

Is Your Pension in Jeopardy?

Learn about Proposed Changes that Could Affect Your Retirement

The events of the past two years have had a dramatic effect on the financial condition of the airline industry. For those of us employed by airlines or airline-related companies, the present condition and future prospects of the industry are personal and pressing concerns.

Among the most significant of these concerns are the condition of our pension plans and retirement security. This "Pension Primer" addresses these concerns.

Defined benefit pension plans, which have been negotiated as part of airline employee contracts and provide those workers with a modest pension for a secure retirement at most major carriers, are under attack by airline management. Management says the plans are too costly and are underfunded.

Often companies, the press, and government officials point to defined benefit pension plans as the main cause of the pension funding problem. Our pension plans are made out to be the villain, and suggestions abound that the only way for the industry again to be profitable is to terminate costly pension plans and reduce other benefits.

It is important for airline workers to educate themselves about pension basics, to learn the true facts surrounding the current situation, and to share this information and their views with their representatives in Congress.

A goal of this "Pension Primer" is to help you accomplish that.

We will give you some basic information about pension plans and pension law, answer some common questions about your pension benefits, explain some of the reasons for the current situation, and, particularly for our members at United and US Airways, explore what could happen when a pension plan terminates and is taken over by the Pension Benefit Guaranty Corporation.

Pension Plans

There are two types of pension plans: defined benefit plans and defined contribution plans.

Defined benefit plans are plans that promise participants a level of retirement income that is determined according to a formula. The formula might be based on years of service and a final average salary, for example.

Under a defined benefit plan, an employee can determine what his or her expected monthly pension benefit will be by putting his or her individual information, such as actual years of service and actual final average salary, into the formula. This amount is promised to the employee by the company. The risk of investment loss is on the company.

Defined contribution plans, or individual account plans, do not promise a specific level of retirement income. Rather, each participant has an account in the plan to which employer contributions are allocated. These plans are generally the only type of retirement plan provided for at smaller major, national and regional carriers.

A defined contribution plan participant's retirement benefit is the value of this account at retirement. This will be determined mainly by the history of salary deferral contributions from the employee, and possibly a matching contribution from the employer, and the investment experience of the monies contributed.

In a defined contribution plan, the employer is not promising that a participant's account will have enough money to fund any specific benefit level. The employer's only obligation is to make the promised contributions, if any. The risk of investment losses is on the employee.

The precarious nature of defined contribution plans was dramatically illustrated by the Enron failure. There were many stories reported of employees who had hundreds of thousands of dollars in their 401(k) accounts¹ before the collapse, but next to nothing after the collapse.² Enron represents the extreme case, but it illustrates dramatically the reality of the risk of investment loss.

Is There a Pension Funding Crisis Now?

You may be surprised to know that there are differences of opinion about whether we really are in a defined benefit pension plan crisis now. Janice M. Gregory, vice president of the ERISA³ Industry Committee, a group that lobbies for large corporations on pensions and other issues regarding employee benefits, is quoted in *The New York Times* as saying, "There is no crisis whatsoever." She attributes the current situation to the fact that interest rates are so low right now. Her group and many other large companies are taking the position that the problem will correct itself when interest rates rise.⁴

¹401(k) plans are popular defined contribution plans. The name comes from the section of the Internal Revenue Code of 1986 (the "Code") that authorizes these pension plan accounts. Section 401(k) is entitled: "Cash or Deferred Arrangements".

²One of the problems with Enron 401(k) accounts was that the employer contributions were made with Enron stock. When the stock price fell precipitously, the value of participants' accounts plummeted as well. The Enron plan also prohibited participants from selling the Enron stock and diversifying their account holdings. The latter problem has been addressed in legislation post-Enron.

³ERISA stands for Employee Retirement Income Security Act of 1974, as amended. ERISA is the law of employee benefit plans and is the source of the funding and contribution rules that are at the center of the current defined benefit pension plan situation.

⁴Mary Williams Walsh, *\$8 Billion Surplus Withers at Agency Insuring Pensions*, New York Times, January 25, 2003.

Although other analysts and commentators are not as sanguine as Ms. Gregory, there is agreement on the significance of two factors that are at the root of the present problem -- the so-called "perfect storm".⁵

The first factor is a 40-year low interest rate that, when used in the formula to calculate a company's pension liabilities, ratchets up liabilities and requires the company to contribute significantly more to the plan.

This interest rate has an inverse relationship to pension liabilities — the lower the rate used, the higher the present value of future pension liabilities will be. Falling interest rates make future pension liabilities look bigger on company balance sheets.

