THE IMPACT OF THE FINANCIAL CRISIS ON WORKERS' RETIREMENT SECURITY

HEARING

BEFORE THE

COMMITTEE ON EDUCATION AND LABOR

U.S. HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

HEARING HELD IN WASHINGTON, DC, OCTOBER 7, 2008

Serial No. 110–113

Printed for the use of the Committee on Education and Labor

Available on the Internet:
http://www.gpoaccess.gov/congress/house/education/index.html

U.S. GOVERNMENT PRINTING OFFICE

44–713 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
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C O N T E N T S

THE IMPACT OF THE FINANCIAL CRISIS ON WORKERS' RETIREMENT SECURITY

Tuesday, October 7, 2008
U.S. House of Representatives
Committee on Education and Labor
Washington, DC

The committee met, pursuant to call, at 1:05 p.m., in room 2175, Rayburn House Office Building, Hon. George Miller [chairman of the committee] presiding.

Present: Representatives Miller, Andrews, Scott, Tierney, Kucinich, Holt, Sarbanes, Sestak, Clarke, and Souder.

Staff Present: Aaron Albright, Press Secretary; Tylease Alli, Hearing Clerk; Jody Calemine, Labor Policy Deputy Director; Carlos Fenwick, Policy Advisor, Subcommittee on Health, Employment, Labor and Pensions; Patrick Findlay, Investigative Counsel; Denise Forte, Director of Education Policy; Ryan Holden, Senior Investigator, Oversight; Jessica Kahanek, Press Assistant; Therese Leung, Labor Policy Advisor; Sara Lonardo, Junior Legislative Associate, Labor; Ricardo Martinez; Policy Advisor, Subcommittee on Higher Education, Lifelong Learning and Competitiveness; Alex Nock, Deputy Staff Director; Joe Novotny, Chief Clerk; Rachel Racusen, Communications Director; Meredith Regine, Junior Legislative Associate, Labor; Melissa Salmanowitz, Press Secretary; James Schroll, Staff Assistant; Michele Varnhagen, Labor Policy Director; Mark Zuckerman, Staff Director; Robert Borden, Minority General Counsel; Cameron Coursen, Minority Assistant Communications Director; Ed Gilroy, Minority Director of Workforce Policy; Rob Gregg, Minority Senior Legislative Assistant; Alexa Marrero, Minority Communications Director; Ken Serafin, Minority Professional Staff Member; and Linda Stevens, Minority Chief Clerk/Assistant to the General Counsel.

Chairman MILLER. The Committee on Education and Labor will come to order for the purposes of conducting an oversight hearing on the impact of the current fiscal and housing crises on workers' retirement security. I want to thank all of the witnesses who have agreed to testify this afternoon. And thank you to the staff for putting this hearing together, and to the members of the committee who were able to make it for the hearing.

Last week, Congress approved an emergency rescue plan in response to the worst financial crisis our country has seen since the Great Depression. We know that this plan alone will not magically turn the economy around, but we are confident that, without it, we would not have a chance to move forward.

We insisted that the plan include strong protection for taxpayers and tough accountability, neither of which was included in the President's original request to Congress. Immediately after the plan was approved, Speaker Pelosi announced that the House would conduct a series of hearings to investigate the causes of the current financial crises and what steps should be taken next to protect homeowners, workers, and families struggling today. As part of that commitment, the Committee on Education and Labor is holding a hearing to explore how this financial crisis is impacting the retirement security of American families.

Yesterday, the House Oversight and Government Reform Committee launched the first of many oversight hearings examining the toxic mix of corporate greed, recklessness, and deregulation that created this financial crisis.

During his testimony, Lehman Brothers' CEO, Mr. Fuld, showed no remorse at his catastrophic mismanagement of the company. In fact, he repeatedly denied responsibility for running the storied Lehman Brothers Investment House into financial oblivion. He refused to admit that his own reckless management and his industry's success in keeping the regulators at bay directly contributed to this historic financial crisis that is costing taxpayers, shareholders, and the Nation's current and future retirees billions of dollars from their nest eggs. All the while he insisted on taking obscene multimillion-dollar bonuses for his executive teammates. Unlike Wall Street executives, America's families don't have a golden parachute to fall back on.

It is clear that retirement security may be one of the greatest casualties of this financial crisis. The current financial and housing crisis are stripping wealth from American families at a record rate. A new poll just found that 63 percent of Americans are worried that they will not have enough savings for their retirement. Tragically, they may very well be right.

Due to the collapse of the housing market, and the financial crisis, trillions of dollars that Americans were counting on has been lost. Americans were counting on much of this wealth for their retirement. Now it is gone, as is their ability to adequately fund their retirement.

Even before the current meltdown, middle-income families were losing ground due to the decline in middle-class wages over the last decade, making it harder for them to save for their retirement and family emergencies. Retirement and financial experts now predict that retirees and older workers who rely on financial investments for their retirement income may suffer more than any portion of the American population in the coming years.

According to a survey released today by the AARP, one in five middle-aged workers stopped contributing to their retirement plans last year because they had trouble making ends meet. One in three workers is considering delaying retirement. Now, the number of investors taking loans on their 401(k) accounts is increasing, and hardship withdrawals are also increasing. T. Rowe Price estimates a 14 percent increase in the hardship withdrawals just in the first 8 months of 2008, and all of the signs point to an increased frequency of 401(k) loans and hardship withdrawals in the coming year. It makes sense that more Americans will be raiding their retirement accounts as they deal with rising unemployment and the increasing cost of basic necessities.

Unfortunately, these drastic measures that have been taken by workers today will have a long-lasting impact by significantly reducing their account balances once these workers reach retirement age.

Over the past 12 months, more than half a trillion dollars have evaporated from more 401(k) plans as a direct result of the crisis in the markets. Some experts say it will take as long as 3 years to recover market losses in 401(k)-style accounts, but only if the market turns around soon.

Just like consumer-directed retirement plans, traditional pension plans are not immune from the financial crisis. Although pension plans hire professional money managers, and are required to be diversified, these plans will likely lose value as a result of the weak performance in the investment markets.

Sophisticated pension plans lost 20 to 30 percent of their value during the 2001 recession, and took several years to overcome those losses. We must keep our eye on these plans and I await further data on the health of our Nation's pensions.

While this crisis began on Wall Street, much of the financial burden will ultimately be borne by Main Street. This did not happen overnight. With the Republicans' help, armed with their powerful lobbyists, Wall Street cunningly held off fair regulations by Congress, arguing that Americans would be better off if they were left to their own devices. As Congress continues our investigations into the crisis, we cannot allow those responsible to emerge unscathed. The American people are paying a price for this "Go, go, Wild West" approach to governing. One cost will be the concern that our Nation's workers will not have sufficient savings to ensure a secure retirement after a lifetime of hard work.

In the coming months, this committee will examine what measures may be needed to ensure safe and secure retirement for workers, retirees, and their families. For starters, we know that 401(k) holders lack critical information about how their money is being managed and what fees they pay. I am here to say right now those days are over. We must have more transparency and complete transparency in 401(k) investment practices. The Wall Street veil of secrecy must end.

I would like to thank all of our witnesses for joining us today, and I look forward to their testimony. I expect that we will be back here repeatedly until we can ensure greater security for the retirement of all hardworking Americans.

Our first witness will be Dr. Peter Orszag, who is the Director of the Congressional Budget Office. CBO's mission is to provide Congress and the public with objective, nonpartisan, and timely analysis of economic and budgetary issues, as well as analytic papers and cost estimates of the proposed legislation.

Dr. Orszag received his BA from Princeton University and his MA and PhD from the London School of Economics.

Next, we will hear from Dr. Jack VanDerhei, who is the Research Director for the Employee Benefit Research Institute. He is also the editor of the Benefits Quarterly, and a member of the advisory board of the Pension Research Council at the Wharton School and the National Academy for Social Insurance. Dr. VanDerhei received a BA and MBA from the University of Wisconsin, Madison, and an MA and PhD from the Wharton School of the University of Pennsylvania.

Mr. Jerry Bramlett currently serves as President and CEO of the BenefitStreet, an independent advisor for 401(k) and other defined contribution plans. Mr. Bramlett founded the 401(k) Company in 1983, and has 25 years of retirement industry experience. He holds a BA from Southern Methodist University.

Dr. Christian E. Weller is Associate Professor of Public Policy at the University of Massachusetts, Boston, and Senior Fellow at the Center for American Progress Action Fund. His work focuses on retirement income security, money and banking, microeconomics, and international finance. Dr. Weller holds a PhD in economics from the University of Massachusetts at Amherst.

Dr. Teresa Ghilarducci is the Irene and Bernard Schwartz Professor of Economic Policy Analysis at the New School for Social Research. Dr. Ghilarducci specializes in pension benefits, and is the author of several books, including, most recently, "When I Am 64: The Plot Against Pensions and the Plan to Save Them." She received her BA and PhD from the University of California at Berkeley.

Dr. Orszag, we will begin with you. As you know, you obviously have testified so many times in front of Congress, but a green light will go on when you begin to testify. We allow you 5 minutes for your opening statements. And then an orange light will go on when you have 1 minute remaining. We suggest you might want to wrap it up, but we want to make sure you complete your thoughts in a coherent fashion. And then a red light when your time has run out. That will allow time for the members of the committee.

Again, I want to thank all of the members for showing up.

Peter, please proceed as you are most comfortable.

[The statement of Mr. Miller follows:]

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

Good afternoon.

Last week, Congress approved an emergency rescue plan in response to the worst financial crisis our country has seen since the Great Depression. We know that this plan alone will not magically turn the economy around. But we are confident that without it we will not have the chance to move forward.

We insisted that the plan include strong protections for taxpayers and tough accountability—neither of which was included in the President's original request to Congress.

Immediately after the plan was approved, Speaker Pelosi announced that the House would conduct a series of hearings to investigate the causes of the current financial crisis and what steps we should take next to protect homeowners, workers and families struggling today.

As part of that commitment, the Committee on Education and Labor today is holding a hearing to explore how this financial crisis is impacting the retirement security of American families.

Yesterday, the House Oversight and Government Reform Committee launched the first of many oversight hearings examining the toxic mix of corporate greed, recklessness, and deregulation that created this financial crisis.

During his testimony, Lehman's CEO, Mr. Fuld, showed no remorse for his catastrophic mismanagement of the company. In fact, he repeatedly denied responsibility for running the storied Lehman Brothers investment house into financial oblivion.

He refused to admit that his own reckless management—and his industry's success of keeping regulators at bay—directly contributed to this historic financial crisis that is costing taxpayers, shareholders, and the nation's current and future retirees billions of dollars from their nest eggs.

All the while, he insisted on taking obscene multi-million dollar bonuses for his executive teammates.

Unlike Wall Street executives, American families don't have a golden parachute to fall back on.

It's clear that their retirement security may be one of the greatest casualties of this financial crisis.

The current financial and housing crises are stripping wealth from American families at a record rate.

A new poll just found that 63 percent of Americans are worried that they will not have enough savings for their retirement. Tragically, they may very well be right. Due to the collapse of the housing market and the financial crisis, trillions of dollars that Americans were counting on has been lost.

Americans were counting on much of this wealth for their retirement. Now it is gone—as is their ability to adequately fund their retirement.

Even before the current meltdown, middle-income families were losing ground due to the decline in middle-class wages over the last decade—making it harder for them to save for their retirement and family emergencies.

Retirement and financial experts now predict that retirees and older workers who rely on financial investments for retirement income may suffer more than any portion of the American population in the coming years.

According a survey released today by the AARP, one in five middle-aged workers stopped contributing to their retirement plans in the last year because they had trouble making ends meet. One in three workers has considered delaying retirement.

Now, the number of investors taking loans on their 401(k) accounts is increasing. And hardship withdrawals are also increasing.

T. Rowe Price estimates a 14 percent increase in hardship withdrawals just in the first eight months of 2008.

And, all the signs point to an increased frequency of 401(k) loans and hardship withdrawals in the coming year.

It makes sense that more Americans will be raiding their retirement accounts as they deal with rising unemployment and increasing costs of basic necessities.

Unfortunately, these drastic measures taken by workers today will have a long-lasting impact by significantly reducing account balances once these workers reach retirement age.

Over the past 12 months, more than a half trillion dollars have evaporated from 401(k) plans as a direct result of the crisis in the markets.

Some experts say that it will take as long as 3 years to recover market losses in 401(k)style accounts—but only if the market turns around soon.

Just like consumer directed retirement plans, traditional pension plans are not immune from the financial crisis.

Although pension plans hire professional money managers and are required to be diversified, these plans will likely lose value as a result of the weak performance of the investment markets.

Sophisticated pension funds lost 20 to 30 percent of their value during the 2001 recession and took several years to overcome those losses.

We must keep our eye on these plans and I await further data on the health of our nation's pensions.

While this crisis began on Wall Street, much of the financial burden will ultimately be borne by Main Street. And this did not happen overnight.

With the Republicans' help and armed with their powerful lobbyists, Wall Street cunningly held off fair regulations by Congress, arguing that Americans would be better off if left to their own devices.

As Congress continues our investigations into this crisis, we cannot allow those responsible to emerge unscathed. The American people are paying the price of this go-go, Wild West approach to governing.

One cost will be the concern that our nation's workers will not have sufficient savings to ensure a secure retirement after a lifetime of hard work. In the coming months, this committee will examine what measures may be needed to ensure a safe and secure retirement for workers, retirees and their families.

For starters, we know that 401(k) holders lack critical information about how their money is managed and what fees they pay.

I'm here to say right now, those days are over.

We must have more transparency in 401(k) investment practices. The Wall Street veil of secrecy must end.

I would like to thank all of our witnesses for joining us today. I look forward to their testimony.

And I expect that we will be back here repeatedly until we can ensure greater security for the retirement of hard-working Americans.

STATEMENT OF PETER R. ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. ORSZAG. Thank you very much, Mr. Chairman, members of the committee.

The turmoil in financial markets that we have experienced over the past year or so will and has affected many aspects of our lives, including pensions, but perhaps for many households the effects have not really manifested themselves dramatically yet. That may start to change as households receive, for example, their 401(k) balances that were mailed out at the end of the last quarter, that are either in the mail or about to be received today.

The most direct effect of the financial market turmoil on pensions occurs through the prices of financial assets, such as corporate equities and bonds. The Standard & Poor's 500 stock market index, for example, has fallen by more than 25 percent over the past year, as the outlook for the economy has worsened and corporate profits have deteriorated and financial turmoil has created stress in our financial markets. Because the majority of pension assets are held in equities, these declines in stock prices have had a significant adverse effect on pension plans.

Data from the Federal Reserve suggests that the decline in the value of financial assets held by pension funds, public and private, defined benefit and defined contribution, amounted to roughly $1 trillion, almost 10 percent, losses on their assets from the second quarter of 2007 through the second quarter of 2008.

Since the end of the second quarter, asset prices have continued to decline, and CBO analysis suggests that there may well be another $1 trillion in losses on pension plan assets. In other words, over the past 15 months or so, pension plans have experienced a roughly $2 trillion decline in the value of their assets.

As you know, the two principal types of pension plans are defined benefit plans and defined contributions plans. If we look at defined benefit plans, CBO's estimate suggests that the value of the assets held by defined benefits plans has declined by roughly 15 percent over the past year.

Offsetting that, to some degree, is that the way obligations are calculated under defined pension plans involves an interest rate. The interest rate that is used for those calculations has increased, and that has partially offset the decline in assets to the degree of change in the net asset position, if you will, of defined benefit plans, has decreased by perhaps only 5 to 10 percent over the past year. Still quite substantial.

Defined contribution plans, if anything, are somewhat even more heavily weighted towards equities than defined benefit plans, so the declines in their asset values, again, if anything, are more significant on a relative basis than defined benefit assets.

State and local government pension plans have also suffered losses. According to data from the Federal Reserve, for example, the assets held by State and local government pension plans declined by more than $300 billion between the second quarter of 2007 and the second quarter of 2008.

Now, what does this all mean for real people and real household? It will mean several things. One is that the decline in the value of retirement assets may well lead households to delay buying a new house or buying a refrigerator, or what have you, consuming things, to the extent that they perceive the assets in their retirement accounts to be part of their net worth.

Another dimension of response may be that some people will delay their retirement. In particular, those on the verge of retirement may decide they can no longer afford to retire, and will continue working longer.

If we look over a longer period of time, through the 1970s and the 1980s, there was a trend towards earlier retirement, which has somewhat reversed since then. The evidence is somewhat ambiguous about the impact of financial market changes on retirement behavior. For example, after the decline in the stock market earlier in 2000, 2001, one paper suggested there was not a significant response on retirement. However, during the boom of the 1990s, other evidence suggests that people did retire earlier in response to rising values in their retirement accounts and other stock market wealth. One would think that the reverse of that would then lead people to retire later. So one dimension of response may well be in longer working lives and later retirements.

I want to just wrap up by commenting on one lesson that we can learn from the turmoil that we have been experiencing, which is that in a defined contribution plan, like a 401(k) plan, exposure to broad market risk is almost unavoidable. That is to say, if all asset prices move in a particular direction, workers bear the risk, almost by definition, under a 401(k) plan, by design. But too many workers seem to be taking on unnecessary risks even in the stocks that they hold. For example, roughly 1 in 15, or about 7 percent of workers, hold 90 percent or more of their 401(k) balances in their own company's stock. I think the experience that we are having with corporate failures or potential corporate failures should underscore the risk of not only risking your unemployment status but also your retirement assets in making a big bet on only one firm. Instead, a strategy of diversification is generally sound. It is unavoidable. It doesn't get away from the risk of an overall market decline, as we have been experiencing, but too many workers are taking on unnecessary risks over and above the risks they would otherwise face in 401(k) plans.

Thank you very much, Mr. Chairman.

[The statement of Mr. Orszag follows:]

Congressional Budget Office

Testimony

Statement of
Peter R. Orszag
Director

The Effects of Recent Turmoil in Financial Markets on Retirement Security

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

October 7, 2008

This document is embargoed until it is delivered at 1:00 p.m. (EDT) on Tuesday, October 7, 2008. The contents may not be published, transmitted, or otherwise communicated by any print, broadcast, or electronic media before that time.

CONGRESSIONAL BUDGET OFFICE
SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

Chairman Miller, Ranking Member McKeon, thank you for inviting me to testify this afternoon about the effects of the crisis in financial markets on pensions and retirement security.

Turmoil in Financial Markets

Financial markets have experienced substantial stress for over a year. The turmoil emanated from the bursting of the housing bubble, which led to substantial losses on mortgage loans and mortgage-related securities. In part because the mortgage-related securities are complex and in part because future rates of defaults on the individual mortgages underlying those securities are hard to predict, financial markets have had difficulty gauging the magnitude of the losses on the securities. That opacity, in turn, has made it difficult to evaluate the financial condition of the institutions holding them.

Those problems have contributed to a broader collapse in confidence, leading to a general pullback from all types of risky lending. Financial institutions have become increasingly unwilling to lend to one another, creating stress in the interbank market for short-term loans that became particularly severe over the past several weeks. The issuance of corporate debt plummeted in the third quarter, and the commercial paper market has also been hit hard. Bank lending, which has thus far remained relatively strong, will likely be severely curtailed by the difficulties that banks are facing in raising capital. The general collapse in confidence is reflected in significant increases in risk spreads (or the difference between the interest rates charged on risky assets and those on Treasury securities). For example, the spread between the interest rate on corporate bonds with the lowest risk (AAA-rated bonds) and the interest rate on Treasury securities has risen by more than a percentage point since the middle of last year.

In sum, recent developments in financial markets represent a severe credit crunch, which could have devastating effects on the U.S. and world economies. In response, the Congress recently enacted a financial rescue package that, among other things, creates the Troubled Assets Relief Program (TARP), under which the Secretary of the Treasury is authorized to purchase, insure, hold, and sell a wide variety of financial instruments. The Congressional Budget Office (CBO) analyzed many aspects of that program in recent testimony before the House Budget Committee.[1]

The turmoil in financial markets has affected many aspects of the economy, including pensions. The most direct effect on pensions is through the prices of financial assets such as corporate equities and bonds. The Standard & Poor's 500 stock market index, for example, has fallen by more than 25 percent over the past year as the outlook for the economy and corporate profits has worsened.

1. Statement of Peter R. Orszag, Director, Congressional Budget Office, before the House Committee on the Budget, *Federal Responses to Market Turmoil* (September 24, 2008).

Because the majority of pension assets are held in equities, drops in stock prices have had a significant adverse effect on pension plans.[2] Data from the Federal Reserve suggest that the decline in the value of financial assets cost pension funds (private-sector and public-sector combined) roughly $1 trillion—almost 10 percent of their assets—from the second quarter of 2007 to the second quarter of 2008 (the latest period for which data are available), and there has been a significant further drop in asset prices since then.

Private-Sector Pension Plans

The two principal types of pension plans are defined-benefit plans and defined-contribution plans. Over the past several decades, the private-sector pension system has shifted dramatically toward defined-contribution plans, such as 401(k) plans.

Defined-Benefit Pension Plans

In a defined-benefit pension plan, benefits are specified by a fixed formula unrelated to the value of the pension fund. The sponsor of the plan is generally responsible for financing the benefits and must therefore make larger contributions when the value of the assets held by the pension fund declines. By CBO's estimates, the value of the assets held by defined-benefit plans has declined by roughly 15 percent over the past year.

Because of the way the obligations of the plans are calculated, their funding position (that is, the relationship between their assets and liabilities) is also affected by the level of interest rates. Because payments will extend far in the future, the amount of funding today necessary to make those payments is adjusted for the time value of money by "discounting" them using certain interest rates. Those rates have increased over the past year, lowering the discounted value of plans' liabilities by roughly 5 percent to 10 percent and partially offsetting the drop in asset values.[3] Overall, according to CBO's estimates, defined-benefit plans' assets net of liabilities may have decreased by 5 percent to 10 percent over the past year.

Those developments have probably left private-sector defined-benefit pension plans' obligations exceeding their assets by a greater amount than last year. That circum-

2. One important question is whether the current value of stocks represents a temporary dip or a permanent adjustment to a new, lower value. Economists have not resolved empirically the question of whether stocks depart only temporarily from some relatively stable average. However, some evidence suggests that stock prices tend to revert to a more stable long-run value after particularly sharp declines. See, for example, James M. Poterba and Lawrence Summers, "Mean Reversion in Stock Prices," *Journal of Financial Economics*, vol. 22, no. 1 (1988), pp. 27–59; Eugene Fama and Kenneth French, "Permanent and Temporary Components of Stock Prices," *Journal of Political Economy*, vol. 96, no. 2 (1988), pp. 246–273; and Jeremy J. Siegel, *Stocks for the Long Run* (New York: McGraw Hill, 2007).

3. That calculation is based on the yields on corporate debt rated A or higher, which have increased over the year, according to several indexes.

stance could force employers to raise contributions to help trim the shortfall, reducing the cash that they have available for investment, hiring, or distribution to shareholders. However, such funding requirements are sensitive to future asset prices, which are highly uncertain given the turmoil in financial markets.

Defined-Contribution Pension Plans

Changes in asset prices have also affected the value of assets in defined-contribution pension plans. In those plans, the resources available to workers upon retirement depend directly on the value of assets in their plan account. Defined-contribution plans apparently are more heavily weighted toward stocks than defined-benefit plans are; over two-thirds of the assets in defined-contribution plans are invested in equities (either directly or through mutual funds). Because of that heavy emphasis on equities, the value of assets in defined-contribution plans may have declined by slightly more than that of assets in defined-benefit plans. To the extent households view balances in defined-contribution plans as part of their overall portfolio of wealth, a decline in those balances could lead people to reduce or delay purchases of goods and services. As described below, it could also lead some workers to delay their retirement.

State and Local Pension Plans

Public pension plans have also been affected by market developments. According to data from the Federal Reserve, for example, the assets held by state and local governments' pension plans declined by more than $300 billion between the second quarter of 2007 and the second quarter of 2008.[4] The composition of public-sector funds mimics that of corporate pension funds. Overall, about 60 percent of the assets in public pension funds are invested in equities, 30 percent in domestic fixed-income securities, 5 percent in real estate, and the remaining 5 percent in alternatives.[5]

Even before the current downturn, concerns had been raised about the funding levels of some public-sector pension plans. According to the most recent survey of public pension funds by the National Association of State Retirement Administrators, plans accounting for about 85 percent of the assets had funded ratios of 86 percent, on average.[6] (Funded ratios measure the degree to which assets and future contributions match current and future liabilities.) Some analysts have expressed concerns that reported funded ratios may be inflated because some public pension plans use relatively high discount rates when computing their future liabilities. The 20 largest public pension plans, which account for about half of all assets in such plans, have funded ratios of about 90 percent on average, but some smaller plans have funded ratios

4. Federal Reserve, Flow of Funds Accounts of the United States, Table L. 119, "State and Local Government Employee Retirement Funds," September 18, 2008, available at www.federalreserve.gov/releases/Z1/Current/z1r-4.pdf.

5. Alternatives include private equity, hedge funds, currency, commodities, and cash.

6. See Public Fund Survey, "Actuarial Funding Levels," (2007), available at www.publicfundsurvey.org/publicfundsurvey/index.htm.

below 60 percent. Smaller plans, particularly those with lower funded ratios, may have a more difficult time weathering the decline in asset values.

Funded ratios have been steadily declining in recent years. In 2000, about 90 percent of public pension plans had funded ratios greater than 80 percent.[7] By 2006, that share had decreased to about 40 percent (though, again, a much larger share of large plans have funded ratios above 80 percent). Lower returns caused by a declining market and the economic slowdown, which will translate into lower corporate and personal income tax revenues, will exacerbate the downward trend in funded ratios.

Many public pension plans use actuarial methods that will mute the effects of recent changes in asset values on funded status. One of those methods is "smoothing," or valuing current assets on the basis of averages over recent years, rather than on current market values. That method generally causes the reported valuations to lag behind the market; in the current environment, it can cause reported valuations to be higher than current market values.

Although the laws governing state and local pension plans vary, significant drops in funded ratios could trigger requirements for higher contributions to the plans from state and local coffers or from public-sector employees at a time when tax collections are also waning.

Households' Assets and Retirement Behavior

Asset prices affect households not only through pension plans but also through their other holdings. Although most households have few assets outside retirement plans, those assets are still substantial in the aggregate. In 2006, income from assets outside retirement plans provided almost as much income for households with elderly members as pensions did: Pensions provided 18 percent of the aggregate income for the population age 65 and older, and asset income accounted for 15 percent.[8] Social Security provided 37 percent, on average; and earnings, 28 percent.

The shares of income coming from pensions and asset income vary widely across the income distribution, however (see Figure 1). Among households with elderly members, those in the lowest income quintile obtained only 4 percent of their aggregate income from pensions and just 3 percent from asset income. At the other end of the distribution, households in the highest quintile received 18 percent of their income from pensions and 21 percent from asset income.

7. Statement of Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security, Government Accountability Office, before the Joint Economic Committee, published as Government Accountability Office, *State and Local Government Pension Plans: Current Structure and Funded Status,* GAO-08-983T (July 10, 2008).

8. Federal Interagency Forum on Aging-Related Statistics, *Older Americans 2008: Key Indicators of Well-Being,* available at agingstats.gov/agingstatsdotnet/Main_Site/Data/Data_2008.aspx.

Some people on the verge of retirement might respond to a decline in financial markets by working longer. In 2006, 36 percent of people age 65 and older were in families with earnings; that share could rise somewhat over the next few years, both because of underlying trends in the labor market and because of the recent turmoil in financial markets.

Older workers' participation in the labor force decreased during the 1970s and early 1980s but has increased since then (see Figure 2). The labor force participation rate of workers 55 to 64 years old, for example, fell from about 62 percent in 1970 to 54 percent in 1986 and then rose steadily, to nearly 64 percent in 2007.[9] The rate for workers age 65 and older followed a similar pattern and is at nearly the same level today as it was in 1970. Moreover, the fraction of people age 55 and older who work full time grew from about 22 percent in 1990 to nearly 30 percent in 2007 (see Figure 3).

Studies that have examined the impact of the stock market boom of the 1990s and the subsequent decline of the early 2000s on retirement decisions show mixed results. One paper, for example, found no evidence of an increase in the retirement age among people in households owning stocks after the stock market decline of 2000.[10] Another paper, however, showed that survey respondents who held corporate equity immediately prior to the bull market of the 1990s retired, on average, 7 months earlier than other respondents.[11]

Mitigating Financial Market Risks

Although severe stresses in financial markets almost inevitably cause wrenching adjustments by workers and employers, the risks can be attenuated by sensibly designing pension plans. For example, although workers enrolled in defined-contribution plans may not be able to avoid bearing the risks associated with broad price changes in financial markets, they can avoid unnecessary risks associated with a lack of diversification. Such unnecessary risks can arise, for example, by overweighting portfolios with individual stocks rather than diversified index funds.

9. Based on data from the Current Population Survey compiled by the Department of Commerce's Bureau of Labor Statistics, available at www.bls.gov/data/#employment.

10. Courtney C. Coile and Phillip B. Levine, "Bulls, Bears, and Retirement Behavior," *Industrial and Labor Relations Review*, vol. 59, no. 3 (April 2006), pp. 408–429, available at digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1218&context=ilrreview.

