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Statement No.198

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Statement of the Shadow Financial Regulatory Committee
On

Taxpayer Exposure to Liabilities of the Pension Benefit Guarantee Corporation (PBGC)

September 22, 2003

The Pension Benefit Guarantee Corporation (PBGC) faces both immediate financial troubles and basic structural problems, both of which expose taxpayers to a large potential liability. The challenges due to the underfunding of defined benefit pension plans are not new. Two Shadow Financial Regulatory Committee statements (Nos 102 and 93, attached) from a decade ago describe the issues that the PBGC faced then, and these are strikingly similar to the ones the PBGC faces today. The main difference is that the size of the underfunding is dramatically larger today than it was in 1993.

The immediate financial difficulty that the PBGC faces is due to recessionary factors that have increased the number of underfunded pension plans that the PBGC has taken over from firms in bankruptcy or may be likely to take over from firms now in financial distress. More generally, the combination of poor stock market performance and low profits has reduced the value of pension fund investments and the ability and willingness of firms to fund their obligations. Low interest rates have reduced the relevant "discount" factor applied to future pension obligations, thereby increasing the present value of these liabilities and thus the level of required funding today.

Funding requirements of firms should be based on appropriate assumptions concerning the likely time patterns of the pension obligations. This involves, for example, using a conservatively low discount rate and accounting for the age structure of a firm's employees.

The structural problems of the PBGC involve poor incentives that can generate typical moral hazard problems. First, the PBGC charges a flat fee per participant to all firms that is not related to soundness of their pension plans. Ultimately, firms with sound, well-funded plans and taxpayers will bear the burdens of unsound, underfunded plans. The PBGC should have greater flexibility to charge higher premiums to firms generating more risk to the system. Second, a firm can promise workers extra benefits if a plant were to close but does not have to begin to fund such benefits until after the shutdown occurs. Since shutdowns are correlated with bankruptcy and plan takeovers by the PBGC, firms in distress have an incentive to offer higher levels of unfunded "shutdown benefits" than they would without the ability to shift the burden of these benefits to the PBGC.

In economic downturns, the problems at the PBGC become large, but many argue that this is the wrong time to increase burdens on firms. In good economic times, however, the PBGC does not face immediate financial problems, so there appears to be no reason to act. Nevertheless, it is essential to ensure that the system be put on a long-term viable path as soon as possible by reducing the poor incentive characteristics of the system and requiring full funding of pension obligations based on appropriate assumptions about the expected costs of these liabilities.

Attachments