The Economics of Pension Insurance

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PART TWO

Efforts to Reform Program

CHAPTER 5

Reform Efforts through 1987

There is an obvious wedge between sound insurance principles and the actual administration of federal pension insurance. This does not mean, however, that the PBGC and Congress have not worked in the direction of a better, albeit still imperfect, program. In this chapter, I will discuss important reforms implemented through 1987. The next step, which will comprise subsequent chapters, is to build on these ideas toward the development of a true economic insurance program. Table 5–1 provides a summary of the regulations, litigation, and legislation discussed in the chapter.

REGULATORY AND LITIGATION EFFORTS

In this section, I will discuss the internal policy decisions that have been the most significant in controlling insurance losses. These are (1) opposition to establishment of follow-on plans after an insufficient termination; (2) vigorous efforts to enforce ERISA safeguards to include the entire control group in the 30 percent net worth employer liability clause; and (3) a conservative interpretation of ERISA language to impose a full actuarial reduction of the maximum benefit for retirement ages earlier than 65.

Follow-On Plans

A basic principle of any insurance contract is coinsurance; and because ERISA was written to insure terminated (not ongoing) benefits, a pension plan termination by definition imposes large coinsurance losses on workers. As discussed in Chapter 2, depending on the interest rate and age distribution of workers, these losses can reasonably be

TABLE 5–1 Important Steps toward Reform

Issue	*Policy Decision*	*Litigation/Regulation/Legislation*	*Year*
Follow-on plans	Prevent replacement of noninsured losses	*PBGC* v. *Wheeling-Pittsburgh*	1985
		PBGC v. *Alloytek*	1979
		PBGC v. *LTV*	1987
		PBGC v. *Facet*	1980
Control groups	Enforce 30 percent net worth rule to control group	*PBGC* v. *Ouimet*	*1979*
		PBGC v. *International Harvester*	*1980*
Maximum benefit	Actuarial reduction for retirement prior to age 65	Limitation on guaranteed benefit (29 CFR 2621.4)	1976
Insurable event	Limit claims event to firms in financial distress	SEPPAA	1986
Multiemployer reform	Limitation of guaranteed benefits and other rules	MPPAA	1980
Pricing and funding	Exposure-related premiums and stricter funding standards	Pension Protection Act	1987

expected to amount to 25 percent to 75 percent of ongoing pension values. If firms can find ways to eliminate this coinsurance, the potential for moral hazard for the PBGC becomes much greater because firms can take advantage of the insurance policy without adversely affecting their workers and thus their reputations in the labor market.

For example, if after an insufficient termination a new plan is created that not only provides future service accruals but also offsets capital losses suffered by workers on termination, then the coinsurance feature is eliminated. Attempts to create these types of follow-on plans have occurred throughout PBGC's history. Through the litigation of various cases, the PBGC has established a policy against the formation of some types of follow-on plans, though it is unclear at this point whether the courts will ultimately ratify the policy.

The PBGC's position on follow-on plans is set forth in Opinion Letters 81–11 and 86–27 and in papers filed by the PBGC in cases involving Wheeling-Pittsburgh and LTV.[1] An excerpt from Opinion Letter 81–11 is given in the appendix to this chapter.

In four cases the PBGC has publicly contested the right of an employer who terminated a plan with insufficient assets to establish a follow-on plan: AlloyTek, Facet, Wheeling-Pittsburgh, and LTV. AlloyTek and Facet have been settled; as of fall 1988, follow-on plan

[1] See *In Re: Chateaugay Corp., Reomar, Inc., The LTV Corporation, et al.*, SDNY, Case No. 06-B-11273 BRL through 86-B-11334 BRL inclusive; and *United Steelworkers of America, Wheeling-Pittsburgh Steel Corp., et. al.* v. *Pension Benefit Guaranty Corporation*, WDPa, Civil Action No. 87-0355.

issues in Wheeling-Pittsburgh and LTV were in litigation. In these four cases (and others), the PBGC opposed establishment of follow-on plans that, when added to the benefits paid by the PBGC, would provide participants with benefits substantially equal to the benefits that would have been provided by the terminated plan if it had continued.

AlloyTek. AlloyTek was the first case involving the follow-on plan issue. AlloyTek filed a notice of intent to terminate its defined benefit pension plan covering hourly employees, which was subject to a collective bargaining agreement between AlloyTek and the United Auto Workers, in October 1979. The plan's assets were approximately $4 million less than guaranteed benefits, and, according to information submitted with the notice, AlloyTek had little net worth and thus would have little employer liability.

AlloyTek and the union had agreed to establish a target benefit plan (an individual account plan not covered by Title IV) and various other plans to allow benefits that were provided under the plan to be terminated. In addition, AlloyTek and the union also agreed that AlloyTek would make up the difference between what an employee would have received if no termination had occurred and what is provided under the combination of new plans. The PBGC rejected this arrangement as a continuation of the original plan.

AlloyTek eventually agreed it would not establish a defined benefit plan or a target benefit plan for hourly employees prior to September 1, 1986. As a result of this agreement, the PBGC accepted the termination of the hourly plan.

