

March 16, 2005

## **FREQUENTLY ASKED QUESTIONS PENSION PLANS AND REFORM**

### **Q1: What is the difference between a defined benefit and a defined contribution plan?**

A1: A **defined benefit plan (DB plan)** is the traditional model in which an employer guarantees workers a specific pension amount generally calculated based on an employee's earnings and years of service. The employer makes contributions into the fund and manages and invests the money. The payment to employees is guaranteed, meaning that the company bears the investment risk. Defined benefit plans that qualify under federal law are insured by the Pension Benefit Guarantee Corporation (PBGC) through premiums paid by the employer.

A **defined contribution plan (DC plan)** includes 401(k)s and similar programs in which employers or employees contribute a specified amount of their earnings, which are sometimes matched by employers. The employee therefore has a retirement investment account, and can often make some decisions about how these funds are invested. The federal government does not guaranty C plans, nor do they provide a guaranteed level of income. The amount a worker gets at retirement depends on how much has been contributed to the plan and the investment performance of those funds. Upon retirement, workers can typically take the account balance as a lump sum or have it paid out monthly. DC plans also are portable, which is attractive to many younger workers who may switch jobs and companies over the course of their careers.

### **Q2: How is American's defined benefit pension program structured?**

A2: Each workgroup is covered by its own retirement program and rules, with all employees eligible after one year of service. Employees are vested after five years with the company and are eligible for normal retirement at age 60.

Each workgroup has a different formula for determining an employee's pension benefit based on length of employment and career average wages.

For senior executives at American, a retirement tool includes a Supplemental Executive Retirement Plan (SERP). We join with our unions in advocating federal legislation that bans funding SERPs when minimum contributions are not being made to the corporate defined benefit plans.

AA employees made clear how important their pension plans were to them during the consensual restructuring process of 2003 in which workgroups opted to keep their pension plans intact and instead make changes to pay, work rules and other benefits.

### **Q3: What is the status of American's defined benefit pension plans?**

A3: AA's defined benefit pension plans are collectively funded at 80% -- the best in the industry -- with an average asset return over the past ten years of 13.3%.

Last year, AA's pension contribution was \$461 million, and we anticipate large and, in some cases, a much higher cash contribution in the future.

**Q4: Are employees' defined benefit pensions guaranteed or insured? If so, at what level?**

A4: As a qualified pension plan, AA's defined benefit plans are insured by the federal Pension Benefit Guaranty Corporation (PBGC). The PBGC guarantees payment of basic pension benefits earned by about 44 million Americans participating in more than 35,000 private defined benefit pension plans. The PBGC is funded by insurance premiums paid by employers.

The PBGC covers only defined benefit plans, not defined contribution plans like 401(k)s. If an under funded defined benefit plan of any company is terminated, typically in the course of bankruptcy, the PBGC takes over the plan and pays pension benefits to retirees, but only up to a prescribed limit. The PBGC does not guaranty health care, vacation pay, or severance pay.

So, depending on a retiree's projected benefit, retirees may not get their full benefit if they would have received more than the PBGC limit. This was the case when the PBGC took over the defined benefit plan for US Airways pilots in 2003. The maximum pension guaranteed for workers in plans terminated in 2003 was \$3,665 a month, significantly less than many pilots would have received had the defined benefit plan not been terminated.

The maximum annual guaranteed benefit for single-employer plans terminating in 2005 is approximately \$3,800 a month for participants who retire at age 65 or beyond.

**Q5: What is American's position on preserving its defined benefit pension plans?**

A5: As Gerard Arpey repeatedly has said, we believe that companies have an obligation to try to protect the retirement benefits that have been promised to their people. To do this, we must be able to afford to continue to live up to our pension commitments. The best way to do this is to become profitable, smartly manage our pension plans, and secure fair and reasonable pension reform.

It is essential that American continues to work collaboratively with all stakeholders under its Turnaround Plan to return to profitability.

**Q6: What is driving the need for defined benefit pension reform?**

A6: The Bush Administration and Congress are examining the issue because they recognize that without some type of reform to help stabilize the Pension Benefit Guaranty Corporation (PBGC) – the government's pension system and insurance program safety net – retirement benefits for millions of U.S. workers could be at risk, with the burden ultimately falling to U.S. taxpayers.

Contributing to the national debate is the concern over the impact on the solvency of the PBGC if troubled companies, including the bankrupt carriers, are able to terminate their pension plans and shift their obligations to the PBGC in order to financially reorganize.

It is a concern for us, too, because in addition to the human ramifications – which we all want to avoid – those carriers will have a significant competitive cost advantage over us and we cannot afford to be uncompetitive in any part of our business.

**Q7: What is American's position on defined benefit pension reform?**

A7: AA is united with our unions in supporting pension reform that does not discriminate based on the credit rating of the plan sponsor, and that better protects employees' retirement benefits by making it more flexible and affordable for companies to fund them, by:

1. Maintaining the flexibility to continue defined benefit plans as an effective means to provide retirement security.
2. Reasonably extending the number of years companies would have to make up the unfunded portions of their plans.
3. Setting reasonable interest rates to determine plan liabilities.
4. Providing simpler, better, and more timely disclosure of important pension plan data.
5. Providing an increase in permitted contributions.
6. Supporting the concept that benefit plans be charged risk adjusted premiums by the PBGC.

We support a ban on preferential funding of Supplemental Executive Retirement Programs while the minimum contributions are not being made to the corporate defined benefit plans.

We also support legislation that would provide pension relief to companies that freeze their plans through the collective bargaining process, rather than terminating them in bankruptcy.

**Q8: What is the role of interest rates in funding defined benefit pension plans?**

A8: The interest rate is used to determine how much money a company must put aside today to pay for future benefits in defined benefit plans and therefore is central to the pension reform debate.

For example, assume that we have to pay \$100 in ten years to a pension plan participant. The pension laws generally require that we put enough money aside today so that there would be \$100 available in ten years. Based on our average asset return over the last ten years of 13.3%, we would need to put aside only \$29 today.

However, the pension laws require that we use a much lower rate, which is 6.1% for 2005. Using this rate, we have to put aside \$55. Under this scenario, the company must put \$26 more in today than it needs to to reach \$100 in ten years.

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