Recent events in the pension crisis are starting to look like the early stages of the 1980s savings and loan (S&L) debacle. Legislative response to underfunded plans resembles the deregulation laws instituted to assist struggling S&Ls. Savings and loan lobbyists imposed political pressure to encourage new laws aimed at aiding the struggling industry but, in the end, increased the cost of the collapse. As with underfunded pension plans, interest rates were a major ingredient in the S&L debacle. S&L insolvency, which had more to do with asset-liability mismatches on balance sheets, led to stopgap interim policies that lowered net-worth requirements until interest rates corrected to “normal” levels. These policies are similar to the discount rate adjustment provided in the Pension Funding Equity Act of 2004, wherein temporary relief is granted to underfunded plans until assets can grow and bring the plans back into funded status.

Similarities also can be found in the agencies that provided insurance during both crises. The S&Ls were insured by the Federal Savings and Loan Insurance Corporation (FSLIC), whose $6.5-billion surplus declined to a $75-billion deficit by 1988.1 By comparison, the Pension Benefit Guarantee Corporation (PBGC), the federal pension insurance agency formed to protect participants of private plans, went from a $7.7-billion surplus in 2001 to a $23.3-billion deficit in 20042 (see figure 1). In the first four months of 2005, the airline industry alone passed on more than $7 billion to the PBGC, and the automotive industry is on the brink of adding billions more.

The most fundamental similarity between the savings and loan debacle and today’s pension crisis is the mismatch of assets and liabilities. Investment strategies largely ignored the fundamental strategy of paying what is owed in favor of risky, complex, and often illiquid investments promising boundless returns. Popular mathematical risk-measurement tools justified and encouraged the risky investment options. These investments caused a good deal of damage to funds and cost to taxpayers. Interest rate movement was not the sole contributor to the massive losses, but it was the catalyst for legislative reaction taken in an effort to save the S&L industry.

Deregulation, relaxed accounting methods, and eventually fraud led to hundreds of S&L failures and cost U.S. taxpayers billions of dollars. So far, the pension crisis of the new millennium seems to be following a similar script.

The Pension Fund Bubble
Although the American Express Company established the first pension plan in 1875, pension insurance wasn’t created until 1974. The Employee Retirement Income Security Act (ERISA) created the PBGC. The agency is not funded by the federal government but by premiums from employers and investment of assets. Until recently, the PBGC has been in good health, receiving more in premium payments than it pays out in benefits.
in most years. But starting in 1998, plan terminations increased and benefit payments started to grow, becoming larger than incoming premiums, worsening each year through 2004. In addition, the net position (assets minus liabilities) of the PBGC historically had been negative $1 billion–2 billion until the 1990s market boom, when assets outperformed liabilities. In 2000, assets came close to doubling the liabilities but quickly reversed when the equity bubble burst. Until 2001, the worst deficit for the PBGC was $2.9 billion. In 2001, the net position swung into deficit and has continued to decline to almost –$30 billion as of April 2005, capturing the attention of the media and forcing Congress to get involved.

 Roots of the Crisis
Today’s pension crisis has many components, but its roots are in the explosion of the U.S. stock markets in the 1990s. Expected returns, convincing fiduciaries that targets could be met easily. And, of course, allocations to equities rose.

In early 2000, the technology bubble burst, asset values fell, and heavy equity allocations quickly moved pensions into underfunded status. To remain funded, pensions required unanticipated cash outflows from operations, exposing flaws in the allocation approach. Management of affected companies found insufficient disclosures and guidelines to explain the pension shortfall. Allocation change was slow to respond; typical pension-plan strategies had been based on long time horizons, so fiduciaries were advised to be patient. In addition, historically low interest rates meant low discount rates, causing present-value pension liabilities to explode, compounding underfunding. Anticipation of interest rates rising to “normal” levels added to delayed action; expectations were that the funded status would fix itself. But interest rates and the stock markets did not cooperate, and pension plans moved closer to insolvency. By the time institutions decided to adjust the allocation approach, the damage already had been done.

Comparative Investment Strategies
Pension-plan liabilities contain characteristics similar to insurance and banking entities, but the investment strategies differ greatly. Insurance companies, which are required to perform dynamic cash-flow modeling and testing, largely use fixed-income instruments to fund liabili-
ties up to and past 30 years. Duration matching is the foundation for building asset allocation. Since the late 1990s, pension plans have focused more on achieving target returns to meet liabilities, even in the short term. With inflated expected returns in equity asset classes, attention was drawn away from the benefits that bonds provided, such as predictable cash flows, duration matching, and measurable maturity. Even though most plans held fixed-income portfolios, they were measured by total return rather than the ability to meet distribution payments. As insurance companies and banks already know, matching liabilities with an instrument with the same characteristics, such as bonds, decreases the risk of developing an asset–liability gap.

