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PBGC Updates Its 'Termination Liability' Mortality Assumptions

BY HAROLD J. ASHNER

On Dec. 2, 2005, the Pension Benefit Guaranty Corporation issued a final rule that amends its benefit valuation regulation by adopting more current mortality assumptions.[1] The updated assumptions (a version of GAM-94), according to PBGC, will better conform to those used by private-sector insurers in pricing group annuities than do PBGC's current assumptions (a version of GAM-83). This article briefly summarizes and analyzes PBGC's final rule, which is available at http://www.pbgc.gov/docs/vbma.pdf.

Applicability of Valuation Regulation. PBGC's valuation regulation[2] sets forth the rules for valuing benefits in a single-employer plan that terminates in a distress or involuntary termination. These rules are used by PBGC to allocate plan assets to the six priority categories of benefits under Section 4044 of the Employee Retirement Income Security Act of 1974 ("ERISA"). This allocation has several important consequences:

■ **Funding of plan benefits.** The most direct consequence of this allocation is that it determines the extent to which, as of the plan's termination date, participants' benefits are funded by plan assets. Under ERISA Section 4044, the plan's benefit liabilities are valued in accordance with PBGC's valuation regulation, and the plan's assets are then allocated to them in a prescribed order. To the extent that plan assets are allocated to benefits that are guaranteed by PBGC, PBGC's losses are reduced; to the extent that plan assets are allocated to nonguaranteed benefits, participants' losses are reduced. (In some cases, plan assets are allocated to nonguaranteed benefits before they are allocated to guaranteed benefits.) The allocation also plays a key role in determining the extent to which participants will receive a portion of their nonguaranteed benefits that are *not* funded by plan assets; this may occur through the "sharing" of PBGC employer liability recoveries under ERISA Section 4022(c).[3]

■ **Determination of employer liability.** The difference between the value of the plan's benefit liabilities and the value of the plan's assets (with both values determined in accordance with PBGC's valuation regulation) equals the amount of PBGC's employer liability claim for the plan's "unfunded benefit liabilities"[4] upon plan termination.

■ **Authorization to attempt private-sector closeout.** PBGC may authorize the plan administrator of a plan that has sufficient assets to provide at least all guaran-

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[1] 70 Fed. Reg. 72205.
[2] 29 CFR Part 4044, Subpart B.

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[3] See ERISA Sections 4001(a)(17)-(19), 4022(c), 4044, and 4062.
[4] ERISA Sections 4001(a)(18), 4062.

teed benefits to attempt a private-sector distribution in lieu of PBGC trusteeship.[5] PBGC's valuation regulation is used to value the plan's benefits for this purpose.[6]

In addition to these PBGC uses of the valuation regulation, employers use the valuation regulation for certain purposes. In particular, those controlled groups that are required to file annual reports under ERISA Section 4010 *must* use this regulation to determine the values of their plans' benefit liabilities to be reported to PBGC. The valuation regulation also *may* be used by employers as a basis for allocating plan assets to benefits under Internal Revenue Code Section 414(l) in spinoffs, mergers, and transfers.

The area in which PBGC's valuation regulation has attracted the greatest controversy is its use to determine the amount of PBGC's employer liability claim, a claim that is virtually always made in the context of a bankruptcy proceeding. Two Courts of Appeals have upheld the reduction of PBGC's asserted claim amount based on a finding that PBGC's interest assumptions are too low and therefore produce benefit values that are too high.[7] More recently, however, PBGC prevailed on its employer liability claim amount in a U.S. Bankruptcy Court decision that "respectfully disagreed" with those two appellate decisions and upheld the use of PBGC's interest assumptions.[8] Even though the final rule that is the subject of this article amends the mortality rather than the interest assumptions that are at the center of these disputes, the final rule is relevant to these disputes because of the effect (discussed below) that PBGC's choice of mortality assumptions has on its interest assumptions.

PBGC's General Approach to Valuation of Plan Benefits.

