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PRIVATE PENSIONS

Airline Plans' Underfunding Illustrates Broader Problems with the Defined Benefit Pension System

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Highlights

Highlights of GAO-05-108T, a testimony before the Committee on Commerce, Science, and Transportation, United States Senate

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Why GAO Did This Study

At the same time that "legacy" airlines face tremendous competitive pressures that are contributing to a fundamental restructuring of the airline industry, they face the daunting task of shoring up their underfunded pension plans, which currently are underfunded by an estimated $31 billion. Terminating these pension plans confronts Congress with three policy issues. The most visible is the financial exposure of the Pension Benefit Guaranty Corporation (PBGC), the federal agency that insures private pensions. The agency's single-employer pension program already faces a deficit of an estimated $9.7 billion, and the airline plans present a potential threat to the agency's viability. Second, plan participants and beneficiaries may lose pension benefits due to limits on PBGC guarantees. Finally, airlines that terminate their plans may gain a competitive advantage because such terminations effectively lower overall labor costs.

This testimony addresses (1) the situation the airlines are facing today, (2) overall pension developments, and (3) the policy implications of addressing these issues.

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To view the full product, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512-5491 or bovbjergb@gao.gov or JayEtta Hecker at (202) 512-8984 or heckerj@gao.gov.

What GAO Found

The problems posed by the airlines' underfunded plans, while extremely serious in the short term, are only the latest symptom of the decline in the health of our nation's defined benefit (DB) pension system. These problems illustrate weaknesses in the pension system overall and demonstrate that the way plans currently fund and insure pension benefits has to change.

Underfunded pension plans are a symptom of the financial turmoil currently facing the airline industry. Industry trends, including the emergence of well-capitalized low cost airlines and other factors, have created a highly competitive environment that has been particularly challenging for the legacy airlines. Since 2000, the financial performance of legacy airlines has deteriorated significantly. Legacy airlines have collectively lost $24.3 billion over the last 3 years. Despite cost-cutting efforts, legacy airlines continue to face considerable debt and pension funding obligations. In this context, a number of legacy airlines have begun to consider terminating their DB pension plans. For example, United Airlines recently announced that it would not make roughly $500 million in contributions to its pension plans this year and US Airways announced that it does not plan to make roughly $100 million in contributions.

The problems of underfunded DB pension plans extend far beyond the airline industry. We have highlighted several problems that have contributed to the broad underfunding of DB plans generally, including airline plans. These problems include cyclical factors like the so called "perfect storm" of key economic conditions, in which declines in stock prices lowered the value of pension assets used to pay benefits, while at the same time a decline in interest rates inflated the value of pension liabilities. The combined "bottom line" result is that many plans today have insufficient resources to pay all of their future promised benefits. Other long term trends suggest more serious structural problems to the system, including a declining number of DB plans, a decline in the percentage of participants that are active (as opposed to retired) workers, and other factors. Existing pension funding rules and the current structure for paying PBGC insurance premiums have not ensured that sponsors contribute enough to their plans to pay promised benefits.

The current pension crisis facing the airline industry and PBGC, and how the Congress chooses to address that crisis, has wide-ranging implications for airlines and other industries, as well as for pension participants, PBGC, and potentially the American taxpayer. This crisis also illustrates the need for comprehensive pension reform that tackles the full range of challenges crossing all industries and not just airlines. Such a comprehensive reform would include meaningful incentives for sponsors to adequately fund their plans, provide additional transparency for participants, and ensure accountability for those firms that fail to match the benefit promises they make with the resources necessary to fulfill those promises.

Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss the serious challenges posed by those underfunded pension plans sponsored by certain companies within our nation's airline industry. Many of these so-called "legacy" carriers currently face the daunting task of shoring up their underfunded pension plans in a highly competitive marketplace, while still dealing with the after-effects of the events of September 11, 2001. The combination of several carriers facing current or potential bankruptcy, each with large underfunded pension plans, presents a threat to the Pension Benefit Guaranty Corporation (PBGC), the federal agency that insures private pension benefits, as well as to the retirement security of affected plan participants and beneficiaries. However, the problems of underfunded pension plans extend far beyond the airline industry, to steel, automotive related manufacturing and other sectors of the economy that sponsor defined benefit (DB) plans. Thus, policymakers must seek both short-term and long-term pension solutions that balance the interests of these industries' active and retired employees, customers, and stockholders, the PBGC, and American taxpayers.

