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Issue Brief

Aligning the PBGC's Single-Employer Premium Structure With Its Objectives

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Key Points

- While private-sector single-employer pension plan security has been sustained over the past half century, PBGC premiums have contributed to the significant decline in the number of covered plan participants, which can be regarded as a major systemic failure.
- PBGC's strong funding level provides an opportunity to rethink the premium structure to better align it with all aspects of its mission.
- A change in premium structure would require legislation and could represent a significant change in the historical contract between PBGC and single-employer plan sponsors.

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The Pension Benefit Guaranty Corporation (PBGC) is a federal government-sponsored insurance program that insures the pension benefits of participants and beneficiaries covered by private-sector defined benefit (DB) plans in the event plans terminate with insufficient funds. The PBGC was established to:

- Encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants;
- Provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under covered plans; and
- Maintain premiums at the lowest level consistent with carrying out its obligations.[1]

Annual premiums in 2024 for single-employer plans covered by the PBGC consist of a per-participant charge of $101 and a variable rate premium (VRP) equal to 5.2% of unfunded vested benefits (UVBs). The variable rate premium is capped at $686 per participant, which equates to underfunding of roughly $13,200 per participant.[2] For plans paying the maximum premium, reducing the number of participants in a plan (headcount) through actions such as paying benefits as a single lump sum or purchasing annuities from insurance companies is often seen as more cost-effective than making additional contributions to the pension plan when it comes to managing premiums.

1 See, for example, the PBGC mission statement.

2 The effective premium rate (i.e., the capped VRP divided by the plan's UVBs) will be less than 5.2% for many plans and will vary based on the size of the UVBs and the number of participants.

As discussed in a previous Academy issue brief, *PBGC Single-Employer Premiums and Their Impact on Plan Sponsorship*, the PBGC's current premium structure, as it relates to single-employer plans, is not well-aligned with this mission. The PBGC's single-employer fund has become much better funded over recent years and is well placed to meet the second of the three objectives noted above. However, this has come at a significant cost to the other two objectives. Based on the PBGC's current funded status and its own projections, premiums are currently well above "the lowest level consistent with carrying out its obligations." The level of premiums, as well as the premium structure, has acted as a significant deterrent to employers' willingness to sponsor DB plans, as discussed in a study commissioned by the PBGC's Office of the Participant and Plan Sponsor Advocate.[3]

While the increase in the security of the pension promise for private-sector single-employer plans has been one of the major successes of the *Employee Retirement Income Security Act of 1974* (ERISA) over the last 50 years, the significant decline in the number of participants covered by these plans can be regarded as one of its major failures. While the PBGC's premium structure is likely not the most significant factor in that decline, it has clearly contributed. At the same time, the PBGC's strong funding level provides an opportunity to rethink the premium structure to better align it with all aspects of PBGC's mission. The sooner changes are made to the premium structure in support of PBGC's mission, as stated in ERISA, the less likely any surplus in the program can be diverted to other purposes by Congress. A change in premium structure requires legislation and could represent a significant change in the historical contract between PBGC and single-employer plan sponsors.

This issue brief discusses options for modifying the PBGC's single-employer premium structure to better support the single-employer DB system while preserving a strong level of retirement security. It does not address the PBGC's multiemployer insurance system, which is subject to a very different premium structure.

3 *Pension De-Risking Study—Plan Sponsor Focus Group: Analyzing the Drivers of Pension De-Risking Activity*; PBGC; July 25, 2018.

The Pension Committee, which authored this issue brief, includes Elena Black, MAAA, FSA, FCA, EA—*Chairperson*; Grace Lattyak, MAAA, FSA, FCA, EA—*Vice Chairperson*; Michael Antoine, MAAA, FSA, FCA, EA; Michael Bain, MAAA, ASA, FCA, FSPA, EA; Rachel Barnes, MAAA, FSA, FCA, CERA, EA; Margaret Berger, MAAA, FSA, FCA, EA; James Burke, MAAA, FSA, FCA, EA; Maria Carnovale, MAAA, FSA; Jonathan de Lutio, MAAA, EA; C. David Gustafson, MAAA, FCA, EA; Scott Hittner, MAAA, FSA, FCA, EA; Lloyd Katz, MAAA, FSA, FCA, EA; Maria Kirilenko, MAAA, ASA, FCA, EA; Gerard Mingione, MAAA, FSA, EA; Maria Moliterno, MAAA, ASA, EA; Nadine Orloff, MAAA, FSA, FCA, EA; Mary Stone, MAAA, FSA, FCA, EA; and Hal Tepfer, MAAA, FSA, FCA, MSPA, EA.

