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BEFORE THE
SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

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Introductory Remarks

Good afternoon Chairman Kohl, Ranking Member Corker, and Members of the Committee. Thank you for inviting me to discuss target date funds and the Department of Labor's activities with regard to the use of target date funds in retirement plans. I am Phyllis C. Borzi, the Assistant Secretary of Labor for the Employee Benefits Security Administration (EBSA). Our mission is to protect the security of retirement, health, and other employee benefits for America's workers, retirees and their families and to support the growth of our private-sector employee benefits system.

EBSA is committed to promoting policies that encourage retirement savings and protect employer-sponsored benefits. The growth of target date funds as an investment option in participant-directed individual account plans over the past few years has been significant. At the end of 2008, an estimated 75 percent of 401(k) plans offered target date funds as an investment option.[1] Target-date funds have been under scrutiny this past year for exposing investors and plan participants to the market downturn. Many funds with the same target retirement date have investments that differ significantly. Some are invested more aggressively in stocks. Such differences in target date funds, and associated differences in recent investment performance, have prompted questions about whether plan fiduciaries and workers have an adequate understanding of target date funds, and their benefits, risks and costs.

[1] *See e.g.*, Jack VanDerhei et al., 401(k) Asset Allocation, Account Balances, and Loan Activity in 2008, Employee Benefit Research Institute Issue Brief No. 335 (Oct. 2009).

The Department shares the Committee's interest in examining whether target date funds provide workers with a secure retirement. The retirement security of American workers increasingly depends upon their individual investment decisions as employers are sponsoring more self-directed defined contribution plans. My testimony today will discuss the steps that the Department has taken to review issues relating to the use of target date funds in retirement plans, including the Department's activities related to the designation of target date funds as qualified default investment alternatives. I will discuss what the Department learned at the June joint hearing with the SEC on target date funds. Most importantly, I will explain the Department's oversight role and outreach activities, as well as initiatives that the Department is considering to provide further guidance on target date funds.

Background

EBSA is responsible for administering and enforcing the fiduciary, reporting, and disclosure provisions of Title I of the Employee Retirement Income Security Act of 1974 (ERISA). EBSA oversees approximately 700,000 private pension plans, including almost 460,000 participant-directed individual account plans such as 401(k)-type plans and approximately 49,000 defined benefit plans, and millions of private health and welfare plans that are subject to ERISA. As of 2006, at least 60 percent of private-sector employees participated in defined contribution plans that allow for participant direction, with these plans covering more than 58 million active participants and holding about $2.7 trillion in assets.[2]

Growth of Target Date Funds

Target date funds (also called "lifecycle" funds) generally are investment products that allocate their investments among various asset classes and automatically shift that allocation toward more conservative investments as a "target" retirement date approaches. This shift in asset allocation, often referred to as a fund's "glide path," may

[2] Based on 2006 filings of the Form 5500.

differ significantly among funds with the same target date; even among investment professionals, there is no "perfect" mix.

At year-end 2008, 75 percent of 401(k) plans offered target date funds as an investment option.[3] These plans offered target date funds to 72 percent of participants in section 401(k) plans. Among participants offered target date funds, 42 percent held at least some portion of their plan account in them at year-end 2008.

At the end of the first quarter of 2009, the amount of employer sponsored defined contribution plan assets invested in target date funds totaled $145 billion.[4] This figure was down from the second quarter of 2008, when the amount of employer-sponsored defined contribution plan assets invested in target date funds totaled $186 billion. Even with this difference, the amount of employer-sponsored defined contribution plan assets invested in target date funds has grown significantly over the past decade from $18 billion in 2000, $37 billion in 2003, and $87 billion in 2005.

Qualified Default Investment Alternatives Guidance

In 2006, Congress—in an effort to increase retirement savings by those workers generally reluctant to take an active role in their retirement plans—included in the Pension Protection Act (PPA) provisions to encourage 401(k) plan sponsors to implement automatic enrollment programs. Among other encouragements, the PPA promoted the broader use of automatic enrollment in self-directed defined contribution plans by providing new fiduciary relief under ERISA for plan fiduciaries investing participant assets in certain types of default investment alternatives in the absence of participant investment direction. Under longstanding ERISA provisions, fiduciaries are generally relieved from responsibility for participants' exercise of control over their own accounts, as long as those participants are provided with prudently selected investment options.