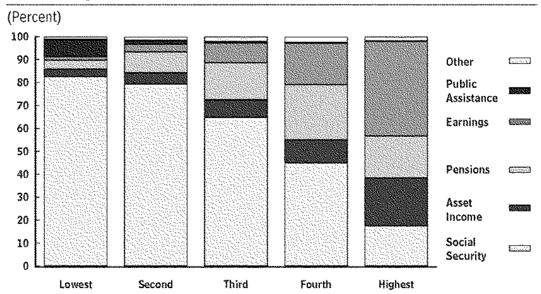
11. Julia Lynn Coronado and Maria G. Perozek, "Wealth Effects and the Consumption of Leisure: Retirement Decisions During the Stock Market Boom of the 1990s," FEDS Working Paper No. 2003-20 (Federal Reserve Board, May 2003), available at ssrn.com/abstract=419721.

In recent years, many firms have adopted automatic enrollment in defined-contribution pension plans.[12] Such automatic enrollment dramatically increases participation rates, especially for subgroups such as workers with low income, for whom participation is otherwise very low. Perhaps of more relevance to a discussion of financial market risks, however, the Pension Protection Act of 2006 requires that the allocation of assets by automatic-enrollment pension plans meet certain criteria that protect against excessive risk for participants. As a result, pension assets for automatically enrolled workers tend to be weighted toward more-diversified portfolios. Such protections against nondiversified investment portfolios can help avoid excessive exposure to financial market risks. By design, however, workers in defined-contribution plans must inevitably bear the risks associated with broad market fluctuations.

12. See, for example, William E. Nesmith, Stephen P. Utkus, and Jean A. Young, "Measuring the Effectiveness of Automatic Enrollment," Vanguard Center for Retirement Research, vol. 31 (2007).

Figure 1.

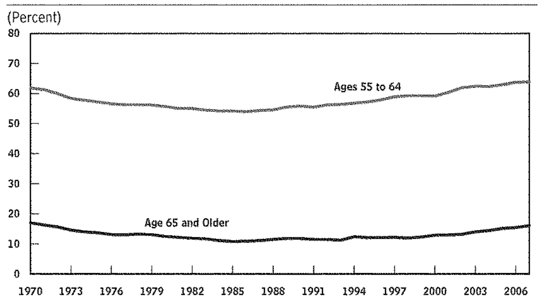
Sources of Income for People Age 65 and Older, by Income Quintile, 2006



Source: Congressional Budget Office based on data from the Federal Interagency Forum on Aging-Related Statistics, *Older Americans 2008: Key Indicators of Well-Being.*

Figure 2.

Percentage of Older People Participating in the Labor Force, 1970 to 2007



Source: Congressional Budget Office based on data from the Bureau of Labor Statistics.

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Chairman MILLER. Thank you.

STATEMENT OF DR. JACK VANDERHEI, RESEARCH DIRECTOR, EMPLOYEE BENEFIT RESEARCH INSTITUTE (EBRI)

Mr. VANDERHEI. Chairman Miller, members of the committee, thank you for your invitation to testify today on the impact of the financial crisis on retirement security. I am Jack VanDerhei, Research Director of the Employee Benefit Research Institute. EBRI is a nonpartisan research institute that has been focusing on retirement and health benefits for the past 30 years. EBRI does not take policy positions and does not lobby.

With your permission, I have a longer written statement that I would like to submit for the Record.

Chairman MILLER. Without objection.

Mr. VANDERHEI. Although the current financial crisis may have an impact on defined benefit participants, the extent and timing of the impact is difficult to assess, given the impact of PPA on plan-sponsored contributions and/or benefit accruals on amendments.

Considerably more is known though about the immediate impact of the current financial crisis on defined contribution plan participants. It should be emphasized that while older employees have average equity allocations that are lower than their younger counterparts, and hence are thought by some to be less vulnerable to negative returns in the equity markets, their average account balances tend to be larger, and therefore they have more to lose in a significant downturn.

Research has shown that a worker's age is a major factor in his or her ability to recover from an economic downturn. In 2002, Sarah Holden and I simulated the likely impact of a major bear market on the overall replacement rates that could be provided by 401(k) accumulations. Based on a baseline replacement rate of 51 percent for a specific group of employees, the decrease was estimated to be only 3.2 percentage points if it took place at the beginning of the career, but 13.4 percentage points if it took place at the end of the career.

However, building or modifying a simulation model that is able to quantify the likely impact of a market downturn on eventual retirement income is a very lengthy process. Consequently, attention is typically focused on how a decline in the financial markets has impacted the average defined contribution balances.

For purposes of this testimony, EBRI has taken the most recent information in the EBRI/ICI 401(k) database, year-end 2006, and used employee-specific information, as well as financial market indices to estimate the percentage change in average account balances among the 2.2 million 401(k) participants that were present in the database from year end 1999 to year end 2006. This so-called consistent sample of 401(k) participants was created several years ago in the annual analysis of EBRI/ICI 401(k) data to provide an estimate of changes in average annual account balances that was not biased downward by job-turnover 401(k) participants.

If you would like a look at the power point slides, figure 1, hopefully, it shows that for the first 9 months of 2008, the percentage loss in average account balances among 401(k) participants in this consistent sample varies from 7.2 percent to 11.2 percent. As you would expect, groups with the lowest average loss tend to have a reduced equity exposure, as well as a larger ratio of contributions to account balance.

Figure 2 shows the cumulative experience for 2007, as well as the first 9 months of 2008. In 2007, the S&P 500 index return was positive, 5½ percent, but not nearly enough to offset the losses in the first 9 months of 2008.

Figure 3 broadens the time span under the analysis and shows that, even with the financial market setback suffered so far in 2008, the percentage change in average account balances from January 1, 2000, through October 1, 2008, was significantly positive for all groups, and all age cohorts in the two shortest tenure categories at least doubled their account balances in nominal terms.

The largest increase, as you would expect, was experienced by the group with the youngest workers and shortest tenure, in large part due to the greater weight of contributions as compared with investment returns. Those having the lowest increase were the oldest workers with the longest tenure. However, this number needs to be interpreted carefully in light of the ability of many employees to start taking in-service distributions from their plans at age 59½.

A research topic that is urgently needed to better understand the vulnerability of 401(k) participants to volatility in equity markets deals with the topic of target date funds.

Figure 4 shows for that same consistent sample the distribution of 401(k) participant account balances to equity at year end 2006. In this case, equity is defined as a percentage of the participants' 401(k) funds in equity funds, company stock, and the equity portion of balance and/or target date funds.

This figure shows that more than one in four, 27 percent of the oldest 401(k) participants, those age 56 to 65 in 2006, had 90 percent or more of their 401(k) assets in equities. Another 11 percent had 80 to 90 percent in equities, and 10 percent had 70 to 80 percent in equities.

Target date funds with automatic rebalancing and a "glide path" ensuring age-appropriate asset allocation are likely to become much more common after full implementation of PPA, with the expected increase in automatic enrollment for 401(k) plans and the attendant interest in QDIAs. Based on unpublished EBRI research, the average equity allocation for target date funds designed for individuals in that 56 to 65 age range was 51.2 at year-end 2006. That would imply that approximately one-half of the consistent sample participants in that age category, those on the verge of retirement, would have had at least a 20 percent reduction in equities if they were allocated 100 percent to target-date funds.

EBRI is currently conducting an extensive research project on the provision and utilization of target-date funds, as well as other defined contribution trends that are likely to impact the retirement income adequacy of today's workers. We would welcome the opportunity to share these results with you and the committee at your convenience.

I thank you for the opportunity to appear before the committee today.

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

http://www.ebri.org

[Additional submission of Mr. VanDerhei follows:]

The Impact of the Financial Crisis on Workers' Retirement Security

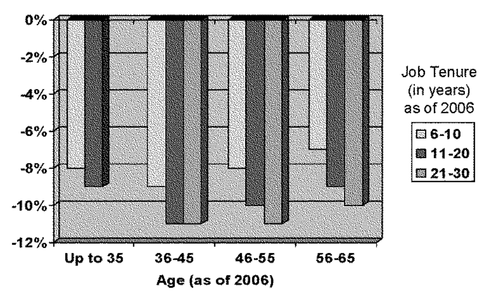
U.S. House of Representatives

Committee on Education and Labor
October 7, 2008

Jack VanDerhei
Employee Benefit Research Institute

Figure 1

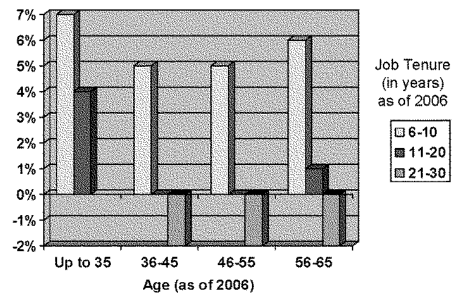
Change In Average Account Balances Among a Consistent Sample of 401(k) Participants, by Age and Tenure, Jan. 1–Oct. 1, 2008



Sources: 1999 and 2006 Account Balances: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project; 2007 and 2008 Account Balances: EBRI estimates. 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.

Figure 2

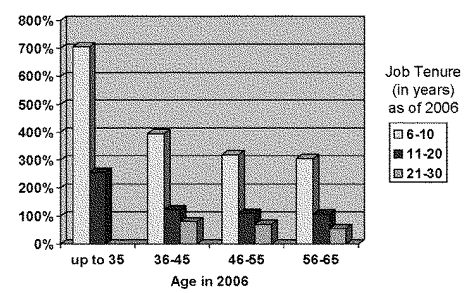
Change In Average Account Balances Among a Consistent Sample of 401(k) Participants, by Age and Tenure, Jan. 1, 2007 through Oct. 1, 2008



Sources: 1999 and 2006 Account Balances: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project; 2007 and 2008 Account Balances: EBRI estimates. 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.

Figure 3

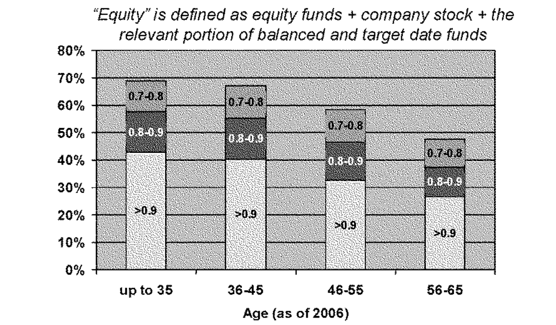
Change In Average Account Balances Among a Consistent Sample of 401(k) Participants, by Age and Tenure, 1/1/00 through 10/1/08



Sources: 1999 and 2006 Account Balances: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project; 2007 and 2008 Account Balances: EBRI estimates. 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.

Figure 4

Dec. 31, 2006 Asset Allocation Distribution of 401(k) Participant Account Balances to "Equity," by Age



Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project. 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.

Chairman MILLER. Thank you.
Mr. Bramlett.

STATEMENT OF JERRY BRAMLETT, CHIEF EXECUTIVE OFFICER, BENEFITSTREET, INC.

Mr. BRAMLETT. Thank you, Chairman Miller, and members of the committee, for the opportunity to speak about this critical issue facing billions of Americans.

My name is Jerry Bramlett, President and CEO of BenefitStreet. Before that, I founded and ran the 401(k) Company for 25 years, beginning in August of 1983. At the time that it was sold to Charles Schwab and Company, we had 425,000 participants, and our average size plan was about $250 million in assets. Pretty much built that business brick by brick over a 25-year period.

401(k) plans have become the retirement foundation for most Americans. Low-income individuals are 20 times more likely to save when they are offered a 401(k) plan at work. However, the current financial crisis has certainly made clear that ill-prepared 401(k) participants bear the investment risk. 401(k) participants are understandably concerned about their retirement savings. The recent substantial decline in the market impacts almost every one of them. The pain is particularly acute for those participants closer to retirement whose retirement income expectations have been significantly impaired, possibly resulting in the need to postpone retirement.

Given that most 401(k) participants are not investment experts, there is a danger that many of them will overreact to the market downturn. I want to caution against this. For participants with many years of retirement, a drastic abandonment of equity positions in the retirement account will only serve to lock in as of yet unrealized losses. Markets do go up and down, and 401(k) participants must try to think long term.

As recently as September 1987, the market declined over 25 percent; or 3,000 points in today's terms. In the following years, the market rebounded and reached even higher levels.

Let me emphasize, exchange in the equity investments in your retirement account for Treasury bills is not a sound long-term investment strategy and will subject retirees to substantial inflation risks. This also applies to participants who are entering retirement, who will likely be managing retirement assets for some time.

To be clear, I am certainly not saying that those with 401(k) accounts should do nothing. Current participants should take the time to evaluate where their new contributions are being invested and perhaps consider less volatile investments that will allow them to better diverse their entire account, which brings me to another point.

I do not believe that the 401(k) system is doing an adequate job of educating participants as to how they need to invest their account as they get closer to retirement. If the retirement income of a 64-year-old is heavily invested in equities, the impact of a major market decline on retirement income expectations can be devastating. However, if that same account had been properly diversified with a greater emphasis on fixed income securities, the impact of a major market decline may very well be manageable.

Although target-date investment funds based on a participant's age has greatly helped in this regard, we need to do more. I would recommend that Congress instruct the Department of Labor to develop education materials specifically for 401(k) participants over age 50 to assist them in better managing their account in preparation for retirement.

The current financial crisis also reveals some fundamental flaws in the 401(k) system that I want to highlight. Given how this turmoil is impacting large insurance companies and banks, plan fiduciaries need to make sure that when offering a so-called stable value fund, or fixed interest fund, such funds are diversified across a number of financial institutions. What we have learned over the last couple of years is that large institutions can fail. In other words, just like plan participants need to diversify the investments in their account, plan fiduciaries need to diversify the initial investment providers used by their plan.

You also may not be aware that if a financial institution holding retirement plan assets becomes troubled, a plan fiduciary may not be able to do anything about it. For example, there are retirement assets invested in insurance contracts that can be subject to back-end loads or may even have contractual provisions on taking the money out, sometimes as long as 5 years. Congress should consider whether such restrictions should be permissible with respect to retirement plan assets.

Finally, it is critically important that we not forget the issue of transparency. While the market is going down, hidden fees are still being assessed. As this committee has already heard, hidden fees can have an enormous impact on participants' retirement accounts. By some estimates, some participants are experiencing as much as 40 to 60 percent loss of the retirement income in the future due to the fact of excessive fees, most of which are hidden.

Those opposed to a fee transparency say that only the overall net return on investment should matter. So what is their argument when the return is a substantial loss compounded with hidden fees?

Mr. Chairman, I fully support the bill you introduced this year, and very much hope you will continue your quest to shine the light on hidden fees in the new Congress.

Thank you for this opportunity. I welcome any questions.

[The statement of Mr. Bramlett follows:]

Prepared Statement of Jerry Bramlett, President/CEO, BenefitStreet, Inc.

Chairman Miller and Congressman Andrews, thank you for this opportunity to speak before you today on this critical issue facing tens of millions of Americans. My name is Jerry Bramlett, President and CEO of BenefitStreet. BenefitStreet is the nation's premier, independent recordkeeping and plan administration firm with more than 1,500 clients across the country. We are a pioneer in the creation and delivery of innovative 401(k) solutions and leading-edge technology.

Throughout my 25 years of building the largest independent 401(k) plan recordkeeping firms in the country, I have experienced every aspect of the retirement industry up close and have developed a good deal of insight as to how we got to this point and where we should go from here. 401(k) plans have become the retirement foundation for most Americans. In terms of promoting savings they have been immensely successful. Low to moderate income individuals are twenty times more likely to save when they are offered a 401(k) plan at work. However, the current financial crisis has certainly highlighted the fact that 401(k) participants—whose 401(k) account represent their sole retirement savings—bear all the investment risk. This contrasts to defined benefit plans, where the burden of funding, asset allocation and investment selection belong to an employer under the constraints of fiduciary laws. With 401(k) plans, all the risk associated with asset allocation and investment selection is shifted to the ill-prepared worker. 401(k) participants are understandably concerned about their retirement savings. The recent substantial decline in the market impacts almost every one of them. The pain is particularly acute for those participants closer to retirement whose retirement income expectations have been significantly impaired possibly resulting in the need to postpone retirement.

Given that most 401(k) participants are not investment experts, there is a danger that many of them will over react to this market downturn—I want to caution against this. For participants with still many years to retirement, a drastic abandonment of equity positions in their retirement account will only serve to lock-in as of yet unrealized losses. Markets do go up and down and 401(k) participants must try to remember to think long-term. It is important to remember, that as recently as September 1987 the market declined over 25 percent—3,000 points in today's terms. In the following years the market rebounded and reached even higher levels. In fact, according to the economist Jeremy Seigel there has never been a 20-year period where the stock market has yielded negative returns.

Let me emphasize, exchanging the equity investments in your retirement account for Treasury bills is not a sound long-term investment strategy and will subject retirees to substantial inflation risk. This also applies to participants who are nearing or entering retirement who will likely be managing retirement assets for some time—on the average another 15 years or so. Even these close-to-retirement employees can impair their long-term retirement assets by acting precipitously.

To be clear, I am certainly not saying that those with 401(k) accounts should do nothing. Current participants should take the time to evaluate where their new contributions are being invested and perhaps consider less volatile investments that will allow them to better diversify their entire account. By changing where these new contributions are being invested 401(k) participants should seek to have an appropriately diversified allocation of assets with a good balance of both equity and fixed income investments.

Which brings me to another point, I do not believe the 401(k) system is doing an adequate job of educating participants as to how they need to invest their account as they get closer to retirement. The practical impact of a substantial market decline on a 64-year old worker months away from retirement can be very different than the impact on a 50-year old 15 years from retirement. If the retirement account of the 64-year old is heavily invested in equities, the impact of a major market decline on retirement income expectations can be devastating. However, if that same account had been properly diversified with a greater emphasis on fixed income securities, the impact of a major market decline may very well be manageable. Although the advent of target-date investment funds based on a participant's age has greatly helped in this regard we need to do more. I would recommend that Congress instruct the Department of Labor to develop educational materials specifically for 401(k) participants that have reached age 50 to assist them in better managing their account in preparation for retirement.

The current financial crisis has also revealed some fundamental flaws in the 401(k) system that I want to highlight.

- Given how this turmoil is impacting large insurance companies and banks, plan fiduciaries need to make sure that, when offering a so called stable value or fixed interest fund, such funds are diversified across a large number of financial institutions. What we have learned over the last couple of weeks is that very large institutions can fail no matter how stable they may appear on the surface. In other words, just like plan participants need to diversify the investments in their account, plan fiduciaries need to diversify the investment providers used by the plan. As far as I know, the Department of Labor places no emphasis on this.
- You may not be aware that since this recent financial crisis began certain retirement funds—such as real estate investment funds—have announced that they are frozen and not available for distributions to participants due to the illiquid nature of the underlying assets. This means that current participants cannot change their investment and retirees cannot get distributions. Congress should examine whether investments subject to this susceptibility are appropriate.
- You also may not be aware that if a financial institution holding retirement plan assets becomes troubled, a plan fiduciary may practically or even contractually not be able to do anything about it. For example, there are retirement assets invested in insurance contracts that can be subject to significant back-end loads or may even have contractual prohibitions on taking the money out. I have seen contracts with such prohibitions lasting as long as five years. Congress should consider whether such restrictions should be permissible with respect to retirement plan assets.
- You should also be concerned about funds that may be advertized as "low-risk" (such as short term bond funds) but, in reality, contain high-risk assets that cause the fund to perform more like an equity fund in a down market. It is important not only to know how a fund is labeled, but what is actually in a given fund regardless of what it may be called.
- Finally, it is critically important that we not forget the issue of fee transparency. While the market is going down, hidden fees are still being assessed. As this Committee has already heard, hidden 401(k) fees can have an enormous impact on a participant's retirement account. Those opposed to fee transparency argue that only the overall net return on an investment should matter. So what is their argument when the return is a substantial loss compounded with hidden fees? Mr. Chairman, I fully support the bill (H.R. 3185) that you introduced this year enhancing 401(k) fee transparency and very much hope you will continue your quest to shine the light on hidden fees in the new Congress.

Thank you for this opportunity to testify on these important issues. I will be happy to answer any questions you may have.

Chairman MILLER. Thank you.
Dr. Weller.

STATEMENT OF DR. CHRISTIAN WELLER, ASSOCIATE PROFESSOR, UNIVERSITY OF MASSACHUSETTS, BOSTON, AND SENIOR FELLOW, CENTER FOR AMERICAN PROGRESS

Mr. WELLER. Thank you very much, Chairman Weller, and I thank the members of the committee for inviting me here today.

The current crisis highlights, in my view, the long-term shortfalls in retirement savings. However, there is no single silver bullet solution to the retirement crisis. Policymakers instead should take a pragmatic approach and pursue policy approaches that are efficient and effective. That means strengthening defined benefit pensions, since they can deliver benefits at lower costs than existing defined contribution plans, as the National Institute on Retirement Security recently showed. Also, it means improving 401(k) plans, particularly by adapting defined benefit features to make them more efficient. Let me talk a little bit about the long-term benefit crisis.

In 2007, just 45 percent of all private sector workers participated in employer-sponsored retirement plans, down from 50 percent in 2000. Minorities, low-income workers, and those working for small employers are much less likely than their counterparts to have a retirement saving plan at work, and all of those ratios have declined since 2000.

But, the Investment Company Institute just last week reported that when employers offer a retirement savings plan, there is no distinction in take-out rates between small and large businesses. That means it is efficient to focus on expanding plan sponsorship, especially among small businesses.

Increasingly, however, many workers with retirement saving plans have individual accounts that can leave them exposed to market fluctuations, and those workers are currently hurt by the sharp downturns in the numbers. The data shows several important trends. Let me just highlight a few.

The total real wealth fell by $4.5 trillion from September 2007, the last peak in household wealth, to June, 2008, just 9 months. This is an annualized average loss of 10.2 percent for the past three quarters compared, for instance, to an average loss of 7 percent in the early 2000s.

Over the three quarters from September 2007 to June, 2008, home equity, which is a large share of retirement savings for older workers in particular shrank by $1 trillion, reflecting a decrease in annualized average rate of 17.8 percent during those quarters. This was the largest decline in home equity since the first three quarters of 1974. Home equity relative to income is now at the lowest level since the end of 1976.

These sharp wealth trends are mirroring peoples' worries about their own retirement income security, which are at the highest levels in most of the service that we know for the past 20 years. Importantly, however, increasing worries about future financial and housing market uncertainty can result in under saving asset misallocation as we go forward.

In my view, there are three policy goals: Improve retirement savings coverage, more equity wealth creation, and reduced risk exposures. The policy responses have to be comprehensive, consistent, and progressive. Comprehensive because the challenges are large. All well-designed options need to be considered and implemented. Consistent, to introduce DB plan features into 401(k) while also pursuing approaches that are not harmful to DB plans. Progressive, to focus on those who most need help, who currently receive a disproportionately small share of saving incentives.

In particular, there are three general policy approaches that I see for policymakers to take in considering to strengthen DB plans. First, build up buffers for bad times. That ultimately means encouraging DB plans to overfund during the good times. Promote standalone entities. Take the pension plans off the books of companies to avoid the inherent conflicts of interest. The public sector already has standalone entities. In the private sector we have plans. I think they are good models.

Encourage regular employer contributions either by requiring minimum employer consideration as is done or considered at a number of State levels or through changes in the calculations of employer contributions, although that will require undoing some parts of the Pension Protection Act of 2006.

The other part to consider is to continue to build a better 401(k) plan. Make it easier for people to save. Continue automating of savings. Equalize the saving incentives by eliminating, for instance, some of the tax deductions and replacing them with a straight-up refundable credit for everybody.

Third, encourage or even require employer contributions, although that would have to be done very carefully so employers don't just simply unload their existing plans and start going to the requirement as a minimum and go through that minimum.

Then, ultimately also lower the cost of saving. The National Institute on Requirement Security recently showed DB plans are inherently more efficient than DC plans. Among DB advantages is professional management and lower fees, which can reduce the cost of achieving a given level of benefits by 21 percent, relative to DC plans, streamlining investments and helping new plans to build up to scale quickly. For instance, through so-called State K plan efforts and default investment options can help protect the nest egg; obviously, all of that in addition to more transparency for the existing fees, as Mr. Bramlett already highlighted.

Thank you very much for inviting me here today. I will be happy to answer any questions.

[The statement of Mr. Weller follows:]

Prepared Statement of Christian E. Weller, Ph.D., Associate Professor, Department of Public Policy and Public Affairs, University of Massachusetts

Thank you Chairman Miller, Ranking Member McKeon, and members of the House Committee on Education and Labor for this opportunity to speak to you today.

My name is Christian Weller. I am an associate professor of public policy in the McCormack Graduate School at the University of Massachusetts Boston, a Senior Fellow at the Center for American Progress Action Fund in Washington, D.C., and an Institute Fellow at the Gerontology Institute at the University of Massachusetts Boston. As my affiliations show, I have substantial expertise and experience working on retirement security issues both in a research and policy context.

I. Introduction and overview

In my testimony today, I would like to focus on the lessons that can be learned from the current financial crisis for retirement income security. In particular, the long-term trend in declining retirement security has been exacerbated by the recent turmoil in the financial markets, and thus ever more poignantly underscores the need for swift and broad action to vastly improve the retirement income security for the majority of American families. Too many Americans rely too heavily on their homes as their primary source of household wealth. Declines in house prices quickly decimate this wealth, especially when families are heavily leveraged, as has been increasingly the case in the past few years, when mortgages grew faster than home values. And, even those families who have some retirement savings—about three quarters of American families nearing retirement—increasingly rely on their own luck and investment savvy to reach their retirement savings goals. Yet economists have long known that the success of "Do It Yourself" savings plans is severely hampered by the underlying investor psychology, which often leads individual investors to buy and sell low in crises like these.

These data point toward three policy goals. First and foremost, more Americans need retirement savings in addition to Social Security and outside of their own home. Second, Americans need to save more for retirement, encouraged by progressive saving incentives and supported by their employers. Substantially raising Americans' retirement security is a heavily lift, as the data further below show, and thus can only be accomplished as a shared responsibility between individuals, employers, and the public. Third, Americans need to be reassured that the money that they will save for retirement will actually be there when they need it. The exposure to large market swings, as we have experienced twice in the past decade, can send individual investors scrambling for an exit at the most inopportune time. This prevents them from saving enough, and actually increases their exposure to financial market risks.

The policy response to these challenges has to be comprehensive, consistent, and progressive. It needs to be comprehensive because the challenge is large. That is, all well-designed options need to be considered and implemented. No one single silver bullet will accomplish all that needs to get done.[1] Moreover, the policy responses need to be consistent with each other. It is an inconsistent policy approach to try to introduce beneficial features from traditional defined benefit, or DB plans, into 401(k)-style defined contribution, or DC plans, while at the same time pursuing policy approaches that are harmful to the same DB plans that are used as model for retirement savings. And finally, the policy approach needs to be progressive in order to focus especially on those families who are most in need of building retirement wealth and who are currently receiving a disproportionately small share of the existing retirement saving incentives that the public allocates each year for this purpose.

With this in mind, there are several specific policy directions that should be explored. Congress should consider both strengthening existing DB plans and vastly improving existing 401(k)-style defined contribution plans.

On improving DB plans, the financial market swings over the past 10 years have clearly shown that legislative and regulatory efforts should increase the incentives for employers to make regular contributions to their pension plans. A large part of the current crisis in retirement security is that employers often either could not or did not want to make additional contributions to their pension plans. Thus, they may have been less well prepared for the financial market crisis that hit after 2000 and again in 2008. New legislation, particularly the Pension Protection Act of 2006, and proposed accounting rule changes—the same ones that banks are now asking Congress to suspend—require smaller contributions during good economic times and larger employer contributions during bad economic times than past accounting rules did or alternative rules would require.

As for DC plans, there are two separate directions that should be pursued by policymakers to "build a better 401(k)." First, the movement to making saving for retirement simpler needs to be elevated. This would reduce the chance that individual investors will fall prey to the well-known pitfalls of saving for retirement on one's own: reducing contributions when prices drop, not regularly diversifying even when prices change dramatically, buying high and selling low by following fads, and hanging on to too much employer stock, among others. Second, Congress should end the system of "upside-down" saving incentives, whereby those who are least in need of support to save more receive the largest relative incentives, and those who need the most help receive the least public support.

II. It was already bad before the crisis hit

While the events that have taken place over the past several weeks have shone a spotlight on how affected Americans' retirement plans can be by such volatility in the financial markets, it is important to keep in mind that Americans' retirement security has been in distress for much longer than the past few weeks. In fact, retirement security has been a growing concern for Americans for many years due to limited retirement plan coverage, little retirement wealth, and increasing risk exposure of the individual.