Institutional impediments

The congressional budget scoring process is a primary driver of the most recent premium increases, as well as an obstacle to reducing premiums. The most recent increases were part of the Bipartisan Budget Act of 2015. As discussed in a 2017 letter from the Pension Practice Council to Senate leadership, PBGC premiums are counted as general revenue to the U.S. government, without offset for the pension benefits expected to be covered by those premiums and disregarding the fact that those premiums may only be used for that specific purpose. This scoring mechanism has made it attractive for Congress to raise PBGC premiums, as these increases can be used to support other spending priorities. Politically, using these premiums to offset expenditures is advantageous as premium increases are not usually labeled as tax increases, even though they effectively serve as a tax on pension plan sponsors.

There is little public awareness of this anomalous budget scoring process. The Social Security Advisory Board (SSAB), or a new Retirement Security Advisory Board, could increase awareness of this issue by addressing the impact the process has on the economic security of our growing population of retirees. This issue would fit within the purview of the SSAB (see the Functions of the Board at www.ssab.gov/), as one of its functions is:

- Analyzing the Nation's retirement and disability systems and making recommendations with respect to how the old-age, survivors, and disability insurance program and the supplemental security income program, supported by other public and private systems, can most effectively assure economic security.

The issue could also be addressed legislatively, and a number of bills have been proposed in recent years that include provisions addressing budget scoring. The change in budget scoring could change the premium structure to reduce the total amount collected.

A second obstacle to changing premiums is that the premiums are set by Congress and do not readily adjust to changing circumstances. Rather than stipulating the specific premium rates in legislation, the PBGC, or a separate entity that includes representation from PBGC and its stakeholders, could be given the authority to set annual premium rates. The charter for premium-setting authority should include objectives and incorporate specific guardrails or parameters relating to the elements of the premiums structure. For example, these parameters could constrain the overall level of premiums to ensure they don't increase more than a certain percentage year over year, while providing the PBGC the flexibility to react to current and near-term needs. The PBGC Advisory Committee already includes representation from a variety of stakeholders; something similar might be considered for a premium oversight group.

Unlike the PBGC, the U.K.'s Pension Protection Fund (PPF) has the statutory authority to determine its premium structure under its enabling legislation, the Pensions Act of 2004. Each year, the PPF reviews its premium structure and communicates any proposed changes to all interested parties for their feedback through an extensive formal consultation process.[4] The PPF regularly updates a Strategic Plan that establishes its funding objectives. The 2011 Strategic Plan targeted self-sufficiency (defined as "being fully funded with no exposure to interest rate, inflation and market risks and with protection against future claims and the risks of longevity improvements in excess of our best estimates") by 2030.[5] It was expected that by 2030, PPF would charge a premium equal to expected claims and utilize the reserves held in 2030 if experience was worse than expected. The 2022 review of the Strategic Plan determined that, largely due to higher-than-expected investment returns in past years, future premiums will be substantially reduced while still meeting PPF's long-term funding objective.

It should be noted that in addition to creating the PPF, the Pensions Act of 2004 also created The Pensions Regulator (TPR), whose main objectives include reducing "the risk of situations arising which may lead to compensation being payable from the Pension Protection Fund."[6] The PPF and its governing structure were informed, in large part, by the experience of the PBGC over the preceding 30 years, which helped to identify shortcomings in the U.S.' premium-setting process. The U.K.'s experience, in turn, provides a valuable blueprint for reform of the PBGC's premium and regulatory structure.

