

April 24, 2008

Honorable George Miller
Chairman
Committee on Education and Labor
U.S. House of Representatives
Washington, DC 20515

Dear Mr. Chairman:

In response to your request, the Congressional Budget Office (CBO) has reviewed the new investment policy recently adopted by the Pension Benefit Guaranty Corporation (PBGC) and supporting materials provided by Rocaton Investment Advisors, LLC, the institutional investment firm that acted in a consulting capacity to PBGC's board of directors prior to the change in policy. As part of its analysis, CBO reviewed the assumptions underlying PBGC's decision and assessed the revised policy's potential for affecting the corporation's ability to meet its obligations to retirees and for increasing costs to taxpayers.

Prior to February of this year, PBGC's investment strategy was to hold about 75 percent of its portfolio in bonds, with the duration of those assets matched to the corporation's obligations. The remainder of the portfolio was invested in equities. PBGC's new strategy reduces to 45 percent its allocation to fixed-income assets, in order to increase the proportion devoted to equities (45 percent) and to further diversify into alternative asset classes (10 percent).

The change in investment strategy represents an effort on the part of PBGC to increase the expected returns on its assets and to diminish the likelihood that taxpayers will be called on to cover some of its liabilities. The new strategy is likely to produce higher returns, on average, over the long run. But the new strategy also increases the risk that PBGC will not have sufficient assets to cover retirees' benefit payments when the economy and financial markets are weak. By investing a greater share of its assets in risky securities, PBGC is more likely to experience a decline in the value of its portfolio during an economic downturn—the point at which it is most likely to have to assume responsibility for a larger number of underfunded pension plans. If interest rates fall at the same time that the overall economy and financial mar-

kets decline, the present value of benefit obligations will increase, and the pension plans likely to be assumed by PBGC will be even more underfunded as a result.

The effect on taxpayers of the change in PBGC's investment strategy depends on assumptions about future premiums and benefits and expectations about the government's ultimate responsibility to covered retirees. Although the Employee Retirement Income Security Act of 1974 (ERISA) explicitly states that the federal government does not stand behind PBGC's obligations, an implicit expectation exists among many market participants and policymakers that taxpayers will ultimately pay for benefits should PBGC be unable to meet those obligations. If policies governing future premiums and benefits remain unaffected by the new investment policy, taxpayers' increased risk of substantial losses will be balanced by the higher expected returns that the new policy allows. However, if the higher expected returns mean that premiums are reduced or benefits increased relative to what would otherwise occur, plan sponsors or beneficiaries will reap some of the benefits of the change in investment policy, but taxpayers will bear the added risks.

Background

The Pension Benefit Guaranty Corporation, which insures the pension benefits of participants in defined-benefit pension plans, is directly responsible for ensuring that it has adequate resources to meet future obligations. But unlike a private insurer, PBGC does not have the ability to underwrite policies and set risk-based premiums. Those limitations have led to the structural underfunding of the corporation because premiums are not set to cover future losses. At the end of 2007, for instance, PBGC reported that the present value of its current liabilities exceeded the value of its current assets by an estimated \$14 billion. Under current law, the one avenue available to PBGC to address its underfunding is to increase the expected return on its investments.

The Congress could address the issue of structural underfunding in three ways:

- Set premiums at a level that will cover expected shortfalls from future claims;
- Reduce retirees' benefit payments; or
- Tighten funding rules for insured plans.

The Pension Protection Act of 2006 addressed funding requirements that sponsors of defined-benefit pension plans have to meet and increased the fixed-rate premium they have to pay to PBGC. However, CBO believes those provisions fail to address the underlying structural problems facing PBGC because the increased premiums are not

commensurate with the amount of unfunded pension claims from terminated plans that PBGC is likely to assume in the future.¹

At certain points in the past, and more recently, PBGC has used an investment strategy that generally sought to match the duration and nature of trustee assets with those of its obligations.² Between 2004 and January 2008, PBGC allocated 15 percent to 25 percent of the trustee assets to investments in equities and 75 percent to 85 percent to fixed-income assets; at the end of 2007, the share invested in equities had increased to 28 percent. That strategy was designed to limit exposure to financial risk and reduce the variability in the value of PBGC's assets.

Such a strategy is similar to that used by some defined-benefit insurers in the private sector, who perform a function similar to that of PBGC. When a company terminates a pension plan, it can remove benefit obligations from its balance sheet by paying an insurer to assume both the assets and liabilities. Those insurers manage the portfolio by investing in fixed-income assets, thereby matching future obligations with cash flows from the portfolio's investments. In such cases, the insurer's goal is to minimize the risk of failing to meet its obligations.

The investment policy adopted by PBGC in February is a significant departure from its recent strategy. The new strategic asset allocation reduces the percentage of fixed-income assets to 45 percent, raises the percentage of equities to 45 percent, and allocates the remaining 10 percent to alternative investments (for example, real estate and private equity). In effect, the more conservative practice of duration matching is deemphasized in favor of increasing the expected return on the invested assets and the likelihood that the value of PBGC's assets will be sufficient to cover all of the corporation's benefit obligations.

1. A fair premium would not charge current plan sponsors for PBGC's current deficit. To be actuarially fair, premiums should be commensurate with the expected amount of underfunding that will be assumed with future plan terminations. If premiums are set at a level below expected losses, they will always be insufficient to fund the gap between assumed obligations and assets.

It may be impossible to fund the PBGC entirely through increases in premiums, because such increases could either increase the number of plans that would fail or encourage plans to voluntarily terminate and pay a private insurer to assume their assets and liabilities. Such closed plans would not provide an income stream for PBGC.

