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RETIREMENT MADE RISKIER

House pension bill, Treasury proposal ignore the real problems

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The U.S. Congress adjourned last year after failing to address the faults in a pension system that has been laid bare by catastrophic 401(k) losses for thousands of workers, the tumbling stock market, and high-profile corporate abuse of retirement plans. Congress is now setting itself up to make the system even worse.

In February, Congressman John Boehner (R-Ohio) and 54 co-sponsors introduced H.R. 1000, the Pension Security Act of 2003, nearly identical to a bill passed by the House in April 2002. Once again proponents are claiming that the bill would help prevent future Enrons and increase retirement security for America's workers. But despite this recycled rhetoric, the bill would do nothing to prevent the kind of devastating retirement income losses suffered by millions of employees and retirees at Enron, WorldCom, and other companies. In fact, it would weaken or even eliminate existing safeguards.

To make matters worse, the Treasury Department has proposed a regulatory change that would remove a moratorium on conversions from traditional defined benefit plans to cash balance plans. Evidence shows that older workers who are employed at companies that have made this switch have seen their retirement nest eggs shrink by 20% to 50%. In other words, these regulations would undermine a relatively safe retirement benefit—traditional defined benefit plans—and add to households' retirement security woes.

Neither proposal will address the three primary problems with today's pension system: lack of coverage for half the workforce, inadequate pension income for low- and middle-income workers, and an unacceptable risk of pension losses for all workers. Clear strategies exist to address each of these issues (Weller 2003), but the Pension Security Act of 2003 and the proposed regulatory changes miss the mark entirely.

Only half of America's workers have pension coverage at any given time

Just 50% of private sector workers had pension coverage in 2000 (Mishel, Bernstein, and Boushey 2003), a level that has increased only slightly since 1970. Whether or not a worker is covered by a pension plan depends on several factors: income level, full- or part-time status, education, and race.

In 2000, 73% of high earners (the 20% with the highest incomes) had pension coverage, compared with just 18% of low earners (the 20% with the lowest incomes). Hispanic workers are covered at a startlingly low rate of 29%, compared with 43% and 55% for their African American and white counterparts, respectively (Mishel, Bernstein, and Boushey 2003).

Stagnant levels of pension coverage are particularly surprising when one considers the large federal expenditures aimed at increasing coverage for U.S. workers. According to the Joint Committee on Taxation, the federal government lost over \$89 billion in tax revenue in 2000 alone as a result of this subsidy (EBRI 2001).

Under current law, employers that receive these federal subsidies must pass a “non-discrimination test,” under which firms can exclude some lower-income employees from coverage, but not all, while covering all higher-income employees. Specifically, the test stipulates that a company that receives such subsidies and provides pension coverage for its employees who earn \$90,000 or more annually must provide coverage for at least 70% of its lower-paid workers. If it can't meet that prong of the test, then the average benefit received by the lower-paid workers must be at least 70% of the benefit received by the highly compensated workers.

But H.R. 1000 will effectively destroy this already-thin layer of protection for low-income workers. Under the guise of the now-familiar refrain of “increased flexibility” (a goal that typically means more money for employers and less money/fewer rights for workers), the House bill would allow companies to exclude more of their employees from pension coverage and avoid the two-tiered test of fairness.

Pension wealth is unequally distributed

Like pension coverage, levels of retirement wealth depend on several factors; however, race, income, and gender are the primary determinants of one's retirement income level. African American and Hispanic retirees are far more likely to experience poverty in retirement. As of 1998, a startling 43% of African Americans and Hispanic workers age 47-64 could expect retirement incomes below the poverty line, compared with 13% of non-Hispanic whites (Wolff 2002).

Not only is there widespread inequity in retirement wealth, the overall level of retirement security has decreased, even during the booming stock market of the 1990s. In fact, the stock market boom benefited a tiny minority of Americans—those with accumulated wealth of \$1 million or more. The share of households age 47-64 that can expect to replace less than half of their pre-retirement income increased from 30% in 1989 to 40% in 1998 (Wolff 2002).

Retirement income risks have increased

Increasingly, households receive their retirement benefits from defined contribution plans, such as 401(k) plans, and not from traditional defined benefit plans. In 1998, 48% of households between the ages of 47

and 64 have a defined contribution plan, up from 8% in 1983. In comparison, 46% of households in the same age group in 1998 could expect some benefits from a defined benefit plan, down from 68% in 1983 (Wolff 2002).

