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**"ERISA at 25; has the law Kept Pace with the Evolving Pension and Investment
World?"**

Subcommittee on Employer-Employee Relations
Committee on Education and the Workforce
U.S. House of Representatives

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Thank you for invitation to share my creative thoughts for reforming and updating ERISA's effectiveness in protecting participants and promoting employer-based pension supplements to Social Security.

The switch from traditional defined benefit (DB) plans to cash balance plans has received healthy attention and debate. However, a far more significant change that has received a fraction of the analysis has been the shift from employer-provided plans to a system where workers take on the responsibility of saving for retirement and, as well, the risks of investing well. This shift will have a tremendous effect on the ability millions of working people to retire. The difference between a comfortable retirement and living on the edge is workers' employer -related pensions that supplement Social Security.

What are the Problem Areas ERISA reform must address?

The shift from employer provided pensions to voluntary individual plans means asking people to bear the risk to a.) save more in a very specific way – to save for retirement, b). to invest intelligently, and c.) to manage their money well at the end of their lives. Taking more responsibility in our economic lives is never inappropriate. But, ERISA reform must ensure that the developing system that requires workers to accumulate and manage small bits of money over an increasing amount of time, with no protection for spouses, do the following:

1. anticipates human behavior,
2. tackles the problem of spotty coverage aggressively,
3. provides insurance where appropriate,
4. encourages best practices,
5. Minimizes self-dealing and conflict of interest among employers and financial agents.

Coverage is limited when it is easy to say no to voluntary savings

Advanced industrial nations have known for centuries that human nature is optimistic, myopic, and prone to regret. These human traits militate against saving for a long-term uncertain event. Thus nations mandate social insurance. Requiring workers to voluntarily save 10 –15% of pay to fund an event 45 years out leads to regret and impoverished elderly.

A full 20% of workers who could contribute to the DC plan offered at work don't and the median 401(k) balance is less than \$5,000 for women and less than \$11,000 for men (EBRI,1997). In fact, in 1998 for the first time, the rate of increase in assets in DB plans was greater than in DC plans. Federal Reserve officials suspect that workers are drawing down their DC accounts before retirement (Anad, 1999).

We know after twenty years of living with 401(k)s that workers, especially moderate and low-income workers are more likely to participate in employer 401(k)s if there is an employer match and or the default is inclusion not exclusion. The McDonalds Corporation, for example, in order to meet nondiscrimination rules includes all employees in the 401K) unless they opt out in writing.

Public policy already helps expand pension coverage to lower income and young class workers through these nondiscrimination rules —IRS regulations allow tax-favored fringe benefits only if lower paid and higher paid employees are included. Analysts attribute pension coverage of blue and pink collar workers in large firms to these provisions (Hinz and Turner, 1998.)

Loss of pension coverage is caused by serious structural changes in the labor market and the way pensions are constructed

Data from the employer cost index shows that employers are not increasing its emphasis on pensions.ⁱ During these good times what compensation growth there was was paid in wages not security.

Patterns in the fastest growing occupations, white collar executives (average wages are over \$25 per hour) and sales occupations (where pay is \$12 per hour) the percentage of all compensation going to wages and salaries is on the rise, 72% and 78% respectively). That means the share going to benefits is falling. There is a slight increase in percent of pay going to retirement but an overall falloff in insurance — sickness, health, life, and disability. For executives, the compensation share for health insurance was 5.7% in 1994 down to 4.9% in 1999. For those in sales the share was 5.4% in 1994 and only 2% in 1999. Retirement contributions went up only slightly. (BLS, Employer Cost Index, various years).

Pensions should be expanding for three reasons: the stock and bond markets are doing well, pensions are more affordable in an expansion, and, very importantly workers are aging and moving into their security conscious years. If we don't get more pension now the question is when. Twenty years ago 43% of women workers were covered by a pension plan; in 1996 just 39% were. The fall is worse for men. More than half of male workers had pensions in 1979 now only 48% do. This decline is affecting all workers at all income levels. (Elwood, 1998)

Table 1 '

Pension (of all kinds) is Falling for Men and Women

	Women	Men
1979	43%	51%
1996	39%	48%

Source: CPS reported in Ellwood, 1998.

