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PBGC: 2004 Showed Record Losses

The Pension Benefit Guaranty Corporation (PBGC) announced yesterday that its Fiscal 2004 results produced a record net loss of $12.1 billion, more than doubling its accumulated deficit to $23.3 billion (see www.pbgc.gov for the details.) The fact of a huge loss should not have been a surprise to observers -- we have known for some time that 2004 would be a very bad year, once it became likely that UAL would eventually terminate its pension plans, bringing PBGC a $6.4 billion claim, its biggest ever. US Airways announcement that it would terminate its remaining plans added another $2.1 billion. (Readers unfamiliar with PBGC may wish to check our website, www.coffi.org for a primer, written in non-technical language, and other reports).

Overall, the figures confirm that PBGC is in serious long-term financial trouble, although it does not appear to be in any worse trouble than we already projected. However, we hope that this third very bad year in a row will help dissuade any who have held to the belief that PBGC could ride out the cycle without fundamental reform. PBGC has now averaged a net loss of over $10 billion a year for the last three years and there is little reason to expect a return anytime soon to the profitability that it showed during the boom years of the 1990's, when it averaged profits of around $2 billion a year for a few years. The $23 billion hole cannot be filled without outright profitability or an infusion of outside money, either of which will require legislation.

The $12.1 billion net loss is on a GAAP accounting basis, which does a good job of estimating the impact over time of this year's actions and news, including the likelihood of specific claims occurring in the near future, such as from UAL and US Airways. COFFI's financial model of PBGC looks at the corporation from a different angle, by tracking the cash flows and their effects on the level of cash and investments. This allows us to estimate when PBGC will run out of the cash to pay retirees their pensions and how much money it will take to prevent that occurrence.

Our cash flow model was reasonably accurate in predicting PBGC's end of year level of cash and investments, with the final result coming in about 4% below our projections. Some items were more positive than expected (particularly premium levels) and some worse. Overall, this is a small enough discrepancy that it could be due to timing issues or minor surprises or estimation errors. We will review and update our cash flow model based on the new information, but do not expect major changes as a result.

The rest of this report will provide a brief explanation of the major elements underlying the reported results.

The Details

The major factor in the huge loss is a total of $14.7 billion in completed and probable claims. This is a historic record; the previous largest figure being $9.3 billion in 2002. Just shy of $3 billion of these claims actually came in during Fiscal 2004, however GAAP accounting for insurance companies requires that "probable losses" be included. That is, if PBGC expects a claim to come in, based on the information available at the end of its fiscal year, it is required to book a charge regardless of how long it might be until the claim actually comes in. $11.8 billion of 2004's GAAP claims are from such probable losses. Although PBGC does not release the names of such probable claimants, we can be confident that they include UAL (parent of United Airlines) and US Airways. The former has indicated in several forums that it is virtually certain to terminate its pension plans and US Airways has in fact recently filed to do the same for its plans. (See "PBGC: Effects of US Air and UAL Terminations", available at www.coffi.org.)

The two airlines account for $8.5 billion of claims, leaving $3.3 billion of new probables unaccounted for, plus almost $4 billion of carryover probable losses that had not terminated in 2004. The author's hunch is that PBGC felt it had to classify another of the major airlines as probable. This is based on the fact that Note 4 of the financials, on page 31, shows that $15.06 billion of the probable losses are in the "Transportation, Communications, and Utilities" sector. Subtracting $8.5 billion for US Airways and UAL leaves $6.6 billion of other claims in this sector, roughly the potential loss from one of several of the troubled legacy airlines.

Future claims may not drop off as quickly as might be hoped. PBGC classified $96 billion of pension underfunding as being at firms where it would be "reasonably possible" that PBGC would eventually take on the claims. This is up from $82 billion last year and $35 billion the year before. The categorization largely hinges on the volume of underfunding at firms with junk bond credit ratings.

On the positive side, PBGC premiums came in at $1.5 billion, much higher than we or PBGC expected. Our estimate had been $1.05 billion (including multi-employer premiums), at the low end of PBGC's official estimate at the end of Fiscal 2003 of $1.0 to $1.2 billion. The change was virtually entirely in variable premiums charged to underfunded pension plans. These premiums shot up from $0.3 billion to $0.8 billion. There are two complementary explanations. First, underfunding in the system may have been higher than expected. This would be consistent with PBGC's estimate that systemwide underfunding was $450 billion at the end of December 2003, versus $350 billion at the end of 2002. (Data lags make December 2003 the most recent figures.) Second, companies may have taken longer than expected to adjust their funding in ways that would allow them to avoid paying the variable premium. The variable premium rules are complicated and companies are often able to position themselves to avoid paying it. For example, the level of variable premiums in Fiscal 2003 implied that only about 10% of underfunding triggered the 0.9% premium. In 2004, this appears to have risen to 20% of the higher $450 billion of underfunding.

Barring new information, which may come out in the next few weeks as the financial report is analyzed, we would tend to believe that variable premiums will return to their historical levels within another year or two. However, we should note that PBGC is now projecting total 2005 premiums to be $1.6 to $1.9 billion, suggesting that it will take more than one year to return to that equilibrium.

Investment income came in at $3.25 billion, for an 8% total return. We believe this is $1.25 billion above sustainable levels under PBGC's target investment strategy, which is consistent with a roughly 5% blended return over time. There are two reasons for the difference. First, September 30th of last year was near the bottom of the stock market's recent trading, resulting in a 15% gain for equities as the markets rebounded. Most experts see a level closer to 8% as being sustainable over many years. Second, PBGC started the year holding 37% of its investments in equities and ending at 30%. Since most of the market's gains were in the first part of the fiscal year, the 37% figure is probably the most relevant. PBGC now has an investment strategy targeting 15-25% in stocks. So, even another 15% year for the stock market would have a considerably lessened effect, as, of course, would a negative 15% year. The yield to maturity on PBGC's bond holdings at the end of the fiscal year was approximately 4.4%, which serves as a good starting point to estimate likely bond returns in 2005 and on. (Note that for the existing portfolio, a rise in market interest rates would be offset by a fall in the market value of the bonds. It would exactly offset if the bonds are held to maturity. So, only new cash to invest would benefit from higher market rates.)

There was a surprise $1.5 billion loss from a change in mortality assumptions. A study commissioned by PBGC showed that its retirees were living longer than had been assumed earlier. The GAAP accounting numbers reflect this change immediately. Our cash flow model will show this as an increase in pension payments in future years.

This was slightly more than offset by an increase in the discount rate to 4.8% from 4.4%, which reduced liabilities by $1.6 billion. This will have little effect on our cash flow model, which predicts cash flows in each year, rather than relying on discounted cash flow values.

Actual pension payments were $3.0 billion, up from $2.5 billion in 2003, $1.5 billion in 2002, and $1.0 billion in 2001. This tripling in 3 years is a forerunner of further sharp increases in future years, due both to new claims, such as UAL and US Airways, and also to additional retirements as the covered participants age. Given the likely timing of terminations, PBGC projects that 2005 will have $3.4 billion in payouts. We believe that this will increase sharply after 2005 as we get full years of payouts for the new claims, as well as the aging effects. UAL and US Airways together expected $900 million of pension payouts in 2004, according to their 10-K reports.

Finally, there is yet more evidence that the federal budget methodology for its insurance activities is terribly flawed. Our model estimates, and we have confirmed this with knowledgable sources outside of PBGC, that PBGC will have contributed only a small gain or a small loss to the federal budget in 2004. Over PBGC's life, it has contributed $12 billion to deficit reduction, while piling up a $23 billion GAAP loss, which is much more consistent with economic reality.

