erosion of the premium base for the PBGC.

³⁵ Refer to Prudential, *Pension Plan De Risking, North America 2014*, March 2014.

Employer surveys indicate that these trends will not only continue, but will likely increase. Aon-Hewitt reported recently that such settlement strategies are gaining interest among employers.³⁶ Their 2014 survey indicates that 26 percent of sponsors will complete a lump-sum buyout within the next two years, while another 43 percent indicated that they are considering this option. This represents a significant shift in the attitude of plan sponsors in just a one-year period. In 2013, 12 percent of plan sponsors completed a lump-sum buyout with only another 14 percent considering this option.



It is important to recognize that PBGC not only loses the premium revenues, but they also lose plans that represent the lowest risk to PBGC. Premium revenues received from these well-funded plans subsidize the costs attributable to prior and future trustee (distress) terminations.

PBGC premiums represent an avoidable prospective cost because plan termination can eliminate the liability. Thus, as premium rates rise (and the new mortality tables take effect), plan sponsors have increasing incentives to use de-risking or the standard termination process to exit the defined benefit plan system and eliminate these costs of plan termination insurance coverage that they are unlikely to need.³⁷

Flat rate premium collections rely exclusively on the number of participants. As plans continue to de-risk or enter standard terminations, the total number of participants will continue to decline.

A further source of loss to the PBGC stems from the nature of the calculation of variable rate premiums. Variable rate premium revenue relies on the funding status of active plans. The payment of this premium depends upon the number of plans that underfund their obligations – not on the number of participants in the plan. Therefore, as the variable rate premium increases, employers must decide if they should divert other resources to funding the defined benefit plan or face higher variable rate premiums in the future. Thus, the anticipated collections from the variable rate premiums do not correlate positively with the variable premium rate. As variable rate premiums increase, employers have a greater incentive to fund their plans, causing variable rate premium revenue to decline.

³⁶ Refer to Aon Hewitt 2014 Pension De-Risking Pulse Survey, Retirement Webinar Series, March 19, 2014.

³⁷ The vast majority of plan terminations are standard terminations, in which the plans have sufficient assets to pay benefits and the PBGC has no role in providing benefits to plan participants. On average, from 1975-2011, the percentage of plans that PBGC has taken over (trusteed terminations) is approximately 3 percent of all plan terminations. See Pension Benefit Guaranty Corporation, *Pension Plan Data at a Glance (1975-2011)*, Table S-3 *PBGC Terminations and Claims (1975-2011)*.

CONCLUSIONS

Further PBGC premium increases pose the greatest risk to the single-employer defined benefit plan system. Steadily increasing PBGC premium rates could drive healthy plans – the premium payers – from the system.

Small changes in interest rate assumptions result in substantial changes in the PBGC's financial position. In addition, the PBGC deficit estimates assume that all of the PBGC's liabilities would be paid off at a single point in time, but in reality the PBGC would continue to pay benefits over a long period of time. PBGC cash-flow estimates show that the PBGC will continue to meet benefit payments for many years into the future.

However, PBGC deficit estimates, most of which relate to legacy costs of plans that terminated in the past, are used to justify repeated increases in PBGC premiums. These constant increases in PBGC premiums could actually *reduce* premium revenue over the long term by driving the lowest-risk employers from the defined benefit plan insurance system. Before enacting yet another round of premium increases, policymakers need to examine the short and long-run effects of the 2012 and 2013 PBGC premium increases.

APPENDIX A: SUMMARY TABLES

Table 1 shows the historical PBGC premium rates.

Table 1. —Historical PBGC Premiums for Single-Employer Pension Plans*			
Plan Years Beginning	Flat-Rate Premium [per participant]	Variable-Rate Premium	
		Rate Per \$1,000 of Unfunded Vested Benefits	Per Participant Cap
2017	\$64.00 (indexed)	2016 rate indexed (at least \$29)	\$500 (indexed)
2016	64.00	2015 rate indexed plus \$5 (at least \$29)	\$500
2015	57.00	\$14.00 (indexed) plus \$10 (at least \$24)	\$400 indexed (at least \$412)
2014	49.00	\$14.00	\$412
2013	42.00	9.00	400
2010-2012	35.00	9.00	N/A
2009	34.00	9.00	N/A
2008	33.00	9.00	N/A
2007	31.00	9.00	N/A
2006	30.00	9.00	N/A
1991-2005	19.00	9.00	N/A
1988-1990	16.00	6.00	N/A
1986-1987	8.50	N/A	N/A
1978-1987	2.60	N/A	N/A
Sept. 2 1974-Dec. 31, 1977	1.00	N/A	N/A

* In addition, an additional premium of \$1,250 per participant per year applies for the three years after a distress or involuntary termination of a single-employer plan (other than certain airline-related plans).
Source: Pension Benefit Guaranty Corporation, *PBGC 2010 Pension Data at a Glance, Table S-39, PBGC's Historic Premium Rates Single Employer Program, PBGC Premium Rates*, accessed at www.pbgc.gov/prac/prem/premium-rates.html, and Section 703 of the Bipartisan Budget Act of 2013.

Table 2, derived from PBGC plan insurance data, shows the number of standard terminations, trustee terminations, and net claims. The table shows that 67.2 percent of the total net claims arose from plan terminations prior to 2006.

Table 2.—PBGC Terminations and Net Claims, 1975-2013 Single-Employer Program			
Fiscal Year	Standard Terminations	Trustee Terminations	Net Claims (in millions)
2013	1,481	111	\$1,879.0
2012	1,451	155	1,010.0
2011	1,400	45	511.8
2010	1,308	112	1,054.4
2009	1,294	175	7,997.7
2008	1,405	78	253.6
2007	1,233	75	313.4
2006	1,247	88	910.4
2005	1,108	126	9,504.7
2004	1,198	164	2,741.6
2003	1,203	170	6,250.2
2002	1,452	186	3,505.8
2001	1,748	117	965.8
2000	1,892	73	85.6
1995-1999	15,089	444	708.5
1990-1994	24,171	694	2,395.0
1985-1989	42,599	537	1,541.0
1980-1984	28,025	622	585.8
1975-1979	7,955	586	195.8
Total:	137,259	4,558	42,410.1

Source: PBGC 2011 Pension Insurance Data Tables, FY 2012 Annual Report, and FY 2013 Annual Report.