

Understanding the multiemployer pension crisis

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The multiemployer pension crisis has been in the news often over the last few years and is likely to be again in the coming weeks as Congress considers additional bills in response to the COVID-19 pandemic.

When discussing retirement security for over 10 million American families, it is important to understand how past legislative decisions led the system to where it is today. This white paper tackles two questions:

- Federal rules have historically limited funding to defined benefit pension plans – how has that impacted the current crisis?
- The Pension Protection Act of 2006 (PPA) made different reforms to the single employer and multiemployer defined benefit pension (DB) systems—did PPA “fix” the single employer pension system?

A strong understanding of the historical regulatory perspective can serve to inform the discussion on future regulatory changes designed to improve the long-term health of multiemployer pension plans.

The history of federal funding limits in the ‘80s and ‘90s

Pension funding has always been highly regulated due to the tax treatment afforded to these plans. Qualified pension plans enjoy three tax benefits:

1. Contributions are deductible to the contributing employer
2. Investment earnings on those contributions are tax-deferred
3. Participants are not taxed on benefits until received from the plan

Whenever tax advantages are involved, there will be rules and regulations to limit these advantages to a perceived desirable level. For pension plans, they come in the form of full funding limits—a concept that restricts pension contributions for plans that are considered “fully funded” under pension law. For both the single employer and multiemployer defined benefit systems, the limits imposed under federal law had unintended consequences on the health of many of the nation’s pension plans.

While it sounds backwards in the face of the current crisis, the overriding concern of lawmakers when it came to pension funding during the 1980s and 1990s was to make sure plan sponsors were not overfunding plans, and therefore garnering excessive tax benefits. Below is a very brief, simplified summary of the history of full funding limits.

ERISA FULL FUNDING LIMIT

When the Employee Security Income Security Act of 1974 (“ERISA”) was enacted deductible contributions could not be made to a defined benefit pension plan in a year where “... plan assets exceed accrued liabilities plus normal cost before contributions were made.”¹ In other words, if a plan had enough of a surplus to cover the next year’s cost of benefits, contributions to the plan were not deductible by the contributing employer. Furthermore, an excise tax would be levied on any non-deductible contribution made. This limit, referred to as the ERISA full funding limit, basically prohibited contributions to a defined benefit plan that was at least 100% funded on an accrued liability basis.

OMNIBUS BUDGET RECONCILIATION ACT OF 1987 (OBRA 87)

Because the original limit was heavily dependent on an actuary’s determination of a plan’s accrued liability, the legislators were concerned that the original limit could be manipulated by using conservative actuarial assumptions and methods in order to increase tax benefits. To reduce the influence of the actuary’s assumptions and methods, OBRA 87 introduced a second measurement that further limited deductible contributions in certain situations. This new limit, referred to as the OBRA full funding limit, was based on a new liability measurement called “current liability,” which in turn was based on a mandated cost

¹ U.S. Department of the Treasury (May 1991). Report to Congress on the Effect of the Full Funding Limit on Pension Benefit Security. Retrieved April 22, 2020, from <https://home.treasury.gov/system/files/131/Report-Pension-Benefit-Security-1991.pdf>.

allocation method and a stipulated discount rate range (from a four-year weighted average of 30-year Treasury rates). Under this new limit, employers could not make deductible contributions if their plans' assets were greater than 150% of their current liabilities. It must be stressed how different the economic environment was at this time—for example, the “current liability” discount range in January 1988 was 8.25% to 10.09%, which was generally higher than the discount rates used by actuaries for multiemployer pension funding calculations.

According to Form 5500 filings, the average discount rate used in 1987, just prior to the enactment of OBRA 87, was 7.9% for single employer plans and 6.9% for multiemployer plans.² The purpose of OBRA 87 was to make sure plan sponsors couldn't have their actuaries use what lawmakers deemed to be artificially low discount rate assumptions, and/or methods that front-loaded the recognition of liabilities, so employers could make higher deductible contributions to their plans than lawmakers deemed necessary. Indeed, the U.S. Department of the Treasury noted that an advantage of OBRA 87 was that it “decreased the maximum funding speed and tax benefits that can result from pension funding for many plans.”³

It should be noted that, in general, the ERISA full funding limit applied more often than the OBRA full funding limit for multiemployer plans. Thus, for multiemployer pension plans, contributions would generally not be deductible—and would instead be subject to an excise tax—if the plan was 100% funded or more using the actuary's assumptions and methods.

