

PENSION INSURANCE: A CRISIS ON THE HORIZON?

“If we are not to ignore the lessons of the past, the time to act is now, before inaction increases dramatically the cost of [the] PBGC’s losses.”

—Lynn Martin, Secretary of Labor

With current attention focuses on the government’s bailout of the savings and loan industry, it is easy to overlook other industries where the potential for a similar failure exists. Actually, whenever a government agency insures the actions of private firms, the possibility of a taxpayer bailout is present. One such industry is pension insurance.

Since 1974, the U.S. federal government, through an agency of the Department of Labor, has been insuring private pension plans against termination and underfunding. The government originally engaged in pension insurance, as it did deposit insurance, with the intention of protecting participants against firm abuse. This well-intentioned regulation, however, can result in the abuse being transferred from the insured parties to the insurer, the federal government.

Pension Insurance Background

The Employee Retirement Income Security Act (ERISA) of 1974 created standardized funding and vesting guidelines for private pension plans operated by firms. (See the shaded insert on page 6 for definitions of terms related to pension plans.) Before ERISA, there were no standards, creating much uncertainty among workers. For example, in 1965, 40 percent of pension participants were in plans that awarded vesting only at normal retirement age, usually 65. This meant that if the worker was fired just before retirement, which occurred frequently, he lost all of his expected benefits.¹ Firms could also simply terminate their pension plans, leaving participants without any benefits. Underfunding was another problem, especially at unionized organizations, leaving participants with either severely reduced or no benefits.²

To reduce the uncertainty associated with possible termination or underfunding, ERISA established the Pension Benefit Guaranty Corporation (PBGC), a government-sponsored enterprise charged with overseeing and insuring pension plans. Essentially, the PBGC guarantees workers that, should their insured pension plans terminate, they will receive the basic

¹See Richard A. Ippolito, "A Study of the Regulatory Effect of the Employee Retirement Income Security Act," *Journal of Law and Economics* (April 1988), p.101.

² In an October 1985 *Journal of Law and Economics* article, "The Economic Function of Underfunded Pension Plans," Richard A. Ippolito argued that firms purposely underfunded their pension plans before ERISA to gain an edge when bargaining with unions.

benefits—regular retirement, death and disability—promised under the plan up to a prescribed monthly cap (about \$2,300), even if the plan is underfunded. Currently, the PBGC insures approximately 95,000 pension plans covering nearly 40 million American workers and retirees.³

The PBGC's growing losses have eclipsed the revenues it collects from premium payments, as more and larger firms have declared bankruptcy with underfunded pension plans. The program's steadily increasing deficits, shown in the figure on page 7, reflect this trend. (The large spike in 1986 results from the terminations of the LTV Corporation's largely underfunded pension plans. Without LTV's terminations, the 1986 deficit probably would have been about \$1.3 billion.) In addition, more firms today with active pension plans have low funding ratios than before, exposing the PBGC to potentially severe losses.

The growing tendency of firms relying on the PBGC to salvage their underfunded pensions worries many at the PBGC's jurisdictional director. As implied by Secretary Martin's comment, the potential for another S&L type crises exists, because, ultimately, any monies paid out by the PBGC in excess of its collections must be provided by U.S. taxpayers.

³See the PBGC's press release, "Top 50 List Shows Increased Underfunding," November 25, 1991.

To fully understand the operations and potential problems of the PBGC, a knowledge of the types of pension plans available is necessary. With this as a foundation, we can then describe the nature and evolution of the PBGC's worries.

Private Pension Plans: A Primer

Pensions are a means through which firms defer a portion of their employees' compensation for the employees' use in retirement.⁴ Firms defer compensation through either defined contribution or defined benefit pension plans. Defined contribution plans guarantee an annual contribution into the employee's account by the firm. Defined benefit plans guarantee the employee an annuity at retirement, the amount of which usually depends on the worker's average salary and final tenure.

