

June 25, 2003

REVIEW & OUTLOOK

A Pension 'Guaranty'

Weary of worrying about Fannie Mae and Freddie Mac? Then how about another troubled, quasi-government agency with an implicit claim on tax dollars -- the Pension Benefit Guaranty Corp. The PBGC is responsible for insuring the pensions of 44 million people. One year ago it had a surplus of \$7.7 billion. Today its deficit is \$5.4 billion.

The agency's troubles are related to the events that last week caused General Motors to announce a \$10 billion bond offering to meet its underfunded pension obligations. But at least GM remains a going concern. The underfunded pensions of the many steel, airline and retail companies that have gone bankrupt have all ended up in the lap of the PBGC.

Worse, these burgeoning liabilities are set against declining PBGC income from insurance premiums. Healthy companies with well-funded pension plans are increasingly unwilling to subsidize weak companies with shaky plans. Companies have been either opting out of the system or have decided not to start defined-benefit pensions in the first place (opting instead for 401(k)s and other defined-contribution plans). The result is that last year PBGC's premium level was the lowest since 1991.

At the same time, company pension plans have developed yawning gaps between assets and liabilities (e.g., GM). Since more than half of plan assets are typically invested in equities, those assets swooned along with the stock market. Meanwhile, plan liabilities, which are discounted based on the 30-year Treasury bond, ballooned. As interest rates fell, the discount rate declined and liabilities shot up. It's been a perfect double whammy: Total company underfunding is now more than \$300 billion.

All of this was predictable because the PBGC is a walking example of what economists call "moral hazard." In insuring private pension plans, the agency is writing an implied taxpayer guarantee all too attractive for any company in distress to exercise. The government shouldn't be in this business, but as long as it is the PBGC's deficit proves it needs better funding rules.

The least good, but most likely, solution would raise the discount rate. In 2001, Congress allowed companies to increase that rate temporarily. The increase expires in December, and the Bush Administration wants to extend it another two years. Business, however, wants the rate based on the 30-year Treasury to be permanently replaced by a long-term corporate bond rate. Either of these two measures reduce the present value of pension liabilities. But they're hardly a long-term solution.

A better idea would be to expand the portion of premiums that are now risk-related. Currently, premiums are

fixed at \$19 per plan participant with a tiny amount levied on plan underfunding. Premiums could be changed to more fully reflect the credit risk. Premiums could also be adjusted for the risk arising from the mix of assets in the plan -- especially since pension plans are heavily invested in stocks.

As Boston University economist Zvi Bodie points out, stocks are not a hedge against fixed-income liabilities, even in the long run. There is a mismatch between the market-risk exposure of assets and liabilities. Assets are vulnerable to declines in the stock market and liabilities are extremely sensitive to a drop in interest rates. An unlucky decline in both stock prices and interest rates creates the potential for large future losses. Mr. Bodie suggests that companies be required to hedge their liabilities by investing in default-free, fixed income securities with the same cash flow pattern as the promised benefits.

And finally, funding requirements could be increased. Benefits can currently be increased as long as a plan is at least 60% funded. This leeway gives companies incentives to make promises they cannot keep. Thus troubled companies increase pension benefits instead of wages. And why not? The cost of a wage increase is immediate, while the cost of benefits can be deferred for 30 years and ultimately passed on to the PBGC if the company fails.

The PBGC's deficit doesn't yet represent a crisis. As long as the agency has a positive cash flow, a negative net worth doesn't have to be fatal. But Congress would be wise to act now, before the PBGC is left with only bankrupt pension plans requiring funding directly by taxpayers -- the ultimate "insurers."

URL for this article:

<http://online.wsj.com/article/0,,SB105650038150991900,00.html>

Updated June 25, 2003

Copyright 2003 Dow Jones & Company, Inc. All Rights Reserved

Printing, distribution, and use of this material is governed by your Subscription agreement and Copyright laws.

For information about subscribing go to <http://www.wsj.com>