Expectations for defined benefit pension plans in 2015

JOHN WIRTSHAFTER | TAX AND BENEFITS CHALLENGES | JAN 07, 2015

Let's face it, 2014 was a relatively tough year for defined benefit pension plans as a whole. The benefits consulting firm, Towers Watson, recently calculated that pension deficits in public company pension plans ended the year with a funding deficit of $343 billion, more than double the $162 billion funding deficit at the end of 2013. By their calculations, about 80 percent of pension funding was covered as of the end of the year, down from 89 percent in 2013. This drop was mostly the result of adverse changes to some of the actuarial assumptions used by plans to calculate liability and occurred despite a relatively strong economy and better than expected investment returns.

This makes 2014 an even tougher year for the Pension Benefit Guaranty Corporation (PBGC), the public agency that insures most private company single employer pension plans and multiemployer pension plans. The PBGC charges covered pension plans an annual premium for the insurance. The fee includes a fixed premium based upon the number of participants in the plan and a variable premium for pension plans that are underfunded. Despite these premiums, the PBGC reported in November that its estimated pension plan deficit had increased to almost $62 billion.

I could spend several articles explaining why so many single employer and multiemployer pension plans have been experiencing funding problems and why the PBGC's funding deficit has risen sharply despite a positive year in the financial markets, but I will spare you the details. Nonetheless, the PBGC indicated "the program's increased deficit in 2014 is largely due to the fact that several additional large multiemployer plans are expected to become insolvent within the next decade". In fact, the portion of the deficit relating to single employer pension plans actually improved during 2014. However, the portion of the deficit relating to multiemployer plans more than quintupled (from $8.3 billion to $42.4 billion). Thus, the total deficit increased by about $26 billion for the year and the looming potential exposure relating to a number of significantly underfunded multiemployer plans threatens to undermine the public insurance agency. In fact, the PBGC recently estimated that the multiemployer pension insurance program has a 59 percent chance of going insolvent by 2022.

With all of this as a backdrop, what should we expect for pension plans in 2015? First, pension plan funding is dependent on a number of variables. Mortality rates and investment returns are two of the factors. Recently, the Society of Pension Actuaries released updated mortality rates that incorporate the fact that people are living longer. As participants and beneficiaries receive pension payments over their now longer lifetimes, more assets are needed in pension plans to fund their retirement payments. As for investment returns, it is hard to predict whether the financial markets will continue to experience strong years as they have done over the past several years. Strong investment results increase plan assets and help to decrease the pension deficit. For reasonably well-funded plans, the positive investment results have helped erase deficits. However, for significantly underfunded plans, the present value of the accrued pension obligations (which is larger and, unfortunately, is also growing) has grown faster than the actual invested plan assets. Thus, the overall deficits have continued to grow; in some cases, significantly.

Perhaps the most significant variable factor impacting pension plan funding is the interest rates a plan must use for determining lump-sum distributions and valuing its future pension obligations. Interest rates are generally based upon a combination of corporate bond rates. Low interest rates means that a plan needs more present dollars to fund future benefit payments. Thus, assume a pension plan owes Sally, beginning upon her 65th birthday, a payment of $600 a month for the rest of her life. If the interest rate is 3 percent, the present value of Sally's future benefit payments will be significantly higher than if the plan can assume an interest rate of 5 percent or 6 percent. Interest rates have been at historical lows for a number of years. It is hard to imagine them going any lower than they are right now. That is good news…or so you would expect. It turns out that economists and pension plan experts have been saying the same thing for quite a while. Assumed interest rates have managed to continue to creep down over the past five years from what was considered to be low rates at that time.

Nonetheless, with the economy continuing to cruise, this may very well be the year in which interest rates start to rise. In addition, the good economy and strong investment returns will help. Thus, my prediction is that single employer pension plans will get healthier in 2015 and the funding status of these plans will slowly improve.

With respect to multiemployer pension plans, the news is not quite as good. There are approximately 1,400 multiemployer plans. The PBGC estimates that 10 percent of these plans, covering approximately 1.5 million people, are in such bad shape that unless significant measures are taken they are likely to become insolvent. On December 16th, President Obama signed into law H.R. 83, the Consolidated and Further Continuing Appropriations Act, providing changes to the rules applicable for multiemployer pension plans. Among other changes (in particular, the extension of certain funding relief and increased PBGC premiums), the new law provides multiemployer pension plans in distress with the ability to cut (suspend) retirement benefits owed to its retirees. The new rules are intended to keep the underfunded multiemployer plans solvent and, thus, to accomplish the same task for the PBGC. By reducing benefits in accordance with the new rules, the funding status of multiemployer plans may be improved to the point they are able to avoid insolvency.

It remains to be seen what actions administrators will take as a result of the new rules. Will they be willing to suspend retiree benefit payments in any significant manner? My prediction is that such actions will be slow to occur. While it is only a subset of the multiemployer plans that are in deep trouble, I don't expect them to be quick to take aggressive action to suspend benefits.

Multiemployer plans are jointly administered by representatives of the union and the participating employers. However, the union representatives have historically had more control over the administration of such plans. Thus, the suspensions are likely to come slowly and in moderation. If this in fact occurs, we will still be looking at a relatively bleak picture for multiemployer plan funding at the end of 2015.

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Having designed and handled employee benefits and executive compensation issues in hundreds of business transactions involving over $30 billion, I bring a broad wealth of legal knowledge, experience and creativity to solving and resolving complex legal issues

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