By their nature, defined contribution pension plans accrue assets at the same rate they accrue liabilities. Each additional year a worker is with the firm adds an extra year's worth of liabilities to the worker's account, which is then exactly offset by the firm's contribution of funds. Thus, defined contribution pension plans are always fully funded. The employee's final benefit depends only upon the amount of the firm's and, possibly, the employee's

⁴For our purposes, retirement means any separation of the worker from the firm after vesting. Minimum age requirements must be satisfied to receive the benefits.

contributions into the plan, adjusted for the rate of return earned on the assets into which these funds are invested. Consequently, participants encounter market risk but not termination or underfunding risk; as a result, defined contribution pension plans are not subject to the funding guidelines under ERISA. These plans, however, are regulated by ERISA's vesting requirements.

Defined benefit pension plans also accrue liabilities over time, but these liabilities are actuarial (statistically calculated) rather than fixed-dollar. Contributions of assets to compensate for the liabilities are made less regularly, as only a portion of the total liabilities ever need to be funded at any particular time. Although ERISA requires mandatory funding, the law gives firms considerable latitude in selecting the values of the actuarial parameters, such as the interest rate, retirement age and mortality assumptions, used to determine the required minimum contribution. The actual benefit the worker receives, however, is determined by the firm's pension benefit formula—hence, a defined benefit—regardless of the return the plan's assets receive from their investment. This accounts for the regulation of funding.

The vesting rights of defined benefit plans are also regulated by ERISA because, by their nature, these plans can affect worker turnover at a firm. Under defined benefit pension plans, the amount of the annuity received at retirement is directly related

to tenure with the firm, creating an incentive for workers not to change jobs too often. Without standardized guidelines, firms may delay vesting to encourage long tenures, converting the pension claim into a reward for service rather than recognizing it as a part of total compensation. As we have already seen, however, before ERISA, the promise of a reward did not guarantee its existence at retirement.

This vesting and tenure argument also suggests that workers indefinitely laid off from jobs lose not only their current compensation, but also the expected increase in their deferred compensation commensurate with tenure. Even if the employees are vested, the portability of the pension—the ability to transfer liabilities from one plan to another—determines the amount of the loss incurred. If the pension rights are not portable, the financial losses can never be recouped in a new pension plan. Nevertheless, recent modifications of the vesting rules, legislated by the Tax Reform Act of 1986 (see shaded insert on page 8 for a summary of these amendments), created an implicit separation cost for the firm, the pension liability, thereby decreasing the probability of a firm-initiated separation after vesting.

Some Basic Problems Incurred by the PBGC

According to the PBGC's 1991 Annual Report, "This year

has seen the largest losses from terminations in our 17-year history”.⁵ These losses included \$700 million from seven Eastern Air Lines pension plans and more than \$900 million from Pan American World Airways. At the end of fiscal 1991 (September 30, 1991), the PBGC had a deficit in the single-employer insurance fund of about \$2.5 billion, with projections of up to \$18 billion by the end of the decade. Offsetting the current deficits were surpluses in the multiemployer insurance fund of only \$187 million.

According to the PBGC’s 1991 survey of its top 50 firms with underfunded plans, the first 10 have funding ratios below 50 percent. The total amount of underfunded liabilities, which the PBGC classifies as “probable” or “reasonably possible,” approximate \$21.5 billion, a greater than 50 percent increase between 1989 and 1990.⁶ This represents an overall underfunding ratio of 25 percent. The PBGC continually monitors the progress of firms in these categories.

One problem facing the PBGC is the moral hazard associated with any insurance scheme.⁷ A firm generally will

⁵ See PBGC, *Annual Report*, p. 3.

⁶ The terms “probable” and “reasonably possible” are Financial Accounting Standards Board (FASB) nomenclature. Probable signifies that a loss is likely to occur, while reasonably possible means that a firm has an underfunded plan and is experiencing significant financial problems.

⁷ Moral hazard is an increase in the chance of a loss brought about by a change in

underfund its pension plans as its financial situation deteriorates. Oftentimes, a firm, foreseeing a bankruptcy, will purposely allow its pensions' assets to dwindle, knowing that the PBGC will have to assume the losses.