This shift toward defined contribution plans and away from defined benefit plans has increased retirement income risks for households (Weller and Eisenbrey 2002). Individual workers and their families bear all the risks associated with a defined contribution plan, while the risks under a defined benefit plan are limited, primarily because they are shared by the federal government, which insures the plans, and by employers.

Workers are often unprepared to deal with the myriad risks inherent in defined contribution plans. Well-known are the risks of picking the wrong investment strategy or of simply being unlucky. Yet there is also the risk of being born in the wrong year. Generally, it is assumed that individuals save and invest for around 20-25 years. However, rates of return have fluctuated widely for 20-year periods. Depending on the starting date, which is determined by the person's year of birth,¹ rates of return have been anywhere from zero to double-digit percentages. And there are other risks, so clearly demonstrated in the case of Enron—fraud, insider trading, and mismanagement.

Finally, there is one risk that is common to both defined contribution and defined benefit plans—the risk that an employer will unilaterally change the rules of the company's retirement plan. For instance, under a defined contribution plan an employer is not obligated to pay promised benefits, and hence it can eliminate any contributions at any time. Also, under a defined benefit plan, the pension plan guarantees only benefits that have been earned up to the present; the pension plan does not guarantee any future benefits that employees may count on. In other words, employers can change the benefit formula for future benefits at any time, thus reducing the retirement benefit that employees had expected.

Proposed changes raise retirement income risk and insecurity

Both the Pension Security Act and the proposed Treasury regulations would exacerbate the three underlying problems of the nation's pension system. In particular, the Pension Security Act would eliminate the existing non-discrimination rule, thereby making it easier for employers to exclude the low- and moderate-income workers who are most likely to have inadequate pension coverage. The House bill would allow companies to exclude more of their employees from pension coverage and avoid the non-discrimination tests that current laws require.

Similarly, the Pension Security Act would weaken the ability of low- and moderate-income households to save for retirement. Workers who are not covered by an employer's pension plan have fewer options to save for retirement. Since the bill would make it easier for employers to exclude low- and moderate-income workers from pension coverage, it would make it less likely that these workers will have saved enough for a decent standard of living by the time they retire.

Similarly, the proposed regulations for the conversion of traditional defined benefit plans to cash balance plans would make it more difficult for many workers to accumulate adequate retirement savings. Under a traditional defined benefit plan, the employee is guaranteed a benefit upon retirement, usually based on years of service, age, and final (and presumably above-average) earnings. The benefit formula is designed so that employees accrue most of their benefits during their last years of service. In comparison, under a cash balance plan, the

employee accrues benefits in direct proportion to his or her current earnings. Essentially, a worker's pension account is credited with an amount equal to a fixed share of his or her annual earnings, and the account balance increases at a pre-determined interest rate. Younger workers accrue greater pension wealth under a cash balance plan than under a traditional defined benefit plan and vice versa. Due to the change in the way the benefits are calculated when converting from a traditional defined benefit plan to a cash plan, older workers lose out. The General Accounting Office (GAO) estimates that older workers whose pension plans are converted to cash balance plans experience a 20% to 50% loss in pension benefits (Revell 2003).

Improving pension security

According to supporters of the Pension Security Act, the bill is designed to protect worker pensions. Congressman Boehner, chairman of the Education and the Workforce Committee, describes it this way: "In order to prevent more massive losses to 401(k) accounts in the aftermath of an Enron-like collapse, Congress' first priority must be providing workers with new pension protections" (Committee on Education and the Workforce 2003).

But in reality, the House bill and the Treasury Department's proposed regulatory changes are a step backward for pension security. The Pension Security Act will weaken current protections and won't curb the kinds of corporate abuse that left Enron and WorldCom workers with empty pension accounts. The House bill would not prevent over-concentration of employer stock in worker 401(k)s, it would not ensure that employees receive unbiased financial advice, it would not prevent insider trading, it would not allow employees to sue executives for criminal activity, and it would not enhance the transparency of pension fund management.

Diversification: prevent over-concentration in employer stock

Diversification of assets in 401(k) plans is the best way to safeguard employees from catastrophic losses to their retirement savings. The more employees invest in a single stock, the more they stand to lose if that stock falters, yet many employers encourage employees to over-invest in employer stock. In January 2001, 60% of Enron employee retirement accounts—then valued at \$2.1 billion—were invested in Enron stock. Over the course of that year, the stock's value fell by more than 95%, causing workers to lose over \$1 billion in retirement savings.

The House bill does not include any restrictions on the amount of employer stock that employees can hold in their 401(k)s. It does allow constraints on employee flexibility with regard to company stock, however: the bill would let employers prevent employees from selling employer stock until they've been with the company for three years or until three years after each contribution is made by the company.

