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The Multiemployer Pension Plan System: Recent Reforms and Current Challenges

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A multiemployer defined benefit (DB) pension plan provides retirement benefits to individuals working for multiple employers, usually in the same industry. A number of large multiemployer plans are significantly underfunded and face insolvency. While these plans are insured by the Pension Benefit Guaranty Corporation, the PBGC does not have the resources to fully cover them. While the U.S. taxpayer is not in any way legally obliged to financially backstop the PBGC, it is hard to imagine that the federal government would not do so if large numbers of pensioners' incomes were put at risk. Policymakers face a difficult situation without any easy answers. At a bare minimum, we should think hard about how we got where we are and how to avoid going there again in the future.

Recent History of Multiemployer Pension Plans

The terms of multiemployer pension plans are negotiated between employers and unions representing employees. Currently, there are roughly 1,400 multiemployer pension plans covering over 10 million workers and retirees. Importantly, employers are jointly liable for the liabilities incurred under a multiemployer plan. If one employer becomes bankrupt or otherwise drops out of the plan, the liabilities are transferred to other plan sponsors.

A substantial number of multiemployer pensions are very poorly funded. This poor funding places the sponsoring employers, their employees and the U.S. taxpayer at risk. Once plans have reached this state, there is no clear-cut answer to this problem. Sponsors of underfunded plans should raise contributions wherever possible, but some cannot afford to do so without putting their own financial viability at stake. The Pension Benefit Guaranty Corporation exists to protect participants in plans that become insolvent, but the PBGC itself lacks the resources to protect all underfunded pensions.¹

The Pension Protection Act of 2006 (PPA) established "zones" to categorize the funding health of corporate plans and, where necessary, mandate action to address funding shortfalls. Plans in the green zone are deemed to be sufficiently funded that no immediate action is mandated, while plans in the yellow ("endangered"), orange ("seriously endangered") and red ("critical") zones are increasingly underfunded and must take action to address those shortfalls.

Plans in the yellow and orange zones must reduce underfunding by specific amounts over stated periods of time, and are prohibited from taking steps that would increase funding shortfalls. Red zone plans, however, are mandated only to take "reasonable measures" to address funding. While red zone plans are authorized to reduce certain ancillary benefits, they also are exempted from excise taxes on funding deficiencies and thus effectively exempted from funding rules.

As of 2008, 80 percent of multiemployer plans were in the green funding zone and only 9 percent in the red zone. As of 2013, the share of green zone plans has dropped to 59 percent while the number of red zone plans has tripled to 27 percent.

While plans in the yellow and orange zones have significantly increased contributions to address funding shortfalls, red zone plans have contributed substantially less than sponsors of plans in the green, yellow and orange zones. Thus, the most financially endangered are doing less than others to catch up. Even as a group, contributions to multiemployer plans are equal to only about 60 percent of annual benefit payments.

More recently, the Multiemployer Pension Reform Act of 2014 created a new "deep red" zone, for plans deemed "critical and declining," meaning that the plan's fund was expected to be exhausted within 15

years. The MPRA allowed these severely underfunded plans to reduce benefits for younger, non-disabled retirees as a way to restore plans to funding health and reduce potential liabilities to the Pension Benefit Guaranty Corporation. However, benefit cuts may be implemented only if they could be expected to return the plan to solvency. The MPRA also doubled PGGC premiums for multiemployer plans to \$26 per participant and indexed premiums to inflation going forward.

Such benefit reductions could have an important impact on the PBGC's funding status. If benefits are not reduced or premiums increased, the PBGC multiemployer fund would run out of money in 2024, according to CBO projections, and require \$1 to \$2 billion in additional cash each year thereafter to pay benefits as guaranteed under law. If multiemployer benefits were cut to the extent allowed under the MPRA, the PBGC's long-term deficit would be cut roughly in half, though premiums would still need to rise substantially. This is important, as it seems near-certain that, should the PBGC run out of money, Congress would step in to avoid precipitous benefit reductions.

