Statement before the House Committee on Education and the Workforce
Subcommittee on Health, Employment, Labor, and Pensions
On

"Retirement Security: Challenges Confronting Pension Plan Sponsors, Workers, and Retirees"

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The views expressed in this testimony are those of the author alone and do not necessarily represent those of the American Enterprise Institute.

Chairman Roe, Ranking Member Andrews, and other members of the subcommittee, thank you for the opportunity to appear before you this morning and discuss an important aspect of retirement security. My name is Alex Brill, and I am a research fellow at the American Enterprise Institute. I commend the Committee for holding this hearing and recognizing that beyond our near-term economic and fiscal challenges, there exist important longer-term policy concerns such as those relating to retirement security.

Introduction

Sound retirement security policy for future retirees requires planning. Ensuring the goal of adequate asset accumulation at retirement necessitates sufficient savings throughout an individual's career. To that end, workers need to be engaged; employers need to be responsible; and policymakers must ensure that pension law, tax law, and the Social Security system operate in a manner that promotes opportunities for private saving, appropriate retirement asset management, and sustainability and predictability. Together, these programs should complement the goal to strengthen the financial security of our workforce.

Pension issues represent a policy area of great concern and with serious long-term consequences. In my view, funding challenges facing defined benefit (DB) plans and inadequate asset accumulation and risk management within defined contribution (DC) plans are under-appreciated long-term risks facing future retirees. These risks are both macroeconomic and microeconomic in nature. From a macroeconomic perspective, inadequate national savings reduces investment, a key determinant to future economic growth and prosperity. At a microeconomic and organizational level, inadequate funding of DB plans poses risks to employers; retirees; and the government backstop, the Pension Benefit Guaranty Corporation.

Proper preparation for workers' eventual retirement is a critical public policy. Yet, while numerous policies exist for this purpose, too many workers' retirements are underfunded. And this underfunding was only exacerbated by the recent financial crisis and recession.

With this in mind, my testimony is organized into three sections, intended to provide a framework for moving forward in the realm of pension policy. First, I will examine the size and scope of the retirement system and the shift in recent years from DB plans toward DC plans. Then, I will discuss the financial crisis and great recession's effects on pension plans and retirement savings. And finally, I will conclude with three policy observations for consideration as the Committee proceeds with its oversight of these areas.

Size, Scope, and Shortcomings of Retirement System

In the fourth quarter of 2010, retirement assets in the U.S. totaled $17.5 trillion.[1] Individual Retirement Accounts totaled roughly 27 percent of all retirement savings in the

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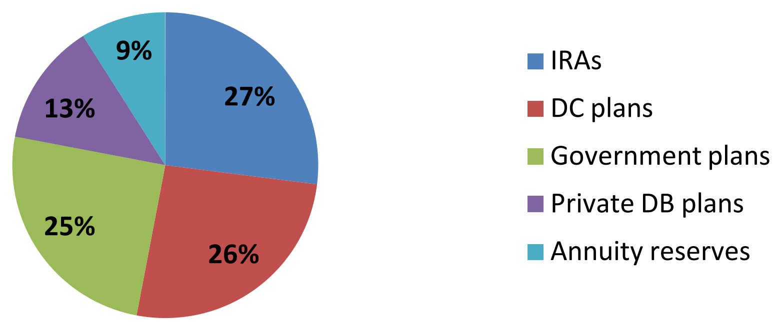
[1] Investment Company Institute, "Retirement Assets Total $17.5 Trillion in Fourth Quarter 2010," April 13, 2011, www.ici.org/pressroom/news/ret_10_q4.

