

# **PENSION REFORM**

## **ISSUES AND PRIORITIES**

**MARCH 2005**

# PENSION REFORM

## HEATING UP IN WASHINGTON

- GROWING CONCERNS ABOUT THE FINANCIAL HEALTH OF THE PENSION BENEFIT GUARANTY CORPORATION (PBGC) IN THE WAKE OF STEEL AND AIRLINE INDUSTRY BANKRUPTCIES.
- THE PBGC INSURES THE PRIVATE RETIREMENT PLANS OF MORE THAN 44 MILLION AMERICANS.
- PBGC DEFICIT IN 2004: \$23.5 BILLION (UP FROM \$11.2 BILLION IN 2003) THE GOVERNMENT ACCOUNTABILITY OFFICE HAS PLACED THE PBGC ON ITS HIGH RISK LIST.
- AT THE END OF CALENDAR YEAR 2003, THE PBGC HAD A POTENTIAL \$31 BILLION EXPOSURE TO 11 AIRLINES AND 440,000 EMPLOYEES.

*“The pension safety net is badly frayed.”*  
*-- Bradley D. Belt, Executive Director, PBGC*

# WHAT'S DRIVING PENSION REFORM?

- BECAUSE OF THE CURRENT STATE OF THE PBGC, THERE IS GROWING CONCERN OVER ITS ABILITY TO REMAIN SOLVENT IF TROUBLED COMPANIES, INCLUDING THE BANKRUPT CARRIERS, ARE ABLE TO TERMINATE THEIR PENSION PLANS AND SHIFT THEIR OBLIGATIONS TO THE PBGC.
- AMERICAN AND ITS UNIONS ARE CONCERNED, TOO, BECAUSE IN ADDITION TO THE PBGC SOLVENCY ISSUES AND THE HUMAN RAMIFICATIONS – WHICH WE ALL WANT TO AVOID – THOSE CARRIERS WILL HAVE A SIGNIFICANT COST ADVANTAGE.

*“We cannot afford to be uncompetitive in any aspect of our business.” -- Gerard Arpey*

# OUR POSITION ON PENSIONS

- WE BELIEVE COMPANIES HAVE AN OBLIGATION TO TRY TO PROTECT THE RETIREMENT BENEFITS THAT HAVE BEEN PROMISED TO THEIR PEOPLE.
- WE MUST BE ABLE TO AFFORD TO CONTINUE TO LIVE UP TO OUR PENSION COMMITMENTS. TO DO THIS, AMERICAN MUST CONTINUE TO WORK COLLABORATIVELY WITH ALL STAKEHOLDERS UNDER ITS TURNAROUND PLAN TO BECOME PROFITABLE.
- WE ALSO NEED TO EFFECTIVELY MANAGE OUR PENSION PLANS AND SECURE FAIR AND REASONABLE PENSION REFORM.

# AMERICAN'S PENSION PROGRAM AT A GLANCE

- EACH WORKGROUP IS COVERED BY ITS OWN PLAN AND RULES, THOUGH ALL EMPLOYEES ARE:
  - ELIGIBLE AFTER ONE YEAR OF SERVICE
  - VESTED AFTER FIVE YEARS
  - ELIGIBLE FOR NORMAL RETIREMENT AT AGE 60
- EACH WORKGROUP HAS A DIFFERENT FORMULA FOR DETERMINING THE PENSION BENEFIT BASED ON LENGTH OF EMPLOYMENT AND CAREER AVERAGE WAGES.

# THE STATUS OF AMERICAN'S PENSION PLANS

- BEST-FUNDED DEFINED BENEFIT PLANS IN THE INDUSTRY
  - ONGOING COMMITMENT TO MEET PENSION OBLIGATIONS
  - 13% AVERAGE ASSET RETURN RATE OVER TEN YEARS
  - CURRENTLY ALL PLANS COMBINED FUNDED AT 80%
- AA MADE ALMOST A HALF BILLION DOLLARS IN PENSION PAYMENTS LAST YEAR (\$461 M), AND WE EXPECT TO MAKE LARGE AND, IN SOME CASES, MUCH HIGHER, CASH CONTRIBUTIONS IN THE FUTURE.