Facet. The Facet case was similar to AlloyTek. It involved the proposed termination of a defined benefit plan and the establishment of a follow-on target benefit plan and other supplementary benefit arrangements. The PBGC originally opposed the termination, as it did in the case of AlloyTek, but subsequently withdrew its opposition when Facet agreed to pay the PBGC employer liability nearly equal to the asset insufficiency of the terminated plan, which was approximately $21 million.

Wheeling-Pittsburgh. Wheeling-Pittsburgh filed a notice of intent to terminate its hourly and salaried pension plans on October 29, 1985, with a proposed termination date of November 8, 1985. At the time of the filing, the firm and seven of its subsidiaries were in a Chapter 11 bankruptcy proceeding. The plans were underfunded by approximately $360 million.

Wheeling-Pittsburgh and its union had signed an agreement for a "pensioners' relief program" to provide payments to current and future retirees in the event the hourly plans were terminated. A similar program was adopted for salaried employees. The programs, in the PBGC's view, appeared to provide substantially the same benefits as the terminating plans; as a result, the PBGC did not initially recognize the termination notices, and it refused to assume trusteeship of the plans.

Following negotiations between the PBGC, Wheeling-Pittsburgh, and the Steelworkers, agreements were entered under which the PBGC agreed to accept the termination of the plans, and the company agreed to cancel the relief programs and not to implement any other follow-on program without PBGC approval or a court order. The PBGC reserved its right to withhold its agreement

> if the proposed follow-on program or any successor, companion, or substitute therefore (*a*) seeks to effect a continuation or restoration of the plans terminated under this agreement, (*b*) consists of . . . a plan covered under Title IV of ERISA . . . , (*c*) consists of an ongoing employee benefit program providing benefits substantially equivalent to those of the hourly plans, (*d*) consists of a qualified or nonqualified defined benefit plan or a target benefit plan for the company's [hourly/salaried] employees proposed prior to the expiration of five years from the date of confirmation of a plan of reorganization of the company, or (*e*) otherwise fails to comply with consistently applied policies of the PBGC under applicable law.[2]

In August 1986, Wheeling-Pittsburgh and the union submitted follow-on plans to the PBGC for its approval. In December 1986, the PBGC disapproved the proposed follow-on plans on the basis that such plans constituted a de facto continuation of the terminated plans. The company and the union subsequently asked the PBGC to recommend acceptable alternatives, which the agency declined to do. On February 9, 1987, Wheeling-Pittsburgh and the union filed suit in district court, seeking an order that they be allowed to establish the proposed follow-on plans and that the PBGC is without authority to restore the assets and liabilities of the terminated plans on the establishment of such follow-on plans. The case was pending as of fall 1988.

The proposed follow-on plans consist of two components: (1) a target benefit plan covering active employees and (2) a supplemental plan covering both active employees and retirees. The proposed supplemental plan is designed to provide retirees with 95 percent of the difference between the benefits they would have received under the terminated plan and the benefits guaranteed by the PBGC.

LTV Corporation. LTV entered Chapter 11 bankruptcy proceedings in 1986; the PBGC initiated termination of four of its pension plans in late 1986 and early 1987. The combined plans covered over 100,000 participants, 60,000 of whom were retired, and had over $2 billion in unfunded guaranteed benefits.

In June 1987, LTV and its union agreed to a collective bargaining

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[2] Brief of PBGC in *United Steelworkers, Wheeling-Pittsburgh, et al.* v. *Pension Benefit Guaranty Corporation*, No. 87-0355 at 30 (W.D.Pa.).

agreement that included a follow-on plan for hourly workers. A similar follow-on plan was formulated for salaried employees. On July 30, 1987, the bankruptcy court approved the follow-on plans, over the PBGC's objection.

The PBGC restored three of the LTV plans to their pretermination status on September 22, 1987.[3] The bases for the PBGC's decision to restore were

1. The abuse of the termination insurance program caused by LTV's establishment of follow-on plans that, along with the PBGC's guaranteed benefits payments, essentially continued the terminated plans.
2. The improvement in LTV's and LTV Steel's financial conditions.
3. The demonstrated willingness of LTV Steel to fund retirement programs.

LTV opposed the restoration, and the dispute became the subject of a district court case—*Chateaugay Corporation, Reomar, Inc., LTV Corporation, et. al.* Among other rulings, the District Court found insufficient evidence that the follow-on plans were so abusive of the insurance system as to justify restoration. As of fall 1988, the case has been appealed by the PBGC in the U.S. Court of Appeals for the Second Circuit.

Control Groups

Another potential gaming issue is related to the concept of control groups. Suppose a holding company comprises three wholly owned subsidiaries: each has net worth of $100 million, two have fully funded plans, and one has $50 million in underfunding. In the absence of a control group policy, one of these subsidiaries could transfer $50 million in underfunded pensions to the PBGC. In exchange, it would be liable for only 30 percent of its net worth, or $30 million. A $20 million profit would be earned by terminating a single plan and making a claim against the insurance company. Anticipating this problem, ERISA provided for a control group liability concept, which, in the above example, would give the PBGC access to $90 million of the control group's net worth.

