JAMES A. WOOTEN

THE TOBIN PROJECT

DISCUSSION PAPER

A Better Way to Promote Solvency in Defined-Benefit Pension Plans

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Jim Wooten is a Professor of Law at Buffalo Law School, State University of New York and Chair of the Tobin Project Retirement Security Working Group.

Over the last three decades private-sector defined-benefit [DB] pension plans in the United States have experienced a marked, even precipitous, decline. Many lawmakers, stakeholders, and scholars have rallied to the defense of DB plans, while more than a few analysts have predicted their demise. Whether private DB plans survive or disappear, they will create financial risk for the Pension Benefit Guaranty Corporation [PBGC] for decades to come. If the PBGC fails, there is every reason to believe taxpayers will pick up the tab for obligations the PBGC guarantees but cannot pay. This potential liability could amount to tens or even hundreds of billions of dollars. Whatever the future holds, the substantial risk of taxpayer liability underscores the need for Congress to devise effective laws for promoting the solvency of DB plans. Since the enactment of the Employee Retirement Income Security Act of 1974 [ERISA], the principal tool for promoting DB solvency has been command-and-control regulation of pension contributions. This essay explains why ERISA's solvency regime has failed to achieve its regulatory purpose and outlines an alternative regulatory strategy that holds greater promise.

To understand why private DB plans—in particular, collectively-bargained single-employer plans—are persistently underfunded, it helps to look at funding practices before Congress passed ERISA. Before ERISA, employees had a strong incentive to care about solvency because they suffered the entire loss if their plan could not meet its obligations. Nonetheless, virtually all collectively-bargained single-employer plans were significantly underfunded before Congress passed ERISA.[1] Far from being the product of fraud or malfeasance, the underfunding in these plans was a reasonable response to the broader economic constraints on collective bargaining.

1 See James A. Wooten, *The Employee Retirement Income Security Act of 1974: A Political History* (Berkeley: University of California Press/Milbank Memorial Fund/Employee Benefit Research Institute, 2004), 67–69, 141; Steven A. Sass, *The Promise of Private Pensions: The First Hundred Years* (Cambridge, Mass.: Harvard University Press, 1997), 183–86.

THE TOBIN PROJECT

One Mifflin Place, Suite 240
Cambridge, MA 02138

t (617) 547-2600
f (617) 547-2601

www.tobinproject.org

Employers do not have unlimited funds to spend on compensation.[2] For this reason, employers and employees face trade-offs between current compensation, such as wages and employee benefits, and deferred compensation. The more resources an employer devotes to current compensation, the less it has to pay deferred compensation. Employers and employees also face tradeoffs among the benefit levels, risks, and cost of a pension plan. For example, employer contributions that are set aside to secure future pensions could have been used to pay higher benefits to retirees today. Before ERISA, union representatives generally sought to bargain relatively liberal pension benefits because larger pensions encouraged older workers to retire. To rapidly fund liberal pensions, an employer must make large contributions to its pension plan. Unions agreed to slower funding of pensions for future retirees because this allowed employers to pay higher wages and benefits to current workers and higher pensions to current retirees. But as the notorious Studebaker case showed, slower funding created the risk that a plan would default on its obligations.

In passing ERISA, Congress meant to protect employees from default risk. To this end, Title IV of ERISA establishes an insurance program that shifts most of the default risk of an underfunded plan to the PBGC. The insurance program also creates "moral hazard." Moral hazard refers to the possibility that the availability of insurance will cause changes in conduct that increase the losses an insurer must pay. ERISA creates moral hazard in two ways. First, by shifting default risk from plan participants to the PBGC, ERISA reduces the incentive for employees to demand adequate funding. This creates downward pressure on pension assets, which increases the shortfall when plans default. Second, when a plan defaults, the PBGC insures participants based on what their plan promised, rather than what their employer reasonably could afford. This gives employees an incentive to push their employer to make extravagant promises. The result is upward pressure on pension liabilities, which also increases the shortfall PBGC must insure when it takes over a plan.

In passing ERISA, Congress meant to protect employees from default risk. To this end, Title IV of ERISA establishes an insurance program that shifts most of the default risk of an underfunded plan to the PBGC. The insurance program also creates "moral hazard."

ERISA's drafters perceived the threat that moral hazard posed to the PBGC. They sought to counter this threat by creating minimum funding standards that force (or purport to force) employers to fund pension obligations in advance. The funding regime has done a poor job of promoting solvency, however, because it is virtually impossible to draft contribution mandates that are both *feasible* for plan sponsors and *enforceable* for regulators.[3]

ERISA's minimum funding standards create affirmative obligations: they force employers to make pension contributions. Because ERISA obliges employers to act, lawmakers rightly worry about whether it will be feasible for employers to do what the standards demand. This concern with feasibility manifests itself in a variety of provisions that smooth an employer's contribution obligations or grant flexibility in

2 See generally Wooten, *ERISA: A Political History*, 52–61.

3 On tradeoffs between feasibility and enforceability, see generally Colin S. Diver, "The Optimal Precision of Administrative Rules," 93 *Yale L. J.* 65, 70-71 (1983); Stephen Breyer, *Regulation and Its Reform* (Cambridge, Mass.: Harvard University Press, 1982), 263–65, 267–69.

the timing or amount of contributions. Moral hazard highlights the problem of enforceability. The federal guaranty of pension obligations creates a conflict between the goals of ERISA's solvency regime and the interests of the entities ERISA regulates. When the targets of regulation have interests that conflict with regulatory goals, regulation is unlikely to be effective unless it is so constraining that the targets cannot act in a manner that undermines the regulatory purposes.

