

Recent Pension Legislation in the United States  
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As I am sure you are aware, last week President George W. Bush signed the Pension Protection Act of 2006 [PPA], which he and others have called the most important legislation affecting private-sector retirement plans in the United States since the enactment of the Employee Retirement Income Security Act of 1974 [ERISA]. The PPA is the product of a long and contentious process of legislative deliberation. The Senate passed pension reform legislation in November of 2005. The House of Representatives passed a bill in December. Because the two bills contained some differing provisions, a conference committee made up of House and Senate members was formed in March 2006 to compromise the differences. Bargaining over the legislation turned out to be very contentious, so the committee's work dragged on for almost five months. The committee announced and failed to meet three deadlines for completing the legislation and appeared to be on the verge of quitting in late July. At that point, the Republican leadership of the House and Senate took the unusual step of circumventing the conference committee. On July 28, a new bill that included provisions the members of the conference committee had agreed upon was offered in the House of Representatives. The House passed the bill the same day. The Senate approved the bill on August 3.<sup>1</sup> President Bush signed the legislation on August 17. The passage of the PPA required months of grueling work, so lawmakers will be reluctant to consider new pension legislation anytime soon unless a crisis of some sort occurs.

Some Basic Features of the U.S. Private Pension System

Before discussing some major provisions of the PPA, I should describe some basic features of the U.S. private pension system. Pension plans in the United States are generally divided into two categories: defined-benefit [DB] plans and defined contribution [DC] plans. In a DB plan, a participant's benefit is calculated according to a formula that determines the amount the participant will be entitled to receive when he reaches normal retirement age. Employees in a DB plan may not receive retirement benefits until decades after they earn the benefits, so a DB plan involves a long-term financial commitment. Because a DB plan promises a precise level or amount of retirement benefits, the employer has the burden of accumulating sufficient funds to pay benefits when they come due. The employer's responsibility for maintaining the solvency of its plan implies that the employer bears the investment risk in the plan (although other parties may bear some of this risk if the employer defaults). If the investments perform well, as occurred in the United States in the 1990s, the employer

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<sup>1</sup> See Michael R. Crittenden and Jacob Freedman, "Pension Overhaul Bill Gets New Life in Hosue," *CQ Weekly*, July 31, 2006, p. 2112; Michael R. Crittenden, "Pension Rewrite Clears After a Long Battle," *CQ Weekly*, August 7, 2006, p. 2176.

will need to contribute less funds to the plan in the future. If the investments perform badly, as investments have done more recently, the employer will have to contribute more.

The other major category of retirement plans is defined-contribution [DC] plans, which are also known as individual account plans. In a DC plan, each participant has an individual account, to which the employer, the participant, or both may make contributions. In contrast to the long-term financial commitments created by a DB plan, the employer that sponsors a DC plan fulfills its financial obligation when it contributes to a participant's account. Because the employer's financial commitment is completed when it makes its contribution, the participant bears the investment risk in the plan. If the investments in a participant's account perform well, the account holder will have more funds to spend in retirement. If the investments perform poorly, the account holder will have less.

Private-sector retirement plans in the United States operate within a regulatory framework that Congress established when it passed ERISA in 1974. ERISA created a comprehensive regulatory program that aimed to ensure that workers actually received the benefits their retirement plan promised. The major components of this regulatory program are standards of fiduciary responsibility, minimum vesting standards, minimum funding standards, and a government-run insurance program for private pension obligations. Briefly, the fiduciary standards regulate the conduct of pension plan managers to ensure that plans are run in a responsible manner and that plan assets are not squandered or stolen. The minimum vesting standards require pension plans to give vested rights to employees who have participated in a pension plan long enough to have a reasonable expectation of receiving a pension so that these employees cannot lose their pension credit as a result of a layoff or termination of their employment. The minimum funding rules require (or purport to require) employers to fund retirement benefits in advance so that pension plans will be less likely to default on their obligations. The pension insurance program, which is administered by the Pension Benefit Guaranty Corporation [PBGC], guarantees vested pension obligations by paying those obligations if a plan cannot afford to do so.

#### Some Major Provisions of the Pension Protection Act of 2006

With these preliminaries out of the way, I return to the Pension Protection Act of 2006. The PPA is roughly 1,000 pages long. For those of you who do not want to read 1,000 pages of legislative text, Congress's Joint Committee on Taxation has published a technical explanation of the bill.<sup>2</sup> It is only 376 pages long, but the print is much smaller, so I think the explanation may have more words than the legislation itself.

Obviously, there are bound to be many provisions worth discussion in a thousand-page law. I will discuss only a handful of provisions that strike me as being particularly

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<sup>2</sup> U.S. Congress, Joint Committee on Taxation, *Technical Explanation of H.R. 4, the "Pension Protection Act of 2006," as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006*, JCX-38-06.

important. I begin by discussing provisions that address two important trends in the private pension system that developed after ERISA – the rise of 401(k) plans and the more recent trend for employers to convert traditional DB plans into hybrid DB plans. I then turn to what is generally considered to be the most sweeping reform in the PPA – the repeal and replacement of the existing minimum funding standards for single-employer plans.

