Prepared Remarks for Roundtable Discussion with the Senate Committee on Health Education, Labor and Pensions on "Pension Modernization for a 21st Century Workforce"

David Madland
Director, American Worker Project, Center for American Progress Action Fund
September 20, 2012

Thank you for inviting me here today to discuss pension modernization for the 21st century.

My name is David Madland and I'm the Director of the American Worker Project at the Center for American Progress Action Fund.

I appreciate the opportunity to present my views on this important topic, a topic which I have been researching for some time. I wrote my dissertation about the decline of the private-sector defined-benefit pension system and have written extensively in academic and popular publications about retirement policy.

In my testimony I will address the three questions posed by this committee, which are focused on how to best improve the private retirement system, and leave discussion about Social Security for another time.

Social Security provides an essential baseline of income for retirees and must be strengthened to ensure that it continues to do so for generations to come, as the Center for American Progress has proposed.[1] But Social Security was never intended to be people's only source of income in retirement.

To maintain their standard of living in retirement, Americans depend upon accumulations in employer-sponsored retirement accounts—such as 401(k)s and pensions—and, to a smaller degree, private savings.

Unfortunately, the private retirement system is failing too many Americans, something that is becoming abundantly clear as the first generation of workers to depend primarily on 401(k) plans—rather than the increasingly rare defined-benefit pension—starts to retire.

The failures of the private retirement system could have troubling consequences. If we continue down the current path, many retirees will outlive their retirement savings, potentially saddling their children and the country with a burden that weighs down the economy and causes significant human suffering.

Defined-benefit pension plans have provided a secure retirement for millions of middle-class Americans, but it is clear that the traditional pension system is in decline and that existing defined-

benefit pension models may not be well-suited for some of our 21st century workforces. What should our pension system look like to meet the challenges of the global economy and the need to provide retirement security for working Americans?

The pension system of the future should ensure all workers have a cost-effective and secure way to save so that Americans can maintain their standard of living in retirement and retire with dignity.

In designing a plan to meet these goals, I think it is essential to understand that all retirement plans involve tradeoffs between costs, risk, and retirement adequacy, and involve different choices about who bears these costs and risks—employers, employees, or taxpayers.

There is no getting around these tradeoffs—but there are better and worse ways to manage these tradeoffs.

Some retirement plans are simply better at managing these tradeoffs because of the way they are designed.

While 401(k)s, the dominant defined-contribution retirement plan in the current system, have worked well for some workers, in general they do not do a particularly good job at managing these tradeoffs. 401(k)s have relatively low risks and costs for employers, but for workers the costs and risks are quite high, such as excessive fees, the potential for significant loss of assets due to drops in the stock market, and the likelihood of outliving assets.[2]

As a result, 401(k)s have proven unable to provide adequate retirement security for most workers. Indeed, the typical near-retirement age worker with a 401(k) has only accumulated only enough money to provide a monthly payment of about $575 in retirement.[3] To make matters worse, less than half of all workers even have a retirement plan at work, and that figure has been declining over the past few decades as 401(k)s have supplanted defined-benefit pensions.[4]

To create the retirement system of the future, we should learn from these challenges. All workers should have access to a high-quality retirement plan that will help create a secure retirement.

The USA Retirement Funds plan that Sen. Tom Harkin (D-IA) proposed in his July report entitled “The Retirement Crisis and a Plan to Solve It” builds upon the lessons we have learned from the weaknesses of the current retirement system and is a good place to start building a modern retirement system because it manages the cost, risk, and adequacy tradeoffs quite well. [5]

Indeed USA Retirement Funds share much in common with the new retirement plan proposal from the Center for American Progress, called collective defined contribution plans—details of which are being released today in a new issue brief.[6]

Both the USA Retirement Funds and collective defined contribution plans are hybrid-type plans that combine elements of a traditional pension—such as regular payments in retirement, professional management, pooled investing, and risk sharing across generations—with elements of a 401(k)—such as predictable costs for employers and portability for workers.

This hybrid approach should be a core part of our future pension system because its features are less costly and less risky than a 401(k). Indeed, retirement plans that have the core features of these hybrid models—professional money management, long investment time horizons, and the ability to spread risks across multiple generations—are estimated to cost about half as much to provide an adequate retirement benefit, while exposing participants to much lower levels of risk than a 401(k).[7]

In subsequent answers I will elaborate more on the advantages of these features and explain why they should be part of the retirement system of the future.

What would make it easier and attractive for businesses—especially small businesses—to provide their employees with a traditional pension benefit? Would reducing the employers' risk and plan complexity help?

Reducing employers' risk and plan complexity would make it easier and more attractive for businesses to provide their employees with a pension benefit.

