United States General Accounting Office

Testimony
Before the Senate Finance Committee

For Release on Delivery
Expected at 2:00 p.m.,
Wednesday, February 27, 2002

PRIVATE PENSIONS

Key Issues to Consider Following the Enron Collapse

Statement of David M. Walker
Comptroller General of the United States

GAO-02-480T

Mr. Chairman and Members of the Committee:

I am pleased to be here today to provide you with preliminary observations on some of the challenges facing our nation's private pension system. Pension income is crucial to American retirees' standard of living. About half of Americans over 65 receive payments from pensions and savings plans, and such income represents about 18 percent of their total income. Over 70 million workers participate in pension and savings plans, and such plans in 1997 represented about $3.6 trillion in retirement savings.

The federal government encourages employers to sponsor and maintain pension and savings plans for their employees. The private pension system is voluntary and consists of defined benefit plans and defined contribution plans. Defined benefit plans promise to provide a level of retirement income that is generally based on salary and years of service. Defined contribution plans are based on the contributions to and investment returns on the individual accounts. Such plans include thrift savings plans, profit-sharing plans, and employee stock ownership plans (ESOPs).

The financial collapse of the Enron Corporation and its effect on the company's workers and retirees suggests certain vulnerabilities in these selected savings mechanisms. Enron's retirement plans, which included a defined benefit cash balance plan, a defined contribution 401(k) plan, and an ESOP, caused Congress to question specifically the use of employer stock as the company match, the continued existence of floor offsets, and the practice of investment freezes or lockdowns during changes in plan administrators. The financial losses suffered by participants in Enron's retirement plans have raised questions about the benefits and limitations of such private pension and savings plans and the challenges employees face in saving for retirement through their employer-provided plans.

You asked me here today to help provide context for considering how to address the vulnerabilities the Enron case may suggest. Accordingly, I will discuss three areas that, because of the experience with Enron, appear particularly salient to policymakers' decisions: (1) the importance of investment diversification and related investor education issues; (2) the crucial role of disclosure, and what information employees need and can expect about their company and their pension plans; and (3) the importance of fiduciary rules in safeguarding employee pension assets. In discussing these three issues, I will also address certain plan design issues such as floor-offsets, using company stock in pension plans, and plan operation issues, such as investment freezes or lockdowns. My

observations are based on prior GAO work, a preliminary review of Enron's and other public companies' plans, discussions with industry experts and senior regulatory officials, and my personal experience, including my former position as Assistant Secretary of Labor for Pension and Welfare Benefit Programs.

In summary, the collapse of the Enron Corporation and the accompanying loss of Enron employees' retirement savings appear to highlight vulnerabilities in the private pension system and help focus attention on strengthening several aspects of this system. Diversification of pension assets is crucially important, particularly in a world where the use of defined contribution plans—those plans in which employees bear the investment risk—is increasing. If both the employees' 401(k) contributions and the company match are largely in employer stock, as was the case at Enron, employees risk losing not only their jobs should the company go out of business, but also a significant portion of their retirement savings. The Enron situation suggests the importance of encouraging employees to diversify but any action would have to be balanced against the desires of employers and employees to maintain a portion of retirement savings in company stock. In addition, the Enron situation illustrates the need to provide employees with investment education and advice that will enable them to better manage their retirement savings.

Workers need clear and understandable information about their pension plans to make wise retirement saving decisions. While disclosure rules state that plan sponsors must provide plan participants with a summary of benefits and rights under their pension plan and notification when plan benefits are changed, such information is not always clear, particularly in describing complex plans, like floor-offset arrangements. We have also observed in earlier work that wide variation exists in the type and amounts of information workers receive about plan changes that can potentially reduce pension benefits, and enhanced disclosure requirements may be warranted. Furthermore, employees, like other investors, need reliable and understandable information about a company's financial condition and prospects.

Finally, fiduciary standards form the cornerstone of private pension protections. These standards require plan sponsors to act in a manner that is solely in the interest of plan participants and beneficiaries. In the end, investigations of Enron's actions related to its plans will determine whether plan fiduciaries acted in accordance with these responsibilities. In light of Enron, policymakers may wish to consider whether current fiduciary standards are sufficient or whether they require strengthening,

and act accordingly to address these fundamental principles of pension management.

