PENSION PLANS, PORTFOLIO THEORY AND RECENT LEGAL DEVELOPMENTS

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ABSTRACT

During recent financial problems of companies such as Enron and Worldcom the employees became the biggest loosers. They lost their jobs as well as substantial portions of their pension invested in company stocks. In light of this developments lawmakers attempted to find legislative solutions to the dilemma. This paper looks at employee pension as part of employee's portfolio under the Modern Portfolio Theory and makes recommendations as to how to protect employee pension funds in a portfolio approach. Needless to say the recent legal developments did not go far enough to remedy the situation. We recommends that legal environment should be improved to enable employee pension funds to be invested in assets other than the employer's assets in order to achieve a diversified personal portfolio for the employees.

Introduction

Salaries and wages are primarily determined by market forces and/or collective bargaining agreements which are negotiated with forces governing current labor market conditions in mind. A pay package includes wages and salaries as well as pension benefits. Both of these monetary compensation components of the pay package are due to employment of non-marketable asset [10] namely human capital [2]).

Wealth accumulation of an employee especially at the beginning of employment is very limited. Hence an employee's investment portfolio is very lumpy and consists of primarily human capital. As employee works over the years and accumulates wealth to be invested in the stocks, bond and other financial assets. As financial assets increase in dollar amount it will also change the composition of the portfolio. As a result proportion of portfolio consisting of lumpy asset (human capital) will go down. This will reduce the problem of lumpy asset but will not eliminate it.

According to portfolio theory all investors including individuals who are employed should hold an efficiently diversified portfolio to reduce diversifiable risk in their portfolio. Wages and pension investments are directly tied to employment and are highly correlated unless pension fund are invested in industries, businesses and markets which are not highly correlated with the employer's sales and earnings it will be difficult for the employees to form an efficiently diversified portfolio. Therefore employee portfolios will have a substantial uncompensated diversifiable risk. Employee portfolios can not tolerate this uncompensated risk component. The legal environment should enable employees to be able to diversify using their pension funds to easily achieve diversification and risk reduction.

Importance of diversification of an individual portfolio including human capital has been studied under portfolio theory assumptions by [10] [11]. [3] have studied the demand for insurance for individuals under portfolio theory assumptions for a portfolio inclusive of human capital. This study borrows from that framework that human capital is an integral part of an individuals portfolio. Instead of looking at insurance and correlation of life insurance and wages this study will compare wages and return on pension funds as part of the same portfolio.

It is clear that limiting employees' ability to invest in assets other than employer's company stocks in their pension fund portfolio results in very undesirable very lumpy portfolios which include unnecessary and uncompensated investment risk. Pension laws should be changed to protect pension fund of the employees. Furthermore the laws should be changes to allow quicker diversification of lumpy portfolio of employees.

To achieve theoretically correct pension fund component of employees' portfolios employee pension fund should place no restriction on selling company stocks in employee pension funds. Indeed for employees with little or no other assets, a prohibition of investment into company stock is necessary to diversify unnecessary risk of employees' portfolios.

Legal and Regulatory Environment for Pension Funds

Regulation of the retirement element of the employee benefits portfolio has been affected by recent corporate scandals involving such companies as Enron and MCI/WorldCom. Much of the value of over 27,000 Enron employees' retirement savings invested in Enron company stock (some $2.1 billion) was effectively wiped out with the firm's bankruptcy in December 2001. Following a 19-month investigation by its Employee Benefits Security Administration ("EBSA"), last June the U.S. Department of Labor sued Enron, its administrative committee and board of directors for liability alleged to have resulted from failure to act properly as fiduciaries over the employee savings and stock ownership plans and to bar the defendants from having any control or influence over any employee benefit plan in the future. [4] [7]

While the result of this litigation remains to be seen, some changes have been made in the legal environment regulating pension investments. The Sarbanes-Oxley Act of 2002, commonly known as the Accounting Industry Reform Act, was signed into law on July 30, 2002. Sarbanes-Oxley focused primarily on accounting reform and tougher regulation of securities law disclosure, but it also contained provisions relating to pension reform, the most significant of which imposed new limitations on "blackout periods" during which employees are restricted form selling employer stock held in individual employee benefit plan accounts. Plan administrators must now give individual account plan participants 30 days advance written notice of a blackout period, and corporate directors and officers are prohibited from purchasing or selling company stock acquired in connection with their employment during the blackout period. The employer may recover any profits realized by a director or officer from the transfer of company stock during a blackout period. (Sternoff & Watson, 2002) The SEC implemented rules in early 2003 spelling out the blackout period restrictions in greater detail (as well as addressing company obligations regarding audit committee financial experts and adoption of codes of ethics). (AFX European Focus, 2003) Tougher criminal penalties have also been imposed for failure to comply with the reporting and disclosure requirements of the Employee Retirement Income Security Act ("ERISA"). Finally, Sarbanes-Oxley generally prohibits companies from making personal loans to their directors or executive officers. [13]

In spite of the flurry of bills, speeches and hearings in Congress which accompanied the initial Enron disclosures, little of substance has yet been enacted beyond Sarbanes-Oxley. The House passed a