United States. DC plans accounted for approximately 26 percent—with 401(k) assets accounting for 69 percent of DC plan assets and 18 percent of all retirement assets. The remainder of retirement assets was held in government pension plans (25 percent), private DB plans (13 percent), and annuities (9 percent).[2] Figure 1 presents this information graphically. At the end of 2010, retirement savings made up 37 percent of all household financial assets.[3]

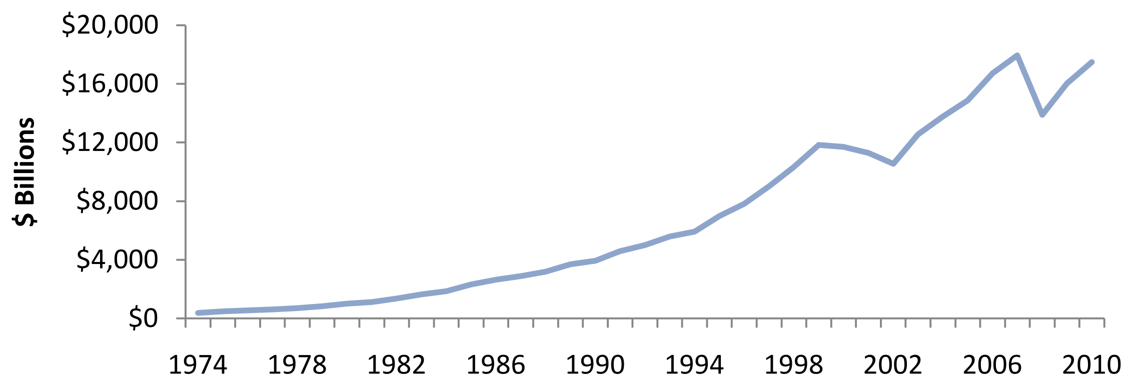
Figure 1. Share of U.S. Retirement Assets by Plan Type



Source: Investment Company Institute.

Total retirement assets have generally grown over time, with the exception of the significant, but temporary, decline in equity values that occurred in 2008–2009. As portrayed in Figure 2, retirement savings have increased from $368 billion to $17.5 trillion since 1974.

Figure 2. Total U.S. Retirement Assets



Source: Investment Company Institute.

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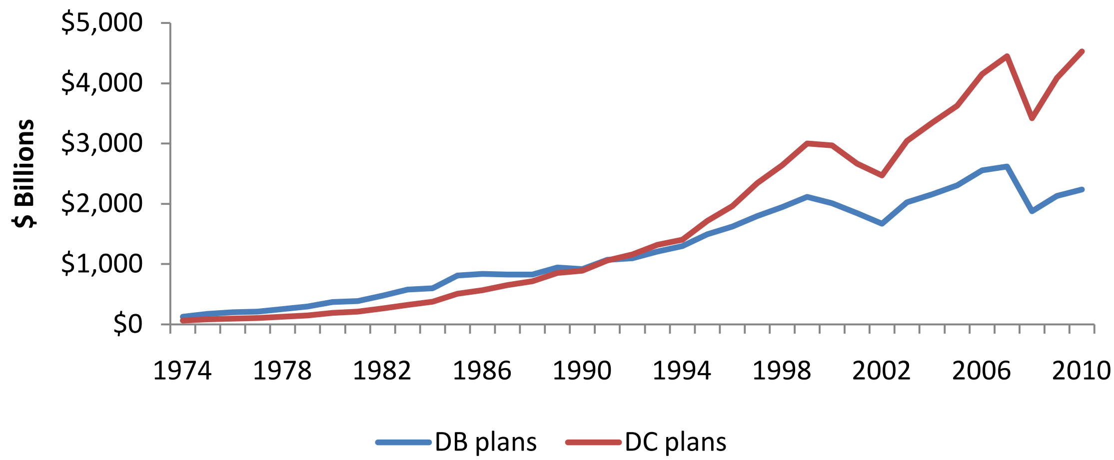
[2] Ibid.
[3] Ibid.

