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## CONSUMER PROTECTION ISSUES

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# ***Consumer Protection Issues***

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The success of any pension program – public or private - relies heavily on the confidence and participation of pension plan members. The consumer – the pension plan participant, the future or current retiree – should have every expectation that their retirement funds will be well managed, prudently invested, and efficiently administered. Thus, by the time someone retires after a lifetime of work, there should be a reasonable assumption that the resources to live comfortably in retirement will be available. As we have so tragically seen in recent months, the pension debacle, which has arisen from the bankruptcy of the Enron Corporation has thrown this expectation into some doubt. President Bush correctly summed up the situation in his January 29, 2002 *State of the Union Address* when he said "a good job should lead to security in retirement."

The tragic situation at Enron underscores the fact that full disclosure of fees, other expenses, and rights of pension plan participants to pension plan sponsors and participants is essential. And, making such essential information available is not impossible. Through the use of advanced technology, efficient plan administration and economies of scale, pension providers are able to deliver affordable retirement plan services to employers and consumers. Enron or, prior to that, the so-called *"pension misselling scandal"* in the United Kingdom, need not be replicated. Further, there are some positive consequences of these situations, not the least of which is that consumers in these two countries now pay more attention to their retirement plans. They also seek more education, financial advice and, in some instances, they are diversifying their retirement investments.

Inasmuch as I consider the question of consumer protection through the prism of the private pension system in the United States, a brief review of this system seems appropriate. The U.S. basic private pension law – the *Employee Retirement Income Security Act of 1974 (ERISA)* – requires private pension plan sponsors to comply with a series of reporting and disclosure, trust, fiduciary, and prohibited transaction rules. The U.S. Department of Labor administers these rules. When ERISA was adopted 28 years ago, it helped to increase the defined benefit plan market, by far the most common employer-sponsored pension plan at the time. In 1975 there were over 103,000 private-sector defined benefit plans. This number peaked at 175,143 plans in 1983. Since then, however, there has been a steady decrease to just over 38,000 defined benefit plans today.

There are also separate plan coverage laws in the U.S. Tax Code that ensure that tax-qualified plans do not discriminate in favor of highly-paid or *"key employees"* in terms of pension coverage and overall benefits.

The highly popular 401(k) plans did not exist in 1974 and personal savings to many Americans meant a bank savings account. Today, in the United States, personal retirement savings mean 401(k) defined contribution plans, Individual Retirement Accounts (IRAs), mutual funds, and a large array of investment choices. Thus, defined contribution plans have become the primary form of retirement asset accumulation for the vast majority of pension-covered workers in the United States – including some governmental employees and military personnel.

The popularity of 401(k) defined contribution plans has resulted in the number of workers covered under such arrangements rising from 12 million to over 45 million in more than 400,000 plans over the past two decades. These plans account for over US$1.7 trillion in assets. This explosive growth of 401(k) plans, combined with the increased investment choices of recent years, has created unique consumer protection issues, not the least of which is the need for accurate investment education and advice.

As the Employee Benefit Research Institute (EBRI) aptly notes, "no one [pension] plan design fits all circumstances. Defined benefit plans are especially valuable for long-service workers but an estimated 75 percent of the labor force will never be long service." [1] EBRI also observes that defined contribution plans for employers with highly mobile work forces and variable profits find 401(k) plans more suitable as they provide a means of offering workers the chance to save for retirement. Workers can take the portable

[1] Dallas L. Salisbury. "Protecting the Pensions of Working Americans: Lessons from the Enron Debacle." Testimony before the U.S. Senate Committee on Health, Education, Labor and Pensions, February, 2002, p. 3.

account balances with them when they change jobs and 401(k) plans allow the employer to vary their contributions tied to profitability."

When the U.S. Congress enacted ERISA it created the *Pension Benefit Guaranty Corporation (PBGC),* a federal government corporation to insure benefits in private-sector defined benefits plans. The PBGC does not insure defined contribution plans, such as 401(k). The PBGC currently insures pension benefits for over 43 million workers in some 38,000 defined benefit plans. PBGC insurance coverage is funded through premiums assessed on all private-sector defined benefit plans. The PBGC premium, set by the Congress, is US$19 per year per pension plan participant. An additional premium of US$9 per US$1,000 of unfunded vested benefits is levied against under-funded plans as such plans present a higher risk of default. [2] The premiums are invested by the PBGC to fund pension benefits for covered workers whose employers become insolvent. No similar insurance protection exists for defined contribution participants. Some lawmakers in the U.S. Congress have suggested that a defined contribution insurance system be adopted.

