Initiative on
Business and Public Policy
at BROOKINGS

JUNE 4, 2009

The Tripling of the PBGC's Deficit: What Does it Tell Us?

Douglas J. Elliott

The Initiative on Business and Public Policy provides analytical research and constructive recommendations on public policy issues affecting the business sector in the United States and around the world.

Initiative on
Business and Public Policy
at BROOKINGS

The Tripling of the PBGC's Deficit: What Does it Tell Us?

Douglas J. Elliott

June 4, 2009

The Initiative on Business and Public Policy provides analytical research and constructive recommendations on public policy issues affecting the business sector in the United States and around the world.

CONTENTS

Introduction	7
How sure are we of the $33 billion figure?	8
What made the deficit go up so fast?	9
What does this mean for the PBGC's financial future?	10

Copyright © 2009 The Brookings Institution

Introduction

The Pension Benefit Guaranty Corporation (PBGC) recently announced a tripling of its deficit from $11 billion to $33 billion. This is a striking increase, especially over six months, and is significant even in these days of huge financial rescue packages. While it is bad news that the PBGC is now $22 billion deeper in the hole, it is not fundamentally surprising news. Numerous studies, including some of my own, have shown that the premium rates set by Congress are insufficient to cover the risks, which themselves are heavily influenced by Congressionally mandated minimum funding rules. Further, the deficit tends to grow in jumps, staying stable or modestly declining in good economic times and soaring when conditions sour.

This paper attempts to put the PBGC's $33 billion deficit in context, by answering the following questions:

- How sure are we of the $33 billion figure?
- What made the deficit go up so fast?
- What does this mean for the PBGC's financial future?
- How can we fix the financial problems?

Those readers desiring more background on the PBGC and its continuing financial crisis should see "A Guide to the PBGC". In addition, the author has written over 25 papers on the PBGC which are available at www.coffi.org, the website for the Center On Federal Financial Institutions.

How sure are we of the $33 billion figure?

The accounting statements for a complex financial institution are essentially best estimates, with the true net worth lying somewhere in a range around the figure shown on the books. While it may be possible to be completely confident of the net worth of a dry cleaner or a grocery store, it is very different for financial institutions, particularly those with long-term claims. The PBGC has taken on promises to pay pensions going out decades into the future, which are therefore difficult to value. In many cases, those payments depend on how long the retiree lives. The PBGC is also required by the accounting rules to make estimates of the level of claims that have not yet officially come in, but which are expected to do so in the future.

That said, the $33 billion figure does appear to be a realistic best estimate arrived at according to Generally Accepted Accounting Principles (GAAP), essentially the same rules that a private sector insurer would follow. It would be foolish to regard it as completely accurate in some ideal sense, but even more foolish to disregard the figure because estimates are involved. Further, as discussed in the rest of the paper, one would expect the PBGC to be running quite a large deficit now, both because of systematic undercharging for the risk taken on and because now is a point in the economic cycle when the PBGC should suffer large claims. In fact, one would expect the deficit to get worse before it stabilizes.

What made the deficit go up so fast?

Although $22 billion is a particularly sharp jump, the PBGC's nature exposes it to such jumps. The PBGC is much like other credit insurers in that, with rare exceptions, it only takes on the obligations of a pension plan if the sponsor is insolvent. Credit insurers generally look quite profitable the large majority of the years, but give back a big chunk of the profits during times of serious recession. The PBGC's situation is similar, but worse, as a result of charging premiums that are too low for the risk. This is exacerbated by the fact that pension deficits are correlated with general economic conditions, effectively increasing the insurance coverage at the time it is most likely to be used. As a result, the PBGC usually looks okay during the good years and horrendous in the bad times, averaging a loss of $1-2 billion a year across the cycle. (My estimate assumes that there will be very substantial additional losses from the current recession and financial market crisis.)

So what specifically caused the PBGC to lose $22 billion in half a year? The PBGC has released only a few summary figures to explain the loss. $11 billion of the increase came from new claims, including , as required by GAAP rules for insurers, expected claims that appear likely in the near future. It appears that the bulk of the loss was from these likely, but not yet realized claims, but we cannot be sure since the PBGC has not released the names of the companies most responsible for the claims. The PBGC makes a practice of not disclosing which firms are included in its probable loss figures, since it could conceivably cause a panic that might trigger a bankruptcy that still had a chance of being avoided.

