Don't Count on That Company Pension

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By Kelly Patricia O Meara

STAN HONDA/AFP

Former Enron employees have learned firsthand the dirty little secret about underfunded defined-benefit retirement plans.

Although Federal Reserve Chairman Alan Greenspan claims the economy is a little soft, millions of employees counting on guaranteed retirement benefits, as well as shareholders looking for a substantial return on investments, might argue that it is he who has gone soft and been caught up in the economic bubble he says he couldn't predict.

At the end of last year, two-thirds of the 360 Standard & Poor (S&P) 500 companies that offer defined-benefit retirement plans reported they were underfunded by more than $300 billion. Unless the market does a speedy and significant about-face, pension deficits will continue to increase, causing serious and prolonged damage to corporate profits and cash flow, say analysts.

Corporations that offer defined-benefit retirement plans pour money into them, which then is invested to protect and increase pension assets. This works well when the market and the economy are healthy. When the economy is soft, and bubbles go undetected, the market takes a bath and profits become losses. By law, corporations committed to these programs must fund their pension plans even if it means taking other corporate assets to meet pension obligations. This avenue, of course, leaves investors very cranky, as it cuts into shareholder profits and, worse yet for the company, risks mass capital flight from the corporate stock.

Eric Fry, an investment strategist for New York-based Apogee Research and a columnist for the Daily Reckoning, tells Insight: "The fact that the vested powers that be say everything is fine means absolutely nothing. Is it fine; is it not fine? No one really knows, and all we can say is that it is dangerous." As Fry explains, "A big bull market will make all of the underfunded pension worries moot. But if the market muddles around where it is now, or goes lower, there are a number of issues to worry about."

For example, says Fry, "Take Deere & Co., the farm-equipment maker. During the fiscal year ending Oct. 31, 2001, it expected its pension plan and post-retirement benefit plans to produce investment gains of $657 million. In actuality, these plans had losses of $1.42 billion -- a difference of more than $2 billion. These latest losses bring Deere's underfunded pension liabilities to more than $3 billion. At some point Deere will have to deposit actual cash into its underfunded pension plan to make up the $3 billion shortfall. That's real money to Deere ... $3 billion represents more than five years' worth of average net income."

As Fry sees it, "Even if the world stands still, it doesn't stand still for these companies because their liabilities are increasing at a double-digit rate every single year. So they not only have to make up the pension shortfall, they also have to make up the 11 percent growth per year in the cost of taking care of their pensioners. Regardless of the market gyrations, these pension obligations are increasing every year."

Assuming that the market continues to deteriorate, and troubled corporations find themselves in bankruptcy, retirees still have some hope of a retirement benefit. After all, there is the Pension Benefit Guaranty Corp. (PBGC), created by Congress in 1974 to protect the retirement benefits of more than 44 million workers and retirees. Some 35,000 insured pension plans participate in the PBGC, paying a flat $19 per employee per year, plus additional variable rates paid by the underfunded plans. Through these premiums and fees, investment income and recovered assets from terminated plans, the PBGC has a premium revenue of $845 million as of 2001 and a surplus cushion of a little more than $4 billion.

Since 1974 nearly 624,000 retirees from nearly 3,000 terminated pension plans have received pension benefits from the PBGC. In 2001 alone, the PBGC paid $1.04 billion to retirees whose pension plans went under with the company. According to Jeffrey Speicher, a spokesman for the PBGC, "We're the insurance behind the defined-benefit programs. We step in when a pension plan is terminated and is underfunded. We typically step in after the company's bankruptcy, taking the assets of the pension plan along with the liabilities, and promise to pay the basic pension benefits up to a certain limit set by law. Typically we take over 100 plans a year."

But what if there are massive corporate problems created by continued market downturns? "The PBGC," says Speicher, "is able to meet its commitment to pay benefits for the foreseeable future. We have been running a surplus, but, even if that should go away, we have the wherewithal to meet our commitments that we were set up to pay."

Lynn Dudley, senior counsel and vice president of the American Benefits Council, seems as optimistic. "When you say that these plans are underfunded, that doesn't mean that they can't meet their current obligations. Underfunded means that corporations will have to put money into it now because in 30 years it may not be able to pay the pensions. It isn't like they can't meet their obligations today." According to Dudley, "Companies anticipate this better than they used to. They have the money. It's really just a question of what kind of hit it's going to have on their earnings and the companies' shareholders. I think people feel confident that there are some pretty tight rules to stop companies from becoming hugely underfunded without having taken action."

Fry doesn't buy it. "When PBGC says it takes over the assets of bankrupt companies, that is true to a point. But there are not nearly enough assets to satisfy the full-term pension liabilities. So it's a little bit like saying, 'Okay, I've got enough to pay my 30-year mortgage for a year before the money runs out.' Taking over the assets of defunct companies for enough money to satisfy the near term, but not enough to satisfy the full-term liability, is like the Social Security program. It's woefully underfunded, but people today are getting paid. What about the long term?"

Meanwhile, explains Fry, "while the PBGC has about a $4.8 billion surplus, it had a $9 billion surplus two years ago. So this ample surplus ... has been cut in half in the last two years, despite the fact that the wave of problems hasn't yet hit. The number of pensioners receiving benefits from them is about 270,000, but they expect that to go to 400,000 by year's end. It isn't hard to imagine what this means. If you boost the number of recipients by 50 percent, and at the old number you eroded half of the surplus in two years, how long would the alleged surplus last?"

According to the outraged Fry, "The reason the underfunded pensions are important is twofold. First, the replenishing of the pensions will drain corporate cash flow. And second, the forced ratcheting back of return assumptions will pressure reported corporate earnings. The only people who can act on this are the investors, and that's where the rubber hits the road. The folks that tell you there is nothing to worry about tend to examine the issue very narrowly. They examine it purely in terms of the pension itself, not in terms of the ancillary liabilities, like health care. In the case of Deere, the largest component of the underfunded liability is sitting over the health-care part of the pension. Most people on Wall Street exclude this analysis. Of Deere's $3 billion underfunded pension liability, $2.6 billion was in health care." Adding to the predicament is the fact that, when the PBGC takes over a pension plan, the agency does not pick up health-care benefits.

Critics agree that the biggest problem of underfunding lies in the drag it is almost certain to have on corporate profits. The estimated $300 billion in underfunding is a big number, says one analyst, "and could cause real problems for these corporations. Some companies are going to find themselves working for the pensioners rather than the stockholders." Concern is growing. The number of underfunded pension plans already is at a 10-year high, and tens of billions in corporate profits will have to be funneled back into the plans this year alone. Like Mr. Whipple in the bathroom-tissue commercials, Greenspan doesn't have to squeeze the economy to know that it is soft.

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10 Most Underfunded Single-Employer Pension Plans for 2002 (in billions)

General Motors	$97.4
Ford Motor Co.	$46.6
IBM	$25.3
SBC Communications Inc.	$19.6
Boeing Co.	$17.7

Exxon Mobil Corp.	$15.5
DuPont	$13.0
Verizon	$13.0
Lucent	$11.9
Delphi Automotive	$11.7

Top 10 Union Underfunded Pension Funds (in billions)	
Western Conf. Teamsters	$22.6
Teamster, Central States	$17.3
National Electric (IBEW)	$10.0
Operating Engineers	$6.4
Boilermaker-Blacksmith	$6.2
UMWA Health-Retirement	$6.1
1199 Health-care	$5.5
Employees	$5.2
Machinists National	$5.0
Bakery & Confectionery	$4.3
Operating Engineers (Local 3)	

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