INVESTMENT COMPANY INSTITUTE

Testimony of
Paul Schott Stevens
President and CEO
Investment Company Institute

On

"Strengthening Worker Retirement Security"

Hearing Before the
Education and Labor Committee
U.S. House of Representatives

February 24, 2009

Executive Summary

This bear market is wider, deeper, more complex, and more unsettling than any downturn in generations, and has had a significant impact on retirement savings accounts. Average defined contribution account balances, according to one report, fell 27 percent in 2008.[1] This downturn is especially hard on those close to retirement.

But this is not the time to abandon ship, either on the 401(k) system or long-term investing generally. We do not know how long this current downturn will last, but history tells us that participants who cash out of the market now will lock in their losses and find it impossible to time their return so as to share fully in the market recovery. And those who continue contributing, even during a market downturn, have seen their accounts rebound significantly after the downturn because the 401(k) system rewards both consistent contributions and patient long-term investing.

We share the Chairman's commitment to "preserve and strengthen" 401(k) plans.[2]

Working Americans, too, strongly support the 401(k) system, and reject the notion that it requires an "extreme makeover." Nonetheless, it is important that we continue to improve 401(k) plans. To this end, we recommend the following:

- We should improve disclosure about all investment options in 401(k)s to ensure that participants have key information – about fees, risks, historical returns, and more.
- We should relax the required minimum distribution rules to reflect changing life expectancy and to help retirees manage assets in retirement.
- We should remove obstacles to allow employers to diversify participants out of heavy concentrations of company stock as they approach retirement.
- After some more time to learn from the tremendous growth in automatic enrollment and automatic escalation, we should consider requiring all 401(k) plans to incorporate these features.
- We should help more employers to offer savings plans by making it less complex, and explore ways to help workers of modest means to put away something for their retirement.
- We should redouble our efforts to provide financial and investor education to all Americans at every level, elementary school through adulthood—a responsibility for educators, national and local government, as well as employers and mutual fund and other financial firms.

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[1] See http://content.members.fidelity.com/Inside_Fidelity/fullStory/1,,7669,00.html.

[2] See http://edlabor.house.gov/newsroom/2008/11/chairman-miller-unveils-princi.shtml.

- We should put Social Security—which has been and will continue to be the primary source of retirement income for millions of low and moderate wage earners—on sound financial footing.

At the same time, we reject certain criticisms of the 401(k) system and of mutual funds serving 401(k) investors. Congress should not mandate specific investment options or distribution methods or attempt to regulate exposure to investment risk. Nor should Congress undermine the ability of plans to pay for services using asset-based fees. Finally, reliable data make it clear that the costs of 401(k) plans and mutual funds in those plans are very reasonable. Congress should reject attempts to scrap or undermine the existing system or fundamentally alter its structure.

Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute
On "Strengthening Worker Retirement Security"
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My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. investment companies, which manage about half of 401(k), 403(b) and IRA assets. The Institute is pleased to testify today on the impact of the present financial crisis on Americans' retirement security and to share our views on how the 401(k) system, which American workers value highly, can be made even better.

Our testimony is in three parts. First, we address the impact of the economic crisis on America's retirement savings and the importance of ongoing contributions and a long-term investment outlook in helping participants share in the rebounds the market historically experiences. Second, we recommend a number of improvements to strengthen 401(k) plans and the retirement system. Finally, we address the stock, ill-formed criticisms of the 401(k) system and of mutual funds serving 401(k) investors.

I. Impact of the Economic Crisis on Retirement Savings

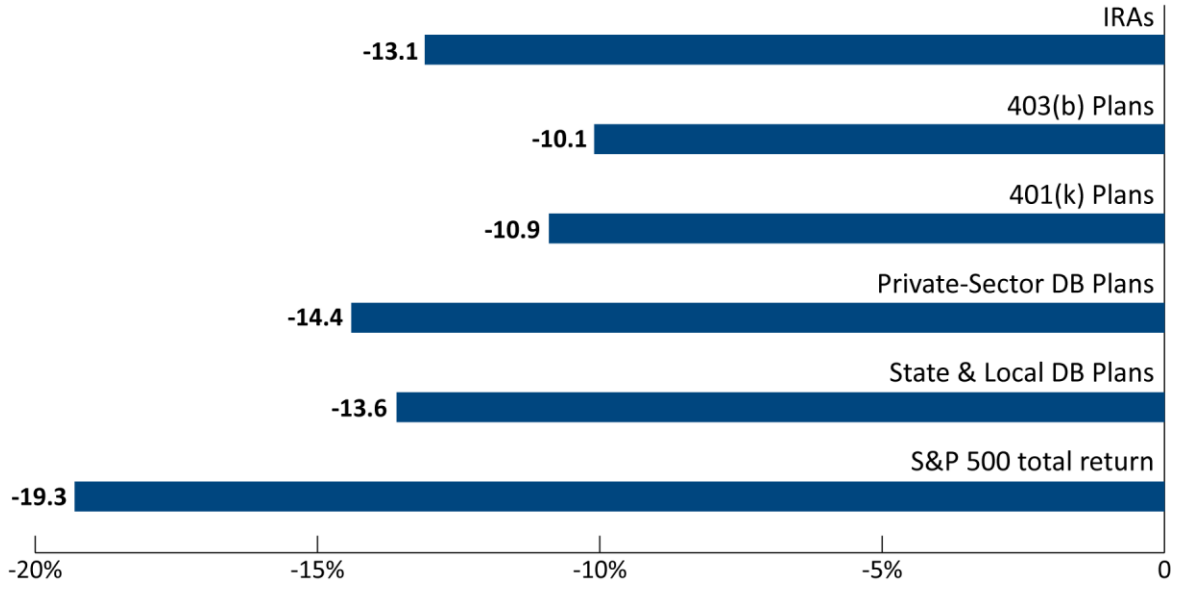
This bear market is wider, deeper, more complex, and more unsettling than any downturn in generations. Workers saving for retirement in 401(k)s, 403(b)s, the Federal Thrift Savings Plan, and other defined contribution plans have seen their account balances significantly reduced in a very short time period. Defined contribution savings are not the only victims: this market downturn has affected defined benefit plans, state and local government plans, and IRAs, because all of these retirement plans are long-term savings vehicles and invest to a large degree in equities.[3] The latest data available show that the assets of private-sector and state and local government defined benefit plans were down 14 percent in the first three quarters of 2008, and IRA assets were down13 percent. Assets of 401(k) plans fell by somewhat less, by 11 percent, and 403(b) plan assets were down 10 percent over the first three quarters of 2008. Because of diversification and ongoing contributions, 401(k) assets fared better than the S&P 500, which fell 19 percent in the same period [Figure 1].

