

American pensions

Broke

Jan 23rd 2003 | NEW YORK
From The Economist print edition

America's system of insuring private pension plans needs fixing

THE pension malaise in America worsens. Corporate pension-fund deficits have swollen to some \$300 billion, weighing down earnings and forcing companies from General Motors to General Electric to find cash to make up the shortfalls. Meanwhile, the economy's continuing sluggishness is pushing ever more companies into bankruptcy and adding yet more billions to the pile of unpaid pension obligations.

Luckily for workers, help is at hand in the form of the Pension Benefit Guaranty Corporation (PBGC), the quasi-governmental agency charged with insuring the basic benefits of the 44m Americans enrolled in private, defined-benefit pension plans. Over the past year, the PBGC has mopped up the unfunded pension liabilities of a host of bankrupt firms, from Polaroid to LTV Steel. So maybe it is no surprise that the state-backed agency itself is on the brink of insolvency.

The tipping point will be the assumption of almost \$5 billion of liabilities belonging to two bankrupt steelmakers, Bethlehem Steel and National Steel. The PBGC applied last month to take these plans over and is likely to do so, despite a challenge from National. The acquisition of the two firms earlier this month was made possible largely because the buyers believed that the PBGC, and not they, would pick up the pensions bill.

Oddly, the PBGC's difficulties have scarcely raised an eyebrow. "It's back to normality," says a Treasury official, alluding to the deficits run by the agency for the first 21 years of its existence until 1995. In fact, although the agency is technically insolvent (ie, its liabilities exceed its assets), it probably has enough liquidity from insurance premiums, assets acquired when taking pension schemes over and investment income from its own portfolio to meet its obligations for many years to come. Should the money ever run out, the government would surely step in.

Indeed, the PBGC's net position is less of a problem than the pricing of its guarantees. Zvi Bodie, a finance professor at Boston University who

specialises in pension funds, points out that the premium it charges companies to insure their pension schemes is not tied to risk.

It is unaffected by credit ratings or other evidence about a company's financial condition. So fundamentally healthy firms in effect subsidise the less sound. It is also unaffected by investment behaviour, creating an incentive to invest riskily. If all goes well, the schemes make handsome returns; if disaster strikes, the PBGC will foot the bill. In addition, firms that are short of cash have an incentive, when negotiating pay, to promise improved pensions instead of higher wages. Not only are the costs of the pay deal postponed; they may end up being borne by the PBGC.

The obvious solution, linking premiums to the riskiness of pension funds, is tricky. Doing so could force already wobbly companies into bankruptcy. And strong steel, airline and labour lobbies in Congress, which sets the PBGC's premiums, make any increases difficult. Workers and pensioners in the steel and airline industries, who account for fewer than 5% of participants in defined-benefit plans, have benefited from 70% of the agency's claims since 1974.

Mr Bodie suggests that restrictions on where pension funds put their money could strengthen the insurance system. Currently, estimates Morgan Stanley, more than half of companies' pension portfolios consist of equities. This partially reflects the view that the riskiness of shares diminishes, the longer they are held; against that, says Mr Bodie, the potential severity of a shortfall in any one year increases with time. Ideally, he thinks, companies should fund their pension schemes entirely with bonds, a strategy adopted recently by Boots, a British retailer. That may be too restrictive a rule; but his arguments at least imply that firms should think twice before allocating large chunks of their pension funds to equities.

Meanwhile, there are two immediate concerns about the PBGC. First, unless America's bankruptcy wave comes to an unexpected halt, the demands on it are likely to rise. Second, the agency invests 35% of its own portfolio in the stockmarket. Yet the PBGC is likeliest to draw on its assets when the stockmarket is doing badly. Shouldn't it know better?

