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PBGC: Effects of Proposed Accounting Changes

Pension accounting may change sharply in the next few years, after more than a decade of agitation by some accountants, and their allies in academia, policy circles, and in the media. It seems clear that this will lead to: a shift by pension funds away from stock investments and towards bonds; greater pension contributions and higher funding levels; more freezes of defined benefit pension plans; and even some outright terminations. The real questions revolve around how strongly these trends will occur and how quickly. There will be few direct impacts on the Pension Benefit Guaranty Corporation (PBGC), but the *indirect* effects should be substantial. Unfortunately, it is unclear whether the net effects will be positive or negative for PBGC, since most of the changes push in both directions.

The Financial Accounting Standards Board (FASB) announced last week that it would undertake two related projects to change the rules for private sector pension obligations under Generally Accepted Accounting Principles (GAAP). By the end of next year it hopes to promulgate new rules, presumably taking effect the following year, that would take the effect of pension obligations out of the footnotes and directly onto corporate balance sheets. Within three years after that, FASB hopes to bring out comprehensive changes to all aspects of pension accounting. We do not know what those changes will be, but it is clear that the intent is to have pensions more clearly reflected on the balance sheet and income statement and to eliminate much of the smoothing that currently exists. Judging by past accounting controversies, any such changes are likely to take longer, possibly much longer, than this schedule suggests. However, the past also suggests that the changes will eventually occur, once FASB starts the ball rolling.

Reform of GAAP pension accounting would have little direct effect on PBGC for two reasons. First, while PBGC does report on a GAAP basis, it reports as an insurer, with rules that are already analogous to much of what FASB will try to accomplish for pension funds. Second, Congress has never tied the key legal requirements for corporate pensions, such as funding rules or premiums, to the GAAP rules. Funding calculations are on a broadly similar basis to the calculations used under GAAP, but only in the same sense that cats and dogs both have fur and four legs.

The indirect effects on PBGC, however, could be very large over time, as corporations change their behavior. These could include:

More freezing of defined benefit plans. FASB appears to be intent on unmasking the economic volatility that lies within pension plans, which has been hidden by smoothing and other accounting conventions. Investors do not like volatility and so managements are likely to react by searching for ways to take the volatility back out. Some will conclude that this cannot be achieved except while still offering defined benefit plans. The most popular way to exit should continue to be through freezing the plans. This means maintaining the legal structure and existing obligations of the pension plans, but ceasing to give employees any additional pension benefits for new service or to reflect wage increases. In most cases, 401(k) contributions are raised as an alternative way of providing retirement benefits. Plan freezes have been common of late and may increase anyway for a variety of reasons.

PBGC would be both helped and hurt by a trend towards freezing pension plans, with the net effect dependent on a variety of unpredictable factors, such as which companies choose to freeze their plans. However, any effects would be quite gradual. In the first moment that the freeze takes place, PBGC's situation is no different than before. There are the same number of participants, since anyone still entitled to a future benefit counts as a participant, and the degree of underfunding is unchanged. Both premiums and underfunding should decline slowly over time as the size of remaining pension obligations shrink and participant numbers fall as people died.

Some additional outright terminations of defined benefit plans. Healthy plan sponsors can only walk away from their pension obligations if they pay an insurer to take them over. This has been very unattractive for large companies and there has only been one major termination of a healthy plan at a large corporation in the last decade or so. (We focus on large firms, because the great bulk of pension obligations are at these large corporations, which is one reason the system has grown on same measures even as tens of thousands of small companies exited.)

Some of the significant disincentives have to do with today's accounting rules. For example, companies are allowed to assume that they will earn a long-term return on stocks in their pension trusts that is considerably higher than the rate of return on bonds. This matters, because a pension termination is effected by purchasing a large group annuity from an insurer. This annuity has an implicit investment return built into its price. Unfortunately for buyers, insurers build in an investment return that is based on holding bonds, since regulations heavily push insurers towards backing pension obligations with investments in high quality bonds. The annual difference between the assumed pension return and the implied annuity return would cause a noticeable reduction in corporate earnings under current rules.

Even under future accounting rules, there is likely to be a significant economic incentive for companies to continue to manage their pension obligations and assets in-house. This avoids paying a premium to reflect the insurers' administrative expenses, profit margins, and greater conservatism on actuarial assumptions. Companies are also likely to choose to invest somewhat less conservatively than insurers, even under new accounting rules. It is true that companies do not like volatility, but large corporations self-insure many significant and volatile risks because they believe it will cost less in the long run. For example, Fortune 500 companies tend to self-insure against large property losses or against major product liability claims.

That said, the disincentives for terminating plans will be less than now and the pressures to eliminate pension volatility will be greater. Directionally, it is clear that more terminations will occur, although this is unlikely to be the tidal wave that some have implied. Like freezes, terminations are both positive and negative for PBGC. Risk exposure goes down, but so do premiums. In the case of terminations, the impact is immediate, rather than the slow seepage that occurs with freezes.

Shifts of pension investments from stocks into bonds. The economic and accounting volatility of pension obligations can be considerably reduced by holding bonds, which match fairly well the characteristics of the underlying pension obligations. However, the lower average returns are likely to make pensions seem more expensive to sponsoring corporations, hastening any exits from the defined benefit system. On the positive side, the direct effects of portfolio realignment are good for PBGC, since stock losses at pension funds have contributed significantly to the volume and frequency of past claims.

Increased funding by plan sponsors. Increased visibility of pension underfunding will give managements a greater incentive to avoid large levels of underfunding. Any shift towards bond holdings is also likely to be accompanied by increased contributions, since companies could no longer plan on high long-term returns from stocks to lower their needed funding levels. Again, the direct effects of greater funding are clearly positive for PBGC.

It is worth noting that the effect of the first phase of the project, which will end up putting pension obligations on the balance sheet, may not change corporate behavior very much. Most companies do not have much reason to care what their accounting net worth is. Outside of the financial industry, and a few selected other sectors, investors do not judge the value of corporations based on their accounting net worth, which they know to be a poor measure of economic value in most industries. Earnings and cash flow tend to drive stock prices.

This is not to say that it will not matter at all. There are certain legal restrictions that can be burdensome for companies with a negative net worth and loan covenants may have to be renegotiated. However, the overall impact is likely to be muted. It is the second, comprehensive phase that will have by far the largest effects.