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# STRENGTHENING WORKER RETIREMENT SECURITY

## HEARING

BEFORE THE

COMMITTEE ON
EDUCATION AND LABOR

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

HEARING HELD IN WASHINGTON, DC, FEBRUARY 24, 2009

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# STRENGTHENING WORKER RETIREMENT SECURITY

**Tuesday, February 24, 2009**
**U.S. House of Representatives**
**Committee on Education and Labor**
**Washington, DC**

The committee met, pursuant to call, at 10:32 a.m., in room 2175, Rayburn House Office Building, Hon. George Miller [chairman of the committee] presiding.

Present: Representatives Miller, Kildee, Payne, Andrews, Scott, Woolsey, Hinojosa, McCarthy, Kucinich, Wu, Holt, Bishop of New York, Sestak, Loebsack, Hirono, Altmire, Hare, Courtney, Shea-Porter, Fudge, Polis, Titus, McKeon, Castle, Biggert, Platts, Kline, Price, Guthrie, and Roe.

Staff present: Aaron Albright, Press Secretary; Tylease Alli, Hearing Clerk; Lynn Dondis, Labor Counsel, Subcommittee on Workforce Protections; Carlos Fenwick, Policy Advisor, Subcommittee on Health, Employment, Labor and Pensions; David Hartzler, Systems Administrator; Ryan Holden, Senior Investigator, Oversight; Jessica Kahanek, Press Assistant; Therese Leung, Labor Policy Advisor; Sara Lonardo, Junior Legislative Associate, Labor; Joe Novotny, Chief Clerk; Megan O'Reilly, Labor Counsel; Rachel Racusen, Communications Director; Meredith Regine, Junior Legislative Associate, Labor; Michele Varnhagen, Labor Policy Director; Mark Zuckerman, Staff Director; Cameron Coursen, Minority Assistant Communications Director; Ed Gilroy, Minority Director of Workforce Policy; Rob Gregg, Minority Senior Legislative Assistant; Alexa Marrero,Minority Communications Director; Jim Paretti, Minority Workforce Policy Counsel; Ken Serafin, Minority Professional Staff Member; and Linda Stevens, Minority Chief Clerk/Assistant to the General Counsel.

Chairman MILLER [presiding]. The House Committee on Education and Labor will come to order. And we meet today to explore the shortcomings in our nation's retirement system and look at solutions, so that Americans can enjoy a safe and secure retirement.

The current economic crisis has exposed deep flaws in our nation's retirement system. These flaws were mostly hidden when the market was doing well. Since the beginning of this crisis, trillions of dollars have evaporated from workers' 401(k) accounts. Millions of workers have seen a significant portion of their retirement balance vanish in just a few short months.

The committee heard testimony last year that the decline has forced many workers to consider postponing retirement or rejoining the workforce if they have already retired. For many retirees coping with rising costs for health care and other basic expenses, this loss in income is simply devastating.

For too many Americans, 401(k) plans have become little more than a high stakes crap shoot. If you don't take your retirement savings out of the market before the crash, you are likely to take years to recoup your losses, if at all.

As a result, we are realizing that Wall Street's guarantee of predictable benefits and peace of mind throughout retirement was nothing more than a hollow promise. And many more are questioning whether our nation's retirement system as a whole is sufficient to ensure retirement security.

Workers and retirees have historically depended upon three sources of income during retirement: from the defined contribution plans, defined benefit plans and other savings and Social Security. One leg of our retirement system is Social Security, and this program has never looked better than it does today. When you consider the trillions that employees have lost in retirement investments, thank goodness we didn't get sucked into gambling with Social Security funds in the Wall Street casino.

Another leg is traditional pension plans. But over the last two decades, many companies have unceremoniously frozen or terminated pension plans. Defined contribution plans, including 401(k)s, and other savings make up the third leg of our nation's retirement system. However, the 401(k) is not the supplemental retirement plan as it was originally designed. In fact, more than two-thirds of the workers with retirement plans rely solely on 401(k)-type plans as their primary retirement vehicle.

While 401(k)s are a fact of life, this committee has found that these plans in their current form do not and will not provide sufficient retirement security for the vast majority of Americans. This is why, in the short term, we must preserve and strengthen the 401(k)s. Hidden fees and conflicts of interest must be rooted out. And 401(k)s need to be run in the interest of the account holder, not the financial service industry.

Wall Street middle men live off the billions they generate from 401(k)s by imposing hidden and excessive fees that swallow up workers' money. Over a lifetime of work, these hidden fees can take an enormous bite out of workers' accounts.

Last Congress, I proposed a bill that would require simple and straightforward disclosure of 401(k) fees. And Wall Street opposed it. The ferocity of Wall Street's response to simple fee disclosure leads me to believe that they do not want 401(k) account holders to find out the billions they skim from Americans' hard-earned savings.

I finally believe that workers have the right to know exactly how much is taken from their accounts. Every penny contributed to a 401(k) account is the worker's money, and it should be used for the worker's retirement.

In addition, as one of our witnesses will testify today, the interests of investment managers selling retirement products to workers do not line up with the interests of the account holders. Too often,

the most marketed investment options are the worst for workers in terms of expense and performance.

Finally, in the long term, we should ask ourselves whether our current system gives workers the ability to ensure a safe and secure retirement. Witnesses appearing today will discuss how the decades-old realignment of our retirement system is putting enormous stress on the Americans' retirement security.

Being able to save for retirement after a lifetime of hard work has always been a core tenet of the American dream. Retirees ought to have financial security that allows them to focus on family and friends without sacrificing their standard of living. In the short-term, Congress must address ways to improve defined contribution plans. The 401(k) needs to be more transparent, fair and operated on behalf of account holders, not Wall Street firms.

But, we must also ask the difficult questions about the state of our nation's retirement system as a whole and look to see whether we need to create a new leg of retirement security. I hope this marks the beginning of an open and frank discussion on where we are today and what we need to do as a country to create a retirement system that works for all Americans, not just the fortunate few.

In the coming weeks and months, this committee and Mr. Andrews' subcommittee will be exploring these issues. And I look forward to the testimony of today's witnesses. And with that, I would like to recognize Congressman McKeon, my colleague from California, who is the senior Republican on the committee for his opening statement.

**Prepared Statement of Hon. George Miller, Chairman, Committee on Education and Labor**

The Education and Labor Committee meets today to explore shortcomings in our nation's retirement system and look at solutions so that Americans can enjoy a safe and secure retirement.

The current economic crisis has exposed deep flaws in our nation's retirement system. These flaws were mostly hidden when the market was doing well.

Since the beginning of this crisis, trillions of dollars have evaporated from workers' 401(k) accounts. Millions of workers have seen a significant portion of their retirement balance vanish in just a few short months.

The committee heard testimony last year that the decline has forced many workers to consider postponing retirement or rejoining the workforce if they have already retired. For many retirees coping with rising costs for health care and other basic expenses, this loss in income is simply devastating.

For too many Americans, 401(k) plans have become little more than a high stakes crap shoot. If you didn't take your retirement savings out of the market before the crash, you are likely to take years to recoup your losses, if at all.

As a result, we are realizing that Wall Street's guarantees of predictable benefits and peace of mind throughout retirement was nothing more than a hallow promise.

And, many more are questioning whether our nation's retirement system as a whole is sufficient to ensure retirement security.

Workers and retirees have historically depended on three sources of income during retirement—from defined contribution plans, defined benefit plans and other savings, and Social Security.

One leg of our retirement system is Social Security, and this program has never looked better. When you consider the trillions that employees have lost in retirement investments, thank goodness we didn't get suckered into gambling Social Security funds at the Wall Street casino.

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But over the last two decades, many companies have unceremoniously frozen or terminated pension plans.

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While 401(k)s are a fact of life, this committee has found that these plans in their current form do not and will not provide sufficient retirement security for the vast majority of Americans.

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In addition, as one of our witnesses will testify today, the interest of the investment managers selling retirement products to workers do not line up with the interests of account holders.

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In the coming weeks and months, this committee and Mr. Andrews' subcommittee will be exploring all these issues.

I look forward to today's testimony.

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Mr. MCKEON. Good morning, and thank you, Chairman Miller.

Last fall, as our nation's financial crisis was worsening, the committee held several hearings devoted to the effects of this crisis on retirement savings. We heard some troubling testimony about the state of our nation's economic affairs, its impact on workers and retirees and a range of proposals for solutions. Some, I think, we would all agree upon. Others were and remain far more controversial.

As I noted in the fall, our economy is in the midst of a serious downturn, constrained by a global credit crisis and burdened by the weight of toxic assets that have made it more difficult for businesses large and small to maintain their day-to-day operations, much less to create the new jobs our economy needs.

And while it would be easy to dismiss the woes of the stock market as merely impacting the wealthy, the reality is that millions of Americans rely on investments in planning for retirement. Because of this, a downturn in our financial markets can have a real impact on workers' retirement security.

While the two major types of retirement plans, defined-contribution and defined-benefit, have many differences, both are impacted by the overall health of our economic system and by investment performance in particular. 401(k)-type savings plans are invested directly, usually managed by workers. Defined-benefit plans require plan sponsors to manage millions in assets over a period of many decades.

With the collapse in recent years of a number of defined-benefit plans, we have seen the risk to workers and retirees when plans are not effectively managed, or when benefits are over-promised and under-delivered.

I understand that the bulk of our examination today will be devoted to 401(k) plans and the defined contribution pension system. I welcome this examination and trust that the information we hear today will be of use to us.

I would caution, however, that to the extent we focus on one side of the equation, the defined contribution side, we must not ignore the other. It may be tempting this morning to talk about the risks associated with defined contribution plans, and how workers would be so much better off if they were all in defined benefit plans. I think that simply misstates the case.

As the Chairman well knows, our nation's defined benefit plans are facing historic challenges in the wake of our financial collapse. While workers with retirement savings in 401(k) plans are rightly worried about what the market is doing in their retirement plans, workers in defined benefit plans face their own worries about whether their companies will still be standing, whether their jobs will still be there and whether their promised benefits will be delivered in the wake of this financial turmoil. I hope the Committee will pay the same attention to those issues as we move forward.

Second, I hope that this morning's hearing will acknowledge the full scope of the challenges facing Americans planning for or entering retirement. I expect we will hear at some length about fee disclosure in 401(k) plans and the need for improvement. I know this is an issue of particular concern to you, Chairman Miller, and one on which I expect we will again see legislation in this Congress.

As I made clear last fall, I think all of us would support improved disclosure that is meaningful and useful to participants. And the question of how we go about that improvement is a fair question for today's hearing.

I would caution, however, that we not suggest that investment fees are to blame for the dramatic declines in retirement savings which our nation's workers and retirees have seen as a result of this historic financial crisis.

In a year where the S&P 500 lost 38 percent of its value, to suggest that the problem is merely one of investment fees is simply not factual or helpful. And indeed, on that point, it bears note that while the S&P lost almost 40 percent of its value, the best numbers available now suggest that the average workplace retirement sav-

ings account lost 27 percent of its value—still a difficult loss, but it does suggest that plans can and will vary with performance and their management.

Finally, I think it is important to recognize that while our defined contribution system could be improved, it would be a real mistake to dismantle it, or nationalize it, as has been suggested in this committee in the past. We have a heavy responsibility in both the legislation we pass and the debates we undertake.

In particular, I would make clear that now is not the time to frighten people out of the market. Triggering a widespread exodus from the system would only exacerbate the market's downward trend, while cementing those deep losses. I hope members and witnesses will keep this in mind with their comments, their remarks today.

Given the fact that, historically and over time, these plans have become vital retirement savings vehicles for millions of Americans, I am very mindful that we do not take any step, even our conversations, to discourage that this morning.

With that, I welcome our witnesses and look forward to their testimony and yield back.

**Prepared Statement of Hon. Howard P. "Buck" McKeon, Senior Republican Member, Committee on Education and Labor**

Good morning, and thank you, Chairman Miller.

Last fall, as our nation's financial crisis was worsening, the Committee held several hearings devoted to the effects of this crisis on retirement savings. We heard some troubling testimony about the state of our nation's economic affairs, its impact on workers and retirees, and a range of proposals for solutions. Some I think we would all agree upon. Others were and remain far more controversial.

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With that, I welcome our witnesses and look forward to their testimony. I yield back.

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Chairman MILLER. I thank the gentleman for his statement. And I would just, if I might remark on it, it is the intent of the chair of this committee to have an exhaustive set of hearings on pension security in this country, including public plans, including defined benefit plans, including the Pension Guaranty Corporation, under the of leadership of Mr. Andrews and his subcommittee.

As I said earlier, the market shined a light on serious problems with 401(k) plans, it is also shining the light on serious problems with other pension plans in terms of, certainly, the expectations of the participants, but also their ability to deliver.

Thank you to all of the witnesses for agreeing to testify today and to give us the benefit of your experience and expertise.

Our first witness will be John C. Bogle who is the founder and former chief executive of Vanguard, the mutual fund organization he created in 1974. While at Vanguard, Mr. Bogle founded the first indexed mutual fund. And Vanguard is now among the largest mutual fund organizations in the world with current assets totaling over $1 trillion. Mr. Bogle received his BA Princeton University.

Dr. Dean Baker is the co-director of the Center of Economic and Policy Research, which he founded in 1999. Dr. Baker is the author of many books on economic issues, including Plunder and Blunder, the Rise and Fall of the Bubble Economy. He received a BA from Swarthmore College and his Ph.D. in Economics from the University of Michigan.

Dr. Alicia H. Munnell is Peter Drucker professor of management sciences at Boston College's Carol School of Management and also serves as the Director for the Center of Retirement Research in Boston College. Prior to joining Boston College, she served during the Clinton Administration as both the Treasury Department and

the Social Security Administration. Dr. Munnell has earned her BA from Wellesley College, and MA from Boston University, and a Ph.D. from Harvard University.

Paul Schott Stevens has served as president and chief executive officer of the Investment Company Institute since 2004. Outside ICI, Mr. Stevens' career included various roles in private law practice as corporate counsel and in government service. Mr. Stevens received his BA from Yale University and received his JD from the University of Virginia.

Mr. Bogle, you are 80 years old. And we are still worried about where you went to college. It is kind of interesting, isn't it? We keep going back in time. Anyway, we are going to begin with you. A green light will go on when you begin to testify. Then there will be an orange light after 4 minutes.

We would suggest that you think about wrapping up your statement at that time. But we want you to finish your thoughts and the purposes of your testimony. And then we will open it up for questions from the committee.

We will go through all of the witnesses first for your testimony. And I believe you are going to have to turn on your mike, Mr. Bogle. And again, welcome to the committee. And we look forward to your testimony.

**STATEMENT OF JOHN C. BOGLE, FOUNDER, VANGUARD GROUP**

Mr. BOGLE. All right. Am I on the air now?

Chairman MILLER. You are on the air.

Mr. BOGLE. All right. Well, good morning, Chairman Miller, and thank you. And members of the committee, thank you for your invitation to join you today to talk about some things that have been on my mind for a very long time.

I think it is perhaps best for me to begin by summarizing the ideal system that I think is the ideal system for retirement today.

Chairman MILLER. We are going to bring the mike a little closer to you.

Mr. BOGLE. Okay, very good—that I have outlined in my statement. Number one, for individual savers who have the financial ability to save for retirement, there would be a single defined contribution plan structured, consolidating all those 401(k), IRAs, Roth IRAs, 403(b)s and so on, a defined contribution system, a unitary defined contribution system that would be open to all of our citizens.

It would be dominated by low-cost, even mutual, providers of services, yes, inevitably focused on all market index funds, investing for the long term and overseen by a newly created federal retirement board that would establish sound principles for the private sector to observe, and asset allocation and diversification, in order to assure appropriate investment risk for each participant in the system, and also to assure full disclosure of all plan costs.

The board, in essence, would also restrict loans very greatly from the system and preclude cash outs when employees change jobs, and would also appraise and approve qualified service providers.

Number two, the idea of number one, is to establish appropriate investment risk, something we have lost sight of for individuals.

And point two is to deal with longevity risk, that other great risk to retirement security that we outlive our resources, mitigated by creating a simple, low-cost annuity plan as a mandatory offering at some point in all DC plans, with some portion of each participants' balance going into this option on retirement.

And number three, and most importantly, we should extend the existing ERISA requirement that plan sponsors, corporations, meet a standard of fiduciary duty to encompass mutual fund planned providers as well. In fact, I think we need to go further.

I believe we need a federal standard of fiduciary duty for all money managers who are agents, who in my opinion have failed abjectly in their responsibility to serve first the interest of their principals, all those mutual fund shareowners and pension beneficiaries. Therefore these agents bear a heavy responsibility for the financial crisis we are now facing.

Now, why do we have to reform the system? Well, we need a new system of worker retirement security, because the present system is imperiled and is headed toward a train wreck of considerable force.

It is not just the 50 percent plus the client in stock prices that we have seen, with $10 trillion, almost $10 trillion of market value erased, some of which—I should importantly—I can't deal with it in my opening statement. But it is in my testimony and my prepared statement, some of which represented speculative phantom wealth, overvalued markets developed by speculators that are described in the statement. So some of the wealth that has evaporated was phantom wealth.

But that only begins that market decline, that big loss, the list of reasons for retirement plans to change the system, the problems that we have created in the system. Retirement plans own about half of all U.S. stock. And in turn, they have borne about $5 trillion of the $10 trillion decline, a whopping—I am using 30 percent, Congressman. But 27 percent might be a better number—a whopping 27 percent hit to the retirement system itself.

So we are not saving nearly enough. We now know, for retirement, corporations have been stingy in funding their defined benefit plans. And they assumed higher levels of return, they are even remotely capable of achieving. They are, in effect, a bad joke, the future 8.5 percent returns these retirement plans were claiming before the great fall of the market last year. And in addition, they have been derelict in funding their defined contribution plans, largely 401(k)s, which have a balance of a pitiful $15,000, the median balance.

What is more, nearly 100 companies already in the last year have either reduced or suspended their contributions to their benefit plans, just as stock prices have come down by that huge amount, creating some kind of extra value at some point. In addition, pension managers and plan participants have made unwise and often speculative investment choices. Too much in equities, especially for investors nearing retirement; too many hedge funds, also known as absolute return funds, now known as absolute negative return funds; too much real estate, and so on.

Our financial system, especially our mutual funds and our hedge funds also are greedy to fault. And they consume far too large a

share of the returns created by our business and economic system. So we must recognize that the interest of our money managers and marketers are in direct conflict with the financial interests of the investors to whom they provide services.

If I could just make one more point, I guess my time has run out here, has it? I would like to just make one more really important point, if I may. All this trading back and forth among investors is not a zero-sum game. The financial system, the traders, the brokers, the investment bankers, the money managers, the middlemen, Wall Street as it were, takes a cut of all this frenzied activity, leaving investors as a group only with what is left. Yes, the investor feeds at the bottom of the food chain of investing.

So what do we have to do to encourage and maximize retirement savings? Using a biblical phrase, if I may, we must drive the money changers, or at least most of them, out of the temples of finance.

Now, here is the most important point in my remarks. I asked you in my testimony to read it twice. If we investors collectively own the markets, as we do, but individually compete to beat our fellow market participants, we lose the game because of those costs. But if we investors abandoned our inevitably futile attempts to obtain an edge over other market participants and simply hold our share of the market portfolio, we win the game. It is not very complicated.

So that is why, inevitably, we will be focused on stock and bond index funds.

Thank you, Mr. Chairman. Sorry to run a little over.

[The statement of Mr. Bogle follows:]

**Prepared Statement of John C. Bogle, Founder and Former Chief Executive of the Vanguard Group[1]**

Our nation's system of retirement security is imperiled, headed for a serious train wreck. That wreck is not merely waiting to happen; we are running on a dangerous track that is leading directly to a serious crash that will disable major parts of our retirement system. Federal support—which, in today's world, is already being tapped at unprecedented levels—seems to be the only short-term remedy. But long-term reforms in our retirement funding system, if only we have the wisdom and courage to implement them, can move us to a better path toward retirement security for the nation's workers.

One of the causes of the coming crisis—but hardly the only cause—is the collapse of our stock market, erasing some $8 trillion in market value from its $17 trillion capitalization at the market's high in October 2007, less than 18 months ago. However, this stunning loss of wealth reflects, in important part, a growing and substantial overvaluation of stocks during the late 1990s and early 2000s, "phantom wealth" which proved unjustified by corporate intrinsic value. (I'll discuss this subject in greater depth later in my statement.)

But four other causes must not be ignored. One is the inadequacy of national savings being directed into retirement plans. "Thrift" has been out in America; "instant gratification" in our consumer-driven economy has been in. As a nation, we are not saving nearly enough to meet our future retirement needs. Too few citizens have chosen to establish personal retirement accounts, and even those who have established them are funding them inadequately and only sporadically. Further, our corporations have been funding their pension plans on the mistaken assumption that stocks would produce future returns at the generous levels of the past, raising their prospective return assumptions even as the market reached valuations that were far

[1] The opinions expressed in this speech do not necessarily represent the views of Vanguard's present management.

above historical norms.[2] And the pension plans of our state and local governments seem to be in the worst financial condition of all. (Because of poor transparency, inadequate disclosure, and non-standardized financial reporting, we really don't know the dimension of the shortfall.)

Second is the plethora of unsound, unwise, and often speculative investment choices made not only by individuals responsible for managing their own tax-sheltered retirement investment programs (such as individual retirement accounts and defined-contribution pension plans such as 401(k) thrift plans provided by corporations and 403(b) savings plans provided by non-profit institutions), but also professionally managed defined benefit plans, largely created in earlier days by our nation's larger corporations and by our state and local governments.

Third, conflicts of interest are rife throughout our financial system. Both the managers of mutual funds held in corporate 401(k) plans and the money managers of corporate pension plans face a potential conflict when they hold the shares of the corporations that are their clients. It is not beyond imagination that when a manager votes proxy shares against a company management's recommendation, it might not sit well with company executives who select the plan's provider of investment advice. (There is a debate about the extent to which those conflicts have actually materialized.) In trade union plans, actual conflicts of interest among union leaders, union workers, investment advisers, and money managers have been documented in the press and in court. In defined benefit plans, corporate senior officers face an obvious short-term conflict between minimizing pension costs in order to maximize the earnings growth that market participants demand, and incurring larger pension costs by making timely and adequate contributions to their companies' pension plans in order to assure long-term security for the pension benefits they have promised to their workers.

Fourth, our financial system is a greedy system, consuming far too large a share of the returns created by our business and economic system. Corporations generate earnings for the owners of their stocks, pay dividends, and reinvest what's left in the business. In the aggregate, over the past century, the returns generated by our businesses have grown at an annual rate of about 9½ percent per year, including about 4½ percent from dividend yields and 5 percent from earnings growth. Similarly, corporate and government bonds pay interest, and the aggregate return on bonds averaged about 5 percent during the same period.

But these are the gross returns generated by the corporations that dominate our system of competitive capitalism (and by government borrowings). Investors who hold these financial instruments, either directly or through the collective investment programs provided by mutual funds and defined benefit pension plans, receive their returns only after the cost of acquiring them and then trading them back and forth among one another. While some of this activity is necessary to provide the liquidity that has been the hallmark of U.S. financial markets, it has grown into an orgy of speculation that pits one manager against another, and one investor (or speculator) against another—a "paper economy" that has, predictably, come to threaten the real economy where our citizens save and invest. It must be obvious that our present economic crisis was, by and large, foisted on Main Street by Wall Street—the mostly innocent public taken to the cleaners, as it were, by the mostly greedy financiers.

*Extracting Value From Society*

I've written about our absurd and counterproductive financial sector at length. Writing in the Journal of Portfolio Management in its Winter 2008 issue, here are some of the things that I said about the costs of our financial system: "* * * mutual fund expenses, plus all those fees paid to hedge fund and pension fund managers, to trust companies and to insurance companies, plus their trading costs and investment banking fees * * * totaled about $528 billion in 2007. These enormous costs seriously undermine the odds in favor of success for citizens who are accumulating savings for retirement. Alas, the investor feeds at the bottom of the costly food chain of investing, paid only after all the agency costs of investing are deducted from the markets' returns * * * Once a profession in which business was subservient, the field of money management has largely become a business in which the profession is subservient. Harvard Business School Professor Rakesh Khurana is right when he defines the standard of conduct for a true professional with these words: 'I will

[2] For example, in 1981, when the yield on long-term U.S. Treasury bonds was 13½ percent, corporations assumed that future returns on their pension plans would average 6 percent. At the end of 2007, despite the sharp decline in the Treasury bond yield to 4.8 percent, the assumed future return soared to 8½ percent. Even without the large losses incurred in the 2008 bear market, it seems highly unlikely that such a return will be realized.

create value for society, rather than extract it.' And yet money management, by definition, extracts value from the returns earned by our business enterprises."

These views are not only mine, and they have applied for a long time. Hear Nobel laureate economist James Tobin, presciently writing in 1984: "* * * we are throwing more and more of our resources into financial activities remote from the production of goods and services, into activities that generate high private rewards disproportionate to their social productivity, a 'paper economy' facilitating speculation which is short-sighted and inefficient."

In his remarks, Tobin cited the eminent British economist John Maynard Keynes. But he failed to cite Keynes's profound warning: "When enterprise becomes a mere bubble on a whirlpool of speculation, the consequences may be dire * * * when the capital development of a country becomes a by-product of the activities of a casino * * * the job (of capitalism) will be ill-done." That job is indeed being ill-done today. Business enterprise has taken a back seat to financial speculation. The multiple failings of our flawed financial sector are jeopardizing, not only the retirement security of our nation's savers but the economy in which our entire society participates.

*Our Retirement System Today*

The present crisis in worker retirement security is well within our capacity to measure. It is not a pretty picture:

Defined Benefit Plans. Until the early 1990s, investment risk and the longevity risk of pensioners (the risk of outliving one's resources) were borne by the defined benefit (DB) plans of our corporations and state and local governments, the pervasive approach to retirement savings outside of the huge DB plan we call Social Security. But in the face of a major shift away from DB plans in favor of defined contribution (DC) plans, DB growth has essentially halted. Assets of corporate pension plans have declined from $2.1 trillion as far back as 1999 to an estimated $1.9 trillion as 2009 began. These plans are now severely underfunded. For the companies in the Standard & Poor's 500 Index, pension plan assets to cover future payments to retirees has tumbled from a surplus of some $270 billion in 1999 to a deficit of $376 billion at the end of 2008. Largely because of the stock market's sharp decline, assets of state and local plans have also tumbled, from a high of $3.3 trillion early in 2007 to an estimated $2.5 trillion last year.

The Pension Benefit Guaranty Corporation. This federal agency, responsible for guaranteeing the pension benefits of failing corporate sponsors is itself faltering, with a $14 billion deficit in December 2007. Yet early in 2008—just before the worst of the stock market's collapse—the agency made the odd decision to raise its allocation to diversified equity investments to 45 percent of its assets, and add another 10 percent to "alternative investments," including real estate and private equity, essentially doubling the PBGC's equity participation at what turned out to be the worst possible moment.

Defined Contribution Plans. DC plans are gradually replacing DB plans, a massive transfer from business enterprises to their employees of both investment risk (and return) and the longevity risk of retirement funding. While DC plans have been available to provide the benefits of tax-deferral for retirement savings for well over a half-century,[3] it has only been with the rise of employer thrift plans such as 401(k)s and 403(b)s, beginning in 1978, that they have been widely used to accumulate retirement savings. The growth in DC plans has been remarkable. Assets totaled $500 billion in 1985; $1 trillion in 1991; $4.5 trillion in 2007. With the market crash, assets are now estimated at $3.5 trillion. The 401(k) and 403(b) plans dominate this total, with respective shares of 67 percent and 16 percent or 83 percent of the DC total.

Individual Retirement Accounts. IRA assets presently total about $3.2 trillion, down from $4.7 trillion in 2007. Mutual funds (now some $1.5 trillion) continue to represent the largest single portion of these investments. Yet with some 47 million households participating in IRAs, the median balance is but $55,000, which at, say, a 4 percent average income yield, would provide but $2,200 per year in retirement income per household, a nice but far from adequate, increment.

*Focusing on 401(k) Retirement Plans*

Defined contribution pension plans, as noted above, have gradually come to dominate the private retirement savings market, and that domination seems certain to

[3] I have been investing 15 percent of my annual compensation in the DC plan of the company (and its predecessor) that has employed me since July 1951, when I first entered the work force. I can therefore give my personal assurance that tax-deferred defined contribution pension plans, added to regularly, reasonably allocated among stocks and bonds, highly diversified, and managed at low cost, compounded over a long period, are capable of providing wealth accumulations that are little short of miraculous.

increase. Further, there is some evidence that DC plans are poised to become a growing factor in the public plan market. (The federal employees' Thrift Savings Plan, with assets of about $180 billion, has operated as a defined contribution plan since its inception in 1986.) Even as 401(k) plans have come to dominate the DC market, so mutual fund shares have come to dominate the 401(k) market. Assets of mutual funds in DC plans have grown from a mere $35 billion in 1990 (9 percent of the total) to an estimated $1.8 trillion in 2008 (51 percent).

Given the plight in which our defined benefit plans find themselves, and the large (and, to some degree, unpredictable) bite that funding costs take out of corporate earnings, it is small wonder that what began as a gradual shift became a massive movement to defined contribution plans. (Think of General Motors, for example, as a huge pension plan now with perhaps $75 billion of assets—and likely even larger liabilities—surrounded by a far smaller automobile business, operated by a company with a current stock market capitalization of just $1.3 billion.)

I would argue the shift from DB plans to DC plans is not only an inevitable move, but a move in the right direction in providing worker retirement security. In this era of global competition, U.S. corporations must compete with non-U.S. corporations with far lower labor costs. So this massive transfer of the two great risks of retirement plan savings—investment risk and longevity risk—from corporate balance sheets to individual households will relieve pressure on corporate earnings, even as it will require our families to take responsibility for their own retirement savings. A further benefit is that investments in DC plans can be tailored to the specific individual requirements of each family—reflecting its prospective wealth, its risk tolerance, the age of its bread-winner(s), and its other assets (including Social Security). DB plans, on the other hand, are inevitably focused on the average demographics and salaries of the firm's work force in the aggregate.

The 401(k) plan, then, is an idea whose time has come. That's the good news. We're moving our retirement savings system to a new paradigm, one that will ultimately efficiently serve both our nation's employers—corporations and governments alike—and our nation's families. Now for the bad news: our existing DC system is failing investors. Despite its worthy objectives, the deeply flawed implementation of DC plans has subtracted—and subtracted substantially—from the inherent value of this new system. Given the responsibility to look after their own investments, participants have acted contrary to their own best interests. Let's think about what has gone wrong.[4]

*A Deeply Flawed System*

I now present my analysis of the major flaws that continue to exist in our 401(k) system. We need radical reforms to mitigate these flaws, in order to give employees the fair shake that must be the goal if we are to serve the national public interest and the interest of investors.

• Inadequate savings—The modest median balances so far accumulated in 401(k) plans make their promise a mere shadow of reality. At the end of 2008, the median 401(k) balance is estimated at just $15,000 per participant. Indeed, even projecting this balance for a middle-aged employee with future growth engendered over the passage of time by assumed higher salaries and real investment returns, that figure might rise to some $300,000 at retirement age (if the assumptions are correct). While that hypothetical accumulation may look substantial, however, it would be adequate to replace less than 30 percent of pre-retirement income, a help but hardly a panacea. (The target suggested by most analysts is around 70 percent, including Social Security.) Part of the reason for today's modest accumulations are the inadequate participant and corporate contributions made to the plans. Typically, the combined contribution comes to less than 10 percent of compensation, while most experts consider 15 percent of compensation as the appropriate target. Over a working lifetime of, say, 40 years, an average employee, contributing 15 percent of salary, receiving periodic raises, and earning a real market return of 5 percent per year, would accumulate $630,000. An employee contributing 10 percent would accumulate just $420,000. If those assumptions are realized, this would represent a handsome accumulation, but substantial obstacles—especially the flexibility given to participants to withdraw capital, as described below—are likely to preclude their achievement.

• Excess flexibility. 401(k) plans, designed to fund retirement income, are too often used for purposes that subtract directly from that goal. One such subtraction arises from the ability of employees to borrow from their plans, and nearly 20 percent of participants do exactly that. Even when—and if—these loans are repaid, in-

[4] I recognize that the Pension Protection Act of 2006 provided important improvements to the original 401(k) paradigm, as described in Appendix A, attached.

vestment returns (assuming that they are positive over time) would be reduced during the time that the loans are outstanding, a dead-weight loss in the substantial savings that might otherwise have been accumulated at retirement.

Even worse is the dead-weight loss—in this case, largely permanent—engendered when participants "cash out" their 401(k) plans when they change jobs. The evidence suggests that 60 percent of all participants in DC plans who move from one job to another cash out at least a portion of their plan assets, using that money for purposes other than retirement savings. To understand the baneful effect of borrowings and cash-outs, just imagine in what shape our beleaguered Social Security System would find itself if the contributions of workers and their companies were reduced by borrowings and cash outs, flowing into current consumption rather than into future retirement pay. It is not a pretty picture to contemplate.

• Inappropriate Asset Allocation. One reason that 401(k) investors have accumulated such disappointing balances is due to unfortunate decisions in the allocation of assets between stocks and bonds.[5] While virtually all investment experts recommend a large allocation to stocks for young investors and an increasing bond allocation as participants draw closer to retirement, a large segment of 401(k) participants fails to heed that advice.

Nearly 20 percent of 401(k) investors in their 20s own zero equities in their retirement plan, holding, instead, outsized allocations of money market and stable value funds, options which are unlikely to keep pace with inflation as the years go by. On the other end of the spectrum, more than 30 percent of 401(k) investors in their 60s have more than 80 percent of their assets in equity funds. Such an aggressive allocation likely resulted in a decline of 30 percent or more in their 401(k) balances during the present bear market, imperiling their retirement funds precisely when the members of this age group are preparing to draw upon it.

Company stock is another source of unwise asset allocation decisions, as many investors fail to observe the time-honored principle of diversification. In plans in which company stock is an investment option, the average participant invests more than 20 percent of his or her account balance in company stock, an unacceptable concentration of risk.

• Excessive Costs. As noted earlier, excessive investment costs are the principal cause of the inadequate long-term returns earned by both stock funds and bond funds. The average equity fund carries an annual expense ratio of about 1.3 percent per year, or about 0.80 percent when weighted by fund assets. But that is only part of the cost. Mutual funds also incur substantial transaction costs, reflecting the rapid turnover of their investment portfolios. Last year, the average actively managed fund had a turnover rate of an astonishing 96 percent. Even if weighted by asset size, the turnover rate is still a shocking—if slightly less shocking—65 percent. Admittedly, the costs of this portfolio turnover cannot be measured with precision. But it is reasonable to assume that trading activity by funds adds costs of 0.5 percent to 1.0 percent to the expense ratio. So the all-in-costs of fund investing (excluding sales loads, which are generally waived for large retirement accounts) can run from, say 1.5 percent to 2.3 percent per year. (By contrast, low-cost market index funds—which I'll discuss later—have expense ratios as low as 0.10 percent, with transaction costs that are close to zero.)

In investing, costs truly matter, and they matter even more when related to real (after inflation) returns. If the future real investment return on a balanced retirement account were, say, 4 percent per year (5 percent nominal return for bonds, 8 percent for stocks, less 2.5 percent inflation), an annual cost of 2.0 percent would consume fully 50 percent of that annual return. Even worse, over an investment lifetime of, say, 50 years, those same costs would consume nearly 75 percent of the potential wealth accumulation. It is an ugly picture.

Given the centrality of low costs to the accumulation of adequate retirement savings, then, costs must be disclosed to participants. But the disclosure must include the all-in costs of investing, not merely the expense ratios. (I confess to being skeptical about applying cost-accounting processes to the allocation of fund expenses among investment costs, administrative costs, marketing costs, and record-keeping costs. What's important to plan participants is the amount of total costs incurred, not the allocation of those costs among the various functions as determined by accountants and fund managers who have vested interests in the outcome.)

• Failure to deal with longevity risk. Even as most 401(k) plan participants have failed to deal adequately with investment risk, so they (and their employers and the fund sponsors) have also failed to deal adequately with longevity risk. It must be

[5] These data are derived from a Research Perspective dated December 2008, published by the Investment Company Institute, the association that represents mutual fund management companies, collecting data, providing research, and engaging in lobbying activities.

obvious that at some point in an investment lifetime, most plan participants would be well-served by having at least some portion of their retirement savings provide income that they cannot outlive. But despite the fact that the 401(k) plan has now been around for three full decades, systematic approaches to annuitizing payments are rare and often too complex to implement. Further, nearly all annuities carry grossly excessive expenses, often because of high selling and marketing costs. Truly low-cost annuities remain conspicuous by their absence from DC retirement plan choices. (TIAA-CREF, operating at rock-bottom cost and providing ease and flexibility for clients using its annuity program, has done a good job in resolving both the complexity issue and the cost issue.)

*The New Defined Contribution Plans*

Given the widespread failures in the existing DC plan structure, and in 401(k) plans in particular, it is time for reform, reform that serves, not fund managers and our greedy financial system, but plan participants and their beneficiaries. We ought to carefully consider changes that move us to a retirement plan system that is simpler, more rational and less expensive, one that will be increasingly and inevitably focused on DC plans. Our Social Security System and, at least for a while, our state and local government systems would continue to provide the DB backup as a "safety net" for all participating U.S. citizens:

1. Simplify the DC system. Offer a single DC plan for tax-deferred retirement savings available to all of our citizens (with a maximum annual contribution limit), consolidating today's complex amalgam of traditional DC plans, IRAs, Roth IRAs, 401(k) plans, 403(b) plans, the federal Thrift Savings Plan. I envision the creation of an independent Federal Retirement Board to oversee both the employer-sponsors and the plan providers, assuring that the interests of plan participants are the first priority. This new system would remain in the private sector (as today), with asset managers and recordkeepers competing in costs and in services. (But such a board might also create a public sector DC plan for wage-earners who were unable to enter the private system or whose initial assets were too modest to be acceptable in that system.)

2. Get Real About Stock Market Return and Risk. Financial markets, it hardly need be said today, can be volatile and unpredictable. But common stocks remain a perfectly viable—and necessary—investment option for long-term retirement savings. Yet stock returns have been oversold by Wall Street's salesmen and by the mutual fund industry's giant marketing apparatus. In their own financial interests, they ignored the fact that the great bull market we enjoyed during the final 25 years of the 20th century was in large part an illusion, creating what I call "phantom returns" that would not recur. Think about it: From 1926 to 1974, the average annual real (inflation-adjusted) return on stocks was 6.1 percent. But during the following quarter-century, stock returns soared, an explosion borne, not of the return provided by corporations in the form of dividend yields and earnings growth, but of soaring price-to-earnings ratios, what I define as speculative return.

This higher market valuation reflected investor enthusiasm (and greed), and produced an extra speculative return of 5.7 percent annually, spread over 20 full years, an event without precedent. This speculative return almost doubled the market's investment return (created by dividend yields and earnings growth), bringing the market's total real return to nearly 12 percent per year. From these speculative heights, the market had little recourse but to return to normalcy, by providing far lower returns in subsequent years. And in fact, the real return on stocks since the turn of the century in 1999 has been minus 7 percent per year, composed of a negative investment return of -1 percent and a negative speculative return of another -6 percent, as price-earnings multiples retreated to (or below) historical norms.

The message here is that investors in their ignorance, and financial sector marketers with their heavy incentives to sell, well, "products," failed to make the necessary distinction between the returns earned by business (earnings and dividends) and the returns earned by, well, irrational exuberance and greed. Today, we realize that much of the value and wealth we saw reflected on our quarterly 401(k) statements was indeed phantom wealth. But as yesteryear's stewards of our investment management firms became modern-day salesmen of investment products, they had every incentive to disregard the fact that this wealth could not be sustained. Our marketers (and our investors) failed to recognize that only the fundamental (investment) returns apply as time goes by. As a result, we misled ourselves about the realities that lay ahead, to say nothing of the risks associated with equity investing.

3. Owning the Stock Market—and the Bond Market. Investors seem to largely ignore the close link between lower costs and higher returns—what I call (after Justice Brandeis) "The Relentless Rules of Humble Arithmetic." Plan participants and employers also ignore this essential truism: As a group, we investors are all

"indexers." That is, all of the equity owners of U.S. stocks together own the entire U.S. stock market. So our collective gross return inevitably equals the return of the stock market itself.

And because providers of financial services are largely smart, ambitious, aggressive, innovative, entrepreneurial, and, at least to some extent, greedy, it is in their own financial interest to have plan sponsors and participants ignore that reality. Our financial system pits one investor against another, buyer vs. seller. Each time a share of stock changes hands (and today's daily volume totals some 10 billion shares), one investor is (relatively) enriched; the investor on the other side of the trade is (relatively) impoverished.

But, as noted earlier, this is no zero-sum game. The financial system—the traders, the brokers, the investment bankers, the money managers, the middlemen, "Wall Street," as it were—takes a cut of all this frenzied activity, leaving investors as a group inevitably playing a loser's game. As bets are exchanged back and forth, our attempts to beat the market, and the attempts of our institutional money managers to do so, then, enrich only the croupiers, a clear analogy to our racetracks, our gambling casinos, and our state lotteries.

So, if we want to encourage and maximize the retirement savings of our citizens, we must drive the money changers—or at least most of them—out of the temples of finance. If we investors collectively own the markets, but individually compete to beat our fellow market participants, we lose. But if we abandon our inevitably futile attempts to obtain an edge over other market participants and all simply hold our share of the market portfolio, we win. (Please re-read those two sentences!) Truth told, it is as simple as that. So our Federal Retirement Board should not only foster the use of broad-market index funds in the new DC system (and offer them in its own "fall back" system described earlier) but approve only private providers who offer their index funds at minimum costs.

4. Asset Allocation—Balancing Risk and Return. The balancing of returns and risk is the quintessential task of intelligent investing, and that task too would be the province of the Federal Retirement Board. If the wisest, most experienced minds in our investment community and our academic community believe—as they do—that the need for risk aversion increases with age; that market timing is a fool's game (and is obviously not possible for investors as a group); and that predicting stock market returns has a very high margin for error, then something akin to roughly matching the bond index fund percentage with each participant's age with the remainder committed to the stock index fund, is the strategy that most likely to serve most plan participants with the most effectiveness. Under extenuating—and very limited—circumstances participants could have the ability to opt-out of that allocation.

This allocation pattern is clearly accepted by most fund industry marketers, in the choice of the bond/stock allocations of their increasingly popular "target retirement funds." However, too many of these fund sponsors apparently have found it a competitive necessity to hold stock positions that are significantly higher than the pure age-based equivalents described earlier. I don't believe competitive pressure should be allowed to establish the allocation standard, and would leave those decisions to the new Federal Retirement Board.

I also don't believe that past returns on stocks that include, from time to time, substantial phantom returns—borne of swings from fear to greed to hope, back and forth—are a sound basis for establishing appropriate asset allocations for plan participants. Our market strategists, in my view, too often deceive themselves by their slavish reliance on past returns, rather than focusing on what returns may lie ahead, based on the projected discounted future cash flows that, however far from certainty, represent the intrinsic values of U.S. business in the aggregate.

Once we spread the risk of investing—and eliminate the risk of picking individual stocks, of picking market sectors, of picking money managers, leaving only market risk, which cannot be avoided—to investors as a group, we've accomplished the inevitably worthwhile goal: a financial system that is based on the wisdom of long-term investing, eschewing the fallacy of the short-term speculation that is so deeply entrenched in our markets today. Such a strategy effectively guarantees that all DC plan participants will garner their fair share of whatever returns our stock and bond markets are generous enough to bestow on us (or, for that matter, mean-spirited enough to inflict on us). Compared to today's loser's game, that would be a signal accomplishment.

Under the present system, some of us will outlive our retirement savings and depend on our families. Others will go to their rewards with large savings barely yet tapped, benefiting their heirs. But like investment risk, longevity risk can be pooled. So as the years left to accumulate assets dwindle down, and as the years of living on the returns from those assets begin, we need to institutionalize, as it were, a

planned program of conversion of our retirement plan assets into annuities. This could be a gradual process; it could be applied only to plan participants with assets above a certain level; and it could be accomplished by the availability of annuities created by private enterprise and offered at minimum cost, again with providers overseen by the proposed Federal Retirement Board (just as the federal Thrift Savings Plan has its own board and management, and operates as a private enterprise).

5. Mutuality, Investment Risk, and Longevity Risk. The pooling of the savings of retirement plan investors in this new DC environment is the only way to maximize the returns of these investors as a group. A widely diversified, all-market strategy, a rational (if inevitably imperfect) asset allocation, and low costs, delivered by a private system in which investors automatically and regularly save from their own incomes, aided where possible by matching contributions of their employers, and proving an annuity-like mechanism to minimize longevity risks is the optimal system to assure maximum retirement plan security for our nation's families.

There remains the task of bypassing Wall Street's croupiers, an essential part of the necessary reform. Surely our Federal Retirement Board would want to evaluate the possible need for the providers of DC retirement plan service to be mutual in structure; that is, management companies that are owned by their fund shareholders, and operated on an "at-cost" basis; and annuity providers that are similarly structured. The arithmetic is there, and the sole mutual fund firm that is organized under such a mutual structure has performed with remarkable effectiveness.[6]

Of course that's my view! But this critical analysis of the structure of the mutual fund industry is not mine alone. Listen to Warren Buffett. "[Mutual fund] independent directors * * * [have] been absolutely pathetic * * * [They follow] a zombie-like process that makes a mockery of stewardship * * * '[I]independent' directors, over more than six decades, have failed miserably." Then, hear this from another investor, one who has not only produced one of the most impressive investment records of the modern era but who has an impeccable reputation for character and intellectual integrity, David F. Swensen, Chief Investment Officer of Yale University: "The fundamental market failure in the mutual fund industry involves the interaction between sophisticated, profit-seeking providers of financial services and naive, return-seeking consumers of investment products. The drive for profits by Wall Street and the mutual fund industry overwhelms the concept of fiduciary responsibility, leading to an all too predictable outcome: * * * the powerful financial services industry exploits vulnerable individual investors * * * The ownership structure of a fund management company plays a role in determining the likelihood of investor success. Mutual fund investors face the greatest challenge with investment management companies that provide returns to public shareholders or that funnel profits to a corporate parent—situations that place the conflict between profit generation and fiduciary responsibility in high relief. When a fund's management subsidiary reports to a multi-line financial services company, the scope for abuse of investor capital broadens dramatically * * * Investors fare best with funds managed by not-for-profit organizations, because the management firm focuses exclusively on serving investor interests. No profit motive conflicts with the manager's fiduciary responsibility. No profit margin interferes with investor returns. No outside corporate interest clashes with portfolio management choices. Not-for-profit firms place investor interests front and center * * * ultimately, a passive index fund managed by a not-for-profit investment management organization represents the combination most likely to satisfy investor aspirations."

*What Would An Ideal Retirement Plan System Look Like?*

It is easy to summarize the ideal system for retirement savings that I've outlined in this Statement.

1. Social Security would remain in its present form, offering basic retirement security for our citizens at minimum investment risk. (However, policymakers must promptly deal with its longer-run deficits.)

2. For those who have the financial ability to save for retirement, there would be a single DC structure, dominated by low-cost—even mutual—providers, inevitably focused on all-market index funds investing for the long term, and overseen by a newly-created Federal Retirement Board that would establish sound principles of

[6] I'm only slightly embarrassed to be referring here to Vanguard, the firm I founded 35 years ago. (My modest annual retainer is unrelated to our asset size or growth.) Even a glance at Vanguard's leadership in providing superior investment returns, in operating by far at the lowest costs in the field, in earning shareholder confidence, and in developing returns and positive cash flows into our mutual funds (even in the face of huge outflows from our rivals during 2008) suggests that such a structure has well-served its shareholders.

asset allocation and diversification in order to assure appropriate investment risk for each participant.

3. Longevity risk would be mitigated by creating simple low-cost annuities as a mandatory offering in these plans, with some portion of each participant's balance going into this option upon retirement. (Participants should have the ability to opt-out of this alternative.)

4. We should extend the existing ERISA requirement that plan sponsors meet a standard of fiduciary duty to encompass plan providers as well. (In fact, I believe that a federal standard of fiduciary duty for all money managers should also be enacted.)

It may not be—indeed, it is not—a system free of flaws. But it is a radical improvement, borne of common sense and elemental arithmetic, over the present system, which is driven by the interest of Wall Street rather than Main Street. And, with the independent Federal Retirement Board, we have the means to correct flaws that may develop over time, and assure that the interests of workers and their retirement security remain paramount.

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Chairman MILLER. Mr. Baker. Dr. Baker.

**STATEMENT OF DEAN BAKER, CO–DIRECTOR, CENTER FOR ECONOMIC AND POLICY RESEARCH**

Mr. BAKER. Thank you very much, Mr. Chairman, for inviting me to speak here today. I will say a few points of emphasizing some of the problems, which I think are all too apparent in the current system, and also try to throw out some quick thoughts on potential solutions.

First point, in terms of basic problems, I mean, we all know we have just seen a massive collapse of the stock market. And we are facing with a situation wherein so far as people had retirement accounts, and here I am thinking of the baby boom generation, the 77 million baby boomers on the edge of retirement, they are overwhelmingly in the form of defined contribution accounts. Defined benefits accounts, whether we like them or not, are rapidly disappearing and certainly going to disappear more quickly in the near future as more and more companies freeze their accounts or end them all together.

