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Legislation that would place an excise tax on short-term capital gains realized by pension funds has sparked debate on pension asset turnover and pension investment horizons.

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Current Pension Investment Issues

- At the end of 1989, pension fund assets totaled more than $2.5 trillion and held 26 percent of all equity and 15 percent of all taxable bonds in the United States.
- A bill introduced by Rep. Peter Visclosky (D-IN) would require an equal number of employer and employee representatives on private pension plans' boards of trustees. The bill addresses the question of whether employees should participate in investment decisions even though the employer is responsible for any investment shortfall.
- Sens. Nancy Kassebaum (R-KS) and Robert Dole (R-KS) have introduced legislation that would place an excise tax on short-term capital gains realized by pension funds. Prompted by concern over a perceived short-term investment mentality among institutional investors, this bill has sparked debate on pension asset turnover and pension investment horizons, and has been criticized as introducing a tax on pension funds.
- The Treasury Department has proposed making debt and equity financing equally attractive by requiring firms to pay one tax rate on all pretax earned income, then issuing a tax credit to those receiving the income, as dividends or as interest. While this proposal does not change the tax deductibility of pension plan investment income, it makes this income nontaxable to other investors, thus limiting the appeal of pension funds.
- Fiduciary rules will be applied to some transactions involving surplus pension assets if a bill introduced by Sens. Howard Metzenbaum (D-OH) and Nancy Kassebaum (R-KS) is enacted. Prompted by a now-canceled transaction between the Coleman Co. and First Executive Corp., the bill has produced debate on the extent of Pension Benefit Guaranty Corporation coverage.
- Employee stock ownership plans (ESOPs) were altered by the Omnibus Budget Reconciliation Act of 1989, which restricted the interest deductions on loans to ESOPs to loans made to ESOPs with 50 percent ownership of the company. Several ESOPs are issuing public debt largely in response to this change.

◆ Introduction

U.S. pension assets exceeded $2.5 trillion at the end of 1989, an increase of more than 120 percent in only 7 years. Pensions now hold 26 percent of all equity and 15 percent of all taxable bonds in the U.S. economy (EBRI, 1990).[1] The size of this money has attracted the attention of many in the financial world and has fueled a number of bills in Congress.

A purely aggregate focus obscures the fact that pension fund money is spread out among different types of plans, styles of management, investment objectives, and other characteristics. This *Issue Brief* examines how these factors affect asset allocation and investment performance among types of plans.

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Proposed legislation currently before Congress signals a continued focus on private pension fund investment and regulation and is sometimes referred to as "pension reform."

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Also, different pension types operate in different regulatory environments. The regulation of private pension plans seems to increase in complexity nearly every year as Congress enacts new legislation. These legislative changes result in additional regulations, requiring various government agencies to plan for their enforcement.

[1]The U.S. Department of Labor (DOL) reports that pensions own 27 percent of all bonds. The Employee Benefit Research Institute (EBRI) number includes government bonds, whereas the DOL estimate does not. Also, the DOL estimate assumes that all pension money held in insurance companies' general accounts is invested in bonds, whereas the EBRI estimate includes only bonds held in separate accounts of insurance companies.

All private pension plans are subject to the provisions of the Employee Retirement Income Security Act of 1974 (ERISA). The current complement of statutory and regulatory private pension laws has led to a complex assemblage of enforcement responsibilities that are divided between the U.S. Department of Labor (DOL) and the Internal Revenue Service (IRS) within the U.S. Department of the Treasury. This *Issue Brief* describes the precise nature of each department's enforcement objectives.

Public pension plans (those of state and local governments) are not subject to ERISA and are therefore not subject to enforcement by DOL or IRS. These plans are self-governing, imposing their own restrictions and requirements.

Proposed legislation currently before Congress signals a continued focus on private pension fund investment and regulation and is sometimes referred to as "pension reform." This *Issue Brief* describes several of these proposals, including those related to joint trusteeship, taxation of pension investments, enforcement changes by DOL, and limitations on asset reversions.[2]

However, the term "pension reform" implies that all plans and all money would be affected equally, which is far from accurate. This *Issue Brief* outlines the proportion of plans and the amount of money that would actually be affected by some of these and other proposals. The enactment of these bills would change the way in which various private pension sponsors plan for funding pension benefits and might affect their decision to sponsor or continue to sponsor a plan.

The final section of this discussion is devoted to companies' use of employee stock ownership plans (ESOPs) as employee benefits and financial instru-

[2]An asset reversion occurs when an employer terminates a defined benefit pension plan, satisfies the legal obligations, and keeps the remaining assets.

ments, which is drawing increasing attention from Congress.

◆ Types of Pension Plans and Their Assets

There are three main divisions among pension plans: defined benefit or defined contribution, single employer or multiemployer, and private or public plans.

Defined Benefit and Defined Contribution Plans

In a defined benefit plan, the employer promises employees specific benefits at retirement through a specified formula that is generally based on a fixed percentage of salary per year of plan participation. The sponsor must ensure that its contributions are sufficient, when combined with earnings on pension assets, to meet the future liability for this promise. In this type of plan, the employer bears the investment risk and benefits from any gains.

In a defined contribution plan, the employer promises to allocate a specific contribution to each employee's account, commonly based on the employee's pay. Investment earnings on these contributions accrue entirely to the employee, as do any losses.

All plans are either defined benefit or defined contribution, whether they are single-employer or multiemployer plans or whether they are public plans, private trusteed plans, or private insured plans. A plan that is intended to be the main source of pension income in retirement is called a primary plan. Other plans covering the same employees are considered secondary.