### The PPA and 401(k) Plans

By all accounts, the most significant development in the U.S. private pension system since the enactment of ERISA has been the dramatic shift away from defined-benefit plans in favor of defined-contribution plans – especially, so-called 401(k) plans. When Congress passed ERISA, defined-benefit plans dominated the private pension system. DB plans enrolled far more participants, held far more assets, received far more contributions, and paid out far more benefits than DC plans.<sup>3</sup> Three decades later, patterns of pension coverage are remarkably different. Although the total number of participants in DB plans (including active employees, former employees, and retirees) has steadily increased, the number of active employees participating in a DB plan has steadily declined.<sup>4</sup> Today, most private-sector employees who are covered by a retirement plan are in a DC plan – generally, a 401(k) plan.<sup>5</sup> DC plans exceed DB plans in terms of benefit payouts, participating employees, and contributions. Assets held by DC plans and individual retirement accounts dwarf the assets of DB plans.<sup>6</sup>

401(k) plans, which are also known as cash-or-deferred arrangements (CODAs), derive their name from section 401(k) of the Internal Revenue Codes, which grants favorable tax treatment to retirement plans in which employees have the option of reducing their cash compensation and having their employer contribute this amount to a retirement plan on a pre-tax basis. In most 401(k) plans, the employer provides a financial incentive for eligible employees to participate by agreeing to match all or a portion of the employee's contribution. Although the first private-sector cash-or-deferred arrangements were established decades before Congress passed ERISA, CODAs did not become common until Congress added § 401(k) to the tax code (1978) and the Treasury Department issued regulations outlining the requirements for creating such a plan (1981).

Many commentators have worried that the emergence of 401(k) plans as the primary retirement-saving vehicle among private-sector employees will leave retirees less secure in the future. 401(k) plans generally require employees to take a much more

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<sup>3</sup> 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)(hereafter *ERISA: A Political History*), 278 and sources cited in note 30.

<sup>4</sup> Pension Benefit Guaranty Corporation, *Pension Insurance Data Book 2004*, 55 (Table S-30), 58 (Table S-33), 86 (Table M-5).

<sup>5</sup> Alicia H. Munnell and Pamela Perun, *An Update on Private Pensions*, An Issue in Brief, Number 50, August 2006, Center for Retirement Research, Boston College, 5 (Figure 9). See also *id.*, 5 (Figure 10).

<sup>6</sup> Munnell and Perun, *An Update on Private Pensions*, 4 (Figure 7); “The U.S. Retirement Income System,” Facts from EBRI, April 2005, 4 (Figure 3), 5 (Figure 4), 6 (Figure 7).

active role in accumulating and managing their retirement income than is required of employees in a DB plan. There is considerable evidence that many employees in 401(k) plans are not prepared for this task.<sup>7</sup> The PPA includes provisions that attempt to make 401(k) plans better vehicles for retirement saving by expanding participation, increasing contributions, and improving investment management.

To increase participation, the PPA creates special tax rules for “automatic enrollment” or “negative election” 401(k) plans. Traditionally, 401(k) plans have required employees to affirmatively elect to participate in the plan. To make such an election, however, an individual has to do more than simply decide to participate. He also must decide how much to contribute and how the contributions should be invested. Research suggests that some employees who would otherwise prefer to join a plan fail to do so because they cannot decide how much to contribute and how to invest.<sup>8</sup>

Automatic enrollment promises to increase participation rates in 401(k) plans by changing the consequences of inaction. As a recent study puts it, “Automatic enrollment changes the worker’s decision from having to choose *to participate* to having to choose *not to participate* in a 401(k) plan.”<sup>9</sup> An automatic enrollment 401(k) plan establishes a default level of contributions and a default allocation of investments. Employees may refuse participation by submitting a negative election. An employee who takes no action participates in the plan, contributing at the default level and investing according to the default allocation. A number of scholarly studies have shown that automatic enrollment can substantially increase participation in 401(k) plans. This research suggests that the easier availability of automatic enrollment plans should have a salutary effect on retirement saving.<sup>10</sup>

One potential problem is that automatic enrollment sometimes leads employees to contribute at lower rates than they would choose if they participated in a traditional 401(k) plan. In a traditional plan, employees must choose a contribution rate when they join the plan. Employees in an automatic enrollment plan can override their plan’s default if they wish to contribute at a higher rate. The problem arises because some employees in automatic enrollment plans view the plan’s establishment of a default contribution rate as an endorsement of that rate. If an automatic enrollment 401(k) plan sets a low default rate, some employees who would have chosen to contribute at a higher rate if they had been offered a traditional 401(k) plan will end up contributing at the lower default rate set by their plan. In this way, automatic enrollment can lead to lower

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<sup>7</sup> See generally Colleen E. Medill, “The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality,” *Emory Law Journal*, vol. 49 (2000), 1.

<sup>8</sup> The research is discussed in Brigitte Madrian, *Enhancing Retirement Savings Outcomes in Employer Sponsored Savings Plan, Part 1: Increasing Participation*, TIAA-CREF Institute, Trends and Issues, October 2005, 6. See also the discussion in Munnell and Perun, *An Update on Private Pensions*, 3.

<sup>9</sup> Sarah Holden and Jack VanDerhei, *The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement*, Issue Brief No. 283, Employee Benefit Research Institute, July 2005, 4.

<sup>10</sup> See Madrian, *Enhancing Retirement Savings Outcomes*, 4-6; Sarah Holden and Jack VanDerhei, *The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement*, Issue Brief No. 283, Employee Benefit Research Institute, July 2005.

rates of saving for some participants.<sup>11</sup> The PPA addresses this concern by requiring automatic enrollment 401(k) plans to set a fairly high default contribution rate to qualify for special tax treatment.