The Enron collapse provides the Congress with clear examples of issues it may wish to consider when deciding whether and how to strengthen the security of plan benefits. These issues include employees' need for enhanced education and appropriate investment advice, plan designs such as floor-offset arrangements and the use of employer stock in retirement savings plans, and plan operations, such as plan investment freezes and lockdowns. Addressing these issues will require balancing the need for greater participant protections with the potential increase in employer burden that could undermine their willingness to sponsor or contribute to such plans.

Background

The Internal Revenue Code (IRC) defines pension plans as either defined benefit or defined contribution and includes separate requirements for each type of plan. The employer, as plan sponsor, is responsible for funding the promised benefit, investing and managing the plan assets, and bearing the investment risk. If a defined benefit plan terminates with insufficient assets to pay promised benefits, the Pension Benefit Guaranty Corporation (PBGC) provides plan termination insurance to pay participants' pension benefits up to certain limits.

Under defined contribution plans, employees have individual accounts to which employers, employees, or both make periodic contributions. Plans that allow employees to choose to contribute a portion of their pre-tax compensation to the plan under section 401(k) of IRC are generally referred to as 401(k) plans. In many 401(k) plans employees can control the investments in their account while in other plans the employer controls the investments. ESOPs may also be combined with other pension plans, such as a profit-sharing plan or a 401(k) plan.[1] Investment income earned on a 401(k) plan accumulates tax-free until an individual withdraws the funds. In a defined contribution plan, the employee bears the investment risk, and plan participants have no termination insurance.

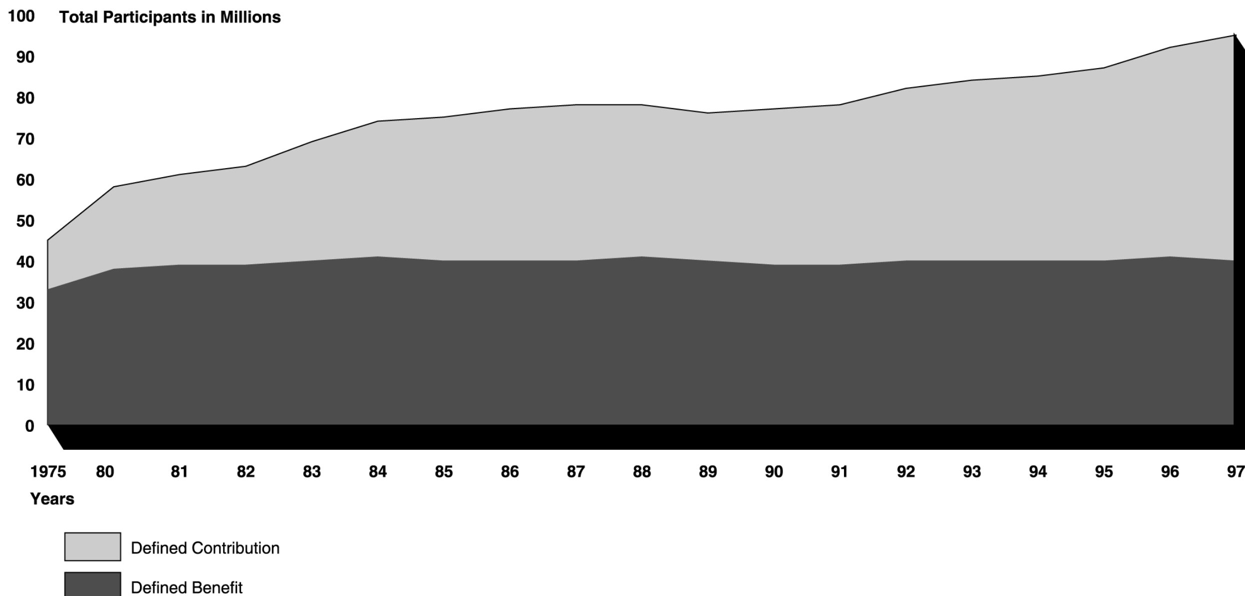
The Internal Revenue Service (IRS) and the Pension and Welfare Benefits Administration (PWBA) of the Department of Labor (DOL) are primarily responsible for enforcing laws related to private pension plans. Under the

[1] When an ESOP is combined with a 401(k) plan, it is called a KSOP.

