THE BROKEN PROMISE OF PENSION FUNDS

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ABSTRACT

It's 2007, do you know where our pension is? It was part of the American Dream, a pledge made by corporations to their workers for their decades of hard work, that they would be assured of retirement benefits such as pension and health care. Now more and more companies are rescinding their promise, leaving millions of Americans at risk. Unfortunately, many companies have already been struggling with underfunding their employees' pension funds and as a result many employees are losing their pensions. The Pension Protection Act of 2006 was passed by Congress and signed by President Bush with a broad overhaul of rules. The Law gives private companies seven years to shore up funding of their traditional pensions. Special rules for seriously underfunded companies require them to pay higher premiums to eliminate their shortfall. A gradual disappearance of pensions is occurring in favor of saving accounts such as 401(k)s that require workers create their own retirement plans.

INTRODUCTION

Pensions and health care benefits were a part of the American dream. A guarantee was made to American workers by corporations that their retirement benefits would be available for them to enjoy a financially secure future when they retire. Now many companies are reducing or eliminating programs leaving millions of American workers at risk financially. Since the United States Bankruptcy Court in 2005 approved United Airlines' request to terminate its employees' pension plans, the once secure road to retirement took a turn for the worst (Randall, 2002). This is not the first time pension plans have been in the spotlight; years ago the Steel industry cut benefits as a way to avoid bankruptcy. It is apparent that the auto industry is following the same route. In 2005 United Airlines was the largest pension default in airline history (Randall, 2002). It indicated the possible formation of a future trend towards ending employer support for retirement pensions. Corporations that have formed in recent years including Google, JetBlue, Microsoft, Dell, and Starbucks have elected to never offer traditional pension plans (Colvin, 2006). Other companies such as IBM, Motorola, Sears, Hewlett-Packard, and Verizon have frozen all pension plans ending the security of a lifetime pension to their employees (Walsh, 2006).

The consequences of pension plan ending are beneficial to corporations so that they can earn a profit. However, without pensions the American worker is forced to provide their own resources for retirement. With a growing elder population and decreased access to healthcare for senior citizens retired workers no longer have the luxury of having an income from pension and healthcare coverage.

HISTORY AND THE RECORD OF FAILURE

After the Civil War, the federal government formulated the first large pension plan. It included both Union Army war veterans and war widows (Lowenstein, 2005). In 1890 Congress approved a plan to extend pensions to include all veterans 65 or over. States and cities followed giving pensions to police officers and firefighters (Lowenstein, 2005).

By World War I teachers were given pensions as well. A form of social welfare, Governments were able to offer stability through pensions while keeping salaries low. The first private company pension was offered in 1875 by American Express, a stagecoach delivery service (Lowenstein, 2005). Soon after

railroads followed instituting pension plans. To qualify, workers were required to complete thirty years of work in order to collect a pension (Lowenstein, 2005). Management regarded pensions as a tool to retain workers rather than an employee benefit.

World War II provided an opportunity to further encourage pensions. Combined with the creation of tax plans pensions became an attractive way to limit taxation. The overall effect presented a tremendous opportunity for unions to force employers to give pensions to their workers.

Back in the 1940's, Alfred P. Sloan, Jr. of General Motors, warned that pensions and other benefits would be extravagant beyond reason for the auto industry to provide (Lowenstein, 2005). Nevertheless, John L Lewis, the well known labor leader, led a strike and won a pension for miners. In 1949, Ford Motor Company surrendered to the demands of the United Auto Workers UAW union by granting pensions to workers. In 1950 a reluctant Alfred P. Sloan, Jr. allowed the creation of a pension plan for General Motors (Lowenstein, 2005). A frenzied rush into the creation of plans occurred. By 1960, 40% of private sector workers were given pensions (Lowenstein, 2005).

Unfortunately, many companies have already been struggling with a big deficit in their employees' pension funds. As a result many employees are losing their pensions. The promises that have been made to them for ten, twenty, and thirty years are now being broken by some of the largest corporations. Table 1 lists the time line for bankruptcy for several major corporations that have broken their pension promises including Enron, Worldcom, Bethlehem Steel, United Airlines, Delta Airlines, Northwest Airlines, Delphi, and Dana Corporations. These underfunded pension liabilities approach $14 billion dollars from a single firm according to the Pension Benefit Guaranty Corporation (www.pbgc.gov, 2006).

