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EDITORIAL COMMENTARY

What Rough Beast

The pension disaster will be borne in more places than just Bethlehem Steel

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EASY COME, EASY GO: The pension pendulum swings again. After years of contributing to corporate bottom lines, pension obligations are once again a drain on corporate cash. As long as their projected earnings from pension assets exceeded their projected payments to pensioners, corporations with defined-benefit pension plans didn't need to save. In fact, federal law prohibited them from building up large surpluses even if they wanted to, because Congress has deemed such security an unwarranted corporate tax shelter. Pension contributions are tax-deductible, after all.

So pension sponsors gaily took a holiday from responsibility. Rising stock and bond markets provided paper profits that generally accepted accounting principles couldn't separate from real earnings. The truth was in the footnotes, of course, but investors who follow earnings reports took their own holiday from responsibility.

Watchdog Dearth

The Financial Accounting Standards Board is conducting a long-overdue review of the rules for reporting on corporate pension plans. It's looking at principles that have proved to be loopholes, such as the computation of expected return on assets that's left to the discretion of the sponsoring company and the actuary it hires. Discount rates and expectations of future wage increases are also actuarial estimates open to -- let's be nice and say interpretation.

The FASB has work to do: The power to estimate is the power to distort, and some corporations have used their pension estimates to distort their reported earnings. Jack Ciesielski, the Baltimore accounting analyst, noted last spring that gains on pension assets dropped to the bottom line at more of Standard & Poor's 100 firms in 2001 than in 2000, and the amount was bigger, too. That's a sure sign of earnings management, since fund assets actually dove in value with the stock market. Ciesielski suggested that managers receiving performance compensation on such numbers ought to share their bonuses with their pension managers.

For another sample of how wacky pension accounting can be, look back three weeks to "Pension Scheme[1]," Cheryl Strauss Einhorn's story in the Dec. 9 issue of *Barron's*, in which she explained how a cash contribution to an underfunded pension plan can boost reported corporate earnings. Corporate cash earns a low market rate, but once it's inserted in the pension plan, it's assumed to earn the estimated long-term rate for plan assets. Bingo. For example, if **IBM** puts in $3 billion, its operating income can rise by $225 million.

The federal Pension Benefit Guaranty Corp., which insures defined-benefit pensions and levies a tax on

all such pension funds to sustain benefits from failed funds, ought to be a leader in tracking funding trends. It used to publish a list of the 50 most underfunded plan sponsors, but that was discontinued in 1997 because it annoyed 50 big companies every year.

The PBGC still calculates underfunding based on sponsors' filings with the Internal Revenue Service, and the results are buried in the agency's Pension Insurance Data Book. But the IRS reports aren't filed until 18 months after a plan year, so the most recent information is for the boom year of 1999.

Even that figure is disquieting: Although the surpluses in overfunded plans were rising with asset values in the stock market, the reverse wasn't true. The deficits in underfunded plans weren't shrinking. They had also grown, to $66.5 billion. That was the third-worst year for underfunding in the agency's history.

A more current but more limited source is a study of the pension footnotes in annual reports of the S&P 500 conducted by Credit Suisse First Boston. Of the 500 big firms, 360 had defined-benefit pension plans at the end of 2001 and 240 of them were underfunded. As Jacqueline Doherty reported in *Barron's*, ("Pay Me Later?[2]" Oct. 21) analyst David Zion estimated that 325 of the 360 would have underfunded plans in 2003.

These companies are likely to end 2002 with about $300 billion of unfunded pension liabilities. Because pensions are financed over long periods, the companies don't have to make up their deficits all at once. Zion estimates they will be making about $29 billion in cash payments in 2003, while recording about a $15 billion hit to earnings.

Such aggregated estimates, however, gloss over the facts that some companies are in much worse shape than others, Among the biggest problem companies in the S&P 500: **General Motors**, $29 billion estimated underfunding at the end of this year; **Ford**, $14 billion; **Boeing**, $6 billion; **Delta Air Lines**, $4 billion; **Delphi**, $4 billion; **Raytheon**, $3 billion; **AMR**, $3 billion; **Xerox**, $2 billion; **Georgia-Pacific**, **Lucent**, **Goodyear**, **EDS** and **Navistar**, more than $1 billion each.

Missing in Action

For that matter, many of the companies with the worst pension underfunding already have fallen out of the S&P 500. The companies with the biggest problems tend to be those in shrinking industries, notably steel, which used to employ huge numbers of people and now don't have the business volume to pay retirees what they were promised.

Look at the biggest failed pension plan, the one covering union workers at Bethlehem Steel. Last week, the Pension Benefit Guaranty Corp. finally yanked Bethlehem's chain -- a year after the company went into bankruptcy. The steel maker's primary pension plan is underfunded to the tune of $4.3 billion.

Wonder why it's in trouble? Bethlehem Steel has 67,000 retirees, 15,000 former employees who will become eligible for payment upon retirement, and only 13,000 active workers. Those 13,000 have to create enough economic value to justify their own salaries and put aside $4.3 billion for themselves and the other 82,000 people riding on their backs. No matter how much faith you have in the power of capital to make workers productive, this burden is more than the people of Bethlehem Steel can bear. What's worse, the burden grows every year as the remaining workers earn bigger pensions.

Combined with the costs of health benefits for retirees, this is what the steel industry calls "legacy costs," as if it inherited them from some crazy uncle. Of course, the industry and its unions created these costs with decades of negotiations.

The termination seriously disrupted Bethlehem's hope of dumping even bigger obligations on the PBGC, which is funded through taxes on all companies with defined-benefit pension plans. Bethlehem was negotiating a merger with International Steel Group and a new contract with the steelworkers union. The hope was to get even more workers to take early retirement before the PBGC took over the pension plan.

Steve Miller, the steel company's CEO, was dismayed that the PBGC had "lobbed in a hand grenade" that would blow up the talks. He warned that Bethlehem might have to liquidate rather than reorganize.

So? Bethlehem Steel has been the tarnished buckle of the Rust Belt nearly as long as the Turkish Empire was the sick man of Europe. As with that empire, it hardly matters if the company lives or liquidates.

All the other companies with defined-benefit plans, and particularly the other steel companies, should be grateful that the PBGC finally had enough.

Day of Reckoning

For a quarter-century, American companies have been turning away from defined-benefit pensions. Nobody should find it odd that this trend began at the same time that Congress created a federal pension-insurance scheme and instituted new regulations for the protection of workers.

More than half of all the companies that had defined-benefit plans in 1975 have terminated them. What's left are the huge pension plans at big corporations, most of them protected by unions vigilantly defending them against change, no matter how much it's needed.

The mess in pension finance, moreover, may yet be dwarfed by corporate promises to provide retirees with the same health benefits they had while working. At least pensions are merely underfunded, and there is a federal agency standing behind the promises companies make. At least pension obligations only change with the size, age and life expectancy of the work force. Retiree health benefits are unfunded, unregulated, unsupported and unpredictable.

We have been talking about the impending disaster in retirement finance for more than two decades. Now, as the leading edge of the Baby Boom approaches age 60, the crisis is right around the corner. For some people, it's here already.

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