STATEMENT OF THE INVESTMENT COMPANY INSTITUTE
Hearing on "The Impact of the Financial Crisis on Workers' Retirement Security"
House Education and Labor Committee
October 21, 2008

The Investment Company Institute appreciates the opportunity to provide its research and expertise in connection with the Education and Labor Committee's October 7 hearing on the impact of the financial crisis on Americans' retirement security.

Financial markets in the U.S. and around the world have experienced unprecedented turmoil in recent weeks. For many Americans, the most visible sign of the current financial crisis is the severe downturn and volatility of the U.S. stock market. Americans saving for retirement understandably are anxious. Institute research demonstrates, however, that the private employer-based system can withstand financial shock and even flourish in its aftermath. Our research finds that plan investors do not overreact to market downturns or panic, that they have a demonstrated commitment to long-term savings, and that consistent 401(k) contributors have seen their accounts rebound after bear markets. It would be a grave mistake to use recent market events as an excuse to dismantle the current retirement system, as some suggested at the October 7 hearing.

The recent market downturn has an impact on the U.S. retirement system, because employment-based defined benefit and defined contribution plans, being long-term savings vehicles, invest to a large degree in equities. On average, 401(k) participants are invested about 60 percent in equity funds and individual securities (primarily company stock) and about 13 percent in balanced funds (which include both equities and fixed-income investments), as of 2006.[1] Defined benefit plans similarly are invested primarily in equities.[2] Volatility in the stock market leads to short-term volatility in defined contribution plan account balances, and because of advances in recordkeeping, 401(k) participants can now track their accounts on a daily basis. Stock market volatility also has an impact on the ability of employers to maintain adequate funding of defined benefit plans.

Based on ICI's extensive research on retirement security and mutual fund investors, our statement makes these points:

- In times of volatility and turmoil, it is important to maintain and project confidence in the United States' private retirement system.
- Long term retirement savers can withstand volatility.

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[1] 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, August 2007, available at http://www.ici.org/pdf/per13-01.pdf.

[2] Federal Reserve data show that, as of 2007, private defined benefit plans held about $2.7 trillion in total financial assets. Of that, $1.7 trillion (or about 63 percent) was held in corporate equities, and another $308 billion was held in long-term mutual funds (which invest in stocks, bonds, or a combination). See U.S. Federal Reserve Flow of Funds Accounts, Z.1 release, Table L.118.b (September 18, 2008), available at http://www.federalreserve.gov/releases/z1/Current/z1r-6.pdf.

- 401(k) investors have demonstrated a commitment to long-term savings.
- While the employer-based retirement system can continue to be improved, it remains a reliable system for providing retirement security to millions of Americans.

Importance of confidence and long-term outlook

In times of volatility and turmoil, it is important to maintain and project confidence in the United States' private retirement system. The trillions of dollars retirement plans have invested in thousands of U.S. companies are at their core an investment in America's long-term future. Panicked selling of defined benefit and defined contribution assets is not in the interest of participants and beneficiaries (or the taxpayers who backstop the PBGC) and would exacerbate market turmoil.

U.S. workers and employers have shown great confidence in the retirement system. U.S. retirement plans held $17.1 trillion, as of first quarter 2008.[3] This represents nearly 40 percent of household financial assets—twice the percentage of just10 years ago. Sponsorship of defined contribution plans by employers has continued to grow. At year-end 2007, there were an estimated 641,000 private-sector defined contribution plans with 54.6 million active participants.[4] Based on our research we believe this confidence is deserved even during downturns of the business cycle.

Long term retirement investors can withstand volatility. In 1999, total U.S. retirement market assets temporarily peaked at $11.8 trillion [Figure 1]. 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 had fallen 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 index fell 37 percent over the same period – because retirement savings are tempered by diversification and ongoing contributions.) Retirement assets quickly rebounded the next year and as of the end of the first quarter of 2008 total assets were up 62 percent from the 2002 bottom.

