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An Examination of the Current State of Retirement Savings with a Focus on Individual Exemptions

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and Stephen P. Paris*****

Abstract: With the heightened concern surrounding the financial position of the Pension Benefit Guaranty Corporation and possible changes to the Social Security retirement system, the protection of employer-sponsored retirement benefits is of critical importance. This study reviews the adequacies of the various retirement savings components and provides an analysis of an often overlooked area of pension management, individual exemptions. Exemptions occur when pension plans or companies that manage pension plan assets are granted special permission to engage in transactions that generally are prohibited by the Employee Retirement Income Security Act (ERISA). This study examines trends in the types of individual exemptions granted between 1997 and 2004. There are several clear trends observed in individual exemptions during the sample period. For example, while the total number of exemptions granted has decreased in recent years, there has been an increase in exemptions related to the acquisition of assets and demutualizations. In addition, most individual exemptions are not granted to specific plans, but rather to parties in interest that manage plans, such as financial institutions. For this reason, the number of plan participants affected by these exemptions may be much larger than it initially appears based on the number of exemptions. A clearer understanding of the nature of individual exemptions and the potential impact of these transactions is important not only to plan participants, but also to those tasked with regulating private pension plans. [Key words: pension plans, exemptions, regulation.]

INTRODUCTION

The Employee Retirement Income Security Act of 1974 (ERISA) substantially changed the way in which private pension plans were regulated. The purpose of ERISA is to protect the retirement income of plan partici-

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pants. Over time, exemptions to the requirements have been granted to a variety of classes of plans as well as individual plans. These exemptions allow parties in interest to conduct transactions normally prohibited by ERISA. For example, in 2003, Northwest Airlines received permission to make up contributions for three underfunded defined benefit plans with the stock of a regional affiliate airline instead of cash (Geisel, 2003a). Given that the intent of ERISA is to protect the retirement benefits of workers, the granting of exemptions to these regulations poses important public policy questions. As such, the nature of these transactions and the potential financial impact on plan participants should be of interest to both workers and regulators. This study examines the types of individual exemptions granted between 1997 and 2004, providing a discussion of both the nature of the exemptions and the potential impact of the exemptions on plan participants.

While the protection of benefits derived from retirement plans has always been important, it is even more critical in the current environment as other key facets of retirement planning are facing financial difficulty or uncertainty. With questions concerning the solvency of the Pension Benefit Guaranty Corporation (PBGC), it is important that care be taken to reduce the frequency and severity of pension plan takeovers by the PBGC. Further, with potential changes to the Social Security system and the continued low personal saving rates, the protection of the assets of employer-sponsored retirement plans is paramount.

The remainder of the study is organized as follows. The first section provides background on the current retirement savings environment and the retirement security of workers, and discusses issues surrounding the solvency of the PBGC and Social Security. Additionally, this section reviews existing literature on ERISA regulations and exemptions. The next section summarizes the exemption process and the general categories of exemptions, discusses the types most commonly granted, and reviews trends observed in exemptions during the sample period. Finally, the conclusion summarizes the major findings of the study and the potential effect of these exemptions on firms and workers.

BACKGROUND

To better understand the role of and potential impact of individual exemptions to ERISA requirements, individual exemptions must be put into a broader context. This section provides general background information on a variety of topics. First, the major components of retirement planning are discussed, focusing primarily on private pension plans. Next,

given the importance of preserving the security of retirement plans, academic and industry research relating to ERISA is reviewed. Finally, a review of existing research in the area of prohibited transactions is provided.

Savings and Retirement Security

Traditionally, retirement income is expected to come from three sources: (1) private pensions; (2) Social Security; and (3) personal savings. For this reason, the current state of the retirement portion of Social Security and individual savings are reviewed briefly. Next, some basic background information is provided on private pensions along with a discussion of the current financial status of the PBGC. Where appropriate, proposed and pending legislation designed to improve the adequacy of each of the components of retirement savings is discussed.

Social Security and Individual Savings

Social Security: A great deal of media attention, as well as academic research, focuses on the adequacy problems of the current Social Security retirement system.[1] Many note that without changes, the system will soon begin paying out more in benefits than it collects in taxes (Devroye, 2003). Specifically, if there are no changes to the current system, by 2018 the system will begin operating at a deficit, and by 2042 the trust will be exhausted. The slow deterioration of the Social Security surplus is due primarily to an increase in the numbr of individuals receiving benefits and changes in the ratio of workers to retirees. For example, in 1975, slightly more than 16 million retirees were receiving benefits. By 2004, this number had nearly doubled, reaching close to 30 million (Social Security Administration, 2005). In addition, in 1950, there were 16 workers to every retiree receiving benefits. Fifty years later, this ratio had dropped to three workers per retiree and is expected to continue to fall (Moynihan and Parsons, 2001).

The potential long-term effects of the changes in the number of Social Security beneficiaries and the shift in the worker-to-retiree ratio have resulted in an array of academic research. Some research has used surveys to determine how people feel about the current system. For example, a 2002 survey study of financial planners finds that 56 percent believe that the system has problems and an additional 34 percent feel that the system is in crisis (Dumm, Colquitt, and Hoyt, 2002). Other studies have explored plausible reform measures including increasing taxes, reducing benefits, and privatization (e.g., Chen, 2002; Devroye, 2003; Nataraj and Shoven, 2003; Longman, 2004). These reform measures focus on actions designed to increase the flow of funds into the system as well as measures to slow

or reduce the flow of funds out of the system. For example, increasing the tax rate paid by employers and employees as well as increasing wages subject to taxation or eliminating the wage cap completely are options that would increase the revenue of the trust.

