AMERICAN BENEFITS COUNCIL

TESTIMONY OF JAMES A. KLEIN

PRESIDENT OF THE AMERICAN BENEFITS COUNCIL

BEFORE A HEARING OF THE SENATE SPECIAL COMMITTEE ON AGING

ON THE ROLE OF EMPLOYER-SPONSORED RETIREMENT PLANS IN INCREASING NATIONAL SAVINGS

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Chairman Smith, Ranking Member Kohl, and Members of the Committee, thank you for the opportunity to appear before this Committee. My name is James A. Klein, President of the American Benefits Council. The Council is a public policy organization representing principally large companies and other organizations that assist employers of all sizes in providing benefits to employees. Our members either sponsor directly or provide services to retirement and health plans covering more than 100 million Americans.

Mr. Chairman, I commend you and the other Members of the Committee for shining the spotlight on the vital role our nation's employment-based retirement system plays in overall savings. Your leadership is critical to strengthening our nation's retirement system, and we urge you to continue to be active in fostering policies that encourage American employers to offer retirement programs to their employees.

The voluntary employer-sponsored retirement system is a bright spot on the savings landscape. As of 2003 (the most recent year for which data is available), American families had accumulated nearly $10 trillion in U.S. retirement arrangements -- the vast bulk of which is attributable to workplace plans. This tremendous pool of capital is an essential source of retirement income security for millions of Americans and a major driver of the U.S. economy.

While individuals can save on their own without an employer-sponsored plan, savings rates are much higher when employees have the opportunity to save through an employer plan. Moreover, employer-sponsored plans increase *retirement* savings, arguably the type of savings that American workers need most.

Despite the success of the employment-based retirement system, Americans today are saving less overall than at almost any time since World War II, and we are saving far less than all of our major international competitors. In just a few short years, the first of the Baby Boom generation will become eligible for retirement benefits, and numerous studies have shown that far too many of them are not saving enough for a secure retirement.

The nation's private sector defined benefit pension system is in distress, providing coverage to only 20 percent of working Americans. The defined contribution plan system has expanded over the last 20 years, with trillions of dollars being saved in 401(k) and similar arrangements. However, millions of Americans have no savings at all and millions more are not saving enough.

Reforms are needed to enhance financial literacy, increase the share of workers in workplace retirement plans, and raise retirement savings. We have a number of policy recommendations for attaining these ends. For example, we strongly support reforms that (1) promote automatic enrollment and automatic increase designs for voluntary savings plans, (2) create a stable and sustainable defined benefit system, (3) affirm the legality of cash balance and other hybrid plans, (4) eliminate barriers to investment advice, (5) encourage lifetime payouts of retirement savings so American families do not outlive their savings, and (6) expand the Saver's Credit to enhance savings among moderate- and lower-income workers. With decisive action in these areas, our nation's retirement system will continue to be an engine for increased savings and retirement security.

Last year, the Council released a long-term public policy strategic plan, *Safe and Sound: A Ten-Year Plan for Promoting Personal Financial Security*, which is attached to this testimony. It assembles in one document a comprehensive analysis of the dimensions of the health, retirement and demographic challenges facing our nation. The report sets forth very specific measurable goals for the retirement (and health benefits) system to be achieved by the year 2014. Drawing on *Safe and Sound*, the remainder of this testimony discusses the role the employment-based retirement system plays in increasing savings and makes a number of policy recommendations for strengthening the system and helping us achieve the goals.

EMPLOYMENT-BASED RETIREMENT PLANS INCREASE SAVINGS

The employment-based retirement system is a proven and effective means of increasing savings. Data suggests that savings rates are much higher when employees have the opportunity to save through an employer-provided plan. If one looks at federal income tax return data, the proportion of filers who claim an IRA or Keogh deduction is fairly modest. In contrast, the participation rate in workplace plans is 66 percent of those eligible for 401(k) plans. Even when no employer match or contribution is offered in a 401(k) plan, contribution rates are high. Analysis shows that employees contribute an average of 7.4 percent of their salary even when there is no employer contribution.

The success of the system at increasing savings, even when it is not provided through employer contributions or other employer-funded benefits, is largely attributable to the characteristics of the employment setting. For example, savings is greatly enhanced by the opportunity for payroll deduction. If workers can elect to have a portion of their pay regularly set aside for savings, rather than having to affirmatively make a decision to set aside funds, it is clear that more is saved. Further, pooling money in employer-sponsored retirement savings vehicles enables individual participants to benefit from economies of scale and to lower their transaction costs, thereby increasing asset accumulation and wealth.

