IV. THE CLEARINING OF THE PERFECT STORM: WHAT DOES THE FUTURE HOLD FOR DEFINED BENEFIT PENSION PLANS?

Weathering the Perfect Storm: Defined-Benefit Pension Plans in the Airline Industry

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With defined-benefit pension plans experiencing record shortfalls, pension funding reform has moved from obscurity to the top of the legislative agenda in Washington. Much of the concern surrounding defined-benefit plan funding centers on recent developments in the airline industry. Because it is the troubling specter of a flood of airline pension liability swamping the pension insurer that is driving calls for legislative reform, it is important to understand the factors that have contributed to the current situation. This report traces the causes of the airline pension funding crisis, describes how firms in the industry have responded, and makes policy recommendations to contain the crisis now and prevent recurrences in the future.

Introduction

In recent months attention has been bubbling up in policy circles to a quite obscure issue, the regulations governing funding for defined-benefit pension plans. The Bush administration and many in Congress have identi-

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fied this issue as a key legislative priority for the coming year. And although there are differences of opinion on the reasons why, almost everyone—Democrat or Republican—agrees that these rules are not working in a way that maximizes benefit security for employees and retirees who participate in defined-benefit pension plans. Much of the concern surrounding defined-benefit plan funding centers on recent developments in the airline industry. The termination of pension plans at US Airways and the threatened termination of plans at United Airlines would dump billions of dollars in unfunded pension liability on the government agency that insures pension plans, the Pension Benefit Guaranty Corporation (PBGC). Coming on the heels of some very large pension plan terminations in the steel industry, these terminations would severely strain an already burdened agency. And many observers believe that, if these two carriers are successful in offloading their pension liabilities to the PBGC, other airlines would not be far behind in attempting to do the same. The fear is that the result, mass airline pension terminations, could trigger a solvency crisis for the PBGC itself, which would in turn affect all other participants in the defined-benefit pension system.

Because it is the troubling specter of a flood of airline pension liability swamping the pension insurer that is driving calls for legislative reform, it is important to understand the factors that have contributed to the current situation. This report traces the causes of the airline pension funding crisis, describes how firms in the industry have responded, and makes policy recommendations to contain the crisis now and prevent recurrences in the future.

Airline Pension Funding Since the Late 1990s

Pensions in the airline industry have become endangered, in part, because of funding rules that may require companies to make no contributions into the plans during good economic times but impose much greater contributions during tough economic times, when companies can least afford them. The rules governing pension plan funding are found in the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC), section 412. These rules set out certain minimum funding standards that a pension plan sponsor (i.e., an employer) must meet to ensure that the plan will have sufficient assets available to pay promised benefits (Krass 2004, sect. 8-1). All else equal, the funded status of a plan will improve if the value of the plan's liabilities decreases and/or if the value of the assets held by the plan grows. Conversely, the plan's funded status will worsen if the value of the plan's benefit liabilities grows and/or if the value of assets in the pension trust declines. Plan benefit liabilities can increase because of benefit improvements, but they can also grow even when benefits themselves stay constant, if the interest rate used to value those liabilities falls.[1]

During the late 1990s, thanks to the strength of the economy, airlines enjoyed several years of sustained profitability and healthy cash flows. During these years, the stock market was also riding high, and pension plans that held stocks enjoyed healthy returns. Interest rates were relatively high by historical standards and quite stable, keeping plan liabilities low and predictable. As a result, companies across America (including airlines) found that their pension plans had more than sufficient assets to pay for all promised benefits and were not required to make (and in some cases were prohibited from making) annual contributions into their pension plans.[2] All that came to an end in 2001. The early part of this decade witnessed a simultaneous dramatic drop in asset values and a sustained drop in interest rates. These two trends, combined with a very weak economic recovery, which depressed corporate earnings, came to be called "the perfect storm." These effects conspired to weaken the funded status of plans that, in many cases, had only a couple of years earlier had assets sufficient or even more than sufficient to cover promised benefits.

One provision in the pension funding regulations had a particularly significant impact in this regard. The regulations subject severely underfunded plans to so-called additional funding charges (AFCs), which are designed to accelerate the pace at which a very underfunded plan will become fully funded again. The AFC requires plan sponsors to make payments, called "deficit reduction contributions" (DRCs), to the plan beyond what would normally be required, which are designed to get the plan fully funded within five years. Many in the industry believe that what was a well-intentioned modification of the funding rules, passed in 1994, has failed under the stress test of the wide swings of the business cycle (Woerth 2003).[3] These observers believe the manner in which the AFC accelerates pension payments may actually be contributing to pension terminations, rather than preventing them.

Researchers have also observed that the counter-cyclical funding burdens inherent in current pension funding rules may be increasing, not decreasing, the likelihood of pension plan terminations (Weller and Baker 2005). Indeed, the past several years have vividly illustrated the effect that counter-cyclical funding burdens have in industries that are themselves highly cyclical. Between 2002 and 2003, the steel industry witnessed an almost wholesale abandonment of defined-benefit pension plans, with the PBGC taking on $6.7 billion in claims in distress terminations at LTV Steel, National Steel, and Bethlehem Steel (PBGC 2003, 29). And PBGC and Congress are fearful that, in the wake of the perfect storm, a similar wave of distress terminations could be on the horizon in the airline industry.

