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Addressing the Insolvency of the Pension Benefit Guaranty Corporation

By Alex J. Pollock

The inherent structural risks of having the government insure—through the Pension Benefit Guaranty Corporation (PBGC)—the future commitments of defined benefit pension plans has resulted in a reported deficit of $23 billion. The present value of the long-term cash deficit has been estimated at $92 billion. Pending legislation would improve the financial exposure of the PBGC, but would still leave a large projected deficit and fundamental structural problems. Issues which must be understood and addressed include the concentrated, very long-term credit risk represented by defined benefit pension plans; the nature of "Wimpy finance"; pensions as equivalent to being in the annuity business; intercorporate leveraged equity holdings; lack of capital requirements; opaque accounting; and conflicting objectives. The "Mendelowitz Plan" should be considered.

In 1961, Nat Weinberg, director of the Special Projects Department of the United Auto Workers (UAW), informed union leader Walter Reuther of a big new idea: have the government guarantee pensions in a way similar to deposit insurance.[1]

Pensions were a major problem, because when the Packard Motor Car Company had closed down in 1958, the termination of its underfunded pension plan had made it clear that "vested pension rights" may come to be worth little. Having made pensions key to their contract negotiations for a decade, the UAW now faced a dilemma. Its leadership knew that to protect the value of the pensions would require negotiating for full funding of the pension plans. But this would be very costly in terms of other negotiating items, including wages, and for weak companies might be impossible.

What to do? How about using the government? It could guarantee the pensions without needing full funding. This was a brilliant solution to their dilemma.

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There followed years of promoting the idea in Washington. It was rejected numerous times, but thirteen years after its initial appearance was incorporated in ERISA, the pension reform act of 1974. The big idea had become a government institution. So was born the Pension Benefit Guaranty Corporation (PBGC).

Thirty-two more years have passed. Today, the PBGC's reported liabilities exceed its assets by $23 billion. In short, it is insolvent. The Center on Federal Financial Institutions projects that the present value of the long-term cash deficit is $92 billion.[2]

If told that the PBGC is insolvent, most Americans would probably reply, "What's the PBGC?" It is certainly not a household name. But this obscure government corporation is involved in huge financial risk exposures, protecting some individual Americans as pension beneficiaries, but putting everybody at risk as taxpayers.

The PBGC guarantees the financial obligations of companies for the liabilities of their defined benefit pension plans, just as the former FSLIC (Federal Savings and Loan Insurance Corporation) guaranteed the obligations of savings and loans for their deposits.

In the 1980s, as the American public realized that a great many savings and loans were insolvent, they discovered that FSLIC, a government corporation, was itself insolvent. Now the public is coming to realize that many pension plans are deeply underfunded and that companies obligated to remedy the underfunding can, and in a number of cases do, go bankrupt instead.

This leaves the pension funds—just like Packard's almost sixty years ago—with insufficient assets to pay their pension obligations. The PBGC guarantees the pensions, but the PBGC is itself insolvent, just as FSLIC was. How does this happen?

PBGC and FSLIC represent the same risky structure: open-ended government guarantees of liabilities dependent on financial performance, other peoples' financial risk decisions, and the behavior of interest rates and asset prices. Both represent mandatory schemes designed by, and with non-market "insurance premiums" set by, the political processes of Congress.

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Concentrated Credit Risk

All employees of companies with defined benefit pension plans have a large, concentrated, and probably imprudent credit risk exposure to their employers. To the extent of any underfunding, the employees are merely unsecured creditors of what may become a bankrupt company. Indeed, this risk runs a very long time—thirty, forty, or fifty years—into the uncertain and unknowable future.

The risk is compounded by the fact that when a company is struggling or failing, putting its shrinking cash into the pension fund will always be a low priority when compared to trying to save the enterprise.

Thus it should be no surprise that having had vast, very long-term risk imposed on it, the government's pension guarantor has a huge deficit. Alas, one generation's reform is the next generation's problem.

Pensions and Creative Destruction

In the dynamic creative destruction of a market economy, companies which seem unassailable may in time fail, and credits which seem impeccable may in time turn out to default. The fundamental principle of diversification of course follows, but the beneficiaries of an underfunded pension plan have an extremely undiversified risk—and any defined benefit plan might in time become underfunded, whatever its status at the moment.