The PBGC vigorously pursued the control group concept outlined in ERISA from very early in the program. One prominent case that helped develop this policy was Ouimet Incorporated, a subsidiary of Avon Sole.

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[3] The other plan was not reinstated because it had insufficient assets to make current benefit payments.

Ouimet (Avon Sole). In 1975, Avon Sole terminated its underfunded pension plan under Title IV of ERISA. The PBGC, pursuant to Sections 4062 and 4001(b) of ERISA, as originally enacted, asserted employer liability against Avon Sole and other members of the same control group. The PBGC's position was that the term *employer* for purposes of employer liability included not only the direct employer of employees covered under the plan but also all trades or businesses under common control of such direct employer.[4]

The bankruptcy court, on March 13, 1977, ruled that only Avon Sole was liable and the other members of the control group were not liable. The PBGC appealed the decision to the district court.[5] The district court reversed the bankruptcy court, holding that Section 4001(b) defines the "employer" for purposes of determining Section 4062 liability and thus "the PBGC may impose liability on each member of a controlled group, whether or not such member contributed to the terminated pension plan."[6] The case went through various appeals, and the PBGC's position was sustained.

International Harvester–Wisconsin Steel. Another way a firm can evade the control test is to sell an about-to-fail division or subsidiary before the division or subsidiary terminates an insufficient plan. Generally, the parent company's net worth would be sufficient to pay off the plan asset insufficiency if plan termination occurred prior to the sale. After the sale, employer liability of the division or subsidiary alone is less likely to be sufficient to offset the underfunding. Thus, after the sale, a greater portion of the underfunding would be transferred to the PBGC. A situation that illustrates the potential of such transfers is the 1977 sale by International Harvester (now known as Navistar) of its Wisconsin Steel Division to subsidiaries of Envirodyne, Inc.

Prior to the sale, Wisconsin Steel had been an unprofitable, capital-intensive operation. To make Wisconsin Steel viable, International Harvester reportedly determined that a large investment was needed. It was unwilling to make that investment. If, however, it were to close Wisconsin Steel and terminate the pension plan, it would be faced with unfunded pension benefits estimated to be $86 million. Instead, the division was sold.

At the time of the sale, Envirodyne was a small, unprofitable company with no experience in steelmaking. It had a net worth of only

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[4] *Common control* is a tax term and generally requires the same individual or company to own at least 80 percent of outstanding stock or five or fewer owners to hold 80 percent of two or more entities.

[5] *Pension Benefit Guaranty Corporation and United Rubber Workers, et. al.* v. *Ouimet Corporation, Avon Sole Company, et. al.*, 470 F. Supp. 945 (Mass., March 22, 1979).

[6] Ibid., at 954.

$8.5 million. Most of the sale price was financed by notes to International Harvester that were secured by assets of Wisconsin Steel.

In 1980, after Envirodyne defaulted on its note payments, International Harvester seized the assets it held as collateral, thereby triggering Wisconsin Steel's bankruptcy and the termination of its pension plans. Total underfunding of guaranteed benefits in these plans amounted to $55 million.

The PBGC filed employer liability claims against International Harvester as well as Envirodyne. The PBGC held that International Harvester continued to exercise substantial control over Wisconsin Steel and its pension plans following the sale, thus making it an employer maintaining the plan at the time of termination and therefore liable for the unfunded plan benefits. In addition, the PBGC maintained that the principal purpose of the sale was to shift the pension liabilities to the PBGC, which is contrary to the intent of ERISA. As of fall 1988, this case was still pending.

MAXIMUM GUARANTEED BENEFITS

Actuarial Reduction of Maximum Benefits

ERISA constrains the guaranteed monthly benefit. The maximum for a single life annuity at age 65 was $1,909 in 1988. For earlier retirement ages, the maximum is actuarially reduced as shown in column 1 of Table 5–2 (column 2 is discussed below). Except for the five-year phase-in rule, the application of a maximum benefit is virtually the only aspect of ERISA that constrains the benefit guarantees across plans.

Though the maximum is set at relatively high levels for age-65 retirees, the application of an actuarial reduction factor to the maximum may have some significant impact on plans that either have early normal retirement ages or permit retirement with full benefits at very early retirement ages on a plant shutdown. The actuarial reduction, however, establishes much more important principles on which reform can be built: that benefit guarantees should be stated in terms of a common retirement age and benefits collected prior to this age should be reduced for all earlier ages of retirement.

The effectiveness of the guarantee level can be seen in Table 5–3. In 1978, the Department of Labor conducted a survey of pension benefits collected by new retirees in 1977 and 1978. I updated the pension amounts to 1988 dollars using the Bureau of Labor Statistics nonagricultural wage index.