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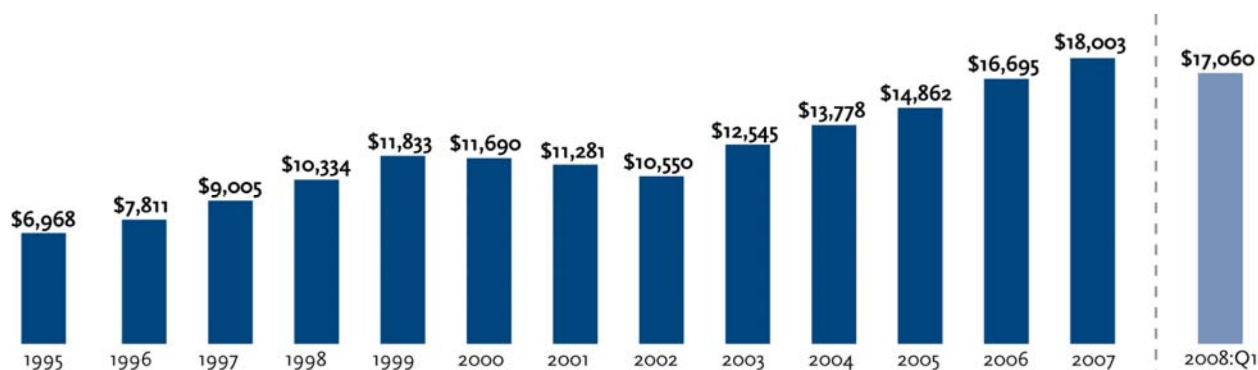
[3] See *The U.S. Retirement Market, First Quarter 2008*, ICI Fundamentals, vol. 17, no.3-Q1 (October 2008), available at http://www.ici.org/statements/res/retmrkt_update.pdf. ICI's latest data are for the end of first quarter 2008, which showed a decrease in total U.S. retirement assets of almost $1 trillion from year-end of 2007 [Figure 1]. Peter Orszag of the Congressional Budget Office estimated at the October 7 hearing that retirement assets could be down another $1 trillion.

[4] See Brady and Holden, *The U.S. Retirement Market, 2007*, ICI Fundamentals, vol. 17, no. 3, n.22 (July 2008) (citing Cerulli Associates estimates). The bulk of these plans were 401(k) plans, with 469,000 plans and 47.2 million active participants.

FIGURE 1

U.S. Total Retirement Market

Billions of dollars, end-of-period, 1995–2008:Q1



Sources: Investment Company Institute, Federal Reserve Board, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division

Mutual fund investors do not overreact to market volatility. Defined contribution plan participants are just one subset of fund investors, and the experience of all mutual fund investors over market downturns is that they do not overreact to market volatility or panic. In the mid-90s, ICI analyzed mutual fund shareholder activity during the 14 major stock market cycles going back to World War II.[5] In none of the stock market breaks and sharp declines did mutual fund investors liquidate their shares en masse.[6] This was seen even in the aftermath of the October 19, 1987 market crash: only about 5 percent of stock fund shareholders liquidated shares in the six weeks after the crash. Analysis of the 1987 market break showed that it was chiefly *institutional* investors, and not individuals in retail accounts, 401(k)s or IRAs, that drove the market down.[7] The 95 percent of mutual fund shareholders

[5] See Rea and Marcis, *Mutual Fund Shareholder Activity During U.S. Stock Market Cycles, 1944–95*, ICI Perspective, vol. 2, no. 2 (March 1996), available at http://www.ici.org/pdf/per02-02.pdf.

[6] The research found that mutual fund investors are not insensitive to stock price movements, but their response tends to be spread over time, and tends to be in response to long-run trends in equity returns. Subsequent research shows that mutual fund shareholders' reaction to significant downturns or major events, such as the September 11, 2001 attacks, is muted. See Reid, Millar, and Sevigny, *Mutual Fund Industry Developments in 2001*, ICI Perspective, vol. 8, no. 1 (February 2002), available at http://www.ici.org/pdf/per08-01.pdf. ICI also looked at net flows of funds during the period between June 2002 and February 2003, when the stock market fell 21 percent, and found equity funds had outflows of only 3.3 percent of assets held in equity funds at the beginning of the decline.

[7] See testimony of Nicholas Brady, Chairman, Presidential Task Force on Market Mechanism, Hearings before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Feb. 2, 3, 4, and 5, 1988), S. Hrg. 100-649, page 52 ("It is a strange commentary on this country that the individuals – or maybe it isn't strange – that the individuals are the guys that stay there, through market turbulence, and that institutions do the trading.")

