Testimony on

"The Cost of Inaction: Why Congress Must Address the Multiemployer Pension Crisis"

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Health, Employment, Labor, and Pensions Plans

I'd like to thank Chairperson Frederica Wilson, ranking member Tim Walberg, as well as the other members of the Health, Employment, Labor, and Pensions Subcommittee for the opportunity to testify today. I hope that my testimony contributes toward a workable solution to the crisis facing the multiemployer plan system.

A multiemployer plan is a pension plan maintained through a collective bargaining agreement between employers and a union. The typical plan has numerous contributing employers, and it is quite common for employers to participate in several different multiemployer plans. For a particular multiemployer plan, the employers are usually in the same or related industries. Today, there are approximately 1,400 multiemployer plans covering 10 million participants. From the participant's perspective, multiemployer plans provide pension portability, allowing them to accumulate benefits earned for service with different employers throughout their careers. In addition, because these plans offer annuity benefits, they represent an efficient source of retirement income due to risk pooling advantages. From the employer's perspective, the scale lessens the administrative and investment costs relative to the operation of numerous small single-employer plans.

Currently, the multiemployer system is chronically underfunded and the retirement benefits of many participants are at significant risk. Once a plan becomes insolvent, the payment of benefits is assumed by the Pension Benefit Guaranty Corporate ("PBGC"), subject to certain limits. However, the PBGC's latest forecast is that its multiemployer pension insurance program will

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become insolvent in 2025, meaning that it will no longer have any resources on hand to pay the pension benefits of failed plans.[2] At that point, the PBGC will become a de facto pay-as-you-go system with its premium collections used to pay only a tiny fraction of the pension benefits of failed plans. In essence, this outcome is equivalent to the complete loss of pension benefits for a very substantial number of participants.

Broadly, there are two main decisions to be made regarding the crisis, both of which highlight the need for immediate action.

The first decision relates to past underfunding, and entails figuring who will cover the shortfall that has arisen because of the difference between what the unions promised their members and what the unions collected from employers to cover these promises. This is not an easy decision, as many union members who relied on the promises made to them by their union leaders are facing severe financial consequences if their pensions are eliminated. In addition, employers vary in their ability to absorb the increased contributions that are currently required or may be required in the future to fund these plans. The PBGC recently reported that the system is $638 billion underfunded for 2015.

The second decision entails figuring out how to ensure that the current level of underfunding does not deteriorate further and how to put the system on a sustainable path going forward. The urgency of this step is evident in the events that have occurred since legislative action was first taken to address the multiemployer pension crisis in 2005—since that time, the level of underfunding has increased by approximately $400 billion on a PBGC basis.

These two decisions require different solutions, and trying to solve both at the same time creates unnecessary difficulty. In my opinion, the more pressing decision is the second one, as that decision offers the hope of limiting any further deterioration of the multiemployer system. For that reason, my testimony will focus on the most important aspects of this decision.

To understand how to set the multiemployer system on a sustainable path, it is necessary to provide some background on the cause of the current crisis. Let me illustrate the critical issue with a simple thought experiment: you exchange part of your current wages for an annuity benefit so that you will have retirement income when you turn age 65. If this transaction is with an insurance company, your forgone wages will be invested primarily in low risk bonds whose payouts are chosen to match the payouts of your annuity benefit, with less than five percent

[2] https://www.pbgc.gov/news/press/releases/pr18-02

invested in the stock market.[3] If this transaction is with your union as part of a multiemployer arrangement, your forgone wages will be invested primarily in the stock market.

This is a striking difference, but it is not the only one.

The insurance company will ask that you contribute wages that are equivalent to the cost of your annuity (i.e., you "get what you pay for"). The multiemployer plan, on the other hand, may only collect a fraction of the value of your annuity benefit, hoping that it can recoup the difference from future generations of union members or through exemplary investment performance.

The contrasting approach taken by multiemployer plans initially generates far lower costs[4], which suggests that they believe they are able to provide annuity benefits for a fraction of what an insurance company would charge. Is this really possible? The answer, of course, is no. It is unreasonable to suggest that multiemployer plans can significantly outperform insurance companies at their core business. It is also unreasonable to expect anything other than a crisis when the approach taken by multiemployer plans is so different from standard business practices.

Multiemployer plans have not collected actuarially sound contributions and have invested the contributions they received aggressively. If these plans had chosen to collect actuarially sound contributions and purchase annuity contracts (or mimic the investing philosophy of life insurance companies), there would be no crisis. Participants would be receiving or would be scheduled to receive the annuity benefits purchased with the contributions made on their behalf. No industry deregulation or competitive events would change this outcome.

It is worth noting that the problem is not that the rules prohibit trustees from managing the plans in this manner—trustees are free to purchase annuities to fund the pension benefits that the plan promises. Even short of purchasing annuities, the rules do not prevent trustees from accurately measuring plan promises and investing in a more conservative manner, concentrating on bonds matching the duration of the liabilities. Trustees chose to take aggressive risks, and the current crisis is the inevitable outcome of these risky choices.

I believe it is critically important that any framework for addressing the multiemployer pension plan crisis incorporate the notion that insurance companies are experts at providing fixed annuity

[3] The assets for life and annuity products that provide predetermined benefit amounts are held in the general account of the insurance company. The Chicago Fed compiles reports of the aggregate general account holdings of US Life Insurance companies. These reports indicate that less than 5% of general account assets are invested in equity securities, with the vast majority invested in fixed income products. For example, see https://www.chicagofed.org/publications/chicago-fed-letter/2013/april-309.

[4] During my career as a consulting actuary, which started in the mid-1990s, I personally observed instances where the proposed cost of the multiemployer plan was only one-third of the cost of a single employer plan that provided equivalent benefits.

benefits, and that their general approach should be adapted for the multiemployer pension plan system.