Oddly, the fall in pension coverage is not perceived as a crisis; ERISA reform is not focused on this key problem. One reason may be because workers are working more at older ages. "If you don't save, you work" is an ascendant idea. Another answer may be what Larry Thompson, President of the Urban Institute observed, "Its not possible to talk sensibly about retirement income security policy when the SP500 is in double digits.: Perhaps he is right but, the lack of expansion is a puzzle.

A representative from one of the world's largest corporations helped answer the puzzle two weeks ago at a National Academy of Social Insurance conference. When asked, "Why does Ford pay for health and pension plans?" She gave a short and eloquent answer,

"We need to have to be competitive in the market place to get and keep good workers, and, of course, we are obligated to by union contract."

Then, after a very brief pause, she said,

"And of course, we care about our workers' health and if they can live well after retirement."

The answer rang true. Employers provide health and pensions for three reasons:

1. The need to stay competitive in the labor market;
2. They have to because of workers' bargaining strength;
3. They want to satisfy paternalistic and corporate responsibility purposes.

Employers as a whole are not facing these reasons to provide more workplace pension and health security despite the expansion. They should have because competition for workers is keen and corporate responsibility is affordable.

Instead we see that, first, firms can attract and retain workers without contributing to pensions. And, second, we see Microsoftian behavior — companies that can afford to pay for worker security programs do not want to. These companies use temporary, contingent, independent contractors, and part time workers to avoid providing social insurance at all.

Proposal number one: labor law regarding leased and temporary workers should be enforced.

Proposal number two: mandating pro-rata benefits for part timers and contingent and temporary workers would extend coverage to those in non-regular work. (Quinn and Burtless, 2000)

Why 401(k)s may discourage coverage.

A few years ago employers wanted some relief from nondiscrimination tests — whose intentions are good but are hard for small employers to handle — and policy makers responded hoping to encourage coverage by allowing a safe harbor for employers providing 401(k)s. Employers could chose the option of providing a generous match - remember 401k) do not have to have an employer match —for all those who elect coverage and avoid a nondiscrimination test. Another option under the safe harbor rule was to include all workers and making a smaller match.

The insidious outcome is that most employers pick the first option and only the highest paid elect to be covered. The highest paid get the generous match — and the generous tax-exempt contribution.

Proposal number three: Abandon the safe harbor rules that allow employers to avoid the nondiscrimination test by contributing generously to top paid workers who elect coverage and require that automatic inclusion is the rule unless workers opt out

Proposal number four: require immediate vesting, or nearly immediate, for newly hired employees to help them develop the habit of retirement saving

Mandating individual accounts would help overcome the stubborn low growth and small balances among employers in small and medium sized firms. We already spend a lot in taxes not collected to promote retirement growth. Mandating coverage with government seed money would make the tax carrot unnecessary and the federal expenditure is made in the form of deposits into accounts not in the form of tax break.

Proposal five: Explore mandating a supplement to Social Security that could be a variant of the Carter Administration MUPS plans (Mandatory Universal Pension system) and Clinton's Retirement Savings Account idea are creative areas of reform.

Instead of recreating the wheel we need to be mindful of best practices. Workers who would not be expected to have pensions because the employers are small and the work is low paid are covered by multiemployer plans. But, in Table 2 we see a solution. All the workers in show repair shops that have pensions are in employer networks, sixty-nine percent in highway construction, etc.

Table 2

Some Industries with Low Paid Workers and Small Firms Have Pensions

Industry	Percent of those in pensions who are in multiemployer plans
Motels, motor hotels and tourist courts	42.3%
Construction	43.1
Trucking and Warehousing	47.8
Producers, orchestras, and entertainers	61
Highway construction	69
Shoe repair and hat cleaning shops	100%

Proposal number six: explore ways to expand and encourage employer insurance networks.

Human nature is worrisome when pensions are voluntary, individual accounts.