Any comparable approach in the U.S. likely needs a similar strategic framework, incorporating objectives related to supporting the ongoing continuation and maintenance of the private DB system. The current PBGC's single employer fund surplus is available to help support these objectives while still allowing for an overall reduction in premium levels.

Potential changes in the premium structure

The remainder of this issue brief discusses specific areas where the premium structure could be modified with the goal of improving the alignment of the structure with the PBGC's mission. This discussion is qualitative; there is no analysis of the level of premium that would apply to each element, nor of the potential interaction between these elements. Incorporating these changes to existing elements, along with the addition of new elements, would lead to a more complex structure that may need to be adjusted as PBGC's level of surplus changes over time.

4 See "Consultation Principles" for a discussion of the rules governing this and similar consultation processes in the U.K.
5 See *Strategic Plan 2011*; Pension Protection Fund; April 2011.
6 See "TPR Strategy: Pensions of the future"; The Pensions Regulator; March 10, 2021.

Lowering the per-person rate of PBGC premiums

The fixed-rate portion of the PBGC premium represents a significant portion of total premiums. As of 2021, it made up 43% of the premium collected for the single employer program. The fixed rate has more than quintupled since the passage of the *Pension Protection Act of 2006* (PPA), going from $19 per covered participant in 2006 to $101 in 2024. This premium has no relation to the exposure of the PBGC to future claims from the participants—it is a simple per-head charge. It is not scaled based on the size of the liability, as is the plan premium for the UK's PPR system, which, in contrast to the American system, targets 10% of its revenue from this source. It is also separate and distinct from the variable rate premium that reflects risk by charging a percentage of the plan's underfunding each year. Structuring the premium in this manner creates strong incentives to discontinue coverage of participants with small benefits through lump sum cashouts and annuity purchases. It also creates strong disincentives to expand plan coverage, either through maintaining an open plan that adds new hires each year or to offer a new plan or extend participation to new groups of employees. Given that the marginal burden that a participant puts on the system in terms of additional administration—unrelated to the size of their liability or the risk associated with it—is very small, one could argue that the fixed-rate premium should be comparably small. The PBGC's recent proposed regulations on valuing plan liabilities refined the expense assumption to more directly reflect this cost. The total charge is only $250 for every participant in excess of 100 ($400 per participant for the first 100), an amount that is covered by about two and a half years of the flat-rate premium. By the time the typical participant vests in their benefit, the sponsor will have paid flat-rate premiums well in excess of PBGC's expenses associated with administering the benefit, should it have to take on this responsibility in the future. The benefits of a healthy DB system may justify an alternative approach that is less directly tied to headcount. That may further argue for even greater reductions in this component of the premium. A larger portion of these costs could, for example, be borne by other components of the premium.

Reducing the variable rate premium

Like the fixed-rate premium, the variable rate premium expressed as a percentage rate applied to the plan's unfunded liability has risen dramatically in the last few years. In 2006, the rate was 0.9% of the unfunded liability. It has since increased to 5.2% of the unfunded liability in 2023. While in some cases this creates an incentive to fund the plan and reduce the amount of the underfunding, essentially promising a guaranteed return of 5.2% on contributions, it also creates an incentive to freeze benefits or to exit the DB system entirely. It diverts a meaningful portion of the assets of the plan away from providing benefits to participants.

Furthermore, the interaction of the variable rate cap with the initial variable rate premium may drastically reduce the incentive to fund the plan. In 2024, the variable rate cap is $686 per participant. That means that once the underfunding of the plan exceeds roughly $13,200 per participant, the variable rate premium is fixed at that cap, no matter how large the unfunded amount becomes. That also means that the unfunded amount must be reduced below that $13,200 per participant level before any reduction in the variable rate premium is realized. Instead, the sponsor has a strong incentive to reduce headcount in the plan by settling the liabilities of those with small benefits and eliminating any future growth in the plan population by closing the plan. To the extent these choices cause fewer people to earn benefits under a DB plan, they are detrimental to the ongoing health of the DB system and to the financial well-being of the participants that might otherwise benefit from the plan. Employing a lower percentage for the variable rate premium reduces the penalty for plans with low levels of underfunding and preserves the incentive to reduce underfunding over a wider range of funding levels. It also results in a more equitable premium structure that increases premiums in proportion to the growth in the system's baseline risk from unfunded liabilities.