Too few people are covered by a retirement savings plan at work. In 2007, the most recent year for which data are available, 52.0 percent of full-time private-sector wage and salary workers participated in an employer-sponsored retirement plan. That is more than five percentage points lower than the 57.4 percent who participated in an employer-sponsored plan in 2000. Twenty-three percent of part-time workers participated in such a plan in 2007, down from 26.9 percent in 2000. Thus, overall, just 45.1 percent of all private-sector wage and salary workers participated in an employer-sponsored retirement plan in 2007, down from slightly more than half of all workers—50.3 percent—in 2000. That is, even at its last peak, almost half of all workers did not participate in an employer-sponsored retirement plan and this share has substantially shrunk since then (Purcell, 2008a).[2]

A breakdown by demographics shows that there is little difference in coverage trends by gender. Rates of participation in an employer-sponsored retirement plan have fallen for both men and women since the beginning of the century. In 2007, 51.1 percent of male private-sector wage and salary workers participated in an employer-sponsored plan, well below the 58.3 percent who participated in one in 2000. Women's participation rates have not fallen as far as men's have, but they were not as high as men's rates in 2000 to begin with. In 2000, 56.1 percent of full-time female workers participated in an employer-sponsored retirement plan, but that share shrank to 52.6 percent in 2007 (Purcell, 2008a).

There are, however, substantial differences in retirement saving coverage by race and ethnicity. Minorities are less likely to participate in an employee-sponsored retirement plan than whites, and are also more likely to lack sufficient funds for a secure retirement than their counterparts. In 2002, the first year for which consistent retirement coverage data by race and ethnicity are available from the Bureau of Labor Statistics' Current Population Survey, 58.8 percent of white, non-Hispanic, private-sector wage and salary workers participated in an employer-sponsored retirement plan. Less than half of black, non-Hispanic workers—47.5 percent—and less than one-third—31.1 percent—of Hispanic workers did. Participation rates were lower for all three of these groups of workers in 2007, with 57.6 percent of white workers, 47.1 percent of black, non-Hispanic workers, and only 30.6 percent of Hispanic workers participating in such a plan (Purcell, 2008a).

In addition, participation in retirement saving plans varies with income, such that lower-income workers are markedly less likely than higher-income workers to participate. Participation in employer-sponsored retirement plans has declined for all quartiles of private-sector workers from 2000 to 2007. Importantly, private-sector workers in the bottom half of the wage distribution had especially low participation rates to begin with. In 2000, 55.5 percent of private-sector workers in the third-highest earnings quartile participated in an employer-sponsored retirement plan, but in 2007, less than half—49.7 percent—did. Workers with earnings in the lowest quartile, or less than $27,000, have fared even worse. Less than one-third participated in an employer-sponsored retirement plan in both 2000 and 2007, with rates of 32.1 percent and 27.7 percent, respectively. Even workers in the highest two earnings quartiles have seen their participation rates decline over this period. Slightly more than two-thirds—67.1 percent—of workers in the second-highest income quartile participated in an employer-sponsored plan in 2000, but that share had dropped to 62.8 percent in 2007. Additionally, 69.2 percent of workers in the highest earnings quartile participated in an employer-sponsored retirement plan in 2007, down from roughly three-quarters—75.5 percent—in 2000 (Purcell, 2008b).

Much of the low coverage rate for lower-income earners is explained by their personal characteristics. For instance, the Investment Company Institute (Brady and Sigrist, 2008) recently concluded that "most workers who have the ability to save and to be focused primarily on saving for retirement are covered by an employer-provided retirement plan." Low participation is thus often a function of low earnings, young age, and working for a small employer. The link between retirement saving participation and income is also supported by the fact that the gap between being offered a retirement plan at work and participating in such a plan in the private sector is largest for low-income earners (Purcell, 2008a).

Additionally, employer size matters. Brady and Sigrist (2008) conclude that only 18 percent of employees at small businesses—those with less than 10 employees—have access to an employer-sponsored retirement plan, as compared to 71 percent of employees working for an employer with more than 1,000 employees in 2004, based on data from the Federal Reserve's Survey of Consumer Finances. Similarly, Purcell (2008a) finds, based on the Bureau of Labor Statistics' Current Population Survey, that only 29.3 percent of employees working for an employer with fewer than 25 employees had access to an employer-sponsored retirement plan. Additionally, only 25.5 percent of all employees at such businesses participated in such a plan in 2007. In comparison, 75.2 percent of employees at large firms, with more than 100 employees, had access to a plan and 65.4 percent participated in 2007.

The data thus lead to two important conclusions. First, there are substantial differences by demographic characteristics. Second, targeting lower-income workers and small businesses in terms of retirement saving policies may generate the largest dividends in terms of improving retirement wealth generation.

III. The crisis: wealth destruction in action

Aggregate data show that household wealth has declined sharply over the past year and thus has taken a serious toll on the retirement security of individuals. With respect to retirement security, it is important to consider total wealth relative to disposable income. For one, wealth is interchangeable. Families, for instance, borrow from their 401(k) plans to pay for their home when they are tapped out on other loans and do not have sufficient savings for the necessary down payment or renovations (Weller and Wenger, 2008). Also, total wealth is a store of future income that can be used to replace income, for instance, in the case of an economic emergency, a disability, a death of a breadwinner, and in retirement.

The trends in total household wealth show that families have lost wealth at a breathtaking speed over the past year. Total real wealth fell by $4.5 trillion dollars from September 2007—the last peak in household wealth—to June 2008. This is an annualized average loss of 10.2 percent for the past three quarters. In comparison, during the first three quarters of the downturn in the early 2000s, from March 2000 to December 2000, the rate of decline averaged to an annualized 6.8 percent. For the entire wealth loss streak from March 2000 to September 2002, it averaged to 7.1 percent. That is, the current wealth loss is more than 40 percent faster than during the last period of wealth loss.[3]

Importantly, this sharp drop in household wealth came after families had not recovered from their relative wealth losses incurred during the last crisis. At its peak, total family wealth amounted to 619.4 percent of disposable income in December 1999. By September 2002, this ratio had fallen to 483.8 percent, before climbing to 575.0 percent in June 2007. For the next four quarters, wealth did not keep pace with disposable income and dropped to 517.4 percent. In other words, if total household wealth had kept pace with disposable income after September 1999, families in June 2008 would have had an additional $11 trillion.[4]

Much of the drop in housing wealth is a consequence of the bursting housing bubble, although an even larger share of total wealth losses is concentrated in financial wealth. Over the three quarters from September 2007 to June 2008, households lost a total of $1.1 trillion in real housing wealth, $351 billion in the last quarter alone. Additionally, their home equity shrank by $1.0 trillion, reflecting a decrease at an annualized average rate of 17.8 percent during those quarters. This was the second-highest drop in real home equity over a three-quarter period and the largest since the first three quarters of 1974. As a result, home equity amounted to 81.2 percent of disposable income in June 2008—its lowest level since the end of 1976.[5]

The figures clearly show a few noteworthy points. First, the loss in household wealth goes well beyond the recent drop in house prices. Second, the drop in household wealth, especially in real estate wealth, is very sharp. Third, the loss of household wealth has put many families in a precarious financial situation by adding to existing economic woes, such as a weak labor market.

IV. Amid the crisis, the public is worried about retirement security

Given growing discomfort, to say the least, in today's economic climate, it should not be surprising that public opinion polling data also indicate that Americans have become increasingly worried about their ability to afford a comfortable retirement. Gallup has polled (non-retiree) Americans about whether they expect to have enough money to live comfortably in retirement. The share of respondents who said that they did expect to have enough money to live comfortably in retirement held steady at 59 percent from 2002 though 2004, before falling to 53 percent in 2005, and dropping to 46 percent in April 2008. The April 2008 Gallup poll also found that nearly two-thirds—63 percent—of Americans are worried that they will not have enough money for their retirement. This share is higher than both the share of Americans who were worried about their ability to pay medical costs associated with an accident or serious illness (56 percent) and the share who were afraid that they will not be able to maintain their current standard of living amid 2008's economic troubles (55 percent) (Jacobe, 2008b).

According to a January 2006 Pew Research Center poll, 71 percent of Americans were either very or somewhat concerned about not having enough money for retirement, up from 60 percent in 2005. This was slightly higher than the 68 percent concerned about their ability to afford necessary health care for their family, and considerably higher than the 44 percent who were concerned about receiving a pay cut or losing their job. An April 2007 Gallup poll found that 56 percent of those surveyed were either very or moderately worried about not having enough money for their retirement. This was a higher percentage than any other economic worry Gallup asked about, including covering unexpected medical costs, maintaining their current standard of living, and paying for housing costs. Especially telling is the fact that even a majority of those in households earning $75,000 or more per year—who would be considered upper-middle income to wealth—indicated that they were worried about their retirement income (Teixeira, 2008).

Other surveys found similar trends. The 2008 Retirement Confidence Survey, which is conducted annually by the Employee Benefit Research Institute, found that both workers' and retirees' retirement security confidence has dropped in recent years. In 2008, just under one-third—61 percent—of workers polled indicated that they were either very confident or somewhat confident in their ability to afford a comfortable retirement, down from 65 percent in 2005. Additionally, current retirees' confidence has declined, with 64 percent indicating that they were very or somewhat confident in their ability to afford a comfortable retirement, down from 80 percent in 2005 (Employee Benefit Research Institute, 2008).

A recent poll conducted by Bankrate Inc. found that only about 3 in 10 workers expected to have enough money to retire comfortably. Nearly 7 in 10 Americans have set low expectations about their retirement prospects. One in five Americans said they were afraid they would never be able to retire (Austin Business Journal, 2008).

Another way to see this increased worry about personal retirement security is to examine the change in how workers expect to fund their retirement. For example, in April 2001, only 10 percent of respondents to a Gallup poll expected to use part-time work as a major source of their retirement funding. By April 2005 that share had risen to 18 percent. By April 2008, it had increased even more, to 20 percent (Jacobe, 2008a).

Additionally, many Americans of retirement age are already struggling to make ends meet. In 2007, the median income of Americans ages 65 and older was $17,382. However, their actual incomes varied widely. Importantly, in 2007, one-fourth of people ages 65 and older had incomes of less than $10,722. When one considers just the quickly rising costs of necessities, it is easy to see why Americans, both of retirement age and younger, are concerned about their retirement security. While 57 percent of households with a head of the house or spouse aged 65 or older earned income on assets in 2007, half of them received less than $1,585. The overall mean income from assets among these households was just $2,254 (Purcell, 2008a).

Because of these worries, retirement has remained an important issue on Americans' minds throughout the election year of 2008. A March-April 2008 CBS News/ New York Times poll showed that while paying everyday bills was the public's top personal economic concern, saving for retirement was the second biggest concern (American Enterprise Institute Public Opinion Studies, 2008). Additionally, an August 2008 poll for George Washington University found that the public viewed retirement as a more important issue for Congress than the mortgage crisis, taxes, or education (Lake Research Partners and The Tarrance Group, 2008).

Clearly there is both public desire for and a defined need to improve the retirement security of America's workers. Policymakers must catch up to fill these voids and design a more fulfilling retirement plan for America's workers. To improve retirement security, we must build a better DC plan and strengthen existing DB plans.

V. Building better retirement plans

If one were to design an ideal retirement plan, it would likely encompass the following features:

- Broad-based coverage, which covers all workers automatically
- Secure money for retirement, with limited opportunities for leakage of retirement assets
- Portability of benefits, which will allow workers to retain benefits if they switch jobs
- Shared financing, with contributions from both employees and employers
- Lifetime benefits, so that retirement income cannot be outlived
- Spousal and disability benefits to provide protections against death or the inability to work
- Professional management of assets
- Low costs and fees

It is important to realize that there are already retirement plans in the United States that meet almost all of these criteria. In particular, the DB plans that provide retirement benefits to employees of state and local governments typically meet all of these criteria for a model retirement system. Also, multiemployer or Taft-Hartley plans in the private sector tend to fit this description.

The implication of this is twofold. First, public policy should strengthen the existing DB plans that already do a good job of offering retirement security to American families. Second, policymakers should adopt policies that will allow plans that do not yet meet these criteria to incorporate features that will bring them closer to this ideal.

The following discussion thus highlights these important plan features, shows how they work in multiemployer and public-sector DB plans, and draws policy lessons for the design of policy approaches to improving existing DB and DC plans.

Broad-based coverage: Employees must simply meet the eligibility requirements of the DB plan to earn benefits in a DB plan. They are then automatically enrolled without having to make any active decisions. This truly "automatic" enrollment is a typical characteristic of all DB plans.

DC plans, on the other hand, often require employees to enroll themselves, and then make difficult decisions about how much to save and where to direct their investments.

Another DB feature that is reflected in proposals to restructure DC is universal coverage, which would make saving for retirement easier. However, there is generally a qualitative difference to DB plans. Universal coverage under DB plans automatically includes benefit accruals for vested employees, while proposals for universal DC coverage generally only include universal access to a savings account, i.e. the possibility of wealth creation without any assurance of contributions.

In passing the Pension Protection Act of 2006, Congress acknowledged this inherent flaw in DC plans and attempted to make automatic enrollment and efficient asset allocation easier. It is too soon to reach any conclusions about the law's effectiveness in increasing automatic enrollment in DC plans. Early indications show, however, that automatic enrollment is a feature of a growing share of existing DC plans. For instance, a survey by Hewitt Associates LLC (2008) showed that 44 percent of responding firms already offer automatic enrollment and 30 percent of those who do not are considering implementing it in 2008. Also, Deloitte (2008) reported that 42 percent of their survey respondents offered automatic enrollment in 2008, up from 23 percent just a year ago.

The evidence on the impact of automatic enrollment in the existing DC universe is too thin to evaluate how much faster employees, especially lower-income ones, are accruing retirement savings than in the past. Time will eventually tell how effective this policy move has been toward achieving greater retirement security for lower-income workers, for minorities, and for employees in small businesses.

Policymakers, though, should not be content with waiting for new evidence to emerge with respect to the impact of past policy changes. After all, the automatic enrollment features that were passed with the Pension Protection Act of 2006 only affect employers, who either already offer a qualified retirement savings plan or plan on offering one.

Instead, policymakers should consider added incentives for employers to offer access to qualified plans. The "automatic IRA" proposal does this by requiring that employers above a certain size offer access to direct deposits into an IRA, or by changing public saving incentives. In particular, two examples of proposals that move toward universal coverage in DC plans are "automatic IRAs" (Iwry and John, 2006), and "universal 401(k)s" (Sperling, 2005). Under the first plan, "automatic IRAs" would require that every employer with 10 or more employees would have to offer employees the opportunity of automatic payroll deductions into designated IRAs. To increase participation, Iwry and John (2006) suggest that this program could be coupled with automatic enrollment. To minimize costs, government administered accounts could be offered as the default investment (Iwry and John, 2006).

The second proposal goes a step further and pays attention to the particular vulnerability that low- and middle-class workers face because of low levels of savings. A universal 401(k), as proposed by my Center for American Progress Action Fund colleague Gene Sperling, adds progressive saving incentives, since all of these plans allow an employee to opt out of their coverage even if they were "automatically enrolled' (Sperling, 2005). Although this would again not automatically guarantee contributions, it would have the advantage of skewing savings incentives more toward low-income earners, where savings shortfalls are largest. The combination of universal access and progressive savings incentives could go a long way toward creating wealth for many middle-class families who currently do not save enough.

These proposals are directly targeted at increasing retirement savings coverage among employees who work for smaller businesses. As discussed before, the chance of being offered a plan when working for a smaller business is substantially lower than when working for a larger employer. Both the "automatic IRA" and the "universal 401(k)" proposals are intended to increase retirement savings coverage especially in this market segment. Coupled with automatic enrollment features, the hope is that increased coverage will also result in faster wealth accumulation.

Secure money for retirement: DB plans provide a secure source of income in retirement for a number of reasons. First, one's funds cannot be borrowed from and typically are not distributed as a lump-sum payment. That is, money under a DB plan will be there to provide a lifetime stream of retirement income.

Second, multiemployer DB plans and DB plans for state and local government employees reduce the impact that bankruptcy of an employer may have. In the case of multiemployer DB plans this is simply a function of many employers banding together to provide benefits. And, in the public sector, this is a result of the fact that state and local governments typically do not go bankrupt. This is sadly not always the case for single-employer, private-sector DB plans.

A third point is that pension plans tend to follow prudent investment principles and thus secure assets as much as possible. The security of assets in DC plans for future retirement income is, by comparison, compromised. Importantly, the vast majority of individuals in DC plans can borrow from their retirement accounts or withdraw funds before retirement age. Economists use the term "leakage" to describe assets that are drawn out of retirement savings plans for purposes other than providing retirement income (Weller and Wenger, 2008). According to one conservative estimate, a full 10 percent of all retirement wealth is lost due to leakage from DC plans (Englehart, 1999). Loans from DC plans have risen, especially to allow families to smooth over economic hard times, which will likely reduce their retirement income security (Weller and Wenger, 2008).

While employer default risk is generally not an issue for DC plans, individuals saving with those plans can be exposed to a number of well-known risks. These include longevity risk, idiosyncratic risk, and market risk among others. Moreover, these risks can be exacerbated by typical psychological responses of individual investors as the literature has demonstrated (Benartzi and Thaler, 2007). Policy can mitigate some of these risks by encouraging automated plan designs. I will return to this point further below.

This leaves the issue of potential leakages from DC plans due to loans. The policy response, however, should not be to eliminate loans from DC plans. It is important to recognize that employees typically take out a loan because they are financially strapped or because of an economic emergency, especially a sick family member (Weller and Wenger, 2008a). Consequently, the complete elimination of loans from DC plans may be simply impractical. If loans are prohibited, employees, who want to take out a loan because of an emergency, may request a hardship withdrawal instead.[6]

Policymakers, however, should encourage employers to limit the incidences for which employees can take out a loan, e.g. by mandating stricter limits on loans. Employers could discourage loans from DC savings plans by limiting the number of loans that can be taken out during a given time period—for example, only two loans in a five-year period. Employees could be required to wait for a minimum amount of time after a previous loan has been paid off before taking out a new loan. Employers could also further restrict the reasons for which a loan can be taken out and require that employees provide proof of those instances.

Portability of benefits: Portability of benefits can be limited within some DB pension plans. It is important to realize, however, that this is a limited issue in the DB world. Single-employer DB plans may not offer lump sum withdrawal options, but more and more single-employer plans follow a cash balance plan design where a lump sum option is typically offered (Weller, 2005).

Further, public pension plans are responding to changing workforce needs in public service by offering much greater portability than in the past. Often, if employees move to another government position within the state, they are able to carry pension benefits with them. Should they move to other jurisdictions, they can usually purchase service credits (Brainard, 2008).

This portability also exists for most DC plans and in multiemployer plans. Little additional policy room exists, except that policymakers may want to consider reducing the maximum vesting period, as was done for cash balance plans in the Pension Protection Act of 2006. Shorter vesting periods will allow more mobile workers to accrue benefits where they may not accrue any right now, and thus enhance benefit portability.

Shared financing: This is a typical characteristic of public-sector pension plans. The funding of state and local DB plans is a shared responsibility between employee and employer. Private-sector defined plans, by contrast, have employers typically finance the entire benefit. In 2004, for workers covered by Social Security, the median employer contribution rate was 7 percent of salary, while the employee contributed an additional 5 percent of salary (Munnell and Soto, 2007).

More could be done, however, to encourage employer contributions to DB plans. Two alternative approaches are available to accomplish this. First, policymakers could require a minimum employer contribution as is already the case or considered in some states for the employer contribution to existing DB plans (Weller et al., 2006). Second, funding rules for DB plans could allow for more smoothing of asset and liability values. This would reduce the pro-cyclicality of existing rules. Currently, the funding rules require larger contributions during bad economic times, when plan sponsors can often ill afford such additional requests on their cash flow. Inversely, current rules tend to lower the required contributions during good economic times, when employers can best afford contributing to their plans. An alternative set of funding rules would thus shift the funding burden from the bad to the good economic times without lowering benefit security. Weller et al. (2006) discuss two different valuation approaches to accomplish greater regularity of employer contributions. One of these approaches would allow for the smoothing of pension plan asset and liabilities over 20 years and require that employers contribute up to a specific level of assets above liabilities, e.g. 120 percent (Weller and Baker, 2005).

Further, the Pension Protection Act of 2006 has opened the door to more shared financing among DC plans. If employers offer the safe harbor option of automatic enrollment, they will have to also offer an employer matching contribution in addition to establishing automatically escalating employee contributions (Groom Law Group, 2006). More could be and should be done to encourage employer contributions, either as match or as non-matching contributions.

In addition, several proposals have included mandatory employer contributions in an effort to increase DC plan coverage. For instance, Weller (2007) develops a proposal called "Personal Universal Retirement" accounts. The costs and risks of these accounts would be kept low by managing the funds through a government entity, for example, the Federal Retirement Thrift Investment Board. Professional fund managers invest the funds of PURE accounts according to a worker's instructions. The investment options are the same as those for the Thrift Savings Plan to keep administrative costs to a minimum. Furthermore, universal employer contributions of at least 3 percent of earnings to a qualified pension plan or to a PURE account are required. These contributions would be pre-income tax, but subject to FICA. In addition, low-income workers would qualify for direct, non-elective contributions, while higher-income earners could qualify, up to a limit, for government matching contributions.

Also, Ghilarducci (2007) proposes "Guaranteed Retirement Accounts" which incorporate the low cost and effective risk management advantages of pooling assets, require coverage, and assure assets are paid-out in annuities. The GRAs are funded by a mandated 5 percent contribution on earnings up to the Social Security maximum, split evenly between the employer and employee. The contribution goes into a national fund comprised of individual accounts. Contributions are recorded in individual accounts and the account values represent an individual's claims on future benefits. Unlike conventional DC plans, the rates of return are guaranteed; the U.S. government will guarantee a rate of return of 3 percent with excess returns added, depending on the fund's earnings. Workers and retirees can add to the accounts at any time with pre- and post-tax dollars. By reconfiguring the current tax subsidies for retirement plans—that give people earning over $100,000 per year over $7,400 in tax subsidies while middle- and working-class workers receive practically nothing—each employee will receive a tax credit of $600. This tax rebate will go directly into workers' individual accounts and will add to national savings. The rebate will also soften the impact of a 5 percent mandated contribution for lower-income workers—most workers will pay much less than 5 percent. The efficient and well-managed Social Security Administration will administer the account. Qualified DB plans will be able to opt out of the mandate. At retirement, the accounts will be annuitized, and "opt to" withdraw a lump sum worth a maximum of 10 percent of the account value. The GRAs, combined with Social Security, are designed to guarantee the average worker 70 percent of pre-retirement earnings at retirement, approaching the level of 75 to 80 percent of pre-retirement income that is typically considered adequate by financial experts.

Lifetime benefits: State and local DB plans are designed so that retirement income can never be outlived—retirees are guaranteed a paycheck for life. This is also the case with private-sector DB plans that have to offer an annuity benefit, even if it is as an alternative to a lump-sum distribution.

This is in stark contrast with DC plans. Here, the burden of managing one's retirement income, so that retirees do not run out of savings in retirement, falls mostly on the individual. In many cases, however, employees do not understand how much money they will need in retirement. The result is that many workers do not save sufficiently and face inadequate income in retirement. In order for a private-sector worker to purchase a modest annual annuity of $20,000, she must accumulate an estimated $260,000 in a 401(k). Yet, the median 401(k) balance for heads of households approaching retirement in 2004 was just $60,000 (Munnell and Soto, 2007). Further, Boston College researchers have found that, in part due to the shift from DB to DC plans in recent years, between 44 percent and 61 percent of households are at risk of being unable to maintain their living standards in retirement (Munnell et al., 2007).

A study by the National Institute on Retirement Security (Almeida and Fornia, 2008) recently quantified the additional cost that DC plans incur to provide the same retirement benefit to employees, who do not annuitize. Their calculations show that if employees self-annuitize, they will have to plan for the maximum life expectancy, instead of the average life expectancy. This increases the required contributions during the build-up phase of a retirement savings account by 15 percent. Consequently, policymakers could lower the implicit costs of DCs and thus deliver a better "bang for the buck" to beneficiaries if they could increase the share of savers, who annuitize their savings upon retirement.

Spousal and disability benefits: DB plans typically provide special protections for spouses of married beneficiaries, as well as disability benefits for active employees who are stricken by illness or injury that prematurely ends a career. Adding these types of benefits to DC plans, however, would require purchasing life insurance and disability insurance policies for beneficiaries. Addressing these ancillary benefits is beyond the scope of this testimony.

Professional management of assets: Public-sector plans and private-sector DB plans are managed by professionals with "considerable financial education, experience, discipline, and access to sophisticated investment tools" (Watson Wyatt, 2008). This is reflected, for instance, in the aggregate asset allocation data of public-sector DB pension plans. These plans tend to regularly rebalance their portfolio in response to price changes, show no signs of employer or trustee conflicts of interest, and appear to follow a best practices model by pursuing strategies similar to those employed by industry leaders (Weller and Wenger, 2008b).

The individualized nature of DC plans, however, means that these rely on self-management. As the Investment Company Institute found using 2006 year-end data, the bulk of 401(k) plan assets are invested in stocks (Investment Company Institute, 2007). When faced with the wide array of complicated and confusing choices that most DC plans have, workers may find themselves more vulnerable to the negative impacts of disturbances in the financial market. These can include a lack of diversification or an improper assessment of risk associated with their choices.

One response to this may be well-managed, balanced default investment options that allow participants in DC plans to take advantage of professional management of assets and thus help to avoid the commonly known pitfalls of individual investing (Benartzi and Thaler, 2007). The Investment Company Institute (2008) reported that lifecycle funds continued to experience growth from the end of 2007 through the first quarter of 2008, despite adverse overall market conditions. Most importantly, more widespread use of default investment options would encourage participants to diversify their assets and regularly rebalance them, thus avoiding the underperformance that often arises in DC plans due to an unintended "buy high, sell low" investment strategy. If the past is any indication, automatic investment options, such as lifecycle funds and model portfolios, will become increasingly prevalent. The Investment Company Institute (2007) reported that recent hires are more likely to choose these funds as their investment option.

Low costs and fees: Evidence shows that administrative costs are substantially higher for DC plans as compared to DB plans. An international study of plan costs finds that while, on average, fees can range between 0.8 percent and 1.5 percent of assets, larger institutional plans can reduce such fees to between 0.6 percent and 0.2 percent of assets (James et al., 2001). The UK Institute of Actuaries finds very high administrative costs for DC plans—of 2.5 percent of contributions and up to 1.5 percent of assets—leading to the equivalent of a 10 to 20 percent reduction in annual contributions. DB administrative costs, however, amount to just 5 to 7 percent of annual contributions (Blake, 2000). Similar differences exist in the United States, with DB plans incurring substantially lower fees than DC plans (Council of International Investors, 2006; Weller and Jenkins, 2007).

Almeida and Fornia (2008) estimate that the combination of professional management and lower fees reduces the costs of a DB plan relative to a DC plan by 21 percent annually. This is by far the largest area of economic inefficiencies in the existing DC structure. Policymakers could help to substantially improve retirement income security by lowering fees and increasing the performance of DC plans, e.g. through more professional management and the avoidance of well-known pitfalls, such as lack of diversification, no regular contributions, and emotionally charged investment decisions ("buy high, sell low") among others.

A number of proposals have focused on the cost savings from pooling a large number of small accounts. Originally, Baker (1999) suggested that the government should establish a default investment option modeled on the Thrift Savings Plan for federal workers. Investment options would be limited to a small number of index funds. Because such a plan could take advantage of economies of scale and simplicity in investment options, management fees would be substantially lower than rates prevailing in private-sector plans (Congressional Budget Office, 2004).

This proposal is currently being studied at the state level as Washington state is studying the feasibility of the Economic Opportunity Institute's proposal for their Washington Voluntary Accounts proposal (Idemoto, 2002). This proposal has also been brought forth in other states, such as the Pennsylvania Voluntary Account proposal of the Keystone Research Center (Weller et al., 2006) or the Michigan Retirement Program Act of 2006 (Michigan Legislature, 2006).[7]

VI. Conclusion

The decline in workers' retirement security is not a new occurrence, but rather a troubling trend, which is especially evident over the course of the current business cycle. We may have very well dodged a bullet last week with the actions taken by Congress and the administration. However, the long-term problems that were highlighted by the recent turmoil in the financial markets, including the overall weak retirement security of Americans overall, will not simply go away. The strength of America's workers' retirement security has been declining for many years and will likely continue to worsen, regardless of what happens as a result of last week's activities. It is because of this, and because of what America owes its workers, that we cannot stand idly by as this happens. We must instead improve retirement security by building a better DC plan and strengthening DB plans so that all Americans can look forward to a comfortable retirement and actually have the means to finance it. Importantly, there is no single "silver bullet" policy response. Instead, policymakers should take a pragmatic approach. They should consider all efficient policy options to increase the number of workers with a retirement savings plan, to raise retirement saving—especially among lower-income workers, those who work for smaller employers, and minorities—and to reduce the risk exposure of retirement savings.

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ENDNOTES

[1] It is also important to note that voters are not consistent, even when they profess support for a particular policy proposal (Madland, 2008). In other words, policymakers need to be mindful that promises of a single policy approach could quickly encounter opposition due to ideological predispositions. Instead, policymakers will need to take a pragmatic approach and promote all efficient policy options to increase retirement savings.

[2] The trends look very similar when the share of workers who have access to an employer-sponsored retirement plan is considered (Purcell, 2008a).

[3] Calculations based on Board of Governors (2008).

[4] Calculations based on BOG (2008).

[5] Calculations based on BOG (2008).