In voluntary, individual accounts management fees are high and the structure of choice creates false promises and self-defeating behavior. We know that workers who change asset allocations often and have a wide range of selections and can borrow from their accounts have lower balances everything held constant. Behavioral finance tells us a lot about how retirement policy based on individual voluntary accounts is bound to fail.

Humans tend to think what just happened has a greater chance of happening again. This is called "over-representativeness and is fatal when most people have to evaluate the long term risk, in say, the stock market (Harless and Petersen, 1998).

Humans also suffer from "saliency," the tendency for people to think that infrequent events, if they just happened, have a greater chance of occurring in the future than they really do. Reactions to plane crashes are a good example. Another example is in the phenomenon described by a Vanguard Fund officer at the most recent American Economics Association conference who said that the biggest problem they find among their clients is that most of them understand there are risks in the stock market. They know they aren't guaranteed a 10% return.

Third, people think they are better than average in all endeavors (90% of persons say they are better than the average driver is), which is fatal in stock picking. Last, is the human trait of anchoring, the last price is the price in which all others are judged, another unfortunate bias when evaluating value in financial markets.

Over-representativeness, salience, overconfidence, and anchoring, are human traits that militate against voluntary long term saving. All of them combined make people bad investors and long term savers without institutions that help people avoid predictable mistakes. ERISA can't change human nature but we can discourage 24 hour, online access to the accounts and unlimited trading because they invite human mistakes.

The plans where workers change asset allocations once a year by filling out a form rather than being able to change allocations and investments 24 hours per day work best. Making employers pay for these bells and whistles that hurt workers ultimately might mean that firms would require workers to make portfolio changes in writing and once or twice a year. We know individual accounts are far more expensive to manage than larger collective accounts and we know that institutional funds get a higher risk-adjusted return because of superior expertise in portfolio allocation. Individual accounts carry a dead weight loss because the fees are so high and education is spotty. Perhaps employer who face the administrative costs would choose money purchase plans instead.

Proposal number seven: require employers to pay fees so they are induced to find the most the efficient provider — bells and whistles cause many problems — to minimize reducing workers' returns.

More important than the firm offering bad investment choices and expensive vendors is the too much of 401(k) assets are in company stock. ERISA requires DB plans to have 10% of their own stock or less; there is no assurance of diversified portfolio or protection against this type of self dealing in the 401(k) world.

Proposal eight: restrict the amount of company stock that is in individual accounts.

ERISA faces brand new agency problems

Who manages pension fund can determine whether "Wall Street" gains are shared on "Main Street." In my study of tens of thousands of private plans I found severe agency problems. Agency problems are such where the agent — the sponsor or fiduciary — follows procedures that maximize their own interests and not the interests of those they are representing.

I found that when labor representatives shared in managing defined benefit funds the tremendous pension earnings enlarged pensions. Otherwise the Wall Street gains were used to lower contributions. The management structure of the plans matter so much that I can conclude that pension funds, whether DB or DC, that have substantial employee representation raised, help the trust fund work like a trust fund — for the sole benefit of the participants. (Ghilarducci, 1999). Please see the Table 3 below.

Table 3

Labor representatives Boost Pension Coverage and Contributions
 Percent Change in Employer Contribution per Active Worker in DB and DC Plans
 for Union and Nonunion Plans
 (\$ per year – 1993 and 1996, in 1996 constant dollars [unweighted for plan size])

Type of Plan	DB annual contributions Change between 1993 and 1996	DC annual contributions Change between 1993 and 1996
Non union corporate plan	17%	-11%
Union corporate plan	430%	41%
Non union Multi-employer plan	9%	-10%
Union Multi-employer plans	13%	2.8%

Source: calculations based on the Form5500 universe and research files

Firms choose DC plans in order to lower contributions.

Of my panel sample of 825 firms, 296 used DC plans to supplement defined benefit plans. Only 21 dropped a DB plan to only provide a DC plans and a full 41 with only a DC plan adopted a defined benefit plan. Worrisome is that 302 firms (Cases 2 and 3) that adopted a DC plan sometime during the 14 year period had the lowest contributions. This, and other data not reported here, suggests that firms were adopting DC plans for many reasons and one of them was to reduce a commitment to pensions.