In my testimony, I will address (1) the situation the airlines are facing today, (2) overall pension developments, and (3) the policy implications for addressing these issues. In short, the problems posed by the airlines' underfunded plans, while extremely serious in the short term, are only the latest symptom of the long-term decline in the health of our nation's DB pension system. The failure to act promptly and effectively to this growing challenge will likely leave us with another wave of plan terminations in other industries down the road, and possibly alter the competitive balance within the airline industry and in other industries in the future. The challenges I describe today also suggest that any effective solution be comprehensive in nature.[1] Such a solution should include meaningful incentives for adequate plan funding, enhanced transparency for participants, and strong accountability for those firms that fail to match the benefit promises they make with the resources necessary to fulfill those promises.

[1]For further information on the financial challenges facing the airline industry, see U.S. Government Accountability Office, *Commercial Aviation: Despite Industry Turmoil, Low-Cost Airlines Are Growing and Profitable*, GAO-04-837T (Washington, D.C.: June 3, 2004) and *Commercial Aviation: Legacy Airlines Must Further Reduce Costs to Restore Profitability*, GAO-04-836 (Washington, D.C.: Aug. 11, 2004).

Before I discuss the airlines more specifically, I want to briefly note the recent, serious financial challenges posed by underfunded pension plans in the airline and other industries for PBGC and the agency's role in protecting DB pension plans. PBGC's single-employer insurance program is a federal program to insure the benefits of the more than 34 million workers and retirees participating in private and not-for-profit DB pension plans.[2] While the program is intended to be self-sufficient through employer premiums and investments, over the last few years, the program's finances have taken a severe turn for the worse. In 2000, the program appeared financially healthy, with the assets exceeding the current value of its liabilities by $9.7 billion. By March 2004, however, this surplus had become a $9.7 billion accumulated deficit, largely as a result of PBGC's takeover of several large, underfunded pension plans of sponsors that had gone bankrupt. This represents a $19.4 billion reversal in PBGC's financial condition in only 3½ years. As I have noted in recent testimonies before several congressional committees, we believe the single-employer program's long-term ability to sustain itself as a self-funded entity is at risk in its present form.[3] Given the structural problems facing the agency, in July 2003, GAO placed the PBGC single-employer pension program on our "high-risk" list of troubled federal programs in need of ongoing attention by the Congress.

[2]DB pension plans promise a benefit that is generally based on an employee's salary and years of service, with the employer being responsible to fund the benefit, invest and mange plan assets, and bear the investment risk. A single-employer plan is a plan that is established and maintained by only one employer. Single-employer plans can be established unilaterally by the sponsor or through a collective bargaining agreement with a labor union.

[3]See U.S. Government Accountability Office, *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks,* GAO-04-90 (Washington, DC.: Oct. 29, 2003); *Private Pensions: Changing Funding Rules and Enhancing Incentives Can Improve Plan Funding,* GAO-04-176T (Washington, DC.: Oct. 29, 2003); *Pension Benefit Guaranty Corporation: Long-Term Financing Risks to Single-Employer Insurance Program Highlight Need for Comprehensive Reform,* GAO-04-150T (Washington, DC.: Oct. 14, 2003); *Pension Benefit Guaranty Corporation: Single-Employer Pension Insurance Program Faces Significant Long-Term Risks,* GAO-03-873T (Washington, DC.: Sept. 4, 2003).