Proposals for slowing or reducing the outflow of funds focus on two primary areas: increasing the retirement age and reducing benefits. Specifically, further increasing the retirement age for full benefits and accelerating the increase in the retirement age to 67 would result in increasing the working lifetime of individuals. Allowing workers to voluntarily divert a percentage of their Social Security taxes into personal accounts also has been proposed.[2]

A final option that has been proposed is to reduce benefits for all retirees by some amount or reduce the benefits of retirees whose income exceeds a certain level. To a limited extent, the latter is already part of the current system since an individual and his/her beneficiaries are eligible to receive Social Security benefits as long as the individual was attached to the workforce and paid into the system during his/her working years. However, benefits can be taxable at either 50 percent or 85 percent, depending on the individual's level of "combined income" (or the "combined income" of married persons if filing jointly).[3] Money collected in the form of federal income taxes then flows back into the Social Security trust fund to pay the benefits of other eligible workers or their beneficiaries. Thus there is a *de facto* means (or needs) test in that retirees whose earnings are above specified levels must "give back" some of their benefits in the form of taxation.

Individual Savings: Studies suggest that average American households nearing retirement are not adequately prepared. In a survey of employees at a major university, Power and Hira (2004) found that respondents commonly indicated that people should think about retirement planning earlier. The results of a study by Mitchell and Moore (1998) suggest that typical households near retirement would have to set aside an additional 20 percent of income up to age 62 to reach wealth accumulation targets for retirement. While insufficient personal savings may result from delaying the savings process, it also may be due to poor market performance, coupled with the low interest rates of recent years. These factors also have affected the retirement savings of individuals, as well as the value of both defined benefit plan assets and defined contribution account balances.

Private Pension Security

The Nature of Pension Plans: The two ways in which employers can assist workers in saving for retirement are through the use of defined benefit and defined contribution plans. Over time, there have been

substantial changes in the use of these plans. For example, though the total number of employer-sponsored plans in existence has increased by less than five percent, the percentage of defined contribution plans has grown from approximately 56 percent in 1993 to more than 64 percent in 1999 (U.S. Department of Labor, 1993, 2004). This shift in the use of defined contribution plans, which began in the 1970s, has sparked a variety of academic research. For example, Kruse (1995) finds that the shift from defined benefits to defined contribution plans is caused not only by the creation of new defined contribution plans, but also by the lower participation rates of existing defined benefit plans. One of the reasons often cited for this trend is the administrative cost differential between the two types of plans, which is partially caused by differences in legislative requirements (Ledolter and Power, 1984; Clark and McDermed, 1990). In addition, the issue of past service credit has likely affected the use of defined benefit plans. Specifically, plans cannot be amended such that the benefits of current participants for past service credit are reduced (Hamilton, 2004). Also, any plan amendment or the establishment of a new plan that gives credit for past service would immediately create a large liability for the employer (Bader, 2004). The observable shift in the market share held by defined contribution plans is likely to continue to grow, especially in light of the IRS final regulations on new comparability plans and proposals that would further increase the cost of maintaining defined benefit plans.[4]

The shift in the number of participants covered by defined contribution plans in comparison to defined benefit plans is important for several reasons. From the sponsoring employers' perspectives, there are several advantages to establishing and maintaining a defined contribution plan, other than costs. Specifically, with defined contribution plans, the market investment risk is shifted to the participants and plans can be designed so that employers have flexibility in making contributions to the plans. For example, a recent survey by Mercer indicates that 13 percent of defined contribution plans have decreased matching programs while ten percent have eliminated or suspended matching altogether (Mercer Human Resource Consulting, 2003).[5] This is one way in which an employer can maintain its retirement plan, but substantially reduce costs, especially during times in which the employer is experiencing financial difficulty.

Some of the advantages employers gain by maintaining defined contribution plans are disadvantages for the employees. Specifically, since the benefits are not predefined and the employees bear the investment risk, there is less financial certainty with defined contribution plans. In addition, the benefits are not insured as they are with defined benefit plans. However, defined contribution plans do have some advantages for employees. For example, defined contribution plans generally allow the employees to

have some control over the way in which the funds are invested, and the plans can be portable.

While employees are somewhat insulated from investment risk in a defined benefit plan, they can be adversely affected by the unfavorable investment performance of the plan. For example, a survey by Aon Consulting reports that more than 20 percent of employers have frozen their defined benefit plans (Anand, 2004). In addition, as discussed in more detail in the following section, several large employers have recently terminated their defined benefit plans. These types of events can alter the retirement benefits of employees. In some cases, the termination may have been, at least in part, driven by poor investment performance leading to volatility in employer contributions. This provides an example of how employees can be negatively impacted by unfavorable investment performance, even within a defined benefit plan.

Some of the problems experienced by sponsors of defined benefit plans today may be the result of high investment returns realized in the 1990s. Specifically, many defined benefit plans that were funded at or above 100 percent on a current liability basis at the turn of the century are severely underfunded today. This may be partially attributable to the fact that the normal cost of the plan was often covered by the return on plan assets during the 1990s, and thus the plan sponsor was not required to make a contribution. As a result of this as well as certain tax and administrative reasons, many firms chose not to make contributions during this period.[6]

Over the last ten years, the volatility in the equities market also has sparked much debate concerning whether defined benefit plans should hold equities at all. The "plan-centric" approach to funding liabilities allows for the inclusion of equities in plan assets whereas the "business-centric" approach uses only fixed income investments to fund liabilities. Those in favor of the "plan-centric" approach argue that the rules of corporate finance cannot currently be applied to a pension fund because of all the regulatory and statutory restrictions placed on pension plans (Owadally and Haberman, 2004). The proponents of a "business-centric" approach argue that plans should not be able to invest in equities since by doing so a fundamental principle of corporate finance is being violated—namely, that accounting and funding rules for defined benefit plans allow equity risk premium to be recognized before the risk is borne (Gold, 2005). The academic debate over this issue has spilled over into practice. However, the vast majority of plans still hold equities.