When the plan's variable rate premium is determined by the per-participant cap, sponsors may find that substantial contributions are required before the plan's funded level improves sufficiently to lower the variable rate premium. These sponsors will generally see more significant premium savings by reducing headcount, rather than by making contributions to the plan. Headcount reduction is achieved by offering a cash-out window for terminated vested participants or buying annuities for a group of retirees, particularly those with smaller benefits. These actions reduce both assets and liabilities, without significantly affecting the overall level of underfunding. Yet, the premium savings can be substantial. In 2024, the maximum per-participant premium is $787, reflecting both the flat rate premium and variable rate premium cap. For a plan that is expecting to pay this maximum premium for 10 years, the expected value of future premiums, and resulting savings for reducing headcount, is roughly $6,000-$7,000 per participant. For a larger plan in this situation, reducing participant headcount by 1,000 will potentially save up to $7 million in premiums without improving the retirement security of the remaining participants or reducing risk to the PBGC.

Measures to encourage the continuation and maintenance of defined benefit plans

Possible modifications to the premium structure include lowering the premium attributable to retired participants. The rationale for such a change includes:

- Providing an incentive for plan sponsors to encourage annuity options instead of a lump sum, thus providing participants with reliable retirement income and encouraging an ongoing commitment to DB pensions.

- Retiree annuity benefits provide a predictable payment stream that is relatively easy to hedge and therefore represents lower risk to plans and to the PBGC than comparable non-retired liabilities. It is also reflected in a lower premium charged by insurers to take on benefits for retirees compared to benefits for non-retired participants.

Should a plan incur a distress or involuntary termination, the assets of the plan are used first to pay benefits for retirees and others who are nearest retirement. These liabilities then present a lower risk of being underfunded than liabilities for deferred and active participants.

On the other hand, the premium savings for actions that reduce headcount without reducing risk could be lowered. The combination of changes discussed here would make it less likely for a premium cap to apply, thereby reducing the most significant source of headcount-related savings.

Risk-based premium-setting

Aligning premiums with a plan's probability of paying out benefits owed requires taking a risk-based approach to the premium structure that reflects more risk factors than just the dollar amount of UVBs. This approach shifts premiums away from financially healthy sponsors with better funded plans. The greatest risk factors for a pension plan requiring the use of PBGC funds are (1) plan sponsor bankruptcy; and (2) plan underfunding at the point of plan termination.

Bankruptcy—A premium structure that encompasses the risk of bankruptcy not only better aligns premiums with risks, but also encourages good financial health. There is an inherent moral hazard with any insurance that encourages risky behavior based on the knowledge of protection in the downside event. In this case, when plan sponsors know their employees' pension income is covered by the PBGC, they may make more risky plan investment and funding decisions or more quickly jump to bankruptcy as a solution.

The risk of bankruptcy is hard to measure, but indicators can be found in the financial health of the plan sponsor. One such measure may be the plan sponsor's credit rating assigned by major crediting agencies. This is publicly available information for many companies, and while it's not public for private companies, it's used by creditors. These credit ratings could be used to develop a probability of bankruptcy, with larger premiums paid for those with higher probabilities. Some plan sponsors, particularly private ones, may not be in favor of sharing this company information. However, the PBGC already has in place procedures for confidential information, such as its confidential letters to plan sponsors.

The credit rating information may not be readily available for smaller employers, and these employers likely pose less of a risk to PBGC. Accordingly, there may be a minimum threshold based on plan size or size of the sponsor to apply a credit-based adjustment.

