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Statement of
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Chairman Parsky and members of the Commission, thank you for the opportunity to meet with you and discuss an important policy issue affecting the financial security of millions of Americans. I am privileged to be here today to share with you some of the insights I have gained during my 35 year career working with retirement plans.

Background

Slide 1

Financial needs in retirement are increasing – longevity increases cause longer retirements and medical care expenses continue to rise for all Americans, particularly the elderly. Yet, private-sector retirement plans are trending toward a structure that will provide substantially less financial security to elderly Americans and result in greater divergence between the wealthy and the poor in our society. This decreasing financial security is the result of less diversified financial resources, less risk sharing, and smaller employer contributions toward retirement.

Slide 2

The past 20 years have seen an overwhelming trend in the private sector toward individual account-based plans, or defined contribution plans, and away from lifetime income plans, or defined benefit plans. Over-reliance on these individual account plans concentrates multiple risk factors on the individual, lessens the diversification of the retirees' financial assets, and forgoes the benefits of risk-pooling.

Individual account-based plans are an essential element of financial security. Changes in legislation over the past 30 years have encouraged these plans, resulting in many more Americans participating in them and accumulating significant assets for their retirement. These changes are desirable and have been successful. Approximately 90% of private sector workers have access to defined contribution plans now versus only about 38% in 1979.[1]

Unfortunately, **excess** reliance on this type of plan is likely to reduce the financial security of retirees. Financial security is enhanced by diversity of the sources of income, such as social security, pensions and personal savings, not just diversification of individual investments. Diversity of income sources has declined over this same time period as defined benefit coverage has decreased from about 84% in 1979 to only 37% in 2005, and it continues to decline as employers close or freeze pension plans.

[1] Facts from EBRI, Employee Benefit Research Institute, June 2007

Furthermore, the amount of contributions employers make to DC plans is often less than was made to the closed or frozen pension plan.

The private sector has recognized that individual savings are an essential part of a secure retirement. Matching contributions in 401(k) plans provide a strong incentive for individuals to save for retirement. But the private sector may be going too far in this direction. As companies close pension plans to new hires or freeze benefits for existing employees, enormous strain is placed on the individual account plans to provide the primary, perhaps the only, source of retirement security. While individual plans are important to a secure retirement, they are far from perfect retirement plans.

Shortcomings of Individual Account Plans as Sole Retirement Vehicle

Slide 3

Many individual account plans rely on voluntary employee contributions, and employer contributions are often contingent on the employees' contributing. Unfortunately, many workers in our society are not able to take full advantage of these opportunities. Despite the significant increases in opportunities for Americans to save on a tax-favored basis, the overall savings rate in America declined from 10% in 1980 to less than 2% in 2003 and in 2005 it actually became negative. Such savings rates are not likely to finance a secure retirement. Furthermore, personal savings and participation in voluntary retirement plans is generally less prevalent among low-paid workers than among high-paid workers, thus increasing the gap between the wealthy and the less fortunate.

The private sector trend to greater reliance on individual account plans is not being matched by increase in worker savings rates. Without a dramatic change in savings, inadequate retirement resources are likely to place a strain on our welfare system for the elderly.

Individual account plans depend on the long-term investment results and the decisions made by individuals. Regardless of the amount of investment education provided to participants, there will always be winners and losers. Not everyone can attain outstanding or even average results. The nature of the investment markets and the laws of mathematics make it certain that half will experience less than median returns. Again, it is likely that this half has a greater share of the lower-paid workers, thus increasing the gap between wealthy and less wealthy.

Even the median return of these plans is generally lower than the investment returns of pooled defined benefit plans. Thousands of individual employees making individual decisions seldom produce the aggregate return that investment professionals attain for defined benefit plans. This is especially true during the retirement years, when individuals generally must invest more conservatively, must maintain higher levels of liquidity, and, if they withdraw a steady income from their assets, are subject to the perverse opposite of dollar cost averaging – they must sell more assets when prices are low to maintain their income.

These plans experience substantial leakage throughout an employee's career. The availability of loans, in-service withdrawals, and lump sum distributions upon termination of employment are irresistible to many employees and gradually erode the assets intended for retirement. Even at retirement, a substantial portion of retirement assets are often used for a major purchase or debt reduction, not for the intended purpose – retirement income.

Individual account plans accentuate the problems associated with economic cycles. Companies faced with difficult economic challenges are sometimes forced to lay off employees. Retirement-age employees terminated at a time when markets are down have even fewer resources than expected for their retirement.