Solvency of the PBGC: After several consecutive years of operating at a surplus, the financial position of the PBGC has begun to deteriorate. The PBGC went from an accounting surplus of $9.7 billion at the end of 2000 to an accounting deficit of $23.3 billion at the end of 2004. This represents a

decrease of $33 billion over the five-year period, including a decrease of $12.1 billion in the year 2004 alone. In November of 2004, the PBGC announced that its deficit was at a 30-year high (Geisel, 2004b). This loss is partially attributable to changes in interest rates, which have affected actuarial charges. In addition, the takeover of several large single-employer plans, primarily of airline and steel companies, has significantly increased the single-employer program liabilities. For example, the takeover of Bethlehem Steel in 2003 resulted in an increase in PBGC program participants of approximately 95,000 as well as unfunded benefits of $3.6 billion. Several other large plans were taken over in 2004, including those sponsored by USAirway and Enron (Geisel, 2004a; Wojcik, 2004). In addition, in early 2005, the PBGC took over four pension plans sponsored by United Airlines that covered more than 121,000 participants and were underfunded by $9.8 billion (Hofman, 2005). More recently, the bankruptcy filings of both Delta Airlines and Northwest Airlines may result in the taking over by the PBGC of the defined benefit plans of these large employers. It is estimated that this would result in additional unfunded liabilities of more than $11 billion (John, 2005). The PBGC's poor return on investments also has contributed to its growing deficit. In response, the PBGC announced that it would gradually reduce its equity holdings to between 15 and 25 percent (Walsh, 2004).[7]

The government is currently seeking pension reform aimed at improving the overall financial[8] position of the PBGC. Specifically, the Bush Administration has proposed several pension reform changes to the federal budget for 2006. These include allowing the PBGC to increase the annual flat rate premium plan sponsors currently pay from $19 per participant to $30 per participant and allowing the PBGC Board the flexibility of raising variable rate premiums for underfunded plans as it deems necessary. Changes also are proposed for interest rate assumptions used by plan sponsors to calculate plan liabilities. Further, in order to help employers create plan surpluses, the Bush Administration proposes allowing employers to fund up to 130 percent of plan liability. Additionally, funding credits for making extra pension plan contributions will be eliminated, making the financial health of pension plans more transparent. Other proposed changes will have a significant impact on plans that are currently underfunded. For example, financially weak companies with over 500 participants whose pension plans are underfunded could face a $700 per participant funding shortfall fee. This funding shortfall would be amortized over seven years. Also, financially distressed companies with underfunded plans would be barred from improving benefits or offering benefits as a lump sum.

The increased uncertainty and/or potential reduction in Social Security retirement benefits, combined with insufficient personal savings, has heightened the importance of private pension plans in retirement planning. However, as is discussed in this study, this component of retirement income also is currently experiencing problems that could adversely affect the adequacy of the benefits for retirees. For this reason, exemptions from the rules designed to protect plan participants are of the utmost importance.

Employee Retirement Income Security Act

The Employee Retirement Income Security Act is a federal law that provides the minimum required standards for the management of private pension plans. Since the law's inception, there has been a wide variety of research related to ERISA. Some studies focus on the compliance of firms with ERISA guidelines as well as methods to increase compliance (e.g., Langbert, 1994, 1996). These studies find that: (1) almost half of large plans had some form of non-compliance; and (2) government audits, the human capital of benefits directors, and management ability all affect compliance levels (Langbert, 1994, 1996). Other research considers the impact of ERISA on various aspects of pension management. For example, a 1980 survey study by Cummins, Percival, Westerfield, and Ramage finds that following ERISA, an increased number of plans adopted a written statement of investment policy, purchased fiduciary insurance, and placed more emphasis on performance measurement. Additional studies suggest that after the passage of ERISA, plan administration costs increased and plans underperformed similar portfolios held by comparable funds not subject to ERISA (Cummins et al., 1980; Johnson and VanDerhei, 1989). The impact of ERISA on termination rates and takeovers of defined benefit plans surrounding the enactment of ERISA also has been examined. The results of these studies suggest there was a short-term impact on private plan growth (Ledolter and Power, 1984).

To add to the stresses in the area of retirement savings, many experts have questioned the long-term implications of recent proposed and passed regulation designed to alleviate some of the problems of plan sponsors. Among the debated solutions are the proposal to waive the requirement of underfunded defined benefit plans to increase contributions to accelerate the make-up of shortfalls and the requirement of employers to disclose investment strategies (Geisel, 2003b; Associated Press, 2004). The current pressure on regulators to improve the retirement security of workers emphasizes the importance of continued research in the area of pension governance. An analysis of the exemptions granted to the current ERISA regulations provides insight into the needs of plan sponsors and pension

managers as well as an understanding of the potential impact of altering the current ERISA standards.

Review of Existing Exemptions Literature

There is very little academic or practitioner literature on the subject of exemptions. While the Department of Labor makes the list of all requested and granted exemptions publicly available, the summaries often lack specific or identifying information on the plan and/or company requesting the exemption. Further, many of the plan sponsors are privately held firms. As discussed in more detail later, this makes empirical research in the area difficult, as matching of the exemption information to specific company information may not be possible.[9]

However, over the past few years, there have been several articles that provide a discussion of the exemption process as well as a review of proposed changes to the system and the potential effect of these changes for plans and companies. For example, a two-part study published in 2003 discusses the basics of prohibited transactions and reviews the various types of exemptions that can be granted that allow these transactions to take place (Pratt, 2003a; Pratt, 2003b). In addition, a study published in 2001 reviews the restrictions on transactions between a plan and a party-in-interest with respect to the plan, focusing primarily on the class underwriting exemption (Myers and Richman, 2001). Myers and Richman (2001) also review the limitations of the current exemptions based on changes that have occurred in the management of pension assets and review several individual exemptions that were granted to ensure that investment decisions that are in the best interest of plans and plan participants are allowed.

