# Lessons from the Financial Crisis for Retirement Security: Building Better Retirement Plans

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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

[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.

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).

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

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]

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

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

[4] Calculations based on BOG (2008).
[5] Calculations based on BOG (2008).

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

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[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.

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]

[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.

## 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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