Funding Health of Multiemployer Plans

As a group, multiemployer plans report having assets equal to roughly 75 percent of plan liabilities. However, these figures are calculated by "discounting" guaranteed benefit liabilities using the expected rate of return on a risky portfolio of investments, usually 7 to 8 percent. Economists almost universally believe that such an approach is incorrect. Indeed, in a 2014 survey of professional economists conducted by the University of Chicago Business School, 98 percent agreed that such an approach understates pension liabilities and the broader cost of providing pension benefits.²

If a pension promises to deliver a guaranteed benefit, it should discount its liabilities using a low interest rate to reflect that guarantee. When multiemployer liabilities are discounted using the yield on US Treasury securities, which most economists would argue better reflect the costs of providing such benefits, funding ratios average about 45 percent and unfunded liabilities approach half a trillion dollars.³

Moreover, these averages reflect a distribution in which a number of multiemployer plans remain reasonably well-funded while others are far worse. Among plans deemed to be in the red zone, funding ratios on a market-consistent basis are about 37 percent, indicating an extremely poor level of funding. Even a "green zone" multiemployer plan is not nearly as healthy as a single employer plan in the green zone, as the single employer plan must value its liabilities using a corporate bond yield.

The argument for looser multiemployer funding rules was that, if one plan sponsor went bankrupt, other sponsoring companies would take on the liabilities. The problem with this theory, however, is that the financial prospects of companies in the same industry will be correlated. If the industry as a whole declines, the liabilities of a bankrupt company will be shifted to other companies whose own financial health has likely declined as well. As it happened, this is what has occurred in many cases.

Future Financial Viability

It is sometimes argued that while multiemployer plan funding suffered during the recent financial and economic downturn, most plans have recovered and are financially sustainable for the future. My own modeling work on state and local pensions – which operate under very similar funding rules and hold similar investment portfolios – shows this is unlikely to be the case. Though both types of plans use actuarial methods to smooth contributions from year to year, the underlying risk of their investments inevitably leaks through and can require contributions that vary significantly over time. In good times, a

plan sponsor may not need to make any contributions and may be tempted to increase benefits. Both multiemployer plans and state and local plans succumbed to that temptation during the late 1990s.

However, the sponsor of a multiemployer plan that holds a risky investment portfolio must also be willing and able to shoulder contributions that in some years will be far above the expected level. Experience in the state and local pension universe shows clearly that it is in these very high-cost years that sponsors are unable to make full contributions, which causes them either to skip contributions or to utilize actuarial methods to reduce costs. In either case, future funding health of the plan suffers.

A general lesson that policymakers should take from this experience is that a financial theory whose effect is to allow pension sponsors to promise more benefits at lower cost while taking more investment risk is likely to be an incorrect theory, and one with significant potential downsides for both plan participants and the taxpayer. In simple terms: a guaranteed retirement benefit is expensive and a cheap benefit is risky. It is better for government, employers and plan participants to digest these trade-offs rather than to pretend they do not exist.

Plan Design

Companies that became involved with multiemployer plans faced a problem. These companies generally offered traditional defined benefit pensions, in which a participant's benefit is calculated based upon his final earnings and his years of service to the company. Defined benefit pensions are "backloaded," which means that the benefit formula rewards full-career employees but penalizes those who work short or mid-length careers. Under a traditional defined benefit pension, for instance, an employee who worked for two companies for 20 years each would receive a substantially lower benefit than an employee who worked for a single company for 40 years. If employees switched jobs more frequently – note that the average employee today has job tenure of under 5 years, according to the Bureau of Labor Statistics – a traditional defined benefit plan, even if offered by every employer, would not provide a decent retirement income.

The lack of portability in DB pension was a problem when employees shifted between different companies within the same industry. Even if they worked in the same field their entire careers, switching between employers could cost them dearly. So employees needed a retirement plan that was portable. Multiemployer pension plans provided this portability.

But this one advantage was countered by a number of significant disadvantages.

For instance, employees and employers want a plan that isn't highly susceptible to stock market downturns. Anyone who watches the stock market throughout American history knows that bull and bear markets aren't merely a 21st century phenomenon. Multiemployer pensions hold about 70 percent of their portfolios in risky assets such as stocks, real estate, private equity and hedge funds. This is just too much risk to take for plans that offer guaranteed benefits and whose participants are mostly retirees or separated workers. Standard financial practice would point toward a much more conservative investment portfolio, but underfunded pensions cannot afford *not* to take investment risk. Moreover, federal accounting standards, which allow multiemployer plans to "discount" – or value – their guaranteed benefit liabilities using the expected return on a portfolio of risky investments encourages these plans to excessive investment risk.