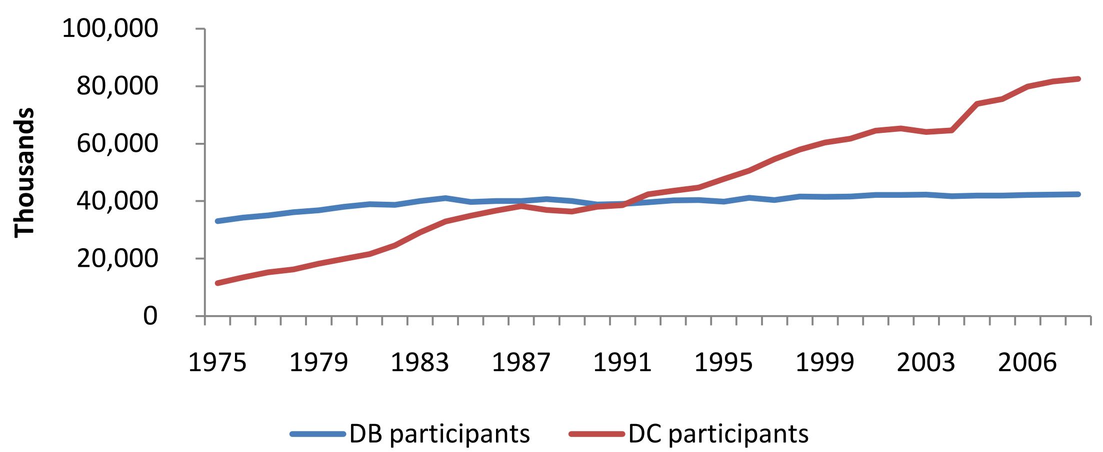
While overall retirement saving has been increasing, there has been a shift among the types and proportion of retirement assets. Figures 3 and 4 show the rise in assets and participants in private-sector DC accounts over DB plans.

Figure 3. Private Employer-Sponsored Retirement Plan Assets



Source: Investment Company Institute.

Figure 4. Private Employer-Sponsored Retirement Plan Participants



Source: Department of Labor.

Though assets and participation are rising, serious problems still persist in these two areas. In terms of participation, while 65 percent of private-sector workers have access to retirement plans, only 50 percent participate.[4] Among state and local government workers, the numbers improve: 90 percent have access, while 85 percent participate.[5]

In terms of underfunding, an assessment by the Employee Benefit Research Institute (EBRI) of the adequacy of Baby Boomers' DC plans to see them through retirement shows that in 2010, 47 percent of "early Boomers" (born between 1948 and 1954) and 44 percent of "late Boomers" (born between 1955 and 1964) were "at risk" of not having enough money for retirement. The "at risk" rating for Gen Xers (born between 1965 and 1974) was 45 percent.[6]

Underfunding is also a problem in both public and private DB plans. State and local government plans are generally DB plans and number over 2,500 nationwide. The Congressional Budget Office recently measured unfunded liabilities of state and local pension plans using two approaches—the Government Accounting Standards Board (GASB) and a more standard fair-value method—and found that plan funding levels are only 80 percent, a shortfall of approximately $600 million by GASB rules in 2009, and underfunding of $2 trillion–$3 trillion by fair-value methods.[7] Using fair-value accounting, the funding ratio of state and local pensions' assets to future liabilities is near 50 percent.[8] The larger funding deficit identified by the fair-value approach reflects differences in actuarial methodology between GASB and measurement assumptions similar to those used by private DB plans. Because public pension underfunding is not adequately measured by GASB standards, the significantly greater underfunding estimate of these plans as measured by fair-value methods is more informative. While beyond the scope of this hearing, the funding status of public pensions should be a matter of important concern for policymakers.

Corporate DB plans are generally better funded than government plans, but still many are significantly underfunded. According to the firm Towers Watson, among Fortune 1000 companies the average ratio of plan assets to projected benefit obligations was 0.77 for 2009, the latest year for which information was available from this source.[9] Funding status improved from 2008 to 2009 as equity values increased significantly and plan contributions were abnormally