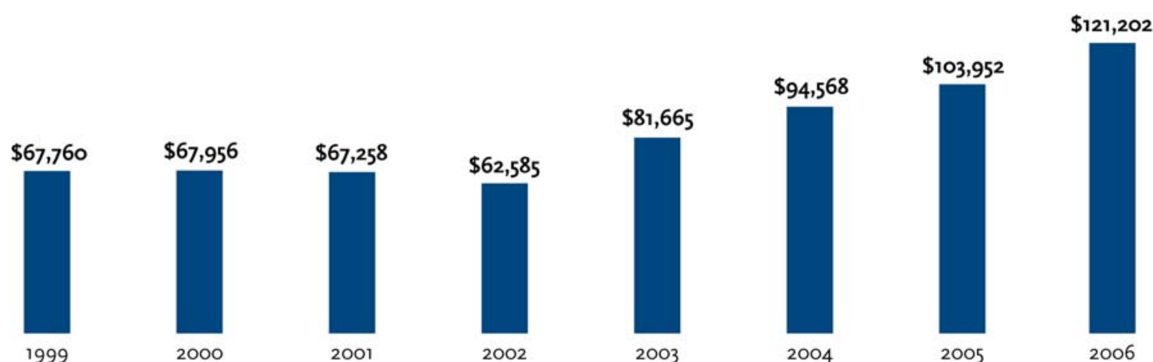
who did not liquidate mutual fund shares in the six weeks after the October 19, 1987 market crash were poised to benefit from the market rebound that followed October 1987.

Rebound in participant 401(k) accounts. The ability to recover from market downturns is also seen in the experience of individual 401(k) accounts. The EBRI/ICI Participant-Directed Retirement Plan Database, the largest, most 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.[8] An analysis of participants with account balances at the end of each year from 1999 through 2006 (that is, consistent savers in the database) shows that between 1999 and 2002, the average account balance of this group fell 8 percent [Figure 2]. But 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 during the 2000–2002 market downturn. If those participants had stopped contributing, left the 401(k) system or moved their balances out of the stock market in 2002, they would have locked in their losses and missed out on the market rebound.

FIGURE 2

401(k) Account Balances Through Last Market Downturn

Average 401(k) account balances among 401(k) participants present from year-end 1999 through year-end 2006,[1] 1999–2006[2]



[1]Account balances are participant account balances held in 401(k) plans at the participants' current employers and are net of plan loans. Retirement savings held in plans at previous employers or rolled over into IRAs are not included.

[2]The analysis is based on a sample of 3.0 million participants with account balances at the end of each year from 1999 through 2006.

Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

The 401(k) system is new enough that no one has yet had a full career in the system, so ICI has examined in collaboration with EBRI whether a full career with 401(k) plans can produce adequate

[8] See Holden, VanDerhei, Alonso, and Copeland, supra note 1.

income replacement rates at retirement.[9] The EBRI/ICI 401(k) Accumulation Projection Model examines how 401(k) accumulations might contribute to future retirees' income based on decisions workers make throughout their careers. The model looks at 401(k) participants of varying income levels and models future accumulations under a range of participant behaviors and scenarios—including modeling various long-term market returns that included significant historical market downturns. The model demonstrates that 401(k) can produce adequate replacement rates at retirement when combined with Social Security. For example, among individuals who were in their late twenties in 2000, after a full career with 401(k) plans, the median individual in the lowest income quartile is projected to replace about 100 percent of his or her pre-retirement income using 401(k) accumulations and Social Security. The model also demonstrates that when workers move into jobs that do not offer a 401(k) plan, median replacement rates fall significantly – by about half for workers in the lowest income quartile. Other research demonstrates that, once Social Security, savings during employment, and taxes are accounted for, even moderate savings rates can lead to adequate replacement rates after retirement.[10]