There are some examples for measuring financial health already in practice, including the U.K.'s PPF and the risk-based premium method used by the U.S. Federal Deposit Insurance Corporation (FDIC). The PPF assesses risk-based premiums, including insolvency risk and underfunding risk. The likelihood of bankruptcy is determined by a credit rating agency, such as the Dun & Bradstreet model, which assesses the likelihood a company will cease operations or use legal relief in the next 12 months on a scale of 1-100 using sponsor credit rating data, if available. See PPF guidance for more details. The FDIC uses a risk-based premiums system to insure bank deposits against loss. The system was set up to encourage lower risk taking, where banks are assessed based on aggregate amount of assets and a rating reflecting capital, asset quality, management, earnings, liquidity, and sensitivity to market risk (referred to as "CAMELS").[7] Similarly, PBGC reportable event rules contain reporting exemptions for sponsors that have a low risk of default based on certain well-defined criteria. PBGC may expand on this approach to permit a reduced premium for certain sponsors.

Plan investments—PBGC premiums currently reflect plan underfunding in the structure, but could be refined to take into account other factors, such as riskiness of plan investments. There are several shortcomings when considering plan underfunding alone, including how much that underfunding may change in the future. Future underfunding may result from high-volatility assets, mismatch of assets against liabilities, lack of required contributions to the plan, or an increase in benefits under plan. Some of these risks are mitigated for single-employer plans by the IRS funding requirements (Minimum Required Contributions) and restrictions on increasing benefits in significantly underfunded plans. That said, risks to the future funded status of the plan from investment volatility and asset-liability mismatch remain and are not reflected in the current premium structure. Moreover, plans are more likely to be subject to bankruptcy in unfavorable economic times. If the plan is invested in volatile assets, the timing of sponsor bankruptcy may be correlated with reduction in asset values, increasing the underfunding at the time of bankruptcy. By incorporating asset riskiness into the premium structure, the risks to the program are better reflected, and the premium structure encourages safer investment practices for plan sponsors.

7 See 2007 GAO paper *Deposit Insurance: Assessment of Regulators' Use of Prompt Corrective Action Provisions and FDIC's New Deposit Insurance System*.

Pension plans have many options when it comes to investment strategies, from simple passive mutual funds to complex active management. The goal of the strategies can also be diverse, from return-seeking to stable value. To incorporate asset risk in the premium structure, a mechanism is required to measure the risk in a transparent and straightforward way that can be applied to the thousands of single-employer pension plans that file PBGC premiums every year.

Some options to measure investment risk include:
Collect information on asset classes and apply a formula based on the standard deviation of returns in each asset class.

- Factor in correlations between the asset classes to develop a more detailed measure of volatility.
- Consider the asset-liability view of the plan to encourage immunized plan investments or liability-driven investments.
- For risk-sharing plans where underfunding does not change based on investment decisions, consider the potential movement of assets in relation to liabilities (funded status volatility).

The PPF provides one example of how investment risk can be addressed in a pension insurance program. It uses an asset stress measurement based on traditional asset classes, and liability-driven investments have their own special stress test. There is an additional risk factor stress for complex assets such as derivatives.

A downside of increased premiums for return-seeking assets is increased premiums for open pension plans taking a long-term strategy to grow assets to reduce employer contributions. The premium structure should not discourage DB plan maintenance. An option for these plans is to permit the sponsor to submit a more detailed risk assessment of assets and liabilities. Premiums could be reduced if this assessment shows lower funded status volatility than might otherwise be expected. Smaller plans could have a different investment-based adjustment reflecting the smaller risk they pose to the system. Also, pension plan sponsors that hold substantial assets outside the plan may wish to reduce their premiums by pledging these assets to the PBGC in the event of bankruptcy.

Collecting investment information may help the PBGC to incorporate investment risk into the calculations of PBGC's long-term funding. If the PBGC has a clearer picture of the pool of assets and asset classes held by all employers, they can better assess the risk of underfunding in the future under different economic conditions and diversify or hedge accordingly.