Table 1: Timeline of Bankruptcy of Major Corporations

Firm	Bankruptcy Date
Bethlehem Steel	10/15/01
Enron	12/02/01
Worldcom	7/21/02
United Airlines	12/09/02
Delta Airlines	9/14/05
Northwest Airlines	9/14/05
Delphi	10/08/05
Dana	3/03/06

Source: New Generation Research, Inc. (www.BankruptcyData.com, 2006)

The trend of filing for bankruptcy has escalated since 2001 as the airline industry suffered losses from the September 11 terrorist attacks. For example, in the attack United Airlines lost two airplanes. Enron and Worldcom were forced to file for bankruptcy after their accounting scandals erupted. Declining car sales have caused Dana Corporation and Delphi Corporation to suffer. The underfunding of pensions is tied to the downfall of the stock market beginning in 2000, lower interest rates, and insufficient funding of post retirement benefits.

PBGC PENSION BENEFIT GUARANTY CORPORATION

The Pension Benefit Guaranty Corporation, PBGC created under ERISA, guarantees payment of basic pension benefits to millions of American workers and retirees participating in private sector defined benefit plans (Enzi, 2006). The agency receives no funds from general tax revenues. Operations are financed largely by insurance premiums paid by companies that sponsor pension plans and PBGC investment returns (Government Media News Archive, 2002). Until 2001 PBGC had a surplus and was able to cover any deficiency in underfunded plans. Combined with a lack of fully funding post retirement benefits by employers, the value of fund assets fell below liabilities resulting in underfunding of pension

and post retirement benefit plans. Presently PBGC has an estimated $23 to $30 billion deficit (Baker, 2006). PBGC has experienced huge deficits caused by the default in recent years by several large defined benefit pension plans and the fall in values of investment returns on PBGC plan assets

Table 2: Top Ten Firms Presenting Claims against the PBGC for Single Employer Program (1975-2005)

Firm	Number of Plans	Fiscal Year(s) of Plan Termination(s)	Claims (by firm)	Vested Participants	Average Claim Per Vested Participation	Percent of Total Claims (1975-2005)
United Airlines	4	2005	$7,093,803,951	122,541	$57,889	22.7%
Bethlehem Steel	1	2003	$3,654,380,116	97,015	$37,668	11.5%
US Airways	4	2003, 2005	$2,861,901,511	58,823	$48.653	9.0%
LTV Steel*	6	2002, 2003, 2004	$1,959,679,993	80,961	$24,205	6.2%
National Steel	7	2003	$1,161,019,567	35,404	$32,793	3.7%
Pan American Air	3	1991, 1992	$841,082,434	37,485	$22,438	2.7%
Weirton Steel	1	2004	$690,181,783	9,196	$75,052	2.2%
Trans World Airlines	2	2001	$668,377,105	34,257	$19,511	2.1%
Kemper Insurance	2	2005	$566,128,387	12,221	$46,324	1.8%
Kaiser Aluminum	3	2004	$565,812,015	17,591	$32,165	1.8%
Top Ten Total	33		$20,062,366,861	505,494	$39,686	63.3%
All Other Total	3,552		$11,646,148,178	1,178,762	$9,880	36.7%
Total	3,585		$31,708,515,039	1,684,256	$18,826	100.0%

*This table shows the Top Ten Firms Presenting Claims against the PBGC for Single Employer Program, (1975-2005). Sources: PBGC Fiscal Year Closing File (9/30/05), PBGC Case Administration System and PBGC Participant System (PRISM). Due to rounding of individual items, percentages may not add up to 100%. Data in this table have been calculated on a firm basis and include all plans of each firm. Values and distributions are subject to change as PBCG conducts its reviews and establishes termination dates. * Does not include 1986 termination of a Republic Steel plan sponsored by the LTV.*

With the threat of financial insolvency of the PBGC, Congress had little choice but to step in and arrange a financial bailout of the agency. Several years of falling interest rates and declining stock prices and the termination of several large unfunded pension plans lead to a rapid deterioration of the PBGC 's financial position. Table 2 lists the 10 largest claims filed with the PBGC. Nine of the ten largest pension plan claims occurred between 2001-2005. The airline and steel industries account for eight of the ten highest claims.

