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A Lump-Sum Threat to Pension Funds

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When the government took over the pilots' ailing pension plan at US Airways earlier this year, some of them lost thousands of dollars of benefits and the ability to take their money as a single payment.

So pilots at [Delta Air Lines](#) were already on edge about their pensions when they learned that their company was taking the precautionary step of putting aside tens of millions of dollars to fully fund a retirement trust for dozens of top executives. The Delta pilots have a pension fund, too, but theirs is now in the red.

"One of my friends called me up and said: 'We've got to think about retiring, don't we? These people could just bankrupt the company and leave us alone,'" recalled Capt. Dave Davis, who is 56.

After thinking it over, he told Delta that he would retire on Sept. 1, a little more than three years early, and take as much of his pension as possible in cash immediately.

Some pilots at American Airlines are also weighing whether to forgo the promise of larger benefits in the future to take what they can now.

"They're faced with the decision, Is it best for them to cut and run or not?" said Stan Spiewak, a financial planner in Downers Grove, Ill., who specializes in advising pilots who work for American.

Though little chronicled, a rush by individuals to pull cash out of a weakened fund represents a hidden risk to pensions. Their accelerating withdrawals can work like a bank run, draining so many assets that the plan's solvency can be threatened.

If sudden withdrawals reduce the plan's finances below a certain level, the company can be required to make large catch-up contributions in a short time. In the worst case, the plan could fail and, even with government insurance, workers and retirees could lose benefits.

This threat is increasing as plans become underfunded and more companies than in the past allow employees to be paid in a lump sum at retirement. Polaroid experienced a run on its pension fund before

the fund failed last year.

Officials of the Pension Benefit [Guaranty Corporation](#), the government agency that insures the plans, say they are monitoring the pension funds of two companies where worried employees are withdrawing their benefits, further eroding weakened plans. A spokesman for the insurance agency declined to identify the companies, citing concerns about the possible effect on their stock prices.

Employees have wrestled with similar concerns at other companies that have shrunk drastically, like [Lucent](#) and [Xerox](#), and must generate cash to pay the pensions of large numbers of retirees.

A Delta spokesman confirmed that pilots have been taking lump-sum distributions but said he did not know the amounts, or the effect this has had on the pension fund's solvency. Lucent says its work force has declined so much that the number of pension-eligible employees today is too small to pose a threat to the pension fund. Xerox, which recently lost an appellate court challenge to the way it calculates lump-sum distributions from its pension plan, declined to comment on the issue yesterday.

Roughly 44 million Americans are covered by defined-benefit pensions — the kind that pay a predetermined benefit and are government insured — and a little more than half allow people to take lump-sum payouts, according to the Employee Benefit Research Institute.

Decisions about when to retire and whether to take benefits monthly or in a single check are difficult, forcing people to consider when they will die and whether they are skilled enough investors to make a payout last. Financial planners say that even though the money can usually be rolled over without incurring tax, many people are better off taking benefits as an annuity — typically, a series of monthly payments from retirement until death — because it reduces the risk of squandering money or outliving the funds paid out in a big check. Annuities can also offer some income to a surviving spouse.

But when an employee must factor in an ailing pension fund and the possibility of retiring early, the calculations multiply.

Pension funds do not have to disclose current information about their financial strength, so employees are forced to make guesses about the security of their benefits. Gauging the reliability of an annuity also means figuring out whether one's employer is likely to survive for the next two or three decades.

"Suppose someone is 55 and he's worked all his life for Delta, developing what he thinks is a substantial pension," said Jack Blaz, a retired pilot and former contract negotiator for the pilots' union. "He's scared to death that this is all going to disappear in a puff of smoke. That's why the lump sum is the holy grail for us."

Delta's pilots can take only half of their total benefits as a lump sum, but at some other airlines, like American, pilots can take their entire benefit immediately. American officials declined to discuss the rate of withdrawals from the pilots' pension plan.

Conversations with pilots at Delta and other major airlines indicate that many of them are rejecting the promise of future riches in favor of retiring early and taking smaller payouts. Delta pilots are retiring and pulling money out of their plan this year at about twice the usual rate, said Mark A. Mischker, chairman of the Air Line Pilots Association's retirement committee at Delta.

Though Delta told employees this week that it would suspend future contributions to the guaranteed pension plan for top executives, it did not rescind the plan, which has already received \$45 million.

"Most guys feel like they'd better grab the money and run because they don't have the assurance that these companies are going to keep paying the pensions that they did have," Captain Blaz said.

A generation ago, a run on a pension fund would have been improbable. The ability to take money out in a single payment was generally limited to executives. The rank and file took theirs as annuities.

The Internal Revenue Service took action 20 years ago, requiring companies to offer lump-sum payments to the rank and file if they did so for executives. Things did not change immediately; some companies merely bumped the executives into separate pension plans.

But over the years, the idea began to take hold that the individual — not the company — ought to be the one saving for retirement. Self-directed retirement plans like the 401(k) proliferated, saving companies money and getting participants accustomed to tracking their benefits as a single account balance in their own names.