A third concern raised by the expansion of 401(k) plans relates to investments. The rules in ERISA that regulate the investments of retirement plans have a feature that seems positively perverse. The rules require the assets of a DB plan to be managed by a fiduciary who has the duty to be loyal and prudent and to diversify plan investments.<sup>12</sup> In contrast, the rules for DC plans may relieve plan managers from liability for bad investment decisions if the decisions were made by the participant who holds the account.<sup>13</sup> The availability of this waiver of fiduciary liability has led most § 401(k) plans to give “ordinary workers, who can hardly be expected to have any skill, experience, or interest in portfolio management,” the job of managing the investments in their accounts.<sup>14</sup> In fact, scholarly research and anecdotal evidence reveals that many individuals do invest their 401(k) accounts in a manner that experts would say is too conservative (for example, putting all or most of their entire account balance in fixed-income investments with low returns) or too risky (for example, the case of Enron, where many employees’ 401(k) accounts were heavily invested in Enron stock).<sup>15</sup>

The PPA includes several provisions that address this concern, two of which are particularly noteworthy. The first provision is based on the premise that if workers do not have the information they need to invest appropriately, federal policy should do more to encourage investment education. The fiduciary provisions of ERISA include “prohibited transaction” rules that generally forbid an investment advisor from participating in transactions involving the plan if the advisor has a conflict of interest. These rules have discouraged mutual fund companies and other service providers from providing investment advice to participants.<sup>16</sup> The PPA creates an exemption from the prohibited transaction rules that will allow the administrators of a plan or the plan’s service providers to advise participants on how to invest their accounts. Although the provision includes safeguards that protect (or purport to protect) participants, one cannot help but wonder how many providers of investment advice will refrain from steering employees toward investment products in which the advisors have a material stake and whether “ordinary workers” will be able to exercise independent judgment in considering the advice they receive.<sup>17</sup>

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<sup>11</sup> See Madrian, *Enhancing Retirement Savings Outcomes*, 6.

<sup>12</sup> ERISA § 404(a)(1).

<sup>13</sup> ERISA § 404(c)(1).

<sup>14</sup> John H. Langbein, Susan J. Stabile, and Bruce A. Wolk, *Pension and Employee Benefit Law* 4<sup>th</sup> ed. (New York: Foundation Press, 2006), 636.

<sup>15</sup> See Colleen E. Medill, “The Individual Responsibility Model of Retirement Plans Today: Conforming ERISA Policy to Reality,” *Emory Law Journal*, vol. 49 (2000), 21-23; William G. Gale and J. Mark Iwry, *Automatic Investment: Improving 401(k) Portfolio Investment Choices*, Retirement Security Project, No. 2005-4, 2.

<sup>16</sup> Medill, “The Individual Responsibility Model of Retirement Plans,” 28-30.

<sup>17</sup> The Pension Rights Center has harshly criticized this provision. See Karen Ferguson and Barbara Kennelly to Senators, August 3, 2006, available at [http://benefitslink.com/articles/20060803\\_prc\\_ltr.pdf](http://benefitslink.com/articles/20060803_prc_ltr.pdf). See also Gale and Iwry, *Automatic Investment*, 4.

Another provision relating to 401(k) investment seems more hopeful. As noted above, the rules for 401(k) and other DC plans may relieve the fiduciaries of a plan from liability for bad investment decisions with respect to a participant's account if the participant made the decisions. The requirements for this waiver of liability created a potential problem for automatic enrollment 401(k) plans. Employees who are eligible to participate in an automatic enrollment 401(k) plan can avoid participation only by formally electing not to participate. Employees who take no action end up participating. Because automatic enrollment plans include employees who have taken no action with respect to the plan, plan managers have to create a default investment allocation for contributions to these employees' accounts. Before the enactment of the PPA, the exemption from fiduciary liability for investments made by participants only applied if the participant affirmatively directed the investment of his account. A default allocation would not be protected because the participant, having taken no action at all, did not exercise control over the investments in his account.<sup>18</sup>

The PPA creates a procedure that will allow the managers of a 401(k) plan to avoid fiduciary liability for default asset allocations. Even if a participant has not affirmatively directed the investments in his 401(k) account, he will be treated as having exercised control if (1) the default investment provided for in his 401(k) plan meets criteria to be established by the Department of Labor and (2) he receives proper notice of his right to direct the investments in his account and of how his contributions will be invested if he does not provide such a direction.<sup>19</sup> One effect of this provision will be to encourage employers to adopt automatic enrollment DC plans. But the provision also provides a means for improving investment allocations in 401(k) plans, since the Department of Labor should be able to come up with better investment allocations than many participants have chosen.<sup>20</sup> I noted in my discussion of 401(k) contributions that employees tend to defer to the default settings in their 401(k) plan. In the case of 401(k) investments, this tendency may result in better investment performance – and larger retirement income – for participants.

### The PPA and Hybrid Plans

Another recent development that is addressed in the PPA is the trend among employers of converting traditional DB plans into “hybrid” plans, which combine features of both DB and DC plans. Hybrid plans are considered to be DB plans because ERISA does not consider a plan to be a DC plan unless participants have individual accounts and hybrid plans do not have individual accounts.<sup>21</sup> Hybrid plans differ from traditional DB plans and resemble DC plans in the manner in which they express a participant's retirement benefit. Traditional DB plans express benefits as an annuity or, as ERISA puts it, “an *annual* benefit commencing at normal retirement age.”<sup>22</sup> In contrast, hybrid plans generally express a participant's benefit as the balance of a

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<sup>18</sup> See Medill, “The Individual Responsibility Model of Retirement Plans,” 37 n. 218.

<sup>19</sup> Pension Protection Act of 2006, § 624 (adding ERISA § 404(c)(5)).

<sup>20</sup> For some suggestions along these lines, see Gale and Iwry, *Automatic Investment*, 5-6.

<sup>21</sup> ERISA § 3(34).

<sup>22</sup> See ERISA § 3(23)(A).

hypothetical account – that is, as a lump sum.

