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How Wall Street Wrecked United's Pension

By MARY WILLIAMS WALSH JULY 31, 2005

HAD anyone listened to Doug Wilsman, tens of thousands of United Airlines employees would not be facing big cuts in their pensions. And the federal agency that guarantees pensions might not be struggling with its biggest losses ever.

So who is Doug Wilsman? He is a retired pilot and a former fiduciary of United's pension plan for pilots, and in 1987 he discovered that the company had abandoned its older, tried-and-true approach of investing retirees' money in bonds timed to pay when the pensions came due. Instead, it had bought into the promises of Wall Street that it could put less money into the plan -- and take out more later -- if it just put most of the assets into the stock market.

Mr. Wilsman was skeptical of such promises, and soon after learning of the change in strategy, he filed a grievance with his union, the Air Line Pilots Association. "Hey, you guys are really building yourselves a trap," he recalled warning them at the time. "Someday, at the worst possible moment, when the bottom falls out of the stock market, the plan is going to have to come up with new money, and it's going to be enough to kill the company."

"Everybody knows stocks are cyclical," Mr. Wilsman said last week. So is the airline business. All along, he said, he thought it was almost inevitable that both would one day go south at the same time, with catastrophic results -- which is just what happened this year.

Given Mr. Wilsman's prescience, one might think that experts would be examining how United's investment strategies contributed to the demise of its pension funds -- and whether similar scrutiny elsewhere could prevent more pension plans from crashing.

Not a chance. Congress, regulators, lobbyists and the news media are all scrambling to find out what has gone wrong with the pension system. Hearings have been convened in the wake of United's default, chief executives examined under oath, bills introduced in Congress, numbers crunched. But virtually everyone is looking at the rules covering how much money a company puts into a pension plan every year -- not at what happens to the money after that.

While the money managers and other pension professionals who ran United's pension plan walked away from the wreck unscathed -- indeed, they collected about $125 million in fees over the last five years alone, records show -- the ones who will have to pick up the bill for the advisers' collective failure will be the airline's 130,000 employees and pensioners, the federal pension guarantor and probably, someday, the taxpayers.

The Pension Benefit Guaranty Corporation has said that since 1974, when the insurance program was created, United has paid a little less than $100 million in premiums to insure employees' pensions. Of the $6.8 billion the agency will pay United's retirees in coming years, all but what United paid in premiums will be borne by the other companies participating in the insurance program.

If those companies ever tire of footing other companies' bills, they may cancel their pension plans and drop out of the system. At that point, the taxpayers will have to step in.

United is far from unique. Lifting the lid on how most pension funds are invested might raise an outcry if the 44 million Americans covered by company plans knew these things:

Pension investing is largely unregulated, even though the federal government effectively covers the investment losses when a defined-benefit plan fails. At United, this freewheeling approach gave rise to investments in junk bonds, dot-coms and even what appears to be an energy venture in Albania.

The Securities and Exchange Commission recently said that more than half of the consultants who help pension funds invest their money have outside business relationships that could taint their advice.

It's impossible to get a current list of a company's pension investments. The most detailed, up-to-date information, on file at the Labor Department, is at least two years old.

The Labor Department records also show that the money managers, actuaries, consultants and other professionals who handled United's pension plan earned about $125 million from 1999 to 2003, paid out of plan assets. The records are silent on how the individual money managers performed, nor do they even mention United's main pension consultant, the Russell Investment Group, or how much it was paid.

OFFICIALS at the Pension Benefit Guaranty Corporation, the federal agency that takes over pension funds when they fail, are combing through United's pension documents, trying to ascertain how much the agency owes. What is clear is that as United's pension obligations soared, its pension assets fell. By the time the airline turned over its plan to the pension agency, the shortfall was $10.2 billion.

While the federal agency tries to pinpoint its obligations, apparently no one in an official capacity is pausing to ask who the plans' outside investment professionals were, much less how they made their decisions and how they responded as the airline's fortunes faded.

"It's just a nonstarter," said Richard A. Ippolito, the pension agency's former chief economist, who is now retired. A few years ago, he recalled, a director of the federal pension agency appeared before Congress and suggested that if companies wanted to invest their pension funds in stocks, they should pay more for their pension insurance coverage.

"I could politely say that he was vilified," he said. "They basically accused him of being un-American because he was asking companies to pay for the privilege of investing in stocks. He just dropped that idea."

United's actions offer a typical example of how most companies manage their pension funds. Its portfolio may look aggressive in hindsight -- including high-yield bonds in companies like Adelphia and Bethlehem Steel that eventually went bankrupt, technology stocks that evaporated when the bubble burst and an assortment of private partnerships.

But the general approach was in keeping with what most companies do: about 60 percent stocks, 30 percent bonds and a mixture of "alternatives" including real estate and private equity investments. Local governments often invest their pension funds much more aggressively.