[4] Bureau of Labor Statistics, "Table 1. Retirement Benefits: Access, Participation, and Take-up Rates," July 27, 2010, www.bls.gov/news.release/ebs2.t01.htm.
[5] Ibid.
[6] Jack VanDerhei, "Retirement Income Adequacy: Alternative Thresholds and the Importance of Future Eligibility in Defined Contribution Retirement Plans," *EBRI Notes* 32, no. 4 (April 2011), www.ebri.org/pdf/notespdf/EBRI_Notes_Apr11.RSPM.pdf.
[7] Congressional Budget Office, "The Underfunding of State and Local Pension Plans," May 2011, www.cbo.gov/ftpdocs/120xx/doc12084/05-04-Pensions.pdf. See also Alicia H. Munnell, Jean-Pierre Aubry, and Laura Quinby, "The Funding of State and Local Pensions: 2009–2013," Center for Retirement Research, April 2010, http://crr.bc.edu/images/stories/Briefs/slp_10.pdf.
[8] Alicia H. Munnell, Jean-Pierre Aubry, Josh Hurwitz, Madeline Medenica, and Laura Quinby, "The Funding of State and Local Pension in 2010," Center for Retirement Research, May 2011, http://crr.bc.edu/images/stories/slp_17_508.pdf
[9] Towers Watson, "Accounting for Pensions and Other Postretirement Benefits, 2010: Reporting Under U.S. GAAP Among the Fortune 1000," November 2010, www.towerswatson.com/assets/pdf/3178/TW_AcctngForPension_NA-2010-17799_perspective.pdf .

high. Nevertheless, 31 percent of companies had funding ratios less than 0.70. Towers Watson also reports the values of plan assets, $1.11 trillion, and liabilities, $1.36 trillion. The net gap was $250 billion at the end of 2009. More recent data released by the actuarial firm Milliman indicate that the benefit funding ratio at the 100 largest corporations improved again modestly in 2010 relative to 2009 as a result of large plan sponsor's contributions.[10]

With regard to plan asset allocation, there has been a marked shift toward more diversification in recent years. Fidelity Investments data on corporate DC plans representing 11 million participants indicate that the share of participants holding either 100 percent or 0 percent of their assets in equities has declined from 47 percent in 2000 to 21 percent in 2010.[11] Research by economist Mark Warshawsky estimates that the share of DB assets allocated to equities has declined from 62 percent in 2006 to 45 percent in 2009.[12]

Financial Crisis and the Great Recession

The U.S. economy is recovering from worst recession since the 1930s. While the recession has been officially over for two years, economic growth remains weak, and high unemployment is persistent. Recent evidence of a decline in hiring is troubling for many forecasters as a durable recovery has yet to take hold.

The impact of the recession and financial crisis on retirement security is twofold. A decline in retirement assets (or the failure for assets to increase in value as expected) has left many workers and retirees with less than anticipated. Some older workers have chosen to remain in the workforce longer to offset the decline in retirement assets, but the overall unemployment rate of older workers remains high relative to pre-recession levels. And younger workers unable to find jobs due to the weak economy are not contributing to employer-provided retirement plans, thereby also reducing future retirement income and security.

Barbara Butrica, Richard Johnson, and Karen Smith of the Urban Institute employ a large simulation model with a sample of over 100,000 individuals to project the impact of the recession on individuals in the workforce in 2008.[13] Their results indicate that the recession will reduce average annual retirement wages at age 70 by 4.3 percent. However, this decline is not primarily the result of the decline in equity values. As they describe:

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[10] John W. Ehrhardt and Paul C. Morgan, "Milliman 2011 Pension Funding Study," March 2011, www.milliman.com/expertise/employee-benefits/products-tools/pension-funding-study/pdfs/2011-pension-funding-study.pdf.

[11] Fidelity Investments, "DC Participant Behavior," presentation, May 2011.

[12] Mark J. Warshawsky, "Corporate Defined Benefit Pension Plans and the 2008–2009 Financial Crisis," Pension Research Council Annual Conference, Wharton School, May 5–6, 2011.

[13] Barbara A. Butrica, Richard W. Johnson, and Karen E. Smith, "The Potential Impact of the Great Recession on Future Retirement Incomes," May 2011, Center for Retirement Research, http://crr.bc.edu/images/stories/Working_Papers/wp_2011-9_508.pdf.