Demonstrated commitment to long-term savings

Contrary to what some believe, most 401(k) investors are not raiding their nest eggs. Loan activity by participants, even during bear markets, is very modest. Less than one in five participants in 401(k) plans that offer loans had a loan outstanding at year-end 2006, and among those with a loan, the loan represented only 12 percent of the remaining account balance on average.[11] The Department of Labor's latest available data shows participant loans represent less than 2 percent of the assets of defined contribution plans.[12]

EBRI and ICI analyzed distribution and hardship withdrawal activity in its database a number of years ago, but the incidence of withdrawal activity was so small we have not repeated the analysis. Surveys of retirement savers find most leave their money invested in a 401(k) plan or IRA until the government *forces* them to remove it at age 70 ½.[13] While there have been recent anecdotal reports of

[9] See Holden and VanDerhei, *Can 401(k) Accumulations Generate Significant Income for Future Retirees?* and *The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement*, ICI Perspective and EBRI Issue Brief, Investment Company Institute and Employee Benefit Research Institute, November 2002 and July 2005, respectively, available at http://www.ici.org/pdf/per08-03.pdf and http://www.ici.org/pdf/per11-02.pdf, respectively.

[10] See Peter J. Brady, "Measuring Retirement Resource Adequacy," *Journal of Pension Economics and Finance* (forthcoming); working paper version (February 2008), available at http://ssrn.com/abstract=1092590.

[11] See Holden, VanDerhei, Alonso, and Copeland, supra note 1, Figures 43 and 44.

[12] See Department of Labor, *Private Pension Plan Bulletin, Abstract of 2005 Form 5500 Annual Reports* (February 2008), Table A3, page 7.

[13] Just-released ICI research based on a 2007 survey of more than 600 recent retirees about their distribution decision from a defined contribution plan finds that more than half of DC plan participants received their distribution as a lump sum. Of these, 86 percent reinvested all or some of the proceeds, usually in rollover IRAs; 62 percent reinvested the entire amount. Only about 3 percent of accumulated DC account assets were spent immediately at retirement. Of those who spent their entire lump sum, most used the proceeds prudently, for example, to buy a primary residence, make home repairs, repay debt, or pay for healthcare. See Investment Company Institute, *Defined Contribution Plan Distribution Choices at Retirement*, *A*

increased withdrawals, this should be viewed in the context of the very small percentage of participants who take withdrawals before retirement. For example, one study of more than 16,000 plans, representing 11.5 million workers, found that in the three month period ending June 30, 2008, only 0.60 percent of participants had made hardship withdrawals, compared with 0.56 percent a year earlier.[14]

Retirement savers also appear to continue to save even during bear markets. An analysis of a large sample of 401(k) participants drawn from the EBRI/ICI database, which includes data for the 2000–2002 market downturn, found that contribution rates were little changed in 2000, 2001, or 2002, compared to 1999.[15]

Asset allocation of 401(k) investors

The Committee heard repeatedly at the October 7 hearing that diversification and age appropriate asset allocation are key to mitigating volatility and reducing unnecessary risk for 401(k) plan participants. We agree, and our research shows that on average participants are following that advice. As participants age, they tend to favor fixed-income securities such as bond funds, guaranteed income contracts, stable value funds, and money market funds [Figure 3].[16] Although the overall percentage asset allocation of equities tends to rise and fall with the stock market,[17] the phenomenon of older workers being more concentrated in fixed-income investments has been consistent in the more than a decade of data reflected in the EBRI/ICI Database.

Survey of Employees Retiring Between 2002 and 2007 (Fall 2008), available at http://www.ici.org/pdf/rpt_08_dcdd.pdf. In addition, among IRA-owning households making withdrawals, the most commonly cited reason is to meet required minimum distributions. See Holden and Bogdan, *The Role of IRAs in U.S. Households' Saving for Retirement,* ICI Fundamentals, vol. 17, No. 1, January 2008, available at http://www.ici.org/pdf/fm-v17n1.pdf.

[14] See Joe Morris, "401(k) Contributions Hold Steady," *Ignites*, August 14, 2008.

[15] Sarah Holden and Jack VanDerhei, "Contribution Behavior of 401(k) Plan Participants During Bull and Bear Markets," *National Tax Association Proceedings, Ninety-Sixth Annual Conference on Taxation, November 13-15, 2003, Chicago, Illinois*, pp. 44-53, Washington, DC: National Tax Association (2004).