# OUR POSITION ON PENSION REFORM

AA JOINS ITS UNIONS TO SUPPORT PENSION REFORM THAT BETTER AND MORE FAIRLY PROTECTS RETIREMENT BENEFITS THROUGH THREE INITIATIVES:

1. MAKING IT MORE FLEXIBLE AND AFFORDABLE FOR COMPANIES TO FUND DEFINED BENEFIT PLANS THROUGH:

- THE CONTINUATION OF DEFINED BENEFIT PENSION PLANS AS AN EFFECTIVE MEANS TO PROVIDE RETIREMENT SECURITY
- MORE TIME TO MAKE UP UNFUNDED PORTIONS OF PENSION PLANS
- REASONABLE INTEREST RATES TO DETERMINE PLAN LIABILITIES
- ABILITY TO INCREASE PERMITTED CONTRIBUTIONS
- SIMPLER, BETTER AND MORE TIMELY DISCLOSURE OF PENSION DATA

# OUR POSITION ON PENSION REFORM

**AA JOINS ITS UNIONS TO SUPPORT PENSION REFORM THAT BETTER AND MORE FAIRLY PROTECTS RETIREMENT BENEFITS THROUGH THREE INITIATIVES:**

- 1. MAKING IT MORE FLEXIBLE AND AFFORDABLE FOR COMPANIES TO FUND DEFINED BENEFIT PLANS**
- 2. BANNING PREFERENTIAL FUNDING OF SUPPLEMENTAL EXECUTIVE RETIREMENT PROGRAMS (SERPS) WHEN MINIMUM CONTRIBUTIONS ARE NOT BEING MADE TO THE CORPORATE DEFINED BENEFIT PLANS**
- 3. SUPPORTING LEGISLATION THAT WOULD PROVIDE PENSION RELIEF TO COMPANIES THAT FREEZE THEIR PLANS THROUGH THE COLLECTIVE BARGAINING PROCESS, IN ACCORDANCE WITH THE PRINCIPLES ABOVE, RATHER THAN TERMINATING THEM IN BANKRUPTCY**

# OUR POSITION ON PENSION REFORM FLEXIBILITY AND AFFORDABILITY

- WE BELIEVE PRESERVING THE FLEXIBILITY TO CONTINUE TO RESPOND TO OUR COMPANY, OUR EMPLOYEES, AND OUR UNIONS BY OFFERING A DEFINED BENEFIT PLAN IS AN EFFECTIVE MEANS TO PROVIDE AFFORDABLE RETIREMENT SECURITY.
- OUR JOINT PLATFORMS ARE ALIGNED WITH OTHER INDUSTRIES, THE BUSINESS COMMUNITY, AND THE EMPLOYEE RETIREMENT INCOME SECURITY ACT (ERISA) INDUSTRY COMMITTEE, TO NAME A FEW, IN SUPPORT OF PENSION REFORM.

# PENSION PLANS

DEFINED BENEFIT vs DEFINED CONTRIBUTION

HOW DO THEY DIFFER?

# DEFINED BENEFIT (DB) PLANS

THE TRADITIONAL PENSION PLAN IN WHICH AN EMPLOYER GUARANTEES A SPECIFIC PENSION AMOUNT, BASED ON AN EMPLOYEE'S EARNING AND YEARS OF SERVICE.

- PREDICTABLE PAYMENTS TO RETIREES
- THE EMPLOYEE GETS THE SAME RETIREMENT BENEFIT REGARDLESS OF THE PLAN'S INVESTMENT PERFORMANCE. EMPLOYER BEARS INVESTMENT RISK
- BENEFITS GUARANTEED BY FEDERAL INSURANCE FUND (PBGC) UP TO A LIMIT
- EMPLOYERS MUST COMPLY WITH FUNDING REQUIREMENTS THAT FLUCTUATE WITH INTEREST RATES AND ASSET RETURNS ... THIS ADDS UNCERTAINTY TO CORPORATE BUDGETING

# DEFINED CONTRIBUTION (DC) PLANS

A PLAN IN WHICH EMPLOYERS OR EMPLOYEES SET ASIDE A SPECIFIC AMOUNT OF MONEY – A “DEFINED CONTRIBUTION” – THAT MAY BE MATCHED BY THE EMPLOYER. THE AMOUNT AN EMPLOYEE RECEIVES AT RETIREMENT DEPENDS ON HOW MUCH MONEY HAS BEEN PUT INTO THE FUND AND THE PERFORMANCE OF THOSE FUNDS.

