

Speech to Corbel September 2006 Conference:

I'd like to thank Corbel for inviting me to speak today. It's an honor and pleasure to be here today. Like you, I've come to this conference to learn about the recent changes made by the Pension Protection Act of 2006. Like you, I'm totally baffled with the enormity of the changes! How one responds to the changes depends on whether someone clings to the defined benefit model as the system for retirement savings, or whether one embraces the defined contribution model. As a baby boomer, I've grown up with the defined benefit model.

In today's speech, I am going to be using those 2006 changes, as well as the legislative changes made over the past 30 years, to illustrate how Congress has effectively destroyed the private-sector defined benefit system as we know it today. And like many systems, once it's gone, it will not return. I'd like to contrast that Congress has allowed public defined benefit plans to remain unregulated – such plans will be facing enormous funding problems that will dwarf the problems that loom the private defined benefit system which has been subject to minimum funding requirements over the past 30 some years. However, that topic is subject to another speech given Congress' reaction to those challenges, especially in light of how ineffective it has been in the private sector.

From my introduction, you know that I am a professor and as such, I strive to make ERISA's pension rules understandable and meaningful to my students by using every day events as illustrations. Often times, I use my family as a readily available set of examples to analogize and explain ERISA's voluntary pension system. Despite my youthful appearance, I have a 22-year old daughter, 20-year old son, and a 19-year old daughter. I find that my parental examples provide me with a wealth of material. During the past calendar year, my 22-year-old daughter has graduated from college and thankfully is gainfully employed with an impressed employer. Despite a salary stream of income, she has financial dilemmas which my husband and I have agreed to shoulder for the short term – her apartment rental is \$1,500 but she can only afford \$800/mo. Obviously, my husband and I will be shouldering the difference to assure her of safe and adequate housing. I'll be using my daughter's financial problems as an analogy to Congress' approach to the private-sector benefit dilemma. While my response to my daughter's situation is understandable from a parental approach, one should really question whether society as a whole should respond in kind.

What I'd like to do is to walk down memory lane with you – tracing what was actually done under ERISA and the Code. Unfortunately, this stroll may unnerve you – it certainly did me. You'll be surprised how Congress has done everything possible to orchestra the demise of the defined benefit system, despite its present legislative rhetoric that it's reforming and preserving the system. Pre-1974, defined benefit plans were the predominant form of retirement savings and Congress became concerned that private-sector employers were promising more benefits than they could provide. Profit sharing plans were some-what popular but viewed as supplements to the benefits afforded to retirees under the pension plan. There were, and continue to be, key advantages for employees of the defined benefit model –

- The employer assumes the investment risk in a noncontributory plan, so the employees' benefits aren't subject to a down market.

- The employer assumes the employee's longevity risk by paying the benefit over the life annuity of the participant or the joint life annuity of the participant and spouse
- The employer often assumes the inflation risk until the employee terminates or retires.
- Defined benefit plans generally cover more employees, except temporary or part-time employees, in contrast with 401(k) arrangements in which many eligible employees do not participate.
- Many defined benefits plans continue to pay only annuities, preventing employees from experiencing leakage risk by depleting savings in advance of retirement.
- Many defined benefit plans provide disability benefits, in contrast with defined contribution plans where the account balance is relatively small if the participant becomes disabled at a young age.
- Some defined benefit plans provide subsidized early retirement benefits, allowing an earlier transition into retirement.
- If the employer does eventually go bankrupt, the pension accrued benefits (subject to a dollar cap) will be guaranteed by the PBGC.

That reminds me of our family model – my daughter relies on our continuous stream of \$700/month to supplement her rental agreement. The defined benefit model guarantees a specific floor monthly amount – which if adequate for retirement – protects the retiree. The defined contribution model (which relies solely on what's currently available) would rely simply on her current stream of income.

Pre-ERISA, there was no mandated limit on the amount of past service liability that an employer could create (assuming its board of directors would approve), and there was no limit on the time period to amortize such liability – other than the cash flow problems that could arise if the plan permitted lump sum distributions and the participant elected such distribution. Guess what happened? Promises of large past service liabilities were given to employees with little or no amortization of the past service liability – leaving employees on the hook if the employer later went bankrupt and couldn't make good on the promise. ERISA's response was to impose minimum funding standards to ensure that pension obligations would be funded over a specified period of time and provided plan termination insurance to guarantee benefit payments for underfunded plans.