A recently proposed change that has led to some discussion relates to pension fund managers. In 1984, an exemption was approved for qualified professional asset managers (QPAMs), such as banks, insurance companies, and investment companies. The exemption allowed these individuals to be exempt to the party-in-interest prohibited transaction rule with certain caveats. The proposed amendment to this exemption sparked a two-part series that reviews the amendment, focusing on how the amendment would alter the existing relationship rules governing the party-in-interest and the QPAM. Specifically, the amendment would alter the "power of appointment" restriction as well as replace the current ownership test with a newer, more narrowly structured test (Barr, 2004a; Barr 2004b).

The use of captives to insure employee benefits is another area of exemption-related research (e.g., Lai and McNamara, 2004). Currently, as long as certain conditions are met, the premiums paid to the captive insurer are a deductible expense for the parent company. However, since a captive

is generally owned by the parent company, it is considered a party-in-interest with respect to the plan. As such, the use of captives to fund employee benefits is generally prohibited, unless a minimum of 50 percent of the captive's business is unrelated to the parent company. However, this may be changing because of a 2000 exemption granted to Columbia Energy Group in which Columbia received approval to use a captive to insure its long-term disability income risk. It was thought that this approval would create a flurry of proposed exemptions from other companies citing this exemption as precedent. While not the case immediately following the approval of this exemption, in the past few years, companies such as Archer-Daniels Midland Company, International Paper Company, Whirlpool Corporation, Alcoa Incorporated, and, most recently, Sun Microsystems Incorporated have requested and/or been granted a similar exemption, primarily related to employer-sponsored life insurance (Geisel, 2004c; Geisel, 2005a).

The current study expands upon prior research in this area by focusing primarily on individual exemptions. As discussed in the following section, while statutory and class exemptions allow all plans that meet the specific requirements to engage in a transaction that is normally prohibited, individual exemptions are granted on the basis of a review of a specific request from a pension plan management firm or an individual pension plan. The decision to grant an individual exemption to a firm or plan permits it to engage in a transaction that is rarely allowed. For example, the type of exemption granted in 2003 to Northwest Airlines, involving three separate plans with more than 70,000 participants, occurs infrequently (Anonymous, 2003). However, the potential exists for the granting of an individual exemption to a particular firm or plan to set a precedent. As such, these individual exemptions decisions can have important public policy implications. By examining trends in the granting of individual exemptions, this study provides additional information on an area of pension management that has been given little attention to date, but that could have wide-scale and long-term implications on the viability of pension plans and the retirement security of plan participants.

Prohibited Transactions

This section reviews the various types of exemptions as well as the process by which an exemption is granted. Next, information is provided on trends observed in individual exemptions granted during the sample period. Within this section, specific examples are provided to demonstrate how companies use exemptions as well as the potential implications of the exemptions for plan participants.

Types of Exemptions and Granting Requirements

ERISA prohibits certain types of transactions by plan sponsors as well as firms that manage plan assets. The purpose of prohibiting certain types of transactions is to protect the assets of pension plans from mismanagement or misuse, thereby providing workers with greater retirement security. However, under certain circumstances, plan sponsors and other firms are allowed to engage in transactions that are typically forbidden by ERISA. The U.S. Department of Labor (DOL), through the Office of Exemption Determinations, is primarily responsible for granting parties-in-interest the right to engage in these types of transactions, called exemptions. The current procedure parties must follow to request exemptions was adopted by the Department on August 10, 1990 (U.S. Department of Labor, 2004).

There are several categories of exemptions: statutory exemptions, class exemptions, and individual exemptions. The statutory exemptions are exemptions allowed by law. These include transactions such as loans to plan participants, loans to employee stock ownership plans, and deposits in certain financial institutions. Class exemptions are exemptions that permit the parties in interest of all pension plans to complete certain transactions without filing for individual exemptions. Allowing sponsoring employers to make interest-free loans to plans as well as sell customer notes to plans are examples of class exemptions that have been granted in the past. Plan sponsors are able to obtain statutory and class exemptions as long as the specific requirements are met. This is not the case for individual exemptions, which are the focus of this study.

An individual exemption is a request by a particular plan sponsor or other party-in-interest to engage in a transaction prohibited by ERISA. According to the guidelines set forth by the Department of Labor, the party-in-interest must provide:

- Description of the transaction
- Description of relevant safeguards and conditions
- Percentage of assets involved in the exemption transaction
- Names of persons with investment discretion
- Extent of plan assets already invested in loans to, property leased by, and securities issued by parties in interest involved in the transaction
- Copies of all contracts, agreements, instruments, and relevant portions of plan documents and trust agreements bearing on the exemption

- Information regarding plan participation in pooled funds when the exemption transaction involves such funds
- Declaration, under penalty of perjury by the applicant, attesting to the truth of representations made in such exemption submissions
- Statement of consent by third-party experts acknowledging that their statements are being submitted to the department as part of an exemption application (U.S. Department of Labor, 2004).

Each application is then reviewed by the Office of Exemption Determinations. The purpose of this process is to ensure that the exemption is feasible and does not violate the interests of the plan itself or the plan participants and beneficiaries. The DOL currently uses over 100 classes to categorize exemptions. Commonly, a single exemption is listed in multiple classes. Some of the DOL classes are very general, while others are very specific in nature. Specific examples of transactions that fall into the major categories are provided in the following section that discusses exemptions granted during the sample period.