So we are looking at a situation where, if people had accounts, they had defined contribution accounts of course. And we all know that those have taken a very large hit. Now, on top of that, one of the points that I want to emphasize in my testimony is that the main source of wealth for most baby boomers approaching retirement is housing. And that also has taken a very large hit. And I think many people failed to fully appreciate the impact that this is likely to have on the retirement of middle-income baby boomers.

I know that there were a number of surveys that have looked at baby boomers' intentions to use the equity in their home for retirement. And I know that most of the surveys show that most don't intend to do that. I would argue that, in spite of their intentions, I think realistically the vast majority of retirees and certainly baby boomer retirees will be, at least in part, dependent on the wealth in their home for their retirement. And there are three reasons for that.

One is that if you have a paid-off mortgage, obviously you are much better situated in retirement, than if you have to continue to make payments on your mortgage long into your retirement. Secondly, many retirees do anticipate moving. And it makes a very big difference if you leave your house and have a large amount of eq-

uity to use as a down payment or possibly even purchase outright the home that you expect to live in during your retirement years.

The third reason is simply that this is fall-back money in the event of emergency, in the event of an unexpected medical condition or other emergency that requires money. If you have no equity in your home, then you obviously have much less fall-back money.

Now, we recently analyzed the Federal Reserve for its survey of consumer finance. I have to confess, we didn't get the most recent data that just came out last week. We will have that shortly. But we are working off the 2004 data. And we just made some crude estimate of what baby boomers can anticipate having in retirement based on the recent declines in the stock market and in housing prices.

And our calculations show that, for younger baby boomers, those between the ages of 45 to 54, their total wealth, including equity in their home, all wealth apart from defined benefit retirement accounts, has fallen from $150,000 in 2004, which was none too generous, to just $82,000 in 2009. And just to put that $82,000 in context, this is median household, that would purchase less than half of the median house.

So we are looking at a situation where half of the baby boomers, half of the younger baby boomers, if they took all their wealth, would be able to purchase less than half the median house. Alternatively, if we converted that into annuities, so they were age 65, that would get you an annuity of about $6,000 a year, $500 per month. That would not go very far in retirement, again assuming that you have no equity in your home in that scenario.

If we looked at older baby boomers, those between 55 and 64, the situation is almost as bad. We have projected their wealth. Total wealth would be $142,700. That is a decline of 38 percent from where it stood in 2004. That would be sufficient for 80 percent of the purchase price of the median home. Again if you took all your wealth and used nothing on anything else, you would be able to purchase 80 percent of the median home.

Alternatively, the annuity you can get for that would be about $10,000 a year, or perhaps a little more than $800 a month. And again, that is assuming that you have no equity in your home.

I think, long and short, people were taking much, much greater risk than they realized, not only with the money that they had in the defined contribution 401(k)-type plan, but also in their home, which they were led to believe as a safe asset.

Now, just very quick points, because I realize I don't have very much times. First, and I realize this isn't necessarily the purview of this committee, but I think a point that we can't emphasize enough. The Federal Reserve Board must take seriously its responsibility to combat asset bubbles.

I know the Federal Reserve Board, under Chairman Greenspan, did not feel that was part of their responsibility. I think there is absolutely nothing more important that the Federal Reserve Board could do than to combat asset bubbles. And I think the current situation demonstrates that clearly. They gambled with the wealth of the country's homeowners. And we all lost very badly.

Secondly in this context, I think it is very important for the Congress and president to re-affirm the commitment to Social Security

and Medicare. The baby boomer generation that are retired or near retirement have just lost on the order of $15 trillion in wealth between their houses and their stock. And we have to assure these people that the one thing they could count on will still be their Social Security and Medicare.

The last point, we obviously need to do more in terms of retirement accounts. I will just say two very quick things about this. There have been efforts to set up state accounts that would be great experiments, California being the most important; Washington State also very close to setting up state-managed system accounts. These have had bipartisan support. Certainly Governor Schwarzenegger in California has been a big supporter of this.

With a little assistance from Congress, I think those plans can make progress. They would be good models, good experiments, for Congress to look at.

Last point is that, given the risk that people have taken, and that I think many were not willing to take, not anxious to take, I think the opportunity to look at some sort of defined benefit that the government can guarantee, a modest amount, say $1,000, per worker per year. I think that would be a very ripe opportunity that could offer a great deal security to the nation's workers at really no cost to the government.

So I realize we have lots of very big problems on our hands. I appreciate the committee's interest in this. And I hope we can make progress on that. Thank you for hearing me.

[The statement of Mr. Baker follows:]

**Prepared Statement of Dean Baker, Co-director, Center for Economic and Policy Research**

Thank you, Chairman Miller for inviting me to share my views on the problems of the current system of retirement income, and ways to improve it, with the committee. My name is Dean Baker and I am the co-director of the Center for Economic and Policy Research (CEPR). I am an economist and I have been writing about issues related to retirement security since 1992.

My testimony will have three parts. The first part, which will be the bulk of the testimony, will explain how the current crisis has jeopardized the retirement security of tens of millions of workers. The second part will briefly reference some of the longstanding inadequacies of our system retirement income, reminding members of problems with which they are already quite familiar. The third part will outline some principles that may guide the committee in constructing legislation to improve retirement security.

*How the Current Crisis has Jeapordized Retirement Security*

The collapse of the housing bubble, coupled with the plunge in the stock market, has exposed the gross inadequacy of our system of retirement income. CEPR's analysis of data from the Federal Reserve Board's 2004 Survey of Consumer Finance (SCF), indicates that the median household with a person between the ages of 45 to 54, saw their net worth fall by more than 45 percent between 2004 and 2009, from $150,500 in 2004, to just $82,200 in 2009 (all amounts are in 2009 dollars).[1]

This figure, which includes home equity, is not even sufficient to cover half of the value of the median house in the United States. In other words, if the median late baby boomer household took all of the wealth they had accumulated during their lifetime, they would still owe more than half of the price of a typical house in a mortgage and have no other asset whatsoever.[2]

The situation for older baby boomers is similar. The median household between the ages of 55 and 64 saw their wealth fall by almost 38 percent from $229,600 in

[1] We used the 2004 SCF, because the micro data from the 2007 is not yet available. This analysis, by my colleague David Rosnick and myself, will soon be available on the website of the Center for Economic and Policy Research, www.cepr.net.

[2] These calculations exclude wealth in defined benefit pensions.

2004 to $142,700 in 2009. This net worth would be sufficient to allow these households, who are at the peak ages for wealth accumulation, to cover approximately 80 percent of the cost of the median home, if they had no other asset.

Even prior to the recent downturn, the baby boom cohorts were not well prepared for retirement. Most members of these cohorts had been able to save far too little to maintain their standard of living in retirement. They would have found it necessary to work much later into their lives than they had planned, or to accept sharp reductions in living standards upon reaching retirement.

The situation of the baby boomers has been made much worse by the economic and financial collapse of the last two years. Ironically, the sharpest decline in wealth took place in an asset that many were led to believe was completely safe, their house. Real house prices have fallen by more than 30 percent from their peak in 2006 and will almost certainly fall at least another 10-15 percent before hitting bottom.[3]

The plunge in house prices has been especially devastating both because it was by far the largest source of wealth for most baby boomers, and also because the high leverage in housing. The fact that housing is highly leveraged is of course a huge advantage to homeowners in times when prices are rising. If a homeowner can buy a $200,000 house with a 20 percent down payment, and the house subsequently increases 50 percent in value, the homeowner gets a very high return, earning $100,000 on a down payment of just $40,000.

However, leverage also poses enormous risks. In this case, if the home price falls by 20 percent, then the homeowner has lost 100 percent of her equity. This is exactly the sort of situation confronting tens of millions of baby boomers at the edge of retirement. They just witnessed the destruction of most or all of the equity in their home. Our analysis of the SCF indicates that almost one fourth of late baby boomers who own homes have so little equity that they will need to bring cash to settle their mortgage at their closing. In a somewhat more pessimistic scenario, almost 40 percent of the home owning households in this cohort will need to bring cash to a closing.

The collapse in the housing equity of the baby boom cohort in the last two years will have enormous implications for their well-being in retirement. Instead of having a home largely paid off by the time they reach their retirement years, many baby boomers will be in the same situation as first time home buyers, looking at large mortgages requiring decades to pay down. Furthermore, the loss of equity in their current homes will make it far more difficult for baby boomers to move into homes that may be more suitable for their needs in retirement. Millions of middle class baby boomers will find it difficult to raise the money needed to make a down payment on a new home.

While the focus of pension and retirement policy has usually been pensions and Social Security, it is important to recognize the role of housing wealth for two reason. First, the massive loss of housing wealth due to the collapse of the housing bubble is likely to be a factor that has an enduring impact on the living standards of the baby boom cohorts in their retirement years.

The other reason why Congress should recognize the importance of housing wealth is that this pillar of retirement income is not as secure as it has often been treated. In other words, the risks associated with housing wealth have generally not been fully considered in evaluating the security of retirement income. While it is reasonable to hope that the economy will not see the same sort of nationwide housing bubble for many decades into the future, if ever, there will nonetheless be a substantial element of risk associated with homeownership, since there will always be substantial fluctuations in local housing markets. This means that workers who have much of their wealth in their home already face substantial risks to their retirement income even before considering their financial investments.

Here also the baby boom cohort has received a very unpleasant surprise in the last two years as stock market has plunged by more than 40 percent from its peak in November of 2007.[4] While the data does not yet allow us to determine exactly how badly the baby boom cohorts have been hit by this decline, it is virtually certain that they felt the biggest impact, simply because they had the most wealth to lose.

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[3] This is based on data from the Case-Shiller 20 City index. The peak level was reached in May of 2006. Most data is from November of 2008. These data are based on sales prices, which means that they reflect contracts that were typically signed 6 to 8 weeks earlier. This means that the most recent data is close to 5 months out of date at present. With prices in the index falling at a rate of more than 2 percent monthly, house prices may already be close to 10 percent lower than the level indicated in the November data.

[4] This refers to the decline as measured by the S&P 500, which is a much broader measure than the Dow Jones Industrial Average.

The Fed's data show that at the end of 2007, more than 70 percent of the assets in defined contribution pension plans were held either directly or indirectly in the stock market.[5]

The baby boomers' losses on their stockholdings will compound the losses incurred on their homes. Of course most baby boomers had managed to accumulate relatively little by way of stock wealth even prior to the market collapse of the last year and half. In 2004, the median household headed by someone between the ages of 55 to 64 had accumulated less than $100,000 in financial assets of all forms, including holdings of stock and mutual funds. Median financial wealth for this age group had fallen to just over $60,000 in 2009 following the collapse of the stock market. The younger 45 to 54 cohort had median financial wealth of just $40,000 in 2004. This had fallen to less than $30,000 in 2009.

To summarize, our system of retirement income security was completely unprepared for the sort of financial earthquake set in motion by the collapse the of the housing bubble and its secondary impact on the stock market. Older workers were already inadequately prepared for retirement even prior to these events. The events of the last two years now put most of the baby boom cohorts facing retirement with very little to depend on other than their Social Security and Medicare benefits.

While a full picture of retirement income would also incorporate estimates of the income that these workers will receive from defined benefit pensions, the vast majority of workers in these age cohorts will receive little or nothing from traditional defined benefit pension plans. Defined benefit plans have been rapidly declining in importance for the last quarter century. This pace of decline is increasing with the downturn as many companies that still have defined benefit plans lay off workers and others freeze benefit levels to conserve cash.

*Other Problems with the Defined Contribution Pension System*

The prior discussion highlights the problem of risk for which the current defined contribution system was completely inadequate. I will just briefly note some of the other problems that have been frequently raised in prior years.

Inadequate coverage—In spite of efforts to simplify the process for employers, most businesses still do not offer workers the opportunity to contribute to a pension at their workplace. Almost half of private sector workers are not currently contributing to a pension plan at their workplace. The primary reason that workers do not contribute because their employer does not offer the option. The Bureau of Labor Statistics reported a take up rate of 83 percent in their most recent survey.[6]

The lack of coverage is overwhelmingly a small business issue. Two thirds of the workers employed in firms with more than 100 workers are contributing to a pension. Just one-third of the workers in workers employing less than 50 workers are contributing to a pension.

Lack of portability—In the modern economy, workers change jobs frequently either by choice or necessity. When workers leave a job with a pension, they generally cannot simply role over their accumulated funds into a plan operated by their new employer (if there is one). While recent legislation has sought to promote rollovers into IRAs, it is still too early to know how effective these rules will be. Until we have a fully portable pension system, changing jobs still provides an opportunity for leakage of funds from retirement accounts.

High Fees—While some pension plans are very efficient, many plans charge annual fees in excess of 1.5 percentage points. These fees can substantially reduce retirement savings. For example, a 1.0 percentage point difference in fees can reduce retirement accumulations by almost 20 percent over a thirty five year period. Private insurance companies will charge between 10 percent and 20 percent of the value of an accumulation to convert it into an annuity. This further reduces workers' retirement income.

*Principles for a New Pension System*

The events of the last two years have brought home the extent to which the current pension system exposes workers to risk both in the value of their pension and also their housing wealth. The federal government has the ability to shield workers from this risk, at very little cost to taxpayers.

Before discussing principles for expanding retirement security, it is important to note the security that the government already does provide through Social Security and Medicare. With the collapse of retirement savings over the last two years, as

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[5] This is taken form the Flow of Funds Table, L.118c, lines 12 plus 13, divided by line 1, available at *http://www.federalreserve.gov/releases/z1/Current/z1r-6.pdf.*

[6] Bureau of Labor Statistics, "Employee Benefits in the United States, 2008," available at *http://www.bls.gov/news.release/pdf/ebs2.pdf.*

well as the plunge in housing equity, the baby boom cohorts will be hugely dependent on these two social welfare programs. It is therefore more essential than ever that Congress maintain the integrity of these programs and ensure that the baby boom cohorts can at least count on the benefits that they have been promised.

The main lesson of the last two years is that, in addition to the problems stemming from inadequate coverage and high costs, the current pension system subjects workers to far more risk than has been generally recognized. The government can solve all three problems by allowing workers the option to contribute to a government run pension system that would provide a modest guaranteed rate of return.

The system would be a universal system like Social Security, however it would be voluntary. To try to maintain high rates of enrollment, there can be a default contribution from all workers of 3 percent, up to a modest level, such as $1,000 a year. Workers could be allowed to contribute some additional amount, for example an additional $1,000 per year, that would also earn them the same guaranteed rate of return.

The system should also be structured to encourage workers to take their payouts in the form of annuities, except in the case of life threatening illness. For example, a nationwide system could easily offer free annuitization, while charging a modest penalty (e.g. 10 percent) to workers who take their money out of the account in a lump sum.

Ideally, there would be tax subsidies for low and moderate income workers that would make it easier for them to put aside 3.0 percent, or more, of their wages. However, if budget limitations make subsidies impractical, there is no reason that Congress could not move ahead to establish a structure and consider adding subsidies at some future date.

The guaranteed return should be set at a level that is consistent with a long-term average return on a conservatively invested portfolio. Such a guarantee should pose little new risk to the government. As recent events have shown, in extreme cases, the government will step in to protect savings, as it did when it opted to guarantee money market funds, even where it has no legal obligation to make such a commitment. Guaranteeing a modest rate of return over a long period of time should present very little additional risk to the government.

The funds in this system would be kept strictly separate from the general budget. The investment would be carried through by a private contractor in a manner similar to the way in which the Federal Employees Thrift Saving Plan current invests the savings of federal employees.

Even a modest contribution could make a large difference in the retirement security of most workers. For example, at a 3 percent rate of return, a worker who saved $1,000 a year for 35 years would be able to get an annuity of $4,200 a year at age 65. This would be 14 percent of the wage of a worker who earned $30,000 a year during their working lifetime. Such a sum would be a substantial supplement to their Social Security benefits. A contribution of $2,000 a year would be sufficient to provide an annuity that is almost equal to 30 percent of this worker's earnings during their working career.

The formulas for this sort of plan can be altered in any number of ways, but the point is that Congress can enormously increase the retirement security of tens of millions of workers simply by making a system with a defined rate of return available to them. This could be done at no cost to the taxpayers.

*Conclusion*

The events of the last two years have shown how exposed workers' retirement income is to market risk. The collapse of the housing bubble has called attention to the fact that the value of not only their pensions, but also their homes, fluctuate with the market, while their homes are an even more important asset for most workers.

While fully restoring the lost wealth of the baby boom cohorts may not prove feasible, Congress can take effective steps to create a better retirement system for future generations. This can be done at no cost to taxpayers, simply by having the government assume market risk by averaging returns over time. There are no economic or administrative obstacles to going this route, it is simple a question of political will.

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Chairman MILLER. Thank you.

Dr. Munnell.

**STATEMENT OF ALICIA MUNNELL, DIRECTOR, CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE AND PETER F. DRUCKER PROFESSOR OF MANAGEMENT SCIENCES**

Ms. MUNNELL. Chairman Miller, Ranking Member McKeon.

Chairman MILLER. I am not sure your microphone is——

Ms. MUNNELL. I appreciate the opportunity to testify today about what we have learned about 401(k) plans in the wake of the financial crisis and to offer some ideas for strengthening our retirement security. As you indicated, I direct the Center for Retirement Research at Boston College. We look at Social Security, public and private pensions and also individual saving and work decisions.

Even before the financial crisis, we were very concerned about the ability of 401(k) plans to serve as the sole supplement to Social Security. I am not here to beat up on 401(k) plans. They were just never intended to do this. They were meant to be supplementary plans on top of old-fashioned defined benefit plans.

They left all the responsibility up to the individuals. All of us individuals make terrible decisions. As a result, balances in these plans were very low. The 2007 Survey of Consumer Finances indicates, for people approaching retirement, the median balance was $60,000. That is before the crisis.

The Pension Protection Act has made steps to make these plans work more effectively. But they are not a cure-all. And we haven't even considered the drawdown aspects of these plans, which are going to be a huge challenge.

Now comes along this huge financial tsunami. And we see that people are exposed to enormous investment risk also. These balances in these accounts have declined sharply. If it was $60,000 before the financial crisis, it is about $40,000 after.

The financial crisis has also affected the real economy. We have lost about 3.7 million jobs. Unemployed people cannot contribute to their plans. And unemployed people also feel like they have to tap their plans to help them over really rough times. The hardship withdrawal rate has ticked up. It is still quite low. But my view is that, if this weak economy continues, you are going to see more and more people taking hardship withdrawals.

The other thing we have seen is employers have cut back on their employer match. They are not doing this because they are evil. They have to make choices. And they are probably doing this instead of laying people off. But it does mean, if it persists for a long time, that people are going to have less in the way of retirement income going forward.

The question is what to do with all this. And I think one point I would like to make is that working longer is going to have to be an important part of the solution. Even before the financial crisis, we argued that working longer was important.

We have a declining retirement income system. And yet, we have people living longer. Working longer avoids the actuary reduction, Social Security, lets your assets accumulate, and shortens the period of which you have to retire. For older people who are caught in this financial crisis, in fact, that is all they can do. They really do not have time to save a lot more money.

The final point is that working longer can't solve the whole problem. We need to shore up our retirement income system. And I

think that has two parts. One is restoring balance to Social Security. Social Security has really shined during this particular crisis. Those checks go out. They provide valuable money, modest benefits, but inflation index and go on for life. We need to make sure that those benefits are not cut back even further.

There is no free lunch. We have to pay up if we are going to do that. But I think that is important.

The other thing is I strongly believe that we need a new tier of retirement income between Social Security and 401(k) plans. I think this tier needs to provide benefits about equal to 20 percent of pre-retirement earnings. I think it needs to be on a funded basis in the private sector. It needs to avoid having people take money out while they are working. Benefits needs to be paid out as an annuity.

It is complicated precisely how to design it, because of the tradeoff between how much you put in and rate of return. So if you can get high rates of return, you have low contributions; high contributions, low rate of return. So there is much work to be done there. Perhaps the best we can do is a model, something like the Federal Thrift Savings Plan. But it would be nice to think if we can do something more creative.

The main message I want to leave with you is that we need more organized retirement savings. We have a declining Social Security system, even under current law, as the retirement age increases. And we have a very fragile system of 401(k) plans. And they are just together not going to be enough for future retirees.

Thank you very much.

[The statement of Ms. Munnell follows:]

# The Financial Crisis and Restoring Retirement Security

Alicia H. Munnell
Peter F. Drucker Professor of Management Sciences
Director, Center for Retirement Research
Boston College Carroll School of Management

Testimony before the Committee on Education and Labor
U.S. House of Representatives

February 24, 2009

Chairman Miller, Ranking Member McKeon, and members of the Committee, thank you for inviting me to testify this morning about the lessons we've learned about our current 401(k) system in the wake of the financial crisis and ideas on how to strengthen our retirement security.

My name is Alicia Munnell, and I am Director of the Center for Retirement Research at Boston College. The Center investigates anything that affects how much money people will have in retirement: we study public and private pensions, the Social Security system, and individual decisions about saving and work.

**Even before the financial crisis, we have been concerned about the ability of 401(k) plans to provide secure retirement income.**[1]

They were not designed for that role. When 401(k) plans came on the scene in the early 1980s, they were viewed mainly as supplements to employer-funded pension and profit-sharing plans. Since 401(k) participants were presumed to have their basic retirement income security needs covered by an employer-funded plan and Social Security, they were given substantial discretion over 401(k) choices.

Today most workers with pension coverage have a 401(k) as their primary or only plan (see Figure 1). Yet 401(k)s still operate under the old rules. Workers continue to have almost complete discretion over whether to participate, how much to contribute, how to invest, and how and when to withdraw the funds. Evidence indicates that people make mistakes at every step along the way. They don't join the plan, they don't contribute enough; they don't diversify their holdings; they over invest in company stock; they take out money when they switch jobs; and they don't annuitize at retirement.

Policymakers came to recognize the challenges inherent in 401(k) plans – and building on studies by behavioral economists that demonstrated the major role that inertia plays in how workers participate and invest – enacted the Pension Protection Act of 2006 (PPA).[2] The PPA encouraged automatic enrollment, fostered automatic increases in deferral rates, and broadened default investment options. This legislation has been helpful, but it is not a "cure all" for 401(k)s. And the PPA did not address the challenges that participants will face on the decumulation side, as they try to figure out the best way to draw down their assets in retirement.

The most telling failure of 401(k) plans is the modest balances that participants have accumulated. Based on reports from Vanguard and the new 2007 *Survey of Consumer Finances* (SCF), median 401(k) holdings for people 55-64 were only about $60,000 in 2007 when the stock market was at its peak.[3] A more complete – and more worrisome – picture of how risky retirement has become is captured in our National Retirement Risk Index, which projects the percent of households that will not be able to maintain their standard of living in retirement. This Index shows that the share of households unprepared for retirement jumped from 31 percent in 1983 to 44 percent in 2006. And the number rises to 61 percent explicitly factoring in health care expenses (see Figure 2).

My conclusion was that exclusive reliance on 401(k) plans was a catastrophe in the making. But I thought the dimensions of the problem would not become clear for another 10 or 15 years when large numbers of people retired reliant solely on Social Security and 401(k)s. Instead, the financial crisis has accelerated a reexamination of our retirement income system.

**The financial crisis – and its impact in the real economy – has highlighted the fragility of 401(k) plans as the sole supplement to Social Security.**

401(k) balances have dropped in value by about thirty percent; people are losing their jobs, resulting in fewer contributions and more hardship withdrawals; and companies under pressure are suspending their matching contributions.

Between October 9, 2007, the peak of the stock market, and October 9, 2008, the Wilshire 5000 declined by 42 percent.[4] Participants in 401(k) plans approaching retirement held about two-thirds of their balances in equities.[5] As a result, the market value of assets in 401(k)s/IRAs tumbled by about 30 percent (see Table 1). That decline means that the median 401(k) holdings for a person 55-64 went from around $60,000 in 2007 to roughly $42,000 at the end of 2008.[6]

The financial crisis has also severely damaged the real economy. Roughly 3.6 million people have lost their jobs.[7] People without jobs cannot contribute to 401(k) plans. And those with jobs increasingly are turning to their 401(k) plans for help. Hardship withdrawals (to cover the purchase of a primary residence, educational expenses, medical expenses, or general financial pressures) – while still at relatively low levels – have ticked up. According to data from Fidelity and Vanguard, to date roughly 2 percent of participants have made a hardship withdrawal.[8] My sense is that many more will tap their 401(k) before the recession is over.

Finally, as the recession gains momentum, companies under severe earnings pressure have announced a suspension of their 401(k) matches. This response mirrored what happened in the wake of the 2001 recession when many large companies stopped matching employee contributions. Once again the automobile companies led the way with Ford and General Motors suspending the match for their salaried employees. But suspensions have also occurred at Kodak, FedEx, US Steel and many other companies. We track these announcements and estimate to date that about 1.6 percent of 401(k) participants have lost their 401(k) match (see Figure 3). The seriousness of the current suspensions depends on whether more firms follow suit and whether the suspensions are a temporary or permanent phenomenon. If, as was the case in the wake of the 2001 recession, the suspensions are temporary, the effects will probably be modest. On the other hand, if these suspensions lead to a permanent decline of the employer match, significantly fewer people will participate – especially among the lower paid – and people will end up with noticeably less retirement income.

**Some older workers can absorb the shock of the financial crisis by working longer. And working longer should be an important component of responding to the crisis and for strengthening our retirement income system.**

Even before the financial collapse, we have argued that people need to work longer.[9] The reason is that the retirement system is contracting and people are living longer. At any given age, Social Security benefits will replace a smaller fraction of pre-retirement earnings than in the past because 1) the Full Retirement Age is moving from 65 to 67, which is equivalent to an across-the-board cut; 2) Medicare premiums, which are automatically deducted from Social Security benefits, are slated to increase sharply; and 3) the taxation of Social Security benefits under the personal income tax will move further down the income distribution, as the exemption amounts in the tax code are not indexed to wage growth or inflation (see Figure 4). In addition, as noted above, balances in 401(k) plans are modest, and people save virtually nothing outside of employer-sponsored plans. While the retirement system is contracting, life expectancy is increasing. For men, life expectancy at 65 was 14.7 years in 1980 and is expected to be 17.5 years in 2030.[10] For women, the comparable numbers are 18.7 years and 21.1 years.

Older workers, whose 401(k) balances have been decimated by the financial crisis, have three options: they can save more, they can live on less in retirement, or they can work longer. Saving enough to offset the impact of the financial collapse is virtually impossible.[11] Reducing an already modest retirement income further is undesirable. So the only real option is to keep working. And that is apparently what many have decided to do. The employment statistics are dramatic. A greater percentage of men age 55 and older are working today than at the peak of the expansion in late 2007 (see Figure 5). This pattern is in sharp contrast to that of younger workers, where the employment rate is over 4 percentage points lower than at the cyclical peak.

Working longer is a powerful antidote to both the immediate crisis and the long-run contraction of the retirement income system. It directly increases current income; it avoids the actuarial reduction in Social Security benefits; it allows people to contribute more to their 401(k) plans; and it shortens the period of retirement. Working longer alone, however, will not ensure security for older Americans.

**To avoid a repeat of the current crisis, we also need to shore up our retirement income system. This task requires avoiding further reductions in Social Security and introducing a new tier of retirement income.**

The collapse of 401(k) plans during the recent financial crisis has highlighted the importance of Social Security as the backbone of our retirement income system. While Social Security faces a shortfall over the next 75 years because of the aging of the population, it has been almost totally unaffected by our current economic woes. The Social Security Administration continues to send out monthly checks, which while modest, are a predictable source of income that people can count on. Moreover, these benefits are a really special type of income because they are adjusted each year for changes in the cost of living and they continue for as long as the recipient lives. As

discussed above, Social Security will replace less of pre-retirement earnings in the future than it has in the past. Any further reductions would put millions of future retirees at risk. My view is that, with little else to rely on, Americans will be willing to pay higher taxes to maintain this extremely successful program.

Stabilizing Social Security is not enough, however. We also need to consider a new tier of retirement income. This tier would help bolster retirement security both for low-wage workers facing declining Social Security replacement rates and for middle- and upper-wage workers who increasingly rely on 401(k) plans as their only supplement to Social Security (see Figure 6).

The goal of this additional tier would be to replace about 20 percent of pre-retirement income. To accomplish the goal, participation should be mandatory, participants should have no access to money before retirement, and benefits should be paid as annuities. The system should be funded and reside as much as possible in the private sector. As we have just learned, funded and pay-as-you-go systems are subject to different kinds of risks, so such an approach would allow us to diversify the risks.

Moving beyond principles is difficult. The challenge hinges on the tradeoff between lifetime returns and the required contribution. Equities offer a higher return, but they also bring greater risk, as we have just seen. Relying on equities therefore creates two types of problems. First, replacement rates will vary dramatically depending on the performance of the stock market over the period when the participant is working and accumulating assets. Some cohorts of retirees will get a lot, and others will end up with little. Second, as the recent financial crisis highlights, values can drop precipitously just as participants are approaching retirement. A sharp drop in retirement balances upsets people's plans, even if the drops merely offset a lifetime of high returns. The net result is inadequate retirement saving.

The natural response is to think about trying to protect people by offering guarantees. The problem is that low rates of guarantee – 2 percent or 3 percent inflation-adjusted – would have done nothing to protect workers over the last 84 years. The reason is that no retiring cohort would have earned less than 3.8 percent on a portfolio of equities, so low guarantees would never have kicked in. Only high guarantees – like 6 percent – would have had any impact, but standard finance theory says such guarantees are not possible, as long as the guarantor shares the market's aversion to risk.

Perhaps the best we can do is a tier modeled on the Federal Thrift Savings Plan with sensible target date funds. Such an approach would avoid unnecessary risks, such as investing in a single stock or holding too large a share in equities just prior to retirement. But it would be nice to think a little more about guarantees and risk sharing.

**In any case, the message that I want to leave is that we need *more* organized retirement saving. A declining Social Security system and fragile 401(k) plans will not be enough for future retirees.**

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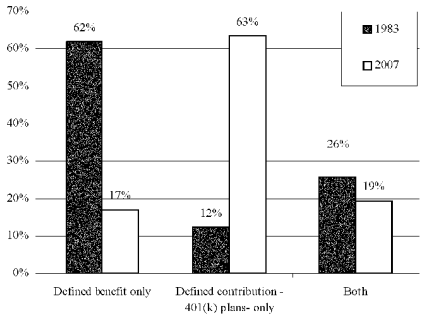
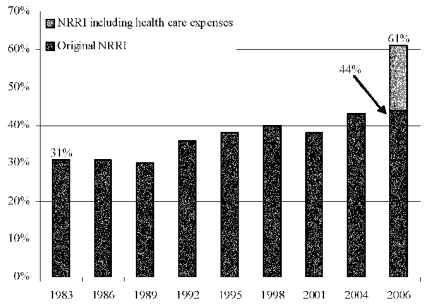
Figure 1. *Percent of Workers with Pension Coverage by Type of Plan from SCF, 1983 and 2007*




Source: Author's calculations based on the 2007 SCF.

Figure 2. *The National Retirement Risk Index, 1983-2006 and 2006 Explicitly Incorporating Health Care*



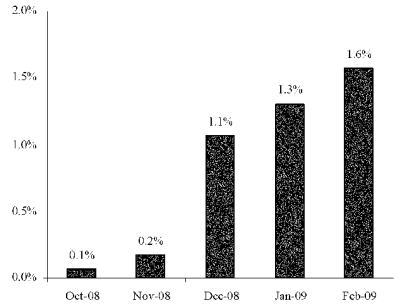

Sources: Munnell, Golub-Sass, and Webb (2007); and Munnell et al. (2008).

Table 1. *Equity Declines October 9, 2007 – October 9, 2008 in Retirement Plans, Trillions of Dollars*

| Type of Plan | 10/9/2007 | 10/9/2008 | Decline |
|---|---|---|---|
| Defined contribution plans | $4.7 | $2.7 | $2.0 |
| IRAs | 2.0 | 1.1 | 0.8 |
| Private defined contribution plans | 2.6 | 1.5 | 1.1 |
| Federal government plan[a] | 0.2 | 0.1 | 0.1 |
| Defined benefit plans | 4.2 | 2.4 | 1.7 |
| Private defined benefit plans | 1.8 | 1.0 | 0.7 |
| State and local plans | 2.4 | 1.4 | 1.0 |
| Total | 8.8 | 5.1 | 3.7 |

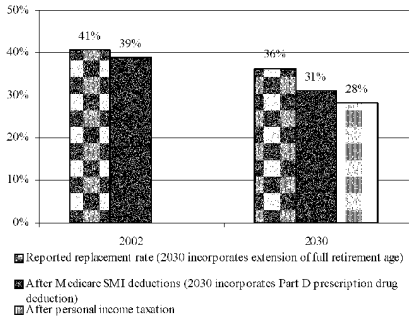
[a]The federal government holdings are those in the Thrift Savings Plan.
Note: Figures may not add to totals due to rounding. Also, this figure varies slightly from that in Munnell and Muldoon (2008) due to changes in the way the Flow of Funds estimates equity holdings and the valuations of firms' market value. Further details can be found in U.S. Board of Governors of the Federal Reserve System (2008).
Source: Author's updates based on Munnell and Muldoon (2008).

Figure 3. *Cumulative Percentage of Private-Sector Defined Contribution Plan Participants Affected by Suspension of Employer Match, 2008-2009*



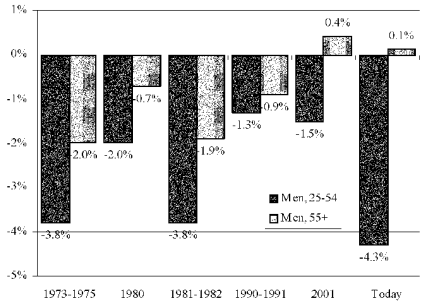

Note: Most participation data are for plan year 2006 – the most recent Form 5500 data available.
Sources: Author's estimates based on U.S. Department of Labor (2006); newspaper articles; and personal communication with companies.

Figure 4. *Social Security Replacement Rates for Average Earner Retiring at Age 65, 2002 and 2030*



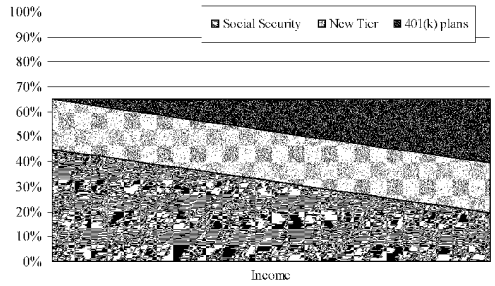

Source: Author's updates based on Munnell (2003).

Figure 5. *Change in Employment to Population Ratio, Men Aged 25-54 and 55 and Older, Recent Recessions and Today*




Note: Data are seasonally adjusted. "Today" covers the period from December 2007-January 2009.
Sources: Author's updates based on Munnell, Muldoon, and Sass (2009).

Figure 6. *Additional Tier of Funded, Privately-Managed Retirement Saving*




Source: Author's illustration.

[1] Munnell and Sundén (2004).
[2] See, for example, Madrian and Shea (2001) and Choi, Laibson and Madrian (2004).
[3] Vanguard (2008); and U.S. Board of Governors of the Federal Reserve System (2007). Focusing on only 401(k) balances understates accumulations because participants often roll money into Individual Retirement Accounts (IRAs). According to the 2007 SCF, median 401(k)/IRA balances for working individuals age 55-64 were $78,000.
[4] As a result, the value of equities in pension accounts declined by almost $4.0 trillion (Munnell and Muldoon 2008). Individuals were sheltered from the immediate impact of the $1.7 trillion of losses in defined benefit plans. But they did experience a direct hit on the $2.0 trillion in losses that occurred in 401(k)s and IRAs.
[5] Fidelity Investments (2007); and Vanguard (2008).
[6] Author's calculations based on U.S. Board of Governors of the Federal Reserve System (2007); and Wilshire Associates (2008).
[7] U.S. Bureau of Labor Statistics (2009).
[8] Fidelity (2009); and Vanguard Center for Retirement Research (2009).
[9] Munnell and Sass (2008).
[10] U.S. Social Security Administration (2008).
[11] For example, a person with eight years to retirement who had been on track to get 50 percent of his retirement income from financial assets would have to raise his saving rate from 6 percent to 21 percent to make up for the drop in the stock market.



Chairman MILLER. Mr. Stevens.

## STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CEO, INVESTMENT COMPANY INSTITUTE (ICI)

Mr. STEVENS. Thank you, Chairman Miller, Ranking Member McKeon and members of the committee. On behalf of the ICI and its members who are entrusted with the retirement savings of 46 million U.S. households, I am pleased to testify this morning.

Let me start out, Mr. Chairman, by joining you in your call to "preserve and strengthen the 401(k) system." Today, half of the nation's retirement assets are invested in DC plans or IRAs. That is more than $8 trillion. And most of those dollars would not have been saved without 401(k)s. In our view, that is just one measure

of the success of the system and on the strong base upon which we have to build.

True, the bear market that we are in is wider, deeper and more unsettling than any downturn in generations. And it has had a significant impact on retirement savings. One large record keeper reports that average balances in defined contribution accounts fell by 27 percent in 2008. These declines are especially hard on workers nearing retirement. But every 401(k) saver, no matter what, takes a deep breath before opening an account statement these days. And I know I am among them.

These declines cannot be traced to any fundamental flaw in 401(k) plans. Balances are down, because the stock market is down. The S&P 500 fell by 38 percent last year. All retirement plans shrank in 2008, not just DC plans, but also IRAs, defined benefit pensions in both the private and public sectors, and the Federal Thrift Savings Plan. There is no shelter from this market storm.

Yet despite these declining balances, working Americans strongly support 401(k)s. We know this, because we examined account records of 22 million DC participants in late 2008. They were not panicking. As of October, only 3 percent had stopped contributing to their accounts. And fewer than one in 25 had taken any withdrawals. Clearly, 401(k) savers are staying the course.

We also surveyed 3,000 U.S. households between October and December. In the teeth of the worst markets in 70-plus years, our survey respondents affirmed their support for 401(k) plans. Almost three-quarters want to preserve the tax incentives of these plans. And more than 80 percent reject the idea that government should take over investment decisions for individuals' retirement accounts.

Now, none of this is to say that 401(k) is a flawless system. In fact, we believe it can and it must be improved. In my written testimony, I spell out seven proposals that ICI believes Congress should consider to strengthen our retirement system.

First, we should improve disclosure, not just about fees, but also as the recent market developments underscore, about risks, about performance and more. ICI began calling for improved disclosure in participant-directed plans in 1976, 5 years before the 401(k) was even born. We have strongly advocated that the Department of Labor complete its comprehensive disclosure agenda. And we thank the leadership of this committee for bringing much-needed attention to this issue.

Second, to help retirees manage their assets more effectively, we should relax the rules on required minimum distributions. The age for RMDs was set at 70½ in 1962. And life expectancies have increased markedly since then. Our research shows that many retirees do not begin to take distributions until they are forced to by these rules.

Chairman Miller and Ranking Member McKeon, among others on the committee, recently worked on a bipartisan basis to suspend these rules for this year. And we should build on that work going forward.

Third, we need to make it easier for employers to diversify participants out of heavy concentrations of company stock as they near retirement. Workers should not have to face the double risk of los-

ing both their jobs and a significant portion of their retirement savings if a single company fails. Some far-sighted employers have proposed plans to help their workers reduce that risk. We should remove the barriers in current law that block these ideas.

Fourth, we should consider requiring all 401(k) plans to use automatic enrollment and automatic savings escalation. Employers have embraced these features rapidly since the Pension Protection Act was enacted in 2006. We need to watch this trend very carefully and consider whether it supports this fundamental change in the 401(k) system.

Fifth, we must make it easier for employers to offer savings plans and for all workers, even those of very modest means, to save for their future. My written testimony suggests two ideas. The first is a greatly simplified employer plan, which could reduce some barriers for employers who want to offer retirement benefits. Second, we suggest a novel proposal for R Bonds, a new series of treasury savings bonds specifically designed to help workers save on a voluntary basis, even if they don't have a plan at work.

Sixth, we must redouble our efforts to provide financial and investor education to all Americans at every age. And this is a job for educators, government at all level, financial institutions like mutual funds, and for that matter, all firms that serve the retirement market.

Lastly, as President Obama has emphasized just this week, we must put Social Security on a sound financial footing for the indefinite future. Social Security has been, and will continue to be, the primary source of retirement income for millions of workers. If Washington wants to bolster confidence in retirement security, it should fix Social Security.

We are pleased to offer these reform proposals for your consideration. I look forward to your questions.

Thank you, Mr. Chairman.

[The statement of Mr. Stevens may be accessed at the following Internet address:]

*http://www.ici.org/statements/tmny/09—house—401k—tmny.html#TopOfPage*

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[An additional submission of Mr. Stevens follows:]

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March 10, 2009

The Honorable George Miller
Chairman
Committee on Education and Labor
U.S. House of Representatives
2205 Rayburn HOB
Washington, DC 20515-0507

Dear Chairman Miller:

At the Education and Labor Committee hearing on February 24, 2009, I relayed some statistics on the percentage of workers who in 1981 (the year Congress created 401(k) plans) received regular income from a private pension and the median amount received in today's dollars among recipients. We would like to supplement the record with additional information.

The numbers I cited were not in our written testimony and were based on my recollection, so I asked the Institute's Research department to prepare information with the latest available data on these statistics and their source. In addition, I focused on the number of Americans who received income from a pension plan in retirement, which is not the same as the number who are covered by a plan, and I believe this may have caused some confusion. The attached paper addresses both issues.

Thank you for the opportunity to supplement the record. If you would like additional information, please contact me or Peter Gunas (202-326-5860).

Sincerely,

Attachment

cc: Honorable Howard "Buck" McKeon, Ranking Member

**Historical Importance of Private-Sector Defined Benefit Plans**

***Coverage***

- In 1981, the year in which 401(k) plans came into existence, 54 percent of private-sector wage and salary workers age 21 to 64 worked for an employer that sponsored a pension plan (Figure 1).
  - The source for these data is the Current Population Survey, a survey conducted jointly by the Bureau of Census and the Bureau of Labor Statistics.
  - Fifty-five percent worked for a firm that sponsored a plan in 1979, the first year the data are available, and 54 percent worked for a firm that sponsored a plan in 2007, the most recently available data.
  - Over this time period, the portion of these workers who work for an employer that sponsors a plan has ranged from 50 percent to 60 percent.

- Among those workers who were active participants in a pension plan in 1981, the majority had a defined benefit pension as their primary pension (Figure 2).
  - Approximately 80 percent of primary plans were defined benefit plans and about 20 percent were defined contribution plans.
  - Of those with a pension, 29 percent had a supplementary defined contribution plan.
  - Over time, the percentage of workers with a primary defined benefit plan has fallen, and the percentage with a primary defined contribution plan has risen. However:
    - It was not the case historically that all participants had a primary defined benefit plan; and it is not case currently that all participants have a primary defined contribution plan.
    - Even in 1981, many active participants had a supplementary defined contribution plan.

***Coverage versus Retirement Income***

- Not all employees who have worked for a firm that sponsored a defined benefit plan would necessarily receive regular income from the plan in retirement.

- Some workers may have left the firm before the benefits were vested.
  - Vesting rules prior to ERISA in 1974 were lenient.
  - In 1974, plans were required to vest benefits at least as fast as either (i) 10-year cliff vesting (i.e., no benefits until 10 years of service, then fully vested thereafter); or (ii) 15-year graded vesting (vested ratably over 10 years from 5 to 15 years of service).
  - In 1986, vesting requirements were tightened to require vesting at least as fast as (i) 5-year cliff vesting or (ii) 7–year graded vesting (vested ratably over 4 years from 3 to 7 years of service).
  - Even long-tenured part-time or part-year workers may not vest in a plan because the rules allow the firm some leeway in defining the number of hours of work during a plan year which would constitute a year of service.

- Even if vested, employees who changed jobs or who separated from an employer for other reasons before normal retirement age may not have earned much in the way of benefits and may have received that benefit as a lump-sum payment at the time of separation.

- In a defined benefit plan where benefits are based on a formula that depends on years of service and final pay (or an average of several years of pay), the accrual of benefits is back loaded.
- For formula-based defined benefit plans, the pension benefits earned in any given year depend on the worker's age and tenure (Figure 3).
  - For example, even for a generous plan in which benefits vest immediately and which has a formula that is 1.5 percent of the average of the highest three years of pay, the value of benefits earned in a given year is less than 10 percent of salary until a worker is in their mid- to late-forties.
  - However, for a worker closer to retirement, the value of pension benefits earned in a given year could reach 50 percent of salary.

- Because of vesting and the pattern of benefit accruals, the bulk of benefits from a typical formula-based defined benefit pension is paid to workers who had long tenure and who separate from the plan close to the plan's normal retirement age.
  - For many, if not most, private-sector firms, these workers have always represented a minority of the workforce.

***Retirement Income***

- The end result is that few workers received regular income from private-sector defined benefit pension plans in retirement.

- In 1981, the year that 401(k) plans were introduced, fewer that 20 percent of individuals age 65 and older who did not work reported regular income from a private pension plan (including both defined benefit and defined contribution plans), and the median benefit was less than $6,000 a year (Figure 4).

- Since 1981, a higher percentage of this group have received payments from private pensions. However, some of this increase is undoubtedly due to the growth in 401(k) plans.
  - ICI survey data indicate that many individuals receive regular income from defined contribution plans and IRAs.
    - Eighteen percent of recent retirees in 2007 with a defined contribution plan annuitized the entire balance at retirement, and another 6 percent took installment payments from the plan.[1]
    - Most of the remaining participants deferred distributions or rolled the money to an IRA.
    - The most common reason to withdraw funds from an IRA is to satisfy annual required minimum distribution requirements.[2]

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[1] For complete survey results, see Sabelhaus, Bogdan, and Holden, *Defined Contribution Plan Distribution Choices at Retirement: A Survey of Employees Retiring Between 2002 and 2007*, Washington, DC: Investment Company Institute (Fall 2008), available at www.ici.org/pdf/rpi_08_decdd.pdf.

[2] For more information on IRA owners and their withdrawal activity, see Holden and Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement, 2008," *ICI Fundamentals*, vol. 18, no. 1 (January 2009), available at http://www.ici.org/pdf/fm-v18n1.pdf.

  - Even in 1981, some of the regular payments received from private pensions were certainly from defined contribution plans.
  - The percentage of regular payments from defined contribution plans has likely increased over time.

- Including regular payments from both defined benefit and defined contribution private pensions, from 1975 to 1995, median annual private pension income fluctuated between $5,000 and $6,500 in 2007 dollars. Only in the past decade or so did median private pension income increase to above $6,500 in 2007 dollars.

***Government Pensions***

- Government pensions are also an important source of pension income.

- In 1981, the year that 401(k) plans were introduced, about 10 percent of individuals age 65 and older who were not working received regular income from a government pension (Figure 5).

- The median amount of annual income from government pensions in 1981 was over $10,500 in 2007 dollars.

- Individuals receiving government pensions typically had lower Social Security benefits than other similar individuals because government workers typically were not covered under Social Security.

***Historical Importance of Defined Benefit Pension Plans***

- Looking at all sources of income in retirement, the historical importance of private-sector defined benefit plans is often overstated.

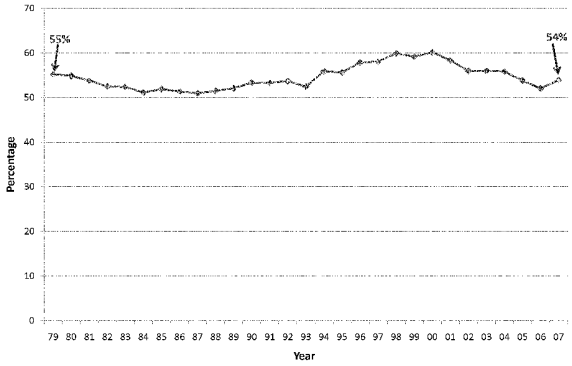
- In 2007, among individuals age 65 and older who were not working, as a group, 53 percent of their income came from Social Security benefits (Figure 6). Only about 14 percent was from private-sector pensions of all kinds (that is, both defined benefit and defined contribution), and only about 12 percent was from government pensions.

- The story has changed little over the past three decades. Social Security has always been the most important source of income. The percentages were roughly the same in 1975.
  - The contribution to income of both private and government pensions has increased over time.
  - The share of income from assets has fluctuated over time, as interest rates are a primary driver of asset income.
    - Asset income includes interest, dividends, and rents.
    - It does not include capital gains, realized or otherwise.

- Looking at the population ranked by income, the bottom half of the income distribution received over 85 percent of their income in the form of Social Security benefits and public assistance in 2007 (Figure 7). In 1975, these statistics were essentially the same.