Legacy Airlines With Underfunded Plans Face Severe Competitive Pressures

The serious underfunding of many airline company pension plans has been widely reported. Underfunded pension plans are a symptom of the financial turmoil the airline industry currently faces. Several industry trends, such as the emergence of well-capitalized low cost airlines and reliance on the Internet to distribute tickets, are fundamentally reshaping the structure of the airline industry. Certain technology trends have served to provide lower cost alternatives to travel for business purposes, such as videoconferencing and network meetings. In addition, a series of unforeseen events, such as the terrorist attacks of September 11, 2001 and the war in the Middle East, have served to sharply reduce the demand for air travel in recent years. These and other factors have combined to create a highly competitive environment, which has been particularly challenging for the legacy airlines.

As we reported in August, the financial performance and viability of legacy airlines has deteriorated significantly compared with low-cost airlines since 2000.[4] Legacy airlines have collectively lost $24.3 billion over the last 3 years, while low-cost airlines made $1.3 billion in profits. During this time Congress provided the industry approximately $8.6 billion in assistance. Airlines responded to these financial challenges by reducing costs and cutting capacity. From October 1, 2001 through December 31, 2003, the collective operating costs of legacy airlines decreased by about $12.7 billion dollars, while capacity fell 12.6 percent. Of this total, legacy airlines worked with unions to achieve $5.5 billion in labor cost cuts. Despite these cost-cutting efforts, low-cost airlines still maintain a significant unit cost advantage over legacy airlines. Legacy airlines also face considerable debt and pension funding obligations in the next few years. Meanwhile, neither legacy nor low-cost airlines have been able to significantly improve their revenues owing to continued pressure on airline fares.

In their efforts to cut costs further, despite significant rises in fuel costs, the legacy airlines have focused on labor costs, since they represent the single largest operating cost the airlines face. As part of reducing their labor costs, a number of legacy airlines have begun to consider terminating their DB pension plans, under current bankruptcy and pension laws. United Airlines recently announced that it would not make roughly $500 million in contributions to its pension plans this year. In addition, US Airways does not plan to make roughly $100 million in contributions to its

[4] GAO-04-836.

remaining pension plans, and stated it would be "irrational" to make pension contributions during its current bankruptcy court filing.

The potential termination of these underfunded pension plans confronts Congress with three key policy issues. The most visible is the financial exposure of PBGC. The agency reports that airline pensions are currently underfunded by $31 billion. This figure includes $8.3 billion of underfunding in United's plans, and $2.3 billion of underfunding for US Airways.[5] Second, thousands of plan participants and beneficiaries will lose pension benefits due to limits on PBGC guarantees and certain provisions affecting PBGC's insurance program. Finally, airlines that terminate their plans may gain a competitive advantage because such terminations effectively lower overall labor costs. Those lower costs may also permit some airlines to continue operating that might otherwise be forced to exit the marketplace.

I would like to emphasize three important facts that should put the airlines' current problems in perspective. First, this is not the first time we have witnessed the simultaneous struggles of the airline industry and airline pension underfunding. As a former Acting Executive Director of PBGC and Assistant Secretary of Labor for Pension and Welfare Benefit Programs in the 1980s, I monitored similar issues plaguing major air carriers at the time. Since then, we've seen PBGC take over a number of badly underfunded plans including Pan American, Eastern, Braniff, and TWA. More recently, in early 2003, US Airways' Pilots Plans terminated, presenting a claim of $754 million to the single-employer program. Second, the airlines' experience illustrates the speed with which a pension funding crisis can develop. In 2001, PBGC reported that as a whole the air transportation industry had more than enough assets to cover the liabilities in its pension plans. Yet just 3 years later the industry threatens to saddle PBGC with its biggest losses ever from plan terminations. Finally, serious pension underfunding is not confined to the airline industry. Of the 10 most underfunded pension plan terminations in PBGC's history, 5 have been in the steel industry, an industry that has faced extreme economic difficulty for decades. Looking ahead, in addition to airlines, automotive related firms may present the greatest ongoing risk to PBGC, with over $60 billion in underfunding as of 2003. Thus, while there

[5]These figures are calculated on a termination basis, which measures the value of accrued benefits using assumptions appropriate for a terminating plan.

are unique circumstances that have contributed to the airlines' competitive and pension troubles, they unfortunately are not alone.