Based on the data available on individual exemptions, plans, and plan sponsors, there are limitations to empirical analysis. From an academic standpoint, it would be beneficial to be able to match the exemption information obtained from the Department of Labor to specific information about the plan and the company. This would make it possible to examine the characteristics of the specific plans engaging in these transactions to determine if there are any observable trends. In addition, it would make it possible to identify common firm-level characteristics associated with companies sponsoring the plans. Finally, it would allow for an empirical analysis to determine what financial effect, if any, granting the exemption had on the firm, and would allow the plan and firm to be tracked following the exemption to determine if any changes were made to the plan (such as changes to the benefits provided or termination of the plan) or to the firm (such as bankruptcy filings or merger/acquisition activity). This type of information would provide a truer analysis of the effect of exemptions.

However, this type of analysis is not possible for two reasons. First, the description of the individual exemptions provided in the *Federal Register* does not provide complete identifying information on the plan or the firm, such as the plan number or the employer identification number. Without this information, it is impossible to accurately match the plan described in the exemption to a particular plan of a particular company. Second, even if the sponsoring company is able to be identified, the financial data needed to accurately determine the potential financial effects of the exemption on the plan participants would be readily available only for publicly-traded firms. As such, a large portion of the sample would be eliminated. Despite

these data limitations, there are still important contributions that can be made with the available data. The study will focus on a broader discussion of the possible effects of exemptions on plan participants based on the nature of the transactions and some notable events documented in the popular press. This will provide the basis for further research if more complete data related to the individual exemptions can be obtained.

Trends in Exemptions

Information concerning exemptions and plan characteristics is obtained from several sources. Individual exemptions granted during the period 1997 through 2004 are first identified by reviewing information posted on the U.S. Department of Labor's Employee Benefits Security Administration website. This website lists all individual exemptions granted by the Office of Exemption Determinations. Detailed information on the specifics of the individual exemptions is obtained from the *Federal Register*, which is a publication of the National Archives and Records Administration.

There are two major types of individual exemptions granted: (1) exemptions granted to financial institutions or insurance companies for the provision of services necessary for the operation of non-specified pension plans; and (2) exemptions granted to specific plans allowing transactions generally prohibited by ERISA. The first type of exemption is granted to a company, rather than a specific plan. These non-plan-specific exemptions generally involve financial institutions or insurance companies that manage the assets of multiple pension plans. The second major category consists of exemptions allowing transactions between a plan and a party-in-interest with respect to the plan and is granted to a specific plan. As discussed earlier, a party-in-interest with respect to the plan may be a plan participant or the plan sponsor, the plan trustee, or other disqualified person with respect to the plan.[10] Transactions that are permitted by the exemptions include the sale, loan, or leasing of assets to a party-in-interest, as well as the extension of credit to a party-in-interest with respect to the plan. Combinations of the above may be granted by a single exemption. For example, a single exemption may permit the purchase of property by the plan from a party-in-interest and the subsequent leaseback of the property to that same party. The number of exemptions granted and the unique number of classes used in the categorization of the exemptions for the years 1997 through 2004 are provided in Table 1. Between 1997 and 2004 there has been a decrease of nearly 70 percent in the number of exemptions granted.[11] It should be noted that while the number of exemptions has decreased this is not to say that the number of participants affected or the total amount of plan assets has decreased as well. Owing to the data

Table 1. Total Individual Exemptions Granted from 1997 through 2004

Year	Number of exemptions	Number of distinct DOL classes used to classify exemptions
1997	95	192
1998	69	161
1999	74	173
2000	80	176
2001	58	128
2002	62	148
2003	53	45
2004	24	29

limitation described earlier, details on plan participant and plan asset trends are not available. However, even without this information, details related to the trends in the types of exemptions have important implications, as trends in the data can suggest areas that need to be more closely monitored or identify exemption policies that the DOL may consider revising.

While the classification structure of the DOL provides detailed information on the specific types of exemptions granted during the sample period, this study condenses the 100-plus classes into six unique classes to provide a more efficient discussion of the nature of the transactions. This is possible because of the number of similar classes in the DOL structure. For example, there are several classes that involve the sale of assets by the plan, including the "Sale by Plan of Employer Securities," "Sale by Plan of Partnership Interests," and "Sale by Plan of Personal Property." In addition, there are multiple classes that involve purchases by the plan, such as the "Purchase by Plan of Other Assets" and "Purchase by Plan of Real Property."

The purpose of the consolidated structure is to provide an easier framework to observe the trends and gain an initial understanding of the scope of these transactions. The six classes used in the remainder of the study are: (1) non-plan-specific exemptions granted to a company; (2) the sale of assets to a party-in-interest with respect to the plan; (3) the loan or leases to a party-in-interest with respect to the plan; (4) the acquisition of assets from a party-in-interest with respect to the plan; (5) demutualization; and (6) miscellaneous transactions. Figure 1 provides an aggregated summary of the exemptions granted during the sample period for each class.

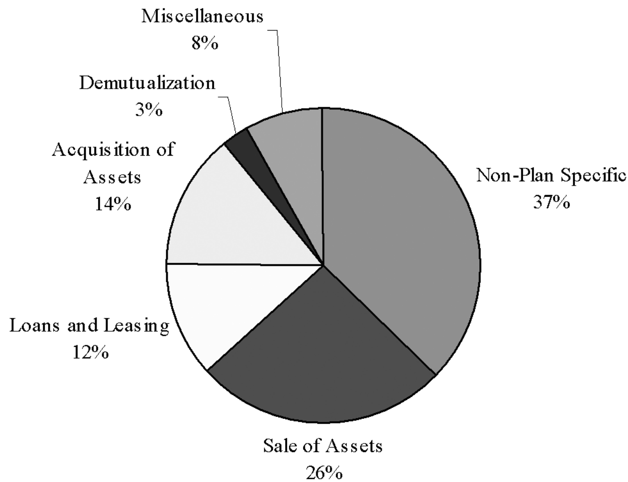

Fig. 1. Types of individual exemptions granted from 1997 to 2004.