Employers have been shifting away from traditional defined-benefit pension plans for a number of reasons, including plan complexity, regulatory changes, and reduced inflation, but a central factor in the shift has been the volatility of pension funding.[8] Some employers have been willing to bear this volatility, but for most employers the risk that additional contributions may be required—especially during tough economic times when money is tight—has been a significant disincentive for employers to offer defined-benefit pensions. The unpredictable nature of pension contributions can cause problems for a company's balance sheet.

Hybrid models, such as CAP's collective defined contribution plan and Sen. Harkin's USA Retirement Funds can reduce this volatility for employers. That is because to employers, these kinds of hybrid plans are defined-contribution plans, like a 401(k).

In these hybrid models the employer is not responsible for guaranteeing benefits, but rather is only responsible for making contributions—just like in a 401(k). Thus the employer would enjoy predictable contribution levels and minimal risk.

I think these hybrid models would be very attractive to employers. Employers would be able to provide a retirement plan that is more likely to lead to a secure retirement for their employees than a 401(k) without taking on the cost, risk, and complexity of a defined-benefit pension plan. In short, these kinds of hybrid plans allow employers to provide a good retirement plan to their workers without bearing the responsibilities of a defined pension plan.

What do employees need from a pension plan to ensure they will have a secure retirement?

As I mentioned before, retirement planning is a tradeoff between cost, risk, and adequacy. Workers need a retirement plan that does a good job managing these tradeoffs, meaning the plan is cost effective, minimizes risks, and has a very high likelihood of providing an adequate retirement benefit.

There are three core elements in retirement plan design that are particularly important in effectively managing the costs and risks of retirement: professional money management, long investment time horizons, and the ability to spread risks across multiple generations. Both Sen. Harkin's USA Retirement Funds and CAP's collective defined contribution plans include these features.

Let's start with how these features reduce the cost of saving for retirement.

Professional money management of a pension fund leads to higher investment returns than most 401(k) participants achieve.[9] Though fund managers have a hard time beating market averages,[10] they typically do much better than individual investors—in large part by avoiding common investing pitfalls such as such as failing to diversify assets and pulling money out of stocks at the bottom of the market and thus missing the rally.[11] Professional money managers would ensure retirement portfolios are properly diversified and invested for the long haul to achieve better returns than most individual investors are likely to achieve.

Similarly, pooling investment risks over a longer time period also boosts investment returns: Individuals in a 401(k) have to become more conservative with their investments as they age because they have less time to recover any possible losses, resulting in lower returns. But when accounts of both older and younger workers are pooled together, the fund manager can maintain a balanced portfolio that achieves higher returns. This effect, called intergenerational risk sharing, can substantially raise pension returns.[12]

Finally, pooling longevity risk across all retirees in the plan means that the plan needs only to accumulate sufficient funds to pay for the average retiree's lifespan in the plan. In contrast, an individual with a 401(k) has to save an amount sufficient for their maximum life expectancy: Saving only enough for the average lifespan could leave retirees without sufficient income in their later years.[13]

These advantages mean that a retirement plan with these features would cost an estimated 46 percent less than a 401(k) to provide the same level of retirement benefit, according to research by the National Institute on Retirement Security.[14] To put this percent savings in dollar terms: A worker earning $50,000 before retirement would need to contribute an estimated $5,200 less in the year before retirement and thousands less in each of the other 29 working years they made retirement contributions to save enough for a secure retirement with a collective defined contribution plan compared to a 401(k).[15]

These features also help reduce the risk of saving for retirement when compared to a 401(k).

A long investment horizon helps mitigate the risk that the market performs poorly while a worker is saving for retirement. While an individual career may seem like a long time horizon for retirement investing, the chance that the market will perform poorly during the time when a worker is most aggressively invested in the market is still quite great compared to the longer timeframe that the intergenerational pooling of the CDC allows. A shorter timeframe increases the chance an individual will experience a period of low growth. For example, the lowest average annual return on the Dow Jones Industrial Average over a 75-year period was 3.05 percent compared to a low of -0.04 percent annual return for investments over a period of 30 years.[16]

Further, the risk that an individual in a 401(k) is hurt by a big drop in the market is much greater than the risk borne by participants in a collective defined contribution plan. That is because investment timing risk can be particularly acute for an individual but is less critical for a pooled investment fund.