RETIREMENT PROTECTION ACT OF 1994 (RPA 94)

An override to the full funding limit was introduced as part of the RPA 94 that could increase the potential deductible contribution to a plan above the limits described above. The RPA override would ensure that employer contributions would be deductible as long as a plan's assets did not exceed 90% of a new current liability measure, which mandated a mortality table in addition to the cost allocation method and the discount rate range. In January 1995, the current liability discount rate range was 6.55% to 8.00%.⁴ Two points should be made about this range:

- The lower end of this range had dropped below the rates that were used by most multiemployer plans' actuaries for their general funding calculations.
- The lower end of this range would produce the largest deductible contribution limit. If the original full funding limit

was restricting deductible contributions, the RPA override at the time it was passed would have allowed contributions to bring a plan's funding level to a maximum funding level of 90% using a 6.55% discount rate.

As interest rates came down over time, the RPA override became the de facto maximum deductible contribution for multiemployer plans.

PENSION PROTECTION ACT OF 2006 (PPA)

In the wake of the dot-com bubble bursting from 2000 to 2002, when the S&P 500 experienced a 49% loss in value from 2000 to 2002,⁵ even plans that had been considered “fully funded” under federal pension funding law developed significant underfunding. In recognition of the fact that existing rules did not allow plans to build up enough surplus to provide a cushion against poor returns, lawmakers added an override to significantly increase the amount of funding allowed as part of the changes implemented with PPA. Multiemployer plans are now allowed to receive deductible contributions if they are under 140% funded on a “current liability” basis. In March 2020, the discount rate range for this measurement was 2.47% to 2.89%. For many plans, this would allow funding in excess of 200% of liabilities measured using the discount rates commonly used by plan actuaries.

The primary takeaway from this history is that, prior to PPA, pension funding limits were primarily driven by concerns about tax revenue as opposed to responsible pension funding, which would involve building a meaningful surplus to be able to withstand poor experience in the future.

Multiemployer pension plan funding

The multiemployer funding mechanism is very different from the single employer funding mechanism, and presents two unique challenges:

COLLECTIVE BARGAINING CONSIDERATIONS

Multiemployer pension contributions are set through the collective bargaining process, are generally predicated on deductibility, and are certainly not intended to generate an excise tax back to the contributing employers. Contributions made in a year are intended to pay for the benefits earned in that year. Contributions made on behalf of an individual participant are often used directly in the calculation of a participant's benefit earned in a year.

² Ghilarducci, T., Mangum, G., Petersen, J.S., & Phillips, P. (1995). *Portable Pension Plans for Casual Labor Markets*.

³ U.S. Treasury (May 1991), op cit.

⁴ See the weighted average interest rates published by the IRS at <https://www.irs.gov/retirement-plans/weighted-average-interest-rate-table>.

⁵ NBC News. 11 historic bear markets. Retrieved April 22, 2020, from http://www.nbcnews.com/id/37740147/ns/business-stocks_and_economy/t/historic-bear-markets/#.XpSNnf3sYdU.

During the 1980s and 1990s (when an investment portfolio with 60% equities and 40% bonds would have returned nearly 15% per year⁶), the excellent investment returns continually put plans in surplus positions, which in turn triggered full funding limits and created contribution deductibility issues. In this situation, bargaining parties and trustees had to make one of two choices:

- Take a “contribution holiday,” which would involve suspending the collectively bargained pension allocation, and instead putting that money toward wages or other fringe benefits.
- Increase plan benefits, which would increase the plan’s liability measurement, in order to keep funding levels at or below the government-imposed limit. The bargained pension allocation would then remain unchanged, and contributions would remain deductible to contributing employers and not generate excise taxes.

Some multiemployer plans took contribution holidays, but most generally chose to increase plan benefits. This decision impacted the level of a plan’s liability, and its cash flow situation (i.e., benefit payments compared to contributions). However, regardless of the choice that was made (contribution holiday versus increased benefits), the full funding rules forced decisions that negatively impacted the funded status of these plans and exacerbated the impact of the market downturns in the 2000s.

SOURCE OF FUNDING

Bargained contributions ultimately come out of the total negotiated wage package for members who are actively working for participating employers. There are natural limits on this funding source that present challenges for underfunded plans, particularly for plans with active populations that have shrunk over time:

- There is a limit to the amount of money that can be diverted from working members’ paychecks while still providing a competitive, living wage.
- There is a limit to how high the overall wage package can be while keeping participating employers competitive in their industries.