Pension Problems Extend Broadly

We have highlighted several potential sources of problems in the pension system that have contributed to the broad underfunding of DB pension plans generally, including airline plans.[6] Single-employer pension plans have suffered from a so-called "perfect storm" of key economic conditions, in which declines in stock prices lowered the value of pension assets used to pay benefits, while at the same time a decline in interest rates inflated the value of pension liabilities. The combined "bottom line" result is that many plans have insufficient resources to pay all of their future promised benefits. While these cyclical factors may improve and reverse some of the pension underfunding, other trends suggest more serious structural problems to the single-employer insurance program's long-term viability. These include a declining number of DB plans, a decline in the percentage of participants that are active (as opposed to retired) workers, and a rise in alternative retirement savings vehicles, such as defined contribution (DC) plans, which provide retirement benefits with more portability but which transfer the investment risk from the employer to the employee. In addition, as the PBGC takeover of severely underfunded plans suggests, the existing pension funding rules have not ensured that sponsors contribute enough to their plans to pay all the retirement benefits promised to date.[7] Also, while the current structure of insurance premiums paid by plan sponsors to PBGC requires higher premiums from some underfunded plans, in many cases these were not enough of an incentive for firms to fund their plans sufficiently. Furthermore, certain provisions of PBGC's current guarantee and recovery provisions also need to be reviewed and possibly revised.

The current pension crisis facing the airline industry and PBGC illustrates the need for comprehensive pension reform that tackles the full range of challenges across all industries, not just airlines. Such a comprehensive reform would focus on incentives, transparency, and accountability. Reforms must include meaningful incentives for sponsors to adequately fund their plans. They must provide additional transparency for

[6] GAO-04-90.

[7] Pension funding rules include minimum funding requirements for all plans, and additional funding requirements for underfunded plans, that dictate a floor to how much a sponsor must contribute annually to its plans.

participants, and ensure accountability for those firms that fail to match the benefit promises they make with the resources necessary to fulfill them. The airline industry's funding problems also highlight the difficulties in addressing these problems during difficult economic times for an industry. These difficulties limit the feasible policy options for pension reform because many firms have fewer resources to support required plan contributions. Therefore, pension reform should attempt to improve incentives for firms to contribute more to their pension plans during good economic times, when they are more likely to be able to afford such contributions. Also, reform needs to consider the voluntary nature of pensions. After all, employers do not have to offer pensions, and reforms that may be deemed to be onerous might drive healthy plans out of the system.

Nevertheless, firms should be held accountable for paying promised pension benefits to their workers. Along these lines, reforms should reconsider PBGC's current premium rate structure to take into account the plan sponsor's financial condition, the nature of the pension plan's investment portfolio, and the structure of the plan's benefit provisions (e.g., shutdown benefits or pension offset provisions). Charging more truly "risk-related" premiums could increase PBGC's revenue while providing an incentive for plan sponsors to better fund their plans. However, significant increases in premiums that are not based on the degree of risk posed by different plans may force financially healthy companies out of the defined-benefit system and discourage other plan sponsors from entering the system.

Pension Policy Issues Have Broad Implications

The rules of the current pension system, and any attempts to reform these rules, carry wide-ranging implications for airlines and other industries, as well as pension participants and beneficiaries, the PBGC, and potentially the American taxpayer. When PBGC takes over a pension plan from a bankrupt sponsor, participants can lose some of their promised pension benefits because PBGC guarantees may be capped. For 2004, PBGC pays a maximum monthly benefit of about $3,700 to a 65-year old pension participant; for younger participants, the guarantee declines, such that a 55-year old is guaranteed only $1,664 monthly. In addition, recent benefit increases and early retirement subsidies can also be reduced based on PBGC's guarantee structure. For the agency itself, continued takeovers of severely underfunded plans make the eventual bankruptcy of PBGC an increasingly likely scenario. In the event that PBGC has insufficient funds to pay the benefits of plans it has taken over, it has the ability to borrow $100 million from the U.S. Treasury. This amount represents only a small fraction of the single-employer program's $9.7 billion deficit as of March 2004. Congress would likely face enormous pressure to "bail out" the PBGC at taxpayer expense. If Congress decided not to fund a bailout of PBGC, pension participants and retirees would likely face drastic cuts in their pension benefits.

