Insight

Fixing the Pension Benefit Guarantee Corporation

CARLOS BONILLA | JULY 18, 2011

The Pension Benefit Guaranty Corporation (PBGC) was created in 1974 to insure the participants in Defined Benefit plans would continue to receive their retirement income in the event their pension plan failed. It was intended to be a self-funding agency, using premium revenues and earnings on assets acquired from failed plans to meet its obligations in the same manner as an insurance company. As of today it faces a known shortfall between its assets and liabilities of over $21 billion. On top of this it has identified an additional $170 billion in exposure for pension plans that it views as "reasonably possible" terminations. Although there is no *explicit* federal guarantee for PBGC's obligations – just as there was no explicit guarantee for Fannie Mae debt — the taxpayer ultimately will be liable for this shortfall. Despite efforts in recent years to improve PBGC's financial position, its liabilities have continued to grow. The time has come to put a limit on the exposure PBGC's poses to the taxpayer, freeze the PBGC guarantee at the level that exists today, and get the Federal government out of the pension insurance business.

Defined Benefit vs. Defined Contribution Plans

In a Defined Benefit (DB) plan the employer commits to paying a benefit upon retirement. That benefit is most often defined by years of service and a measure of average earnings. Any shortfall between what the plan has accumulated in assets and the benefits it must pay must be paid by the employer. In contrast, a Defined Contribution (DC) plan sets aside contributions in individual accounts that upon retirement define the available benefit – the larger the DC account the greater will be the amount that can be withdrawn at retirement. The most common such DC arrangement is a 401k plan.

By and large DB plans have been replaced with DC Plans. This transition has been in response to numerous forces, notably:

- DB plans are not portable. That is to say, a plan that defines the retirement benefit by tenure with the employer will disadvantage workers who change jobs
- Employers were less willing to assume the risks (actuarial and investment) that DB plans pose.
- Credit rating agencies increasingly recognized the liability inherent in these plans and downgraded firms with large liabilities.

PBGC and its Liabilities

The Employment Retirement Income Security Act of 1974 (ERISA) was a legislative response to chronic underfunding in DB plans, a practice that had allowed employers to make retirement income promises without setting aside adequate resources to meet those commitments. In the event of a bankruptcy the retirement plan would find itself unable to pay benefits leaving retirees without the income stream they expected. ERISA established funding standards for DB plans and created the PBGC to pay benefits in the event of a plan failure.

Defined Benefit pension plans have declined from a high of 112,000 plans in 1985 to 26,000 today. In the process the Pension Benefit Guaranty Corporation (PBGC) has been transformed from an agency which insured the pensions of a broad cross-section of the American workforce to one that insures benefits for a much narrower slice of America, essentially those in industries dominated by collective bargaining agreements, a group that represents less than seven percent of the private sector workforce.

Since the passage of ERISA over 160,000 DB plans have voluntarily terminated and been able to achieve an orderly closure without drawing on the PBGC guarantee, typically using existing plan assets to purchase private market annuities to completely cover benefits earned to date or by making a lump sum payment to participants. A small subset of these plans, roughly 4,100, have been *Distress Terminations*. Distress terminations are plans that have insufficient assets to pay vested benefits and cease to operate, either because of the plan sponsor's bankruptcy or because PBGC accepts that continuing the plan will force the company to shut down. These plans are trusteed by the Pension Benefit Guaranty Corporation (PBGC) which then makes pension payments directly to beneficiaries, subject to a cap on payments — $54,000 annually for a plan terminating in 2010[1].

These 4,100 trusteed plans represent $43b in claims on the PBGC. Strikingly, of these plans, a mere two dozen represent 73 percent of the monetary value of claims made on the PBGC to date, over $31b.

The unifying feature of these two dozen high-cost failed plans is most often described by the industry the plan operated in. Airlines (United Airlines, US Airways, Delta Air Lines, Pan American, TWA, and Eastern Airlines) account for six of the top 24 failed plans. Primary Metals (Bethlehem Steel, LTV Steel, National Steel, Weirton Steel, Kaiser Aluminum, Wheeling-Pitt Steel, LTV Republic Steel, Kaiser Steel, CF&I Steel, and Northwestern Steel & Wire) account for another ten, and so on.

While this industry allocation is *factually* correct, the most common thread among the two dozen expensive plan failures is the presence of a workforce largely covered by collective bargaining agreements. Only two of the most expensive plan failures – Kemper Insurance and Polaroid — were in industries not typified by the presence of collective bargaining agreements. Over 97 percent of the claims (by dollar value) in these high-cost failed plans came from industries with a high presence of collective bargaining agreements. Note that less than 7% of private sector workers are covered by such agreements. As a former Director of PBGC stated:

*"In too many cases, management and workers in financially troubled companies may agree to increase pensions, in lieu of larger wage increases. The cost of wage increases is immediate, while the cost of pension increases can be deferred for up to 30 years and may ultimately be passed on to PBGC's premium payers if the company fails.**[2]**"*

It is not the case that defined benefit plans in unionized industries are less well run than in other industries. After all, they operate under the same funding rules as other plans. Rather it comes down to the fact that in the presence of a collective bargaining agreement management is denied the flexibility to terminate a plan, freeze accruals, or transition to a Defined Contribution plan to protect the firm and plan participants. Instead of terminating the plan at a point when benefits can still meet already vested obligations, the plan continues to operate, vesting more benefits and participants and often even becoming more generous. Looking at Fortune 1000 firms which terminated or froze[3] DB plans, Watson Wyatt reported in 2005 that "In most cases, these firms froze/terminated their DB plans for salaried employees but maintained active plans for their unionized workers (or another segment of their workforce).[4]

PBGC Operation

PBGC levies an insurance premium of $35 per year participant in a single employer DB plan, regardless of the generosity of the pension being insured. Underfunded plans are also assessed a variable rate premium of $9 on every $1,000 of underfunding (as defined under complex rules by PBGC). About a third of all plans today are sufficiently underfunded to be paying the additional variable rate premium. In addition, the PBGC earns income on the assets of failed plans that it takes control of, assets that are earmarked for the beneficiaries of those failed plans. Unlike private sector insurance, the PBGC lacks the power to set its own premiums, deny insurance to plans that fail to meet underwriting standards, or risk-adjust premiums.

