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Pay Me Later?

An increase in underfunded pension plans could pose trouble for companies and shareholders

By JACQUELINE DOHERTY

Last week investors were rudely awak-ened to the troubles that underfunded pension plans could pose for corporate America. With the stock market down and pension-fund assets shrinking, companies ranging from Continental Airlines to Avon Products to New York Times indicated they had made, or planned to make fresh contributions to bolster the value of their pension plans.

The numbers only get bigger when the auto industry's pension funds are examined. General Motors reported that assets in its U.S. pension plan had dropped by 10% this year, which means the company's after-tax pension expense could rise by about $1 billion, or $1.80 a share, in 2003. Ford said the return on its pension assets has fallen by 15% this year, pushing the plan's underfunded status to $6.5 billion in the third quarter. Standard & Poor's downgraded GM's debt rating a notch, to triple-B, and added it might give Ford the same treatment, as well.

These companies are not alone in having to face up to pension shortfalls. According to David Zion, an accounting analyst at Credit Suisse First Boston, 360 companies in the Standard & Poor's 500 index have defined pension-benefit plans. Of these, 240 had underfunded plans at the end of 2001, the highest level in ten years. With stocks and interest rates both in retreat -- a poisonous combination that spells lower returns on fund assets and increased pension liablities -- Zion believes the number of companies with underfunded plans could balloon to 325 in 2003.

In a recent report on pension accounting, Zion listed the U.S. companies with the largest estimated pension-fund deficits in 2002, relative to their market capitalization. According to his calculations, companies such as AMR, parent of American Airlines, and Goodyear Tire & Rubber could have underfunded pension liabilities this year that exceed their stock-market capitalizations.

Zion's data rely on assumptions about interest rates, equity returns, wages, employee growth and a host of other factors. He acknowledges both that he lacks all the information necessary to perfect his estimates, and that his model is not as sophisticated as those used by corporate actuaries. But the chart and his report provide a starting point for investors to gain perspective on an issue of looming concern.

Stuart Goldenberg for Barron's

It is important to note the companies listed do not have to cover the entire estimated shortfalls in 2002 because of accounting rules that smooth out gains and losses over a period of years. And, if the stock market rebounds or interest rates rise, shortfalls could disappear or, better yet, be transformed into excesses -- a benevolent circumstance that pertained in the late 1990s.

If a pension plan remains underfunded, however, a company over time might need to direct its cash flow to pay its pension obligations before investing in its business, paying down debt, repurchasing shares or making other strategic moves that would benefit investors. The upshot: Companies could end up working for their retirees instead of their shareholders.

In a worst-case scenario, shareholders' equity could be wiped out. Recall that pension obligations were a big contributor to the bankruptcy filings of TWA, early in 2001, and Bethlehem Steel, later that year.

"I think it's a huge issue unless the markets rebound," says Trevor Harris, head of Morgan Stanley's valuation and accounting research group. "We have over $300 billion of pension-fund deficits in 2002 for S&P 500 companies. That's $300 billion of cash these companies have to come up with over the next few years, and $300 billion that comes out of corporate cash flow."

Zion estimates that S&P 500 companies with defined benefit plans will have to make $29 billion in cash contributions to their underfunded plans in 2003, up from $15 billion in 2001. But pension funding problems affect more than cash flow. Generally, a company is required by accounting rules to record a noncash expense if the amount by which its pension is underfunded increases over the previous year.

Zion estimates that pension surpluses contributed $7 billion of reported income to S&P 500 earnings in 2001. While many companies were grateful for the assist, notwithstanding investors' complaints about the deteriorating quality of earnings, the virtuous circle is apt to turn vicious in the next two years. Indeed, Zion figures deficits could result in a $1 billion expense this year, and $15 billion in 2003. At the least, this suggests some chief financial officers might have done a better job, during the fat years, of locking in pension-fund gains through insurance and other measures.

The accompanying chart ("Something's Not Working") includes Zion's estimates of the effect of pension accounting on 2003 reported earnings for the companies listed. On the dark side, he expects General Motors to incur an expense of $5.83 a share. But companies such as Electronic Data Systems and Unisys could reap gains, due to the smoothing effect of the accounting rule.

Companies also could find that pension liabilities hurt their balance sheets, and those with underfunded plans might have to take a charge against shareholders' equity to reflect their minimum liabilities. Zion has estimated these charges for 2003, and they are also in the table.

The deterioration in pension-fund values has been swift and violent. From the end of 1999 to the end of 2001, plan assets lost $80 billion as the stock market swooned. At the same time, Zion says, pension obligations -- the amount a company must pay employees at retirement -- increased by $170 billion, because of a decline in interest rates.

Lower rates have wreaked havoc because of the way future liabilities are calculated. Pension obligations represent the amount an employer would need to invest today, based on a rate that discounts the present value of future liabilities, to have sufficient funds to meet those future obligations. Companies typically use as a discount rate the interest rate on high-quality corporate bonds. When interest rates decline, as they have done furiously in the past year, the discount rate decreases and the future obligation increases.