A further $10 billion resulted from a shortfall in the PBGC's investment performance compared to the increase in the liabilities that the investments are meant to cover. That is, its liabilities rose by $7 billion as a result of declining interest rates, which make future pension promises more expensive to fund in today's dollars. At the same time, the value of its investments fell by $3 billion, rather than rising to match the increased liability. This is an example of why the large majority of financial economists believe the PBGC should own bonds with maturities matching its liabilities. Had it done so, the bonds would generally have risen in value in proportion to the decrease in the interest rate, offsetting the loss from higher liabilities.

Finally, there were actuarial charges of $2 billion. It is unclear what this reflected and whether this should be viewed as part of a trend or a one-time adjustment. Actuarial charges can include almost anything that affects the value of the future pension promises other than interest rate changes, such as a change in the expected lifespans of retirees or an adjustment to expected retirement dates.

What does this mean for the PBGC's financial future?

The PBGC's deficit is likely to worsen significantly before it bottoms out. Bankruptcies tend to peak well after the economy bottoms out, as companies try to hang on by taking increasingly desperate measures. Credit losses, including those suffered by the PBGC, will likely peak at some point in 2010. The requirement for the PBGC to post losses from probable claims in advance of the actual claim will accelerate this somewhat, but it still seems likely that the middle of next fiscal year will see the worst deficit for the PBGC in this economic cycle. The deficit could easily rise to $50 billion or more. The actual figure will depend strongly on the stock market's performance as well as the level of future bankruptcies. Most pension funds are heavily invested in the stock market, which makes their funding levels volatile. A strong stock market revival, on top of the more than 30% gains already registered since the bottom in March, would reduce the level of future claims. On the other hand, if the stock market drops further or rises only slowly, it will exacerbate the PBGC's losses from future bankruptcies.

In addition, the PBGC has its own investments of $49 billion. The bulk of these are in bonds whose value is likely to rise or fall in a way that offsets the effect of changes in the value of the PBGC's pension promises. Another 30% or so of the investments are in the stock market, meaning that if stocks rise by 10 percentage points more next year than the interest rate used to calculate the value of the pensions, this would improve the PBGC's finances by $1.5 billion. An underperformance by 10 percentage points would add to the deficit by a similar amount. One implication is that for the stock market alone to rescue the PBGC from its current deficit, the shares currently owned by the PBGC would need to triple, in addition to whatever rise would be needed to keep pace with the interest factor.

Whatever the peak of the PBGC's deficit this cycle, it is important to stay focused on the PBGC's long-term financial problems. My previous modeling has shown that it could take a $100 billion rescue to save the PBGC if no other actions are taken. Even in today's terms, this is not a small problem.

For all the complexity of pension issues, the problem is at one level a simple one. The PBGC has simply not been authorized to charge a premium rate sufficient to cover the risk level imposed by the combination of Congressionally mandated funding rules and the investment and funding choices made by the companies that sponsor the pension plans insured by the PBGC.

This imbalance could be cured in a number of ways; 14 of the options are explained at the back of "A Guide to the Pension Benefit Guaranty Corporation." In essence, the cost of repairing the existing deficit and avoiding the creation of new deficits will have to be split in some manner between: the companies which sponsor pension plans ; the employees and retirees (who are politically unlikely to bear much cost); and the taxpayers. There are many ways to do this, but all of them involve a measure of pain. On the bright side, the PBGC's deficit remains small in relation to the available resources in the system. There are approximately $2 trillion of assets at the pension plans insured by the PBGC, so the current $33 billion deficit represents less than 2% of those pension assets.

ABOUT THE AUTHOR

DOUGLAS J. ELLIOTT is a Fellow in Economic Studies at the Brookings Institution.

Initiative on
Business and Public Policy
at BROOKINGS

The Brookings Institution
1775 Massachusetts Ave., NW, Washington, DC 20036
(202) 797-6000

The Initiative on Business and Public Policy provides analytical research and constructive recommendations on public policy issues affecting the business sector in the United States and around the world.