American Academy *of* Actuaries

ISSUE BRIEF

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Key Points

- Sponsors of defined benefit pension plans pay annual premiums to the Pension Benefit Guaranty Corporation (PBGC) for the cost of insuring pension benefits. The premium structure is set by statute and has been modified several times over the years.
- Both policymakers considering revisions to the structure of PBGC premiums and the general public need to understand the challenges of financing this valuable insurance.
- When evaluating PBGC premium proposals, the costs faced by the PBGC should be divided into two distinct categories:

  Going-Forward Costs, which are associated with the risks of ongoing coverage by the PBGC and exclude legacy costs;

  ***Legacy Costs*,** which are associated with existing or imminent claims on the PBGC, such as the unfunded liability for plans that are already in the hands of the PBGC or that are expected to be in its hands in the near future.
- Applying basic insurance principles, premiums for going-forward costs should be adequate and appropriately risk-related. The traditional insurance model, however, does not adequately address legacy costs. That is a policy decision in need of congressional attention.

Examining the PBGC Premium Structure

Policymakers are considering revisions to the Pension Benefit Guaranty Corporation (PBGC) premium structure to improve its financial viability. The administration proposal, first introduced in 2011 and proposed again in the 2012 budget, raises fixed premiums from the current $35 per-participant rate to $44 in 2014 with further increases each year until it reaches $70 in 2021. After 2021, the fixed premium would rise with the national average wage index. The proposal gives the PBGC board of directors the authority to establish a new variable rate premium. The variable rate premium, currently set by Congress, has been 0.9 percent of a plan's unfunded vested liability since 1991. The proposal suggests that the variable premium for each plan be more directly correlated to the risk the plan poses to the PBGC but leaves the mechanics of that increased correlation to the PBGC board of directors. Analysis of this proposal is spurring questions and debate among plan sponsors, plan participants, and taxpayers.

The American Academy of Actuaries' Pension Practice Council has prepared this brief for policymakers and the public at large to provide an analysis and exploration of this proposal based on actuarial and insurance principles. The Council believes consideration of any proposed change should reflect two clear and fundamental principles:

- First, the PBGC has two distinct categories of costs—*going-forward costs* and *legacy costs*—**that should be evaluated and addressed separately;** and
- Second, premiums for the going-forward costs should be both **adequate** and appropriately **risk-related—**with ad-

American Academy *of* Actuaries

1850 M Street NW, Suite 300, Washington, DC 20036
Tel 202 223 8196, Fax 202 872 1948
www.actuary.org

Mary Downs, Executive Director
Mark Cohen, Director of Communications
Craig Hanna, Director of Public Policy
Don Fuerst, Senior Pension Fellow
Jessica Thomas, Senior Pension Analyst

equate referring to the overall level of the premiums relative to the true cost of the insurance provided and risk-related referring to the degree to which the premiums charged to the insured reflect the risk the insured presents to the PBGC.

Background

The PBGC is the agency of the federal government that insures certain private sector pension benefits. Through this insurance, participants in defined benefit (DB) pension plans are guaranteed that they will receive their pension benefit (up to certain limits) if the company sponsoring the plan is unable to support the plan (for example, due to bankruptcy) and the plan doesn't have enough assets to pay all the promised benefits.

Sponsors of DB pension plans are charged annual premiums to pay for the cost of the PBGC insurance. The premium structure is set by statute and has been modified several times since the PBGC was created in 1974 with the passage of the Employee Retirement Income Security Act (ERISA). The current premium structure has two elements. Every plan pays a flat-rate premium of $35 per participant. And plans with unfunded vested liabilities pay an additional premium equal to 0.9 percent of the plan's actuarially determined unfunded vested liability.

The PBGC's mission includes encouraging the continuation and maintenance of private-sector DB pension plans. Excessive or inequitable premiums could lead sponsors to exit DB plans and may be an impediment to the creation of new DB plans. A fair and equitable premium structure, therefore, not only helps fund the insurance coverage, but also can contribute to stabilizing the retirement system.

Two Categories of Costs

When evaluating PBGC premium proposals, the costs faced by the PBGC should be divided into two distinct categories:

GOING-FORWARD COSTS are those associated with the risks of ongoing coverage by the PBGC, and they exclude the legacy costs.

LEGACY COSTS are those associated with existing or imminent claims on the PBGC, such as the unfunded liability for plans that are already in the hands of the PBGC or that are expected to be in its hands in the near future.

Separating costs into these two categories is important because they have widely different attributes when considered from a perspective that is based on insurance principles.

Going-forward Costs

Going-forward costs are the costs to cover unfunded benefits of future bankruptcies/insolvencies among the currently viable plan sponsors. These are the "true insurance costs."

Premiums covering going-forward costs need to be both adequate and appropriately risk-related.

- **ADEQUATE** premiums generally are expected to cover fully the going-forward claims and administrative costs over a reasonable period of time.
- **RISK-RELATED** premiums, in this context, refer to the degree to which the premium structure reflects the relative insurance cost of each plan. The cost should reflect the benefit guarantees that the PBGC provides in excess of the plan's assets and the likelihood of the PBGC incurring that obligation.

The proposed legislation directs the PBGC to adopt a more sophisticated risk-based model. A comprehensive risk-based model would scale premiums so that, all else being equal, a plan sponsor that represents a greater risk of placing unfunded liability upon the PBGC would pay relatively more premium than a plan sponsor that represents lesser risk. PBGC's current premium model is based on one risk factor—the degree of underfunding. The proposed legislation considers "the plan's assets and liabilities, the financial condition of the contributing sponsor, and such other factors as the board of directors considers relevant."