When this happens, to stay in compliance with ERISA, companies are forced to set aside more money to contribute to their pension plans. IBM put almost \$4 billion into its pension plans in December 2002, and although its contribution is among the largest, other large companies have had to contribute hundreds of millions of dollars in the past few months.⁶

The second factor of the "perfect storm" is a precipitously declining stock market that has ravaged pension fund asset values.

These factors are threatening all but the most over-funded defined benefit pension plans — not just those in the airline industry.

According to a recent Merrill Lynch study, the average pension of a Standard & Poor's 500 company could be underfunded by about \$323 million at the end of 2002, a dramatic change from being over-funded by about \$500 million at the end of 2001.⁷

The Uncertain Future of Defined Benefit Plans

Corporate executives are attempting to use this "perfect storm" to create uncertainty about the viability of defined benefit plans in the future. That puts the retirement security of hundreds of thousands of airline employees at risk.

⁵Charles Ruffel and Nevin Adams, *The Perfect Storm -- America's Pension Funding Crisis*, PlanSponsor.com, 11.02, p. 92-96.

⁶Honeywell International reported in November that it might have to contribute as much as \$900 million more to its pension plans; likewise, Johnson & Johnson (\$750 million), 3M (\$789 million), and Ford (\$500 million, with another \$500 million possible depending on tax considerations). Mary Williams Walsh, *Companies Fight Shortfalls in Pension Funds*, New York Times, January 13, 2003.

⁷Ruffel and Adams, *Op.Cit.*, p. 96

The current situation calls into question some of the funding and contribution rules presently applicable to these plans. Also, some in industry and government who are hostile to the idea of defined benefit plans are reacting to the current situation by calling for an end to this type of guaranteed retirement income benefit.

“This is the death knell for many defined benefit plans,” says Tom Healy, Senior Fellow at Harvard’s Kennedy School of Government and an advisory director at Goldman Sachs. “CFOs are going to more aggressively seek to reduce their exposure to this type of liability and hand it off to employees.”⁸

We believe that defined benefit plans can and should survive and that there are reasonable means that Congress, federal agencies, and companies can take to insure that they do.

First, we must stress that almost all defined benefit plans, including the plans of United and US Airways, do have enough assets to continue paying current obligations for many, many years to come. The present problems are almost entirely the result of the twin factors of historically low interest rates and the sharp decline in the stock market over the past two years.

This is not to say that defined benefit plans are not expensive and that many companies would not like to be freed from this expense. Defined benefit plans are an expensive benefit, but they are one that AFA believes is vital to the retirement security of its members.

AFA is actively involved with the AFL-CIO’s Pension Working Group (the “Working Group”) to coordinate the efforts of all workers in protecting these important retirement benefits. The Working Group is composed of representatives of many unions and plans — multi-employer plans, Electrical Workers, Auto Workers, Teamsters, Communications Workers, and Air Line Pilots, to name a few.

The Working Group is formulating a plan to preserve defined benefit plans and to help companies weather the present funding and contribution storm. Together, we are working to forestall any precipitous changes in pension law or regulations that would significantly affect the continued existence of defined benefit plans.

The Working Group is exploring ideas like establishing a moratorium on certain contributions, such as the Deficit Reduction Contribution, that ERISA requires under certain pension funding formulas. A moratorium would allow companies some breathing room and allow Congress and federal agencies time to formulate considered and reasonable rules for the future.

It could be that the mere passage of time, if during that time there is recovery in the stock market and an increase in the interest rate used to calculate pension liabilities, would correct most of the pension woes we are seeing now.

⁸*Ibid.*

One analyst reports that a 50 basis point (one half of one percent) decrease in the discount rate used by airlines would increase the airline sector's total pension obligations by approximately \$2.1 billion.⁹

The converse also is true. An increase in the interest rate used to calculate present pension liability would reduce these obligations just as dramatically.

Other recommendations under consideration are quite technical, but all are designed to preserve and strengthen the important retirement security benefit of defined benefit plans now and for the future.

Another assault on defined benefit plans as we have known them is the conversion of traditional defined benefit plans to so-called "cash balance" plans. Delta Air Lines recently converted its pension plan for non-union employees to a cash balance plan.

Cash Balance Plans and the Older Worker

Many companies have converted their traditional defined benefit plans to cash balance plans, and many more companies would like to convert their plans. The concern about conversion to a cash balance plan is that the older worker will be adversely affected and will receive less of a retirement benefit than he or she otherwise would receive under the traditional defined benefit plan.¹⁰

A cash balance plan is a type of defined benefit plan. Typically, a defined benefit plan provides a determined monthly retirement payment for life based on a formula stated in the plan. Usually the formula is based on a percentage of salary or an average of several years' salary multiplied by years of service.

