

LEADERSHIP COUNCIL
of
AGING ORGANIZATIONS

Pension Principles

Workplace Pensions and Retirement Savings Plans

LCAO Principles for Protecting Benefits and Extending Coverage

OVERVIEW

The baby boomers are nearing retirement. The generation's vanguard is now over 50 and nearly all the boomers will be eligible to retire within the next 30 years. By 2030, they will double the size of the senior population to 73 million. Twenty percent of all Americans will be over 65.

Considering the size of the boomer generation, it's imperative that they be able to retire with enough income to maintain a decent standard of living. If a great percentage is unable to meet basic needs, the boomers will eventually place an enormous burden on government and the taxpayers who fund it.

The Leadership Council of Aging Organizations (LCAO) is deeply concerned about the financial security of future generations of senior citizens. While we are confident that Social Security will be able to correct its long-range shortfall and continue to be the foundation of retirement income for nearly all Americans, we recognize that Social Security was never meant to be the sole source of support. It works best when complemented by an employer-sponsored pension and personal retirement savings.

There are serious questions, however, about the strength of America's pension system and its ability to provide retirement security for the nation's workers. Pension contributions by employers and their employees account for the U. S. Treasury's largest tax subsidy - reducing tax revenue by over \$190 billion in 2002. Yet, only half the workforce is covered by a pension plan at any given time.

The basic reasons for lack of coverage are fairly obvious. First, many employers don't offer a retirement plan to employees. Second, even when a plan is offered, too many workers don't participate. According to a report issued by the General Accounting Office (GAO) in 2000, approximately 85 percent of workers who lack pension coverage have one or more of the following characteristics: low income, work less than full time, work for a small company, or are relatively young.

Participation tends to be concentrated among large employers and higher-income workers, who are the ones most likely to sign up for an *optional* retirement plan that requires an employee contribution. Clearly, these employees have more money to save after paying for life's necessities than their lower-wage colleagues. But they're also in higher tax brackets, which make their tax-deferred contributions worth more. Tax deferral and pre-tax contributions don't provide strong incentives to households with a low- or zero-rate tax bracket.

Recent trends in pension reform seem to be exacerbating inequalities in coverage - particularly by raising saving limits in 401(k)-style retirement plans. The effect is to provide even bigger benefits to high-income households without increasing overall savings or creating new savers. High earners tend to save under any circumstances, using a variety of vehicles, and will merely shift their savings to tax-advantaged plans when contribution limits are raised.

According to GAO, raising employee contribution limits affects less than 3 percent of participants in 401(k) plans because the vast majority of participants fails to contribute the maximum allowed under *current* law.

LCAO believes that the chief goal of pension reform should be to *expand coverage and participation*, especially among low- and moderate-wage earners. This will enhance retirement security for those who are least likely to be saving on their own. And, because it will create new savings, rather than merely shift funds to tax-advantaged vehicles, it will contribute to the *national* savings rate as well.

Coverage can't be expanded, however, if currently covered workers continue to experience erosion or elimination of their retirement plans. Recent economic conditions are contributing to this problem. The stock market decline that began in 2000 has caused most retirement plans, in both the public and private sectors, to lose value.

In addition, a rash of corporate bankruptcies has led to plan terminations and a decline in retirement assets for thousands of workers - many of whom suffered job loss at the same time. Executive malfeasance and an over-reliance on company stock have exacerbated the damage.

Plan termination is a worst-case scenario, and can occur in bankruptcy situations or in cases where an employer simply wants to limit its financial outlays. Employers can also temporarily freeze their retirement plans. This can occur in either a traditional defined benefit plan - in which case, participants would earn no new benefits -- or a defined contribution plan, with the employer ceasing contributions.

Faced with a need or desire to cut costs, some employers have converted their traditional defined benefit pension plans to other types of retirement plans. Conversions to cash balance plans - a cross between a defined benefit plan and a 401(k)-style defined contribution plan - have been most common and have caused particular concern. That's

because mid-career and longtime employees often lose valuable benefits in conversions, and currently there are few legal protections for workers who suffer these losses.

Clearly, an improved American pension system has to maintain a delicate balance between the needs of employers and the needs of workers. If federal pension rules are too complex and employers' costs and obligations too onerous, fewer and fewer employers will agree to offer any type of pension plan. At the same time, employees and retirees must be treated fairly and their precious savings preserved. All assets of a pension plan - including employer contributions - are deferred wages. Therefore, they always must be considered the property of the employees.

Following are a series of basic principles that have been adopted by LCAO. They serve as guidelines that enable the coalition to judge the fairness and effectiveness of current laws governing pensions and retirement savings plans, as well as future legislation and policy initiatives designed to change the status quo.