As private pension schemes are developed, service providers such as Principal in the U.S. and BrasilPrev in Brasil fully disclose the plan costs - both to the employer and/or to the prospective pension plan participant. Plan costs usually occur as follows:

- Investment Management Fees – the cost of managing assets in the funds in which the pension plan invests.
- Recordkeeping and Administration Fees – the cost of keeping participant account records and providing plan level services such as government tests and reports.

These fees are collected by several methods:

- Total cost – those billed to the plan sponsor or collected through reduced investment return.
- Flexible payment options – fees are paid as a separate business expense or net fees are taken directly from member accounts or a combination of these two. In some instances in the U.S. the Labor Department may prohibit certain member fees.
- Simplified concept – fees are based on the amount of retirement funds, the number of pension plan participants, and the services provided to the employer.

The base fee for administering a pension plan is calculated by using basic services chosen by the pension plan sponsor for the particular *plan year.* Base fees include charges for administrative services, recordkeeping, compensation, report bar coding, passive trust services from a non-deposit trust, and anticipated compliance, document, supplemental services, and other special services. There are also member fees, which are calculated and collected separately from the plan sponsor's base fee. These would include loan recordkeeping, nonelectronic investment direction changes or transfers, and personal retirement account. Fairness dictates that any fees participants pay should be fully spelled out in benefits statements. Increasingly regulators are requiring much clearer and fuller disclosure of 401(k) fees. This trend will surely continue in view of disclosures from Enron, Global Crossing and similar recent corporate retirement scandals.

Unique challenges also confront those employers who choose to provide a pension plan for their workers, especially for small and medium-sized employers. As they sponsor a pension scheme they are obliged to:

- Increase the awareness and appreciation by the workers of total retirement benefits.
- Increase pension plan participation and deferrals.

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[2] Patrick J. Purcell. "The Enron Bankruptcy and Employer Stock in Retirement Plans." *CRS Report for Congress.* Congressional Research Services, Library of Congress, Washington, D.C., January 23, 2002.

- Assist pension plan members to make informed investment decisions.
- Encourage the use of available education tools and resources.
- Fully inform pension plan members of fees and other expenses.

Particularly in those nations whose tax regimes encourage private retirement savings, additional disclosure and prohibited transaction requirements are often imposed on the plan sponsor. Although these legal requirements are well intended, pension regulators and supervisors should be cautious to ensure that employers are not overburdened by costly and cumbersome regulations. In societies in which private pensions are voluntary, small and medium size employers will be discouraged from offering pension schemes. Nonetheless, private pension plan laws must provide plan participants with the confidence and security that their benefits will be paid to them upon their retirement.

Pension plan participants' interests would be enhanced by receiving at least one pension benefit statement annually, informing them of their total accrued benefits under the plan. Where possible, this statement could be provided electronically.

For those pension plans in which employees are permitted to direct the investment of their accounts, a quarterly statement would be desirable. The quarterly statement might also include the value of investments in the account and an explanation of restrictions on an employee's right to change investment options. Here, too, the statement could be made available electronically.

The Enron Affair dramatically underscores the continued need for meaningful financial and investment education for pension plan participants. This is especially critical for those workers in pension schemes that allow participant directed accounts. There is no question that diversification across several different asset classes is critical for managing risk. The Principal Financial Group continually stresses to plan participants that putting a large part of retirement savings in any one investment, including the stock of the company, can be very risky.

*Diversify, Diversify, Diversify* should be the mantra of private pension plan participants. Workers covered by private pension arrangements should spread their investments over different asset classes such as stocks, bonds, and short-term investments. There should also be diversity within each asset class, with a mixture of funds representing companies of different sizes and industries. This strategy will provide the potential for the best return over time, as well as protection.