A spokeswoman for United, Jean Medina, said United's pension investments "have outperformed other similar large plans." She added: "United has always operated our plans in the best interests of our participants and beneficiaries, and believe our advisers act similarly."

Companies do not generally invest their pension money themselves, but instead farm out the work to an array of outside professionals. There are pension consultants to help set an investment strategy and recommend the money managers who actually pick the stocks and other particular investments. There are actuaries to design benefits packages and calculate how much companies need to contribute each year.

Custodial banks hold the assets in trust. Brokers execute trades. Once a year, an outside auditor is supposed to review the plan and issue an opinion about its conformity with generally accepted accounting principles.

Problems can arise when there are undisclosed relationships among these different service providers.

"Asset allocation is very much driven by hidden financial considerations," said Edward A.H. Siedle, the president of Benchmark Financial Services, a company that audits pension funds. He said one reason that pension funds tend to invest heavily in high-turnover, active equities is that "those investments have commissions and fees that can be shared with gatekeepers and others that pave the way." Companies that sponsor pension plans can also reap accounting gains if they increase the risk of their pension investments.

There are regulations and other legal safeguards intended to protect pensions, and companies often cite the cost and difficulty of complying with those rules. But much of this protective superstructure was designed decades ago, before the rise of the independent money manager -- and before some of today's investment instruments were invented.

"Pensions are heavily regulated," Mr. Siedle said, "yet it's a kind of funny regulation where the regulators who are responsible for pensions really don't know much about managing money."

Thus there are rules to make sure that pension plans are not really tax shelters in disguise, rules to make sure companies treat low- and high-income workers equitably and, since 1989, rules to keep companies from taking money out of pension funds and using it to run their businesses.

But there is no rule limiting aggressive investment strategies or requiring companies that want to pursue them to pay more for their pension insurance.

Congress sets the premium rates, and there are bills in both houses that would raise them. But even now, the bills make no mention of studying, much less capping, investment risk, or of setting insurance premiums based on portfolio risk factors.

The S.E.C. monitors investment advisers but has no legal standing to enforce the pension rules. In a study, released in May, of pension consultants, it found the industry vulnerable to abuse and referred a dozen consultants to its investigative branch for possible enforcement action.

But it did not name individual consulting firms it suspected of conflicts, nor did it look specifically at how United's pension consultant, the Russell Investment Group, performed in the years leading up to the collapse of the airline's plans. Nor did the S.E.C. say if Russell was one of the consultants now being investigated more deeply.

A spokeswoman for Russell, Jennifer Tice, said the company had not received any inquiries from S.E.C. since the commission completed its general examination of the industry.

Ms. Tice said Russell could not explain why its name and fees were not listed in the United plan's official records, noting that plan sponsors file those records, not the consultant. United said Russell's omission from its filings was an oversight. Both Russell and United declined to say how Russell was compensated.

Ms. Tice, however, said Russell helps its clients answer any questions raised by the S.E.C.'s findings, and regularly tells its consulting clients in the United States about potential conflicts of interest and Russell's policies for managing them. "Russell is committed to full and timely disclosure of any potential conflicts of interest," she said.

THE Internal Revenue Service provides yet another layer of protection to pensions, but it has authority only over how companies design their benefits and contribute money to their plans -- not over whether they have fulfilled their fiduciary duty to invest prudently. That is a job for the Labor Department.

In June, the Government Accountability Office warned of chronic weakness in the Labor Department's enforcement of the pension law, and said the department ought to be coordinating its efforts with the S.E.C.

The Labor Department also has authority over the disclosure of pension data. It collects long lists of all the investments in each pension fund, and of all of the money managers. But it does not track which money managers were responsible for which investments.

That does not sit well with the United employees and retirees who are waiting to find out how much of their pension benefits is covered by the federal pension agency's insurance and how much they may lose.

"When I get a job, I put my name, my file number and my license in a permanent record, and I'm accountable if something goes wrong," said Bob Stone, a lead mechanic for United Airlines who retired this year. "It's possible for every single aircraft mechanic in the country to keep track of every single job they do. But we can't keep track of the money managers. That's too complicated for us."

Because of limits on the government's pension insurance, they will collectively lose benefits worth about $3.4 billion. Pilots will lose the most because they were promised the richest pensions.

Finally, at the end of the regulatory patchwork is the Pension Benefit Guaranty Corporation. Officials there have access to some of the most current and detailed information about pensions, but they cannot do a lot with it; a 1994 act of Congress requires them to keep it secret.

Officials at the pension agency sometimes confide that they feel like they are running not an agency but a big garbage can, where companies can dump their defunct pension plans, no questions asked.