**Figure 1: Percentage of Workers Whose Employer Sponsors a Retirement Plan**

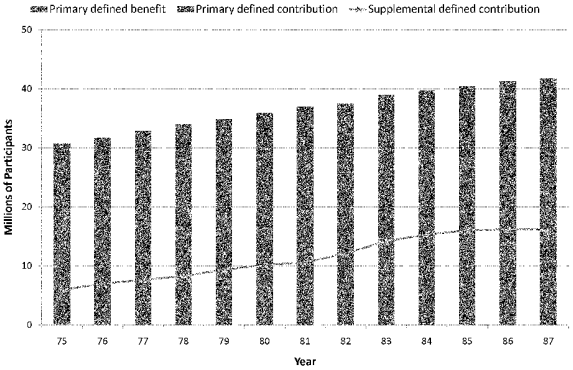
Private-sector wage and salary workers, age 21 to 64, 1979 to 2007




* Retirement plans include both defined benefit and defined contribution pension plans.
Source: ICI tabulations of March *Current Population Survey*

**Figure 2: Active Pension Plan Participants by Type of Pension Coverage**

Millions of participants, 1975 to 1987




Source: U.S. Department of Labor, *Trends in Pensions 1992*, p.86, Table 4.10

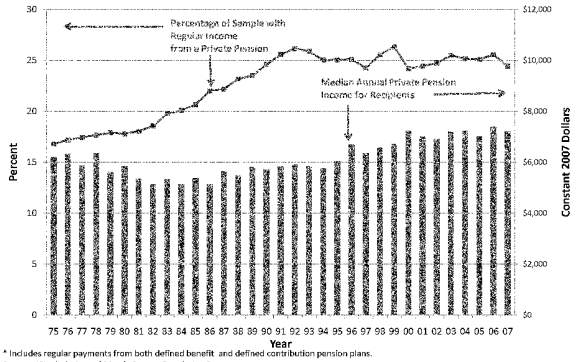
**Figure 3: Benefit Accrual under Defined Benefit Pension by Age and Age at Start of Continuous Employment**

Formula: 1.5% per year up to 30 years; average of high three years of salary; vest immediately
Assumptions: annual inflation 3%; annual increase in real earnings 1%; future liabilities discounted at 6%

Source: ICI calculations

**Figure 4: Percentage of Individuals Receiving Regular Income from a Private Pension* and Median Amount among Recipients**

Among individuals age 65 and older with non-zero income and not working, 1975 to 2007




* Includes regular payments from both defined benefit and defined contribution pension plans.
Source: ICI tabulations of March *Current Population Survey*

**Figure 5: Reciept of Regular Income from Private and Government Pensions***

Among individuals age 65 and older with non-zero income and not working

All dollar amounts in constant 2007 dollars

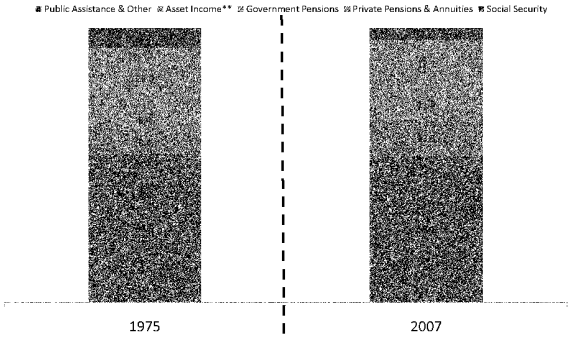
| | With Private Pension Only | | | With Government Pension Only | | | With Both Private and Government Pension | | |
|---|---|---|---|---|---|---|---|---|---|
| Year | Percent of Sample | Median Pension | Median Pension plus Social Security | Percent of Sample | Median Pension | Median Pension plus Social Security | Percent of Sample | Median Pension | Median Pension plus Social Security |
| 1975 | 16.0% | $6,359 | $18,668 | 8.1% | $11,589 | $19,875 | 0.8% | $9,635 | $23,571 |
| 1976 | 16.4 | 6,494 | 18,231 | 8.1 | 13,009 | 21,671 | 1.0 | $7,652 | 23,733 |
| 1977 | 16.4 | 6,142 | 17,963 | 8.2 | 12,317 | 21,213 | 0.9 | $12,482 | 25,959 |
| 1978 | 16.7 | 6,487 | 18,483 | 8.2 | 11,448 | 20,222 | 0.7 | $12,402 | 26,471 |
| 1979 | 17.2 | 5,712 | 17,256 | 9.0 | 10,967 | 18,715 | 0.6 | $12,549 | 25,958 |
| 1980 | 17.2 | 5,888 | 17,511 | 9.4 | 11,077 | 18,980 | 0.6 | $12,290 | 24,207 |
| 1981 | 17.5 | 5,385 | 17,436 | 9.5 | 10,511 | 19,007 | 0.7 | $10,821 | 22,833 |
| 1982 | 17.8 | 5,157 | 17,621 | 9.8 | 11,089 | 20,201 | 0.8 | $12,307 | 24,999 |
| 1983 | 18.9 | 5,404 | 17,916 | 10.1 | 12,690 | 21,783 | 1.0 | $12,466 | 25,930 |
| 1984 | 19.1 | 5,189 | 17,817 | 10.7 | 12,464 | 20,942 | 0.9 | $13,025 | 26,797 |
| 1985 | 19.7 | 5,478 | 18,214 | 10.4 | 12,186 | 21,093 | 1.0 | $11,668 | 25,451 |
| 1986 | 21.0 | 5,242 | 18,398 | 10.1 | 12,864 | 21,839 | 1.1 | $12,516 | 25,449 |
| 1987 | 21.0 | 5,720 | 18,716 | 12.6 | 13,141 | 20,579 | 0.9 | $18,670 | 28,915 |
| 1988 | 22.2 | 5,531 | 18,256 | 12.4 | 12,977 | 21,032 | 1.2 | $16,403 | 26,383 |
| 1989 | 22.3 | 5,817 | 18,393 | 12.8 | 12,501 | 20,090 | 1.3 | $17,096 | 29,464 |
| 1990 | 23.2 | 5,749 | 18,353 | 12.6 | 13,326 | 21,142 | 1.3 | $15,832 | 27,497 |
| 1991 | 24.4 | 5,937 | 18,341 | 12.7 | 12,879 | 20,538 | 1.1 | $16,423 | 27,442 |
| 1992 | 25.1 | 5,969 | 18,621 | 12.1 | 13,513 | 21,577 | 1.1 | $13,335 | 26,035 |
| 1993 | 24.7 | 5,935 | 18,695 | 12.0 | 14,205 | 22,235 | 1.1 | $16,283 | 28,698 |
| 1994 | 24.0 | 5,862 | 19,057 | 11.4 | 14,271 | 23,069 | 1.0 | $19,122 | 28,291 |
| 1995 | 24.0 | 6,249 | 19,283 | 11.3 | 14,143 | 23,054 | 1.1 | $15,412 | 27,103 |
| 1996 | 24.2 | 6,740 | 19,592 | 10.7 | 15,847 | 23,953 | 0.9 | $17,688 | 32,215 |
| 1997 | 23.1 | 6,356 | 19,924 | 12.0 | 14,856 | 23,933 | 1.1 | $20,664 | 32,102 |
| 1998 | 24.3 | 6,518 | 19,855 | 10.9 | 16,536 | 24,957 | 1.2 | $23,446 | 34,250 |
| 1999 | 25.5 | 6,747 | 20,393 | 11.0 | 16,114 | 24,674 | 0.8 | $18,071 | 32,192 |
| 2000 | 23.3 | 7,224 | 20,770 | 11.5 | 15,749 | 24,480 | 0.8 | $18,899 | 32,445 |
| 2001 | 23.5 | 7,025 | 20,470 | 11.3 | 14,752 | 24,024 | 1.0 | $18,123 | 29,854 |
| 2002 | 24.0 | 6,915 | 20,123 | 11.3 | 16,154 | 25,642 | 0.7 | $19,155 | 32,156 |
| 2003 | 24.5 | 7,343 | 21,077 | 11.3 | 16,227 | 25,539 | 1.0 | $19,932 | 33,923 |
| 2004 | 24.4 | 7,244 | 20,918 | 11.5 | 17,123 | 26,081 | 0.8 | $16,464 | 30,953 |
| 2005 | 24.3 | 7,007 | 20,832 | 12.0 | 15,925 | 25,480 | 0.8 | $19,369 | 30,480 |
| 2006 | 24.7 | 7,405 | 20,938 | 11.5 | 14,810 | 25,122 | 0.9 | $18,920 | 32,428 |
| 2007 | 23.8 | 7,200 | 21,522 | 11.0 | 16,260 | 25,800 | 0.7 | $19,520 | 32,880 |

* Includes regular income from both defined benefit and defined contribution pensions.

Source: ICI tabulations from March *Current Population Survey*

**Figure 6: Social Security Is the Primary Source of Retirement Income**

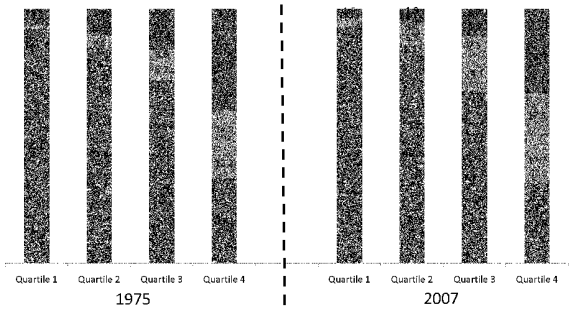
Percentage of total income by source, individuals age 65 and older with non-zero income and not working,* 1975 and 2007




* For married couples, neither individual nor spouse worked.
** Includes interest, dividends, and rents.
Source: ICI tabulations of March *Current Population Survey*

**Figure 7: Lower Income Particularly Reliant on Social Security**

Percentage of total income by source by income quartile,* individuals age 65 and older with non-zero income and not working,** 1975 and 2007




* For purposes of ranking by income, income of married couples is pooled and each spouse is allocated half of total income, as well as half of income from each source.
** For married couples, neither individual nor spouse worked.
*** Includes interest, dividends, and rents.
Source: ICI tabulations of March *Current Population Survey*

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Chairman MILLER. Thank you very much.

And thanks to all for your testimony.

Mr. Bogle, I am sure that I have probably been misquoting you. But I have suggested that you have raised the issue saying that the issue for investors and savers is a competition between the miracle of compounded interest and the tyranny of increasing cost. And that suggested to me that you believe that costs do matter in the long-term management of people's retirement savings. Is that a fair statement.

Mr. BOGLE. Yes, sir, Mr. Chairman. That is a very fair statement. And as far as I can tell you, there is not a single academic

study that does anything but reaffirm that point. There is not a single independent financial publication, say Morningstar, for example, that doesn't affirm it in spades. It is basically universally true.

What I would add is, however, of course we need better disclosure of costs for employers and employees alike, because costs are the reason that the returns of institutions and the returns of all investors as a group fall short of the returns earned by stock funds and bond funds, as I said in my testimony.

What I want to emphasize, though, is that we seem to be relying on the fund's expense ratio, its expenses as a portion of the asset as the talisman, or it is the standard of what costs are. And those costs run somewhere between eight-tenths of 1 percent to 1.3 percent a year. That number, Mr. Chairman, grotesquely understates the total amount of costs involved in mutual funds, even when you don't talk about sales loads, which are largely outside of the large retirement plan arena, however are very tough on some of the smaller retirement plans.

And the other cost, which is huge, is the substantial undisclosed transaction cost that mutual funds in particular incur, reflecting the rapid turnover of their investment portfolios. It is absolutely amazing, sir, how these portfolios turn over, because the mutual fund industry, it seems to me on the data, has become an industry engaged in short-term speculation rather than long-term investment.

Chairman MILLER. This is the activity within the funds that you might——

Mr. BOGLE. Funds buying——

Chairman MILLER [continuing]. Invest in as your 401(k) plan in. You are talking about the internal management——

Mr. BOGLE. I am talking about the——

Chairman MILLER [continuing]. Of the shares within that fund.

Mr. BOGLE. And just think about this. The average assets of actively managed funds last year were something in the realm of $4.8 trillion. And the total transactions, just guess at what the total transactions, members of the committee and Chairman, might be in your mind. And I will tell you what it is.

They bought and sold $7.2 trillion dollars with the securities, trading by and large back and forth with one another. So the elephant in the room, if you will, is the ignoring of transaction costs, which have a huge impact, something like half a percent to 1 percent a year in addition to that expense ratio, which is—for the fun of it, we will call 1 percent for the actively managed equity fund.

So now, think about this. And an index fund, of course, goes for about one-twentieth of that 2 percent, because it—transaction costs, nor management fees, but overall expenses of about a tenth of 1 percent compared to 2 percent for the industry.

Now, think about this when you get to compounding this. And this is the point which you quote me, sir, accurately. And that is the miracle of compounding investment returns turns out to be overwhelmed by the tyranny of compounding cost.

Let us assume, just for the fun of it, counting a stock-and-bond portfolio together, that it earns over the next 10 years, let us say, 6.5 percent. That is phenomenal return. If we assume 2.5 percent

inflation, just a guess, but probably not one with which most people in the room would disagree, that leaves you with a 4 percent real return on a balanced investment portfolio, of which costs are consuming 2 percent. Costs are taking half of the real return.

But of course, given that formulation, it is much worse than that, because if you compound 2 percent and 4 percent over an investment lifetime, call it 50 years, you find that costs have consumed 75 percent of the return of the investment.

So you, the investor, who puts up 100 percent of the capital and takes 100 percent of the risk gets 25 percent of the market return. That just doesn't seem right to me, sir.

Chairman MILLER. Well, I obviously agree with you. You know, I have always been stunned at whenever you allocate these costs, and people can argue whether 1.5 percent or 2 percent or what is fair and all the rest. And then the internal transaction costs that are taking place within the investment programs that people purchase, the only source of all of that revenue is my retirement.

You know, American families make a decision. And it is very difficult for the huge middle-class families in this country, that huge class of people, to make a decision after all of their other obligations, to also save. And yet, that is the source by which all of these trillions of dollars in transactional fees and others is from. Nobody else is contributing that.

There was a while, and it was fairly common, that we shared that with the employer. But now the employers have figured out that that should be offloaded more and more onto the employees if they are managing the funds and on individuals.

And so, you know, I am very jealous. I know how hard people in my district work to create a little bit of savings. And I know, as Dr. Munnell has pointed out, how small their total savings are. And if you combine that with what Dr. Baker said in terms of what they thought was going to be an equity account that they had, but they made choices, some good, some bad.

We are talking about a population that is in a desperate situation. And I don't think we can tell the next generation of savers that they would want to put their savings at that same risk with respect to cost. Somehow we have got to figure out that the idea of these savings makes sense to the American public to make the determination that they want to participate.

But the struggle, the incredible struggle and the energy put into fighting against that transparency is just really quite phenomenal, you know, really quite phenomenal. But we will continue on down this path.

I just would like to ask, if I might, Dr. Munnell, one question in this round of my questioning. You had mentioned that you would like something like the Thrift Savings Plan. But we could be more creative. What are you talking about?

I will come back to you in the second round. But I just wanted to put that on the table.

Ms. MUNNELL. There is enormous trade-off between the contribution people have to make and the rate of return they earn. And the question is can you ensure people higher returns. And so we have really been looking into this issue of guarantees, which is a very tough subject, because what you can do according to standard fi-

nance theory, if the insurer has the same preference as the market, it is very modest. And insuring 2 percent real rates of return really would have done nothing over the last 84 years.

And the question is can you somehow construct higher level of guarantees or different ways of risk-sharing. But it is not something you want to do casually. But it is really worth looking into.

Chairman MILLER. I see. Okay, I just want to know what the parameters of that discussion were.

Ms. MUNNELL. Right.

Chairman MILLER. Thank you.

My time has expired. I just want to know, Congressman Hare finally showed up a little late to this hearing. You would think that someone who just turned 60 would be here early to figure it out.

But anyway, happy birthday.

Mr. McKeon.

Mr. MCKEON. We did that in lieu of singing happy birthday, I guess. He may not be so happy when he is done with the hearing. He is worried.

I really appreciate your testimony. One of the things that, whenever we talk about this subject, one of the things that really bothers me is, I think Dr. Munnell you made the point that sometimes we make bad decisions. I think human nature seems to be that we always go for the maximum possible return, thinking that that will always be there.

I remember talking to a golf pro one time. And he said every shot, it seems like, we hope is going to be the best shot we ever make. And I think sometimes we plan our future retirement on that basis. That is, I guess, why gambling casinos are doing so well. People go there always expecting to win. And in our retirements, we expect that we maybe can lose a little bit here, because we are always going to make it up on the big play.

And I am wondering how much responsibility the federal government should take in protecting people from bad decisions. Do we have the ability, being that we are all very intelligent, smart here, now that we have been elected to Congress, to avoid all of those bad decisions. And you can see how successful we have been lately.

Mr. Stevens, my understanding is that the mutual fund industry holds about half of the assets in 401(k) plans, which means about half of those assets are held somewhere else. Can you tell us where the other half are, and how those plans have suffered as a result of the financial downturn? How bad is how they have been affected?

Mr. STEVENS. Thank you, Mr. McKeon. Yes, it is true. Mutual funds are an important component of the system. But if you look broadly, there are different types of retirement plans, including defined benefit plans who have been hit, as my testimony describes. But there are also other components of the 401(k) system and of individual retirement accounts, which are not mutual funds.

We are sometimes frustrated, because we are such a large component, that we are sometimes identified as the entire system. But you have to consider, for example, products that are sponsored by insurance companies, by banks and other financial institutions that are part of the system as well. It is one of the reasons frankly that we have emphasized from the very beginning the need for a disclo-

sure regime that extends to all investment options that a 401(k) participant might be able to invest in in their plans.

We have lived under the regime of the Securities and Exchange Commission throughout our history, since 1940. And I think whatever deficiencies people might think there are, we have as comprehensive a set of disclosures on virtually every subject, more so than any other financial product.

We have been saying for years that we ought to bring the other components of the system up to something that is comparable. And that has been a very important part of our public policy emphasis now for 33 years. It is certainly gratifying to us to think that that might begin to be the case.

Certainly we are more than happy to talk about mutual funds. But let us not confuse mutual funds with the entire defined contribution system.

Mr. MCKEON. Thank you.

Dr. Baker, you mentioned something at the end of your statement about we should have another kind of a defined benefit of $1,000. And there would be no cost to the government. How would that work?

Mr. BAKER. Well, the point here, and I think I am thinking along similar lines to Dr. Munnell, that if we established in effect an expanded defined benefit building on Social Security, where workers would contribute voluntarily, perhaps with some strong-arming by some automatic contributions and default—I should say, default contributions and perhaps subsidies for low-income workers, that we could have an additional amount put aside targeting, say, $1,000 a year, which would be a modest increment to a higher-income worker, but would be fairly large for, say, a more moderate income worker, where we would guarantee somewhere perhaps 3 percent being a little more ambitious than the 2 percent we overturn, that could provide a very substantial supplement to——

Mr. MCKEON. Excuse me. The worker would contribute $1,000.

Mr. BAKER. Yes, in the government-managed account, which would then be invested privately similar to the thrift savings plan.

Mr. MCKEON. And who would guarantee the 3 percent?

Mr. BAKER. The government would provide the guarantee. So the government would be taking some risk. But again, I would just contrast that to the, in effect, guarantee we have given to the bond holders of corporations like Bear, Stearns and AIG, where that is being very costly to the taxpayer. And there were certainly no commitment on the part of the government to make those bonds good in advance.

Mr. MCKEON. Sometimes we go through periods of growth. Sometimes we go through periods like we are in right now, where things really collapse. How would the government guarantee that 3 percent without any risk to the taxpayer?

Mr. BAKER. Well, I should not say that it is no risk. But it is a very, very modest risk. So if you had a portfolio that was, say, 60 percent equities, 40 percent other, you know, bonds, mutual funds, that, over a long period, there would be very limited risk that you would——

Mr. MCKEON. How would that vary from Social Security?

Mr. BAKER. Well, the difference is that it would be defined contribution, that people would voluntarily be putting their money in there. So if they didn't want to do it, they wouldn't have to.

Mr. MCKEON. Whether they put the money in, or whether the government puts the money in now for Social Security.

Mr. BAKER. Well that is, as you know, that is mandated. In this case, it would be voluntary.

Mr. MCKEON. I see. And then all it takes——

Mr. BAKER. So again—that is strongly encouraged.

Mr. MCKEON. Why not make it mandatory if it is not——

Mr. BAKER. Well, again I——

Mr. MCKEON. Why not just increase Social Security deductions?

Mr. BAKER. Well, that is something that I think would be reasonable to consider. But I think, in this case, it is not a tax. If you do not want to pay it, you don't have to pay it. So we could have a default.

Mr. MCKEON. But then don't we get back to where we are right now?

Mr. BAKER. Well, I think——

Mr. MCKEON. Some people are going to live forever, and are going to hit the big jackpot at some point. And they don't need to worry about it until, you know, they get to be about 55.

Mr. BAKER. Well, in this case, the 3 percent real return should be consistent with what the financial markets can give over the long term. When I was saying that there could be some risk, we could have a prolonged period, as we may have now, of a down stock market, in which case it would involve some modest commitment for the government.

Mr. MCKEON. A couple of years ago, it would have been great.

Chairman MILLER. I did. And I am—this hearing is going to end at 12:30. So we will try to limit going over now that Mr. McKeon and I have gone over.

Mr. MCKEON. I yield back.

Chairman MILLER. Mr. Payne.

Mr. PAYNE. Thank you very much. It is a very important hearing. Just looking over some of the notes that the cumulative decline in the value of the financial assets as a result of the current economic crisis cost Americans almost $2.7 trillion in their retirement savings. As we remember years ago, the defined contribution plans were really what was in. And the defined benefit was less popular.

Of course, when employers started to end their defined benefit plans, the old-type retirement that, you know, I used to hear my father talk about, we saw a shift, even in the 1980s. 60 percent of workers were covered by defined pension plans and 17 percent by their defined contribution 401(k)-type. However, just 20 years later, only 11 percent of the workers are covered by defined benefit plans. And 56 percent, almost 60 percent, by the defined contribution plans.

Now, if we are having the problem with the market, you know, I guess my question, maybe Dr. Baker might take it. I don't believe that policymakers ever intended that the ability of a worker to retire would depend on whether the stock market was up or down in a particular year. How can we modify the 401 plan, so that work-

ers' ability to retire is not dependent on the state of the stock market.

You know, like I said, years ago you had that guarantee coming out. The check would come each month, like Social Security, more or less. But how is the future? It looks bleak right now. My colleague said that we have ups and downs. Look like this down is pretty down and going to be down for a while, maybe not out, but a nine count. And maybe like the Dempsey fight, we are trying to have a long count to not call 10. We don't want the knock-out.

So what do you think, Dr. Baker?

Mr. BAKER. Well again, I agree with you completely that we have subjected workers to much greater risk than I think any of us realized and certainly that they realized. And I was making the point that, in addition to their retirement wealth, they also had their housing wealth at risk as well.

So that is why I was thinking that, given the circumstances, I think it does make sense to talk about having some additional guaranteed benefit that could be available to workers. Again, it is possible you would want to look to expand Social Security. I think that is a reasonable thing to consider.

But I think to allow workers the opportunity to invest voluntarily in an account that will give them a guaranteed return, I think would be something that would be of enormous value to the country's workers at very low risk. Again, I can't say no risk, sir, but very little risk to the government. I think it is a case where the trade-offs, I think, are very much in favor of offering that sort of guaranteed benefit.

Mr. PAYNE. Thank you very much.

Well, since the chairman is trying to rush through, I will stop with the one question. All right.

Chairman MILLER. I thank the gentleman. His time has expired.

Mr. Kline.

Mr. KLINE. Thank you, Mr. Chairman.

Thank you, lady and gentlemen, for being here with us today. A tremendously important subject, and of course now we are all looking at it, I think, much differently even than we did a year ago.

We all, Mr. Stevens, look at our account statements with some trepidation now. I make my wife read them myself. It works in our house.

I am a little bit intrigued. And I am tempted to get in the whole discussion sort of suggested by Dr. Baker. And that is doing something to kind of shore up Social Security, which I think he is suggesting an additional voluntary effort to put money in, maybe $1,000 that we guarantee by the government. That is a very interesting idea, and one which I certainly wouldn't reject out of hand.

But I am very concerned that one of our pillars here that we are looking at is Social Security, and it is Medicare. And by every measure by anybody, we are some $50 trillion or more underfunded in those programs. So I am just kind of reluctant to turn in that direction very hard.

Because I don't have much time, let me go to Mr. Stevens. According to the note I have here, and I remember saying this. Professor Munnell notes that, during this crisis, we have had about 2 percent I think of 401(k) plan participants have made hardship

withdrawals from their 401(k). Can you tell me, looking at the industry from your perspective, how does that number compare historically to plan withdrawals?

Mr. STEVENS. Thank you, Congressman. As I indicated in my testimony, when you actually look at behaviors in the major record-keeping systems, they are very much at the norm that we would have predicted historically, very little increase in hardship withdrawals. People are not massively taking loans against their accounts. They seem to have an understanding that these are assets that are there for their retirement with some kind of mental accounting.

In fact, I would say in general, there is a tendency to look at 401(k) investors like their children who don't know what they are doing. And in fact, if you look carefully at their behaviors, they are much more grown up than sometimes they are given credit for.

Mr. KLINE. They probably let their wife do it too. The Thrift Savings Plan has been used as an example a number of times as an investment plan with relatively low expenses. We have talked about in the last Congress. I just want to sort of bring us up to date here. Again, going to Mr. Stevens, tell us how it is possible for the Thrift Savings Plan to operate at what seems to be very low expenses. And in general, can you speak to the performance of funds in the TSP during this crisis?

Mr. STEVENS. Yes. Well, as I said, the Thrift Savings Plan's funds have been hit like all others. There has been no shelter from the storm in the market. But the TSP really doesn't compare to the private retirement system. And I think this is a very important point to make.

The TSP is about seven times larger than the largest defined contribution plan in the United States. If memory serves, I think it only has about three payrolls, large payrolls, that it has got to process. There may be a number of other smaller ones.

But you compare that with the literally hundreds of thousands of different payroll systems and therefore record-keeping requirements that exist in the private sector. You don't get remotely the economies of scale.

It is also true that virtually none of the compliance and regulatory and reporting and other burdens that exist for sponsors of 401(k) plans exists for the federal government. Those requirements have been waived with respect to the Thrift Savings Plan. Not so with respect to any employer, no matter how small. And remember, most of the employers in 401(k)s have 100 employees or less. So we are talking about relatively small businesses.

And then, you know, it is simply true that some of the costs of the Thrift Savings Plan are not apparent. I am a former federal employee. There are federal personnel offices up and down every department and agency of government who support the Thrift Savings Plan. And I have never seen an estimate for what their cost is. And it is not reported as an additional cost to the saving of the system. You could think of that as corresponding to any number of activities that have to take place to support 401(k) plans.

So I think it is even more remote than comparing apples with oranges and just doesn't provide an appropriate frame of reference in

which to think about cost factors in the 401(k) system by any means.

Mr. KLINE. Thank you very much.

Mr. Chairman, I yield back.

Chairman MILLER. Mr. Andrews. And I want to say that the witness is not just to do on Mr. Andrews' time. But to the extent you think you want to say something in response, and you can politely figure out how to do that, you are more than welcome to do that.

Mr. Andrews.

Mr. ANDREWS. Thank you.

I thank the panel for very, very good testimony that is going to help this process considerably. You know, this hearing would be compelling under any circumstances. But it is particularly compelling when we look at the real pain and anxiety that people all across this country are feeling, that is subsumed in that $2.7 trillion loss of pension assets.

But we are not here to comment on the size of that loss. We are here because our hypothesis here is that, because the 401(k) system, the DC system, is in need of reform, the loss is worse that it would have otherwise been. And when things get better, the recovery won't be as good as it would otherwise be. So this hearing would be timely whether people had gained $2.7 trillion or lost $2.7 trillion. And that is what I want to focus on, is those reforms that I think could make the DC system better.

Mr. Stevens, one thing I want to ask you. On page 5, you have a graph, which shows declines in asset values. And it shows that 401(k) plans have declined 10.9 percent. The S&P 500 declined 19.3 percent.

But I do want to understand, though, as you point out that that includes the contributions that were made to the 401(k) plans. Correct?

Mr. STEVENS. Actually, Congressman, the graph on page 5 is intended to depict as of the third quarter of 2008.

Mr. ANDREWS. Yes.

Mr. STEVENS. The depreciation that different types of retirement plans——

Mr. ANDREWS. But that depreciation takes into account the contributions that were made to 401(k) plans. It is not simply their performance net of contributions. Correct?

Mr. STEVENS. Yes, I think that is correct.

Mr. ANDREWS. Okay. So we are really not comparing apples to apples when we look at the S&P return and the contribution returns. Let me ask you this question to supplement the record. If you could supplement for the committee what that number would be, if you subtracted the contributions were made and just looked at the performance of the fund as it exists in the prior period, we would appreciate that. I think that would clarify the situation.

I notice on page 9, in footnote 19 I believe it is, I am encouraged by your—see, in law school, they teach you always to read the footnotes.

Mr. STEVENS. They do indeed.

Mr. ANDREWS. So I am encouraged by the fact that I think you have extended an opportunity to work with the chairman and with all of us and the work that we did in the last Congress when you

say: We agree with the approach taken by the bill reported out of the committee in the last Congress, names the bill, and similar proposals ensuring the disclosure rules apply equally to all products offered by 401(k) plans.

I agree with that. And we would invite your participation as we try to craft good rules that make meaningful disclosure to all participants about all assets. And we appreciate you making that comment.

Mr. Bogle, I was taken by much of what you had to say. We appreciate the tremendous contribution you have personally made in this area and your firm has made. Your third recommendation, which is the inclusion of some sort of annuity product as an option, are you advocating that each plan should be required to offer an annuity product as an option?

Mr. BOGLE. Each plan, I think, certainly should offer it. And the question is to what extent one should make it mandatory. The idea of locking in or locking out, I guess one would say, longevity risk, seems to me to be a fundamentally good idea.

Mr. ANDREWS. Do I understand your proposal correctly that what you are proposing is that certain participants would have a certain percentage of their assets put in that annuity-type plan, unless they opted out. Is that your proposal?

Mr. BOGLE. That is correct.

Mr. ANDREWS. Okay. Could you describe to us what the annuity product would look like and how it might be designed?

Mr. BOGLE. Well, like the mutual fund industry, the annuity industry takes huge amounts of cost. Out of the returns, you get marketing cost and administrative cost and investment cost. So most annuities are not particularly attractive to a—so we need a better system.

I would argue, I think, that—not I think, I know, that TIAA-CREF, for example, has one of the outstanding annuities in the country, very low cost. But it stands almost alone, because the annuities have to support this big marketing system. I don't see any reason that some governmental or quasi-governmental agency couldn't provide just an actuarial based annuity, but without all those costs in it.

And the whole idea is to take the cost out, because that is so fundamental to everything we do in retirement savings.

Mr. ANDREWS. Dr. Mussell [sic], would you care to comment on whether you think that there should be a fixed asset annuity-type option included in every plan? Do you think that should be?

Ms. MUNNELL. I think that we are really going to face, even if we didn't have this impact of this financial crisis, that we were going to see a crisis when people retired with 401(k) balances, because it is really hard to figure out how to drawn down that money over unknown lifespan. And so——

Mr. ANDREWS. But do you think we should require such a——

Ms. MUNNELL. I think it should be a default in 401(k) plans. It is not as obvious as automatic enrollment. But I think it is the better option to have the default be an annuity. And then people can back out.

Mr. ANDREWS. So I just may ask one more quick question. There is a subtle difference between a default position and an option that must be offered, right?

Ms. MUNNELL. If you just offer it as an option, no one will take it. People hate annuities. So I think——

Mr. ANDREWS. Not everyone.

Ms. MUNNELL. I think you put them in. You let them try.

Mr. ANDREWS. Okay.

Ms. MUNNELL. And then if they don't like it, they can go to their HR people and get out. But that is where you put them.

Mr. ANDREWS. Thank you very much.

Chairman MILLER. Mr. Castle.

Mr. BAKER. I think if I could state quickly, I think your question was whether it should be mandated. And I think we had agree that every plan should offer that at least as an option.

Mr. ANDREWS. Okay.

Ms. MUNNELL. No, I would say something——

Mr. ANDREWS. Well, I think, yes. I think the Boston College folks wanted to be a QDIA-type, a default, but not offered as an option per se. is that what you are saying?

Ms. MUNNELL. I am saying every plan should have it. And——

Mr. ANDREWS. Right.

Ms. MUNNELL [continuing]. Put everybody in it when they retire. And then people can say oh, this isn't right for me. I have cancer.

Mr. ANDREWS. So if you don't pick a vegetable, it has to brussel sprouts. Okay.

Chairman MILLER. Mr. Castle, help us.

Mr. CASTLE. Good luck. Thank you, Mr. Chairman.

Dr. Munnell and Mr. Stevens, you both mentioned the fact, something to the effect of we have to shore up or firm up Social Security. We in Congress say this on a daily basis in speeches we give or whatever. And then it gets down to the specifics of how do we do this? I realize that is a little beyond perhaps the context of this meeting. But you mentioned it. And I would be curious as to whether you have any specific ideas about how to so-called shore up Social Security.

Ms. MUNNELL. Shore up Social Security. People say oh, we can do some with tax cuts, benefit cuts, and some with tax increases. Social Security replacement rates are going down under current law as the normal retirement age goes from 65 to 66 to 67. For people who continue to retire at 62, you are going to see very low levels of replacement. And they do tend to retire at 62.

So I think that anything that cuts benefits any further is really dangerous and is going to put people at risk. But there is no free lunch. I don't think people are going to grow ourselves out of it. So that means more revenues in somehow.

And, you know, you put in the estate tax. I would change the COLA. I would actually index the full retirement age to longevity, and then maybe put in some more payroll taxes.

But I think it is important to maintain it as the backbone of our retirement income system. We have seen that we really need it. And we should do what we have to do to fix it.

Mr. CASTLE. Thank you.

Mr. BAKER. If I could quickly point out the small free lunch.

Mr. STEVENS. I think that I was asked the question as well, if I could respond.

Mr. BAKER. Okay.

Mr. STEVENS. We do not have a plan to fix Social Security. I consider it a bit above our pay grade. I would say that we have never supported the idea of private accounts in Social Security. We believe that the Social Security system should essentially stay the system that our grandfathers knew and grandmothers. It is the best inflation-adjusted annuity that anyone will ever, ever receive. And it ought to be maintained as such.

Among individuals who are over age 65 and who are no longer working, the bottom 50 percent ranked by income get 86 percent of their income from Social Security. That is not new. That has been the same since 1980. And it is very important to maintain that stability of income and replacement value for the lower income workers in the United States.

Mr. CASTLE. Thank you.

Mr. Baker, do you wish to comment on that?

Mr. BAKER. Yes, very quickly. Just the sort of pseudo-free lunch I was going to refer to is that one of the problems facing the program was that we had an increasing portion of wage income going over the wage cap as there had been an upward redistribution of income over the last 30 years.

There is early evidence thus far that that redistribution is being reversed. In other words, there has been a big increase in wages for those at middle and bottom. If that persists, then we don't have enough data yet to say that will be true. If that persists, that will substantially reduce the projected shortfall in the program, since more income will be subject to the tax. A larger portion of wage income will be subject to the tax.

We don't know that will stay the case. But at least, thus far, it looks like that was one outcome of this crisis.

Mr. CASTLE. I hope you are right. Although the crisis makes me nervous, perhaps that is not going to happen. But let me ask you another question, Mr. Baker. I think you said that the Federal Reserve should combat asset bubbles. Is that correct? And if so, how should the Federal Reserve combat asset bubbles?

Mr. BAKER. Well, I did say that. And I think the Federal Reserve has a variety of tools that it can use. But the first tool that I would have used if you were going to make me Federal Reserve Board chair——

Mr. CASTLE. Yes. We will do that temporarily.

Mr. BAKER [continuing]. Would have been to basically use the bully pulpit of the fed, to use their congressional testimonies, use their other public speaking opportunities to call attention to the misalignment of asset prices and the fundamental realities.

I think it was easy to see that in the case of both the stock and the housing bubbles. You had very clear evidence that these prices were out of line.

Yet, if Chairman Greenspan had used his public speaking opportunities as occasions to point that out, backed it up with research from the fed, so I don't just mean mumbling irrational exuberance. I mean, pointing out here is why real estate prices are out of line with the fundamentals in the market, you will end badly. If he had

used his bully pulpit to do that repeatedly, I think it could have had a very large impact.

Now, obviously they have regulatory authority. They could have prevented a lot of the bad mortgages that we saw and that contributed to this. But first and foremost, I think that bully pulpit is extremely valuable. And he wasted the opportunity to use it.

Mr. CASTLE. Does that pertain to others, like members of Congress, chair of the committee and the president of the United States. I mean, it is to just the Federal Reserve in other words. It is——

Mr. BAKER. Absolutely. I mean, this was the most important problem, economic problem, facing the country over the last 5 or 6 years by far. I mean, everything else that we—and I am not saying this in retrospect. I was saying this at the time. Everything else by comparison is really small change.

Mr. CASTLE. Very quickly, Dr. Munnell, I came in the middle of your testimony. But I think you talked about another tier of up to 20 percent before retirement or something of that nature. In other words, it sounded like a new program. And maybe it was in your writing, which I haven't read. But can you briefly tell us what that is all about?

Ms. MUNNELL. Yes. I firmly believe that just having 401(k) plans, no matter how good you try to make them, and Social Security as the only two components of our retirement income system is not going to provide people with enough money. I think that people at the low end, who are going to get less from Social Security going forward, are going to need something more. And I think that people with 401(k) plans are also going to need more than just these balances that they have now.

And so I think we need a new tier across the income groups for everybody, and let the poor old 401(k) plans go back to what they originally were, which were sort of supplementary plans, almost play money, for people who had solid coverage to being with.

They weren't designed for this. And we keep trying to tweak them to make the work better. And they do work a little better. But they are still flawed.

Chairman MILLER. Mrs. McCarthy.

Mr. STEVENS. Mr. Chairman, could I——

Chairman MILLER. I am going to move along here. I mean, we will try to figure out how to get your comments here.

Mrs. McCarthy.

Mrs. MCCARTHY. I want to thank the panel for the information. It has been very helpful. One of the things that I would like to go into a little bit deeper.

Mr. Stevens, I know you basically support financial literacy programs, which is something that I am trying to work on Financial Service Committee to get all that in. It has been a battle for a number of years.

But one of the things that you spoke about was the importance of relaxing the required minimum distributions rules individually age 70½. As you point out, Congress worked in a bipartisan manner to suspend the rules for 2009. And you are talking about basically making that permanent or a lock-in for the losses.

Could you elaborate why Congress should consider an extension of the minimum distribution or waiver or permanent raising the age trigger from the current 70½ and anybody else that wants to jump in?

Mr. STEVENS. Yes, ma'am. Thank you. The 70½ age at which required minimum distributions are triggered now has been the standard for many, many years. In the meantime, life expectancy has grown. And it seems to us a very reasonable accommodation to Americans in retirement, who are trying to manage their assets, to give them more time before they are required by law to begin drawing down their retirement account balances.

When we asked people about this, fully 60 percent responded that the only reason that they were withdrawing from their retirement accounts was because they had reached that magic age. And the law required them to do so.

So obviously, there are many Americans who are in a position where they can husband these assets for a longer period of time. And given life expectancy and given other pressures on retirement assets, we ought to help them do so.

Mrs. MCCARTHY. Does anybody else have an answer to that?

Ms. MUNNELL. I would support looking at it. But the reason it is there in the first place is that so these aren't estate planning tools. So perhaps we can make the age later. But I think that it would require careful study. And you definitely want some age.

Mr. BAKER. Just very quickly, I think the concern about locking in losses is perhaps exaggerated, because keep in mind, you only have to cash out at 6 percent. It is a relatively small share. I think you would find very few people who will reach the age of 70, who are invested 100 percent in equities. In other words, almost all of them would have enough in bonds or money funds. But they would be able to meet that distribution requirement without touching their equities.

Mr. STEVENS. No, my point was not their locking in losses, but their having to withdraw from their accounts however they are invested.

Mrs. MCCARTHY. I will yield back the balance of my time.

Chairman MILLER. Mr. Guthrie.

Mr. GUTHRIE. Thank you, Mr. Chairman. And thank you for conducting this meeting. This is extremely important for people I know of. Now that we have changed the systems, and then they have changed. And people are now mostly not in defined benefits. They are approaching retirement age, a lot of people in that group. So I know this is important, and they are facing this.

And Mr. Stevens, you were going to make a comment to Mr. Castle and didn't have the opportunity to make. We ran out of time. Did you get to make that? If so, I would give you the opportunity to do so.

Mr. STEVENS. I didn't. Thank you very much. No, much of what you have heard this morning assumes that there was a point in time when the vast majority of working Americans enjoyed the benefit of a defined benefit plan. This is a nostalgia we have, I think, as a country, and understandably, for an age that never existed.

Before 401(k)s came online, and then rise of the defined contribution system, only 16 percent of Americans in retirement, 16 percent, received any payment from a private pension plan. And the payment in today's dollars represented $6,000. So the golden age of the gold watch simply never existed.

So the idea that somehow or other defined contribution plans came and displaced this wonderful paternalistic system of defined benefit arrangements is simply not true.

Mr. GUTHRIE. Anybody else want to comment on that?

Ms. MUNNELL. Can I just respond to that? I mean, there were a period in which everyone who had a pension did have a defined benefit plan. And that has changed to a situation where everyone has a pension has the defined contribution plan. The defined benefit plans weren't perfect. But one has really displaced the other.

Mr. GUTHRIE. So the comment is, if you had a pension, you had defined benefit.

Ms. MUNNELL. Yes.

Mr. GUTHRIE. But still, 16 percent had pensions, if that number is correct. The 16 percent is what——

Mr. STEVENS. Or the inverse is 84 percent had no form of pension. And you have to think of what defined contribution has done to enlarge some pension provision for working Americans. And that was my point.

Ms. MUNNELL. Can I just add one comment?

Mr. GUTHRIE. Sure.

Ms. MUNNELL. If you take a snapshot of the private sector work force at any period of time, and this has been true from the 1970s right to the present, roughly half of the people have any employer-provided pension of any sort. And in the old days, 1980s, those were defined benefit plans. Today, they are defined contribution plans.

So the percent of population with anything has not changed. But the nature of what they have has changed.

Mr. GUTHRIE. Thank you. One more, and then I guess I will yield back after this comment.

Mr. STEVENS. I think it is important to understand too that, in the traditional defined benefit system, you had to spend a long time at a single employer, and then retire from that employer to get the pension benefit. The reason defined contribution plans have become so popular really has to do with the fact that that is not the working model any longer. Individuals will have seven to eight different employers during the course of their lifetime. So the DC plan is a better fit, in our judgment at least, then the conventional DB plan.

Mr. GUTHRIE. Thank you.

Thank you, Mr. Chairman. I yield back.

Chairman MILLER. Mr. Wu. Mr. Wu is not here.

Marcia Fudge. No questions?

Mr. Bishop is not here.

Mr. Sestak, there you are. The gentleman is recognized for 5 minutes.

Mr. SESTAK. Thanks, Mr. Chairman.

Mr. Bogle, if I——

Chairman MILLER. Why don't you see if you can use Ms. Hirono's mic?

Mr. BOGLE. Congratulations.

Mr. SESTAK. Can you hear me now?

Mr. BOGLE. Yes, we can.

Chairman MILLER. No.

Mr. BOGLE. Well, I can.

Chairman MILLER. Yes, let us. I don't know why the——

Mr. SESTAK. Can you hear me?

Mr. BOGLE. Yes, I can.

Mr. SESTAK [continuing]. Question has make sure that I understand it. It seems to me as though what you are most interested in is trying to spread the risk of investing to the entire group of investors. And that is kind of your bottom line that I am taking out of it.

Mr. BOGLE. Correct.

Mr. SESTAK. You don't seem as interested or feel it is as apropos to getting to that overall objective by, if I read your testimony right, by debundling all of the various fees. That is nice. It is interesting. We would like to know, if we don't know, that you have an expense ratio. But we really don't know the 0.5 to 1 percent that is added on because of transaction costs. You would like to make that apparent.

Further debundling is nice on the margins. What you really want to do is spread the risk to the market as a whole. Do I get it right?

Mr. BOGLE. Yes. But I would say, sir, only partially right. And that is with respect to the equity risk, it is mathematically correct to spread the risk as widely as you can. And then all investors as a group will win. Where if they are fighting with each other in the marketplace, which is the way the markets work, it is like the casino or the racetrack or the lottery, they are going to lose. So yes, absolutely correct with respect to the equity.

However, I don't think we have given much attention at all here today to something we should give a lot of attention to. And that is one of the things that went wrong, is that we didn't spend nearly enough time on educating investors about the risks of stocks and the need to have a bond component of their retirement plan. And for more years, more decades, maybe 30 years, I don't know how many years, I have been saying investors ought to be very conscious of a balanced program.

Now, I grew up, since 1951, with Wellington Fund, which is a balanced fund. And that was my first defined contribution plan investment in 1951. So I have been at it for a long, long time. And it has worked great.

But the reality is that, and what I have been saying for at least three decades, is your bond position should have something to do with your age, because things happen when you get older. I don't want to get into all of them at least.

But among the things that happen are you have less time to recoup bad times. You have more money at stake. And you probably get a little more jumpy when we get the crazy stock markets like this one, which is certainly a once-in-a-generation thing.

Mr. SESTAK. So your proposal would be that your federal retirement board would mandate the shares that go towards the bond index as opposed to the stock index.

Mr. BOGLE. Yes, sir, I do. And however I would, you know, not make it rigid; maybe a range in bonds. In other words, if you are 65, you wouldn't be bound to 65 percent. If you are 65 years of age, you wouldn't be bound to 65 percent in bonds. But maybe somewhere between 50 and 80 percent, depending on your own requirements.

Mr. SESTAK. And——

Mr. BOGLE. And just to get a little protection against these things that happen in this life, that we don't expect.

Mr. SESTAK. The last question I had, again for my edification is, in your great article "Black Swan," you called it an expectations market. But I think here, in your testimony, you call it the phantom. My question is, if you really do move towards an index-type of an approach, hearing your testimony, you talked about between 1999 and today, we actually had, I think, a 7 or 8 percent loss on the stock market when you know, in reality, rather than the 12 percent that had gone from 1975 to 1999.

How do you remove the, what you called the coop year from that? I mean, is it because everything is an index fund? Or you just let those that still want to go over to the non-index that you still with the——

Mr. BOGLE. Well, as a reality, and we in the financial system I don't think honor that reality very well. And that reality is that stock returns come and go. But in the long run, the whole idea of investing in equities, just working on that part of the portfolio is to capture the returns that are developed by American businesses, I said in my statement the dividend yields and the earnings growth; because over 100 years, that is a 100 percent of the return that you get if you invest in stocks before those costs are taken out.

The problem is the markets go into these crazes of speculation, irrational exuberance, call them what you will, where we had two consecutive decades, in the 1980s and 1990s, where we had the price earnings multiple, which is speculation, how much people will pay for a dollar of earnings. And it went from 10 to 20 to 40. And at 40, buying stocks is basically a bad joke. You can't recover from that.

So we are now coming back. Unfortunately the earnings are fading away at this moment in time. But that will take are of itself in time. But we have to focus on investment return and try and avoid getting captivated by the speculative return. And yet, in all the data you see from the industry, they just ignore what I would call the, as I did in my statement, these phantom returns that markets periodically develop and have been developing, you know, since—or maybe even before that, maybe since Ancient Greece as far as I know.

Chairman MILLER. Mr. Polis.

Mr. POLIS. No additional questions, Mr. Chairman.

Chairman MILLER. Ms. Shea-Porter.

Ms. SHEA-PORTER. There we go. I have a couple of questions. First, Dr. Munnell, I heard you talking about raising the age for

retirement. And if I heard that correctly, what age were you proposing?

Ms. MUNNELL [continuing]. Going to 67. And that means that people retiring at 62, which is when people retire. It is not desirable. But it is when they do retire, are going to get less and less.

And so that is just built in the cake. And it means that, when you look at Social Security going forward, people are going to get less than they think. The replacement rates are really going to be going down over time. So it matters enormously what is on top of Social Security. And I just want to repeat again and again, it is my view is that 401(k) plans, even fixed-up 401(k) plans, are never going to provide people with enough additional money. And we need another tier between Social Security and 401(k) plans, so people will have enough in retirement.

Ms. SHEA-PORTER. Okay. And do you support raising the cap on Social Security so that people at higher incomes pay on the dollars like those in the lower incomes do?

Ms. MUNNELL. Oh, I think you can raise the cap somewhat. But I think that it is really important that there is some link between contributions and benefits. I think it really strengthens political support for the program. So do it. Yes, it can go up somewhat. But do it cautiously.

Ms. SHEA-PORTER. Okay, so raising the ages is the direction you are looking at. I also wanted to ask you about this new plan. Why not put everybody into the TSP? Would that work, if you want this new layer there, then everybody gets enrolled in the same plan that we use?

Ms. MUNNELL. I think there are just two issues that are important here. I think that, for this additional tier, I think it is important that it is basically a private sector activity. I think we have got Social Security, which will provide a good base. It is pay as you go. It is publicly run.

I think you want to diversify your risk. Pay-as-you-go systems have demographic risks. Funded systems have capital risks. And I think you want some of each.

And so I think the TSP is a good model in terms of index funds, low-cost. But I think that any private sector firm that could meet those should be able to compete for the available monies.

Ms. SHEA-PORTER. Okay, thank you.

And Dr. Baker, I heard you talking about the housing bubble. Is there anything else you wanted to add about your testimony that you hadn't been asked before?