Evidence of pension-plan fixation on total return was demonstrated when hedge funds began to replace fixed-income portfolios because of higher returns with the same amount of statistical risk. Although hedge funds are a great risk–return diversifier for equities, illiquidity and the inability to measure duration and maturity make it impossible for hedge funds to match liabilities.

**Eerie Similarities**

In a move that was eerily similar to the deregulation of the savings and loans, Congress overwhelmingly approved the Pension Funding Equity Act of 2004 (PFEA). This temporary relief allowed institutions to use an average long-term corporate bond index rate rather than the long-term 30-year Treasury bond rate to discount liabilities at higher rates, taking pressure off unfunded plans. Akin to the goodwill accounting reconstruction in valuing assets for S&Ls, PFEA did nothing more than adjust the formula used to test pension assets versus liabilities. The purpose was to buy time until the crisis could be analyzed fully and pension reform could be implemented.

![FIGURE 4 Treasury Yields 1990-2005](Source: Commodity Systems Inc.)

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Consequences of pension plans’ improper investment strategies are arising as the airline and auto industries continue to unload plans to the PBGC. The Congressional Budget Office expects the PBGC deficit to grow to $71 billion during the next 10 years. As companies and unions lobby for leeway, Congress and the Bush Administration are well aware of the regulatory changes made during the S&L crisis and have publicly expressed urgency to not repeat the same mistakes.

**A Current Proposal**

In early 2005, the Bush Administration introduced a pension proposal to tighten funding rules, increase disclosure, and raise PBGC insurance premiums. The decree would stiffen the standards by which pension plans must operate and move to a more mark-to-market approach similar to the United Kingdom’s Financial Reporting Standard No. 17 and the 2004 changes to the International Accounting Standard (IAS) No. 19, the current international standard. The current U.S. pension accounting standard, FAS 87, has been criticized as complicated and vague. A Financial Accounting Standards Board (FASB) move toward the stricter accounting rules found in IAS No. 19 would require more timely recognition of pension gains and losses as well as more plan disclosure. Changes to IAS No. 19 became effective January 1, 2006. The FASB is in the first phase of a long-term project to reconsider the accounting for post-retirement benefits including pensions.3 Thus, the administration’s proposal is an attempt to accelerate the stabilization of the current pension environment.

On cue, corporate lobbyists and union representatives associated with General Motors Corp., DuPont Co., and Delta and United airlines are protesting the administration’s proposal. Cries of foul are resonating among beneficiaries, who see the stricter rules as death sentences for corporate pension plans. Threats of strikes are on picket signs as
active and retired workers march in fear of losing their retirements. Already competitors are complaining that a Chicago bankruptcy judge has given United Airlines a competitive advantage by allowing United to dump its pension plans on the PBGC, rewarding the airline for mismanagement. Unlike the fight for Social Security, pension reform has been bipartisan so far. But, as plans continue to default, beneficiaries continue to lose their retirements, and the pension crisis moves further into the media spotlight, politics and finger pointing may obscure the need for quick, decisive change.

**Will It Rhyme This Time?**

Interest rate movements, mismatched investments, and bad legislative changes led to fraud and the S&L debacle of the 1980s. The $160-billion cost to taxpayers might have been avoided with patience and forethought. Regulators, politicians, and the public received valuable lessons about how quick fixes and accounting illusions can create more harm than good.

Now, a decade later, the United States faces a familiar scenario with pension plans. Will the lessons taught in the 1980s lead to better decisions about pensions? So far, Congress and the Bush Administration recognize the predicament and are set to implement the international standard provided in IAS No. 19 as the template for prudent pension-plan management. Institutions no longer will be able to gamble with employees’ retirements by executing risky investment strategies based on theoretical probabilities of reaching target returns. Eventually, the pension crisis will be resolved. Whether it happens quickly or over the next 20 years depends on the ability of institutions, government, and beneficiaries to accept the consequences of cutting corners and come together for reform.

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**Endnotes**


3. For more information, see the FASB Project Update available on the world wide web at http://www.fasb.org/project/postretirement_benefits.shtml.

**References**


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