Weaknesses in Pension Law Requirements

The primary weaknesses of the former pension law requirements are (Congressional Research Service 2006): 1) The sponsors or firms participating in underfunded plans were not required to make additional contributions if their plans were at least 90 per cent funded, 2) Interest rates used to calculate pension plan liabilities were averaged over four years and asset values used to calculate minimum funding could be averaged over five years resulting in neither plan assets nor liabilities being measured accurately, 3) Underfunded plans that increased benefits under the plan could be amortized over thirty years creating shortfalls, 4) Some sponsors or firms of underfunded pensions could avoid making payments for several years because they had made contributions beyond the minimum in the past called "credit balances", 5) As the Federal Reserve reduced interest rates to low levels, equities or stock values of companies fell, PBGC investment returns also were reduced. The possibility that the termination of defined benefit pension plans with large unfunded liabilities might lead to the insolvency of PBGC created in 1974 contributed to pension reform and the enactment of the Pension Protection Act of 2006.

PENSION PROTECTION ACT OF 2006

On August 16, 2006, President Bush and Congress signed into law the most extensive revision of the nation's pension law in three decades (Baker, 2006). The new law is aimed at restoring stability to company pensions. This law is the most comprehensive reform of the U.S. pension laws since the Employment Retirement Income Security Act of 1974, ERISA, enacted over thirty years ago

(Congressional Research Service 2006). ERISA is the Employees Retirement Income Security Act of 1974. This act established the basic requirements for employee benefit plans. The authority for enforcing ERISA is divided between three federal agencies, the Internal Revenue Service, IRS, the Department of Labor, DOL, and the Pension Benefit Guaranty Corporation, PBGC.

The new law identifies troubled pension plans, helps to stabilize the plan before employers resort to bankruptcy, increases minimum funding requirements of their pension plans, and strengthens the Pension Benefit Guarantee Corporation - the pension provider of last resort. A plan is considered to be fully funded if there are enough assets to cover the liabilities of the pension plan which includes pensions and health benefits. The PPA uses the tax law allowing a higher limit on employer contributions that are deductible while requiring higher funding levels in order for sponsor or firms participating to continue a qualified plan tax status (Congressional Research Service, 2006). The law requires private sector companies to fully fund defined benefit plans over seven years (Baker, 2006). The law attempts to close loopholes by forcing companies to pay higher premiums to PBGC if underfunding occurs. Funding provisions of the new law will not take effect for two years. (Baker, 2006) The airline industry and certain government contractors were given a break by allowing extension of time for the repayment of any underfunding in their pension plans.

Along with addressing pensions, the Pension Protection Act stipulates requirements for defined contribution plans including 401K's and IRA's. It appears that the funding requirements will tend to push companies toward dropping traditional pensions in favor of employee financed 401K and IRA plans. The new law allows companies to automatically enroll workers in 401K programs which could help to increase workers savings for retirement.

What Does The Pension Protection Act of 2006 Do?

In order for a plan to be fully funded the assets must be sufficient in dollars to cover the liabilities of the plan. The PPA of 2006 makes various pension plan changes. The changes affect different types of pension plans in different ways. For example, single employer plans have different requirements than multi-employer plans.

Single Employer Plan: A single employer defined benefit plan is an employer sponsored retirement plan where employee benefits are prefunded and plan assets are held by a trustee in a fund controlled by the employer. Benefits are paid to retirees from the fund by the trustee. The employer is responsible for the investment risk.

The new Pension Protection Act of 2006 establishes new stricter funding requirements for single employer defined benefit pension plans effective January 1, 2008. Under the prior law, plans were generally funded on a 90% funding target. Under the Pension Protection Act of 2006, the funding target is increased to 100% within a seven year period to fund the targeted amount. This provision strengthens traditional pension plans by insuring that there are funds available to pay benefits as well as protect the Pension Benefit Guaranty Corporation.

