The Role of the Government and Guarantee Organizations: Laissez Faire or Welfare State Discussion of Papers

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* The conclusions and recommendations expressed here are the author's and do not represent the views of the PBGC or its staff.

Let me begin with the Pollack paper. The paper makes a thoughtful case for the elimination of the Pension Benefit Guaranty Corporation (PBGC). It has been thoroughly researched, especially in its review of the origins and the early history of the program. However, it may not come as a great surprise that I don't share its premise or its conclusions. Times are difficult for the defined benefit (DB) system, but abolishing the PBGC is not the cure for the system's ills.

One of the critical arguments in the paper is the author's contention that the only two alternatives to reforming the PBGC and the DB system are not viable: that is, in the author's words, "actuarially fair premiums are not practical" and "the social insurance model … is not viable." The argument is made in extremis. However, no one has proposed either of these extremes, but, rather, most are looking for a reasonable middle ground.

More importantly, the Pollack paper bases its assessment of viability solely on the limited analysis done by the Center on Federal Financial Institutions (COFFI). Now, Doug Elliot of COFFI has performed a very valuable service in clearly articulating the key issues so that decision makers understand the basic dynamics of the DB system. However, COFFI's modeling of the DB system is not as helpful or informative. COFFI's model of the PBGC relies upon a simple deterministic spreadsheet approach that projects results for the next 75 years based upon many historic averages and several subjective assessments of plan sponsor behavior. Most actuaries would not utilize such a model to evaluate the viability of a catastrophic insurance program.

At the PBGC, we rely upon our Pension Insurance Modeling System (PIMS) to inform our analysis. PIMS is a stochastic simulation model that incorporates a detailed database of 400 actual plans, sponsored by nearly 300 firms, which represent about 50 percent of the liabilities and underfunding in the DB system. The database includes plan demographics, plan benefit structure, asset values by type, liabilities, and actuarial assumptions from the most recent Schedule B's for these 400 plans. It also includes key financial information about the employers sponsoring the plans.

PIMS simulates contributions, premiums, and underfunding for these plans using the minimum funding rules under current law and alternative approaches such as the administration's proposal and the House Education and Workforce proposal. PIMS extrapolates these results to the universe of single-employer plans. It also uses the employer's financial information as the starting point for assigning probabilities of bankruptcy, from which it projects losses to the insurance program under both current law and the various funding proposals. When used in a stochastic mode, PIMS provides

a range of possible outcomes and quantifies the likelihood of these outcomes. This range of outcomes is reported each year in the PBGC's annual report.

Let me give you one example of the difference between PIMS and the COFFI model. As the Pollack paper reports, COFFI announced in September that the PBGC would run out of cash in 2021. Based upon the results of 500 economic scenarios, PIMS shows less than a 10 percent probability of running out of assets by 2021. A simple spreadsheet model is not sufficient to assess the future of a catastrophic insurance program in which the key variables have such a large variance—that is, in which the key variables are not "well behaved" unlike those, for instance, in Social Security.

Let's return to the fundamental question: Is there a viable alternative to preserve the DB system? There are many proposals that could restore the system to health—the administration's legislative proposal is not the only path to recovery. However, we have modeled the administration's proposal in PIMS, and the results are encouraging. Claims can be substantially reduced over time, contributions can be about as variable as under current law, and the variable rate premium can stay at about the same level per $1,000 of underfunding as under current law. Minimum contributions would be moderately higher over the next 10 years, but as actuaries we know that over the long term the value of the future contributions will be the same whether they're paid now or later.

The specter of overwhelming premium levels is raised in the Pollack paper. The paper states that an increase in premium levels "could easily push struggling sponsors into bankruptcy." This is not the case. PBGC premiums at almost any foreseeable level are an immaterial footnote to the financial statements of any company. More importantly, the premium income necessary to support the insurance program will not come from the struggling sponsors—it will come primarily from the companies with underfunded plans that to date have used the full funding limit exemption to avoid paying a premium. Despite record levels of underfunding in the system, last year only 17 percent of participants were in plans that paid a variable rate premium.