Employee Retirement Income Security Act of 1974 (ERISA), as amended, IRS enforces coverage and participation, vesting , and funding standards that concern how plan participants become eligible to participate in benefit plans, earn rights to benefits, and reasonable assurance that plans have sufficient assets to pay promised benefits. IRS also enforces provisions of the IRC that apply to pension plans, including provisions under section 401(k) of the IRC. PWBA enforces ERISA's reporting and disclosure provisions and fiduciary standards, which concern how plans should operate in the best interest of participants.

Since the 1980's, there has been a significant shift from defined benefit plans to defined contribution pension plans. Many employers sponsor both types of plans, with the defined contribution plan supplementing the defined benefit plan. However, most of the new pension plans adopted by employers are defined contribution plans. According to the Department of Labor, employers sponsored over 660,000 defined contribution plans as of 1997 compared with about 59,000 defined benefit plans. As shown in figure 1, defined contribution plans covered about 55 million participants, while defined benefit plans covered over 40 million participants in 1997.

Figure 1: Participants in Private Pension Plans, 1997



The number of employer-sponsored 401(k) plans has also increased substantially in recent years, increasing from over 17,000 in 1984 to over 265,000 plans in 1997. In 1997, 401(k) plans accounted for 40 percent of all employer-sponsored defined contribution plans and approximately 37 percent of all private pension plans. Approximately 33.8 million employees actively participated in a 401(k) plan, and these plans held about $1.3 trillion in assets as of 1997.[2]

The continued growth in the number of defined contribution plans and plan assets is encouraging, but concerns remain that many workers who traditionally lack pensions may not be benefiting from these plans, and the overall percentage of workers covered by pensions has remained relatively stable for many years. Furthermore, the trend toward defined contribution plans and the increased availability of lump-sum payments from pension plans when workers change jobs raises issues of whether workers will

[2] "Private Pension Plan Bulletin: Abstract of 1997, Form 5500 Annual Reports." US Department of Labor, Pension and Welfare Benefits Administration. Winter 2001.

preserve their pension benefits until retirement or outlive their retirement assets.

Similar to other large companies, Enron sponsored both a defined benefit plan and a defined contribution plan, covering over 20,000 employees. Enron's tax-qualified pension plans consisted of a 401(k)-defined contribution plan, an employee stock ownership plan, and a defined benefit cash balance plan. Under Enron's 401(k) plan, participants were allowed to contribute from 1 to 15 percent of their eligible base pay in any combination of pre-tax salary deferrals or after-tax contributions subject to certain limitations.[3] Enron generally matched 50 percent of all participants' pre-tax contributions up to a maximum of 6 percent of an employee's base pay, with the matching contributions invested solely in the Enron Corporation Stock Fund. Participants were allowed to reallocate their company matching contributions among other investment options when they reached the age of 50.[4]

Enron's employee stock ownership plan,[5] like other ESOPs, was designed to encourage employee ownership in their company. The plan provided employee retirement benefits for workers' service with the company

[3] Participants were immediately fully vested in their voluntary contributions and employees hired after July 1999 are fully vested in their company contributions after 1 year of service.

[4] For defined benefit plans, ERISA limits the amount of employer stock and real property that can be held to 10 percent of plan assets. However, defined contribution plans, including 401(k) plans, ESOPs, and other defined contribution plans with individual accounts, are generally exempt from this requirement. While the vast majority of 401(k) plans are thus not subject to any restriction on the amount of employer stock that it may hold, there are limited circumstances under which the 10 percent limitation could apply to a 401(k) plan.

