The Impending Crisis in Defined Benefit Pensions

Article

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Many corporations offer employees “defined benefit” pensions, the amounts of which usually are based on the employees’ years of service and end-of-service pay.

The Employee Retirement Income Security Act of 1974 (ERISA) requires employers to fund pension plans to ensure payment of the promised pension. Out of concern that the plans’ assets might be insufficient to meet pension obligations, ERISA also established the Pension Benefit Guarantee Corporation (PBGC), which takes over the plans of bankrupt employers and pays the pensions. For people who retire at age 65, the current maximum payment amount is $44,386 annually. But through time many corporations have failed to fully fund their pensions, because they experienced serious financial difficulties and/or because they invested pension funds in assets that substantially declined in value. To reduce the pain of bringing their plans to full funding, in April 2004 the Congress allowed employers to discount their pension liabilities at a higher interest rate, which reduces the reported amount of their liabilities, and allowed financially troubled airlines and steel companies to delay required payments. Both measures make the shortfall worse.

This situation is likely to become much more serious. More corporations will attempt to buy off employees who want salary raises by promising higher pensions, letting them know that their pensions are guaranteed by the PBGC. Increasingly, others will declare bankruptcy to shift their obligations to the PBGC.

As the PBGC's deficit increases, it will have to increase the current annual premium of $19 per covered worker plus 0.9 percent of the plan's under funding. With higher premiums, strong corporations with fully funded plans will have an additional incentive to convert them to defined contribution plans (wherein the funds are transferred to individual employee accounts), relieving the employer from having to buy insurance from the PBGC. Should this continue (as we think it will), the PBGC will be left with very weak corporations that have underfunded plans. The PBGC itself would become even more insolvent. A bailout of the PBGC with taxpayer funds will then be politically required, much as the insolvent Federal Savings and Loans Insurance Corporation (FSLIC) was bailed out rather than imposing losses on depositors.

There is not much that now can be done to prevent this disaster. However, it can and should be limited. The longer we wait to impose limits, the greater will be the liability. First, the Administration and the Congress should insist that corporations fully fund their plans quickly with assets that can be and are revalued at least quarterly at market prices and that they measure their pension liabilities by discounting actuarially determined pension obligations by the relevant discount rate, e.g., the rate on long-term U.S. Treasury or risk-equivalent bonds or swaps. That way, the true extent of the funding shortfall will be better known. Second, the PBGC should be closed to new pension guarantees, but of course continue paying pensions to retirees of plans it has taken over and to guarantee the pension obligations of other plans to the extent of amounts already earned by employed persons. No new pension entitlements would be covered. Employers that wanted to continue offering defined-benefit pensions to their employees then could purchase additional pension guarantees from private insurance companies or replace defined-benefit with defined-contribution plans. Third, the PBGC should attempt to pay its obligations to the extent feasible by increasing employers' premiums. Finally, since the Administration and Congress are unlikely to allow employees of bankrupt companies to lose their pensions when the PBGC legally becomes insolvent, the amount of taxpayers' funds that will be required to meet the PBGC's obligations should be estimated and budgeted for. On November 14, 2004 the PBGC announced that its fiscal-year-end balance-sheet deficit on single-employer plans had increased to $23.3 billion from $11.2 billion a year ago. It projected a "reasonably possible" exposure of $96 billion, up from $82 billion in 2003. As the Committee noted above, there is reason to believe that even this amount is understated, because plan assets tend to be overstated. Taking action now and recognizing the problem no doubt will be painful. But, waiting would be irresponsible and end up being much more costly.