- ALLOW EMPLOYEES TO MAKE THEIR OWN INVESTMENT CHOICES
- DO NOT PROVIDE A GUARANTEED INCOME LEVEL AT RETIREMENT
- ARE PORTABLE – ACCOUNTS CAN BE TAKEN WITH AN EMPLOYEE WHO LEAVES THE COMPANY

	<b>DEFINED BENEFIT</b>	<b>DEFINED CONTRIBUTION</b>
<b>GUARANTEED MONTHLY BENEFIT UPON RETIREMENT?</b>	<b>YES</b>	<b>NO</b>
<b>INSURED BY THE GOVERNMENT?</b>	<b>YES</b>	<b>NO</b>
<b>EMPLOYEE CAN CHOOSE INVESTMENT OPTIONS?</b>	<b>NO</b>	<b>YES</b>
<b>EMPLOYEES CAN CONTRIBUTE?</b>	<b>NO</b>	<b>YES</b>
<b>PORTABLE?</b>	<b>NO</b>	<b>YES</b>
<b>EMPLOYEE BEARS INVESTMENT RISK?</b>	<b>NO</b>	<b>YES</b>

# OUR POSITION ON PENSION REFORM FLEXIBILITY AND AFFORDABILITY

## THE NEED FOR MORE REASONABLE INTEREST RATES

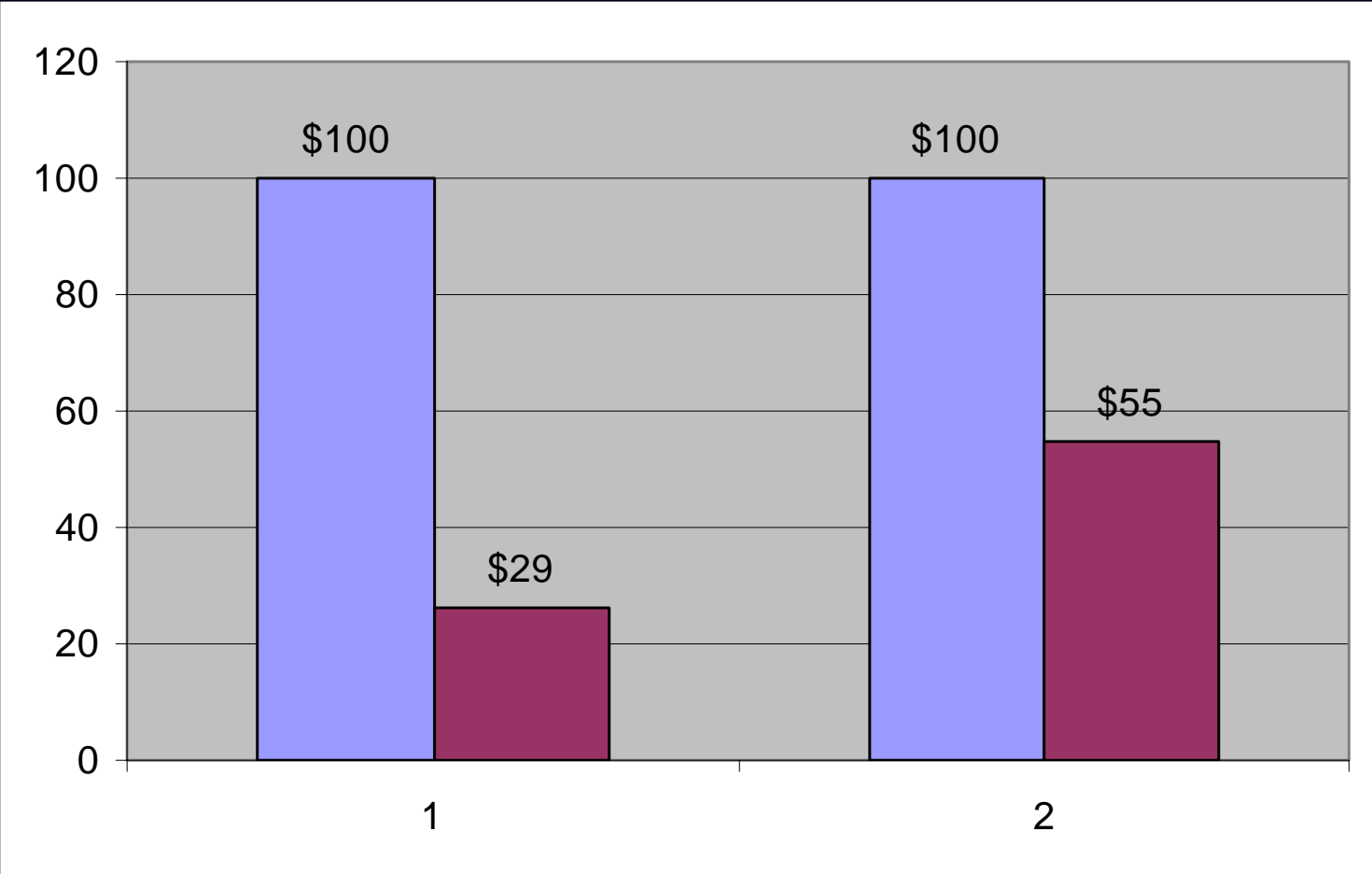
- FEDERAL LAW ESTABLISHES THE INTEREST RATE THAT IS USED TO DETERMINE HOW MUCH MONEY A COMPANY IS REQUIRED TO PUT ASIDE EACH YEAR TO PAY FOR FUTURE BENEFITS IN DEFINED BENEFIT PENSION PLANS.
- IF THIS RATE IS SET TOO LOW, COMPANIES ARE REQUIRED TO CONTRIBUTE MORE THAN NECESSARY TO PAY OUT THE BENEFIT, LIMITING CAPITAL FOR OTHER BUSINESS NEEDS.

