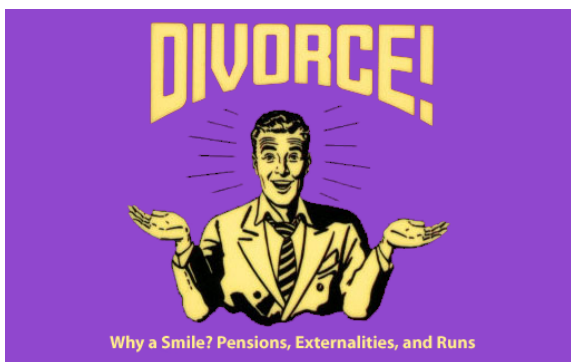


Freakster: Pension Runs?

Freaksternalities, Episode 1

Continental suggests in lawsuit that some pilots got fake divorces to cash out of their pensions early. What does this teach us about “runs”?

According to a recent [ABC News story](#), Continental Airlines is currently suing nine of its (now mostly former) pilots alleging that they faked divorces to fraudulently gain early access to pension benefits prior to retirement. In particular, by getting divorced, federal laws on defined benefit pensions plans (ERISA) allow spouses of the beneficiary to cash out a share of these benefits immediately. In the case of Continental, these early payoffs reached as high as \$900K.



From the perspective of the pilots and their families, a strategic divorce seems perfectly consistent with the pursuit of self-interest. Given the uncertainty in their industry, the economy in general, and losses in the stock market, they are worried about their financial well-being. The solvency of Continental Airlines, in particular, is terrifying for these pilots in two ways: (i) They might lose their jobs and need access to a reserve of funds (i.e., they fear a liquidity shock) and (ii) Their defined pension assets might lose substantial value since pension insurance, provided by the PBGC, is (currently) capped at \$54K per year. Getting this early payoff secures them on both fronts since it provides a cushion to absorb a liquidity shock and increases the lower bound on the value of their pension assets (Remark: As I understand it, they would still be entitled to getting up to \$54K on their remaining defined pension plan balance).

Of course, their gains come at the expense of others. So who loses? It's natural to assume that Continental is the lone loser here but this is wrong. In fact, Continental

is, at most, an indirect loser. The direct losers are the other pilots who do not divorce. Why? Because the defined pension assets are commonly shared by all pilots and, in circumstances where there is a benefit to being “first out of the common pool”, those who are “last out” get the shaft. Moreover, if Continental is in distress, it is arguably not even the indirect loser with the most to lose. The federal government is. Why? Because it funds pension insurance payouts and the size of the payout increases as the value of the common pool of assets diminishes. In economic parlance, the existence of losers implies that there is a negative externality associated with strategic divorce. Negative externalities usually lead to too much of the activity that causes this externality. So, given these observations, one might wonder: “Is it surprising that some pilots seem to be strategically divorcing or is it surprising that other pilots are not doing this?”

Prior to touching on this, I'd like to point out that the economic logic that drives strategic divorce in this case is identical in spirit to many settings with collective decision-making where individuals can take actions to be “first out of a common pool of illiquid assets”. A concrete and notable example of this is a bank run. Bank runs can arise in commercial banking because of the nature of demand deposits or short-term lending. For an example, think (or Google) Northern Rock and, to some extent, IndyMac. Can you figure out the logic behind a bank run and draw the analogy to “pension runs”? While many readers will get the essence of the answer on their own, there are some neat nuances that come up when rigorously thinking about the micro-foundations of bank runs. For details on these, interested and ambitious readers can consult a [paper by Douglas Diamond and Philip Dybvig](#) (a summary of their original 1983 paper “Bank Runs, Deposit Insurance, and Liquidity,” an extremely influential paper in the field). In fact, given recent innovations and events in financial markets, other academics have begun exploring some new varieties of runs in the world of finance. For instance, a recent Kellogg PhD, Zhiguo He, has a working paper on “funding runs” that emphasizes roll-over risk in a dynamic financing environment. The paper, which is joint work with Wei Xiong, is currently titled “[Dynamic Bank Runs](#)”. Other examples of runs can be found in settings of delegated asset management with illiquid assets (e.g. hedge funds, private equity, venture capital, etc.). Indeed, the anticipation of inefficiencies associated with such runs probably explains why many funds of this type place liquidity provisions that restrict how and when their investors can redeem their investments in the fund.