That the system has been a success at saving is nearly indisputable. Of the $10 trillion in the U.S. retirement system in 2003, more than $4.5 trillion had been put aside through the use of private employer-sponsored retirement plans, including defined benefit and defined contribution plans. An additional $2.1 trillion has been collected through the use of state and local government plans and individuals have accumulated more than $3 trillion in IRAs -- amounts which are largely attributable to rollovers from employment-based plans.

While some of these funds undoubtedly would otherwise have been contributed to other types of accounts, it seems apparent that much of the savings in the U.S. retirement system is new savings. The current voluntary employer-sponsored retirement system involves a careful balancing of interests designed to encourage employers to maintain plans while ensuring that retirement savings are accumulated for the benefit of workers at all income levels. For many workers who are living from paycheck to paycheck, the savings created by employer contributions and other employer-funded benefits is their only savings. For others, matching contributions offer an important incentive to save more. Even for active savers, the convenience of payroll deduction encourages greater savings.

In one recent study conducted on behalf of the National Bureau of Economic Research (NBER), economists found that in addition to increasing retirement savings, employer-sponsored retirement plans significantly increase overall savings. The study even suggests that having a retirement plan may "induce an increase in the holding of other assets," thereby resulting in a further increase in total savings.

It is also critical to recognize that savings that could be considered shifted into the U.S. retirement system from other accounts represents amounts that are set aside for retirement purposes. Without dedicated retirement savings, it is doubtful that many workers will accumulate enough savings in other sources to maintain their pre-retirement standard of living.

In this regard, the employment-based retirement system serves two essential public policy goals. It increases overall capital accumulation and wealth, and it enhances retirement security of American families. In both respects, the U.S. retirement system has been an enormous success.

REFORMS ARE NEEDED TO REVITALIZE AND STRENGTHEN THE EMPLOYMENT-BASED RETIREMENT SYSTEM

Changing workforce patterns, shorter job tenures, changes in employee benefit preferences, regulatory burdens, funding requirements, and accounting rule changes have led more employers, especially small businesses, to switch from defined benefit plans to defined contribution plans. As a result, far fewer workers are likely to receive a pension annuity when they retire today than was the case a generation ago.

Defined contribution plans have demonstrated their ability to provide a vehicle for retirement savings for more and more of the workforce. For nearly 25 years, the 401(k) plan (and other similar arrangements) has enabled millions of Americans to save for their retirement future. Today, there are 465,000 401(k) plans covering more than 54 million working Americans. As of the end of 2003, 401(k) plans held nearly $2 trillion in assets, making the 401(k) plan one of the most effective wealth-building tools ever conceived.

However, there are still too many businesses that do not offer any retirement plan. Small employers are focused on covering their payroll, managing labor, and providing health insurance access. Retirement plans are perceived by many small employers as an additional administrative burden. This leaves countless individuals without access to a retirement plan.

Further, voluntary savings plans mean that employees need to choose to participate and, even where plans are offered, participation rates are not as high as they could be. The lowest participation rates are found among lower- and moderate-income workers who can least afford to forego preparing for retirement.

The shift to defined contribution plans and the increasing prevalence of retirees opting to take lump sums from their defined benefit plans has also meant that workers and retirees are increasingly responsible for managing their retirement assets. Not enough plans, however, offer the type of personal guidance that participants want because pension rules place unnecessary burdens on providing investment advice. More than half of workers with access to 401(k) plans have indicated a need for assistance in deciding how to invest their plan assets and more than 20 percent of 401(k) participants have accounts invested entirely in a single non-blended investment option, lacking any diversification.

Whatever the mix of types of benefit plans in the future – be it defined benefit, defined contribution or hybrid plans – it is critical that sufficient incentives be in place to ensure adequate savings for, and income in, retirement. Since more of the responsibility for saving for retirement will undoubtedly be borne by workers given current trends, it is important they save adequately for retirement.

Raise Financial Literacy

Safe and Sound's first goal is to raise financial literacy. It states, "by 2014, virtually all households will have access to some form of investment education and advice and nearly 75 percent of households will have calculated the amount of retirement savings needed to maintain their standard of living throughout retirement, as well as the savings rate necessary to achieve this target."

