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Statement of the Shadow Financial Regulatory Committee

On

The Pressing Need for Corporate Pension Reform

Recently, the actual and potential deficits of the Pension Benefit Guarantee Corporation (PBGC) have increased to alarming levels. Secretary of Labor Elaine L. Chao noted in her capacity as Chairman of the Board of the PBGC: "the defined benefit system is now confronted with the most significant challenges it has faced in over a decade. As of the end of fiscal year 2003, total underfunding in America's private pension plans exceeded $350 billion, by far the largest number ever recorded." The PBGC's reported net worth is negative $11 billion and its "reasonably possible" projected exposure to loss in the near term is roughly $85 billion. Should the PBGC have to take over many more plans, as it might have to do should troubled airlines and other companies declare bankruptcy, the "challenge" could turn into a disaster for taxpayers, similar to the savings and loan association (S&L) insolvencies in the 1980s.

The underfunding problem is likely to grow:

- Discounting by a higher-than-risk-free rate, as recently permitted by Congress, allows companies to understate their actual pension liabilities, giving them greater opportunities to under fund their plans.

- Some companies will invest pension funds in very risky assets, hoping for substantial returns that might bail them out, much as many S&Ls took greater risks as they gambled for resurrection. The resulting greater S&L disaster should have taught us that these gambles do not always turn out well, and the PBGC will have to bear a large part of the cost of the negative outcomes should the sponsoring companies also become bankrupt. Thus, the PBGC's deficit is likely to increase.
- Companies that are experiencing financial difficulties will additionally delay funding their pension plans. They also might promise their employees larger pensions in exchange for wage concessions, telling the employees that their pensions are guaranteed by the PBGC. This will additionally increase the present PBGC deficit.
- PGBC will have to increase its premiums. As a result, companies that have been fully funding their plans will have growing incentives to leave the pension guarantee system, by converting their defined benefit plans to defined contribution plans or by transferring the pensions plans and present obligations to insurance companies.
- The net result most likely will be a taxpayer bailout of the PBGC, unless legislators are willing to allow employees to take the loss. Considering the politicians' previous bailout of the Federal Savings and Loan Insurance Fund, shifting the burden to taxpayers is a likely outcome.

Several aspects of the financial deficits of the PBGC are reminiscent of the S&L debacle.

- Much of the problem can be traced to poor incentives resulting from the combination of protection and inadequate prudential regulation. In the case of PBGC, that takes the form of insurance (up $44,386 annually per pensioner) for defined benefit pension plans, combined with rules that permit companies to avoid recognition of asset losses, delay asset replenishment, and take imprudent risks – all of which allow companies to abuse PBGC protection.
- In the 1980s, the Federal Home Loan Bank Board (then regulator of S&Ls) invented so-called regulatory accounting to overstate S&Ls' actual capital so that the Board could avoid recognizing S&L insolvency. Today, Congress is responding in a similar fashion to the pension problem by creating a false and misleading valuation method that understates the liabilities of defined benefit pension plans. Congress's willingness to use legislative paper to cover over the hole in defined benefit plans is especially pronounced in the case of the steel and airlines industries, which have been granted special exemptions allowing them to undervalue their pension liabilities even more than other companies. The

Pension Funding Equity Act, signed by the President in April 2004, lowered companies' reported (but not actual) pension liabilities by increasing the allowable discount rate. Airlines and steel companies were granted additional forbearance from having to fully fund their pension plans.

- Candid recognition that assets are inadequate to meet liabilities is as necessary in this case as it was in the 1980s. If pension liabilities were valued properly, and if companies were required to fully fund their pension plans, many plans would be recognized as underfunded. Companies would then be required either to make up the difference or, if they were unable to do so, to declare bankruptcy. The PBGC's deficit would also increase substantially and immediately (rather than being delayed by pension "forbearance"). This, of course, would be politically difficult, but as in the S&L debacle, the alternative is allowing the loss to grow over time, thus worsening the future cost to employees, well-run companies, and taxpayers.

The Shadow Financial Regulatory Committee warned about this situation more than ten years ago. Statement 93 (March 1, 1993), issued when the PBGC's exposure to potential loss was much smaller than it is today, proposed similar reforms. Statement 102 (December 13, 1993) commended the Administration then in office for putting forth proposals that at least partially addressed some of the problems. These proposals were not adopted and the unprecedented increase in the value of stocks (in which many pension funds were invested in the 1990s) "solved" the problem for a while. It is unreasonable now to depend on such a fortuitous outcome.

The Committee recommends:

(1) Congress should reverse its temporary "fix" of the pension underfunding problem. The true value of liabilities should be recognized now by discounting pension obligations by the riskless long-run interest rate, not the higher corporate rate as recently permitted by Congress, which results in a lower measure of actual pension liabilities. The riskless rate is appropriate, since employers' fulfilling their obligations should not be in question.

(2) ERISA regulations should be reformed to ensure that defined benefit plans are fully funded with appropriate assets, that asset values are measured properly, and that deficiencies in assets resulting from price declines are remedied quickly.

(3) Congress should not delay this process (as it did in the earlier S&L crisis). The sooner pension plan underfunding and the actual deficit of the PBG are recognized and dealt with, the lower will be the costs.

Adoption of the Committee's proposal would not eliminate the problems outlined in this statement. Some companies would have to declare bankruptcy and the PBGC would have to take over their plans (at least to the extent of the statutory obligation). As PBGC premiums increased, other companies would shift to defined-contribution plans. Many other companies would meet their pension plan funding obligations and have strong reasons to forebear from making promises to employees that they might not be able to keep. Taxpayers may still have to bear a substantial burden, but it should be much lower than if the proposed changes were not adopted. Taxpayers can pay now, or pay more later. The PBGC recognizes the difficulties that it, well-run companies, and taxpayers are likely to face if changes, such as the ones the Committee recommends, are not adopted. The Administration and the Congress should not wait to act until another S&L-type disaster becomes obvious.