Multi Employer Plans: Multi employer defined benefit plans are agreed upon plans of several employers in similar industries and usually with labor unions. These defined benefit plans are subject to funding requirements different from single employer defined benefit plans. Funding requirements for multi employer plans were established before the Pension Protection Act of 2006 was enacted. The PPA has formulated a new set of rules for improving the funding of multi employer plans that are identified as being "endangered" or "critical".(Congressional Research Services 2006). Currently any new underfunded past service liabilities are funded over a 30 year period. Beginning in 2008 the funding period will be reduced to 15 years.

Hybrid Plans: Hybrid and cash balance plans are insured by the PBGC. Rather than leave employees with no pension plan at all, some employers have been opting for hybrid or cash balance plans. These plans are part pension and part savings plans. The defined benefit pensions under single employer plans is as stated under single employer plans. The savings plan under defined contribution does not require any funding. The risk assessment remains with the employer with the employee not being at risk. No additional funding requirements are mentioned in the Act.

Defined Contribution Pension Plans

The new law addresses retirement savings in 401(K) and IRA plans. Effective immediately, federal laws preempt all state laws that prohibit automatic enrollment of employees. Risk assessment in these plans eliminates employer risk. The employee has all the risk for their Investment choices. By introducing new and improved rules and expanding benefits scheduled to expire after 2010, PPA offers improvements to encourage interest in these plans.

Highlights include: 1) Enrollment of employees in the plans is automatic. Employees must opt out in order not to participate, 2) Investment advice and personalized service are available, 3) IRA's and tax refunds can be split by the employee and directed to deposit in three bank Accounts, 4) Military and Public Service personnel of individuals called to active duty can make penalty free early withdrawals from their 401(K) or IRA's, 5) 401(K) hardship withdrawals will be allowed, 6) Non-spouse beneficiaries will be allowed tax free rollovers into IRA's by beneficiaries, 7) Direct Plan to allow Roth IRA rollovers will be available, and 8) charitable donations include tightening of rules requiring documentation and proof of items donated and the expansion of opportunities for giving.

Defined Benefit Pension And Defined Benefit Post Retirement Plans (Healthcare Etc) Single Employers

The Pension Protection Act will also require stricter funding requirements to extend to both defined benefit pension plans and defined benefit post retirement plans including healthcare. With regard to risk assessment- the employer has all the risk. The employee has no risk. Other issues include the key elements in using an actuary determination to include: 1) Employers obligation to pay retirement benefits in the future, 2) Plan assets given to a trustee by the employer from which retirement benefits will be paid in the future to retirees, 3) Periodic expense of having a pension plan and 4) As of December 15, 2006, any company with a calendar year ending December 31, 2006 or a fiscal year .ending thereafter must follow new Financial Accounting Standards Board #158 requirements to report any overfunded asset or underfunded liability in the statement of financial condition [balance sheet]. Employers obligation and plan assets have not been previously reported in the financial statements, but have been disclosed in the footnotes of the financial statements.

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

The FASB, Financial Accounting Standards Board is the independent rule making body for financial accounting that reports to the Securities and Exchange Commission. The FASB Financial Accounting Standards Board sets the US accounting rules (Chasan, 2006) is authorized to issue Statements of Financial Standards and other authoritative pronouncements representing official positions on generally accepted accounting principles (GAAP) and financial reporting requirements.

FASB has issued statement No.158 employers accounting for defined benefit pensions and other post retirement benefits amending previous statements #87,88,106, and 132R, (FASB, 2006). The rules will apply to single employer defined benefit plans and to certain not for profit organizations as well. The new rule requires a recognition on the statement of financial position (balance sheet) of an asset for a

plan's overfunded status or a liability for a plan's underfunded status (FASB, 2006). Although underfunding was previously disclosed in footnotes to financial statements, it was not fully recorded or included in the figures reported on financial statements. Now it will be required by the new FASB Financial Accounting Standard requirement No. 158 issued September 29, 2006 (FASB, 2006). The requirement will be effective for fiscal years ending after December 15, 2006 (FASB, 2006). Thus, companies following a calendar year must report the change in the 2006 financial statements (Chasan, 2006).

