

OVER THE PAST FEW MONTHS, THE MEDIA AND THE AMERICAN PUBLIC HAVE BEEN SPELLBOUND BY THE CRASH AND BURN OF THE ENRON CORP. AS HAS BEEN WIDELY REPORTED IN THE PRESS, ENRON EMPLOYEES LOST MORE THAN JUST THEIR JOBS—THEY LOST BILLIONS OF DOLLARS IN RETIREMENT ASSETS. Enron's 401(k) included a company match of employee contributions in the form of Enron stock, and employees could invest their own contributions in company stock. In total, approximately 11,000 Enron employees lost about \$1 billion within a very short time as the company's stock price dropped to just pennies. For ten days during late October and early November, employees were unable to change the investment of their 401(k) assets from one option to another because of a "blackout" period during which Enron was switching their 401(k) administrator and records were being transferred. Enron's stock fell from \$13.81 to \$9.98 during this blackout period, a drop that represented less than five percent of the stock's total decline in value.

# COULD THE ENRON COLLAPSE HELP LEVEL THE PENSION PLAYING FIELD?

More than just raising questions about corporate ethics and accounting practices, the meltdown of Enron also shines a light on the weaknesses in our current pension system.

In response to this debacle, Congress and the media have turned a critical eye on the nation's retirement system. The post-Enron examination of the employer-sponsored pension system is appropriate and, in fact, long overdue. Thus far, however, the pundits have focused mainly on what has been described as the inadequate regulation of defined contribution (DC) plans generally and 401(k) arrangements in particular.

Another important lesson of Enron, however, is not about blackout periods or investment options – it is about the sea change in the retirement system that has left many Americans dependent on 401(k) accounts to provide security in retirement.

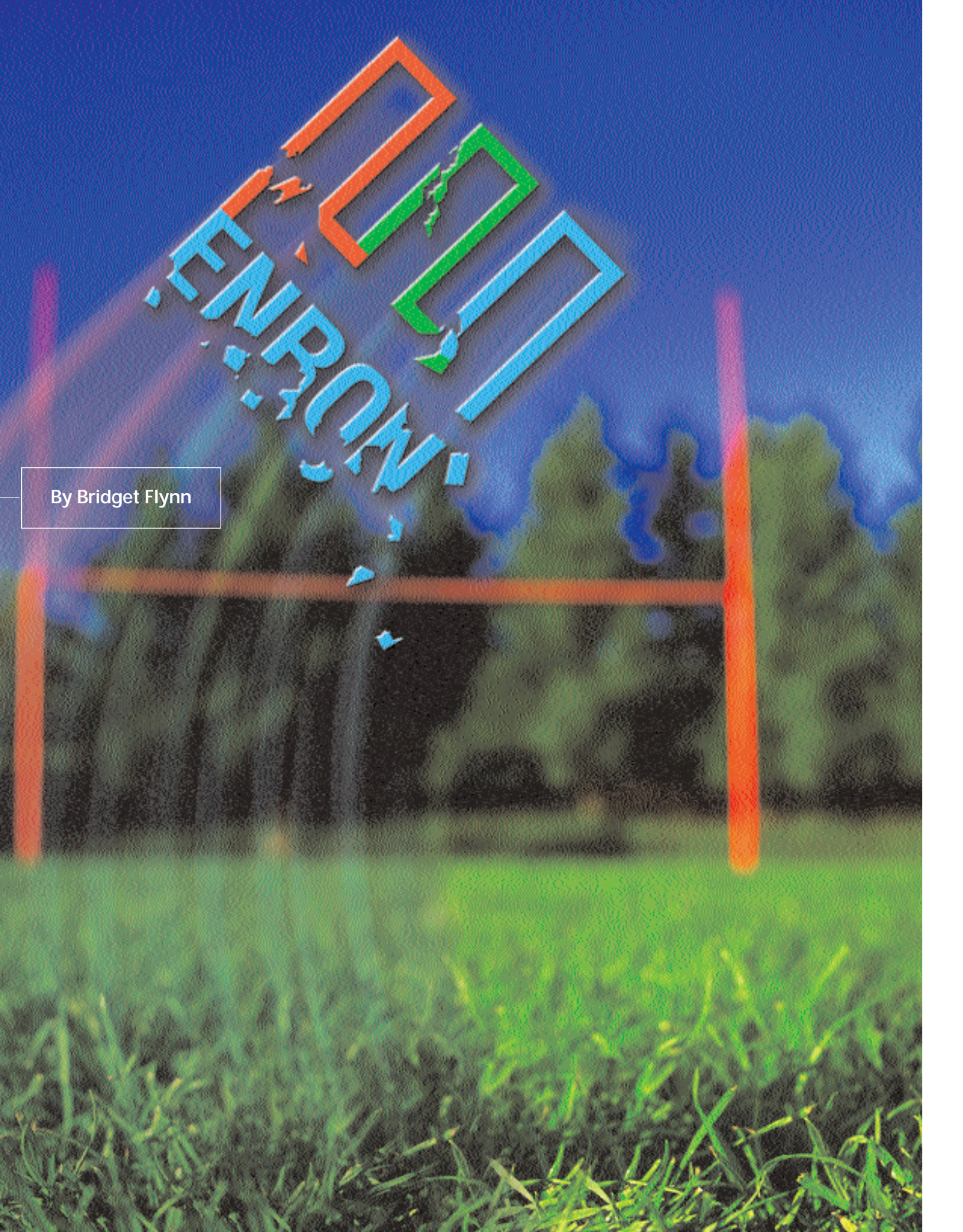
The retirement system in the United States has often been described as a three-legged stool composed of Social Security, employer-sponsored retirement plans, and personal savings. Each of these three legs is essential to the stability of the entire system. Over the past few decades, however, the employer-sponsored pension system has undergone a dramatic shift.

