What Should We Do About the PBGC?

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The consensus among corporate pension plan sponsors has long been that a pension asset mix containing 60 to 80 percent in equities is prudent. Some dissenters have stressed that the safest investment policy is to match the pension liability by holding a 100% bond portfolio. But the prevailing belief has been that over the long run equities are virtually certain to offer a higher rate of return than bonds, and that the risk of a shortfall is negligible.

This belief is false.

Since March 2000, a steep drop in stock prices has made clear the risk inherent in investing a large fraction of pension assets in equities. During the same period, interest rates have also fallen, thus increasing the present value of pension liabilities. This so-called "perfect storm" turned generally adequate pension funding into massive underfunding. The PBGC's balance sheet net worth has gone from a surplus of $7.7 billion at the end of 2001 to a deficit today of roughly $5 billion and growing, prompting concerns that a taxpayer bailout may become necessary in the not-so-distant future. In Congressional testimony on September 4, 2003, Steven A. Kandarian, PBGC's executive director, estimated that aggregate corporate underfunding now stands at $350 billion – down from $400 billion before recent rises in stock prices and interest rates.

But the financial problems that now threaten the viability of the PBGC and indirectly threaten to kill our traditional system of defined-benefit pensions in the U.S. are not new. The PBGC faced a similar, although less dire, situation in the early 1990's and recently Treasury Secretary Snow drew parallels between today's PBGC position and that of the Federal Savings and Loan Insurance Corporation during the S&L crisis of the late 1980's. Had Congress acted immediately to correct the S&L crisis of the 1980s, the bailout would have cost taxpayers about $20 billion. By pursuing a policy of wishful thinking for several years before biting the bullet, it eventually cost taxpayers about ten times as much. Will we ever learn from our past mistakes?

Those who steered us into the present mess are blaming the perfect storm for the PBGC's problems, as if nothing could have been done to prepare. But financial experts had repeatedly warned that the mismatch between the heavy equity exposure of pension funds and the interest rate exposure of corporate pension obligations made the system vulnerable to a storm like the current one. These experts urged the PBGC to require that plans sponsored by financially weak companies hedge their insured liabilities by holding bonds with the same duration as their PBGC-insured liabilities. In the late 1990s many of these funds were more than fully funded. Had they hedged their exposure to a decline in interest rates at that time, they would have easily survived the subsequent storm intact.

But so far, Congress, appears not to have learned the lesson of the S&L crisis. Members of Congress have accepted the perfect storm excuse and enacted "temporary" funding relief (weaker standards). They are now considering extending the deadlines for making up funding gaps.

Compounding the pension underfunding problem is the fact that the PBGC itself invests a substantial portion of its own reserves in equities. This policy is akin to an insurance company writing hurricane insurance and investing its premiums in Florida beachfront property – a strategy sometimes called a "Texas hedge." In the face of all the equity risk that it underwrites by guaranteeing mismatched plans, the PBGC should, at a minimum, invest its own funds in safe assets.

Although today's dilemma may require transitional relief lest we turn serious stress into an immediate debacle, the permanent solution cannot be further weakness. Congress must signal an end to the mismatch-based roller coaster that regularly threatens the PBGC and the participants it is designed to protect. If Congress requires corporate plan sponsors to maintain full funding of their accrued pension promises at all times, after a suitable period of transition, prudent sponsors will promise less and match more.

No one either in the Bush administration or in Congress has had the nerve to propose this policy publicly, although many recognize its wisdom privately. Lobbying efforts of weak plan sponsors and their unions appear to have cowed those astute enough to know what is necessary. The lobbyists have combined common false beliefs about stock market risks and our national appetite for free lunches into a story that none dare challenge.

When Congress and the Executive branch make clear that they expect corporate promises to be kept by the corporations that make them, plan sponsors will fund fully and will invest most assets in high-quality bonds. Assuming that it survives the transition, the PBGC need never face another crisis. The PBGC's role would be reduced to covering the "legacy" cost of underfunded pension plans inherited from the past – and to protecting employees against the truly unusual events that, unlike low interest rates and equity prices, cannot be hedged in the financial markets.

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