Given the pre-ERISA model requiring no amortization of past service credit was required, Congress compromised in deciding the minimum level of amortization of past service. As we know, it was a 40-year amortization for existing plans and a 30-year amortization for new plans. While the fixed term was easy to administer, it had no relationship to the actual required amortization of liabilities for benefits actually due under an actual employer's plan. Nor was it related to the employer's financial health – what if a financial poor employer agreed to excessive past service liabilities without the wear-withall to pay for such liabilities? That's likely giving my 22-year-old 30 years to pay off her apartment debts – not only has she forgotten about the excess costs 30 years ago, she's gone on to amount new debts that she'd like us to pay-off. Under the tough-love defined contribution model, if she wants the \$1,500/month rental, that cash is needed now, not 30 years from now. What are the consequences of this mind-set? Employers who are cash poor contribute the minimum, forestalling the inevitable when the past service liability has to be paid. Such minimums also set the floor – making it more difficult to impose more restrictive contribution requirements in the future.

Thus, two main themes propelling the adoption of ERISA in 1974 focused on minimum funding requirements for pension plans and governmental insurance benefits for these promised benefits. As profit sharing plans provided discretionary employer contributions, such plans would be exempt from the new minimum funding requirements and the need for governmental insurance was not required as the participants bore the investment and mortality risk under such plans. Hence, the federal government didn't have to insure such protection for those participants and beneficiaries.

Back in 1974 and even today, the defined contribution model does not necessarily guarantee annuity options and utilizes a "use it or lose it" model – take advantage of the deduction and the accrual in a given year or forever lose it. This is the family model of tough love – if you can't afford it, then tough luck – get whatever apartment you can afford regardless of the conditions or safety. While the defined contribution model focuses on personal savings – it assumes that the individual is in a position to save and that the individual is savings at an early age. Given our family model, our 22-year-old daughter can't even afford her daily apartment costs, let alone save for retirement. By the time her salary increases sufficiently to cover her apartment costs, she'll likely be married and will be using discretionary savings to purchase a house, instead of paying rental income. So much for retirement savings! Our government promotes the advantages of the defined contribution model, but down-plays the effectiveness of such a model on the savings of individual employees.

What would I have done? When ERISA was passed, an employer's defined benefit plan funding model should have been tied to its actual demographics – instead of granting the same amortization period for funding past service liabilities to all employers. Hence, employers whose average remaining active worker's lifetime was just 10 years, past service liability should have been amortized over 10 years, not 40 years. However, Congress deliberately permitted longer amortization schedules which resulted in smaller required contributions. Some employers took advantage of the 40-year and 30-year funding period and terminated plans prior to funding period, relying on the PBGC to provide unfunded benefits. This certainly should have been no surprise to Congress – it certainly won't surprise me if I extended \$2,000 credit card privileges to one of my children and then discovered that they took advantage of the privilege.

The other defects of ERISA included ignoring the financial health of the employer if it was creating large amounts of past service liability granted and designing the PBGC premium coverage as a flat dollar per employee, totally unrelated to liability. Here's where the law was truly dysfunctional. Regardless of the financial health of an employer to make current and past service promises, the PBGC was made to guarantee such benefits (subject to certain phase-in rules and dollar caps) and was to finance the cost of such guarantee equally for all participants. The phase-in for benefit coverage was only 5 years – hardly a deterrent for adopting a large past service liability. The credit balance, which has caused so much controversy, simply allowed employers who pre-paid on the funding requirements to offset such excesses against future payments. Again, I'm not a big fan of the credit balance system, but it's what Congress passed when ERISA was enacted.

To help you understand why ERISA's pension funding and plan termination rules were flawed from the beginning, I'm going to use the analogy of purchasing car insurance for my three teenagers/young adults. Six years ago, we added our first teenager to the car insurance. I can't tell you the jump in car insurance costs we experienced not only in that first year, but in the next six consecutive years, as we've added two more teenagers to our coverage. Like your car insurer, my insurer prices our annual insurance costs based on the number and age of drivers, the number and types of cars insured, and our driving history. From an actuarial perspective, costs should be assessed to the group that has the greater predicted history for claims. While my son, the 20-year-old, has never had an insurance claim, statistically he belongs to a group of high claimants and thus our premiums are adjusted accordingly. Certainly, the longer our family maintains a claim-free policy, the lower our annual premium. As an actuary, all of this I understand.

By making PBGC insurance premiums totally unrelated to risk, guess what? Some employers gamed the system. Bethlehem Steel unloaded a claim of \$3.7 billion to the PBGC after paying only \$60 million in premiums to the PBGC over a 10-year period from 1994 to 2003; likewise United Airlines has paid \$75 million in premiums over a 10-year period from 1995 to 2004, yet its pensions are underfunded on a plan termination basis by more than \$5 billion.