Lowering premiums for risk-sharing plan designs

Certain plan designs are inherently less risky to plan sponsors and to the PBGC. For example, variable annuity plans and cash balance plans that adjust benefits based on the return on plan assets eliminate most of the investment risk as long as benefits are fully funded as they accrue. Under current IRS rules—and, by extension, the measurement of the value of vested benefits for PBGC purposes—it is not clear that the liability value reflects this alignment. Ideally, measures for both funding and premium purposes could be clarified to reflect appropriate valuation of these liabilities and avoid artificially overstating or understating liabilities, therefore misstating the plan's funding level. Further, if a plan's assets or funding level are adjusted to reflect the riskiness of investments, as discussed in the plan investments section, such an adjustment does not need to apply to assets backing risk-sharing designs to the extent that asset volatility is offset by corresponding changes in benefit liabilities. These concepts are discussed in some detail in the *Variable Annuity Plans* practice note.

Higher charge for practices that perpetuate or increase underfunding

Risk charges for the exposure that a plan presents to the system need not be exclusively based on a snapshot of the financial condition of the plan and the sponsor at a given time. Certain practices, when employed consistently, increase the risk of the plan and may be charged accordingly. To a certain extent, this already exists in the current premium structure. Plans failing to meet certain funding criteria over at least two consecutive years are deemed "at-risk" and begin to phase-in the use of liabilities assuming accelerated timing of benefit commencement and the addition of certain specified loads to the liability. These liabilities are fully phased-in after five consecutive years of "at-risk" status. The "at-risk" liabilities are currently used for calculating the variable rate premium. However, this effect may be limited due to the application of the variable premium cap and the use of stabilized interest rates to determine whether a plan is deemed to be "at-risk." For premium purposes, PBGC could require at-risk status to be determined without regard to interest rate stabilization, thereby tying this calculation more closely to current market conditions.

There are other practices that might reasonably increase plan risk and warrant increased premium, including:

- When a sponsor fails to contribute at a rate that closes the funding deficit over a reasonable period of time, it raises the probability that a downturn in the business cycle will coincide with a plan's inability to meet its obligations without additional cash from the sponsor. In this scenario, it is unlikely that the sponsor will be able to offer that additional cash support. Minimum funding rules may not be sufficient to

meet this standard. There are several ways this concept could be incorporated into the premium determination, including permitting the employer to enter into an agreement with the PBGC to accelerate funding in order to reduce the premium.

- Failure to adjust investment risk over time as the plan matures, which may also increase exposure to the system that is incrementally subtle but accumulates to an imposing risk to the single-employer program. Implementing additional charges for such practices could help to protect the system against the risks incurred and provide incentives for sponsors to manage their plans more responsibly.
- A pattern of adopting plan amendments that improve past-service or shutdown benefits results in a plan that appears better funded than if those future improvements were incorporated into the plan by formula. Certain limits on PBGC guarantees that exclude recently adopted amendments already mitigate this practice to some extent.

Transition

Transition from the current premium structure to a new structure will inevitably produce winners and losers. In particular, full implementation of the risk adjustment factors described above could result in substantial premium increases for some of the less well-funded plans and less financially healthy sponsors. These sponsors may be least able to handle such an increase and may have incorporated the current structure into their financial planning. Fortunately, the PBGC's existing surplus provides an opportunity to mitigate some of the challenges—such as an abrupt increase in premiums for some sponsors—that could otherwise result from such a change. Possible transition approaches include:

- Allowing determination of premiums under the current structure for a specified period and/or phasing in any increases resulting from the new structure.
- Applying a smaller risk-based charge to liabilities associated with benefits earned prior to these changes, and to a corresponding amount of plan assets, applicable to liabilities for benefits earned after the changes.

Ongoing application of PBGC surplus

PBGC may also apply a portion of the surplus to longer-term goals that encourage behaviors that extend the life of DB plans. These would include further reductions in premium rates relating to retired liabilities or recent benefit accruals or accruals for new hires.

Conclusion

A more flexible and responsive premium structure could go a long way toward supporting the PBGC's objective of encouraging the continuation and maintenance of private-sector DB pension plans. This issue brief discusses several elements that might be incorporated into a revised premium structure. Much of the details to implement any of these concepts need development, ideally by a body that is knowledgeable about the associated risks and sensitive to the interest of stakeholders. The single-employer program's current surplus provides an opportunity to introduce changes in a manner that avoids disruptions to the system and to participating sponsors.

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