Mr. BAKER. Well, I guess I would just emphasize the point that, for most middle-income Americans, most of their wealth in retirement is going to be reflected in their house. And I think we had wrongly led many people to believe that that was a secure asset.

And I think it is very apparent to people today that it is not, which to my mind raises the argument to increase the strength of the argument for providing some sort of defined benefit plan in addition to Social Security, because people do need some security in retirement. And not only are they risking it with their 401(k) accounts, but they were also risking it with their house as well.

Ms. SHEA-PORTER. So looking 15 or 20 years out for a couple who is just buying a home, your message to them would be plan to live

in your house and enjoy your house. But make sure that you have something else that it is not going to be the traditional cash cow that it was at the end.

Mr. BAKER. Well, simply that there is risk, yes. I mean, certainly we hope that housing values will, you know, eventually stabilize and that they will at least rise in step with the inflation as they have done historically. But people have to recognize that there is a big element of risk there. We can't guarantee that your house price will appreciate. And clearly, there always was that regionally. So many people, even during normal market times, took a big hit on their home values.

But certainly you can have very erratic movement, as we see in house prices. So it is not the rock bed of your retirement.

Ms. SHEA-PORTER. Okay, thank you. And I yield back.

Chairman MILLER. Thank you.

Mr. Altmire.

Mr. ALTMIRE. Thank you, Mr. Chairman.

I want to ask Mr. Stevens to get specific about a couple things. One is you outlined a number of proposals to improve the 401(k) system. And you have mentioned specifically in your testimony increasing automatic features into plans, increasing investor education, ensuring Social Security is on sound footing, as we have discussed, and others. And I want to ask you, can you prioritize some of those for us?

Mr. STEVENS. Well, it seems to me that, since Social Security is the bedrock upon which all retirement planning in the United States has got to rest, that as a confidence-building measure in Americans' ultimate retirement security, that is a good place to start.

I would say that there are very specific things that we can do about the 401(k) system. And as I indicated, we strongly support the chairman's leadership on improved disclosure and do want to work with the committee as you continue to consider those issues in this Congress. It is important, at long last, that 401(k) participants get the kinds of disclosures that will help them in their investment decision making.

That in a sense is a step towards improved education, information and the like that is a broader national priority. I would think, in light of the downturn in the markets, that a similar step that we could take now has to do with required minimum distributions.

Undoubtedly, there are people who are reaching the age of 70½ or thereabouts who are saying, boy, I would like these assets to be with me a bit longer. But I have got to take them out of my account. And so just as we did in sympathy to their plight in 2009, we ought to look at what more we can do.

I think that the committee has the opportunity to seriously consider the rapid acceptance of these auto features that were characteristic of a pension protection act. But I think universally are now acclaimed as having, not only gotten many more people covered by 401(k)s, but increased the level of their contributions. The behavioral economics behind them, it seems to me, are demonstrating their validity.

And at some point, perhaps in the not-too-distant future, it is worth considering that we essentially make a plan that is offered

by an employer an opt-out, not an opt-in arrangement. That could cover many more people.

And then finally the toughest thing, Congressman, is how you get more of those 50 percent who aren't covered by a plan in their workplace into the system. That raises many, many larger and more difficult considerations. But that certainly is something that the Congress ought to work on, because there clearly are people who do not have the opportunities we would like them to, to invest and to save whatever they are able to for retirement.

Mr. ALTMIRE. And similar to that, you mentioned in your testimony and again in the Q and A, that 401(k) plan is so successful in your opinion, because it integrates both consistent contributions and long-term investing, which is what you said in your testimony. Can you elaborate on that? And are you trying to make the point that savers should take advantage of the benefits of dollar cost averaging, which means acquiring more shares during market downturns, like we are in now?

Mr. STEVENS. Yes, thank you. And it is actually the point I was trying to make in response to the question from Congressman Andrews. On page 6 of my written testimony, you have a depiction of what happens in a market downturn for consistent participants in 401(k) accounts.

Yes, their account balances do dip. But because 401(k) combines the power both of consistent savings and potential returns on investing, what you see is that the participants' accounts continue to climb at a faster rate than the stock market.

It is evidence to us, and this is in the context of a market downturn in recent years that was reasonably significant, that if you stay the course dollar cost average and continue to save, and realize the investment potential when the market recovers, that that is a very, very powerful mechanism for increasing your retirement wealth. And the demonstration of that is for us in the chart in that page of my testimony.

Mr. ALTMIRE. Thank you.

No further questions, Mr. Chairman.

Chairman MILLER. Mr. Price.

Dr. PRICE. Thank you, Mr. Chairman. And I appreciate the panel's discussion. I apologize for being late and having a conflict. I have heard some of the testimony back in my office and read much of it.

Clearly there is an attractiveness to certain returns. If we remove risk completely, however, we remove reward. I think all would agree with that. I wonder, Mr. Stevens, if you might comment on one of my great concerns has been the role of the federal government, and how the federal government can, I believe, step over a line that varies, but step over a line, and then result in decreasing return on investment to all folks and specifically in 401(k) plans.

For example, the great discussion that has been going on over the past couple of weeks about the nationalization of banks. And you see bank stocks decreasing significantly, I believe, because of that discussion. Do you have any thoughts as it relates to 401(k) plans and the intrusion of the federal government in roles like that?

Mr. STEVENS. Thank you, Congressman. Let me just give one example. And it is the issue that concerns us all about the decumulation phase. It is people who are now in retirement. They have a stock of retirement assets. And how should they be managed?

This is certainly an issue that both public policy makers like yourselves, people who are outside experts, like my colleagues here, participants in the financial community and individuals are wrestling with. My concern is that if government says we have the solution that is "it is this, it is nothing but this," what happens in the marketplace is all other experimentation and all other, if you will, innovation, competition, et cetera, essentially stops.

We spend a lot of time thinking about these things. And what I believe is that there is no one right solution for everyone at the point of retirement. Some of my colleagues here think that we can't trust Americans with their retirement savings. And we need to force them to do something, so there is no more risk in their portfolio for the balance of their life.

We talked to the American people in December. Again, markets were pretty bad. And they told us, overwhelmingly, we don't want Washington telling us what to do with our investments.

There is tremendous competition and innovation in the market by annuity providers, by asset managers, by the two working in tandem to try to give people tools to manage that longevity risk. I think we ought to encourage that kind of innovation in the market. It is what has created the strengths of the 401(k) system to date.

And so I would think there are conditions in which competitors ought to be encouraged to meet in the marketplace. And government has an important role there. Accountability to the investors, transparency in the system. But let us not straightjacket it, because ultimately the participants in these plans and American retirees are going to be the losers.

Dr. PRICE. Yes. No, there may be some merit to the American public's concern about the advisability of federal government control of whatever they can do with their retirement savings. One of the other lines, I think, that we can pass as a nation is to increase regulatory burdens so much, that we stifle any flexibility or ingenuity within the market of pension planning, 401(k) planning.

Do you believe that there is a—what would the consequences be, I guess, to employees or employers who would voluntarily choose not to participate, if the regulatory burden increases to such an extent that they believe that it is a hurdle over which they can't go?

Mr. STEVENS. Well, it is important to remember that this is a voluntary system. Employers are not required to have 401(k) plans. They are a benefit that they elect to have and to provide to their employees. And I think that one of the persistent problems about moving beyond the 50 percent who are covered now into smaller and smaller workplaces are the kinds of burdens that employers have to bear.

It is one of the reasons that a lot of the thinking in the, sort of, expert community has been dedicated towards simplifying 401(k)s, making them less burdensome, more manageable for smaller em-

ployers, so that they would have the wherewithal to adopt a plan and make it available to their employees.

And I think that is an important objective. It is one of the specific recommendations that we made in our written statement.

Dr. PRICE. Are there specific activities that you believe that Congress ought to avoid in terms of regulatory imposition on 401(k) plan?

Mr. STEVENS. I think mandating specific investment options is one important one, attempting to manage from Washington all of the risk return characteristics that exist in these funds, and essentially substituting your judgment for the judgment of the employer who sponsors the plan.

The design of the system was a judgment by Congress that the employer, as a conscientious fiduciary, held to very high standards, is in the best position to make those decisions for his or her work force. And that system has had a lot of success. And despite the market downturn, we see no reason why it should be overturned.

Chairman MILLER. Mr. Hare.

Dr. PRICE. I thank you for your responses.

Thank you, Mr. Chairman.

Chairman MILLER. Mr. Hare.

Mr. HARE. Mr. Bogle, I apologize. I missed your testimony. So if I am going over something you have already talked about, I hope you will bear with me here. It also goes to being 60 years old, evidently.

In your testimony, you called our financial system greedy. And you pointed out the imbalance between corporations and hedge fund managers and the investor who feeds at the bottom of the costly food chain of investing. So I have about three questions here. And then I will be happy to hear what you have to say.

What can be done to change this? Do workers have any means at all to defend themselves, particularly when they reach their retirement age, and they see that their 401(k) plans are losing half their value, or find out that their employer cannot pay out the promises that he or she made? And then finally, what protections do they need, do you think, from us?

Mr. BOGLE. Okay, well, let us start off with that. A great advantage of 401(k)s compared to defined benefit plans, and that is you are not at the risk of your employer's financial security or stability and the risk of bankruptcy.

And if you just take a look, for example, General Motors, you can describe that as a corporation with a $75 billion pension plan, surrounded by a few automobiles. And the few automobiles happen to have a market capitalization of something in the range of $1.5 billion. Once you get these huge disparities in the system of competitive capitalism and creative destruction.

So you could, and I think should, say the decline of the defined benefit plan in favor of the defined contribution plan is a plus. Now, the pluses for defined contribution are you can take it with you when you move jobs. That is very important. You don't run the risk of corporate failure. That is very important.

You can make your own asset allocations, something I have talked about a couple of times here. And that the typical corporate plan used to be defined benefit plan, around 60 percent stocks was

the convention and 40 percent bonds. But that applied and affected the youngest workers and the oldest workers. It was a package.

In the defined contribution plan, you can set your own allocation, gradually building up the bond allocation as you grow older. And that is a big plus. The big minus to get back to the first part of your question, the big minus in the defined contribution plan is it costs about two times or three times or four times as much as the defined benefit plan, because we are all paying individually for those services, instead of collectively.

So how do you get away from that? How do you get a better system? Well, there are really just two ways. One, wake up the investor to his own economic interest. This is what we can call the invisible hand solution.

Now, if we each will just operate in our own best interest, in our own economic interest, we will gradually move to a very low-cost, certainly an index system over time. And that is the way the market has moved over two or three decades now, first very slowly, and then decently rapidly in recent years. So the investor has to be aware of owning the market and of keeping costs down. And that is a very important part of it.

The other solution, and I come back to this, and I mentioned it in the testimony, is the institutional investors out there, including the mutual fund managers, really have not done a very good job of protecting the interest of their shareholders. Where were all our financial analysts in this industry when Enron went down. Did they not know what was going on there? And how about when Citibank and AIG went down?

I don't think our security analysts, our institutional—I know what they are paid all that money for. But they don't delve very deeply. Why aren't they challenging the corporations out there, where are you going to get that 8.5 percent return a year ago? And now, it has got to be, obviously, a lot more than that to make up for what was lost in that year.

So the institutional investor is, when you think about it—and this is pretty much known. I mean, read brokerage reports on money managers that are publicly held. Institutional investing has become a game of gathering assets. Why? Because the more assets you have, the bigger your fees are. This is not a complicated mathematical equation.

And therefore, and I almost hate to stomp on innovation. But having said that, I would like to stomp on innovation. How much innovation can we handle? Do we need more securitization? Do we need more credit default swaps? Do we need more collateralized debt obligations? Do we need more severing the link between lenders and mortgage lenders and mortgage borrowers?

Have those innovations helped us? No, but they sure as heck have helped the financial system, which has made billions and billions of dollars out of all those innovations.

So I think, you know, it sounds kind of funny. I am all for technology, innovation. I am all for mechanical innovation. I am all for engineering innovation. I am all for building a better world through innovation. But they ought to take innovation a little bit lightly when the idea of innovation in the financial business is to enrich the providers rather than enrich the beneficiary.

Mr. HARE. Thank you, sir.

Thank you, Mr. Chairman.

Chairman MILLER. Mr. Scott.

Mr. SCOTT. Thank you. Thank you, Mr. Chairman.

Mr. Bogle, you have indicated one of the advantages of the defined contribution plan is it is separated from the financial ups and downs of the corporation. Why can't the employee buy a defined benefit and still have the separation? Why can't that be in a separate set-aside account?

Mr. BOGLE. I am not sure it is possible, actually, to set up a defined benefit plan individual by individual. You are dealing with the overall wage profile, future retirement, the future demands on the company's assets. You are dealing with a pool of assets. I just, honestly, I haven't thought about it, sir.

Mr. SCOTT. Do you think——

Mr. BOGLE. I don't see how you can have an individual defined benefit plan.

Mr. SCOTT. You could buy as you go an annuity that kicks in when you are 65 and buy shares or something in an annuity and make the individual calculations.

Mr. BOGLE. Well, you can do that, of course, sir. But you have to realize, particularly in these days of tremors and toxic assets in the financial business, that there is no guarantee that annuity provider is going to be there when it comes time for your annuity. So I think one has to approach a single person taking a single risk very differently than, kind of, collectively dealing with longevity risk and investment risk.

Mr. SCOTT. Well, so——

Mr. BAKER. Very quick though, just say I think the public sector could have a role there, if you so chose. So you could provide a backdrop either to private issuers or to offer it directly.

Mr. SCOTT. And this goes to Mr. Bogle's original point. We are kind of all in this together. If you take it all together, it is a lot cheaper. We kind of share, spread the wealth. And if you had a government backup insurance requiring the insurance companies to be solvent, so that the government isn't taking that much risk, but we spread that risk, you could end up with a defined benefit, which I think a lot of people like.

You know what you are going to get. The stock market isn't going to up and down. You don't have to care.

We heard that, on average, market goes up and down, drops 20 points on average, we are still okay. Well, that is fine, unless you are a couple of years from retirement. If you are 15 years from retirement, you know, up and down 20 percent, actually the lower it gets, the cheaper you are buying in. So that works out fine.

But one of the things that people like about Social Security is they know what they are going to get. They don't have to worry about the finances. They don't have to worry about the company going up and down. They know what they are going to get.

And when we talk about trying to invent this thing right above Social Security, again, isn't there some way where we can take advantage of the fact that we are all together and improve Social Security rather than what they say reform Social Security, which means when you get down to it, cut it. You are either going to in-

crease the retirement age, or you are going to reduce the COLA. You somehow reduce benefits. Can we improve Social Security so that we get a little more rather than trying to reinvent the wheel?

Mr. BOGLE. My own opinion is that your ideas about improving Social Security are the correct ideas. And Social Security, as other speakers have said, is indeed the bedrock of our system, a defined benefit plan that we all know and love—I think love.

The reality is that, when you go beyond that and start making contributory retirement plans, such as 401(k), the possibility any defined contribution plan is going to be limited to a certain portion of the population. To pick a number out of the air, I don't think more than half of our U.S. population can add significantly to their retirement income with something that goes on in additional to Social Security.

It is very hard to save money when you are making an inflation-adjusted $18,000 a year, which I think is about the number, the total of the average income adjusted for 1980 dollars today. You know, families just can't do that or perceive they can't do it. And yet, in that group, unfortunately, according to David Brooks, they are spending 13 percent of their income on the lottery. And that is not what we want. We don't want to go there today.

Chairman MILLER. Mr. Scott, if I might, I hate to—I told the witnesses we would be out of there at 12:30. I have Ms. Woolsey, Mr. Kucinich, Ms. Hirono yet to ask questions. And I would like to trim everybody down here to 3 minutes, because we are leaving at 12:30. So you can take 3 minutes or no minutes or whatever you want to do.

Mr. SCOTT. Can I forward a question and not get an answer and——

Chairman MILLER. Yes.

Mr. SCOTT [continuing]. Maybe they could respond in writing. The present taxation of dividends and capital gains is at a historic low. If you put your money into a tax-sheltered account, when you pull out the profits, you are paying regular income. Could you make some comments about how valuable the tax-deferred accounts are when actually your tax rate on the profits might go up.

Chairman MILLER. We are going to take those off the air, as they say. We will submit those questions to you in writing. If you could get back to the committee, I would appreciate that.

Mr. BOGLE. I would be happy to do that.

Chairman MILLER. Ms. Woolsey.

Ms. WOOLSEY. Thank you, Mr. Chairman.

Chairman MILLER. For 3 minutes.

Ms. WOOLSEY. Aren't we glad that Social Security was not privatized and invested in the stock market right now.

Mr. BOGLE. That is an innovation we didn't need.

Ms. WOOLSEY. That wasn't.

Ms. MUNNELL. Exactly.

Ms. WOOLSEY. You are absolutely right. But Social Security, to me, was intended, from what I understand, to be a floor, a safety net that people could count on. But they can't live on it. Who can live on Social Security? And the—who are forced to live on Social Security, and look how they have to live.

So I am sorry that I missed your testimony. Has there been a thread among the four of you that is common between all four of you that would set us in a better direction, so that we can have our Social Security, and then have a life beyond it?

Ms. MUNNELL. I think there is a general consensus that we need to restore balance to Social Security. I would like to think there is a general consensus that we shouldn't cut back on Social Security benefits, so that means putting more resources into the program.

I think where this panel really divides is that can we have 401(k)s as the only supplement to Social Security? Some people think yes. I think absolutely not. Even if we fix them up, make them more automatic, we hear all these good things about what a success the system has been. But we also have really, really good data on how much money people have in these plans. And the Federal Reserve just released a new survey showing that people approaching retirement have $60,000 in these plans.

Now, the system hasn't been in forever. But that is not a lot of money. And even if you take into account the money that is rolled over into IRAs, the figure is only a little bit higher. So there just hasn't been a lot of money in these plans. I don't think these plans are ever going to be adequate. And I think we need more retirement saving, a new system.

Ms. WOOLSEY. Dr. Baker.

Mr. BAKER. I would agree with Dr. Munnell that I think we need some additional account. And I was arguing the case for having some sort of guaranteed benefit that would be offered on a voluntary basis by the government, a contributory account. I was giving $1,000 per worker per year as sort of the target that we would be looking to as a modest supplement to Social Security.

Ms. WOOLSEY. Okay.

Mr. Stevens.

Mr. STEVENS. Yes, and just to clarify, we do in fact think that the 401(k) system can work to contribute an enormous amount of pre-retirement income. And it is absolutely true, as Dr. Munnell said, the people that we are talking about today, with that $60,000 account, or whatever its balance is, have not been in the 401(k) system by and large through their working life. That figure also doesn't take into account what other financial resources they may have, by the way.

When we modeled based upon the EBRI/ICI database, which is the largest database of actual 401(k) accounts that is subject to research in the United States. And we asked on the basis of normal behaviors, not optimal behaviors——

Chairman MILLER. Mr. Stevens, we are going to wrap up here. We are going to take you——

Mr. STEVENS. I will, Mr. Chairman. Normal behaviors over a working life, you can get a very substantial replacement of your pre-retirement income, which with Social Security, will mean retirement adequacy.

Chairman MILLER. Ms. Hirono for 3 minutes.

Ms. HIRONO. Thank you, Mr. Chairman.

I like the idea that we are going to need another tier besides Social Security and the 401(k)s. And so obviously I like Dr. Baker's idea. And I was curious to know, Ms. Munnell, why you thought

that this tier that Dr. Baker talked about should be done by the private sector, since part of the attraction of what Dr. Baker is suggesting is that there would be a guaranteed return. And would the private sector be able to guarantee a return?

Ms. MUNNELL. I think we would all like to have a guaranteed return.

Ms. HIRONO. A modest return.

Ms. MUNNELL. It would be very nice to have 20 percent that you knew that you were going to get for sure. The concept of guarantees is very hard. You really need a very high guarantee of return to make it worthwhile. If we had had a guaranteed return of 2 or 3 percent, it would never have kicked in once during the last 84 years. And so it would not have had any impact.

To have had any impact, you really need this very huge guaranteed return. And the financial literature says you can't do it, unless you can figure out some way to argue that government has a different set of preferences than individuals.

So I think guarantees would be wonderful. Risk-sharing of some sort, like it may be the Netherlands or in Canada, would be good. But I think we need a second tier above Social Security that is substantial, that is reliable, that maybe is not absolutely guaranteed, but is more secure than what people have in 401(k) plans.

Ms. HIRONO. Well, I am not an—but I just don't think that in this environment, that people are looking for a guarantee of a 20 percent. You know, if you can get a guarantee of——

Ms. MUNNELL. No, I was talking six.

Ms. HIRONO. Six, okay. Or even six, I think that sounds like a lot to me. I think there are a lot of employees who would want to be able to contribute in a voluntary way to a modest addition to their Social Security. These are not the folks that are going to get into 401(k)s, et cetera. So, you know, if the major concern you have is what is the level of guarantee that will induce people to participate in a voluntary tier program like this, a second tier program, then I guess, you know, we can go somewhere with this idea. So thank you.

Chairman MILLER. Mr. Kucinich, 3 minutes.

Mr. KUCINICH. Thank you.

I would like to address these remarks to the panelists. But particularly I would be interested to see what Mr. Bogle and Mr. Baker would have to say about these observations.

I heard your testimony. I have re-read it. And with the decline in house values, the decline in the value of defined pension plans, decline in the value of 401(k)s, workers losing jobs and health care benefits connected with that, and with the understanding that we have an aging work force, more and more elderly are in—you know, the work force is aging more other than work force, and also comprising more of the jobless.

Are we looking at our baby boomer generation, which is going to be driven into poverty unless we come up with some corrections in our health care, protecting Social Security and some kind of annual benefit that is guaranteed? Mr. Bogle, Mr. Baker.

Mr. BOGLE. Okay, let me start by saying that I don't think we are looking at a benefits-less, poverty kind of a situation. I know that the markets are kind of unusual. When they are going up, we

think they are going to go up forever. And now that they are going down, we think they are going to go down forever. That is not the case.

I mean, value gets created when stocks drop by 55 percent. Dividend yields are higher. Price earnings multiples are lower. The ratio of the price of the stock to its tangible book value, all that plant and equipment, technology, all those things, get much more attractive.

So having had two great decades for stocks, too great, that was the phantom return I talked about in my testimony. And then a terrible decade, which should not surprise anybody. I mean, this was predictable. I mean, I have speeches I gave at the beginning of the—not saying that it was going to be this bad, but saying you can be looking for 2 or 3 percent return on stocks.

Mr. KUCINICH. Mr. Baker, does what goes down must come up?

Mr. BAKER. Well, it depends what level you are looking at. I think in many cases, we were correcting from exaggerated heights. Certainly that was the case in housing markets. I wouldn't make any bets on the housing market rising more rapidly than inflation over, you know, some time to come. In fact, I hope it would not, because I am not in favor of an unaffordable housing policy.

In terms of the stock market, I think market stock prices are depressed. But the fact is, most of the baby boomer cohort doesn't have very much by way of stock. And they are not going to be able to accumulate very much in the years they have left in the work force.

Mr. KUCINICH. Unless we make corrections? Are we looking at a lot of baby boomers put in poverty? That is what I am——

Mr. BAKER. I would say yes. And in particular, you have a lot of people running around this town who want to further cut the benefits that baby boomers have in the name of generational equity, which is rather perverse to me.

Mr. KUCINICH. Okay.

Thank you, Mr. Chairman.

Chairman MILLER. Thank you very much.

Let me again thank the panel for all of your insights here in answering the questions of the members of the committee. I think this has been a great kickoff to this continued inquiry on pension security by the committee that will be led by Congressman Andrews.

I would like to, without objection, submit for the record the following documents for this hearing, one by the Investment Company Institution on 10 Myths about 401(k)s, a statement for the record by Matthew Hutchison, an independent pension fiduciary, a statement from the American Society of Pension Professionals and Actuaries, and a statement from the Profit-Sharing Council of America to be included in the record, if there is no objection. Hearing none, so ordered.

[The information follows:]

**10 Myths About 401(k)s—And the Facts**

401(K)S AND THE FINANCIAL CRISIS

*MYTH No. 1: Thanks to the financial crisis, Americans are bailing out of their 401(k) plans.*

FACT: Americans are not abandoning their 401(k)s.

True, 401(k) accounts have been hard-hit by the broad economic downturn. One large recordkeeper reports that the average balance in accounts it administers dropped 27 percent in 2008.

But these losses are not driving Americans out of their 401(k)s. ICI's study of 22.5 million defined-contribution (DC) accounts shows that only 3 percent of plan participants had stopped making contributions through October 2008. Only 3.7 percent of plan participants had taken withdrawals from their participant-directed retirement plans, including 1.2 percent who had taken hardship withdrawals. This level of withdrawal activity is in line with past years' experiences. Recent loan activity is also in line with historical experience: in 2008, 15 percent of participants had outstanding loans, compared to 13 to 17 percent with loans in annual studies since 1996. Most loans tended to be small, amounting in 2007 to 12 percent of the remaining account balance, on average.

Retirement-saving assets are down—in all forms of accounts—because the stock market is down, not because of any fundamental flaw in 401(k)s. In fact, thanks to diversification and ongoing contributions, the average account fared better in 2008 than the S&P 500, which was down 38 percent.

*MYTH No. 2: Americans have lost confidence in the 401(k) system.*

FACT: Americans of all income groups support 401(k)s.

A comprehensive survey of 3,000 American households, conducted by ICI from October to December 2008, shows that Americans of all income groups support 401(k)s. Even among households that don't currently own DC plans or Individual Retirement Accounts, large majorities support the tax incentives for these retirement savings plans. More than 80 percent of DC-owning households agreed that the "immediate tax savings from my retirement plan are a big incentive to contribute." More than half of the lowest-income households—those making less than $30,000—say they probably would not invest for retirement at all if they didn't have a plan at work.

*MYTH No. 3: 401(k) savers have suffered much greater losses than other retirement investors.*

FACT: There is no shelter from the market storm: All retirement plans have seen their assets fall.

All retirement plans—DC plans, defined benefit (DB) plans, state and local government retirement plans, and IRAs—are long-term savings vehicles and invest a large share of their assets in equities. Thus, they all have suffered in the market turmoil. The latest data available, from the first three quarters of 2008, show that the assets of private-sector and state and local government DB plans were down 14 percent, and IRA assets were down 13 percent. Assets of 401(k) plans fell somewhat less, by about 11 percent, and 403(b) plan assets were down 10 percent over the first three quarters of 2008. Over the same period, the S&P 500 total return index was down 19 percent.

401(K)S' ROLE IN RETIREMENT

*MYTH No. 4: Before 401(k)s, most workers had defined benefit plans offering guaranteed, risk-free benefits.*

FACT: Defined benefit pensions never were universal or risk-free.

In 1981, before the creation of 401(k)s, not one in five retirees received any benefits from a private-sector pension. For those who did, their median benefit was $6,000 a year in today's dollars. The golden age of the golden watch never existed.

*MYTH No. 5: DB plans are fairer to workers and would protect them from the market turmoil.*

FACT: Today's lower-income workers get better coverage—and more portable benefits—thanks to DC plans.

Today, lower-income workers are more likely to be covered by 401(k) or other DC plans than by DB plans: 19 percent of working age households earning less than $25,000 have a DC plan, versus only 7 percent with a DB plan. For working age households earning $25,000 to $34,999, 42 percent have DC plans, versus 17 percent with DB plans.

Although defined benefit plans will and should continue to be an important component of the private-sector retirement plan system, they are not the answer to the insecurity created by today's markets. As noted, DB plan assets have fallen along with all other retirement assets. And DB plans expose workers to other forms of risk, such as the risk that the sponsor will freeze workers' benefits (by freezing the plan, terminating the plan, or going out of business) or that a worker will lose or change jobs without accruing significant DB benefits. For today's typical worker—who will hold seven or more jobs in his or her career—DB plans can be a poor fit.

401(K)S AND FEES

*MYTH No. 6: Participants in 401(k) plans pay exorbitant fees, up to 5 percent of assets.*

FACT: The numbers bandied about by critics of the 401(k) system vastly exaggerate the fees that most plans charge.

In fact, the fees that employers and participants pay are very reasonable. ICI and Deloitte Consulting LLP recently compiled a detailed survey of fees paid by 130 plans of various sizes, and using various recordkeeping models. The survey found that the median all-in fee—covering investment, recordkeeping, administration and plan sponsor and participant service expenses—was 0.72 percent of total assets in 2008. In dollar terms, based on the average account size, the median fee per participant was $346 a year. While fees vary across the market, 90 percent of all plans surveyed had an all-in fee of 1.72 percent or less.

Half of all 401(k) assets are invested in mutual funds. ICI research shows that 401(k) investors concentrate their assets in low-cost mutual funds. The average asset-weighted total expense ratio incurred by 401(k) investors in stock mutual funds was 0.74 percent in 2007, substantially less than the industry-wide asset-weighted average of 0.86 percent.

*MYTH No. 7: The cost of 401(k)s invested in mutual funds is substantially understated because funds don't disclose trading costs—a hidden and excessive fee.*

FACT: Funds follow SEC rules on disclosing trading costs—and fund managers have strong legal and market incentives to minimize those costs.

All investment products—commingled trusts, separate accounts, exchange-traded funds (ETFs), mutual funds, and others—incur both explicit and implicit costs in buying, holding, and selling portfolio securities. Brokerage commissions are the most obvious and easily calculated trading cost. Other trading costs—market impact costs and opportunity costs—cannot be measured as easily or accurately.

The Investment Advisers Act of 1940 requires all mutual fund managers to seek "best execution" of trades, a standard that requires close attention to total trading costs. Further, trading costs directly affect a fund's performance—the most important consideration that most investors use to judge funds. So fund managers have strong legal and market incentives to minimize these costs.

The SEC has examined disclosure of trading costs repeatedly and has concluded that the portfolio turnover rate, which measures how often a fund "turns over" its securities holdings, is the best proxy for trading costs. Recent changes to mutual fund disclosure rules make the disclosure of portfolio turnover more prominent in fund prospectuses. Mutual funds also make available to investors, including retirement plans, detailed information on their total brokerage commissions and trading policies.

ICI research shows that 401(k) investors in mutual funds tend to own funds with low turnover rates. The asset-weighted turnover rate experienced in stock mutual funds held in 401(k) accounts was 44 percent in 2007, compared to 51 percent for all stock funds.

*MYTH No. 8: The mutual fund industry opposes disclosure of 401(k) fees.*

FACT: Mutual funds have more comprehensive disclosure than any other investment option available in 401(k) plans, and have strongly supported improved disclosure.

Under the securities laws, mutual funds must and do provide robust disclosure of fees and other information of importance to their investors. ICI and its member funds have advocated for better disclosure in retirement plans for more than 30 years. In 1976—at the dawn of the ERISA era and before 401(k) plans even existed—ICI sent a letter to the Department of Labor arguing that participants in participant-directed plans should receive "complete, up-to-date information about plan investment options." ICI has continued to advocate that participants in all plans receive key information—not just on fees, but also including data on investment objectives, risks, and historical performance—for all products offered in 401(k) plans. ICI strongly supports the comprehensive fee disclosure agenda the Department of Labor is pursuing.

401(K)S AND SMART INVESTING

*MYTH No. 9: Participants should base their choices among investment options in their 401(k) plan solely on the options' fees.*

FACT: Fees are only one factor participants should weigh in meeting their savings goals.

The most important task for a 401(k) participant is to construct a diversified account with an asset allocation appropriate for the participant's savings goals. Fees and expenses are only one piece of necessary information and should always be considered along with other key information, including investment objectives, historical performance, and risks. The lowest-fee options in many plans often are those with relatively low long-term returns (for example, a money market fund) or higher risk (such as employer stock). Most employees will fare poorly if they invest solely in these low-fee options without regard to the risks or historical performance.

Participants must be told that fees are only one factor in making prudent investment decisions—and must be shown the importance of other factors by presenting fees in context. For example, any disclosure associated with employer stock also should describe the risks of failing to diversify and concentrating retirement assets in shares of a single company (especially when that company is also the source of an employee's earned income).

*MYTH No. 10: 401(k) savers should only invest in index funds because they are always superior to actively managed funds.*

FACT: Index funds are a good option—but aren't necessarily a "one-stop" solution.

Mutual funds were the first to make index investing broadly available to individual investors more than three decades ago, and today there are hundreds of index mutual funds available in the market. Index funds are innovative investments that are appropriate for many investors in many situations.

But index funds are not necessarily a "one-stop" solution for retirement investing. Index funds vary widely in their choice of index, which leads to widely varying risks and returns. No one index fund is right for all investors in all markets.

Index funds are hardly immune from market downturns. One of the largest indexed investments, the Federal Thrift Savings Plan's C Fund, which attempts to track the S&P 500 index, was down 37 percent in 2008. The TSP's indexed I Fund, which attempts to track the Morgan Stanley Capital International EAFE Index, was down 42 percent.

Actively managed funds, like index funds, can be excellent investments. The returns that investors receive on either kind of fund will depend heavily on the mix of actively managed and index funds that is considered, as well as the period over which returns are measured. For example, ICI examined the top 10 mutual funds (in terms of 401(k) assets) in 1997, which included some actively managed funds and some index funds. Over the 10-year period to 2007, an investment made at year-end 1997 in those actively managed funds would have earned a higher return (6.82 percent, net of fees) than a comparable investment made in the index funds (5.83 percent, again net of fees).

Employers recognize the benefits of both forms of investing when they select menus of investment options for 401(k) plans. A survey by the Profit Sharing/401k Council of America found that 70 percent of plans offered a domestic equity index investment option in 2007. These are decisions properly left to plan sponsors—fiduciaries who are held to ERISA's stringent standards.

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## Prepared Statement of Matthew D. Hutcheson, Independent Pension Fiduciary

FIVE STEPS TO RESTORING TRUST IN THE 401(K) SYSTEM

*Introduction*

It is widely accepted that 401(k) and similar arrangements are the way most Americans will invest for retirement. Therefore, it is incumbent upon us all to be absolutely certain there are no unnecessary obstacles (whether intentional or unintentional) to its long-term success.

The 401(k) concept is excellent. It has always had great potential, but that potential was sacrificed on Wall Street's altar of greed, corruption, and the 401(k) industry's harmful business model. It is not too late for the 401(k), but that will require a complete and unequivocal shift in public thinking. In other words, the public—including elected representatives, and regulators—must cast off the marketing-induced stupor that has befallen them.

It is with a deeply felt commitment to the success of our private retirement system that this statement is shared with the Committee. There are reasons the 401(k) is failing. If those reasons are understood and acted upon, the 401(k) can be saved. This statement will explain those reasons and what is required to correct and restore the viability of the 401(k) for generations to come. If all six of the steps described herein are not implemented, the 401(k) system will be doomed to mediocrity—and, more likely, continuing failure.

*Step 1: Elevate stature of 401(k) to the original level contemplated by statute*

"Give a dog a good name and he'll live up to it."[1]

While the 401(k) as a concept is excellent, the way the plan has been interpreted, marketed, delivered, implemented and operated is not. The 401(k) is suffering because many people inside and outside of the 401(k) and financial services industry view its purpose incorrectly. It is seen as a financial product, not a delicate retirement-incomegenerating system deserving of fiduciary protections and care.

Many believe that 401(k) plans are nothing more than financial planning or simple savings tools. That is incorrect. 401(k) plans are true retirement plans, with all the attendant obligations and implications. They must be viewed and operated as such for the system to begin to restore the public trust.

From a statutory perspective, a 401(k) plan is as much a retirement plan as a traditional pension plan. Until the 401(k) plan, and the system that it operates within is elevated to the intended stature of a "pension benefit plan" under ERISA section 3(3) (which is why 401(k) plans are reported as a pension benefit plan on form 5500), society and the 401(k) and financial services industry will continue to view the 401(k) as being of "lesser" importance and stature. Behavior and attitudes toward the 401(k) will follow accordingly.

The 401(k) needs a fine reputation to live up to, and that can only happen if all Americans begin viewing it not as just another financial product, more like E*Trade than ERISA, but as an income-producing mechanism, as correctly stated under ERISA, with the ability to financially undergird society as it ages.

*Step 2: Create the right types of safe harbors and incentives*

"Faced with this statutory and regulatory riddle, the Department of Labor ("DOL") and now, Congress, support various investment advice schemes that allow plan sponsors to seek fiduciary relief under ERISA section 404(c). Although these schemes have the potential to resolve the ERISA section 404(c) dilemma, their structural flaws only create more problems—for example, they allow investment advisors to self-deal and operate despite conflicts of interest. And so the riddle of ERISA section 404(c) continues."[2]

The conventional 401(k) system is not founded solely upon principles that will yield favorable results for participants and beneficiaries. Ironically, there are regulatory incentives to produce mediocre or poor results. Nothing has produced more chaos and confusion in the 401(k) system than Department of Labor section 2550.404c-1, commonly referred to as "404(c)." 404(c) is not just one of many problems with the 401(k) system. It's the problem.

We wouldn't let our loved ones get on an airplane that does not strictly adhere to principles of aeronautical science and physics. And we certainly wouldn't knowingly let our loved ones ride in an airplane with a missing wing or a visibly cracked fuselage. That airplane will surely fall short of its destination; and that fact would be obvious long before takeoff. Yet we have a system that permits our loved ones to do just that with 401(k) plans operating within the meaning of Department of Labor regulation 404(c). In many cases, participants merely guess about which funds to invest in, and they often guess wrong. It is commonplace for incomplete or sub-optimal portfolios to be randomly selected. Without even realizing it, participants choose the wrong funds, or the wrong combination of funds, or the most expensive funds—thereby unnecessarily sacrificing years of potential retirement income. To continue the analogy, they choose a portfolio that is not "flight-worthy." Sadly, they will discover that reality far too late in life, and find that their only option is to work harder and longer—perhaps well into their 70's or even beyond.

Section 404(c) was not originally meant for 401(k) plans anyway. It was intended for Defined Benefit Plans with after-tax mandatory employee contribution requirements or the precursor to the 401(k)—the Thrift Savings plans that some employers sponsored in addition to a traditional Defined Benefit Plan. Since the benefits provided under a traditional Defined Benefit Plan were protected by employer funding and the PBGC, it mattered far less if a participant made poor decisions with their after-tax mandatory or Thrift Savings account. The number of participants affected by 404(c) prior to the creation of the 401(k) is not known—but likely insignificant. Perhaps most 401(k) participants today participate in a plan with a section 404(c) provision. The drafters of ERISA could not have foreseen how 404(c) would damage a system that did not yet exist. ERISA section 404(c) existed prior to the 401(k), and its corrosive effects could not have been known.

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[1] Attributed to Dale Carnegie

[2] Chicago-Kent Law Review. ERISA Section 404(c) and investment advice: What is an Employer or Plan Sponsor to do? Stefanie Kastrinsky. Page 3 May 16, 2005.

In 1991, final regulations under 404(c) were issued by the Department of Labor as a provision that 401(k) plans could utilize. That regulation was ill-conceived. By issuing those regulations, the Department of Labor consigned the 401(k) to mediocrity or worse. It should have been clear that 404(c) should be the exception, not the rule—as there were pre-existing laws in place that gave participants the right to a well diversified, prudent portfolio.

The application of 404(c) to 401(k) plans opened the floodgates to the chaos in speculation and deviation from sound economic and financial principles—placing the burden of "flight-worthiness" on the passenger and taking it away from trained professionals at the airline or the FAA, as it were.

If trust in the 401(k) system is to be restored, the strangle-hold of 404(c) must be broken. That will prevent participants from making incorrect decisions based on emotion, ignorance, greed, or all of the above. It will place investment decision-making back where it belongs—with prudent fiduciaries.

If 404(c) is allowed to remain, it should require a beneficiary waiver before a participant may choose to disregard the portfolios put in place by professional fiduciaries because the result will almost certainly be less favorable for both the participant and the beneficiary. If both agree, so be it. However, a prudent portfolio constructed by an investment fiduciary should be the standard established by law, and it should be accompanied by a safe harbor.

Congress should consider clarifying for the courts that complying with 404(c) requires affirmative proof that all of its requirements have been satisfied. That of course is impossible, because there is no way to determine whether plan participants are "informed." It is the "informed" requirement that gives 404(c) legitimacy, not the offering of a broad selection of funds. The Courts have missed that point entirely. Since it is impossible to know who is truly informed and who is not, even after extensive efforts to provide investor education, 404(c) is simply not viable in a system where the overwhelming population of American workers persists in its failure to grasp the elementary differences between a stock and a bond.[3] Again, 404(c) could perhaps be the exception, but it is a mistake of massive proportions to have permitted it to become the rule.

"Many Americans, alas, know little about stocks, bonds, and retirement. This is the conclusion reached by none other than the companies and organizations that would benefit most from a system of private accounts. The Vanguard Group, the National Association of Securities Dealers, the Securities Industry Association, the Investment Protection Trust, Merrill Lynch, Money magazine, and the Securities and Exchange Commission have all done studies or issued reports that reach the same general conclusion. To make matters worse, much of the research over the past five years has focused on the knowledge of individuals who already own stock and are thus presumably more familiar with the workings of financial markets; the research has still found severe financial illiteracy."[4]

Beyond the requirement that participants be "informed," virtually everyone in the 401(k) industry knows that only a tiny fraction of any plan actually complies with the long list of requirements. Section 404(c) is a waste of time, money, and it is also the cause of many billions of dollars wasted each year that otherwise would have been legitimately earned by professionally constructed and managed portfolios. When employers see a safer route (less fiduciary risk) that also has the promise of better results, the system will begin to heal and public trust will be restored.

An employer that sponsors a 401(k) plan should be assured by a clear, unequivocal statutory safe harbor for appointing a professional independent fiduciary, acting pursuant to sections 3(21) or 3(38) of ERISA, or both. That will do more to protect the plan sponsor from fiduciary risk than anything else, and it is consistent with the duty of loyalty in a way that participants do not currently enjoy. Such a safe harbor would reduce or eliminate conflicts of interest. Results would improve through professional application of sound economic and financial principles. No longer would America's employers have to wear two hats and grapple with divided loyalties to their shareholders and their 401(k) plan participants. Such a safe harbor would restore order to the system.

Creating better safe harbors and other incentives that give plan sponsors confidence and a sense of security for having done the right thing the right way will wean the 401(k) from concepts that have only confused and frustrated an otherwise excellent program with potential for long-term success.

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[3] Dave Mastio, "Lessons our 401(k)s Taught us. How much do Americans know about investing for retirement? What investors don't know." *http://www.hoover.org/publications/policyreview/3552047.html*

[4] Ibid

*Step 3: Participants have a right to know the expected return of their portfolio*

"If [investment] returns could not be expected from the investment of scarce capital, all investment would immediately cease, and corporations would no longer be able to produce their sellable goods and services. The truth is that we invest, not with an eye to making speculative gains, but because we have an expectation of a specific return over time." [5]

Every week, thousands of enrollment meetings are held in the lunch-rooms of corporate America. Those enrollment meetings seek to explain to participants why they should enroll in their company's 401(k), and which investment options are available to them.

That is fine, with one exception. Most of the paperwork and enrollment materials will provide participants with useless information about the type of investor they are. Participants will take a 5 minute quiz, and that quiz will tell the participant that they are a "conservative" investor, or a "moderate" investor, or perhaps an "aggressive" investor. Perhaps a particular list of funds with suggested ratios for which to allocate new contribution dollars will be associated with each investor type.

There are two fundamental flaws with that approach.

First, whether a participant has a conservative or an aggressive investor profile is dependent on emotion; how much market volatility they can stomach. A participant's tolerance for market turbulence is not static. It can change day-to-day. For example, if a participant with an aggressive profile gets in a car accident, their profile may immediately switch to conservative. That is an emotional profile that does not tie well to the economics of prudent, long-term investing.

Second, the emotion of identifying an investor profile does not help the participant understand the interplay between new funding (ongoing contributions/deposits to the plan) and future retirement income streams that can be expected (not to be misunderstood as "guaranteed.")

Therefore, the most important thing a participant needs to know is not their emotionally determined ability to endure market turbulence, but rather the long-term economic output of the participant's portfolio. This is called the "expected return." Knowing that, a participant cannot truly understand how much money they should be contributing to the plan, when coupled with any employer generosity, if any, to achieve a future income-replacement goal.

The expected return is the most fundamental concept of investing because if those with capital to invest could not expect a return, that capital would be invested elsewhere—or not at all. The concept of expected return is perplexingly absent in the current 401(k) system and is not understood by participants or fiduciaries. That misunderstanding can easily be corrected.

It should be mandated by law that all participants be told what the expected return is for the actual portfolio they are in. That way, the one thing that participants can control—the amount they contribute to the plan—is a decision made in light of the expected return of the portfolio they will invest in so their decision is both informed and founded upon a process that is likely to yield favorable results.

Participants may not be able to afford what they wish they could contribute based on the expected return of their portfolio. For example their portfolio may have an expected return of 5%, and to comfortably retire they may learn that they will need to contribute twice as much as they can afford in order to get there. That is an understood reality of life that many face each day when purchasing goods and services. However, participants should at a minimum know the economic characteristics of their portfolio so they can choose to get more education in order to earn more, work longer, spend less on other things, or a combination thereof.

Consider how different things would be if we stopped inducing emotional decisions in participants and began given them solid, reliable information based on modern principles of economics and finance.

*Step 4: Transparency*

Our retirement savings system and its participants deserve protection. The bedrock of any mechanism as delicate as the 401(k) should be clarity and transparency.

The debate over whether the cost of a 401(k) plan is reasonable is pointless without standardized transparency. Can something be determined reasonable if it cannot first be seen and understood in a comparative context?

In the case of plans with known economic impact to participants, perhaps all fees and costs are deemed reasonable when compared to the industry as a whole, yet simultaneously excessive in light of the quality or value of services rendered to a specific plan. In other words, all 401(k) plans could eventually have fees that some-

[5] "Investment Risk vs. Unprincipled Speculation" Journal of Pension Benefits (c)Wolters Kluwer Law and Business. Volume 16, Number 2, Winter 2009. Page 76.

one deems reasonable, but those same fees may be genuinely excessive at the same time—therefore it is not an either-or scenario.[6] That conundrum cannot be resolved in an environment of opacity.

Given the seriousness of the crisis we face, where an estimated $1 trillion in 401(k) assets has been lost in the past few months, we cannot accept anything less than full and absolute transparency—even if fees and other charges become very low by today's standard. In other words, there may come a time when fees are reasonable, non-excessive, and absolutely transparent. It is in times such as those, transparency will be no less important or necessary for the purpose of protecting trust in the system.

Passage of HR 3185 or a fundamentally similar Bill will begin the process of restoring broken trust. Distilling disclosure of expenses into an understandable format will deliver value to participants, beneficiaries, and employers. The gross-to-net methodology, which means clearly showing gross returns on the investments in a 401(k) account and also showing the net returns that the participant gets to keep, makes the most sense. It reveals total investment returns, the net return to each participant, and by simple subtraction, the actual costs of delivering those net returns to each participant.[7] Any other method obscures both returns and costs from the view of the participants, plan sponsors, and regulators alike. Gross-to-net disclosure establishes true transparency, a pre-requisite to restoring trust in the 401(k).

Transparency should also be required for new financial products that are developed in the future, such as fund-of-funds, lifestyle, and target date funds. Some of those may be well constructed. Some of them are not. Transparency is required to ensure fiduciaries and plan participants understand the difference.

*Step 5: Retire-ability measurements*

As stated earlier, the 401(k) has not been managed to produce future retirement income. Rather, it has been managed like merely another of an array of ordinary financial products. Thus, the ability of conventional 401(k) plans to produce financially secure retirees is not a primary discussion item of fiduciaries and committee members in their meetings.

Many factors go into creating a successful program, each having differing importance and weight at different stages of a participant's progression from entry into the workforce to retirement. Also, participants at different ages are affected differently by plan provisions or economic conditions.

For example, younger participants with smaller account balances are most affected by matching or other employer contributions. Older participants with larger account balances are most impacted by fees and other charges. Employers and fiduciaries must understand what helps participants, what hurts them, and when those effects are most likely.

If 401(k) plans are to thrive, employers and fiduciary committees must engage in regular proactive and thoughtful assessments of the "retire-ability" qualities of their plan, while taking into account the demographics of the plan participants as a whole.

Society requires more that ever a more astute body of fiduciaries who understand that improved future retirement income for individuals also enables an improved future economy for all. Higher retirement incomes can help stabilize the economy, sustain tax revenues necessary to deliver essential government services and provide economic opportunity for the rising generation.

Employers must not fear the question, and then answer honestly, "Will our employees be able to retire at their chosen time? If not, what can we do to improve their chances?"

*Summary*

1 Return to Roots—Congress can make it unequivocally clear that plan sponsors need to understand 401(k) plans must not as mere financial planning tools, but rather the a pension benefit mechanism that produces retirement income that will be the financial undergirding mechanism of society.

2 Safe Harbors & Incentives—Congress can create meaningful safe harbors and incentives that give employers confidence to proceed in managing their 401(k) plans in accordance with modern principles of economics and finance—thus improving results. Congress can remove or suppress harmful elements of the conventional sys-

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[6] See 9th Meigs question for further explanation about the relationship between "reasonable" and "excessive" fees and expenses. *http://www.401khelpcenter.com/401k/meigs—mdh—interview.html*

[7] See "Gross-to-Net" proposed fee and expense disclosure reporting grid. *http://www.dol.gov/ebsa/pdf/IF408b2.pdf.* See also *http://advisor.morningstar.com/articles/article.asp?s=0&docId=15714&pgNo=2*

tem, such as Department of Labor regulation 404(c). That regulation, 404(c), is the lead in the paint, the salmonella in the peanuts, the goose in the jet engine of the retirement system. Fix it, and you will fix the root cause of the problems that plague the 401(k).