In general, application of a risk-based model is appropriate for the PBGC's going-forward costs. The proposal, however, delegates to the PBGC's board of directors full discretion for setting both the methodology and the level of the risk-based premium. Without sufficient detail from the PBGC regarding how a model would operate, there is little upon which to form an opinion. Any model that the PBGC might develop would benefit from public exposure to proposed levels of adequacy and risk-related premiums.

Legacy Costs

In an insurance model, the cost of insurance for members of any group should be borne by the members of that group. As such, the insurance model would have those plan sponsors that are responsible for the going-forward costs bear responsibility for paying premiums to fully cover the anticipated going-forward costs—the insurable future events.

Legacy costs already incurred clearly are not insurable future events. Legacy costs generally have been incurred either from past bankruptcies or from bankruptcies expected in the near future and are not associated in any meaningful way with the group of viable ongoing plan sponsors. That group would not bear the legacy costs in an insurance model; if they did, the price of the insurance would exceed the true value of the coverage, and thus provide a market incentive for the insured to decline coverage or move their business to another insurer.

The existing PBGC model is not a true insurance model. Federal pension insurance is mandatory for private sector employer-sponsored DB plans and must be procured through one insurer—the PBGC—that assesses premiums (for both ongoing and legacy costs) on only the group of viable, ongoing plan sponsors. Plan sponsors cannot decline coverage or change their coverage provider.

Sponsors under the current system cannot avoid paying for more insurance than they are receiving short of terminating their DB plan or, in some cases, declaring bankruptcy, neither of which is a desirable outcome from anyone's perspective. Both those actions are detrimental to employees in particular and society in general, and to meeting the PBGC's mission of encouraging DB pension plans.

The existing legacy costs arose as a result of the underfunded plans that already largely have been taken over by the PBGC. The PBGC calculates this unfunded liability to be approximately \$26 billion.[1] In insurance terms, this liability represents claims that already have occurred for entities no longer carrying insurance and implies that past premiums were inadequate to cover the actual risk.

Other models exist for funding similar legacy costs. State insurance guarantee funds assess all insurers in a state to fund shortfalls from an insolvent insurance company. The Federal Deposit Insurance Corporation (FDIC) charges all banks to cover losses from bank insolvencies. Even though such industry support is compulsory, ongoing insurance companies and financial institutions have a more pronounced common interest in assuring widespread confidence in their industries without which they would be unable to effectively market their products and services. But pension plan sponsors do not share this kind of common market interest and are reluctant to pay for the unfunded benefits of other firms.

A new premium structure should be transparent and spell out how it will address ongoing costs and legacy costs. Ongoing viable plan sponsors should pay ongoing costs. Determining who should pay for the legacy costs is not an actuarial issue; rather it is a policy decision that needs congressional attention. There are multiple options for allocating this legacy cost:

- Assign the full legacy costs to existing DB

[1]The \$26 billion figure cited here includes \$1.2 billion from insolvent multiemployer plans. While the nature of the insurance the PBGC provides to single vs. multiemployer plans differs somewhat, those differences do not affect the categorization of the cost as a legacy cost. The \$26 billion also includes \$4.1 billion for single and multiemployer plans the PBGC considers highly probable terminations/insolvencies. The PBGC has been reasonably accurate in its projections of probable terminations, and we believe it is reasonable to assume that the PBGC will be paying most of these costs, and receiving very little premium income from the sponsors of these plans. Source: 2011 PBGC Annual Report

plan sponsors, spread over future years to reduce the immediate burden. This is the current approach and, as noted above, it may not be perceived as "fair." In addition, it also may drive companies away from DB plans by making the cost of a DB plan ever more uncompetitive as the same legacy costs are spread over an ever-shrinking pool of ongoing DB sponsors.

- Assign only a portion of the legacy costs in the premium structure so that it does not create a significant impediment to sponsors continuing or establishing DB pension plans. Find other sources of funds for the remaining legacy costs, such as one or more of the following methods.
  - Charge all or part of the remaining cost to the industries that have caused most of the PBGC deficit. Those costs could be assessed to all companies in the industry (thus maintaining a level playing field between competitors in the same business) or to consumers using products of the industry.
  - Assign the costs to all employers on a per-employee basis, percentage of payroll, percentage of profits, or similar method. This approach implicitly recognizes that all employers have a stake in the health of the retirement system, regardless of whether they sponsor a DB plan, defined contribution (DC) plan or no plan. This method also might be applied solely to employers who sponsor a retirement plan of any type.
  - Tax the beneficiaries of qualified pension plans. A small surcharge on the income tax of individuals who earn benefits or receive distributions from pension plans, as an annuity or lump sum, could finance part of the legacy costs. The surcharge could be progressive and/or means-tested. This approach has the advantage of not charging plan sponsors for legacy costs yet keeping the funding within the DB system. It has the disadvantage of burdening individuals who did not cause the deficit.
  - Fund remaining legacy costs via general revenues.

Regardless of where legacy costs are assigned, immediate funding of the entire amount is not required. The PBGC current assets are sufficient to pay beneficiaries for many years without cash flow difficulty. The PBGC currently has assets equal to approximately 75 percent of reported liabilities. Stabilizing the deficit is an immediate issue, while funding the deficit is important but not as urgent.

Summary

Guaranteeing the pension benefits of millions of workers is an expensive task. Policymakers and the public need to understand the challenges of financing this valuable insurance. The traditional insurance model does not adequately address the legacy costs. These costs already have been incurred and are unrelated to the businesses or the risk profiles of ongoing sponsors and pension plans. 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.

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1850 M Street NW
Suite 300
Washington, DC 20036
Tel 202 223 8196
Fax 202 872 1948
www.actuary.org