The biggest potential additional loss to the PBGC today is the threat that it would be forced to assume the liabilities of the General Motors (GM) pension fund, with constant speculation in the press that GM may at some point declare bankruptcy. But as the idea which became the PBGC was developed in the 1960s, it was reasonable to view GM as presenting virtually no risk.

Imagine a twenty-year-old going to work for GM forty years ago, in 1966. It was the preeminent industrial company in the world. It was number one in both revenue and profit in the Fortune 500. Its bond rating was triple-A. Its U.S. market share was about 50 percent. Now this employee has reached sixty and is facing a far different world. Commitments which run a very long time entail a lot of risk.

As further perspective on long-term risk, consider a 1954 *Fortune* article about the automobile industry, which listed "such familiar makes as Studebaker, Packard, Nash, Hudson, and Willys"![3]

Defined benefit pension plans should remind us of the character Wimpy in old Popeye cartoons, whose motto was, "I'll gladly pay you Tuesday for a hamburger today."

The defined benefit pension plan says, "I'll gladly pay you forty years from Tuesday for a hamburger"—namely your work—"every day until then." What if, when the hamburgers are all eaten and the distant Tuesday finally arrives, the pension plan's assets don't cover the promised payments—and neither do the assets of the PBGC?

Pension Reform in 2006

There are three ways generally discussed to reduce the financial deficit of the PBGC. These are:

1. raise the insurance premiums paid by all pension plans to the PBGC;
2. raise them even more for plans which are severely underfunded, companies which are risky, or both; and
3. force companies to put more money into their pension plans more quickly.

All of these would raise more money for the PBGC and reduce its risk exposure. But they also present problems, because they all make offering defined benefit pensions more expensive for employers. They would thus tend to accelerate the trend of companies moving away from continuing to offer such plans. They would in addition put even more financial pressure on weaker companies, while stronger companies do not want to pay for the shortcomings of others.

Combinations of these ideas are contained in pending pension reform legislation in Congress. Projections suggest, however, that even with enactment of the reform, movement away from defined benefit plans will continue—as will the PBGC's financial problems. The Center on Federal Financial Institutions estimates that the most likely legislative package would reduce the PBGC's long-term deficit from $92 billion to about $60 billion, in their base case.[4]

This brings into view a well-understood fourth approach, which is unattractive for many reasons but certainly conceivable:

4. have a taxpayer bailout, just as there was a taxpayer bailout of FSLIC.

In this regard, HVB Bank economist Roger Kubarych has written, "All I can say is read up on the PBGC and dust off the books about the Resolution Trust Corporation, because a big government bailout is definitely on the horizon—and will be a major headache for the next president."[5]

We should do our best to avoid a bailout. It would mean that the 80 percent of American private-sector employees who do not have defined benefit plan pensions would be forced to pay for the pensions of the 20 percent who do.

As we struggle to reform the reform of thirty-two years ago, the PBGC will continue to be insolvent. The situation reflects not just bad luck, but structural, long-term issues.

Structural Issues

The trend away from defined benefit pension plans is obvious. The number of plans and the percentage of all employees covered by them have dropped precipitously over the last generation—the proportion of private-sector employees covered has fallen by nearly half, from about 40 percent to 20 percent, and the number of such plans has fallen by about 75 percent from its peak in 1985. In the meantime, the deficit of the PBGC has ballooned. AEI resident fellow James K. Glassman has concluded, "Defined benefit plans are headed for the dustbin of history—and good riddance."[6]

Glassman suggests further, "Things change, as GM employees now know. It makes far more sense for workers to carry their retirement assets on their own backs, rather than counting on the company to ante up decades later."[7] Decades later, the company may not exist, having joined the ranks of Studebaker, Packard, Nash, Hudson, and Willys.

Discussions of defined benefit pensions often refer to them as "guaranteed" or "creating certainty for retirement income," but this is certainly not true; this is because of their inherent credit risk. A "guarantee" is only as good as the assets of the guarantor.