> This drop results almost entirely from the anemic wage growth that occurred during the recession, which the model assumes will permanently reduce future wages. Employment declines will have little effect on future aggregate retirement incomes because most workers remained employed during the recession and the losses that occurred are generally inconsequential when averaged over an entire career. Retirement incomes will fall most for high-socioeconomic-status groups, who have the most to lose, but relative income losses will not vary much across groups. Those workers who were youngest when the recession began will be hit hard. They are most likely to have lost their jobs and the impact of lower wages will accumulate over much of their working lives. But retirement incomes will also fall substantially for those in their late fifties in 2008, because the drop in the economy-wide average wage will lower the index factor in the Social Security benefit formula, permanently reducing their annual benefits. Also, many workers who lost jobs late in life will never become reemployed.[14]

With regard to the direct effect of the financial crisis and subsequent recession on pension plans, three metrics can be employed to gauge the impact: market impact, plan and participant behavioral change, and estimated asset adequacy risk for future retirees.

Market decline. The S&P 500 plunged over 40 percent from the third quarter of 2008 through the first quarter of 2009. At the lowest point (first quarter of 2009), retirement savings in the United States had fallen by $2.7 trillion from pre-recession levels (third quarter of 2007).[15] The stock market, as measured by the S&P 500, recovered by the beginning of 2011, and retirement assets are just 5 percent below peak 2007 levels (adjusted for inflation).[16] But damage was already done for those approaching or in retirement at the time of the recession who held equities as a large share of their retirement portfolio.

Behavioral responses. A recent AARP survey found that over 36 percent of workers over 50 had to stop or reduce retirement saving during the recession, while 9.1 percent were compelled to withdraw funds prematurely from retirement accounts.[17] At the same time, employers were cutting back on matching contributions to employees' DC plans. It is estimated that about 5 percent of all 401(k) participants experienced suspension of employer matches after the recent financial crisis, though these are either in the process of being or are likely to be restored.[18] Recent evidence indicates that 83 percent of active plan participants received an employer match in the year ending March 31, 2011, a 1.3 percentage point increase from the year prior.[19]

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[14] Ibid.
[15] Barbara A. Butrica and Philip Issa, "Retirement Account Balances," fact sheet, Urban Institute Retirement Policy Program, April 2011, www.urban.org/UploadedPDF/411976_retirement_account_balances.pdf.
[16] Ibid.
[17] Sara E. Rix, "Recovering from the Great Recession: Long Struggle Ahead for Older Americans," AARP Public Policy Institute *Insight on the Issues* 50 (May 2011), http://assets.aarp.org/rgcenter/ppi/econ-sec/insight50_recovering.pdf.
[18] Alicia H. Munnell and Laura Quinby, "Why Did Some Employers Suspend Their 401(k) Match?" Center for Retirement Research, no. 10-2 (February 2010), http://crr.bc.edu/images/stories/Briefs/IB_10-2.pdf.
[19] Fidelity Investments, "DC Participant Behavior," presentation, May 2011.

Risk for future retirees. Researchers at Boston College have estimated the number of workers "at risk" after the recession of not having the resources to maintain in retirement their pre-retirement standard of living.[20] They found that the financial crisis increased the number of those at risk as well as the level of risk they face. From 2007 to 2009, the percentage of households whose post-retirement standard of living is at risk at age 65 increased by 5 percentage points (from 44 percent to 51 percent).[21] In a post-crisis analysis of Baby Boomers' and Gen Xers' retirement savings, EBRI estimates that 3.8 percent–14.3 percent of at risk households would not currently be at risk had it not been for the recession.[22]

Policy Issues and Conclusion

While savings behavior and plan assets have improved in recent years, there remains additional retirement security challenges. I would like to conclude my testimony with three broad policy observations. The first relates to the importance of individual responsibility and engagement in one's own retirement security. The second and third points focus on broader macroeconomic issues: the need to increase national savings to encourage economic growth and the need for policymakers to focus more on long-run economic policy matters by promoting structural reforms instead of attempting to micromanage the near-term economy.