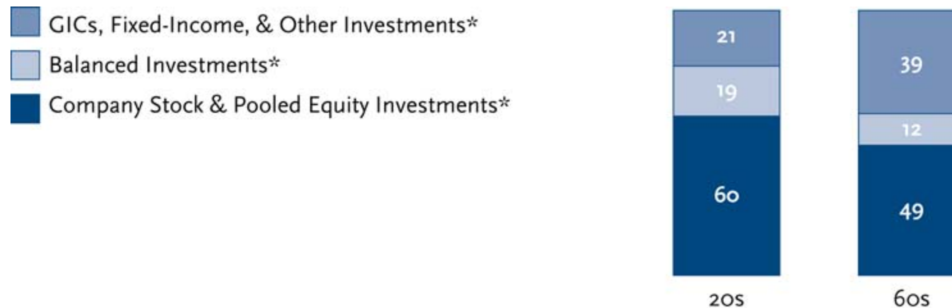
[16] There is no asset allocation that is correct for all individuals. The proper asset allocation depends on an individual's own tolerance of risk. In addition, asset allocation needs to be considered across an individual's entire portfolio: the proper allocation inside a 401(k) cannot be determined independent of the individual's other assets. For most individuals approaching retirement, the bulk of their wealth is in the form of promised future Social Security benefits. Social Security benefits have characteristics similar to a bond indexed to inflation. Thus, observing only the asset allocation inside a 401(k) account typically overstates the amount of an individual's wealth allocated to equity.

[17] See Holden, VanDerhei, Alonso, and Copeland, supra note 1, figure 20.

FIGURE 3

401(k) Participants Asset Allocation Varies with Age

Percent of assets, year-end 2006



*Includes mutual funds and other pooled investments.

Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project

The Committee also heard about participants at the extremes who fail to properly diversify their accounts or fail to alter their risk allocations over time. For example, some participants' accounts are heavily invested in the stock of their employer – EBRI/ICI data show that in 2006 nearly 9 percent of participants in plans that offered company stock as an investment had more than 80 percent of their account balances invested in company stock (although the share of company stock in 401(k) participants' accounts has diminished since 1999).[18] Even participants who properly allocate their account at one time may fail to rebalance or alter the allocation over time.

Plan sponsors and the 401(k) service industry saw the need to foster diversification and age appropriate allocations and developed innovative features to make participants better investors and automate their decisions to position participants to weather exactly the conditions that currently plague the stock market. Many of these innovations have now been adopted by public sector plans, including the federal Thrift Savings Plan:

- *Investment options like lifecycle or target date funds, and balanced funds, that encourage diversification and age appropriate asset allocation*. From their introduction in the 1990's to the end of first quarter 2008, lifecycle mutual fund assets have grown to $185 billion.[19] The availability of these options continues to grow—about one-third of plans offered target date funds in 2007, up from about 25 percent in 2005.[20] These "one-stop" investments have been

[18] See Holden, VanDerhei, Alonso, and Copeland, supra note 1, figures 20 and 32.

[19] See *The U.S. Retirement Market, First Quarter 2008*, supra note 3, figure 13. (Lifecycle mutual funds were significant enough by 1996 for ICI to track them separately.)

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

added to the Thrift Savings Plan as the "L" funds (which as of the end of 2007 had almost $25 billion in assets).[21]

- *Autoenrollment and autoescalation that facilitate savings*. Even before the passage of the Pension Protection Act of 2006, plan sponsors began automatically enrolling participants in 401(k) plans and increasing their contribution rates each year, unless a participant opts out. Congress strengthened this feature through a number of PPA provisions, including removing legal uncertainties, creating a safe harbor incentive, and facilitating qualified default investment options. The Thrift Savings Plan is now looking to add autoenrollment.[22]
- *Improved participant communication*. 401(k) participants now have access to sophisticated call centers, websites, educational materials, and access to professional investment managers — high touch ways for participants to receive information about their accounts and get reassurance in difficult market conditions. 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. Although the volume increased significantly, nine in ten participants did not make a change to their accounts and less than 2 percent of assets have been moved. This firm was able to react quickly by increasing its service center capacity by 50 percent to handle participant inquiries. That 401(k) investors tend to be patient during this market turmoil is encouraging. As the Committee heard from a number of witnesses on October 7, and as the data we present on the 2000-2002 bear market demonstrates, staying in the market rather than engaging in panicked selling is generally the better strategy. Recent communications from the Thrift Savings Plan to federal workers about market volatility also have sought to reassure and emphasize long-term investing.[23]