In the wake of Enron and a weakened national economy, a recent *Principal Financial Well-Being Index*™ [3] revealed that American workers had increasing concerns about their overall financial well-being. And, they are closely monitoring their financial situations; they have real short-term financial well-being concerns.

Also, as Enron remains in the headlines, American workers are further sensitized to the basic tenets of managing a retirement investment portfolio. Unfortunately, however, many of these workers have not sought or do not have access to professional investment advice. Nearly 70 percent of workers look to family and friends for financial advice while the remainder consults with financial planners and financial services firms for professional advice on financial products and investment decisions. The *American Council for Capital Formation (ACCF)*, a Washington-based economic policy think tank, has recommended that "*more employers should be encouraged to offer personal finance courses in the workplace by offering incentives such as a tax deduction for the cost of such education.*" [4] Legislation to provide a tax credit for investment advice has been introduced in the U.S. Congress and was adopted by one of its tax committees.

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[3] The Principal Financial Well-Being Index is a national survey of 1,500 American workers at businesses with between 10 and 1,000 employees. The survey is conducted quarterly.

[4] "Should We Worry About Trends in the U.S. Saving Rate?" Pinar Çebi, ACCF Center for Policy Research, September 2001, p.7.

The current situation among American workers might serve as a model as to what not to do! Policymakers must take a very careful look at the level of investment education and advice available to private pension participants. Improved, simpler consumer information is essential as pension schemes move from PAYG governmental plans to private, third pillar plans. The U.S. Congress, our Labor Department, public policy organizations, and asset management companies such as Principal have spent many months debating the need to amend ERISA to permit pension plan sponsors and retirement services companies to offer professional investment advice to consumers.

Contrary to claims by some, there is a clear need for investment advice and counseling in the United States and in other countries that allow private pension arrangements. Principal's professional enrollment associates encounter the investment advice dilemma in virtually all employee enrollment meetings. The most frequent questions they receive are "Can you tell me where to invest my money?" and "Where would you invest your money if you were me?" Questions surrounding investment advice are frustrating, as these professionals are unable to address these questions directly. Current federal law prohibits them from fully answering these questions and providing the guidance sought by consumers.

In those cases where workers are able to make their own investment choices the inherent problem with not receiving sufficient direction is that the employee may avoid taking any action. Or, equally as bad, the employee may simply save and invest in a manner wholly inconsistent with their time horizon and/or risk tolerance. Investment advice is *the* missing piece to a successful retirement plan and the prospect for a secure financial future. But – and this is especially important to provide adequate consumer protections – only qualified and appropriately regulated entities and individuals should be permitted to provide investment and retirement planning guidance to pension plan participants to avoid unscrupulous or incompetent advisers. Further, financial advisers must provide a high level of disclosure to persons they serve. Disclosure must be timely, clear and conspicuous, including disclosure of fees, potential conflicts of interest, and the scope of any investment advice provided.

Targeted consumer education campaigns are essential. These campaigns should be conducted by both the public and private sectors. Such campaigns should focus on both employers to encourage them to offer private plans and to potential or current pension plan participants. They should help consumers identify retirement challenges – to assess current retirement savings, the anticipated age of retirement, and expected retirement income from all sources, including government plans. One size does not fit all! Everyone's retirement picture and needs are different so workers should be helped to define individual retirement goals. Pension plan providers and administrators can work with employers and, where appropriate, with trade unions to develop and analyze employee retirement surveys and research industry results.

For the past several years the *Organisation for Economic Co-operation and Development (OECD)* has devoted substantial time and resources to ageing and retirement policy issues directly impacting consumer protections. Foremost among such initiatives has been the work done on pension fund governance. The OECD's regulatory policies for private pension schemes state that private pension plan security can be best served by funding. "*These regulatory policies have as their main aim the protection of beneficiaries' rights and ensuring the financial security of the schemes.*" [5]

The OECD has fashioned a set of *Basic Principles on Regulation of Private Occupational Pension Schemes.* These principles encourage the promotion of appropriate disclosure and education regarding costs and benefit characteristics of pension plans, particularly where individual choice is offered. In its *Revised Guidelines for Pension Fund Governance* [6] the OECD addresses such consumer protection issues as disclosure and redress. It confirms that pension funds should *"disclose relevant information to all parties involved (notably pension plan members, market participants, supervisory authorities, etc.) in a*

[5] "Pension Fund Governance." Organisation for Economic Co-operation and Development, Directorate for Financial, Fiscal and Enterprise Affairs, Insurance Committee, Working Party on Private Pensions (DAFFE/AS/PEN/WD(2000)14), November 16, 2000, p. 3.
[6] OECD. (DAFFE/AS/PEN/WD (2001)2/REV2). November 30, 2001.