The result is a sharp conflict between the feasibility and enforceability of ERISA's solvency regime. If the minimum funding standards are to fulfill their regulatory purpose, they must prevent employers and employees from acting on the incentives the insurance program creates. This requires regulations that dictate contributions on the basis of mechanical calculations that give sponsors little capacity to plan and little discretion in the timing or amount of contributions. Unfortunately, the sort of mechanical rules that will make the funding standards more enforceable will be less feasible for sponsors because contribution obligations will become more volatile (unless a plan immunizes its obligations) or because contribution obligations will increase (if a plan immunizes its obligations). In sum, reforms that make ERISA's funding standards more enforceable will produce greater contribution volatility or higher contribution obligations, which will make it less feasible for employers to sponsor DB plans, while reforms that make contribution obligations less volatile and give plan sponsors more flexibility will compromise enforceability by giving employers and unions more opportunities to engage in practices that undermine plan solvency and the PBGC.

A better approach to promoting solvency would give a larger role to regulations that address the *liability* side of the pension balance-sheet. In particular, Congress should place greater reliance on rules that restrict benefit increases by underfunded plans. Unlike ERISA's minimum funding standards, rules that restrict benefit increases do not create affirmative obligations. Benefit restrictions do not oblige an employer to do anything; they tell the sponsor what it may not do—increase benefits when a plan is poorly funded. Because benefit restrictions do not force sponsors to perform affirmative acts, there is no need for concern that the rules will create infeasible obligations. In other words, statutory restrictions on benefit increases do not create a conflict between feasibility and enforceability.

A better approach to promoting solvency would be to give a larger role to regulations that address the liability *side of the pension balance-sheet. In particular, Congress should place greater reliance on rules that restrict benefit increases by underfunded plans.*

Because benefit restrictions do not raise feasibility concerns, they can be applied using simple, relatively transparent calculations. For example, asset and liability values under a benefit restriction can be calculated on a marked-to-market basis. In addition, the absence of feasibility concerns allows a benefit restriction to take account of considerations that cannot be used to calculate contribution obligations. For example, although employers with poor credit ratings pose a significant risk to the PBGC, a regulation that ramped up their contribution obligations might harm the PBGC by pushing weak firms into bankruptcy.[4] Using credit ratings in the

4 See the criticisms of the Bush Administration's proposal to link contribution obligations to credit ratings in House Ways and Means Committee, *President's Proposal for Single-Employer Pension Funding Reform: Hearing before the Committee on Ways and Means*, 109th Cong., 1st sess. (2005), 50, 76, 100–101.

application of benefit restrictions creates no such problem. Indeed, a rule that prevented weak firms from increasing pension benefits when they had not funded their existing obligations would make it harder for such firms to overextend themselves.

Enactment of more stringent benefit restrictions also would improve incentives for funding. Under current law, employees have little reason to care about pension funding because the PBGC pays benefits if their plan does not. If ERISA prevented employers from increasing benefit levels unless a plan had attained a high level of solvency, employees would have a direct incentive to care about funding. Giving employees a reason to care about funding is bound to have a salutary effect on the solvency level of pension plans.

Another advantage of greater reliance on benefit limitations is that it will address solvency issues before "the horse is out of the barn." Even after passage of the Pension Protection Act of 2006, ERISA allows a sponsor to increase benefit levels when it has not demonstrated that it can afford the promises it has already made. Experience has shown that if sponsors can overextend themselves, some will do so. By the time funding problems emerge, however, "the horse is out of the barn" in the sense that the sponsor has "overpromised" to such an extent that it is or can plausibly claim to be unable to meet its statutory contribution obligations. Because the PBGC faces potential liability for these benefit promises, Congress looks for ways to help overextended firms fund their way out of their difficulties. This commonly involves granting special treatment to overburdened employers or industries, which undermines the credibility of the funding regime. Clear, strict benefit restrictions could stop firms from overpromising in the first place.

Finally, the current funding regime mandates conduct that lawmakers hope will promote solvency. To draft effective standards, lawmakers must figure out what actions by employers will produce the result that Congress desires. Yet pension funding is extraordinarily complex. Actuaries, accountants, and financial economists disagree about the nature and value of pension obligations and how best to finance those obligations.[5] When experts disagree, it seems very unlikely that legislators will be able to divine the particular course of conduct that best promotes solvency. Greater reliance on benefit limitations would not require lawmakers to resolve issues on which experts disagree. Rather than prescribing actions that employers must undertake, benefit restrictions set a target or outcome that a plan must achieve before the employer may increase benefits. If the plan meets the target, the employer may do so. If the plan does not meet the target, the employer may not. Reliance on benefit restrictions allows lawmakers to define a target and leaves it to the experts to determine how best to reach that target.

5 See the papers presented at the symposium on the Great Controversy: Current Pension Actuarial Practice in Light of Financial Economics, available at http://66.216.104.119/library-html/m-rs04-1-tableofcontents.html.