Hybrid plans and especially so-called “cash balance” plans have provoked intense resistance because of another of their similarities to DC plans. In traditional DB plans, the accrual pattern tends to be heavily backloaded. That is to say, the value of the accruals that an employee earns late in his career is far larger than the value of accruals that he earns early in his career. The accrual pattern in hybrid plans tends to be much flatter than in traditional DB plans and may even be level, as in a DC plan. As a result of the flatter accrual pattern in hybrid plans, a conversion from a traditional DB plan to a hybrid plan generally reduces the future accruals that may be earned by older employees, unless the plan sponsor provides some form of transitional relief.<sup>23</sup>

Hybrid conversions accelerated through the late 1990s and into the new millennium, until litigation alleging that cash-balance plans violated prohibitions against age discrimination brought the trend to a virtual standstill. According to a recent report, few hybrid plans have been created since 2003.<sup>24</sup> The business community lobbied hard for Congress to give its blessing to hybrid plans, while groups representing employees called for provisions that would protect workers when a conversion occurred. In the PPA, Congress affirms the legality of cash-balance and other hybrid plans, while offering limited protection to employees whose firm converts from a traditional DB to a cash-balance plan. The PPA’s approval of hybrid plans applies prospectively, which leaves it to the courts to determine the legality of existing hybrid plans and past hybrid conversions. In a very important development, a federal appeals court reversed a lower court ruling that held that IBM’s cash balance plan violated prohibitions on age discrimination.<sup>25</sup> Together, the PPA and the court’s decision seem likely to revive the trend toward hybrid conversions.

### The PPA and Single-Employer Funding

Both 401(k) plans and cash-balance plans are relatively new additions to the private-pension system in the United States. In contrast, the final issue I will discuss – the funding of single-employer DB plans – is older than ERISA. The solvency of DB plans was one of the two key issues, the other being the vesting of pension benefits, that led Congress to pass ERISA. DB funding has continued to be a problem in the three decades since ERISA’s enactment. Congress has attempted several times to refine or improve the regulation of pension funding practices. The reforms in the PPA are just one more in a series of attempts to implement Congress’s original goal in ERISA of ensuring that pension promises are adequately funded.

The PPA was a direct response to the “crisis” of pension funding that emerged in

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<sup>23</sup> For a succinct discussion of the legal issues raised by cash-balance conversions, see John H. Langbein, Susan J. Stabile, and Bruce A. Wolk, *Pension and Employee Benefit Law* 4<sup>th</sup> ed. (New York: Foundation Press, 2006), 879-883.

<sup>24</sup> Alicia H. Munnell and Pamela Perun, *An Update on Private Pensions*, An Issue in Brief, Number 50, August 2006, Center for Retirement Research, Boston College, 6 (Table 1).

<sup>25</sup> *Cooper v. IBM Personal Pension Plan*, United States Court of Appeals for the Seventh Circuit, Case No. 05-3588, decided August 7, 2006.

the early years of this decade. Employers, union officials, and consultants have blamed the woes of DB plans on a “perfect storm” of recession, poor investment experience, and low interest rates.<sup>26</sup> I take a different view. The problem was and is ERISA itself. There were serious problems with the solvency of single-employer DB plans because ERISA gave employers and unions an incentive *not* to fund pension obligations and because ERISA’s reliance on command-and-control regulation of employer contributions as the primary tool for promoting solvency was fundamentally flawed. The PPA is unlikely to alleviate the solvency problems of DB plans because it does not address the incentives ERISA creates against funding and because it places too much reliance on funding mandates to promote the solvency of DB plans.

### Funding Practices before ERISA

Before Congress passed ERISA, unions had a compelling reason to be concerned about pension funding: employees bore the entire loss if a plan defaulted. For example, when the Studebaker-Packard Corporation terminated the pension plan for hourly employees of the Packard Motor Car Company in 1959, retirees had their pension cut by 15%, while employees who were eligible to retire but had not yet done so received cash payments worth about 19 months of pension benefits. Others, including all vested employees who were not yet eligible to retire, got nothing.<sup>27</sup> Although the Packard termination and similar cases alerted union officials to the *default risk* of underfunded pension plans, few, if any, unions demanded full funding of pension obligations. As a result, few, if any, collectively bargained pension plans had enough assets to meet their obligations.<sup>28</sup> Why would unions agree to funding practices that exposed their members to default risk when the effects of a default were so calamitous?

The answer to this question lies in the broader economic constraints of collective bargaining. Employers do not have unlimited funds to spend on labor costs. Consequently, when an employer and union bargain the terms of the employment contract, they must allocate scarce funds among competing uses. The more money a firm

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<sup>26</sup> See, e.g., Memorandum in Support of the Debtors’ Motion to Reject Their Collective Bargaining Agreements Pursuant to 11 U.S.C. § 1113(c), filed December 14, 2004, *In re UAL Corp., et al.*, Case No. 02-B-48191, U.S. Bankruptcy Court for the Northern District of Illinois, Eastern Division, 38 (hereafter “United § 1113 Memo”); Steve Brown, “Broader Impact from Airline Pension Woes Feared,” *Employee Benefit News*, November 2004 (<http://www.benefitnews.com/pfv.cfm?id=6669>); Statement of Duane E. Woerth, President, Air Line Pilots Association, Senate Committee on Commerce, Science, and Transportation, Hearing on the Impact of Federal Pension and Bankruptcy Policy on the Finance Health of the Airline Industry, October 7, 2004; House Committee on Education and the Workforce and House Committee on Ways and Means, *Examining Pension Security and Defined Benefit Plans: The Bush Administration’s Proposal to Replace the 30-Year Treasury Rate: Joint Hearing Before the Committee on Education and the Workforce and the Committee on Ways and Means*, 108<sup>th</sup> Cong., 1<sup>st</sup> sess., 2003, Serial No. 108-26, 56, 67, 92; House Committee on Education and the Workforce, *The Pension Underfunding Crisis: How Effective Have Reforms Been? Hearing before the Committee on Education and the Workforce*, 108<sup>th</sup> Cong., 1<sup>st</sup> sess., 2002, Serial No. 108-40, 33, 72.