The non-plan-specific exemptions category, or exemptions granted to a financial institution or insurance company for the provision of services necessary for the operation of general, non-specified plans, is the largest category of exemptions. As noted above, non-plan-specific exemptions are exemptions granted to a company that manages the assets of pension plans. These exemptions have important implications. First, because of the nature of the exemptions, it is possible that multiple plans or multiple plan sponsors may be affected. These exemptions normally relate to the fiduciary responsibility of those managing the plan or controlling plan assets, so the income and security of plan assets can be directly affected if the party-in-interest exploits the relationship.

Among the range of non-plan-specific exemptions, a few specific examples may shed some light on the type of transactions in this class. In 2002, Fidelity Management Trust Company and its affiliates were granted an exemption that permitted the extension of certain lines of credit to employee benefit plans of which Fidelity acts as directed trustee, investment manager, or other administrative service provider. The exemption specifically stated that the loans be "made on terms at least as favorable to the Plan as those the Plan could obtain in an arm's-length transaction with an unrelated party" to ensure that Fidelity not profit from this transaction at the expense of the plan and its participants and beneficiaries (National Archives and Records Administration, 2002e). This exemption provides an example of a situation in which a fiduciary is allowed to act in potentially

conflicting roles with respect to the management of plan assets and interaction with plan participants.

Another 2002 non-plan-specific exemption was granted to J. P. Morgan Chase & Company and its affiliates to amend prior exemptions granted in 1990. The prior exemptions allowed J. P. Morgan Chase & Company to hold certificates or debt instruments issued by asset pool investment trusts with which J. P. Morgan Chase & Company or one of its affiliates is the lead underwriter or a co-managing underwriter. Again, this highlights a situation in which a fiduciary is allowed to act in potentially conflicting roles. In this case, there is the potential for J.P. Morgan Chase & Company to profit from transactions that may adversely affect the plan assets and plan participants. The 2002 exemption amended the prior exemptions by further allowing the trustee of such asset pool investment trusts to be an affiliate of the company. Included in the conditions placed on these transactions were that: (1) "a plan's investment in each class of Securities does not exceed 25 percent of all of the Securities of that class outstanding at the time of the acquisition"; and (2) "immediately after the acquisition of the Securities, no more than 25 percent of the assets of a plan with respect to which the person has discretionary authority or renders investment advice are invested in Securities representing an interest in an Issuer containing assets sold or serviced by the same entity" (National Archives and Records Administration, 2002b). The restrictions placed on these two exemptions are designed to provide plans with some level of protection against adverse movement in the value of the security. However, due to the data limitations, it is not possible to know the full impact of these exemptions in terms of the number of and extent of the financial effect for the firms and workers participating in the plans managed by these companies.

The sale of assets ranks second in terms of overall frequency. Most commonly, the sale of assets class involves the sale of securities or property held by the plan to the sponsor or other party-in-interest with respect to the plan. With these transactions, the main criterion is that the sale of assets is at a fair market value and that the parties in interest do not profit at the expense of the plan or plan participants. Often, restrictions on commissions or terms of sale are used to further protect plan assets and plan participants as well as to prevent parties in interest from using these transactions to unfairly expropriate assets from the plan or for the plan to enter into unfavorable agreements. For example, an exemption granted to the defined contribution plan of Kimball International Inc. Retirement Plan, in 2002, permitted the sale by the plan of the stock of Springs Valley Bank and Trust Company to Springs Valley, the parent company of the plan trustee. Two of the required conditions included in the exemptions were: (1) "the fair market value of the Shares (be) determined by a qualified, independent

appraiser"; and (2) "the Plan does not pay any commissions, costs or other expenses in connection with the Sale" (National Archives and Records Administration, 2002a). Again, conditions of this type were likely included to ensure that the parent company of the trustee did not benefit from the transaction at the expense of the plan, its participants, and beneficiaries.

Exemptions involving the acquisition of assets by the plan from the sponsor or other party-in-interest with respect to the plan represent 14 percent of the exemptions granted during the sample period. The issues related to the sale of assets to a party-in-interest with respect to the plan are similar to those related to the acquisition of assets from a party-in-interest with respect to the plan. A representative example is the 2001 exemption granted to the defined benefit plan of Cranston Print Works Company General Employees' Retirement Plan, which permitted the plan to purchase shares of the common stock of the plan sponsor. In addition, the exemption allowed "the acquisition and holding by the plan of an irrevocable put option, which permits the plan to sell the stock to Cranston at a price which is the greater of: (i) the fair market value of the stock determined by an independent appraisal at the time of the exercise of the put option, or (ii) the price at which the stock originally was sold by Cranston to the plan" (National Archives and Records Administration, 2001a).

Transactions involving loans and leasing account for approximately 12 percent of the exemptions granted during the sample period. An example of the types of transactions allowed by an exemption in this category is the 2002 exemption granted to J. Penner Corporation Profit Sharing Plan. The exemption permitted: (1) the sale of certain real property by two of the participants in the plan to their respective participant directed individual investment accounts in the plan; and (2) the simultaneous lease of the property by the accounts to J. Penner Corporation. According to the exemption, as of December 31, 2001, the plan had 18 participants and the accounts of the two participants involved in this exemption accounted for approximately 75 percent of the total plan assets. Several conditions were placed on the exemption, including that the price paid does not exceed the fair market value and the rental amount is no less than the fair market rental value (National Archives and Records Administration, 2002d). As noted earlier, these conditions are used to protect the plan assets and ultimately the plan participants.