The most prominent example of this strategy is the LTV Corporation, which had three pension plans, underfunded by about \$2.5 billion, terminated by the PBGC in 1987. Subsequently, LTV established new, almost identical, plans in their place. The PBGC sued LTV, arguing that the follow-on plans constituted a clear abuse of the system. The PBGC also restored the terminated plans to full active status after an improvement in LTV's financial condition, making LTV again responsible for them. The New York District Court, in a decision upheld by the State Court of Appeals, disallowed this restoration and ruled that the follow-on plans did not constitute an abuse of the system. Then, in June 1990, the U.S. Supreme Court overturned this decision and ordered the lower court to issue a new ruling.⁸

Adding to the legal complications, a U.S. District Court, in September 1991, denied the PBGC bankruptcy priority status, which would have allowed it the same rights as the IRS in recovering claims, and ruled that LTV may not be forced to fund a

behavior because of insurance. Insurance companies usually require deductibles and copayments to offset moral hazard.

⁸ PBGC 1990 Annual Report, p. 13.

fourth terminated pension plan while in bankruptcy.⁹ This ruling still stands, although legislation has been proposed to overturn it. This example demonstrates the moral hazard faced by the PBGC from any firm that chooses to declare bankruptcy, especially when one of the firm's goals is to eliminate its pension liabilities. The next example also demonstrates this.

Continental Airlines Holdings, Inc. (formerly Texas Air) is the parent company of Continental Airlines and the now-defunct Eastern Air Lines. When Eastern declared bankruptcy and had seven pension plans terminated, the PBGC was able to hold Continental jointly responsible for the pension liabilities with Eastern and negotiated a settlement plan. After making an initial payment in September 1990, however, Continental was unable to provide adequate collateral to meet the remaining obligations. In December 1990, it filed for bankruptcy. This action resulted in the PBGC being responsible not only for Eastern's pensions, but also for an additional \$183 million shortfall from Continental's own underfunded plans.¹⁰

As a response to the moral hazard, the Pension Protection Act of 1987 required for the first time that firms with underfunded pensions pay a variable-rate premium based on the degree of

⁹ PBGC 1991 Annual Report, pp. 18-19.

¹⁰ Ibid, p. 19.

underfunding. The Act also increased the fixed-rate premium for all plans (fully funded and underfunded). The cap for the total premium (fixed- plus variable-rate) was increased again in 1991 to \$72 per plan participant from \$50. The PBGC fears, though, that any further increase in its premium may “eventually drive out the least risky, better funded plans. [The] PBGC has already seen a large exodus of small plans.”¹¹ Thus, it is possible that the insurance can make it too costly for a firm to maintain a defined benefit pension, resulting in its termination and replacement with a defined contribution pension plan. In addition, because most covered pensions plans are well-funded and because the PBGC’s revenues come from collected premiums, the well-funded plans are, in effect, subsidizing the underfunded plans. This could lead to a second problem at the PBGC, adverse selection, where only firms that underfund keep their defined benefit plans.¹²

Where Do We Go From Here?

While the potential losses from underfunded pension plans amount to only a fraction of the losses experienced from savings and loan institutions, the likelihood for a burdensome bailout does

¹¹ Ibid, p. 14.

¹² Adverse selection occurs when only risky clients opt into an insurance program and safer clients opt out. This results in higher premiums because the insurance company expects larger losses.

exist. James Lockhart III, Executive Director of PBGC, testified to Congress in February 1991 that, while the PBGC has enough cash to last for a decade, it will need to acquire more assets if it has to continue salvaging the pensions of large companies.¹³ If such losses cannot be contained, individuals will likely lose some of the income promised to them under the original employment agreement and owed as compensation for work already performed. Couple this with workers' increasing dependence on pensions as their sole retirement income (except for Social Security), and this predicament becomes all the more serious.

The basic problems facing the PBGC, moral hazard and adverse selection, are the same as for any other insurance company; however, it is the taxpayer who ultimately incurs any losses not recovered from the defunct plans or through premiums suffered by *this* insurance company. Therefore, firms, government and, especially workers, must maintain a watchful eye on pension plans to ensure that each party keeps its part of the bargain.

¹³See "The Protector of Pensions Develops Its Biceps," *Business Week*, (March 11, 1991), p. 80.