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[3] *See e.g.*, Jack VanDerhei et al., 401(k) Asset Allocation, Account Balances, and Loan Activity in 2008, Employee Benefit Research Institute Issue Brief No. 335 (Oct. 2009).
[4] *See e.g.*, Investment Company Institute, The U.S. Retirement Market, First Quarter 2009, ICI Research Fundamentals, Volume 18, Number 5-Q1 (Aug. 2009).

Under this PPA provision, a participant is deemed to have exercised control over assets in his or her account if, in the absence of investment direction from the participant, the plan fiduciary invests the assets in a qualified default investment alternative (QDIA).

In 2007, the Department published a final regulation describing the types of investments that constitute qualified default investment alternatives (QDIAs) and providing relief under ERISA for fiduciaries that select a QDIA for their plan. The regulation specifies three categories of investments that can qualify as QDIAs. One of the categories is an age-based investment fund that changes over time such as a lifecyle or target-date fund that is selected for a participant based on the participant's age, target retirement date or life expectancy. The QDIA regulation defines a target date fund as an investment that: (1) applies generally accepted investment theories; (2) is diversified so as to minimize the risk of larges losses: and (3) is designed to provide varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age, target retirement date, or life expectancy.

The regulation does not contain any requirements regarding the composition of target date funds. Nor does it specify a required ratio of stocks and bonds as the fund nears its target. The preamble to the final regulation reiterates that a fiduciary continues to have the obligation to prudently evaluate, select and monitor any investment option that will be made available to the plan's participants and beneficiaries, regardless of whether the plan includes an automatic enrollment feature or whether the fiduciary seeks to comply with the QDIA regulation. When the Department proposed the QDIA regulation in 2006, it received more than 120 comments, which were generally favorable toward target date funds being included as a QDIA.

Impact of the Economic Downturn on Target Date Funds

The design of target date funds was intended to simplify investing for the typical American, who may not have the time, interest, or expertise to sort through dozens of funds to determine the right mix of investments to suit their retirement needs or risk tolerance. Following the enactment of the Pension Protection Act and issuance of the Department's QDIA regulation, many 401(k) plans changed their default investment funds for their automatically-enrolled participants to QDIAs. For example, in 2007, 22 percent of Vanguard's defined contribution pension plans were utilizing a QDIA and 84 percent of these plans used a target date fund as their automatic enrollment vehicle.[5]

The financial downturn that started in 2008 increased volatility and lowered returns of target date funds.[6] Many target date funds designed for people recently in or near retirement had large losses. For example, funds with target dates labeled 2010 lost as much as 41 percent last year. On average, participants invested in target date funds dated 2010 and 2015 lost about a quarter of their value in 2008. Many of these funds typically held about half of the holdings in stocks, following glide paths that did not significantly reduce that percentage for 5 years or more after the average investor retired. The average fund in the 2050 category declined 39 percent in 2008, while the S&P 500 Index dropped 38 percent.

Responding to these developments, the Senate Aging Committee began an investigation of certain target date funds marketed to 401(k) plans. In preliminary findings shared with the Department and the Securities and Exchange Commission (SEC), the Committee found a wide range of objectives, portfolio compositions, and risks among same-year target date funds. In particular, Chairman Kohl expressed concern over what he called "significant differences" in equity holdings among eight "2010" target date funds, which ranged from eight to 68 percent of assets in funds designed to match risk and return goals

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[5] *See e.g.*, The Vanguard Group, Inc., *How America Saves 2008: A Report on Vanguard 2007 Defined Contribution Plan Data* (2008). See Figures 30 & 31.