For example, a formula might state that a retiree will receive 1.5 percent of her final salary times years of service. Under this formula, a retiring flight attendant with 20 years of

⁹Fitch Ratings, *Rapid Descent: Pensions in the U.S. Airline Industry*, www.fitchratings.com, p. 4. The discount rate is the rate used to discount future pension obligations to determine pension benefit obligations ("PBO"). (PBOs are used in the funding and contribution formulas required by ERISA.) As a result, the discount rate plays a significant role in both the funded status and pension expense (an increase in the obligation results in higher interest expense). From 1999 to 2001, the average discount rate used by the airlines dropped from 8.11% to 7.5%. Fitch estimates that approximately \$3 billion of the \$10 billion increase in airline sector pension benefit obligations was due to decreases in the discount rate.

¹⁰See generally, Elliott, Kenneth R. and Moore, James H., Jr., *Cash Balance Pension Plans: The New Wave*, Compensation and Working Conditions, Summer 2000.

service would receive 30 percent of her final salary in monthly retirement benefits at age 65. All monies in the plan are paid by the employer.¹¹

Under a cash balance plan, the employer also makes all the contributions. The amount that will be paid to the worker on retirement is not a determinable sum based on a formula. Rather, the amount will depend on how much the employer contributes to the plan every year and the rate of return on the account.

In this regard, a cash balance plan is similar to a 401(k). A cash balance plan is portable, allowing workers to cart their pension accounts from one employer to another.¹²

Although there are some surface similarities between a cash balance plan and a 401(k) plan, there are several important differences.¹³ A cash balance plan is a type of defined benefit plan. A 401(k) plan is a type of defined contribution plan. For the cash balance plan, the investment decisions and risks associated with those decisions are on the employer.

Even though the benefits under a cash balance plan are described in terms of an “individual account,” that is an accounting fiction. There really is no individual account, all plan assets are managed, in the aggregate, by a trustee.

A cash balance plan is covered by the Pension Benefit Guaranty Corporation insurance program, which is described in more detail below; 401(k) plans are not covered by the insurance program. Another difference is that cash balance plans must offer participants the ability, within the plan, to convert their account balances to lifetime annuities at no additional cost.¹⁴

The controversy about cash balance plans is that future benefits are reduced for many workers, especially older workers. Over the last ten years, about 700 companies have converted their traditional pension plans to cash balance plans.

Experts report that most of these conversions have drastically reduced future benefits. Representative George Miller (D-Calif.), a critic of conversions to cash balance plans that reduce the retirement benefits of older workers, estimates that about 8 million current and retired workers have lost about \$334 billion in promised benefits.¹⁵ This is because cash balance plans

¹¹Kristof, Kathy, *Return Eyed for Criticized Pension Plan*, Miami Herald, December 22, 2002.

¹²*Ibid.*

¹³ Elliott and Moore, p. 4.

¹⁴*Ibid.*

¹⁵Kristof, Kathy, Miami Herald, *Return Eyed for Criticized Pension Plan*, December 22, 2002.

are based on average career earnings, not the average of an employee's highest salary over three or five years that is typical of the benefit formula for a defined benefit plan.¹⁶

Currently, there are proposed Treasury regulations that would allow companies to convert traditional defined benefit plans to cash balance plans provided that current workers start out with at least the present value of their benefits under the former plan. Future earnings are based on the new formula.

"Anybody with around 12 or more years of service with the company [is] going to get the short end," says John Holz, deputy director of the Pension Rights Center ("PRC"), a Washington-based advocacy group for workers and retirees. "They could lose as much as half the benefits they were originally promised."¹⁷

This hits older workers the hardest because they can no longer count on receiving their promised benefits and are too old to save enough on their own to make up the difference, said Karen Ferguson, Director of the PRC.¹⁸

Federal pension law prohibits companies from taking away retirement benefits that have already been earned. The problem is that cash balance plans often stop older workers from accruing any additional benefits after the conversion.

For example, assume that the conversion from a defined benefit plan to a cash balance plan occurred when a worker was 50 years old. At the time of the conversion, the worker would be allocated a benefit equal to the present value of his future pension at age 50. It is quite possible though, that the same worker could work for 15 more years without getting any additional retirement benefit. Younger workers, meanwhile, would continue to accrue benefits.¹⁹

This period of time during which older workers accrue no additional retirement benefit is called the "wear-away" period. Many workers at companies that converted their traditional pension plans to cash balance plans sued the companies, claiming age discrimination because of the wear-away period.

During the Clinton administration, the IRS imposed a moratorium on approving new cash balance plans. On December 10, 2002, the Treasury Department and the IRS issued proposed regulations on cash balance plans addressing the application of pension age discrimination rules to cash balance plans and conversions.

¹⁶Branch-Brioso, Karen, St. Louis Post-Dispatch, *Longtime Employees Are Eyeing Treasury's New Pension Rules*, February 1, 2003.