Were employees instead offered defined contribution 401(k) plans, they could make their own judgments regarding how much investment risk to take. And it is very unlikely that individuals making their own judgments would take nearly as much investment risk as their pension plans are taking on their behalf.

Likewise, employees and employers want a plan that isn't overly susceptible to a downturn in their particular industry. We know from American economic history that industries rise and decline: the horse-and-buggy makers gave way to auto manufactures; IBM gave way to Microsoft which gave way to Google. The joint liability provision of multiemployer pensions is similar to when Enron's employees foolishly invested their 401(k)s in Enron's own stock: it increases their risk because employees' sources of labor income and investment income aren't diversified. The joint liability provision of multi-employer plans is very similar to a company investing its pension in its own stock. If some change affects an entire industry – be it trucking regulations in the 1980s or environmental regulations in the 2000s – the pension sponsors are themselves in a weaker financial position, plus they bear the liabilities of companies that went bankrupt or otherwise left the pension plan.

Were employees offered a 401(k) plan, they could protect against industry risk by holding a diversified portfolio that did *not* include stocks from companies in their own industry. Again, this is an example of how multiemployer pension design worked contrary to principles of financial risk management.

Finally, employers and employees would like a plan whose finances are not adversely affected by changing demographics. If employees participate in 401(k)s, it makes no difference whether the average participant is young or old. So long as participants and employers make their contributions, demographics essentially don't matter. It should be the same for defined benefit plans: plan sponsors should fully fund benefit liabilities *as they accrue* and not use money allocated for current workers to pay for current benefits. The fact that many multiemployer plans are worried about their ratios of workers to retirees indicates that they did not fully fund. In essence, they are beginning to look more like Social Security, a pay-as-you-go transfer program, and less like a pre-funded pension plan.

I raise these points not because we can go back and rewrite history. Multiemployer plan sponsors made the choices they made and they are where they are. Plan sponsors, plan participants and ultimately the federal government will have to decide how to allocate the pain, bearing in mind moral considerations toward retirees, the economic importance of the plan sponsors' continuing in business, and the need not to set a precedent that encourages others companies to come to the federal government for assistance.

Rather, I make these points as a way to move toward the next subject, which is where multiemployer plans should go in the future so as to serve their participants and protect employers and taxpayers from financial risk.

Hybrid Pension Plans

Employers and unions currently involved with multiemployer plans have discussed replacing certain underfunded plans with new retirement programs. One option currently being discussed is a hybrid between defined benefit and defined contribution plans. These hybrids are often referred to as "collective defined contribution plans," "composite plans," "shared risk," or other terms. While the details vary from proposal to proposal, these plans aim to combine the stable lifelong benefits of DB plans with the fixed employer contributions of DC pensions.

A second option is that sponsors of multiemployer plans should transition employees to state-of-the-art defined contribution plans that build on the experience and research of recent years. Such a plan might be similar to the Thrift Savings Plan offered to federal government employees and could offer simple investment choices, low costs and the option to turn account balances into a lifelong annuity at retirement. Such a plan design would not pretend to have any magic formula for high, guaranteed retirement benefits at low costs to employers and employees. But since such a magic formula does not exist, a state-of-the-art DC plan is less likely to disappoint participants or endanger plan sponsors and taxpayers.

To summarize my own view, so long as plans invest heavily in equities or other risky assets in order to keep contributions low, it will be difficult or impossible to provide a stable benefit for retirees. All investors, be they individuals, corporations or governments, face the same trade-offs between risk and return and there is no actuarial magic that can make those trade-offs go away. If traditional defined benefit plans produced contribution volatility that was unacceptably high for employers, it is not clear why benefit volatility would not be similarly unacceptable for participants in a hybrid pension plan.