From 1974 to September 1987 (the latest data available), the percentage of total plans that were defined

Table 1
Asset Distribution of Private Trusteed Pension Plans by Plan Type and Asset Category, 1982–1989

	Single-Employer			
End of:	Defined benefit	Defined contribution	Multiemployer	Total Assets
				(billions)
1982	60.9%	29.5%	9.2%	$ 655
1983	59.1	31.5	9.4	760
1984	57.8	32.2	10.0	795
1985	56.3	33.6	10.1	967
1986	55.4	33.9	10.7	1,061
1987	54.3	35.0	10.6	1,102
1988	55.0	34.5	10.5	1,237
1989	55.2	34.0	10.8	1,362

	Directly Held Assets					
End of:	Equity	Bonds	Cash items	Other assets[a]	Bank pooled funds[b]	Total Assets
						(billions)
1982	35.8%	20.1%	10.7%	20.4%	13.1%	$ 655
1983	36.3	18.4	11.6	20.3	13.4	760
1984	35.0	19.1	11.2	20.6	14.0	795
1985	36.3	18.3	9.8	20.3	15.3	967
1986	38.1	18.6	8.6	19.9	14.8	1,061
1987	37.2	17.4	9.4	19.1	16.9	1,102
1988	36.4	15.7	10.1	18.4	19.4	1,237
1989	40.5	16.4	7.5	18.7	17.0	1,362

Source: Employee Benefit Research Institute, *EBRI Quarterly Pension Investment Report,* fourth quarter 1989 (March 1990).
[a]Other assets are residual investments. They include private mortgages and mortgage backed securities, guaranteed investment contracts, mutual funds, real estate, receivables, physical property, and other.
[b]Bank pooled funds include all bank pooled fund holdings of equity, bonds, cash, and other.

benefit (both single employer and multiemployer) decreased from 34.0 percent to 26.7 percent. The remaining plans were defined contribution. The largest growth of plans of both types occurred during the early 1980s.

Single-Employer and Multiemployer Plans

In a single-employer plan, one plan sponsor maintains the pension plan and its fund. In a multiemployer plan, several plan sponsors offer one plan and share the cost of maintaining it. The default risk of one employer within the multiemployer group is, by law, spread throughout the group.

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Public pension plans for employees of state and local governments are sponsored by a government body and are not subject to ERISA.

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Multiemployer plans were originally created so that members of a union could work for any of the employers in the multiemployer group without losing pension benefits (that is, the benefits would be portable among employers).

Private Plans and Public Plans

Private plans are those sponsored by private-sector organizations. They can be either trusteed or insured or may be split between the two. In a trusteed plan, the sponsoring employer maintains control over the investment of the pension fund, while in an insured plan this responsibility is transferred to an insurance company.[3] All private plans must follow the law as stated in ERISA.

Public pension plans for employees of state and local governments are sponsored by a government body and are not subject to ERISA. They are regulated by the individual state or municipality. The federal government maintains pension plans for its own employees, which are also exempt from ERISA.

Assets of Private Pension Plans

Private trusteed pension assets totaled $1,362 billion at the end of 1989 (EBRI, 1990).[4] Of this amount, single-employer defined benefit plans had $752 billion in assets; single-employer defined contribution plans, $463 billion; and multiemployer plans, $147 billion. This shows a 108 percent increase from 1982, when private trusteed pension funds held $655 billion, with $399 billion in single-employer defined benefit plans, $196 billion in single-employer defined contribution plans, and $61 billion in multiemployer plans. During those seven years, capital gains added $542 billion to pension assets, dividends and interest added $436 billion, and net contributions led to a decrease of $272 billion.

The distribution of these assets in aggregate has also changed, from 35.8 percent held directly in equity at the end of first quarter 1982 to 40.5 percent at the end of 1989. The portion of total assets invested directly in bonds decreased from 20.1 percent to 16.4 percent during that time, and the percentage invested in bank pooled funds increased from 13.1 percent to 17.0 percent (table 1). Including the asset allocation of bank pooled funds (both direct and indirect investments[5]), 40.0 percent of total private trusteed assets were invested in equity at the end of 1982, increasing to 48.2

[3]The split of assets between these two plan types, for which data are available through the end of 1989, is discussed later in this *Issue Brief*.

[4]Private insured pension assets totaled $517 billion as of the end of 1988 (the latest date for which data are available).

[5]Indirect equity holdings, for example, would be the equity held by a bank pooled fund to which pension plans contribute.

percent by the end of 1989. The amount invested directly and indirectly in bonds decreased from 22.2 percent to 19.7 percent during that period.

Among pension plan types, the distribution of assets varies according to their different goals and environments. On aggregate, single-employer defined contribution plans invest more of their assets directly in equity, compared with single-employer defined benefit plans and multiemployer plans. Multiemployer plans invest a larger percentage of their assets in bonds than the other two plan types do (table 2).

The difference in asset allocation among plan types has been a point of speculation. Possible reasons include different work force demographics and different contribution constraints (which for multiemployer plans may be affected by union contracts in addition to ERISA requirements). Another possibility is that the union

[6]Multiemployer plans are required to have a board of trustees that is equally divided between employer representatives and union representatives.