[5] The ESOP provided for three subaccounts, (1) a savings subaccount where the plan allocated shares of Enron stock equal to 10 percent of each participant's base pay; (2) a retirement subaccount where the plan allocated shares of Enron stock based on each participant's age, years of service, and base pay; and (3) a special subaccount for participants active on December 31, 1994, where the participants received an allocation to this account and the defined benefit portion of their retirement plan. This allocation in total equaled 5 percent of their base pay and was in lieu of an accrual to their 1995 defined benefit plan. According to Enron plan documents, the vested portion of a participant's retirement subaccount was used to offset the benefit they earned from Enron's cash balance plan from January 1, 1987 through December 31, 1994. The offset was calculated using the value of the shares of Enron stock based on the earlier of when the shares were distributed or when the shares were available to be withdrawn from the ESOP. Once a plan participant has access to the shares of his or her retirement subaccount, the shares' value is used to offset the benefit they have earned from the Enron defined benefit plan for their service between January 1, 1987, and December 31, 1994.

between January 1, 1987, and December 31, 1994. No new participants were allowed into the ESOP after January 1, 1995.

Finally, Enron sponsored a cash balance plan, which accrued retirement benefits to employees during their employment at Enron. An employee was eligible to be a member of the cash balance plan immediately upon being employed. According to DOL officials, the cash balance plan did not have any investments in Enron stock as of the end of 2000. If the plan is unable to pay promised benefits and is taken over by PBGC, vested participants and retirees will receive their promised benefits up to the limit guaranteed under ERISA.

Greater Diversification and Investment Sophistication May Be Needed

The Enron collapse points to the importance of prudent investment principles such as diversification, including diversification of employer matching contributions. Diversification helps individuals to mitigate the risk of holding stocks by spreading their holdings over many investments and reducing excessive exposure to any one source of risk. Many workers are covered by participant-directed 401(k) plans that allow participants to allocate the investment of their account balances among a menu of investment options, including employer stock. Additionally, many plan sponsors match participants' elective contributions with shares of employer stock.

When the employer's stock constitutes the majority of employees' account balances and is the only type of matching contribution the employer provides, employees are exposed to the possibility of losing more than their job if the company goes out of business or into serious financial decline. They are also exposed to the possibility of losing a major portion of their retirement savings. For example, DOL reports that 63 percent of Enron's 401(k) assets were invested in company stock as of the end of 2000. These concentrations are the result both of employee investment choice and employer matching with company stock. The types of losses experienced by Enron employees could have been limited if employees had diversified their account balances and if they had been able to diversify their company matching contributions more quickly.

Companies prefer to match employees' contributions with company stock for a number of reasons. First, when a company makes its matching contribution in the form of company stock, issuing the stock has little impact on the company's financial statement in the short term. Second, stock contributions are fully deductible as a business expense for tax purposes at the share price in effect when the company contributes them. Third, matching contributions in company stock puts more company

shares in the hands of employees who some officials feel are less likely to sell their shares if the company's profits are less than expected or in the event of a takeover. Finally, companies point out that matching with company stock promotes a sense of employee ownership, linking the interests of employees with the company and other shareholders.

Some pension experts have said that easing employer restrictions on when employees are allowed to sell their company matching contributions would increase their ability to diversify. In 1997, a majority of the Pension and Welfare Benefits Administration Advisory Council working group on employer assets in ERISA plans recommended that participants in 401(k) plans be able to sell employer stock when they become vested in the plan.[6] Additionally, legislation has recently been introduced that would limit the amount of employer stock that can be held in participants' 401(k) accounts and provide participants greater freedom to diversify their employer matching contributions. Proponents of allowing employees to diversify employer stock matching contributions more quickly say that this would benefit both employers and employees by maintaining the tax and financial benefits for the company while providing employees with more investment freedom and increased retirement benefit security. However, others have expressed concern that further restrictions on employer plan designs may reduce incentives for employers to sponsor plans or provide matching contributions.

Even with opportunities to diversify, studies indicate that employees will need education to improve their ability to manage their retirement savings. Numerous studies have looked at how well individuals who are currently investing understand investments and the markets. [7] On the basis of those studies, it is clear that among those who save through their company's retirement programs or on their own, large percentages of the investing population are unsophisticated and do not fully understand the risks associated with their investment choices. For example, one study found that 47 percent of 401(k) plan participants believe that stocks are components of a money market fund, and 55 percent of those surveyed

[6] Pension and Welfare Benefits Administration Advisory Council on Employee Welfare and Pension Benefits Plans, Report of the Working Group on Employer Assets in ERISA Employer-Sponsored Plans, November 13, 1997.