Pension Security Act (H.R. 3762) in 2002, which (1) gave employees new freedom to sell their company stock within three years of receiving it in their 401(k) plan, (2) imposed liability on company insiders for abuses resulting in loss to employee savings during blackout periods, (3) allowed employees to sue company pension officials if they violate their fiduciary duty to act solely in the interests of 401(k) participants, (4) encouraged employers to provide their employees access to investment advice, and (5) added significant new fiduciary and disclosure safeguards to ensure that workers receive quality advice that is solely in their best interests. [13] [5] and [14] Another bill passed by the House in 2003 (H.R. 1000) would amend ERISA (which, to avoid conflicts of interest, prohibits an insurer or other financial services company from providing advice to plan participants while they are at work) to allow such firms that are already providing services and products at work sites to also provide advice; that bill would also provide a new tax incentive to help employees pay for the cost of retirement planning services so that it may be offered as an employee benefit. [8]

As noted earlier, while under current law individual account plans can restrict a plan participant's ability to sell employer stock held in the plan, pending House and Senate bills would set limits on a plan's ability to restrict employees from selling company stock held in the plan. They would also require individual account plans to permit participants to immediately diversify elective salary deferrals that are invested in employer stock. The bills in both houses of Congress are also uniform in requiring employers to provide participants with quarterly benefits statements which would identify the value of plan assets held in employer stock, explain any limitations on a participant's right to direct plan investment, and contain a statement regarding the benefits of diversification in a well balanced investment portfolio. Senators Kennedy and Bingaman would also require the plan to provide participants with all information required to be disclosed to investors by federal securities law. [13]

Beyond legislative proposals, there has also been regulatory agency action focusing on additional disclosure. The U.S. Financial Accounting Standards Board ("FASB") responded to concern over inadequacies in pension accounting by including in its technical agenda for 2003 a limited-scope project to improve disclosures relating to employers' accounting for pensions, with the goal of promulgating a new standard to become effective in 2004. [15] In addition to the already significant disclosure requirements prescribed by FASB, the Securities & Exchange Commission ("SEC") has been asking companies to justify expected asset return assumptions. The SEC has asked many companies to expand their reported "management discussion and analysis" to provide more details in a number of areas.

On an international level, the International Accounting Standards Board ("IASB") is working on a convergence project dealing with the treatment of pensions and employee benefits. The IASB's initial focus is to provide guidance on more candid disclosure of plan expense and balance sheets. In addition, in July 2002 the Organization for Economic Cooperation and Development ("OECD") promulgated a set of Guidelines for Pension Fund Governance which has been adopted as an international benchmark by OECD's thirty member governments. The 12-point Guidelines address governance structure (specifically, identification of responsibilities, governing body, expert advice, auditor, actuary, custodian, accountability and suitability) and governance mechanisms (specifically, internal controls, reporting, disclosure and redress). [12]

The three traditional converging streams of retirement income—company pensions, tax-advantaged savings accounts, and Social Security—on which Americans have come to rely are all experiencing problems just as 75 million baby boomers approach retirement age. The problems of Social Security are self-evident in a context in which the federal government has gone from budget surpluses to record deficits in a two-year period. The Social Security Trust Fund, which constitutes the sole source of income for one fifth of all retirees, will be exhausted by the time people born in 1962 reach their 80^{th} birthday. Workers in the steel and airline industries, among others, have been among hundreds of thousands of employees who have discovered how easily pension promises can evaporate when their companies go bankrupt [5]. Concurrent with the termination of several large pension plans during 2002-03 (LTV Steel, Polaroid, Bethlehem Steel, National Steel, and US Airlines Pilots), the net position of the Pension Benefit Guarantee Corporation ("PBGC"), established by Congress in 1974 to mitigate pension risk by providing pension insurance, declined from a surplus of $9.7 billion in 2000 to a current deficit of about $5.4 billion. [9]

This fall, the House and Senate have drafted competing versions of company pension relief to take over when temporary pension repair legislation enacted in 2001 expires at the end of the year; if no new bill is passed by then, pension obligations for companies will balloon. Approaching the deadline, the Senate Finance Committee voted in mid-September to give companies a break on their pension requirements that would save them about $60 billion over the next three years. According to a PBGC study, about half of the savings to companies in the Senate bill would come from a provision that would change how they calculate the value of their pension promises to employees. For three years, it would allow companies to alter a crucial interest rate used in their calculations.

Summary, conclusions and recommendations

Employees have an investment portfolio including financial assets, real assets and human capital. Human capital is non-marketable, and non-divisible and causes employee's individual portfolio to be not well diversified. Lack of diversification due to human capital is exacerbated by allowing pension funds of the employees to be invested in the employer's stock. It get even worse, by limiting the ability of the employer to sell employer's stocks in their portfolio problem of lack of diversification is increased. If one believes in Modern Portfolio Theory, this forcibly created non-diversified portfolio is not acceptable and must be remedied.

Even tough substantial attention was paid to pension fund issues by the legislator regulators and international organization the situation is not much improved for the employees to have a diversified portfolio to minimize the negative effect of lumpy asset (human Capital) in their portfolio. Sarbanes Oakley 2002 brought blackout period but did not overcome the problem of easy elimination of employer stocks in employees' portfolio to achieve diversification.

What is needed at this point is not only attention to pension issue but clear legislation to prohibit investment of pension funds in employer's stock. If employer contribution to the pension fund is in the form of employer's stock, passage of legislation is needed to enable the employee to sell these stocks as soon as possible to obtain a diversified portfolio.

Moreover, merely changing the statutory remedial framework will not suffice; REAL enforcement mechanisms must also be implemented to achieve any sort of comprehensive resolution of the difficult issues we confront.

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