A hybrid plan generally pays retirement benefits as a monthly annuity, rather than as a lump sum in the typical 401(k). The hybrid plan targets a given benefit level, but can adjust either benefits being paid or the rate at which future benefits are earned as a means to stabilize funding. In some cases, these composite plans would pay a base benefit coupled with an additional benefit that could be adjusted before retirement, but remains fixed once the employee had retired. In other cases, all benefits could be adjusted as needed at the discretion of the plan's trustees. While numerous options have been discussed, these two basic approaches are discussed in a 2013 proposal from the Retirement Security Review Commission of the National Coordinating Committee for Multiemployer Plans.

Certain varieties of hybrid plans are already authorized under law, but others would require new legislation. Hybrid plans have a number of attractive features, such as centralized investment to lower costs and automatic annuitization, which offers protection against outliving your assets.

But it is not clear if the advantages of collective DC plans outweigh their downsides. I have done a great deal of work modeling the finances of state and local government pension plans.⁴ These plans aim to offer a stable benefit for retirees while reducing contribution volatility for employers. This goal is not greatly different from hybrid plans' goal of offering a stable contribution to employers while reducing benefit volatility for retirees. What my modeling work on state and local pensions indicates that the investment risk taken by a plan *inevitably* produces volatile employer contribution requirements, with contributions often being so high that even state and local governments cannot meet them. State and local pensions use a variety of long-term smoothing and amortization techniques to reduce their contribution volatility but still they cannot do so. The fact that state and local plans cannot significantly reduce the volatility of required employer contributions, despite smoothing investment returns over five years and amortizing unfunded liabilities over 30 years, gives me very little confidence that a composite retirement plan could return to "full funding" over a slated 15-year period without disruptive reductions in employee benefits. When a pension plan invests principally in risky assets such as stocks, private equity or hedge funds, *something* – either contributions or benefits – is going to end up being highly volatile.

A recent analysis of a stylized composite plan by the actuarial firm Segal validates my intuitions.⁵ Segal tested a composite plan's ability to return to full funding within 15 years after being hit with either a

small (-5%) or large (-22%) single-year investment loss, coupled with a loss of employment to the industry. Even using these single-year events, changes to employee contributions and benefits were significant. Had Segal Conducted a full “Monte Carlo” analysis of investment returns, which mimics the real world’s ability to produce strings of high or low returns over time, I suspect that in a number of outcomes the composite plan’s financing and benefit structure would prove untenable.

So I am not confident that composite plans can produce what they promise. The reality is that if you want a stable, safe benefit in retirement you have to invest in stable, safe assets while you are working. For instance, Sen. Hatch’s proposal to allow state and local governments to purchase deferred annuities for their employees would provide those employees with a true guaranteed retirement benefit along with portability between jobs. Some might claim that these private annuities are “expensive.” The reality is that their cost in financial markets reflects the security they provide. Proposals that “cost” less do so by providing less income security. There is no magic formula.

Moreover, I am personally not sure that the annuitized benefits offered by hybrid plans are of great value to the employees who would participate in such plans. Annuities offer valuable protection against outliving your assets in retirement, but at the cost of lost liquidity, of not having cash when you might need it. The low- and middle-income employees who currently participate in multiemployer plans already receive much of their retirement income as an annuity, though Social Security benefits. The value of *additional* annuitization will be far smaller than the first dollar of annuitized benefits. While it is not clear to researchers precisely why so few individuals wish to purchase annuities, the fact that individuals spurn annuities is undisputed. It is easy to argue for overriding individual preferences based upon the notion that individuals are short-sighted and financially illiterate. But defined benefit pension funding, either in the corporate sector or the public sector, did not get where it is by *not* being short-sighted and financially illiterate. I don’t accept the view that top-down control produces better retirement funding outcomes than letting individuals make more of their own decisions. One look at the funding of Social Security or state and local government pension plans should disabuse an observer of that notion.