Overall, the average first-year benefit collected by the 1977–78 retiree cohorts was $6,255 in 1988 dollars; the median was $4,505. The

TABLE 5–2 Maximum Benefits for Single Life Annuity, 1988

Age	*Maximum Monthly Benefit: Existing Law (1)*	*Supplemented by Age-65 Full Benefits Limitation* (2)*
65	$1,909	$1,909
64	1,775	1,650
63	1,641	1,410
62	1,508	1,191
61	1,374	988
60	1,240	805
59	1,164	709
58	1,088	620
57	1,011	535
56	935	457
55	859	376
54	820	352
53	782	320
52	744	289
51	706	261
50	668	233
49	630	207
48	591	182

* Numbers in this column assume that amounts in the previous column are payable in full at age 65 and thus subject to actuarial reduction if taken at the age shown in the table. Thus, if a 55-year-old worker was entitled to a full benefit of $859 starting immediately, he would be entitled to only $376 under a rule whereby the full benefit was available only at age 65 and was subject to actuarial reduction on earlier receipt.

TABLE 5–3 Distribution of Retirement Benefits

		Age of Retirement		
Annual Pension	*All*	*Less than 55*	*55–59*	*65*
Less than $4,250	47%	39%	47%	54%
$4,250–6,800	19	22	15	20
$6,800–10,200	16	13	14	13
$10,200–17,000	14	25	20	9
More than $17,000	4	1	4	4
Median	$4,505	$5,320	$ 4,775	$ 3,890
Mean	6,255	6,870	6,495	5,440
Maximum guaranty	—	8,930*	11,810†	22,908

Note: Numbers in table depict distribution of first-year retirees in 1977 and 1978. Pension amount categories have been adjusted to 1988 dollars using the Bureau of Labor Statistics nonagricultural wage index.

* Assumes retirement occurs at age 52.

† Assumes retirement occurs at age 57.

SOURCE: David McCarthy, *Findings from the Survey of Private Pension Benefit Amounts*, U.S. Department of Labor, Office of Pension and Welfare Benefits Programs, 1985, p. 22.

more interesting data, however, are the distributions of benefits across different ages of retirement.

Those retiring at age 65 had a mean annual benefit of $5,440. The maximum annual benefit for a single benefit annuity is $22,908, over 300 percent higher than the mean. Thus, the maximum is constraining for very few highly paid individuals at retirement age 65. Only 4 percent of those retiring at age 65 have pension benefits greater than $17,000 per year. The maximum, however, presents a more meaningful constraint at earlier ages.

For workers retiring between the ages of 55 and 59, the maximum guaranteed annual benefit is between $10,300 and $13,900. Almost one fourth of all retirees over this age range collect benefits in excess of $10,200 per year. For ages 48 to 54, the maximum benefit range is $7,090 to $9,840; almost 40 percent of workers who retire before age 55 (including special early retirements, such as those involved in shutdowns) have pensions in excess of $6,800 per year. Thus, the actuarial reduction of the maximum benefit amount in 1976 apparently has had an impact on a significant portion of the insured population.[7]

Alternate Approach to Maximum Guaranty

Though the full actuarial reduction of the maximum guaranteed benefit does reduce PBGC exposure, the PBGC could have written its benefit guarantee regulations to have a much more dramatic impact on the program's solvency. In particular, early in the program the PBGC decided, through regulation, to interpret ERISA to pay full pension benefits regardless of the age of first receipt. If, for example, full benefits are available in the plan at age 55, the guarantee covers this amount, subject to the maximum amount in column 1 of Table 5–2. If full benefits are available at, say, ages 45 or 50 in the case of a plant shutdown, these too are guaranteed, subject to the same maximum benefit schedule.

An alternative structure consistent with the small, flat premium set by Congress would have been to establish a common normal retirement age for purposes of paying the guarantee. Suppose the social security normal retirement age of 65 was chosen. All full benefits would be payable by the PBGC at age 65, regardless of the plan provisions, actuarially reduced to age of first receipt. The $1,909 maximum in 1988 would remain as the maximum benefit payable at age 65, and thus the schedule in Table 5–2, column 1, would still be binding. But before applying this constraint, all full benefits would be actuarially reduced from age 65.

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[7] The reduction was permitted by ERISA. But presumably, the PBGC could have interpreted the provision much more liberally than it chose to.

For example, suppose a worker aged 55 was entitled to full monthly benefits equal to $859, which is exactly the maximum benefit amount guaranteed at age 55 under the current PBGC insurance system (see Table 5–2). Thus, if a termination occurred, the PBGC would pay $859 to this worker starting at age 55.

Under an alternative age-65 guarantee rule, the $859 would be payable at age 65, not age 55. That is, even though the plan provided for full benefits at age 55, the guarantee could be redefined to begin at age 65; that is, $859 would be payable at age 65. The worker could still choose to collect benefits at age 55, but, in this case, benefits would be actuarially reduced. For example, if $859 represented full benefits at age 65, then the actuarially reduced amount payable on an age-55 receipt would be $376. In an age-65 guarantee rule, plans that permitted full benefits prior to age 65 would receive the same benefits as retirees from plans that paid full benefits at age 65.[8]

For illustration, a schedule of maximum payments implied by this approach is shown in column 2 of Table 5–2 under the assumption that a worker was entitled to a full benefit exactly equal to the benefit listed in column 1 at the corresponding ages. Thus, the individual previously entitled to a full benefit of $859 at age 55 would be subject to a maximum of $376 under an age-65 normal retirement rule.