Table 4

DC's Are Supplements But They Lower Employer Contributions
 Time series of 825 of the Same Firms

Nine Possibilities	Number of firms	Rank in Employer Contributions
1. Were DB only in 1981 and Stayed DB during 1981-'95	76	
2. Were DB only in 1981 and Adopted a DC sometime during 1981-'95	265	8
3. Were DB only in 1981 and Dropped the DB and Adopted DC sometime during 1981-'95	37	9
4. Were DB and DC in 1981 and Stayed DB and DC during 1981-'95	295	2
5. Were DB and DC in 1981 and Kept the DB and dropped the DCs sometime during 1981-'95	16	6
6. Were DB and DC in 1981 and Dropped the DB and Kept the DC sometime during 1981-'95	21	5
7. Were DC only in 1981 and Stayed DC only during 1981-'95	74	3
8. Were DC only in 1981 and adopted a DB sometime during 1981-'95	40	4
9. Were DC only in 1981 and Dropped the DC and adopted a DB sometime during 1981-'95	1	1

Compilations from other tables (Ghilarducci, 1999)

ERISA, unlike most other industrialized nations, does not require worker representation on investment boards.

Proposal number nine: Militate against agency problems by requiring worker representation on all pension boards, not just multi-employer plans. U.S. Representative Visclosky in the late 1980s and Rep Marcy Kaptur in the mid 1990's introduced such legislation.

Voluntary individual pension accounts should have the same spousal protection as DB plans have.

Under ERISA regulations for DB plans the employer must offer the joint and survivor option as the first option and the worker can choose a single life annuity only if their spousal signs a waiver. If the pension plan is a 401K) the employer can take loans, roll it out, and there is no requirement for an annuity disbursement, much less a joint and survivor option. The only protection a spouse has in terms of claiming some share of the pension is if she has a QUADRO, a qualified domestic order or is under divorce proceedings. As regulation stands now divorced women have more pension protection than married women.

Proposal number ten: Extend ERISA to protect spouses of workers with 401(k) plans.

DC plans Lack Any Insurance like the PBGC

The Pension Benefit Guaranty Corporation (PBGC) insures payment (up to a high limit) of defined benefit payments in case the employer is bankrupt. This insurance has to be provided by the government because no insurance company would take on the risks. The PBGC monitors their potential risk much like a very sophisticated insurance company would do. Historically, the PBGC forecast it's future risk crudely by assuming that past rates of default by employers sponsoring defined benefit plans was close to the future rate. In 1998, the PBGC began using a sophisticated model to assess the probability a weak firm will present claims to the PBGC. The PBGC also has a sophisticated staff of lawyers and financial analysts who identify corporate mergers, acquisitions, borrowing, and other financial transactions that might put their pension funds that are insured at risk.

Proposal number eleven: explore how to insure DC plan assets against some risk, at the same time reducing the risk. Proposal eight that restricts the concentration of company stock in a 401(k) is a step in the right direction)

ERISA's Prohibited Transaction rules are designed to protect against agency self-dealing.

The Investment Company Institute and some academicians have recommended that lifting ERISA's prohibitions against transactions between owned-brokers and managers and cross trading would help get larger pensions.

Why public funds don't allow cross-trading and owned broker deals – even though they are not covered by ERISA

We must step back from the theoretical efficiencies and cost savings from cross trading in active equity accounts and allowing advisers to trade with their affiliated

brokers and ask why the one trillion dollars in state and local pension funds that are not prohibited from doing so don't. The public trustees and officers are fiduciaries who, for the lowest cost possible, manage money for the sole benefit of the covered workers and beneficiaries. Cross trading and broker-advisor relationships create chronic temptation for self dealing which would require elaborate and minute by minute monitoring.

For example, say the smaller Indiana Public Employees Relations Fund and the giant California Fund have the same manager, say Barclays. Indiana wants to sell; California buys. The real possibility that the internal judgements about the price and process of the trade will favor the larger and perhaps over staffed fund is not worth the cost savings in the trade. The reason this theoretically good practice doesn't exist is because it is practically a bad idea.