[6] Deloitte Financial Advisory Services LLP, *Target Date Funds: Historical Volatility/Return Profiles*, unpublished presentation to the U.S. Department of Labor, Employee Benefits Security Administration (Sept. 30, 2009). In particular, the research found that the 1-year volatility was generally greater than the 3-year volatility and the 1-year returns were lower than the 3-year returns. Deloitte also found that funds with target date 2010 were more volatile in 2008 than they were in 2007. In addition, Deloitte reports that volatility among 2010 target date funds correlated with the fraction of the funds that are invested in stock and small 2010 funds are more heterogeneous in rates of return and in volatility than large funds.

for a worker intending to retire in 2010. In relaying this information, the Committee expressed concern that, given these variations, some investors may be investing in target date funds without being aware of the financial risk. In letters to both the Department and the SEC, Chairman Kohl urged the two agencies to commence a review of target date funds.

Joint DOL/SEC Hearing on Target Date Funds

On June 18, 2009, the Department and the SEC held a joint day-long hearing on issues relating to investments in target date funds and similar investment options by 401(k) plan participants and other investors. The purpose of the hearing was to determine whether additional guidance by either agency would be helpful. The hearing addressed a variety of topics, including: investor and plan participant considerations; exploration of glide paths and underlying investments; plan sponsor considerations; utilization of target date funds in defined contribution plans; understanding, selecting and monitoring target date funds; and disclosures relating to target date funds. The hearing consisted of nine panels, with 39 organizations testifying. A variety of organizations also submitted supplemental testimony and other materials.

A variety of issues, problems and options were discussed at the hearing with certain themes emerging from the testimony. Nonetheless, the panelists generally believed that target date funds continue to be an extremely beneficial investment option for the majority of plan participants. One common concern related to the widely divergent allocations to equities and fixed-income investments, with some concerns expressed as to whether strict limits should be imposed on equity and fixed-income allocations within target date funds. A majority of the panelists were against any sort of mandated one-size-fits all or “range” requirement for target date funds; rather, some argued that customization and choice were ultimately good for the participant.

Several issues were raised with regard to the “glide path,” which refers to the shift in asset allocation as the target date approaches. One panelist discussed that while a glide path generally implements the principles of diversification, rebalancing, and reallocation, glide path variations generally reflect the preferences and judgment of the individual investment manager. Some panelists agreed that target date funds should contain some equity exposure at the point of retirement, and that glide paths should continue to progress after the target date. This further led to a discussion of whether target date fund glide paths should continue to change "to" the target date or "through" the target date, with some panelists arguing that glide paths should continue to vary beyond the target date.

Many panelists focused on the importance of disclosure and the challenges that exist with regard to full and clear communication about the sometimes complicated aspects of these funds. In particular, it was suggested that target date funds disclose whether the fund's glide path is designed to manage assets to or through retirement.

Several panelists suggested that the Department should consider reviewing the QDIA language and determining whether a higher standard should be established for fiduciaries when selecting a particular QDIA. Some panelists suggested that the Department and the SEC set mandatory glide path parameters.

Department of Labor Oversight, Recent Regulatory Projects, and Next Steps

Since the June hearing, the Department has been reviewing the testimony presented and the other materials submitted for the public record, collecting additional data on target date fund characteristics and performance, and considering possible initiatives to ensure that plan fiduciaries and participants have an adequate understanding of target date funds, and their benefits, risks and costs. In order to ensure a coordinated approach, we have been working with the SEC, which is responsible for administering federal securities laws that address disclosures to investors in target date funds structured as mutual funds.

Of the target date funds available, mutual funds comprise approximately 78 percent of target date funds.[7]

In EBSA's oversight role, we assist plan fiduciaries and others in understanding their obligations under ERISA through comprehensive education and outreach, and regulatory programs. EBSA also provides oversight through its enforcement program. EBSA investigates issues related to plan investments focused on plan fiduciaries and service providers such as investment advisors, pension consultants, and investment managers.

Enforcement

Title I of ERISA establishes standards of fiduciary conduct for persons who are responsible for the administration and management of benefit plans. ERISA protects participants and beneficiaries by holding plan fiduciaries accountable for prudently selecting service providers and plan investments. In carrying out this responsibility, plan fiduciaries must follow a prudent process taking into account relevant information relating to the plan and the investments available under the plan.

