Stopping the InSanity

ERISA is more complicated than it needs to be. Just a few basic changes to the law's components would result in what the public really wants—pensions that are adequately funded, prudently managed, and fairly taxed.

By Jeremy Gold

in Pension Funding

In the three decades that preceded the 1974 passage of the Employee Retirement Income Security Act (ERISA), actuaries and their plan sponsor clients were largely free to establish pension plan contribution budgets. The process was disciplined primarily by the professional responsibility to produce an "actuarially sound" budget. Regulatory oversight was minimal and generally related to nondiscrimination and tax issues.

The 1963 failure of the Studebaker Corp. stimulated media attention and a public outcry that culminated in the enactment of ERISA. While ERISA tightened regulation in numerous dimensions, its main thrust was to set *minimum requirements* for sponsor *contributions.* The existing actuarial process used a series of measures to rationalize the contribution process (e.g., assumptions about interest rates and the expected return on plan assets, discounting techniques that used such rates to define "actuarial liabilities," and funding methods that assigned these liabilities to various past and future years).

Complex and arcane, these methods defined the past service liability, the accrued liability under the funding method, normal costs, actuarial gains and losses, and amortizations of bases that were attributable to past service, to plan amendments, to changes in actuarial assumptions, and to annual gains and losses. Upon this foundation, ERISA built rules for acceptable funding methods, reasonable expected rates of return, and separate minimum and maximum amortization periods for past service costs, for plan amendments and assumption changes, and for gains and losses.

If you're not a pension actuary, the previous paragraph probably sounds like mumbo-jumbo. If you're a plan sponsor laboring to understand your consulting actuary, you have my sympathy.

ERISA and its primary regulators, the Internal Revenue Service (IRS) and the Department of Labor, tried to prevent repetition of the Studebaker debacle by manipulating all the dials and levers implied by the arcane paragraph above. When plans continued to fail, the newly created Pension Benefit Guaranty Corp. (PBGC) picked up much of the shortfall.

Using the actuarial dials was a mistake, a design flaw, an engineering error. What the public needed was plans that were adequately funded, prudently managed, and limited as to tax favor. What the public got was plan terminations by sponsors when the capital markets continued their poor performance through most of the decade following 1973. Then, after the beginning of the great bull market in 1982, the public observed even more plan terminations, these motivated by the opportunity to revert excess plan assets to the plan sponsors.

The public still needed plans that were adequately funded, prudently managed, and fairly taxed. In order to fix the big problems of the early 1980s, Congress added a new measure of funding sufficiency called the current liability (defined in Internal Revenue Code Sec. 412 (l)), new crippling excise taxes designed to prevent reversions to sponsors, and top-heavy rules to limit excessive tax shelters. Computing the current liability requires complex calculations based on a moving average of yields on 30-year Treasury bonds. The averaging process was designed to balance funding adequacy with smooth contribution cash flows.

The 1990s saw a powerful bull market in securities that substantially increased the ratio of pension plan assets to liabilities and resulted in contribution holidays for many overfunded defined benefit plans. The economy was so robust that the nation found itself faced with budget surpluses for as far as the eye could see—so far that in 2001 the government stopped issuing the 30-year Treasury bonds that formed the mechanical basis for the poorly designed current liability calculation.

Long-term interest rates, which had peaked in the mid-teens in the early 1980s, declined steadily. Following the bear market that began in early 2000, as interest rates declined to their lowest levels in four decades, pension plans found they had sudden and serious troubles.

For many plans, funding ratios (the market value of assets to the current liability based on benefits accrued to date) tumbled from well above 100 percent to well below. Minimum required contributions rose. Benefit security declined. Actuarial spokesmen pointed to the scarcity, and rising price, of the 30-year Treasury bond, arguing that this exacerbated the newly developed pension deficits. In 2002 and early 2003, the $8 billion surplus at the PBGC was turned into a multi-billion-dollar deficit by bankruptcies in the steel and airlines industries.

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The Ultimate Safe Harbor

At the 2002 Enrolled Actuaries Meeting, Tonya Manning and Donald Segal asked ERISA authorities to "stop the insanity." In the remainder of this article, I outline a rational replacement for the myriad and conflicting ERISA rules and regulations. My proposal offers sponsors and actuaries new freedom and simplicity inside a broad safe harbor, while it simplifies and strengthens the tools that regulators may use to meet the public's need for funding adequacy and limited tax shelter.

As Manning and Segal have documented, 29 years of ERISA have resulted in a chaotic deluge of overlapping, often contradictory, measurements and restrictions designed to regulate the funding of qualified defined benefit plans for U.S. employees. We may understand such rules as the expression of the public's interest in what otherwise would be a matter of private contracts between employers and employees. Although the public interest in these matters is legitimate, we can do the public's will in a fashion that will stop the insanity.

