



United Airlines' Pension Problem: Who, Ultimately, Is Going to Pay?

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United Airlines' proposal to halt payments to its pension funds suggests serious problems in the nation's pension-guarantee system, according to Wharton faculty and pension experts. The troubled airline, which declared bankruptcy in December 2002, said in July that it would stop funding its pension plans while it struggles to restructure under bankruptcy protection. Two of the company's unions challenged the decision, but last week a federal bankruptcy judge gave the airline another month to work out a restructuring solution.



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United isn't alone in its pension problems. Declining stock prices, low interest rates, and fierce corporate competition, both domestic and foreign, have put pressure on companies to back away from pension promises and could eventually lead to a taxpayer bailout.

The Pension Benefit Guarantee Corp. (PBGC), the quasi-government agency that insures private pensions for 44 million workers and retirees, has objected to United's plan, and warns that the airline's \$8.3 billion underfunding is just part of a \$400 billion gap between the assets and liabilities of private companies' defined benefit plans.

United's problems became front-page news last month when it failed to make a \$72.4 million payment that was owed to three of its employee pension plans. The company said it planned to forgo additional payments as a condition of a new financing pact that would allow the company to emerge from bankruptcy.

"The United case raises some very important implications, not only for its own employees but for the rest of the airline industry. I think it also raises questions about the PBGC. It really can't take many more hits like this," says [Olivia Mitchell](#), Wharton professor of insurance and risk management.

In addition to lower stock prices, pension funds have been hurt by lower interest rates, which inflate the value of pension obligations to be paid out – thereby requiring companies to put even more money into their funds in the short-run. "It's been an unfortunate set of circumstances," says Mitchell.

Last year, US Airways Group terminated its pilot pension plan during its climb out of bankruptcy, setting a precedent in the airline industry that could cascade to other companies. Delta, Northwest, and American also have severely underfunded pension plans. The decision to pull back on pension obligations is now a strategic management decision in many industries, notes Mitchell. "I've heard people suggest the auto industry will be next. We're in tough times."

United, however, has raised the pension stakes higher than most, suggesting at one point that it may have to replace its four employee pension plans with ones that offer employees lower benefits. According to an Aug. 19 report in the *New York Times*, that statement, which the airline later backed away from, "was a milestone in recent airline history." No other airline, the paper said, "has terminated all of its pension plans, short of a liquidation."

Ironically, US Airways may once again be facing bankruptcy following a breakdown last weekend in its labor negotiations with the pilots union. Without a new agreement, the company could default on federal loan guarantees, a situation that indicates a "substantial and increasing risk of bankruptcy in the near term," according to Standard & Poor's, which downgraded US Airways' credit ratings on Friday.

According to [Elizabeth Bailey](#), Wharton professor of business and public policy, this latest crisis in the airline industry represents the biggest potential pension problem since the steel industry collapsed in the 1970s. "In the steel case and the airline case, retirement pension funds seem to definitely be in play, just like rewriting of health benefits seems to be in play."

A cut in retiree pension and health benefits, Bailey adds, amounts to a pay cut for workers in established U.S. companies that are now running up against foreign competitors with lower – or no – pension commitments. Young domestic start-ups, such as the new, no-frills airlines, are not burdened by the same level of retiree obligations either. "To me, it's all part of globalization and the need to be competitive," she says.

A further consideration, notes Mitchell, is that during the 1980s and 1990s companies poured pension fund investments into the stock market, which delivered strong returns. "These companies did well with those riskier investments, but when the market tanked in 2000, what looked like over-funded plans become drastically under-funded," she says.

Moral Hazard

Companies pay congressionally-set premiums to the PBGC of \$19 per worker or retiree plus an additional \$9 to cover each \$1,000 of promised pension benefits that are not yet set aside. The agency – created 30 years ago as part of the Employee Retirement Income Security Act (ERISA) – guarantees pensions only up to \$44,386.32 a year.

By charging the same premium for each type of plan – as opposed to varying premiums based on the degree of investment risk in a fund – the PBGC system encourages companies to speculate in riskier pension investments. The set premium does not offer incentives to companies to choose a safer, slow growth investment, argues Zvi Bodie, professor of finance at Boston University. The cost of taking a big risk is the same as playing it safe; companies are covered by the PBGC either way.

Bodie suggests the PBGC require companies to invest in low-risk securities, such as government bonds, to protect against pension shortfalls, or adjust the premiums to reflect more high-risk, high-reward investing styles.