PBGC's general approach to valuing plan benefits in a distress or involuntary termination is to try to match pricing in the private-sector annuity market. The American Council of Life Insurers (ACLI), on PBGC's behalf, conducts periodic surveys asking insurers for pricing information on group annuities. The reported prices, which are net of administrative expenses, are for both immediate and deferred annuities across a range of ages. PBGC uses these data to "solve" for interest factors that, when combined with the healthy-life mortality assumptions prescribed in PBGC's valuation regulation, will best "fit" with the prices across the range of ages. Each year, PBGC reevaluates this "fit" by "recalibrating" its interest factors to the survey results; between these annual recalibrations, PBGC adjusts its interest factors up or down based on changes in the yield on long-term corporate investment-grade bonds. The valuation regulation calls for the use of the mortality assumptions prescribed in the regulation (healthy or disabled, as applicable), together with the derived interest factors and other prescribed assumptions (including the expected retirement age), to value the plan's benefits.

Interrelationship Between Mortality Assumptions and Interest 'Factors.' Because PBGC uses the healthy-life mortality assumptions prescribed in its valuation regulation to "solve" for the interest factors that best "fit" the ACLI annuity pricing data, a change in those mortality assumptions will ordinarily lead to a corresponding change in PBGC's derived interest factors. A move to stronger mortality assumptions, *i.e.*, mortality tables that assume people live longer, leads to a corresponding increase in the derived interest factors, in roughly the same way as one would have to assume greater investment returns on a given principal amount in order to expect to be able to pay $1,000 a month for 11 years rather than for 10 years before depleting principal. Thus, the move to a version of GAM-94, which assumes greater longevity than does the GAM-83-based assumptions currently in use, will result in higher derived interest factors.

The updating of the mortality assumptions, viewed in isolation, will serve to increase benefit values, while the corresponding increase in the derived interest factors, viewed in isolation, will serve to decrease benefit values. However, the two changes are part of an integrated package and thus should not be viewed in isolation. PBGC addressed the net effect of the two changes in the preamble to its final rule:

> Because of the way the PBGC determines its interest factors, the choice of mortality assumptions generally is expected to have no significant effect on benefit valuations. The effect that a change in mortality assumptions will have on valuations generally will be offset by the effect of the corresponding change in the PBGC's interest factors. For example, the use of GAM-94 mortality assumptions will result in higher interest factors than would the use of GAM-83 mortality assumptions (because GAM-94 has lower mortality rates than GAM-83). When those higher interest factors are combined with GAM-94, the resulting value for a given benefit will generally be about the same as it would be using GAM-83 along with the lower interest factors derived from the ACLI surveys using GAM-83. (For a more detailed explanation, see the preambles to the PBGC's proposed rule published on Jan. 19, 1993, at 58 Fed. Reg. 5128, and final rule published on Sept. 28, 1993, at 58 Fed. Reg. 50812.)[9]

Of course, the net effect of the two changes on a particular plan may depend on the demographics of the plan.

PBGC emphasized the distinction between its derived interest "factors" and market interest rates:

> These derived interest factors are not market interest rates. The factors stand in for all the many components used in annuity pricing that are not reflected in the given mortality table—*e.g.*, assumed yield on investment, margins for profit and contingencies, premium and income taxes, and marketing and sales expenses. Because of the relationship among annuity prices, a mortality table, and the derived interest factors, it is never meaningful to compare the PBGC's interest factors to market interest rates. The PBGC's interest factors are meaningful only in combination with the PBGC's mortality assumptions.[10]

Notwithstanding the distinction between PBGC's derived interest "factors" and market interest "rates," the reality is that there will be those who will compare the two and who may not easily comprehend why the "factors" may not line up with the "rates." By moving to up-

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[5] See ERISA Section 4041(c)(3)(B).
[6] See ERISA Sections 4001(a)(17)-(18) and 4041(c)(3)(A).
[7] *In re CF&I Fabricators of Utah Inc.*, 150 F.3d 1293 (10th Cir. 1998), *cert. denied,* 526 U.S. 1145, 143 L. Ed. 2d 1032, 119 S. Ct. 2020 (1999); *In re CSC Indus. Inc.*, 232 F.3d 505 (6th Cir. 2000), *cert. denied,* 534 U.S. 819, 151 L. Ed. 2d 20, 122 S. Ct. 50 (2001).
[8] *In re US Airways Group Inc.*, 303 B.R. 784, 792 (Bankr. D. Va., 2003).