A related thought from a labor union point of view was expressed by James Hoffa: "Pension increases in lieu of salary increases [were] writing workers a check they can no longer cash."[8]

In addition to creating a concentrated credit risk for employees and a growing deficit for the PBGC, defined benefit plans also create large—sometimes very large—and very difficult to manage financial risks for the companies that sponsor them. This is especially true for companies whose market share and profitability have declined from the historical levels and expectations at the time the plans were designed. Retired employees then grow large relative to current employees, and pension plan obligations, costs, and risks become a heavier burden relative to the current business which must support them.

The decline in market share and profitability may reflect the emergence of new competitors—foreign or domestic—competitive technological innovations, the loss of regulatory protection, the breakup of formerly comfortable oligopolies, or all of the above. In the long run, in a market economy with lively Schumpeterian competition, this will usually happen.

Thus defined benefit plans might be said to reflect the beliefs of their founding era, the 1950s, when large U.S. companies seemed securely on top of the economic world and seemed safely able to issue long-term unfunded guarantees. The marked trend away from these plans reflects the realization of their true risks.

Pensions as Being in the Annuity Business

What is the role of a defined benefit pension fund in the business of the company? Of course, it is thought of as an element of employee compensation, an employee benefit in the form of deferred compensation—a cost center, probably overseen by a retirement committee and the compensation committee of the board of directors.

But it might equally be seen as putting the company into the business of writing fixed life annuities, with the attendant risks and requirements. The company receives premiums in the form of wages foregone to get a pension, and in exchange issues annuity contracts to its employees.

How might it change the way pensions are managed and regulated if defined benefit pension plans were viewed as being in the annuity business under another name? This is a key question for considering the risks of the PBGC. We can compare the pension plans which the PBGC guarantees to the explicit fixed life annuity business as carried out by life insurance companies and regulated by insurance commissioners.

How might it change the way pensions are managed and regulated if defined benefit pension plans were viewed as being in the annuity business under another name?

The essential risks of the annuity business are underestimating life expectancy, overestimating future interest rates and yields on investments, and adverse market value changes affecting any mismatch of assets and liabilities. These are the same risks that pension plans face.

Life insurance companies that write fixed life annuities are required to invest the corresponding asset reserves principally in bonds, so that their fixed income portfolios can achieve a reasonable match to their liabilities for annuity payments. Depending on the quality of the assets and the asset-liability match, they have a risk-based capital or solvency requirement.

Pension funds, in contrast, typically invest a majority of their assets in equities and have no capital requirement. They desire the higher long-run expected return from equities, but thereby create a notable asset-liability mismatch, with no capital cushion against the possibility of adverse market price or interest rate movements or both.

One reform in the pending pension fund legislation is to move the minimum funding target from 90 percent of liabilities to 100 percent. Note that this is equivalent to moving from a negative 10 percent to a 0 percent capital ratio.

Suppose that pension funds were conceived of, managed, and regulated as the annuity writing business they functionally are. How would their asset-liability mismatch be controlled? What would their risk-based capital requirement be? It seems certain that in such a situation the risk of the PBGC would be much reduced.

A Business: Borrow and Buy Stocks

The equity investments of defined benefit pension plans are entirely financed with what is, in effect, debt owed to the employees. They are something like stocks owned 100 percent on margin. The not-unreasonable argument for this financial structure is that the long-term return to equities is historically greater than the yield on bonds. But put in a cynical way, one can argue that a business plan in the guise of a pension plan has been devised: borrow money and buy stocks.

The financial risk of a pension plan is, in fact, part of the financial risk of the company, since the company is indirectly but truly on the hook for the pension liabilities. Indeed, these liabilities can become a force pushing it toward bankruptcy. So the risk position of borrow and buy equities is part—perhaps a large part—of the financial risk of the company. But it is obscured by being in the pension plan.

Suppose while keeping the total risk the same, the location of the financial positions were reversed. The company matched its pension liabilities with investments in bonds like an insurance company would do, but then announced a new line of business: borrowing and investing the proceeds in the stock market. This would be done on its own balance sheet instead of off balance sheet in the pension fund.