Will the future be painless under this and other proposals? No. Will the moderate increase in premiums and contributions overwhelm the system and drive all companies either into bankruptcy or out of the system? Of course not. That is the rhetoric of lobbyists. The current system does not work, and the only way to rebuild confidence in it is to establish a set of rational rules that minimizes the opportunity for manipulation and sets reasonable goals for plan funding.

In Mr. Pollack's defense, the details of the administration's proposal—that is, the PBGC's White Paper on the proposal, the related federal budget documents, and the transcripts of the many congressional hearings over the last several months—may not have been complete or available when he was writing his paper.

In its conclusion, the paper says "Certainly, transitioning to a system without termination insurance would raise several difficult and controversial issues. One contentious issue would be what to do with the benefits for which the PBGC is currently responsible." Ironically, the author uses this issue—that is, there are no acceptable alternatives to pay for the PBGC's current $23 billion shortfall—in building the case for abolishing the PBGC. Getting rid of the PBGC does not make the shortfall go away, nor does it make the $450 billion in system underfunding disappear.

In fact, there are very few, if any, specifics in the paper about how to make the DB system stronger after abolishing the PBGC—just a faith that things will get better without the PBGC. The one exception is the suggestion in the conclusion that the funding rules should be weakened for ailing industries.

There is no mention in the paper of any other contributing factors to the current plight of the DB system. Nothing is said about the minimum funding rules that shut down far too early. Nothing is said about the huge asset-liability mismatch that gave rise to much of the current dilemma. Nothing is said about the deception caused by the smoothing of asset and liability values.

In describing the DB world without the PBGC, the paper returns to one of its key themes: absent the PBGC, unions will focus on funding in their negotiations, and they will have incentives to monitor pension activities more closely. Now, the author is very familiar with the airline plans and cites the US Air and United Airlines bankruptcies. The pilots' plans of these two airlines present a situation that may provide some insights into a world without the PBGC. These plans provide benefits that are substantially larger than the PBGC maximum guarantee, which is currently about $29,000 a year at the mandatory retirement age for pilots. ALPA, the pilots' union for most of the airlines, is very aware of the need to keep their plans well funded to provide nonguaranteed benefits through Priority Category 3 under Title IV. Both USAir and United were below investment grade companies for many, many years prior to bankruptcy. And yet the two pilots' plans were respectively 33 and 50 percent funded at termination. Perhaps union plan funded levels will not improve in a world without the PBGC—only the losses to participants will increase.

Finally, the paper concludes that "some will argue that it would be politically impossible to end termination insurance." Interestingly, the authors of several recent papers from the Cato Institute and the Heritage Foundation also fall in this category: they propose solutions to the PBGC's problems but never suggest that the pension guaranty should be abolished. And the British Parliament must be placed in this category for establishing a new British PBGC this year after having thoroughly reviewed the history and the financial condition of the PBGC.

More importantly, I am not aware of a single member of Congress even considering such a Draconian course of action as abolishing the PBGC. Based upon my experience, the Congress is totally committed to this program that provides meaningful benefits to their constituents when their employers fail due to no fault of these constituents.

Turning now to the Coronado and Liang paper, I welcome this very valuable contribution to our understanding of how the pension world works. The paper's conclusion that "firms tend to reduce cash contributions to their DB plans as they get riskier" certainly is supported by the PBGC's own research and observations.

The paper concludes with this statement: "However, the fact that pension insurance does not account in any way for firm insolvency risk has led to a great deal of moral hazard behavior among riskier firms and any attempts to shore up the insurance system need to provide strong incentives for these weaker enterprises to make different choices with their pension fund finances." All I can add to that is an AMEN.

