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## For Pension Plans, Risky Is Fine

### Accounting Rules Let Companies Benefit From Investment Upside, Escape Consequences of Mistakes

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(See *Corrections & Amplifications* [item below](#)<sup>0</sup>.)

Pine trees in a pension plan?


In the past decade, many employers have quietly taken on more risk in pension plans -- loading up on stocks, their own securities and nontraditional and illiquid investments -- thanks to accounting rules for pensions that enable employers to capture all of the investment upside, while postponing losses and shifting the consequences of poor investment results to their workers and retirees.

Consider **U.S. Steel Corp.** The Pittsburgh steel maker has asked the Labor Department for permission to contribute timber rights on two parcels of Alabama land to its underfunded pension plans, in lieu of cash. The seedlings won't be turned into furniture or pulp anytime soon, but the company says the investment has "long-term growth potential."

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That may not appear to be the most surefire way to shore up a pension plan that lost \$434 million last year. But the move will be immediately profitable for U.S. Steel. Regardless of how well the investments in its pension plan perform next year, the company can assume that the stocks, bonds and timberland earn 8.8%, and it can add that return to its income.

U.S. Steel is merely taking advantage of accounting rules that can make pension investments a no-lose

#### PENSION RISK

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See [charts detailing](#)<sup>0</sup> how pension funds increased their stock holdings in the 1990s to capture double-digit returns, and the percentage of waivers the Labor Department granted to pension-plan sponsors hoping to avoid a variety of rules.

proposition for employers. The key to this investing success lies in accounting rules that allow companies to use "assumed" returns for the pension assets. In 2002, large companies generally assumed rates of return between about 8.5% and 9%, though a few used assumptions as high as 10%.

If the investments do better than expected, companies can stockpile the excess gains and use them later. Meanwhile, if the investments go sour, companies can postpone the losses, and dribble them into their income calculations over many years.

While these rules were intended to cushion companies from the ups and downs of their pension investments, they have also given companies an incentive to take on more risk than they otherwise might if they were truly on the hook for lousy investment results.

In fact, the percentage of pension assets invested in stocks rose from 47% of assets in 1990 to 62% as of the end of September -- despite hefty declines in the stock market during 2001 and 2002, according to data supplied by Wilshire Associates, a firm that tracks institutional investments. While this equity exposure paid off handsomely in the bull market, it also contributed to the huge asset losses in recent years.

Meanwhile, Labor Department figures suggest that employers have increasingly contributed riskier investments to their pensions. Although employers aren't supposed to contribute parking lots, pine trees, shares of closely held companies or other illiquid assets to their pension plans, they can and increasingly have received special permission to do so. Through early December, the agency has granted 70% of pension waiver requests, up from 49% five years ago and 39% in 1993.

The Labor Department is accepting public comments on the U.S. Steel proposal until Dec. 18, but pension experts say the request will probably get a thumbs-up, considering that the agency this summer gave **Northwest Air Lines Inc.** permission to put a total of 13.3 million shares of a subsidiary airline into its underfunded pension plan, over the copious protests of its retirees, who said the move left the pension plan too exposed to the airline's financial fate. (The pension plan has since sold the subsidiary's shares.)

By law, employers are required to invest pension assets prudently, and must make investment decisions in the interests of the employees in the pension plan. Historically, employers had a good reason to do so: After all, if the pension plan loses money, employers have to come up with the shortfall eventually, and might even have to dump more into the plan to pay the promised benefits. (That's what makes pensions different from 401(k)s, in which employees bear all of the investment risk.)

But increasingly, that risk equation has changed, thanks in part to the accounting rules, which protect employers from any immediate consequences for bad investment decisions in the pension plans. That's because the rules let employers use hypothetical, or assumed, rates of return for the assets in the pension plan, rather than the actual returns, when calculating the pension plan's impact on company earnings.

As a result, any investment, regardless of quality -- leases in overbuilt strip malls, timber rights, high-grade corporate bonds, cash or a company's own stock -- provides a guaranteed "return" of 9% or so. (Plus a tax deduction for the assessed value of the asset.)

The risk equation is further skewed by employers' ability to cut pensions: When the pension assets lose

money, employers can cut benefits, which generates accounting gains that offset the stockpiled investment losses before they begin to hurt the company's financial results.

Indeed, in the past year, many companies, citing pension-plan losses, have cut pensions by making the formulas less generous, or even terminated the pension plans.

Wire Rope Corp., a wire and cable maker in St. Joseph, Mo., loaded its pension plans up with stock in the 1990s, enjoying hefty investment returns, a company executive says. But when the stock market plummeted, the pension plans lost 30% in 2001, and an undisclosed amount in 2002.