[6] In addition, the evidence suggests that the existence of a loan option may result in higher contribution rates (GAO, 1997). This link should weaken, if it hasn't already done so, if default employer contribution rates and automatic enrollment become more widespread, since an ever smaller share of employees will likely make a contribution decision that will differ from the employers' default option. This follows logically from the fact that automatic savings options are successful because they are taking advantage of people's inertia. Consequently, more people, who otherwise would not have contributed anything to their DC plan, will participate because it is the default option and will contribute the default contribution rate. The incentive provided by a loan option will thus be no longer necessary and policymakers limiting loan options will not inadvertently reduce savings incentives.

[7] This proposal was introduced as House Bill 6250 and Senate Bill 1329 in 2006, which both propose the Michigan Retirement Program Act. The act transfers Michigan's retirement plan to a private or non-profit entity no later than five years after this act is passed. Michigan's Department of Management and Budget would administer the retirement plan and would be the sole fiduciary of any plan. Administrative expenses would be paid by the participants and beneficiaries who have not closed their accounts.

Chairman MILLER. Dr. Ghilarducci.

STATEMENT OF DR. TERESA GHILARDUCCI, IRENE AND BERNARD L. SCHWARTZ PROFESSOR OF ECONOMIC POLICY ANALYSIS, THE NEW SCHOOL FOR SOCIAL RESEARCH

Ms. GHILARDUCCI. Thank you, Chairman Miller, for inviting me to talk about guaranteed retirement accounts. As you mentioned——

Chairman MILLER. We just heard from four people about the unguaranteed plans. So we thought we would have you come.

Ms. GHILARDUCCI. Yes, I like the placement. It does make sense, because my proposal actually meets the principles of Dr. Weller.

As we sit here, the number that you cited that most Americans don't feel they can live comfortably in retirement has only gotten worse. I mean, as we sit here, hour by hour, as the market fails, and Peter Orszag's numbers get worse. The panic now actually tops off chronic anxiety that we have been seeing for the last 10 years, and that anxiety is caused by the corrosive effects of 401(k) plans and other defined contribution plans.

Despite a 30-year history with 401(k) plans and DC plans, we have seen that we have not expanded pension coverage, we have not increased the national savings rates. Though, we have added to the profits of the financial sector and to the expansion of the financial sector, and we have extracted ever increasing tax subsidies from the Treasury.

Now every English major knows that if you show a gun in the first act, it will be used by the last one. I am going to show you $80 billion of tax subsidies. By the end of my presentation, I am going to spend it, to help everybody.

Short term, I propose—and last week I did an op ed to the New York Times—that the Congress allow workers to swap out their 401(k) assets, perhaps at August levels, for a guaranteed retirement account. Just a one-time swap, trade in your 401(k) for a guaranteed retirement account that will be composed of the equivalent of government bonds that pay 3 percent real return, and the promise will be that when you collect Social Security you can draw from that account balance for an annuity that would top off your Social Security plan. That plan is detailed in a longer paper that I have submitted.

How would this work? You go back to your districts and you meet up with a 55-year old who had had $50,000 in his account last month, and now has $40,000 in the account. He can swap out that $50,000, valued in August, for that guarantee of what would become, if he retires at 62, a $500 a month addition to Social Security.

The economy is probably in recession. We economists don't call it until after it is over. But a guaranteed income from his 401(k) account could actually take off some anxiety that that recession is going to cause him.

A long run solution is for you all to recognize that we have a long-term retirement crisis. It is not in Social Security, but it is in this heavily subsidized voluntary commercial tier of retirement security. Half the workers have not been covered at any one point in time by any kind of retirement account. Most Americans, especially the folks in your districts who are now under 60, are going to be at a real risk of not even replacing 70 percent of their retirement income.

I propose that every worker get a guaranteed retirement account, that we mandate that they save 5 percent on top of Social Security. That will, with a government credit of $600, that will actually give every worker at least 1 percent replacement rate, which will, on top of Social Security, give you 70 percent replacement rate.

Where do I get that $600 credit for everybody? I mean everybody, people who aren't covered. I get it from the $80 billion we now spend on DC accounts.

The way the government now encourages 401(k) plans is to spend $80 billion in tax breaks, which, with Peter Orszag's research, we know goes to the very highest income earners. Fifty percent of these subsidies go to 6 percent of the population. All that happens is that we transfer money from taxed accounts to untaxed accounts.

Worse, this inefficiency is growing. If you look at your Treasury numbers, the value of these tax expenditures to these wasted tax breaks are projected to grow 49 percent, while those for traditional plans are only going to fall by 8 percent. If we implement automatic IRAs or we expand the 401(k) system, all we are doing is adding to this inefficiency.

So I propose that Congress establish a universal pension plan on top of Social Security, funded by workers' own contributions but subsidized by a rejiggering of those tax breaks so that everyone has $600 going forward every year into their retirement account.

Thanks.

[The statement of Ms. Ghilarducci follows:]

Prepared Statement of Teresa Ghilarducci, Irene and Bernard L. Schwartz Professor of Economic Policy Analysis, the New School for Social Research, Department of Economics

As Congress reacts to the modern financial order changing forever, we should also realize that individual retirement plans based on that financial order, have also changed forever. In the last few weeks, we've been confronted with older worker and retirees' lives being turned upside down; their panic tops-off an already existing state of chronic anxiety about retirement futures. Much of both—the panic and anxiety—is caused by the corrosive effects of 401(k) and 401(k)—like plans,[1] including IRA plans. 410(k) plans have not expanded pension coverage, increase the savings national rates; though they did add to the profits and growth of the financial sector and extracted ever increasing tax breaks from the Treasury.

Short Term Solution to the Retirement Crises

Short term, I propose that since 401(k) accounts and the like are financial institutions—the bank about where 38% of the workforce[2] can intend to save for their retirement—Congress let workers trade their 401(k) and 401(k)—type plan assets (perhaps valued at mid-August prices) for a Guaranteed Retirement Account composed of government bonds (earning a 3% return, adjusted for inflation). When the worker collects Social Security, the Guaranteed Retirement Account will pay an inflation adjusted annuity, based on the accumulated funds.

How would this work? Take a 55 year old who had $50,000 in his 401(k) account in August and faces job loss and eroded assets because of the erosion of his retirement accounts.[3] Let him swap out the $50,000 for a guarantee of $500 per month.[4] The economy is probably in a recession, but a guaranteed income from his former 401(k) removes a source of financial anxiety, and—this is not trivial—it end fruitless discussions with brokers and financial sales agents, who are also desperate for more fees and are often wrong about markets.

Long Term Solution to Eroding Retirement Income Security

Because there is a long run retirement crises, not in Social Security, but in the heavily tax-subsidized, private, voluntary, and commercial tier of our nation's retirement income security system, about half of workers will not have enough income after age 65 to replace, the bare necessity, 70% of their pre-retirement income according to Boston College's Retirement Risk Index. The erosion is primarily caused by Congressional bias towards 401(k) plans, their fundamentally flawed design and little regulation.

Going forward, I propose Congress establish universal Guaranteed Retirement Accounts and the federal government deposit $600 (inflation indexed) in those Guaranteed Retirement Accounts every year for every worker.

Every worker (not in an equivalent defined benefit plan) would save 5% of their pay into their Guaranteed Retirement Account to which the government pays a 3% inflation-indexed guaranteed return. Workers would earn pension credits based on these accumulations.

The 5% target comes from the basic math that an average earner saving 5% of pay over a life time with a guaranteed 3% rate of return plus inflation would supplement their Social Security benefits to achieve a 70% replacement rate at retirement. In other words had GRA been in effect instead of 401(k) plans an average earner reaching 65 today would have accumulated enough to pay about 1% for every year of service. (This rate is equivalent to the average defined benefit pension plan payout because it its inflation indexed.)

This basic math, though, comes up against the basic reality that many Americans can not afford to save that much. That is why workers' contributions would be mitigated by a $600 a year contribution from the federal government indexed for inflation which will be paid for by scaling back substantially the tax breaks for 401(k) type accounts. The $600 defrays the expense for most low and middle class workers (it pays for all the contribution for a minimum wage worker). Employers could top it off, pay a portion, and workers could add to it.

Advantages of a GRA?

First, this is a fiscally responsible plan. Rearranging tax breaks is revenue neutral, efficient and fair because the current tax breaks.[5] High-income earners get a much higher subsidy than anyone else because they are more likely to have a 401(k) and contribute more.[6] This design has shocking results: 6% of taxpayers with incomes over $100,000 per year get 50% of the tax subsidies.[7] And, for all this effort, the nation gets no extra savings and workers no extra retirement security (see Appendix). At most, this complicated system creates economic activity when accountants happily transfer money between taxed accounts to tax-sheltered accounts and tax payers foot the bill.

Worse, the inefficiency is growing: the value of tax expenditures for DC plans is projected to grow 49 percent while those for traditional plans are projected to fall by 8.9 percent between 2009 and 2013. The sooner we admit that our 30 year experiment with 401(k) accounts has failed the sooner we can use these precious government subsidies efficiently and equitably.

Second, GRAs are responsible because they are prefunded. A government agency connected to the Thrift Savings Plan and Social Security (for administration efficiency) governed by trustees representing workers, business, and the public, invests the GRA contributions in a range of assets, like the sovereign wealth funds of Alaska, Alabama, New Mexico Wyoming, and many other nations do to ensure the federal government can pay a 3% inflation-indexed rate of return to the Guaranteed Retirement Account lifetime annuities.

Third, GRAs are universal;

Fourth, GRAs provide adequate retirement income and encourages people to save more;

Fifth, the money is locked away until retirement;

Sixth, the payout is for a person's life;

Seven, every America has the opportunity to save in a low cost, professionally managed account with guaranteed returns.

GRAs are better than automatic IRAs. Automatic IRAs add complicated requirements on small and medium sized employers. Automatic IRAs expand the risks workers already face in individual retirement account plans: the risks they won't save enough because of high fees and wrong in investments choices; the risk financial markets tank, the risk of inflation eroding income and that you will out-live your money. Automatic IRAs cause deadweight losses to the economy because, net of fees, 401(k) and other individual retirement accounts are among the lowest earning among all financial vehicles. Add the risks of preretirement—withdrawals, moral hazard, and adverse selection Automatic IRAs would entrench inefficiency and risk and a dollar of retirement income becomes more expensive to fund. Automatic IRAs are worse than nothing.

Disadvantages of GRAs

Scaling back 401(k) deductions going forward may put pressure on vendors to lower fees and boost returns. Also people like the option of saving at work for hardships. Fine, Congress may to subsidize precautionary savings but don't call them retirement accounts. Put them in a separate category.

Should we mandate savings in a recession? Yes, as long as fiscal policy provides for short term stimulus. No one is proposing we suspend Social Security taxes in recessions. Households need a source of disciplined savings over the business cycles; it is not the job of households to go in debt and spend wildly to get us the nation out of recessions. This ethos—debt-led consumer spending—got us in the trouble we are in.

Predicted Popularity of Guaranteed Retirement Accounts

Even before the financial crises of September 2008, workers are catching on that Congress needed to provide more secure sources of retirement income security.

Surveys show less than 50% of people think they will live comfortably in retirement and, crucially, that they bear personally responsibility for their supplements to Social Security benefits. Though they accept the responsibility—they want the government to help.[8] Over 77% of people support mandated pensions.

In 2006, HSBC bank asked 21,000 workers in 20 nations what the government should do about the expense of aging societies- on average, workers preferred compulsory savings to any other policy. A third of Americans wanted the government to force them to save more for retirement; far fewer; 16% would support a tax increase; and, only 9% wanted the government to reduce benefits.[9]

In October 2007, a whopping 91% of Americans told a Wall Street Journal poll that the government should do something to secure retirement and 41% said they were not hearing enough from the Presidential candidates about retirement income issues.[10]

Conclusion

American workers know we have a short term and long term pension crises but it is not with Social Security but with the voluntary, self-directed, commercial-account-based pension system. The loss of retirement security is a reversal of fortune and the result of very specific flawed governmental policies that have been biased toward 401(k) plans, rather than the result of technological change or the logical consequences of global economic trends. That is the good news. Government policies eroded pensions government can help secure workers' retirement futures. If you implement the short term 401(k0 asset swap and Guaranteed Retirement Accounts, we can look back at the financial crises and bailout and know Congress did permanent good for workers' retirement income security.

TABLE 1

Tax Subsidies for Retirement Plans	2009 ($ Billion)	2009 growth to 2013 estimated
DB plans	$45.67 Billion	−8.9%

TABLE 1—Continued

Tax Subsidies for Retirement Plans	2009 ($ Billion)	2009 growth to 2013 estimated
401(k) (325 B) Individual retirement plans and Plans covering partners and sole proprietors ("Keogh Plans")	$75. 70 Billion	49.5%

EBRI calculations Original data from Executive Office of the President, Office of Management and Budget, Analytical Perspectives, Budget of the United States Government, Fiscal Year 2009 www.whitehouse.gov/omb/budget/fy2009/

APPENDIX: THE SAVINGS PARADOX

Savings rates should be higher now than at any time in the history of the United States. The American workforce has never been more educated and people with more education save more. Middle-aged workers save more than any other age group and there are an estimated 73 million baby boomers in the U.S. who are between age 48 and 63 in 2008. High income people have higher savings rates the richest Americans have gained the most income since the 1990s. Further, as national income grows the demand for normal goods grow because when people have money they buy more of what they want Ipods, better health, and retirement "leisure:" witness the 1960s and 1970s, when, as the economy grew, older people lived longer AND retired earlier.[11] And, in an attempt to further increase retirement savings Congress has relentlessly expanded tax breaks for retirement savings since the 1980s.

The value of the favorable tax treatment for retirement savings is at an all-time high 110 B, while its effectiveness is at an all time low.

To be clear, saving is hard. Humans often lack the foresight, discipline, and investing skills required to sustain a savings plan. But human characteristics haven't changed as much as retirement savings as eroded.

The deep decline in national savings rates showed up in the 1990s when employers started to reduce their contributions into defined benefit pension plans,[12] these plans were a main driver of national savings. The expansion of 401(k)-type plans did not boost savings for three reasons: they supplanted already existing defined benefit plans, were cheaper for the employer, and did not expand pension coverage to people who had no pension plan. This is surprising: although 401(k)—type plans are growing,[13] they don't expand pension coverage. Instead, they replace existing traditional pension plans. When groups of workers who ordinarily don't have pensions get them—poultry workers, janitors, home-health care workers, etc.—it is most likely because they are included in a newly negotiated collectively-bargained defined benefit plan.[14]

Defined benefit plans are institutionalized, contractual forms of saving that happen automatically at work. Workers have little discretion about whether to save or spend. Workers can't opt out, decide how much to invest, or take out lump-sum payments without difficulty. Even though 401(k) plans do not increase pension coverage nor secure retirement income, people like their portability and like to watch their individuals accounts grow. People do not like the financial and investment risks, or the risks of outliving their money, inherent in 401(k) accounts.

Therefore we understate the true spending on pensions because the U.S. Government maker uses "tax expenditures"—the value of the tax code's exemption of income generated for certain activities—to encourage workers and the nation's business owners to spend their income in socially approved ways.

In 2007, Social Security and Medicare cost $800 billion. Tax expenditures for retirement plans—traditional employer pensions (defined benefit plans), 401(k) plans, Individual Retirement Accounts, other savings vehicles dedicated for disbursement at older ages, and exemptions of Social Security and other federal pensions from tax—totaled over $156 billion in 2007.[15]

In 2004, taxes not collected on pension contributions and earnings equal a fourth of annual Social Security contributions and, at over $114 billion, are perversely larger than household saving of over $102 billion.[16] The tax breaks were supposed to expand pension coverage and increasing retirement security.

Pension tax breaks are deductions from income; high-income earners get more breaks than low-income workers. If a lawyer earning $200,000 makes a $1000 contribution to his 401(k) plan, he reduces his income tax by $350. If his receptionist, earning $20,000, makes the same $1000 contribution (which is much less likely), she will save only $150 in taxes. The Brookings Institution and Urban Institute calculate that the 3% of taxpayers with incomes over $200,000 per year get 20% of the tax subsidies.[17] And, for all this effort, the nation gets no extra savings. At most, this complicated system creates economic activity when accountants happily transfer money between taxed accounts to tax-sheltered accounts and tax payers foot the bill. The value of tax expenditures for 401(k) plans is projected to grow 49 percent while those for traditional plans are projected to fall by 2.1 percent between 2009 and 20013.[18] (The estimated tax expenditures for 401(k) plans, Individual Retirement Accounts, and Keogh plans in 2009 is estimated to be $75.1 billion and for defined benefit plans $45.7 billion.)

In sum, the shift towards 401(k) plans increases tax expenditures, does little to expand retirement savings, and favors workers who need the help least. All told, the tax subsidies are not meeting a public purpose. The top heavy benefits for 401(k) plans create a sad paradox: since 1999, tax expenditures for retirement plans grew by 20%, while retirement plan coverage fell.

401(k) plans Exist Because They are Cheaper for Employers; but they Earn Subpar Returns

If 401(k) plans are so bad why are there so many of them? Though workers don't gain much from 401(k) plans, some employers and Wall Street firms do. I followed 700 firms over 17 years and found that firms that adopted a 401(k) lowered pension expenses by 3.5—5% without sparking worker complaints.[19] Since 401(k) plans are voluntary, many (about 20%) workers who can don't bother to contribute "leave money on the table" by not accepting the employer match. Employers' contributions are 26% lower than they would be if everyone participated.[20] Employers could pay the match to every worker, as they do under defined benefit plans. Because workers have to trigger the match, and some don't, 401(k) plans boosts profits at the expense of retirement income security. Firms find sponsoring 401(k) plans is more profitable than sponsoring defined benefit plans. For firms, defined contribution plans are less costly, less risky, and can be funded with their own stock, not with hard cash.

Wall Street firms collect over $40.5 billion annually in 401(k) fees.[21] Yet, brokers and human resources often tell workers the fees on their accounts are zero. A good way to see what workers lose when they invest in a 401(k) plan rather than a group—based pension fund is to compare what each earns after fees are subtracted. A comprehensive study by Dutch and Canadian researchers Ron Bauer and Keith Ambachtsheer[22] found that U.S defined benefit plans—where individuals do not direct their own accounts—earned a 2.66% higher return NET of fees on equities than did retail mutual funds. In Canada, the skim was even higher; the retail mutual funds earned 3.16% less. (These shortfalls are the averages for the 25 year period between 1980 and 2004.) The gap makes sense—investing in retail funds means investors pay for advertising, shareholder profits, and glossy brochures. Add the fact that workers buy high and sell low—because people follow the leaders and buy stock as its rising in value and sell when its falling—and you have self-directed accounts earning much less. This isn't just a leakage, it's a levee break. Hidden from view, workers are unwittingly transferring huge sums of money to financial firms.

The unpublished report confirmed that the GRA 3% real rate of return was a conservative long-run estimate under a range of plausible investment strategies that a government agency could undertake and not take any substantial risk of underperforming.[23]

ENDNOTES

[1] 401(k)—type plans are defined contribution plans include and include the following: 401(k) plans [about 80% of participants in defined contribution plans are in 401(k) plans]; profit sharing plans; money purchase plans; individual retirement accounts; and 403(b) plans which are 401(k) plans for employees in the public sector.

[2] Center for Retirement Research Boston College. 2004. "Eligibility and Participation in 401(k) Plans by Age, 2001 and 2004" *http://crr.bc.edu/frequently—requested—data/frequently—requested—data.html* accessed October 4, 2009.

[3] Note the macroeconomic destabilizing effects of 401(k) plans—and all defined contribution plans—when asset values go down; people increase their job search just when jobs become scarce. This makes the recession worse.

[4] This is what the annuity would pay at a 3% inflation rate and a 3% real return.

[5] The GRA plan as written is budget neutral. If we allow tax breaks for the first $5000 in voluntary 401(k) contributions the plan will cost $25 billion. But know that accounts that allow hardship withdrawals are savings for hardship which is different from retirement income security.

[6] Because the tax subsidies come in the form of tax deductions and not credits they are regressive. For example, if a lawyer earning $200,000 makes a $1000 contribution to his 401(k) plan, he reduces his income tax by $350. If his receptionist, earning $20,000, makes the same $1000 contribution (which is much less likely), she will save only $150 in taxes.

[7] A good paper on the distributional effects of the tax expenditures for DC plans is Burman, Leonard E.,William G. Gale, Matthew Hall, and Peter R. Orszag. 2004a. Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts. Washington, D.C.: Urban-Brookings Tax Policy Center.

[8] Madland, David. 2008. “Reforming Retirement: What the Public Thinks.” For the Georgetown University conference on “The Future of Retirement Security.” Held October 3, 2008. department of History

[9] HSBC Bank. “How should governments finance ageing populations” *http://www.hsbc.com/1/PA—1—1—S5/content/assets/retirement/2006—for—news—release—final.pdf.*) HSBC. 2007. “The Future of Retirement: What People Want.” *http://a248.e.akamai.net/7/248/3622/7d1c0ed7aa1283/www.img.ghq.hsbc.com/public/groupsite/assets/retirement—future/2006—for—what—people—want.pdf* (accessed online February 2, 2007).

[10] Bright, WSJ.com November 2007 online Harris personal finance poll

[11] Ghilarducci, Teresa. 2008. When I am Sixty Four: The Plot Against Pensions and the Plan to Save Them. Princeton University Press, Princeton, NJ. Chapter 1.

[12] Bosworth, Barry, and Lisa Bell. 2005. The Decline in Saving: What Can We Learn from Survey Data?” Unpublished draft written for the 7th Annual Joint Conference of the Retirement Research Consortium, “Creating a Secure Retirement” (Washington, DC, August 11-12, 2005). *http://www.bc.edu/centers/crr/dummy/seventh—annual.shtml.*

[13] 401(k)—type plans are defined contribution plans include and include the following: 401(k) plans [about 80% of participants in defined contribution plans are in 401(k) plans]; profit sharing plans; money purchase plans; individual retirement accounts; and 403(b) plans which are 401(k) plans for employees in the public sector.

[14] From 1999-2005, the correlation between defined benefit coverage growth rates and pension coverage growth rates was 79%, while the correlation between defined contribution and pension coverage growth rates was a negative 10%. Ghilarducci. Teresa. 2006. “Future Retirement Income Security Needs Defined Benefit Pensions.” Center for American Progress. www.americanprogress.org/kf/defined—benefit—layout.pdf

Back in 1981, Congress rejected President Carter’s Pension Commission’s call to reconsider the social value of these tax breaks and create a mandatory universal pension system (MUPS). Because they are designed to meet a social goal there were always conditions on these tax breaks. When the federal income tax was implemented in 1913, employer pension contributions were given special tax treatment only if the managerial plans included most of the rank and file. This is in direct acknowledgement that the tax breaks were targeted to the wealthy. The wrangling—over how many tax breaks that higher income employees get in exchange for how many lower paid workers are in employer pension plans—continues to this day and is part of a healthy process of assessing if the federal government tax breaks have the intended effects. Instead, in that same year, Congress satisfied the lobbyists for executives and made way for 401(k) plans by creating a section of the tax code which allowed workers to save, pre tax, in plans at work. After Wall Street firms and consultants successfully marketed 401(k) plans, the rest—to use a shop-worn phrase—is a history we all know: 401(k)-type plans replaced traditional defined benefit (DBs) pensions.—over 63% of pensions are DC plans; whereas, in 1975, most pensions were DBs.

[15] Employee Benefit Research Institute. 2008. “Facts From EBRI: Tax Expenditures and Employee Benefits: Estimates from the FY 2009 Budget.” EBRI, 1100 13th St. NW #878, Washington, DC 20005. February

[16] See Bell, Elizabeth Adam Carasso and C. Eugene Steuerle, “Retirement Savings Incentives and Personal Savings,”Tax Notes, December 20, 2004.for this provocative insight.

[17] A good paper on the distributional effects of the tax expenditures for DC plans: Burman, Leonard E.,William G. Gale,Matthew Hall, and Peter R. Orszag. 2004. “Distributional Effects of Defined Contribution Plans and Individual Retirement Accounts.”Washington, D.C.: Urban-Brookings Tax Policy Center.

[18] Employee Benefit Research Institute. 2008. “Facts From EBRI: Tax Expenditures and Employee Benefits: Estimates from the FY 2009 Budget.” EBRI, 1100 13th St. NW #878, Washington, DC 20005. February

[19] Ghilarducci and Sun 2006. How Defined Contribution Plans and 401(k)s Affect Employer Pension Costs: 1981-1998.” With Wei Sun. Journal of Pension Economics and Finance, 5(2): 175-196

[20] I used information from Munnell and Sunden. 2004. Munnell, Alicia, and Annika Sunden. 2004. Coming Up Short: The Challenge of 401(k) Plans. Washington, DC: Brookings Institution Press to get participation rates, average contribution levels by earnings, the distribution of employees by earnings (Calculated from the CPS (2003) to make the three billion dollar estimate. The average savings per worker is $156, calculated for their sample of over 800 employees in one firm that the employer saved over $250 per older worker who did not participate in the 40(k) even when they were eligible. Choi, James J., Laibson, David I. and Madrian, Brigitte C.,$100 Bills on the Sidewalk: Suboptimal Investment in 401(K) Plans(August 2005). NBER Working Paper No. W11554. Fidelity’s (2004) annual report documents employers’ match behavior.

[21] There are $2.7 trillion in 401(k) assets Employee Benefit Research Institute. 2007. “401(k) Plan Asset Allocation, Account Balances, and Loan Activity” An Information Sheet from the Employee Benefit Research Institute (EBRI). www.ebri.org/pdf/InfSheet.QDIA.23Oct07.Final.pdf. The average fee is over $700 per year and average fees are 1.5% of assets which equals $40.5 billion.

[22] Ambachtsheer, Keith, Bauer, Rob. 2007. “Losing Ground.” Canadian Investment Review; Spring, Vol. 20 Issue 1, p8-14.

[23] My report for the Economic Policy Institute explains the GRA plan in depth Ghilarducci, Teresa 2007. “Guaranteed Retirement Accounts Toward Retirement Income Security” Economic Policy Institute, 1333 H Street, NW Suite 300, East Tower Washington, DC 20005-4707 (202) 775-8810, Economic Policy Briefing Paper #204, November 20.

Chairman MILLER. Thanks very much. Well, if I may characterize what I heard, we are talking about a system—a number of you touched on broader pension issues, but with respect to the 401(k), it appears to be a plan that is not really well devised for the changes in the market, that we load an awful lot onto the back of the individual. I have been to more seminars and conferences where they ask for more and more education about savings and investing.

But we keep asking this person to get smarter and smarter about their savings, and that is sort of it, and they are on their own. Then the market takes an abrupt turn, or they are not tuned in, they don't see it, and all of a sudden their future has changed to some extent.

I think the key point raised by Dr. Ghilarducci and, Mr. Orszag, I direct this to you, is that we have invested $80 billion a year into subsidizing this activity which originally I thought was sort of a savings plan and now it has become a retirement plan. I don't know when it changed, but now everybody is told that is their retirement supplement.

Again, it appears that while we lament it all the time, the savings rate isn't going up with the investment of this $80 billion. In fact, it is probably going down. It has been on a downward trend a number of years.

What is the policy? What do we have to start to think about in Congress about whether we want to continue to invest that $80 billion for a policy that is not generating what we now say it should?

Mr. ORSZAG. Let me say three things. Let me start with your comment about 401(k) plans because they involve shifting two things onto workers. The first is risk and the second is decision-making responsibility. That first shifting of some risk is unavoidable to the design of a 401(k) plan as opposed to a defined benefit plan. It is who bears the risk.

The second part though, in terms of decision-making burdens, we could do a lot more to help workers, and we are starting through the Pension Protection Act and what have you to help workers. I would raise a big caution flag about the benefits that we should expect from financial education. I think as we look back over the history of financial education efforts, I am starting to become increasingly skeptical that they work. And we can talk more about that.

The second part of this is now what about the tax preferences for 401(k) plans. We have designed them relatively inefficient. They are tilted towards higher income households because they are linked to your marginal tax rate. So you put $1 into a 401(k), and you are in the 15 percent tax bracket, you are saving 15 cents. If you are in the 35 percent tax bracket, you are saving 35 cents. That would make sense if higher income workers are more responsive to the tax incentive or were more deserving of financial assistance. I think it is hard to make the argument in either case that this is an efficient approach.

The idea has already been mentioned that instead of that you could on a revenue neutral basis take that same amount of money and when you put $1 in, you get 35 cents if you are high-income worker and 15 cents if you are a middle-income worker, everyone gets 20 or 25 cents matched into their account on a revenue neutral basis. That would arguably not only be more fair, but do more to promote retirement saving. Here is the reason.

High income households are much more likely to have other assets that they can just shift into the 401(k) plan. So that dollar showing up into the 401(k) plan is much less likely to be new saving as opposed to just shifting from a nontax preferred account if it comes from a high-income worker than if it comes from a middle-income or low-income worker.

So the more you tilt the tax benefits towards low-income workers and middle-income workers, the more likely it is that you are on net raising total savings as opposed to just sloshing funds around, in addition to any distributional concerns you would have.