The General Accounting Office (GAO) recently completed a somewhat similar study. In their May 2005 report entitled "Recent Experiences of Large Defined Benefit Plans Illustrate Weakness in Funding Rules," the GAO analyzed the experience from 1995 to 2002 of the 100 largest plans insured by the PBGC. The report states that "on average, 9 percent of the largest 100 plans had a sponsor with a speculative grade credit rating, suggesting financial weakness and poor creditworthiness. As a group, speculative grade-rated sponsors generally had lower average funding levels, and were more likely to incur an AFC than other sponsors." It goes on to say: "Of PBGC's 41 largest claims since 1975 in which the rating of the sponsor was known, 39 have involved plan sponsors that were rated as speculative grade just prior to termination. Among these claims, over 80 percent of plan sponsors were rated as speculative grade 10 years prior to termination."

I have a couple of observations about the data used in the study. We all know that 5500 data is out of date by the time that they become available and do not include sufficient information to determine asset allocations. As Coronado and Liang report, they have used the FASB disclosures in the 2003 10-K's of the Fortune 1000 firms, which include some asset allocation information. But the FASB data have several shortcomings as well:

- Currently, the funded status information for all DB plans is combined, and only the aggregated amounts are disclosed. The totals include amounts for noninsured DB plans such as Supplemental Executive Retirement Plans (SERPs) and foreign plans. Showing amounts in total paints an incomplete picture of each plan's funded status (and the PBGC's potential exposure) because upon termination one plan's surplus cannot be used to cover another plan's shortfall.
- Because funding rules are so complicated, the amount required to be contributed can vary significantly from year to year. A company may report that no contribution is due for the coming year solely because a credit balance exists that can be used in lieu of contributing additional cash. However, once that credit balance is used up, the sponsor will need to start making large annual contributions. Because the current funding rules can create short-term funding holidays during which no contributions are required, relying on contribution information for just one year can be misleading. This is particularly true of 2003, when substantial contributions in excess of the minimum were made for the first time in many years.
- Plan obligations reported on FASB disclosures are usually calculated using a higher discount rate assumption than would be used upon plan termination. The rates also vary from plan to plan, resulting in underfunding values that may not be comparable from plan to plan or company to company. The PBGC often adjusts reported liabilities to estimate what plan liabilities would be on a termination basis. The change in obligation resulting from a change in the discount rate varies significantly from plan to plan based on the underlying demographics.

It is also good to keep in mind that not all companies have a pension funding policy that is targeted to funding up their FASB liabilities. Some companies are more focused on the statutory minimums or maximums, others on maintaining predictable and stable contributions, and yet others on avoiding the PBGC variable rate premium or the additional funding charge or employee notices of underfunding. These variations in funding policies may make the paper's results more difficult to interpret clearly.

A fundamental principle of insurance design is to recognize and address the key risk factors. That's why banks and insurance companies have risk-based capital standards, drivers with poor driving records face higher premiums, smokers pay more for life insurance than nonsmokers, and homeowners with smoke detectors get lower rates than those without. Some have objected to the use of credit ratings to determine funding and premium levels. It is not clear whether the principal concern is with the use of the rating agencies themselves, or with the concept of incorporating credit risk into the funding and premium requirements. As to the first point, the cost of capital for most large companies is, to a significant degree, derived from the rating agencies' calculation of creditworthiness. And it is reasonable, fair, and prudent to require higher plan contributions and premium payments from companies that pose a higher risk of underfunded terminations.

As some of you may have seen, the British Pension Protection Fund, their new PBGC, announced this week that their risk-adjusted premiums for 2006–2007 will be based upon 10 risk bands using rating agency techniques to gauge the risk of firm insolvency; 80 percent of total premiums will come from the risk-adjusted premiums. The National Association of Pension Funds, which represents the bulk of Britain's retirement fund industry, stated: "We are pleased to see the PPF is clearly prepared to listen to the industry and is taking a pragmatic approach."

Hopefully, we will benefit from the PPF's initiative in this area. We have certainly benefited already from the Coronado and Liang paper on this subject.