AMERICAN ACADEMY *of* ACTUARIES

May 31, 2005

The Honorable Ted Kennedy
644 Dirksen Senate Office Building
Washington, DC 20510-6300

Dear Senator Kennedy,

We appreciate the opportunity to respond to your question following the April 26, 2005 hearing of the Subcommittee on Retirement Savings and Aging on PBGC Reform:

> *Question: The American Academy of Actuaries has proposed a number of solutions to tighten existing pension funding rules. How would these proposals compare with what the Administration is proposing in terms of improving pension funding levels?*

We must note that while we make suggestions on various ways to improve the pension funding rules, we do not offer one particular suggestion. However, we have provided some specific responses to the request below. More details can be found in our 60-page issue analysis, *Pension Funding Reform for Single Employer Plans*, and our analysis of the administration's pension funding proposal (March 2005). In addition to these papers, which apply only to single-employer pension plans, the Academy has presented a separate paper, *Principles of Pension Funding Reform for Multiemployer Plans*, because there are so many differences between single and multiemployer plans.

Targeting a 100 Percent Ceiling Funding Level: The administration provision that improves funding levels the *most* is their requirement that sponsors fund all their plans until they are 100 percent funded for accrued benefits. The current rules were designed around a 90 percent funding target. In addition, the administration proposal requires PBGC variable premiums until the plan is 100 percent funded. That creates an incentive to contribute up to the 100 percent funding level. The Academy also suggested these two ideas. However, the administration target is also a ceiling. As soon as the 100 percent funding level is reached, minimum contributions stop. We would go further, as suggested in the section on funding margins (see below).

At-Risk Liability Target: The administration proposal increases the funding target if the credit rating of the plan sponsor falls below investment grade. However, the additional funding to the administration's "at-risk" liability may happen too late, because a company may already be too weak to make the additional contributions. Thus, it may not have the intended impact. For example, some plans in bankruptcy have not paid their minimum contributions even under the current rules, which don't include the at-risk increase. Some practitioners have suggested that this provision may cause employers of plans that have much larger termination liabilities to seek bankruptcy protection to avoid these larger funding obligations.

The Academy considered suggesting these higher funding targets for all companies, but the additional funds may never be needed and any excess funds cannot be accessed without paying prohibitive taxes of over 90 percent. For example, some companies have been below investment grade for many, many years without going bankrupt, and investment bankers consider it unlikely they ever will, so the higher at-risk calculation using earlier retirement ages would be inaccurate. Another response would be for Congress to consider requiring funding margins for all plans as suggested below.

Speed to Funding Target: The administration would require sponsors to fund a plan's underfunding over seven years (or possibly 10 years). The Academy has not taken a position on how fast the amortization should be, but has suggested anywhere from five years (the current number of years for benefit improvements to be guaranteed by the PBGC phase-in) to 15 years (if the plan doesn't deplete itself with the payment of lump sums). Of course, five-year amortization would improve funding levels the most, but the trade off would be that contributions would be higher and more volatile.

The administration proposed an amortization rule that some are calling one-sided (or the high-water-mark method), because their amortization payments do not decrease if the plan experiences unusually good asset returns or liability loses. Under this rule, plans would probably reach 100 percent funding sooner than seven years.

As an alternative, the Academy suggested an ***anti-volatility rule*** that would keep the contribution from falling or increasing too fast. The attached chart, used for my April 26, 2005 testimony, shows that if the administration proposal had been applied in the economic scenario of the past 10 years, the minimum contribution for the sample plan would have fallen quickly to zero in the late 1990s, and jumped back up in 2002. The anti-volatility rule we suggest would have kept the minimum contribution from falling so fast, so funding ratios would have been higher. In fact, in all economic scenarios we studied, the funding ratios were about as good as or better than the funding ratios produced by the administration proposal. Faster five-year amortization and our creation of funding margins also play a part in that analysis.

Creating Funding Margins: The minimum required contribution under the administration proposal is *zero* after 100 percent funding is reached. However, due to the increased volatility risk and the penalties for plans being less than 100 percent funded, the administration's proposal may drive sponsors to reduce their risk by building up funding margins and/or allocating more assets to bonds to avoid the penalties for underfunding (e.g., variable premium, quarterly contributions, benefit freezes). This would be a positive outcome for the PBGC. However, we do not think this will be enough motivation for weak employers with poorly funded plans to contribute the large amounts needed to avoid these penalties, or to move to bonds.

The Academy suggests that more than encouragement might be needed for all plans to build up funding margins. Strong companies may build funding margins, but the weak employers will only contribute the minimum required, and their plans are the ones that are more likely to be taken over by the PBGC. Ways to require contributions above 100 percent funding levels would be as follows:

- Require a contribution equal to the cost of current year accruals until some higher threshold is reached, such as 100 percent + X percent of accrued liabilities, 100 percent of accrued liabilities using projected pay (or projected multipliers for hourly plans), or 100 percent of accrued liability including contingent benefits, or
- Phase out the normal contribution more gradually than the dollar-for-dollar phase-out in the administration proposal. For example, the minimum contribution could equal the normal cost plus the surplus divided by a N-year amortization factor. This could be the same factor used in amortizing the deficit for underfunded plans, which would make for a very simple formula.