From as early as the turn of the 20th century, the employer-sponsored pension system has been characterized by the dominance of the defined benefit (DB) pension plan. A DB plan is a tax-qualified retirement arrangement

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# NEWSPAPER

By Bridget Flynn



## According to a 1996 study, changes in the regulatory environment

in which the employer guarantees participants a certain benefit in retirement.

Although some DC plans have been in existence for decades, beginning in the 1970s, the employer-sponsored retirement system began a dramatic shift toward DC plan dominance (following the enactment of the Employee Retirement Income Security Act [ERISA], which imposed significant and costly new regulations on DB plans). A DC plan is a tax-qualified retirement arrangement in which an employer may have no financial obligations other than making the promised contributions on behalf of employees. During the 1980s, as 401(k)s gained popularity, DC plans started to replace, rather than merely supplement, DB plans.

This trend raises concerns among some experts in the retirement field, who believe that DC plans, while a critical component of the employer-sponsored pension system, should be used in conjunction with, and not in lieu of, DB plans. Ironically, Congress didn't create 401(k)s to replace DB plans. In fact, section 401(k) was quietly added to the tax code in 1978 not to create a new type of qualified retirement arrangement but to clear up a dispute over the taxation of certain types of profit-sharing plans. At the time, no one knew or could predict how important section 401(k) would become. Richard Hinz, director of the Office of Policy and Research at the Department of Labor's Pension and Welfare Benefits Administration, calls the 401(k) "the accidental pension."

This accidental development, however, could put a portion of Americans' retirement savings at risk. Defined benefit plans provide certain features and safeguards that aren't generally available through DC plans. Perhaps most important, defined benefit plans protect workers from investment risk. In a DB plan, the employer invests plan assets on behalf of the employees and bears the investment risk. Even when a plan sponsor of an underfunded plan goes bankrupt, plan participants still have most of their benefits guaranteed by the federal Pension Benefit Guaranty Corporation (PBGC).

In a DC plan, by contrast, the plan participant bears all the investment risk. True, participants have the freedom to make their own investment decisions. But if they make unwise decisions or happen to retire during a "bear" market, their retirement income security can suffer dramatically.

In addition, defined benefit plans protect workers from longevity risk by offering benefits in the form of an annuity payable for the life of the participant and for the life of a spouse as well (unless the participant, with spousal consent, waives this requirement). By contrast, under most DC plans, annuitization of account balances upon retirement is currently voluntary, and the majority of participants do not annuitize.

While DB plans clearly offer important safeguards, there has been a marked decrease in the number of these plans relative to defined contribution plans over the past few decades. According to analysis of U.S. Department of Labor data by the Employee Benefit Research Institute (EBRI), the share of private

wage and salary workers participating in a primary DB plan fell from 38 percent in 1977 to 22 percent in 1996. During that same period, by contrast, the portion participating in a primary DC plan rose from seven percent to 23 percent.

If defined benefit plans are such an important element of retirement security, then why the precipitous decline? There are several reasons. For one thing, employees often express a preference for DC plans, in part because the benefits are portable; they follow the employee from one job to another, or can be rolled over into an individual retirement account (IRA). This can be especially important to employers who are trying to appeal to younger, more mobile workers. In addition, DC plans are easier to understand; employees like having control over their retirement assets; and they find the employer match feature attractive. Employee preferences and employer recruiting needs aside, perhaps the most important reasons for the decline of DB plans are changes to the regulatory structure and tax code that have had a strangling effect on such plans.

In the 1980s, an era dominated by substantial federal budget deficits, Congress targeted DB plans in attempts to raise revenue. By placing more restrictions on DB plans, legislators were able to reduce the amount employers could take as a business deduction. (Annual funding contributions to DB plans are tax deductible.) Many of the changes in the tax code affecting DB plans, including complex restrictions on funding of such plans, were enacted in the 1980s, culminating with the Omnibus Budget Reconciliation Act (OBRA) of 1987. While the provisions placing greater restrictions on DB plans were not enacted because Congress wished to strangle such plans, that was the practical result.

Regardless of congressional intent, however, these additional restrictions had a negative effect: during the '80s and early '90s, DB plan administrative expenses skyrocketed, as did plan terminations. According to a 1996 study by Edwin Husted of the Hay Group, changes in the regulatory environment had significantly increased the cost of administering DB plans. According to the study, in 1980, the administrative costs of a DB plan with 10,000 participants were actually lower than a DC plan of the same size. By 1996, the administrative costs of a DB plan with 10,000 participants were almost 40 percent greater than the administrative costs of a DC plan of the same size.