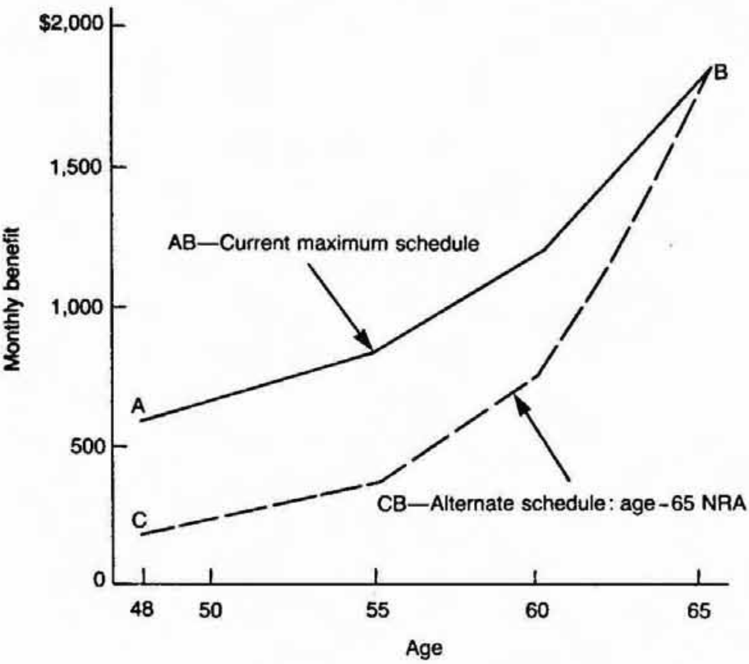
The impact of this alternative rule on maximum allowable benefits at various ages is shown visually in Figure 5–1. The numbers depicted by schedule AB are the maximum benefits for various ages currently enforced by the PBGC. The numbers depicted by schedule CB represent the implied maximums resulting from enforcement of a rule setting all normal retirement ages to 65 for purposes of paying guaranteed benefits. We will return to a discussion of this alternative concept in Chapter 10.

Costs of Special Early Benefits

The cost implications of the current PBGC policy of paying unreduced and subsidized benefits prior to age 65 are significant. For example, it is not uncommon for a "rule of 65" to prevail in the event of a plant shutdown: as long as a worker is at least 45 years old with 20 years' service, he is entitled to unreduced benefits commencing immediately. In 1983, the PBGC conducted a study of 18 large terminations that occurred through 1981. The results of the study were contained in a report entitled *Cost of Supplemental Early Retirement Benefits*.

[8] In general, benefits collectible by the worker according to his plan's provisions would be adjusted to age 65 using the firm's actuarial rates, then rediscounted back using PBGC actuarial rates. This puts all firms on the same basis, regardless of the subsidy that may be implicit at early retirement.

FIGURE 5–1 Maximum Benefits Alternatives



The study calculated the extra liabilities created by providing (1) unreduced full benefits prior to the plan's normal retirement age (this included, for example, the cost of "30-and-out" provisions, which award full benefits as early as age 55); (2) unreduced benefits in the event of plan shutdown (for example, the "rule of 65" cited above); and (3) special supplements to early benefits paid until the normal retirement age (these are often paid until age 62, when social security benefits are available). Benefits actually collected were compared against those payable at the earliest retirement age in the plan, using an actuarial discount factor from the normal retirement age. The normal retirement age in most of these plans was 65.

The study did not calculate the cost imposed by partially subsidized early retirement, only the full benefits available prior to normal retirement age. Nor did the study count extra shutdown payments made to workers prior to the termination as claims costs. It counted only the future flow of these payments as claims costs, even though past payments clearly deteriorated the plan's funding condition.

The results are summarized in Table 5–4. Despite the maximum benefit schedule, special early retirement provisions amounted to 18.4

TABLE 5–4 Costs of Supplemental Early Retirement (SER)

			Percent of	
Industry	*Plans*	*Costs of SER (millions)*	*Guaranteed Benefits*	*Claims*
Auto	3	$ .8	5.8%	7.4%
Steel	7	36.2	21.2	28.6
Rubber	4	3.8	11.1	14.6
Cement	2	6.1	21.3	32.3
Glass	2	.2	6.9	8.2
Total	18	$47.1	18.4%	24.9%

Note: Numbers reflect shutdown benefits, unreduced benefits payable prior to normal retirement age, and special supplements payable prior to normal retirement age. They do not include subsidized early retirement benefits or funding deterioration attributable to payment of shutdown benefits prior to termination.

SOURCE: *Cost of Supplemental Early Retirement Benefits*, unpublished PBGC report, 1983.

percent of guaranteed benefit liabilities and 24.9 percent of claims in the sample. This experience suggests PBGC claims could be reduced significantly if either (1) all special early benefits were not guaranteed (that is, all benefits were rediscounted as of some common normal retirement age) or (2) the maximum benefit schedule were sharply reduced. (Data discussed in Chapter 7 suggest that the cost impact of special early benefits has increased significantly since the 1983 study was completed.)