EBSA identifies potential investigations related to a number of investment issues. These range from the prudence of investments, to improper receipt or payment of fees relating to plan assets, to self-dealing, or conflicts of interest. For selection of investments an investigation would focus on whether the plan fiduciary acted prudently in selecting or recommending the investment. An investigator would review whether the plan fiduciary performed proper due diligence in selecting an investment for the plan and followed a prudent process.

Under ERISA, plan fiduciaries are not liable for plan losses merely because an investment lost money but because they acted imprudently in selecting and monitoring the investment. Accordingly, when investigators review the selection of investments,

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[7] 52nd Annual Survey, Reflecting 2008 Plan Experience, Profit Sharing / 401k Council of America, September 2009.

they will generally focus on the procedures used by a plan fiduciary, rather than the ultimate performance of the asset.

Education and Outreach

To help educate plan sponsors and fiduciaries about their obligations under ERISA, EBSA's education and outreach program provides information to fiduciaries about their responsibilities, focusing on specific topics such as selecting and monitoring service providers and investment options, and automatic enrollment. These initiatives include publications as well as seminars. Specific publications include "Meeting Your Fiduciary Responsibilities," "Understanding Retirement Plan Fees and Expenses," "Automatic Enrollment 401(k) Plans for Small Businesses" and "Adding Automatic Enrollment to Your 401(k) Plan." EBSA also provides two tip sheets to help plan sponsors select plan service providers: "Selecting and Monitoring Pension Consultants - Tips For Plan Fiduciaries" and "Tips For Selecting and Monitoring Service Providers For Your Employee Benefit Plan."

Our campaign, "Getting It Right – Know Your Fiduciary Responsibilities," includes nationwide educational seminars and webcasts to help plan sponsors understand the law. The campaign focuses on fiduciary responsibilities. EBSA has conducted 31 fiduciary education seminars since May 2004 in different cities throughout the United States. EBSA also has conducted 65 health benefits education seminars, covering nearly every state, since 2001. Beginning in February 2005, these seminars added a focus on fiduciary responsibilities. EBSA will continue to provide seminars in additional locations under each program.

In order to help participants understand investment choices offered through their plan and automatic enrollment, EBSA has recently updated the publication "What You Should Know About Your Retirement Plan" and "Savings Fitness – A Guide to Your Money and Your Financial Future." Other publications providing education in this area include "A

Look at 401(k) Plan Fees for Employees" and "Taking the Mystery Out of Retirement Planning."

EBSA continues to expand available information, including adding seminars, webcasts and other outreach, and updating our materials as new guidance is issued.

Regulatory and Other Initiatives

The Department is considering a number of initiatives to assist plan fiduciaries and participants and beneficiaries in understanding the benefits, risks, and costs of plan investment options, including target date funds. For instance, one of our ongoing regulatory initiatives involves improving disclosure to plan participants concerning their plan investment options. As part of this initiative, we are considering what disclosure should be made about target date funds. We are similarly re-examining the Department's QDIA regulation to ensure that meaningful disclosure is provided to participants when the plan's default investment is a target date fund.

We also are considering whether the Department can assist plan fiduciaries by providing more specific guidelines for selecting and monitoring target date funds for their plans, whether as a default investment or more generally as one of investment options offered by the plan.

A related regulatory initiative is the Department's activity related to investment advice. The Department intends to withdraw the final rule implementing the investment advice provisions of the Pension Protection Act of 2006 (PPA) and accompanying class exemption that the Department published in January 2009. We intend to issue a new proposed rule that will support affordable and unbiased investment advice for 401(k)-type plans and IRAs. The new rule will provide participants access to quality investment advice that will assist participants in choosing investments, including target date funds.

Finally, we understand that this Committee is concerned about fee levels associated with some target date funds. As you know, the Department is engaged in regulatory projects relating to the disclosure of fees to plan sponsors and participants, and it is our hope that adequate disclosure will be an added step in protecting participants in these plans. I appreciate your leadership in advocating for better fee disclosure and look forward to working with you on this and other important consumer protection issues.

Conclusion

Thank you for the opportunity to testify at this important hearing. The Department remains committed to protecting the security and growth of retirement benefits for America's workers, retirees, and their families.