The principles are divided into three categories: Protecting Workers and Retirees Under Defined Benefit Retirement Plans; Protecting Participants of Defined Contribution Retirement Plans; and Expanding Retirement Plan Coverage to More Workers and Workplaces.

LCAO PRINCIPLES

Protecting Workers and Retirees Under Defined Benefit Retirement Plans

In a defined benefit (DB) plan, employers agree to provide sufficient contributions in pre-tax dollars to assure participants a monthly retirement check based on a specific formula. The benefits are guaranteed to continue over the course of the retirees' lifetime, and usually include options to provide for a surviving spouse as well.

Generally, the benefit formula depends on a worker's years of service and the amount of wages in his/her highest earning years. With the exception of public-sector plans, employees usually make no direct contribution to DB plans; the employer funds the plan. Most benefits are protected by the Pension Benefit Guaranty Corporation (up to \$42,954 a year in 2002) and participants typically do not have access to their funds prior to retirement.

Optimum public policy regarding defined benefit plans should recognize the following:

- Pension plan assets are deferred wages and therefore belong solely to a plan's participants.
- All DB plans should be adequately funded in order to meet their benefit obligations to all participants.
- The boards of trustees that govern DB plans should include employee and retiree representatives as well as employer representatives, as all three groups have an important stake in a plan's effective management and administration. Employee and retiree trustees should be chosen by their peers.

- When an employer terminates a DB plan, the workers' stake in the plan must be safeguarded. If termination occurs as a result of corporate bankruptcy, the Pension Benefit Guaranty Corporation (PBGC) must provide fair and adequate benefit protections for employees and retirees. The latter group includes those who took "early" retirement - a factor that can result in significantly reduced benefits under current PBGC rules.
- When employers convert their traditional DB plans to cash balance plans or similar hybrids, participant protections must be in place. There is a particular concern regarding mid-career and longtime employees. They have a significant stake in their plans and stand to lose valuable benefits in these conversions. At retirement, they should be allowed *the choice* of receiving benefits under the old formula *or* the new formula, whichever benefit is higher.
- Divorced spouses and widows of workers and retirees covered by DB plans need strong legal protections to guarantee their rightful share of pension assets. Current safeguards should be improved.
- In order to preserve a pension's purchasing power over the course of retirement, benefits should include post-retirement adjustments that help offset the effects of inflation.
- As there are no uniform standards for state and local government pension plans, rules determining the rights of beneficiaries are left to the discretion of each sponsoring jurisdiction. To ensure that all participants enjoy adequate security, Congress should enact a set of fiduciary standards and participant protections similar to those that govern private-sector plans under ERISA (Employees Retirement Income Security Act).
- Many DB plans allow employees to take lump-sum disbursements at the time of retirement, instead of the standard annuity. This can leave retirees without reliable monthly income throughout the retirement years. These total cash outs should be discouraged - using the tax code and other types of incentives -- in favor of monthly pay outs over the life span.
- Because a plan's assets belong to the participants, it is incumbent on the plan sponsor and administrator to provide full disclosure of the financial status of the fund and full explanation of participants' rights. Federal disclosure rules and regulations must be improved and implemented.
- To ensure that all workers ultimately receive pension benefits under private- and public-sector plans, the earliest possible vesting should be encouraged.
- Federal law should eliminate the practice of integrating benefits, whereby an employer deducts part of a beneficiary's Social Security payments from promised pension benefits in order to reduce plan pay outs.

Protecting Participants of Defined Contribution Retirement Plans

In a defined contribution (DC) plan, employers and/or employees contribute a portion of wages to an investment account that belongs to the individual worker. In the most common type of individual accounts plan, the 401(k), employees' contributions are excluded from their current taxable income and invested in mutual funds or similar vehicles. Investments may also include an employer's company stock. Account assets grow tax-deferred. At retirement, or separation from the employer, the worker receives

the account balance. The amount carries no guarantee, unlike the pension benefits of a DB plan, and is subject to all the risks inherent in any investment in stocks and bonds.