LEGISLATIVE EFFORTS

Three important pieces of legislation after ERISA have worked to reduce the scope of the problems that have emerged in the insurance program: the Single-Employer Pension Plan Amendments Act of 1986 (SEPPAA), the Multiemployer Pension Plan Amendments Act of 1980 (MPPAA), and the Pension Protection Act of 1987.

SEPPAA

At the time ERISA was enacted, any firm—regardless of its financial viability—could exchange its pension plan underfunding for 30 percent of its net worth. Thus, the insurable event was not firm failure or even evidence of firm difficulty. This option became known as *the pension put*. That is, a firm could "put" its underfunded obligation to the PBGC in exchange for 30 percent of its net worth anytime it was advantageous to do so.

SEPPAA redefined the insurable event.[9] A firm could terminate its insufficient pension plan and make a claim against the PBGC in one of four situations: if the firm (1) files for bankruptcy under Chapter 11 of the bankruptcy code (which permits reorganization of the firm as an ongoing entity), and the court approves the termination; (2) files under Chapter 7 of the bankruptcy code (which is essentially a liquidation proceeding); (3) demonstrates that it cannot pay debts and continue in business *unless* the plan is terminated (which means the firm will enter bankruptcy without a PBGC transfer); or (4) demonstrates to the PBGC that its pension costs are "unreasonably burdensome" due solely to a decline in employment covered by a plan.[10] In addition, the 30 percent net worth limitation was increased.[11] In short, the pension put was replaced by a distress criterion: PBGC claims would be valuable only to firms in financial difficulty, thus eliminating the opportunity for gaming by essentially healthy firms.

SEPPAA may have had significant impact on a few large, potential claims by firms that could have taken advantage of the 30 percent net worth limitation. More important, SEPPAA represents the first attempt to constrain the insurable event. Though somewhat vague in its criteria (notably the last two), the law at least tried to limit the insurable event to firms experiencing significant financial difficulties.

As a practical matter, however, it is not obvious that SEPPAA had an important effect on the insurance program. For example, recall from Table 3–2 that of the 12 largest claims paid by the PBGC, fully 10 were in bankruptcy proceedings, and the remaining two (Rath Packing and Allis-Chalmers) might conceivably have qualified under the remaining conditions.[12]

In its 1985 exposure estimates, the PBGC identified firms with at least a $5 million potential claim against the PBGC that could have profited from the pension put; that is, these firms had unfunded pension liabilities exceeding 30 percent of net worth. Of the eight firms identified, seven were already on the very-high-risk list and one was on

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[9] Technically, the insurable event was still termination of the pension plan, but the *conditions* required to qualify for a PBGC transfer were changed.

[10] Aside from rules covering terminations instituted by the plan sponsor, the PBGC itself is required to involuntarily terminate a plan where plan assets are not available to pay benefits currently due.

[11] In particular, when the 30 percent rule was limiting, the PBGC was entitled to make an additional claim for up to 75 percent of the underfunded amount. Thus, if underfunding was 100 and net worth 30, pre-SEPPAA rules constrained the PBGC claim to 9, or 30 percent of 30. SEPPAA permitted an additional claim in the amount of 68 or a total of 77 percent of 100. The Pension Protection Act of 1987 increased the PBGC's claim to 100 percent of underfunding.

[12] In fact, because Allis-Chalmers essentially had no assets to pay benefits, the PBGC would have been required to involuntarily terminate the plan. See ibid.

the moderate-risk list. Most large firms for which the put option is valuable are in distress, according to measures of firm viability.

MPPAA

Though this book is confined to evaluation of the single-employer insurance program, it is instructive to consider rules that apply to a parallel (but different) program covering multiemployer plans. Provisions in the latter suggest useful reforms for the single-employer program.

Multiemployer plans usually cover union workers in a common pension plan administered by the union and contributing firms. Each employer is responsible for making contributions to the plan each period (usually x number of dollars per hour of each worker's time at that firm). These plans are popular in the construction, trucking, mining, and textile industries.

Until 1980, ERISA provided guaranteed benefits to multiemployer plans at the discretion of the PBGC (though these plans were required to pay premiums). MPPAA instituted mandatory guarantees for these plans and established special rules under which this insurance would apply. The premium for multiemployer plans was only $2.20 per participant in 1988 (increasing to $2.60 in September 1988), and the system is currently showing a surplus.

Several MPPAA provisions are worthy of attention in comparison to single-employer insurance. First, MPPAA incorporates a control group notion that goes beyond individual firms: it requires a type of self-insurance scheme among all contributors to a common multiemployer plan. To illustrate, suppose five trucking firms in a particular area form a multiemployer plan for the members of the Teamsters that they employ. Suppose all firms are the same size, and the plan is underfunded by $20 million. If one firm withdraws from the plan, it carries with it a $4 million liability, its share of the group obligation (a so-called withdrawal liability). If one firm fails, the PBGC does not assume the $4 million liability: it merely passes to the remaining four firms in the plan. As a practical matter, a large portion of participating firms must fail before the PBGC is required to pay benefits. In addition, firms generally are liable to the plan for the entire amount of the underfunding.