The movement away from the stock market may be viewed as a poor choice by some because equity investments generate higher expected returns than low risk bonds, and these higher returns could narrow the funding gap. However, it is important to recognize the equity investments can just as easily increase the funding gap, as higher expected returns come with higher volatility and risk. One cannot generate high returns that are low in risk.

I am not aware of any convincing reason why multiemployer plans should invest primarily in the stock market. They cannot be compared to single employer pension plans, where a single firm sponsors a pension plan that is generally viewed as an extension of its corporate structure. Multiemployer plans are essentially an organization that manages the contributions of its members to provide retirement income, which is similar to an insurance company. They do not have the ability to respond to large fluctuations in the value of the assets in the pension trust, both because contributions are typically set over multiple years and because contributing employers vary over time, either because of bankruptcy or because of selective exit through withdrawal. These plans also cannot carry a funding surplus, which is necessary to withstand the negative returns that are an inevitable component of risky investment choices. Given the structure of multiemployer plans, certain participants have even claimed that trustees' use of risky investment choices, such as those in private equity and emerging markets, are potential violations of a plan's fiduciary duty.[5]

Moving to an annuity purchase framework is a critical first step in addressing the current crisis because it will at least freeze the amount of the total underfunding. Because it is a more conservative basis, the number of healthy multiemployer plans will be drastically reduced under an annuity purchase model. While approximately 60% of multiemployer plans are currently certified in the green zone in recent PBGC reports, that number would drop to around 7% if discount rates were based on current corporate bond yields. In other words, on an annuity purchase basis, only 7% of plans have 80% of the assets needed to purchase annuities for their participants. The movement to an annuity purchase model doesn't generate this substantial level of underfunding, it simply makes it transparent.

Moving to an annuity purchase basis will also increase the annual cost to employers of providing retirement benefits through the multiemployer system. While the calculation of the required contributions for a multiemployer plan are complex in practice, the framework for these calculations is relatively straight-forward. In essence, there are two key components. First, there

[5] For example, see https://www.musiciansforpensionsecurity.com/news/2018/6/8/federal-judge-calls-afm-epf-trustees-investment-approachextraordinarily-risky

is the normal cost, which is the present value of the benefits accrued by active participants during the year. Second, there is an amortization of the plans unfunded benefits. In essence, this component captures the carrying cost of previously accrued benefits (e.g., the cost that arises because participants are one year closer to collecting their benefits), the investment returns on the pension plan assets, and the difference between the total obligation and the assets on hand to pay those obligations. Both components are higher under an annuity purchase model because of the use of much lower discount rates to determine the present value of the promised pension benefits. A lower discount rate will produce a higher normal cost and a higher pension liability.[6]

However, the increase in costs is not a persuasive argument against adopting an annuity purchase approach, because the increase in cost arises due to a movement from a gross understatement of the participant's pension benefits to the actual fair economic value of the participant's benefits. In other words, the costs will be higher because the reported costs in the past were far lower than the economic value of the promised pension benefits.[7]

There are two basic components to the projected level of underfunding in the multiemployer pension system—the benefits that were promised in the past, and the benefits that will be promised going forward. Shifting the investment allocation toward low risk bonds will freeze the current level of underfunding associated with past benefits. In addition, to the extent that plans are required to fund new benefit promises with actuarially sound contributions based on annuity purchase costs, there will be no incremental pension underfunding associated with these new benefit promises. Collectively, an annuity purchase approach will set the parameters of the underfunding, and ensure that future issues are averted.

There is an urgent need to take action along the lines I've suggested. If left as is, the risk mismatch between the promised pension benefits and the underlying equity investments could generate substantial additional costs. Furthermore, the ability of unions to provide for future

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[6] Currently, multiemployer plans are able to artificially lower their costs by valuing annuity-type benefits, which are low in risk, using the expected return on the assets held in the pension trust. Intuitively, the present value of the promised retirement benefits should not decrease just because the underlying assets are invested in high-risk equity investments rather than low-risk bonds, but that is an outcome of the current funding rules for these plans. The promised retirement benefits would be valued correctly if the assets were held in low risk bonds, similar to those held by an insurance company.

[7] Rather than shifting investments into low risk bond portfolios (similar to how an insurance company would fund an annuity), others might suggest that now is the time to increase the risk of the investment portfolio to boost returns. While this is clearly a poor choice, the suggestion is somewhat predictable based on the current condition of multiemployer plans. Suppose you are a trustee facing an almost insurmountable pension deficit. There are two possible outcomes that accompany a shift toward a high risk investment strategy. On the one hand, the high risk strategy could work, in which case the plan could be saved, and the trustee is viewed as a hero. On the other hand, the high risk strategy could fail, in which case the plan will be shifted to the PBGC—the same outcome that would occur if no risk were taken. This type of asymmetry in the internalization of gains and losses results in what financial economists refer to as "gambling for resurrection."

benefit accruals without adequately funding these accruals may also substantially increase future costs.

In addition, once the decision is made to adopt some form of annuity purchase model, it will be far easier to address other issues related to the amount of aid to be provided to failing plans, the amount of the PBGC guarantee and how the PBGC should interact with failing plans, as well as any potential changes in the amount of PBGC premiums. To ensure that employers do not selectively withdraw from plans, it is worth amending the current withdrawal rules to prohibit withdrawals until a legislative solution to the current crisis is finalized.

In closing, I want to re-iterate the need for urgent action. The enormous risk in the system has the potential to make matters far more difficult to address in the future.

Thank you again for this opportunity, and I look forward to answering any questions you may have.