Finally, individual account plans are less efficient in providing income that will last a lifetime. This inefficiency results from the absence of risk-pooling. Individuals needing to provide a lifetime income cannot base their plans on surviving to the average life expectancy. Workers, and even actuaries, don't have a crystal ball and cannot predict how long an individual will live. If their assets are exhausted by the time that age is reached, the consequences are severe. Consequently, true financial security is attained only if retirees plan to survive considerably beyond life expectancy, thus spending less each year, on average, than would be possible if the longevity risk were pooled.

These shortcomings of individual account plans are the reasons we should avoid over-reliance on them to provide retirement security. They are essential elements of retirement income, but over-reliance results in less diversified financial security and a less efficient retirement income.

Balancing DC and DB plans offsets deficiencies of each

Slide 4

A balance of individual account retirement plans and lifetime income provided through employer-sponsored defined benefit pension programs results in better diversified and more secure financial retirement. Defined benefit programs offset many of the shortcomings of individual account plans:

- Pension plans generally provide universal coverage for all employees and usually do not require the employee to contribute to the plan in order to receive a benefit. DC plans could be designed this way, but generally are not.

- The benefits from a pension plan are generally uniform for all employees and are not influenced by individual investment decisions.

- Investment returns on pension plans are generally greater than on individual account plans owing to professional asset allocation decisions, lower transaction costs and other expenses, and lower liquidity needs.

- There is generally no leakage from pension plans, as most do not allow loans or in-service withdrawals, and many do not permit lump sum distributions – benefits are generally paid as a lifetime income at retirement.

- Pension plans offer the ability to provide special benefits to workers forced out of employment due to layoffs or other unforeseen consequences. Special window benefits for employees near retirement can provide a humane cushion even when individual account benefits have declined.

- Longevity pooling in pension plans allows the sponsor to fund for the average life expectancy of participants, thus producing considerable efficiencies in funding.

Despite the many advantages to a balanced retirement program, the past 20 years have seen an enormous shift toward a system that relies excessively on individual account plans. If this trend continues over the next 20 years we will experience a less efficient and less reliable retirement system for most Americans.

Why the Change? The Shortcomings of Pension Plans

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Why has this happened? Pension plans have significant shortcomings also, and many of these, particularly the financial shortcomings, have become more apparent in recent years.

Private sector pension plans grew rapidly in the 1950s and 1960s. Favorable tax rules, relatively little funding requirements, and lax accounting treatment made it easy for companies to establish pension plans and promise employees significant deferred benefits with relatively low **perceived** cost. But the real cost may have been much greater.

Many, but not all, employers funded these pension plans responsibly. A few well publicized plan terminations highlighted the pitfalls of inadequate funding when a plan sponsor becomes insolvent. This led to the passage of ERISA and the adoption of minimum funding rules for private sector plans and the creation of the Pension Benefit Guaranty Corporation.

Minimum funding rules were originally not onerous, but also were not adequate. Sponsors could choose one of six different funding methods, could make relatively optimistic assumptions regarding investment returns, could smooth volatile investments returns, and could amortize liabilities over as much as 40 years. But the rules changed over the years, with generally shorter amortization periods and more emphasis on current funded ratios. Even before the adoption of the Pension Protection Act, many companies' contributions were driven by relatively short amortization of liabilities determined at low interest rates based on Treasury securities.

The recent passage of the Pension Protection Act changes the focus of private sector funding from that of a long term cost with substantial smoothing of volatility to attaining a 100% funded ratio on an accrued benefit basis with assets and liabilities determined on market value basis.

The establishment of the PBGC significantly affected pension plans also. Seen by many as a mixed blessing, it provides an ultimate guarantee of certain pension benefits for the individual, but also creates unintended consequences throughout the system. The premium structure was initially minimal ($1 per participant), but has grown to a significant level ($30 per participant plus 0.9% of any unfunded liability). Sponsors view this cost as an additional cost of pension plans that is not required in defined contribution plans.

The existence of the PBGC creates potential hazards to pension funding. Weak pension sponsors may be encouraged to take on more risk than is appropriate, knowing that if their risky investments prove beneficial they will lower their cost, but if they lose the PBGC may ultimately take over liabilities. Strong pension sponsors with well funded plans feel they may incur additional costs because of the indiscretions of weak sponsors.

The problems of the PBGC and rapid deterioration of funding ratios for most pension plans in the early part of this decade placed an increased focus on the solvency of pension plans.

Multiple accounting rule changes and the evolution of financial theory have increased the emphasis on transparency and reporting pension obligations on a current value basis with both liabilities and assets marked to market value.

The combination of funding rules and accounting changes that both focus on transparency and market values for reporting funding status and plan cost is pushing many plan sponsors toward benefit design under which the cost is certain and predictable.