Future of defined contribution plans

The employer-based retirement system can continue to be improved, but it remains, even in a time of financial turmoil, a reliable means to provide retirement security to millions of Americans. We recommend, in particular, two areas for reform: covering more workers and improving disclosure. First, the system could cover even more workers through tax incentives and streamlined administrative requirements to encourage employers to offer retirement savings plans to their workers. A number of proposals have been aired and we look forward to working with the Committee and other policymakers on these issues in the 111th Congress.

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[21] See Thrift Savings Plan, L Funds Fact Sheet, available at http://www.tsp.gov/rates/fundsheet-lfunds.pdf.

[22] See testimony of Gregory T. Long, Executive Director, TSP, Before the House Subcommittee on the Federal Workforce, Postal Service, and the District of Columbia (April 28, 2008), available at http://www.tsp.gov/curinfo/pressrel/2008April29-testimony-GregLong.pdf. The House passed a bill (H.R. 1108) on July 30, 2008 that would add autoenrollment features to TSP.

[23] See Special Message from TSP Executive Director (October 8, 2008), available at http://www.tsp.gov/curinfo/login/2008Oct7-Message-Exec-Direct.pdf.

Realistic goals are critical for increasing workplace plan coverage. Recent comprehensive research by the Institute[24] shows that employers that do not offer plans tend to have workforces that are less likely to value and utilize retirement savings—such as younger workers whose savings is focused instead on education, home purchase, or building a savings cushion. Lower-income workers are less likely to have, currently, the ability to save for retirement — and 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.

Second, the system could be improved by requiring consistent and transparent disclosure of key investment and fee information in all participant-directed defined contribution plans. The Institute consistently has supported improvements in 401(k) plan disclosure that gives participants and plan sponsors the information they need to make the decisions charged to them. We agree that this Committee should focus on this issue and continue its oversight of the Department of Labor's efforts. The Department of Labor will soon complete comprehensive regulations that should close the gaps that exist under current regulations. Successful completion of the Department's initiatives is in the interest of plans and participants and will assure that improved disclosure is implemented most quickly.

Some have suggested that the recent market downturn, which has been felt in all parts of the U.S. economy and throughout the world, shows that 401(k) plans are a failure.[25] We strongly disagree. The employer-based retirement system plays a critical role in ensuring retirement security for millions of Americans, and the best evidence is the thousands of employers – including federal and state governments – and millions of workers who have entrusted trillions of dollars of their retirement savings to this system.

One witness at the October 7 hearing 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.[26]

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

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

[25] This assumes that a system in which participants control their own account, with both the risk and reward associated with that, is somehow unsustainable. Recent developments in the defined benefit system that places the investment risk on the employer have shown that system is not safer or more sustainable. It is difficult for a mobile workforce to accumulate significant benefits under defined benefit plans. Many employers have decided that they cannot sustain their defined benefit plans and compete in the global economy. The market downturn and the new funding and accounting rules have put even more pressure on these plans. While defined benefit plans will continue to play an important role in sectors of our economy, they never were and never will be universal.

[26] This would, in effect, be the world's largest cash balance plan.

ensuring that Social Security continues to provide adequate benefits to workers. It cannot be overemphasized that workers with low to moderate lifetime earnings have historically and will continue to replace most of their pre-retirement earnings through Social Security. We look forward to working with policymakers on proposals to strengthen and sustain the Social Security system so that it can continue to provide adequate benefits to workers with low to moderate lifetime earnings.

The recent market turmoil highlights the need to continue the improvements started in the Pension Protection Act to make the 401(k) system stronger, more resilient and more transparent, to bring more employers into the system, and to continue to help workers make smart decisions—not to dismantle the current retirement system. We applaud the Committee for examining this important topic and look forward to continuing to work with the Committee and its staff through this difficult time.