[9] 70 Fed. Reg. 72206.
[10] *Id.* at 72205.

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dated mortality assumptions and, therefore, to derived interest factors that are likely to be more in line with familiar market rates, PBGC may be improving its prospects of persuading others to accept its employer liability calculations in bankruptcy cases.

Choice of Updated Mortality Assumptions. PBGC last updated its mortality assumptions in 1993, when it adopted a version of the 1983 Group Annuity Mortality (GAM-83) Tables.[11] In the preamble to the proposed rule leading to this change, PBGC made clear that it anticipated that further updating may be necessary: "The PBGC intends to keep each of its individual valuation assumptions in line with those of private sector insurers, and to modify its mortality assumptions whenever it is necessary to do so to achieve consistency with the private insurer assumptions."[12] The Dec. 2, 2005, final rule is the first updating since the 1993 rulemaking.

PBGC relied on a special ACLI survey of insurers and a Society of Actuaries survey of pricing actuaries in selecting its updated mortality assumptions. Under the final rule, PBGC will use the 1994 Group Annuity Mortality Basic (GAM-94 Basic) Table (also known as the 1994 Uninsured Pensioner Mortality Table (UP-94)) as the basis for its healthy-life mortality assumptions; for a particular valuation, PBGC will use the GAM-94 Basic Table projected to the year of that valuation plus 10 years using Scale AA. PBGC stated that the use of these updated mortality assumptions "will result in interest factors that, when combined with those updated mortality assumptions, will provide prices that match the ACLI survey prices more closely across the entire range of ages than had GAM-83 been used."[13]

The use of a projected table means that the valuation regulation will be able take into account expected improvements in mortality. The PBGC explained that it chose a projected mortality table rather than a fully generational mortality table in the interest of simplicity, since "the use of fully generational morality table (i.e., a table that provides for full generational mortality improvement). . .would be unduly complex."[14] In order to "achieve results very close to those of a fully generational table but in a much less complex manner,"[15] PBGC is adopting a methodology that projects the current table for a specified number of years and then uses the resulting table without further projection. For a particular valuation, the projection will be from 1994 to the year of the valuation plus 10 years, with the additional 10 years intended to serve as "a rough approximation for the duration of liabilities in plans that terminate in distress or involuntary terminations."[16]

In addition to updating its healthy-life mortality assumptions, PBGC is updating its mortality assumptions for Social Security disabled participants and for non-Social Security disabled participants.

■ For Social Security disabled participants, PBGC will use the Mortality Tables for Disabilities Occurring in Plan Years Beginning After December 31, 1994, from Rev. Rul. 96 7 (1996 1 C.B. 59). In response to a comment seeking clarification as to the appropriateness of using these tables, which differ from other popular

rates tables for disabled lives (for example, the RP-2000 disabled life mortality table), PBGC explained that it chose these tables because they are based on the population of Social Security disabled lives rather than—like certain other popular tables (in particular, the RP-2000 table)—on a population of all disabled lives.

■ For non-Social Security disabled participants, PBGC will use the healthy life tables projected from 1994 to the calendar year in which the valuation date occurs plus 10 years using Scale AA, but setting the resulting table forward three years.

To avoid having non-Social Security disabled participants at older ages assumed to have greater mortality than same-age Social Security disabled participants, PBGC will cap the mortality rate for non-Social Security disabled participants at the corresponding rate for Social Security disabled participants.

Continued Use of Common Mortality Assumptions for all Plans. In 1997, PBGC had issued a notice of intent to propose rulemaking in which it sought public comments on, among other things, the appropriateness of updating its mortality assumptions.[17] Several commenters had suggested that PBGC adopt mortality assumptions that vary depending on industry or workforce type or that vary by plan. PBGC chose not to adopt any of these suggested approaches, explaining its continued use of a common set of mortality assumptions as follows:

> [T]he mortality assumptions are selected with the goal of achieving consistency with the mortality assumptions used by private-sector insurers for pricing group annuity contracts. To this end, ACLI respondents were asked to identify the mortality tables they used and any variations to those tables. Neither the proposed GAM 94-Basic Table, the most commonly identified table, nor any of the other tables identified by the survey respondents provided mortality assumptions that vary depending on industry or workforce type. Moreover, none of the survey respondents reported that they make modifications or adjustments based on industry or workforce type. As for the use of plan-specific mortality assumptions, the PBGC's general valuation approach is to apply a common set of assumptions (*e.g.*, mortality, expected retirement age) to all plans with the goal of producing reasonable results *on average*. Shifting to a plan-specific approach for mortality would be a fundamental change that could require burdensome verification procedures. Therefore, the PBGC proposes to continue to use more general mortality assumptions that, like its other assumptions, produce reasonable results on average.[18]

Relationship to mortality assumptions used to determine current liability. On the same day PBGC published its final rule updating the mortality assumptions under its valuation regulation, IRS published a proposed rule setting forth the methodology IRS and Treasury would use to establish mortality tables to be used under section 412(l)(7)(C)(ii) to determine current liability for participants and beneficiaries (other than disabled participants).[19] PBGC made clear in the preamble to its final rule its view that the two sets of mortality assumptions may properly differ:

> There is no reason to expect that the mortality tables under this regulation will match the tables that are prescribed for certain funding purposes under Treasury regulations at any

[11] 58 Fed. Reg. 50812 (Sept. 28, 1993).
[12] 58 Fed. Reg. 5128, 5129 (Jan. 19, 1993).
[13] 70 Fed. Reg. 72206.
[14] *Id.*
[15] *Id.*
[16] *Id.*

[17] 62 Fed. Reg. 12982 (Mar. 19, 1997).
[18] 70 Fed. Reg. 72207 (emphasis in original).
[19] 70 Fed. Reg. 72260 (Dec. 2, 2005).

point in time. The PBGC's mortality tables are based on the mortality experience of group annuitants. In contrast, the tables to be used for certain minimum funding purposes are based on the mortality experience of individuals covered by pension plans.[20]

Effect on Private-Sector Lump Sums. PBGC uses the assumptions in its valuation regulation to value all benefits in distress and involuntary terminations for the purposes outlined at the beginning of this article. This includes those benefits (primarily de minimis benefits) that PBGC will pay in lump-sum form using a different set of assumptions that apply only to such lump-sum benefits.[21] PBGC publishes a set of "Lump Sum Interest Rates for Private-Sector Payments" (Appendix C to 29 CFR Part 4022) that are used by those plans that call for use of PBGC's historical interest rates (*i.e.*, those determined based on the methodology in effect before PBGC updated its mortality assumptions in 1993) as an alternative basis for lump-sum calculations (where they produce greater lump sums than the minimum required lump sums). Because the Dec. 2, 2005, final rule affects only PBGC's assumptions in its valuation regulation (29 CFR Part 4044), it will have no effect on the "Lump Sum Interest Rates for Private-Sector Payments" that PBGC publishes under its benefit payments regulation (29 CFR Part 4022).

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[20] 70 Fed. Reg. 72206.
[21] See 29 CFR § 4022.7(d).

Issues Not Addressed in Rulemaking. This rulemaking is limited to the choice of mortality assumptions. PBGC recognized the limited nature of this rulemaking and the possible need for further changes, noting that it "will continue to explore other ways to improve its benefit valuation regulations and may make other changes through separate rulemaking actions."[22] Thus, the rulemaking does not address whether there should be changes to PBGC's basic approach of trying to match pricing in the private-sector annuity market rather than, for example, trying to reflect PBGC's own experience and expected costs of providing the benefits. It also does not address whether other specific assumptions, such as the expected retirement age assumptions, should be revised. Perhaps the most interesting question, one that is admittedly somewhat premature, is what kinds of changes PBGC should make in its valuation regulation if some version of the various pending pension reform proposals were to become law. The issue here would be whether PBGC's assumptions and methods should more closely match those used to determine a plan's "at-risk" funding target, which is designed to reflect the liability the plan is likely to face in the event of plan termination. That regulatory debate, of course, may have to await the outcome of the current legislative debate.

Applicability of Final Rule. The amendments in the final rule apply to any plan with a termination date on or after Jan. 1, 2006.

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[22] 70 Fed. Reg. 72207.