Not surprisingly, plan terminations also increased during this period. In 1990 alone, more than 16,000 DB plans, or nearly 8 percent of all such plans in existence at the time, were terminated. In a 1993 American Academy of Actuaries' survey, increased government regulation was cited as a major factor in 44 percent of DB plan terminations. (The next most frequently cited reasons were plan cost, which was cited as a major factor in 38 percent of terminations; and business considerations, which were cited as a major factor in 26 percent of plan terminations.)

"Over the past 15 years, increased government regulation of defined benefit plans has had a significant dampening effect in terms of employers' interest in and ability to provide such plans,"

## had significantly increased the cost of administering DB plans.

says James M. Delaplaine, vice president, retirement policy for the American Benefits Council. "Removing some of these restrictions would greatly benefit plan sponsors as well as participants."

During the mid-to-late 1990s, Congress began to recognize the need for comprehensive reform of the employer-sponsored pension system. This effort culminated in the inclusion of several pension provisions in the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), which was enacted in July 2001. A few of these provisions help defined benefit plans by raising annual limits on benefits and removing the artificial cap on plan funding.

While the pension provisions in EGTRRA did provide some benefit to DB plans, substantial burdens remain. For example, the new tax law did not provide significant relief to DB plans in terms of the extremely complex funding rules governing such plans. In 1980, a DB plan sponsor was required to complete only one actuarial valuation of its plan every three years. Today, a DB plan sponsor is required to complete anywhere from four to six actuarial valuations every year. By contrast, most DC plans are not subject to funding rules and do not undertake actuarial valuations at all.

As another example, in defined benefit plans, employees aren't permitted to make pre-tax contributions to increase their benefit, whereas in many DC plans, such contributions are common (in 401(k)s they are essential), and contribute to the plans' popularity among workers.

Also, in defined benefit plans workers cannot receive "in-service distributions," i.e., retirement benefits paid while the participant is still working, even part time, for the plan sponsor. Many workers, however, want to phase into retirement and continue working part time without delaying receipt of their pension benefit. In a defined benefit plan, such workers must

retire fully before receiving their benefits. In a defined contribution plan, by contrast, retirement benefits may be paid out at age 59½, regardless of whether the participant is still working for the plan sponsor.

While Congress as a whole has not focused on the shift away from DB plans, some members have, and have expressed an interest in revitalizing these plans.

"There are too many workers with only an employer-sponsored 401(k) plan as their main vehicle for retirement savings," says Rep. Earl Pomeroy (D-ND), member of the House tax-writing Committee. "I... am considering a range of proposals that would ease the administration and regulation of DB plans in an attempt to make them more attractive to employers."

### Conclusion

As the dust settles, the Enron debacle may help refocus attention on the nation's retirement system: For the first time since the addition of section 401(k) to the tax code, Congress is holding hearings examining the shift from DB to DC plans. This is a good first step, but it's only a first step. As the retirement of the baby boom generation looms on the horizon, and the Social Security system strains to meet future liabilities, Congress should consider whether removing certain restrictions on defined benefit plans would help improve Americans' retirement income security.

**BRIDGET FLYNN** IS THE PENSION POLICY ANALYST FOR THE AMERICAN ACADEMY OF ACTUARIES. SHE PREVIOUSLY SERVED AS A LEGISLATIVE ASSISTANT TO A MEMBER OF THE U.S. HOUSE OF REPRESENTATIVES. SHE IS A GRADUATE OF HARVARD UNIVERSITY. THE OPINIONS EXPRESSED HERE DO NOT NECESSARILY REFLECT THOSE OF THE AMERICAN ACADEMY OF ACTUARIES.

## EXPLAIN THE DIFFERENCE FOR ME ONE MORE TIME

A defined benefit (DB) plan is a tax-qualified retirement arrangement in which the employer guarantees participants a certain retirement benefit (which is often expressed as a percentage of salary) for each year of service. Generally, no contribution is required on the part of the employee, and the investment risk is borne by the employer. Plan sponsors are required to contribute a sufficient amount to their pension plan annually, to ensure that liabilities are adequately funded. Plan sponsors are also required to insure the plan by paying annual premiums to the federal government's Pension Benefit Guaranty Corporation (PBGC). Upon retirement, plan participants typically receive their benefit in the form of an annuity.

Defined contribution (DC) plans (including all

401(k) plans) are tax-qualified retirement arrangements in which an employer may have no financial obligations other than making the promised contributions on behalf of employees. Some employers do not contribute on behalf of their employees at all; they only allow for employee contributions. Employers may allow participants to direct the investment of their own accounts. Whether they direct the investments or not, however, the participants bear the investment risk. In some DC plans, employees are either required or permitted to make pre-tax contributions to their own accounts. Some DC plan sponsors match their employees' contributions. Upon retirement, plan participants typically receive benefits in the form of a lump sum.