Between December 2007 and June 2009 (the duration of the Great Recession), for example, workers who were near retirement, aged 55 to 64, and had a 401(k) for 20 to 29 years, saw their account balance decrease by 17.4 percent on average—and though account balances have recovered slightly since then, they are still down significantly.[17] In contrast, estimates suggest that because of investment losses suffered during the Great Recession, hybrid pensions in the Netherlands—where the hybrid model is common—may need to be reduced by much less.[18]

In short, hybrid models with professional money management, long investment time horizons, and the ability to spread risks across multiple generations are a good way to manage the tradeoffs inherent in retirement planning because they reduce costs and risks and make a secure retirement more likely.

The pension system of the future should include a hybrid model to ensure all workers have a cost-effective and secure way to save so that Americans can maintain their standard of living in retirement and retire with dignity.

Endnotes

[1] Christian E. Weller, "Building It Up, Not Tearing It Down: A Progressive Approach to Strengthening Social Security" (Washington: Center for American Progress, 2010).

[2] Rowland David, Nayla Kazzi, and David Madland, "The Promise and Peril of a Model 401(k) Plan: Measuring the Effectiveness of Retirement Savings Plans Offered by Private Companies and the Federal Government" (Washington: Center for American Progress Action Fund, 2010).

[3] Alicia H. Munnell, "401(k) Plans in 2010: An Update From the SCF" (Chestnut Hill, MA: Center for Retirement Research at Boston College, 2012). According to the 2010 Survey of Consumer Finances, the typical household approaching retirement with a 401(k) balance had only $120,000 in 401(k)/IRA holdings. The $575 per month figure cited assumes an individual purchases an annuity at age 65. Note that the $120,000 figure includes IRA balances, as these are largely due to 401(k) rollovers. Note also that when those with no 401(k) wealth are included in these calculations, the median retirement balance is significantly lower. Indeed, EBRI surveys indicate that 48 percent of respondents had less than $10,000 in savings. See: Ruth Helman, Craig Copeland, and Jack VanDerhei, "The 2012 Retirement Confidence Survey: Job Insecurity, Debt Weigh on Retirement Confidence, Savings" (Washington: Retirement Benefit Research Institute, 2012).

[4] Alicia H. Munnell, Rebecca Cannon Fraenkel, and Joshua Hurwitz, "The Pension Coverage Problem in the Private Sector" (Chestnut Hill, MA: Center for Retirement Research at Boston College, 2012). Note that over a lifetime of working, the authors' estimates indicate that about one-third of workers will never be covered under workplace retirement plans.

[5] U.S. Senate Committee on Health, Education, Labor and Pensions, "The Retirement Crisis and a Plan to Solve It" (2012).

[6] David Madland, "Making Saving for Retirement Easier, Cheaper, and More Secure" (Washington: Center for American Progress, 2012), available at http://www.americanprogress.org/issues/economy/report/2012/09/17/38263/.

[7] Beth Almedia and William B. Fornia, "A Better Bang for the Buck: The Economic Efficiencies of Defined Benefit Pension Plans" (Washington: National Institute on Retirement Security, 2008); Madland, "Making Saving for Retirement Easier, Cheaper, and More Secure."

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[9] Ibid.

[10] Ron Elmer, "College Endowment and Public Pension Fund Returns Are Not Good," Investor Cookbooks, February 9, 2012, available at http://investorcookbooks.blogspot.com/2012/02/college-endowment-and-public-pension.html; Sydney P. Freedberg and Connie Humburg, "Easy investments beat state's expert pension planners," *Tampa Bay Times*, July 31, 2011, available at http://www.tampabay.com/news/politics/article1183442.ece; Jeff Hooke and Michael Tasselmyer, "Wall Street Fees and The Maryland Public Pension Fund" (Germantown, MD: The Maryland Public Policy Institute, 2012).

[11] Chris Flynn and Hubert Lum, "DC Plans Under Performed DB Funds" (Toronto, CEM Benchmarking, 2006); Towers Watson, "Defined Benefit vs. 401(k) Investment Returns: The 2006-2008 Update" (2009).

[12] Christian Gollier, "Intergenerational risk-sharing and risk-taking of a pension fund," *Journal of Public Economics* 92 (6) (2008): 1463–1485.

[13] Almedia and Fornia, "A Better Bang for the Buck."

[14] Ibid.

[15] Author's calculations using data from: Almedia and Fornia, "A Better Bang for the Buck."

[16] Author's calculation of historical Dow Jones Industrial Average.

[17] Employee Benefit Research Institute, "Change In Average Account Balances (by Age and Tenure) From January 1, 2008 – June 30, 2009 Among 401(k) Participants with Account Balances as of Dec 31, 2007" (2010).

[18] Leen Preesman, "Dutch regulator confirms more than 100 pension funds facing discounts," *Investment & Pensions Europe*, February 21, 2012; Personal communication from Pieter J. Kiveron, Managing Director, Holland Financial Centre, September 7, 2012.