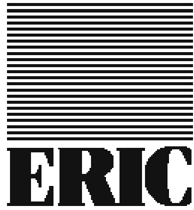

THE ERISA INDUSTRY COMMITTEE

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Advocating the Benefit and Compensation Interests of America's Major Employers

ERIC PENSION POINTERS

Issue briefs providing information about the pension funding debate

ASSESSING THE STATUS OF THE PENSION BENEFIT GUARANTY CORPORATION (PBGC)

Terminations of underfunded plans in the steel and airline industries have highlighted concerns about the adequacy of current law pension funding rules. The challenge to Congress is to assess the status of the vast majority of pension plans in the face of widespread publicity focused on problems in these two industry sectors and their impact on the Pension Benefit Guaranty Corporation (PBGC).

The ERISA Industry Committee (ERIC) has proposed comprehensive reforms to current law regarding pension funding, the PBGC, and disclosure to participants (see, www.eric.org). The proposals are designed to redress issues in the current law funding rules while also creating a funding structure that encourages employers to establish and maintain defined benefit plans.

Testimony and published reports analyzing current pension funding issues frequently have emphasized increases in the PBGC's current deficit and calculations of large amounts of underfunding in private sector pension plans. However, the true long-term financial picture of the PBGC is not clear from this information. What are the key numbers, how are they put together, and what do they mean?

ESTIMATES OF WIDESPREAD PENSION UNDERFUNDING

In September 2004, the PBGC estimated that pension plans insured by the PBGC were underfunded by $450 billion. More recently, the PBGC stated that, at the end of 2004 among 1108 companies whose plans were underfunded by more than $50 million, total underfunding stood at $354 billion – up from $279 billion the year before.

- These numbers are calculated "on a termination basis" – that is, as though all these companies were going to fail and be forced to terminate their plans.

This is not going to happen. A recent analysis by Goldman Sachs states, "Quite frankly, if all of those sponsors were to fail, pension plan underfunding would be the least of the worries for the US economy and the capital markets."

- These numbers purport to represent the present value of all future obligations. Discount rates are used to calculate present values; and the lower the discount rate used, the greater the liability. The discount rates used by the PBGC are very low and are not in-line with how the PBGC operates. Thus the liabilities are artificially inflated.

  - The rate used by the PBGC is designed to represent a conservative annuity purchase rate – but the PBGC does not, and never has, purchased annuities. Instead it pays benefits like an ongoing pension plan, for which a higher discount rate is typically used. In other words, the PBGC calculates its liabilities as if they all had to be settled today rather than – as is actually the case – paid out over the lifetimes of the covered individuals.

  - The PBGC discount rates at the end of 2004 were 3.8% for the first 20 years of payments and 5.0% for payments after 20 years. By comparison, the current liability rate for funding purposes, based on conservative corporate bond rates, was 6.1% at the end of 2004. Each 100 basis points difference inflates liabilities by as much as 10-12%.

  - Use of a lower discount rate not only artificially inflates liabilities, it cuts participants' benefits. Plan assets are used first to cover retiree benefits and employee guaranteed benefit amounts, and any assets left over pay for benefits that are not guaranteed by the PBGC. If liabilities are inflated, little or no money is left to cover non-guaranteed benefits.

- The PBGC sets its own discount rates. The increase in the estimated gap between liabilities and assets from $279 billion in 2003 to $354 billion in 2004 appears to be caused by a sharp and arbitrary reduction in the PBGC's discount rates from 4.7% at the end of 2003 to 3.8% at the end of 2004.

  - In fact, plan assets in the 1108 plans in the PBGC survey increased substantially during 2004 – from $914 billion to $1.141 trillion. Even using the PBGC's flawed liability calculations, the funded ratio of plans remained virtually the same during 2004 – changing from 69.7% at the end of 2003 to 69% at the end of 2004. Thus, <u>all</u> of the numbers merely got bigger – and the overall system held steady even in the face of a sharp decrease in the presumed discount rate.

  - The PBGC's 90 basis point drop in its key interest rate (from 4.7% to 3.8%) is out of line with market changes. During 2004, Moody's AA dropped only 35 basis points, two key Merrill Lynch high quality bond indices dropped 22 and 24 basis points respectively, Citigroup's high grade index dropped 31 basis points, and the yield on 30-year Treasury bonds dropped only 24 basis points.

- Thus, the PBGC liability calculations appear to be inflated both because they are based on termination liability and because the interest rate used does not reflect market reality.