The final point is I think the entire history of trying to promote retirement saving through the tax preference reflects an over emphasis on what I call Econ 101 thinking. I think we need to dial way down Econ 101 thinking and dial way up Psychology 101 thinking in not only retirement saving but in health care and lots of other areas, and thinking that we are all hyper rational super computers that are just optimizing our lifetime income and behaving perfectly rationally is not likely to correspond to actual behavior.

Chairman MILLER. With the indulgence of my colleagues, I would like to ask one more question because of the title of the hearing. Given that this is what is going on out there, and we had a housing crisis in the eighties and sort of in the nineties, and we had a tech bust, and now we have a combination of all of those, and we are talking about people who appear at the outset that they may not have the ability to recover those assets for the purpose for which they were going to use them.

We know that people not only are losing money in the market, but huge numbers of people have tapped the equity in their homes, and as a result of the housing crunch and the market's failure, they are also getting credit card bills with new higher interest rates or cutting off their lines of credit, and wages haven't kept up terribly well. That is a very bleak picture, from where I sit.

But we have these studies on whether people will be able to recover or not. Mr. VanDerhei, you have talked about this long-term study that you have done. I just want to ask, and if you can touch on it because I would like to come back to it in the next round, but what do you anticipate and, Peter, this has a lot of other policy considerations for the Congress because these people could end up using a lot more public services later in life, but what do you really think about the ability of these families or individuals to recover sufficiently to provide for the retirement that they were considering in January 1 of this year?

Mr. ORSZAG. Well, other than dramatic asset recovery, I mean financial market booms which may or may not happen that can offset the losses, there are basically three things: You can spend less now and save more to offset it; you can spend less when you retire; or you can retire later. You have to respond in one of those three ways, other than just hoping for a financial market recovery, which may or may not happen, and is not a wise or prudent course to adjust to a financial market downturn like we are experiencing.

Chairman MILLER. But in one of those three options you are suggesting that people would be able to continue to provide something for savings.

Mr. ORSZAG. Well, this is just simple accounting, in some sense. One way you can adjust is by saving more and spending less today. By the way, in the very short run that will adversely affect the overall economy. In addition to the financial market downturn that we are experiencing, I think it is implausible that, given the employment numbers that we are seeing and the strength of the credit crisis that we are experiencing, that this period will ultimately not be termed a recession. In that environment, having households spend even less is exactly the opposite of what you want in the short run.

Chairman MILLER. Thank you.

Mr. VanDerhei.

Mr. VANDERHEI. I certainly agree with everything Peter just stated. One thing that might be instructive to take a look at is in 2003 EBRI actually did a series of simulation models for the various States to show what this type of impact would be on their Medicaid system. One very important point of that is as these individuals hit retirement age, if they have insufficient assets what is going to happen with respect to the potentially catastrophic health care costs they have, which are not being picked up obviously by Medicare, more and more of this is being shifted in our modeling to the State governments through their programs as far as picking up the overall things like nursing home costs.

Chairman MILLER. Mr. Bramlett.

Mr. BRAMLETT. Just in terms of more of a long-term issue and then talk about the short-term issue. This issue of fees I think is—we just don't talk about it enough. We have gone——

Chairman MILLER. I try. God knows, I try.

Mr. BRAMLETT. We have gone from an economy that 2 percent of the GDP's earnings were from financial institutions to over 20 percent. That is a tenfold increase in 20 years. We have gone from the estimated cost of securities intermediation from $2.8 billion in the last 28 years to $528 billion.

To quote John Bogle here, "Does this explosion intermediation cost create an opportunity for money managers? You better believe it does. Does it create a problem for investors? You better recognize that too. For as long as financial service systems delivers to our investors in the aggregate, whatever returns our stock and bond markets are generous enough to deliver, but only after the cost of financial intermediation are deducted. These enormous costs seriously undermine the odds in favor of success for our systems who are accumulating savings for retirement. A loss, as we all know, investor fees are at the bottom of the costly food chain."

Then he goes on to say, "In any event, we are moving, so it seems, towards becoming a country where we no longer are making anything. We are merely trading pieces of paper, swapping stocks and bonds back and forth to one another and paying our financial properers," I think that is somebody who works a roulette wheel, right—"a veritable fortune. We are also adding even more costs by creating even more complex financial derivatives in which huge and unfathomable risks have been built into our financial system." And it is this implosion that we are seeing right now.

Chairman MILLER. Quickly. Did you want to finish?

Mr. BRAMLETT. The only other thing I would say is that where we are today, it is not inconceivable—I don't think a huge program that rescues a system is something that would necessarily be good for the system. But I think that there will have to be adjustments made, and I think those adjustments need to be made in that area.

Chairman MILLER. Dr. Weller.

Mr. WELLER. I think we have to realize we have had massive losses, and they came very quickly in the last year. A lot of them in terms of absolute amounts are concentrated especially among those nearing retirement. I was recently asked what I see as the biggest challenges to retirement savings, and the answer is, quite frankly, the labor market. We have had the weakest labor market performance since the Great Depression in terms of jobs, wages, and benefits. I think we need to focus on getting people good jobs that will allow them to save rather than crossing our fingers that somehow asset values will rebound from the current downtime.

Chairman MILLER. Thank you.

Dr. Ghilarducci. Sure. Do what you can. You added on a stimulus package to help out the job loss and the recession. But to refer back to retirement income security, I propose that you treat 401(k) asset accounts like the banks and take some of those toxic assets away from workers and give them a vehicle so they know they can get a guaranteed retirement on top of Social Security. That won't solve the recession, but it will certainly help this problem we are talking about today.

Also, I am just very curious about Mr. Bramlett's testimony because on one hand he gives a most powerful indictment of our experiment with 401(k) plans. He says that the 401(k) plans is actually a part of the problem of the meltdown in the financial industry and the misstructuring of our economy, and yet he wants to expand it with education programs from the DOL.

I really have one point here and that is to end the experiment with tax subsidized 401(k) accounts as a retirement vehicle. They are fatally flawed in a way that Mr. Orszag pointed out. They are too risky, and it is not good policy to have workers run their own retirement plan. They want government help and they also want to be responsible.

So savings. And all sorts of studies shows that this is a way that people actually become engaged in their own futures, and they need Congress' help to do it in a secure way.

Chairman MILLER. Thank you.

Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. Thank you for convening us today at a time when these questions really need to be asked and answered. I thank the witnesses for very provocative, thought-provoking testimony.

Dr. Ghilarducci, I want to go back to the 55-year old constituent that you hypothesized about and think about what her situation looks like today. Let me first confess my bias. I wish she were in a defined benefit plan. Because if she were, the value of the fiduciary duty would have protected her. I am not saying that defined benefit plans are immune from the virus that is sickening the American economy, but I think my constituents who are in them are a heck of a lot better off than those who aren't today. That is something I think we better think about.

But, second, I want to think about how she is faring if she is in a defined contribution 401(k) type account. Dr. VanDerhei tells us in his research that going into 2007, at the end of calendar 2006, of people over the age of 55, about half of them, 48 percent, had at least 70 percent of their assets in equities. Now we don't know what those numbers are today, but we do know that across the economy a lot of American investors are rushing to the protection and security of Treasury bills to protect themselves.

I want to explore what this 55-year old constituent's options are today under the 401(k) regime; what she has going for her, what her risks are. First of all, I don't know that there are any data about how many plans do not have the option of switching to an account that is largely government secure. Does anybody know that? I think most plans have such an option. But does anybody know how many plans or what percentage of them do not offer that as an option to a participant?

Mr. Bramlett, Dr. VanDerhei.

Mr. BRAMLETT. You have government bonds, but they can go up and down in the market. There is no government guarantee that I am aware of.

Mr. ANDREWS. I didn't say guarantee, I said a plan that is largely government securities. T bills.

Ms. GHILARDUCCI. You can go into cash or you can go into government bonds. But that would not be a good thing to do now.

Mr. ANDREWS. It may or may not. The question I am asking is I have this image of this 55-year old standing aboard the deck of the Titanic as it is sinking and seeing other people getting on lifeboats in the form of Treasury bills, escaping the risk market to do that. How many of our 401(k) plan participants don't have an option like that in their plan right now? Does anybody know?

Mr. ORSZAG. I can't quote a specific number, but I think the vast majority of 401(k) plans offer the option to go into a fixed income kind of thing.

Mr. ANDREWS. Do you think we should require that all of them offer such an option? What do you think?

Mr. BRAMLETT. I mean the risk in the U.S. Treasury is essentially mainly inflation risk.

Mr. ANDREWS. Of course there are tips.

Mr. BRAMLETT. That as well. That is possible.

Mr. ORSZAG. You are asking a different question.

Mr. ANDREWS. I am asking whether we should require DC plans to offer a government-fixed income type option as an option. Should it be required?

Mr. ORSZAG. I think it is hard to make an argument necessarily against that, although again I am not sure how binding it will be because I think that option exists in most cases.

Mr. ANDREWS. I think it does, too. Let me ask a second question, which I think is more vexing. In 2006 we had a long and tortuous debate over conflicted versus independent investment advice. Looking at that debate in this context becomes even more interesting.

The chairman and I were pretty steadfastly on the side that any conflicted investment advice ran great risk, and I think this is the day that we were talking about that coming.

It is my understanding that the Department of Labor is considering two loopholes in a regulatory sense to the statute that we passed in 2006; one dealing with the use of subsidiaries and the other dealing with—I frankly forget the substance of it, but two potential loopholes.

Does anybody on the panel think this is a good time to be considering loopholes to the prohibition against conflicted investment advice?

Mr. BRAMLETT. Absolutely not.

Mr. ANDREWS. Anybody else care to offer a thought on that? I don't mean that to be a rhetorical question. There were good solid arguments made in 2005 and 2006 that deregulation, to coin a phrase, the deregulation of this ERISA provision was a good idea because it would open up investment advice for people who don't have it. In retrospect, that doesn't seem like such a good idea to me.

Mr. BRAMLETT. In many ways, it is salt into the wound because investment advice is a very simple, straightforward thing that can be given at a very low cost across a broad number of employees. We showed that at the 401(k) Company for many, many years. It can be provided for literally pennies per participant. To add that fee on top of all the other fees is just another, to me, more salt in the wound.

Mr. ANDREWS. I see my time has expired. The comment I would simply make is that one can only imagine the potential for abuse in this kind of context where firms are starving for cash, and a likely person to give bad advice to is someone who has a modest 401(k) plan. This is an issue I think we have to revisit. I, frankly, think the compromise we struck in 2006 is not terribly workable or wise. I hope we are here to revisit it in January, 2009.

Mr. WELLER. I think it goes back to the question of is it efficient; is it a good use of, in this case, investor dollars; and in this case it probably isn't. And I am with Peter, I think the value of financial education and financial advice is often overstated. I think in terms of the regulation side, you are better off just simply automating, for instance, default investment options possibly giving some sort of guaranteed income options in a 401(k). There is a bigger bang for the buck for the investor.

Mr. ANDREWS. I think we also have to reexamine the department's QDIA thoughts that happened before this crisis came along, too. Thank you.

Mr. SCOTT. Mr. Chairman, thank you for holding the hearing.

Just following up, we have always had problems—some of us have had problems with the idea that the investment adviser would have a direct financial interest in your decisions, which suggests that you may not get the best advice, you might get the advice that would steer you to that particular product. And in terms of what your investment ought to be, we have talked about the safest investments. But isn't it true that long term, if you are a young person, the safest investments through a lifetime will offer you the worst returns?

Mr. ORSZAG. Yes. In general, when you reduce your risk exposure, you are also reducing your expected return over long periods of time.

Mr. SCOTT. We have talked about these defined contributions. That is where you put in a defined amount of money, and at the end what you see is what you get based on whatever the market did.

Dr. Orszag, you mentioned how worse off people were after a few months from this year. What were those totals again, 10 percent in last quarter and——

Mr. ORSZAG. So from the second quarter of 2007 through the second quarter of 2008, the end of the second quarter, pension plan assets combined, public-private defined benefit, defined contribution, declined by about $1 trillion. Our estimates suggest that since the end of the second quarter——

Mr. SCOTT. What does that mean to somebody's individual account? What kind of percentage drop are we talking about?

Mr. ORSZAG. That is roughly a 10 percent decline in overall pension assets. Again that includes defined benefit plans. Defined contributions plans, actually, since they are weighted slightly more heavily towards equities, the percentage may be slightly higher.

Mr. SCOTT. What has it done since the end of the quarter?

Mr. ORSZAG. Roughly same decline since then.

Mr. SCOTT. So it is about a 20 percent drop——

Mr. ORSZAG. Yes.

Mr. SCOTT [continuing]. On average, in a defined contribution plan. What does that mean to somebody's check upon retirement? If they had retired back at the beginning of this drop they would have made something. If they retired now, they would be getting 20 percent less. Is that a fair estimate?

Mr. ORSZAG. From the retirement slice—and we need to remember that for a significant share of the population, Social Security is the bulk of their retirement income, and of course that is not directly——

Mr. SCOTT. Just from the pension you are going to get 20 percent less by waiting——

Mr. ORSZAG. If they experience a 20 percent decline in that account balance then a feature of the 401(k) system is in general you have 20 percent less to consume in retirement.

Mr. SCOTT. You alluded to the Social Security part, which you kind of inferred that that is a secure payment. If a few years ago we had gone to this privatization thing and people could be betting on the stock market, is it fair to say their whole retirement would have dropped 20 percent if we had privatized Social Security?

Mr. ORSZAG. That depends on the structure. Those plans have different structures. It depends on the structure of the plan.

Mr. SCOTT. If you had gotten into a you can invest in your own kind of thing, your retirement would have gone down with the market.

Mr. ORSZAG. What is clear is that a lot of those plans do have the feature of more financial market risk in the upside, but more financial market risk is shifted to individual workers. And in the current environment that would mean that in general there would be a larger deterioration in retirement prospects.

Mr. SCOTT. Mr. Weller, you mentioned something about a stand-alone pension. If you have a defined contribution plan where you have your own account, is that not stand-alone?

Mr. WELLER. Those are stand-alone, but my remarks were specifically toward targeting. If you think about what works in the DB world, in the the defined benefit world, it is the stand-alone entities, the Taft-Hartley plans in the private sector, or the government pension plans. And I think it can serve as a good model for the defined contribution world.

Mr. SCOTT. Now, on a defined defined benefit when you suggested it is separate, is the defined benefit plan now part of the corporate balance sheet?

Mr. WELLER. The single employer plans are, and that does create enormous conflicts of interests and created some of the problems we have seen since 2001.

Mr. SCOTT. For example, underfunded funds.

Mr. WELLER. Largely there are good strong incentives to take advantage of the good times and basically take advantage of contribution holidays in the public sector where we are struggling with some of that, but the States are tackling that aggressively by putting a floor, for instance, under employer contributions. In the multi-employer plan and the Taft-Hartley plan, the collective bargaining agreement actually sets a rate of contribution into the plan and their contribution holidays are less likely to happen.

Mr. SCOTT. A couple of years ago when this committee looked into it, a lot of the major corporations in America were at about two-thirds solvency. We considered legislation to try to make them more solvent. If we separated it and required the funds to be solvent, what effect would that have?

Mr. WELLER. Well, it is hard to say. I think if you generally, however, look at what employers wanted—and we had substantial discussions during the negotiations of the Pension Protection Act—what employers were were looking for in particular was regular contributions. So I think if Congress required or set up rules that regularized contributions to DB plans, we would ultimately have better-funded plans and we would have more of them.

I think the Pension Protection Act of 2006 went exactly the opposite direction and made, for instance, the contribution to pension plans much less predictable and ultimately led a lot of employers to abandon their plans.

Ms. CLARKE. Mr. Chairman, thank you so much for calling this very timely hearing, and to each of the panelists thank you for sharing your expertise today. I have to tell you that I just got back from my district, and what we are talking about here is flying above the heads of everybody. They are just reeling from what is happening to them and are really in a state of shock.

And so my question to you is really coming from the people of the district. What they do understand is that we are in the midst of a reorganization of our financial system. They do understand that. Some people paint it as demise. But at the end of the day, we are going to have a system. And they recollect that there were tax cuts for the wealthy. That is a piece they really, really, really remember. And in the midst of this current financial crisis, they are trying to figure out, how do I just hold on? How do I hold on and land safely and work things through?

As a result of the current financial crisis, many of my constituents are either borrowing or contemplating borrowing from their 401(k) plans either in the form of a loan for themselves, to themselves, or as a hardship withdrawal. These actions either carry a penalty, hidden fees for early withdrawal and/or possible exposure to additional taxation if they are unable to pay back the loan.

In your opinion would it be appropriate for Congress, in light of our current economic downturn, to repeal the penalties and/or the imposition of taxes for withdrawals from 401(k) plans?

Mr. WELLER. A colleague of mine, Professor Wenger from the University of Georgia, and I wrote a paper this summer on 401(k) loans. I think it is a fairly tough issue because a lot of families need to take those loans. In our research we find that they often serve for supplemental unemployment insurance or supplemental medical insurance. I think there you could help them out.

But on the other hand our research also showed that even a small amount of loans can have severe impacts on retirement security. For a typical average earner, $40,000 a year, if that person took a $5,000 loan early in their career, and even paid that off it can reduce their retirement savings ultimately by 15 to 20 percent.

So I think where we are at this point, my recommendation would be to restrict access to loans to really just the emergencies and maybe help out there. But we have, unfortunately over time, moved towards making it easier for people to rob their future retirement income security to pay for their current financial security.

Ms. CLARKE. I want to go back and, I am trying to recall who it was who said we are actually dealing with a psychological issue here. So when you talk about robbing your retirement, people feel robbed right now. Right now. We want to be very honest with the American people. We want to really deal with this in a constructive way. People are trying to make ends meet. And they feel like their life is in crisis right now, whether they are ready to retire or not. And so the options to them are few and far between.

Think about the psychology of that and looking at what is happening with their 401(k) and trying to figure out mortgage payment, or do I watch this 401(k) continue to diminish? Maybe this is the time to do what I can, is reorganizing our financial system to at least save myself for now.

Can anyone respond to that type of psychological pressure that is hitting the American people right now?

Mr. BRAMLETT. Keep in mind the difference between financial hardship and a loan. Financial hardship, you are taking money out that can't go back in. There is a penalty. On a loan you are actually borrowing the money from yourself. You are paying yourself back, the money goes back into the plan. Ultimately there are limits set on that, and basically whatever the interest rate return is on the loan is the earnings that you are getting on the loan. So to me it is fairly easy to rationalize loans as a way of distribution.

Financial hardship is another thing, and that is a more difficult thing. So it is a real challenge because they need it now, but they are going to need it in the future. And with life being extended, and it will continue to be extended, people are going to be challenged in their older age. And so we have got to find ways to help people keep money in these accounts when it is very difficult and it is very challenging.

I don't want to sound harsh but there is a study recently that said people's happiness maximizes at $17,000 a year, and that is hard to believe. But the reality is that your basics, once they are taken care of, you know, and in the future, people in retirement may not be able to take care of their basics. And so there may not be anybody there to help them. It would be great to have across-the-board plans, but chances are that is going to be challenging. But loans I think are a good positive thing.

Ms. GHILARDUCCI. I just want to say that if you do that, if you need to do that, then you just know that Congress should just abandon the subsidies for 401(k)s going forward, because those penalties were put in by Congress to preserve it for retirement. If in a recession you now reduce those penalties, then you have actually erased all the reasons to have those tax subsidies. So if you do it, you can only do it once and, going forward, don't have tax subsidies for the way that 401(k)s are structured now.

Ms. CLARKE. Just in closing, Mr. Chairman, the whole issue of the loan, if you don't pay back the loan, the money is added as income and taxed. Isn't that correct?

Ms. GHILARDUCCI. Yes. Right.

Ms. CLARKE. So I think it is just important as we go through this process for the layperson out there who is really just trying to figure out what life needs to be like for them right now, these are the types of bread-and-butter issues that they are drawing upon right now. And they are looking to us to come up with the best way to navigate and to hold onto the life preserver. And they are looking at their 401(k)s, they are seeing them shrink, and they are thinking my life preserver is melting away before my eyes.

Thank you very much, Mr. Chairman.

Chairman MILLER. Thank you. Mr. Sarbanes.

Mr. SARBANES. Thank you, Mr. Chairman.

What is the credit access of retirees? In other words I know that you can get a fair number of credit cards with pretty high limits on them if you are a working adult. But what does that world look like for your typical retiree? Anybody. Quick.

Mr. WELLER. Well, the data does show that more retirees or more older households have loans these days than in the past. These data are before the current crisis, so we know for instance increased access in particular for mortgages, that is typically where we see the expansion of credit for older households. Less so among credit cards.

Mr. SARBANES. So reverse equity loans and so forth. They are pulling the equity out of their homes essentially.

Mr. WELLER. Yeah, or prolonging——

Mr. SARBANES. So they don't have as much access to the typical credit card, the value of their home is dropping, and their retirement is sinking. So all the directions they could turn to try to come up with dollars to get through the day basically are on the downslope. So everything that is happening right now is hitting them.

Mr. WELLER. There are fewer job opportunities for them in the current market.

Mr. SARBANES. That is a fourth one.

Let me ask you this. I represent a district that has a very high number of retirees and an increasingly high number of retirees, so I am very sensitive to these issues. Do we have a pension system in this country?

Ms. GHILARDUCCI. Yes, we have a tiered pension system. On the bottom is Social Security. It is in pretty good shape. In the middle tier are employer pensions subsidized very generously by Congress. They are increasingly individual-directed, they are defined contribution, and they are heavily tax subsidized, and that system is eroding.

On top of that is personal savings which you just alluded to is also eroding. There is in that top also home equity which is an important part of our pension system. We don't usually talk about that. But we have a pension system, but it is increasingly only secure in the Social Security base.

Mr. SARBANES. I guess what I am getting at is that doesn't strike me as a system. If it is eroding, if two of the tiers are eroding, how is that a system? And compare it if you could, anybody who knows enough about it, to systems other places. Is there any country out there that has a pretty decent system that is not sort of eroding every time you turn around?

Mr. BRAMLETT. Well, there are the European systems which are the strongest, but they are largely underfunded and they also exclude a lot of people who are immigrants and so——

Mr. SARBANES. Why are they the strongest quote-unquote? What makes them strong?

Mr. BRAMLETT. They are the most comprehensive in terms of coverage, from in terms of——

Mr. SARBANES. Is there more of a public-private partnership?

Mr. BRAMLETT. For instance in 2012, the U.K. Will have a program that will require every single employer to contribute to a plan which will be matched and employees will automatically be defaulted into that, and it is called the personal account. And so there are systems that are emerging that are broad based, that are government mandated, that require employer contributions and require employee contributions and are not optional. And so those exist out there.

And the issue I think, really, is how competitive can we be on a worldwide basis with our own labor, in our own economic system, if we have a hugely expensive pension system and people are living very long and there is just no money there to pay for it?

Mr. SARBANES. If they don't have money then they can't buy things, as Mr. Orszag was saying too, which is going to undermine the economy.

Mr. ORSZAG. I think the defining characteristic of many of those other systems is that they involve a mandate somewhere. It is really hard to get to basically universal coverage on a pension system solely through voluntary means. And so if you are looking at, you had said, an eroding system which is partially because we don't have anywhere near full coverage, one of the reasons is that we do rely on incentives for both planned sponsorship and then for participation. And you don't get full kick to that, you don't get universal take-up in part because it is optional.

Mr. SARBANES. What I see here is that we really have like a pension evaporation system in our country. And the problem is we never told the retirees that that is what it was. We actually represented to them, employers represented to them, people that entered into collective bargaining agreements represented to workers, et cetera, that we actually had a pension system. And it turns out we don't really have a pension system. And so a lot of these people who thought they were going to be looked after in their retirement years are figuring out where they are going to go get a job.

Mr. SOUDER. Thank you, Mr. Chairman. I am sorry, I was over with AIG asking questions over there.

Chairman MILLER. How are things going over there?

Mr. SOUDER. Pretty rowdy.

I have a general question first, and that is that in the retirement funds, wasn't the higher—in other words if you received higher benefits you were taking higher risks—maybe you have covered some of this ground, but was that risk fully disclosed?

Now what has happened here is that it was very hard to predict the very high risk we have. But anybody who was trying to maximize and got more return presumably had more risk. Could you comment on that? Because part of the question here is that while certainly some people scammed the system and should go to jail and others manipulated the weaknesses in the regulation, some of this was everybody was trying to maximize their return, which encouraged people to take riskier and riskier subprimes and all that type of thing. Would you kind of discuss that from a retirement——

Mr. WELLER. I would say we could definitely do more in terms of disclosing and showing risks. By and large, especially with the mutual fund industry, what you do is, what is your attitude toward risk, and you check a few boxes and they put you in the green bucket, the yellow bucket, and the red bucket, red being the riskiest one, and you go on your merry way. There is more you can do. There is a chance if you go in this red bucket in your investments, your chance of losing 20 percent in the next 5 years is much higher than if you stayed in the green bucket. So there is definitely more to be done in terms of disclosure.

But let me also say the one thing that Peter Orszag already alluded to, we have to get back to psychology 101. We know that people do make what seems irrational choices for economists. In particular, about 20 percent of all 401(k) assets are in employer stock. Peter had some numbers that 15 percent of people have more than 90 percent of their money in employer stocks. So that is one thing; the lack of diversification; the phenomenon of buying high and selling low.

People started opening up subprime loan funds in 2006. That doesn't seem like such a wise decision today. But clearly a lot of people did. So clearly—there is not much that you can do in terms of disclosure, you can't tell the participant at the bottom of your fund prospectus "Warning, your psychology may lead you to make irrational choices." So I think we have to think about how we can structure better 401(k) plans.

Mr. SOUDER. But one of the questions is, when people—my fundamental question is: Is there anything that pays higher return that doesn't have higher risk?

Ms. GHILARDUCCI. No, there isn't. But if the stock market is going up, surveys show that more and more people will say their stock market can never go down. Or more people will say, yes, I can expect 8 percent return. All the retirement calculators on the Web, all the financial education you get, start with assuming you get 6 and then you get to choose whether or not you want to assume 8 or 10 percent.

So we have an industry that actually wasn't up against irrational humans, but actually knew these irrational humans and made enormous profits. So the financial sector went from 2 percent of the economy to 20 percent on the backs of these 401(k) plans and on the backs of congressional subsidy. This means, what Representatives Clarke and Andrews said, that all the disclosure in the world would not fix the problem we have now; that people who have these 401(k) assets have no flight to safety. It is just practically not an option for them. They didn't know they needed the safety. And if they do do it, they are stuck with selling at the very bottom of the market. They are instructed to not save anymore because Congress is not helping them restructure their other debt.

Why don't you pass laws that make every credit card company, every home mortgage, restructure the debt before you have them go into the only asset they have? I would suggest that.

So we have set up a system, and there is really no way of fixing it on the margin, that requires people what they can't have, and setting up a whole vendor, a commercial vending class that will take advantage of what humans do when they try to do something that they are not trained to do. It is fundamentally flawed.

Mr. BRAMLETT. We need a paternalistic system. Except the parents we have put in charge turned out to be—the furthest paternalistic system has been the financial institutions. And that is like the fox guarding the chicken house, as they say.

So, you know, there is what Teresa is saying is that what the average person experiences in a stock plan in terms of return is about half of what that actual fund actually produces. And that is because they get in too late, and they follow the returns in, that kind of thing. And there are all kinds of reasons for this. The average turnover in a mutual fund has gone from 20 percent in 1970 to 113 percent today. What in the world has happened between 1970 and today that we have had to have turnover go up from 20 percent to 113 percent? So that the average stock being held in a mutual fund is like 8 months. Is that long-term investing? And why is it churning so much? And how much expenses are being generated as a result of that?

So yes, risky assets do. But people don't take advantage of that return.

Mr. BRAMLETT. If I could just add and summarize briefly, Congressman, you have identified exactly the right point, which is that in general when you assume more risk you get a higher expected return. However, there are two parts of the 401(k) system where we need to modify that conclusion. First, people assume too much risk that they don't get compensated for by investing in a single stock, their employers', and way overinvesting in that single stock and not diversifying. And you don't get compensated for that so the normal trade-off doesn't work. And secondly, as has already been mentioned, administrative costs, especially on actively managed funds, are higher than on passively managed index funds, and the academic research suggests you don't get anything in return for those additional fees. So many investors are overinvested in a single stock instead of being diversified, and therefore they don't get the extra return in return for extra risk. And then they are overinvested in a high-cost fund which the research suggests doesn't get you any extra return; you just pay higher fees.

Chairman MILLER. Mr. Kucinich.

Mr. KUCINICH. Thank you, Mr. Chairman. I also just came over from the AIG hearings, so if I ask any questions that have already been answered, forgive me. But these are areas that I think bear scrutiny.

A few years ago, there was a lot of talk in Congress about privatizing Social Security, which meant that Social Security would have bought into, quote, invested, unquote, in the market. We know now that would have been an absolute disaster for the American workers. As a matter of fact, I think it was the Lehman Brothers, had holdings which included the country of Norway's pension funds, invested in the U.S. market. And that has gone down. What is going to happen to those people? We don't hear much discussion about it. But it is in Norway.

I have for the record here, Mr. Chairman, without objection, an article that says Norway's Finance Minister was being summoned to the Parliament this week to answer questions tied to investments made by the country's oil fund in a bankrupt U.S. investment bank, Lehman Brothers. Without objection.

