AREF
American Retirees Education Foundation

NRLN
NATIONAL RETIREE LEGISLATIVE NETWORK

Pension Guarantees that Work for Retirees

A Proposal for Commonsense PBGC Reforms

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EXECUTIVE SUMMARY

The recent economic downturn has highlighted just how vulnerable America's workers and retirees are to the threat of corporate bankruptcy and the dumping of company pension obligations onto the government's pension guarantee system. The Pension Benefit Guaranty Corporation (PBGC) took over 155 failed plans during fiscal year 2012, a 75% increase from 2008. The pace of plan terminations has accelerated greatly since the severe recession that began that year.

As required by the Employee Retirement Income Security Act (ERISA), pension plan sponsors pay a per-participant "insurance premium" to the PBGC – a cost paid from plan assets. Although these premium payments remain below the projected long-term cost of insuring the benefits, retirees are led to believe their benefits are protected, at least up to the statutory maximum ($57,460 per year for a 65-year-old, in 2013, but substantially less for retirees under age 65). Unfortunately, workers and retirees learn only after plan termination that a number of PBGC policies can leave them with benefits that are permanently reduced by 30% or more.

Arbitrary gaps in ERISA's benefit guarantee program are imposing unanticipated and devastating losses on tens of thousands of retirees and older workers forced into retirement by the bankruptcy of their employer. In some cases corporate transactions and financial engineering spin off weaker business divisions or subsidiaries that end up in bankruptcy and lead to pension plan terminations. Whatever the cause, when an under-funded plan terminates and is taken over by the PBGC, the benefits actually paid by the agency can be much lower than the vested benefits earned. Some limitations on PBGC's guarantee are imposed specifically by ERISA – such as the maximum annual benefit guarantee (which varies based on age). This paper focuses on one *statutory* and two *discretionary* policies that PBGC maintains despite the fact that it leads to unexpected and unfair benefit losses for a large number of older workers and retirees.

First, while ERISA imposes limitations on benefit guarantees, ***the largest loss of earned benefits suffered by most retirees after a plan termination is caused by the PBGC's decision to estimate the future cost of benefits using an unrealistically low interest rate assumption.*** The lower the interest rate, the greater the estimated present value of future benefit obligations. While other qualified pension plans are required by law to calculate their funded status based on the market-based corporate bond yield curve prescribed by the Treasury Department, the PBGC at its discretion uses a much lower discount rate (2.95% in September 2012) that is derived from the prices charged by private insurance companies for fixed and deferred annuities.

The government is confusing and misleading 44 million insured plan participants by requiring companies to send them year after year an Annual Funding Notice that discloses a plan funding level that is substantially rosier than what the PBGC later calculates as "termination liability." In other words, after a plan terminates the PBGC chooses to use a different – and far more conservative – interest rate assumption in valuing benefit obligations than a plan sponsor is required to use under ERISA's minimum funding rules. And because the PBGC assumes a much lower discount rate on future benefit obligations (recently under 3%), it allocates plan assets *as if* it will not be offsetting a substantial portion of future benefit costs by investing the plan assets, just as other plan sponsors offset future costs with expected market rates of return on investment.

As a result, the assets recovered from a terminated plan cover the inflated "present value" of guaranteed and non-guaranteed benefit obligations to a much lesser degree than if the PBGC assumed that plan assets would earn a long-term average market rate of return (typically 6% to 8%). Because the present value of benefit liabilities are exaggerated, plan assets rarely cover most of the non-guaranteed vested benefits, such as benefit increases within five years of termination or earned benefits above the PBGC monthly maximum benefit. This results in unnecessarily large and permanent losses for participants. ***Congress should require PBGC to use the same corporate bond yield curve and other assumptions as plan sponsors for the purpose of allocating plan assets to pay non-guaranteed benefits.***

The second discretionary PBGC policy that unnecessarily reduces benefits for a subset of retirees is flatly contrary to the plain language of ERISA. One of the statutory limitations on guaranteed benefits is the five-year phase-in of "any increase in the amount of benefits under a plan *resulting from a plan amendment.*" If such a benefit increase becomes effective within one year of the plan termination date, it is not guaranteed at all; if the amendment made the benefit increase effective more than one year prior to termination, the guarantee phases in 20% per year.

Despite the statutory definition of the five-year phase-in as "*resulting from a plan amendment*," the PBGC has determined that the annual statutory inflation adjustment of the maximum annual compensation that can be considered in calculating a benefit (the IRC Section 401(a)(17) limit) and the maximum annual benefit payable by a qualified plan (the IRC Section 415(b)(1)(A) limit) is a benefit increase subject to the five-year phase-in. As a result, older workers or retirees whose accrued monthly benefit simply adjusted automatically in line with the statutory inflation adjustment suffer a disproportionate loss of benefits. Although vested, these benefits are rarely paid because the portion not guaranteed under the five-year phase-in is moved to a low Priority Category (PC-5), at which point there are rarely plan assets remaining to pay these "non-guaranteed" claims (and less so because PBGC chooses to use an artificially low discount rate to estimate liabilities, as noted above). ***The PBGC should change this policy or Congress should clarify that a benefit increase triggered by a federal statute is not subject to the five-year phase-in limitation.***

A third indefensible gap in ERISA's guarantee system is the statutory three-year 'look-back' that PBGC applies to determine what benefits are eligible for payment under Priority Category 3. On the date of plan termination (or bankruptcy filing, whichever is earlier), if a plan participant has not been retired (in "pay status") or eligible to retire for at least three years, then no portion of his or her benefit is eligible for PC-3 prioritization. The guaranteed portion of the benefit will still be paid (under PC-4), but the *non-guaranteed* portion will almost always be unfunded and lost forever. Since all of the non-guaranteed benefits of recent retirees are demoted to PC-5, this group takes a big reduction whether they have been retired for one month or nearly three years. ***Congress should amend Section 4044(a)(3) so that the benefits of all plan participants who are already retired, or eligible to retire, on the date of plan termination are protected equally*.**

Finally, the paper addresses the growing concern about the PBGC's ability to deter plan terminations by, or recover assets from, foreign-owned or foreign-based plan sponsors. Actually collecting on a liability in practice requires that foreign entities have sufficient assets within the jurisdiction of U.S. courts. Because of this increased risk, PBGC should add foreign ownership, and proposed sales or spin-offs to foreign owners, to the list of transactions triggering an Advance Notice of Reportable Events, as well as special scrutiny under the PBGC's Early Warning Program. In addition, ***Congress should clarify that the PBGC has the authority to enforce a lien against all U.S.-based assets of a foreign plan sponsor and require that plan fiduciaries – particularly a plan's "named fiduciary"– be U.S. citizens subject to the jurisdiction of U.S. courts***.

The whitepaper researched and written for the American Retirees Education Foundation (AREF) is the source of information for this Executive Summary. The AREF expands the research and education reach of the NRLN.

For a copy of the whitepaper on this subject, contact Alyson Parker at 813-545-6792 or executivedirector@nrln.org