In December 2002, executives for Wire Rope, which was operating under bankruptcy-law protection, terminated the company's pension plans. Now, employees and retirees will receive only a fraction of their pensions, which are being paid by the Pension Benefit Guaranty Corp., a quasi-insurer that takes over pension plans of bankrupt companies.

In contrast, companies invest their executive-pension trusts more securely. AMR Corp., for example, invests its executive pension trusts in high-grade bonds, in accordance with investment guidelines that state explicitly that the "the primary purpose is preservation of principal and liquidity."

"We do invest the funds for the [executive pension] more conservatively than we do the funds for the regular pension plans," says a spokesman for the airline. But he says that the investments must be more conservative because the executive pension has fewer participants -- just 40 or so -- and will have to pay out sooner.

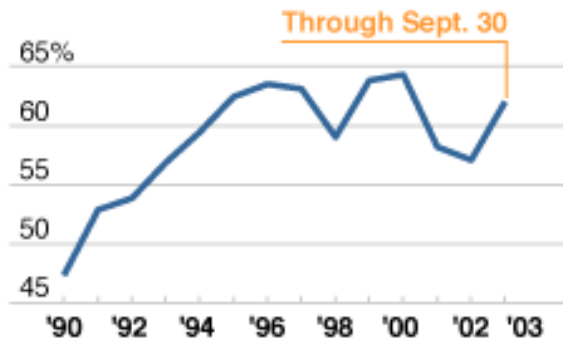
Similarly, executive pensions are rarely invested in company stock. Employees with regular pensions have often complained that rules permitting employers to invest as much as 10% of pension assets in company stock leave the pension underdiversified.

**Delta Air Lines Inc.**, for instance, specifically forbids the use of Delta stock or debt obligations in its executive trusts. Delta confirmed this information, but declined to comment further.

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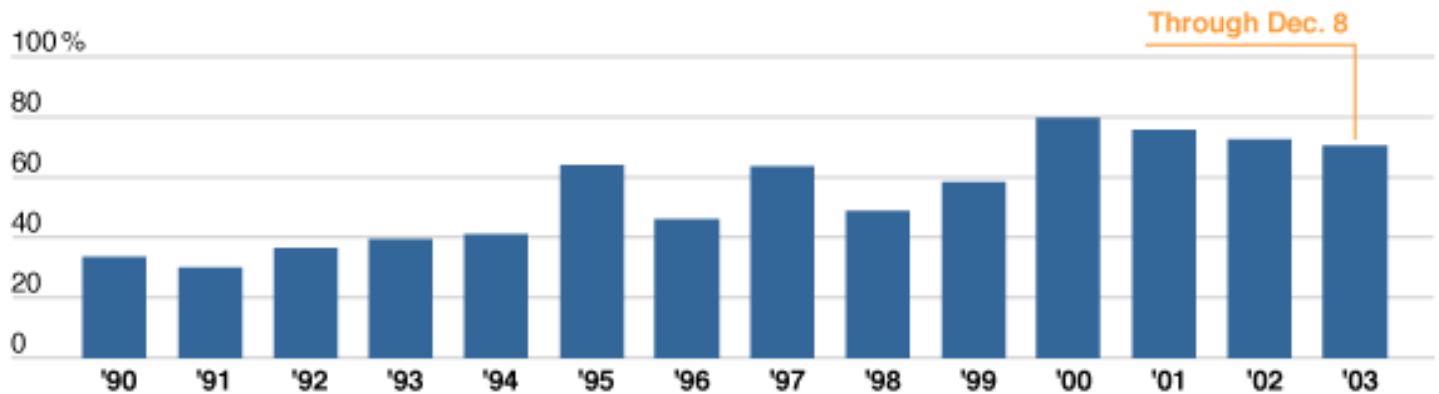
## PENSIONS LOAD UP ON STOCKS...

Pension plans increased their stock holdings in the 1990s to capture double-digit returns, even though the practice led many to become more exposed to market risk. Below, the percentage of stock holdings in corporate pension plans, according to Wilshire Associates.



## ... AND ADD MORE UNUSUAL INVESTMENTS, TOO

The Labor Department has granted an increasing proportion of waiver applications it receives from pension-plan sponsors hoping to avoid a variety of rules, including those governing which assets may be contributed to a pension plan. Below, the number of waivers granted as a percentage of waivers requested, according to the Labor Department.



### Corrections & Amplifications:

U.S. Steel Corp.'s assumed rate of return for pension assets is 8.2% for 2003. The article above incorrectly gave the figure as 8.8%.

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