[3] The Institute's latest available comprehensive data show that between June 30, 2008 and September 30, 2008, total retirement assets fell 5.9 percent, from $16.9 trillion to $15.9 trillion. See Investment Company Institute, *The U.S. Retirement Market, Third Quarter 2008*, ICI Fundamentals, vol. 17, no. 3-Q3 (Feb. 2009), available at http://www.ici.org/pdf/retmrkt_update.pdf.

FIGURE 1

All Plan Types Have Seen Declines in Asset Value

Percentage change in total assets from year-end 2007 to third-quarter 2008



Sources: Investment Company Institute, Federal Reserve Board and Standard & Poor's

We know from history that staying the course prevents savers from locking in their losses and missing out on the market rebound. Even those close to retirement can see their accounts come back because savers typically do not need, and rarely spend, their entire account right away at retirement.[4]

Just as importantly, participants in 401(k) and other defined contribution plans have the advantage of regular contributions by payroll deduction, through good and bad markets, which allows them to take advantage of dollar-cost averaging—buying more when market prices are depressed.

This is exactly what happened during the last downturn, which came after the bursting of the tech bubble.[5] The EBRI/ICI Participant-Directed Retirement Plan Database, the largest, most

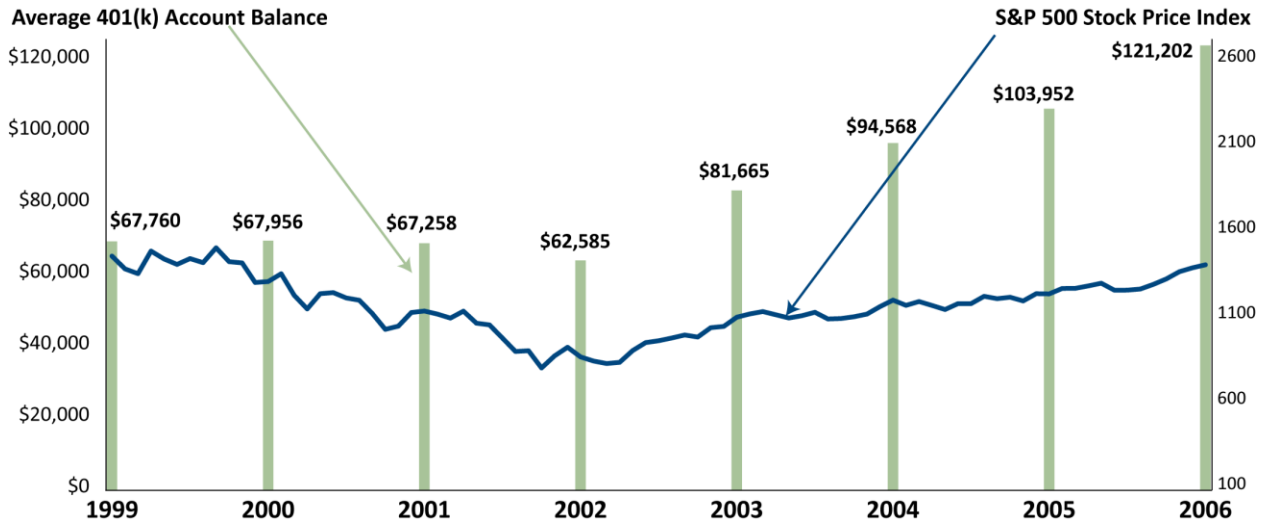
[4] For research on defined contribution plan–owning households' decisions surrounding the disposition of their defined contribution plan balances at retirement, see Sabelhaus, Bogdan, and Holden, *Defined Contribution Plan Distribution Choices at Retirement: A Survey of Employees Retiring Between 2002 and 2007*, ICI Research Series (Fall 2008), available at http://www.ici.org/pdf/rpt_08_dcdd.pdf.