[The information follows:]

[From *Upstream,* Wednesday, September 24, 2008]

Lehman Collapse Hits Oslo Oil Fund

By Upstream Staff

Norway's Finance Minister Kristin Halvorsen will address parliament later this week after it emerged that the country's oil fund substantially boosted its holdings in now-bankrupt US investment bank Lehman Brothers in the final stages of the bank's collapse.

The move follows a report published in the Financial Times which revealed that as the investment bank's share price fell to catastrophic levels, some schemes invested heavily in Lehman shares, effectively placing speculative bets that private or government groups would bail it out.

Halvorsen initially refused to answer questions about the fund's potential losses on the investment, but will now address parliament, daily newspaper Aftenposten said.

According to the FT, the $346 billion Norwegian Government Pension Fund—Global, the country's oil fund, looks set to be one of the largest Lehman victims.

Norges Bank Investment Management (NBIM), the fund's investment manager, added 15 million Lehman shares to its holding in the latter phase of the collapse. This took the total number of shares held in the bank to 17.5 million.

The FT said that, according to the shareholder database of Mutual Fund Facts About Individual Stocks (MFFAIS), the scheme could face up to $238 million in equity losses.

NBIM would not comment about any losses or the most recent value of its holdings in Lehman Brothers.

An NBIM spokeswoman told the FT: "We are very concerned and are following the situation closely. But we only disclose our holdings once a year in our annual report and will not comment on any single investment."

However, equity losses could be the least of the fund's worries. It is believed that the fund has exposure to debt securities in Lehman, as well as more holdings in Lehman subsidiaries and existing mandates and contracts with the collapsed bank.

The losses will be difficult to calculate, the FT reported, at least until the bank's remaining assets are sold off.

The report added that the oil fund has $779 million in Lehman debt securities that are now trading at distressed levels. It also has both bond and equity holdings in various Lehman subsidiaries.

Mr. KUCINICH. I am looking at this report that Mr. Orszag has done, and thank you for your excellent work, and you talk about mitigating financial market risks by sensibly designing pension plans. But here it is: If you had any degree of money in the market one way or another you were putting aside for your pensions, there are many people who have put themselves—who are in a situation right now, where they are going to have to continue working, right? Is that true?

Mr. ORSZAG. That is likely to be one response, yes. People will live longer.

Mr. KUCINICH. So somebody who may have been saving to retire at age 64 or 65 is quite likely, as a result of these circumstances with the market, could be working until they are 70 or more; is that not true?

Mr. ORSZAG. It is possible. One caveat is, and one would expect that to be part of the response. One caveat is that in response to the decline in the stock market in 2001 and 2002, when you would have expected the same thing, the research that has been done there doesn't suggest any significant effect on delaying retirement post the 2001 decline.

But I would say that one would expect, again, at least directionally, that one response would be to delay retirement.

Mr. KUCINICH. And if people are delaying their retirement, they are also wearing out at a faster rate physically. It is just axiomatic. My concern is that with the Pension Benefit Guaranty Corporation seeing even more stress as a result of these circumstances, what do we say to all these Americans who are on the threshold of retirement about what can the government do? Maybe you have covered this already. But what should we be doing to try to find a way to salvage the retirement position of American workers?

You know, it seems that Congress—excuse me, with no disrespect to anybody on this panel—rushed to protect Wall Street in hopes that some benefits would trickle down to workers, right? And the question is what should we be doing apart from the bailout—which I voted against because I thought it was a fraud—what should we be doing to help America's workers right now? What kind of legislative action should we be taking now?

Mr. ORSZAG. I would say three things. First, it is not legislative but just a reminder, as you know, that for the majority of American households in retirement, Social Security does provide a majority of their income, and that is a base; it is not a full solution, and it is not anything that anyone would want to live on exclusively, but it is a base. Secondly, that the best outcome for 401(k) balances will be a general recovery of the economy and a general recovery of financial markets so we can talk more about the steps that would bolster the economy in the short run.

Mr. KUCINICH. If we prime the pump of the economy, for example?

Mr. ORSZAG. As I said earlier, I think at this point it is very undoubtedly the case that when the official NBR committee that looks back on these things looks back at this period, given the strength of the credit crisis that we are experiencing and therefore the further diminution in economic activity that will come and the job losses that have already occurred, it seems implausible to me that this period will not be labeled a recession. In that kind of setting, there are additional aggregate demand steps that could be beneficial.

Mr. KUCINICH. Mr. Chairman, I just want to say—my time has concluded for questioning—that I think Congress has a chance here to really do something that will help pensions as well as other areas by taking steps to have the government assume a controlling interest in these mortgage-backed securities, so that we can create a fix for people who are worried about losing their homes, through changing the terms of their repayments of their mortgage and also create jobs. This is something the Chairman certainly knows about because this is the religion that a lot of Democrats were raised on, priming the pump of the economy, getting people back to work, help people save their homes. And that has a percolating effect on banks and on markets.

So I want to mention that, because apparently the market isn't responding too well to the bailout and maybe we will get a chance to do something else.

Thank you, Mr. Chairman.

Chairman MILLER. I would like, to say you might want to direct yourself—I know you came in late and didn't get an opportunity to hear Dr. Ghilarducci's suggestions about allowing a swap-out of 401(k)s for government bonds.

Mr. KUCINICH. If you could, I would appreciate it if you would just give me a synopsis.

Chairman MILLER. I will let the author do that. I am smarter than that.

Ms. GHILARDUCCI. I will do it in 15 seconds. I propose that you offer up to 401(k) asset holders now a swap-out of their toxic assets for a government guarantee, so you do for them what you have done for the banks.

Mr. KUCINICH. I am ready with the legislation, Mr. Chairman.

Chairman MILLER. You have to run faster than that. If I might—thank you. Oh, Mr. Holt—I am sorry—Mr. Holt.

Mr. HOLT. Thank you, Mr. Chairman, and thank you for arranging this hearing. I thank the witnesses. I apologize for arriving late. I was caught up on some of what has transpired.

I would like to ask Dr. Weller, if I may, a little about the savings problem. You state that low- and middle-income workers are particularly vulnerable in retirement because of low levels of savings, and you suggest the use of various kinds of progressive incentives.

Could you describe a little bit more, if you haven't already put this in the record, dollar-for-dollar matching, tax credits, et cetera, to encourage savings? And who would provide those incentives? Is this going to be another obligation of the Federal Government? How could that be done?

Mr. WELLER. There are basically, the way I would describe it, three different approaches. All would require essentially taking back the current tax incentives for saving, largely tax deductibility off contributions to qualified plans and replacing them with something else. You have professor Ghilarducci's proposal where everybody would get a $600 flat amount.

You have the proposal of my colleague and friend, Gene Spurling, where it would be a match of—I think 20 percent is Gene's proposal, if I am remembering correctly. Again, it is intended to be revenue-neutral in that case by taking back some of the tax deductions that you have.

And then the third part that a number of people, including myself, have proposed is to match—to give additional matches to low-income people, let's say a 2-for-1 match or 3-for-1 match that would gradually be phased out. Again, that could be done, either revenue-neutral by taking back some of the tax deduction incentives that you have, or by taking back some of the tax cuts that were implemented since 2001 and pay for that. For instance, some of the estate tax reductions.

So those are generally the three approaches to make the tax incentives under the current system substantially more progressive.

Mr. HOLT. Mr. Orszag, or others, would you care to comment on the effectiveness of those kinds of incentives?

Mr. ORSZAG. I would say the effectiveness of the current tax system is relatively low in encouraging net additions to saving. And I touched upon this earlier. But the reason is that the current tax incentives are tilted towards—for each dollar of contribution—towards higher income households who more easily can shift assets, and the evidence suggests that is what they do. They shift assets from tax accounts into the tax preferred accounts, and when you are just shifting assets around you are not getting any new saving.

So a lot of these ideas are aimed at trying to focus incentives on lower- to moderate-income households who don't have as many other assets, and therefore any dollar—any assets outside of retirement accounts—any dollar that shows up in a 401(k) plan from them is much more likely to be new saving rather than just asset shifting. And that is important.

Mr. HOLT. Dr. Ghilarducci.

Ms. GHILARDUCCI. I used to be a fan of progressive incentives, and that experiment is over. My reading of the research is that the systems that work, either in this country, and when people are—defined benefit systems, big employer groups, or, in the Netherlands, Australia, and in other systems—the only thing that works is a mandatory tier on top of a basic state plan. In this country it would be Social Security.

So I have proposed a mandatory universal pension system on top of Social Security where workers would save 5 percent of their income all their working lives and much of that would be subsidized by a rearranging of the government subsidies that we have now that don't work for 401(k).

Mr. HOLT. Quickly in the moment I have remaining, let me ask about what appears to be a disincentive, which is something known as "reserve plus" that allows you to have a debit card where you can draw on your 401(k), pay it back over 60 months at 2.9 percent above prime. Should we allow that?

Mr. WELLER. I am usually not a big fan of outlawing financial products, but I call this the subprime version of the 401(k) world, yes. Because it is exactly 3 percent more. It is enormously punitive. It is exactly the wrong direction to go in 401(k)s.

I know that Members of Congress have proposed outlawing it, and I think that is probably the right direction.

Mr. BRAMLETT. Just to follow up to the comment on progressive versus mandate, to me it is either/or. In other words, if you mandate the system it works. If you don't mandate the system, then it has to be progressive.

The small employer is the one who has the—the employee of the small employer has the lowest 401(k) account balance. They have about one-third of the average account balance of a Fortune 500 company. They typically also do not have a defined benefit plan, so they have the smallest amount. So there has to be incentives for the small employer to establish 401(k) plans which are tax incentives for the highly paid people. And that works to some degree, not to a perfect degree. To take that away and not go to a mandatory system is probably not going to work. It is one or the other.

Mr. ORSZAG. Could I just add one other counterproductive thing, which is that in many cases we are encouraging people to save in 401(k)s and IRAs. And then it is often the case, and people will experience this to some degree during an economic downturn like today, that because of the asset tests that apply in programs like Medicaid and Food Stamps and other means-tested benefit programs, we have encouraged people to save. And then if they do, we often then cut off their access to programs that help them during economic downturn, which, from a rational economics perspective, is effectively a tax on saving.

So on the one hand we are trying to encourage saving through the Tax Code, and on the other hand we have a huge potential disincentive to saving through the asset tests that apply to many of these programs, although there have been some improvements recently.

Chairman MILLER. Thank you. I am a little concerned that we are here having this discussion and we are using the language that might be appropriate to yesterday, last year, 2000. We act as if this is the same, and if you just hang onto your 401(k), your pension plans, whatever you do, it will all come back to you. Some of you may be too old and it won't come back in time, but for most of you it will come back.

My sense is that this somehow is different. In just the negotiations over the recovery plan, we watched the Secretary of the Treasury, essentially with his partner, the Chairman of the Fed, sort of like Butch Cassidy and Sundance, they kicked open the doors of the Congress, they said give us $700 billion, no questions asked, and no liability. That is after four times they told us they thought they had it contained. I don't fault them. But I still think that they were looking as if this was sort of typical.

I am maybe one of the oldest guys in the room here, but I don't remember when we had an implosion of the housing market, that we had an implosion of financial institutions, what now appears on a worldwide scale, implosion of the credit markets and the seizing of the credit markets and an implosion of the stock market. I don't know how you just get well tomorrow the way you did yesterday. There is something wrong in this equation here.

I think for the millions of families and certainly for the families that I visited this weekend in my district, the fear factor is huge and they don't see the availability of resources to them to get well. They are openly talking about if they can, deferring retirement; or if they can, go back to work; if they can, they hope the housing market recovers, because they may own their home or they may have a loan on it. They are not in trouble with the home, but they know the value is dropping rapidly and that was part of their saving and retirement plan.

So in every window they look out, there is trouble. And the idea that, well, you just gather yourself and hold on and in 3 to 7 years it will all be back. The Japanese waited 12 or 14 years before it ever got back. And now more and more people are saying instead of this being deep and long—I mean shallow and long, this is going to be deep and long in terms of the recovery.

And so I just think that we as policymakers have got to think about what do we do for these people who are in this fix? We are going to inherit them one way or the other if they don't have adequate resources for their retirement. We are going to inherit them in public expenditures for nutrition, for savings for health care. And a lot of people don't want to see themselves in that position. They wouldn't talk in those terms. But the margin between being in a public program in health care and health care is not too great anymore today. And you don't control it. And this is why we are having this hearing.

I don't know if Dr. Ghilarducci's proposal is right, or what used to be the Orszag plan, or the other plans, talking about how we rationalize——

Mr. ORSZAG. I didn't know I had a plan.

Chairman MILLER. You worked on one for years, in your other life. But the point is, somehow we have to rationalize what is the security going to be, the financial security going to be for American citizens who worked their entire lives? I think that has been thrown into the abyss at this moment. Maybe I am wrong and maybe this is something like we have seen before. Except most of the people that saw this before I call them mom and dad, you know, so I don't know how this—and that is why I guess people are kind of blowing by the "recession" word. But they are thinking when it was cataclysmic, it was something other than that. And this starts to look very cataclysmic for middle-class families, very cataclysmic for middle-class families.

I was struck, I was crossing the Golden Gate Bridge, listening to the discussion of the financial situation on the radio and about what is happening to families, and there was the largest sailboat in the world, $125 million I think spent on a sailboat cruising around San Francisco Bay. And I thought, my God, what has happened here?

And I am deeply concerned that people are—you know, we did—somehow this economy did a magnificent job of lifting a huge number of senior citizens out of poverty with health care, with Social Security, with economic expansion and the rest of that.

I am really very concerned about whether or not there is a significant cohort of people, 45 and older—maybe I am starting too young, but I think this is a serious dislocation that has taken place—that are going to be in a position to provide for their wherewithal for themselves, their family, and their immediate family. And I just am very concerned that the idea is, well, you know, dollar cost averaging, you all get back there. I don't know that that is the case.

Mr. ORSZAG. Could I make a comment, because I would agree. I think the period we are experiencing is arguably the greatest collapse in confidence that we have experienced since the Great Depression. And one of the frustrations is that even before this immediate period, as has already been remarked upon, both the pension system and the health care system and other aspects of our—the way in which we conduct our economic activities had imperfections, were tattering or fraying, and the political system does not deal well with gradual long-term problems like retirement security or like rising health care cost.

So I think a key question out of this crisis, is there an opportunity to refashion things that had to be refashioned anyway in a much more sensible way? And I would hope that the Congress and other policymakers, as we struggle with a very challenging economic environment, will look to trying to solve those underlying problems, because we can do that. I am confident that we can do that if we seize an opportunity to refashion things in a way that actually will work better for not only the American public but for the public fisc.

Chairman MILLER. I think that people in good faith invested. Some people took more risk than they should have. Some people took more debt than they should have. All those things happened, and that is human nature and that exists and that is typical and we recovered from those ideas.

But when you are talking about the pace of the implosion here, the loss of $2 trillion, Peter, in a very short period of time in pension assets, $2 trillion, and then you kick that with the loss of equity in homes, that is multi-trillions of dollars for individuals. Whether they are in mortgage trouble or not, they have lost that value and they had plans for it. Maybe they were wrongfully placed, but that is what was going on in America.

We have got to think about now that health care system can trip them up, the pension system can trip them up, the unemployment system can trip them up, and they really do engage in a personal catastrophe, and their ability to recover from that is nil, I think probably, given what their age is.

But these other systems, as you point out, that aren't properly designed for today's economy and today's society are also really hazards to them at this point in terms of them entering into bankruptcy or whatever financial difficulties they find on the road.

Mr. Weller.

Mr. WELLER. If I my may, I think the numbers are staggering. If you look—actually, if wealth had stayed the same relative to income since 1999, households would have another $11 trillion in wealth, so clearly the last 7 years——

Chairman MILLER. That is a huge chunk of wealth, the stripping of wealth that has taken place.

Mr. WELLER. We have certainly set an incredible wealth destruction machine into motion over the last 7 years. And that is only one part of the overall equation. You have to remember at the same time we have not kept pace in terms of employment generation, for instance. That is one of the biggest sources of wealth for families is their labor income, and we have not kept pace in terms of employment generation relative to population growth.

And I think that gets me back to a larger point. We can debate, we can certainly agree on how to build a better retirement plan. But I think this may, as challenging as these times are, certainly be an opportunity to rethink what kind of economy do we want and how do we make sure that we get growth back on track?

Certainly the last 7 years have shown us how not to get it back on track. And how do we then translate job economic growth into job growth, into wage growth so that families are well prepared? So I think this could be an opportunity to really start thinking and talking about what does a solid, short-term, medium-term, long-term economic recovery plan look like? And I think that is ultimately what is needed to recover these trillions of dollars that have been lost.

Chairman MILLER. I just don't see that people have the assets to recover. Wages haven't kept up with the real cost of living. So, again, where do they turn to make this recovery? To spend less? We already know that they are taking on huge amounts of debt just to stay even.

Mr. WELLER. They are turning to local governments. I think we are going to see more demands on local and State governments because that is often where the social services, the first-line defense are being paid. And ultimately local governments have to make the choices between providing education, health care, and social services.

Ms. GHILARDUCCI. But I think Congress has helped.

Chairman MILLER. We must help.

Ms. GHILARDUCCI. I have proposed that you provide special issue bonds so that people can swap out their 401(k) eroding assets, once and for all, and that will be a permanent asset for them to use at retirement. So that is a very short-term proposal.

I also urge Congress to think about helping people restructure their other debt. Interest rates are going up. Stop that. Let people rejigger their debt. That usually happens in bankruptcy court. Do a fast track for that restructuring of debt.

Also going forward, don't have a tax system that subsidizes those sailboats when there is a financial crisis. And the way that you subsidize that middle tier of retirement accounts, turn those tax deductions into tax credits. The fairest way I have come up with, the easiest, simplest one, is $600 for everyone, going forward.

Chairman MILLER. Mr. Bramlett.

Mr. BRAMLETT. I keep going back to $528 billion in securities intermediation, what is a future value of that? And we have allowed the 401(k) participants for 25 years to essentially be preyed upon by the financial services institutions. We have had a body of law called ERISA that says every plan's sponsor must act in the best interest of the participants, and they have a fiduciary obligation to do so. And they haven't, and it is clear.

There is now a whole slew of plaintiff lawsuits, about 20 of them. They may generate something tantamount to what the tobacco suits have generated in terms of capital. But everything you mentioned is all financially related. We are talking about a bloated financial system that is not necessary for us to function as a good economy. And that threatens not only us, individual retirement income, it threatens us as a country.

If we are just trading and selling each others' stocks and bonds and insurance, and young minds are going off and sitting in front of Bloomberg screens and buying and selling IBM all day long, what are we going to be providing the world? And so we need serious financial reform of the financial services. We need people to be given access to the real economy at the lowest possible cost.

Chairman MILLER. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. I think we are all prisoners of our present circumstances, and I think the Chairman has liberated us from that for a minute. And I would echo what he says in this regard. I don't think the question is whether we are in a recession or not. I think we clearly are. I think the question is, how are we going to deal with what I would view as a shift of the tectonic plates that underlie the domestic economy?

I don't think we are in the middle of a blip in the business cycle. I think we are in the middle of a fundamental long-term change in the way Americans work and save and earn and spend. And I would argue there are two things different about our present circumstances.

One is that capital can move at the speed of light. Labor cannot. In the 1970s when there was a recession, an auto plant would lay people off, but it couldn't just rematerialize in Asia in a week. Well, now a call center essentially can. A financial services back office essentially can. So that is the first change.

And then the second one is that I think there no longer is an American economy. There is a global economy of which we are a part. So decisions, bank failures that happened in Europe last week, had a profound effect on the ability of small businesses in my district to borrow money. Problems in the Japanese economy had an effect on the price of commodities that my construction firms use to either hire or not hire bricklayers and welders and electricians. So this is all reality.

So given that, I would argue that the last 100 years of economic history in this country can be characterized as resolving or negotiating the tension between preserving the dynamism that makes new companies and new industries grow, but providing a safety net or a floor below which decent innocent people cannot fall.

Teddy Roosevelt answered that question with antitrust laws. Franklin Roosevelt answered that question with the New Deal. Lyndon Johnson answered that question with the Great Society. And I think it is our time to answer that question now. And I think the tools from the 1970s or fifties or sixties don't work because the circumstances are different. And we find ourselves in a situation with retirement savings where an increasing number of people are not in a defined benefit plan. They are in a sort of "wild wild west" of the defined contribution world where there is a fiduciary duty to safeguard assets, and it is a fiduciary duty taken very seriously by plan sponsors and vendors. They do a very good job.

But of course that fiduciary duty does not extend, by definition, to the preservation of wealth. Those are not the ground rules of a 401(k) or defined contribution plan. The present system is built on choice by the individual worker or investor or retiree. So if that is the case, I would come back to my earlier questions about whether the range of choices are adequate or sufficient to protect the interests of people. And I think that focuses on three questions:

One, are workers getting sufficient independent investment advice? I think the answer is no. And I think we have to figure out a way they can get that advice.

The second is how many workers are offered the most stable and safe choice? The question I began with in my first round of questions—and Michele has found in the 51st annual survey of profit sharing 401(k) plans, an interesting piece of data: that the percentage of plans that offer a cash equivalent or CD money-market-type option, which I would argue is sort of the safest thing out there right now, is only 47 percent. So half of the plans, at least according to this document, do not offer what I would regard as the safest vanilla—but I don't just regard it that way, by the way. So do wealthy investors. They are flocking to the T-bill market in droves right now. So I think we have to revisit that.

But here is a question I want to ask more directly for Ms. Ghilarducci. Your proposal, which would institutionalize in statute a whole different kind of choice for people where they could opt into this guaranteed income plan, is this an irreversible choice? If we adopted your idea and someone opted in, could they ever opt out again, or are they in for good?

Ms. GHILARDUCCI. Yes, they are in for good; like you are in Social Security, which is actually the only thing that is working now.

Mr. ANDREWS. So they wouldn't get the upside if things turn back up again?

Ms. GHILARDUCCI. What you get is a 3 percent guarantee from the government, plus inflation.

Mr. ANDREWS. Would you cap the assets that someone could choose to put in? What if I had—which I do not—$20 million in a DC plan? Could I put all of it in this?

Ms. GHILARDUCCI. Yes. It is capped 5 percent up to the Social Security maximum; otherwise you are subsidizing millionaires.

Mr. ANDREWS. Is it open to any age group? Is it open to young people like myself?

Ms. GHILARDUCCI. Yes, that is the point.

Mr. ANDREWS. When this cash is collected—let's say that my constituents en masse swap for this idea—who holds the cash? How do they invest it? Under what ground rules do they invest it?

Ms. GHILARDUCCI. The cash is held by TARP, by the critter that you just created, by the Federal Government; and the Federal Government will invest it and hold it in the way that you all are seeing fit. The point is that you can do it better than any other financial institution that is around. The government is now a financial institution.

Mr. ANDREWS. If the Federal Government makes a profit on this, if we would pay out 3 percent present value and make 6 or 7 the way we hope the TARP program does, sort of, who gets to keep the profit? What do we do with it?

Ms. GHILARDUCCI. I have that figured out. There would be a board of trustees that would decide how much of a reserve fund the government needed, and if you went above that, then they would pay extra interest. I am in TIAA-CREF for college professors; TI is actually very similar to the plan that I am proposing. We all love it. It is a hybrid, DC/ DB plan, and those of us who are young and conservative, we have most of our money there and we are doing just fine in this financial crisis, like many other people in hybrid DC plans, DB plans.

Mr. ANDREWS. My time has expired. I want to thank the panel for very thought-provoking testimony this afternoon.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Weller, you mentioned that the home equity as a function of income is the lowest since 1974?

Mr. WELLER. 1976. The ratio of home equity relative to disposable income is the lowest since 1976.

Mr. SCOTT. What about home prices?

Mr. WELLER. Haven't they fallen 10 percent since last year? We have a lot more to go.

So we have a lot more to go.

Mr. SCOTT. Are the home prices as a multiple of income at a low range or high range?

Mr. WELLER. They are at the higher range still, but the problem is that for the past 10 years we have increased mortgages faster than home values, and thereby we have leveraged houses. At this point, homeowners own, on average, about 46 percent of their homes.

Mr. SCOTT. And that is a fairly low percentage?

Mr. WELLER. That is the lowest since 1952, since the Federal Reserve has started collecting data.

Mr. SCOTT. We have heard all about the defined contribution plan, where you define what you put in but don't know what you are going to get out, as opposed to the defined benefit plan, where you know what your pension is going to be when you get it. Now, all of the stock market decline, if you are in a defined benefit plan—are any people in a defined benefit plan at risk because of the collapse of the stock market?

Ms. GHILARDUCCI. No. Only if they are employer-sponsored defaults. There is some risk that if it is underfunded, they won't have improvements, but much less risk.

Mr. SCOTT. So as long as the corporation, the employer is solvent, their benefit is protected?

Ms. GHILARDUCCI. You also have the government guarantee, the Pension Benefit Guarantee Corporation.

Mr. WELLER. You have also got to remember the largest group of American workers with the defined benefit plans are State and local government employees. We presume that they

won't all go bankrupt.

Mr. SCOTT. When I was in the State legislature, the stock market was doing great, and some years we figured we didn't have to contribute anything. Other years, it even did better, we actually took a little bit out to fund the rest of government. I assume the private employers were doing the same thing.

Mr. WELLER. That is correct.

Mr. SCOTT. Now when the market goes down, can they afford to make up—I mean what do they have to do when the market goes down precipitously?

Mr. WELLER. Under the current system, they have to start—depends, again, on the rules of the system they are in. Depends on how many reserves they have. But they have to make up the shortfall faster than before. But the problem is that we didn't really build up more reserves than we had in the past. So it is entirely possible that a private sector underfunded plan can move towards a crisis situation and then ultimately require substantial additional contributions from the employer.

So far, yes, I think we can do more. I agree we should do more in terms of building plans to build up buffers and require them actually to build up buffers during the good times, so that when the bad time happens——

Mr. SCOTT. Continue to make contributions even though it looks like it is well funded.

Mr. WELLER. Correct. I have suggested 120 percent of liabilities as the target you should fund to, not 90 percent or 100 percent, but really build up a buffer.

Mr. SCOTT. Not 65 percent, where a lot of them are now.

Mr. BRAMLETT. If Britain is any sign, DB plans will be gone from this country before too long.

Mr. SCOTT. I am sorry?

Mr. BRAMLETT. If Britain is any sign of what will happen, DB plans will be gone, because these employers with these heavy restrictions will not want to continue. So they will keep terminating them and terminating them.

Mr. SCOTT. Because they want to shift the risk of the market going up and down from the corporate to the employee.

Mr. ORSZAG. Can I just comment on that? That trend has been going on for a while. One reason is that workers have undervalued the risk protection that they get through a defined benefit plan. I wouldn't want to hazard guesses here, but it is plausible the kind of experience that we are currently going through will refocus attention on why that kind of protection is very valuable. If that were to occur, then firms would start to offer something that workers saw as valuable.

Mr. WELLER. It is certainly the case that some employees do not fully value the DB plans, but I think we also have got to look at what happened in Britain that has driven employers away, and has also happened in the U.S., and that is changes in the valuation rules that make the contributions from the pension plans substantially volatile and have ultimately led a lot of employers to abandon their plans. I think that is something Congress should revisit.

Mr. SCOTT. If I could, Mr. Chairman, very quickly. What effect on all of this will the recent legislation, the $700 billion bailout, have on all the problems we are having with pensions?

Ms. GHILARDUCCI. There is a provision for the bailout to help out defined benefit plans. I think Congress can do more to recognize that extracting more contributions in a recession from corporations will just, like the Pension Protection Act does, just accelerates their decline. So we didn't focus on how to help defined benefits plan in this hearing. Perhaps we should have. But you can use some of the provisions in what you just passed and actually double back and repeal some of the aspects of the PPA.

Mr. SCOTT. That would mean it would make less contributions to the plans?

Ms. GHILARDUCCI. To give them some relief during the depression, and then implement what Christian Weller has proposed, is to make the target 120 percent of liability.

Mr. SCOTT. Temporarily they would be less solvent than they are now?

Ms. GHILARDUCCI. Yes, but they won't disappear.

Mr. WELLER. The proposal I testified before Congress several years ago, we would smooth the assets and the liabilities over 20 years. That would require fewer contributions during bad economic times but substantially more contributions during good economic times, and your target would be about 120 percent of liabilities. I think that still seems like a completely reasonable proposal to me, but it is exactly the opposite direction from where the PPA went in 2006.

Mr. BRAMLETT. Which is why a lot us in the industry call the Pension Protection Act somewhat of an oxymoron, because of the fact it actually encouraged the termination of defined benefit plans rather than encouraged their preservation.

Chairman MILLER. Ms. Clarke.

Ms. CLARKE. I want to add another dimension to the questions that I have asked today. Everything we are talking about is relative to your position along the financial spectrum, and a concern I have out of my district is the large numbers of single-headed female households. With wage discrimination lowering a woman's lifetime earnings, thereby reducing the amount of money that women put into their pension plans, 401(k)s generally inhibiting their ability to save for retirement, women, and women of color, suffer more adverse effects than their male counterparts when it comes to wage discrimination.

