Testimony on "How the Multiemployer Pension System Affects Stakeholders"

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I am very grateful for the opportunity to testify today and hope that my testimony contributes toward a workable solution to the crisis facing the multiemployer plan system.

A multiemployer plan is a pension plan maintained through a collective bargaining agreement between employers and a union. The typical plan has numerous contributing employers, and it is quite common for employers to participate in several different multiemployer plans. For a particular multiemployer plan, the employers are usually in the same or related industries. Today, there are approximately 1,400 multiemployer plans covering 10 million participants. From the participant's perspective, multiemployer plans provide pension portability, allowing them to accumulate benefits earned for service with different employers throughout their careers. In addition, because these plans offer annuity benefits, they represent an efficient source of retirement income due to risk pooling advantages. From the employer's perspective, the efficiencies of scale facilitates diversified investment opportunities and lessens the administrative and investment costs relative to the operation of numerous small single-employer plans.

Currently, the multiemployer system is chronically underfunded and the retirement benefits of many participants are at significant risk. I believe that the most important factor that informs the appropriate approach to addressing this crisis is an understanding as to whether the current predicament is primarily attributable to bad luck or is an inherent attribute of how plan trustees have run the plans.[2] While luck may play some part in which individual plans are in the most critical condition, I firmly believe that the current crisis is a function of trustee choices. Even though these choices may not violate a clear numerical bright line test in the rules governing

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[2] In the case of multiemployer plans, the plan trustees are typically a board with equal representation from contributing employers and union officials.

multiemployer plans, the rules, most of which were requested by the multiemployer plans themselves, were interpreted as leaving broad discretion over the making and funding of pension promises. In my testimony, I am going to explain how this broad discretion made the current crisis inevitable.

To begin, I'm going to state an obvious fact. If plans were required to collect actuarially sound contributions and purchase annuity contracts, there would be no crisis. Participants would be receiving or would be scheduled to receive the annuity benefits purchased with the contributions made on their behalf. In addition, the rules governing these plans would be far simpler. There would be little need for PBGC premiums, calculations of plan funding requirements, and certainly no need for withdrawal liability provisions.

Rather than follow this type of approach, multiemployer plans generally choose to invest in risky equity investments and to collect contributions that are inadequate relative to the promised benefits. In effect, the plans are hoping that growth in the number of active participants or superior investment returns will take care of the shortfall. The reasons trustees pursue such a strategy are relatively simple—assuming that the overall cost per employee was fixed, a relatively low pension contribution means that employees might be able to receive higher non-pension compensation from their employers through the collective bargaining process. In addition, it encourages employers to join a multiemployer system rather than sponsor their own plan as seemingly equivalent benefits can be promised through the multiemployer plan at a lower cost.

Congress enacted several rules to protect the solvency of the multiemployer system, most notably with the 1980 Multi-Employer Pension Plan Amendments Act. Starting in 1980, there were four notable aspects of the framework governing multiemployer plans.

First, even though employer contributions are determined as part of the collective bargaining process, the starting point for identifying the aggregate contribution is typically the present value of benefits determined using a discount rate based on anticipated investment returns. Because the plans invest in equity securities, this means that the present value of benefits calculation does not reflect the economic value of pension promises.[3] If plans invest in annuities or in duration-matched bonds, there is no understatement of the plan's present value of benefits.

[3] Actuaries and standard setters have long known that this approach understates the actual obligations of the plan. As an illustration, Statement of Financial Accounting Standards (SFAS) No. 87, Employers' Accounting for Pensions, which was adopted in 1985, requires that the reported pension liability for financial reporting purposes be calculated using a discount rate that reflects the rate at which the obligation to pay the pension benefits can be settled rather than the expected investment return on the pension assets. In seeking these rates, SFAS87 requires that employers look to "rates of return on high-quality fixed-income investments currently available and expected to be available during the period to maturity of the pension benefits." In practice, companies typically use zero-coupon duration-

Second, because sufficient contributions are not required, it is possible for employers to withdraw from a multiemployer plan having not contributed adequate funds to cover the benefits promised to their own workers. This concern is addressed through "withdrawal liability", whereby employers exiting a multiemployer plan are required to contribute funds intended to cover their share of plan underfunding.

Third, because not all exiting employers pay the withdrawal liability (e.g., due to bankruptcy) and because plans are free to invest in risky securities, it is possible that the plan could face a shortfall due to poor experience. This concern is addressed by requiring that all contributing employers be jointly and severally liable for all plan promises, including for so-called "orphan" participants whose employers left the plans without paying for their share of the plan's underfunding.[4]

Fourth, in the event that the assessment of withdrawal liability and the application of joint and several liability do not generate sufficient funds to cover promised benefits, the PBGC provides benefit guarantees.[5] Importantly, and at the request of the multiemployer plans themselves, PBGC coverage for multiemployer plans is separate from that for single employer plans, so that large shortfalls in multiemployer plans do not affect the PBGC's coverage of single employer plans (and vice versa).[6]

In short, rather than collecting contributions reflecting the value of promised benefits and investing those funds appropriately, the trustees used the discretion in the multiemployer plan rules to provide for insufficient contributions and to pursue risky investment choices, with the understanding that employers would be required to bail out insolvent plans. The rules further provided that if employers were unable to bail out insolvent plans, the PBGC would provide

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matched Aa corporate bond rates to determine their pension liability for financial reporting purposes to meet the requirements of SFAS87. Using an Aa rate provides an estimate of the cost of extinguishing the pension liability through the purchase of an annuity contract from a highly rated insurance company.