[5] In 1999, total U.S. retirement market assets temporarily peaked at $11.8 trillion. Because of the bursting of the tech bubble and the terrorist attacks on September 11, 2001, the U.S. stock market entered a multi-year downturn. By year-end 2002, the U.S. retirement market fell to $10.6 trillion, an 11 percent drop from the 1999 peak. (Although this is a significant decline, it was not as bad as the market overall—the S&P 500 price index fell 40 percent over the same period—because retirement savings are tempered by diversification and ongoing contributions.) Retirement assets quickly rebounded the next year to $12.5 trillion at year-end 2003.

representative repository of information about individual 401(k) accounts, shows that participants who stay in the system and continue saving see their accounts rebound significantly after a market downturn.[6] An analysis of consistent savers in the database (participants who had account balances at the end of each year from 1999 through 2006) shows that between 1999 and 2002, the average account balance of this group fell 8 percent [Figure 2].[7] But, just one year later, in 2003, the average account balance was up 30 percent. The average account balance almost doubled from the bottom (2002) through 2006. Overall, the average account balance from 1999 to 2006 was up 79 percent, despite the multi-year bear market and even though U.S. equity prices had not recaptured all their losses from the 2000–2002 market downturn. This highlights the value of ongoing contributions and diversification in 401(k) plans.

FIGURE 2

Average 401(k) Balance of Consistent Savers and S&P 500 Stock Price Index, 1999–2006



Sources: EBRI/ICI Participant-Directed Retirement Plan Data Collection Project and Standard & Poor's. Account balances are participant account balances held in 401(k) plans at the participants' current employers and are net of loans. Participants represented are those with an account balance at the end of each year from 1999 through 2006.

We do not know how long this current downturn will last or whether we have seen the worst. We do know that, so far, Americans are demonstrating again their resilience and commitment to long-

[6] For more information on the EBRI/ICI Database, see Holden, VanDerhei, Alonso, and Copeland, *401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2007*, ICI Perspective, vol. 14, no. 3, and EBRI Issue Brief, Investment Company Institute and Employee Benefit Research Institute (Dec. 2008), available at http://www.ici.org/pdf/per14-03.pdf.

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

term savings. Attached to this testimony is a research report ICI released in December 2008 on what 401(k) participants actually did with their accounts recently.[8] The research shows that participants have not panicked and pulled out of 401(k) plans en masse; to the contrary, 401(k) participants have continued to contribute. Although recordkeepers report that call center and web activity are up significantly, participants made few changes in asset allocation—activity that is broadly in line with prior years.

For example, the 401(k) recordkeepers surveyed indicated that through October 2008, only 3 percent of plan participants have stopped making contributions to their participant-directed retirement plan. Further, only 3.7 percent of plan participants had taken withdrawals, including the 1.2 percent who had taken hardship withdrawals.[9] These levels of activity are not significantly different from those in other years.[10]

II. Future of the Retirement System and Defined Contribution Plans

Defined contribution plans are a true success story of U.S. public policy. Latest available official Department of Labor data indicate that in 2006, there were 645,971 private-sector defined contribution plans with more than 65 million active participants.[11] Institute research on Americans' attitudes towards 401(k) plans tells us that Americans strongly support the current 401(k) system and greatly value the tax incentives 401(k)'s provide.[12] Almost nine in 10 households surveyed rejected the idea that the government, and not individuals, should make investment decisions for retirement

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[8] Investment Company Institute, *Retirement Saving in Wake of Financial Market Volatility* (Dec. 2008), available at http://www.ici.org/pdf/ppr_08_ret_saving.pdf and attached to this testimony. The Institute surveyed firms that keep account-level records of 401(k) and other defined contribution plans, and the results in the text are based on that survey. The surveyed firms track the accounts of about 40 percent of all defined contribution plan participants, and provided data through October 2008.

[9] Some news reports have noted significant percentage increases in hardship withdrawals, but this statistic can be misleading because the increase is from a very low base. See for example Nancy Trejos, "Toll on 401(k) Savings Adds Years More of Toil," *Washington Post* (Jan. 29, 2009) (reporting 6.9 percent increase in hardship withdrawals in 2008, but also noting that percentage of employees taking hardship withdrawals remains under 2 percent).

[10] Preliminary data through year-end 2008 are similar.

[11] See U.S. Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin: Abstract of 2006 Form 5500 Annual Reports* (Dec. 2008), available at http://www.dol.gov/ebsa/PDF/2006pensionplanbulletin.pdf. The bulk of these plans were 401(k) plans, with 465,653 plans and more than 58 million active participants. As explained by the Department of Labor, a change in required filings has resulted in a broader definition of "active participants" for data starting with plan year 2005 (see U.S. Department of Labor, Employee Benefits Security Administration, *Private Pension Plan Bulletin Historical Tables* (Feb. 2008) available at http://www.dol.gov/ebsa/pdf/privatepensionplanbulletinhistoricaltables.pdf). Thus, official estimates of the number of active participants in defined contribution plans are higher than they would have been under the previous measure.

[12] The Institute surveyed 3,000 American households. The survey was conducted in late October through December 2008—that is, during some of the most jarring days in the history of our financial markets. See attached research report cited in supra note 8 for more information.

accounts. Even households without 401(k) or IRA savings see value in the 401(k) system and do not want drastic changes.

That does not mean the defined contribution system cannot be improved, and in fact we believe it *must* be improved because of the trillions of dollars of retirement savings that employers and workers have entrusted and will continue to entrust to these plans. Our specific recommendations are detailed below.

A. We should improve disclosure about all investment options in 401(k)s to ensure that participants have key information—about fees, risks, historical returns, and more.

