Why be Yellow (or Green) When You Can Be Red

Determining the optimal zone and how to get there

By: Bradford L. Rigby, ASA, EA, MAAA
- Cowden Associates, Inc.
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The multiemployer zone status provisions under the Pension Protection Act have an implied order of preference just in the way they are commonly referred to: green zone, yellow zone, and red zone. Even if you know very little about how pension plans operate, you are probably assuming that any Fund would prefer to be green over yellow, and yellow over red. And in most situations you would be right.

However in some situations a Board of Trustees may actually prefer to have the Fund certified red (Critical Status) instead of yellow (Endangered Status) or even over the green zone. If a Fund can be green and is projected to stay green indefinitely, then odds are that the best option is to stay green. But what if projections show that the green zone isn't expected to be a permanent thing? The red zone may provide some preferable options for a Board of Trustees to set the Fund on a path to long-term financial health and stability.

Why Be Red

A red zone certification causes the need to develop a Rehabilitation Plan ("RP"), a combination of benefit cuts and/or contribution increases, that improves the projection of plan funding over a period of time. Similarly a yellow zone certification requires a Funding Improvement Plan ("FIP"), with slightly different rules on what benefits can be cut and how the Fund is to operate during the period of improvement. It is in these slight differences that the red zone may be preferable.

While benefit cuts aren't necessarily an appealing concept, certain benefits that the law considers "adjustable" may be desirable for a Board to cut. Presumably, this would be the case with special benefits provided to people who have left the Union before retirement. Consider special early retirement benefits: a Fund in the red zone can eliminate special early retirement provisions while one in the yellow zone cannot. If a Board is allowed to eliminate these high-value benefits to terminated vested participants who have left the Union or Trade, why wouldn't they do it? Similarly a Board may want to tighten up Suspension of Benefits provisions if they see retirees competing against Union jobs. Other benefit changes are permitted and may be advantageous depending on the situation and Board.

Another reason to be red is in the design and operation of a RP compared to a FIP. A FIP must cause the level of underfunding to decrease by 33% and the credit balance must remain positive throughout the period. Keeping the credit balance positive may not be an easy task, especially if work in the Union isn't booming. However a RP must just emerge from the red zone, and the credit balance is allowed to become negative for a short time. And to top it off, if a reasonable RP cannot be agreed to by the Board, then the RP doesn't have to meet the funding percentage and credit balance benchmarks within the period, but instead must just "forestall insolvency".

It is true that a RP must impose surcharges on employers following a red zone certification, but those can be avoided by quick implementation of a RP. The flexibility of a RP compared to a FIP may make the red zone preferable.

How to Get Red

Since the zone determination is made from a projection of short-term future plan funding, numerous factors in the calculation come into play and can have an effect on results. The key responsibility of the actuary in securing the red zone certification is determining the approach that makes the resulting RP the least punitive. It is likely that whatever approach is used to get the Fund into the red zone, will also have to be used in the projections to design the RP. If assumption changes are the approach then they still need to fall within the bounds of whatever is reasonable and justified.

While there are several conditions that may cause a Fund to be certified red, the most common factor related to a projected funding deficiency – when the credit balance is expected to become negative. To be certified red the credit balance must be projected to become negative within the current or following three plan years (four if the funded percentage is under 65%). Changing actuarial assumptions such as investment return, mortality, or work levels can all potentially cause this to happen. However, changing assumptions like these can often make the necessary benefit cuts and/or contribution increases of a RP more painful.

One of the most effective, yet often overlooked, tools that an actuary has at their disposal is the ability to almost arbitrarily reduce the credit balance projection. This is done by combining amortization charges under Code Section 431(b)(5) to speed up the amortization of past losses. By recognizing those losses more quickly, the credit balance is projected to become negative sooner. This is an easy tool that can be done as often as the Board wishes and without IRS approval. And the impact on long-term projections is minor since the amortization was going to occur anyway.

Conclusion

The actuary's focus needs to remain on achieving the best possible result, as viewed by the Board of Trustees. Sometimes having the ability to clean up undesirable plan provisions is the best possible result, even if it means having to communicate that the plan has entered the red zone.

Every actuarial tool in the law must be analyzed to determine the best way to achieve the result. Leaving no stone unturned will take extra time early in the process, but the successful development of a plan to get the Fund onto a course of long-term financial stability is the due reward of this solid planning.

For more information please contact:

Bradford L. Rigby, ASA, EA, MAAA
Vice President, Retirement and Actuarial Services
Ph: 412-394-9980
Email: bradr@cowdenassociates.com