Because the source of funding for multiemployer plans is limited in this way, once all of the tools available under the law have been used, if the total wage package of the covered population is not sufficient to fix a plan’s underfunding, then the resources to solve the problem simply don’t exist. For the approximately 10% of multiemployer plans that are considered “critical and declining” (as shown in [Milliman’s Multiemployer Pension Funding Study: December 2019](#)) this is the situation they are facing.

⁶ Kenny, T. (November 17, 2019). Aggregate Bond Index Returns vs. Stocks ’80-’18. The Balance. Retrieved April 22, 2020, from <https://www.thebalance.com/stocks-and-bonds-calendar-year-performance-417028>.

The impact of federal funding limits on multiemployer pension plans

It is likely that multiemployer pension plans were never the intended target of these rules; the legislators’ concern was with single employer plan sponsors using pension plans as tax shelters. However, these funding limits directly contributed to the multiemployer system’s current situation in two distinct ways:

1. Prior to 2006, pension funding rules simply did not allow plans to build up a sufficient surplus. Based on Internal Revenue Service (IRS) filings for the 2000 plan year, the median multiemployer plan was 92% funded on the RPA 94 current liability basis⁷—an indication that most plans were bumping up against full funding limits. Over the next 11 years, the S&P 500 would achieve annualized returns of about 0% per year⁸ (including a 49% loss in value from 2000 to 2002 when the dot-com bubble burst, and a 56% loss in value during the global financial crisis of 2008 to 2009⁹). Plans needed to build up cushions during the good years to be able to withstand the bad years, and federal pension funding rules impeded the ability to do so.
2. As described above, the combined impact of the full funding limits and returns well above actuarial assumptions generally resulted in a series of benefit increases to spend the “funding surpluses” that were continually created. These increases produced benefits in excess of what the initial annual contributions were ever anticipated to actuarially support. And, prior to PPA, those benefits could never be reduced once they had been granted, regardless of future investment experience. Even at these higher benefits levels, many plans were restricted from additional funding by the deductibility limits. However, the benefit increases resulted in higher liabilities than would have otherwise existed and therefore, when underfunding developed, it was larger in dollar terms. In addition, the benefit increases contributed to the significant cash flow disparities many plans are now experiencing (i.e., benefit payments that far exceed contributions), which impacts a plan’s ability to address underfunding with limited sources of funding. As noted in our recent [Multiemployer Alert](#), cash flow is the main driver of a plan’s ability to recover from poor returns.

⁷ Employee Benefits Security Administration. Form 5500 Datasets. Retrieved April 22, 2020, from <https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/public-disclosure/foia/form-5500-datasets>.

⁸ Ibid.

⁹ 11 historic bear markets, op cit.

The impact of PPA on pensions

PPA addressed funding reforms for single employer plans and multiemployer plans in very different ways. One reason for this is the different funding mechanisms, described above. For example, in recognition of the limited funding sources, multiemployer plans that are considered “critical” can reduce some portions of the benefit, such as early retirement subsidies and ancillary death and disability benefits, for participants who have not yet retired. However, these tools provide limited ability to correct the cash flow disparities between outgoing benefit payments and incoming contributions in the near term because they primarily reduce benefits earned in the future and not those currently payable. In 2014, PPA was amended to introduce a new classification of “critical and declining” for plans projected to run out of money within 20 years. These plans can apply to Treasury to reduce accrued benefits for all participants, including retired participants who are already in pay status receiving monthly benefits, which more directly impacts cash flow in the near term. (At publication, 17 plans have implemented such reductions, and another four applications are currently under review.)