3 Expected Returns—Congress can require that participants be given the expected return (economic characteristic) of the portfolio in which their funds are invested. Unlike knowing the expected return of a portfolio, the emotional risk profile most 401(k) participants are given to help them choose investments is not useful in calculating future retirement income nor is it helpful in making appropriate portfolio changes. The expected return is already required by case law to be known and understood by fiduciaries. That same information should also be made known to participants.

4 Pass HR 3185—Congress can pass HR 3185 or its fundamental equivalent to clarify plan expenses by a simple gross-to-net calculation in order to help employers and plan participants make better decisions, and also to restore trust and confidence in the system. No system as important as the 401(k) should have any lingering questions about fee or expense transparency. Thus, the passage of HR 3185 or its equivalent is at a minimum, urgent.

5 Retire-Ability Measures—Congress can encourage employers to look beyond the robotic fund selecting process that has become synonymous with being a 401(k) committee member and to look more deeply at how their plans are designed to produce financially secure retirees. And participants can be provided tools to assess their projected retirement dates and expected income levels.

*Conclusion*

There are problems with how the 401(k) has been delivered; that goes without saying. That does not mean we need to accept what has not worked and protect the status quo. No one is suggesting that employers guarantee benefits. It is proposed, rather, that 401(k) plans be managed like the retirement-income-producing mechanism they were always intended to be. It is because the benefits delivered by a 401(k) are not guaranteed that we should demonstrate particular care and compassion. Participants are entirely vulnerable, and deserve better protections. Protecting the interests of participants will require a sweeping shift in thinking toward a system that enables (1) A fiduciary level of care; (2) Improved safe harbors and incentives; (3) Disclosure of expected investment returns; (4) Transparency via actual gross-to-net disclosure; and (5) Measurements of each participant's ability to retire at targeted dates and income levels. The benefits of these five reforms to the 401(k) system will reach more than fifty million working Americans. Without this shift in thinking and behavior, including abandoning the misused 404(c) provisions, the 401(k) will fail to deliver on its original promise. There is hope for the 401(k) to rebuild savings and regain the trust of American workers, but it must be operated as ERISA originally contemplated; like a "pension benefit" plan.

## Comments to the U.S. House of Representatives Committee on Education and Labor

### Strengthening Worker Retirement Security

February 24, 2009

The American Society of Pension Professionals & Actuaries (ASPPA) and the Council of Independent 401(k) Recordkeepers (CIKR) appreciates the opportunity to submit our comments for the record to the U.S. House of Representatives Committee on Education and Labor on the very important issue of how to strengthen American workers' retirement security.

ASPPA is a national organization of more than 6,500 retirement plan professionals who provide consulting and administrative services for qualified retirement plans covering millions of American workers. ASPPA members are retirement professionals of all disciplines, including consultants, administrators, actuaries, accountants and attorneys. ASPPA's large and broad-based membership gives ASPPA unusual insight into current practical problems with ERISA and qualified retirement plans, with a particular focus on the issues faced by small to medium-sized employers. ASPPA's membership is diverse, but united by a common dedication to the private retirement plan system.

CIKR is a national organization of 401(k) plan service providers. CIKR members are unique in that they are primarily in the business of providing retirement plan services as compared to larger financial services companies that primarily are in the business of selling investments and investment products. As a consequence, the independent members of CIKR, many of whom are small businesses, make available to plan sponsors and participants a wide variety of investment alternatives from various financial services companies without bias or inherent conflicts of interest. By focusing their businesses on efficient retirement plan operations and innovative plan sponsor and participant services, CIKR members are a significant and important segment of the retirement plan service provider marketplace. Collectively, the members of CIKR provide services to approximately 70,000 plans covering three million participants holding in excess of $130 billion in assets.

### Current Environment

The current economic and financial markets crisis has had a devastating effect on Americans' retirement savings. Testifying before this Committee in October, Peter

Orszag, the Director of the Office of Management and Budget, testified that American retirement plans had lost as much as $2 trillion – or about 20 percent of their value – in the past 15 months. This figure is likely higher today.

With respect to 401(k) plans, Fidelity recently announced in its analysis of 11 million participants in more than 17,000 plans that account balances went down on average 27 percent in 2008. The average 401(k) account balances dropped from $69,200 in 2007 to $50,200 in 2008.[1]

According to the Urban Institute, assets in defined contribution plans and individual retirement arrangements (IRAs) lost $2.8 trillion – or 32 percent of their value – over about a one year period. These assets reached $8.7 trillion on September 30, 2007. Just about a year later, as of December 2, 2008, the value of the retirement accounts was $5.9 trillion.[2]

It should be noted that it isn't just private retirement plan assets that have suffered. Federal employees saw their stock fund investments in the Thrift Savings Plan (TSP) plummet as well. Twelve-month returns[3] on the common (C), small cap (S) and international (I) stock index funds showed losses ranging from 38.62% for the C Fund to 44.57% for the I Fund.

But American families already know this – they see the impact every time they check their 401(k) account balance. And understandably many Americans are worried about their financial security in retirement – especially those who are just a few years away from retirement. A recent survey conducted by the National Institute on Retirement Security found that 83 percent of Americans are concerned about how the current economic crisis will impact their ability to attain a secure retirement.[4] Seventy-one percent of Americans believe it will be harder to retire than it was for their parents – and 51 percent believe today's system is worse than when workers relied more on traditional pensions. Furthermore, only about half of Americans with 401(k)-type plans believe they will have enough money to retire.

### 401(k) Plans Are Effective Savings Vehicles

In light of these trends, 401(k) plans have come under intense fire. Testifying before this Committee in October, Professor Teresa Ghilarducci declared that the 401(k) plan was a "failed experiment" and should be replaced with a $600 tax credit for contributions to retirement accounts maintained by the government and providing a guaranteed three percent return. In addition, hundreds of media stories have questioned the viability of

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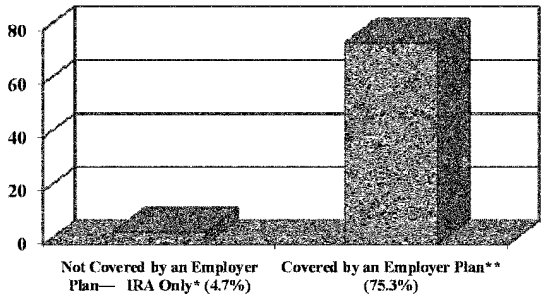
[1] Fidelity Investments, "Fidelity Reports on 2008 Trends in 401(k) Plans," January 28, 2009, available at http://personal.fidelity.com/myfidelity/InsideFidelity/index_NewsCenter.shtml?refhp=pr.
[2] Soto, Mauricio, Urban Institute, "How Is the Financial Crisis Affecting Retirement Savings?" December 3, 2008, available at http://www.urban.org/UploadedPDF/901206_retirement_savings.pdf.
[3] Returns updated through February 2, 2009.
[4] National Institute on Retirement Security, "Pensions & Retirement Security: A Roadmap for Policy Makers," January 14, 2009, available at http://www.nirsonline.org/index.php?option=content&task=view&id=172.

401(k)-type retirement plans. For example, in a recent article in the Los Angeles Times, the reporter argued, "there's been little discussion of the way in which this economic implosion has exposed the utter failure of the now-ubiquitous 401(k) retirement accounts. In fact, the entire 401(k) system looks increasingly like the sort of bait-and-switch con relished by the Bernie Madoff's of the world."[5]

401(k)-bashing has certainly become fashionable, but blaming the plan design itself is unjustified. The 401(k) plan is not a pension plan and was never intended to be one. It was originally viewed as a supplemental retirement savings plan, not as the primary one.

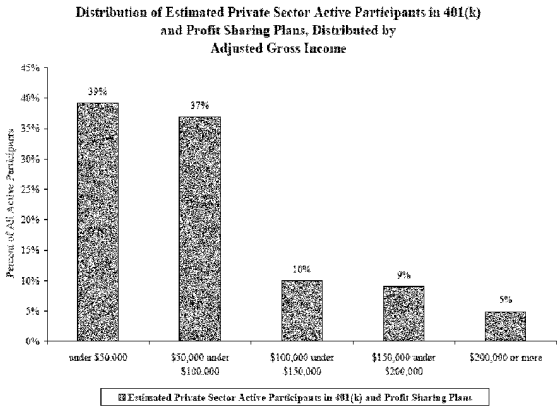
401(k) plans are savings vehicles – and as a savings vehicle, 401(k) plans have worked extremely well. In fact, 401(k) plans are the only effective way we have ever gotten working Americans to save. As demonstrated in the 2008 Employee Benefit Research Institute analysis below, over 75 percent of workers making between $30,000 and $50,000 contribute when covered by a 401(k)-type plan. These workers are 20 times more likely to save as compared to those workers not covered by an employer plan.

**Participation Rates by Moderate Income ($30,000–$50,000) Workers Not Covered by a 401(k)-Type Plan versus Covered by a Plan**

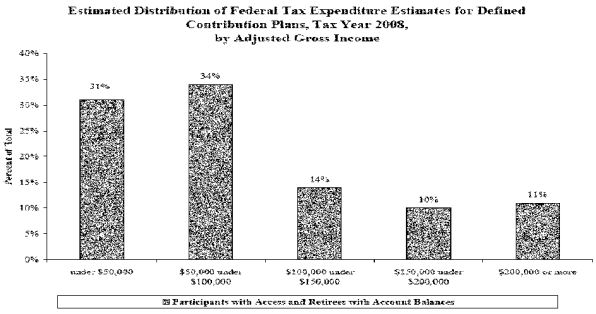



It also is true that lower income workers are the primary beneficiaries of 401(k) and profit sharing plans. The chart below, based on our analysis of Internal Revenue Service data, shows 76 percent of participants in defined contribution plans have annual household incomes of less than $100,000. Eighty-six percent of benefitting households have incomes of less than $150,000 – and only five percent have incomes of $200,000 or more.

[5] Rutten, Tim, "The failure of our 401(k)s," Los Angeles Times, January 10, 2009.

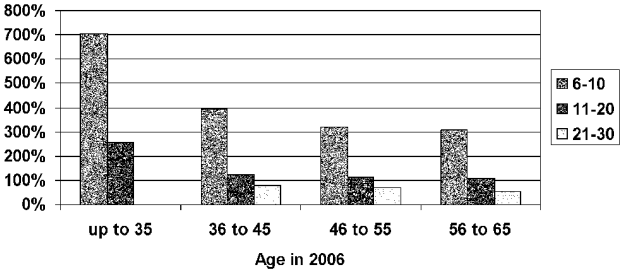



Our research also demonstrates that most of the tax benefits for defined contribution plans go to middle-income Americans. As shown in the chart below, approximately 65 percent of the total tax benefits go to those taxpayers who earn less than $100,000 a year in adjusted gross income (AGI) - and about 79 percent go to those with less than $150,000 of AGI. Almost one-third of the benefits go to Americans with less than $50,000 of AGI.




Furthermore, although the recent market crisis has had a negative impact on the value of 401(k) account balances in 2008 and into 2009, as demonstrated below, the overall impact has been considerably positive. Over about an eight year period, the percentage change in average account balances of all age groups was significantly positive.

**Percentage Change in Average Account Balances among 401(k) Participants Present From Year End 1999 through Year End 2006 by Age and Tenure January 1, 2000 through October 1, 2008[6]**




[6] Statement of Jack VanDerhei, Research Director, Employee Benefit Research Institute, before the House Committee on Education and Labor, *The Impact of the Financial Crisis on Workers' Retirement Security* (October 7, 2008).

Also despite the difficulties in the markets, participants continued to contribute to their 401(k) plans last year. According to the Fidelity analysis, 96 percent of active 401(k) participants as of the third quarter of 2008 continued to contribute in the difficult fourth quarter. This percentage is in line with normal fourth quarters where it is typical to see a slight decline reflecting those participants who have reached their IRC § 402(g) limits. Fidelity also found that 401(k) participants contributed a slightly higher amount to their plans in 2008 than in 2007.[7]

Although 401(k) plans were not intended to be a worker's primary retirement plans, for most Americans, the 401(k) plan will be supplementing Social Security, not Social Security and an employer-provided pension, and the Committee is to be applauded for considering ways to strengthen the 401(k) system. ASPPA and CIKR have been a strong supporter of proposals such as the improved disclosure regime in the 401(k) Fair Disclosure for Retirement Security Act (H.R. 3185) passed by this Committee in the 110th Congress. The principles outlined by Chairman Miller last November[8] will serve as a thoughtful guide for this Committee's deliberations as it works to preserve and strengthen the 401(k) system.

Summary

In response to the current economic and financial markets crisis, 401(k) plans have come under fire. However, you can't blame the drought on the well. 401(k) plans are savings vehicles, and blaming the vehicle itself for the investment losses within the plan is unfair and unjustified. In fact, 401(k) plans work as savings vehicles and they are the only effective way we have ever gotten working Americans to save.

That being said, the reality is that for most working Americans the 401(k) plan has become their sole and primary retirement plan. The drop in values of 401(k) plan accounts has many Americans worried about their financial security in retirement – especially those who are just a few years away from retirement. We stand ready to work with this Committee to strengthen the rules governing 401(k) plans to ensure that all Americans are secure in retirement.

[7] Fidelity Investments, *supra*.
[8] http://edlabor.house.gov/newsroom/2008/11/chairman-miller-unveils-princi.shtml#more



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## Prepared Statement of the Profit Sharing/401k Council of America (PSCA)

The Profit Sharing / 401k Council of America (PSCA), commends Chairman Miller for convening a series of hearing to examine the employer provided retirement plan system. PSCA, a national non-profit association of 1,200 companies and their six million employees, advocates increased retirement security through profit sharing, 401(k), and related defined contribution programs to federal policymakers. It makes practical assistance available to its members on profit sharing and 401(k) plan design, administration, investment, compliance, and communication issues. Established in 1947, PSCA is based on the principle that defined contribution partnership in the workplace fits today's reality. PSCA's services are tailored to meet the needs of both large and small companies, with members ranging in size from Fortune 100 firms to small entrepreneurial businesses.

*The market crisis must be addressed*

401(k) plan participants, working in partnership with employers, can successfully manage normal market risks and cycles and accumulate ample assets for retirement. However, they cannot succeed without efficient and transparent capital markets.

The drop in 401(k) account balances in 2008 was not caused by a defect in the 401(k) system or by ignorant participants. These plans are caught in the same financial crisis that has paralyzed business and financial organizations throughout the world. 401(k) participants have suffered along with everyone else. Inadequate enforcement, misguided policy, reckless conduct, and unethical behavior in the capital markets are the problem, not 401(k) plans. We urge the Committee, and Congress, to direct their efforts to ensuring that a similar market collapse never again occurs. 401(k) participants, as well as all other investors, will then be able to move confidently forward, knowing that saving and investing for the long term will pay off as expected.

The Department of Labor reports that in 2006, the latest year available, participants and employers contributed over $250 billion to 401(k) type plans. The plans continue to improve, benefitting from a regulatory structure that permits flexible plan design and innovation. Automatic enrollment and target date funds were rare five years ago, but they are quickly becoming dominant plan design features. PSCA urges Congress to fix the markets and continue to work together with plan sponsors and providers to continually improve the very successful 401(k) system

Contrary to several published reports, real current data indicates that 401(k) participants are remaining resolute. They are not stopping contributions or increasing their loan activity. Hardship withdrawals have increased slightly, but the percentage of participants taking a hardship distribution remains well below two percent.[1]

*Defined contribution plans work for employees, employers, and America*

Employers offer either a defined benefit or defined contribution, and sometimes both types, of retirement plan to their workers, depending on their own business needs. According to the Investment Company Institute, Americans held $15.9 trillion in retirement assets as of September 30, 2008, the latest available date.[2] On June 30, 2008, retirement assets totaled $16.9 trillion and they were $18 trillion on September 30, 2007. Government plans held $3.9 trillion. Private sector defined benefit plans held $2.3 trillion. Defined contribution plans held $4.0 trillion in employment based defined contribution plans, including $2.7 trillion in 401(k) plans, and $4.1 trillion in IRAs. Employer-based savings are the source of half of IRA assets. Ninety-five percent of new IRA contributions are rollovers, overwhelmingly from employer plans. Annuities held $1.5 trillion.

There are questions about the ability of the defined contribution system to produce adequate savings as it becomes the dominant form of employer provided retirement plan. Some claim America is facing a retirement savings crisis. To answer this question, a baseline for comparison is required. The Congressional Research Service reports that in 2007, 22.8% of individuals age 65 and older received any income from a private sector retirement plan. The median annual income from this source was $7,200.[3] This income stream represents a lump-sum value of $90,000, assuming the purchase of a single-life annuity at an 8% discount rate. Individuals age 65-69 had higher median annual income from a private sector retirement plan, $9,700 ($121,250 lump sum value), but only 19.6% of those age 65 or older received any income from this source. Overall, however, the elderly are not impoverished. In 2007, 9.7% of Americans 65 and older had family incomes below the federal poverty rate, the lowest rate for any population group. How will the next generation of retirees fare compared to current retirees?

We hear about a negative savings rate in America, with some noting that Americans are saving less now than during the Great Depression. Intuitively, something must be wrong with this statistic as the total amount set aside for retirement has almost tripled in 12 years.[4] A 2005 analysis by the Center for Retirement Research sheds considerable light on the matter. They discovered that the NIPA (National Income and Products Account) personal savings rate for the working-age population was significantly higher than the overall rate, which was then 1.8%. Working-age Americans were saving 4.4% of income, consisting almost exclusively of savings in employment-based plans. This does not include business savings, which, of course, are owned by individuals. Those 65 and older were "dissaving" at negative 12% because they were spending their retirement assets, which are not considered income. The report accurately predicted that, as baby-boomers begin to retire, they will consume more than their income and the savings rate as currently defined would go even lower.[5]

A recent paper from the AARP Public Policy Institute includes the following finding:

"While the personal saving rate has declined steadily for the past 20 years, aggregate household net worth, including pension, 401(k), IRA, and housing wealth have increased dramatically. As an indicator of the adequacy of retirement assets, the personal savings rate, despite being cited regularly in the media, is not very useful because it excludes capital gains, which are far more important to changes in net worth than annual personal saving. The change in household net worth, and not the saving rate, should be used to indicate changes in retirement preparation." [6]

The Congressional Research Service reports that married households in which the head or spouse was employed and the head was age 45-54 held median retirement account assets of $103,200 in 2004. Similar unmarried households held $32,000. An identical married household headed by an individual age 55 and older held median retirement account assets of $119,500 in 2004.[7]

While some workers have enjoyed a full working career under a defined contribution plan such a as profit sharing plan, 401(k)-type plans in which the employee decides how much to save have existed for only slightly over twenty years, and most participants have participated in them for a much shorter period of time. The typical participant in 2000 had only participated in the plan for a little over seven years.[8] Policymakers must be wary of statistics citing average 401(k) balances and balances of those approaching retirement because they have not saved over their full working career and some balances belong to brand new participants. For example, a recent Investment Company Institute report stated that at the end of 2006, the average 401(k) balance was $61,346 and the median balance was $18,986.[9] The median age of the participants in the study was 44 and the median tenure in their current 401(k) plan was eight years. But when the study looked at individuals who were active participants in a 401(k) plan from 1999 to 2006 (including one of the worst bear markets since the Depression) the average 401(k) balance at the end of 2006 was $121,202 and the median balance was $66,650. Long-tenured (30 years with the same employer) individuals in their sixties who participated in a 401(k) plan during the 1999-2006 period had an average account balance of $193,701 at the end of 2006. The study does not reflect that many individuals and households have multiple 401(k)-type accounts or assets rolled over into an IRA.

In their April 2007 paper, The Rise of 401(k) Plans, Lifetime Earnings, and Wealth at Retirement, James Poterba, Steven Venti, and David A. Wise reported the following:

"Our projections suggest that the average (over all persons) present value of real DB benefits at age 65 achieved a maximum in 2003, when this value was $72,637 (in year 2000 dollars), and then began to decline. The projections also suggest that by 2010 the average level of 401(k) assets at age 65 will exceed the average present value of DB benefits at age 65. Thereafter the value of 401(k) assets grows rapidly, attaining levels much greater than the historical maximum present value of DB benefits. If equity returns between 2006 and 2040 are comparable to those observed historically, by 2040 average projected 401(k) assets of all persons age 65 will be over six times larger than the maximum level of DB benefits for a 65 year old achieved in 2003 (in year 2000 dollars).

Even if equity returns average 300 basis points below their historical value, we project that average 401(k) assets in 2040 would be 3.7 times as large as the value of DB benefits in 2003. These analyses consider changes in the aggregate level of pension assets. Although the projections indicate that the average level of retirement assets will grow very substantially over the next three or four decades, it is also clear that the accumulation of assets in 401(k)-like plans will vary across households. Whether a person has a 401(k) plan is strongly related to income. Low-income employees are much less likely than higher-income employees to be covered by a 401(k) or similar type of tax-deferred personal account plan."

The Congressional Research Service estimates that a married household that contributes ten percent of earnings to a retirement plan for 30 years will be able to replace fifty-three percent of pre-retirement income. If they save for forty years, they will replace ninety-two percent of income.[10] A ten percent savings rate is realistic given average contribution rates of seven percent and average employer contributions of three percent. These estimates do not consider Social Security payments

The lesson is clear—long-term participation in a 401(k) plan will result in the accumulation of assets adequate to provide a secure retirement.

These statistics mean little if a worker is not saving for retirement. One fact is abundantly clear—whether a worker saves for retirement is overwhelmingly determined by whether or not a worker is offered a retirement plan at work. In 2008, sixty-one percent of private sector workers had access to a retirement plan at work

and fifty-one percent participated. Seventy-one percent of full-time workers had access and sixty percent participated. Seventy-nine percent of workers in establishments employing 100 or more workers had access and sixty-seven percent participated. Only forty-five percent of workers in establishments of less than 100 workers had access to a plan and thirty-seven percent participated, but for establishments with between 50 and 100 workers, fifty-eight percent had access and 45 percent participated.[11] These participation rates are at a single point in time. They are not indicative of whether or not a non-participant or their household will choose to participate in a 401(k) plan for a substantial period of a working career.

*DB and DC plans—understanding the risks and rewards*

Defined benefit plans and defined contribution plans are very different, and each plan has strengths and weaknesses. A traditional defined benefit plan pays a benefit at retirement that is based on a formula that considers years of service and compensation, (usually compensation in the last few years of employment). The employer assumes the investment risk for funding the plan and, accordingly, benefits from high investment returns.

In a defined contribution plan, the employer commits to a certain contribution level and the employee is impacted by investment gains and losses. Proper investment strategies, such as diversification and age-based asset allocations, can greatly reduce investment risk. Target date funds and managed accounts permit a participant to delegate these actions to experts. A risk-averse participant can usually invest in a very conservative, but low-yielding investment. All DC plan participants can independently annuitize their retirement assets if they wish to do so.

Many observers view the different impact of investment risk to claim, incorrectly, that DB plans are risk-free. DB plans are "back-loaded"—the final benefit is strongly determined by earnings in the final years of employment and years of service. Older employees and long-term employees benefit most under a DB plan. Individuals who are involuntarily separated, and those who leave voluntarily, loose a major portion of their future benefit. Traditional DB plans are not portable to a new employer. A second major risk is that the employer will decide to terminate the plan. In both cases, the employee is left only with their accrued vested benefit, usually payable many years in the future. If the sponsoring employer becomes bankrupt, benefits may be further reduced to the PBGC guaranty level. Some defined benefit plans limit payments to a fixed annual amount, resulting in default and inflation risk. Finally, a DB plan benefit ends when the participant (or perhaps a spouse) dies. Those who die early subsidize long-lived participants and there is no opportunity to pass on wealth.

Both types of plans have risks for participants. The primary difference is that in the DC plan system the individual can take responsibility for managing risk. In DB plans, most of the risk is beyond the control of the individual.

*Opportunities for improvement*

What does all these data tell us? First, the employer provided defined contribution system has demonstrated that it can provide asset accumulation adequate for a secure retirement for participants at all income levels. The participation rate when offered a plan is encouraging, but can be improved. There are two areas in which to concentrate our efforts—lower-paid workers and small business plan coverage. We also need to increase participation by African-Americans and some ethnic groups, as revealed by some recent studies. Small business owners need simplicity and meaningful benefits for themselves to compensate for the costs of providing a plan to their workers.

The growth of automatic enrollment plans will substantially increase retirement plan participation by lower and middle-income workers that are most likely to be induced to save by this type of plan design. Ninety percent of workers that are automatically enrolled choose not to opt out of the plan.[12] A 2005 ICI/EBRI study projects that a lowest quartile worker reaching age 65 between 2030 and 2039 who participates in an automatic enrollment program with a 6% salary deferral (with no regard for an employer match) and investment in a life-cycle fund will have 401(k) assets adequate for 52% income replacement at retirement, not including social security that provides another 52% income replacement under today's structure.[13]

The important automatic enrollment provisions in the Pension Protection Act are already producing results. In the latest PSCA survey of 2006 plan year experience, 35.6% of plans have automatic enrollment, compared to 23.6% in 2006, 16.9% in 2005, 10.5% in 2004, and 8.4% in 2003. 53.2% of plans with 5,000 or more participants reported utilizing automatic enrollment in our survey. A Hewitt survey indicated that 36% of respondents offered automatic enrollment in 2007, up from 24% in 2006. Fifty-five percent of the other respondents are "very likely or somewhat

likely" to offer automatic enrollment in 2007.[14] More than 300 Vanguard plans had adopted automatic enrollment by year-end 2007, triple the number of plans that had the feature in 2005. Large plans have been more likely to implement automatic enrollment designs. In 2007, Vanguard plans with automatic enrollment accounted for 15% of plans but one-third of total participants. In the aftermath of the PPA, two-thirds of automatic enrollment plans have implemented automatic annual savings rate increases, up from just one-third in 2005.[15]

*401(k) fees in the erisa framework*

Numerous aspects of ERISA (the Employee Retirement Income Security Act of 1974) safeguard participants' interests and 401(k) assets. Plan assets must generally be held in a trust that is separate from the employer's assets. The fiduciary of the trust (normally the employer or committee within the employer) must operate the trust for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable expenses of administering the plan. In other words, the fiduciary has a duty under ERISA to ensure that any expenses of operating the plan, to the extent they are paid with plan assets, are reasonable.

To comply with ERISA, plan administrators must ensure that the price of services is reasonable at the time the plan contracts for the services and over time. For example, asset-based fees should be monitored as plan assets grow to ensure that fee levels continue to be reasonable for services with relatively fixed costs such as plan administration and per-participant recordkeeping. The plan administrator should be fully informed of all the services included in a bundled arrangement to make this assessment.

Many plan administrators prefer reviewing costs in an aggregate or "bundled" manner. As long as they are fully informed of the services being provided, they can compare and evaluate whether the overall fees are reasonable without being required to analyze each fee on an itemized basis. For example, if a person buys a car, they don't need to know the price of the engine if it were sold separately. They do need to know the horsepower and warranty. Small business in particular may prefer the simplicity of a bundled fee arrangement.

It is important to understand the realities of fees in 401(k) plans. There are significant recordkeeping, administrative, and compliance costs related to an employer provided plan that do not exist for individual retail investors. Nevertheless, because of economies of scale and the fiduciary's role in selecting investments and monitoring fees, the vast majority of participants in ERISA plans have access to capital markets at lower cost through their plans than the participants could obtain in the retail markets.

The Investment Company Institute reports that the average overall investment fee for stock mutual funds is 1.5% and that 401(k) investors pay half that amount.[16] The level of fees paid among all ERISA plan participants will vary considerably, however, based on variables that include plan size (in dollars invested and/or number of participants), average participant account balances, asset mix, and the types of investments and the level of services being provided. Larger, older plans typically experience the lowest cost. Employer provided plans are often the only avenue of mutual fund investment available to lower-paid individuals who have great difficulty accumulating the minimum amounts necessary to begin investing in a mutual fund or to make subsequent investments. Finally, to the degree an employer provides a matching contribution, and most plans do, the plan participant is receiving an extraordinarily high rate of return on their investment that a retail product does not provide.

A study by CEM Benchmarking Inc. of 88 US defined contribution plans with total assets of $512 billion (ranging from $4 million to over $10 billion per plan) and 8.3 million participants (ranging from fewer than 1,000 to over 100,000 per plan) found that total costs ranged from 6 to 154 basis points (bps) or 0.06 to 1.54 percent of plan assets in 2005. Total costs varied with overall plan size. Plans with assets in excess of $10 billion averaged 28 bps while plans between $0.5 billion and $2.0 billion averaged 52 bps. In a separate analysis conducted for PSCA, CEM reported that, in 2005, its private sector corporate plans had total average costs of 33.4 bps and median costs of 29.8 bps.

Other surveys have found similar costs. HR Investment Consultants is a consulting firm providing a wide range of services to employers offering participant-directed retirement plans. It publishes the 401(k) Averages Book that contains plan fee benchmarking data. The 2008 Ninth Edition of the book reveals that average total plan costs ranged from 161 bps for plans with 25 participants to 96 bps for plans with 5,000 participants. The Committee on the Investment of Employee Benefit Assets (CEIBA), whose more than 120 members manage $1.5 trillion in defined benefit and defined contribution plan assets on behalf of 16 million (defined benefit

and defined contribution) plan participants and beneficiaries, found in a 2005 survey of members that plan costs paid by defined contribution plan participants averaged 29 bps.

*Principles of reform*

PSCA supports effective and efficient disclosure efforts. The following principles should be embodied in any effort to enhance fee disclosure in employer-provided retirement plans.

• Sponsors and Participants' Information Needs Are Markedly Different. Any new disclosure regime must recognize that plan sponsors (employers) and plan participants (employees) have markedly different disclosure needs.

• Overloading Participants with Unduly Detailed Information Can Be Counterproductive. Overly detailed and voluminous information may impair rather than enhance a participant's decision-making.

• New Disclosure Requirements Will Carry Costs for Participants and So Must Be Fully Justified. Participants will likely bear the costs of any new disclosure requirements so such new requirements must be justified in terms of providing a material benefit to plan participants' participation and investment decisions.

• New Disclosure Requirements Should Not Require the Disclosure of Component Costs That Are Costly to Determine, Largely Arbitrary, and Unnecessary to Determine Overall Fee Reasonableness. Bundled service providers should disclose the included services in detail. However, a requirement to "unbundle" bundled services and provide individual costs in many detailed categories would be arbitrary and is not particularly helpful and would lead to information that is not meaningful. It also raises significant concerns as to how a service provider would disclose component costs for services if they were not offered outside a bundled contract. These costs will ultimately be passed on to plan participants through higher administrative fees. The increased burden for small businesses could inhibit new plan growth.

• Information About Fees Must Be Provided Along with Other Information Participants Need to Make Sound Investment Decisions. Participants need to know about fees and other costs associated with investing in the plan, but not in isolation. Fee information should appear in context with other key facts that participants should consider in making sound investment decisions. These facts include each plan investment option's historical performance, relative risks, investment objectives, and the identity of its adviser or manager.

• Disclosure Should Facilitate Comparison But Sponsors Need Flexibility Regarding Format. Disclosure should facilitate comparison among investment options, although employers should retain flexibility as to the appropriate format for workers.

• Participants Should Receive Information at Enrollment and Have Ongoing Access. Participants should receive fee and other key investment option information at enrollment and be informed periodically about fees.

*HR 3185*

PSCA supports legislation that will effectively improve fee transparency for sponsors and participants. HR 3185, as reported by the Committee on April 16, 2008, reflects many of our principles and is a significant improvement over the original legislation. In addition to numerous minor adjustments to ensure that HR 3185 reflects the complexity of the retirement plan system, PSCA recommends three key changes. First, the legislation needs to include a "matching proposal" that specifies that the fiduciary duty to determine that fees are reasonable is limited in scope to the fees required to be disclosed under the legislation. The Committee agreed to examine this issue when Representative Kline offered and withdrew an implementing amendment during the 2008 mark-up. Second, Congress should abandon the "unbundling' requirement in the bill and permit both models to compete in the marketplace. Bundled providers should provide a detailed description of the services they offer so that plan fiduciaries can determine that the aggregate fee is reasonable. Finally, the index fund requirement in the revised bill remains problematic.

ENDNOTES

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[7] Retirement Savings: How Much Will Workers Have When They Retire?, CRS Report For Congress, January 29, 2007.
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[9] 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2006, Investment Company Institute, August, 2007.
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Ms. MUNNELL. Mr. Chairman, could I also ask that an article that we had on guarantees be included.

Chairman MILLER. It is on the level?

Ms. MUNNELL. Yes.

Chairman MILLER. Okay, without objection.

[The information follows:]

CENTER FOR RETIREMENT RESEARCH AT BOSTON COLLEGE

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# WHAT DOES IT COST TO GUARANTEE RETURNS?

By Alicia H. Munnell, Alex Golub-Sass, Richard A. Kopcke, and Anthony Webb*

## Introduction

The financial crisis has dramatically demonstrated how a collapse in equity prices can decimate retirement accounts. The crisis highlights the fragility of existing 401(k) plans as the only supplement to Social Security and has sparked proposals to reform the retirement income system. One component of such a system could be a new tier of retirement accounts. Given the declines in the share of earnings Social Security will replace, these accounts would bolster replacement rates for low-wage workers and increase the security of middle- and upper-wage workers who increasingly rely on their 401(k) plans to supplement Social Security. However, these new accounts could face the same risk of collapse in value seen over the past year in 401(k)s. So policymakers may find some form of guaranteed return or risk sharing desirable to prevent huge variations in outcomes.[1] This *brief* explores the feasible range and the cost of the first option – guarantees.

This *brief* is structured as follows. The first section reviews the argument for more retirement saving and shows the inevitable volatility that results from leaving the outcomes completely up to the market. The second section shows that, *in retrospect*, it would have been quite cheap to have guaranteed relatively high real rates of return on individual account balances and that only high guarantees would have smoothed returns across cohorts in a meaningful way. The third section uses finance theory to price guarantees *prospectively*, finding that guarantees in excess of the risk-free rate are not possible if the guarantor shares the market's aversion to risk. The fourth section concludes that, as long as the guarantor shares the market's aversion to risk, rate of return guarantees are unlikely to solve the problem of wide variations in outcomes due to market fluctuations. Guaranteeing the riskless rate would have had no impact historically. And finance theory suggests that insurers cannot guarantee returns greater than the riskless rate unless they are willing and able to bear more risk than other investors.

## The Need for More Retirement Income

People need more retirement saving because the existing retirement income system is contracting

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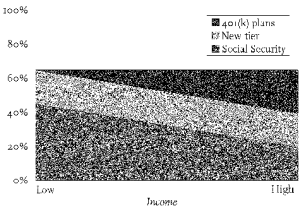
and people are living longer. At any given retirement age, Social Security benefits will replace a smaller fraction of pre-retirement earnings than in the past. First, the increase in the Full Retirement Age from 65 to 67 is equivalent to an across-the-board cut. Second, the taxation of Social Security benefits under the personal income tax will move further down the income distribution, as the exemption amounts in the tax code are not indexed to wage growth or inflation. Additional benefit cuts that might be enacted to shore up the solvency of the Social Security program would further lower replacement rates.

With a diminished role for Social Security, retirees will be increasingly dependent on employer-sponsored pensions. At any moment in time, however, less than half of the private sector workforce age 25-64 participates in any employer-sponsored plan. And those who do have employer-sponsored coverage find themselves increasingly reliant on 401(k) plans. In theory, workers could accumulate substantial wealth in a 401(k), but the Federal Reserve's 2004 *Survey of Consumer Finances* reports that the typical household head approaching retirement (age 55-64) had 401(k)/IRA balances of only $60,000.[2] Although 401(k) plans received a boost from the Pension Protection Act of 2006, which encouraged employers to make their plans easier and more automatic, the basic fragility of 401(k)s was exposed by the current financial crisis, which has reduced the value of equities in 401(k)s/IRAs by about $2 trillion.[3]

Given the decline in Social Security and employer-provided pensions, workers could save more on their own. But they have not. Thus, many future retirees – both those who must rely only on Social Security and those who have a supplementary 401(k) plan – are likely to have inadequate retirement income. Proposals to expand coverage through automatic IRAs or a universal 401(k) implicitly claim that those who already have a supplementary plan will be adequately prepared for retirement. As indicated above, this assumption is not correct. Thus, the vast majority of future retirees will need an additional tier of retirement saving. Figure 1 presents a schematic of what an additional tier might look like.

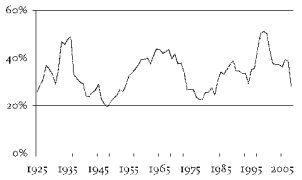
An earlier *brief* showed that replacement rates – benefits as a percent of pre-retirement earnings – produced by a defined contribution account will vary dramatically depending on the performance of the stock market during the period over which the participant is working and accumulating assets (see Figure 2).[4] This pattern occurs even when individuals invest in a target date fund. These accumulations are only somewhat offset by variations in interest rates at retirement when individuals are assumed to use their accumulations to purchase a real (inflation-adjusted) annuity.

Figure 1. Additional Tier of Funded, Privately-Managed Retirement Saving




*Source:* Authors' illustration.

Figure 2. Replacement Rate from a Real Annuity Based on Accumulations in a Target Date Fund




*Source:* Munnell, Webb, and Golub-Sass (2008).

The recent financial crisis highlights another problem with defined contribution accounts – namely, values can drop precipitously just as participants are approaching retirement. Sharp drops in retirement balances upset people's plans even if the drops merely offset a lifetime of high returns. Earlier high returns are likely to have encouraged people to cut back on their saving, sensing they had "enough" for retirement. As a result, a market collapse leaves most people with inadequate retirement saving.

The question is whether policymakers would view as acceptable such widely different replacement rates and the potential for large declines. If such outcomes are not acceptable, mechanisms would be needed to address these problems in the new tier of retirement saving. Interestingly, the two problems are intertwined, and solving one substantially ameliorates the other, as will be shown below.

## Guarantees in *Retrospect*

The most straightforward approach would be to guarantee rates of return.[5] The following exercise estimates when and how much the guarantor would have had to pay out to cover different levels of guarantees. The model assumes that workers enter the workforce at 22, work steadily for 43 years and retire at age 65, and enjoy real wage growth of 2 percent a year. Each year from 1883 to 2008 workers contribute 4 percent of their income to their account and invest their contributions in a fund of U.S. equities. Over that period, the stock market returned 7.6 percent after inflation with a standard deviation of 19.5 percent. In the analysis below, the first cohort reaches age 65 in 1925.

Although we are ultimately interested in replacement rates rather than age 65 accumulations, to simplify the exercise we ignore the effect of interest rates on annuity prices and focus on accumulations at age 65. Thus, the question becomes how often and how much would a guarantor have had to pay in order to provide workers when they reached age 65 a real return of 2 percent, 3 percent, 4 percent, 5 percent, or 6 percent on their lifetime contributions. To satisfy each of these guarantees, Table 1 shows the dates and the amounts that would have had to be transferred to those age 65 as a percent of Gross Domestic Product (GDP). Note that the table shows only those years that involve a required payment. See the Appendix for additional details on the calculations.

The results reveal, *based on historical data*, that a 2-percent and 3-percent guarantee would never have required any payments. The reason is that, over the period under consideration, a portfolio fully invested in equities never yielded less than 3.8 percent averaged over an individual's work life. A 4-percent guarantee would have required payments in three years out of the 84 years; a 5-percent guarantee would have required payments in eight years; and a 6-percent guarantee would have required payments in 27 out of the 84 years. For example, with a 6-percent guarantee, the guarantor would have had to pay out to those turning 65 in 2008 an amount equal to 0.42 percent of GDP, about $60 billion.

Table 1. Required Guarantee Payment as a Percent of GDP by Guaranteed Rate of Return

| | Guaranteed Rate of Return | | | | |
|---|---|---|---|---|---|
| Year | 2% | 3% | 4% | 5% | 6% |
| 1925 | - | - | - | - | 0.39% |
| 1926 | - | - | - | | 0.52% |
| 1931 | - | - | 0.06% | 0.82% | 1.83% |
| 1932 | - | - | 0.17% | 1.19% | 2.53% |
| 1933 | - | - | - | - | 1.04% |
| 1934 | - | - | - | 0.05% | 1.39% |
| 1937 | - | - | - | - | 1.01% |
| 1939 | - | - | - | - | 0.21% |
| 1940 | - | - | - | - | 0.51% |
| 1941 | - | - | 0.01% | 0.32% | 0.74% |
| 1942 | - | - | - | 0.23% | 0.61% |
| 1943 | - | - | - | 0.04% | 0.38% |
| 1944 | - | - | - | - | 0.25% |
| 1946 | - | - | - | - | 0.31% |
| 1947 | - | - | - | 0.05% | 0.39% |
| 1948 | - | - | - | 0.07% | 0.41% |
| 1949 | - | - | - | - | 0.28% |
| 1974 | - | - | - | - | 0.36% |
| 1977 | - | - | - | - | 0.10% |
| 1978 | - | - | - | - | 0.28% |
| 1979 | - | - | - | - | 0.28% |
| 1980 | - | - | - | - | 0.07% |
| 1981 | - | - | - | - | 0.40% |
| 1982 | - | - | - | - | 0.26% |
| 1983 | - | - | - | - | 0.06% |
| 1984 | - | - | - | - | 0.14% |
| 2008 | - | - | - | - | 0.42% |

*Source:* Authors' calculations based on U.S. Bureau of Economic Analysis (2008); Officer and Williamson (2008); U.S. Bureau of Labor Statistics, *Current Population Survey* (CPS) (1962-2008); and U.S. Census Bureau, *Decennial Census* (1920-1960).

Two key questions regarding guarantees in retrospect are how much they would have cost and whether they would have done the job of smoothing replacement rates and avoiding major upset to people's plans. The following discussion assumes that the guarantor is the government.[6] Relying on the private sector for even low levels of guarantees raises issues relating to the continuity of the insurer and the availability of a natural hedge. Given the recent demise of Bear Stearns and Lehman Brothers and the plight of AIG, individuals would have no confidence that the firm offering the guarantee would be there for the payoff forty years down the road. And private sector firms would have no natural hedge to insure against the possibility of having to cover the guarantee, since very few counterparties exist that would gain from a sharp economic downturn. Thus, the government becomes the only realistic source of guarantees and the questions are whether the government *in retrospect* could have afforded the cost of guarantees and whether guarentees would have smoothed fluctuations.

## *Cost of Guarantees in Retrospect*

The cost depends on what happens to returns in excess of the government guarantee. That is, assume the government guarantees a 4-percent return, but those turning 65 in a given year had earned 8 percent over their worklives. The additional 4 percent could accrue to the individuals – that is, they get the upside – or it could go to the government to offset future bad years. Over the past 84-year period, if the government had gotten the whole upside, it would have experienced no net cost – even at a guarantee level of 6 percent. In fact, the government would have made money (see Table 2).

Table 2. Cost of Government Guarantees as a Percent of GDP, Depending on Entity Keeping the Upside, 1925-2008

| Guaranteed rate of return | Entity keeping the upside | |
|---|---|---|
| | Government | Individuals |
| 3 percent | -2.194% | 0.000% |
| 4 percent | -1.864 | 0.003 |
| 5 percent | -1.424 | 0.033 |
| 6 percent | -0.834 | 0.183 |

*Source:* Authors' calculations based on U.S. Bureau of Economic Analysis (2008); Officer and Williamson (2008); 1962-2008 CPS; and 1920-1960 *Decennial Census*.

On the other hand, if individuals had kept the whole upside, the government would have faced some costs (see Table 2). The government could have issued debt when the payments were made and spread the costs over, say, the next 30 years. On average, the government would have needed to raise taxes by an amount equal to 0.18 percent of GDP (roughly $26 billion in 2008). Alternatively, the costs could have been covered by increasing the individual contribution rate. For example, to guarantee each individual retiring at age 65 an annual average rate of return of 6 percent, the contribution rate would have had to be raised from 4 percent to 4.36 percent. The basic conclusion is that regardless of how costs are measured, guarantees – even high levels of guarantees – would have been totally affordable in retrospect.

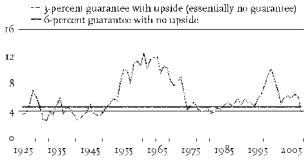
## *Effect of Guarantees in Retrospect*

The impetus for the discussion of guarantees was twofold. First, policymakers might not want a government-sponsored tier of retirement income to have replacement rates varying from 20 percent to 50 percent. Second, it might be desirable to avoid a system where participants can see their account balances drop by 30 percent as they approach retirement. The question is the extent to which guarantees solve these problems.

*Smoothing replacement rates.* Providing low levels of guarantees – say 2 or 3 percent – and allowing individuals to keep the upside, does virtually nothing to eliminate the fluctuations. As discussed above, no group turning 65 in the last 84 years would have seen a lifetime return of less than 3.8 percent. Therefore, the guarantee would never have been paid, and the pattern of accumulations relative to final earnings would have been identical to that produced by the fluctuations in the market (see Figure 3 on the next page). On the other hand, a guarantee of, say, 6 percent, with the upside going to the government, stabilizes accumulations relative to final earnings by providing everyone with the same amount.

The stability in accumulations relative to earnings appears to be purchased at the expense of some groups of retirees foregoing substantial gains. This outcome is the result of picking a guarantee of 6 percent when equities have yielded 7.6 percent. A higher guarantee would eliminate the apparent problem, but would put future taxpayers on the hook for bigger payments. But it is worth noting that even a guarantee of 6 percent allows individuals to invest all their

Figure 3. Ratio of Assets to Final Salary, Assuming a 3-Percent Guarantee with Upside and a 6-Percent Guarantee with No Upside

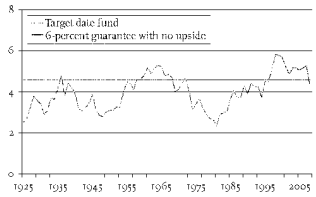



*Source:* Authors' calculations based on Burtless (2000); and Burtless (2008).

contributions in the new tier in equities. Without a guarantee, most financial experts would advise individuals to invest in a suitable target date fund where the percent in equities declines as the person ages. Such an approach would produce not only wide variations in accumulations, as discussed earlier, but also lower accumulations than a 6-percent return (see Figure 4).

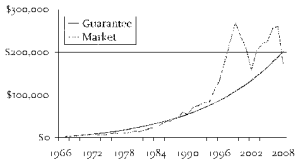
*Avoiding sharp drops.* As in the case of smoothing, a guarantee of 2 or 3 percent would have had no effect, while a guarantee of 6 percent would have avoided a major calamity in 2008. Figure 5 shows the accumulated balances in a defined contribution account for a hypothetical individual entering the labor force in 1966 at age 22 and turning 65 in 2008 under a 6-percent guarantee and under market returns.[7] Under a 6-percent guarantee, where the government gets the upside, the individual would have been entitled to $188,000 in 2007, while the market value of assets in the account would have been $259,600. In 2008, the financial collapse would have reduced the market value of assets by 35 percent to $169,600. But, with the guarantee of a cumulative lifetime return of 6 percent, the government would have transferred $31,500 to the individual's guaranteed account. This transfer would have brought the total to $201,100 – producing a predictable lifetime guarantee of 6 percent on accumulated contributions.

Figure 4. Ratio of Assets to Final Salary, Assuming a 6-Percent Guarantee with No Upside and a Target Date Fund




*Source:* Authors' calculations based on Burtless (2000); Burtless (2008); and Fidelity Investments (2008).

Figure 5. Guaranteed Account Balance Assuming a 6-Percent Return and Market Values




| Year | Guarantee | Market |
|---|---|---|
| 2007 | $188,000 | $259,600 |
| 2008 | $201,100 | $169,600 |

*Source:* Authors' calculations.

## *Prospective* Guarantees

The past 83 years represent only a limited number of draws from an unlimited number of outcomes that could have occurred, and therefore cannot be used to determine the potential cost of guarantees going forward. Instead, standard finance theory allows us to estimate the market price of future guarantees in a manner that reflects both the risk of insurers' experiencing substantial shortfalls and their aversion to bearing these risks.

A guaranteed minimum average rate of return on pension balances invested in stocks is a kind of put option, commonly known as a floor, which commits insurers to top up retirees' pension accounts when their average returns fall short of the guaranteed return. The price of a floor can be estimated assuming that insurers' aversion to risk matches the market average and that, in the future, equity returns follow a random walk with the same mean (7.6 percent) and standard deviation (19.5 percent) that they have displayed in the past.[8] As shown in Table 3, this calculation indicates that the market price for guaranteeing a floor equal to the risk-free real rate of return, 2 percent, amounts to 29 percent of a saver's annual contributions (see the Appendix for details on calculations).[9] In other words, for every dollar contributed to the savings plan, the participant would have to pay an additional 29 cents to the insurer.[10] Buying a floor at a 3-percent rate of return comes at a higher price, 46 percent of contributions. As the floor increases, the price of the insurance jumps sharply.