Earlier this year, when United defaulted, Mr. Stone's union began to ask questions about the money managers who handled its pension plan in its final years -- who they were and how they had made their decisions. That labor group, the Aircraft Mechanics Fraternal Association, began to represent United's mechanics only in 2003, after the airline had gone bankrupt. It had no qualms about asking questions about how the pension fund was handled when the previous union had some say over it.

"We have to learn what went wrong," Mr. Stone said. He added that he was sure that some money managers "did their level best for people," but that they all should stand by their decisions. "Unless you separate it out and have accountability," Mr. Stone said, "how are you ever going to reward the good guys and get rid of the bad guys?"

This summer, the labor group wrote to Labor Secretary Elaine L. Chao and Bradley D. Belt, executive director of the pension agency, asking for a forensic audit of United's pension plans, "to determine whether any of the parties providing financial services to the plans may have contributed to their demise."

The letter, signed by the association's national director, O.V. Delle-Femine, cited the recent S.E.C. report warning of potential conflicts of interest among pension professionals, and it urged the pension agency to find out whether tainted advice had played any role in plan losses or underperformance.

"While the plan sponsor may be bankrupt, the parties that have been dealing with the plan are not," Mr. Delle-Femine wrote. "It may be possible to recover assets from these parties on behalf of the plan's participants."

The association also called for an audit of the pension plans at Northwest Airlines, where it also represents the mechanics. Northwest is still running its pension plans but intends to freeze one of them, for salaried employees, at the end of August, locking in employees' benefits at current levels rather than allowing them to increase as they normally would as people worked longer.

Northwest is also seeking its unions' permission to freeze the other three plans. The airline has been warning that if it does not get a break on its pension funding requirements, it may have to declare bankruptcy sometime next year. Bankruptcy is often a prelude to a pension default.

Mr. Delle-Femine sent his letter in June. So far, said the association's legislative liaison, Maryanne DeMarco, there has been no response from the pension agency. The Labor Department told her that Ms. Chao could not participate in an audit of Northwest's pension plans because she served on that airline's board before her confirmation as labor secretary and had recused herself from any involvement in its labor disputes. The Labor Department has yet to respond to the request for an audit of United's pension fund.

"We're all stunned that there isn't a review taking place," said Bill Moons, a United mechanic and the president of the union's local in Denver. "We all want the truth."

He said he and Mr. Stone were two-time losers, having earlier lost another chunk of their retirementsavings when United first went bankrupt and its employee stock ownership program lost all of its value.

The pilots' union had pushed hard for the employee stock ownership program back in the 1980's, at about the same time that Mr. Wilsman, the retired pilot, noticed that the airline had changed its previous investment policy for people like him.

In the past, whenever a pilot retired, the airline used money from the pension fund to buy him or her an annuity from an insurance company. Annuities are lifelong streams of monthly payments, but insurance companies pay them, not pension funds.

Insurance companies are regulated differently, and they have no federal guarantor like the Pension Benefit Guaranty Corporation to cover potential losses. Therefore they tend to invest conservatively, in assets that will not become wildly out of step with the payments they owe.

Mr. Wilsman said he thought that an annuity was a surer thing than a pension promise backed by stocks. He also thought United had violated the terms of the pension plan, and maybe the pilots' labor contract, by making the change unilaterally.

He persuaded other retired pilots to join him in bringing a case before the airline's pension board. Each retiree chipped in $25 to cover the cost of a lawyer. At roughly the same time, Mr. Wilsman also filed a grievance with the union.

But the retired pilots were no match for the siren song of the stock market. The union, which handled their grievance, sided with the airline on investment policy. It said it believed that a high-risk, high-return strategy was best because, over time, it would lower United's compensation costs and free up more money to raise salaries.

"The argument was that the new people could get more benefits if they could do it by gambling than if the plan was secure," Mr. Wilsman said.

A spokesman for the pilots' union said he could not recall Mr. Wilsman's grievance and was unable to comment on it.

Ms. Medina, the United spokeswoman, said that United tried to buy all the pilots' annuities in 1985, as part of a plan to terminate the pension fund and take out the surplus assets for business purposes, but that the pilots' union had blocked it. Two years later, when Mr. Wilsman and the other retirees said they wanted annuities, United told them they were too late, she said.

NOT only were United and the pilots' union lined up against the retirees, Mr. Wilsman said. Even the arbitrator who was brought in to hear the case before the pension board said that he couldn't see why the retirees preferred an annuity to a pension, if the monthly payout was the same either way.

"He said that as far as he was concerned, there was absolutely no difference between an annuity and the company's promise," Mr. Wilsman recalled. Afterward, he said, he thought he should have come up with an example of why they weren't the same, but he was tired of arguing with people dead-set against him. So he withdrew the grievance.

"It has always haunted me that I failed to cite an example," he said in a recent telephone interview.

But the best example didn't happen until 18 years later.