Imagine the market reaction to this announcement. But the total risk would be the same.

Intercorporate Equity Holdings

A little-noticed result of defined benefit pension plans is that corporations come to own large amounts of each other's stock on a leveraged basis through the vehicle of their pension funds. This creates a procyclical effect. As the stock market goes up, the market value of pension fund assets increases, pension funding ratios improve, and through pension fund accounting, corporate profits increase, supporting further increases in stock prices, while smaller contributions to pension funds are made.

The cycle inevitably turns. Now the stock market goes down, pension fund assets fall, pension funding ratios deteriorate, and through pension fund accounting, corporate profits are reduced, supporting further downward pressure on stock prices, and greater contributions to pension funds are required. The larger the pension fund relative to the core business, the greater this effect will be on the individual company.

Both sides of the cycle are accentuated as a result of being, through the pension fund, in the side business of owning each other's equity.

A Capital Instrument?

In 1961, the proposed government guarantee of pensions was conceived as an analogy to its guarantee of deposits through federal deposit insurance. In the case of deposits, the government insists on the maintenance of required capital ratios in all depository institutions to control the risk of the federal deposit insurance fund—still remembering that with FSLIC, one such fund went negative and needed a massive taxpayer bailout.

In the case of pensions, the PBGC's insurance fund balance is already negative, and as discussed above, there is no required positive capital ratio for the insured plans.

If pension funds had to maintain a positive risk-based capital ratio against the risks of life expectancy, future interest rates, and adverse market price movements, companies could achieve this by making greater payments to the fund so that the funding ratio had to be maintained at a minimum, for example, of 105 percent (equivalent to a 4.8 percent capital ratio). Of course they would not like having to do this, although the currently pending legislation would at least remove the tax penalty for doing so. Once in a pension fund, assets are hard to get out.

Another possibility would be to create a capital instrument for pension funds, which would continue to be a direct asset of the company, like an investment in an affiliate, while still subordinated to and protecting the pension liabilities. This might be in the form of subordinated debt or preferred stock whose interest or dividends are constrained by capital requirements, like the investment of a bank holding company in a subsidiary depository institution.

Accounting

Corporate pension accounting stands out as one of the more opaque, abstruse, and Byzantine of the Financial Accounting Standards Board's (FASB) complex accounting rules. It is now appropriately in process of revision.

The FASB's current direction, repeating what has already been implemented in the United Kingdom, is straightforward and sensible. It is to take the best estimate of the total pension obligations of the fund, subtract the current market value of the fund's assets, and book the difference on the sponsoring company's balance sheet. If the plan is underfunded, the difference will be negative and appear as debt of the company. This is indeed just what it is.

This approach seems obvious, but some object that this will introduce volatility into the debt and capital ratios shown in the financial statements because of the volatility of market values. To this, New York University economist Larry White has responded, "The effort to abstract from volatility doesn't make the volatility go away; it just masks it."[9]

A further objection is that such revised accounting would be a disincentive to invest pension funds in equities, with their (nearly certain, many think) higher long-term rates of return. But if the equity strategy is really convincing, as it may be, companies pursuing it should not be afraid to show accurately the funding shortfall which is, in fact, their debt to employees, and explain the investment strategy by which they intend to make it up in the long term. Investors and the market can then make up their own minds.

The Mendelowitz Proposal

At an AEI conference on the problems of the PBGC in April 2006, Allan Mendelowitz proposed what I believe is the first truly big new idea on the subject since 1961.[10] The topic Mendelowitz addressed was what lessons might be applied to fixing the PBGC from the Chrysler bailout of 1980, which turned out to be a financial success. He pointed out that a fundamental principle in salvaging such situations is that all the stakeholders must contribute something to solving the problem.

In the PBGC case, the companies sponsoring pension plans will most likely be paying higher premiums to the PBGC and be subject to tighter funding and accounting rules. The government is providing its implicit guarantee to the PBGC, without which the entire risk structure would unravel.

Mendelowitz asks us to consider who the true beneficiaries of the PBGC's insurance are. The answer is not the pension *plans*, but the individuals whose pension rights and retirement income are being guaranteed. They are the ones who are actually insured by the PBGC, and behind it, the government. But they pay nothing for this insurance. Why not? How much is it worth to these individuals to have their pensions guaranteed?