2. PBGC's investment strategy between 1990 and 1994 and between 2004 and January 2008 was intended primarily to reduce balance-sheet volatility (arising from a mismatch between the sensitivity of PBGC's assets and liabilities to interest rates) through investment in fixed-income securities with long-duration. From 1974 to 1990 and 1994 to 2004, PBGC's investment policy was designed to maximize expected returns within acceptable levels of risk by investing more heavily in equities.

Asset Diversification and the Risk to PBGC's Funded Status

PBGC asserts that greater investment in equities and diversification into alternative asset classes will increase the expected rate of return of its investment portfolio over the long run without increasing the long-term risk of that portfolio. Although increased investment in risky securities will likely raise the expected rate of return, it also entails a greater downside risk. That risk is the probability that the value of PBGC's assets will be below the amount necessary to meet benefit obligations as they come due, imposing on taxpayers a potential burden that increases as the shortfall grows larger.

It is widely accepted that an investor benefits from having as diversified a portfolio as possible, given an established level of risk tolerance. A portfolio containing a mixture of risky securities will generally pose less risk to an investor than a portfolio consisting of just a single risky asset. Most observers would agree that the portion of assets allocated to equities and other risky securities should be well-diversified in order to maximize return for a given level of risk.

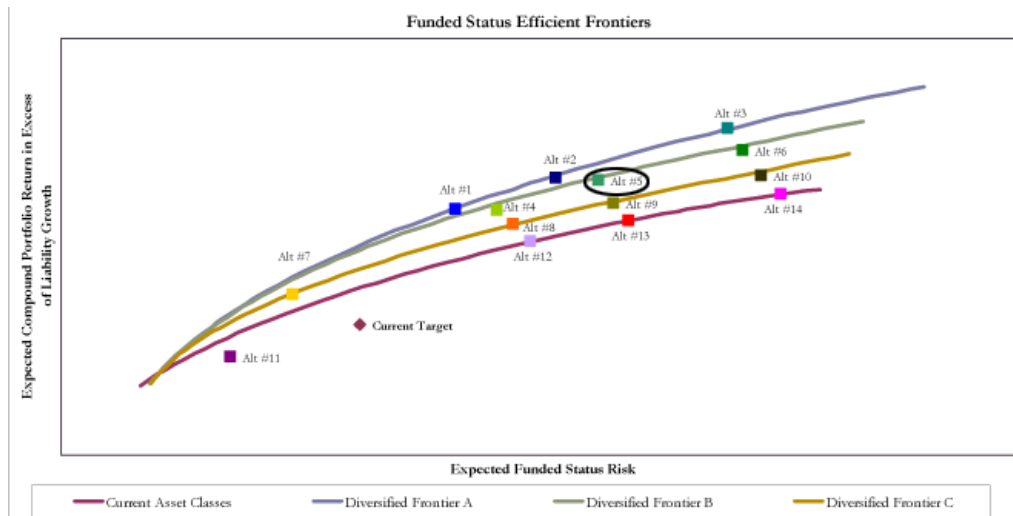
There is a significant difference, however, between the riskiness of PBGC's *asset* portfolio and the risk posed by the new investment strategy to the corporation's *funded status*—the difference between the value of PBGC's assets and the present value of its liabilities. That is, although Rocaton's analysis suggests the new investment strategy offers greater expected returns with lower risk to the assets held in PBGC's portfolio, that strategy reduces the timing match between the corporation's future pension obligations and cash-flow streams from its investments. The increased risk to funded status is illustrated in principle on page 28 of Rocaton's report in a graphic that is reproduced in this letter (see Figure 1). In particular, "Alternative #5" (which most closely represents the new strategy) is further to the right than the "current target" (which represents the recent strategy).³

Implications for Taxpayers

The effect on taxpayers of PBGC's new investment strategy will depend on policymakers' response to that strategy. If the new investment policy does not cause the government to lower premiums or raise benefits relative to what otherwise would occur, taxpayers should be largely indifferent to the choice of a riskier investment strategy because the higher expected returns will compensate for the greater risk. Conversely, taxpayers could expect to be worse off if, in response to the new investment strategy, policymakers convey some of the benefits of greater returns to other stakeholders, increasing taxpayers' exposure to any losses that PBGC might incur. For example, taxpayers might bear a greater burden if policymakers lower premiums when investment returns are good but are unwilling to increase premiums when returns are poor.

3. In determining funded status, liabilities are measured using the market cost of annuities.

Figure 1.
Funded Status Efficient Frontiers



Source: Rocatton Investment Advisors, LLC, "Investment Policy and Strategy Discussion" (presentation to the Pension Benefit Guaranty Corporation, December 4, 2007), p. 28.

Notes: ALT = alternative.

The "current target" represents the portfolio as maintained under PBGC's recent investment strategy.

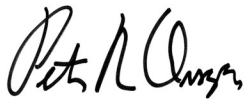
Costs of the New Investment Strategy

Managing a riskier portfolio implies higher administrative and transaction costs, but those are lesser considerations. The costs associated with switching to and administering a portfolio that is more heavily invested in risky securities are not likely to be significant because the amounts under consideration are not large relative to the volume of capital-market transactions, and trades can be spread over an expanded period. If, however, the fund managers trade shares frequently or attempt to "time the market," the PBGC's fund will be exposed to high transaction costs and additional risk.

Honorable George Miller
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If you or your staff would like additional information on this subject, we would be pleased to provide it. The staff contacts are Wendy Kiska and Kim Kowalewski, who can be reached at 202-226-2750.

Sincerely,

A handwritten signature in black ink, appearing to read "Peter R. Orszag". The signature is fluid and cursive, with the first letters of the first and last names being capitalized and prominent.

Peter R. Orszag
Director

cc: Honorable Howard P. "Buck" McKeon
Ranking Member