The smallest categories of exemptions occurred with respect to the frequency of the demutualization and miscellaneous classes, with these exemptions collectively accounting for only 11 percent of the total number of exemptions granted during the period. The nature of a demutualization exemption can be illustrated with a 2001 example involving Anthem

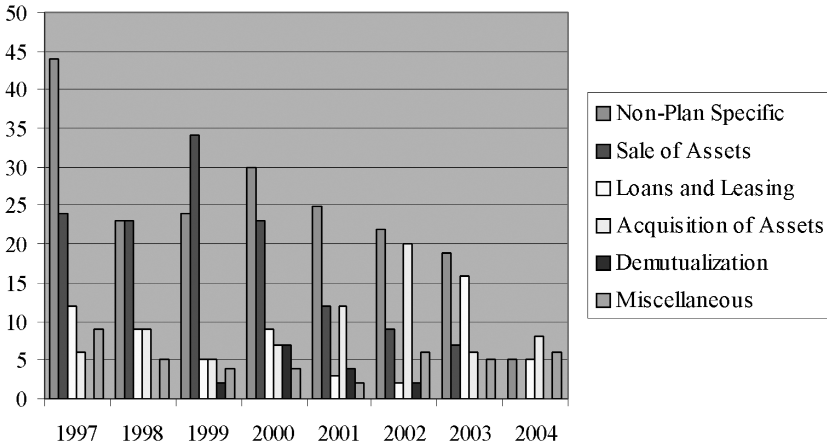

Fig. 2. Frequency of individual exemptions granted from 1997 through 2004.

Insurance Companies Inc., based in Indianapolis, Indiana. The exemption permitted the plan and eligible members to receive: (1) common stock issued by Anthem Inc., a newly formed holding company, by reason of the ownership of an insurance policy or contract issued by Anthem; or (2) cash in exchange for mutual membership interest in Anthem (National Archives and Records Administration, 2001b).

The miscellaneous transactions class consists of exemptions involving a range of transactions that are not widely or commonly granted. These include changes to correct prior mistaken contributions and transactions required because of pending litigation. A specific example of an exemption in the miscellaneous category is the 2002 exemption granted to the Adams Wood Products Inc. Profit Sharing Plan. The exemption allowed Adams Wood Products Inc. to make an interest-free loan to the plan to reimburse the plan for investment losses incurred by the plan involving unsecured promissory notes. In addition, the exemption permitted the potential repayment of the loan to the plan sponsor if the plan recovered any of the investments in the notes (National Archives and Records Administration, 2002c). Since these types of transactions are generally corrective in nature or required as a result of the outcome of a legal case, the potential for the plan or plan participants to be adversely affected is less of a concern with these types of exemptions.

The number of exemptions granted within each class per year is shown in Figure 2. There has been some movement in the percentages of exemptions within each class. The largest change has occurred in the non-plan-specific class. Though this category represents the largest proportion of

total exemptions granted, as shown in Figure 1, it actually experienced the greatest decrease during the sample period, dropping from 44 exemptions in 1997 to five exemptions in 2004. This decrease is closely followed by decreases in two other classes—the sale of assets and loans and leasing. Exemptions involving acquisition of assets are the only category to experience an increase.

CONCLUSION

Owing to the expected insufficient savings patterns of individuals and the uncertain future of the Social Security system, the adequacy and efficient management of employer-sponsored plans has become of increasing importance. This study explores a particular aspect of pension management that has been given little attention in both the trade press and academic literature. Specifically, it examines trends in individual exemptions occurring between 1997 and 2004 and considers some characteristics of plans granted these exemptions.

The study finds that the number of exemptions granted has declined significantly in recent years. When considering all types of individual exemptions, the largest category of exemptions granted during the sample period is non-plan-specific exemptions, which are exemptions that are tied not to a specific pension plan, but to companies managing pension plan assets, commonly banks and insurance companies. In addition, the category of exemptions involving the acquisition of assets by the plan was the only category of exemptions to increase during the sample period.

While these transactions can serve a useful purpose in the efficient management of pension plans, they also may have some adverse effects for workers. For example, if an exemption creates a situation in which parties in interest exploit their relationship with the plan, assets may be expropriated. In extreme cases, this could lead to reduced benefits to workers or potential takeover by the PBGC. The exemption granted to Northwest Airlines in 2003, which allowed the company to make up contributions to three separate underfunded defined benefit pension plans with the stock of an affiliate airline, may serve as a recent illustration. Just over two years after the exemption was granted, Northwest froze two of its defined benefit pension plans, and less than one month later the company filed for bankruptcy (Geisel 2005b; John, 2005). The filing occurred just one day before Northwest was required to make millions of dollars in contributions to its defined benefit plans. At the time of the filing, the plans were underfunded by approximately $5.6 billion (John, 2005). While it is unclear if the plans granted exemptions were among those frozen by the airline, the underfund-

ing of all of the defined benefit plans will adversely affect all employees covered by these plans. Specifically, to the extent that the exemption resulted in a larger deficit in specific plans and allowed the airline to mask the extent of its financial troubles for a longer period, it may have prolonged an inevitable bankruptcy filing while allowing the funding ratios of these plans to further decline. As a result, this may ultimately lead to a larger financial obligation for the PBGC if the plans are ultimately taken over.

As noted in the study, while it would be of interest to provide some information on the characteristics of the plans and the sponsoring firms that are granted exemptions as well as some empirical analysis of the financial effect of these transactions on the firms, this type of analysis is not possible because of data limitations. However, the findings of this study provide some insight into individual exemptions and how they are structured to ensure that the pension plans, and thereby plan participants and beneficiaries, are not adversely affected.