Second, the maximum benefit is less generous for multiemployer plans. The PBGC insures benefits up to $16.75 per month per year of service to multiemployer retirees, independent of the age of retirement (the amount is unindexed). Shutdown and other special early retirements are rare events in multiemployer plans, and thus, age 55 is usually the earliest retirement age. With 35 years of service, the maximum benefit a 55-year-old retiree could collect from the PBGC in

1988 is $586, one third less than the $859 in single plans. For 65-year-old retirees, the multiemployer guaranty for a worker with 45 years' service is only 40 percent of the maximum guaranty for single plans.

In addition, instead of having a five-year phase-in for increased benefits, MPPAA establishes five-year cliff vesting. No benefit increases within five years of termination are guaranteed. This substantially reduces the PBGC obligation. In addition, because virtually all multiemployer plans pay flat benefits (x dollars per year of service, instead of percent times service times wage), this guarantees five years of inflation erosion in benefit payments. Not only does this discourage moral hazard (increasing benefits prior to termination), it guarantees a substantial coinsurance payment by workers. The lower guarantee levels and the stricter phase-in rules in multiemployer plans provide a model for our discussion of a basic benefits reform package in Chapter 10.

Pension Protection Act

On December 22, 1987, as part of the 1987 Omnibus Budget Reconciliation Act, the Pension Protection Act was enacted into law. This probably was the most significant piece of single-employer reform legislation during the post-ERISA period. Spurred by the growing deficit at the PBGC and the clear inadequacy of current rules to keep claims consistent with prevailing premium levels, Congress instituted new rules for federal pension insurance dealing with virtually every aspect of the insurance program.

Some of the reforms were more binding than others on current practices, but the package erected a framework that, with further modifications, could lead to a solvent pension insurance program in the long run. In this chapter, I highlight only the major provisions of the law. Chapters 6 through 8 will consider these reforms in more detail. Table 5–5 lists the major reform provisions discussed below.

Pricing. The legislation abandoned a flat one-price policy and instead instituted a two-part premium structure. The first part is a flat charge (increased from $8.50 to $16). The second part is composed of a $6 assessment against each $1,000 of underfunding in the pension plan. While the new price structure represents an important step in the right direction, it is far from a private market price scheme. The risk of default is not incorporated, and, more important, the premium is limited by a maximum of $50. Chapter 6 will demonstrate that the new price structure still incorporates large subsidies to many firms.

Benefits. The new law leaves intact the current policy to pay full benefits at any age, including, for example, ages less than 50 in the event of shutdowns. But it has a provision that prevents plans from awarding increases in benefits without posting security if the plan is

TABLE 5–5 Major Provisions of the Pension Protection Act

Issue	*Reform*
Pricing	Premiums related to underfunding, limited by unindexed maximum of $50
Funding	Reduced amortization periods
Benefits	No increase in (flat) benefits without posting security if funding ratio is less than 60 percent
Insurable event	Chapter 11 distress test requires the bankruptcy court to find that without termination, the plan sponsor will not be able to complete Chapter 11 reorganization
Liens	Liens arise if certain minimum contributions are not made
Waivers	Number reduced from five to three in any 15 years

Note: A more extensive list of the act's provisions is given in Appendix E to the book.

less than 60 percent funded. This is the first time since ERISA that reform has addressed benefit levels.[13] As we will later show, however, because the funding floor is set in terms of termination benefits, the rule might be circumvented in periods when interest rates increase, later leaving large additional underfunding in the event of subsequent decreases in interest rates.

Insurable event. Congress declined to eliminate Chapter 11 as one of the four distress tests under SEPPAA. Doing so would have left Chapter 7 (dissolution) as the only trigger for termination in bankruptcy. Instead, the new law "blends" the first and third distress tests under SEPPAA (see page 81). That is, it permits Chapter 11 (reorganization) terminations but requires the bankruptcy court to find that if the plan is not terminated, the sponsoring company will not be able to complete Chapter 11 reorganization.

Given the subjective nature of the new provision, this requirement may not constrain the Chapter 11 proceeding in a substantial way. If nothing else, however, it lays the groundwork for potentially more constraining legislation in some future period (for example, restriction of the insurable event to Chapter 7 of the bankruptcy code).

Liens and waivers. The new legislation made two changes that, in principle, addressed the pre-claim defunding process. (This phenomenon is addressed in detail in Chapter 7.) The legislation retains the Internal Revenue Service waiver process but reduces the number of permissible waivers from five to three in each 15 years. This would have reduced the claims of some past claimants (for example, Rath

[13] Arguably, the genesis for this provision is found in Section 4243(d) of MPPAA, which triggers stricter funding rules if benefits are increased in seriously underfunded multiemployer plans.