Table 2
Asset Distribution of Private Trusteed Pension Plans by Plan Type and Asset Category, 1982–1987

End of:	Equity	Bonds	Cash Items	Other Assets[a]	Total Assets
		single-employer defined benefit plans			
					(billions)
1982	36.3%	22.0%	7.5%	34.1%	$399
1983	37.9	19.8	7.4	34.9	449
1984	35.4	20.9	7.1	36.6	460
1985	36.8	20.0	5.8	37.4	545
1986	38.2	20.0	5.2	36.6	588
1987	36.6	19.0	5.2	39.2	598
1988	36.4	17.0	4.8	41.9	680
1989	40.2	17.3	4.0	38.5	752
		single-employer defined contribution plans			
1982	38.5%	10.8%	16.1%	34.6%	$196
1983	36.7	9.0	20.5	33.8	239
1984	37.7	8.6	19.7	34.0	256
1985	38.7	8.2	17.4	35.7	325
1986	41.5	8.1	15.3	35.1	359
1987	41.7	7.3	16.2	34.8	386
1988	39.6	6.6	18.1	35.6	427
1989	44.5	7.2	13.3	35.0	463
		multiemployer plans			
1982	23.5%	36.9%	14.2%	25.5%	$ 61
1983	24.4	41.1	9.0	25.5	72
1984	23.8	43.0	8.2	25.1	79
1985	25.7	42.2	6.8	25.2	98
1986	26.7	44.5	4.8	24.0	114
1987	25.1	42.5	8.8	23.7	117
1988	25.8	38.8	11.6	23.8	130
1989	29.0	40.5	7.4	23.1	147

Source: Employee Benefit Research Institute, *EBRI Quarterly Pension Investment Report*, fourth quarter 1989 (March 1990).
[a]Includes all investments in bank pooled funds as well as those included in the "other assets" category in table 1.

Table 3
Rates of Return for Periods Ending December 31, 1989, by Plan and Asset Type

Plan Type, Asset Type, and Indices	Quarterly	1 Year	3 Year[a]	5 Year[a]
All Assets				
All plans	1.1%	20.7%	14.4%	16.7%
Single-employer defined benefit	0.9	20.7	15.0	17.3
Single-employer defined contribution	1.2	21.4	14.4	16.4
Multiemployer	1.8	18.4	11.6	14.7
Consumer price index	1.0	4.7	4.5	3.7
Equity				
All plans	–0.1	30.4	19.0	22.4
Single-employer defined benefit	–0.3	29.8	18.9	22.1
Single-employer defined contribution	0.3	31.3	19.2	22.9
Multiemployer	0.1	30.9	19.7	22.3
S&P 500	2.1	31.5	17.4	20.4
Bonds				
All Plans	3.5	14.8	8.6	13.0
Single-employer defined benefit	3.7	15.1	8.6	13.2
Single-employer defined contribution	3.3	14.1	8.8	11.8
Multiemployer	3.3	14.5	8.5	13.1
Shearson/Lehman[b]	3.6	14.2	7.9	12.0

Source: Employee Benefit Research Institute, *EBRI Quarterly Pension Investment Report*, fourth quarter 1989 (March 1990).
[a]Three and five year returns are expressed as annualized rates.
[b]Shearson Lehman Brothers Kuhn Loeb Government/Corporate Bond Index.

representatives who are on the board of trustees of multiemployer plans[6] choose more conservative investments. In light of a bill recently introduced by Rep. Peter Visclosky (D-IN), which proposes to require joint trusteeship of all private pension plans, further investigations of this latter possibility have occurred. (See description of this bill and data pertaining to that proposal under "Current Legislative Issues.")

Rates of return achieved by private trusteed pension funds for 1989 were 20.7 percent for all assets, 30.4 percent for equity, and 14.8 percent for bonds. The S&P 500 and the Shearson Lehman Brothers Kuhn Loeb Government/Corporate Bond Index reported returns of 31.5 percent and 14.2 percent, respectively, for 1989 (table 3). For all assets, single-employer defined benefit plans outperformed the other types of plans with a five-year annualized return of 17.3 percent, compared with 16.4 percent for single-employer defined contribution plans and 14.7 percent for multiemployer plans. These differences in return on total assets may result from different asset allocation decisions among plan types.

Assets of Public Pension Plans

Public plans sponsored by state and local governments held $721 billion in assets at the end of 1989. These assets are invested by the sponsoring governmental body. At the end of March 1989, these plans had 33 percent of their assets in corporate stocks, 17 percent in corporate bonds, and 30 percent in federal government

[7]The quarterly survey on which these investment figures are based includes major retirement systems covering employees of state and local governments and represents approximately 87 percent of total assets in all state and local plans.

securities.[7]

State and local governments sometimes place limits on the amount that can be invested in a particular type of investment and/or have lists of permissible investments. In a study covering pension plans sponsored by state governments, the National Conference of State Legislatures reported that 30 percent of these plans permitted or encouraged the fund to invest in economic development projects in that state, with one-half having no limit on such activity. Slightly more than one-half of the plans were under a state law specifying the maximum percentage of the fund that could be invested in equities. The most common limits were 50 percent to 60 percent of total assets. Forty percent of the plans were under state laws that restricted the amount that could be invested in foreign securities. Eighty-four percent of the plans were held to a prudent man rule, and 14 percent had an ERISA-type "prudent expert rule."[8] Nearly 40 percent had a statutory list of permissible investments.

Recent attempts by public pensions with large equity holdings to become involved in corporate governance have attracted national attention. In January 1990, the New York and California public employees' pension funds sent a letter to the board of directors of General Motors (GM) requesting more information on the selection process to be used to replace retiring CEO Roger B. Smith. The funds wanted the process to be "complete and open," with consideration of candidates from both inside and outside the company. They cited poor financial performance by GM over an extended time as the reason for the letter.