# OUR POSITION ON PENSION REFORM FLEXIBILITY AND AFFORDABILITY

## THE NEED FOR MORE REASONABLE INTEREST RATES

- BASED ON AA'S AVERAGE ASSET RETURN OF 13.3% (OVER TEN YEARS), WE WOULD SET ASIDE \$29 FOR EVERY \$100 WE EXPECT TO PAY OUT IN PENSION BENEFITS TEN YEARS FROM NOW.
- BUT FEDERAL PENSION LAW ESTABLISHES A MUCH LOWER INTEREST RATE – 6.1% FOR 2005 – MEANING THAT WE MUST PUT ASIDE \$55 FOR EVERY \$100 IN PENSION OBLIGATIONS.
- THEREFORE, THE COMPANY HAS TO CONTRIBUTE ALMOST DOUBLE WHAT IS NECESSARY TO PROVIDE THE BENEFIT TO THE EMPLOYEE.

# AFFORDABILITY: THE NEED FOR MORE REASONABLE INTEREST RATES



**Employee Benefit: AA Interest  
Rate @ 13.3% over 10 yrs**

**Employee Benefit: Government  
Interest Rate @ 6.1%**

# **SUPPLEMENTAL EXECUTIVE RETIREMENT PLANS**

**EACH WORKGROUP IS COVERED BY ITS OWN RETIREMENT PLAN, WHICH FOR SENIOR EXECUTIVES INCLUDES A RETIREMENT TOOL KNOWN AS A SERP, OR SUPPLEMENTAL EXECUTIVE RETIREMENT PLAN.**

**WE JOIN WITH OUR UNIONS IN ADVOCATING LEGISLATION THAT BANS FUNDING SERPS WHEN MINIMUM CONTRIBUTIONS ARE NOT BEING MADE TO THE CORPORATE DEFINED BENEFIT PLANS.**

# PENSIONS IN THE AIRLINE INDUSTRY: THE COMPETITIVE LANDSCAPE

## LEGACY CARRIERS:

*USAIRWAYS:* USED CHAPTER 11 PROCESS TO TERMINATE ALL DEFINED BENEFIT PENSION PLANS

*UNITED:* PLANS TO TERMINATE DB PENSION PLANS IN MAY 2005.

*DELTA:* FROZE DB PLANS FOR PILOTS, CREATED NEW DC PLAN

*NORTHWEST:* SEEKING TO FREEZE PILOT DB PLAN, CREATE A DC PLAN

# IS YOUR DEFINED BENEFIT PENSION GUARANTEED OR INSURED?

- YES, THE PBGC INSURES DEFINED BENEFIT PLANS, BUT ONLY UP TO A CERTAIN LIMIT. IT DOES NOT INSURE DEFINED CONTRIBUTION PLANS LIKE 401(k)S.
- FOR PARTICIPANTS THAT RETIRE AT AGE 65 YEARS, THE MAXIMUM ANNUAL GUARANTEED BENEFIT FOR SINGLE-EMPLOYER PLANS TERMINATING IN 2005 IS \$3,800 PER MONTH.
- THEREFORE, WHEN THE PBGC TAKES OVER A PLAN, RETIREES SCHEDULED TO RECEIVE MORE THAN THE PBGC LIMIT LIKELY WILL NOT GET THEIR FULL BENEFIT.
- THIS WAS THE CASE FOR US AIRWAYS PILOTS IN 2003. THE MAXIMUM PBGC GUARANTEE THEN WAS \$3,665 – SIGNIFICANTLY LESS THAN THEY WOULD HAVE RECEIVED HAD THEIR PLAN NOT BEEN TERMINATED.