Two Paths Forward: Bringing Long-Term Sustainability to the Multiemployer Pension System

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Prior to the 2021 passage of the American Rescue Plan Act, the multiemployer pension system was engulfed in crisis. Well over 100 plans faced inevitable insolvency, and more than a million participants were certain to lose their retirement benefits. Not only were plans failing, the government agency charged with backstopping the plans also faced insolvency. ARPA averted this catastrophe. Many people try to avoid using the word ‘bailout’ because of the negative reactions it generates, but the multiemployer pension section of ARPA is a bailout if there ever was one.

This disastrous situation was not the result of misdeeds or bad actors. Nobody stole anything and nobody lied. Plans faced insolvency despite having followed all of the myriad rules that Congress and the regulatory agencies created for them. The problem was the rules themselves, which were developed piecemeal over a period of several decades. Each provision of law and regulations was well-intentioned and seemed reasonable at the time, but in the aggregate, they led to a dangerously unstable retirement system.

Now that the crisis has subsided, surely steps have been taken to ensure that it does not happen again, right? After all, a good rule of thumb is that if the federal government needs to write a $100 billion dollar check to rescue you, you should reconsider how you do things. Alas, despite years of hard work and earnest negotiation, members of Congress were unable to agree on a bipartisan approach to reforming the multiemployer pension system. Today plans are funded more-or-less in the same manner as before, and their benefit promises are similarly unchanged.

The most obvious consequence is the risk of another funding crisis. There are hundreds of plans categorized in the so-called “green zone” that currently do not face any funding distress but would also have great difficulty recovering from large investment losses coupled with sizable declines in their covered workforces. In other words, they are vulnerable to the exact same forces that necessitated the ARPA bailout.

A secondary consequence is that employers are generally very reluctant to accept the risks of participating in the multiemployer pension system. Underfunding results in escalating contribution costs and exposure to withdrawal liabilities, both of which create business hardships for employers who must still compete with companies that do not sponsor pension plans. Contributing employers effectively provide long-term insurance against stock market losses, which is a risk that even actual insurance companies are unwilling to accept. Very few employers will even consider entering these plans, and many that currently contribute would prefer to stop, which is not a recipe for long-term success.

Pension actuaries can attest to the complexity of pension funding, as they spend years studying for actuarial exams to develop their expertise in this area. But complex problems can often be distilled down into simple concepts, and that is the case here. The multiemployer system lacks stability because it promises benefits that are intended to be *guaranteed*, while supporting those promises with resources that are *uncertain*. Sooner or later, that mismatch is going to cause very large problems.

Outside of unusual circumstances, and subject to many limitations, the trustees of multiemployer pension plans do not have the ability to reduce pension benefits after a participant earns them. When reductions do occur, it is widely perceived to be a failure rather than an anticipated and accepted part of the system.

Most sponsors allocate a majority of the plan assets to equities and other return-seeking asset classes. Over the long investment horizons in which pension plans operate, it is likely that these investments will substantially outperform low-risk investments, although they are also capable of producing significant losses during periods of economic decline. This approach is aligned with the advice provided by personal financial advisors, nearly all of whom recommend investing a large portion of 401(k) balances in risk-bearing asset classes. Pension funding calculations anticipate the expected returns on these assets, as well as the expected contributions from employers, both of which are uncertain.

The crisis occurred because plans *promise* benefits that they *expect* to be able to pay. Bringing stability and sustainability to the multiemployer pension system requires aligning the risk characteristics of the benefits with the risk characteristics of the resources supporting those benefits. There are two approaches to accomplishing this goal:

- <u>Invest plan assets exclusively in low-risk asset classes.</u> The investments would be expected to produce lower rates of return compared to current asset allocations, resulting in a combination of smaller retirement benefits and higher contribution costs. But the highly predictable nature of the returns would minimize the possibility of plans being unable to pay the promised benefits.

- <u>Provide benefits that are intended to be variable.</u> Plans could continue to take greater investment risk and participants could expect to receive higher benefit levels associated with higher returns, but when investment losses result in underfunding, all stakeholders would understand that benefit reductions may be necessary to mitigate the underfunding.

The first approach sacrifices superior investment returns to achieve predictability, while the second approach sacrifices predictability to achieve superior investment returns. Either method would work, but what does not work is pretending that it is possible to have both. This tradeoff is consistent with a fundamental concept of finance, and arguably a fundamental concept of life. Following a conservative path protects you from getting hurt but also limits the upside. Taking risk is necessary to achieve strong results, but you must be prepared to accept the consequences when those risks do not pay off.

There are practical limitations with respect to applying these principles to the existing benefits and liabilities in the multiemployer pension system. It would be unreasonable to expect employers to bear the increased costs that would result from moving current plan assets into low-risk investments. Similarly, it would be unreasonable to expect employees to accept variability in benefits that they were told would be guaranteed. These limitations, however, do not exist with respect to the future benefit accruals.

The best way to bring stability to the multiemployer pension system is to require that going forward, benefit accruals must either be supported by investments held in low-risk asset classes, or the benefits must be allowed to vary in response to adverse investment experience. There would, of course, be many details to be worked out, but implementing these principles would put the system on a path towards long-term sustainability. Plan sponsors, or perhaps even plan participants, could choose either approach, or a combination in which the benefit accruals are split between the approaches.

Experience has revealed the fallacy of taking investment risk without acknowledging the potential consequences of that risk. You cannot have the good without the bad. The rules governing multiemployer pension plans should be updated to require that plans make a choice between return-seeking investments and guaranteed benefit levels. Perpetuating the illusion that it is possible to have the best of both worlds will lead to future crises and the continued erosion of the system.