<sup>27</sup> See Merton C. Bernstein, *The Future of Private Pensions* (New York: Free Press, 1964), 94-95; *ERISA: A Political History*, 67.

<sup>28</sup> See *ERISA: A Political History*, 67-69, 141; Steven A. Sass, *The Promise of Private Pensions: The First Hundred Years* (Cambridge, Mass.: Harvard University Press, 1997), 183-86.

devotes to its pension plan, the less it has available for wages and other employee benefits. Current retirees will be more secure if a plan pays relatively liberal benefits. All other things being equal, however, a plan that pays a higher level of benefits will be more costly. Likewise, future retirees (that is, current employees) will be more secure if an employer sets aside enough resources to fully fund future pension benefits at the time the employees earn those benefits. But the money an employer sets aside to fund *future* pensions might have been used to pay higher pensions to current retirees or higher wages to active employees.

For as long as employers and unions in the United States have bargained over pensions, they have chosen to set aside less money than was needed to fully fund pensions for future retirees so that they could pay higher pensions to current retirees and higher wages to active employees. The decision to pay generous pensions in part reflects a humanitarian impulse, but there are compelling instrumental reasons for providing liberal benefits to retirees. A pension plan is a tool for managing workers. One of the most important functions of a pension plan is to get older workers to leave a firm when managers and union officials want them to go. A worker who expects a generous pension will retire more willingly than one who expects a meager pension.<sup>29</sup> But the decision to provide relatively generous pension benefits confronts unions with a choice. To fully fund the obligations of a plan that pays liberal benefits, an employer must make large contributions, which, in turn, leaves less money for wages or other benefits for active employees.

Before ERISA, unions facing this choice agreed to funding practices under which collectively bargained pension plans would never have enough assets to meet their liabilities. Union officials accepted these practices knowing that the plans they bargained would be substantially underfunded and that participants – especially younger employees – would bear the loss when a plan defaulted.<sup>30</sup> But union negotiators got something for accepting this risk. The money that did not go to fund future pensions did not disappear. It went to pay higher pensions to current retirees and to provide higher wages and benefits for active employees. In light of the broader context of collective bargaining and, in particular, the need to pay liberal pensions to induce older employees to retire, this balancing of the interests of older and younger workers does not seem unreasonable.<sup>31</sup> Nonetheless, when union negotiators agreed to slower funding of pension promises, they exposed (and knew they exposed) employees to default risk.

It is worth digressing briefly to explain the process by which underfunding occurs in a collectively-bargained DB plan. In the United States, benefits in collectively-bargained DB plans are generally expressed as an annuity that is calculated by multiplying an employee's length of service times a flat-dollar amount. For example, if the benefit multiplier were \$60 per month and an employee had 30 years of service, the

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<sup>29</sup> *ERISA: A Political History*, 34-35; Steven A. Sass, *The Promise of Private Pensions: The First Hundred Years* (Cambridge, Mass.: Harvard University Press, 1997), 140.

<sup>30</sup> See *ERISA: A Political History*, 58-60, 67-69, 141-42.

<sup>31</sup> See Robert E. Royes, "Pension Plan Funding," *Proceedings of Nineteenth Annual New York University Conference on Labor*, ed. Thomas G. S. Christensen (1967), 317-25.

employee would be entitled to a pension equal in value to a single-life annuity of \$1,800 per month beginning at the normal retirement age in the plan.

In order to keep retirement benefits in line with the growth in wages, the benefit multipliers in collectively-bargained DB plans generally are increased in each successive round of collective bargaining. When a union bargains a higher level of benefits, the new higher multiplier generally applies retroactively to years of service before the plan granted the increase. The retroactive application of the multiplier increases the value (and cost) of pension benefits deriving from past service and creates to a new unfunded liability for the plan. Taken together, the tendency for unions to negotiate a higher benefit multiplier in each successive round of collective bargaining and the tendency of applying increases in the multiplier to past service caused (and continues to cause) collectively-bargained DB plans to be perpetually underfunded.<sup>32</sup>

### Pension Insurance, “Moral Hazard,” and the Regulation of Pension Funding

As my account of the history of pension funding shows, it was very common and perfectly reasonable for collectively bargained plans to be substantially underfunded before Congress passed ERISA. ERISA altered the “incentive structure” of pension bargaining so that it made even more sense for unions to accept unfunded pension promises.<sup>33</sup> Title IV of ERISA created an insurance program that shifts most of the default risk of an underfunded plan to the PBGC. If a pension plan terminates without enough assets to pay its vested obligations, the PBGC takes over the plan’s assets and liabilities and pays participants their vested benefit up to a statutory maximum amount.<sup>34</sup> The statutory cap on insurance is sufficiently generous – about \$48,000 per year for plans terminated in 2006 – that the insurance program has paid the entire pension benefit for the great majority of participants in the plans the PBGC has taken over. Because the PBGC’s guaranty mitigates the harsh effects of a plan default, the insurance program makes it less costly for unions to trade slower funding of future pensions in return for higher pensions and wages in the present. Moreover, the PBGC’s guarantee does more than create downward pressure on assets. It also puts upward pressure on liabilities. When a pension plan terminates without enough funds to meet its liabilities, the PBGC pays participants based on *what their plan promised*, rather than what their employer reasonably could have afforded. As a result, unions have an incentive to bargain bigger pension promises even when a firm is unlikely to fund those promises because bigger promises produce bigger insurance payouts.