Mendelowitz suggested that a very modest insurance premium paid by employees and retirees covered by the PBGC would solve not only the current, but also the projected future PBGC deficit. It would make the insured defined benefit plan system financially workable and would reduce the pressure on companies to freeze or terminate their defined benefit plans.

For example, a premium of only $10 per month, paid by the 44.4 million individuals covered by the PBGC and collected by withholding, would generate about $5.3 billion per year of PBGC income.

The Center on Federal Financial Institutions projects that the PBGC under current law will run out of cash in about fifteen years. With the $10 monthly premium, it would collect an additional income of about $80 billion in fifteen years. Adding interest earned at 5 percent, it would have at the end of this period $115 billion in additional assets. This looks good compared to the projected $92 billion estimated long-term deficit. To target just the $92 billion in fifteen years, under the same assumptions, would require a monthly premium of $8—the cost of two large caffé lattes.

But as noted above, the Center on Federal Financial Institutions projects that if pending legislation is enacted, the long-term PBGC deficit will be reduced to about $60 billion. Under the same fifteen-year assumptions, this would suggest a required monthly premium of only about $5—the cost of two small caffé lattes at Starbucks or two beers at the local bar. This would be a great consumer value.

I call this simple, insightful solution to the PBGC deficit the Mendelowitz Plan. For those who wish to preserve the defined benefit plan system, it is the best hope.

Objectives in Conflict

A successful strategy requires coherent—not conflicting—objectives.

In spite of the long-term trends in the opposite direction, the official objectives of the PBGC include "encouraging the continuation and maintenance" of defined benefit plans.[11] It is obvious that this is in conflict with addressing the PBGC's insolvency. Except for a government bailout and the Mendelowitz Plan, every step toward restoring the solvency and limiting the risk of the PBGC would result in making defined benefit plans less attractive to sponsoring companies. These steps definitely would discourage—not encourage—continuation of defined benefit plans. The fundamental dilemma is exactly the same as that faced by the UAW in 1961.

A government bailout is certainly to be avoided. Therefore, consistent objectives for addressing PBGC insolvency boil down to two: A) adopting (along with other pending and possible reforms) the Mendelowitz Plan to finance the inherent risks of the PBGC structure, or B) giving up encouraging, and instead working to transition out of defined benefit plans, while keeping the PBGC deficit as low as possible. This would be, so to speak, helping these complex exercises in Wimpy finance along to the "dustbin of history."

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Notes

1. For the history of the origin of the PBGC, see James A. Wooten, "'The Most Glorious Story of Failure in the Business': The Studebaker-Packard Corporation and the Origin of ERISA," *Buffalo Law Review* 49 (2001): 683–739.

2. Douglas J. Elliott, "PBGC: Legislation May Not Restore Solvency," Center on Federal Financial Institutions, June 20, 2005, available at www.coffi.org/pubs/PBGC%20Legislation%20May%20Not%20Restore%20Solvency.pdf.

3. Quoted in James A. Wooten, 693.

4. Douglas J. Elliott, "Pension Reform Legislation, Where Does It Stand; What Would It Do?" (presentation at "Pensions—Regime Change Ahead," JP Morgan Investor Forum, Pebble Beach, CA, May 2006).

5. Roger M. Kubarych, "The Coming Private Pension Plan Crisis," *The International Economy*, Fall 2004, 35.

6. James K. Glassman, "Good Riddance to Traditional Pensions," Scripps Howard News Service, January 9, 2006.

7. Ibid.

8. James P. Hoffa, "Retirement Insecurity," AARP, *Global Report on Aging*, Spring 2006, 7.

9. Lawrence J. White (Stern School of Business, New York University), personal communication, February 27, 2006.

10. Allan Mendelowitz (presentation at "The PBGC and Structural Reform," conference at AEI, Washington, D.C., April 5, 2006), information available at www.aei.org/event1270.

11. Pension Benefit Guaranty Corporation, *2004 Annual Report* (Washington, D.C.), i.

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