For the single employer system, PPA introduced higher minimum funding requirements, tying liability measures to corporate bond rates, and required faster funding of deficits. Due to a rapid decline in corporate bond yields, coupled with the global financial crisis of 2008 to 2009, the minimum required contribution rules for single employer plans have been relaxed several times since 2006 but still generally remain higher than required under pre-PPA rules. It is sometimes claimed that the changes in PPA successfully addressed the single employer system’s funding challenges, so similar changes would be just as successful in the multiemployer arena. The single employer defined benefit system, that line of thinking suggests, is as healthy as it has ever been thanks to those reforms. For example, during a U.S. House Ways and Means hearing in July 2019, Texas Representative Kevin Brady, ranking member of the committee, said:

“In truth, the underlying problem for [multiemployer] plans is severe mismanagement. It’s not unforeseeable market circumstances. We know that because pension plans for single businesses have recovered from the financial crisis, plus more.”¹⁰

Additionally, Charles Blahous, former public trustee for Social Security and Medicare, stated recently that over the last decade, as a result of PPA’s single employer reforms:

“... the single-employer pension system was becoming healthier than it had been in decades.”¹¹

However, from a high of around 112,000 single employer defined benefit pension plans in the mid-1980s,¹² the Pension Benefit Guaranty Corporation (PBGC) counted just over 23,000 remaining defined benefit plans in the single employer system by 2018. About 7,500 of these remaining plans were frozen to either new entrants, new accruals, or both.¹³ While the plans that remain may be better funded as a result of PPA, the system remains in decline. To say that the single-employer system is healthier while disregarding the fact that fewer Americans will have secure retirement benefits is misleading.

For single employer plans, the impact of the full funding limits and strong investment returns generally resulted in the contribution holidays described above—a period of time when they didn’t have to make contributions to their pension plans. As a result, going into the 2000s, many single employer sponsors had not made significant contributions to their pension plans in years. Similar to multiemployer plans, these pension plans often did not have enough surplus to withstand the poor returns in the first decade of the 2000s. Large contribution requirements came back for most plans after the dot-com bubble burst. Shortly thereafter, PPA changed the rules for these plans to significantly increase both funding requirements and year-to-year funding volatility. Accounting standards also changed in a way that increased the volatility on a plan sponsor’s financial statements. And the insurance premiums these plans had to pay to the PBGC were significantly increased. The combined impact of these events has been a continued decline in the number of plans and participants in the system.

Many of the single employer plans remaining don’t provide new benefits or allow new employees to participate and will ultimately terminate when their funding is strong enough, and the annuity market is affordable enough, for it to make economic sense. From a macro standpoint, a system that for decades provided the security of lifelong income to millions of Americans is quickly dwindling. Application of the single-employer type rules to the multiemployer system would likely have similar results.

¹⁰ Federal lawmakers debate on union pension crisis fix, chief investment officer.

¹¹ Wall Street Journal. No bailout for broke pensions.

¹² PBGC Pension Insurance Data Books and Tables, 2017.

¹³ Ibid.

Summary

The multiemployer defined benefit pension system provides meaningful retirement benefits to over 10 million American families. While many (in fact, most) multiemployer pension funds are considered healthy and continue to address challenges as they arise, the multiemployer pension funding crisis is real. Many plans—as well as the PBGC, which is the backstop for the system—are in significant financial trouble.

It is important that lawmakers understand the many contributing factors to this crisis. Trustees on multiemployer plans (which consist of a joint board made up of both employer and union representatives) were dealt a hand coming into the 2000s that generally included:

- A limited surplus because the government's rules were more focused on limiting tax benefits than responsible pension funding,
- Benefits and liabilities that had often been inflated in order to avoid excise taxes to contributing employers, again as a result of the government's rules that discouraged building a funding cushion, and
- A funding source with limited ability to make up for investment losses, paired with corrective tools that, for many plans, were simply inadequate to fix the problems from two major financial downturns in the span of nine years.

Retirement planning is a long-term proposition, and the consequences of rules and regulations may not be known until years, or even decades, after they are implemented. The rules limiting pension funding in the 1980s and 1990s did not allow pension plans to build up enough of a cushion when investment returns were strong, which would have positioned these plans to absorb the impact when returns were poor. Many of the problems that the system is currently facing were, if not directly caused by these rules, made worse by them. Trustees have spent the last 20 years making difficult decisions as they try to repair their plans and situate them for the future, too often with inadequate tools and in the face of math that simply doesn't work.

Pension reform is always complex, multi-faceted, and (as with all legislative undertakings) must attempt to balance many competing demands on limited resources. The unintended consequences of prior laws have at least partially exacerbated the problems faced by multiemployer plans. Further, while the rules imposed on single-employer plans have led to better funded levels, many plans have been terminated or have frozen benefits, resulting in fewer covered workers. As lawmakers consider options to help with the multiemployer pension crisis it is essential that they consider these factors and the millions of working families that will be impacted by their decisions.



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