The New York City comptroller has recommended that the city's pension funds vote, when possible, for a set of environmental measures called the Valdez Principles. These principles were scheduled to be the subject of a proxy vote in the Exxon Corporation on April 25, 1990. The city's pension funds own 5.1 million Exxon shares. The 8.2 million Exxon shares owned by California's Public Employees' Retirement System will also vote in favor of these principles.

Finally, at the recent annual meeting of Lockheed, a proxy vote determined whether the current board of directors would be unseated. More than a dozen institutional investors, including the Florida and California state pension funds, reportedly voted for the unseating, as they were promised a larger voice in the proposed new management. Seeing the funds' strong support for the unseating, the existing management offered the institutional investors three seats on the board, expanding their role in the company's management.

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The federal government pension plans have changed substantially as plan participants have been allowed to direct the investment of the funds in their accounts.

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Actions of this sort have largely involved public pension plans rather than private plans governed by ERISA. Whether the private funds' lack of similar action is a function of perceived legal restraints under ERISA, a philosophical difference, or other factors is an area worthy of future exploration.

The federal government pension plans have changed substantially as plan participants have been allowed to direct the investment of the funds in their accounts. Employees who were hired before 1984 are covered by the Civil Service Retirement System (CSRS), while those hired after December 31, 1983, are covered by the Federal Employees' Retirement System (FERS). Federal employees hired before 1984 were given an opportunity to switch to FERS during an "open season." FERS

[8]See later in this *Issue Brief* for an explanation of the prudent man and prudent expert rules.

includes three components: Social Security, a basic annuity, and a thrift savings 401(k)-type plan. CSRS includes Medicare and a defined benefit retirement plan; participants can also contribute to the 401(k) plan, although their contributions are not matched by the government.

The assets in the federal government plans are divided several ways. Benefits from CSRS and FERS are paid from the Civil Service Retirement and Disability Fund.[9] This fund's assets grew from $96 billion as of September 30, 1982, to an estimated $214 billion by September 30, 1989.

All government employees can place some pretax dollars into the Thrift Savings Plan (TSP). Employees covered by CSRS can contribute 5 percent of their salaries to TSP, with no match from the government, while employees covered under FERS have 1 percent of pay automatically contributed by their employing agency and can invest up to 10 percent of their salaries in TSP, with a 50 percent match by the government. There are three funds within TSP: the G-Fund, which is invested in U.S. Treasury securities, the C-Fund, which is the stock market option; and the F-Fund, which is invested in bonds. All contributions from CSRS-covered employees go into the G-Fund, while FERS-covered employees can distribute their contributions among the three funds. As of September 1989, the G-Fund had $3.6 billion in assets, the C-Fund had $46 million, and the F-Fund had $13 million. During 1989, the G-Fund achieved a rate of return of 8.81 percent, the C-Fund achieved a 31.03 percent rate of return, and the F-Fund a 13.89 percent rate of return.

◆ Pension Investment Regulation and Enforcement

Private pension plans are regulated by ERISA and its amendments. DOL and the IRS enforce ERISA regulations for these plans. Public pension funds are regulated by their sponsoring governmental body, which sometimes creates lists of acceptable investments and may impose regulation similar to ERISA's. However, when governmental bodies adopt such regulation for their public plans, they assume responsibility for enforcing it.

ERISA is the backbone of current private pension regulation. Changes in the management and regulation of private pensions have come through amendments to ERISA or the tax code. ERISA includes four primary sections or titles: Title I, Protection of Employee Benefit Rights, established the reporting, participation, vesting, and funding requirements as well as fiduciary responsibilities and administration and enforcement procedures; Title II, Amendments to the Internal Revenue Code Relating to Retirement Plans, exempted pension plans from taxes and includes other tax provisions; Title III, Jurisdiction, Administration, Enforcement, and Joint Pension Task Force, established enforcement procedures for the Treasury and DOL; Title IV, Plan Termination Insurance, created the Pension Benefit Guaranty Corporation (PBGC) to insure benefits promised by private defined benefit plans in case a plan sponsor is unable to fulfill those benefit promises.

Fiduciaries

Fiduciaries are those who exercise control or discretion in managing plan assets, provide investment advice to the plan, or have discretionary authority in administering the plan, irrespective of their titles. Fiduciaries must

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Fiduciaries are held personally liable to cover any losses resulting from their failure to meet their responsibilities and must return any personal profits realized in the course of performing their duties.

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[9]The federal retirement program includes disability benefits.

act in the exclusive interest of plan participants and plan beneficiaries, manage the plan's assets to minimize risk of large losses, and act in accordance with the plan's governing documents.

In addition, there is an overriding "prudent man rule." Under this rule, fiduciaries must act "with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims."[10] Because the performance standard is so high, the prudent man rule can be translated to require the actions that a prudent expert would take.

The plan document names one or more fiduciaries who have the authority to control and manage the plan's operation and administration. This document allows participants to know who is responsible for managing the plan.

Finally, fiduciaries are held personally liable to cover any losses resulting from their failure to meet their responsibilities and must return any personal profits realized in the course of performing their duties.

Fiduciary duties can be divided into two parts: trustee responsibilities and all other fiduciary duties. With some exceptions, IRS and DOL require that a qualified private retirement plan hold its assets in a trust with one or more trustees who are named in the trust agreement and appointed according to a procedure described in the plan document or appointed by a named fiduciary. The trustee(s) have exclusive authority and discretion to manage and control the plan's assets except if the plan stipulates that the trustee is subject to the discretion of a named fiduciary or the plan permits the appointment of an investment manager who will have the authority to manage, acquire, or dispose of plan assets.

