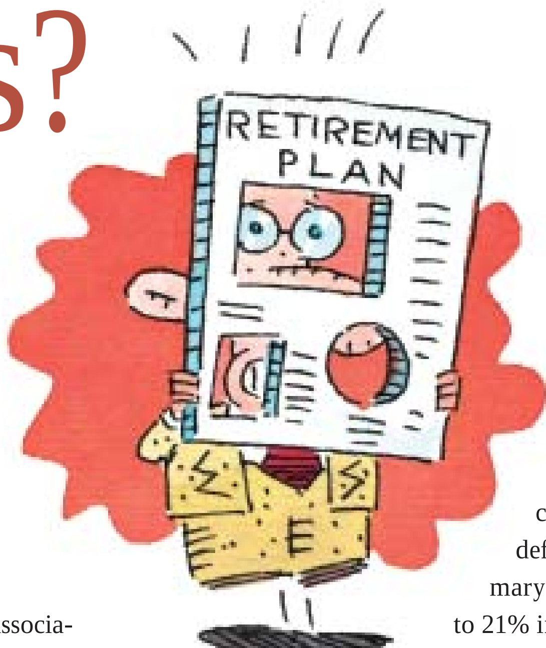
What's the Future of Defined Benefit Plans?

BY MILTON ZALL



The U.S. Pension Benefit Guarantee Corporation (PBGC) is concerned about pension plan underfunding at "troubled" companies with defined benefit plans because it will have to bail them out if these plans fail. The American Benefits Council (ABC), a national trade association that represents companies with defined benefit plans, says the PBGC is crying wolf! Who's right? First, some background information.

Some employers maintain defined benefit plans that promise to pay their retiring employees a specific benefit that's based on years of service and final salary—and these employers pay insurance premiums to the PBGC, a government agency, to ensure that the plans make good on their promises. The PBGC is financed by these premiums and by its return on the investment of these premiums—it receives no tax dollars.

While the defined benefit system helps millions of Americans achieve retirement income security, it's a system in which fewer and fewer employers participate. The total number of defined benefit plans has decreased from a high of approximately 170,000 in 1985 to about 56,000 in 1998 (the most recent year for which official Department of Labor statistics exist), and most analysts believe there are fewer than 50,000 plans in the U.S. today. There has been a corresponding decline in the percentage of American workers with a defined benefit pension as their primary retirement plan from 38% in 1980 to 21% in 1997.

Looking at this decline over the past several years makes this downward trend all the more stark. The PBGC reports that it insured 39,882 defined benefit plans in 1999 but only 32,321 plans in 2002, a decrease of more than 7,500 defined benefit plans, or 19%, in just three years. But the reason for these declines isn't hard to figure out. Increasingly, employers prefer to establish defined contribution plans that allow them to avoid promising retiring employees a specific benefit. Unfortunately, this leaves an ever-increasing number of financially unsophisticated retirees with a lump-sum payment they are ill equipped to manage.

TALK ABOUT PROBLEMS

Notwithstanding the decrease in the number of defined benefit plans, PBGC's executive director recently made the rounds of congressional committees, telling them that

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the PBGC estimates that financially weak firms sponsor retirement plans with $80 billion in unfunded benefits and that these plans could become PBGC liabilities if the companies fail. Airline bankruptcies (US Airways and United Airlines Corp.) account for nearly a third of this amount, and the steel and manufacturing industries are also major contributors.

At a recent Senate hearing, the General Accounting Office (GAO) identified several structural problems threatening the defined benefit pension system. It said that lax funding rules are allowing corporations to avoid making needed contributions to their pension plans. That drastically increases the size of a plan's shortfall if the PBGC is forced to take it over. In the case of Bethlehem Steel, the company's plan was more than 50% underfunded when the PBGC took it over. Under existing PBGC rules, Bethlehem Steel wasn't required to make any extraordinary contributions in the five years preceding its takeover.

The GAO also said Congress could consider tightening rules to require businesses to use more pessimistic criteria when deciding what to contribute each year. For example, funding requirements could be set based on what it would cost to cash out a plan immediately rather than pay benefits over time. Congress could also expand the number of companies required to make accelerated contributions to make up for underfunding and limit a plan's ability to use prior history of adequate funding to shield itself from extra contributions during lean years. Of course, moves such as those suggested by the GAO and/or the PBGC would make defined benefit plans even less attractive to employers and accelerate the movement to defined contribution plans.

So, is there another savings and loan bailout in the offing? That depends on whom you talk to.

WHAT ABOUT DEFICITS?

The PBGC showed a deficit of $8.8 billion at the end of September 2003, up from $3.6 billion in July 2002 and a $9.7 billion surplus in 2000. Henry Talavera, a Texas attorney who's a shareholder and member of the ERISA and ESOP practice groups of the Jenkens & Gilchrist law firm, doesn't fret over such numbers. Talavera says this is nothing new. The PBGC often runs a deficit. Part of its current financial situation, Talavera believes, is attributable to recent bailouts of a few large pension plans, including those of several large retailers and steel makers, but much of its deficit is attributable to the fact that it invests its funds in stocks and bonds, and, like other insurers, the last few years haven't been kind to their investment portfolios.