Meaningful and effective disclosure to 401(k) participants and employers has long been an Institute priority. In 1976—at the very dawn of the ERISA era—the Institute advocated "complete, up-to-date information about plan investment options" for all participants in self-directed plans.[13] We have consistently urged the Department of Labor to complete its fee disclosure agenda, and we hope the new Administration will finish these projects quickly.[14]

This change is necessary because there are significant gaps in the current disclosure system, creating unequal disclosure. The rules do not cover all participant-directed 401(k) plans and the information participants receive depends on the investment product.[15]

The current economic crisis highlights the need for participants to focus not just on the fees of a product but on its investment objectives, risks and historical return. In plans offering investment in employer stock, the employer stock fund may be the lowest fee option because essentially no active investment management is involved, but it also would not be appropriate for participants to invest solely in one security. Effective disclosure must point out the need for diversification and the risks of placing too large a share of retirement assets in the stock of one company. Similarly, insurance and other fixed-return products carry risks—including, as recent events highlight, the risk of insolvency of the issuer.

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[13] Letter from Matthew P. Fink, Associate Counsel, Investment Company Institute, to Morton Klevan, Acting Counsel, Plan Benefit Security Division, Department of Labor (June 21, 1976).

[14] See, e.g., Investment Company Institute comment letter on Participant Fee Disclosure Project (Sept. 8, 2008), available at http://www.ici.org/statements/cmltr/08_dol_401k_disclosure_com.html.

[15] The Department of Labor's current rules cover only those plans relying on an ERISA safe harbor (section 404(c)); no rule requires that participants in other self-directed plans receive investment-related information. In plans operating under the safe harbor, the information participants receive depends on the investment product. Participants receive full information on products registered under the Securities Act of 1933, such as mutual funds, because the Department requires that participants receive the full SEC-mandated prospectus. For other investment products, such as bank collective trusts and separately managed accounts, key information, including annual operating expenses and historical performance, is required to be provided only upon request and only if that information has been provided to the plan.

In strengthening 401(k) disclosure, the following principles must govern. First, there is broad agreement[16] that participants need simple, straightforward disclosure focused on the key information that allows comparisons among the investment options available in their plan. Voluminous and detailed disclosure will not serve the interests of participants, whose primary decisions are whether to participate in the plan (and at what level) and how to allocate their accounts among the options the plan sponsor has selected. The best disclosure approach is one that is layered to deliver the right level of information based on participants' actual needs[17]—key information on every investment option provided to all upon enrollment, and more detailed information available to all online and in paper form upon request.[18]

B. We should relax the required minimum distribution rules to reflect changing life expectancy and to help retirees manage assets in retirement.

Workers with retirement savings in defined contribution plans and IRAs face the challenge of managing those assets in retirement. Extensive research by the Institute[19] shows that, by and large, people act responsibly with their defined contribution plan account balances at retirement and are responsible stewards of their IRA assets (which often contain significant rollover amounts from employment-based plans). In fact, retirees tend to preserve these accounts in retirement until the government *forces* a distribution. Sixty-one percent of traditional IRA–owning households not making

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[16] See, e.g., Joint Letter to the Department of Labor from the Investment Company Institute, American Benefits Council, American Council of Life Insurers, Committee on Investment of Employee Benefit Assets, The ERISA Industry Committee, American Bankers Association, Profit Sharing / 401k Council of America, Securities Industry and Financial Markets Association, National Association of Manufacturers, U.S. Chamber of Commerce, The Financial Services Roundtable, and Society for Human Resource Management (July 24, 2007), available at http://www.ici.org/statements/cmltr/2007/07_dol_401k_joint_com.html.

[17] After years of effort, the SEC recently completed a widely-praised overhaul of mutual fund prospectus requirements, which allows funds to provide investors a "summary" prospectus that all investors receive, with the full statutory prospectus available online or in paper upon request. See Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, 74 Fed. Reg. 4546 (Jan. 26, 2009). This lengthy process has immediate relevance to 401(k) disclosure efforts.

[18] We agree with the approach taken by the bill reported out of this Committee in the last Congress, H.R. 3185, and similar proposals, ensuring that disclosure rules apply equally to all products offered in 401(k) plans. Any new disclosure rules should require that participants receive key information—including investment objective, risks, historical return, and fees—on all investment products. Disclosure that is focused and useful to participants serves an important role in helping workers be better savers and better investors. Nonetheless, we had concerns about those provisions of the bill that failed to complement existing regulatory disclosures focused on providing useful information and that required disclosure to plan fiduciaries that favored one business model. We also objected to the portion of the bill conditioning vital fiduciary protection on a plan offering an investment option meeting very specific and subjective requirements.

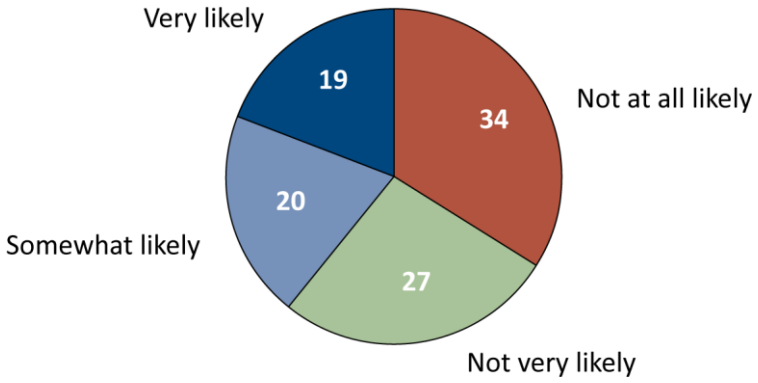
[19] See Holden and Schrass, *The Role of IRAs in U.S. Households' Savings for Retirement, 2008*, ICI Fundamentals, vol. 18, no. 1 (Jan. 2009), available at http://www.ici.org/pdf/fm-v18n1.pdf; Sabelhaus, Bogdan, and Holden, *Defined Contribution Plan Distribution Choices at Retirement: A Survey of Employees Retiring Between 2002 and 2007* (Fall 2008), available at http://www.ici.org/pdf/rpt_08_dcdd.pdf.

withdrawals in tax year 2007 indicated it was unlikely they would withdraw from their IRAs before age 70½ [Figure 3]. Slightly more than half of traditional IRA–owning households without withdrawals indicated a future use of the monies would be to cover an emergency, such as healthcare expenses.