How have airlines responded to the perfect storm? What can policy makers do to contain the crisis? These are questions to which we now turn.

Airline Responses to the Perfect Storm

Certainly, not every defined-benefit pension plan is in imminent danger of termination. Although many companies are struggling under the weight of increased payments to fund their pensions, relief is available to plan sponsors. When Congress drafted ERISA, the foremost concern was to ensure that companies funded the pension promises they made. At the same time, however, the law recognized that, from time to time, companies may experience temporary business hardship that makes it difficult to meet funding obligations, so the law provides plan sponsors with certain opportunities for relief. For example, the law provides for funding waivers and charge extensions that allow companies to stretch their pension payments out over time. (See Internal Revenue Code, sects. 412[d] and 412[e].) Indeed, many companies have taken advantage of this relief since the “perfect storm” hit. Northwest Airlines for example, twice received IRS waivers of the minimum funding standards, in as many years.

Another option available to plan sponsors is to make noncash, in-kind contributions to the plans. Normally, this will require approval from the Department of Labor, which must allow an exemption from the so-called prohibited transactions rules in ERISA (Krass 2004, sects. 24-1 to 24-33). In 2003, Northwest Airlines received such approval, which allowed it to contribute stock of a subsidiary airline into its pension plans. The Department of Labor gave approval only after an independent fiduciary was appointed to ensure that the transaction truly was in the employees’ and retirees’ best interests. The agency also held public hearings on the issue before approving the transaction (Grow and Chandler 2003, 1). Continental Airlines made similar in-kind contributions to its pension plans, using stock belonging to its formerly wholly-owned subsidiary, ExpressJet. Thus, for companies that are truly committed to keeping the promises they make, the law does allow for some flexibility for plan sponsors in meeting funding obligations and offers avenues for relief.

Last year, Congress became convinced that this existing relief was not enough. In April 2004, it passed the Pension Funding Equity Act to provide temporary interest rate relief for all plan sponsors, which reduced the value of plans’ liabilities and thus reduced measured underfunding. Congress also saw fit to provide additional assistance for airlines and steel companies, who were relieved of 80 percent of deficit reduction contributions for a period of two years (Shannon 2004). But, even this help was not enough to keep some large, underfunded plans from terminating.

Companies that are motivated to stay out of bankruptcy will generally do what they can to take advantage of relief that law provides. They will make their pension payments because they have to; if they fail to do so, they will be in violation of ERISA and IRC. All that changes when a company files for protection from its creditors under Chapter 11 of the bankruptcy code. Bankruptcy laws do little to assist in preserving benefit security. Rather, they afford companies the opportunity to shed their pension obligations, with retirees and PBGC paying the price. For a company in bankruptcy, a wholesale abandonment of pension plans can be a windfall to creditors and provide a company with a substantial edge over competitors. Often, companies in bankruptcy ignore the pension funding rules. They will make only partial payments to their plans, or they may stop payments altogether, as United Airlines did in July 2004 (Maynard 2004, C1). Normally, if a plan sponsor failed to make the legally required minimum funding payments to its pension plan, under its authority to enforce plan funding rules, PBGC would move to attach a lien to the company's assets for the amount of the missed funding; however, because assets of a debtor in reorganization are protected by the bankruptcy code's "automatic stay" provisions, PBGC's enforcement tools are basically without any teeth. Reorganization in bankruptcy presents companies with a very tempting opportunity to shed pension obligations for another reason as well. An employer can petition a bankruptcy judge to reject the collective bargaining agreement in its entirety if the union does not accede to its demands. This was vividly illustrated by the January 7, 2005, decision by Judge Stephen Mitchell in the US Airways case, which rejected the IAM contracts at that carrier (Choe and Mecia 2005).

Even for bankrupt companies that are in good faith trying to support their pension plans, there may be a conflict between the goals of ERISA (which is designed to get underfunded plans back to fully funded status quickly) and the economic realities facing a plan sponsor in reorganization, which legitimately may not be able to generate the cash flows immediately upon exit to meet the plans' funding requirements, especially in light of the accelerated payments due under the DRC rules. Either way, the recent pattern of airline pension plan terminations has been troubling.

Since September 11, 2001, the first large airline plan termination was that of the plan covering US Airways pilots. During US Airways' first bankruptcy, PBGC determined that US Airways would not be able to support the plan and successfully reorganize and therefore agreed to allow the company to terminate the plan. More recently, in December 2004, PBGC reached the same conclusion with respect to the company's other pension plans, those covering flight attendants, mechanics, and other employees, during the company's second bankruptcy case in as many years. All told, the US Airways pension plan terminations will leave the pension insurance agency with claims of $3 billion (PBGC 2005).

