The Administration's PBGC Premium Proposal Deserves Support

Charles Blahous | April 18, 2011

In this year's budget submission, the Obama Administration included a proposal to partially reform the finances of the Pension Benefit Guaranty Corporation (PBGC). In essence, the proposal would give PBGC increased authority to modify both the level and structure of premiums that pension sponsors are charged for pension insurance.

Proposals similar to President Obama's have previously been offered both by the George W. Bush Administration and by the Simpson-Bowles commission. The proposal also faces energetic opposition from much of the business community. I believe that the basic conception of the Administration proposal is sound and that its enactment would strengthen the insurance system standing behind worker pension benefits.

Background

When employers make defined-benefit (DB) pension promises to their workers, those benefits are insured (up to a statutory cap) by the PBGC. Employers are assessed premiums for that insurance. A core principle underlying the PBGC system is that it is supposed to be self-financing; that is, funded by pension sponsors without taxpayer support.

If a pension plan terminates (e.g., if its sponsor goes bankrupt), the PBGC assumes its assets and benefit payment obligations. If the plan lacks the assets to fund the benefits insured by the PBGC, the insurance fund takes a hit. The solvency of the fund thus depends on both the adequacy of pension funding and on the adequacy of premium assessments. Funding requirements and premium assessments are currently established by federal law.

PBGC's insurance programs currently face a deficit of roughly $23 billion in present value. This deficit was made worse by the recent recession but was not caused by it. Even when financial markets were at their recent peak, PBGC had reported substantial deficits for several consecutive years.

Who Will Pay? The Big-Picture Policy Choice

One way or the other, the substantial imbalance between PBGC's benefit obligations and the assets it commands must be resolved. We face a fundamental value judgment as to who should bear the cost of eliminating this shortfall. Possibilities include:

1. Workers Who Were Promised Pension Benefits
2. Employer Sponsors Who Fail to Fund Their Pension Plans
3. Employer Pension Sponsors as a Whole
4. Taxpayers

To shed light on fairness considerations, it bears noting that the $23 billion figure represents PBGC's deficit to date. It accounts for past pension terminations as well as future terminations that are already "probable." It does not incorporate the cost of other possible future terminations.

Choices #1 and #4 above (imposing costs on workers and taxpayers) seem to be the least fair options. Workers who were promised pension benefits would bear the costs if the PBGC insurance system were simply allowed to collapse (Choice #1). Again, recall that the current deficit arises primarily from past benefit promises, not future ones. Large numbers of workers would thus lose vital retirement benefits that they were not only promised (and in many cases utterly depending upon), but which had also been represented by the federal government as safely insured (at least up to a limit). This outcome clearly seems inequitable.

It would also be unfair to bail out PBGC with taxpayer money. Only 21% of workers have access to DB pensions of the kind insured by PBGC. It would not be equitable to require the other 79% of Americans to pay for benefits they cannot receive.

The fairest outcome, then, requires that the PBGC shortfall be met by employer sponsors, continuing the historic ethic of a self-financing insurance system. But which sponsors should make up the shortfall? All of them, including those who have responsibly funded their pensions? Or should the costs be confined to those who dump underfunded pensions onto the PBGC?

At first glance, it seems fairest for employers who have failed to fund their pension promises to shoulder the burden. But there are at least three problems with relying exclusively on this approach. First, among sponsors that go bankrupt with underfunded pensions, adequate resources probably aren't there. Second, PBGC's current shortfall arises primarily from past terminations, for which sponsors of yet-to-be-terminated plans are generally no more culpable than are other employers. And third, the foundational idea behind pension insurance is to share the risks of pension underfunding among the full community of sponsors, thereby reducing the costs that hit any particular one.

This isn't to say, however, that we shouldn't assess the costs upon underfunded plan sponsors where practicable. Doing so is not only fair, it mitigates the moral hazard temptation to shift one's pension funding obligations to others. Mechanisms for this would include risk-based premiums (premiums that reflect the risk of a sponsor transferring its pension obligations to the PBGC), as well as the "termination premium" (an additional premium assessed upon the termination of a pension plan). But even with such measures in place, responsible sponsors of well-funded pensions will face substantial costs (e.g., general premiums) to resolve the PBGC deficit. The only likely alternative is to pass a large bill to taxpayers.

Who Should Set Pension Insurance Premiums?

The Obama Administration has proposed granting the PBGC authority to set insurance premiums, much in the way that the Federal Deposit Insurance Corporation (FDIC) currently does. The employer community has pushed back, arguing that this authority would eliminate "the public's ability to engage in a policy dialogue with Congress regarding the level of PBGC premiums."