The PBGC made numerous reports to Congress since the enactment of ERISA, demanding restrictive funding rules and increased premiums. By 1987, Congress tightened the funding rules with the advent of the legislative changes made to the deficit reduction contribution charge (DCR), intended to strengthen protection for the PBGC from liability. The minimum funding rules now were based on plan termination liability, not an actuarial value of liabilities. Congress imposed a fixed interest rate to be used in valuing plan termination liability -- regardless of the probability of the plan's termination and the employer's financial health -- let alone the plan's interest rate experience. Instead of viewing defined benefit plans as long-term commitments, Congress decided to impose annual funding targets -- if the plan was less than 90% funded, certain consequences flowed; less than 60% funded, other consequences flowed. It also added a second-tier premium for plans with unfunded vested benefits -- however it was capped at \$50/participant regardless of the amount of unfunded vested benefits.

On the flip side, plans that were in a surplus funding position were attracting some attention in the mergers & acquisitions realm in order to access the plan's surplus. Congress's reaction to this in 1987 was to impose a 50% excise tax on the surplus of a terminating defined benefit plan. It was no surprise that the employers' reaction was to draw down the surplus in order to avoid the excess tax. Guess what? Plans were discouraged, to the tune of 50% excise tax, to keep a plan overly funded. It should be no surprise to Congress that if plan assets plummeted and interest rates were reduced, plans that had been fully funded would become underfunded -- subjecting the PBGC to potential liability.

Between 1987 and 1994, Congress introduced a mandated mortality table in the calculation of the plan's currently liability; reduced smoothing of the interest rate used to value liabilities; and restricted the amount of retroactive benefit increases that underfunded plans could enact. While these rules strengthened the minimum funding rules, they did not result in the full funding of current liabilities. Fully funded plans had no incentive to increase plan contributions beyond the minimum due to the 50% excise tax. In fact, some employers with surplus defined benefit assets

reacting to younger employees' desire for defined contribution plans converted the defined benefit plan to a cash balance plan to use the surplus for future allocations of eligible participants.

Between 1994 and 2000, the funding of defined benefit plans was defined solely in terms of various funding current liability targets and the goal of the employer was to hit the various targets to avoid certain consequences. Funding a defined benefit plan from an actuarial perspective (i.e., long term perspective) was no longer an option. These plans were to be regarded as assets or liabilities on the corporate account balance depending on the plan's surplus or deficiency. Such funding targets did little to alter how an employer will alter future behavior. Hence, instead of determining what the best level of funding should be for a defined benefit plan, the employer became consumed on attaining current year funding targets. Due to large credit balances between 1994 and 2000, 62.5% of the sponsors of the largest plans made no cash contributions. Using my parental perspective, this makes perfect sense – I can certainly get my children to do something presently with sufficient economic incentives – however, to get them to “buy into” that behavior on a long-term basis takes more than just short-term perks.

Now let's usher in the perfect storm of the early 2000s – 30-year Treasury rates are at an all time low and the bull market burst depressing the value of most plan assets – resulting in plan liabilities increasing and plan assets decreasing, causing an underfunding for plans that years before had been fully funded or in a surplus. For on-going companies, this was simply a bump in the road for funding contributions; but for companies on the verge of bankruptcy, this posed a huge unfunded liability potential for the PBGC. Now suddenly the White House was interested – would PBGC become the next bailout for pension plans? The Administration introduced legislation – drastically altering the rules of the game. That would be like your bank informing you that your 30-year mortgage is now a 15-year mortgage and look forward to the increased monthly payment statement in the mail. Would you stand up and take notice? Absolutely.

What happened? The Bush administration adopted the PBGC perspective – one that curtailed government liability and increase premium contributions in order to reduce potential insurance exposure. Was that the correct response? In my viewpoint, certainly not. Changing the rules mid-stream for employers that are financing long-term defined benefit commitments does not promote confidence within the existing employer community, let alone the promotion of subsequent defined benefit plans. Certainly, financially strapped employers are unable to respond to increased minimum funding contributions and will terminate such plans and shift liability to the PBGC. Plans that are near the full funding requirement may decide to fully fund benefits in order to terminate the plan under the standard plan termination rules – which certainly has an enormous impact on older-age employees who had hoped that future compensation gains would be used to increase the final benefit amount.

