TESTIMONY OF RANDALL S. KROSZNER
PROFESSOR OF ECONOMICS
UNIVERSITY OF CHICAGO, GRADUATE SCHOOL OF BUSINESS
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

March 1, 2005

Good afternoon Chairman Grassley, Ranking Member Baucus, and members of the Committee. I am delighted to be invited before you to discuss the single employer defined benefit pension system and the Pension Benefit Guarantee Corporation (PBGC). I applaud the Committee for taking up this important and complicated issue at this time because I believe that the system is in crisis and in urgent need of fundamental reforms. It is a ticking time bomb waiting to explode and the longer we wait to defuse it, the more powerful the blast will be.

The PBGC, a government-sponsored enterprise that takes over the pension obligations of financially troubled firms, reported a deficit of $23.3 billion at the end of the 2004 fiscal year, up from $11.2 billion a year earlier. The PBGC also projected a "reasonably possible" exposure of roughly $96 billion. In its "base case" estimate, the Center on Federal Financial Institutions, a non-partisan watchdog organization, projects a $78 billion deficit for the PBGC. These are disturbingly large numbers that are likely to grow over time if no reforms are undertaken. Simply standing idly by and watching the deficits grow would undermine the security of the retirement benefits of employees and retirees and expose the taxpayer to ever greater costs.

Déjà Vu All Over Again: Don't let PBGC become the S&L Crisis of the New Millennium

The situation at the PBGC today closely parallels the situation in the Savings and Loan industry and its insurer, the Federal Savings and Loan Insurance Corporation (FSLIC), in the 1980s. First, the FSLIC was a government-sponsored enterprise that insured deposits of S&Ls up to $100,000, much as the PBGC provides insurance for pension plans up to a current maximum per retiree of approximately $45,000 per year. Second, both the FSLIC and the PBGC financed themselves by levying insurance premiums. Third, in neither case did or does the premium vary with the risk of the underlying thrift or employer. Fourth, a series of economic shocks caused financial trouble in thrifts and in industries using defined benefit pension plans. During the 1980s, higher interest rates and a sharp decline in real estate values in many parts of the country, for example, pushed many thrifts either into insolvency or to the brink of insolvency. The recession of 2001, the shocks of 9/11, and poor investment choices have led many defined benefit plans to become significantly underfunded, with estimates of this underfunding exceeding $400 billion. Fifth, these financial troubles led both the FSLIC and the PBGC to become effectively insolvent, that is, their expected liabilities far outstripped their assets.

The sixth, and the most disturbing parallel, is that many observers – both in the 1980s for the FSLIC and for the PBGC today – acknowledge that the agencies face challenges but that the trouble is/was simply a temporary phenomenon. As the economy recovered from recession in the early 1980s, many argued that the thrift problem would right itself. Thus, no fundamental policy change was necessary. This is the policy of "forbearance," that is, wait and hope with fingers crossed. Many commentators are advocating the same wait and hope policy for pension system today.

As the sad history of the thrift crisis demonstrates, the wait and hope policy was a disaster. Despite a robust overall economic growth after 1982, troubled thrifts never recovered. Many took high risks, ultimately at taxpayer expense. This is the so-called moral hazard problem: If you provide insurance at below market rates that do not adequately adjust for risk, recipients of the insurance, especially those who are in financial difficulties, will take on greater risk. They do this because they have little to lose, that is, if the thrift is insolvent or financially troubled, the owners have little or nothing at stake. The depositors don't care because they know that they have the guarantees so troubled thrifts could continue to gather deposits, often by paying slightly higher interest rates to attract large inflows of money. The taxpayer was left to bail-out the depositors at a cost exceeding $100 billion. If the trouble had been resolved earlier, the costs would have been much lower (see Kroszner and Strahan 1996).

The current pension system suffers from exactly this moral hazard problem and forbearance will only make it worse. Firms falling into financial distress or in bankruptcy in particular tend to defer funding their pension obligations. The current system of funding rules allows firms to have significant pension funding gaps for long periods with little or no consequence. In addition, much as in the S&L crisis, employers have an incentive to invest in excessively risky assets, hoping that a lucky pay-off will make up for the funding gap. Since the PBGC provides the guarantees of the obligations, the employees (much like the insured depositors in the S&Ls) are willing to tolerate more funding shortfalls and risks in the pension system than they otherwise would. In addition, the system provides an incentive for financially troubled employers to promise larger pension benefits in return for wage concessions and employees might accept this due to the PBGC guarantee. The ability of financially troubled firms to delay pension funding and offer continuing and, in some cases, increased benefits despite large funding shortfalls and risky pension investments, is at the heart of the moral hazard problem in the pension system today (see Kroszner 2003).