FIGURE 3

Likelihood of Withdrawing from Traditional IRA Before Age 70½

Percentage of traditional IRA-owning households that did not take a withdrawal in tax-year 2007



Source: Investment Company Institute IRA Owners Survey

We can do a better job, however, giving workers flexibility to manage their assets in retirement. Chairman Miller and Ranking Member McKeon were strong supporters of the temporary waiver of the required minimum distribution rules included in the Worker, Retiree and Employer Recovery Act of 2008, and the Institute applauds that effort. This first step provides a good opportunity to examine whether those rules should be changed to reflect longer life expectancy and the challenges of healthcare expenses.

One option is to extend the temporary waiver another year, which may be appropriate if the economic conditions that prompted the 2009 waiver persist. Another, better, option is to increase the age at which distributions must begin from age 70 ½ to, for example, age 75. According to the Social Security Administration, the average life expectancy at age 65 is about four years longer for men, and three years longer for women, today than it was in 1962, when the 70 ½ rule was first added to the retirement plan rules as part of the creation of Keogh plans.[20] Meanwhile, the Social Security normal retirement age has increased, from 65 to 67.[21]

[20] See http://www.ssa.gov/OACT/TR/TR08/lr5a3.html.

[21] For a chart indicating the time frame for the change in normal retirement age, see http://www.ssa.gov/retire2/retirechart.htm.

C. We should remove obstacles to allow employers to diversify participants out of heavy concentrations of company stock as they approach retirement.

The Pension Protection Act of 2006 established the right of employees to diversify out of employer stock. Although the share of company stock in 401(k) participants' accounts has diminished since 1999, some participants' accounts continue to be invested heavily in stock of their employer; in 2007, in plans that offered company stock as an investment, nearly 8 percent of participants had more than 80 percent of their account balances invested in company stock, according to EBRI/ICI research.[22]

During lean times, these participants face the double risk of losing both their jobs and a significant portion of their retirement savings based on the health of a single company. Peter Orszag, then Director of the Congressional Budget Office and now Director of the White House Office of Management and Budget, testified to this Committee last October that although workers enrolled in defined contribution plans may not be able to avoid bearing the risks associated with broad price changes in financial markets, they should avoid unnecessary risks associated with overweighting portfolios with individual stocks.[23]

Current law presents some obstacles to employers from including a feature in their plans that would diversify participants automatically out of heavy concentrations of company stock as they age. Congress should remove these obstacles, and we are pleased that Representative Andrews, Chairman of the Subcommittee on Health, Employment, Labor, and Pensions, has made a proposal along these lines.[24] An automatic diversification feature should allow participants to opt out—as new enrollees are allowed to opt out of qualified default investment options—so that employees who affirmatively decide that significant investment in company stock is appropriate for them could continue to hold that investment.

D. After some more time to learn from the tremendous growth in automatic enrollment and automatic escalation, we should consider requiring all 401(k) plans to incorporate these features.

Since passage of the Pension Protection Act of 2006, employers have been adopting automatic enrollment at a rapid pace. The Profit Sharing/401k Council of America survey of plans reported that 35.6 percent of plans used automatic enrollment in 2007, the year after enactment of PPA, an increase

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[22] See Holden, VanDerhei, Alonso, and Copeland, supra note 6, figure 30.

[23] Statement of Peter R. Orszag, Director of Congressional Budget Office, before the Committee on Education and Labor (Oct. 7, 2008), available at http://edlabor.house.gov/testimony/2008-10-07-PeterOrszag.pdf.

[24] Legislation introduced in the last Congress (H.R. 6143) included a provision that would address technical prohibited transaction issues with this plan design.

of 51 percent in a single year. More than half of large plans (5,000 or more participants) used automatic enrollment in 2007.[25]

The Institute is a strong supporter of using automatic enrollment and automatic contribution escalation, but these are innovations fostered by the Pension Protection Act that need time to work. Because employers are adopting automatic enrollment at a rapid pace, it may be premature to consider making it mandatory, since there is concern that this might discourage some employers from offering a plan.

Adoption of automatic features has been slower in plans offered by small employers. While it is not unusual for larger employers to be early adopters of new innovations, we need more time to understand the costs of automatic enrollment on employers, especially small businesses, in light of the financial pressures on many companies today. But as experience with and comfort with automatic enrollment grows, it may at some point be appropriate to hard wire it permanently into the 401(k) system.

E. We should help more employers to offer savings plans by making it less complex, and explore ways for workers of very modest means to put away at least something for their future.

The Department of Labor estimates that 61 percent of all private-sector workers, and 71 percent of all full-time private-sector workers, had access to an employer-provided retirement plan in 2008. Whether or not an individual's employer offers a plan has as much to do with the nature of the employer's workforce as it does the size of the employer. Recent research by the Institute[26] shows that employers that do not offer plans tend to have workforces that are less likely to value and utilize retirement savings. These would include younger workers whose savings goals are focused instead on education, home purchase, or building a savings cushion; workers with low current income, who are less likely to have excess resources available to fund retirement savings; or workers with lower lifetime earnings, for whom Social Security replaces a higher proportion of their working earnings. In contrast, most workers who are likely to have the ability to save and to be focused primarily on saving for retirement are covered by an employer-provided retirement plan. Reform should recognize the differing savings needs of the American workforce and work toward realistic goals.