If appointed, the investment manager has substantial authority in the management of the assets for which he or she is responsible. This authority includes the voting of proxies unless that responsibility is reserved for a fiduciary or a trustee.

The institutions that manage pension money are also regulated by other laws and agencies. For example, pension money invested in a mutual fund is regulated by the Securities and Exchange Commission, and money in a bank is regulated by the Federal Deposit Insurance Corporation.

U.S. Department of Labor

DOL is charged with enforcing the reporting, disclosure, and fiduciary aspects of pension plans. It conducts audits of pension plans through the Pension and Welfare Benefits Administration (PWBA), which can take several steps on finding a violation and can ultimately refer to IRS for imposition of an excise tax against a plan.

Another area of DOL enforcement that has recently received renewed attention is the voting of proxies. On January 23, 1990, DOL issued a letter to Robert Monks, president of Institutional Shareholder Services, Inc., stating that pension fund investment managers cannot escape their legal obligation to vote proxies in corporate matters, even if their contract with a fund says they will not vote such proxies. Only if the plan documents specifically assign the voting responsibility to someone else, such as the fiduciary or plan trustee, can the investment manager not vote proxies with impunity. The letter also stated that "the named fiduciary must periodically review voting procedures pursuant to which the investment manager votes the proxies and the actions taken in individual situations, and the investment manager responsible for voting proxies must keep accurate records as to the voting of proxies."

Internal Revenue Service

[10]From ERISA section 404(a)(1)(B).

IRS processes determination requests from plan administrators and conducts plan examinations. Determination letters must be obtained by plans if they wish to begin, amend, or terminate a pension plan. Plan examinations are completed to enforce ERISA's minimum funding, participation, vesting, and nondiscrimination laws. If a violation is found, IRS can impose an excise tax, a penalty, and/or revoke a plan's tax-qualified status.

◆ Goals of Pension Investment

There is a consensus that pensions should fund benefits in advance. Their goal is to provide current workers with a level of retirement income significantly beyond that achievable with Social Security alone. This seemingly simple goal is difficult because of the large amount of money required. In the event of a plan termination, the plan's funded status will determine—in most cases—the benefits participants receive. In the case of joint trusteeship, investment goals may change.[11] The goals of pension investment, therefore, are the basis of much debate.

Employers sponsoring defined contribution plans face what could be considered simpler issues, because the money is placed in individual accounts for employees, who generally have discretion to invest among several funds. There are regulations concerning the type and number of funds that an employer must offer. Generally, though, employees can direct their pension monies toward or away from equity investments.

In a defined benefit plan, however, the debate is much more heated and less clear. As stated above, the employer promises a retirement benefit to employees and bears the investment risk, investing monies in the participants' interests. The employer must also make contributions to the plan that fall within the minimum and maximum allowable limits set by Congress.

Participants in defined benefit pension plans do have an interest in the funds' investment performance, however. Better performance by the pension fund may lead to more frequent ad hoc benefit increases for current and future retirees to compensate for inflation. Some have suggested that the benefits promised by the employer to the employee are a floor, and that good investment performance can lead to more increases in these benefits above that floor.[12] Others, however, believe that the promised benefit is the amount that employees should count on, and that excess pension assets beyond that promised benefit belong to the employer, who has voluntarily accepted the downside risk of providing the benefits.

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Several proposals concerning the governance, taxation, and enforcement of private pension plans have emerged in the 100th and 101st Congresses.

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The resolution of this debate will affect legislation on reversions and joint trusteeship, as well as employers' decisions to sponsor plans.

◆ Current Legislative Issues

Several proposals concerning the governance, taxation, and enforcement of private pension plans have emerged in the 100th and 101st Congresses. The attention to these issues and the arguments on each side provide a general idea of areas of concern to Congress that may be acted on in the current session or resurface in subsequent sessions. The bills are outlined in table 4, and the major proposals are discussed below.

Joint Trusteeship

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[11]The nature of these changes are discussed later in this *Issue Brief*.
[12]For example, see Bodie and Papke, 1990.

Table 4
Selected Legislation in the 101st Congress Affecting Private Pension Plan Governance and Taxation of Private Pension Plans

Primary Sponsor	Bill No.	Provisions
Rep. Visclosky	H.R. 2664	Create joint board of trustees for all private pension plans.
Sen. Kassebaum	S. 1654	Tax short-term capital gains on certain sales of pension funds.
Sen. Metzenbaum	S. 685	Restrict reversions; amended version places reversions under fiduciary restrictions.
Rep. Clay	H.R. 1661	Restrict reversions and treatment of pension plan assets upon termination.
Sen. Sanford	S. 2160	Prohibit employers from using excess pension assets to finance takeovers or leveraged buyouts.
Sen. Kassebaum	S. 2069	Place an 18 month moratorium on pension asset reversions.
Rep. Glickman	H.R. 3945	Require annuities purchased after termination to be from an insurer with a specified rating.

Source: Employee Benefit Research Institute.

Rep. Peter Visclosky (D-IN) introduced the Employee Pension Rights Act (H.R. 2664) on June 15, 1989, which states that "the assets of a single-employer plan shall be held in trust by a joint board of trustees, which shall consist of two or more trustees representing on an equal basis the interests of the employer or employers maintaining the plan and the interests of the participants and their beneficiaries." This employer and employee representation on the board of trustees is commonly referred to as joint trusteeship.

The bill provides that, in the case of collectively bargained agreements, the employee organization will designate the participant/beneficiary representatives or waive the right to such representation. For noncollectively bargained plans, the representative(s) would be one or more participants elected to that position through a secret ballot.