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<sup>32</sup> See Robert C. Krivicky, “The Funding of Negotiated Pension Plans,” *Transactions of the Society of Actuaries*, vol. 33 (1981), 405-459; Wooten, *ERISA: A Political History*, 59-60; Prepared Statement of Ron Gebhardt Bauer, Senate Committee on Finance, *Funding Challenge: Keeping Defined Benefit Pension Plans Afloat: Hearing before the Committee on Finance*, 108<sup>th</sup> Congress, 1st sess., 2003, 52.

<sup>33</sup> I owe the concept of “incentive structure” to Douglass North, “Institutions,” *Journal of Economic Perspectives* 5 (1991), 97.

<sup>34</sup> If a plan has recently increased benefits, the PBGC may not cover the entire amount of the increase. Insurance coverage for benefit increases is phased in over five years. ERISA § 4022(b).

It has long been recognized that insurance creates a conflict of interest between the insurer and the insured. The drafters of ERISA were well aware of “moral hazard,” as this phenomenon is called. They included several provisions to hinder employers and unions from bilking the PBGC.<sup>35</sup> For example, if the insurance program gave immediate coverage to new plans or to plan amendments that increase benefit levels, employers would have an incentive to run up pension liabilities and then terminate their plan. To counteract this incentive, ERISA phases in coverage of new plans and plan amendments over five years.<sup>36</sup> Similarly, Congress included provisions that make the plan sponsor liable for the unfunded liabilities of its pension plan to deter healthy firms from dumping poorly funded plans on the PBGC.<sup>37</sup> Congress’s principal response to moral hazard, however, was ERISA’s regulation of pension plan funding. Lawmakers and pension experts understood that a government guarantee would give firms an excuse not to fund pension obligations while giving employees less reason to demand adequate funding. ERISA’s funding regime exists as much to protect the PBGC as to protect employees.<sup>38</sup>

ERISA seeks to promote the solvency of pension plans by means of command-and-control regulation that operates primarily on the asset side of the pension ledger. The centerpiece of this regime is a scheme of statutory minimum standards that purports to force employers to contribute at a level that will push the plan’s assets into balance with its liabilities. Discipline on the liability side of the pension ledger derives indirectly from the funding mandates. Firms should be deterred from making extravagant pension promises today by the prospect of have to make larger contributions tomorrow. At least, that was the theory. The reality turned out to be very different.

In their original form, ERISA’s funding standard for single-employer plans called for a sponsor to contribute enough to its plan each year to fund the cost of benefits attributed to that year (the normal cost), a portion of the cost of unfunded benefits attributed to past years (the unfunded actuarial liability), and a portion of the net losses from experience or from changes in actuarial assumptions.<sup>39</sup> Experience soon provided that this standard did not do nearly enough to protect against moral hazard. In its first few years of operation, the PBGC’s single-employer insurance program ran a moderate deficit. In the mid 1980s, however, PBGC was hit with a number of large claims involving plans that had fully complied with the funding rules but were nonetheless woefully underfunded.<sup>40</sup> Congress responded by passing the Pension Protection Act of

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<sup>35</sup> See *ERISA: A Political History*, 70-73, 132-35, 181, 252-56.

<sup>36</sup> ERISA § 4022(b). See *ERISA: A Political History*, 73, 255-56, 263-64.

<sup>37</sup> ERISA § 4062(b). See *ERISA: A Political History*, 181, 254-55, 274.

<sup>38</sup> See *ERISA: A Political History*, 72, 132-35, 199; Remarks of Jacob K. Javits at Convention of AFL-CIO Industrial Union Department, *Daily Labor Report*, September 26, 1969, F-1 – F-2.

<sup>39</sup> *Employee Retirement Income Security Act of 1974*, Public Law 406, 93d Cong., 2d sess. (September 2, 1974)(hereafter ERISA), § 302(b), IRC § 412(b). See generally U.S. Congress, Joint Committee on Taxation, *Present Law and Background Relating to Employer-Sponsored Defined Benefit Pension Plans and the Pension Benefit Guaranty Corporation*, JCX-03-05 (hereafter *JCT Background Paper on DB Plans and PBGC*), 24-26.

<sup>40</sup> See Richard A. Ippolito, *The Economics of Pension Insurance* (Homewood, Ill.: Irwin 1989), 39; C. David Gustafson, “An Apologia for the Pension Benefit Guaranty Corporation,” *Tax Notes*, December 26, 1994, p. 1677. See also Pension Benefit Guaranty Corporation, *Pension Insurance Data Book 2004*, 26 (Table S-1).

1987, which created an additional funding standard that required more rapid funding for plans that were substantially underfunded.<sup>41</sup> Congress bolstered the funding provisions several years later when it passed the Retirement Protection Act of 1994.<sup>42</sup>

Concern about private-pension funding waned in the late 1990s, as a strong economy buoyed funding levels and the PBGC's finances. The dramatic rise in corporate equities in the United States pushed aggregate overfunding in single-employer DB plans to historic highs and reduced aggregate underfunding to levels that were reassuringly low.<sup>43</sup> In 1996, the PBGC's insurance program for single-employer plans showed the first surplus in its history. The surplus increased in each year after 1996, reaching a peak in 2000.<sup>44</sup> These gains were quickly reversed by the "perfect storm" of recession and low interest rates that marked the new millenium. In the space of two years (2000 to 2002), the single-employer insurance program swung from the largest surplus in its history to the largest deficit. The deficit continued to rise in 2003 and 2004.<sup>45</sup> In 2005, PBGC's deficit declined slightly.<sup>46</sup> This stunning reversal in the fortunes of private-pension plans produced renewed interest in pension funding. A spate of hearings, government reports, and academic research have revealed that, even after several attempts at fine tuning, there remained many "leaks" in ERISA's funding regulations for single-employer DB plans.