My question is twofold. First, can you discuss the impact that the current financial crisis is having on women, women's retirement security in general, and if any of you know, what effect does this current financial crisis have specifically on retirement security for women of color? And then I have some other follow-up questions.

Ms. GHILARDUCCI. We just had a conference on this at my university. Women generally do poorly in retirement security because they live longer. So it is lower wages, lower savings rates, and these longer lives. So that has to be put into place.

The good news is that for many low-income single women the most valuable source of retirement income security is Social Security. Since you didn't touch Social Security 2 years ago, the good news is they didn't have that many assets so they haven't lost that many. However, their chronic problem still persists.

There is a good case to be made to expand Social Security now to solve the problems of very high risks of poverty of older women. So that is another subject. But we go back to the fact that when we had a financial crisis this deep, the response was the Social Security system and aid to families with dependent children. It was a massive income replacement and income security bill.

Ms. CLARKE. My next question is to Mr. Jerry Bramlett. I haven't heard this explicitly yet but I am trying to get a sense of how the recent financial crisis impacts current retirees, those who are already living off the proceeds of their 401(k) accounts. Can you give me a sense of what they would be going through right now if they are actually living off that?

Mr. BRAMLETT. There is a lot of encouragement in the financial services industry to invest in equities. And I believe that that is rooted in the fact that people make more money when they sell equities than when they sell other types of vehicles. That is why you see a lot of things slanted towards equities.

A lot of people are told at retirement, Gosh, you know, you're going to live another 15, 20, 25 years. The market always rebounds in a 10-year period, or whatever. You can afford to have a large percentage in equities. And so we do have an inordinate amount of people in retirement who do have large exposure to equities and are being hit very hard. I don't know the exact numbers on that, but I know I have heard a lot of stories about that.

The other thing to remember, 60 percent of all participants in 401(k) plans make an election and they never change it again. So, 60 percent. So if I retire, I leave my money in a 401(k) plan, and I start to draw down on it, I am probably not making any changes either.

Here, again, that is why there is a need for more oversight for these individuals, more help, more maternalism, if you will, but it needs to not be the people who are making the money off of the products, which has been the case the last 25 years.

Ms. CLARKE. Just in closing, you stated that due to the current financial crisis, certain retirement funds such as real estate investment funds have announced that they are frozen and not available for distribution to participants due to the liquid nature of their underlying assets. You suggest that Congress should examine whether investments subjected to this susceptibility are appropriate.

My question to you is: Can you suggest some investments that would be appropriate, meaning that they would not be susceptible to the liquid nature of the underlying assets?

Mr. BRAMLETT. One of the things that is required under ERISA is that a person be an informed, prudent person. If they cannot be informed and understand what they are doing, they need to hire an outside expert. So the whole idea is you can't just look at the label, you have got to look at the underlying securities themselves. You need to hire outside independent investment advice, understand how they are being paid, who is paying them to help you look through these vehicles.

There are certain situations where a real estate fund, for instance, because of its very nature could freeze up on you and you can't create liquidations. There are other real estate funds in which you can. So it is not as if real estate should not be an investment in a 401(k) plan, it is just the nature of the vehicle should be highly liquid. That was the basis of 404(c), was that people be able to trade from one fund to the other without any kind of restrictions.

Now, people have found themselves locked in. The same thing goes for interest contracts with back-end loads, redemption fees, all these little things that they get hit with whenever they try to move money around. They should have some freedom in order to be able do that. And it should be on the burden of the plan sponsor as fiduciary, held under the law of ERISA, to be able to make sure that happens.

Ms. CLARKE. Thank you, Mr. Chairman.

Chairman MILLER. Mr. Holt, you can have the last question here.

Mr. HOLT. Thank you again, Mr. Chairman. I thank the witnesses. It is a reminder that I think this committee has some action to take if we are supposed to give shape to the retirement situation of America's workers. I, of course, lament the decline of the defined benefit programs, but since it has gone that way, let me ask about defined contribution.

How serious a problem is the lack of diversity in the equities employees who are encouraged to buy in their own company, for example? There have been some changes and some different patterns, I think. But is that a serious problem and, if so, what is to be done about it? Is this legislation that we should be considering?

Mr. ORSZAG. I consider it to be a very serious problem. Again, there are some risks that in a 401(k) plan are unavoidable, especially if you are trying to get over the long term some expected return. But overinvesting in an individual stock is not sound financial theory, and overinvesting in a single stock that happens to be your employer is particularly problematic because you are not only exposed to that company's well-being through your job but also through your retirement fund.

It is extraordinarily difficult to come up with any scenario where on average for workers it makes sense to be investing so dramatically in your own employer stock. Again, something like 7 percent, so 1 out of every 15 workers has 90 percent or more of their account balance in their employer's stock. It is very difficult to justify that kind of lack of diversification under any finance theory.

We had discussions earlier about the different funds that are offered, trying to move toward diversified funds, and just briefly I would note that while the CD and money markets were only offered by about half the funds, bond funds and stable value funds and what have you would raise that number dramatically and get you close to 100 percent.

But I think moving towards defaults where people are automatically invested in diversified low-cost index funds offers the most auspicious way forward for balancing the various tradeoffs. I can't justify the over concentration in employer stock that pervades the pension system.

Mr. HOLT. Other witnesses, and in particular should we be imposing requirements?

Mr. VANDERHEI. Could I add some actual real data here? The numbers Peter gave had been very representative of what the situation had been prior to Enron. For 20 million individuals that we track, in 2006 the number has gone down to only 7.3, which admittedly is still a large number that have 90 percent or more.

The good news is what is going on with respect to the new participants. A lot of that money, as Peter and others have mentioned, is very sticky. Once the money is put in company stock, oftentimes people do not diversify out. The good news is if you look at the new individuals, people who have been in the plan 2 years or less, the number now that have 90 percent or more in company stock is down to 4.8. That had been up as high as 11.1 percent.

Mr. ANDREWS. Will the gentleman yield?

Mr. HOLT. Looks like Dr. Ghilarducci and Dr. Weller want to get a word in.

Yes.

Mr. ANDREWS. To what extent is that attributable to the QDIA provision?

Mr. VANDERHEI. That is exactly the point I was going to make. We don't have the ability to go back and break out to the extent to which employers have either allowed diversification more rapidly on the part of the employees and/or change——

Mr. ANDREWS. That is very material to Mr. Holt's question though because it is happening by default. That is nice, but it is not really addressing the problem he is raising. Right?

Mr. BRAMLETT. One option in our plan, BenefitStreet plan, we don't have individual asset classes, we only have portfolios. A lot of the advisers who come to us, a lot of them especially who use ETFs, low-cost index funds, do not have individual asset classes, they only have portfolios, be they target-date portfolios or target-risk portfolios. So one very simple way to do it is to simply eliminate the ability of an individual to buy an individual asset class within a plan. That may seem a little Draconian, but that would guarantee you immediate diversification for all employees.

Mr. WELLER. You can never really make a DC plan as efficient economically as a DB plan. But one big step forward is exactly what Peter said, a well diversified default low-cost index can go a long way, according to the calculations. You can really improve retirement savings by 20 percent by simply giving a better investment option.

Ms. GHILARDUCCI. A dollar in a defined benefit plan goes further than a dollar in a defined contribution plan because of fees, because of the asset allocation. If you do limit single stock in a plan, that is a good idea. You also might have the effect of smoothing out the volatility in the stock market because a place where companies lard up their stock value is by shoving it onto their employees. So you have these microeconomic good effects as well.

Mr. HOLT. Thank you again, Mr. Chairman.

Chairman MILLER. Thank you very much. I want to insert in the record a statement by Ranking Member Buck McKeon and also a statement from the American Benefits Council.

[The statement of Mr. McKeon follows:]

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

The American 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.

The stock market is often a reflection of the nation's mood, and today's widespread economic uncertainty can be seen clearly in the stock price rollercoaster ride of the past few weeks. 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.

An increasing number of workers rely on 401(k)-type savings plans, in which they invest pre-tax earnings that are often matched by their employer. These plans are portable and protected, in that an employer or a union can never take away the benefits an employee has accrued.

A smaller share of workers participates in defined-benefit plans, in which a plan sponsor—usually an employer or a union—agrees to pay an established benefit throughout retirement.

While these plans—defined-contribution and defined-benefit—have many differences, both are impacted in large measure 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, requiring effective management of resources and risk. 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.

The current downturn in our financial markets has brought considerable uncertainty, particularly for those workers nearing retirement. More than half of people surveyed in an Associated Press-GfK poll released last week said they worry that they will have to work longer because the value of their retirement savings has declined. Particularly for those workers whose savings were held in too risky a portfolio for their savings goals, or for those who were not well-diversified, these are difficult times.

Recognizing the challenges Americans face in planning for retirement, Congress passed crucial reforms in 2006—through the "Pension Protection Act"—to shore-up defined-benefit plans, increase participation in defined-contribution plans, and, importantly, to allow workers to access high-quality investment advice in managing their retirement savings. In these times of financial turmoil, those reforms should help to make a real difference for workers and retirees.

Today's hearing is an important first step in examining how the ups and downs of the financial markets impact workers' retirement security. However, this issue cannot be understood in a vacuum. Our committee does not have jurisdiction over the government sponsored enterprise mortgage giants Fannie Mae and Freddie Mac, but it is clear that the appropriate committees in both the House and Senate must ask the tough questions and hold to account those who allowed these agencies to put us on this path to economic instability.

And while I commend Chairman Miller for holding today's hearing, it is critical that Congressional oversight in this area not be limited to pre-election political theater. Members on both sides of the aisle should be permitted to examine these issues when Congress is in session, and with a full opportunity to explore the causes of the current financial crisis, the impact on workers and families, and what can be done to prevent such a catastrophe in the future."

[The statement of the American Benefits Council follows:]

Prepared Statement of the American Benefits Council

Chairman Miller and Ranking Member McKeon, these are indeed unsettling times for American workers and American employers. The current difficulties in our financial system are posing a wide range of challenges for individual American families and American businesses. One of the challenges faced by American workers is an understandable sense of anxiety regarding their retirement planning and retirement security. We appreciate your consideration of these issues in today's hearing and are pleased to share our perspective on the effect of these periods of market and financial uncertainty on our nation's employer-sponsored retirement system.

We appreciate the opportunity to submit this statement on behalf of the American Benefits Council in conjunction with the hearing you are holding today on The Impact of the Financial Crisis on Workers' Retirement Security. The Council is a public policy organization representing principally Fortune 500 companies and other organizations that assist employers of all sizes in providing benefits to employees. Collectively, the Council's members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

The Strengths of the Employer-Sponsored Retirement System

The Council and its members have worked collaboratively with this Committee and with the entire Congress to build an employer-sponsored retirement system that is strong and resilient and that helps to advance the retirement security of American families. This successful system is marked by a number of key characteristics. It facilitates employer sponsorship of plans, encourages employee participation in pension programs, promotes prudent investing, insists on transparency, operates at reasonable cost and is subject to strict fiduciary obligations and sound regulatory oversight. This is a system that is built to serve the long-term retirement interests of workers and that is designed to weather changes in market, financial and economic conditions, even conditions as anxiety-provoking as the ones we are experiencing today. We, like you, believe we should always be asking whether this system can be improved to better serve the interests of plan participants, and today's economic challenges present another opportunity to ask such questions. But we believe our current employer-sponsored retirement system plays a critical role in advancing workers' retirement security, even when markets, 401(k) account balances and pension funding levels are down.

The Long-Term Focus of Defined Benefit Plans

Employer-sponsored retirement plans, whether defined benefit or defined contribution, provide an invaluable supplement to workers' Social Security benefits and personal retirement savings. Defined benefit plans provide broad coverage, employer financing, professional asset management, spousal protections and lifetime income backed by guarantees from the Pension Benefit Guaranty Corporation. In managing defined benefit plan assets, fiduciaries must act prudently and solely in participants' interests and must diversify plan investments so as to minimize large losses. Defined benefit plan sponsors invest for the long-term so as to secure the promises employers make to provide benefits many decades into the future. Unlike some others, defined benefit asset managers do not have a short-term investment focus. Pursuant to these legal obligations and investment principles, defined benefit plan sponsors invest in a broad array of asset classes and have avoided the heavy focus on mortgage-related investments that has contributed to the collapse of certain financial institutions and the weakening of others. As is true of all investors when markets fall, funding levels in defined benefit plans are down somewhat and this will impose financial obligations on employers, some of which may be struggling in the current economic environment. As the Chairman and Ranking Member are aware, we believe there are certain steps Congress could take to address these challenges, such as prompt enactment of two provisions relating to the funding requirements of the Pension Protection Act of 2006 (PPA). One of these provisions would clarify the permissibility of asset smoothing under PPA and the other would institute a more effective transition regime to the PPA funding rules. Both changes would help avoid undue financial burdens on employers. The Council has recommended these two steps for some time as we believe they will assist in providing needed predictability and stability to the defined benefit system. Given the current economic situation, they have become even more important.

We also hope to continue our conversations with policymakers regarding the accounting standards applicable to defined benefit plans. The Financial Accounting Standards Board has recently adopted new standards in this area and even more dramatic changes are on the horizon. These new approaches pose significant challenges for employer sponsors and contribute to the concern among some that defined benefit plans are simply too unpredictable from a financial perspective.

The Recent Enhancements to Defined Contribution Plans

Defined contribution plans likewise offer important benefits to workers, among them choice and control over investments, portability and access to funds in times of financial distress. As defined contribution plans have become more dominant in the workplace, Congress has taken a number of important steps to make these plans even more successful and to assist plan participants in carrying out their responsibilities under these plans. The Pension Protection Act, in particular, strengthened the defined contribution plan system in ways that fundamentally assist participants—especially in financial circumstances such as those we face today. PPA encouraged automatic enrollment so that more employees would participate in plans, it facilitated default investments, which are a critical component of automatic enrollment arrangements, it provided new diversification rights so that employees would avoid the concentrations in company stock that proved so heartbreaking for the workers at Enron and it expanded opportunities for investment advice so that employees could have professional counsel, which is particularly important in times such as these (most especially for workers nearing retirement). While implementation of these PPA provisions is continuing, participants are in better shape to weather the current market downturn because they have been put in place.

This Committee has been at the forefront of the recent efforts to ensure that our defined contribution system is marked by transparency regarding fees. We share the Committee's strong commitment to ensuring that plan participants have clear information about the fees they are charged and that plan fiduciaries have clear information about the compensation earned by plan service providers. Such transparency regarding fees facilitates sound decision-making by both participants and sponsors and helps ensures that fees are reasonable in light of the services, features and quality provided. As members of the Committee have noted. when fees are kept at reasonable levels, participants have more in their accounts at retirement. This is an outcome we can all support. We look forward to working with this Committee and with the regulators at the Department of Labor to ensure that changes to fee disclosure practices are implemented smoothly, in a coordinated fashion and with sufficient transition periods. We want to be certain that the advantages of enhanced transparency are achieved without in any way deterring plan participation or plan sponsorship.

The Added Value of Employer Sponsorship

Regardless of the type of plan (or plans) an employer offers to its workforce, there is a dimension of employer plan sponsorship that deserves particular mention as it brings tremendous value to plan participants in financial circumstances like those we are experiencing. That is the simple fact of employer plan sponsorship and the fiduciary oversight that accompanies this employer role. Retirement plan participants have a fiduciary whose legal obligation it is to act solely in the interest of participants and beneficiaries and for the exclusive purpose of providing benefits. The benefits of this employer sponsorship and fiduciary oversight are manifold—preselection of quality investments, ongoing investment oversight, use of employer bargaining power regarding fee and service levels and investment education, to name but a few. In response to current market events, many plan sponsors have communicated with plan participants and made information available about key investment principles and the importance of continuing to calmly review one's financial situation. Plan sponsors are also devoting particular attention at this time to their ongoing monitoring of plan investments. Thus, despite today's market challenges, those who participate in employer-sponsored retirement plans are fortunate relative to those who do not. We hope to continue to work with the Committee to expand the number of employers that sponsor retirement plans and further increase the number of workers who participate. Certainly we should take no steps that would frustrate either of these important goals.

The Importance of Financial Literacy

Chairman Miller and Ranking Member McKeon, another issue that is worth discussing in the context of today's hearing is one that the Council highlighted in our 2004 report, Safe and Sound: A Ten-Year Plan for Promoting Personal Financial Security. That is the issue of financial literacy. While knowledge and understanding of financial principles cannot completely conquer the anxiety that many Americans are feeling today, it certainly can reduce such anxiety and can help prompt sound decision-making in challenging times such as these. In Safe and Sound, we articulated a goal that "by 2014, virtually all households will have access to some form of investment education and advice and 75 percent of households will have calculated the amount of retirement savings needed to maintain their standard of living throughout retirement, as well as the savings rate needed to achieve this target." To assist in reaching this goal and to facilitate the equally important goal of improving financial literacy generally, our report recommended (1) expansion of financial education efforts by employers, the government and other stakeholders, (2) the establishment of financial literacy requirements at the high school and college level, and (3) the inclusion in the annual Social Security statement of a tool to calculate retirement savings goals. Adoption of these steps will ensure both that Americans are financially prepared for challenging economic times and equipped with the skills and knowledge to make sound decisions in times of market turbulence.

The Council sincerely appreciates your consideration of our views. We look forward to collaborating with the Committee to analyze the effects of the current financial environment on workers' retirement security and to determine whether there are any policy steps that can be taken to promote this security and further strengthen the nation's voluntary employer-sponsored retirement system.

Chairman MILLER. The record of this hearing will remain open for 14 days so members will have an opportunity to submit additional materials for the hearing record. Also, they may have follow-up questions. We would ask that you would respond to those when we forward them to you.

Thank you very much for your time and your expertise and your experience in this. I suspect this is the beginning of a new conversation and a new atmosphere about the need to protect people's retirement and pensions. I hope that we will be able to continue to call on your expertise as we work our way through this in the next Congress and the next administration. Thank you very much.

With that, the committee stands adjourned.

[Additional submission of Mr. Miller follows:]

STATEMENT OF THE INVESTMENT COMPANY INSTITUTE
Hearing on "The Impact of the Financial Crisis on Workers' Retirement Security"
House Education and Labor Committee
October 21, 2008

The Investment Company Institute appreciates the opportunity to provide its research and expertise in connection with the Education and Labor Committee's October 7 hearing on the impact of the financial crisis on Americans' retirement security.

Financial markets in the U.S. and around the world have experienced unprecedented turmoil in recent weeks. For many Americans, the most visible sign of the current financial crisis is the severe downturn and volatility of the U.S. stock market. Americans saving for retirement understandably are anxious. Institute research demonstrates, however, that the private employer-based system can withstand financial shock and even flourish in its aftermath. Our research finds that plan investors do not overreact to market downturns or panic, that they have a demonstrated commitment to long-term savings, and that consistent 401(k) contributors have seen their accounts rebound after bear markets. It would be a grave mistake to use recent market events as an excuse to dismantle the current retirement system, as some suggested at the October 7 hearing.

The recent market downturn has an impact on the U.S. retirement system, because employment-based defined benefit and defined contribution plans, being long-term savings vehicles, invest to a large degree in equities. On average, 401(k) participants are invested about 60 percent in equity funds and individual securities (primarily company stock) and about 13 percent in balanced funds (which include both equities and fixed-income investments), as of 2006.[1] Defined benefit plans similarly are invested primarily in equities.[2] Volatility in the stock market leads to short-term volatility in defined contribution plan account balances, and because of advances in recordkeeping, 401(k) participants can now track their accounts on a daily basis. Stock market volatility also has an impact on the ability of employers to maintain adequate funding of defined benefit plans.

Based on ICI's extensive research on retirement security and mutual fund investors, our statement makes these points:

- In times of volatility and turmoil, it is important to maintain and project confidence in the United States' private retirement system.
- Long term retirement savers can withstand volatility.

[1] See Holden, VanDerhei, Alonso, and Copeland, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2006*, ICI Perspective, vol. 13, no. 1, and EBRI Issue Brief, Investment Company Institute and Employee Benefit Research Institute, August 2007, available at http://www.ici.org/pdf/per13-01.pdf.

[2] Federal Reserve data show that, as of 2007, private defined benefit plans held about $2.7 trillion in total financial assets. Of that, $1.7 trillion (or about 63 percent) was held in corporate equities, and another $308 billion was held in long-term mutual funds (which invest in stocks, bonds, or a combination). See U.S. Federal Reserve Flow of Funds Accounts, Z.1 release, Table L.118.b (September 18, 2008), available at http://www.federalreserve.gov/releases/z1/Current/z1r-6.pdf.

- 401(k) investors have demonstrated a commitment to long-term savings.
- While the employer-based retirement system can continue to be improved, it remains a reliable system for providing retirement security to millions of Americans.

Importance of confidence and long-term outlook

In times of volatility and turmoil, it is important to maintain and project confidence in the United States' private retirement system. The trillions of dollars retirement plans have invested in thousands of U.S. companies are at their core an investment in America's long-term future. Panicked selling of defined benefit and defined contribution assets is not in the interest of participants and beneficiaries (or the taxpayers who backstop the PBGC) and would exacerbate market turmoil.

U.S. workers and employers have shown great confidence in the retirement system. U.S. retirement plans held $17.1 trillion, as of first quarter 2008.[3] This represents nearly 40 percent of household financial assets—twice the percentage of just10 years ago. Sponsorship of defined contribution plans by employers has continued to grow. At year-end 2007, there were an estimated 641,000 private-sector defined contribution plans with 54.6 million active participants.[4] Based on our research we believe this confidence is deserved even during downturns of the business cycle.

Long term retirement investors can withstand volatility. In 1999, total U.S. retirement market assets temporarily peaked at $11.8 trillion [Figure 1]. Because of the bursting of the tech bubble and the terrorist attacks on September 11, 2001, the U.S. stock market entered a multi-year downturn. By year-end 2002, the U.S. retirement market had fallen to $10.6 trillion, an 11 percent drop from the 1999 peak. (Although this is a significant decline, it was not as bad as the market overall – the S&P 500 index fell 37 percent over the same period – because retirement savings are tempered by diversification and ongoing contributions.) Retirement assets quickly rebounded the next year and as of the end of the first quarter of 2008 total assets were up 62 percent from the 2002 bottom.

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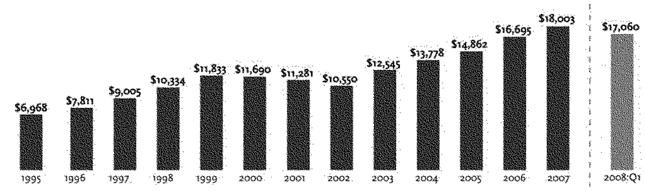
[3] See *The U.S. Retirement Market, First Quarter 2008*, ICI Fundamentals, vol. 17, no.3-Q1 (October 2008), available at http://www.ici.org/statements/res/retmrkt_update.pdf. ICI's latest data are for the end of first quarter 2008, which showed a decrease in total U.S. retirement assets of almost $1 trillion from year-end of 2007 [Figure 1]. Peter Orszag of the Congressional Budget Office estimated at the October 7 hearing that retirement assets could be down another $1 trillion.

[4] See Brady and Holden, *The U.S. Retirement Market, 2007*, ICI Fundamentals, vol. 17, no. 3, n.22 (July 2008) (citing Cerulli Associates estimates). The bulk of these plans were 401(k) plans, with 469,000 plans and 47.2 million active participants.

FIGURE 1

U.S. Total Retirement Market

Billions of dollars, end-of-period, 1995–2008:Q1



Sources: Investment Company Institute, Federal Reserve Board, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division

Mutual fund investors do not overreact to market volatility. Defined contribution plan participants are just one subset of fund investors, and the experience of all mutual fund investors over market downturns is that they do not overreact to market volatility or panic. In the mid-90s, ICI analyzed mutual fund shareholder activity during the 14 major stock market cycles going back to World War II.[5] In none of the stock market breaks and sharp declines did mutual fund investors liquidate their shares en masse.[6] This was seen even in the aftermath of the October 19, 1987 market crash: only about 5 percent of stock fund shareholders liquidated shares in the six weeks after the crash. Analysis of the 1987 market break showed that it was chiefly *institutional* investors, and not individuals in retail accounts, 401(k)s or IRAs, that drove the market down.[7] The 95 percent of mutual fund shareholders

[5] See Rea and Marcis, *Mutual Fund Shareholder Activity During U.S. Stock Market Cycles, 1944–95*, ICI Perspective, vol. 2, no. 2 (March 1996), available at http://www.ici.org/pdf/per02-02.pdf.

[6] The research found that mutual fund investors are not insensitive to stock price movements, but their response tends to be spread over time, and tends to be in response to long-run trends in equity returns. Subsequent research shows that mutual fund shareholders' reaction to significant downturns or major events, such as the September 11, 2001 attacks, is muted. See Reid, Millar, and Sevigny, *Mutual Fund Industry Developments in 2001*, ICI Perspective, vol. 8, no. 1 (February 2002), available at http://www.ici.org/pdf/per08-01.pdf. ICI also looked at net flows of funds during the period between June 2002 and February 2003, when the stock market fell 21 percent, and found equity funds had outflows of only 3.3 percent of assets held in equity funds at the beginning of the decline.

[7] See testimony of Nicholas Brady, Chairman, Presidential Task Force on Market Mechanism, Hearings before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Feb. 2, 3, 4, and 5, 1988), S. Hrg. 100-649, page 52 ("It is a strange commentary on this country that the individuals – or maybe it isn't strange – that the individuals are the guys that stay there, through market turbulence, and that institutions do the trading.")

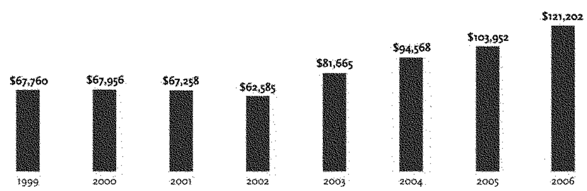
who did not liquidate mutual fund shares in the six weeks after the October 19, 1987 market crash were poised to benefit from the market rebound that followed October 1987.

Rebound in participant 401(k) accounts. The ability to recover from market downturns is also seen in the experience of individual 401(k) accounts. The EBRI/ICI Participant-Directed Retirement Plan Database, the largest, most representative repository of information about individual 401(k) accounts, shows that participants who stay in the system and continue saving see their accounts rebound significantly.[8] An analysis of participants with account balances at the end of each year from 1999 through 2006 (that is, consistent savers in the database) shows that between 1999 and 2002, the average account balance of this group fell 8 percent [Figure 2]. But in 2003 the average account balance was up 30 percent. The average account balance almost doubled from the bottom (2002) through 2006. Overall, the average account balance from 1999 to 2006 was up 79 percent, despite the multi-year bear market and even though U.S. equity prices had not recaptured all their losses during the 2000–2002 market downturn. If those participants had stopped contributing, left the 401(k) system or moved their balances out of the stock market in 2002, they would have locked in their losses and missed out on the market rebound.

FIGURE 2

401(k) Account Balances Through Last Market Downturn

Average 401(k) account balances among 401(k) participants present from year-end 1999 through year-end 2006,[1] 1999–2006[2]



[1]Account balances are participant account balances held in 401(k) plans at the participants' current employers and are net of plan loans. Retirement savings held in plans at previous employers or rolled over into IRAs are not included.

[2]The analysis is based on a sample of 3.0 million participants with account balances at the end of each year from 1999 through 2006.

Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

The 401(k) system is new enough that no one has yet had a full career in the system, so ICI has examined in collaboration with EBRI whether a full career with 401(k) plans can produce adequate

[8] See Holden, VanDerhei, Alonso, and Copeland, supra note 1.

income replacement rates at retirement.[9] The EBRI/ICI 401(k) Accumulation Projection Model examines how 401(k) accumulations might contribute to future retirees' income based on decisions workers make throughout their careers. The model looks at 401(k) participants of varying income levels and models future accumulations under a range of participant behaviors and scenarios—including modeling various long-term market returns that included significant historical market downturns. The model demonstrates that 401(k) can produce adequate replacement rates at retirement when combined with Social Security. For example, among individuals who were in their late twenties in 2000, after a full career with 401(k) plans, the median individual in the lowest income quartile is projected to replace about 100 percent of his or her pre-retirement income using 401(k) accumulations and Social Security. The model also demonstrates that when workers move into jobs that do not offer a 401(k) plan, median replacement rates fall significantly – by about half for workers in the lowest income quartile. Other research demonstrates that, once Social Security, savings during employment, and taxes are accounted for, even moderate savings rates can lead to adequate replacement rates after retirement.[10]

Demonstrated commitment to long-term savings

Contrary to what some believe, most 401(k) investors are not raiding their nest eggs. Loan activity by participants, even during bear markets, is very modest. Less than one in five participants in 401(k) plans that offer loans had a loan outstanding at year-end 2006, and among those with a loan, the loan represented only 12 percent of the remaining account balance on average.[11] The Department of Labor's latest available data shows participant loans represent less than 2 percent of the assets of defined contribution plans.[12]

EBRI and ICI analyzed distribution and hardship withdrawal activity in its database a number of years ago, but the incidence of withdrawal activity was so small we have not repeated the analysis. Surveys of retirement savers find most leave their money invested in a 401(k) plan or IRA until the government *forces* them to remove it at age 70 ½.[13] While there have been recent anecdotal reports of

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[9] See Holden and VanDerhei, *Can 401(k) Accumulations Generate Significant Income for Future Retirees?* and *The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement*, ICI Perspective and EBRI Issue Brief, Investment Company Institute and Employee Benefit Research Institute, November 2002 and July 2005, respectively, available at http://www.ici.org/pdf/per08-03.pdf and http://www.ici.org/pdf/per11-02.pdf, respectively.