Table 3. Price of Guaranteed Floors and Ceilings with Market Risk Aversion, Percent of Contributions

| Rate of Return | Price of floor (1) | Price of ceiling (2) | Net cost for a collar (3)=(1)-(2) |
|---|---|---|---|
| 2 percent | 29% | 29% | 0% |
| 3 percent | 46 | 22 | 24 |
| 4 percent | 71 | 16 | 56 |
| 5 percent | 107 | 11 | 97 |
| 6 percent | 157 | 7 | 150 |
| 7 percent | 224 | 4 | 220 |

*Source:* Authors' calculations.

Savers can offset the cost of buying floors by surrendering some of their upside returns to the insurer. This ceiling for average returns is a kind of call option, and the participant can sell this option to the insurer. The insurer would then receive any returns that exceed the ceiling. Unlike the price of floors, the price of a ceiling falls rapidly as the ceiling increases because higher ceilings reduce the potential gain to the insurer (see Table 3, column 2). As a result, savers cannot expect to pay for generous floors by selling high ceilings.

The combination of a floor and a ceiling is known as a collar.[11] As shown in Table 3, the net price of a collar at the risk-free rate of return is zero – the cost of purchasing a floor is exactly covered by selling a ceiling.[12] Collars at higher rates of return involve much higher net costs. For example, a floor at 6 percent combined with a ceiling at 6 percent would cost 150 percent of the contribution – that is, $1.50 for each $1 dollar contributed. The net result – within this framework – is that the return on the *combined* insurance payment and contribution – the gross contribution – never exceeds the riskless rate.

If the participant is allowed some upside potential, say a floor of 2 percent and a ceiling of 3 percent, then the effective guarantee on the gross contribution must be less than the riskless rate (see Table 4). In short, an individual who wants any upside potential must pay for it.

The message from standard financial theory is that insurers cannot guarantee anything more than the riskless rate when they share the market's aversion to risk.[13] On the other hand, at least historically, a riskless rate guarantee would have done nothing to smooth out fluctuations since no cohort would have received a lifetime return of less than 3.2 percent.

This gap between past experience and finance theory's cap on feasible guarantees is due to limits on the market's willingness and ability to bear risk. This gap can be diminished if the government is less averse to risk than the market. Indeed, citizens acting in concert through the government can impose arrangements – such as intergenerational risk sharing – not possible by private agents acting on their own. In addition, credit-worthy governments can access capital

Table 4. Price of Collars with Market Risk Aversion

| Floor/ Ceiling | Net price of collar | Gross contribution | Effective guarantee on gross contribution |
|---|---|---|---|
| 2% / 2% | 0% | $1.00 | 2.00% |
| 2% / 3% | 7.0 | 1.07 | 1.68 |
| 3% / 3% | 24.1 | 1.24 | 2.00 |
| 3% / 4% | 30.3 | 1.30 | 1.77 |

*Source:* Authors' calculations.

markets at the risk-free rate of interest, provided their obligations are not excessive relative to their capacity to raise revenues now and in the future.[14] Experience also suggests that the government is more willing and able to bear macroeconomic risk than the private market. In its provision of unemployment insurance and its conduct of countercyclical fiscal policy, the government assumes commitments that appear too risky for private investors to provide. One question, then, is whether government guarantees should be priced according to the risk aversion evident in capital markets, or should they be priced with less aversion to risk?

Suppose, for example, the government's level of risk aversion were only one half that of private insurers. The price of a floor at the risk-free rate would be only 13 percent of contributions, less than half of its price using the market's aversion to risk (see Table 5).

Table 5. Price of Guaranteed Floors and Ceilings with Half Individuals' Risk Aversion, Percent of Contributions

| Rate of Return | Price of floor (1) | Price of ceiling (2) | Net cost for a collar (3)=(1)-(2) |
|---|---|---|---|
| 2 percent | 13% | 97% | -84% |
| 3 percent | 23 | 83 | -60 |
| 4 percent | 40 | 68 | -28 |
| 5 percent | 66 | 53 | 13 |
| 6 percent | 106 | 40 | 66 |
| 7 percent | 165 | 28 | 137 |

*Source:* Authors' calculations.

More striking, by using collars, savers can purchase much higher guarantees at no, or little, net cost. For example, by purchasing a collar with a floor at a 4 percent rate of return and a ceiling at about 6 percent, savers would, at no net cost, be guaranteed an average rate of return on their retirement savings in this range.[15] The size of feasible guarantees, therefore, depends on the insurer's degree of risk aversion.[16]

## Conclusion

This *brief* has been a speculative discussion of what might be involved if a new tier of retirement saving were introduced and if large variations in replacement rates were viewed as unacceptable. The only way to avoid wide variations in replacement rates is to provide a guarantee or some form of risk sharing. And, when a guarantee is the method chosen, the only way to eliminate most of the variation is for the guarantee to be relatively high. Even though high guarantees would have been feasible historically, standard finance theory says that guaranteeing more than the riskless rate is impossible going forward. Finance theory also shows that the magnitude of feasible guarantees depends critically on insurers' capacity for bearing risk. When the government is less averse to risk than other investors, it can guarantee rates of return higher than the riskless rate. Consequently, the feasibility of providing attractive guarantees for returns in a new tier of savings accounts depends on whether applying private insurers' risk preferences to the government is appropriate.

## Endnotes

1 Munnell, Webb, and Golub-Sass (2008).

2 Munnell and Sundén (2006).

3 Munnell and Muldoon (2008).

4 Munnell, Webb, and Golub-Sass (2008).

5 A recent proposal would offer a guarantee with a real rate of return of 3 percent and allow a Board of Trustees to raise the guarantee if the economy performs better than expected (Ghilarducci 2008).

6 Although we are unaware of any governments that directly offer defined contribution pension plan guarantees, both Germany and Switzerland require fund managers to guarantee some level of investment returns (see Ammann (2003) and Maurer and Schlag (2002), respectively).

7 These balances assume that the individual began working in 1966 at a salary of $19,200 in 2008 dollars, experienced annual wage growth of 2 percent, earning the reported average of $44,000 for those employed at 65. The individual contributed 4 percent of salary each year, and received the return to U.S. equities each year.

8 This illustration could have used other distributions of returns, including distributions that specify some form of mean-reversion in returns or the price of equity. Replacing the random walk assumed here with mean-reverting returns would tend to compress the range of payoffs for pension balances, thereby reducing the cost of floors on average. However, if the reversion to mean is sufficiently slow, the potential cost of floors would be higher for participants who join the plan during years when returns are particularly low compared to the floor for those who join when returns are particularly high.

9 This analysis uses the simplifying assumption that the risk-free rate is a fixed real two percent. Lachance and Mitchell (2003) present a model in which the risk-free rate is a stochastic process.

10 Savers who purchase a floor at the risk-free rate can invest only $1 per $1.29 of contributions. Consequently, they are really guaranteeing only 78 percent of the retirement wealth that they could attain by investing each dollar of contribution in risk-free bonds. Of course, their investment in equities offers an upside that risk-free bonds lack. Savers who purchase floors above the risk-free rate insure a higher rate of return, but their guaranteed minimum wealth in retirement falls as a result of the substantial cost of these floors.

11 See Feldstein and Ranguelova (2001).

12 A collar at the risk-free rate fixes the return on stocks to match that on risk-free bonds. No-arbitrage features in standard financial theory require that investments with identical payoffs be priced the same. Consequently, an investment in stocks combined with this collar has a return and yield equivalent to an investment in risk-free assets.

13 The coefficient of relative risk aversion implied by the risk-free rate and distribution of returns on equity in this brief is 2. This figure rests at the low end of the range reported in the literature, which tends to cluster between 2 and 10 depending in part on whether the estimates are derived from portfolio theory, purchases of insurance, economic experiments, or preferences over lotteries (Chetty 2003). Three factors are important in considering the reasonableness of the implied level of risk aversion in this *brief*. First, the 2 applies only to the marginal investor; infra-marginal investors could well have higher levels of risk aversion. Second, the market pricing of securities reflects the risk aversion of active institutional and professional investors, who are likely to be more willing and able to bear risk than the average investor. And, third, the pricing of securities likely reflects the assessments of investors who are most optimistic about future returns, which tends to depress the coefficient of risk aversion implied by market pricing.

14 Gollier (2008) shows that the ability of governments to enforce intergenerational risk sharing can increase the certainty equivalent rate of return by allowing pension funds to invest their financial assets more aggressively than would otherwise be optimal.

15 When an insurer's aversion to risk is less than that in the market, the insurer can capture a share of the market's risk premium in the return on equity. When the insurer is not averse to risk, it can offer the entire premium, at no extra cost, in guarantees of returns.

As a result, whereas market pricing does not allow guarantees in excess of the risk-free rate, an insurer with no aversion to risk could offer guarantees approaching 7.6 percent at no net cost.

16 A stable and responsible central government is likely less averse to risk than its households and businesses. This *brief* finds that the coefficient of relative risk aversion is about 2 for marginal private investors, given its assumptions about the risk-free rate and the distribution of the returns on equity. Older public finance literature defended a low social discount rate on public investment, reflecting the government's broad scope for diversifying risk and its risk-free cost of capital (Samuelson 1964; Vickery 1964; and Arrow 1965, 1966), thereby implying a low coefficient of risk aversion in its pricing of investments from the viewpoint of the private market. Some more recent work suggests discount rates for public investments that could exceed those of private investments (Jensen and Bailey 1972; and Bazelon and Smetters 1999). But, when the public investment covers the risk in the entire market portfolio averaged over long horizons, and the government can access capital, even in difficult times, at the risk-free rate, then the case for an effectively low coefficient of risk aversion for the government is more compelling. This *brief* uses a value of 1 simply to illustrate the potential magnitude of the public benefit that the government might provide.

17 See Black and Scholes (1973).

18 See LaChance and Mitchell (2003).

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# APPENDIX

## Retrospective Guarantees – Tables 1 and 2

To compute when payments are required, we compare two types of accounts at retirement: a guaranteed account and a non-guaranteed account. In each case, workers are assumed to enter the labor force at age 22, have earnings rise 2 percent a year, contribute 4 percent of earnings into the account, and retire after 43 years, at 65. Each year, the guaranteed account earns the level of guarantee specified in the model. The non-guaranteed account earns the return experienced by U.S. equities each year for the individual's 43-year worklife.

To calculate the values in Table 1, we determine whether the non-guaranteed account's final balance falls short of the guaranteed account's final balance. To calculate the amount of the payment, we need to determine the final wage of each cohort. For the years after 1962, we use the *Current Population Survey* (CPS) to calculate the average wage for individuals at age 56 for that particular cohort. (We use this procedure because a substantial segment of the age 65 population does not receive a wage.) We then project forward to age 65 using the model's assumed annual growth rate of 2 percent. Before 1962, we assume that the fraction of total wages earned by individuals aged 56 before 1962 equals the average fraction of total wages earned by individuals aged 56 after 1962. For each year before 1962, we divide this fraction of total wages by the total population of individuals age 56 to find the average wage. Again, because the CPS began in 1962, we must estimate the age 65 population for all preceding years. Age 65 populations are calculated using the weighted averages of forecasts and backcasts made from the Decennial Census reports issued before and after the year in question, respectively, and Social Security Administration cohort life tables. (Note: all values are presented in chained year 2000 dollars). Finally, this value is then divided by Gross Domestic Product (GDP) for each year in which a payment needed to be made on a guarantee. Table 2 is based on the values calculated for Table 1.

For column 1, we calculate the net gain or loss in each year as a percent of GDP. We then take the average of those gains and losses over the entire 84-year period. For columns 2 and 3, we find the sum of the net losses as a percent of wages and GDP, respectively, and divide by 84 – the total number of years.

## Prospective Guarantees – Tables 3, 4, and 5

The guarantee of a minimum return for a participant in a defined contribution pension plan is a kind of put option. We value this option with Monte Carlo simulations instead of the Black-Scholes equation because the option's payoff depends on the path taken by returns.[17] The sequence of returns is critical when the option covers the average rate of return earned on a portfolio that receives annual contributions.[18]

For each of the 10,000 simulations, an individual makes a yearly contribution equal to a constant percent of his wages, the individual's contribution is added to his assets and the balance earns a return. The terminal balance $b_T$, will be equal to

$$b_T = \sum_{t=1}^{43} c_t \prod_{j=t}^{43} (1+r_j); \; c_t = c_1 (1+w)^{t-1} \qquad (1)$$

where $c_1$ is the initial contribution, $w$ is the assumed rate of wage growth, and $r_t$ is the return experienced in year $t$. Returns were randomly generated as independent and identically distributed normal variables with a mean of 7.6 percent and a standard deviation of 19.5 percent.

Each of the 10,000 terminal balances is sorted, arrayed, and assigned a probability of 1 in 10,000 to form the actual probability density function (PDF). The analysis examines guarantors whose aversion to risk matches that of the market (Table 3) and those who are less averse to risk (Table 5).

Assuming guarantors are averse to risk, we value the payoffs according to a constant relative risk aversion (CRRA) utility function with a coefficient of risk aversion of 2.02. The coefficient of risk aversion is consistent with investors' requiring a 5.6 percent risk premium to hold a risky asset for 43 years with the normally distributed returns described above. The risk-neutral PDF for these guarantors is the product of the actual PDF for terminal balances derived from the Monte Carlo simulations and the pricing kernel (the marginal utility of wealth divided by consumption), which is then normalized to sum to one.

The entries in Table 5 assume that guarantors are less averse to risk. The risk-neutral PDF in this case is the product of the actual PDF and the pricing kernel derived from a CRRA utility function with a coefficient of risk aversion of 1.0.

To calculate the cost of a floor, we first use equation (1) to calculate the risk-free terminal wealth that would result from receiving the risk-free return each year. We then use equation (1) to calculate the guaranteed terminal wealth that would result from receiving the guaranteed rate of return each year. The cost of the floor is the present value of the expected value of terminal balances that are less than guaranteed terminal wealth. The cost of the floor per dollar of contributions equals the conditional expectation of terminal balances that are less than guaranteed wealth divided by risk-free terminal wealth. To calculate this conditional expectation, the entries in Table 3 use the risk-neutral PDF that incorporates a coefficient of risk aversion of 2.02, while those in Table 5 use the risk-neutral PDF that incorporates a coefficient of risk aversion of 1.

To calculate the cost of a ceiling, we use equation (1) to calculate the maximal terminal wealth that would result from receiving the ceiling rate of return each year. The cost of the ceiling is the present value of the expected terminal balances that exceed maximal terminal wealth. The cost of the ceiling per dollar of contributions equals the conditional expectation of terminal balances that exceed the maximal balance divided by risk-free terminal wealth. Again, the entries in Table 3 use the risk-neutral PDF that incorporates a coefficient of risk aversion of 2.02, while those in Table 5 use the risk-neutral PDF that incorporates a coefficient of risk aversion of 1.0

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Chairman MILLER. Thank you, again, very much for—oh. And as previously ordered, members will have 14 days to submit additional materials for the hearing. And as somebody submitted—Mr. Scott submitted a question to ask for Mr. Bogle to follow up on. And we will send that forward. And with that, the hearing stands adjourned. Thank you.

[Additional submissions by Mr. Miller follow:]

[Internet addresses to the Ariel/Schwab Black Investor Survey follow:]

*http://www.arielinvestments.com/content/view/560/1173/*

*http://www.arielinvestments.com/content/view/354/1228/*

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**Prepared Statement of Mellody Hobson, President, Ariel Investments, LLC and Chairman, Ariel**

Chairman Miller, Ranking Member McKeon, distinguished Members, thank you for the opportunity to submit this statement for the hearing "Strengthening Worker Retirement Security." My name is Mellody Hobson and I am the President of Ariel Investments, LLC, a privately owned Chicago-based money management firm with more than $4.4 billion in assets under management, founded in 1983 by John W. Rogers, Jr. In addition to managing separate accounts for corporate, public, union and non-profit organizations, Ariel Investments also serves as the investment adviser to the publicly-traded, no-load Ariel Mutual Funds.

Patience serves as the core of our investment philosophy. Ariel Investments was built around the belief that patient investors will be rewarded—that wealth can be created by investing in great companies, selling at excellent prices whose true value would be realized over time. As such, we believe our long-term performance is driven by our disciplined and focused approach, our stock selection across industries where Ariel has proven expertise, our exhaustive investigative research process and our commitment to investing in quality businesses that are typically undervalued or ignored.

With the largest generation in American history set to begin retiring, the country is facing a retirement crisis. Almost half of Americans today have little or nothing saved. The vast majority have far short of what they will need. Fewer and fewer Americans today have jobs offering guaranteed pensions and many public and private pension systems are underfunded. Many pensions affiliated with financially troubled companies are also at risk of collapse, and the federal agency set up to insure them is severely underfunded.

By most estimates, Social Security is in need of supplement and even under the best of circumstances is inadequate to funding a secure retirement for working Americans. The typical retiree lives for 17 years after retiring at 65. The typical retired couple spends more than $200,000 on health care in their old age. Defined contribution plans (401(k), 403(b), and 453) were never intended to replace traditional pensions (defined benefit plans) but for more and more people today, they are the only way of saving for retirement. The problem, however, is that most people do not save nearly enough and do not manage well the money they have.

These problems are even more extreme among minorities, who have less first-hand experience with money management than society as a whole. I have provided the results of the 2008 Ariel-Schwab Black Investor Survey and the Ariel-Schwab Black Paper. At Ariel we have learned that for middle-class African-Americans, the march toward financial security has been an uphill journey marked by half steps, pauses and, for some, retreat. Over the last decade, Ariel Investments and The Charles Schwab Corporation have commissioned annual research comparing the saving and investing habits of middle- and upper-income Black and White Americans. The results consistently reveal that Blacks save less than Whites of similar income levels and are less comfortable with stock investing which impedes wealth building across generations and contributes to the growing retirement crisis.

The 11th Annual Black Investor Survey shows White Americans have more than twice as much saved for retirement as Blacks, but finds employers well positioned to make a difference. African-Americans are on equal footing with Whites when it comes to accessing and enrolling in employer-sponsored defined contribution plans, but save far less each month and have a considerably smaller nest egg than their White counterparts, according to the 11th annual Ariel/Schwab Black Investor Survey. The survey also found that with some help from employers, all employees, but particularly African-Americans, would be likely to ramp up their monthly 401(k) savings

This year's survey found that for many younger African-Americans, saving for retirement is more of a dream than a priority. Both Ariel and Schwab have made a major investment in financial education for youth. Through Ariel's foundation, the Ariel Education Initiative, the company supports the Ariel Community Academy, a Chicago public school that integrates financial literacy into the school's curriculum. Charles Schwab Foundation funds Money Matters: Make it Count, an after-school financial literacy program with Boys & Girls Clubs of America.

I thank the Committee again for taking up this important issue, and welcome any questions or comments you may have.

**Prepared Statement of the American Benefits Council**

Employer-sponsored 401(k) and other defined contribution retirement plans are a core element of our nation's retirement system and successfully assist tens of millions of families in accumulating retirement savings. While individuals have understandable retirement income concerns resulting from the recent market and economic downturns—concerns fully shared by the American Benefits Council—it is critical to acknowledge the vital role defined contribution plans play in creating personal financial security.

Congress has adopted rules that facilitate employer sponsorship of these plans, encourage employee participation, promote prudent investing, allow operation at reasonable cost, and safeguard participant interests through strict fiduciary obligations. As a result 401(k) plans are valued by workers who participate in them as important resources for delivering retirement benefits. Nevertheless, improvements to the system can certainly be made. Helping workers to manage market risk and to translate their defined contribution plan savings into retirement income are areas that would benefit from additional policy deliberations. An additional area in which reform would be particularly constructive is increasing the number of Americans who have access to a defined contribution or other workplace retirement plan.

The goal should be a 401(k) system that functions in a transparent manner and provides meaningful benefits at a fair price. At the same time, we all must bear in mind that unnecessary burdens and cost imposed on these plans will slow their growth and reduce participants' benefits, thus undermining the very purpose of the plans. It is important to understand the facts relating to these plans. The Council believes the following principles are critical in evaluating any reform measures in this area:

• Defined Contribution Plans Reach Tens of Millions of Workers and Provide an Important Source of Retirement Savings. There are now more than 630,000 private-sector defined contribution plans covering more than 75 million active and retired workers, with another 10 million employees covered by tax-exempt and governmental defined contribution plans.

• Employers Make Significant Contributions Into Defined Contribution Plans. Many employers make matching, non-elective, and profit-sharing contributions to complement employee deferrals and share the responsibility for financing retirement. Recent surveys of defined contribution plan sponsors found that at least 95% make some form of employer contribution.

• Employer Sponsorship Offers Advantages to Employees. Employer sponsors of defined contribution plans must adhere to strict fiduciary obligations established by Congress to protect the interests of plan participants. Employers exercise oversight through selection of plan investment options, educational materials and workshops about saving and investing and professional investment advice.

• Defined Contribution Plan Coverage and Participation Rates Are Increasing. The number of employees participating in these plans grew from 11.5 million in 1975 to more than 75 million in 2005, and 65% of full-time employees in private industry had access to a defined contribution plan in 2008.

• Defined Contribution Plan Rules Promote Benefit Fairness. Congress has established detailed rules to ensure that benefits in defined contribution plans are delivered across all income groups. Extensive coverage, nondiscrimination and top-heavy rules promote fairness regarding which employees are covered by a defined contribution plan and the contributions made to these plans.

• 401(k) Plans Have Evolved in Ways That Benefit Workers. Both Congress and private innovation have enhanced 401(k) plans, aiding their evolution from bare-bones savings plans into retirement plans. Among these enhancements have been incentives for plan creation, catch-up contributions for older workers, accelerated vesting schedules, tax credits, automatic contribution escalation, single-fund investment solutions and investment education programs.

• Recent Enhancements to the Defined Contribution System Are Working. The Pension Protection Act of 2006 (PPA) encourages automatic enrollment and automatic contribution escalation. PPA also provided new rights to diversify contributions made in company stock, accelerating existing trends toward greater diversification of 401(k) assets.

• Defined Contribution Plan Savings is an Important Source of Investment Capital. With more than $4 trillion in combined assets as of March 2008, these plans represent ownership of a significant share of the total pool of stocks and bonds, provide an important and ready source of American investment capital.

• Defined Contribution Plans Should Not Be Judged on Short-Term Market Conditions.

Workers and retirees are naturally concerned about the impact of the recent market turmoil. It is important, however, for policymakers and participants to judge defined contribution plans based on whether they serve workers' retirement interests over the long term.

• Inquiries About Risk Are Appropriate But No Retirement Plan Design is Immune from Risk. The recent market downturn has spawned questions about whether defined contribution plan participants may be subject to undue investment risk. Yet it is difficult to imagine any retirement plan design that does not have some kinds of risk. Any efforts to mitigate risk should focus on refinements to the existing successful employer-sponsored retirement plan system and shoring up the Social Security safety net.

The Council has prepared the attached white paper to more fully develop these principles. We encourage a full and vigorous debate over ways to improve retirement security for American workers. At the same time, it is critical that the debate not serve to undermine retirement security by inadvertently increasing the costs to participants or discouraging plan sponsorship.

*February 5, 2009.*

## DEFINED CONTRIBUTION PLANS: A SUCCESSFUL CORNERSTONE OF OUR NATION'S RETIREMENT SYSTEM

### *Introduction*

Employer-sponsored 401(k) and other defined contribution retirement plans are a core element of our nation's retirement system, playing a critical role along with Social Security, personal savings and employer-sponsored defined benefit plans. Defined contribution plans successfully assist tens of millions of American families in accumulating retirement savings. Congress has adopted rules for defined contribution plans that:

• facilitate employer sponsorship of plans,
• encourage employee participation,
• promote prudent investing by plan participants,
• allow operation of plans at reasonable cost, and
• safeguard plan assets and participant interests through strict fiduciary obligations and intensive regulatory oversight.

While individuals have understandable retirement income concerns resulting from the recent market and economic downturns—concerns fully shared by the American Benefits Council—it is critical to acknowledge the vital role defined contribution plans play in building personal financial security.

### *Defined Contribution Plans Reach Tens of Millions of Workers and Provide an Important Source of Retirement Savings*

Over the past three decades, 401(k) and other defined contribution plans have increased dramatically in number, asset value, and employee participation. As of June 30, 2008, defined contribution plans (including 401(k), 403(b) and 457 plans) held $4.3 trillion in assets, and assets in individual retirement accounts (a significant share of which is attributable to amounts rolled over from employer-sponsored retirement plans, including defined contribution plans) stood at $4.5 trillion.[1] Of course, assets have declined significantly since then due to the downturn in the financial markets. Assets in 401(k) plans are projected to have declined from $2.9 trillion on June 30, 2008 to $2.4 trillion on December 31, 2008,[2] and the average 401(k) account balance is down 27% in 2008 relative to 2007.[3] Nonetheless, 401(k) account balances are up 140% when compared to levels as of January 1, 2000.[4] Thus, even in the face of the recent downturn (which of course has also affected workers' non-retirement investments and home values), employees have seen a net increase in workplace retirement savings. This has been facilitated by our robust and expanding defined contribution plan system. As discussed more fully below, employees have also remained committed to this system despite the current market conditions, with the vast majority continuing to contribute to their plans.

In terms of the growth in plans and participating employees, the most recent statistics reveal that there are more than 630,000 defined contribution plans covering more than 75 million active and retired workers with more than 55 million current workers now participating in these plans.[5] Together with Social Security, defined contribution plan accumulations can enable retirees to replace a significant percentage of pre-retirement income (and many workers, of course, will also have income from defined benefit plans).[6]

*Employers Make Significant Contributions Into Defined Contribution Plans*

When discussing defined contribution plans, the focus is often solely on employee deferrals into 401(k) plans. However, contributions consist of more than employee deferrals. Employers make matching, non-elective, and profit-sharing contributions to defined contribution plans to complement employee deferrals and share with employees the responsibility for funding retirement. Indeed, a recent survey of 401(k) plan sponsors with more than 1,000 employees found that 98% make some form of employer contribution.[7] Another recent study of employers of all sizes indicated that 62% of defined contribution sponsors made matching contributions, 28% made both matching and profit-sharing contributions, and 5% made profit-sharing contributions only.[8] While certain employers have reduced or suspended matching contributions as a result of current economic conditions, the vast majority have not.[9] Those that have are often doing so as a direct result of substantially increased required contributions to their defined benefit plans or institution of a series of cost-cutting measures to preserve jobs. As intended, matching contributions play a strong role in encouraging employee participation in defined contribution plans.[10]

*The Defined Contribution System is More Than 401(k) Plans*

The defined contribution system also includes many individuals beyond those who participate in the 401(k) and other defined contribution plans offered by private-sector employers. More than 7 million employees of tax-exempt and educational institutions participate in 403(b) arrangements,[11] which held more than $700 billion in assets as of earlier this year.[12] Millions of employees of state and local governments participate in 457 plans, which held more than $160 billion in assets as of earlier this year.[13] Finally, 3.9 million individuals participate in the federal government's defined contribution plan (the Thrift Savings Plan), which held $226 billion in assets as of June 30, 2008.[14]

*401(k) Plans Have Evolved in Ways That Benefit Workers*

Even when focusing on 401(k) plans, it is important to keep in mind that these plans have evolved significantly from the bare-bones employee savings plans that came into being in the early 1980s. As discussed more fully below, employers have enhanced these arrangements in numerous ways, aiding their evolution into robust retirement plans. Congress has likewise enacted numerous enhancements to 401(k) plans, making major improvements to the 401(k) system in the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, the Economic Growth and Tax Relief Reconciliation Act of 2001, and the Pension Protection Act of 2006. Among the many positive results have been incentives for plan creation, promotion of automatic enrollment, catch-up contributions for workers 50 and older, safe harbor 401(k) designs, accelerated vesting schedules, greater benefit portability, tax credits for retirement savings, and enhanced rights to diversify company stock contributions.

There also has been tremendous innovation in the 401(k) marketplace, with employer plan sponsors and plan service providers independently developing and adopting many features that have assisted employees. For example, both automatic enrollment and automatic contribution escalation were first developed in the private sector. Intense competition among service providers has helped spur this innovation and has driven down costs. Among the market innovations that have greatly enhanced defined contribution plans for participants are:

- on-line and telephonic access to participant accounts and plan services,
- extensive financial planning, investment education and investment advice offerings,
- single-fund investment solutions such as retirement target date funds and risk-based lifestyle funds, and
- in-plan annuity options and guaranteed withdrawal features that allow workers to replicate attributes of defined benefit plans.

These legislative changes and market innovations have resulted in more employers wanting to sponsor 401(k) plans and have—together with employer enhancements to plan design—improved both employee participation rates and employee outcomes.

*Long-Term Retirement Plans Should Not Be Judged on Short-Term Market Conditions*

Workers and retirees are naturally concerned about the impact of the recent market turmoil. It is important, however, for policymakers and participants to evaluate defined contribution plans based on whether they serve workers' retirement interests over the long term rather than over a period of months. Defined contribution plans and the investments they offer employees are designed to weather changes in

economic conditions—even conditions as anxiety-provoking as the ones we are experiencing today. (Market declines and volatility are, of course, affecting all types of retirement plans and investment vehicles, not just defined contribution plans.) Although it is difficult to predict short-run market returns, over the long run stock market returns are linked to the growth of the economy and this upward trend will aid 401(k) investors. Indeed, one of the benefits for employees of participating in a defined contribution plan through regular payroll deduction is that those who select equity vehicles purchase these investments at varying prices as markets rise and fall, achieving effective dollar cost averaging. If historical trends continue, defined contribution plan participants who remain in the system can expect their plan account balances to rebound and grow significantly over time.[15] That being said, the American Benefits Council favors development of policy ideas (and market innovations) to help those defined contribution plan participants nearing retirement improve their retirement security and generate adequate retirement income.

It is important to note that in the face of the current economic crisis and market decline, plan participants remain committed to retirement savings and few are reducing their contributions. Rather, the large majority of participants continue to contribute at significant rates and remain in appropriately diversified investments. One leading 401(k) provider saw only 2% of participants decrease contribution levels in October 2008 (1% actually increased contributions) despite the stock market decline and volatility experienced during that month.[16] Another leading provider found that 96% of 401(k) participants who contributed to plans in the third quarter of 2008 continued to contribute in the fourth quarter.[17] Research from the prior bear market confirms that employees tend to hold steady in the face of declining stock prices, remaining appropriately focused on their long-term retirement savings and investment goals.[18]

Demonstrating the importance of defined contribution plans to employees, a recent survey found that defined contribution plans are the second-most important benefit to employees behind health insurance.[19] The same survey found that 9% of employees viewed greater deferrals to their defined contribution plan as one of their top priorities for 2009.[20]

*Defined Contribution Plan Coverage and Participation Rates Are Increasing*

Participation in employer-sponsored defined contribution plans has grown from 11.5 million in 1975 to more than 75 million in 2005.[21] This substantial increase is a result of many more employers making defined contribution plans available to their workforces. Today, the vast majority of large employers offer a defined contribution plan,[22] and the number of small employers offering such plans to their employees has been increasing modestly as well.[23] In total, 65% of full-time employees in private industry had access to a defined contribution plan at work in 2008 (of which 78% participated).[24] Small businesses that do not offer a 401(k) or profit-sharing plan are increasingly offering workers a SIMPLE IRA, which provides both a saving opportunity and employer contributions.[25] Indeed, as of 2007, 2.2 million workers at eligible small businesses participated in a SIMPLE IRA.[26]

The rate of employee participation in defined contribution plans offered by employers also has increased modestly over time[27]—with further increases anticipated as a result of automatic enrollment adoption. Moreover, participating employees are generally saving at significant levels—levels that have risen over time.[28] Younger workers, in particular, increasingly look to defined contribution plans as a primary source of retirement income.[29]

There are understandable economic impediments that keep some small employers, particularly the smallest firms, from offering plans. The uncertainty of revenues is the leading reason given by small businesses for not offering a plan, while cost, administrative challenges, and lack of employee demand are other impediments cited by small business.[30] Indeed, research reveals that employees at small companies place less priority on retirement benefits relative to salary than their counterparts at large companies.[31] As firms expand and grow, the likelihood that they will offer a retirement plan increases.[32] Congress can and should consider additional incentives and reforms to assist small businesses in offering retirement plans, but some small firms will simply not have the economic stability to do so. Mandates on small business to offer or contribute to plans will only serve to exacerbate the economic challenges they face, reducing the odds of success for the enterprise, hampering job creation and reducing wages.

Some have understandably focused on the number of Americans who do not currently have access to an employer-sponsored defined contribution plan. Certainly expanding plan coverage to more Americans is a universally shared goal. Yet statistics about retirement plan coverage rates must be viewed in the appropriate context. Statistics about the percentage of workers with access to an employer retirement

plan provide only a snapshot of coverage at any one moment in time. Given job mobility and the fact that growing employers sometimes initiate plan sponsorship during an employee's tenure, a significantly higher percentage of workers have access to a plan for a substantial portion of their careers.[33] This coverage provides individuals with the opportunity to add defined contribution plan savings to other sources of retirement income. It is likewise important to note that individuals' savings behavior tends to evolve over the course of a working life. Younger workers typically earn less and therefore save less. What younger workers do save is often directed to non-retirement goals such as their own continuing education, the education of their children or the purchase of a home.[34] As they age and earn more, employees prioritize retirement savings and are increasingly likely to work for employers offering retirement plans.[35]

*Defined Contribution Plan Rules Promote Benefit Fairness*

The rules that Congress has established to govern the defined contribution plan system ensure that retirement benefits in these plans are delivered across all income groups. Indeed, the Internal Revenue Code contains a variety of rules to promote fairness regarding which employees are covered by a defined contribution plan and the contributions made to these plans. These requirements include coverage rules to ensure that a fair cross-section of employees (including sufficient numbers of non-highly compensated workers) are covered by the defined contribution plan and nondiscrimination rules to make certain that both voluntary employee contributions and employer contributions for non-highly compensated employees are being made at a rate that is not dissimilar to the rate for highly compensated workers.[36] There are also top-heavy rules that require minimum contributions to non-highly compensated employees' accounts when the plan delivers significant benefits to top employees.

Congress has also imposed various vesting requirements with respect to contributions made to defined contribution plans. These requirements specify the timetable by which employer contributions become the property of employees. Employees are always 100% vested in their own contributions, and employer contributions made to employee accounts must vest according to a specified schedule (either all at once after three years of service or in 20% increments between the second and sixth years of service).[37] In addition, the two 401(k) safe harbor designs that Congress has adopted—the original safe harbor enacted in 1996 and the automatic enrollment safe harbor enacted in 2006—require vesting of employer contributions on an even more accelerated schedule.[38]

*Employer Sponsorship of Defined Contribution Plans Offers Advantages to Employees*

As plan sponsors, employers must adhere to strict fiduciary obligations established by Congress to protect the interests of plan participants. ERISA imposes, among other things, duties of prudence and loyalty upon plan fiduciaries. ERISA also requires that plan fiduciaries discharge their duties "solely in the interest of the participants and beneficiaries" and for the "exclusive purpose" of providing participants and beneficiaries with benefits.[39] These exceedingly demanding fiduciary obligations (which are enforced through both civil and criminal penalties) offer investor protections not typically associated with savings vehicles individuals might use outside the workplace.

One area in which employers exercise oversight is through selection and monitoring of the investment options made available in the plan. Through use of their often considerable bargaining power, employers select high-quality, reasonably-priced investment options and monitor these options on an ongoing basis to ensure they remain high-quality and reasonably-priced. Large plans also benefit from economies of scale that help to reduce costs. Illustrating the value of this employer involvement, the mutual funds that 401(k) participants invest in are, on average, of lower cost than those that retail investors use.[40] Recognizing these benefits, an increasing number of retirees are leaving their savings in defined contribution plans after retirement, managing their money using the plan's investment options and taking periodic distributions. With the investment oversight they bring to bear, employers are providing a valuable service that employees would not be able easily or inexpensively to replicate on their own outside the plan.

Employers also typically provide educational materials about retirement saving, investing and planning, and in many instances also provide access to investment advice services.[41] To supplement educational materials and on-line resources, well over half of 401(k) plan sponsors offer in-person seminars and workshops for employees to learn more about retirement investing, and more than 40% provide communications to employees that are targeted to the workers' individual situations.[42] Surveys

reveal that a significant percentage of plan participants utilize employer-provided investment education and advice tools.[43] Although participants can obtain such information outside of the workplace, it can be costly or require significant effort to do so, yielding yet another advantage to participation in an employer-sponsored defined contribution plan.

*Recent Enhancements to the Defined Contribution System Are Working*

Recent legislative reforms are improving outcomes for defined contribution plan participants. The Pension Protection Act of 2006 ("PPA"), in particular, included several landmark changes to the defined contribution system that are already beginning to assist employees in their retirement savings efforts.

Employee participation rates are beginning to increase thanks to PPA's provisions encouraging the adoption of automatic enrollment. This plan design, under which workers must opt out of plan participation rather than opt in, has been demonstrated to increase participation rates significantly, helping to move toward the universal employee coverage typically associated with defined benefit plans.[44] And more employers are adopting this design in the wake of PPA, in numbers that are particularly notable given that the IRS's implementing regulations have not yet been finalized and the Department of Labor's regulations were not finalized until more than a year after PPA's enactment.[45] One leading defined contribution plan service provider saw a tripling in the number of its clients adopting automatic enrollment between year-end 2005 and year-end 2007,[46] and other industry surveys show a similarly rapid increase in adoption by employers.[47] Moreover, many employers that have not yet adopted automatic enrollment are seriously considering doing so.[48]

Employers are also beginning to increase the default savings rate at which workers are automatically enrolled,[49] which is important to ensuring that workers have saved enough to generate meaningful income in retirement. Studies show that automatic enrollment has a particularly notable impact on the participation rates of lower-income, younger, and minority workers because these groups are typically less likely to participate in a 401(k) plan where affirmative elections are required.[50] Thus, PPA's encouragement of auto enrollment is helping to improve retirement security for these often vulnerable groups.

PPA also encouraged the use of automatic escalation designs that automatically increase an employee's rate of savings into the plan over time, typically on a yearly basis. This approach is critical in helping workers save at levels sufficient to generate meaningful retirement income and can be useful in ensuring that employees save at the levels required to earn the full employer matching contribution.[51] Employers are increasingly adopting automatic escalation features.[52]

In PPA, Congress also directed the Department of Labor (DOL) to develop guidance providing for qualified default investment alternatives, or QDIAs—investments into which employers could automatically enroll workers and receive a measure of fiduciary protection. QDIAs are diversified, professionally managed investment vehicles and can be retirement target date or life-cycle funds, managed account services or funds balanced between stocks and bonds. There has been widespread adoption of QDIAs by employers and this has helped improve the diversification of employee investments in 401(k) and other defined contribution plans.[53] Congress also directed DOL in PPA to reform the fiduciary standards governing selection of annuity distribution options for defined contribution plans, and the DOL has recently issued final regulations on this topic.[54] As a result, fiduciaries now have a clearer road map for the addition of an annuity payout option to their plan, which can give participants another tool for translating their retirement savings into lifelong retirement income.

*Defined Contribution Plans Provide Employees with the Tools to Make Sound Investments*

As a result of legislative reform and employer practices, employees in defined contribution plans have a robust set of tools to assist them in pursuing sound, diversified investment strategies. As noted above, employers provide educational materials on key investing principles such as asset classes and asset allocation, diversification, risk tolerance and time horizons. Employers also provide the opportunity for sound investing by selecting a menu of high-quality investments from diverse asset classes that, as discussed above, often reflect lower prices relative to retail investment options.[55] Moreover, the vast majority of employers operate their defined contribution plans pursuant to ERISA section 404(c),[56] which imposes a legal obligation to offer a "broad range of investment alternatives" including at least three options, each of which is diversified and has materially different risk and return characteristics.

The development and greater use by employers of investment options that in one menu choice provide a diversified, professionally managed asset mix that grows more conservative as workers age (retirement target date funds, life-cycle funds, managed account services) has been extremely significant and has helped employees seeking to maintain age-appropriate diversified investments.[57] As mentioned above, the use of such options has accelerated pursuant to the qualified default investment alternatives guidance issued under PPA.[58] These investment options typically retain some exposure to equities for workers as they approach retirement age. Given that many such workers are likely to live decades beyond retirement and through numerous economic cycles, some continued investment in stocks is desirable for most individuals in order to protect against inflation risk.[59]

One potential challenge when considering the diversification of employee defined contribution plan savings is the role of company stock. Traditionally, company stock has been a popular investment option in a number of defined contribution plans, and employers sometimes make matching contributions in the form of company stock. Congress and employers have responded to encourage diversification of company stock contributions. PPA contained provisions requiring defined contribution plans (other than employee stock ownership plans) to permit participants to immediately diversify their own employee contributions, and for those who have completed at least three years of service, to diversify employer contributions made in the form of company stock.[60] And today, fewer employers (23%) make their matching contributions in the form of company stock, down from 45% in 2001.[61] Moreover, more employers that do so are permitting employees to diversify these matching contributions immediately (67%), up from 24% that permitted such immediate diversification in 2004.[62]

The result has been greater diversification of 401(k) assets. In 2006, a total of 11.1% of all 401(k) assets were held in company stock.[63] This is a significant reduction from 1999, when 19.1% of all 401(k) assets were held in company stock.[64]

*New Proposals for Early Access Would Upset the Balance Between Liquidity and Asset Preservation*

The rules of the defined contribution system strike a balance between offering limited access to retirement savings and restricting such saving for retirement purposes. Some degree of access is necessary in order to encourage participation as certain workers would not contribute to a plan if they were unable under any circumstances (e.g., health emergency, higher education needs, first-home purchase) to access their savings prior to retirement.[65] Congress has recognized this relationship between some measure of liquidity and plan participation rates and has permitted pre-retirement access to plan savings in some circumstances. For example, the law permits employers to offer workers the ability to take loans from their plan accounts and/or receive so-called hardship distributions in times of pressing financial need.[66] However, a low percentage of plan participants actually use these provisions, and loans and hardship distributions do not appear to have increased markedly as a result of the current economic situation.[67] To prevent undue access, Congress has limited the circumstances in which employees may take pre-retirement distributions and has imposed a 10% penalty tax on most such distributions.[68]

In 2001, as part of the Economic Growth and Tax Relief Reconciliation Act (EGTRRA), Congress took further steps to ease portability of defined contribution plan savings and combat leakage of retirement savings. EGTRRA required automatic rollovers into IRAs for forced distributions of balances of between $1,000 and $5,000 and allowed individuals to roll savings over between and among 401(k), 403(b), 457 and IRA arrangements at the time of job change.[69]

As a result of changes like these, leakage from the retirement system at the time of job change has been declining modestly over time—although leakage is certainly an issue worthy of additional attention.[70] Participants, particularly those at or near retirement, are generally quite responsible in handling the distributions they take from their plans when they leave a company, with the vast majority leaving their money in the plan, taking partial withdrawals, annuitizing the balance or reinvesting their lump sum distributions.[71] In sum, policymakers should acknowledge the careful balance between liquidity and preservation of assets and should be wary of proposals that would provide additional ways to tap into retirement savings early.

*Defined Contribution Plan Savings is an Important Source of Investment Capital*

The amounts held in defined contribution plans have an economic impact that extends well beyond the retirement security of the individual workers who save in these plans. Retirement plans held approximately $16.9 trillion in assets as of June 30, 2008.[72] As noted earlier, amounts in defined contribution plans accounted for approximately $4.3 trillion of this amount, and amounts in IRAs represented ap-

proximately $4.5 trillion (much of which is attributable to rollovers from employer-sponsored plans, including defined contribution plans).[73] Indeed, defined contribution plans and IRAs hold nearly 20% of corporate equities.[74] These trillions of dollars in assets, representing ownership of a significant share of the total pool of stocks and bonds, provide an important and ready source of investment capital for American businesses. This capital permits greater production of goods and services and makes possible additional productivity-enhancing investments. These investments thereby help companies grow, add jobs to their payrolls and raise employee wages.

*Inquiries About Risk Are Appropriate But No Retirement Plan Design is Immune from Risk*

The recent market downturn has generated reasonable inquiries about whether participants in defined contribution plans may be subject to undue investment risk. As noted above, the American Benefits Council favors development of policy proposals and market innovations that seek to address these concerns. Yet it is difficult to imagine any retirement plan design that does not have some kind or degree of risk. Defined benefit pensions, for example, are extremely valuable retirement plans that serve millions of Americans. However, employees may not stay with a firm long enough to accrue a meaningful benefit, benefits are often not portable, required contributions can impose financial burdens on employers that can constrain pay levels or job growth, and companies on occasion enter bankruptcy (in which case not all benefits may be guaranteed).

Some have suggested that a new federal governmental retirement system would be the best way to protect workers against risk. Certain of these proposals would promise governmentally guaranteed investment returns, which would entail a massive expansion of government and taxpayer liabilities at a time of already unprecedented federal budget deficits. Other proposals would establish governmental clearinghouses or agencies to oversee retirement plan investments and administration. Such approaches would likewise have significant costs to taxpayers and would unnecessarily and unwisely displace the activities of the private sector. Under these approaches, the federal government also would typically regulate the investment style and fee levels of retirement plan investments. These invasive proposals would constrain the investment choices and flexibility that defined contribution plan participants enjoy today and would establish the federal government as an unprecedented rate-setter for many retirement investments.

Rather than focusing on new governmental guarantees or systems, any efforts to mitigate risk should instead focus on refinements to the existing successful employer-sponsored retirement plan system and shoring up the Social Security safety net.

*The Strong Defined Contribution System Can Still Be Improved*

While today's defined contribution plan system is proving remarkably successful at assisting workers in achieving retirement security, refinements and improvements to the system can certainly be made. Helping workers to manage market risk and to translate their defined contribution plan savings into retirement income are areas that would benefit from additional policy deliberations. An additional area in which reform would be particularly constructive is increasing the number of Americans who have access to a defined contribution or other workplace retirement plan. The American Benefits Council will soon issue a set of policy recommendations as to how this goal of expanded coverage can be achieved. We believe coverage can best be expanded through adoption of a multi-faceted set of reforms that will build on the successful employer-sponsored retirement system and encourage more employers to facilitate workplace savings by their employees. This multi-faceted agenda will include improvements to the current rules governing defined contribution and defined benefit plans, expansion of default systems such as automatic enrollment and automatic escalation, new simplified retirement plan designs, expanded retirement tax incentives for individuals and employers, greater use of workplace IRA arrangements (such as SIMPLE IRAs and discretionary payroll deduction IRAs), more effective promotion of existing retirement plan options, and efforts to enhance Americans' financial literacy.

ENDNOTES

[1] Peter Brady & Sarah Holden, The U.S. Retirement Market, Second Quarter 2008, INVESTMENT COMPANY INST. FUNDAMENTALS 17, no. 3-Q2, Dec. 2008. This paper reveals that, as of June 30, 2008, total U.S. retirement accumulations were $16.9 trillion, a 13.4% increase over 2005 and a 59.4% increase over 2002. As noted above, these asset figures have decreased in light of recent market declines although assets held in defined contribution plans and individual retirement accounts still make up more than half of total U.S. retirement assets. See

Brian Reid & Sarah Holden, Retirement Saving in Wake of Financial Market Volatility, INVESTMENT COMPANY INST., Dec. 2008.

[2] 2007 Account Balances: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project; 2008 Account Balances: Estimates from Jack VanDerhei, EBRI.

[3] Press Release, Fidelity Investments, Fidelity Reports on 2008 Trends in 401(k) Plans (Jan. 28, 2009).

[4] 1999 and 2006 Account Balances: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project; 2007 and 2008 Account Balances: Estimates from Jack VanDerhei, EBRI. The analysis is based on a consistent sample of 2.2 million participants with account balances at the end of each year from 1999 through 2006 and compares account balances on January 1, 2000 and November 26, 2008. See also Jack VanDerhei, Research Director, Employee Benefit Research Institute, What Is Left of Our Retirement Assets?, PowerPoint Presentation at Urban Institute (Feb. 3, 2009).

[5] According to the Department of Labor, there were 103,346 defined benefit plans and 207,748 defined contribution plans in 1975. In 2005, there were 47,614 defined benefit plans and 631,481 defined contribution plans. U.S. Department of Labor, Employee Benefits Security Administration, Private Pension Plan Bulletin Historical Tables (Feb. 2008). See also Sarah Holden, Peter Brady, & Michael Hadley, 401(k) Plans: A 25-Year Retrospective, INVESTMENT COMPANY INST. PERSPECTIVE 12, no. 2, Nov. 2006.

[6] A joint ICI and EBRI study projected that 401(k) participants in their late 20s in 2000 who are continuously employed, continuously covered by a 401(k) plan, and earned historical financial market returns could replace significant amounts of their pre-retirement income (103% for the top income quartile; 85% for the lowest income quartile) with their 401(k) accumulations at retirement. Sarah Holden & Jack VanDerhei, Can 401(k) Accumulations Generate Significant Income for Future Retirees?, INVESTMENT COMPANY INST. PERSPECTIVE 8, no. 3, Nov. 2002.

[7] Report on Retirement Plans—2007, Diversified Investment Advisors (Nov. 2007).

[8] 401(k) Benchmarking Survey—2008 Edition, Deloitte Consulting LLP (2008).

