

THE LIFE CYCLE OF THE FIRM: PENSION MANAGEMENT INCENTIVES WITHIN THE PBGC STRUCTURE

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There has been great concern regarding the Pension Benefit Guaranty Corporation's (PBGC's) potential liability. The problem received considerable attention within the last few years, with analysis and media attention drawn to the similarities between the recent savings and loan debacle and the potential losses the PBGC faces.

A good deal of the current banking literature focuses on managerial incentives within the structure of the Federal Deposit Insurance Corporation (FDIC) and the banking regulatory environment. While the PBGC makes an actuarial estimate of its liability, little consideration is given to pension management incentives to increase the ultimate liability within the current guarantee structure of the PBGC. Pension managers have incentives to impose a significant potential liability on the PBGC.

As this paper establishes, the life cycle of the firm may influence its incentive to 'put' the pension obligation to the PBGC. The additional liability cannot currently be estimated using only bankruptcy incentive models, since pension fund managers can use pension asset management to increase the liability to the PBGC without increasing the risk of corporate bankruptcy.

As a test of the life cycle hypothesis, participating PBGC trusted pension plans were matched to settled, merged/acquired and ongoing plans by size. A sample of 91 plans were observed in nine-year windows from 1980 through 1992. An evaluation of those 91 plans indicated that, when controlled for size, a life cycle proxy (the ratio of active to benefit-eligible

employee count) contributed significantly to prediction of the trusteeship event, given that the termination event had occurred. Specifically, a probit model of the conditional probability of trusteeship given termination which included the life cycle proxy was statistically significant using a 5% confidence level.

If the life cycle contribution can be quantified and proves to have a significant impact, the PBGC estimate of its liability can be adjusted to account for this effect. Additionally, employees could use the firm's life cycle status to aid in their estimate of future pension reliability.