On introducing the legislation, Visclosky expressed concern about pension monies being used in mergers and acquisitions and for investment in junk bonds. He said that money in a pension fund is deferred compensation to which workers are entitled and, therefore, they should have a say in how it is invested. In his opening statements at hearings on this bill held on February 21 and 28, 1990, by the House Education and Labor Subcommittee on Labor-Management Relations, Visclosky maintained that joint trusteeship would enhance, rather than impede, pension participation and that the issue remains a simple matter of fairness.

According to David Ball, DOL assistant secretary for the Pension and Welfare Benefits Administration, who testified at the hearings, the Bush administration strongly opposes the Visclosky legislation. He stated that the bill would increase the cost of providing defined benefit plans due to lower returns on assets and, therefore, higher employer contributions would be necessary to maintain the benefit level. According to Ball, the Bush administration believes the enactment of this bill could adversely affect capital markets by causing a flight of pension assets from equity investments.

Other arguments against the Visclosky bill were raised at the hearings, as follows.

- Since multiemployer plans—which are currently required to have joint trusteeship—invest more in bonds than in equity (perhaps as a result of a more conservative investment approach desired by employee representatives), the same requirement for single-employer plans might also lead to increased bond investment and to lower long-term average returns.

- DOL would incur large costs in overseeing the elections of employee representatives.
- There would be no improvement in addressing participants' concerns because plan fiduciaries are already required to act in the participants' best interests or be held personally liable under ERISA.
- The bill would compel employees in single-employer plans to vote for their representatives, possibly violating the National Labor Relations Act, which guarantees the right of employees to engage in, or refrain from engaging in, concerted activities as they desire.
- Joint trusteeship may discourage the formation and continuation of defined benefit single-employer pension plans since the sponsors would not have full investment control of the money.
- Elections of employee representatives would result in the politicization of plan trustees.

Those who support the legislation note that its enactment would guarantee retirees and participants access to information on pension fund investments, give them the right to a voice in how proxies are voted, allow employers and participants to "keep an eye on the other to ensure honesty and fairness" (Dodds, 1990), create more loyalty from the workers toward the employer (Ghilarducci, 1990), and potentially prevent abuses that have occurred despite fiduciary requirements and government enforcement.

EBRI submitted written testimony to the subcommittee on different investment returns of jointly trusteed and nonjointly trusteed plans and the effects of joint trusteeship on those returns. Based on data from the *EBRI Quarterly Pension Investment Report* (*QPIR*), nonjointly trusteed defined benefit funds achieved a five year annualized rate of return 2.6 percent higher than jointly trusteed defined benefit funds for the period ended September 1989. These nonjointly trusteed defined benefit funds would have had to contribute an additional $87 billion had they experienced the same rate of return as jointly trusteed defined benefit funds from the end of 1982 to September 30, 1989. Single-employer defined contribution funds achieved a five year annualized rate of return that was 1.8 percent higher than jointly trusteed defined benefit plans. The data also show a significant difference in asset allocation between the two plan types. However, these data cannot be used to settle the debate on joint trusteeship definitively as they cannot reveal the reasons behind the decisions concerning asset allocation, such as demographically different work forces (Davis, 1990).

EBRI also submitted testimony, including an analysis of Form 5500 data, that examined the motivations in asset allocation of jointly trusteed funds. The study found that the more conservative asset allocation decisions made by jointly trusteed defined benefit plan sponsors do not appear to be associated with the more mature participant population of multiemployer plans compared with nonjointly trusteed single-employer plans; therefore, the decisions may be related to the plans' joint trusteeship. The study also showed that, while nonjointly trusteed defined benefit plans decrease the percentage of their portfolio invested in stocks and increase the percentage in bonds as the plan participant population matures, neither of these trends is evident in jointly trusteed defined benefit plans (VanDerhei, 1990).

Taxation of Pension Plan Investment Income

In September 1989, Sens. Nancy Kassebaum (R-KS) and Robert Dole (R-KS) introduced the Excessive Churning and Speculation Act of 1989 (S. 1654), which would place an excise tax of 10 percent on capital gains from assets held 30 days or fewer and 5 percent on capital gains from assets held more than 30 days but not more than 180 days. Plans with less than $1 million in assets at their most recent valuation and transactions entered into as a hedge (that is, to reduce risk) would be exempt from these taxes. When introducing the bill, Kassebaum stated that in previous hearings held by the Senate Committee on Banking, Housing, and Urban Affairs it became clear from the testimony of several witnesses that the United States "must lengthen our institutional investors' short-term investment mentality. Corporate America is increasingly being acquired by institutional investors having only a transient interest in the companies they own and control," she stated.

Kassebaum rejected the idea that this proposal would injure low- and middle-income workers since, according to her, 80 percent of pension plan beneficiaries are covered by defined benefit plans, and that the excise tax therefore would be paid by the employers in these instances (Kassebaum, 1989). Others feel that the tax may be shared by participants and beneficiaries through fewer benefit increases.

In hearings before the Senate Finance Committee, Treasury Secretary Nicholas Brady stated that the administration, while agreeing with the objective of lengthening the investment horizon of pension funds, does not support S. 1654. The administration feels that an excise tax should be viewed as a last resort for achieving this goal. Others who oppose the proposal maintain that pension funds already work in the best interests of participants and beneficiaries, and that this bill would limit the range of short-term investments, thereby limiting the return and perhaps the participants' benefits (McGrath, 1990). It has also been argued that pensions could obtain the same investment position as taxed transactions while avoiding the tax by increasing their use of options and futures as hedges, although they would incur additional transaction costs. Proponents state that the bill would discourage destabilizing speculation, excessive financial engineering, and excessive shareholder impatience (Summers, 1990).[13]

S. 1654 would also place excise taxes on defined contribution plans, with the amounts probably appearing as line items on individual account statements.