Analysts predict some companies will have to increase recorded liabilities greatly, and some may have shareholders equity or net worth wiped out (Chasan, 2006). Some of the biggest changes in balance sheets of companies like General Motors, Ford Motor Company, Goodyear Tire and Rubber Co., and Exxon Mobil Corporation which have some of the largest US pension and other post-retirement benefit plans is likely to occur (Chasan, 2006). The new accounting standard FASB No.158 requirements and the Pension Protection Act of 2006 are likely to result in major changes in defined benefit pension fund and post retirement accounting.

Financial Accounting Standards Board, FASB No. 158 Accounting for Defined Benefit Pension and Other Post Retirement Plans

This statement requires single employer defined benefit plans to recognize the funded status of both its benefit plans measured as the difference between plan assets at fair value and benefit obligation (liability) actuarial present value in its statement of financial position (balance sheet) as at the end of their calendar or fiscal accounting year. The example below presents how to report overfunded assets and underfunded liabilities. In the first case the fair value of the asset plans at the end of the year is 50 billion dollars minus the benefit obligation or liability of 10 billion dollar leaving an overfunded asset of 40 billion to be reported as an overfunded asset in the financial statement. In the second case the fair value of the asset plan at the end of the year is 20 billion dollars with a benefit obligation or liability of 40 billion dollars at the end of the year leaving an underfunded liability of 20 billion dollars to be reported as an underfunded liability in the financial statement. Reporting these figures in the financial statements is a new requirement of FASB No. 158 whereas these figures were previously estimated and reported as a footnote to the financial statement.

Example

Fair value of asset plans at year end	50 Billion
Benefit obligation (liability) at year end	10 Billion
Overfunded Asset	40 Billion
Reported as an asset in the financial statement	
Fair value of asset plan at year end	20 Billion
Benefit obligation (liability) at year end	40 Billion
Underfunded Liability	20 Billion
Reported as a liability in the financial statement	

Public Pension Plans

Public pension plans include state and local pension plans. These plans are not like the private sector pensions plans covered by the recently enacted Pension Protection Act of 2006. State and local plans, known as public pension plans, are facing an estimated huge funding gap of $300 billion to $700 billion (McKeon, 2006). These plans include state and local pensions. The plans are not like the private sector pension plans covered by the Pension Protection Act of 2006. The federal government is not responsible for the regulation of public pension state and local plans. The Internal Revenue Code IRC 412 H (IRS,

2006) exempts all governmental employers such as state and local Governments as defined in Internal Revenue Code IRC 414D (RSM McGladrey, 2006) from funding requirements. Pension plans of state and locals are not held to the same federal standards as private sector plans. The federal government is not responsible for the regulation of public pension state and local plans. The crisis in public pensions underfunding is real, but state and local funding is not covered or protected by the Pension Protection Act of 2006, a law enacted to protect private sector funding only. Public pensions of state and local funds are an issue that has not yet been addressed.

Ways to Improve The Pension Protection Act of 2006

The enactment of the Pension Protection Act of 2006 has not solved all the pension reform problems. Expansion of the tax saver's credit to include all qualified taxpayers is an area that should be addressed. Tax saver's credits are a deduction on the tax return after the taxpayer calculates how much federal income tax is owed. Tax saver's credits are subtracted from the amount of income tax owed to the IRS by the taxpayer.

The Tax saver's credit was due to expire under the Economic Growth Reconciliation Act of 2001 EGTRR at the end of 2006, but was made permanent by the PPA of 2006. Carrying forward, the retirement savings tax credit (also called the saver's credit) appears on Form 8880 Credit For Qualified Retirement Savings Contribution and on Form 1040 and 1040A Tax Returns for 2006. This rewards low and middle income wage earners who save for retirement. The tax law allows a qualified taxpayer to contribute up to $4000 in 2006 ($5000 if you are age 50 or older) to their IRA or 401 K accounts with a deadline of April 17, 2007 for 2006 return contributions. Of that contribution, only $2000 will count in figuring the tax saver's credit. Applying the allowable rates to the $2000, a maximum $1000 tax credit is allowed. Although allowable contributions and income levels are indexed for inflation in 2007, the result is the lower the income, the larger the tax credit allowed. Again this is of benefit to lower income taxpayers only. However, making a $2,000 contribution at a low level of income is not economically feasible. The PPA of 2006 needs to be expanded to encourage qualified taxpayers at all levels of income to invest and save by giving them a sizable tax break by increasing the tax saver's credit, increasing both contributions allowed and maximum income levels to determine eligibility.