In December 2004, PBGC moved to terminate the pension plan covering pilots at United Airlines (Crenshaw 2004). The fate of the pension plans covering other United employees has not been definitively determined as of this writing, although United has petition the judge in that case to reject the collective bargaining agreements of any union that does not agree to allow its pension plan to be terminated. Should PBGC end up with the remaining United plans, many observers believe there is a very high likelihood that other airlines will file for bankruptcy in a competitive race to the bottom to shed their pension liabilities as well. Because deregulation, cut-throat, deflationary pricing in the airline industry has driven competitors to match cost cutting move for move, with employees and retirees at the bottom of the food chain (Roach and Almeida 2005). But the potential for pension plan terminations at US Airways and United to unleash an avalanche of unfunded pension liability onto the PBGC has many in Washington highly concerned that the effects would reach far beyond the airline industry. According to a recent report by the Congressional Research Service, if PBGC assumed the pension liabilities of just two major carriers, United and Delta, in addition to the US Airways liabilities it is due to take on soon, the agency's \$3.0 billion fiscal year 2004 benefit payout would increase by more than 50 percent, to \$1.7 billion a year (Ranade 2004).

What Happens Now?

The impact of mass airline pension plan terminations would be far-reaching to say the least. Tens of thousands of airline employees and retirees would experience reductions in earned, vested benefits, to the extent that these benefits exceed the maximum benefit guarantees that PBGC is allowed to pay out by statute. And even though "follow on" defined contribution pension plans might be negotiated as a replacement for the plans being terminated, these plans will inherently leave employees' retirement security exposed to more market risk. Beyond the airline industry, employees, retirees and plan sponsors would be affected if PBGC's shortfalls require (as they likely will) an increase in PBGC insurance premiums. According to one estimate, premiums would have to more than quadruple in a worst-case scenario (Elliott 2004). It is not a stretch to believe that such an event would overwhelm the pension insurance system itself, requiring a taxpayer bailout similar to the savings and loan rescue, not to mention a major public policy initiative to restore secure retirement benefits in the wake of the demise of defined-benefit plans.

In light of these developments, the effectiveness of pension funding rules has been fundamentally questioned. Also, being questioned is whether the balance of the equities in bankruptcy courts is tilted too far in favor of companies and their nonemployee creditors. It is clear that reforms are in order to prevent a wholesale collapse of the defined-benefit pension system in our country—a system upon which more than 34 million employees and retirees still rely. In approaching these reforms, there are three broad principles that should guide policy makers.

First, we need to change the rules governing pension funding to better synchronize with the business cycle. Current funding rules do not make sense, because plan sponsors often are not required to make any payments to pension plans (in fact, they may be prohibited from doing so) when times are good and profits are flush, but then face substantial payments when the economy takes a downward turn and companies can least afford to pay. The experience of highly cyclical industries, like steel and airlines, has shown the flaws in the existing system. We need to fix these.

Second, we need to change bankruptcy laws to bring balance back to the bargaining table. Negotiations cannot happen in good faith if one side is "bargaining" with the ability to appeal to a third party to simply impose their view on the other side. Although the letter of the law in sections 1113 and 1114 of the bankruptcy code requires good faith negotiations, in practice bankruptcy judges have the tendency to side with the debtor—companies are aware of this and use it to their advantage. Another problem that requires correcting is PBGC's lack of effective enforcement tools when dealing with companies in bankruptcy. PBGC needs to have the ability to enforce the funding rules with bankrupt companies and nonbankrupt companies alike.

Finally, although it is hoped that changes to the funding rules and bankruptcy laws will help avert future crises, they may not be enough to prevent pension plan terminations at companies that are at this moment moving forward in that direction, like United. Termination of the United plans is a lose-lose-lose proposition. Employees and retirees lose. PBGC loses. And all companies that pay PBGC premiums lose. If United terminations triggered a "domino effect" of other airlines rushing to dump their plans on PBGC, ultimately, the U.S. taxpayer could lose as well. To that end, it is important for public policy to encourage negotiated settlements. If all of the stakeholders in the outcome—the company, the unions, the PBGC—can come together to figure out a less drastic alternative to termination that is in the best interest of plan participants and the pension insurance system as a whole, policy makers should embrace and accommodate such an outcome.

Notes

The views presented herein are those of the author and not necessarily those of the International Association of Machinists and Aerospace Workers.

1. A plan's actuary is required to use "reasonable" assumptions in determining the value of a plan's liabilities. Although the rules are rather complex, it is sufficient to note that this valuation involves the plan's actuary determining the present value of promised benefits. The higher the discount rate used to calculate this present value, the lower the value of the liabilities. The lower the discount rate used, the higher the value of a plan's liabilities.

2. Just as the funding regulations govern the minimum amount a plan sponsor must contribute to a pension plan in a given year, there are also rules restricting the maximum deductible amounts that may be contributed to a plan. (See Krass 2004, sects. 12-18, 12-21.)

3. One way to illustrate the troubling nature of the DRC is by comparing it to a "balloon payment" that would be due immediately on a mortgage if the value of a home dropped by, for example, 20 percent. It is clear that a household facing mortgage terms such as this could quickly find itself insolvent.

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