[13]Summers would prefer a transaction tax over the proposed tax.

EBRI is currently working on a project to determine the investment turnover for pension assets through a survey of pension sponsors. The survey is collecting turnover rates by type of asset, the most relevant to this discussion being U.S. equities, although rates are also being collected on international equities, short-term bonds, long-term bonds, and other investments. In addition, another survey will ask for the criteria used in hiring and firing investment managers and investment manager tenure, and another survey will ask investment managers how investment strategy is determined and whether currently used strategies inherently favor a short-term perspective. The results of these surveys and final turnover numbers will be available next fall.

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The Treasury is currently considering a proposal whose aim would be to make debt financing and equity financing equally attractive to firms.

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The Financial Executive Institute's Committee on Investment of Employee Benefit Assets completed a survey of a portion of its members, covering 8.5 million participants and 300 defined benefit plans. The survey showed a 33 percent turnover rate for U.S. common stock during the first nine months of 1989, down from 38 percent in 1988 and 51 percent in 1987. The results also showed a significant difference in turnover rates between passive and active equity portfolios. During the first nine months of 1989, passive equity portfolios experienced a turnover rate of 13 percent, compared with 47 percent in active equity portfolios. The percentage of managers terminated was 7.4 percent during the first nine months of 1989 and 7.0 percent during 1988. The average tenure of terminated managers was 7.6 years during the first nine months of 1989 and 8.0 years for 1988.

Proposal to Eliminate Double Taxation

The Treasury is currently considering a proposal whose aim would be to make debt financing and equity financing equally attractive to firms. Currently, dividends are taxed at the company level before distribution and at the shareholder level as income after distribution. Interest paid on bonds, however, is tax deductible to the company and taxed only at the bondholder level as income. This proposal would require companies to pay one tax rate on all pretax income earned, which would be the same whether this income was distributed as dividends or as interest. A tax credit would then be given to those receiving the income (either as dividends or interest) to be used during the tax period in which the income was received.

This proposal has different implications for tax-exempt organizations such as pension funds, however. The tax status of pension funds would not be changed; pensions would continue not to pay tax on investment income. However, the proposal would make investment income nontaxable to other, taxable investors and thus reduce one of the attractions of pension funds. Moreover, since pension fund beneficiaries are currently taxed when benefits are distributed, the proposal would result in double taxation of this investment income (first by the corporation and again when received by the beneficiary). The more far-reaching effects of this proposal, then, might be to discourage companies and individuals from placing money in pension funds and perhaps even to discourage firms from sponsoring them.

Reversions/Rollovers

On April 4, 1989, Sen. Howard Metzenbaum (D-OH) introduced the Employee Pension Protection Act (S. 685), which sets limits on employer reversions. The bill originally established requirements—based on the type of replacement plan—for the provision of cushions to protect active workers against market downturns and provide inflation adjustments for retired workers. A companion bill (H.R. 1661) was introduced by Rep. William Clay (D-MO).

On February 28, 1990, the Senate Labor and Human Resources Committee approved an amended version of S. 685 offered by Metzenbaum and Kassebaum that would apply fiduciary rules to decisions to distribute surplus assets from a terminated pension plan, transfer surplus assets to a retiree medical account, or purchase annuities. Currently, these decisions are not subject to this restriction.

To determine whether an employer may recover excess assets, the fiduciary would be required to consider whether an adequate portion of the residual assets is being retained in a comparable replacement plan, cost-of-living adjustments are provided to retirees, and the plan is financially stable enough to continue providing benefits. Similar criteria are outlined for transfers of funds. The person exercising these fiduciary decisions would be personally liable for any reversion or transfers plus any interest, and participants would have the right to challenge the administrator's decision in court.

This bill grew out of concern over a specific case involving Coleman Company of Wichita, Kansas, which terminated a pension plan and bought annuities from First Executive Corporation, an insurance company with a large portfolio of "junk" bonds. First Executive's rating was downgraded from AAA to A by Standard & Poor's Corporation, thus increasing the risk to these annuities. The decision to purchase annuities from First Executive has since been canceled.[14]

Also, as a result of that situation, the Senate Finance Committee held a hearing on April 5, 1990, to explore what happens to pension benefits if a company from which annuities have been purchased becomes insol-

[14]This situation with First Executive Corporation also resulted in Kassebaum introducing a bill (S. 2069) on February 5, 1990, which would place an 18 month moratorium on pension asset reversions and limit the uses of plan surpluses in the case of termination.

vent. There is no consensus whether such annuities are covered by PBGC. James Lockhart, executive director of PBGC, told the panel that Title IV of ERISA does not authorize PBGC to guarantee benefits distributed through irrevocable commitments purchased from insurance companies. However, the American Association of Retired Persons and the AFL-CIO disputed this statement by referring to a preamble to a 1981 regulation in which PBGC indicated that the agency would pay guaranteed benefits if an insurer defaulted and the state insurance funds did not cover the loss. However, in 1983 and 1985, PBGC and the administration made legislative proposals to add language to Title IV clarifying that PBGC would not guarantee against insurance company insolvency, but the proposals were never enacted.

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On January 29, 1990, PWBA announced that its budget for fiscal year 1991 includes an additional 133 positions dedicated to the enforcement of ERISA.

