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original issue date: November 16, 2005
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PBGC: 2005 Annual Results

PBGC announced a very surprising, albeit small, profit for the 2005 fiscal year. Net income was $0.5 billion, compared to a large loss of $12.1 billion last year. PBGC did note that subsequent events would have made the results $2.9 billion worse (for a loss of $2.4 billion.) This may refer to the bankruptcy filing for Delphi, which occurred in the first week of the 2006 fiscal year.

One's view of the results will depend heavily on one's assumptions about whether Delphi, Delta, and Northwest will actually terminate their pension plans as they work through their bankruptcy proceeedings. We had expected another large loss in 2005 on the basis that PBGC was likely to treat the plans at all three companies as "probable losses", which would be reflected immediately in their financial statements. These three firms present total potential claims on PBGC of $15.3 billion, based on earlier PBGC estimates. Instead, only $4.7 billion in new probable losses were added during 2005. It may be that PBGC's internal or external accountants were not comfortable including the airlines as probable losses when there was the possibility that pension reform legislation would help keep them from terminating their plans. If so, this could be a nail-biting year for PBGC, since it does not have the accounting cushion from already including these potential losses.

Since probable losses are the key to understanding this year's results compared to last year's, it is worth briefly restating the rationale for their existence. PBGC reports its financials according to Generally Accepted Accounting Principles (GAAP) as applied to insurance companies. Those rules require that PBGC show the effect on its financials of claims that will probably come in, even if they have not yet occurred. Thus, much of fiscal 2004's high claim levels almost certainly represented the expectation of losses from United and US Airways that, in fact, materialized in 2005. All of our discussion of probable losses is complicated by the fact that PBGC does not divulge which companies it considers probable, on the reasonable grounds that it would not be helpful to have a public agency label a troubled company as likely to terminate its plan. We do know from this year's report that all but $0.3 billion of the $10.7 billion of claims that actually came in during 2005 were already in PBGC's probable loss figure for 2004.

Therefore, counterintuitively, 2005's results reflected very little effect from the heavily publicized large terminations at United and US Airways this year, since virtually all of their losses were already included in last year's financials.

On the other hand, PBGC could have chosen to include in 2005's results as much as $15.3 billion in probable losses for Delta ($8.4 billion), Northwest ($2.8 billion), and Delphi ($4.1 billion.) (All figures are based on previously published PBGC estimates of the expected claim if the plans are terminated.) However, it seems likely that one of Delta's plans was already included in 2004, accounting for as much as $3 billion of probable loss, in which case the potential new probable losses from the three firms would have been $12.3 billion. Of that $12.3 billion or more, only $4.7 billion was added this year, leaving a potential of at least $7.6 billion that could have been included. All this, of course, acts as if those three firms were the only new potential probables, although we know that there are many other troubled firms out there.

How do we know that the $15.3 billion was not already in last year's probables? 2004's report showed that $15.0 billion of cumulative probable losses were in the "transportation, communications, and utilities" sector. At that time, it was already clear that United and US Airways must have been included as probables in 2004, given the near certainty that their plans would be terminated. Taking them out reduces the $15.0 billion to $6.4 billion. However, there are also many troubled companies that are smaller and receive less attention. Thus it seems unlikely that more than, perhaps, $3 billion of the $6.4 billion was from Delta. (Delta has multiple pension plans, so it is possible to treat one as probable and not the others.) Delta appeared to be weaker than Northwest a year ago, which is why the focus is on Delta. For its part, Delphi was almost certainly not included last year. It would either be in the same "transportation" category as the airlines, in which case there was not room for both it and Delta to be included in the numbers we just gave, or it would have been in "manufacturing" which only showed a $0.6 billion total in both years, much too small for Delphi.

PBGC also follows GAAP rules by publishing a footnote with "reasonably possible" losses. These figures are in the footnote only and, unlike probables, do not affect any of the financial statements. As a general matter, PBGC counts the underfunding at junk grade companies in calculating reasonably possible losses. The 2005 level is $108 billion, up from $96 billion in 2004.

What does the Annual Report tell us about PBGC's situation? Clearly, 2005 was a terrible year for PBGC in the real world. Some of this was expected. United came in with the largest claim in PBGC history and US Airways added another $2.3 billion of claims. However, unexpected news was also very poor. Delta, Northwest, and Delphi deteriorated to the point of bankruptcy, with potential claims of $15.3 billion, which was not a given 12 months before. The remainder of the auto sector deteriorated dramatically, although there is still considerable reason to hope that all of the major automakers will avoid eventual bankruptcy.

On the bright side, PBGC's investment performance was perhaps a billion dollars better than would have been expected at the beginning of the year and liability values declined a couple of billion dollars due to higher interest rates. It is also noteworthy that no large companies collapsed so quickly that their actual pension termination in 2005 was not already in 2004's probable loss figures. Nonetheless, it is hard to imagine a neutral observer viewing PBGC's total situation as better than it was 12 months before, which may explain the negative tone of PBGC comments made in conjunction with the release of the results.

The Details

"Losses from completed and probable terminations", which we will refer to as "claims", were $4.0 billion much lower than last year's $14.7 billion for the reasons described above. The addition of $4.7 billion in new probable losses more than accounted for this figure. The $4.0 billion total claims figure is lower than the additional probable losses of $4.7 billion because adjustments to prior year estimates for existing claims were a net negative. For example, PBGC used a discount rate of 5.2% for the first 25 years of cash flows, compared to 4.8% in last year's calculations. This resulted in a $2.3 billion reduction in the value of existing claims, compared to a $1.6 billion reduction when rates rose the preceding year.

Other net actuarial adjustments were only $0.2 billion in 2005 compared to $1.5 billion last year. Almost the entirety of last year's adjustment came from $1.5 billion of added reserves resulting from an actuarial review that had concluded PBGC's previous numbers had underestimated lifespans.

Premiums amounted to $1.5 billion, steady with 2004's and slightly below an estimate of $1.6 to $1.9 billion for 2005 that was made in PBGC's Annual Report last year. Fixed premiums remained stable, as one would expect, since they are based on headcounts, at $0.6 billion. Variable premiums were stable as well at $0.9 billion. PBGC's estimate for 2006 premiums is a range from $1.2 billion to $1.5 billion.

Investment income came in at $3.9 billion, an 8.9% total return, compared to $3.25 billion and an 8% return in 2004.

Actual pension payments were $3.7 billion this year, up from $3.0 billion in 2004, and way up from $1.0 billion in 2001. PBGC's role as a pension provider has expanded dramatically as a result of terminations over the last few years. This figure should rise sharply further as we get a full year of payments for United and US Airways and again farther along if some of the other major potential claims do result in terminations.

PBGC's administrative expenses, which do not include the direct cost of servicing claims, rose to $311 million from $263 million in 2004 and $271 million in 2003.

A final reminder, all of these numbers are on a GAAP basis. Do not expect federal budget effects to line up with these figures. Federal budgeting for PBGC follows rules that substantially understate the economic loss that is better reflected by GAAP. Up to last year, PBGC contributed $12 billion to deficit reduction over its life, while piling up a $23 billion economic loss – a $35 billion difference between budget and reality.