Table: What, Us, Worry?

The problem may worsen if plan sponsors start changing their discount-rate assumptions on pension obligations. At the end of 2001 the median discount rate used by S&P 500 companies to calculate pension liabilities was 7.3%, although the number ranges from AFLAC's 4.75%, at the low end, to the 8.15% used by Whirlpool. Zion believes most companies will lower their discount-rate assumptions half a percentage point this year, which should increase pension obligations by about 5%. The result: Underfunded plans will grow more underfunded, and surpluses will shrink.

Meanwhile pension-fund assets have not returned the 9.2% most companies currently expect. Since the end of 1999 pension assets have underperformed pension liabilities by 70%, says Ron Ryan, president of New York-based Ryan Labs, an asset manager and developer of liability indexes. "The pension crisis will be one of the largest, if not the largest financial crises in U.S. history," he warns, adding that it's a problem facing companies, states and the federal government.

Zion believes a more appropriate assumption on asset returns is closer to 8.5%, implying a 5.5% fixed-income return and a 10% equity return. But fabled investor Warren Buffett warns that an expectation of 6% to 7% returns would be more realistic, and he practices what he preaches. Last year Berkshire Hathaway, which Buffett controls, lowered its assumed pension-plan return by 1.8 percentage points, to 6.5%. Other companies appear to be moving, albeit slowly, in the same direction. IBM last week reduced its expected return on pension assets to between 8% and 8.5% for 2003, from 9.5% to 10% this year. Likewise, Bank of America changed its expectations to 8.5% from 9.5%.

Once again, as the assumed return on assets declines, the amount by which a pension plan is overfunded shrinks, or the amount by which it is underfunded increases. If companies reduce their asset-return assumptions by half a percentage point in 2003, Zion estimates pension costs would increase by $5 billion.

Even though the stock market has been in retreat since early 2000, alarms about pension funds didn't ring until recently. In part, that's because many funds, as noted, enjoyed surplus assets, and few companies expected so brutal a selloff. But the seeming lack of concern on the part of companies and their investors also can be explained by the complex rules that govern pensions and accounting.

Smoothing the impact of market fluctuation effectively prevents short-term changes in asset prices from boosting, or battering, reported earnings or cash flow. Thus, only a sustained market slide is apt to be felt in most pension plans. For example, companies whose plans are underfunded by less than 10% don't have to make additional contributions to their pension funds. And even in the case of deficits, a company has 18 months to meet the obligation.

Although pension-fund assets lost $90 billion in 2001, an accounting sleight-of-hand allowed companies to show that income of $104 billion had been generated, Zion says. If the smoothing mechanisms were eliminated, aggregate earnings for the S&P 500 would have dropped by 69% last year and by 10% in 2000, though 1999 earnings would have increased by 26%.

Pension-fund obligations are an off-balance-sheet liability. "It wouldn't surprise me if the FASB [Financial Accounting Standards Board] took another look at pension accounting and perhaps put pension funds back on the income statement and the balance sheet," Zion says.

Were that to happen, full plan details would be incorporated into financial documents, and plan assets and liabilities would be marked to market. A change so dramatic likely would take years to accomplish, however, once corporate lobbyists swung into action.

Morgan Stanley's Harris believes the U.S. should adopt the U.K.'s accounting standard, which incorporates pension-plan assets and liabilities into company financials, and marks them to market.

How might a train wreck be avoided? The stock market could rally sharply, as it did last week, or interest rates could rise, although that might not happen soon. The financial markets helped bail out many an underfunded plan in the early 1990s. But rates were much higher at that time.

Today's problem also may be graver because many older industrial companies have fewer active workers to support their ranks of retirees. Moreover, companies have enrolled many newer employees in defined contribution plans like 401Ks. The good news is these companies will run off their pension obligations sooner rather than later. But the near term could bring a drain on cash flow.

If a company is forced to seek bankruptcy protection, the Pension Benefit Guarantee Corporation, a government corporation, could ride to retirees' rescue. The PBGC would become a trustee of the fund and a creditor in the company's bankruptcy, and would make up the difference between the pension plan's assets and liabilities, up to a point.

But here's the rub. The PBGC had only $4.8 billion in surplus funds as of June 30. A PBGC spokesman, Jeffrey Speicher, notes that the fund operated with a deficit from 1974 to 1996, yet always paid benefits. As the economy improves, there are fewer

bankruptcies, and the PBGC continues to collect fees from covered companies that replenish its coffers. "Even if we go into deficit we will meet our obligations," he says. "Our financial situation could not be characterized as in a crisis."

Either way investors should take the time to brush up on the idiosyncratic rules and regulations surrounding pension accounting. Zion thoughtfully warns at the start of his report that his dense subject might put some readers to sleep. Here's another warning: Wake up.

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