Clearly, if pensions plans are being eliminated and 401 K's and IRA's are becoming the retirement savings plan preference, more incentives have to be made available to encourage all workers to save for retirement. It is a known fact that Americans do not save. Part time and seasonal as well as full time employees should be allowed to participate in employer sponsored retirement savings plans. Further focus of the PPA should include expanding investment education planning for workers. In order for people to successfully plan for retirement they need both education, advice and help in selecting investments.

ISSUES FOR FUTURE RESEARCH

Profit sharing is not a new idea. It has been generally unsuccessful in American Industry. The failure of profit sharing has usually been attributed to frustration and resentment when profits vary each year, fall, and often turn to losses. Also unions have historically been opposed to profit sharing plans. (Fosbre, 1984)

Generally abandoned after the Great Depression, workers feared that a promise of a bonus based on profits was in fact an excuse for a low wage; an anti union policy. As a result, when unions became strong in the manufacturing area after 1940, union leaders proposed fixed fringe benefits rather than profit sharing (Allen, 1997).

The Employment Retirement Income Security Act of 1974 passed to protect retirement plan participants included the establishment of an Employee Stock Ownership Plan. Retirement plans were simplified by the Revenue Act of 1978 which established the 401 K Retirement Plan. While each of the legislative changes addressed different levels of profit sharing plans, the general focus shifted from defined benefit to defined contribution plans (Allen, 1997).

While a great deal of attention has focused on defined benefit plans in the Pension Protection Act of 2006 and FASB #158 Accounting Requirements, it appears that a far more reaching impact will be on defined contribution plans with profit sharing and 401 K plans already in place.

Unions could well position themselves to embrace profit sharing plans as a replacement for lost pensions. By giving employees stock for outstanding profit performance companies are able to provide security to the worker so they are able to obtain the benefits of what would constitute a pension without putting a severe financing burden on the organization. A major benefit, more understandable today, is that when an employee becomes an owner of company stock, their interest in profit performance is increased dramatically. This becomes a huge benefit to both the employee and the company.

After an employee has become vested, another option is to allow diversification from company owned stocks into stocks of other companies. This would avoid the decimation of retirement accounts and avoid a situation similar to what happened in Enron’s collapse. These are some suggestions for consideration in dealing with issues on pension reform.

Starbucks is an example of a company that has never offered a pension. They have offered profit sharing as well as a retirement savings plan. This is a company that has become highly profitable and successful. Its employees are content with their benefits. These are some suggestions for various issues dealing with pension reform.

LIFE’S LESSON: SAVE, INVEST AND DEPEND ON YOURSELF

The PPA of 2006 and FASB No. 158 both recognize the evolution occurring in worker’s benefits. Corporations that have formed in recent years including Google, JetBlue, Microsoft, Dell, and Starbucks have elected to never offer traditional pension plans (Colvin, 2006). The warning that pensions and other benefits would be “extravagant beyond reason” (Lowenstein, 2005) expressed by Alfred P. Sloan, Jr., in the 1940’s has proven to be correct. Sloan’s idea reinforces the financial threat for firms with pension plans creating a competitive advantage for those firms who never offer these extravagant benefits that greatly reduce profits. In today’s society, where according to the Bureau of Labor Statistics an average American worker holds ten jobs between ages 18 and 38, (Colvin, 2006) making the concept of working for one employer for 30 years to earn a pension not realistic. The gradual disappearance of pensions in favor of 401(K)’s and IRA’s which require workers to amass their own retirement savings represents a major change in pensions and retirement benefits in the U.S. for the American worker.

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