Under existing law, generous retirement plans pay the same premium as miserly plans and plans run by financially sound employers pay the same premium as those in financial distress. Both the Obama Administration and the Bush Administration before it proposed that the PBGC be allowed to include risk when defining a plan's insurance premium. Congress has yet to act to allow risk-based premiums and this proposal will certainly face opposition from pension plans seeking to avoid higher costs. While such a policy may very well have prevented the funding crisis we see in PBGC today, it may simply be too late to prevent even larger losses to the program, if for no reason other than the reduction in participants paying premiums into the PBGC pool.

In 2006 the Pension Protection Act tightened funding requirements for DB pension plans. Despite this, "reasonably possible" losses have risen by close to $100 billion, from $73 billion then to $170 billion today. Two major forces are driving the financial risk PBGC will impose on the taxpayer: the finite lifespan of the employers sponsoring pension plans and the inherently high cost of insuring against systemic risk.

The Myth of Immortality

In large measure the failure of DB plans to meet their commitments has its origin in the presumption that firms offering these plans will live long enough to meet their obligations, essentially that the firm and pension plan will continue forever. That is the premise behind the funding rules that have been in effect throughout PBGC's existence. To witness firsthand the finite lifespan of the American corporation – and thus of the pension promises they make — one needs go no further than the Kennedy Center for the Performing Arts. Etched into the marble walls of the Hall of States are the names of 94 corporate sponsors that helped build the institution. But to read those names is to travel back in time less than 40 years and see that over a fifth of these firms have gone through at least one bankruptcy, or been sold off (in whole or in pieces) while in financial distress. This list includes three of the largest pension plan terminations trusteed by the PBGC and four of the largest bankruptcies ever recorded in US history. Charles Millard, former head of the PBGC summarized the problem in exactly this way:

*"…the threat to the PBGC generally is not just underfunding. It's the bankruptcy of (companies sponsoring) underfunded plans that is our threat, not the underfunding of healthy companies.****[5]****"*

Insuring Against Systemic Risk

An uncontrollable source of financial exposure facing PBGC comes not from intrinsic plan underfunding but rather the exposure from what is known as *systemic risk*. Here the risk stems not from the possibility that a plan may fail to accumulate sufficient assets to pay benefits but rather that an economic downturn may reduce the value of assets held by all plans. Typically this happens at the very same time that the employer sponsoring the plan is itself threatened by the downturn. What was designed as insurance against plan underfunding becomes instead insurance against a recession and the long term reduction in asset values.

This insurance against systemic risk is one that working Americans participating in defined contributions plans are not offered by the Federal Government. From an equity perspective there is no reason why participants in DB plans should be compensated for systemic risk by the Federal government (as will happen given the liabilities held and anticipated by PBGC) while individuals saving for retirement on their own are not.

The Future of Pension Guarantees

Adequate funding of pensions 37 years after the passage of ERISA should have been a foregone conclusion. That it hasn't occurred reflects the tension inherent in a program that has the conflicted goals of both encouraging pensions and requiring their proper funding. This conflict has manifested itself in a number of ways that are adverse to the financial soundness of the PBGC and thus ultimately to the American taxpayer. Notably, it is only in 2011 that pension plans are finally required to fund their obligations at the 100 percent level. But even this funding level assumes the immortal pension plan and it is only severely underfunded plans that are required to meet an "at risk" funding requirement. The "at risk" standard requires that liabilities be determined as if eligible participants retire as soon as possible and take the most valuable form of payment – the situation typically faced by a plan sponsor in its death throes.

While most working Americans have transitioned to Defined Contribution plans – the 401k being the most common such arrangement – the PBGC continues to operate in a world that no longer exists, one where Defined Benefit plans were common. Policy makers thus are faced with two choices. Either continue the current policy and prepare for another large bailout – already roughly $200 billion and rising — or act to limit the taxpayers' exposure by recognizing that all parties – workers, plan sponsors and taxpayers are better served by a system that acknowledges the primacy of Defined Contribution plans.

There is nothing that can be done to change the red ink at PBGC for already failed plans, and little for those that may fail in the near future. But taxpayer exposure to future failure can be mitigated by freezing the guaranty PBGC offers to the level of benefits vested today. That is to say, limit the PBGC guarantee to the level of retirement benefits that the participant would be entitled to today. PBGC would continue to operate to enforce plan funding standards, would continue to make benefit payments to retirees it has assumed responsibility for, but it would cap taxpayer liability to benefits earned to date in order to protect the taxpayer.

Pension plans could, or course, continue to operate and offer benefit accrual should they choose to do so, subject to existing or more stringent funding rules, but those higher benefits would be without a federal guarantee, and would have to be disclosed as such to participants. Plan sponsors would also be free to buy private insurance for these benefits. It has been widely noted that such private insurance would be markedly more expensive than the insurance offered by PBGC. No doubt that is true. The implication of this argument is that these plans only survive because of an insurance subsidy offered by the federal government, a subsidy which no longer serves the population as a whole and which, in the current fiscal climate, we can no longer afford.

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[1] This discussion is limited to single-employer plans. Multi-employer plans, although also guaranteed by the PBGC, operate under a different policy environment.