In an ideal world, pension insurance premiums would be set by a well-functioning market and reflect the actual value of insurance provided. In the real world, PBGC premiums have instead been set via legislative processes (the aforementioned "dialogue with Congress") that have fairly conclusively proved incapable of adequately pricing risk. The Congressional Budget Office (CBO) has estimated that premiums would need to be roughly 6.5 times higher to cover PBGC's expected losses.

In my book *Pension Wise*, I explain how moral hazard associated with DB pension systems results in persistent cost-shifting. Whether the DB system is the employer system, state/local pensions or Social Security, there is the irresistible temptation to shift the risks of underfunding to third parties. In state/local pensions and in Social Security, these cost burdens are shifted to future taxpayers via such methods as aggressive liability discounting (in state/local plans) and pay-as-you-go financing (in Social

Security). Analogous political processes surrounding employer-provided pensions result in cost-shifting to the pension insurance system – and potentially to taxpayers.

This moral hazard is pronounced when PBGC premiums are established in legislation. One of the few things that labor and management can consistently agree upon is that it would be nice to have more funding available for wages than tied up with the pension fund, especially if others stand ready to finance the pension benefits. This creates persistent, bipartisan political pressure both for lower premiums and looser funding standards. The only realistic alternatives to change this dynamic are either to empower the pension insurer to assess actuarially fair premiums, or to replace PBGC with a system of compulsory private insurance that charges true market rates.

Should Insurance Premiums Account for Sponsor Risk?

The Administration's proposal would not only give PBGC authority to increase premiums, but would specifically direct PBGC "to take into account the risks that different sponsors pose to their retirees and to PBGC." This is critical to minimize moral hazard, and to protect sponsors of well-funded pensions from the actions of others.

Again the employer community has pushed back on this concept, specifically raising the concern that basing premium assessments on credit ratings would harm companies that are already facing financial difficulties, creating a "downward spiral" resulting in additional pension plan terminations.

A few points here: first, to remain viable any insurer must be able to assess the risk of insuring a particular entity and to price its insurance coverage appropriately. This principle is already recognized in federal insurance programs. The FDIC, for example, has the authority to levy risk-based assessments for bank deposit insurance. The principle is not even wholly new to PBGC: PBGC's current variable rate premium is supposed to capture one element of risk (though it doesn't do a very good job of it), as it is based on plan underfunding. A second critical point is that empirically, a sponsor's credit rating is one of the most important statistical determinants of whether its pension plan is likely to be terminated. (See Warshawsky, McCall and Worth, "Regulating Single Employer Defined Benefit Pension Plans," 2005. Pension Research Council Working Paper 2005-12, 2005.)

Clearly it would not be in PBGC's interest to levy premium assessments upon weak sponsors in such a way as to produce the negative consequences about which employer groups have expressed concern. One can always fairly question the competence of a government agency to get this balance right. The agency's interests, however, would at least operate in the right direction.

In any case Congress would retain ultimate legislative authority over the PBGC, and with it the ability to overturn any counterproductive premium policy that it establishes. The question on the table is whether it makes the greatest policy sense for Congress to take the first crack at setting premiums. Past practice is reasonably definitive that the answer is a resounding no.

How Should Pension Policy Reflect Broader Economic Recovery Policies?

A final concern raised about the Administration's pension proposal is that requiring higher premiums would "hinder economic recovery." Though this might sound the most compelling among the arguments against the proposal, it is actually the least compelling.

The purpose of premium assessments should not be to advance broader economic policy objectives far beyond the scope of the pension insurance system. Such an approach carried through to its logical conclusion would find that optimal premium assessments should be zero, for this is the level that would maximize financial resources immediately available to employers to facilitate job creation and wage growth.

Such a policy, however, would further shift the risks of pension underfunding to the pension insurance system and potentially to taxpayers. It would embody a policy decision to pursue economic stimulus through the vehicle of a weaker pension insurance system. This is not how pension premiums should be determined.

Conclusion

The Administration's proposal to increase PBGC's authority to establish a more appropriate level and structure for PBGC premiums is conceptually sound. If enacted, its application should be continually refined to address the legitimate concerns expressed by the pension sponsor community. The current legislative process for establishing pension premiums, however, has repeatedly failed the fundamental test of facilitating premiums that are both adequate and appropriately structured. If the PBGC is not abolished and replaced with a system of private insurance, Congress would do well to establish a new premium assessment process along the general lines proposed by the Administration.

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