[9] In an October 2008 survey, only 2% of employers reported having reduced their 401(k)/403(b) matching contribution and only 4% said they planned to do so in the upcoming 12 months. WATSON WYATT WORLDWIDE, EFFECT OF THE ECONOMIC CRISIS ON HR PROGRAMS 4 (2008).

[10] According to one study, defined contribution plans with matching contributions have a participation rate of 73% compared with 44% for plans that do not offer matching contributions. Retirement Plan Trends in Today's Healthcare Market—2008, American Hospital Association & Diversified Investment Advisors (2008). Some have wondered whether employers would reduce matching contributions as they adopt automatic enrollment since automatic enrollment is proving successful in raising participation rates. Current data suggest this is not occurring. For example, from 2005 to 2007 the number of Vanguard plans offering automatic enrollment tripled. During the same period, the percentage of Vanguard plans offering employer matching contributions increased by 4%. How America Saves 2008: A Report on Vanguard 2007 Defined Contribution Plan Data, The Vanguard Group, Inc. (2008); How America Saves 2006: A Report on Vanguard 2005 Defined Contribution Plan Data, The Vanguard Group, Inc. (2006).

[11] W. Scott Simon, Fiduciary Focus, Morningstar Advisor, Apr. 5, 2007.

[12] Brady & Holden (Dec. 2008), supra note 1.

[13] Brady & Holden (Dec. 2008), supra note 1.

[14] Gregory T. Long, Executive Dir., Fed. Ret. Thrift Inv. Fund, Statement Before the House Subcommittee on Federal Workforce, Postal Service, and the District of Columbia (July 10, 2008).

[15] The average 401(k) account balance increased at an annual rate of 8.7% from 1999 to 2006, despite the fact that this period included one of the worst bear markets since the Great Depression. Sarah Holden, Jack VanDerhei, Luis Alonso, & Craig Copeland, 401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2006, INVESTMENT COMPANY INST. PERSPECTIVE 13, no. 1/EMPLOYEE BENEFIT RESEARCH INST. ISSUE BRIEF, no. 308, Aug. 2007.

[16] Jilian Mincer, 401(k) Plans Face Disparity Issue, WALL ST. J., Nov. 6, 2008, at D9.

[17] Fidelity Investments (Jan. 28, 2009), supra note 3. See also Reid & Holden (Dec. 2008), supra note 1 (noting that only 3% of defined contribution plan participants ceased contributions in 2008); The Principal Financial Well-Being Index Summary—Fourth Quarter 2008, Principal Financial Group (2008) (finding that, in the six months leading up to its October 2008 survey, 11% of employees increased 401(k) contributions, while only 4% decreased contributions and only 1% ceased contributions entirely); Retirement Outlook and Policy Priorities, Transamerica Center for Retirement Studies (Oct. 2008) (finding that participation rates are holding steady among full-time workers who have access to a 401(k) or similar employer-sponsored plan, with 77% currently participating; 31% of participants have increased their contribution rates into their retirement plans in the last twelve months; only 11% have decreased their contribution rates or stopped contributing); Press Release, Hewitt Associates, Hewitt Data Shows Americans Continue to Save in 401(k) Plans Despite Economic Woes (Nov. 24, 2008) (finding, in a November analysis, that average savings rates in 401(k) plans have only dipped by 0.2%, from 8.0% in 2007 to 7.8% in 2008).

[18] See Sarah Holden & Jack VanDerhei, Contribution Behavior of 401(k) Plan Participants During Bull and Bear Markets, NAT'L TAX ASS'N 44 (2004) (citing a number of studies which indicate little variation in before-tax contributions and a slight decrease in employer contributions as a percentage of participant pay during the 1999-2002 bear market).

[19] Principal Financial Group (2008), supra note 17.

[20] Id.

[21] Private Pension Plan Bulletin Historical Tables (Feb. 2008), supra note 5.

[22] In 2007, 82% of employers with 500 or more employees offered 401(k) plans to their employees, and 19% of these employers offered a defined contribution plan other than a 401(k) plan to their employees. 9th Annual Retirement Survey, Transamerica Center for Retirement Studies (2008).

[23] 59% of employers with between 10 and 499 employees offered their employees 401(k) plans in 2007, as compared with 56% in 2006. Transamerica Center for Retirement Studies (2008), supra note 22; 8th Annual Retirement Survey, Transamerica Center for Retirement Studies (2007).

[24] U.S. DEP'T OF LABOR & U.S. BUREAU OF LABOR STATISTICS, BULL. NO. 2715, NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN THE UNITED STATES, MARCH 2008, tbl. 2 (Sept. 2008).

[25] As of December 2007, there were more than 500,000 SIMPLE IRAs. At the end of 2007, $61 billion was held in SIMPLE IRAs. See Brady & Holden (Dec. 2008), supra note 1; Peter Brady & Stephen Sigrist, Who Gets Retirement Plans and Why, INVESTMENT COMPANY INST. PERSPECTIVE 14, no. 2, Sept. 2008.

[26] Brady & Sigrist (Sept. 2008), supra note 25. See also U.S. DEP'T OF LABOR & U.S. BUREAU OF LABOR STATISTICS, BULL. NO. 2589, NATIONAL COMPENSATION SURVEY: EMPLOYEE BENEFITS IN PRIVATE INDUSTRY IN THE UNITED STATES, 2005 (May 2007) (indicating 8% of private-sector workers at eligible small businesses participated in a SIMPLE IRA).

[27] Among all full-time, full-year wage and salary workers ages 21 to 64, 55.3% participated in a retirement plan in 2007. This is up from approximately 53% in 2006. Craig Copeland, Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2007, EMPLOYEE BENEFIT RESEARCH INST. ISSUE BRIEF, no. 322, Oct. 2008 (examining the U.S. Census Bureau's March 2008 Current Population Survey). See also The Vanguard Group, Inc. (2008), supra note 10 (noting that, out of all employees in Vanguard-administered plans, 66% of eligible employees participated in their employer's defined contribution plan); 51st Annual Survey of Profit Sharing and 401(k) Plans, Profit Sharing/401(k) Council of America (Sept. 2008) (noting that 81.9% of eligible employees currently have a balance in their 401(k) plans).

[28] Participants in plans administered by Vanguard saved 7.3% of income in their employer's defined contribution plan in 2007. The Vanguard Group, Inc. (2008), supra note 10. Among non-highly compensated employees, the level of pre-tax deferrals into 401(k) plans has risen from 4.2% of salary in 1991 to 5.6% in 2007. Profit Sharing/401(k) Council of America (Sept. 2008), supra note 27.

[29] See Transamerica Center for Retirement Studies (Oct. 2008), supra note 17 (finding that 35% of Echo Boomers, 34% of Generation X, 28% of Baby Boomers, and 7% of Matures consider employer-sponsored defined contribution plans as their primary source of retirement income).

[30] Jack VanDerhei, Findings from the 2003 Small Employer Retirement Survey, EMPLOYEE BENEFIT RESEARCH INST. ISSUE NOTES 24, no. 9, Sept. 2003.

[31] Both small employers and workers in small businesses consider salary to be a greater priority than retirement benefits, but the inverse is true for the majority of larger employers and workers in larger businesses. See Transamerica Center for Retirement Studies (2008), supra note 22 (finding that 56% of employees in larger businesses consider retirement benefits to be a greater priority, where 54% of employees in smaller companies rank salary as a priority over retirement benefits). See also Brady & Sigrist (Sept. 2008), supra note 25.

[32] For example, one survey found that more than half of small business respondents would be "much more likely" to consider offering a retirement plan if company profits increased. VanDerhei (Sept. 2003), supra note 30. See also Transamerica Center for Retirement Studies (2008), supra note 22 (finding that large companies are more likely than smaller companies to offer 401(k) plans (82% large, 59% small)).

[33] It should also be remembered that those without employer plan coverage may be building retirement savings through non-workplace tax-preferred vehicles such as individual retirement accounts or deferred annuities.

[34] See Brady & Sigrist (Sept. 2008), supra note 25.

[35] Based on an analysis of the Bureau of Labor Statistics' Current Population Survey, March Supplement (2007), of those most likely to want to save for retirement in a given year, almost 75% had access to a retirement plan through their employer or their spouse's employer, and 92% of those with access participated. Brady & Sigrist (Sept. 2008), supra note 25.

[36] Voluntary pre-tax and Roth after-tax contributions must satisfy the Actual Deferral Percentage test ("ADP test"). The ADP test compares the elective contributions made by highly compensated employees and non-highly compensated employees. Each eligible employee's elective contributions are expressed as a percentage of his or her compensation. The numbers are then averaged for (i) all eligible highly compensated employees, and (ii) all other eligible employees (each resulting in a number, an "average ADP"). The ADP test is satisfied if (i) the average ADP for the eligible highly compensated employees for a plan year is no greater than 125% of the average ADP for all other eligible employees in the preceding plan year, or (ii) the average ADP for the eligible highly compensated employees for a plan year does not exceed the average ADP for the other eligible employees in the preceding plan year by more than 2% and the average ADP for the eligible highly compensated employees for a plan year is not more than twice the average ADP for all other eligible employees in the preceding plan year. Treas. Reg. § 1.401(k)-2. Employer matching contributions and employee after-tax contributions (other than Roth contributions) must satisfy the Actual Contribution Percentage test ("ACP test"). The ACP test compares the employee and matching contributions made by highly compensated employees and non-highly compensated employees. Each eligible employee's elective and matching contributions are expressed as a percentage of his or her compensation, and the resulting numbers are averaged for (i) all eligible highly compensated employees, and (ii) all other eligible employees (each resulting in a number, an "average ACP"). The ACP test utilizes the same percentage testing criteria as the ADP test. Treas. Reg. § 1.401(m)-2.

[37] A trust shall not constitute a qualified trust under 401(a) unless the plan of which such trust is a part satisfies the requirements of section 411 (relating to minimum vesting standards). See I.R.C. § 401(a)(7).

[38] See I.R.C. §§ 401(k)(12) and (13).

[39] ERISA § 404. I.R.C. § 401(a) also requires that a qualified trust be organized for the exclusive benefit of employees and their beneficiaries.

[40] Sarah Holden & Michael Hadley, The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2007, INVESTMENT COMPANY INST. PERSPECTIVE 17, no. 5, Dec. 2008.

[41] See Transamerica Center for Retirement Studies (2008), supra note 22 (finding that, regardless of company size, almost two-thirds of employers offer investment guidance or advice as part of their retirement plan; of those who do not currently offer guidance or advice, 18% of large employers and 7% of small employers plan to offer advice in the future); Deloitte Consulting LLP (2008), supra note 8 (51% of 401(k) sponsors surveyed offer employees access to individualized financial counseling or investment advice services (whether paid for by employees or by the employer)); Trends and Experience in 401(k) Plans 2007—Survey Highlights, Hewitt Associates LLC (June 2008) (40% of employers offer outside investment advisory services to employees).

[42] Profit Sharing/401(k) Council of America (Sept. 2008), supra note 27.

[43] 46% of plan participants consulted materials, tools, or services provided by their employers. John Sabelhaus, Michael Bogdan, & Sarah Holden, Defined Contribution Plan Distribution Choices at Retirement: A Survey of Employees Retiring Between 2002 and 2007, INVESTMENT COMPANY INST. RESEARCH SERIES, Fall 2008.

[44] See, e.g., Measuring the Effectiveness of Automatic Enrollment, Vanguard Center for Retirement Research (Dec. 2007) (stating that "[a]n analysis of about 50 plans adopting automatic enrollment confirms that the feature does improve participation rates, particularly among low-income and younger employees"); Deloitte Consulting LLP (2008), supra note 8 (stating that "[a] full 82% of survey respondents reported that auto-enrollment had increased participation rates"); Building Futures Volume VIII: A Report on Corporate Defined Contribution Plans, Fidelity Investments (2007) (stating that in 2006 overall participation rates were 28% higher for automatic enrollment-eligible employees than for eligible employees in plans that did not offer automatic enrollment; overall, automatic enrollment eligible employees had an average participation rate of 81%).

[45] A recently-surveyed panel of experts expects automatic enrollment to be offered in 73% of defined contribution plans by 2013. Prescience 2013: Expert Opinions on the Future of Retirement Plans, Diversified Investment Advisors (Nov. 2008).

[46] See The Vanguard Group, Inc. (2008), supra note 10.

[47] See Deloitte Consulting LLP (2008), supra note 8 (42% of surveyed employers have an automatic enrollment feature compared with 23% in last survey); Hewitt Associates LLC (June 2008), supra note 41 (34% of surveyed employers have an automatic enrollment feature compared with 19% in 2005); Profit Sharing/401(k) Council of America (Sept. 2008), supra note 27 (more than half of large plans use automatic enrollment and usage by small plans has doubled).

[48] See Deloitte Consulting LLP (2008), supra note 8 (stating that 26% of respondents reported they are considering adding an auto-enrollment feature).

[49] One leading provider has noted an upward shift since 2005 in the percentage of sponsors that use a default deferral rate of 3% or higher, and a corresponding decrease in the percentage of sponsors that use a default deferral rate of 1% or 2%. The Vanguard Group, Inc. (2008), supra note 10.

[50] See, e.g., Copeland (Oct. 2008), supra note 27 (noting that Hispanic workers were significantly less likely than both black and white workers to participate in a retirement plan); Jack VanDerhei & Craig Copeland, The Impact of PPA on Retirement Savings for 401(k) Participants, EMPLOYEE BENEFIT RESEARCH INST. ISSUE BRIEF, no. 318 (June 2008) (noting that industry studies have shown relatively low participation rates among young and low-income workers); Fidelity Investments (2007), supra note 44 (stating that, in 2006, among employees earning less than $20,000, the participation boost from automatic enrollment was approximately 50%); U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-08-8, PRIVATE PENSIONS: LOW DEFINED CONTRIBUTION PLAN SAVINGS MAY POSE CHALLENGES TO RETIREMENT SECURITY, ESPECIALLY FOR MANY LOW-INCOME WORKERS (Nov. 2007); Daniel Sorid, Employers Discover a Troubling Racial Split in 401(k) Plans, WASH. POST, Oct. 14, 2007, at F6.

[51] See Fidelity Investments (2007), supra note 44 (noting that, in 2006, the average deferral rate for participants in automatic escalation programs was 8.3%, as compared to 7.1% in 2005).

[52] See The Vanguard Group, Inc. (2008), supra note 10 (post-PPA, two-thirds of Vanguard's automatic enrollment plans implemented automatic annual savings increases, compared with one-third of its plans in 2005); Hewitt Associates LLC (June 2008), supra note 41 (35% of employers offer automatic contribution escalation, compared with 9% of employers in 2005); Transamerica Center for Retirement Studies (2008), supra note 22 (26% of employers with automatic enrollment automatically increase the contribution rate based on their employees' anniversary date of hire).

[53] A leading provider states that "QDIA investments are often more broadly diversified than portfolios constructed by participants. Increased reliance on QDIA investments should enhance portfolio diversification." The Vanguard Group, Inc. (2008), supra note 10. See also Fidelity Investments (2007), supra note 44 (where a lifecycle fund was the plan default option, overall participant asset allocation to that option was 19.4% in 2006; where the lifecycle fund was offered but not as the default option, overall participant asset allocation to that option was only 9.8%).

[54] Selection of Annuity Providers: Safe Harbor for Individual Account Plans, 73 Fed. Reg. 58,447 (Oct. 7, 2008) (to be codified at 29 C.F.R. pt. 2550).

[55] See Holden & Hadley (Dec. 2008), supra note 40.

[56] One survey found that 92% of companies surveyed stated that their plan is intended to comply with ERISA section 404(c). Deloitte Consulting LLP (2008), supra note 8.

[57] In 2006, the percentage of single investment option holders who invested in lifecycle funds—"blended" investment options—was 24%. 42% of plan participants invested some portion of their assets in lifecycle funds. The average number of investment options held by participants was 3.8 options in 2006. Fidelity Investments (2007), supra note 44.

[58] In 2007, 77% of employers offered lifecycle funds as an investment option, compared with 63% in 2005. Hewitt Associates LLC (June 2008), supra note 41. See also Fidelity Investments (2007), supra note 44 (noting that, in 2006, 19% of participant assets were invested in a lifecycle fund in plans that offered the lifecycle fund as the default investment option, compared with 10% of participant assets in plans that did not offer the lifecycle fund as the default investment option).

[59] See Target-Date Funds: Still the Right Rationale for Investors, The Vanguard Group, Inc. (Nov. 28, 2008) (noting that "even investors entering and in retirement need a significant equity allocation" and citing the 17- to 20-year life expectancy for retirees who are age 65). See also Fidelity Investments (2007), supra note 44 ("In general * * * the average percentage of assets invested in equities decreased appropriately with age * * * to a low of 45% for those in their 70s.").

[60] I.R.C. § 401(a)(35); ERISA § 204(j).

[61] Hewitt Associates LLC (June 2008), supra note 41.

[62] Hewitt Associates LLC (June 2008), supra note 41.

[63] Holden, VanDerhei, Alonso, & Copeland (Aug. 2007), supra note 15. See also Fidelity Investments (Jan. 28, 2009), supra note 3 (noting that, at year-end 2008, company stock made up approximately 10% of Fidelity's overall assets in workplace savings accounts, compared with 20% in early 2000).

[64] Holden, VanDerhei, Alonso, & Copeland (Aug. 2007), supra note 15. See also William J. Wiatrowski, 401(k) Plans Move Away from Employer Stock as an Investment Vehicle, MONTHLY LAB. REV., Nov. 2008, at 3, 6 (stating that (i) in 2005, 23% of 401(k) participants permitted to choose their investments could pick company stock as an investment option for their employee contributions, compared to 63% in 1985, and (ii) in 2005, 14% of 401(k) participants permitted to choose their investments could pick company stock as an investment option for employer matching contributions, compared to 29% in 1985).

[65] See U.S. GOV'T ACCOUNTABILITY OFFICE, GAO/HEHS-98-2, 401(K) PENSION PLANS: LOAN PROVISIONS ENHANCE PARTICIPATION BUT MAY AFFECT INCOME SECURITY FOR SOME (Oct. 1997) (noting that plans that allow borrowing tend to have a somewhat higher proportion of employees participating than other plans).

[66] See I.R.C. §§ 72(p) and 401(k)(2)(B).

[67] See, e.g., Reid & Holden (Dec. 2008), supra note 1 (stating that, in 2008, 1.2% of defined contribution plan participants took a hardship withdrawal and 15% had a loan outstanding); Fidelity Investments (Jan. 28, 2009), supra note 3 (noting that only 2.2% of its participant base initiated a loan during the fourth quarter of 2008, compared with 2.8% during the fourth quarter of 2007, and 0.7% of its participant base took a hardship distribution during the fourth quarter of 2008, compared with 0.6% during the fourth quarter of 2007); Holden, VanDerhei, Alonso, & Copeland (Aug. 2007), supra note 15 (noting that most eligible participants do not take loans); Fidelity Investments (2007), supra note 44 (noting that only 20% of active participants had one or more loans outstanding at the end of 2006). Most participants who take loans repay them. See Transamerica Center for Retirement Studies (2008), supra note 22 (only 18% of participants have loans outstanding, and almost all participants repay their loans).

[68] I.R.C. § 72(t).

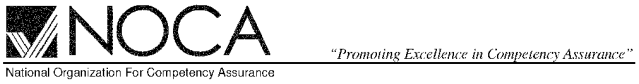
[69] See I.R.C. § 402(c)(4). 70 In 2007, among participants eligible for a distribution due to a separation of service, 70% chose to preserve their retirement savings by rolling assets to an IRA or by remaining in their former employer's plan, compared with only 60% in 2001. The Vanguard Group, Inc. (2008), supra note 10; How America Saves 2002: A Report on Vanguard Defined Contribution Plans, The Vanguard Group, Inc. (2002).

[71] See Sabelhaus, Bogdan, & Holden (Fall 2008), supra note 43 (stating that retirees make prudent choices at retirement regarding their defined contribution plan balances: 18% annuitized their entire balance, 6% elected to receive installment payments, 16% deferred distribution of their entire balance, 34% took a lump sum and reinvested the entire amount, 11% took a lump sum and reinvested part of the amount, 7% took a lump sum and spent all of the amount, and 9% elected multiple dispositions; additionally, only about 3% of accumulated defined contribution account assets were spent immediately at retirement).

[72] Brady & Holden (Dec. 2008), supra note 1.

[73] Id. It is highly doubtful that Americans would have saved at these levels in the absence of defined contribution plans given the powerful combination of pre-tax treatment, payroll deduction, automatic enrollment and matching contributions.

[74] See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FEDERAL RESERVE STATISTICAL RELEASE Z.1, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES (December 11, 2008); Brady & Holden (Dec. 2008), supra note 1.




# Statement for the Record

Submitted by
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National Organization for Competency Assurance (NOCA)

To the
Subcommittee on Higher Education,
Lifelong Learning, and Competitiveness
Committee on Education and Labor
U.S. House of Representatives
Washington, DC

Regarding its Hearing on
*New Innovations and Best Practices Under the Workforce Investment Act*
February 26, 2009

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*Right now, three-quarters of the fastest-growing occupations require more than a high school diploma… And so tonight, I ask every American to commit to at least one year or more of higher education or career training. This can be community college or a four-year school; vocational training or an apprenticeship. But whatever the training may be, every American will need to get more than a high school diploma.*

*– President Obama, Address to Joint Session of Congress, February 24, 2009.*

**Introduction**

On behalf of the National Organization for Competency Assurance (NOCA), an international association representing organizations that grant occupational certifications, I am pleased to provide the Subcommittee with our views on the reauthorization of the Workforce Investment Act (WIA).

**What is Certification?**

The certification of professional and occupational skill sets affirms the importance and measurability of a knowledge and experience base for practitioners in a particular field, their employers, and the public at large. Certification represents a measureable demonstration of a particular individual's professional competence. In some professions certification is a requirement for employment or practice. In other professions and occupation, certification is a means of demonstrating mastery over skill sets and competencies required by the work place or consumers. In all instances, certification enhances the employability and career advancement of the individual practitioner or employee.

A certification is generally developed when an industry or profession is able to identify a "fundamental body of knowledge for the profession. There should be a relatively stable, expert-identified, peer-reviewed, objective, consensual set of tasks, activities and understanding that identifies what individuals in the profession do."[1]

The benefits of certification include:

- A more productive and highly trained workforce for employers
- Higher wages and a competitive edge for workers
- Consumer confidence and safety through verification of competence
- Protecting the general public from incompetent and unfit practitioners
- Establishment of professional standards for individuals in a particular field.
- Assisting consumers in making informed decisions about qualified providers
- Assisting employers in making more informed hiring decisions

Numerous occupations, such as doctors, nurses, accountants, and physical therapists, require a license to practice the profession at the state level. Certification is distinct from licensure in that it is voluntary and frequently requires recertification to maintain the currency of the credential. Recertification frequently takes the form of continuing education and testing. Recertification provides a reaffirmation of competency assurance by ensuring the certificant is up to date with the latest training techniques, research and methods for a particular field.

[1] John E. Kasper, Ph.D., CAE, *To Certify or…Not to Certify?*, Forum Magazine (January 2009), 28.

**WIA Reauthorization Should Recognize Importance of Certification**
NOCA recommends including information about occupational certification and licensure opportunities as a core service available through One-Stop employment and training career centers. NOCA also recommends including certification and licensure in the scope of services offered through the One-Stop system.

The Department of Labor launched its CareerOneStop[2] website several years ago. This user-friendly website allows job seekers to easily search for certification options in a number of different fields and professions. NOCA recommends that Congress continue to encourage the expansion of this valuable tool by providing resources to allow DOL to raise awareness about the site to workers as well as career development professionals.

In 2003, both the Senate and the House passed different versions of WIA reauthorization. NOCA supported the Senate version of the WIA reauthorization (S. 1021) in particular as it included provisions calling for a national study of the benefits of earning an occupational certification. The results of the study were to be presented to Congress and were required to include recommendations designed to promote the acquisition of occupational certifications. We recommend that this committee include a similar provision when reauthorization is written as a national study would provide quantitative evidence of the value of certifications to the workforce. A third provision would require states to determine if training programs would lead to industry certifications. The measure also authorized 10 pilot projects designed to create a "system of industry-validated national certification of skills" targeting the high tech and homeland security sectors.

NOCA was instrumental in ensuring these provisions were put into the 2003 Senate bill and again strongly supports the inclusion of similar language in the reauthorization. To the high technology and homeland security pilot projects, however, we would add certifications that would help build or expand our nation's investments in an electronic healthcare infrastructure and that advance the green technology and energy independence sectors.

Occupations in emerging green technologies are projected to continue to grow. With recent federal investments towards retrofitting buildings for energy efficiency and new investments in solar, geothermal, and wind energy, trained workers will be necessary to fully implement these policies. "Green jobs exist, and are growing, in a range of industries and at every skill and wage level. Many are in the skilled trades: manufacturing, construction, operation and maintenance, and installation. Most are 'middle-skill' jobs, requiring more education than a high school diploma, but less than a four-year degree. Some are a bridge to high-skill professional jobs or entrepreneurial opportunities; others are perfect entry level or transitional jobs for urban residents looking for a pathway out of poverty. In short, green jobs are the kind of family-supporting jobs that once anchored the American middle class, but in the industries of the future: industries like wind turbine manufacturing, solar panel installation, energy efficiency retrofits, and green building."[3] The U.S. Green Building Council, the nation's leader in developing green construction standards, is a member of NOCA and offers several occupational certifications in green technologies.

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[2] http://www.careeronestop.org/.
[3] *Green Collar Jobs in America's Cities: Building Pathways Out of Poverty and Careers in the Clean Energy Economy*, Apollo Alliance, Green for All with the Center for American Progress, and the Center on Wisconsin Strategy (March 13, 2008). Available at: http://www.americanprogress.org/issues/2008/03/green_collar_jobs.html.

**Certification Leads to Better Jobs and Better Wages**

Many organizations in today's challenging economy have recognized their workforce as their most valuable asset. Likewise, as President Obama stated in his February 26 joint address to Congress, individuals recognize that now more than ever before they must acquire and maintain more comprehensive skill sets to ensure their own attractiveness and ability in the workplace.[4]

Certification offers a meaningful and direct pathway to re-employment for many individuals eligible for assistance through the One-Stop system. Certification may be a part of the training for specific job skills required in local markets. Including information about the vast array of credentials available to job seekers when they visit One-Stops is an excellent way to assist individuals in obtaining new work and possibly better career opportunities. In many instances, securing a voluntary credential will be the quickest and most effective means for an individual to achieve re-employment.

The value of acquiring an occupational certification is underscored in the existing data. Research conducted by the American Board of Nursing Specialties (ABNS) (a NOCA member) "document[s] a high level of agreement among certified nurses, non-certified nurses and nurse managers that certification is greatly valued among nurses."[5] Respondents to the ABNS survey revealed that some of the incentives their employers offer to promote and recognize nursing certifications include the reimbursement of exam fees, a listing of their credential on nametags and/or business cards, and receiving reimbursement for continuing education.[6] Other surveys indicate that certification results in higher wages for credentialed employees, as well as bonuses.[7] The data help career counselors point job seekers towards certification as a means to new job opportunities.[8]

Certification programs whose prerequisites and requirements displaced workers may quickly access—like those in the green technology movement--would enable those workers to move back into gainful employment and possibly enhanced career opportunities. Certification of one's specialized skills learned from years on the job may well be one of the quickest pathways to reemployment.

In many instances, an occupational certification does not require a four-year college degree. College is an expensive and time-consuming undertaking which may not represent a viable alternative for all job seekers. Persons who do not wish to pursue a bachelor's degree can pursue viable and rewarding careers in such fields as medical transcription, automotive mechanic, and medical assisting, among many others. These professions, as well as others, can open up a rewarding career path with excellent pay and opportunities for advancement for many individuals. Examples of occupations not requiring a baccalaureate degree include:

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[4] See also Su Bacon, "Setting Strategy: Earning professional credentials has many benefits for businesses." *Kansas City Star* (Jul. 2, 2007), available at http://www.kansascity.com/business/story/174739.html.
[5] *Value of Certification Executive Summary*. American Board of Nursing Specialties (May 2006). 4. Available at http://www.nursingcertification.org/pdf/executive_summary.pdf.
[6] Ibid.
[7] *Poll Indicates Certified Workers Earn More*, press release, Sept. 5, 2003. Available at: http://www.noca.org/portals/0/Poll%20results.doc. See also *CertMag's 2006 Salary Survey*. Available at http://www.certmag.com/articles/templates/CM_gen_Article_template.asp?articleid=2479&zoneid=223.
[8] *12 Money-Making Certifications to Boost Your Career*, Yahoo! HotJobs. Available at: http://hotjobs.yahoo.com/career-articles-12_money_making_certifications_to_boost_your_career-653.

- Court reporters. This profession remains in high demand. According to the National Court Reporters Association, 81% of those holding the Registered Professional Reporter (RPR) certification say their professional designation is important to them.[9] Court reporters earn close to $64,000 annually on average.[10]
- Crane operator. The Bureau of Labor Statistics lists the annual mean salary for crane operators as $42,940.[11] Most states require crane operators to have a certification obtained from an accredited certification body.
- Automotive technician. According to the National Automotive Technicians Education Foundation, automotive technicians receiving the ASE certification can earn $60,000 or more per year. Positions such as automobile technician, autobody technician, truck technician, and parts specialist are in high demand across the nation.
- Medical transcriptionist. According to the American Association of Medical Transcription, the volume of dictation requiring transcription continues to grow; however, the availability of qualified medical transcriptionists has not grown at the same rate. This is an excellent career, offering a competitive annual salary. BLS statistics indicate the mean annual wage in 2006 for a medical transcriptionist is $30,660.[12]
- X-ray technician. There continues to be a demand for trained professionals in healthcare. X-ray technicians can expect to earn a mean annual wage of over $51,000 according to BLS statistics.[13]

These are just a small sampling of the occupations available to dislocated workers, new workforce entrants, and others seeking meaningful employment and living wages, who may choose not to go on to pursue a 2 or 4 year degree. Occupational certification is in most instances an affordable retraining option for many workers. A voluntary survey conducted by NOCA indicated the average cost of certification tests is $350.[14]

The certification industry is also recognizing the changing face of the American workforce. While the United States has always been a nation of immigrants, U.S. Census figures indicate that the number of persons who speak a language other than English at home increased from 31.8 million in 1990 to 47 million in 2000.[15] In addition, while some immigrants enter the United States with high quality training and education, others lack advanced skills and will need to obtain training in order to advance in the workforce.

Certification bodies are adapting swiftly to meet the needs of America's changing workforce. For example, many certification boards are administering their coursework and examinations in languages other than English. Credentialing examinations for numerous occupations are now administered on a global scale. A 2006 survey of NOCA member organizations revealed that over 50% of respondents administer their exams in countries other than the United States and that 37% of respondents translate their exams into languages other than English.[16]

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[9] See http://ncraonline.org/certification/Certification/rpr/default.htm.
[10] See http://ncraonline.org/NCRA/pressroom/AboutCourtRept/.
[11] http://www.bls.gov/oes/2007/may/oes537021.htm.
[12] See http://www.bls.gov/oes/current/oes319094.htm.
[13] http://www.bls.gov/oes/2007/may/oes292034.htm.
[14] *Average Certification Exam Fee Tops $350*, press release, May 20, 2004. Available at: http://www.noca.org/portals/0/exam%20fee_header.pdf.
[15] See Hyon B. Shin with Rosalind Bruno, "Language Use and English-Speaking Ability: 2000." U.S. Census Bureau (Oct. 2003). Available at: http://www.census.gov/prod/2003pubs/c2kbr-29.pdf.
[16] *NOCA International Staff Summary Report*. National Organization for Competency Assurance (Oct. 20, 2006). Not available online.

Certification bodies are also in full compliance with the Americans with Disabilities Act, thus allowing persons with disabilities to earn certifications with reasonable accommodation that does not compromise the validity or reliability of the testing process.

**About the National Organization for Competency Assurance (NOCA)**

NOCA, the oldest and largest organization representing certification agencies, testing companies, consulting firms and individuals involved in professional certification, was created in 1977 as the National Commission for Health Certifying Agencies (NCHCA) with federal funding from the Department of Health and Human Services. Its mission was to develop standards for quality certification in the allied health fields and to accredit organizations that met those standards. With the growing use of certification in other fields, NCHCA's leaders recognized that what is essential for credible certification of individuals in the healthcare sector is equally essential for other sectors. With this vision, NCHCA evolved into the National Organization for Competency Assurance. NOCA is a non-profit, 501(c)(3) organization, committed to serving the public interest by ensuring adherence to standards that ensure the highest competence of certification programs.

NOCA's membership is composed of more than 400 organizations responsible for certifying specific skill sets and knowledge bases of professions and occupations at the national and international level. Through certification, NOCA members represent more than 6 million individuals around the world and include certification programs of some 150 professions and occupations, including 60 healthcare professions. NOCA members certify individual skills in fields as diverse as construction, healthcare, automotive, and finance. A current roster of NOCA members is included in the appendix.

NOCA also brings the expertise of its internationally recognized accrediting arm, the National Commission for Certifying Agencies (NCCA). NCCA uses a peer review process to evaluate adherence to its standards by certification programs and grants accreditation to those programs that have met those standards. These standards exceed the requirements set forth by the American Psychological Association and the U.S. Equal Employment Opportunity Commission and thus help to protect the health, safety, and welfare of the public. NCCA is the national accreditation body that provides this service for private certification organizations in all disciplines.

**Conclusion**

The nation's growing numbers of unemployed are desperate to get back to work in an occupation that allows them to support themselves and their families. Improving the prospects for reemployment into new career opportunities represents the core of the Workforce Investment Act. Individuals, whether employed or self-employed, know that now more than ever before they must acquire and maintain more comprehensive skill sets to ensure their own marketability and competence in the workplace.

Certification represents an excellent pathway to employment opportunities for workers in all areas in the economy. It also serves as an important assurance for employers and the general public that individuals have attained the necessary skill sets to provide the services or carry out the scope of their employment. We hope that the Subcommittee will recognize the important role that certification has to play in the Workforce Investment system.

Respectfully Submitted,

James Kendzel, MPH, SPHR
Executive Director
National Organization for Competency
Assurance (NOCA)
2025 M Street, NW, Suite 800
Washington, DC 20036
Phone 202.367.1165

## APPENDIX

### NOCA Organizational Members

AACE International
Academy of Ambulatory Foot and Ankle Surgery
Academy of Applied Personal Training Education
Academy for Certification of Vision Rehabilitation and Education Professionals
Academy of Lactation Policy and Practice
Accrediting Bureau of Health Education Schools
Accreditation Council for Accountancy and Taxation
Advocis
Aerobics and Fitness Association of America
American Academy of Nurse Practitioners
American Academy of Personal Training
American Academy for Pet Practitioners
American Academy of Wound Management
American Association of Colleges of Nursing
American Association of Critical-Care Nurses Certification Corporation
American Association for Medical Transcription
American Association of Medical Assistants
American Association of Medical Audit Specialists
American Association of Physician Specialists
American Association of Poison Control Centers
American Association for Respiratory Care
American Board of Audiology
American Board of Cardiovascular Perfusion
American Board for Certification in Orthotics, Prosthetics, and Pedortrics
American Board of General Dentistry
American Board of Genetic Counseling
American Board of Industrial Hygiene
American Board of Lower Extremity Surgery
American Board of Multiple Specialties in Podiatry
American Board of Nursing Specialties
American Board for Occupational Health Nurses
American Board of Optiolenry
American Board of Registration of Electroencephalographic and Evoked Potential Technologists, Inc.
American Board of Surgical Assistants
American Board of Transplant Coordinators
American Certification Agency for Healthcare Professionals
American Chiropractic Board of Sports Physicians
American Chiropractic Neurology Board
American Chiropractic Registry of Radiologic Technologists
American Clinical Board of Nutrition
American College of Sports Medicine
American College of Veterinary Ophthalmologists
American Construction Inspectors Association
American Council on Exercise
American Culinary Federation
American Fitness Professionals and Associates
American Health Information Management Association
American Hospital Association Certification Center
American Institute of Certified Public Accountants
American Indoor Air Quality Council
American Manual Medicine Association

American Medical Massage Association
American Medical Technologists
American Midwifery Certification Board
American Nurses Credentialing Center Commission on Certification
American Occupational Therapy Association
American Optometric Association Commission on Paraoptometric Certification
American Organization for Bodywork Therapies of Asia
American Payroll Association
American Phlebotomy Association
American Physical Therapy Association
American Registry for Diagnostic Medical Sonographers
American Registry of Magnetic Resonance Imaging Technologists
American Registry of Radiologic Technologists
American Society for Association Executives
American Society for Metabolic and Bariatric Surgery
American Society for Clinical Pathology
American Society of Anesthesia Technologists and Technicians
American Society of Military Comptrollers
American Speech-Language-Hearing Association
American Veterinary Chiropractic Association, Inc.
American Veterinary Medical Association
APICS - The Association for Operations Management
Aquatic Exercise Association, Inc.
Architectural Woodwork Institute
Art Therapy Credentials Board
ASIS International
Association of Certified Anti-Money Laundering Specialists (ACAMS)
Association of Christian Alcohol and Drug Counselors
Association of College and University Housing Officers International
Association for Death Education and Counseling
Association for Financial Professionals
Association of Government Accountants
Association for Investment Management and Research
Association of Regulatory Boards of Optometry
Association of State and Provincial Psychology Boards
Association of Social Work Boards
Association of Surgical Technologists, Inc.
Association of Water Technologies, Inc.
Axiom Resources Management, Inc.
Behavior Analyst Certification Board
Biofeedback Certification Institute of America
Board for Certification in Clinical Anesthesiology
Board for Certification of Addiction Specialists
Board for Orthotist/Prosthetist Certification
Board of Canadian Registered Safety Professionals
Board of Certification for Emergency Nursing
Board of Certification in Professional Ergonomics
Board of Certification of Medical Illustrators
Board of Certified Safety Professionals
Board of Environmental, Health & Safety Auditor Certifications
Board of Pharmaceutical Specialties
Board of Registered Polysomnographic Technologists
Training Institute
California Association for Alcohol and Drug Educators
California Association of Alcoholism and Drug Abuse Counselors (CAADAC) and the California Certification Board of Alcohol and Drug Counselors (CCBADC)

California Association of Drinking Driver Treatment Programs
California Association of Community Managers, Inc.
California Certification Board of Chemical Dependency Counselors
California Certifying Board for Medical Assistants
California Contractors State License Board
California-Nevada Section, American Water Works Association
California Water Environment Association
Canadian Alliance of Physiotherapy Regulators
Canadian Board for Respiratory Care, Inc.
Canadian Chiropractic Examining Board
Canadian Council of Human Resources Associations
Canadian Council of Professional Engineers
Canadian Nurses Association
Center for Credentialing and Education
Certification Board for Music Therapists
Certification Board for Radiology Practitioner Assistants
Certification Board for Sterile Processing and Distribution
Certification Board for Infection Control and Epidemiology
Certification of Disability Management Specialists Commission
Certified Financial Planner Board of Standards, Inc.
Certified Fund Raising Executive International
Certified General Accountants Association of Canada
Certified Mine Safety Professional Certification Board
Certifying Board for Dietary Managers
Chartered Realty Investor Society
Child Life Council
College and Association of Registered Nurses of Alberta
College of Massage Therapists of Ontario
College of Medical Laboratory Technologists of Ontario
College of Medical Radiation Technologists of Ontario
College of Occupational Therapists of Ontario
College of Opticians of Ontario
College of Physiotherapists of Ontario
College of Respiratory Therapists of Ontario
Commission for Case Manager Certification
Commission for Certification in Geriatric Pharmacy
Commission on Dietetic Registration of the American Dietetic Association
Commission on Graduates of Foreign Nursing Schools
Commission on Rehabilitation Counselor Certification
Competency and Credentialing Institute
Compliance Certification Board
Cooper Institute
Council for Accreditation in Occupational Hearing Conservation
Council on Certification of Health, Environmental, and Safety Technologists
Council on Certification of Nurse Anesthetists
Council on Licensure, Enforcement and Regulation
Council on Professional Standards for Kinesiotherapy
Crane Institute of America Certification, Inc.
Crane Operator Certification Authority
CSI Global Education Inc
Defense Activity for Non-Traditional Education Support
Dental Assisting National Board
Department of Environment and Labor Province of Nova Scotia
Entertainment Technician Certification Program (ETCP-ESTA)
Esthetic Skin Institute
Examination Board of Professional Home Inspectors

Financial Planners Standards Council
Financial Planning Standards Board
Financial Planning Association of Australia
Fitjour
Florida Certification Board
Florida Nursery, Growers & Landscape Association
Hand Therapy Certification Commission, Inc.
The Healing Oasis Wellness Center
Healthcare Financial Management Association
Healthcare Information and Management Systems Society
Healthcare Quality Certification Board
Herman & Wallace Pelvic Rehabilitation Institute
Human Resource Certification Institute
Human Resources Professionals Association
IEEE
Illinois Department of Financial & Professional Regulation
Infocomm International
International Medical University of Natural Education (IMUNE)
Indian Alcoholism Commission of California
Infusion Nurses Certification Corporation
Institute of Business and Finance
Institute for the Certification of Pharmacy Technicians
Institute of Hazardous Materials Management
Institute of Internal Auditors
Institute for Supply Management
International Accounts Payable Professionals, Inc.
International Air Filtration Certifiers Association
International Alliance for Fitness Professionals
International Association for Colon Hydrotherapy
International Association of Eating Disorders Professionals
International Association of Healthcare Central Service Material Management
International Board of Lactation Consultant Examiners
International Executive Housekeepers Association, Inc.
International Fitness Association
International Fitness Professionals Association
International Foundation for Retirement Education
International Lactation Consultant Association
International Society of Arboriculture
International Society for Clinical Densitometry
International Special Events Society
International Society for Performance Improvement
Investment Management Consultants Association
Irrigation Association
ISA
Joint Commission on Allied Health Personnel in Ophthalmology
Kassian Dyck and Associates
Lamaze International
The Lash Association for Safety and Health
Med Dogs Athletics
Marketing Research Association
Massachusetts Association of 766 Approved Private Schools
Michigan Institute for Health Enhancement
Mountain Measurement
NAA Education Institute
NAADAC - The Association for Addiction Professionals
National Academy of Sports Medicine

National Accrediting Commission of Cosmetology Art and Science
National Alliance Wound Care
National Association of Boards of Pharmacy
National Association of Certified Valuation Analysts
National Association of College Stores
National Association of Forensic Counselors
National Association of Legal Assistants
National Association for Health Professionals
National Association of Medical Staff Services
National Association of Mortgage Brokers
National Association of the Remodeling Industry
National Association of Social Workers
National Association of State Contractors Licensing Agencies
National Asthma Educator Certification Board, Inc.
National Athletic Trainer's Association Board of Certification
National Board of Certification for Community Association Managers, Inc.
National Board for Certification in Dental Laboratory Technology
National Board for Certification in Hearing Instrument Sciences
National Board for Certification of Hospice and Palliative Nurses
National Board for Certification of Orthopaedic Technologists
National Board for Certification in Occupational Therapy
National Board for Certification of Orthopedic Physician Assistants
National Board for Certified Counselors
National Board of Chiropractic Examiners
National Board of Examiners in Optometry
National Board of Nutrition Support
National Board of Orthodontics, U.S.
National Board for Professional Teaching Standards
National Board for Respiratory Care
National Board of Surgical Technology and Surgical Assisting
National Business Aviation Association
National Center for Competency Testing
National Certification Board for Diabetes Educators
National Certification Board for Therapeutic Message and Body Work
National Certification Commission for Acupuncture and Oriental Medicine
National Certification Corporation for the Obstetric, Gynecologic, and Neonatal Nursing Specialties
National Commission on Certification of Physician Assistants
National Commission for Health Education Credentialing
National Commission for Certification of Continuing Medical Education Professionals
National Commission for the Certification of Crane Operators
National Concrete Masonry Association
National Contact Lens Examiners
National Cooperative of Health Networks Association
National Council for Interior Design Qualification
National Council for Therapeutic Recreation Certification, Inc.
National Council of Architectural Registration Boards
National Council of Examiners for Engineering and Surveying
National Council of State Boards of Nursing, Inc.
National Council on Strength and Fitness
National Credentialing Agency for Laboratory Personnel
National Dental Hygiene Certification Board
National Enrichment Teachers Association
National Examining Board of Ocularists
National Exercise and Sports Trainers Association (NESTA)
National Exercise Trainers Association (NETA)
National Federation of Professional Trainers

National Fitness Professionals Association
National Healthcareer Association
National Indian Child Welfare Association
National Institute for Automotive Service Excellence
National Institute for Certification in Engineering Technologies
National Kitchen and Bath Association
National League for Nursing
National Occupational Competency Testing Institute
National Recreation and Park Association
National Registry of Emergency Medical Technicians
National Registry of Food Safety Professionals
National Strength and Conditioning Association (NSCA) Certification Commission
Nephrology Nursing Certification Commission
North American Board of Certified Energy Practitioners
North American Registry of Midwives
North Carolina Substance Abuse Practice Board
Nuclear Medicine Technology Certification Board
Oasis Certification & Competency Board
Oncology Nursing Certification Corporation
Ontario College of Pharmacists
Ontario College of Social Workers and Social Service Workers
Ophthalmic Photographers' Society, Inc. Board of Certification
Pediatric Nursing Certification Board
Performance Testing Council
Petrofac Training International
Pharmacy Examining Board of Canada
Pharmacy Technician Certification Board
PHI Pilates
Pilates Method Alliance, Inc.
Professional Development Solutions, LLC
Professional Landcare Network
Psychiatric Rehabilitation Certification Program
Radiology Coding Certification Board
Registry of Interpreters for the Deaf, Inc.
Rain Bird Services Corporation
School Nutrition Association
Society of Actuaries
Society of American Foresters
Society of Cable Telecommunications Engineers
Society of Certified Senior Advisors
Society of Permanent Cosmetic Professionals
Society of the Plastics Industry
Society of Tribologists and Lubrication Engineers
Software Engineering Institute
Southern California Crane and Hoisting Certification Program
Tire Industry Association
Top Tier Personal Trainer Certification
Transportation Professional Certification Board, Inc.
Turnaround Management Association
UCSD - Center for Criminality Addiction Research, Training, and Application (CCARTA)
Universal Public Purchasing Certification Council
U.S. Green Building Council
Veterinary Hospital Managers Association
The Wedding Planning Institute
Wound, Ostomy, and Continence Nurses Certification Board

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[Questions for the record sent:]

U.S. CONGRESS,
[VIA EMAIL],
*Washington, DC, February 26, 2009.*

Mr. JACK BOGLE, *Founder,*
*Vanguard Group, Malvern, PA.*

DEAR MR. BOGLE: Thank you for testifying at the Tuesday, February 24, 2009, Committee on Education and Labor hearing on "Strengthening Worker Retirement Security."

One of our Committee Members had additional questions for which he would like written responses from you for the hearing record.

Congressman Scott asks the following questions:

1. Could you please comment on the long-term implications of tax-sheltered accounts?

2. Also, how are retirees being affected by the decision to either pay income taxes on funds once they are withdrawn from a tax-sheltered account or to pay capital gains taxes during the life of their investments?

Please send your written response to the Committee on Education and Labor by COB on Tuesday, March 10, 2009—the date on which the hearing record will close. If you have any questions, please contact the committe. Once again, we greatly appreciate your testimony at this hearing.

Sincerely,

GEORGE MILLER, *Chairman.*

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U.S. CONGRESS,
[VIA EMAIL],
*Washington, DC, February 26, 2009.*

Dr. DEAN BAKER, *Co-Director,*
*Center for Economic and Policy Research, Washington, DC.*

DEAR DR. BAKER: Thank you for testifying at the Tuesday, February 24, 2009, Committee on Education and Labor hearing on "Strengthening Worker Retirement Security."

One of our Committee Members had additional questions for which he would like written responses from you for the hearing record.

Congressman Scott asks the following questions:

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Sincerely,

GEORGE MILLER, *Chairman.*

---

U.S. CONGRESS,
[VIA EMAIL],
*Washington, DC, February 26, 2009.*

Dr. ALICIA H. MUNNELL, *Director,*
*Center for Retirement Research at Boston College, Chestnut Hill, MA.*

DEAR DR. MUNNELL: Thank you for testifying at the Tuesday, February 24, 2009, Committee on Education and Labor hearing on "Strengthening Worker Retirement Security."

One of our Committee Members had additional questions for which he would like written responses from you for the hearing record.

Congressman Scott asks the following questions:

1. Could you please comment on the long-term implications of tax-sheltered accounts?

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Sincerely,

GEORGE MILLER, *Chairman.*

U.S. CONGRESS,
[VIA EMAIL],
*Washington, DC, February 26, 2009.*

Mr. PAUL SCHOTT STEVENS, *President and CEO,*
*Investment Company Institute, Washington, DC.*

DEAR MR. STEVENS: Thank you for testifying at the Tuesday, February 24, 2009, Committee on Education and Labor hearing on "Strengthening Worker Retirement Security."

One of our Committee Members had additional questions for which he would like written responses from you for the hearing record.

Congressman Scott asks the following questions:

1. Could you please comment on the long-term implications of tax-sheltered accounts?

2. Also, how are retirees being affected by the decision to either pay income taxes on funds once they are withdrawn from a tax-sheltered account or to pay capital gains taxes during the life of their investments?