Investment advice: end conflicts of interest

Part of the risks that employees face with their individual accounts results from fraudulent, biased, or inaccurate advice from an investment advisor. In particular, when an investment advisor has a financial interest in a particular product, he or she may be incapable of providing unbiased investment advice,

thereby jeopardizing the retirement security of workers. Current law, implemented through the “prohibited transaction” rule under ERISA (the Employee Retirement Income Security Act), protects employees from such conflicted advice by disallowing fiduciaries with a financial or other conflict of interest from providing investment counsel to employees. The Pension Security Act creates an exemption from the current “prohibited transaction” rule, removing the safeguards in current law that protect employees from conflicted investment advice. The strictures imposed under current law need to be maintained.

Deter insider trading

Insider trading refers to the fact that some people, such as corporate managers, who have superior information due to their position in a company, take advantage of this information by selling or buying stocks before everyone else does. Such actions are illegal. However, because insider trading is often completed through undocumented methods, it is extremely difficult to prove. Therefore, employees should be immediately notified of any large transactions in company stock by insiders.

At Enron, such notification would have alerted workers to the company’s rapidly declining financial position. At the same time that managers and executives dumped over \$1 billion in stock, they were encouraging employees to continue investing, hoping that employee investments would slow the stock’s sinking value. The Pension Security Act includes no provision to notify employees of large transactions by managers and executives.

Hold employers accountable

Executives must be held accountable for deliberately providing misleading information regarding employee 401(k) accounts. In August 2001, Enron Chief Executive Officer Ken Lay told employees “...I want to assure you that I have never felt better about the prospects for the company” (U.S. Senate 2002), as he and several other executives unloaded over \$1 billion in Enron stock. The House bill includes no provision to expand liability beyond plan fiduciaries, thus preventing employees from suing top executives for culpability in providing misleading information.

Guarantee employee representation on investment boards

As the case of Enron demonstrated, many problems arise from a lack of transparency on the financial health of retirement plans. Executives and financial advisors misled employees who did not possess the same information that company insiders had. To reduce the risks that employees face with their retirement savings, transparency of 401(k) plans must be increased. One means to achieve this goal would be to require participant representation on boards of trustees. The House bill does not require companies to give rank-and-file employees a position on the board of trustees of pension plans.

Protect against conversion to cash balance plans

By making it easier for employers to switch from traditional defined benefit plans to cash balance plans, the Treasury Department would allow many older Americans to lose a significant percentage of their expected retirement income. In order to halt the Administration’s plan, Congress would have to vote to stop the regulatory

changes. Representative Bernard Sanders (D-Vt.) has proposed an amendment that would require companies to allow employees to choose whether to convert to a cash balance plan and to give them sufficient information to determine the impact of a conversion on their retirement income. Since the GAO estimates that only 9% of companies who switch to cash balance plans give employees the option of staying in their defined benefit plan (Revell 2003), millions of older workers are likely to lose out without legislative protection.

Conclusion

The recent decline in the stock market and the high-profile collapses of companies like Enron and WorldCom have focused attention on the inadequacies of the nation's private retirement system. Only half of all workers are covered by a pension plan at any given time, and retirement wealth is becoming more unequally distributed, leaving many low- and moderate-income households with inadequate retirement savings. The huge losses at these companies also illustrated the increased risk exposure that many households are facing as the retirement system shifts from traditional defined benefit plans to defined contribution plans.

Both the Pension Security Act and the Treasury Department's proposed cash balance conversion regulations for defined benefit plans would make the pension system less secure for workers. The Pension Security Act would erode one of the most important protections for workers by eliminating existing non-discrimination rules and pushing coverage and retirement savings for low- and moderate-income households further out of reach. It would also weaken existing laws that protect employees from conflicts of interest. And the proposed regulations would make it easier for companies to unilaterally reduce the benefits that employees would receive under their defined benefit plans.

Instead of ill-advised policies that will erode retirement income security, policy makers should consider a number of steps that will improve retirement security for most households, especially low- and moderate-income ones. These policy measures include mandatory pension coverage, mandatory employer contributions, direct and matching government contributions for low- and moderate-income households, safeguards for savings held in defined contribution plans, and protections of promised benefits in defined benefit plans (Weller 2003).

Endnote

1. Arguments that tout the superior performance of stocks relative to bonds tend to look at the long run (e.g., 75 years). However, no individual will invest for 75 years, which makes 20-year periods a more relevant comparison.

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