¹⁷ *Ibid.*

¹⁸Kristof, *Op.Cit.*

¹⁹*Ibid.*

Essentially, the proposed regulations would allow conversions to cash balance plans and provide that, if the regulations are followed, any “wear-away” period during which older workers do not accrue any additional retirement benefit is not a violation of age discrimination laws.

It may be that companies converting to cash balance plans will fashion transition rules that will minimize the effects of “wear-away,” but that is not required by the proposed regulations.

There is a comment period on the proposed regulations that closes on March 13, 2003. AFA intends to send its comments opposing the proposed regulations to the IRS and join with Representative Miller and others who oppose these regulations.

Plan Termination and The Pension Benefit Guaranty Corporation

The Pension Benefit Guaranty Corporation (“PBGC”) is a federal corporation created under ERISA. The PBGC’s role is to carry out the purposes of Title IV of ERISA. Those purposes are:

- encouraging the continuation and maintenance of defined benefit pension plans;
- providing for the uninterrupted payment of benefits to participants and beneficiaries in covered plans; and
- maintaining premiums at the lowest level consistent with the fulfillment of PBGC obligations.²⁰

The PBGC currently guarantees payment of basic pension benefits earned by about 44 million American workers and retirees participating in over 35,000 private-sector defined benefit pension plans. The PBGC receives no funds from general tax revenues. Its operations are financed by insurance premiums paid by companies that sponsor pension plans, plan assets of pension plans that PBGC takes over, and by PBGC’s investment returns.²¹

The main activities of the PBGC are regulating and overseeing the termination of plans covered by Title IV of ERISA and administering the program of termination insurance.²²

²⁰Conison, Jay, *Employee Benefit Plans, 2nd Ed.*, West Group, 1998, p. 426.

²¹PBGC Press Release, December 16, 2002, *PBGC to Protect Pensions of 95,000 at Bethlehem Steel*, http://www.pbgc.gov/news/press_releases/2002/pr03_09.htm

²² Title IV covers only pension plans and only those plans that, in fact, have operated as qualified plans for at least five years or that have received a favorable determination letter from the IRS. ERISA §4021(b). More specifically, Title IV covers only single employer and multi-employer plans. Title IV does not cover defined contribution plans. *Ibid.*

Defined benefit plans are covered under Title IV. Defined contribution plans such as 401(k) and profit sharing plans are not covered.

The Title IV benefit guarantee program is called “plan termination insurance.” If the defined benefit plan of any airline is terminated, in the course of bankruptcy proceedings or otherwise, this plan termination insurance would apply. The PBGC would guarantee and actually pay nonforfeitable pension benefits in terminated, underfunded single employer plans, up to a prescribed limit.²³

Under federal pension law, when there are insufficient plan assets to fund the entire pension benefit originally promised, there is a maximum amount that each worker can be paid by PBGC. The maximum pension guaranteed for workers in plans that terminate in 2003 is \$3,664.77 a month (or \$43,977.24 a year) for persons retiring at age 65. This maximum guarantee is adjusted for those who elect to retire at ages younger than 65 or who elect survivor benefits.²⁴

The PBGC guarantees “basic benefits.” Basic benefits include:

- pension benefits at normal retirement age;
- most early retirement benefits;
- disability benefits for disabilities that occurred before the plan was terminated (for terminations starting after December 7, 1994, the reduced maximum guarantee for ages younger than 65 does not affect the benefits received by disabled participants who receive a disability benefit from both the pension plan and Social Security); and
- certain benefits for survivors of plan participants.

The PBGC does not guarantee health care, vacation pay, or severance pay. Also, there may be limitations on benefits created or amended within five years of the plan’s termination.

There are no cost of living adjustments for payments made by the PBGC. Federal taxes are deducted. You are responsible for state taxes and any other amounts presently deducted from your pension payment.

What You Can Do

²³Conison, p. 427-428.

²⁴The information in this part is from the PBGC web site, www.pbgc.gov. PBGC is located at 1200 K Street, N.W., Suite 930, Washington, DC 20005-4026, 202-326-4000. The guaranteed monthly payments for those retiring before age 65 are: \$2,895.17 at age 62; \$2,382.10 at age 60; and \$1,649.15 at age 55. There are monthly maximums set for every year of age between age 50 and 70.

AFA opposes any actions that will undermine the continued vitality of traditional defined benefit plans. We will continue to work with others who support the rights of unionized men and women to better working conditions and benefits.

We ask you to consider doing the same -- educating yourself and others about the present and future assaults on your retirement benefits, and making your views known to those here in Washington who are in a position to stop the erosion of your rights and benefits. Keep checking the website for more information. In March, AFA will provide an easy way for flight attendants to contact their elected representatives and tell them to protect our pensions.