Does Congress agree on a plan? Obviously not. During the summer of 2006, the House and the Senate agreed on different pension reform bills, which were supposed to be resolved in a Conference Committee. What Congress passed results in extremely restrictive funding obligations for single-employer and even multi-employer pension plans. What will happen? Single employer plans will fund until they reach the 100% funding target in order to freeze benefit accrual and/or terminate the plan. Multi-employer plans have a little more latitude with

respect to funding the past service service, so freezing or terminating participation in the plan may be delayed. New defined benefit plans will come only from the small employer community which may be able to amortize past service liabilities over a short period of time. Large and medium-size employers will be retreating from defined benefit plans by freezing future accruals or terminating the plan completely. The only market for defined benefit plans will be the small employer market, where shareholders wish to retire and maximize deductions with maximum defined benefit plans. That's exactly what's been happening in response to existing and anticipated legislation. For me, the litmus test for the demise of corporate defined benefit plan came when IBM announced during 2006 the freeze on its existing defined benefit plan and shifting over to the 401(k) defined contribution model.

In light of reduced interest rates which automatically increased liabilities and a stock market that plummeted in value, 2000 ushered in an environment where defined benefit plan liabilities increased in value and plan assets decreased in value – a perfect storm to create unfunded plan liabilities. What would I have done if I wanted to encourage the demise of defined benefit plans? I'd urge the demise of actuaries – have funding based solely on new targets -- 100% of all plan termination liabilities compared to the market value for plan asset values; curtail any use of prior or post credit balances, eliminate amortization of other actuarial assumptions changes as they are no longer relevant in determining minimum contribution levels. Defined benefit liabilities would be viewed like a purchase of inventory – valued and depreciated over its expected useful lifetime as compared with plan assets which would be valued in terms of present market value.

Certainly Congress' covert intent was not to dismantle the defined benefit system as we know it today; however, its patchwork of misguided and ill-fitted “reforms” made it increasingly more difficult for sponsors of defined benefit plans to comply with legislative changes. Since our private pension system is a voluntary system, the employer response during the past 5 years has been to freeze existing defined benefit plans with respect to all future accruals or with respect to new entrants. The only new defined benefit plans that will be seeing prospectively are with small employers who wish to maximize benefits and deductions under a defined benefit model, that for older employees, is a superior model than the defined contribution model. That of course will spur more nondiscrimination requirements as the owners of small businesses use their demographics (with age and service) to provide more benefits to the higher paid than the rank and file.

What has been Congress' response with the Pension Protection Act of 2006? A set of requirements that should tell all single employers (except small employers utilizing the deduction afforded by defined benefit plans) to freeze benefits or terminate defined benefit plans alternatively, a dismal set of requirements exist for single employer sponsors of defined benefit plans –

- increased annual costs due to faster amortization of past service liabilities (favorable for the PBGC if the employer has the financial ability to make the payment)
- more volatility valuation of assets and liabilities (subjecting employer to greater risk and therefore having some employers opting out of such risk)
- new set of funding targets to avoid limitations on benefit restrictions (additional restrictions making defined benefit plans less flexible)

- increased PBGC premiums for on-going and terminated plans – resulting in employers deciding to freeze accruals under current plans that are underfunded and terminate plans that are fully funded. Such increased premiums also increase the cost of plans subject to the new rules.

The defined benefit model provides an invaluable role in providing retirement security. From the employees' perspective, it allows the employer to pool risks on behalf of employees, something that may be unavailable to the employee under a defined contribution model. Like so many models, once it is lost, it is gone forever. Small employers, seeking retirement of key shareholders may embrace the minimum and maximum deductible limits to provide defined benefit plans; however, medium and large employers faced with a larger younger employer workforce explained to its mature workforce that it simply can't afford the costs of a defined benefit model.

Depending on the age demographics of the employer, the defined benefit model may have offered preferred tax deferral options in comparison to the defined contribution model. To maximize deductions under the defined benefit model, use of past service liability credit requires both board of directors' approval and the ability to facilitate cash flow distribution if the plan permitted lump sum distributions of accrued benefits

Before I examine the rules pre-ERISA, I have to admit a total irrelevance to Congress' approach to regulating pension plans. Back in 2005, when United Airlines' parent shifted \$6.6 billion of its \$9.8 billion in pension liabilities to the PBGC as a result of its bankruptcy, Senator Grassley publicly remarked "[t]he question we are asking are simple ... [h]ow did this happen, why did this happen, and, most importantly how can we stop it from ever happening again?" When I heard his remarks, I was aghast – Senator Grassley passed all of ERISA's pension funding and plan termination legislation and it did exactly what it was suppose to! How could he be bewildered with the results of the existing pension legislation? And this new 2006 pension funding legislation will guarantee that it will never happen again – but that's because they won't be any defined benefit plans to terminate in the future.

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What has Congress enacted? New valuation of plan assets and plan liabilities to trigger the plan's funded ratio; an increased annual funding contribution for plans less than 100%; a new valuation of plan liabilities and plan assets; new benefit restrictions based on the underfunded plan's funding ratio.