[10] See Peter J. Brady, "Measuring Retirement Resource Adequacy," *Journal of Pension Economics and Finance* (forthcoming); working paper version (February 2008), available at http://ssrn.com/abstract=1092590.

[11] See Holden, VanDerhei, Alonso, and Copeland, supra note 1, Figures 43 and 44.

[12] See Department of Labor, *Private Pension Plan Bulletin, Abstract of 2005 Form 5500 Annual Reports* (February 2008), Table A3, page 7.

[13] Just-released ICI research based on a 2007 survey of more than 600 recent retirees about their distribution decision from a defined contribution plan finds that more than half of DC plan participants received their distribution as a lump sum. Of these, 86 percent reinvested all or some of the proceeds, usually in rollover IRAs; 62 percent reinvested the entire amount. Only about 3 percent of accumulated DC account assets were spent immediately at retirement. Of those who spent their entire lump sum, most used the proceeds prudently, for example, to buy a primary residence, make home repairs, repay debt, or pay for healthcare. See Investment Company Institute, *Defined Contribution Plan Distribution Choices at Retirement, A*

increased withdrawals, this should be viewed in the context of the very small percentage of participants who take withdrawals before retirement. For example, one study of more than 16,000 plans, representing 11.5 million workers, found that in the three month period ending June 30, 2008, only 0.60 percent of participants had made hardship withdrawals, compared with 0.56 percent a year earlier.[14]

Retirement savers also appear to continue to save even during bear markets. An analysis of a large sample of 401(k) participants drawn from the EBRI/ICI database, which includes data for the 2000–2002 market downturn, found that contribution rates were little changed in 2000, 2001, or 2002, compared to 1999.[15]

Asset allocation of 401(k) investors

The Committee heard repeatedly at the October 7 hearing that diversification and age appropriate asset allocation are key to mitigating volatility and reducing unnecessary risk for 401(k) plan participants. We agree, and our research shows that on average participants are following that advice. As participants age, they tend to favor fixed-income securities such as bond funds, guaranteed income contracts, stable value funds, and money market funds [Figure 3].[16] Although the overall percentage asset allocation of equities tends to rise and fall with the stock market,[17] the phenomenon of older workers being more concentrated in fixed-income investments has been consistent in the more than a decade of data reflected in the EBRI/ICI Database.

Survey of Employees Retiring Between 2002 and 2007 (Fall 2008), available at http://www.ici.org/pdf/rpt_08_dcdd.pdf. In addition, among IRA-owning households making withdrawals, the most commonly cited reason is to meet required minimum distributions. See Holden and Bogdan, *The Role of IRAs in U.S. Households' Saving for Retirement,* ICI Fundamentals, vol. 17, No. 1, January 2008, available at http://www.ici.org/pdf/fm-v17n1.pdf.

[14] See Joe Morris, "401(k) Contributions Hold Steady," *Ignites*, August 14, 2008.

[15] Sarah Holden and Jack VanDerhei, "Contribution Behavior of 401(k) Plan Participants During Bull and Bear Markets," *National Tax Association Proceedings, Ninety-Sixth Annual Conference on Taxation, November 13-15, 2003, Chicago, Illinois*, pp. 44-53, Washington, DC: National Tax Association (2004).

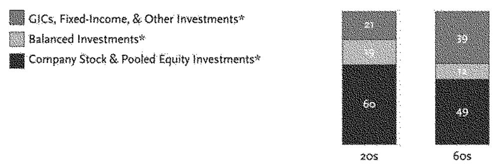
[16] There is no asset allocation that is correct for all individuals. The proper asset allocation depends on an individual's own tolerance of risk. In addition, asset allocation needs to be considered across an individual's entire portfolio: the proper allocation inside a 401(k) cannot be determined independent of the individual's other assets. For most individuals approaching retirement, the bulk of their wealth is in the form of promised future Social Security benefits. Social Security benefits have characteristics similar to a bond indexed to inflation. Thus, observing only the asset allocation inside a 401(k) account typically overstates the amount of an individual's wealth allocated to equity.

[17] See Holden, VanDerhei, Alonso, and Copeland, supra note 1, figure 20.

FIGURE 3

401(k) Participants Asset Allocation Varies with Age

Percent of assets, year-end 2006



*Includes mutual funds and other pooled investments.

Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

The Committee also heard about participants at the extremes who fail to properly diversify their accounts or fail to alter their risk allocations over time. For example, some participants' accounts are heavily invested in the stock of their employer – EBRI/ICI data show that in 2006 nearly 9 percent of participants in plans that offered company stock as an investment had more than 80 percent of their account balances invested in company stock (although the share of company stock in 401(k) participants' accounts has diminished since 1999).[18] Even participants who properly allocate their account at one time may fail to rebalance or alter the allocation over time.

Plan sponsors and the 401(k) service industry saw the need to foster diversification and age appropriate allocations and developed innovative features to make participants better investors and automate their decisions to position participants to weather exactly the conditions that currently plague the stock market. Many of these innovations have now been adopted by public sector plans, including the federal Thrift Savings Plan:

- *Investment options like lifecycle or target date funds, and balanced funds, that encourage diversification and age appropriate asset allocation.* From their introduction in the 1990's to the end of first quarter 2008, lifecycle mutual fund assets have grown to $185 billion.[19] The availability of these options continues to grow—about one-third of plans offered target date funds in 2007, up from about 25 percent in 2005.[20] These "one-stop" investments have been

[18] See Holden, VanDerhei, Alonso, and Copeland, supra note 1, figures 20 and 32.

[19] See *The U.S. Retirement Market, First Quarter 2008*, supra note 3, figure 13. (Lifecycle mutual funds were significant enough by 1996 for ICI to track them separately.)

[20] See Profit Sharing/401k Council of America, *51st Annual Survey Reflecting 2007 Plan Experience* (2008).

added to the Thrift Savings Plan as the "L" funds (which as of the end of 2007 had almost $25 billion in assets).[21]

- *Autoenrollment and autoescalation that facilitate savings.* Even before the passage of the Pension Protection Act of 2006, plan sponsors began automatically enrolling participants in 401(k) plans and increasing their contribution rates each year, unless a participant opts out. Congress strengthened this feature through a number of PPA provisions, including removing legal uncertainties, creating a safe harbor incentive, and facilitating qualified default investment options. The Thrift Savings Plan is now looking to add autoenrollment.[22]
- *Improved participant communication.* 401(k) participants now have access to sophisticated call centers, websites, educational materials, and access to professional investment managers — high touch ways for participants to receive information about their accounts and get reassurance in difficult market conditions. One Institute member with a large recordkeeping business reported to us that participant calls increased 60 percent, and website visits increased by 65 percent, during the recent market volatility. Although the volume increased significantly, nine in ten participants did not make a change to their accounts and less than 2 percent of assets have been moved. This firm was able to react quickly by increasing its service center capacity by 50 percent to handle participant inquiries. That 401(k) investors tend to be patient during this market turmoil is encouraging. As the Committee heard from a number of witnesses on October 7, and as the data we present on the 2000-2002 bear market demonstrates, staying in the market rather than engaging in panicked selling is generally the better strategy. Recent communications from the Thrift Savings Plan to federal workers about market volatility also have sought to reassure and emphasize long-term investing.[23]

Future of defined contribution plans

The employer-based retirement system can continue to be improved, but it remains, even in a time of financial turmoil, a reliable means to provide retirement security to millions of Americans. We recommend, in particular, two areas for reform: covering more workers and improving disclosure. First, the system could cover even more workers through tax incentives and streamlined administrative requirements to encourage employers to offer retirement savings plans to their workers. A number of proposals have been aired and we look forward to working with the Committee and other policymakers on these issues in the 111th Congress.

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[21] See Thrift Savings Plan, L Funds Fact Sheet, available at http://www.tsp.gov/rates/fundsheet-lfunds.pdf.

[22] See testimony of Gregory T. Long, Executive Director, TSP, Before the House Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia (April 28, 2008), available at http://www.tsp.gov/curinfo/pressrel/2008April29-testimony-GregLong.pdf. The House passed a bill (H.R. 1108) on July 30, 2008 that would add autoenrollment features to TSP.

[23] See Special Message from TSP Executive Director (October 8, 2008), available at http://www.tsp.gov/curinfo/login/2008Oct7-Message-Exec-Direct.pdf.

Realistic goals are critical for increasing workplace plan coverage. Recent comprehensive research by the Institute[24] shows that employers that do not offer plans tend to have workforces that are less likely to value and utilize retirement savings—such as younger workers whose savings is focused instead on education, home purchase, or building a savings cushion. Lower-income workers are less likely to have, currently, the ability to save for retirement — and Social Security replaces a higher proportion of their working earnings. In contrast, most workers who are likely to have the ability to save and to be focused primarily on saving for retirement are covered by an employer-provided retirement plan. Reform should recognize the differing savings needs of the American workforce.

Second, the system could be improved by requiring consistent and transparent disclosure of key investment and fee information in all participant-directed defined contribution plans. The Institute consistently has supported improvements in 401(k) plan disclosure that gives participants and plan sponsors the information they need to make the decisions charged to them. We agree that this Committee should focus on this issue and continue its oversight of the Department of Labor's efforts. The Department of Labor will soon complete comprehensive regulations that should close the gaps that exist under current regulations. Successful completion of the Department's initiatives is in the interest of plans and participants and will assure that improved disclosure is implemented most quickly.

Some have suggested that the recent market downturn, which has been felt in all parts of the U.S. economy and throughout the world, shows that 401(k) plans are a failure.[25] We strongly disagree. The employer-based retirement system plays a critical role in ensuring retirement security for millions of Americans, and the best evidence is the thousands of employers – including federal and state governments – and millions of workers who have entrusted trillions of dollars of their retirement savings to this system.

One witness at the October 7 hearing proposed to replace 401(k) plans with a new government system funded with mandatory contributions to the Treasury (i.e. taxes). This proposal would eliminate the tax incentive for employers to offer, and workers to participate in, a 401(k) plan, and instead require an additional 5 percent payroll tax that would be paid to the government in exchange for the government "guaranteeing" a return of 3 percent over inflation.[26]

The United States already has a system of guaranteed retirement income funded by taxes—Social Security—and one of the most crucial tasks in addressing retirement security in the future is

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[24] See Brady and Sigrist, *Who Gets Retirement Plans and Why*, ICI Perspective, vol. 14, no. 2 (September 2008), available at http://www.ici.org/pdf/per14-02.pdf.

[25] This assumes that a system in which participants control their own account, with both the risk and reward associated with that, is somehow unsustainable. Recent developments in the defined benefit system that places the investment risk on the employer have shown that system is not safer or more sustainable. It is difficult for a mobile workforce to accumulate significant benefits under defined benefit plans. Many employers have decided that they cannot sustain their defined benefit plans and compete in the global economy. The market downturn and the new funding and accounting rules have put even more pressure on these plans. While defined benefit plans will continue to play an important role in sectors of our economy, they never were and never will be universal.

[26] This would, in effect, be the world's largest cash balance plan.

ensuring that Social Security continues to provide adequate benefits to workers. It cannot be overemphasized that workers with low to moderate lifetime earnings have historically and will continue to replace most of their pre-retirement earnings through Social Security. We look forward to working with policymakers on proposals to strengthen and sustain the Social Security system so that it can continue to provide adequate benefits to workers with low to moderate lifetime earnings.

The recent market turmoil highlights the need to continue the improvements started in the Pension Protection Act to make the 401(k) system stronger, more resilient and more transparent, to bring more employers into the system, and to continue to help workers make smart decisions—not to dismantle the current retirement system. We applaud the Committee for examining this important topic and look forward to continuing to work with the Committee and its staff through this difficult time.

[The statement of Mr. Altmire follows:]

Prepared Statement of Hon. Jason Altmire, a Representative in Congress From the State of Pennsylvania

Thank you, Chairman Miller, for holding this important hearing on the impact of the financial crisis on workers' retirement security.

The recent events in the global financial markets have highlighted the vulnerability of American's retirement plans. Over the last year, American workers have lost nearly $2 trillion in retirement savings. The problems we are now confronting in the financial market bring to light the problems that have plagued our nation's retirees for years. The American Association for Retired People (AARP) reported that in the last year, 20 percent of baby boomers have stopped contributing to their retirement plans because they need that money at the end of the month to make ends meet. Additionally, the AARP found that about a third of workers in the U.S. are considering delaying retirement as a result of the housing and financial crisis.

Americans have worked hard throughout their lives believing that they would one day be able to enjoy retirement, but instead are forced to put their retirement on hold. Action must be taken to stabilize our markets and ensure protection for American workers' retirement.

Thank you again, Mr. Chairman, for holding this hearing. I yield back the balance of my time.

[Submission of Mr. Sestak follows:]

U.S. CONGRESS,
Washington, DC, October 21, 2008.

Hon. GEORGE MILLER, *Chairman;* Hon. HOWARD MCKEON, RANKING MEMBER,
Committee on Education and Labor, Rayburn House Office Building, Washington, DC.

DEAR CHAIRMAN MILLER AND RANKING MEMBER MCKEON: At the request of Vanguard, a well-established financial institution based in my district, I am submitting the attached report as written testimony to be included in the record of the House Committee on Education and Labor's hearing on October 7, 2008, on "The Impact of the Financial Crisis on Workers' Retirement Security". As I have discussed with the Vanguard representative, I respect their right to have their views heard, but I am not necessarily in full agreement with all of their conclusions.

Sincerely,

JOE SESTAK,
Member of Congress.

Written Statement of R. Gregory Barton
Managing Director
Vanguard

Submitted to the
House Education and Labor Committee
U.S. House of Representatives

"The Impact of the Financial Crisis on Workers' Retirement Security"

October 21, 2008

Vanguard appreciates the opportunity to submit written testimony to be included in the record of the House Committee on Education and Labor's hearing on October 7, 2008 on "The Impact of the Financial Crisis on Workers' Retirement Security."

Vanguard administers defined contribution plans for over three million participant accounts serving 1,800 organizations, including large, medium and small companies in both the for-profit and non-profit sectors. Vanguard offers a broad array of high-value investment options, including mutual funds, stable value funds, and commingled trust funds. We also provide a wide variety of investment education and advice services to plan sponsors and their participants. Our mission is to partner with plan sponsors to improve the retirement security of their participants. We do this with a deep commitment to fiduciary best practices, transparency and plain talk disclosure, and a low-cost value proposition. This substantial experience with thousands of employers and millions of plan participants positions us well to provide insight on the impact of the current financial crisis on retirement security.

Perspective on Market Turmoil

Clearly, the recent market turmoil is unprecedented when evaluated by any measure. As we have advised plan sponsors, plan participants and retail shareholders over recent days and weeks, we are confident of one thing in the midst of the uncertainty in the financial markets – this turmoil will surely end and the markets will stabilize. This is the tenth bear market since 1958 and, although the duration and cause of each one varies, we do know that they end and that investors who avoid rash action and stay the course are best positioned to reap the benefits of their prudence.

Our investment philosophy guides us and our shareholders in these difficult times and reinforces the importance of a long-term perspective and a diversified approach to investing. Although we have seen a rise in exchange activity (purchases and redemptions of shares) by defined contribution plan participants in recent weeks, a large majority of plan participants are not taking action at this time, which is a testament to their own good judgment. The essentials of prudent investment remain the same: diversify, rebalance, keep investment costs low, and maintain a long-term perspective.

Defined Contribution Plans are a Cornerstone of Americans' Retirement Security
A consistent theme expressed by the witnesses at the hearing was concern about the inadequacy of defined contribution plans as compared to defined benefit plans, in part due to increased risk inherent in defined contribution plans. Both types of plan design pose risk, although there are different risks inherent in each. Moreover, as a major provider of investment management and administration for defined contribution and defined benefit plans, we respectfully and emphatically disagree with the premise that defined contribution plans are unable to deliver adequate retirement income.

For decades, defined benefit pension plans have provided meaningful benefits to many individuals, but they are not without risk to American workers. Participants in defined benefit plans have less control over their benefit than those in defined contribution plans. Defined benefit plan participants forfeit future benefit accruals if they change jobs, if their firm fails, if their plan is frozen, or if it is terminated with inadequate funding and transferred to the Pension Benefit Guaranty Corporation. Their benefits are typically not adjusted for inflation and so the value erodes over time. This can be particularly damaging if a participant is relying on a deferred annuity payment.

Defined benefit plan payments make up a significant component of retirement assets for many current retirees, and defined benefit pension plans remain a vital component of the total benefits package for a shrinking, but still significant, number of private and public sector employers. But, the fact is that most participants now and in the future will rely on defined contribution plans for their employment-based retirement savings. Of course, two-thirds of all workers will receive a significant portion of their retirement income from a defined benefit system – Social Security. Importantly, Social Security pools risk and provides an indexed annuity. In fact, data show that low-wage workers who take advantage of opportunities to save through a defined contribution plan will, when those savings are combined with Social Security benefits, replace more than 100% of their pre-retirement income.[1] In addition, when assessing retirement income adequacy it is also important to consider other savings such as bank deposits and other household assets.

Although it is true that participants in defined contribution plans are subject to market risk, well-designed plans are, and will continue to be, ideally positioned to provide retirement security.

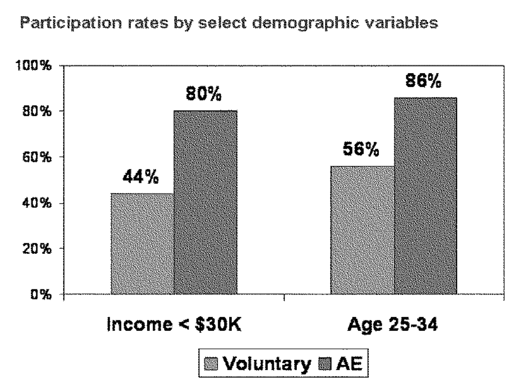
Historic Defined Contribution Plan Improvements Recently Adopted

The Pension Protection Act of 2006 contained the most sweeping changes to the defined contribution system since the passage of ERISA. Building on years of plan experience and insights from research on behavioral finance, the PPA fundamentally altered the way most defined contribution plans will be designed in the future. The very characteristics we value in defined benefit plans – universal participation and professional investment management – will now be available to an increasing number of defined contribution plan participants through auto-enrollment and default investing. The adoption of these new designs is occurring at an unprecedented pace. And, the market is increasingly focused on how to replicate another feature of defined benefit plans, lifetime payouts, in a defined contribution environment. Significantly altering the tax incentives that are part and parcel of the defined contribution plan system interrupts the highly beneficial innovation to which the PPA gave momentum.

[1] See Employee Benefits Research Institute Issue Brief No. 283, 2005.

The following describes some of the innovation that is occurring in defined contribution plans, innovation that we believe will fulfill the promise to American workers of a retirement savings vehicle that is portable, secure and capable of generating sufficient retirement income.

Automatic Enrollment. The PPA endorsed an innovative plan design that, somewhat paradoxically, harnesses the power of participants' inertia by automatically enrolling them in a 401(k) plan and automatically increasing their savings deferrals over time. Behavioral finance undergirds the effectiveness of this plan design and Vanguard's research on the early results of this design is quite positive. For participants with incomes lower than $30,000, automatic enrollment has increased the participation rate from 44% to 80%. For participants in the 25-34 age bracket, automatic enrollment has increased participation from 56% to 86%.[2] These are significant improvements over such a short period of time.



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[2] See Vanguard Center for Retirement Research, "Measuring the Effectiveness of Automatic Enrollment," 2007.

Retirement security is dependent on individuals saving early and consistently throughout their working careers. This plan design encourages plan sponsors to assist their employees in doing just that. Employers have begun to embrace PPA's innovations to the great benefit of their participating employees.

Qualified Default Investments. Another significant reform initiated by the PPA was the provision of fiduciary relief for sponsors who default participants who have taken no affirmative action with respect to the investment of their accounts into a qualified default investment alternative ("QDIA"). By design, QDIAs ensure that participants' accounts have appropriate, long-term exposure to equities. As amply documented in the preamble to the QDIA regulations, the Department of Labor ("DOL") took great care to identify QDIAs that would prudently enable long-term retirement investors to have risk-appropriate exposure to the equity markets. The regulations are sufficiently flexible to permit plan sponsors to select target date maturity funds, a balanced fund, or a managed account option. That means that sponsors can and should evaluate what type of equity exposure they think is appropriate for their participants. For example, they can select a balanced fund that has 40 or 50 or 60% equity exposure. Or, they can choose a target date fund with a glide path that eases into fixed income earlier than another one.

In addition, the QDIA regulations encourage sponsors to be even more innovative in their plan design. At Vanguard, we have begun to see innovations already, as plan sponsors actively consider "reenrolling" some or all of their participants into a QDIA as a mechanism to re-set their asset allocation and immediately get their participants on a path to retirement security.

The QDIA regime is intended to permit sponsors of defined contribution plans to assist their participants with achieving retirement security. Sponsors are still responsible for selecting and monitoring all investment options, including the QDIA, so plan participants continue to have the benefit of the oversight provided by fiduciaries. Having a diversified portfolio is a critical component of achieving retirement security. The course set by the PPA on this important initiative should not be altered and certainly not in a time of market turmoil.

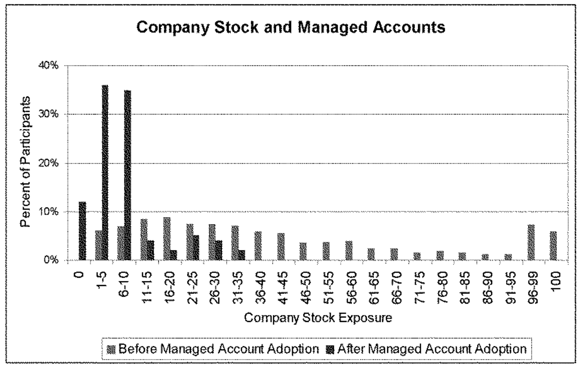
Since the passage of ERISA, plan sponsors and providers have been the drivers of innovation in the defined contribution plan system and have availed themselves of the flexibility that ERISA provided them in structuring their retirement programs. Plan sponsors who work with us have relied on the fundamentals of modern portfolio theory to make a wide variety of low cost and transparent mutual funds and other investment vehicles available to their participants, thereby ensuring that their participants have been and will continue to be able to take advantage of developments in the marketplace and the democratization of the markets. Congress should continue to encourage this kind of innovation on the part of the marketplace and plan sponsors.

Advice. The PPA also provided plan sponsors with the ability to arrange for the provision of investment advice to their participants without fear of increased fiduciary liability. There is no doubt that sponsors often feel under fire due to the increasingly litigious environment in which they operate, as well as the maze of regulatory burdens that accompanies the sponsorship of retirement plans. They want to do right by their participants and many feel that this includes providing their participants with much-needed investment advice so as to enable them to have a better diversified portfolio. The PPA gave the green light to this. As this committee knows, the DOL issued proposed regulations very recently implementing the advice provisions of the PPA. We believe that the regulations include important safeguards to ensure that participants receive professional investment advice from providers who fully disclose their fees and take on fiduciary responsibility for the advice they provide. This type of regime provides participants with necessary protections, while affording them much-needed access to professional investment advice.

For years, Vanguard has provided a range of investment education and advice to plan participants. Our products and services have evolved as research on behavioral finance has informed our perspective. We continue to offer a robust array of education services, but we have increasingly offered a range of advice programs that are responsive to what sponsors and participants need, whether that is a computer-based modeling program, actual account management, or individual consultation with a certified financial planner. Individuals need and deserve investment advice that is provided by professionals in a regulated and fully transparent manner and in a form that suits their needs.

One of our offerings is specifically targeted to those reaching retirement age – Vanguard Financial Plan 55+ – and provides for a consultation with a CFP and an annual check-up. Another of our advice products provides ongoing asset management for those participants who want to take a hands-off approach to investing. Our experience with this product – our managed account program – proves that professional asset management can be provided at a very reasonable cost to "rank and file" participants providing them with a risk-appropriate, well- diversified portfolio. Vanguard studied the impact of our managed account program on participant portfolios and found that 62% of participants in the study saw their equity exposure increase by an average of 39 percentage points; 30% saw an average equity reduction of 18 percentage points; and, at the extremes, 27% moved from an all equity or no equity portfolio to a balanced portfolio.[3] These results indicate that low-cost, professional advice can have a very significant and positive impact on portfolio construction.

[3] See Vanguard Center for Retirement Research, "Managed Accounts and Participant Portfolios," 2006.



Employer Stock Reforms. The Committee is rightfully concerned about some participants' overconcentration in employer stock, but that concern should be placed in perspective. First, the majority of participants in Vanguard-administered plans, 65%, do not have employer stock as an investment option. Second, in a post-Enron environment, most plan sponsors with employer stock as an investment option have been increasingly sensitized to the importance of advising participants to limit their exposure to company stock. Third, the PPA imposed required diversification rights on most defined contribution plans so that all participants have the right to diversify out of company stock after 3 years of service and are required to be provided a notice of their right to do so. In our experience, most plan sponsors now permit immediate diversification. In addition, the expansion of access to investment advice should result in lower concentrations in employer stock. Our managed account program, for instance, limits a participant's exposure to employer stock to 20% of their portfolio. Finally, we have seen a meaningful shift in stock holdings among plans Vanguard administers. The number of participants in plans with company stock and holding a concentrated position of more than 80% of their account balance fell almost by half, from 15% in 2005 to 8% in 2007.[4] We expect this trend to continue and urge the Committee to give this reform time to take full effect.

Concern About Retirees and Those Nearing Retirement

We know based on our many interactions with older investors that they are concerned about their retirement nest eggs. This is understandable given the recent market turmoil. The media has fueled the anxiety by reporting that too many older investors are overexposed to equities and will not be able to recover from this bear market. A few important points bear mentioning here. First, as people near and enter retirement, their investing horizon is still quite lengthy – frequently measured in decades. Diversification over this time period permits their portfolios to recover over time. Second, data for the plans we administer do not support the proposition that older participants are over-invested in equities. The average pre-retiree at Vanguard has allocated 67% of assets to equities, which, again, appears appropriate in light of their likely retirement timeframe. Third, continuing innovations on the spend-down phase will support older participants in the years ahead so they can manage investment risk over their retirement years.

Finally, it is important to note that many participants do not take immediate distributions from their plans. During 2007, about one-third of all Vanguard participants could have taken their account balance as a cash distribution because they had separated from service in the current or prior years. However, only 17% of these participants did so, while the majority (83%) continued to preserve their plan assets for retirement by either remaining in their employer's plan or rolling over their savings to an IRA or a new employer plan. There are similar patterns of continued deferral of payment for participants who reach retirement age. Participants in Vanguard-administered plans who terminated employment in 2007 bear that out. Of participants in their 60's, 38% deferred distribution and another 42% rolled over their account to an IRA. Participants in their 70's were somewhat similar, in that 20% remained in the plan, 34 % rolled over, and 10% took installment payments (presumably required minimum distributions).[5] This

[4] See How America Saves 2008, Vanguard.
[5] Id.

continued deferral of payment into and beyond retirement age suggests that QDIAs – in particular target date funds – provide a real service to participants in managing the drawdown phase, as well as the fact that many plan participants do not need immediate access to their accounts.

What's to Come

While much progress has been made, and we strongly urge Congress to give the recent reforms time to take full effect, important gaps in our retirement system have been identified that we think merit close attention and action: increasing coverage and assisting participants with the drawdown phase of their investing career. For many Americans, the issue is not the adequacy of their 401(k) balance, it is the existence of a balance at all. Forty-five percent of American workers do not have access to an employer-provided plan.[6] The coverage problem is real and one that Congress should address. The 401(k) system is not broken – it needs to be able to cast a wider net to ensure that more Americans can plan and prepare for their retirement.

Similarly, Congress needs to let investment and insurance providers continue to innovate in the area of retirement income products and solutions. Vanguard is deeply committed to this and has a variety of annuity products and investment payout options available to help retirees manage the spend down phase. Our research highlights how diverse the needs and desires of retirees are in this area. More research and product innovation needs to occur before we legislate in this area.

Conclusion

In these times of market turmoil, Vanguard is committed to its bedrock principles of diversification, prudence and low-cost investing. That guides us in serving the sponsors and participants who partner with us on their retirement. There will always be periods where investments in the financial markets lose value and this will impact preparation for retirement. No retirement system can be designed to avoid this. Experience has shown

[6] See National Compensation Survey, U.S. Department of Labor, U.S. Bureau of Labor Statistics, 2007.

that the perceived impact of short-term turmoil like we've experienced recently lessens as time passes and markets recover. It may be wise to avoid drastic policy changes while in the midst of the crisis. We urge this Committee to let the reforms of the PPA continue to motivate the private sector to make enhancements in the defined contribution system. Continued evolution of the defined contribution system will enable employers, service providers, and financial institutions to continue to make strides in enhancing the retirement security of all American workers, retirees and their families.

[Whereupon, at 3:21 p.m., the committee was adjourned.]