If employers wish to provide a solid plan to supplement their employees’ Social Security benefits, they can take advantage of recent enhancements to defined contribution retirement plans. Fifty-nine percent of workplace pensions today automatically enroll employees, versus only 14 percent in 2001.⁶ Automatic enrollment can significantly increase participation in retirement plans. Likewise, 41 percent of today’s employees invest their 401(k) plans in target-date funds that automatically reallocate their portfolios to reduce risk as they approach retirement, versus just 19 percent of participants in 2006.⁷ And a recent study from Vanguard showed that, for the 5-year period ending in 2012, individual investors holding target date funds earned the same return as state and local pension plans, which supposedly are much more sophisticated investors.⁸ Administrative costs also are being addressed. More than 80 percent of today’s 401(k) plans offer low-cost stock index funds, which helped reduce fees by 20 percent in recent years.⁹ According to the Center for Retirement Research at Boston College, state and local pensions have an average administrative cost of 0.43% of assets, or 43 “basis points.”¹⁰ According to a recent study by the Investment Company Institute based on federal regulatory data, large 401(k) plans have an average administrative cost of just 28 basis points.¹¹ There is no reason a defined contribution plan cannot compete on costs. Likewise, the Department of the Treasury recently enacted regulations making it easier for 401(k) plans to incorporate annuities, which convert lump sums into to a guaranteed income that lasts for life.¹²

Perhaps the most important advantages of true DC pensions are transparency and responsibility. In a 401(k)-type plan, it is clear to employer and employee alike what the employer has promised to contribute in a given year. Employees know whether the contribution has been made and they will protest if it is not. Likewise, in a DC plan the party that chooses to take investment risk is the party that bears the consequences of that investment risk, which is the best enforcement mechanism against excessive risk-taking.

Defined benefit plans have neither of these advantages. In a DB plan there are many ways for plan sponsors to put off making contributions, be it through assumptions regarding investment rates of return, labor force growth or mortality. Indeed, we recently have seen sponsors of single-employer pensions lobby Congress successfully to increase the discount rate used to value their liabilities and thus reduce plan sponsors' pension contributions. Likewise, with a DB pension it is very difficult for anyone other than the plan sponsor or their actuaries to know what is going on. Financial manipulation of plan assumptions is common among state and local pension plans. Members of Congress should be aware of this, should the day come when state and local plans come knocking on Congress's door.

My fear with composite plans is that these incentives to put off difficult decisions could lead them to become similarly underfunded down the road. Under some of these plans, Trustees are given discretion to alter benefit accruals or payouts. But the need to make such adjustments depends upon assumptions regarding investment returns, the growth of employee payroll or the life expectancies of retirees – in other words, precisely the assumptions that state and local pensions game in order to reduce their current costs.

For instance, I could easily see the trustees of a hybrid plan taking additional investment risk as a way to forestall the need for contribution increases or benefit reductions. But, as we have witnessed with state and local government pensions, such a choice could lead to disastrous outcomes down the road. If a hybrid plan took additional investment risk and lost, future benefit reductions could be even larger. Who will those employees look to if their Congressionally-sanctioned and regulated hybrid plan runs short of money in the future?

Conclusions

The difficult truth with regard to pension funding, whether the plan sponsor is a corporation or a government, is that it is easy to promise benefits but harder to fund them. Complexity of pension plan design allows many avenues for the plan sponsor to avoid paying what it has promised. Complexity of pension design is the enemy of full funding. Across sectors, across time and across countries, there is too long a track record of pension underfunding for me personally to feel comfortable with another design that appears to promise more benefits at lower cost.

What employees need are well-designed, well-run defined contribution plans that offer automatic enrollment at responsible contribution rates coupled with simple and low-cost investment options such as target date funds. The other bells and whistles, which seem to offer something for nothing, pose the risk of delivering the opposite.

End Notes

- ¹ On this subject, see Brown, Jeffrey R. and Andrew G. Biggs. "Reforming the Pension Benefit Guaranty Corporation." In Brown, Jeffrey R., ed. "Public Insurance and Private Markets." American Enterprise Institute, 2010.
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- ⁴ Biggs, Andrew G. "The Public Pension Quadrilemma: The Intersection of Investment Risk and Contribution Risk." *The Journal of Retirement* 2.1 (2014): 115-127.
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- ⁸ Vanguard Research. "Professionally managed allocations and the dispersion of participant portfolios." August 2013.
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- ¹² Jeffrey Brown, "New Treasury Guidance Will Encourage Annuities In 401(k) Plans," *Forbes*, October 24, 2014, www.forbes.com/fdc/welcome_mjx.shtml.