[4] The existence of orphan plan participants can result in a worsening funding situation for the multiemployer plan, because plan assets are comingled in a trust and are not assigned to a particular employer's contributions or participant's benefit. Thus, benefit payments for all participants draw down general plan assets.

[5] PBGC guarantees benefits up to a statutory maximum level. When a multiemployer DB pension plan becomes insolvent, the plan must reduce participants' benefit to the PBGC maximum amount before the plan receives assistance. The statutory maximum benefit in multiemployer plans that receive financial assistance from PBGC is the product of a participant's years of service multiplied by the sum of (1) 100% of the first $11 of the monthly benefit accrual rate and (2) 75% of the next $33 of the accrual rate. For a participant with 40 years of service, the statutory annual maximum benefit is $ 17,160.

[6] The assets and income of PBGC's Multiemployer Program are currently only a small fraction of the amounts PBGC will need to support the guaranteed benefits of participants in plans expected to become insolvent during the next decade. In its FY2017 Projections Report, PBGC indicated that the multiemployer insurance program has a 90% chance of becoming insolvent by the end of 2025.

benefits (up to guaranteed levels) as long as it had the resources in its multiemployer program to do so.[7]

It is worth noting that the problem is not that the rules prohibit trustees from running the plans conservatively—trustees are free to purchase annuities to fund the pension benefits that the plan promises. Even short of purchasing annuities, the rules do not prevent trustees from accurately measuring plan promises and investing in a more conservative manner, concentrating on bonds matching the duration of the liabilities.

The trustees choose to take risk, and there is nothing necessarily wrong with this choice in other circumstances not presented by multiemployer pensions. In general, the assumption of risk is an appropriate course of action to the extent that one can respond to the inevitable volatility. Unfortunately, this is not the case with the multiemployer system, where there is a structural inability to respond to poor experience.

Over time, there has been an inevitable decline in the number of participants covered by these plans, driven in part by withdrawal liability requirements (which, again, exist because plans do not collect contributions commensurate with promised benefits).[8] This decline in participation has occurred, in part, because financially healthy employers are especially concerned with the possibility of withdrawal liability or the prospect that they fund the benefits of orphaned participants, and hence these employers are not interested in participating in multiemployer plans.

During my career as a consulting actuary, which started in the mid-1990s, I personally observed several clients who decided to sponsor their own defined benefit plan rather than participate in a multiemployer plan because of the withdrawal liability provisions and the requirement that they be joint and severally liable for plan underfunding. The choice to forgo membership in a multiemployer plan was not a difficult decision for these employers, even when the proposed cost of the multiemployer plan was only one-third of the cost of a single employer plan.

The withdrawal liability provisions not only discourage new employers from joining the multiemployer system, but also create incentives for the most financially healthy employers to withdraw. These incentives are especially strong when the withdrawal liability is less than the

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[7] In extreme cases, participant benefits can be curtailed well below the stated guaranteed benefit levels, as these levels are only binding to the extent that the PBGC has the resources to pay these amounts. This isn't necessarily an event that requires that the PBGC run out of funds. ERISA 4022A(f) indicates that it is possible for benefits to be curtailed immediately to the extent that the PBGC does not have the resources necessary to meet its expected future obligations under the multiemployer system.

[8] The lack of new entrants is reflected in the increasing share of inactive members—over the past thirty years, the share of inactive participants has increased fourfold from around 17 percent to 61 percent of total participants across multiemployer plans.

anticipated cost of remaining in the plan. In the past, this was often the case because the withdrawal liability rules were inconsistent and oftentimes too lenient. Employer withdrawal liability payments typically do not capture the employer's full economic obligation because plans have the option to measure unfunded vested benefits using the plan's funding rate, typically 7.5 percent, which is too high for a termination liability because it doesn't reflect the settlement value of the promised benefits. In addition, the withdrawing employer's share of the unfunded vested benefits is further reduced based on past contributions, or based on special rules for certain industries.[9]

The inevitable consequence of inadequate contributions, risky investment choices, and the withdrawal liability provisions is a funding crisis. This crisis first manifested more than 10 years ago, and the statutory response at that time has made matters worse. While those statutory actions did marginally increase funding requirements, in most cases contributions still do not reflect the economic value of promised benefits. There were no changes in withdrawal liability, with the inevitable outcome that new employers are not joining the system and current employers continue to exit when it is advantageous to do so. In addition, the Pension Protection Act of 2006 ("PPA") response included provisions that waived required contributions for the most troubled plans, thus ensuring that the situation would almost certainly deteriorate as these plans are able to promise additional benefits without setting aside the funds needed to cover these benefits.