Congress should consider the incentives that pension rules and reform may have on other financial decisions within affected industries. For example, under current conditions, the presence of PBGC insurance may create certain "moral hazard" incentives—struggling plan sponsors may place other financial priorities above "funding up" its pension plan because they know PBGC will pay guaranteed benefits. Firms may even have an incentive to seek Chapter 11 bankruptcy in order to escape their pension obligations. As a result, once a sponsor with an underfunded pension plan gets into financial trouble, existing incentives may exacerbate the funding shortfall for PBGC.

This moral hazard effect has the potential to escalate, with the initial bankruptcy of firms with underfunded plans creating a vicious cycle of bankruptcies and plan terminations. Firms with onerous pension obligations and strained finances could see PBGC as a means of shedding these liabilities, thereby providing them with a competitive advantage over other firms that deliver on their pension commitments. This would also potentially subject PBGC to a series of terminations of underfunded plans in the same industry, as we have already seen with the steel and airline industries in the past 20 years.

Overall, despite a series of reforms over the years, current pension funding and insurance laws create incentives for financially troubled firms to use PBGC in ways that Congress did not intend when it formed the agency in 1974. PBGC was established to pay the pension benefits of participants in the event that an employer could not. As pension policy has developed, however, firms with underfunded pension plans may come to view PBGC coverage as a fallback or "put option" for financial assistance. Further, because PBGC generally takes over underfunded plans of bankrupt companies, PBGC insurance may create an additional incentive for troubled firms to seek bankruptcy protection, which in turn may affect the competitive balance within an industry. This should not be the role for the pension insurance system.

Certain rules that affect funding for underfunded plans of troubled sponsors can also create perverse incentives for employees that aggravate a plan's underfunding. To the extent that participants believe that the

PBGC guarantee may not cover their full benefits, many eligible participants may elect to retire and take all or part of their benefits in a lump sum rather than as lifetime annuity payments in order to maximize the value of their accrued benefits. In some cases, this may create a "run on the bank," exacerbating the possibility of the plan's insolvency as assets are liquidated more quickly than expected, and potentially leaving fewer assets to pay benefits for other participants. As previously noted, it can also create incentives for workers to retire prematurely, creating potential labor shortages in key occupations for the firm. We have seen aspects of these effects in some airline pilots' reaction to the deteriorating financial condition of their employers and pension plans.

Further, current rules may create an incentive for financially troubled sponsors to increase benefits, even if they have insufficient funding to pay current benefit levels.[8] Currently, sponsors can increase plan benefits for underfunded plans, even in some cases where the plans are less than 60 percent funded. Thus, sponsors and employees that agree to benefit increases from an underfunded plan as a sponsor is approaching bankruptcy can essentially transfer this additional liability to PBGC, potentially exacerbating the agency's financial condition. These represent just a few of the many issues that deserve the attention of the Congress. We have and will continue to perform work in this area in an effort to assist the Congress.

The current problems plaguing many pensions in the airline industry should be seen as symptomatic for the pension system overall and should demonstrate that the way we currently fund and insure pension benefits has to change. Ignoring this warning would serve to adversely affect employers who continue to sponsor DB plans, workers and retirees who depend on those pension plans, and American taxpayers who may be asked to pay for these benefits in the future.

Finally, the tragic events of September 11, 2001 combined with other factors are not only having an adverse affect on the financial condition of the airline industry, they are also affecting the financial condition of the Federal Aviation Administration's Airport and Airway Trust Fund. This is a

[8] Currently, some measures exist to limit the losses incurred by PBGC from newly terminated plans. PBGC is responsible for only a portion of all benefit increases that the sponsor adds in the 5 years leading up to termination.

matter beyond the scope of this hearing that the Committee may want to address in the future.

I would be happy to take any questions the Committee might have.

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