One of the most basic elements of savings is understanding the need to save. Yet financial literacy is deficient across all generations and socio-economic levels. The National Council for Economic Education Studies (NCEE) reports that nearly two-thirds of American adults and students do not understand basic economic principles such as "inflation."

One aspect of financial literacy is understanding how much one needs to save to reach one's retirement goals. However, according to the 2004 Retirement Confidence Survey by the Employee Benefit Research Institute (EBRI), the majority of Americans -- 58% -- have not calculated how much money they will need to save in order to live comfortably in retirement. Of those individuals that have considered retirement, data from the survey suggests that many of these individuals may be underestimating how much savings they will need for a secure retirement.

Another aspect of financial literacy is managing the investment of retirement assets. Yet many lack the knowledge necessary to make prudent investment decisions. Even participants who are relatively knowledgeable may lack the time to make and update investment decisions in a consistent and well-informed manner. Moreover, many participants are uncomfortable making investment decisions without assistance and there is an enormous demand for investment advice.

Findings from the 2004 Retirement Confidence Survey make clear that Americans both want and need to be more financially literate. Just one third of workers surveyed reported receiving retirement education materials or seminars from an employer or work-related retirement plan provider in the ten months prior to the survey being conducted. For the 21 percent of workers who did report receiving education materials or seminars from their employer, 67 percent of the workers reported implementing some of the recommendations provided in the education materials or seminars.

Further, it is clear that savings would be materially enhanced if Americans across all socio-economic classes were more financially literate. Listed below are policy recommendations drawn from *Safe and Sound* for achieving the goal of raising financial literacy.

Policy Recommendations:

- **Eliminate barriers to investment advice**. Enact legislation to allow employees to receive financial education and advice through their workplace and/or from a retirement plan administrator. If provided through the employer, qualified advisers affiliated with plan investment offerings should be permitted to participate (with certain worker protections provided) and employers should be protected from fiduciary liability for the specific advice provided to individual participants.

- **Support efforts to expand financial education**. Provide public sector and private foundation funding to develop educational tools that can be used by employers, government and other stakeholders in educating workers about saving, investment and income management principles. Education efforts should also include information about the longer life spans people are expected to have in the future, and how workers can financially prepare for longevity risk.

- **Establish financial literacy requirements**. Financial education should be a high school and college graduation requirement. More states need to be encouraged to adopt financial literacy requirements.

- **Promote a focus on retirement planning**. Include in the Social Security Administration annual statement mailed to workers information on how to calculate a rough estimate of the amount one needs to save that, when combined with one's projected Social Security benefit, will provide a replacement income of 70 percent of one's pre-retirement earnings.

Increase the Share of Workers in Workplace Retirement Plans

Safe and Sound's second goal is to increase the share employer-sponsored retirement plan coverage and participation. Specifically the goal states that: "by 2014, 96 million (74 percent) of full-time and part-time private sector employees will participate in workplace retirement plans."

According to the most recent federal data from a survey of employers, about 50 million full-time and part-time private sector workers in 2003 -- approximately 49 percent of 103 million workers—were covered by a workplace retirement plan. Projecting increases in the size of the workforce, this goal represents a 50 percent increase in retirement plan participation.

If participation is to increase, more employers will have to offer retirement plans. This outcome, in turn, depends on devising innovative and flexible plans that are attractive to employers, especially small- and mid-sized businesses.

A different challenge faces defined benefit plans. Such plans, which provide a guaranteed income in retirement, now cover only 20 percent of full-time and part-time workers in the private sector. The number of single-employer plans insured by the Pension Benefit Guaranty Corporation declined dramatically from approximately 112,000 in 1985 to about 30,000 plans in 2003. Half of the nation's roughly 57,000 defined benefit plans in existence in 1994 had been terminated a decade later in 2004. However, defined benefit plans remain a critical part of how most large and many mid-size employers provide retirement security to their workers. In this regard, single-employer defined benefit plans paid benefits in excess of $120 billion during 1999 (the most recent year for which official Department of Labor statistics have been published).

Funding rules, market declines, and low interest rates used for a variety of pension calculations, including determining plan liabilities, caused some employers to freeze their defined benefit plans whereby the plans are closed to employees who are hired after a certain date and/or current participants do not earn any further benefit accruals for their working years after an established date. These developments have also deterred other employers from starting new defined benefit plans including hybrids, such as cash balance plans. Concerns about the volatility of the funding liability have complicated the task of preserving these plans and devising policies to get more companies interested in traditional defined benefit and hybrid defined benefit plans.