In any case, let's now revisit the strategic divorce decision for Continental pilots (i.e., the “run” vs. “don't run” decision). Personally, I don't think it's surprising that most pilots choose not to run in this setting. My reasoning is threefold:

- First and foremost, PBGC insurance does provide some (plausibly adequate) fallback in the case that the pension fund becomes insolvent. Keep in mind that the trade-off in the run vs. don't run decision would be very different if no such insurance was provided. In that hypothetical case, I believe everyone would try to run if they could and this might even precipitate the occurrence

of insolvency itself (i.e., insolvency would be self-fulfilling). Actually, these observations highlight some important points from the Diamond-Dybvig model: (i) a run can be self-fulfilling and (ii) insurance provision (e.g., pension insurance or deposit insurance) can help avoid runs altogether.

- Second, strategic divorce for the purpose of getting an early pension payoff constitutes fraud (referred to as QDRO fraud) so one runs the risk of getting into trouble with the law when running. This, of course, is highlighted by the existence of the Continental lawsuit. Indeed, it might be difficult to implement a strategic divorce without incurring substantial inconvenience costs (loss of certain perks, but this might be naïve since I haven't been married that long) or making it obvious that your divorce was strategic. In the case of the Continental pilots, they got divorced but never physically separated. In what I would describe as both striking and humorous but certainly not smart, some didn't even tell their friends and family about the divorce! For a discussion on how firms can respond to such fraud, check out the QDRO fraud opinion below in the context of a similar case from the late 90's involving United Airlines and some of its maintenance workers.
- Third, some people are reluctant to take actions that will directly harm others even when they, in some narrow sense, benefit from these actions. Put differently, some folks actually care about others. Standard research in economics often ignores this. Not all though. One of my colleagues recently described work in experimental economics that suggests that altruism is very real (somehow many economists view this as "thought provoking") and is especially prominent with respect to other people in your social network. I don't remember the exact reference but it seems like this might apply for the Continental pilots.

Of course, I also don't find it surprising that a small number of pilots have decided to run in this case. As we all know, some people have a strong preference towards more money versus less money, are confident that they can get away with almost anything, and don't really care about others...

Rather than end this blog with an obvious set of observations, let me end it with an assignment. Read [this New York Times article](#). It claims to describe a new type of run. Does it? In comparing the freeze in credit markets to a bank run, determine which key elements of each phenomena are common between the two and which are distinct. Feel free to post your answers below . . .

Appendix A: [Here](#) is an advisory opinion obtained by United Airlines in 1999 regarding its legal options when suspecting QDRO fraud. Also, acronyms (in order of appearance): ERISA: Employee Retirement Income Security Act, PBGC: Pension Benefit Guaranty Corporation, and QDRO: Qualified Domestic Relations Order.

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About "Freaksternalities": Freaksternalities will be a 3 episode series of short essays that touch upon fringe issues in contracts, regulation, and the law that are, directly or indirectly, relevant to financial economics. The purpose of this series will be to take eye catching and odd storylines from the press and interpret them from the perspective of a financial economist. In so doing, the main goal of these episodes will be to introduce the reader to some important and fundamental ideas developed by prominent economists and financial economists in ways that are (hopefully) "made to stick". This series is meant to complement current submissions in the "Everything Finance" blog by focusing on how ideas relevant to finance can be applied more broadly. Think "Finance Everything" rather than "Everything Finance". Expect one episode a month over the summer of 2009.

About the "Freakster": The Freakster is equally known as Jiro E. Kondo, Assistant Professor of Finance at the Kellogg School of Management, Northwestern University. He holds a BA in Economics from Princeton University and a PhD in Financial Economics from MIT's Sloan School of Management. He joined Kellogg in the Fall of 2007 and teaches introductory finance at the school. His research interests lie at the intersection of economics, law, and finance with an emphasis on statutory and private contracting issues.