We believe certain changes would encourage more employers to offer retirement savings plans to their workers. Enhanced tax incentives for small employers are a place to start. Second, we should attempt to eliminate for certain employers the impediments of cost and complexity more effectively.[27]

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

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

[27] The SIMPLE IRA plan, which came about in 1998, is a good case study in streamlined administrative requirements. SIMPLE plans have increased the number of covered workers somewhat, but have not made a dramatic difference. The SIMPLE, as its name would imply, is easy to administer, but it requires the employer to commit to contributing additional

One proposal that should be considered is called the "Model T."[28] It would combine some of the best innovations from the 401(k) realm, including automatic enrollment and simple diversified investment options, relieve employers of burdensome plan testing, and make it easier to fulfill fiduciary responsibilities.

Several other proposals for increasing savings also deserve serious consideration. It has been suggested previously before this Committee that a new type of system limited to investing in a U.S. government security replace the entire 401(k) system.[29] For numerous reasons, we strongly oppose this idea. But the creation of a government bond designed specifically for retirement saving *is* worth considering. Rather than replacing defined contribution plans, such an "R" bond could be used as a complement to the system. A retirement bond, for example, sold through the Treasury Direct system, would be an easy way for workers of very modest means to put away, on a voluntary basis, some money for use in retirement. This type of savings vehicle might be ideal for many of the workers who are not currently covered by a workplace plan—it could easily accommodate small amounts, and could be tied to the individual's Social Security number rather than his or her present job.

The Institute on behalf of its members is actively studying the Model T, the "R" bond, and other proposals to increase coverage and retirement security. In fact, in partnership with the leading employer and financial services associations focused on retirement issues, we are convening a retirement summit on March 5 to consider these and other topics with a range of retirement experts.

F. We should redouble our efforts to provide financial and investor education to all Americans at every level, elementary school through adulthood—a responsibility for educators, national and local government, as well as employers and mutual fund and other financial firms.

We disagree with those who say investment education does not work. In many ways the economic crisis provides an opportunity to strengthen the focus of plan participants on the importance of a commitment to savings, smarter investing, and a long-term outlook.

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amounts to the employee's account each year. While employer contributions are a very important component of our system for millions of workers, some companies for which the SIMPLE plan is designed likely cannot afford to make this annual commitment and, as a result, do not offer any plan at all. New plan designs for small employers that pair simplicity with reduced expense could go a long way toward achieving near-universal coverage.

[28] The Model T was developed by a broad coalition called the Conversation on Coverage, spearheaded by the Pension Rights Center. See http://www.conversationoncoverage.org/about/final-report/wg-iii-report.pdf.

[29] One witness at the October 7, 2008 hearing before this Committee proposed to replace 401(k) plans with a new government system funded with mandatory contributions to the Treasury (i.e. taxes). This proposal would eliminate the tax incentive for employers to offer, and workers to participate in, a 401(k) plan, and instead require an additional 5 percent payroll tax that would be paid to the government in exchange for the government "guaranteeing" a return of 3 percent over inflation. The United States already has a system of guaranteed retirement income funded by taxes—Social Security—and one of the most crucial tasks in addressing retirement security in the future is ensuring that Social Security continues to provide adequate benefits to workers.

No one doubts, however, that, for many Americans, 401(k) saving and investing can be complex and confusing. The growth of automatic features and of products like target date funds are in part a response to this challenge. Plan sponsors and service providers have also worked hard to develop innovative and interactive tools to help explain investing concepts and to open multiple ways to communicate with and assist participants.

Indeed, the elaborate mechanisms for communicating with retirement savers that are unique to today's 401(k) system play a crucial role in reassuring participants during volatile markets. One Institute member with a large recordkeeping business reported to us that participant calls increased 60 percent, and website visits increased by 65 percent, during the recent market volatility. This firm was able to react quickly by increasing its service center capacity by 50 percent to handle participant inquiries. Another large retirement service provider reported that the volume of calls during the most volatile period (late September and early October 2008) spiked to over 100,000 calls per day.[30] But as noted earlier, despite this level of concern, the data show that participants did not overreact.

We need to redouble our efforts to provide financial and investor education to all Americans at every level, elementary school through adulthood. This is a task not just for educators and national and local government but also for plan sponsors and service and investment providers. Mutual funds already provide much information, advice, and help to their investors. And I have challenged our industry to do even more to meet this vital need.

G. We should put Social Security— which has been and will continue to be the primary source of retirement income for millions of low and moderate wage earners—on a sound financial footing for the indefinite future.

Any examination of the American retirement system must look at the whole system, including the crucial role of Social Security. It cannot be overemphasized that workers with low to moderate lifetime earnings will continue to rely, as they have historically, on Social Security for the bulk of their retirement income. Social Security forms a baseline—a universal guaranteed retirement income annuity for all workers—that allows retired Americans to live in dignity. As a group, the lowest income half of the retiree population gets more than 85 percent of their income from Social Security and public assistance, and that has been the case for at least the past 25 years.

Unfortunately, Social Security faces a funding shortfall: by 2017, Social Security will start paying out more money than it is taking in—and by 2041, it will only be able to pay 78 percent of scheduled benefits.[31] This gap must be closed, while preserving the essential nature of Social Security as a universal, employment-based, progressive safety net for all Americans. The mutual fund industry will

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[30] See http://content.members.fidelity.com/Inside_Fidelity/fullStory/1,,7669,00.html.