The system was around $200 billion underfunded at the time of the PPA on a PBGC rate basis. For 2015, PBGC just reported that the system is $638 billion underfunded on that basis. Almost 75% of participants are in plans that are less than 50% funded and more than 95% of participants are in plans that are less 60% funded.

With a small base of active participants, it is cost prohibitive to increase contributions to a level that fully funds many of these plans. Moreover, with the exit of the most financially healthy employers, there is insufficient resources among the remaining employers to cover the shortfalls in many plans.

So what can be done? There are several steps that I believe should be adopted to set the system on the correct path going forward.

[9] There are also some special rules that allow employers in the construction and entertainment industries to avoid any withdrawal liability. For example, in the case of plans operating in the construction or entertainment industries, an employer is not required to pay a withdrawal liability if the employer is no longer obligated to contribute under the plan and ceases to operate within the jurisdiction of the collective bargaining agreement (or plan) or does not resume operations within five years without renewing its obligation to contribute.

First, and foremost, multiemployer plans need to have accurate measurement of liabilities and strong funding rules so that they can provide promised benefits.[10] It is not enough to simply adopt the single employer plan rules. Multiemployer plans need to have even stricter rules than single employer plan because there is an interconnectedness across plans and contributing employers (i.e., most plans have several contributing employers, and most employers contribute to several different plans) that exacerbates the consequences of poor outcomes. Liabilities and contributions should reflect the cost of annuity products from highly rated insurance companies.

Second, the PBGC should have broad discretion to assume control of troubled plans and implement necessary changes, including reductions in accrued benefits. Currently, the PBGC is unable to intervene, even in those cases where the plan's condition is continuing to deteriorate and there is no expectation that the condition of the plan will improve. The PBGC has this authority with regard to single employer plans and exercises it when necessary, even sometimes where a plan is meeting the much more stringent funding rules applicable to single employer plans. Similarly, it would be reasonable to have certain automatic triggering events, such as a funding deficiency for two or three consecutive years, that would require that the PBGC take control of a troubled plan. It is also reasonable for there to be a termination premium, similar to what is required for single employer plans.

Third, amend the withdrawal liability provisions. One suggestion for the withdrawal liability would be to mirror what is done in a plan termination for single employers—that is, the withdrawing employer should be required to cover the cost of purchasing annuities from highly rated insurance companies for each of its participants. This cost could be offset by prior contributions, with or without investment returns, and could be adjusted to incorporate some portion of the costs associated with orphaned participants. However, what is important is that the withdrawal liability reflect the actual economic cost of promised benefits. Congress should also consider a moratorium on withdrawals while it is deliberating on the legislative response to immediately end the opportunistic use of these provisions.[11]

While these suggestions should help set the multiemployer system on a sustainable path, they do not provide clear prescriptions for how past underfunding should be resolved. While the union

[10] The difference between measuring the plan liability using anticipated investment returns versus settlement rates is startling. A recent report prepared by Horizon Actuarial Services LLC finds that based on current funding rules, over 60% of all multiemployer plans are in the green zone (i.e., at least 80% funded and no projected funding deficiency for at least 7 years). In contrast, based solely on using corporate bond rates and assuming all other funding rules remain unchanged, the percentage of green zone plans would fall to just 7%. With corporate bond rates, 87% of all multiemployer plans are in critical or critical and declining status.

[11] Even with the adjustment to withdrawal liability provisions, the number of active participants covered by multiemployer plans is unlikely to return to historical levels. Over the past 30 years, the U.S. economy has shifted fundamentally away from unionized industries. According to the Bureau of Labor Statistics, union workers made up only 12 percent of the workforce in 2009, down from 21 percent in 1983.

and contributing employers almost certainly knew that contributions were insufficient relative to promised benefits, it seems clear that neither party has sufficient resources to address prior underfunding. Therefore, at least part of the resolution will involve concessions on the part of plan participants, who were unlikely to have known about the mismanagement of their promised pensions until the crisis began to materialize, or taxpayers.

My suggestions also focus on improving rather than replacing the current system, as I believe that the correct approach is to develop a sustainable defined benefit program rather than switching to a defined contribution plan. A conversion, by definition, will hurt those employees closest to retirement.[12] More importantly, a well-run defined benefit plan is far more effective at ensuring retirement security for the types of workers who participate in these plans.

No matter how prior underfunding is addressed, I strongly advocate for urgent changes to the rules governing multiemployer plans. I believe the rule changes I suggest can be implemented without a final framework for how to handle the allocation of past underfunding, and so delays, which will inevitably lead to larger deficits and choices that are more difficult, can and should be avoided at all costs.

[12] The rate of benefit accruals vary by age across defined benefit and defined contribution plans, with accruals becoming much more valuable in defined benefit plans as participants age. As a result, the accumulation of benefits in a defined benefit plan accrue much more rapidly in later years (sometimes referred to as “golden handcuffs”). Therefore, if participants are switched mid-career, then over their full career they receive lower accumulations from the time before the plan change (when the DB accruals are worth less than DC accruals) and lower accumulations after the plan change ( when the DC accruals are worth less than DB accruals), which combine to ensure that the participant has lower retirement income.