Workers may borrow against their accounts or withdraw assets prior to retirement under certain circumstances. Retirement withdrawals can't begin before a certain age (usually 59-1/2), and the account must start to be drawn down by a specified age (usually 70-1/2). In addition to 401(k)s, other DC models include the 403(b) plan - primarily for non-profit workplaces - and the public-sector 457 plan. Most 457s, however, are not primary retirement plans. Instead, they serve as savings plans *that supplement* a traditional defined benefit pension plan and generally receive no employer contributions. Optimum public policy regarding defined contribution plans should recognize the following:

- All workers, at every wage level, should have guaranteed access to his/her employer's DC plan.
- All employees should have the same rules and rights under the employer's DC plan. There should be no special rules to benefit executives.
- DC plans should be governed by a board of trustees that includes both employer and employee representatives. Employee trustees should be chosen by their peers.
- Plan participants should have strong legal protections, with federal government enforcement capabilities, against the loss of DC-plan assets due to corporate fraud, theft or fiduciary mismanagement.
- Providers of investment advice to plan participants should be free of conflicts of interest.
- The federal government should establish an advocacy office for retirement plan participants, similar to the IRS Taxpayer Advocates Office, that would function as an ombudsman for workers in DC plans.
- Workers should be encouraged to preserve their retirement accounts and not cash them out or borrow against them. When workers leave the employ of their plan's sponsor and/or change jobs, they should be encouraged to roll over their account assets into other tax-advantaged retirement vehicles (such as IRAs or another DC plan).
- There should be greater incentives for employees to annuitize their DC-plan accounts at retirement. Employers should offer annuity options at group rates.
- While employee risk is inherent in DC plans - since the proceeds depend on the success of individual investments -- these risks should be minimized as much as possible. Employees should be encouraged to diversify their DC-plan investments.
- Participants need special protections when employers make retirement plan contributions in the form of their corporate stock. In all such matters, employers need to provide full disclosure to employees. Employers should be prohibited from concentrating too much of a plan's assets in corporate stock and workers should be given greater rights to sell these equities. In addition, plan participants should always have ample notice before employers institute lockdowns - periods when workers are prohibited from selling the employer's stock.

- Standards of corporate governance need improvement. Better-run corporations will help maintain the value of company stock in DC plans. Fewer bankruptcies and cases of executive malfeasance will mean greater security for corporate plans and less risk to employees' retirement savings.
- The earliest possible vesting of employer contributions should be encouraged.
- Employers should be discouraged from switching from DC plans to less regulated Employee Stock Ownership Plans (ESOPs), which increasingly are being substituted for retirement savings vehicles. ESOPs have even greater investment risks than 401(k)s. Other disadvantages include an ESOP's ability to prevent any employee sale of company stock prior to age 55.
- Divorced spouses and widows of workers covered by DC plans need strong legal protections to guarantee their rightful share of plan assets. Current protections should be improved.

Expanding Retirement Plan Coverage to More Workers and Workplaces

LCAO's goal is to ensure income security for all current and future retirees. To that end, we support public policy that will eventually lead to *retirement-plan coverage for 100 percent of workers in all workplaces*.

Following are some of the reform proposals that could help Americans achieve this objective.

- Establish federally sponsored Universal Retirement Accounts - designed to *supplement* Social Security - with automatic government contributions for low- and moderate-income savers.
- The Savers Credit enacted under the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA) should be made a *refundable* tax credit in order to provide a better incentive for low-wage, non-taxed workers to contribute to retirement savings plans. Income limits should be raised somewhat to include more workers.
- In workplaces that currently offer no retirement plan to employees, encourage the creation of hybrids that combine the best features of DC and DB plans: the portability and simplicity of DC plans and the lifelong benefit guarantees and insurance protection of DB plans.
- Adopt new rules for DC plans that encourage greater participation, especially among low- and moderate-income workers. Employers, for example, could offer plans with a "reverse match," whereby the employer contributes a percentage of wages regardless of whether a worker makes his/her own contributions. This is similar to the way contributions are generally handled in private-sector DB plans.
- To ensure broader plan participation, workers should be enrolled *automatically* in their workplace retirement plans (DB, DC or hybrid). A worker could still opt out, but would need to take a specific action to do so.
- Employers could be encouraged to ask workers to commit a portion of *future* pay raises to the workplace retirement plan. Studies show that workers are more likely to earmark contributions in this way than make them from current income.

- Establish greater tax incentives for employers who start plans and/or agree to cover *all* their workers.
- Create policies that encourage multi-small-employer pools. These pools would administer a retirement savings plan for small employers who might not be able to provide plans on their own.
- To encourage employers to offer plans, simplify reporting and other administrative rules while being sure to balance simplification with safeguards for plan participants. Create more incentives for employers to adopt Simplified Employee Pensions (SEPs) - the most basic and least complex retirement plan yet devised by the federal government.
- Require workplace education programs that explain the importance of retirement savings to employees. These should always be conducted by impartial third parties.
- Establish a national education campaign for *employers* that explains the importance of starting pensions and retirement savings plans for workers. Employers should be advised of their own self-interest in sponsoring these plans, including a greater ability to attract the highest quality workers and achieve a more stable workforce. Once retired, the employees will have the means to purchase their employer's goods and services, pay taxes, and continue contributing to the economic well-being of the community.

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