All types of defined benefit plans, including hybrid plans, can play a role in increasing participation rates in workplace retirement plans. To the extent that further erosion of the defined benefit system can be halted, or slowed down, the task of expanding coverage through other types of plans becomes less daunting.

Also, to the extent that new, innovative hybrid designs can attract more employers to offer defined benefit plans, it can help increase participation rates in retirement plans. Enrolling more employees in defined benefit plans of various designs, potentially can provide more workers a guaranteed income in retirement.

Efforts are under way to develop additional ways to strengthen savings through defined contribution plans such as new types of simplified guaranteed annuity arrangements to be offered in combination with a 401(k) plan.

The current debate over devising new funding rules for single-employer defined benefit plans also has the potential to strengthen the system. We believe the system can be reformed without tearing down something that is a core part of how employers provide, and millions of Americans receive, retirement income security. To the extent new policies are established, they should help preserve and/or expand participation in defined benefit and hybrid plans. Listed below are policy recommendations drawn from *Safe and Sound* for achieving the goal of increasing the number of workers in employer-sponsored retirement plans.

***Policy Recommendations*:**

- **Promote automatic enrollment and automatic increase designs**. Enhance default mechanisms (e.g., automatic enrollment, lifestyle funds, retirement target funds) to ensure that individuals who decline to make a choice are more likely to be enrolled in a plan (and be savers) and to invest their assets appropriately for their age and for the best risk-adjusted return. Auto enrollment is a proven tool for increasing participation dramatically, particularly among low and moderate-income workers, typically raising participation rates from the 60-65% range to the 85% plus range.

- **Encourage and protect defined benefit plans**. Support plan funding reforms that reduce the volatility of the funding obligation in defined benefit plans. Support policies that provide for new types of defined benefit plans that can offer guaranteed levels of retirement income. Such guaranteed annuity plans could be offered alone or in conjunction with a 401(k) or other defined contribution plan.

- **Confirm the legality of alternative plan designs**. New policies should ensure that employers have a range of plan designs available, including cash balance and other hybrid designs, so employers can select the retirement plan design that best suits their workforce needs. This would include enhancing all existing plan design types and encouraging new simplified plan designs that offer employer tax incentives, reduced administrative requirements, and provide for worker education on saving for retirement.

- **Make the 2001 improvements permanent**. Make today's retirement savings opportunities permanent. The retirement savings and pension reforms contained in the 2001 tax relief act -- from catch-up contributions to small business pension incentives to expanded IRAs and 401(k)s -- have proven extremely successful. Unfortunately, the retirement savings reforms of the 2001 act are scheduled to sunset at the end of 2010, frustrating the long-term planning that is critical for both individual savers and employer sponsors of retirement plans.

- **Provide a "clearinghouse" plan**. Authorize the creation of a "clearinghouse" model plan through federal legislation so workers who change jobs frequently can contribute to one retirement plan. This plan would be modeled on a multi-employer plan model that could provide individuals with one account that would stay with them when they change jobs. Employer contributions to the plan would be voluntary and no financial or administrative requirements would be imposed on employers (other than transferring worker contributions to the plan). This model plan would accept differing levels of employee contributions and employer contributions, and would be able to accommodate different investment vehicles. Any financial services firm meeting certain qualification criteria would be able to offer the "clearinghouse" model plan.

- **Facilitate new models for retirement**. Eliminate rules that restrict workers and employers from creating flexible working relationships and benefits arrangements such as phased retirement programs.

- **Maintain support for company stock in retirement plans**. Maintain support for the voluntary use of company stock in retirement plans through employer contributions or by making company stock available to employees as an investment alternative in the retirement plan. Employees should be educated about the special risks of company stock ownership in retirement plans.

Raise Retirement Savings

Safe and Sound's third goal relates to raising retirement savings. Specifically it states: "by 2014, the gross personal savings rate, which covers saving for all purposes, will reach 15 percent of disposable income. In addition, many, if not most individual workers across the income spectrum will be saving at a rate between 7 and 15 percent of earnings specifically to provide a retirement income that is at least 70 percent of pre-retirement earnings."