[7] U.S. General Accounting Office, *Social Security: Capital Markets and Educational Issues Associated With Individual Accounts*, GAO/GGD-99-115 (Washington, D.C., June 1999).

thought that they could not lose money in government bond funds. Another study on the financial literacy of mutual fund investors found that less than half of all investors correctly understood the purpose of diversification. These studies and others indicate the need for enhanced investment education about such topics as investing, the relationship between risk and return, and the potential benefits of diversification.

In addition to investor education, employees may need more individualized investment advice. Such investment advice becomes even more important as participation in 401(k) plans continues to increase. ERISA does not require plan sponsors to make investment advice available to plan participants. Under ERISA, providing investment advice results in fiduciary responsibility for those providing the advice, while providing investment education does not. ERISA does, however, establish conditions employers must meet[8] in order to be shielded from fiduciary liability related to investment choices made by employees in their participant-directed accounts. In 1996, DOL issued guidance to employers and investment advisers on how to provide educational investment information and analysis to participants without triggering fiduciary liability. DOL recently issued guidance about investment advice making it easier for plans to use independent investment advisors to provide advice to employees in retirement plans.

Industry representatives that we spoke with said more companies are providing informational sessions with investment advisors to help employees better understand their investments and the risk of not diversifying. They also said that changes are needed under ERISA to better shield employers from fiduciary liability for investment advisors' recommendations to individual participants. ERISA currently prohibits fiduciary investment advisors from engaging in transactions with clients' plans where they have a conflict of interest, for example, when the advisors are providing other services such as plan administration. As a result, investment advisors cannot provide specific investment advice to 401(k) plan participants about their firm's investment products without approval from DOL. Various legislative proposals have been introduced that would address employers' concern about fiduciary liability when they make investment advice available to plan participants and make it easier for fiduciary investment advisors to provide investment advice to

[8] These include a minimum number of investment options and related material that must be provided to participants.

participants when they also provide other services to the participants' plan. However, concerns remain that such proposals may not adequately protect plan participants from conflicted advice.

Enhanced Disclosure Could Help Employees Understand Investment Risks They Face

Enron's failure highlights the importance of plan participants receiving clear information about their pension plan and any changes to it that could affect plan benefits. Current ERISA disclosure requirements provide only minimum guidelines that firms must follow on the type of information they provide plan participants. Improving the amount of disclosure provided to plan participants and also ensuring that such disclosure is in plain English could help participants better manage the risks they face.

Enron's pension plans illustrate the complex nature of some plan designs that may be difficult for participants to understand. For example, Enron's pension plans included a floor-offset arrangement. Such arrangements consist of separate, but associated defined benefit and defined contribution plans. The benefits accrued under one plan offset the benefit payable from the other. In 1987, Congress limited the use of such plans. However, plans in existence when the provision was enacted, including Enron's plan, were grandfathered. In addition, Enron's conversion of its defined benefit plan from one type of benefit formula to another illustrates the types of changes and their consequent affect on benefits that plan participants need to understand. Enron's defined benefit plan was converted from a final average pay formula—where the pension benefit is a percentage of the participant's final years of pay multiplied by his or her length of service—to a cash balance formula, which expresses the defined benefit as a hypothetical account balance. As we have previously reported, conversions to cash balance plans can be advantageous to certain groups of workers—for example, those who switch jobs frequently—but can lower the pension benefits of others. [9]

The extent to which Enron employees were informed or understood the effect of the floor-offset or the conversion of their defined benefit plan to a cash balance formula is unclear. As stated in a prior GAO report on cash balance plans[10], we found wide variation in the type and amounts of information workers receive about plan changes and that can potentially

[9] U.S. General Accounting Office, *Private Pension Plans: Implications of Conversions to Cash Balance Plans*, GAO/HEHS-00-185, (Washington, D.C., September 2000).