A *New York Times* analysis of the United pension fund investments in 2002 found the company held a fairly typical mix of assets, including 61.2% of its holdings in U.S. and foreign stocks, 30.9% in government securities and corporate bonds, 5.1% in private equities and 2.8% in other investments. That compares to an asset mix for all corporations of 60.2% in stocks, 30.4% in government securities and corporate bonds, 3.4% in private equity and 6.1% in other investments.

United has paid more than \$50 million in premiums to the PBGC since 1974, but the agency could be on the hook for more than \$6 billion – taking into account PBGC's ceiling on individual payouts – if the company defaults on its pension obligations.

Indeed, the executive director of the PBGC acknowledges the agency has a so-called moral hazard problem that encourages risky investments and could lead to destabilization of the nation's private defined-benefit pension system. "To be sure, any insurance system runs the risk of encouraging bad

behavior, but the level of moral hazard plaguing the pension insurance system is staggering. Simply put, management and labor at financially troubled companies have a powerful temptation to make promises that they cannot or will not fund," said Bradley D. Belt, executive director of the Pension Benefit Guaranty Corp., in a speech August 13 to the Retirement Research Consortium.

Bodie likens the current pension situation to the savings and loan crisis of the 1980s. A collapse in the pension system will prompt a taxpayer bailout, which politicians will be forced to approve because so many people will be caught without expected retirement income. "It's too big to fail," says Bodie of the defined-benefit pension plan system. "It's truer of the pension system than the S&Ls. It's clear there will be some form of bailout if there is a crisis."

Bailey, too, suggests a bailout is possible, although it would be hard on the economy given a spike in other government spending. The PBGC, she adds, was created as the "pension fund of last resort" and is not equipped to cover the liabilities now looming. "It's a political problem. With all this money going to Iraq, what if the federal government suddenly has to [increase] spending on Social Security and Medicare and also pick up pensions? I don't know how the government is planning to fund it."

"Wishful Thinking"

Under current rules, companies use an assumed rate of return on pension assets in computing their pension expense: The higher the assumed rate of return on pension assets, the lower the pension expense. This amounts to "wishful thinking," says Bodie, suggesting that companies be required to report their actual gains and losses on pension assets (the fair-value accounting method).

However, he adds, the Financial Accounting Standards Board (FASB), which oversees accounting rules in the U.S., would probably meet with strong opposition from corporations if it proposed such a change. The board is already up against resistance to its proposal to recognize stock options as an expense. Although action by the board could have a huge impact on this issue, "FASB is not likely to do that given the experience with stock options," Bodie says. Meanwhile, opponents of fair-value accounting for pensions argue that it adds unnecessary short-term volatility to the system of accounting for long-term obligations.

According to Jeremy Gold, a New York pension consultant, it is difficult to reform the PBGC now given that so many companies are struggling with weak pension funds, but he argues the system must be shored up. "We should be requiring that every plan be fully funded at all times," he says. "Anything less is like allowing banks to let their liabilities exceed their assets and say, 'That's okay because the FDIC is behind them.'" Many weak companies "with badly funded defined-benefit plans are keeping their fingers crossed, hoping the stock market will bail them out," he adds.

[Jerry Rosenbloom](#), Wharton professor of insurance and risk management, says UAL's proposal is a challenge to federal pension law that requires companies to adequately fund their plans. PBGC, he adds, is meant to be a back-up in extraordinary circumstances. "It's not supposed to be that you can just turn it over to them, which is the issue that's being raised here. The implications are enormous."

To head off pension financing problems, Mitchell says the PBGC has become more proactive and is stepping in to negotiate settlements with troubled companies before they renege on their pensions. Similar negotiations with the steel industry went on for years, she points out, adding that the largest PBGC bailout – of LTV Corp. – amounted to \$2.2 billion. But with the possibility of United owing more than \$6 billion alone, she adds, "it's not clear how much good negotiating is going to do."

Over time, the number of plans covered by ERISA and the PBGC will diminish. The number of private sector defined benefit plans peaked at 112,000 in the mid-1980s when they covered 40% of Americans. Now there are 31,000 plans covering 20% of the workforce, according to the PBGC. In addition, companies have shifted pensions from defined benefit plans with a guaranteed payout to defined

contribution plans, such as 401(k) programs, in which employees take a greater role in their own investing decisions.

Meanwhile, however, retirees are depending on employers' pension promises to finance their golden years. As the baby boom ages, retiree income security may have a major effect on economic growth overall. "The hard thing is to get a soft landing out of all of this," says Mitchell. Realistically, "the defined-benefit plan, at least the way it has been configured, is a thing of the past. The problem is, you have a lot of people relying on it. It's going to be a painful transition."

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