Public interest in the funding of private defined benefit plans comprises two issues:

- Funding should be sufficient to secure promises that have been made by employers and earned by employees—i.e., accrued benefits, measured at market values.
- Tax-deductible contributions should be limited. Such limitation may be defined in terms of the ratio of plan assets to the value of accrued benefits.

The hodgepodge of actuarial measures and jargon outlined earlier in this article, when used as regulatory controls, contribute mightily to the Manning-Segal insanity. Although these components may help the actuary rationalize the sponsor's contribution budget, the public's limited needs can be met most simply and most minimally without their use.

I propose two simple limits: a minimum (sufficiency level) below which contributions are required, and a maximum (excess level) above which contributions are prohibited. Between these levels, the public has no interest and plan funding is entirely discretionary. Actuaries may design funding schemes therein, employers may negotiate with employees and their repre-

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sentatives therein, stockholders and lenders may argue with management therein. The public doesn't care.

My proposal is the ultimate safe harbor. Within the harbor, actuaries and plan sponsors may use the hodgepodge of elemental actuarial building blocks much as a sailor uses the tiller and the positions of sails to guide a boat. As long as the boat neither runs aground nor heads out to the open sea, the Coast Guard can rest easy.

The public must choose its measures of sufficiency and excess carefully. Although setting the levels will be inherently political, the liability measure should be financially sound, transparent, and objective. Discounting the cash flows implied by benefit accruals to date at the Treasury yield curve is one way to meet these tests. Once set, the measures should be administered with minimal discretion and subjected to minimal political interference. Most of the political debate should focus on the heights of the lower (sufficient) and upper (excessive) bars, each defined in terms of the ratio of market-valued assets to the objective liability measure.

Suppose (and I really mean this as an example and not as a recommendation) that the lower bar is set at 100 percent and that any shortfall must be one-third funded currently. The shortfall has no history and no amortization schedule. If the plan is $3 million short, the sponsor must fund $1 million currently, regardless of whether the plan was underfunded or overfunded last year. There's no schedule for the other $2 million. If the plan remains underfunded next year, the sponsor must contribute one-third of the shortfall determined at that time.

I would expect PBGC premiums to be collected from all qualified plans with a basic per-capita amount for plans that are sufficiently funded and increased amounts for plans in shortfall. Shortfall plans might be further restricted from making benefit-increasing amendments.

The trade-off for the rigorous attack on poorly funded plans is the freedom offered to the great majority of well-funded plans. This combination should provide substantial incentive to sponsors to manage the asset/liability positions of their plans prudently as well as to exercise caution in granting benefit increases.

Suppose, again as an example not a recommendation, the upper bar is set at 150 percent. The sponsor of a plan that is $1 million short of this ceiling could contribute and deduct $1 million if it desired. From the public perspective, it seems to me that plans funded above the upper bar should be free to recoup such excess funding without excise taxes and without strings on the redeployment of such moneys (after payment of appropriate income taxes). Congress may want to limit this practice for companies that appear to be taking undue advantage.

The initial bar-setting process may be as technically complicated and as political as the public demands or will tolerate. Congress will be the arena for the bar-setting process; the regulatory agencies will administer what Congress devises. Congress might choose to assign authority for lower-bar issues to the Department of Labor (DOL) and the PBGC and upper-bar issues to the IRS.

An example of a technical, complicating issue that lies within the initial process: Those who share my financial economics perspective may want the lower bar to be set to recognize the nature of the plan's asset/liability mismatch. Plans invested in a liability-matching fashion might have a lower bar set at 100 percent, while poorly matched plans might face a bar set at 120 percent. Alternatively or additionally, PBGC premiums might be set to reflect the mismatch risk.

A second example: If Congress is concerned about tax losses attributable to excessive inside build-up as well as excessive contributions, it may wish to define an upper-upper bar above which reverting and taxing the funds would be mandatory. Congress might also deem it necessary to limit tax deductions for small plans that principally serve as tax shelters for owner-employees or other narrow groups.

Takeaways

I've suggested a practical response to the Manning-Segal plea for sanity. My proposal offers a broad safe harbor for actuaries and their client sponsors and simple, rigorous, minimalist tools to enable regulators to effect the public will, all dusted lightly with political judgment. The success of such a simplification scheme requires that:

- The basis for liability measurement be scientific, objective and market oriented; the thumb should be off the scale with respect to measurement.
- Setting the levels of the lower and upper bars should be as simple as possible, but no more so.

Looking beyond the immediate and practical, I hope that the inner harbor will provide substantial room for pension actuarial science to evolve, free of much of the regulation that has stunted its growth over the past three decades. ●

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