These rules could be relaxed if the employer increases its allocation to bonds and/or reduces its exposure to subsidized early retirement benefits and subsidized lump sums.

Penalties for Underfunding: The administration increases the incentives for funding by increasing or adding new penalties for underfunding (e.g., no benefit improvements if funded under 80 percent, benefits frozen and lump sums eliminated at 60 percent funding levels). We have made similar suggestions. However, to reduce the possibility of a run-on-the-bank, we suggest a provision that would allow the plan to pay the lump sum only to the extent funded.

For example, if the plan is 90 percent funded, then it could pay 90 percent of the lump sum. Alternatively, the rules could increase the minimum contribution by the underfunded portion of the lump sum. Sponsors also could be encouraged to eliminate their lump-sum provisions and replace them with a 20-year certain life annuity, which would make sure that unhealthy employees would not lose value. We also note that the current rules in the Code of Federal Regulations (CFR) 1.401(a)(4)-5(b)(3) already restrict lump sums for highly compensated employees (HCEs) or the top 25 when funding ratios are less than 110 percent. They could be applied to all HCEs.

The penalties are also more volatile under the administration proposal, because they use market assets and market liabilities. Some sponsors might avoid them by increasing funding levels or investing more pension assets in bonds, as suggested above.

Incentives for Improved Funding: The administration proposal has less incentive for employers to contribute more than the minimum, due to (1) eliminating the credit balance and (2) not allowing employers any economic advantage for super surpluses. In fact, their proposal to eliminate the credit balance has already discouraged some employers from contributing this year, even though they may be cash rich due to a law encouraging repatriation of funds from oversees. We would tighten up the rules for the credit balance, such as growing it at the same rate at which the plan assets grow (as discussed in the Academy's fact sheet on credit balances). With this fix, credit balances could actually increase the funding levels shown in PBGC's white paper on funding. Congress could also restrict the use of the credit balance if funding falls below a specified level, or it could always require that the normal cost be paid. These would improve funding levels beyond those found in the administration proposal.

The administration proposal would allow deductible contributions until plan assets equaled 130 percent of liabilities, which is good, but it only *allows* greater contributions. It won't work unless sponsors can get economic value for plan surpluses, as suggested in our analysis of the administration proposal on pages 5 and 6.

The Academy had concerns about prior proposals to access plan assets in the 1990s, but that is because the threshold, based on a smoothed liability number, was set far too low. In addition, the proposal encouraged companies to take the surplus by eliminating the excise tax for only a short period. There are better ways to make this idea work for both employers and employees, and we would be happy to work with you on this.

Assumption Setting: The administration proposal sets the retirement assumption for at-risk companies, but as discussed earlier, it would produce inaccurate assumptions for companies that are poorly rated, but have a low probability of terminating. History has shown that using the law and regulations to specify actuarial assumptions has not been successful, as evidenced by the delays in setting the discount assumption and the long-running debate on replacing the currently required 1983GAM mortality table. We recommend that the law allow actuaries to set the mortality assumption because mortality experience differs by plan participant populations. Large plans could use actual experience (with an assumption for expected mortality improvement), and smaller plans could use tables with collar adjustments, as suggested in our December 2003 letter to the Internal Revenue Service on this issue. The law and actuarial standards both now require each assumption to be individually reasonable for single employer plans, which is a stronger rule than when Congress first started specifying assumptions. We also suggest the actuary continue to set the retirement assumption. If there are concerns that the individually reasonable rules are not strong enough, then actuaries could be required to justify their assumptions in writing if they seem out of the ordinary.

Yield Curves: The administration's yield curve provision, when compared with an equivalent rate determined from a typical plan, would increase the liability numbers by around 1 percent for unusually mature plans and decrease them by around 1 percent for unusually young plans. A single interest rate could be selected to achieve the same liability amount for a typical plan. Thus, instead of a plan being say 100 percent funded, for example, the unusually old or young plans might be 99 percent funded or 101 percent funded, respectively. If the yield curves are steep, which happens in recessions, then the results would be further apart, but analysis has shown it would be at most 3 percent or 4 percent. Thus, in aggregate, the charts in PBGC's white paper showing total funding in the pension system would be about the same. The charts showing the plans that PBGC takes over (and PBGC's deficit) would be worse, since they are more likely to take over mature plans during recessions, but the difference is so small that the change to their graphs would be subtle.

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In summary, you will note from above, that the use of an anti-volatility mechanism and an equivalent rate instead of a yield curve, and the retention of a modified credit balance provision, if done in connection with funding margins, will achieve similar and sometimes better funding levels when compared with the administration proposal, particularly if a shorter amortization period is used. I hope these comments have been helpful in responding to your question. Please let Heather Jerbi or myself know if we can be of further assistance by calling us at 202-223-8196.

Sincerely,

Ron Gebhardtsbauer, MAAA, EA, FCA, FSA, MSPA
Senior Pension Fellow
American Academy of Actuaries

Cc: The Honorable Mike DeWine, Chairperson, Subcommittee on Retirement Savings and Aging
The Honorable Mike Enzi, Chairperson, Senate Committee on Health, Education, Labor and Pensions
The Honorable Barbara Mikulski, Ranking Member, Subcommittee on Retirement Savings and Aging

Minimum Required Contribution
(For a Sample Pension Plan)