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For Information Contact:

Charles W. Calomiris 202-862-7151
Richard Herring 215-898-5613

Statement of the Shadow Financial Regulatory Committee

on

Pension Reform in the Wake of Enron's Collapse

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Enron employees suffered large losses in the value of their 401(k) defined contribution pension assets as the result of their employer's collapse because a large fraction of their 401(k) assets were in Enron stock. Some of those pension losses occurred during periods when employees were contractually or administratively prohibited from selling their shares. Much of the loss occurred outside of these periods, too, when employees were able to sell but chose not to.

A central principle of asset management is diversification. Many observers have noted that it is unwise for investors to hold a large proportion of their wealth in the assets of one firm, especially if their employment income also depends on the health of that firm. At the same time, there are legitimate reasons why employee pension plans tend to result in concentrations of the employer's stock in the pension portfolio. Employers will tend to make larger pension contributions if they can make those contributions in the form of their own stock, particularly if employees cannot sell the shares for an initial period.

In reaction to the Enron pension losses, policy makers have been considering various means of constraining corporate pension practices in a way that would reduce employees' exposures to loss. The challenge is to find a way of doing so that does not discourage employers from making pension contributions and that does not infringe significantly on the freedom employees currently enjoy under 401(k) plans to manage their own portfolios as they see fit.

President Bush has advocated an approach that (1) limits to three years the duration of the required holding period during which employees are prohibited from selling stock granted to them by their employers, (2) limits insiders' ability to sell stock during so-called "blackout" periods (when employees are unable to sell their shares because of administrative changes in pension management), (3) requires that employers give 30-day notice of impending blackout periods and increases corporate responsibility for worker losses on employer stock during blackout periods, (4) mandates quarterly disclosure of information about 401(k) investments by employers and reminds employees of their rights to diversify, and (5) removes existing legal barriers to employer-provided financial counseling and encourages the expansion of workers' access to investment advice in a manner consistent with the Retirement Security Advice Act, which has passed the House of Representatives.

The President's proposed three-year limit for initial stock holdings would not apply to Employee Stock

Ownership Plans (ESOPs). This exemption is appropriate. ESOPs were created by Congress as a combination of a pension program, incentive compensation, and a corporate financing tool, and it was envisioned from the outset that these would not generally result in diversified pension portfolios. Unlike 401(k) plans, ESOPs are not under the control of employees.

The Shadow Committee believes that the President's approach achieves an appropriate balance between, on the one hand, the desire to protect employees from unfair treatment and from losses due to inadvertent under-diversification and, on the other hand, the desire to preserve sufficient flexibility so that 401(k) plans continue to grow and employees continue to control their own portfolio allocations.

There are calls to go further with government limits on pension plans, which the Committee believes would be excessive. For example, one proposal, by Senators Boxer and Corzine, would limit the proportion of the employer's stock in an employee's plan to 20 percent. The disadvantages of this approach are that it might discourage employer pension contributions and prevent employees from being able to concentrate their stock holdings, if they choose to do so.

The Committee thinks it is also worth considering additional reforms that might provide better information to employees about their rights and about the benefits of diversification, and thereby encourage workers to diversify their pension assets. Such reforms might require employees to sign waivers acknowledging that they are aware of the risks of holding more than a given percentage of their assets in any one stock whenever their holdings in one stock exceed some threshold percentage of their portfolio.