Packing—see Table 4–4). In general, because pre-SEPPAA waivers were not reported to the PBGC, no database is available to measure the importance of this reform. It is unlikely, however, that the typical large claim had more than three waivers prior to termination.

A potentially more important reform is the creation of a lien potential anytime a minimum contribution beyond a certain threshold is not paid on time (except in the case of waivers).[14] As will be shown in Chapter 7, the problem of unpaid contributions is large. The solution's shortcoming is that in order for the lien to be fully effective, the PBGC or a party designated by the PBGC must "perfect" the lien.

Because the firm and creditors know of this possibility in advance, they might be expected to game this reform by "liening up" all available assets before the PBGC can take action. This reaction is not far-fetched, given that other creditors may well discern the firm's troubled status before the PBGC does and will have strong incentives to act as soon as a required contribution is not made.

Funding. The new funding standards are, by far, the most significant changes imposed by the new law. The funding provisions do not go into effect until 1989 and effectively give a five-year exemption to firms in the steel industry. Further, while the law reduces the amortization period for past service credit substantially, the period for existing underfunding in 1988 is reduced only from 30 to 18 years. (How past service credits create underfunding is discussed in Chapter 7.) These transitional rules suggest substantial underfunding may well be retained in the system for at least a decade.

The longer-term prognosis is better. For example, for underfunded plans, future past service credits are amortized over much shorter periods (see Chapter 8). Shutdown benefits, once triggered, are amortized over no more than 7 (instead of the current 15) years. Waivers are amortized over 5 (instead of 15) years, and experience and actuarial gains and losses over 5 and 10 (instead of 15) years. These new rules hold significant potential for reducing underfunding in the pension system. It will be shown later, however, that although the new restrictions will likely increase average funding for the worse-funded plans, the new system does not necessarily prevent rapid defunding prior to termination.

CONCLUSION

Though Congress and the PBGC have violated many insurance principles during the short history of the pension insurance program, and amassed a large deficit as a result, they have taken some significant

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[14] The size threshold is met when unpaid contributions amount to $1 million.

steps toward correcting the problem. The value of the pension put has been reduced significantly, and the gaming potential in general has been reduced through a strong emphasis on retaining workers as coinsurers and treating groups of related firms as single entities. Some progress has been made toward narrowing the gap between the benefits and costs of the insurance system.

Nevertheless, the cross-subsidies remaining in the insurance system are great, and moral hazard potential is still sizable. No private insurance firm would willingly operate the pension insurance system under the current inadequate, albeit reformed, rules and prices. The next two chapters will attempt to quantify the nature of the two largest problems in the system—inappropriate prices and inadequate funding provisions—and to discuss the impact of the 1987 legislation in more detail.

APPENDIX
Excerpt from Opinion Letter 81–11—Follow-On Plans

"The termination insurance program of Title IV was not intended to subsidize an employer's ongoing retirement program. Accordingly, we believe that a purported termination of one plan, contrived in concert with the establishment of new retirement arrangements which are designed to provide substantially the same benefits for the future, should not be treated as a termination within the statutory contemplation so as to require the payment of PBGC guarantees.

"If PBGC guarantees were to be paid under such circumstances, then any company whose unfunded liabilities under a defined benefit pension plan exceed 30 percent of its net worth could find it advantageous to establish similar arrangements to secure PBGC's payment of the major portion of its costs of an ongoing retirement program. Such a result would have extremely adverse cost consequences for this insurance system.

"Our review of available data for major corporations whose pension liabilities are reported by Standard & Poor's Compustat service has readily identified over 20 very large firms whose unfunded pension liabilities substantially exceed 30 percent of their net worth, and whose financial difficulties would undoubtedly make tempting the adoption of arrangements similar to those you are proposing. The combined unfunded pension liabilities of those plans which have been thus identified is approximately \$6 billion, and PBGC's potential exposure if they were to terminate, based upon net worth estimates, is some \$4.1 billion. Thus, the consequences of our acceptance of the type of proposal you are advancing could be either a huge shift of pension costs to PBGC's premium payers, or the total collapse of the insurance system.

"We do not believe the statute should be read so narrowly as to require PBGC to accept a result so patently at odds with the legislative purpose—which is, after all, to protect the pension expectations of individual retirees and workers, not to provide bail-outs for financially pressed firms—and so inimical to this program's continuing viability.

"For example, Section 4047 of ERISA, 29 U.S.C. 1347, provides PBGC with express authority to limit plan terminations. That section states in pertinent part:

> Whenever the corporation determines that a plan which is to be terminated, or which is in the process of being terminated, under this subtitle, should not be terminated *as a result of such circumstances as the corporation determines to be relevant*, the corporation is authorized to cease any activities undertaken to terminate the plan, and to take whatever action is necessary and within its power to restore the plan to its status prior to the determination that the plan was to be terminated. [emphasis added]

"The breadth of this provision is further reflected in its additional grant of authority to PBGC to restore to its pretermination status, a plan whose termination has already been completed. In addition, under Section 4048 of ERISA, 29 U.S.C. 1348, there is no date of plan termination unless one is agreed to by PBGC (or established by a court)."