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DOL Enforcement

A DOL Inspector General report released on November 30, 1989, stated that the U.S. pension system was at risk because of inadequate monitoring of plans by DOL and compared the pension system to the savings and loan crisis. The Inspector General stated in the report, "These vulnerabilities do not reveal a pension system currently in crisis; but they do demonstrate it to be at risk." Labor Secretary Elizabeth Dole refutes these conclusions and stated in a letter to House Speaker Thomas Foley, "America's private pension system is fundamentally sound and has never been healthier."

The DOL Inspector General's report focused on the limited scope of audits in determining the soundness of individual pension plans and called for rules requiring public accounting firms to determine, as part of their audit, whether a plan is in compliance with federal law and accounting rules. DOL estimates that this would add 30 percent to the cost of an audit.

On January 29, 1990, PWBA announced that its budget for fiscal year 1991 includes an additional 133 positions dedicated to the enforcement of ERISA, increasing the staff by about 50 percent. The budget also includes monies for the data base system, allowing improvements in checking financial transactions.

In a letter on March 20, 1990, to the Employment and Housing Subcommittee of the House Government Relations Committee, DOL proposed legislative changes to reduce fraud in private retirement plans. The proposals would make it easier for individuals to sue trustees for allegedly mismanaging pension plans and require the trustees to pay the plaintiffs' legal fees. The proposals also include a bounty to be paid by the Secretary of Labor to whistleblowers, court review in cases of conflict of interest between an administrator and a claimant, and the discontinuation of limited-scope audits.[15]

◆ Employee Stock Ownership Plans

Employee stock ownership plans (ESOPs) have recently received attention from Congress because of their perceived use in mergers, acquisitions, and leveraged buyouts. ESOPs are of special interest as they provide several tax incentives that are not available to other types of pension plans.

A survey by the ESOP Association conducted in September 1989 revealed that the three main reasons for establishing an ESOP were to buy the stock of an existing owner, to respond to the attraction of the

[15]In limited-scope audits, accountants are required to accept the statements of state examiners.

employee ownership concept, and to provide an employee benefit. However, another reason—the availability of tax incentives for the company—increased from 13 percent of respondents in 1988 to 35 percent in 1989. Without any tax incentives, 30 percent of respondents said they still would have established the ESOP, 9 percent said it would have been a smaller plan, and 33 percent said they would not have established the plan. Nine percent were not sure.

Approximately 40 percent of the companies felt that the ESOP had improved their companies' productivity, with the remaining respondents split between believing that the ESOP had not improved productivity and that it was having an unclear effect. Legislative and regulatory changes were mentioned by 48 percent as an obstacle to sponsoring an ESOP, up from 40 percent in 1988.

ESOPs that use borrowed funds are called leveraged ESOPs. In this type of plan, the borrowed funds are used to acquire a large block of employer securities, in contrast to a nonleveraged plan, in which stock is acquired slowly through employer contributions. In 1989, ESOPs borrowed a record $24 billion, up from $6.5 billion in 1988, according to the National Center for Employee Ownership. In 1989, 85 percent of this borrowing came from public companies, up from 15 percent in 1988.

In the Omnibus Budget Reconciliation Act of 1989, Congress limited one of the larger attractions of ESOPs: The partial interest deduction to qualified lenders on loans made to ESOPs after November 17, 1989, is now limited to loans made to ESOPs with 50 percent of a company's ownership. This change in the tax law is expected to add $1.1 billion to federal revenues in fiscal 1990. Congress did not alter the deduction for dividends paid on stock held in an ESOP.

It was expected that, in response to this action, companies might issue public debt to prefund ESOP contributions. According to an article in *Pensions & Investments*, BellSouth Corporation was the first company to issue public debt for use in an ESOP. On January 24, 1990, the company issued $275 million, the first of three such issues planned, which together will total $850 million. The company plans to use the proceeds from all the sales to buy 16 million shares of its own stock on the market during the year (Vosti, 1990). Upjohn and Mobil plan to make similar debt issues. In addition to the congressional action, the companies are choosing this time to buy on the belief that their stock is undervalued and in response to evidence that the market for this debt is lucrative, as high-quality corporate paper is selling quickly.

Again according to the ESOP Association survey, the percentage of all ESOPs owning more than 50 percent of the stock of the sponsoring employer (and therefore able to continue to take advantage of interest deductions) increased from 28 percent in 1988 to 39 percent in 1989. Between these two years, the percentage of plans using the deductibility of ESOP dividends increased from 27 percent to 39 percent.

Rep. Beryl Anthony (D-AR) introduced a bill (H.R. 4226) March 8 to promote and improve ESOPs. One provision of the bill would reduce the 50 percent threshold for ESOP holdings to 30 percent.

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Taxation of pension contributions will probably continue to be an issue in the 1990s.

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◆ Conclusion

The financial environment in which pension plans invest is complicated and challenging. Regulatory and legislative changes continue to affect the responsibilities and decisions of pension fund investment managers, trustees, and fiduciaries. Changes in private plans are made by Congress and enforcement agencies, while changes in public plans are made by the governing body of the state or locality.

Currently, there are several bills on Congress' docket that would affect how private pensions operate and invest. The arguments on each side of these issues provide insight into future pension debates. Taxation of pension contributions will probably continue to be an issue in the 1990s. The extent and limits of that taxation will be decided within the halls of Congress after extensive debate throughout the country.

Issues concerning the responsibilities of fiduciaries, trustees, and investment managers will probably also come under scrutiny as the baby boom ages and nears retirement. If employers face increased labor costs at that time due to a smaller work force, the temptation to lower pension benefit payments may increase, creating a schism between generations and between employers and retirees.

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