From there, it was just a short step to letting employees withdraw that balance.

The most notorious run on a pension fund happened in 1987 at [LTV Steel](#), where fleeing salaried employees depleted the pension fund to just \$7,000, leaving more than \$250 million worth of promised benefits outstanding.

That disaster prompted Congress to regulate pension distributions more closely, barring lump-sum withdrawals unless a pension fund had liquid assets of at least three times the prior year's payouts. In the 1990's, pension funds were generally healthy and the new rule was thought to have eliminated the risk. But now the risk is back.

Employees have taken readily to the idea of getting a big check. Study after study has shown that when offered the choice, most spurn the annuity and go for a single payout.

Companies also benefited before market conditions changed because paying out all at once meant extinguishing long-term pension debt. The recent Xerox decision involved complaints that the company was paying lump sums that were smaller than the real value of the benefits the retirees had earned.

But the grafting of individual rights onto a collective pension trust has brought risks that have become apparent only as pension funds have weakened. Every participant in a pension plan does not, in fact, have a separate balance, as they do in a 401(k) plan. So if large numbers of participants decide to retire early and withdraw what they see as "their" money, they will, in fact, be pulling out funds that were pooled for everybody.

That is what happened at Polaroid.

"I don't think lump-sum payments were introduced to benefit one group of people at the expense of another, and yet there you have it," said Ann Liebowitz, a retired Polaroid vice president who lost benefits worth roughly \$8,000 a year when that plan failed.

Ms. Liebowitz retired in 1995 and took her pension as an annuity, the only option at the time. But the plan was redesigned three years later, allowing employees to begin taking their benefits as single checks.

The change was billed as an improvement, letting people take their benefits with them if they changed jobs. The new design also made the plan less costly for Polaroid. But when Polaroid slid into bankruptcy in autumn of 2001, the lump-sum option helped fuel a run on the plan.

"The company was going downhill and people were leaving in droves," Ms. Liebowitz recalled.

Over the first six months of 2002, 675 Polaroid employees bailed out, taking one-time checks that drained the pension plan of \$81 million. Falling stock prices battered the plan even more. By the time the government took over the plan that July, it had only about two-thirds of the assets it needed to meet obligations of \$981 million.

A plan's shortfall at the time it fails is one of many factors the government considers when determining how much of each person's benefit it will pay. As a result, people like Ms. Liebowitz, who were receiving annuities, had their benefits cut. Some retirees lost more than she did, and some less, but none of them would have lost as much as they did if Polaroid had not opened the floodgates to one-time payouts.

While the run was on, Ms. Liebowitz and about 20 other retired officers of Polaroid, including two former chief executives, tried to make the company suspend lump-sum distributions.

"We thought they had a fiduciary obligation to maintain the assets of the plan to the benefit of the greatest number of people," she said. "We engaged counsel, and they engaged counsel, and then there was the battle of the lawyers."

Polaroid refused to stop the distributions, and the Pension Benefit Guaranty Corporation ultimately took over the failing plan. Polaroid has since emerged from bankruptcy as a privately held company. Its

employees no longer have a pension plan, just 401(k) accounts.

The run at Polaroid, and the risk now at airlines and other companies, is being made worse by a technical issue that turns lump-sum distributions into a much larger obligation than the companies accounted for when making contributions to their plans.

This is because a company must use a different interest rate to calculate a plan's obligations than it does to calculate how much an individual can withdraw.

Low interest rates mean that the value of future obligations look very large in today's dollars. This basic financial principle, when applied to lump-sum calculations, means that employees approaching retirement in the current low-rate environment are entitled to unusually large upfront payouts.

But the interest rate that companies must use to calculate their overall liabilities is different, and currently higher. As a result, companies are not making pension contributions aggressively enough to cover a spate of lump-sum withdrawals.

Both rates were set by statute years ago, and the difference did not seem to matter in times when plans were healthy and few people were taking lump-sum distributions. But now it does matter.

The implications of this are not lost on members of Congress, who could change the statute to close the gap between the rates. Companies have been lobbying hard, not only to bring the two rates together, but also to make the new, single rate a higher one. That would reduce both pension contributions and payouts, saving companies money.

This approach is extremely unpopular with people approaching retirement, whose distributions would be reduced. A compromise, which would phase in such a change, has been incorporated into a pension bill expected to be considered in the House, after Congress returns from the August recess.

By that time, Captain Davis will have claimed his single check and retired. So will some of his colleagues, he said. Every day, someone calls to discuss the stay-or-go quandary, and the conversation always returns to the executives securing their own pensions.

"Prior to that, we never really thought of how our pension was funded," he said.

At a recent pilots' meeting, Captain Davis had the chance to approach Delta's chief executive, Leo Mullin, and ask what the pilots were to make of the millions going to the executive pensions, given the rickety state of their own plan.

"He hemmed and hawed a little bit, and said, 'Well, the best way to protect your pension is to see that we stay out of bankruptcy,'" Captain Davis said. "I realized that I'd just lost my only hope. Now I feel like it's every man for himself."

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