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A Pension Pandemic – Summer 2020

Merriam-Webster defines a *Pandemic* as ”... an event occurring over a wide geographic area and affecting an exceptionally high proportion of the population.“ The growing number of retirees dependent on public assistance for basic living needs and health care is a pandemic. Pension plan coverage rates have fallen to 25% of private sector workers with other negative trends emerging. There will likely be an additional 25 million or more private sector employees entering the over-age 50 population during the next generation with insufficient retirement income.

The reasons for this situation include:

- U.S. personal savings rates were as low as 2.2% of wages in 2005, with no savings for the bottom wage earners having no disposable income. This is why the Social Security retirement system was established.
- Jobs are no longer viewed as long-term relationships with employers that build meaningful pension benefits.
- Investopedia indicates that the average Section 401(k) balance at ages 65-69 for the few who have balances is about $182,100, sufficient to provide only about four years' living expenses at a reasonable living standard.
- Workers lack the critical thinking skills to see the need for future retirement benefits; so, do not demand bona fide pension benefits in lieu of direct wages.
- Employers do not want the responsibilities for Defined Benefit Plans (DB Plans) that have arisen from flawed pension regulations, so take a path of least resistance, i.e., few new real pension plans are adopted.
- DB Plans that pay Lump Sum Distributions (LSDs) and/or purchase Single Premium Life Annuity (SPLA) contracts incur unreasonably large liabilities due to historically low IRS mandated valuation interest rates.
- Plan assets liquidated during depressed financial markets to pay LSDs or to purchase SPLA contracts activate realized investment losses from unfunded liabilities that can not be recovered.

Some serious misconceptions discourage the formation of new DB Plans:

- *Costly pre-packaged investment products with prototype plan documents are required* - many employers do not realize they can "own" their plan documents and pay monthly benefits from investment funds they control.
- *PPA '06 negates the advantages of DB Plans* – well designed DB Plans that pay only life annuity benefits from managed investment funds permit favorable plan design provisions to control funding costs.
- *Self-administered investment funds impose excessive investment fiduciary liability* – ERISA permits the delegation of investment management fiduciary responsibility to a professional investment manager.
- *DB Plans must offer a LSD payment option* – DB Plans have traditionally restricted payment options to life annuity benefits. Fair Market Value (FMV) fluctuations recover the comparatively minimal realized investment losses from periodic benefit payments directly from plan assets.
- *DB Plans are too expensive* – well designed DB Plans return a profit from tax deferrals for management employees and redirection of some direct compensation to pension funding.

ERISA enacted in 1974 retained Plan Sponsors' discretion in the selection of actuarial assumptions to determine funding and benefit present values as part of their Funding Policy for their DB Plans. Beginning in the late 1980s and early 1990s, employers' rights to select single employer DB Plan

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assumptions were gradually confiscated through a series of Pension Acts in the name of employee protections. In 2006, PPA '06 completed the takeover of discretionary employer assumptions selection for both minimum funding valuations and LSD present value determinations. Employers rebelled at the loss of their ERISA granted rights to select plan assumptions meeting their objectives. This, and the complexity of the PPA '06 requirements discourages new DB Plan formations.

After fixed income interest rates fell to near-zero levels from over 7.0% after 2008, the regulations continued to apply corporate bond rates for LSD present value calculations. This was despite granting liberal "funding relief" measures to overstate reasonable minimum funding interest rate assumptions.

LSD present values are based on the Minimum Present Value Segment (Interest) Rates (MPVSRs) shown in the third page of IRS' monthly interest rate Notices. The Notices define the MPVSRs as the "... spot first, second, and third segment rates for the month ..." calculated from the Corporate Bond Monthly (100 year) Yield Curve that shows on both the fourth page of each Notice for the month before and the St. Louis Federal Reserve's website. Investopedia defines a Yield Curve as "... a line that plots yields 'investment rates' of bonds having equal credit quality but differing maturity dates.", and says the slope of the yield curve predicts " ... future interest rate changes ...". The spot rates are averages of the yield curve rates as defined under 26 CFR § 1.430(h)(2)-1 (c)(2) (i), (ii) and (iii), and best illustrated from the Corporate Bond Yield Curve shown in IRS Notice 2020-57 for June 2020 as show below:

	Rate	How Calculated Over Years	How Applies
First Spot Rate	0.74%	Average of Maturities 0.5 – 5.0	Discounts benefit payments years ≤ 5
Second Spot Rate	2.57%	Average of Maturities 5.5 – 20.0	Discounts benefit payments years 6-20
Third Spot Rate	3.32%	Average of Maturities 20.5 – 100.0	Discounts benefit payments years ≥ 20

These are the rates that discount each benefit payment to its single sum value at the valuation date. Present values vary inversely with discount rates, i.e., lower discount rates produce higher LSD present values because more of the benefit payment is from monetary principle. MPVSRs have continued to decline with declining corporate bond rates. Recent 1st, 2nd, and 3rd segment rates and a sample of increased unfunded liabilities on $500,000 of funded liability from a mature DB Plan follow:

	IRS	MPVSRs			FMV	LSD Present	Unfunded
As of	Notice	1st	2nd	3rd	Plan Assets	Value	Liability
November, 2018	2019-03	3.43%	4.46%	4.88%	$500,000	$500,000	$ -0-
November, 2019	2020-01	2.04%	3.09%	3.68%	600,000	573,000	(27,000)
May, 2020	2020-45	1.08%	2.78%	3.47%	450,000	675,000	225,000
June, 2020	2020-57	.74%	2.57%	3.32%	490,000	695,000	205,000
August, 2020	2020-72	.52%	2.22%	3.03%	530,000	735,000	205,000

Historical charts on the Internet indicate high quality corporate bond rates were at their lowest since the mid-1950s at the end of July 2020. Corporate bond rates, hence MPVSRs, will remain abnormally low until investors can obtain larger risk premiums for corporate bonds compared to default-free U.S. Treasuries. Current monetary policies and economic conditions do not imply stable investment return rates that will lower unfunded pension liabilities in the absence of other changes. The short-term equity spikes during late Summer from government stimulus infusions are most likely temporary.

Public policy will eventually return employers' discretion to assumptions selection to promote privately sponsored DB Plans. Please call or e-mail any questions or comments.

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