It is worth briefly reviewing a couple of these "leaks":

Discount rates: To fund pension benefits, a sponsor must set aside money in the present to make payments that are due years or decades in the future. To know how much to save, the sponsor must discount the value of future obligations to the present. Because pensions are long-term contributions, a small change in the discount rate can have a big effect on a plan's funding status and, thus, on the sponsor's contribution obligations. As enacted in 1974, ERISA's funding standards accorded great deference to actuarial judgment, allowing a plan's actuary to select assumptions that were "reasonable" in the aggregate and, "which, in combination, offer the actuary's best estimate of anticipated experience under the plan."<sup>47</sup> In the mid 1980s, it emerged that firms could "defund" a plan by increasing discount rates so that the value of pension liabilities and the sponsor's contribution obligation declined.<sup>48</sup> This led Congress to develop a new measure of liability that was more mechanical in its application and deferred less to actuarial judgment.<sup>49</sup> Plans were allowed to select a discount rate from within a "permissible range" around a rate that reflected the average return on benchmark

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<sup>41</sup> ERISA § 302(d); IRC § 412(l). See generally *JCT Background Paper on DB Plans and PBGC*, 27-29.

<sup>42</sup> Gustafson, "An Apologia for the Pension Benefit Guaranty Corporation," p. 1677-78.

<sup>43</sup> Pension Benefit Guaranty Corporation, *Pension Insurance Data Book 2004*, 68 (Table S-43), 69 (Table S-44).

<sup>44</sup> Pension Benefit Guaranty Corporation, *Pension Insurance Data Book 2004*, 26 (Table S-1).

<sup>45</sup> Pension Benefit Guaranty Corporation, *Pension Insurance Data Book 2004*, 26 (Table S-1).

<sup>46</sup> Pension Benefit Guaranty Corporation, *2005 Annual Report*, 2.

<sup>47</sup> *Employee Retirement Income Security Act of 1974*, Public Law 406, 93<sup>d</sup> Cong., 2<sup>d</sup> sess. (September 2, 1974), §§ 302(c)(3), 1013 (adding IRC § 412(c)(3)).

<sup>48</sup> Ippolito, *Economics of Pension Funding*, 118-20.

<sup>49</sup> See American Benefits Council, *Funding Our Future: A Safe and Sound Approach to Defined Benefit Pension Plan Funding Reform*, February 2005, 11-12. See also Allen, et al., *Pension Planning*, 248 n. 2.

securities over several years.<sup>50</sup> The revised regulations provided for the use of an averaging formula and a “permissible range” of rates in order to mitigate contribution volatility.<sup>51</sup> Yet as the Government Accountability Office [GAO] pointed out in a recent study, these features of the new discount rate could substantially overstate a plan’s level of funding.<sup>52</sup>

Valuation of assets: To gauge a plan’s funding status, it is necessary to place a value on its assets. Before Congress passed the PPA, a sponsor could use “any reasonable actuarial method which takes into account fair market value and is permitted under regulations prescribed by the [IRS].”<sup>53</sup> Treasury regulations allowed a sponsor to use an “average value” based on the five most recent plan years as long as this figure did not fall outside of the corridor between 120% and 80% of the fair market value of plan assets at the time of the valuation.<sup>54</sup> As in the case of discount rates, the use of an averaging formula and range of values were meant to mitigate contribution volatility.<sup>55</sup> But as the GAO’s recent study observes, in a falling market the use of average values can make the funding status of many pension plans look far better than circumstances warrant.<sup>56</sup>

These two examples illustrate what I believe to be the Achilles’ heel of ERISA’s funding regime – the assumption that plan solvency should be maintained primarily by means of regulating the *asset* side of the pension balance sheet. This focus on the asset side implies that regulation of employer contributions will be the primary mechanism for promoting solvency. As I noted earlier, however, the existence of the pension insurance program gives employers and unions an incentive to pursue courses of action – for example, reducing pension contributions in return for higher wages – that compromise solvency. This conflict between the interests of the regulated and the goals of regulation highlights the issue of *enforceability*. Regulations are enforceable to the extent that they produce conduct that advances, rather than undermines, the policy goals that led to regulation. In light of the conflict between the interests of employers and unions and ERISA’s goal of promoting solvency, the funding rules are unlikely to be enforceable unless those rules are so constraining that employers and unions cannot act in a manner that undermines solvency. My brief account of the history of ERISA’s treatment of

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<sup>50</sup> IRC § 412(l)(7)(C). See also U.S. General Accounting Office, *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks*, GAO-04-90, 6-7, 45.

<sup>51</sup> *Private Pensions: Recent Experiences of Large Defined Benefit Plans Illustrate Weaknesses in Funding Rules*, May 2005, GAO-05-294 (hereafter *GAO Report on Recent Experiences of DB Plans*), 14.

<sup>52</sup> *Ibid.*, 27. See also Senate Committee on Health, Education, Labor, and Pensions, *PBGC Reform: Mending the Pension Safety Net: Hearing before the Committee on Health, Education, Labor, and Pensions*, 109<sup>th</sup> Cong., 1<sup>st</sup> sess., 2005, S. Hrg. 109-122, 62.