[31] See http://www.ssa.gov/OACT/TRSUM/trsummary.html.

support efforts to close that gap, but our industry has and will continue to oppose privatizing Social Security or creating personal accounts within the system.

President Obama convened a high-level meeting yesterday on fiscal responsibility to address, among other pressing issues, the long-term solvency of Social Security. We support Congress and the Administration making this a priority.

III. Response to Criticism of the 401(k) System

Despite the success of the defined contribution system and the advantages offered by mutual funds available to 401(k) investors, the system has its critics, who have not hesitated to seize on the current economic crisis to propose radical reforms. Like most Americans, we fundamentally disagree with attempts to scrap or undermine the existing system or radically alter its structure.

A. Congress should retain flexibility in the 401(k) system and should not mandate investments or distribution methods or attempt to regulate exposure to investment risk.

The hallmark of the PPA is that Congress removed obstacles and encouraged the current generation of good ideas, like automatic enrollment, autoescalation and default investments. Congress should eliminate additional legal obstacles to the next generation of good ideas but should not dictate the investment or distribution line-up of plans, or try to legislate their risk characteristics or prescribe approaches to asset allocation. All of these are tasks for which Congress is singularly unsuited and in the 401(k) system are left to the conscientious oversight of plan sponsors.

1. Mandated index funds or other investments

Eighty-seven percent of respondents in our survey agreed that government should allow individuals to make their own investment decisions in DC retirement accounts and IRAs, and we agree. Innovations like index funds, automatic enrollment, and target date funds have been developed to simplify savings and investing and enhance retirement preparedness. These innovations, which began in the private sector, have now been adopted or are being considered for adoption by the Federal Thrift Savings Plan. Mandating today's good ideas will freeze the retirement system in 2009 and chill development and acceptance of tomorrow's good ideas.

Specifically, we oppose government mandating that all plans offer *any* particular investment, including an index fund. Congress should not endorse one investment strategy over another or get in the business of deciding what types of investments should be in plan investment lineups, particularly when there is no indication that plan fiduciaries cannot make prudent judgments in selecting plan investment menus.

These are decisions properly left to plan fiduciaries who are held to ERISA's stringent standards. When an employer selects the menu of investment options for its 401(k) plan, it can and often does include an index fund in the menu. A survey by the Profit Sharing/401k Council of America found that fully 70 percent of plans offered a domestic equity index investment option in 2007.[32]

Mutual funds were the first to make index investing broadly available to individual investors more than three decades ago, and today there are hundreds of index mutual funds available in the market. But there is no one index fund right for all investors in all circumstances throughout all their investing life. In fact, index funds are hardly immune from market downturns. One of the largest indexed investments, the Federal Thrift Savings Plan's C Fund, which attempts to track the S&P 500 index, was down 37 percent in 2008. The TSP's indexed I Fund, which attempts to track the Morgan Stanley Capital International EAFE Index, was down 42 percent.[33]

2. Mandated distribution methods

The spirit of innovation that defines the 401(k) system already is addressing the distribution, or "decumulation," phase with products and services that speak to a wide range of income needs. Some combine the features of annuities with mutual fund investments. Others rely on mutual fund payout options to provide regular income. Insurers are offering innovations in annuities, such as guaranteed minimum withdrawal benefits, inflation protection, and death benefits.

The optimal distribution choice for a participant could be a single product or combination of products and will depend on individual circumstances, including health status, other income sources, such as Social Security and defined benefit plans, and whether a retiree hopes to leave an inheritance to children. That there is no solution that is right for all retirees means that education and advice are of great importance in the distribution phase. It also means that government should not favor one solution over others, but should nurture a robust and transparent market where innovative products can be developed and understood by retirees.

3. Mandated asset allocation of target date funds

Some have expressed concern about the asset allocation of target date funds, especially for those nearing retirement. Target date funds are professionally designed pre-packaged asset allocation portfolios that an individual selects or is defaulted into based on his or her anticipated retirement age. An individual target date fund is generally part of a suite of similar funds that span an individual's working life, in 5- or 10-year increments (e.g., 2010, 2015, 2020). These funds automatically become more conservative over time. The "glide path" designs vary from provider to provider, reflecting

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

[33] See http://www.tsp.gov/rates/annual-returns-tsp-indices.html.

differences in assumptions and investment approaches, but all are based on modern portfolio theory. There is no right single glide path and government should not dictate the solution or attempt to regulate exposure to investment risk.

Target date funds have a moderating influence on extremes in investment allocation. One large target date provider reports that among those participants who are not target date fund investors, 16 percent hold no equities, and 30 percent hold only equities.[34] Target date investors cannot hold extreme positions because target date options include both equity and fixed income assets.

B. Congress should not undermine the ability of plans to pay for services using asset-based fees.

Investments and administrative services are delivered to 401(k) plans in many different ways, and often they involve paying for plan administrative costs in whole or in part through asset-based fees. Although some have criticized asset-based fees, there are sound reasons an employer would choose this method. Using asset-based fees to cover administrative services effectively spreads the costs of acquiring necessary services over a shareholder or participant base. All mutual fund investors experience "mutualization," whether in a 401(k) plan, IRA, or taxable account. Some costs of administering a mutual fund shareholder's account are relatively fixed, such as the costs of printing prospectuses, maintaining shareholder accounts, and sending shareholder statements. Because mutual funds charge asset-based fees, shareholders with larger accounts subsidize those with smaller accounts. Mutualization of this kind is not unique to funds. Wrap fees in separately managed accounts or other brokerage accounts and mortality and expense charges in insurance products likewise mutualize certain costs.