The context for this goal is to raise our savings rate to a comparable level of our principal global competitors among the Organization for Economic Cooperation and Development nations and to provide 70 percent of pre-retirement earnings which is commonly suggested by many experts as the necessary income replacement rate to maintain one's standard of living in retirement. (This is a conservative target inasmuch as in recent years the suggested figure has been raised by many other experts.) If one assumes that most workers begin to save between 21 and 35 years of age, then an overall household savings rate of 15 percent would likely be high enough to encompass what households need to save for retirement and still leave room for other forms of saving, such as saving to buy a home, for emergencies, for college education, and medical care. To the extent workers delay too long past age 30 to begin saving for retirement, however, a 15 percent household savings rate (already a challenge to achieve) would not be adequate to assure a 70 percent replacement rate in retirement for most workers.

The calculation of how much one needs to save for retirement must be made on an individual basis. That amount most importantly depends on how early in one's working life a person begins to save. The earlier a worker starts, the lower the savings rate required to reach an income level after retirement close to what the worker earned before retirement. The amount one needs to save also depends on assumptions about a number of other factors, including the rate of return on retirement savings, the rate of future wage and salary growth, and how many years one expects to live after age 65.

A study by the Employee Benefit Research Institute in collaboration with the Millbank Memorial Fund calculates that Americans will need an additional $400 billion more than they will have saved to cover basic expenditures in retirement and any expense associated with an episode of care in a nursing home or from a home health care provider. The study simulates retirement income from Social Security projections and savings from current patterns of saving in tax-preferred retirement savings vehicles, including defined benefit plans, defined contribution plans, and IRAs of all types. It also simulates retirement expenditures on basic living, health care and long-term care. It calculates the shortfall between retirement savings and expenses by age and income cohorts from 1936 to 1965.

The study finds that most couples in the top two quartiles of income born after 1945 can close the gap by increasing their savings rate by just 5 percentage points. However, most couples in the lower two income quartiles born after 1945 would need to save an additional 10 to 17 percent in order to close the gap. Those born in 1945 and earlier will need to save more to meet their needs. Single men and women need to save more than couples to close the gap.

The study does not, however, translate the additional retirement savings needed to meet retirement needs for the various cohorts in the study into an explicit aggregate savings rate for the entire economy. Its findings do, however, generally support the goal of raising overall savings to 15 percent from recent levels of 6.4 percent. That would be enough to close the retirement savings gap for the great majority of Americans born after 1945 provided the savings were spread relatively evenly across the population. To that end, a number of legislative solutions are appropriate to help achieve the goal of raising retirement savings.

Policy Recommendations:

- **Create tax incentives for lifetime payments**. More Americans are retiring with lump sum payments from their retirement plans and many face the prospect of having no defined benefit pension. These retirees confront the difficult task of making their savings last throughout their lives, a task that is only becoming more daunting as life expectancies continue to increase. Annuitizing some retirement savings is an effective way to protect against outliving one's assets. Congress should enact modest tax exclusions to encourage lifetime payouts.

- **Enhance the Saver's Tax Credit**. Provide an enhanced saver's tax credit for low-income individuals above and beyond current law, which provides a partial tax credit for employee contributions made to defined contribution plans and Individual Retirement Accounts. The Saver's Credit has proven quite successful. According to official IRS data, more than 5.4 million households claimed the Saver's Credit in 2003. Yet the Saver's Credit is scheduled to expire at the end of 2006. Given its track record of success, Congress should make the Saver's Credit a permanent part of the retirement savings tax incentives offered to the American people.

- **Increase tax incentives for savings**. Provide increased tax incentives to all individuals to encourage them to maximize retirement savings and to ensure that their savings last throughout retirement.

- **Remove complex and superfluous rules**. Retirement plan rules are often complex and arbitrary. As a result, employers, especially small employers, are unwilling to voluntarily sponsor retirement plans for their employees. Simplifying onerous plan administration and compliance requirements (e.g., nondiscrimination testing) will help maximize individual savings and encourage employers to start up and/or maintain qualified retirement plans.

CONCLUSION

The current voluntary employer-sponsored retirement system has been an enormous success. While individuals can save on their own without an employer-sponsored plan, savings rates are much higher when employees have the opportunity to save through an employer-provided plan.

However, the nation's retirement system faces enormous obstacles and there are a number of trends on the horizon that will test the system. A broad array of demographic, workplace and economic changes in the decade ahead will provide challenges to personal financial security and the employment-based retirement system. These challenges include the aging of America, changes in the composition of the workforce, evolving changes in social structure and families, and continuously rising health care costs.

Reforms are needed now to address these issues and allow the retirement system to grow and retain its vigor. With decisive action, our nation's retirement systems will continue to be an engine for increased savings and retirement security.