<sup>53</sup> IRC § 412(c)(2)(A).

<sup>54</sup> 26 C.F.R. § 1.412(c)(2)-1(b)(4), (6), and (7).

<sup>55</sup> See *House Report 93-807*, 96; *JCT Background Paper on DB Plans and PBGC*, 24.

<sup>56</sup> *GAO Report on Recent Experiences of DB Plans*, 15. See also House Committee on Education and the Workforce, *The Retirement Security Crisis: The Administration’s Proposal for Pension Reform and Its Implications for Workers and Taxpayers: Hearing before the Committee on Education and the Workforce*, 109<sup>th</sup> Cong., 1<sup>st</sup> sess., 2005, Serial Number 109-3, 16; Senate Committee on Health, Education, Labor, and Pensions, *PBGC Reform: Mending the Pension Safety Net: Hearing before the Committee on Health, Education, Labor, and Pensions*, 109<sup>th</sup> Cong., 1<sup>st</sup> sess., 2005, S. Hrg. 109-122, 62.

discount rates and asset valuations suggests that even after Congress tightened the funding rules several times, employers and unions could act in ways that undermined the solvency of DB plans and the viability of the guaranty program.

One potential response to this enforceability problem is to refine the funding standards so that they further narrow employer discretion. This was the general approach that Congress adopted in the PPA. To return to the example of asset valuations, before the enactment of the PPA a sponsor could smooth the value of plan assets over the five most recent plan years provided that the resulting figure was between 80% and 120% of the fair market value of plan assets on the valuation date. The PPA shortens the period over which values may be averaged to 24 months and requires the resulting figure to fall between 90% and 110% of fair market value at the time of the valuation. The potential problem with this strategy of basing contribution obligations on formulas that more narrowly constrain employers' freedom of action is that it increases the volatility of contributions and gives an employer less flexibility to accommodate the demands of a pension plan to its broader financial circumstances. As a consulting firm put it, "It's axiomatic that a reduction of smoothing will result in greater contribution volatility and reduced contribution predictability."<sup>57</sup> This is a serious objection because increased volatility compromises the feasibility of ERISA's funding regime by making it harder for firms to manage pension costs.<sup>58</sup>

In sum, ERISA's emphasis on regulating the asset side of the pension balance sheet creates an intractable conflict between the *feasibility* of the regulatory standards used to promote the solvency of pension plans and the *enforceability* of those standards. If Congress passes legislation that makes the funding regulations more enforceable, then contribution volatility will increase, DB sponsorship will become less feasible for employers, and the exit from DB plans will continue. On the other hand, reforms that make contribution obligations less volatile and give plan sponsor more flexibility will compromise enforceability by giving employers and unions more opportunities to engage in practices that compromise plan solvency and the pension guaranty program. This will lead to higher PBGC deficits and higher PBGC premiums and a continued decline of DB plans. Neither course of action is likely to improve the viability of DB plans in the United States.

Because I do not want to close on a pessimistic note, I will point it that the dilemma between feasibility and enforceability is a product of ERISA's emphasis on regulating the asset side of the pension balance sheet. The focus on the asset side leads policy-makers to pursue solvency through rules that impose affirmative obligations –

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<sup>57</sup> "Comprehensive Revision of DB Funding Rules," August 4, 2006, CCA Strategies available at [http://share.ccastrategies.com/Insight/Documents/PPA\\_funding.aspx](http://share.ccastrategies.com/Insight/Documents/PPA_funding.aspx).

<sup>58</sup> See, e.g., Association of Senior Human Resource Executives, *Support DeWine Mikulski Amendment to S. 1783, the Pension Security and Transparency Act*, October 7, 2005, available at [www.hrpolicy.org](http://www.hrpolicy.org); Optimal Benefit Strategies, LLC, *Promises to Keep: The True Nature of the Risks to the Defined Benefit Pension System*, September 2005, 10-11; ERISA Industry Committee, *Consensus Proposals for Pension Funding, PBGC Reform, and Hybrid Pension Plans*, May 2005, 4; Senate Committee on Finance, *Private-Sector Retirement Savings Plans: What Does the Future Hold? Hearing before the Committee on Finance*, 109<sup>th</sup> Cong., 1<sup>st</sup> sess., 2005, S. Hrg. 109-90, 13-14.

contribution obligations – on employers. It is the regulation of employer’s affirmative obligations that creates the trade-off between feasibility and enforceability. I believe there are other ways to promote solvency that do not give rise to a conflict between feasibility and enforceability.

One possibility is to make ERISA’s limitations on benefit increases by underfunded plans much stricter. The PPA moves in this direction but does not go far enough. Stricter benefit limitations will not create a tradeoff between enforceability and feasibility because a benefit limitation does not create affirmative obligations. A limit on benefit increases tells an employer what it may not do, rather than what it must do. Because benefit limits do not create affirmative obligations, concerns about flexibility and volatility that led Congress to include smoothing mechanisms in ERISA’s minimum funding standards do not arise. This would allow a benefit limit to be applied according to a simple and mechanical formula that would be much easier to understand and enforce than are calculations under the minimum funding standard.

Even more important, stricter limits on benefit increases would give employees and their union an incentive to care about pension funding. As I explained previously, the pension insurance program drastically reduces employees’ incentive to care about funding levels. If Congress strictly limited benefit increases by underfunded plans, employees and unions would have a direct incentive to care about pension funding because employees could not get benefit increases unless their plan had attained a high level of solvency. I believe that the direct incentives created by stricter benefit limitations would do more to solve the funding problems of single-employer DB plans than any scheme of command-and-control regulations can hope to do.