Please send your written response to the Committee on Education and Labor by COB on Tuesday, March 10, 2009—the date on which the hearing record will close. If you have any questions, please contact the committe. Once again, we greatly appreciate your testimony at this hearing.

Sincerely,

GEORGE MILLER, *Chairman.*

---

U.S. CONGRESS,
[VIA EMAIL],
*Washington, DC, March 3, 2009.*

Mr. JACK BOGLE, *Founder,*
*Vanguard Group, Malvern, PA.*

DEAR MR. BOGLE: Thank you for testifying at the Tuesday, February 24, 2009, Committee on Education and Labor hearing on "Strengthening Worker Retirement Security."

Two Republican Committee members, Senior Ranking Member McKeon and Congresswoman McMorris Rodgers, have additional submitted questions for which they would like written responses from you for the hearing record.

Senior Republican Member McKeon asks the following question:

1. You testified before the Committee regarding the trading costs of mutual funds. As we heard at the hearing, approximately half of 401(k) assets are invested in mutual funds. The remainder is invested in other products, such as separately managed accounts, commingled trusts, insurance contracts, and exchange-traded funds. Given that research has demonstrated that a significant driver of trading costs is the cost of buying and selling securities to accommodate investor contributions and withdrawals, do not these investments incur the same types of trading costs as those incurred by mutual funds? Are you able to provide the Committee with data regarding the trading costs of these other investments?

Congresswoman McMorris Rodgers asks the following questions:

1. On page 15 of your testimony you outline a new defined contribution retirement system. Tell me if we had this system in place five years ago could such a board know about the home mortgage collapse? If we were discussing the safety of mortgage backed securities five years ago would you have testified that they are a high risk or low risk

investment? Would it not follow that there are real risks even for what may be considered today to be a conservative investment?

2. On page 15 of your testimony you state "For those who have the financial ability to save for retirement, there would be a single DC structure, dominated * * *" What about those who are unable to save for retirement?

3. Are you proposing that 401(k)s, IRAs, the government TSP program, and any retirement saving plans with tax incentives be abolished for this single Federal retirement system under this Federal Retirement Board?

4. If one can save for retirement, would the only way to do so that would get tax benefit would be through this new Federal Retirement System under the proposal you are advocating?

5. It seems that you are making the argument that since some people can make the wrong investment decisions for retirement that no one should be able to have a real control over how their money should be invested in the future. Is that correct?

6. You propose a Federal Retirement Board; I would imagine that such a board would have control over trillions of dollars for investment. What could be done to

ensure that these savings would not be invested to further any political agenda and only ensure a decent return for the potential retiree?

Please send your written response to the Committee on Education and Labor by COB on Tuesday, March 10, 2009—the date on which the hearing record will close. If you have any questions, please contact the committe. Once again, we greatly appreciate your testimony at this hearing.

Sincerely,

GEORGE MILLER, *Chairman.*

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U.S. CONGRESS,
[VIA EMAIL],
*Washington, DC, March 3, 2009.*

Dr. DEAN BAKER, *Co-Director,*
*Center for Economic and Policy Research, Washington, DC.*

DEAR DR. BAKER: Thank you for testifying at the Tuesday, February 24, 2009, Committee on Education and Labor hearing on "Strengthening Worker Retirement Security."

Republican Committee member, Congresswoman McMorris Rodgers, has submitted a question for which she would like a written response from you for the hearing record.

Congresswoman McMorris Rodgers asks the following question:

1. On page five of your testimony you describe your proposal modeled on the Thrift Savings Plan as voluntary and on page six give examples of the benefits that can be received. Dr. Munnell's testimony describes how low the balances of 401(k)s are today for folks near retirement. Tell me how many people making the $30,000 you give in your example do you believe will volunteer to have contributions taken out of their paychecks even if the government could afford a small match to the contribution?

Please send your written response to the Committee on Education and Labor by COB on Tuesday, March 10, 2009—the date on which the hearing record will close. If you have any questions, please contact the committe. Once again, we greatly appreciate your testimony at this hearing.

Sincerely,

GEORGE MILLER, *Chairman.*

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U.S. CONGRESS,
[VIA EMAIL],
*Washington, DC, March 3, 2009.*

Dr. ALICIA H. MUNNELL, *Director,*
*Center for Retirement Research at Boston College, Chestnut Hill, MA.*

DEAR DR. MUNNELL: Thank you for testifying at the Tuesday, February 24, 2009, Committee on Education and Labor hearing on "Strengthening Worker Retirement Security."

Republican Committee Member, Congresswoman McMorris Rodgers, has submitted questions for which she would like written responses from you for the hearing record.

Congresswoman McMorris Rodgers asks the following questions:

1. On page four of your testimony you advocate for an additional tier of retirement savings to support 20 percent of a retiree's income. You suggest that this be modeled after the Thrift Savings Plan (TSP) that all federal workers, all Members of Congress and their staff are in. Furthermore you state "participation should be mandatory; participants should have no access to [the] money before retirement." Could you tell the Committee where the money would come for these new accounts? Does the government fund it or does the individual make contributions?

2. If it is the individual who makes the contributions, can you tell me where they are supposed to come up with this extra money? In 2006, the average per capita income in Washington State was $38,067. Please tell the Committee how much you believe should someone in Washington State making $38,067 be required to contribute?

3. Or if it is the government, do you have any estimates for how much this will cost the taxpayer? What are your recommendations for Congress for where we should raise this funding?

4. You advocate for a mandatory TSP program for all. Now I can tell you that my TSP account has taken a similar hit in the last year along the lines of what you describe for 401(k)s. If we could go back in time and make your proposal law

how would we be any better off today, other than folks having less money in their paychecks for these mandatory contributions? If yes, please quantify how much more money a contributor would have in an account invested in a Vanguard 401(k) S&P 500 fund and the government's S&P 500 "C" fund?

Please send your written response to the Committee on Education and Labor by COB on Tuesday, March 10, 2009—the date on which the hearing record will close. If you have any questions, please contact the committe. Once again, we greatly appreciate your testimony at this hearing.

Sincerely,

GEORGE MILLER, *Chairman.*

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[Responses to questions submitted follow:]

**Mr. Baker's Responses to Questions for the Record**

*Follow-up Questions from Congressman Robert C. "Bobby" Scott*

**1. Could you please comment on the long-term implications of tax-sheltered accounts?**

There will be some change in the timing of tax receipts as a result of the accumulations in these accounts. The government is collecting somewhat less in revenue than would otherwise be the case at present because workers have the opportunity to shelter a portion of their income in these accounts.

However, this is being reversed as the baby boom cohort is reaching ages at which they can withdraw funds from these accounts. This effect is not likely to be very large, primarily because the accumulations in these accounts has fallen sharply due to the recent decline in the stock market. It is unlikely that the withdrawals even in the years where the peak effects of the baby boomers' retirement is being felt (2020-2035)will have very much impact on the overall budget. Of course, the net effect will depend on the extent of new tax exempt contributions. Insofar as policy encourages more retirement savings in future decades, then we will feel even less of a boost from the baby boomers drawing down of their accounts and paying taxes on their accumulations.

**2. Also, how are retirees being affected by the decision to either pay income taxes on funds once they are withdrawn from a tax-sheltered account or to pay capital gains taxes during the life of their investments?**

Retirees would obviously benefit from not having their withdrawals subject to tax. If this policy was made as a trade-off for paying capital gains on investments while they were tax sheltered, then savers would presumably opt for investments that paid interest or dividends rather than capital gains. This would allow their accumulations to increase during their working lifetimes without being taxed, and then allow them to withdraw their money tax free in retirement. I assume that this is not the intention of this switch, but it can be assumed that many savers will try to game any changes in order to get the most benefit from it.

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**Mr. Bogle's Responses to Questions for the Record**

*From Senior Republican Member Howard P. "Buck" McKeon*

*1. You testified before the Committee regarding the trading costs of mutual funds. As we heard at the hearing, approximately half of 401(k) assets are invested in mutual funds. The remainder is invested in other products, such as separately managed accounts, commingled trusts, insurance contracts, and exchange-traded funds. Given that research has demonstrated that a significant driver of trading costs is the cost of buying and selling securities to accommodate investor contributions and withdrawals, do not these investments incur the same types of trading costs as those incurred by mutual funds? Are you able to provide the Committee with data regarding the trading costs of these other investments?*

You are correct that approximately half of 401(k) assets are held in investment products other than mutual funds. While data on these other products are more difficult to find, it would be shocking to find that their turnover rates are materially different than the rates reported by actively managed mutual funds, primarily because many, if not most, asset managers manage these other accounts as well. Morningstar data, for instance, show that the average actively managed equity insurance fund has a turnover rate of 83 percent—not far from the 96 percent rate of the average actively managed equity mutual fund. (Unsurprisingly, because they

are index funds, the average exchange-traded fund has a much lower turnover rate of 37 percent.)

I also agree that some portion of portfolio transactions (in all investment products) is attributable to contributions and withdrawals from investors. However, the record is crystal-clear that this activity plays only a minor role in the staggering degree of portfolio turnover we see today.

Examining net cash flow to equity funds and common stock purchases by equity funds provides a crude if revealing estimate of just how much of this activity is attributable to investor cash flow. In 1991, net cash flow to equity funds of $40 billion accounted for only 9 percent of common stock purchases of $224 billion. By 2007, that share had fallen to 2.6 percent, as net cash flow of $93 billion was dwarfed by $3.6 trillion of stock purchases by equity funds. Just last year, stock purchases and sales by equity funds totaled $6.9 trillion, compared to average equity fund assets of $5.1 trillion.

The simple fact is that portfolio turnover has risen dramatically. In my first twenty years in this business, annual turnover averaged 21 percent; in the last twenty years, it has averaged 91 percent. As I wrote in my statement, the problem with this stunning rise lies in this mathematical reality: investors as a group earn the market's return, minus the expenses they incur. Thus, mutual funds trading stocks back and forth with one another at a furious rate, incurring transaction costs, does two things: 1) it reduces, by definition, the returns of investors as a group; 2) it enriches the intermediaries who earn commissions on each sale and purchase, expenses that detract, dollar for dollar, from the returns earned by mutual fund investors.

*From Congresswoman Cathy McMorris Rodgers*

*1. On page 15 of your testimony you outline a new defined contribution retirement system. Tell me if we had this system in place five years ago could such a board know about the home mortgage collapse? If we were discussing the safety of mortgage backed securities five years ago would you have testified that they are a high risk or low risk investment? Would it not follow that there are real risks even for what may be considered today to be a conservative investment?*

The purpose of the Federal Retirement Board I described would not to be to predict what will happen in our financial markets and our economy, were that even possible. Nor would it be to protect plan participants from the inevitable bear markets they will encounter. Rather, its purpose would be to oversee our nation's private retirement savings market, requiring, for instance, that employer-sponsored plans have the following features:

- Automatic enrollment of all employees
- Automatic annual increases of participant deferral rates
- The use of age-appropriate target retirement funds as default investment options
- Strict limits on loans and withdrawals during the participant's career
- The inclusion of low-cost, broadly diversified total stock and bond market index funds among the plan's investment options
- A low-cost annuity option for participants reaching retirement age
- Full disclosure of all plan-related expenses

Such a system would set plan participants, by default, on the path toward funding a secure retirement. As I noted in my statement, such a plan would be far from perfect, but would represent a vast improvement over the system we have in place today.

*2. On page 15 of your testimony you state "For those who have the financial ability to save for retirement, there would be a single DC structure, dominated * * *" What about those who are unable to save for retirement?*

As I wrote on page ten of my statement, the Federal Retirement Board I envision might create a public defined contribution plan. Using both tax incentives and matching contributions from the federal government, such a plan might enable investors who are currently unable to save for retirement to set aside a relatively nominal amount (perhaps $1,000 per year). Invested prudently, at low costs, and with strict limitations on access during the participant's working years, such an account would provide a healthy supplement to Social Security in retirement.

*3. Are you proposing that 401(k)s, IRAs, the government TSP program, and any retirement saving plans with tax incentives be abolished for this single Federal retirement system under this Federal Retirement Board?*

I am not. Our current retirement system is an amalgam of plans—each with its own tax incentives, contribution limits, and eligibility requirements—that makes saving for retirement needlessly complex. What I suggest is simplifying this system,

creating one universal retirement plan structure, with one set of contribution limits and eligibility requirements.

An example to clarify the benefits of such a change: In 2009 participants in 401(k) plans can contribute $16,500; individual retirement accounts (IRAs) limit contributions to $5,000. Thus a worker whose employer does not offer a retirement plan can save only fraction of the amount that an employee with access to an employer-sponsored plan can. Doing away with the needless and seemingly arbitrary distinctions between retirement plans would seem to be a painless and common sense step toward enhancing the ability of all workers to save for retirement.

*4. If one can save for retirement, would the only way to do so that would get tax benefit would be through this new Federal Retirement System under the proposal you are advocating?*

I believe I covered this in the answers above, but to summarize, the Federal Retirement Board I envision would simplify our nation's retirement system, establishing a single plan structure with high limits on contributions and universal eligibility requirements. It would also establish certain minimum standards for all employer-sponsored plans, as described in my answer to the first question.

*5. It seems that you are making the argument that since some people can make the wrong investment decisions for retirement that no one should be able to have a real control over how their money should be invested in the future. Is that correct?*

That is not correct. I have never and would never take the position that no one should have any control over how their money should be invested, for retirement or otherwise.

In examining our nation's retirement system, there are a few undeniable facts:

- Most workers do not participate in an employer-sponsored retirement plan
- The median balance of those who do participate—approximately $15,000 currently—is, by any definition, insufficient to make even a moderate contribution to retirement funding
- A large number of participants make decisions that are detrimental to their wealth: most cash out their plans when they change jobs; most contribute far too little to their plans; many have asset allocations that are highly questionable, either investing too heavily in stocks as they near retirement age, or investing too conservatively at a young age.

If left unaddressed, the inadequacy of our nation's retirement savings will become a crisis. The crisis, in fact, is not that these workers will be unable to retire, in that retirement implies a voluntary separation from the workforce. Rather, the crisis will be that a large segment of our population will have insufficient savings to maintain even a basic standard of living as they become unable—not unwilling—to work. Such a crisis would undoubtedly have enormous social and economic costs.

The plan I have outlined would make relatively minor changes to our existing system, changes that would use the typical participant's inertia in their favor by setting them, by default, on a path toward accumulating the assets necessary to support them in retirement. It would change our system from one based on the assumption that the average employee has the interest and ability to take charge of their retirement savings—assumptions that have left millions of workers behind—to one based on the assumption that the average employee does not posses those traits, and takes a number of decisions out of their hands by default.

*6. You propose a Federal Retirement Board; I would imagine that such a board would have control over trillions of dollars for investment. What could be done to ensure that these savings would not be invested to further any political agenda and only ensure a decent return for the potential retiree?*

The Federal Retirement Board I envision would neither control any investment dollars nor be charged with ensuring a decent return for potential retirees. Rather, such a Board would oversee a retirement system that, as I state on page ten of my statement, would remain in the private sector. As I indicated in my answer to the first question, such a Board would establish minimum standards for all employer-sponsored plans.

Additionally, I would like to see the Federal Retirement Board do away with the confusing myriad of retirement savings plans we currently have and establish a universal retirement savings structure. I would also like such a Board to consider using tax incentives and nominal government-matching contributions to establish a private sector-based system that would cover the millions of employees who cannot currently afford to save for retirement.

ADDITIONAL FOLLOW-UP QUESTIONS

*1. Could you please comment on the long-term implications of tax-sheltered accounts?*

It's hard to overemphasize the benefits of investing in a tax-sheltered account. Aside from costs, deferring taxes represents the single best way to maximize portfolio growth over the long term. Morningstar data show that over the past 15 years, the average domestic equity fund has earned 5.2 percent annually on a pre-tax basis. After adjusting for taxes, the return of the average fund tumbles to 3.5 percent—a difference of 1.7 percent per year.

Compounded over an investment lifetime of 40 years, $1 would grow by $6.60 at 5.2 percent annually, while a 3.5 percent return would grow $1 by $2.96. In this scenario, the ability to defer taxes would provide the investor with a 123 percent increase in wealth.

Amazingly, the mutual fund industry, by and large, seems to ignore the role of taxes. Managers turn their portfolios over at rates that often exceed 100 percent, generating tremendous tax consequences for shareholders who hold their funds in taxable accounts. Tax-deferred accounts, then, provide the protection our industry fails to.

What is not clear is that tax-sheltered accounts actually add to national savings. A given portion of the money in such accounts would doubtless have been saved anyway, just as it was before the huge growth of defined contribution pension plans.

*2. Also, how are retirees being affected by the decision to either pay income taxes on funds once they are withdrawn from a tax-sheltered account or to pay capital gains taxes during the life of their investments?*

All else equal, most advisors would recommend that their clients hold a highly tax-efficient equity fund (such as a total stock market index fund) in a taxable account, and hold their bond allocation in a tax-deferred account. Such a strategy would allow the owner to benefit from the current lower tax rates on long-term capital gains and dividends, while deferring taxes on the interest income earned on their bond investments.

But while such a practice might make sense in theory, it is of little use for the large segment of investors whose retirement accounts—containing stocks and bonds—represent the overwhelming majority, if not the entirety, of their investment portfolio.

And while it is currently inefficient, from a tax perspective, for investors to pay income tax rates on earnings that would otherwise be taxed at now-lower long-term capital gains rates, a few facts remain:

- Tax policy is ever-changing, and there is no guarantee that today's comparatively low tax rates on long-term capital gains will continue into the future.
- Investors who own equities in tax-deferred accounts are, by and large, able to control the timing and amount of their tax liability. Investors in actively managed equity funds, on the other hand, lack such control, and are at the mercy of the fund's manager.
- It is likely that a retiree taking a distribution from a tax-deferred retirement plan will be in a lower marginal tax bracket than he or she was prior to retirement, thus lowering the tax liability on any distributions.

In sum, I doubt that a large segment of the investor population spends a great deal of time worrying structuring their portfolios to achieve the maximum tax efficiency, partly because of a lack of understanding, partly because it's an ever-moving target, and partly because restrictions on access and tax considerations prevent assets from moving from tax-deferred accounts to taxable accounts and back again as tax policies change.

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**Ms. Munnell's Responses to Questions for the Record**

*1. Could you please comment on the long-term implications of tax-sheltered accounts?*

Retirement saving conducted through typical employer plans—both defined benefit pension and 401(k) plans—is tax advantaged because the government taxes neither the original contribution nor the investment returns on those contributions until they are withdrawn as benefits at retirement. If the saving were done outside a plan, the individual would first be required to pay tax on their earnings and then on the returns from the portion of those earnings invested. Deferring taxes on the original contribution and on the investment earnings is equivalent to receiving an interest-free loan from the Treasury for the amount of taxes due, allowing the indi-

vidual to accumulate returns on money that they would otherwise have paid to the government.

Tax benefits are designed to encourage retirement saving. Tax benefits are clearly not the only reason why employers sponsor retirement income plans. At the end of the nineteenth century, long before the enactment of the Federal Personal Income Tax in 1916, a handful of very large employers, such as governments, railroads, utilities, universities, and business corporations, had put in place defined benefit pension plans. They did so because the pension was a valuable tool for managing their workforce.

The transition from defined benefit to 401(k) plans, which began in the early 1980s, has enhanced the importance of the advantageous tax treatment of pensions. The 401(k) plan is essentially a savings account. It is much harder to argue that this form of pension, as opposed to traditional defined benefit plans, is a key personnel management tool to retain skilled workers and encourage the retirement of older employees whose productivity is less than their wage. Once vested, workers do not forfeit any benefits when they change employers. Nor do 401(k) plans contain the incentives to retire at specific ages that employers embed in defined benefit plans. The tax preferences afforded pensions, as a result, have become the major advantage of employer-sponsored 401(k) plans.

The bottom line is that the tax advantage costs the government money because it defers the date when taxes are due. This deferral is equivalent to an interest-free loan. It is useful to question whether the foregone revenues are effective in achieving the goal of more retirement saving and whether the incentives are being offered to the right people.

*2. Also, how are retirees being affected by the decision to either pay income taxes on funds once they are withdrawn from a tax-sheltered account or to pay capital gains taxes during the life of their investments?*

One often hears the lament that people taking their money out of 401(k) plans are taxed at ordinary income rates, while those investing in equities outside of 401(k) plans only have to pay capital gains rates. The lament implies that people with 401(k) plans are bearing a greater burden. This implication is not correct.

Of course, the value of the preferred tax treatment depends on the taxation of investments outside of 401(k)s. And the taxation of capital gains and dividends has been reduced dramatically—particularly in recent years—making saving outside of 401(k) plans relatively more attractive and lowering the value of the tax preference. But saving through a 401(k) is still advantageous from a tax perspective.

The intuition is clearest when considering stock investments inside and outside of a Roth 401(k). (And although a conventional 401(k) and a Roth 401(k) may sound quite different, in fact they offer identical tax benefits.) Assume the tax rate on capital gains and dividends is set at zero. In both cases, the investor pays taxes on his earnings and puts after-tax money into an account. In the Roth 401(k) plan, he pays no taxes on capital gains as they accrue over time and takes his money out tax free at retirement. In the taxable account, he pays no tax on the dividends and capital gains as they accrue and takes the money out tax free at retirement. In short, the total tax paid under the Roth and the taxable account arrangement is identical.

How close is the assumption of a "zero" tax rate to the real world? Table 1 summarizes the maximum tax rates applied to capital gains and dividends since 1988. The 1986 tax reform legislation set the tax rate on realized capital gains equal to that on ordinary income. The capital gains tax rate became preferential in 1991-1996, not because it changed but because the rates of taxation of ordinary income increased. Subsequently, Congress explicitly reduced the tax rate on capital gains to 20 percent effective in 1997 and to 15 percent effective in 2003.[1] Dividends, with the exclusion of $100 or $200, traditionally have been taxed at the rate of ordinary income. That pattern was changed effective in 2003 when the rate on dividend taxation was reduced to 15 percent.

TABLE 1.—TOP RATES ON ORDINARY INCOME, CAPITAL GAINS, AND DIVIDENDS, 1988–2005

| Year | Top rate on ordinary income | Top rate on "realized" capital gains | Top rate on dividends |
|---|---|---|---|
| 1988-1990[a] | 28 percent | 28 percent | 28 percent |
| 1991-1992 | 31 percent | 28 percent | 31 percent |
| 1993-1996 | 39.6 percent | 28 percent | 39.6 percent |
| 1997-2000 | 39.6 percent | 20 percent | 39.6 percent |

[1] For taxpayers in the 10-percent and 15-percent tax bracket, the tax rate on capital gains is 5 percent.

TABLE 1.—TOP RATES ON ORDINARY INCOME, CAPITAL GAINS, AND DIVIDENDS, 1988–2005—Continued

| Year | Top rate on ordinary income | Top rate on ''realized'' capital gains | Top rate on dividends |
|---|---|---|---|
| 2001 | 39.1 percent | 20 percent | 39.1 percent |
| 2002 | 38.6 percent | 20 percent | 38.6 percent |
| 2003-2008 | 35 percent | 15 percent | 15 percent |

[a] In 1988-1990, the top rate on regular income over $31,050 and under $75,050 was 28 percent. Income over $75,050 and under $155,780 was taxed at 33 percent. And any income over $155,780 was taxed at 28 percent.

Source: Citizens for Tax Justice (2004).

Table 2 shows the difference in return between saving through a 401(k) plan and through a taxable account, taking all personal income taxes into account. The calculations are based on the following assumptions: 1) the worker earns $100 and wants to save the proceeds; 2) the proceeds are invested for 30 years in equities with a 6-percent rate—2 percent paid out in dividends and 4 percent in the appreciation of the value of the stock; 3) the worker is in the maximum tax bracket; and 4) the worker does not trade the stock during his working years, so capital gains taxes are due only when gains are realized at retirement. The bottom line is that while the difference between saving inside and outside a 401(k) has narrowed, 401(k) saving still produces higher after-tax returns.

TABLE 2.—NET AFTER-TAX RETURNS FOR TAXPAYERS FACING MAXIMUM TAX RATE IN TAXABLE ACCOUNT[a]

[Percentage]

| Year | Rate of return | | Difference between 401(k) and taxable account |
|---|---|---|---|
| | Taxable account | Conventional/Roth 401(k) Plan | |
| 1988-1990 | 3.7 | 4.8 | 1.1 |
| 1991-1992 | 3.5 | 4.7 | 1.2 |
| 1993-1996 | 2.8 | 4.2 | 1.4 |
| 1997-2000 | 3.0 | 4.2 | 1.2 |
| 2001 | 3.1 | 4.3 | 1.2 |
| 2002 | 3.1 | 4.3 | 1.2 |
| 2003-2008 | 3.9 | 4.5 | 0.6 |

[a] Assumes appreciation of 6 percent per year—2 percent from dividends and 4 percent from increase in the price of the equities.

Source: Author's calculations based on rates in Table 1 and assumptions described in the text.

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**Ms. Munnell's Additional Responses to Questions for the Record**

*1. On page four of your testimony you advocated for an additional tier of retirement savings to support 20 percent of a retiree's income. You suggested that this be modeled after the Thrift Savings Plan (TSP) that all federal workers, all Members of Congress and their staff are in. Furthermore you state "participation should be mandatory; participants should have no access to [the] money before retirement." Could you tell the Committee where the money would come for these new accounts? Does the government fund it or does the individual make contributions?*

The intent of the proposal is to help insure that people after a lifetime in the labor market have an adequate income in retirement. Social Security is scheduled to pay benefits at age 62 to the typical worker, who earns roughly $40,000 at retirement, a benefit equal to 29 percent of previous earnings. That level of benefit will not be adequate for tomorrow's workers to maintain their standard of living once they stop working. If the typical individual can hold off until Social Security's Full Retirement Age (66 today rising to 67), the replacement rate increases to 41 percent. Even this higher level of replacement will not be enough.

Increasingly, the only source of additional retirement income will come from employer-sponsored 401(k) plans. (People simply do not save on their own—with the exception of building up equity in their house.) As of 2007, median 401(k) holdings for individuals 55-64 were $60,000. After the collapse of the stock market, these balances average about $40,000. These balances will not provide enough supplementary income for people to maintain their standard of living over 20 years of retirement. Hence, tomorrow's workers need an additional tier of retirement income.

There is no free money. To have more in retirement, people will have to save more during their working life. Under my plan, the new tier would generally be funded

by the employee. The precise contribution rate depends on the expected rates of return earned on the invested assets, but assume a contribution rate of 5 percent. Middle-income individuals would be expected to make the contribution; low-income individuals would need help from the government. Again, nothing is free, so low-income support would require additional tax revenues.

While making people put aside more for retirement is unpleasant, the alternative—ending up with inadequate income in old age—could be disastrous.

*2. If it is the individual who makes the contributions, can you tell me where they are supposed to come up with the extra money? In 2006, the average per capita income in Washington State was $38,067. Please tell the Committee how much you believe should someone in Washington State making $38,067 be required to contribute?*

As suggested in the response above, the contribution rate might be, say, 5 percent. If you and others believe that people need less than an additional 20-percent replacement rate in retirement, the contribution rate could be lower. The key point is that if the typical person in Washington State does not save more, or work much longer than they do currently, they will be at risk in retirement.

*3. Or if it is the government, do you have any estimates for how much this will cost the taxpayer? What are your recommendations for Congress for where we should raise this funding?*

The cost to the government would be the contributions for low-income individuals. The precise cost would depend on how the government contribution was structured. If the government paid the full contribution for everyone earning less than $20,000, the annual cost would be about $25 billion. That should probably be viewed as an upper bound, since some type of matching arrangement would be more appropriate and would reduce the cost.

*4. You advocate for a mandatory TSP program for all. Now I can tell you that my TSP account had taken a similar hit in the last year along the lines of what you describe for 401(k)s. If we could go back in time and make your proposal law how would we be any better off today, other then folks having less money in their paychecks for these mandatory contributions? If yes, please quantify how much more money a contributor would have in an account invested in a Vanguard 401(k) S&P 500 fund and the government S&P 500 "C" fund?*

As I indicated in my testimony, it would be nice if we could structure a second tier that provides some type of guarantee. The problem is that low rates of guarantee—2 percent or 3 percent inflation-adjusted—would have done nothing to protect workers over the last 84 years. The reason is that no retiring cohort would have earned less than 3.8 percent on a portfolio of equities, so low guarantees would never have kicked in. Only high guarantees—like 6 percent—would have had any impact, but standard finance theory says such guarantees are not possible, as long as the guarantor shares the market's aversion to risk. But it would be nice to think a little more about guarantees and risk sharing.

In the absence of an answer on how to provide guarantees, I conclude in my testimony that perhaps the best we can do is a tier modeled on the Federal Thrift Savings Plan. The advantage is that the investment options would include only index funds and the structure could be target date funds. This arrangement does not eliminate risk, but target date funds would at least insure that those approaching retirement do not have two-thirds their assets in equities as they approach retirement, as was the case in 401(k)s, and that index funds would keep costs down.

My sense is that it may be possible to design a risk-sharing arrangement that would offer more security, but it would require careful thought.

In any case, the message that I wanted to emphasize is that we need more organized retirement saving. A declining Social Security system and fragile 401(k) plans will not be enough for future retirees. We need a new tier of retirement saving, but I certainly do not have all the answers on how that tier should be designed.

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March 10, 2009

The Honorable George Miller
Chairman
Committee on Education and Labor
U.S. House of Representatives
2205 Rayburn HOB
Washington, DC 20515-0507

Dear Chairman Miller:

This is in response to your letter of February 26 forwarding follow-up questions from Representative Robert "Bobby" Scott. The Investment Company Institute is pleased to supplement the record and thanks Mr. Scott for his interest in these issues.

***Question 1. Could you please comment on the long-term implications of tax-sheltered accounts?***

Saving in employer-sponsored 401(k) and other defined contribution retirement plans and IRAs has important tax advantages. Contributions that a worker makes to these plans reduce the worker's taxable income by the amount of the contribution. In addition, the account benefits from tax-deferred growth because taxes are not due until the individual receives a distribution. Roth IRAs and Roth 401(k) accounts have equivalent tax advantages, but in reverse order. In a Roth, the contribution is made on an after-tax basis but no income tax is due when the account is distributed, in a qualifying distribution (generally after five years and reaching age 59½, death or disability).

We believe that the tax incentives of 401(k) and other defined contribution plans and IRAs provide an important long-term incentive for retirement saving. Americans agree. The survey data of 3,000 households we presented to the Committee on February 24 found that 81 percent of households owning DC plans agreed that the immediate tax savings from their retirement plan are a big incentive to contribute.[1] Strong support for the tax incentives is seen in those households with income of less than $30,000 (75 percent agreed) and those younger than 35 (78 percent agreed).

[1] See Investment Company Institute, *Retirement Saving in Wake of Financial Market Volatility* (Dec. 2008), fig. 3, available at http://www.ici.org/pdf/ppr_08_ret_saving.pdf.

***Question 2. Also, how are retirees affected by the decision to either pay income taxes on funds once they are withdrawn from a tax-sheltered account or to pay capital gains taxes during the life of their investments?***

The rate at which capital gains are taxed is important because of the effect it has on U.S. capital investment and savings, an issue beyond the scope of this letter. But the capital gains rate is largely irrelevant to the decision by a worker to save in a tax-sheltered account like a 401(k) or IRA. Savers will typically accumulate more savings on an equivalent investment in a tax-sheltered account like a traditional or Roth 401(k) or IRA than investing in a taxable account, regardless of the capital gains rate.

The best way to illustrate this is first to compare a Roth IRA with a taxable account. Assume a worker has a marginal income tax rate of 25%. A worker receives $1,000 in salary and, after taxes, receives $750, which he contributes to a Roth IRA. The contribution is invested for 10 years (and until the worker reaches at least 59½), in which time the account has doubled to $1,500. The worker then takes a distribution and keeps all $1,500 because no taxes are due. Compare this to a taxable account. The worker receives the same salary of $1,000, contributes the same after-tax $750 to a taxable account, and liquidates it after 10 years. The worker will have less than $1,500 because capital gains will be paid upon sale of the assets (and depending on the investment, could have been paid during the 10 year period as well). In short, assuming the worker holds the contribution in the Roth IRA account long enough to receive a qualifying distribution, a Roth IRA is always preferable to a taxable account, regardless of the capital gains tax rate.

The same is true of traditional IRAs and 401(k)s, because a traditional 401(k) or IRA yields the same after-tax distribution on comparable contributions as a Roth, so long as the individual's tax rate is the same at the time of contribution and distribution.[2] This equivalence can be illustrated with a numerical example:

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[2] If an individual's tax rate is higher in retirement than at the time of contribution, Roth 401(k) or IRA tax treatment is more favorable than traditional 401(k) or IRA tax treatment. If the tax rate is lower in retirement, a traditional 401(k) or IRA would have more favorable tax treatment.

The Honorable George Miller
March 10, 2009
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**Equivalence of Roth and Traditional IRA/401(k) Tax Treatment**

| | Traditional IRA/401(k) | Roth IRA/401(k) |
|---|---|---|
| ***Contribution*** | | |
| Wages (before tax) | $1,000 | $1,000 |
| Tax on wages | $0 | $250 |
| Contribution | $1,000 | $750 |
| ***Investment returns after 20 years*** | $5,727 | $4,296 |
| ***Distribution after 20 years*** | | |
| Account balance distributed | $6,727 | $5,046 |
| Tax on distribution | $1,682 | $0 |
| **After-tax distribution** | **$5,046** | **$5,046** |
| ***Assumptions:*** | | |
| Rate of return | | 10% |
| Tax rate (on both contributions and distributions) | | 25% |

* Tax on deductible distribution is equivalent to the tax saved at the time of distribution ($250) plus investment earnings on that tax savings at the account's rate of return (10%) over 20 years; tax = $(\$250)*(1.1)^{20}$

There is one situation in which saving in a taxable account could be more advantageous and that is where the savings are intended to be short-term. Both traditional and Roth 401(k) plans and IRAs impose restrictions and penalties for early withdrawals that do not fall with specified exceptions. This simply emphasizes that Congress designed 401(k) plans and IRAs to be primarily long-term savings vehicles for retirement.

Thank you for the opportunity to follow up with Mr. Scott. If you or Mr. Scott would like additional information, please contact me or Peter Gunas (202-326-5860).

Sincerely,

Paul Schott Stevens
President and CEO

cc: Honorable Howard "Buck" McKeon, Ranking Member
Honorable Robert "Bobby" Scott

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[The statement of Mrs. Mcmorris Rodgers follows:]

## Prepared Statement of Hon. Cathy McMorris Rodgers, a Representative in Congress from the State of Washington

Thank you Chairman Miller and Ranking Member McKeon for holding a hearing on such an important issue. I want to also thank our witnesses for being here today to share their perspectives of how the current economic crisis impacted on workers' retirement savings.

Right now, our economy faces challenges that many of us haven't seen before in our lifetime. The current downturn in our financial markets has brought considerable uncertainty, particularly for those workers nearing retirement. A recently released poll said they worry they will have to work longer because the value of their retirement savings has declined. Particularly for those workers whose savings were

held in a risky portfolio and also for those who were not well-diversified, these are difficult times.

America also faces a crisis with our current defined benefit pension system. As Rodger Lowenstein points out in his recent book "While America Aged," today we have approximately 38 million senior citizens. It is predicted that in a generation this number will almost double to 72 million and that by 2030 one in five Americans will be over 65. Over 60 million Americans have been promised pensions; however this number is shrinking. Another concern is that over one third of the workforce has no savings for retirement or pension at all. Still another concern is that in the private sector the available pension plans are underfunded cumulatively by 350 billion dollars. Many employers, like IBM, Sears and Verizon have frozen their pension plans to keep their obligations from growing further. Unfortunately, some did not act quickly enough and have been forced to declare bankruptcy while others, like the U.S. auto industry teeter on the brink with only enormous government subsidies keeping them alive.

The Pension Benefit Guarantee Corporation (PBGC) created by the ERISA law in 1974 is currently responsible for the pensions of 1.3 million people whose pension plans have failed. With 94 of these plans failing in 2006 alone, the PBGC is deeply in the red with a taxpayer bailout increasingly likely. Even worse the states and localities that have promised pensions to first responders, teachers, transit workers and others are hundreds of billions of dollars behind on their promises to state pension funds. This is money owed by the taxpayer, and under the state constitutions this debt is required to be paid. Pensions can never be defaulted upon and this growing obligation has all the markings of the next financial crisis since these pensions are the longest enduring promises that exist.

One General Motors retiree recently passed in 2006 at the age of 111. He had been collecting pension and retiree benefits for 48 years. When he started work in 1926, there was little thought given to what they would pay him 80 years later. Pensions have always been the way to over promise future obligations that would have little effect on the company or municipality today. I find it ironic that the federal government was one of the first entities to get out of the pension business in 1984 as part of a solution then to save the Social Security system.

At the same time, millions of Americans rely on investments in planning for retirement. Because of this, a downturn in our financial markets can have a real impact on workers' retirement security. An increasing number of workers rely on 401(k)-type savings plans and a smaller share of workers participate in defined-benefit plans. Today, 630,000 private-sector defined contribution plans cover 75 million active and retired workers. In addition, there are more than 10 million employees of tax-exempt and governmental workers who participate in other plans such as 403(b), 427 and the Thrift Savings Program (TSP).

The financial crisis has also had an impact on defined contribution assets and this is a great concern to workers and retirees. Assets have declined from $2.9 trillion on June 30, 2008 to $2.4 trillion on December 31, 2008. The average 401(k) balance decreased 27 percent in 2008. However, 401(k) balances are still up 140 percent since January 1, 2000. If historical trends continue, plan participants who remain in the system can expect their plan assets to rebound significantly over time. A vast majority of these participants have remained committed to their defined contribution plans.

Congress has made progress in this effort. For instance, we made sweeping reforms of defined contribution plans in the Pension Protection Act of 2006 including enhanced pension plan financial disclosure requirements to participants. However, much more remains to be done.

I had the opportunity to review the testimony from our witnesses and I am greatly concerned that may of them are advocating for a new federal retirement system in addition to Social Security modeled on the federal TSP that covers all federal workers. It is alarming to see calls for such a dramatic change due to losses incurred under our current system. A government retirement savings board that may or may not require all employees to contribute will lower choices for workers and create a huge new bureaucracy in Washington, D.C. courtesy of the American worker.

Employer-sponsored 401(k) plans play a vital role in the retirement security of tens of millions of Americans. Although the recent economic downturn represents an historic challenge, it should not be used as an excuse to tear down or radically overhaul the 401(k) retirement system. I believe Congress should approve legislation that gives plan sponsors (typically employers) greater incentives to offer pension plans that match individual's contributions, offer many options for investment and give the individuals greater incentives to participate, not create a one size fits all government program with limited investment options and mandatory contributions.

I look forward to hearing the thoughts and perspectives of our witnesses regarding our nation's defined contribution plans.

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[The statement of Ms. Titus follows:]

**Prepared Statement of Hon. Dina Titus, a Representative in Congress from the State of Nevada**

Chairman Miller, Ranking Chairman McKeon, esteemed witnesses, and fellow Committee members—thank you for coming together today to examine the challenges workers face as they prepare for retirement. I'm honored to be a Member of this Committee and I look forward to hearing the testimony of the esteemed panel of witnesses joining us. Panelists—thank you for your time and input today.

We all know about the sad state of our nation's economy. The people of Southern Nevada and the Third Congressional District have been particularly hard hit by the economic downturn. Unemployment is nearing 10 percent—the highest it has been in 25 years—and it is expected to get worse. Sadly, Nevada also leads the nation in foreclosure and bankruptcy rates. These numbers are a stark reminder that we must take action, and we must take action soon to create reforms that will help restore savings for Nevadans nearing retirement, that will help Nevadans save for a secure retirement, and that will safeguard Nevadans' savings against any future economic crises that may befall us.

We will hear today from witnesses that will address numerous problems in today's defined contribution plans, and specifically 401(k) plans. Some of the witness testimony faults the market, some faults individuals for not saving adequately or for taking out hardship loans, some faults greed of financial management corporations, some faults companies that offer limited plans or cease to match employer contributions when times are tough. Ladies and gentleman of the Committee, and esteemed witnesses, I firmly believe that this cannot be a blame game. We must study in a bi-partisan fashion—bridging the gap between "labor" and "business"—to find reforms that can benefit all parties. I do not see these as competing interests and I don't believe anyone on this Committee, on the panel, or in Nevada can afford to see them as such.

I am eager to hear the testimony of today's witnesses and to continue discussions with my fellow Committee members on our best path forward as Members of Congress and the role we can play as Members of the House Education and Labor Committee.

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[A submission by Mr. Andrews follows:]

INVESTMENT COMPANY INSTITUTE

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March 10, 2009

The Honorable Robert Andrews
Chairman
Subcommittee on Health, Employment, Labor, and Pensions
U.S. House of Representatives
2265 Rayburn HOB
Washington, DC 20515

Dear Chairman Andrews:

At the Education and Labor Committee hearing on February 24, 2009, you asked a question about Figure 1 in my written testimony and whether we could provide data about contribution activity versus investment returns in 401(k) plans. Unfortunately the data currently available do not allow us to report directly 401(k) plan asset changes in 2008 net of contributions and distributions.

We are able to provide, however, some information responsive to your request. First, we use the latest available Department of Labor data (through 2006) to provide a picture of the dynamics of how contributions, distributions and investment returns affect the growth in assets in 401(k) plans. The investment returns for 401(k) plans in the aggregate reflect the broad range of asset classes that 401(k) participants hold in their accounts. We conclude this letter with snapshot data of the asset allocation of 401(k) plans to show the range of investments that 401(k) participants hold.

***Official Data: Contribution Inflows Generally Outstrip Outflows in 401(k) Plans***

Figure 1 of the Institute's testimony (reproduced as Figure 1 at the end of this letter)—showing the percentage change in total assets of various retirement plans from year-end 2007 to third quarter 2008—highlights that 401(k) plans were not unique in having seen significant declines in asset value because of the recent bear market. As I stated in my testimony, 401(k) plan assets did not fall in value by as much as the total stock market did because of (1) ongoing contributions and (2) diversification of retirement plan assets to include other assets in addition to U.S. equities.

You asked what the data in Figure 1 would be after accounting for the contributions and distributions in the 401(k) plans. Unfortunately, official data from the Department of Labor are only

available through 2006[1] and the data necessary to make this calculation accurately are not available for more recent years.

We can, however, use official Department of Labor data through 2006 to give you a sense of the effect of contributions and distributions in relation to the investment returns of 401(k) plans.

The Department of Labor aggregates financial information reported by private-sector pension plans (defined benefit and defined contribution, including 401(k) plans). The change in a 401(k) plan's assets in any given year is the combination of: (1) contributions into the plan, whether from the employer, the employee, or rollovers from other plans; (2) amounts distributed from the plans, reported as benefits paid, which include rollovers out of the plan (into IRAs or other qualified plans); and (3) investment returns, including reinvested dividends, interest, earnings, and capital gain distributions, as well as unrealized appreciation in asset values.

As summarized in Figure 2, in 2006, 401(k) plans saw contributions totaling $251 billion, which increased plan assets by 10.5 percent. Another $304 billion, which represented investment returns, increased plan assets by 12.7 percent. Outflows (predominately benefits paid), removing $233 billion from 401(k) plans in 2006, pulled plan assets down 9.7 percent, although much of those dollars is reinvested in IRAs. All told the change in 401(k) plan assets in 2006 was an increase of 15.5 percent.[2] The S&P 500 total return index increased 15.8 percent in 2006, while the Citigroup Broad Investment Grade Bond Index increased 4.3 percent.

***401(k) Plans Hold a Range of Investments***

Although official DOL data are available only through 2006, other sources report asset allocation and estimate 401(k) assets for later dates. For example, in a collaborative data collection effort with the Employee Benefit Research Institute, the EBRI/ICI 401(k) database examines the asset allocations of individual 401(k) plan participants (through year-end 2007 at this time).[3] In addition, ICI collects information on 401(k) plans' holdings of mutual funds and estimates total 401(k) plan assets (through 2008:Q3 at this time).[4] Both sources indicate that 401(k) plans hold a range of investments. Thus, it is to be expected that changes in 401(k) plan assets would reflect U.S. equity

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[1] For the full report see, U.S. Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin: Abstract of 2006 Form 5500 Annual Reports* (December 2008), available at: http://www.dol.gov/ebsa/PDF/2006pensionplanbulletin.PDF.

[2] The change in assets includes net contributions, investment returns, and miscellaneous (any difference between the change in assets and the reported flow information not otherwise covered by net contributions and investment returns).

[3] See Holden, VanDerhei, Alonso, and Copeland, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007*," EBRI Issue Brief and ICI Perspective (Dec. 2008) available at http://www.ici.org/pdf/per14-03.pdf.

[4] See Investment Company Institute, *The U.S. Retirement Market, Third Quarter 2008*, ICI Fundamentals, vol. 17, no. 3-Q3 (Feb. 2009), available at http://www.ici.org/pdf/retmrkt_update.pdf.

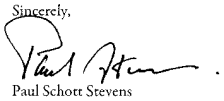
market performance, but would be tempered by other investment holdings (in addition to ongoing contributions).

At year-end 2007, the EBRI/ICI 401(k) data indicate that about two-thirds of 401(k) participants' assets were invested in equity securities through equity funds (which include mutual funds and other pooled investments primarily invested in equities), the equity portion of balanced funds, and company stock (Figure 3). About one-third was invested in fixed-income securities such as stable value investments and bond and money market funds.

As of third quarter 2008, mutual funds represented about half of 401(k) plan assets (Figure 4). Within mutual funds held in 401(k) plans, the bulk was invested in equity securities: 49 percent were domestic equity mutual funds, 15 percent were foreign equity mutual funds, and 20 percent were hybrid or balanced funds (Figure 5). Ten percent of mutual fund assets in 401(k) plans were bond funds and 6 percent were money market mutual funds.

Thank you for the opportunity to supplement the record. If you would like additional information, please contact me or Peter Gunas (202-326-5860).

Sincerely,



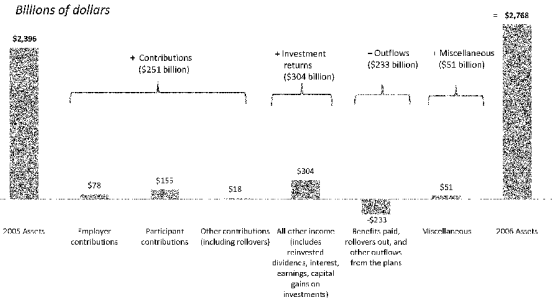
Paul Schott Stevens
President and CEO

cc: Honorable George Miller, Chairman, House Education and Labor Committee
Honorable Howard "Buck" McKeon, Ranking Member, House Education and Labor Committee

Figure 1
**All Plan Types Have Seen Declines in Asset Value**
*Percentage change in total assets from year-end 2007 to 2008:Q3*

Sources: Investment Company Institute, Federal Reserve Board, and Standard & Poor's

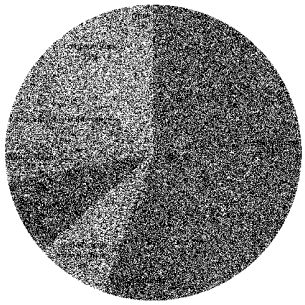
Figure 2
**Change in 401(k) Plan Assets, 2005 to 2006**
*Billions of dollars*




Note: Components may not add to the total because of rounding.

Source: ICI Summary of U.S. Department of Labor, Employee Benefits Security Administration, Summary of Form 5500

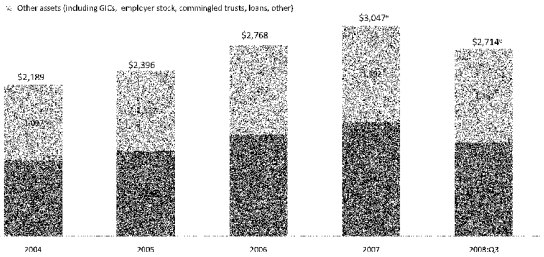
Figure 3
**Average Asset Allocation of 401(k) Accounts**
*Percentage of account balances, 2007*



Note: "Funds" include mutual funds and other pooled investments. Loans are not included. Percentages are dollar-weighted averages.

Source: EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

Figure 4
**Mutual Funds Are About 1/2 of 401(k) Assets**
*Billions of dollars*



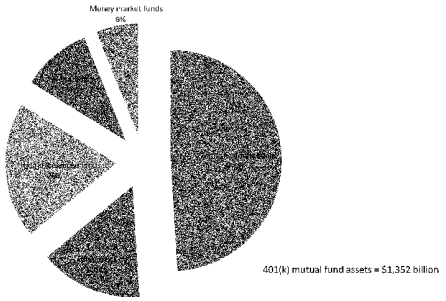

e = estimated
Note: Components may not add to the total because of rounding.

Sources: Investment Company Institute, U.S. Department of Labor, and Federal Reserve Board (See "The U.S. Retirement Market, Third Quarter 2008," *Investment Company Institute Fundamentals* (February 2009))

Figure 5

**401(k) Mutual Fund Assets by Type of Fund**

*Percentage of total mutual fund assets held in 401(k) plans, 2008:Q3*




Source: Investment Company Institute (See "The U.S. Retirement Market, Third Quarter 2008," *Investment Company Institute Fundamentals* (February 2009))

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[Whereupon, at 12:33 p.m., the committee was adjourned.]

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