In plans, asset-based fees allow new participants and those with lower wages or smaller accounts to participate without their fixed share of administration costs falling disproportionately, as a percentage of account balance, on them. From its inception, Congress structured the rules around 401(k) plans—most notably the vesting and nondiscrimination rules—to create a social contract between and among employees at a firm to encourage broad participation. The social contract is designed to increase participation among new employees and lower paid employees. Replacing asset-based fees with per-participant based fees would be particularly onerous for these employees, and create significant disincentives to their participation.

Take for example a new employee in the average plan in a recent ICI and Deloitte Consulting LLP survey.[35] The median plan's total annual fees and expenses equaled 0.72 percent of plan assets or

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[34] See "Target-date funds: Plan and participant adoption in 2007," *Vanguard Center for Retirement Research*, vol. 33 (Nov. 2008), available at https://institutional.vanguard.com/iam/pdf/CRRPPA2007.pdf.

[35] ICI and Deloitte Consulting LLP examined fees in defined contribution plans through a detailed survey of 130 plans of various sizes, a variety of investment and recordkeeping arrangements, a range of industries, and from all regions of the United States.

72 basis points. Based on the average account size, the average per-participant dollar charge for that median plan was $315. If a new employee making $40,000 a year and contributing $3200 a year (8 percent of salary) paid the average per participant charge of $315, the employee's fees would equal 10 percent of his or her contribution for the year. Indeed, if this employee's average return before fees was 6 percent, the employee would not earn a positive return for nearly two years, and it would take him or her 11 years to eventually reach the plan's asset-based fee of 72 basis points.

Asset-based fees allow those that are higher paid or with longer tenure (who have higher balances) to pick up a greater dollar share of the expenses by charging the same asset-based fee as other plan participants, providing an incentive for lower paid or newer employees to join the plan. This allows *both groups* to save more for retirement because the lack of participation of lower-income and new employees places significant restrictions on the contributions of higher-income employees. [36] Asset-based fee arrangements also help pay for plan start-up or service provider transition costs, which can be significant. To avoid the plan incurring all those expenses in the first year, asset-based fees allow a provider to recoup its expenses over several years as plan assets grow.

The decision whether to use asset-based fees should be made by the employer based on its particular needs and in accordance with ERISA's fiduciary obligations. Forcing plans into a particular pricing model could lock out some employers and workers, especially those new to the 401(k) system, from participating.

C. The fees of a typical 401(k) plan are very reasonable.

1. 401(k) plan and mutual fund fees

The fee numbers bandied about by some critics of the 401(k) system vastly exaggerate the fees of most plans. As described earlier, a recently completed and detailed survey of 130 plans of various sizes by the ICI and Deloitte Consulting LLP found that the median all-in fee (that is, investments and recordkeeping) across all plans surveyed was 0.72 percent as a percentage of total assets. While fees vary across the market, 90 percent of all plans surveyed had an all-in fee of 1.72 percent or less.

As for the investing behavior of plan participants, ICI research shows that 401(k) investors concentrate their assets in low-cost mutual funds. The average asset-weighted total expense ratio incurred by 401(k) investors in stock mutual funds was 0.74 percent in 2007, about half the 1.46 percent simple average for all stock funds and substantially less than the industry-wide asset-weighted average of 0.86 percent.[37]

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[36] The nondiscrimination rules in the tax code effectively require that the contributions of the higher paid employees must be limited unless the employer can encourage sufficient contributions by lower paid employees.

[37] See Holden and Hadley, *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses, 2007*, ICI Fundamentals, vol. 17, no. 5 (Dec. 2008), available at http://www.ici.org/pdf/fm-v17n5.pdf.

2. *Mutual fund trading costs*

Some critics suggest the fees of mutual funds are substantially understated because the SEC-mandated expense ratio does not include brokerage costs, and that they constitute a large "hidden fee." In reality, all investment products—commingled trusts, separate accounts, ETFs, and mutual funds—incur costs in buying, holding, and selling portfolio securities. Brokerage commissions are the most obvious and easily calculated trading cost, but they are only one part of the cost. Other trading costs—market impact costs and opportunity costs—cannot be measured easily or accurately.

Fund managers have strong legal and market incentives to minimize these costs. The Investment Advisers Act of 1940 requires all mutual fund managers to seek "best execution" of trades, a standard that requires close attention to total trading costs. Further, trading costs have a direct, negative impact on a fund's performance—the most important consideration that most investors use to judge funds.

The SEC has examined disclosure of trading costs repeatedly and has concluded that the portfolio turnover rate, which measures how often a fund "turns over" its securities holdings, is the best proxy for trading costs. Recent changes to mutual fund disclosure rules make the disclosure of portfolio turnover more prominent in fund prospectuses. Mutual funds also make available to investors, including retirement plans, detailed information on their total brokerage commissions and trading policies.

IV. Conclusion

We applaud the Committee for examining this important topic and thank you for providing the Institute this opportunity to testify. Like most Americans, we believe strongly in the 401(k) system and its inherent power of savings and long-term investing. We believe the improvements we have recommended can make the 401(k) system even better. We look forward to continuing to work with this Committee and its staff to preserve and strengthen defined contribution plans.

ATTACHMENT

- Investment Company Institute, *Retirement Saving in Wake of Financial Market Volatility* (Dec. 2008).