[10] See footnote 9.

reduce pensions benefits. Based in part on our recommendations, the Congress, under the Economics Growth and Tax Relief Reconciliation Act of 2001, required that employers provide participants more timely and clear information concerning changes to plans that could reduce their future benefits. The Treasury Department is responsible for issuing the applicable regulations implementing this requirement. [11]

Other types of information may also be beneficial to plan participants. Currently, ERISA requires that plan administrators provide each plan participant with a summary of certain financial data reported to DOL. As we previously reported,[12] the Secretary of Labor could require that plan administrators provide plan participants with information about the employers' financial condition and other information. Such information could enable employees to be more fully informed about their holdings and any potential risks associated with them.

ERISA Requires Fiduciaries to be Prudent and Reasonable

Under ERISA, fiduciaries are held to high but broad standards. Persons who perform certain tasks, generally involving the use of a plan's assets, become fiduciaries because of those duties. Others, such as the plan sponsor, the plan administrator, or a trustee are fiduciaries because of their position. Fiduciaries are required to act solely in the interest of plan participants and beneficiaries. They are to adhere to a standard referred to as the prudent expert rule, which requires them to act as a prudent person experienced in such matters would in similar circumstances. Fiduciaries are required to follow their plan's documents and act in accordance with the terms of the plan as it is set out. If fiduciaries do not perform their duties in accordance with ERISA standards, they may be held personally liable for any breach of their duty.

Yet, even with the high standards and broad guidance provided by ERISA, in some cases the actions of fiduciaries can seem to conflict with the best interests of plan participants. During the period when revelations about Enron's finances were contributing to the steady devaluation of Enron's stock price, Enron's plan fiduciaries imposed a lockdown on the 401(k) plan, preventing employees from making withdrawals or investment

[11] Public Law 107-16.

[12] U.S. General Accounting Office, *401(k) Pension Plans: Extent of Plans' Investments in Employer Securities and Real Property*, GAO/HEHS-98-28 (Washington, D.C., November 1997).

transfers.[13] Enron imposed the lockdown to change recordkeepers, an acceptable practice. Some observers, however, have questioned whether Enron employees were sufficiently notified about the lockdown. Observers have also questioned the equity of treatment between Enron senior executives and Enron workers during the lockdown. Enron's employees were unable to make changes to their 401(k) accounts during the plan's lockdown period. However, Enron executives did not face similar restrictions on company stock not held in the plan. Fairness would suggest that company executives should face similar restrictions in their ability to sell company stock during lockdown periods when workers are unable to make 401(k) investment changes. This is especially true for those executives who serve as pension plan fiduciaries, including plan trustees.

Conclusions

The Enron collapse, although not by itself evidence that private pension law should be changed, serves to illustrate what can happen to employees' retirement savings under certain conditions. Specifically, it illustrates the importance of diversification for retirement savings as well as employees' need for enhanced education, appropriate investment advice, and greater disclosure. All of these may help them better navigate the risks they face in saving for retirement.

In addition to the broad issues of diversification and education, Enron's collapse raises questions about the relationship between various plan designs and participant benefit security. In particular, Congress may wish to consider whether further restrictions on floor-offset arrangements are warranted, whether to provide additional employee flexibility in connection with matches in the form of employer stocks, and whether to limit the amount of employer stock that can be held in certain retirement saving plans. Resolving these issues will require considering the tradeoffs between providing greater participant protections and employers' need for flexibility in plan design. Finally, Congress will have to weigh whether to rely on the broad fiduciary standards established in ERISA that currently govern fiduciary actions or to impose specific requirements that would govern certain plan administrative operations such as plan investment freezes or lockdowns.

[13] The Department of Labor is investigating Enron to determine whether there were any ERISA violations in the operation of the company's employee benefit plans. DOL also recently reached an agreement with Enron to appoint an independent fiduciary to assume control of the company's retirement plans.

Mr. Chairman this concludes my statement. I would be happy to answer any questions you or other members of the Committees may have.

Contacts and Acknowledgments

For further information regarding this testimony, please contact Barbara D. Bovbjerg, Director, or George A. Scott, Assistant Director, Education, Workforce, and Income Security (202) 512-7215. Individuals making key contributions to this testimony include Joseph Applebaum, Jeremy Citro, Tamara Cross, Patrick DiBattista, Raun Lazier, and Roger Thomas.