The PBGC deficit, according to Executive Director Steven A. Kandarian, is the amount by which the PBGC's long-term liabilities exceed its assets. "If you use that yardstick," Talavera says, "The PBGC's finances look pretty good compared to the Social Security trust fund." Kandarian freely admits that there is no immediate danger that the PBGC will be unable to pay the approximately $2.5 billion that it pays out each year to participants in plans that go belly up and that it takes over. The PBGC currently has more than $30 billion in liquid assets, Talavera notes, so whether or not there's a problem looming depends on whether employers with defined benefit plans—often referred to as traditional pensions—adequately fund these plans. Kandarian says that the funding rules for traditional pensions need reform to ensure that companies adequately fund their plans. Although Kandarian may be correct, his perspective ignores the fact that employers aren't required to maintain defined benefit plans, Talavera says. Talavera thinks that too much reform will only drive more employers to defined contribution plans.

Corporations that run traditional pensions see things as Talavera does and think the fears being expressed by Kandarian are unfounded and politically motivated. That's the perspective taken by Christopher Bone, executive vice president, national retirement practice leader, and chief actuary for Aon Consulting. Bone thinks much of the PBGC's recent underfunding is due to the coincident decline of both the stock market and interest rates. This has reduced the value of pension plan investments while causing "computed liabilities" to rise. Bone expects the situation to improve as markets return to more normal conditions.

MORE WORRIES

Members of the American Benefits Council represent the entire spectrum of the private employee benefits community and cover more than 100 million Americans. ABC President James A. Klein says, "The current PBGC deficit does not represent a serious long-term threat to the agency's viability, and in fact there are numerous more critical threats to the defined benefit pension system."

Klein is worried about the imminent expiration of a temporary provision that eases the rules for computing pension liabilities. The funding burdens caused by the continued use of the 30-year Treasury bond to calculate required contributions has made the sponsorship of defined benefit plans much more difficult. Until 2001, plans had to use the interest rate on 30-year Treasury bonds to estimate expected portfolio income, but the Treasury stopped issuing these bonds that year. Because of the shrinking supply of these bonds and the continuing demand for the relative safety of U.S. government debt, the secondary market interest rate on existing 30-year Treasury bonds has reached historic lows and no longer correlates with the rates on other long-term bonds. A consequence of these low rates is to substantially inflate pension liabilities, requiring increased plan contributions. This in turn has led to the spate of plan freezes and terminations in recent years.

The Treasury Department itself has said that using the 30-year Treasury bond rate no longer produces an accurate measurement of pension liabilities. It has proposed to remedy this situation through the use of a so-called "yield curve" concept in place of the 30-year Treasury rate following a transition period during which a corporate bond rate would be used. The yield curve formula would take into account the demographics of a company's workforce.

At the time this article was written, the temporary provision that allows a less rigid formula to be used in calculating liabilities was scheduled to expire at the end of 2003. The ABC strongly endorses replacing the 30-year Treasury rate for pension calculations with a rate based on a composite blend of the yields on high-quality corporate bonds. Otherwise, Klein believes that many employers will freeze or terminate their plans.

Kathy Cissna, director of retirement plans for R.J. Reynolds, notes that defined benefit pension plans have become increasingly expensive and complicated to administer, and, as a result, plan funding and design flexibility has been impaired. She maintains that during the past 20 years Congress has repeatedly reduced the benefits that could be earned and paid from defined benefit plans in order to increase federal tax revenues. She says, "The deterioration in the funding status of many defined benefit plans is attributable in large measure to the current unique combination of historically depressed asset values and historically low interest rates." In addition, Cissna joins the ABC in its dislike of the use of the 30-year Treasury bond rate to measure a plan's funded status and value a plan's liabilities because it distorts the true picture. Using this artificially low rate, Cissna believes, makes plan liabilities seem larger than they really are and makes a plan's funding level seem more dire than it really is.

Talavera also thinks the PBGC is crying wolf and frightening employers that have traditional plans. To prove his point, he points to the precipitous drop in the number of PBGC-covered defined benefit pension plans over the last two decades: from 114,396 in 1985 to 32,321 in 2002. Talavera says the PBGC's current rhetoric will encourage cash-strapped employers to terminate their plans. "The government should be encouraging the formation of defined benefit plans, but talk like this won't do it," he notes. "So far, the PBGC has not been a drain on the taxpayer, and when the economy improves (as appears to be the case now), employers will be able to narrow shortfalls in their funds' funding, and the PBGC's coffers will swell. Increasing insurance premiums, which the PBGC favors, is the wrong thing to do—it'll cause a mass exodus away from traditional plans."

NEW DEVELOPMENTS

A Senate panel recently approved a three-year interest-rate adjustment that would let employers pay less into their workers' retirement plans while Congress works on a long-term fix. This action means all four congressional committees with jurisdiction—two each in the House and Senate—have moved legislation on this issue. While the four versions differ slightly, the consensus signals that Congress is all but certain to prevent businesses from having to use the 30-year Treasury bond in pension calculations. Under a plan sponsored by Sen. Judd Gregg (R.-N.H.), employers would be allowed to assume a higher rate of return on their pension contributions based on high-grade corporate bonds. That approach would lower the payments that companies must make to meet their pension obligations and would also reduce the calculated level of plan underfunding. The Gregg bill also creates a two-year bipartisan commission on pension overhaul. In all likelihood, a short-term fix will be enacted to temporarily resolve what could be a tempest in a teapot. Long range, it would be no surprise if defined benefit plans and the PBGC went the way of the dodo. ■

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