The single biggest problem for multiemployer pension plans

In brief

• There has been a significant shift toward defined contribution plans as the primary vehicle for helping individuals save for retirement, but defined benefit plans still account for a significant share of retirement assets.

• The financial crisis left many pension plans - both public and private - in an uncomfortable situation. As risk assets tumbled in 2008 and early 2009, the funded status of these plans deteriorated, with private multiemployer pension plan funded status reaching a low of 53% in early 2009.

• Multiemployer defined benefit plans are unique in the sense that the discount rate used to determine the present value of liabilities is based on the plan’s expected return, rather than a market-based rate.

• While the bull market and rising interest rates have helped to bring the funded status of many plans back into balance, the multiemployer system continues to struggle, and has not enjoyed the same benefits from rising rates as has been the case with single-employer plans.

The current landscape

In 2016, there were 1,296 multiemployer plans covering approximately 10.3 million participants. Of these participants, 3.8 million were active participants, 3.7 million were retirees and beneficiaries, and 2.8 million were former employees who worked long enough to earn vested benefits in a pension plan but left the company sponsoring the plan and are not yet receiving retirement benefits. Many of these participants are employed by small companies in the building and construction industries, but these plans also cover employees in retail trade, manufacturing, mining, trucking and transportation, and entertainment industries (Exhibit 1).

1 http://www.milliman.com/mpfs/
In 2015, nearly 65% of plans were in the Green Zone, meaning that they would most likely be able to pay all of the participants’ benefits without changes to employer contributions or participant benefits. However, 12.5% of plans were classified as endangered, meaning that their funded status was less than 80% and they were projected to have a funding deficiency in one of the next six years. The remaining nearly 24% of plans were classified as “critical or declining,” as their funded status was less than 65% and the plan was expected to be insolvent within five years. These “critical or declining” plans are required to adopt a rehabilitation program to improve funded status over a 10-year window, and simultaneously provide notice to all plan participants, beneficiaries, the collective bargaining parties, Pension Benefit Guaranty Corporation (PBGC) and the Department of Labor (DOL). These solvency problems stem from a number of areas. To start, the multiemployer system has not enjoyed the same benefits from rising rates as has been the case with single-employer plans, which have seen the value of future liabilities come down as interest rates have risen. Additionally, the ERISA anti-cutback rule has prevented plan administrators from amending plans in a way that decreases accrued benefits, and excise taxes on contributions to overfunded pensions have incentivized some trustees to increase benefits during good times in order to avoid paying this tax. Furthermore, the decline of the U.S. manufacturing sector and union membership more broadly, coupled with demographic headwinds, have led this situation to become increasingly unsustainable given the reliance on employer contributions to fund these plans.

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EXHIBIT 2: TOTAL NUMBER OF PARTICIPANTS AND BENEFICIARIES IN DEFINED BENEFIT PLANS
Millions of participants and beneficiaries

<table>
<thead>
<tr>
<th>Plan Type</th>
<th>Participants</th>
</tr>
</thead>
<tbody>
<tr>
<td>Single employer</td>
<td>28.6</td>
</tr>
<tr>
<td>Multiemployer</td>
<td>10.3</td>
</tr>
</tbody>
</table>

Source: Department of Labor, J.P. Morgan Asset Management. Based on Form 5500 filings for plan year ending 2015. Single employer plans include single employer plans, plans of controlled groups of corporations and multiple-employer non-collectively bargained plans. All defined benefit plans paying premiums to PBGC’s single employer program are included. Multiemployer plans include multiemployer plans and multiple-employer collectively bargained plans. All defined benefit plans paying premiums to PBGC’s multi-employer program are included. Data are as of November 12, 2018.

Broad economic impact

Unfortunately, prospects for improvement seem limited at the current juncture. Potential solutions, such as decreasing the discount rate used to determine the value of future liabilities, would exacerbate an already problematic situation, while increasing contributions would increase the financial burden on employers, dragging on profitability and potentially putting these companies out of business. The best solution seems to be one based on federal loans; while our read of the situation is that this outcome is somewhat inevitable, it may be challenged given uncertainty around the ability for the loans to be repaid.

While few of the proposed resolutions are palatable to all those involved, the collapse of the multiemployer pension system would create notable headwinds for the U.S. economy. With some of the largest multiemployer plans at risk of insolvency if restructuring does not occur, there is the potential for the PBGC - which insures benefits promised by defined benefit private pension plans - to become insolvent as well. In fact, a recent report from the PBGC suggested that it would be insolvent by 2025 if some sort of corrective action is not taken (Exhibit 3).

