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# PBGC: 2006 Results

The Pension Benefit Guaranty Corporation (PBGC) announced last week that it earned $4.2 billion in net income in 2006, reducing its accumulated deficit to $18.9 billion. This is an improvement over the previous year's $0.4 billion of net income and a dramatic turnaround from the three preceding years, when it lost over $30 billion in total.

PBGC would have recorded a loss for 2006 of approximately $4 billion were it not for the reclassification of $8 billion in "probable losses" as only "reasonably possible". The reclassification was driven by the airline relief provisions in the Pension Protection Act that passed in September. According to Generally Accepted Accounting Principles (GAAP), probable losses must be shown on the income statement and balance sheet as if they were certain. Reasonably possible losses show up only in the footnotes. The direct effect of the reclassification was to reduce the accumulated deficit by $8 billion and to increase 2006's net income by the same amount.

The Pension Protection Act provides airlines with the opportunity to dramatically reduce their minimum cash funding requirements for their pension plans. This ability to deal with the problem over a much longer time period has eased the pressure to terminate these plans now, reducing the probability of a claim on PBGC sufficiently to support the reclassification. Delta and Northwest have both indicated that they will attempt to fund their remaining plans over time rather than terminating them in their current bankruptcy proceedings. (Except for Delta's pension plan for pilots, which was already in the process of termination.)

It is impossible to know at this time whether the $8 billion reclassification represents a permanent improvement in PBGC's position. The question is whether one or more of these plans will be terminated at a later point, either because the pressure to terminate during the current bankruptcy proceedings becomes too great or because there is another bankruptcy farther down the pike. In this regard, there has been speculation that US Airways' proposed hostile acquisition of Delta could lead to termination of the pension plan for non-pilots. This could occur as part of a takeover by US Airways or as part of an alternative proposal to merge with another airline or for Delta to emerge independently.

The $8 billion reclassification was partially offset by new probable losses and adjustments to prior estimates of the size of existing probable losses that were not reclassified. (It appears that loss estimates for at least one of the non-airline plans, perhaps Delphi, increased substantially.) The combined effect was a $5.6 billion reduction in probable losses compared to 2005.

PBGC's Interim Director, Vince Snowbarger, remarked that "[t]he PBGC's financial condition appears to have stabilized for the time being." This seems an apt way of expressing the situation. PBGC started this fiscal year by adding a $2.9 billion probable loss, presumably from one of the bankruptcies announced in early October. It has not faced unexpected major new claims since then.

Further, improvements in plan funding, coupled with modestly higher interest rates, cut PBGC's estimate of the aggregate underfunding of the single-employer defined benefit system by $100 billion, to $350 billion at the end of the fiscal year. (Multi-employer plans had underfunding of $150 billion, down from $200 billion.) This has to be viewed as an encouraging trend, although it could be reversed in the event of a recession or a substantial decline in the stock market. (For comparison, it would take only a 10-15% underperformance of stock prices, compared to the discount rate, to undo the $100 billion improvement, all else equal.)

On a less positive note, PBGC's "investments underperformed its liabilities" by $3.1 billion. PBGC attempts to invest in bonds that will move roughly in tandem with its liabilities, so that if interest rates fall by 1 percentage point, raising the cost in today's dollars of making future pension payments, this will be offset by an increase in the market value of the bonds. This strategy did not work well in 2006 for technical reasons.

PBGC values its liabilities each year based on a survey of the prices being charged by life insurers to take on pension promises and similar types of annuity payments. These prices move not only because of changes in market interest rates, but also due to other factors, such as changes in mortality expectations by insurers and the relative attractiveness of annuity business compared to other business opportunities available to the insurers. Sometimes these differences will work in favor of PBGC and other times, as in 2006, the differential will go against PBGC.

Premium revenue of $1.5 billion was essentially flat at 2005's levels. Premiums could increase substantially over time as a result of the variable rate premium changes contained in the Pension Protection Act (see "Pension Reform: Summary of the Final Bill" on www.coffi.org). For 2007, though, PBGC projects slightly higher premiums, in the range of $1.5 to $1.7 billion.

Benefit payments to retirees rose to $4.1 billion from $3.7 billion in 2005. (This is four times higher than the level 5 years ago of roughly $1 billion.) PBGC projects this to rise sharply to $4.8 billion in 2007. Demographics and further plan terminations will push these figures up much further in subsequent years.

Administrative expenses in the Single-Employer program amounted to $352 million in 2006 up from $311 million, principally due to higher caseloads as PBGC continued to absorb plans. On a somewhat different basis, the President's 2007 budget estimates $402 million in total PBGC expenses for 2007, up from $381 million on that same basis.

 