Greater individual engagement in retirement savings is essential. A recent EBRI survey found that 27 percent of workers are not at all confident that they will have the funds for a comfortable retirement, while only 13 percent are very confident that they do.[23] One popular approach to the apathy that workers display about their retirement security has been to establish various "automatic default" strategies to encourage more retirement savings. Facilitated by provisions in the Pension Protection Act of 2006, these policies include automatic enrollment in employer-sponsored retirement plans, automatic defaults into lifecycle funds, and auto escalation whereby the employee's contribution in a plan increases over time. The purpose of a lifecycle fund is to invest a worker's DC assets more heavily in equities earlier in an individual's work life and move to less risky investments as retirement approaches. Fidelity Investments reports that the share of plans using lifecycle funds increased from 5 percent in December 2005 to 68 percent in December 2010. The participation rate in plans that provide auto-enrollment of workers in DC plans is 82 percent, while the participation rate in non-auto-enrollment plans is only 56 percent.[24]

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[20] Alicia H. Munnell, Anthony Webb, and Francesca Golub-Sass, "The National Retirement Risk Index: After the Crash," Center for Retirement Research, no. 9-22 (October 2009), http://crr.bc.edu/images/stories/Briefs/IB_9-22.pdf.
[21] Ibid.
[22] Jack VanDerhei, "A Post-Crisis Assessment of Retirement Income Adequacy for Baby Boomers and Gen Xers," *EBRI Issue Brief*, no. 354 (Employee Benefit Research Institute, February 2011), www.ebri.org/pdf/briefspdf/EBRI_02-2011_No354_Post-Crisis_Ret-IncAd.pdf.
[23] Ruth Helman, Craig Copeland, and Jack VanDerhei, "The 2011 Retirement Confidence Survey: Confidence Drops to Record Lows, Reflecting 'the New Normal,'" *EBRI Issue Brief*, no. 355 (Employee Benefit Research Institute, March 2011), www.ebri.org/pdf/briefspdf/EBRI_03-2011_No355_RCS-2011.pdf.
[24] Fidelity Investments, "DC Participant Behavior," presentation, May 2011.

While I have been and remain a strong advocate for policies that establish default settings for retirement savings that encourage more participation, more appropriate asset allocation, and higher savings rates, it is important that policymakers understand that these tools should be complements to not substitutes for active education, engagement, and participation by workers in their own retirement planning. Workers need a better awareness of their own retirement security, and this includes an understanding of the risks posed by the current Social Security system as well as the annuity value of their personal retirement assets. Improved financial literacy training, particularly if targeted,[25] and more (not less) appropriate investment advice will contribute to this goal.

Beyond personal retirement security, the macroeconomic consequences of savings are important as well. As I have outlined above, from a microeconomic perspective, increased retirement savings are essential for the well-being of future retirees. But there is a serious macroeconomic concern as well. Long-term, sustainable economic growth comes from businesses and individuals saving and investing. When we save, we defer consumption to the future, allowing our savings to be invested in productive ways that lead to long-term economic growth. In short, my savings account is your investment fund. Our collective savings are the funds available for investing in stocks, bonds, and other securities that allow businesses access to the capital they need to grow. In other words, increasing retirement savings helps improve our economic situation and enable growth.

Policymakers have been plagued in recent years by a myopic fiscal agenda that jeopardizes long-term retirement security. U.S. fiscal policy tilts heavily toward near-term economic, fiscal, and budget concerns at the expense of longer-horizon policy risks. The 2009 stimulus bill, the American Recovery and Reinvestment Act, pumped hundreds of billions of dollar into the economy in an ill-fated attempt at Keynesian stimulus. While adding nearly $1 trillion to the debt, that legislation accomplished little in terms of reducing unemployment and returning our economy to a path of self-sustaining growth. Retirement policy suffers from a similar myopia. The Social Security system, not in crisis today but facing a certain and significant shortfall in two short decades, is being ignored. Medicare, while recognized by some as an unsustainable program as currently constructed, lacks the bipartisan cooperation necessary to achieve meaningful savings through policies geared at reducing utilization and increasing beneficiary responsibility. More broadly, the projected rise in the debt burden as a share of GDP in the absence of serious spending reform poses additional threats to our economy, including the asset values and incomes of retirees.

In conclusion, I would like to thank the Committee for the opportunity to testify on the important topic of retirement security. I look forward to answering your questions.

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[25] Annamaria Lusardi and Olivia S. Mitchell, “Financial Literacy and Retirement Planning in the United States,” National Bureau of Economic Research, Working Paper no. 17108, June 2011.