Now Wall Street Wants Your Pension, Too

by Matthew Goldstein
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JPMorganChase, Citi, Cerberus, and Morgan Stanley are among the firms lobbying Washington to let them take over and run corporate pension funds

The folks who brought you the mortgage mess and the ensuing hedge fund blowups, busted buyouts, and credit market gridlock have another bold idea: buying up and running troubled corporate pension plans. And despite the subprime fiasco, some regulators may soon embrace Wall Street's latest scheme.

In preparation for that moment, the world's biggest big investment banks, insurers, hedge funds, and private equity shops have been quietly laying the groundwork for such deals over the past year. They would be a big prize for Wall Street. The $2.3 trillion pension honey pot has $500 billion in "frozen plans" that are closed to new employees and whose benefits are capped, including those at IBM, Hewlett Packard, Verizon, and Alcoa. And that figure could triple by 2012, according to consulting firm McKinsey. By managing those troubled plans, Wall Street also gains entrÃ©e to an appealing set of customers to whom it can sell a broad array of fee-generating products. "We have identified several clients who would be willing to be first to sell a plan," says Scott Macey, a senior vice-president at Aon Consulting. "But the question is, when is a good time for this?"

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The concept of off-loading pension funds sounds great. For businesses it's a chance to rid themselves of struggling plans, which can weigh down a balance sheet. It's especially good timing now. New accounting rules take effect in the next year or so that will require companies to mark their pension assets to prevailing market prices each quarter—a change that could devastate some companies' profits. Meanwhile, many companies no longer want to pay for pensions, troubled or otherwise. A recent report from the U.S. Government Accountability Office found that most companies freeze their pension plans merely to avoid "the impact of annual contributions to their cash flows."

But the gambit to turn pensions into for-profit enterprises raises troubling questions. Critics, including some on Capitol Hill, worry that financial firms don't have workers' best interest at heart, which would put some 44 million current and future retirees at risk. "We think it's just a terrible idea," says Karen Friedman, policy director for advocacy group Pensions Rights Center. "In the wake of the subprime crisis, it would be crazy to allow financial institutions to manage these plans."

Wall Street's Dumping Ground

Historically, pension funds have been managed conservatively, in keeping with the broad goals of long-term wealth accumulation. Alternative investments such as hedge funds, derivatives, and asset-backed securities represent less than 25% of pension assets. If financial firms get involved, exotic investments could swell to 50% of pensions assets by 2012, predicts McKinsey. The biggest fear is that Wall Street could use retirement portfolios as a dumping ground for its most toxic and troublesome investments. It's not unlike what regulators allege UBS officials did with its stockpile of risky auction-rate securities by trying to off-load them to wealthy clients.

If Wall Street gambles with those pension assets and loses, U.S. taxpayers would probably foot the bill. When a company with a pension goes belly up today, the Pension Benefit Guaranty Corp., under federal law, has to take on the fund's obligations and dole out money to its beneficiaries. It's a costly burden: The PBGC currently runs a $14.1 billion deficit.

Former PBGC director Bradley Belt argues that pension buyouts could actually strengthen the agency. If financially strapped companies could dump the plans rather than ponying up money for them, they might stay out of bankruptcy. That would mean the PBGC wouldn't have to step in and pick up the pieces of the pension. "While there are legitimate regulatory and policy considerations, much of the criticism is misplaced," says Belt, who two years ago teamed up with private equity firm Reservoir Capital to form Palisades Capital Advisors, a pension buyout boutique. "This is really in the public interest if it's done correctly."

The federal agencies that oversee the nation's pension system are expected to weigh in on the issue—potentially paving the way for big firms that have been pursuing it, such as Aon, Cerberus Capital Management, Citigroup, JPMorganChase, Morgan Stanley, and Prudential. JPMorgan has been particularly active in this crusade, sending a letter in September 2007 to several federal agencies with its own "guidelines for pension transfers." The Government Accountability Office, which began studying the proposal at the behest of the Congress, plans to issue a report later this year.

How They Do It Across the Pond

The biggest regulatory kink that needs to be ironed out is a tax one. Under federal pension laws, an employer can deduct part of its pension plan contributions. But it's unclear if banks or private equity firms that buy the plan would get the same tax break since they don't technically employ the workers. Squashing that perk could make such buyout deals less appealing to Wall Street. Sources familiar with the situation say the Internal Revenue Service is expected to offer a dim view of extending the current tax break to purely financial buyers. The Bush Administration is likely to take a different stance, favoring such deals in certain circumstances.

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Regulators are almost certain to put the kibosh on buyouts by free-standing, independent firms that aren't tied to the books of any big firm. The worry is that such a weakly capitalized company wouldn't have the balance sheet heft to deal with the pensions if their assets soured. After all, even big Wall Street firms have been crippled by the $400 billion in subprime related losses.

Belt, a former top aide to presumptive Republican Presidential nominee Senator John McCain, had pushed a similar vehicle to make buyouts. The proposal created controversy in the industry. In its letter to regulators, JPMorgan took pains to distance itself from the strategy shopped around by Belt and other private equity firms. The bank's legal team recommended that regulators green-light buyouts only by "institutions and structures that are well regulated" and "subject to high standards of financial strength and stability."

Although any restrictions by the federal government could dampen the spirits of the buyout brigade, Wall Street are likely to simply follow the lead of financial firms in Britain. Companies there off-load their pension assets by purchasing a group annuity from an insurer. That market took off 18 months ago when the country's regulators instituted more onerous pension accounting rules. Since then, nearly a dozen specialized insurers have opened up shop to offer the products. Many of the new players are backed by Goldman Sachs, JPMorgan, Cerberus, Warburg Pincus, and Deutsche Bank—some of the same names that are trying to import the concept to the U.S.

U.S. companies already have that avenue of escape thanks to the federal pension rules. But the high costs associated with such insurance products have limited their use. That's already changing. A dozen U.S. life insurers, including John Hancock, Prudential, and MetLife, now offer a way for companies to get rid of the pension burden. And though the market remains small, insurers sold $2.88 billion worth of such policies last year—triple the amount three years ago. Those figures could rise if Wall Street decides set up insurance units to offer those types of annuities.

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