In addition, this broad examination of exemptions leads to additional research questions related to this aspect of pension management. Specifically, the decrease in the number of individual exemptions granted over the sample period is significant. As noted earlier, it is possible that this decline is due to variety of reasons including precedents set by prior exemptions or the expansion of the types of transactions allowed by class and/or statutory exemptions over time; a more detailed exploration of the potential causes of this decrease is warranted. Also, if detailed plan-level and firm-level data could be obtained, a closer examination of non-plan-specific exemptions as well as the financial characteristics of the firms involved in these exemptions could be explored. This would be of interest since non-plan-specific exemptions make up 37 percent of the exemptions granted during this period and because these exemptions could affect a large number of participants since financial institutions generally manage multiple pension plans. In addition, an expanded analysis that would include an examination of changes to both plan and plan sponsor characteristics surrounding exemptions to determine whether exemptions have any effect—good or bad—on the plans and firms would provide additional insight into the potential short- and long-term effects of exemptions on plan participants. This type of analysis also would provide some information on the effect of exemptions on the financial soundness of the sponsoring firms. Finally, while it does appear that the DOL places conditions on the transactions in an effort to protect pension plans and plan participants, more research in this area is warranted to determine if these restrictions are enforced.

NOTES

[1] The concern over adequacy takes two major forms. One is the adequacy of funds available to provide the promised benefits for retirees. Another concern relates to the adequacy of the benefit provided to fund a person's retirement. With respect to the discussion of Social Security in this paper, it is the solvency of the fund and the ability of Social Security to meet promised benefits that is the focus of the adequacy discussion and reform debate.

[2] Though various models exist, the basic structure would result in a reduction in traditional Social Security benefits for workers selecting this option. In addition, workers would have some discretion over how the portion diverted into private accounts were invested, including having the option to invest in the private sector (Calmes, 2005).

[3] "Combined income" includes adjusted gross income, nontaxable interest, and one-half of the Social Security benefits received.

[4] New comparability plans are defined contribution plans that often allow for higher allocation rates for highly compensated employees than for non-highly compensated employees. For additional information on these types of plans see IRC Section 401(a)(4)-8. In addition, the proposed increases in the administrative costs of maintaining a defined benefit plan as a result of the increase in the PBGC premium are discussed later in this section.

[5] It should be noted that not all plans have restricted matching programs in recent months. In fact, the report notes that some employers have actually increased the generosity of pension plans during the period.

[6] From a tax perspective, high returns on assets created a situation in which many of these plans had a minimum required contribution of zero as well as a maximum deductible contribution of zero. To avoid paying taxes on the contributions, plan sponsors were essentially forced into taking a contribution holiday. For those plans that were able to make a tax-deductible contribution and did so in an amount greater than the minimum required contribution, pension funding rules allow the excess of the contribution amount over the minimum required contribution to be declared a credit balance. This credit balance is then accumulated at the valuation interest rate, regardless of the actual return on assets, and can be used to offset future contribution requirements at a later date. Therefore, during the depressed economic times in the early part of this decade, many plan sponsors were using credit balances to pay their minimum required contributions. An extreme example of this can be seen by examining the defined benefit pension plans of UAL, the parent company of United Airlines, which filed bankruptcy in 2002. For the four major UAL defined benefit plans, the 2002 plan year minimum required contributions, the end of plan year credit balances, and actual contributions are reported in Table 1. All of the plans had an end of year credit balance that more than offset the required contribution. In addition, the interest on the credit balance for the Ground Employees Plan exceeded the minimum required contribution for 2002 so there was actually an increase in the credit balance for the 2002 plan year. It should also be noted that actual plan assets experienced a –16.5 percent return during this time.

UAL Defined Benefit Plans Summary Information

United Airlines defined benefit plans	Minimum required contribution	End of year credit balance	Actual contribution
Pilot	$86,899,230	$612,377,216	$0
Ground employees	$21,087,420	$354,802,354	$0
Flight attendant	$53,941,734	$316,570,426	$0
Management, administrative, and Public Contact	$69,731,088	$114,069,059	$0

*Information obtained from 2002 Schedule B filings from www.freeerisa.com. In 2003, the PBGC had more than 40 percent of its assets in stocks (Walsh, 2004).

[7]Currently the interest rate used to calculate liability is based on a four-year weighted average of long-term corporate bond yields, but under the pension reform package, the interest rate used would be based on bond rates averaged over 90 business days.

[8]Further details related to the data limitations are discussed in the next section of the paper.

[9]A disqualified person is defined in Title 26 of the Internal Revenue Code as "a person who is: (A) a fiduciary; (B) a person providing services to the plan; (C) an employer any of whose employees are covered by the plan; (D) an employee organization any of whose members are covered by the plan; (E) an owner, direct or indirect…which is an employer or an employee organization described in subparagraph (C) or (D); (F) a member of the family (as defined in paragraph (6)) of any individual described in subparagraph (A), (B), (C), or (E); (G) a corporation, partnership, or trust or estate…of which (or in which) 50 percent or more…is owned directly or indirectly, or held by persons described in subparagraph (A), (B), (C), (D), or (E); (H) an officer, director (or an individual having powers or responsibilities similar to those of officers or directors), a 10 percent or more shareholder, or a highly compensated employee (earning 10 percent or more of the yearly wages of an employer) of a person described in subparagraph (C), (D), (E), or (G); or (I) a 10 percent or more (in capital or profits) partner or joint venturer of a person described in subparagraph (C), (D), (E), or (G)."

[10]A decline in the number of exemptions of 70 percent over the sample period of eight years is substantial. It is possible that this decline is due to precedents set by prior exemption rulings which have resulted in a decline in applications for similar types of exemptions, or the expansion of the types of transactions allowed by class and/or statutory exemptions that would not require plans to apply for individual exemptions to engage in the specified transactions. In addition, the decline may be due to changes in the demographics of companies in existence today including type, size, and industry. Finally, it may be that there is some cyclical nature to exemptions that is not being captured over the sample period. However, given the current data limitations, this study is unable to fully explore this issue.

[11]The DOL classifications that fall within each of the six classes discussed in this study are available from the authors upon request.

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