Defined contribution plans provide cost certainty and complete transparency. The sponsor’s cost is simply the contribution made each year. There are no liabilities and no funded status to report.

Defined benefit pension plans present greater complications. The ultimate cost of the plan can only be estimated. These estimates entail many assumptions. To determine the benefits that will be paid, one must estimate how long employees will work, how much they will be paid, when they will retire, and how long they and their spouses will survive. Even that is not enough – one must determine the asset amount to provide these benefits and that requires estimating current and future interest rates and investment returns.

These estimates involve a great deal of uncertainty and as estimates change, the cost and reported funding ratios become volatile. Past funding and accounting rules made it easy for a sponsor to adopt relatively optimistic assumptions and low estimates of cost. When these optimistic assumptions did not pan out, costs increased dramatically. The current demand for more transparency and greater emphasis on predictable results makes these plans less attractive.

Pension plans are also perceived as more expensive than DC plans. There are multiple aspects to this perception. First, pensions often provide higher level of benefits, but this is an unfair comparison. When evaluated on the basis of providing comparable levels of retirement income, pensions are actually less expensive. Second, pension plans are perceived to have higher administrative expense. This perception results primarily from the sponsor paying all expenses in a pension plan, while administrative expenses are often passed to the plan participant in a DC plan. Pension plans also have the additional expense of PBGC premiums.

Finally, not all the shortcomings of pension plans are finance related. Private sector employers have experienced a more mobile workforce, with less emphasis on career employment. DC plans are often seen as more attractive than traditional final pay pension plans. This is actually more an issue with the final pay design of most plans rather than the DB versus DC aspect. Cash balance plans and variable annuity plans are DB plans that can be attractive to a mobile workforce.

Public sector plans are affected by many of the same issues that drive private sector employers to DC plans. Although insolvency as seen with bankrupt private sector sponsors is less of an issue, equity among various generations of employees and taxpayers is important to preserve a stable system. Poor estimates of cost can lead to substantial intergenerational risk transfer. Excess risk transfer will quickly lead to an unstable system with demands for change or even termination of what are perceived as unfair and inequitable benefits.

Creative response

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The private sector is constrained in its response by the extensive regulation of federal law and rule driven accounting system. Creative responses are relatively uncommon. Most hybrid pension plans (generally cash balance or pension equity plans) are simply DB plans designed to look like DC plans, but they still involve most of the inherent uncertainties of traditional pension plans.

Governmental plans are not as constrained (at least with regard to future employees) and may consider more creative solutions. We seem to be locked into a mentality that retirement benefits must be either defined contribution or defined benefit. In a DC plan, the sponsor contributes a fixed amount, but the ultimate benefit is uncertain. In a DB plan, the participant's benefit is fixed and certain, but the sponsor's cost is only estimated.

The efficiencies of pooling longevity risk and providing lifetime income can be accomplished without strict adherence to the traditional DB model. For example, in some European countries, benefits and contributions are initially fixed but periodically adjusted if funded ratios exceed or fall below predetermined levels. Both participants and sponsors share in the adjustment. This provides lifetime income to the participant and greater cost stability to the plan sponsor.

In the US a few plan sponsors have adopted variable annuity plans. These plans transfer investment risk and reward to the participant, but pool the longevity risk. They provide a lifetime income to the participant with the potential, but not the guarantee, of inflation protection. At the same time, they provide a high degree of cost certainty to the sponsor without the potential of large unfunded liabilities.

These innovative variations of the traditional DB/DC model offer compromises that adopt the best features of both plans.

Summary

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Our workforce is aging. We are faced with a future in which an ever larger percentage of our population will be retired. If these retirees face widespread economic challenges, it is likely to be detrimental to our entire economy and strain our public welfare system. The looming retirement of the baby boom generation provides the catalyst to design a retirement system that will work for many future generations. A successful system will have a balance between capital accumulation plans and lifetime income plans, but the allocation of risk and costs in these plans may vary significantly from the paradigms we see today.

An effective retirement system should be diversified. The three-legged stool analogy is in danger. Individual account plans essentially convert employer contributions to the employee savings leg of the stool since after the employer contributes funds, they have little risk or responsibility with respect to these funds. The employee bears all investment risk and longevity risk. The original concept of the three-legged stool involved each leg bearing risk and responsibility, not just contributing funds and subsequently having no involvement.

We have an opportunity now to restore balance to this analogy before it becomes excessively lopsided. I urge the Commission to adopt recommendations that will enhance the diversity of financial resources for future retirees and provide balance to retirement system. Thank you very much for the opportunity to share these thoughts.