Public funds don't permit cross-trading and manager-manager-owed broker relationships because they are difficult to monitor and potentially detrimental. Also, in practice, the firms' own lawyers do not recommend using owed-brokers due to a conflict of interest.

A conflict of interest is deadly to a fiduciary who has sworn to manage funds solely for the participants' benefit. In having a manager use an owned-broker creates incentive problems. The incentive to move securities around for the benefit of the manager exists. Example, client A's return is lagging client B's return because of a variety of reasons like contributions, or purchase timing (not due to manager manipulation, but due to, investment of cash flows or the start date of the account). There is a temptation to trade "good" stocks into client A's account at a market low point during the day to bolster return at the possible expense of client B. The manager benefits by increasing a client's return keeping the business - and if market value increases, increasing fee revenue. Other situations include a firm on a Fidelity size scale where they have thousands of clients in one mutual fund that trades with another mutual fund with thousands of clients.

How would these intra-manager trades be monitored? That is an issue for the public funds in that monitoring a manager's internal operations is at best difficult. Managers do not open their activities easily; one reason could be that it might possibly open the accounts of other clients to each other. Another is that trading impacts return and trading activity/philosophy/operation could be "proprietary" - like showing your cards in a very expensive card game. If the monitoring is to look like the typical transaction analysis reporting, which uses market data to create volume weighted average highs and lows, it is helpful, but not enlightening if a manager actually tries to hit a low or prices after the fact.

Trade monitoring requires either very sophisticated systems, or a custodian with sophisticated systems and a good trade database. I am not aware of any public fund that does trade/broker monitoring to such an extent. Monitoring is an absolute requirement insofar as all securities, the commissions - everything - are plan assets for which fiduciaries have responsibility. Fiduciaries generally take the position if you can't monitor it don't put it in the policy otherwise you can be held accountable and possibly negligent.

Relaxing ERISA prohibitions affects the entire financial markets

Second, relaxing ERISA prohibitions would raise costs. Only the largest firms could market the insider dealing and the cross trading. Pension funds would be attracted by these initial lower costs, the competition would diminish, and monopoly pricing would go into effect, with little chance for reinstating healthy competition. We do not want to legislate a pre-break-up ATT in financial services. Here is one example, compare Fidelity to a firm like Brinson. Fidelity has multiple sources and outlets, whereas Brinson, while large, has fairly homogenous stock holdings, and must go to the market for new/additional names. Fidelity is likely to hold a stock somewhere across all its products. Which gives rise to the question, would managers then hold stocks for trading purposes rather than investment purposes?

Third, as a public policy concern, pension fund professionals are aware of their impact on the larger community. It is ironic that the investment industry that has helped the American government make the argument to the global community that transparency in financial transaction is vital in Asia, Latin America and Eastern Europe is proposing to take a bulk of American trades off the market.

The conflict of interests that exist for active traders simply do not exist for passive accounts. Passive accounts are also able to access the futures markets to accomplish investment, and any market impact is limited to only those stocks in the index which may not be the same as the potential impact for actively managed accounts. Trading costs should come down, but this could increase costs and produce more deleterious effect on the financial system.

Conclusion

ERISA reform must address the coverage, protection, and adequacy gaps in the growing voluntary individual pensions sectors. ERISA regulators should figure clever and employer-responsive ways to expand defined benefit coverage to small and medium employers and moderate and to income workers. Other policies reforms are side-shows to these core issues.

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ENDNOTES

ⁱ In 1991, at the depths of the recession, 6% of pay went to health insurance; 2.9% went to retirement and both increased to 6.7% and 3% by 1994. But after that, what employers saved in health insurance premiums, brought their percent share of pay going to health insurance down to 5.4% in 1999 but the extra did not go to other forms of insurance. The percentage for all insurance (excluding retirement) fell from 7.2% in 1994 to 5.9% in 1999 and the payment share to retirement stayed the same.