- Even from a PBGC perspective, these numbers overstate the problem. They are calculated based on the estimated total value of accrued benefits, not on the amount relevant to the PBGC, which is limited to benefit amounts guaranteed under law. For example, the total value of accrued benefits in the recently terminated United Airlines plans was $16.8 billion, but the amount of benefits guaranteed by the PBGC was $3.2 billion less.

In summary, these inflated numbers, based on the presumed collapse of a very large portion of the American economy, shed more heat than light on the actual future prospects of the PBGC and of defined benefit plans.

REASONABLY POSSIBLE TERMINATIONS

The PBGC estimates there are unfunded liabilities of $96 billion that are sponsored by companies with a credit rating below investment grade. These are called "reasonably possible" claims.

- However, as recently as 2002, the PBGC's Annual Reports stated that: "PBGC's historical claims experience also shows that less than 10 percent of companies classified as reasonably possible have had their classification subsequently changed to probable." And, of course, not all "probable" claims actually occur.

- Even if some of the plans on the "reasonably possible" list do terminate, liability figures alone do not provide an accurate picture of the PBGC's future ability to pay benefits because they ignore the assets gained by the PBGC. For example, when the PBGC assumed responsibility for the United Airlines pension plans, it also received $7 billion in assets held in those plans. Earnings on the PBGC's assets and premium payments also are available to pay benefits.
  - At the end of 2004, the PBGC had $39 billion in assets and was paying $3 billion annually in benefits. The PBGC invests and earns money on its assets and receives substantial amounts of premiums from all plan sponsors. In 2004, the agency earned $3.2 billion on its assets and received approximately $1.5 billion in premiums.

- PBGC's calculation of reasonably possible terminations also suffers from the same flaws noted in the first section of this analysis:
  - It is unrealistic to assume all those plans will fail. If they did, there would be far worse issues for the country to face than the problems of the PBGC.

The number is calculated on a termination basis using an artificially low interest rate and includes all accrued benefits, not just those guaranteed by the PBGC.

THE CURRENT DEFICIT

At the end of 2004, the PBGC announced it carried a $23 billion deficit, increasing its year-end 2003 deficit by $12 billion.

- The increase in the deficit was due almost entirely to the agency increasing its estimates of "probable" terminations to $17 billion. Probable terminations are those expected in the near future but not yet received.

    - Probable terminations may or may not occur during the coming year. Historically, according to footnote 4 of the PBGC Annual Report, about 20% of probable plans never actually terminated.

    - The PBGC's deficit calculations obscure the funded status of the agency. At the end of 2004, PBGC stated it had $39 billion in assets to cover $62.3 billion in liabilities. The liability figure includes the impact of probable terminations – but the asset number does not. For example, if the probable plans are excluded, PBGC held $39 billion in assets to cover $45 billion in liabilities. If estimates of probable terminations are fully included, liabilities would jump to $76 billion, but assets also climb to $53 billion.

    - In press releases outlining newly terminated plans, the PBGC fails to adequately describe the impact of the terminations on its published deficit. For example, if the terminated plan was already in the probables (i.e., the plan termination has already been anticipated or "booked"), the deficit is basically unchanged.

- The PBGC deficits are calculated using their very low interest rates. If the PBGC used the yield curve rate being proposed by the Administration, its $23 billion projected deficit would drop by a substantial amount immediately.

The PBGC has operated in a "deficit" position for all but a few years of its existence and never missed a benefit payment. Independent analysis shows that the PBGC had enough assets on hand at the end of 2004 to pay benefits for 20-25 years.

CONCLUSION:

Any calculation of the PBGC's surplus or deficit at a particular point in time reveals little, if anything, about what really matters – the PBGC's ability to pay benefits due to plan participants over time. Too much of the current debate has focused on point-in-time calculations based on inflated liabilities. The current debate also has focused on industry specific analysis and unrealistic, worst case scenarios.

In fact, 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. These plans currently pay approximately $120 billion in benefits every year – amounts that in the future will have to be made up from another source if employers are discouraged from maintaining their plans.

Congress must ensure that, at the end of the day, employers have rules that will encourage them to sponsor and maintain defined benefit plans.

To learn more about *ERIC's Consensus Proposals for Pension Funding, PBGC Reform and Hybrid Pension Plans*, go to ERIC's website www.eric.org and click on the box found on the front page.

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