*clear and timely fashion."* [7] This would include contribution schedules for plan participants and sponsors, fees, investment guarantees and benefit promises, and, primarily for defined contribution plans, clear and simplified description of the pension plan's investment policy.

The OECD's important initiatives in the area of pension fund governance led to the *Principles for the Regulation of Private Occupational Pensions,* which have been universally endorsed. For the first time global best practices for private pensions have been drafted and approved. The *International Network of Pension Regulators and Supervisors (INPRS),* established under OECD auspices in 2001 has affirmed it.

Of particular interest for purposes of this paper is Principle No. 3 – *Rights of the Beneficiaries.* This important principle makes clear that private pension schemes should be available on a non-discriminatory basis. To protect the pension consumer it continues: *"Regulation should aim at avoiding exclusions based on age, salary, gender, period of service, terms of employment, part-time employment, and civil status."* [8] the principle also encourages pension rights of portability, protection of vested rights and proper entitlement processes, and mechanisms for pension plan members who may retire early.

Other speakers have addressed other OECD actions and similar ones by various individual nations. It is worth noting, however, one of the basic tenets of pension plan governance as envisaged by the OECD Secretariat:

> "In order to protect the interest of plan members and beneficiaries, governance regulations should cover the functions and the decision-making process of pension funds and should offer pension plan members and beneficiaries channels to monitor those responsible for the management of pension funds." [9]

Consumer protections can also be provided by the use of the *prudent person rule.* This principle is a basic tenet of ERISA in the United States and is also observed in the United Kingdom. The OECD broadly describes the prudent person rule as follows:

> "A fiduciary must discharge his or her duties with the care, skill, prudence and diligence that a prudent person acting in a like capacity would use in the conduct of an enterprise of like character and aims." [10]

This rule or principle can be applied to investment management as well as to a fiduciary's and/or trustee's duties and obligations in administering a plan, trust or fund.

Further protections can be afforded to private pension plan consumers – particularly those in plans that permit self-directed accounts – by employing some meaningful rating system. In the United States, the United Kingdom and a few other countries rating systems – such as Morningstar, Lipper Investment Services, the Russell 500 index and similar programs – enable the pension consumer to make easy and understandable comparisons of companies, products and services to help them make better informed pension decisions. *"A ratings system allows the consumer to make a simple assessment of performance and functioning of the* [pension] *products both in the short and long term."* [11]

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[7] *Op. Cit., p*. 17.

[8] "The International Network of Pension Regulators and Supervisors (INPRS) Endorses Principles for Private Occupational Pensions." Press Release. Paris, April 26, 2001, p. 2.

[9] OECD, (DAFFE/AS/PEN/WD(2000)4REV2), December 6, 2001. p. 3.

[10] OECD, "Prudent Person Approach." (DAFFE/AS/PEN/WD(2001)15), November 27, 2001, p. 3.

[11] David O. Harris. "At the Intersection. Public Confidence in the Life Insurance and Superannuation (Pensions) Industry." AMP Churchill Fellowship. Sydney, 1996, p. 102.

A ratings system must not become overly relied upon but it can provide timely and useful information and guidance to the consumer. At the end of the day many ratings are very subjective. We should recall that Enron had a triple A rating just before it headed into bankruptcy!

Time does not permit an exhaustive discussion of consumer protection in private pension plans – either occupational schemes or individual (defined contribution) plans. However, public policymakers and the private sector, in ensuring appropriate and timely disclosure of information to pension plan participants and in developing useful education for workers, may be guided by the *International Labor Organization (ILO)* admonition of *"extending the coverage of pension schemes, improving their governance, and ensuring that the design of the schemes is both economically efficient and compatible with internationally accepted human and social values."* [12]

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[12] *"Call for Global Pension Reform,"* BBC News, April 28, 2000.