The collapse of the multiemployer system would lead participants and retirees to receive only 50% of what they had expected, and the subsequent collapse in the PBGC would leave them only receiving about 2% of those expected benefits. Put another way, if the average worker expected to collect $20,000 per year in retirement, failure of the multiemployer system would lead this amount to fall to $10,000, followed by a mere $400 if the PBGC were to fail as well3.

EXHIBIT 3: EXPECTED INSOLVENCY FOR MULTIEMPLOYER PENSION PLANS IN CRITICAL AND DECLINING STATUS
Cumulative number of participants, thousands, cumulative benefits paid, millions of U.S. dollars

Source: Congressional Research Service, J.P. Morgan Asset Management. Based on 2015 Form 5500 data. Plans in critical and declining status must indicate the year in which they expect to become insolvent. This chart is for illustrative purposes only. Data are as of November 12, 2018.

The failure of these institutions and sharp drawdown in benefits received would have a significant impact on the economy through a number of channels. First, employers would struggle, as increased contribution requirements, coupled with increasing unfunded liabilities, would make it difficult for these firms to compete. In many cases this could drive these employers into bankruptcy, hitting small employers

hardest, but also would impact large multinational employers who contribute to multiemployer plans. As these firms come under pressure, they would likely take action in an effort to get things back on track. These actions would likely be characterized by cost cutting and layoffs, leading the unemployment rate to rise and economic growth to slow. This environment of softer economic growth would lead to a more challenging return environment for a plan’s investments, thereby creating a negative feedback loop, which further exacerbates the underfunded status of the multiemployer system.

Diving in deeper, 3.7 million retirees and beneficiaries received about $41 billion in benefits in 2016, which is estimated to have generated around $83.5 billion of economic output\(^4\). This suggests that each dollar of benefits that a participant receives has historically generated just over two dollars of economic output.

With the number of retirees expected to increase over time, and nearly 70% of nominal GDP coming from consumption, multiemployer pension plans will remain as an important support for economic growth in the years to come. However, with nearly $560 billion in unfunded liabilities\(^5\) (as of 2015) and 13.6 million total jobs related to the multiemployer system\(^6\), failure to pay these benefits could result in a significant drag on consumption and a notable reduction in federal, state and local taxes (Exhibit 4).

So what can we do?

There have been a number of suggestions as to how to fix this problem; the issue is, very few of them will actually work. A common proposal involves reducing the discount rate that these plans use to calculate their future liabilities. While discount rates in the multiemployer system are meant to measure the expected return on a pool of assets – and given our expectation for more muted returns going forward, a lower discount rate may be appropriate in certain situations – substantially reducing the discount rate would dramatically increase the funding required to keep these plans solvent (Exhibit 5). For example, with 64% of plans currently sporting a funded status of greater than 80% (putting them in the Green Zone), a shift to either a corporate bond or 30-year U.S. Treasury yield would reduce the share of plans in the Green Zone to 7% and 2%, respectively\(^7\). Furthermore, the impact of higher discount rates on required contributions would be severe. Required contributions are a function of the value of the benefits accrued during the year, the operating expenses of the plan, and a payment to help reduce any unfunded liabilities. The use of a higher discount rate would not only create a headwind to reducing unfunded liabilities, it would simultaneously increase the value of accrued liabilities and likely result in

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higher operating costs as well. It is also important to note that the use of market rates would increase the volatility of plan funded status, a potential issue when contribution rates are often times determined for three years or more through the collective bargaining process.

EXHIBIT 5: PLAN ARRTITUTES UNDER DIFFERENT DISCOUNT RATES

As a result, it seems that there are three things that could be done to address this issue: increase contributions, decrease benefits or obtain a loan to improve the funded status of these plans. The first option is relatively challenging to implement, as few employers would be able to sustain the financial burden of the contributions required to remedy the problem. The second option – decreasing benefits – is equally challenging, as the ERISA anti-cutback rule prevents this from occurring. While the Multiemployer Pension Reform Act (MPRA) of 2014 did provide one channel through which struggling pensions can reduce benefits, there have only been seven instances since 2016 where reductions were approved. The third route – some sort of loan – seems like the best option, but may be challenged given significant growth in the debt and deficit this year and uncertainty around the ability for the loans to be repaid. As such, the road to any resolution looks set to be a rocky one.

The broader issue here is that increasing contributions, decreasing benefits or providing a federally backed loan all call the viability of the broader defined benefit system into question. If confidence in the system is eroded, the potential economic drags described above may become even more severe as participation decreases and employers see profitability come under pressure. In other words, if employers do not believe that their employees will receive their promised benefits, there will be a race for the exit and only an empty bag left behind. As a result, while the road to resolution will be challenging, it is one that must be taken. In the end, policymakers and stakeholders will need to work together in order to come up with a viable solution that is acceptable to all parties, as failing to do so could have significant implications for the broader U.S. economy.

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