Research Project #6: Insurance Against Pension Plan Failure: The Pension Benefit Guarantee Fund and Its Alternatives

Research Paper: Insurance against Plan and Sponsor Failure: Examining Alternative Systems to Guarantee Private Pension Payments

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Executive Summary

Bankruptcy risk accrues to pension plan participants if a plan sponsor fails when the pension plan is underfunded. This research examines the extent of that risk, alternative approaches to mitigating that risk, and offers considerations around the public policy decision regarding who bears the remaining risk. It reviews theoretical reasons for underfunding, including a review of the literature on incentive-based and capital-based explanations, as well as the approaches available – at least theoretically – to mitigate and manage the risk of sponsor bankruptcy.

The second section of the report summarizes the systems in place around the globe to handle pension default risk. The report assembles information on guarantee funds from other jurisdictions, approaches to pension default risk other than government-based guarantee funds, and approaches to protecting consumers from default risks in non-pension financial services. Attention goes first to the U.S. Pension Benefit Guaranty Corporation (PBGC) which applies to most defined benefit (DB) plans and has experienced multi-billion-dollar losses annually since the year 2000. Academic evidence suggesting that adverse selection and moral hazard are genuine issues in such funds is reviewed as are the most recent estimates of the PBGC's exposure from the Congressional Budget Office (2005). A summary of recent reform efforts, through the provisions of the *Pension Protection Act of 2006,* is provided with emphasis on changes to the PBGC.

Looking beyond North America, the report provides information about guarantee funds in other nations, viz. Germany, Japan, Sweden, Switzerland, and the United Kingdom. Alternatives to government-based guarantee funds are examined from other Canadian jurisdictions, the Netherlands, and Finland. Relevant elements of the banking literature and the insurance literature were reviewed for their insight into how providing insurance will lead to a potential increase in inappropriate risk-taking. For example, Kane and Demirgüç-Kunt's (2001) empirical examination of the effects of deposit insurance for banks led them to recommend characteristics for an insurance scheme that enhance market discipline and reduce moral hazard.

Section 3 of the report summarizes the major strengths and weaknesses of each of three public policy choices of mechanisms to manage the residual of plan sponsor bankruptcy:

- do nothing in advance,
- rely on private market mechanisms, or

- implement a government-based mechanism like a guarantee fund.

- These three alternatives are assessed in terms of their ability to deliver equity, effectiveness, and/or political viability.

- *Doing nothing in advance* by definition leaves the door open to *ad hoc* responses to circumstances as they develop. This has the advantage of being adaptable to each circumstance but may produce inconsistent results across jurisdictions, firms, and citizens.

- *Private market mechanisms* are perhaps the best way to use the full capabilities of the market to assess, monitor, and price default risk. It also adapts readily to changes in technology and circumstance. However, private mechanisms are limited in the type of risk reduction they can deliver effectively. Most importantly, private pooling mechanisms are not easily able to eliminate systematic risk, will be more readily available to some firms than others, and tie up capital in the economy in order to make private guarantee viable.

- *Government-based guarantee funds* have the advantage in providing protection that is by definition available to all firms. It has additional options available with which to manage risk intertemporally, e.g., by accumulating funds during a boom and running a deficit during a recession. A guarantee fund can assist in managing the expectations of retirees with respect to aid while simultaneously managing the expectations of plan sponsors as to the assessments that the system will require with the latter providing some assistance in managing contagion risk.

- Overall, the literature supports the notion of a government-based entity to provide pension protection, primarily because of the extent to which the risk of sponsor default is systematic in nature. Such a program should be established with an expectation that financial results will exhibit wide swings over time.

With these theoretical and global views as background, Section 4 of the report narrows its focus to look more closely at Ontario where the 1980 *Pension Benefits Act* established the Pension Benefits Guarantee Fund (PBGF). Ontario's PBGF, still the only guarantee fund to protect the pension promises of Canadian private employers, guarantees specified benefits, up to $1,000 per month per member. The amount of claims payable with respect to already-terminated pension plans as of March 31, 2006, was reported by the PBGF to be $104,064,000. That figure does not include any amount for claims that may arise from future insolvencies of sponsor employers.

Following this, the financial condition of the Ontario plans covered by the PBGF was examined. A regression model of plan assets per DB-plan participant finds that plan assets go up with real earnings of workers and down with higher unemployment; that level of assets also is moderated by the influence of taxes with higher plan assets observed when and where tax rates are higher. Several other factors help to explain the up or down movement of the per-participant asset level across plans and across time, including investment markets, plan design, and regulatory factors. Ontario-registered pension plans had on average $17,816 less in asset value per participant. Beyond that, plans covered by the PBGF have an average of $17,037 less per participant than other Canadian DB plans that are not backed by a guarantee fund. The latter result is

statistically significant at the 1% level. Though regression results do not conclusively prove a causal relationship, the strength of these results suggests that, despite controlling for a number of sources of variation, the guarantee fund is either a cause or is highly correlated with something that causes Ontario plan sponsors to invest fewer dollars into their DB pension plans.

These statistical results support recommendations found in several places in the literature that, in order to avoid unwarranted incentives for risk-taking (moral hazard), pension benefit guarantee systems should follow a set of principles designed to operate an economically efficient manner. The present PBGF does meet two of the required principles – it provides limited benefit coverage and operates within a system of consistent funding rules. Overall, however, the PBGF falls short of qualifying as an economically efficient pension benefit guarantee system because it does not have the effective risk-based pricing and probably does not have sufficient powers to prevent moral hazard.