"Prompt Corrective Action" Provisions of FDICIA Provide Guidelines for Preventing Crisis

To avoid an enormous and inappropriate taxpayer-financed bail-out of the PBGC, action must be taken swiftly. Fortunately, we can learn from the S&L experience what should be done. The 1991 Federal Deposit Insurance Corporation Improvement Act (FDICIA) introduced two important changes that have dramatically reduced moral hazard in the depository institutions and has helped to strengthen the industry so that it could weather recession and shocks from 9/11 with very few failures or troubles. Depository institutions have been thriving since these changes were implemented.

FDICIA permitted insurance premiums to increase to provide greater assets for the deposit insurance agency to cover its obligations and, importantly, for the premiums to vary with risk. These were extremely important steps in returning the deposit insurance system to solvency and reducing moral hazard. In the context of PBGC, given its large and increasing deficits, it is clear that the currently levels of premiums are below the actuarily appropriate level. Thus, increasing premiums will help to increase the security of insured retirement benefits and reduce the potential exposure of the taxpayers.

In addition, premiums must be permitted to adjust for the risk. The application of this basic principle of economics and finance has done much to reduce the moral hazard incentives to take on excessive risk. If premiums vary with risk, then thrifts and employers will have to pay a cost of taking on excessive risk, unlike in a system premiums that are not risk-sensitive. When premiums are not risk adjusted, the guarantee system effectively subsidizes risk taken and ultimately the taxpayer may bear the burden of these excessive risks. Thus, PBGC premiums be adjusted to take into account the risks that a particular plan poses. These include the extent of the funding gap, the riskiness of the assets in the pension portfolio, and the likelihood that the PBGC will have to take over the obligations (e.g., a proxy for the probability of financial distress, bankruptcy, and the "putting" of the pension obligations to the PBGC). By structuring the premiums this way, firms are rewarded for funding their pension plans adequately and conservatively and are punished for underfunding and taking excessive risks. This is one important means of reigning in the moral hazard problem and improving the retirement security of employees.

Another extremely important aspect of FDICIA that has helped to reduce moral hazard problems is the requirement of "prompt corrective action" against depository institutions that are in financial trouble and taking on excessive risk (see Kroszner 2000). As an institution falls into distress, prompt corrective action restricts the activities of the institution to reduce its risk taking behavior and requires the institution to resolve its problems quickly. In the context of the current pension system, the parallel to prompt corrective action would involve two reforms: First, eliminate the ability of firms in distress to increase their (guaranteed) pension obligations; and Second, require that underfunded plans return to adequate funding levels quickly. In the prompt corrective action provisions of FDICIA, the further that an institution is out of compliance with its obligations, the more restrictions are put on its activities and the greater the obligations to come into compliance. This graduated approach of taking the greatest actions against the plans with the greatest shortfalls and risk makes much sense in the pension area also.

Conclusion

Without fundamental reform, the single employer defined benefit system in the US faces a major crisis. To ensure the security of retirement benefits for employees and retirees and to protect the system from inefficiencies of moral hazard (and thereby reduce taxpayer exposure), reforms parallel to those introduced by the FDICIA are necessary. In undertaking reform, I urge your Committee to make a serious assessment of the objectives of the system and explore options that might involve harnessing greater use of market forces in achieving security of the pension system without encouraging undue risk (see Kroszner 1999). One question that arises is whether a government-sponsored enterprise is the best way to achieve the objectives. For instance, the Congress has successfully moved Sallie Mae, the government-sponsored enterprise that guarantees student loans, into the private sector. In the home mortgage area, private mortgage insurers provide guarantees that allow many to purchase homes who otherwise could not receive a mortgage. Investigating the feasibility of some form private insurance or of the purchase of annuities by employers for their employees would be valuable in addition to the immediate reforms of the PBGC.

Thank you very much for the honor of allowing me to express my views before the Committee, and I will be happy to answer any questions you may have.

References

Jeffrey Brown, Randall S. Kroszner, and Brian Jenn, “Federal Terrorism Risk Insurance,” National Tax Journal, September 2002, 55(3), 647-57.

Randall S. Kroszner, "Can the Financial Markets Privately Regulate Risk? The Development of Derivatives Clearing Houses and Recent Over-the-Counter Innovations," Journal of Money, Credit, and Banking, August 1999, 569-618.

Randall S. Kroszner, “The Economics and Politics of Financial Modernization,” Federal Reserve Bank of New York’s Economic Policy Review, October 2000, 25-37.

Randall S. Kroszner, “Taxpayer Exposure to Liabilities of the Pension Benefit Guarantee Corporation,” Shadow Financial Regulatory Committee, Washington, DC, Statement No. 198, September 22, 2003.

Randall S. Kroszner and Philip E. Strahan, "Regulatory Incentives and the Thrift Crisis: Dividends, Mutual-to-Stock Conversions, and Financial Distress in the Thrift Industry," Journal of Finance, September 1996, 1285-1320.