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The Pension Protection Act of 2006: Past, Present, and Future

Vanguard Chairman and CEO's Remarks at the Pension Protection Act Developments Conference

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Past, Present, and Future

Remarks by

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Thanks for that kind introduction. And thanks to the ICI team for offering me this opportunity to share my views about the Pension Protection Act (PPA).

Before I turn to the PPA, I'd like to extend my thanks to all of you in this room for the hard work you do every day in making our private retirement system a success. I'm a longtime observer of, and service provider to, the private retirement system—and a longtime plan participant. But I know that I am by no means a technical expert. What I do know is that your expertise—your legal, regulatory, and policy knowledge—is critical to making the system work. And it is critical to the retirement security of millions of Americans. So, thank you for your effort and your diligence and your care.

As for the PPA, I'm a big fan of what Congress accomplished in the legislation. In fact, in my third-quarter 2006 Chairman's Corner column on Vanguard.com, our company website, I encouraged clients to put the PPA on their personal reading list! Admittedly, that was a little tongue-in-cheek, but my enthusiasm for what PPA accomplished is real. And today I'll attempt to explain my optimism by looking at the PPA in a broad way—as I said, not from the view of a technical expert, but from a longtime observer of, supplier to, and participant in the U.S. retirement system. To me, what is most important about the PPA is what it says about the past, the present, and the future of that system. And, that's how I'll organize my remarks today—past, present, and future.

The Past

First, the past. Six months after the passage of PPA, it's hardly time to start drawing sweeping historical conclusions. But in my mind, passage of the PPA was an important historical event. When we look back in the decades to come, we will recognize that the PPA and ERISA (the Employee Retirement Income Security Act) 32 years earlier stand as the two bookends of an era of transformation and change.

You know the details. In 1974, 80 percent of all private-sector workers who had a retirement plan at work were in a defined benefit (DB) plan. Twenty percent had a defined contribution (DC) plan—typically a trustee-directed profit-sharing or money purchase plan. Fast forward to today. Now 80 percent of the private workers with a retirement plan are in participant-directed defined contribution plans. The proportion covered by trustee-directed DB plans continues to decline.

Most of the more than 900 pages of the PPA are about the past. Most of the legislation is about rethinking, once again, the balance between employer-funding obligations in DB plans and the pension guarantee provided by the Pension Benefit Guarantee Corporation (PBGC). The original funding rules of ERISA and the creation of the PBGC were important innovations. But few of the architects of ERISA anticipated the moral hazard problem of today—employers in financial distress offering defined benefit promises they probably couldn't keep, and then transferring those obligations to the PBGC in bankruptcy.

Congress has altered DB funding rules many times in the past, and in one way, you could think of the PPA as just another shift in the rules—a 900-page shift! But the lesson I draw from the PPA funding rules is different. Despite the many changes Congress has made over the years to funding rules, I see that policy as limited in its ability to overcome fundamental market forces—in this case, fundamental changes in the U.S. labor market.

For 30-some years now, the service sector of the economy has been the source of job growth in America. Think of companies like Microsoft or Yahoo! (or even Vanguard), barely known—or even nonexistent—in the early 1980s, and now substantial employers. As these companies grew and expanded, one of the notable steps they did not take was to introduce a defined benefit plan. Traditional pensions were typically associated with old-line industries such as manufacturing, utilities,

transportation, telecommunications, and so on. But the new service economy found defined contribution plans easier to administer and operate and more appealing to employees. Moreover, service companies never saw the need to tie their long-term employees to the company using the retirement plan, as DB plan sponsors often did.

These labor market decisions, made by thousands of employers and millions of employees over the years, have transformed the private retirement system from a trustee-directed DB system to a participant-directed DC one. Although many in Washington tend to believe that this dramatic change occurred solely because of section 401(k) of the Internal Revenue Code, in our view, the real driver of this change was the very dramatic transformation in the nature of the U.S. workforce and job market over the past 30 years.

What the PPA teaches us about the past, overall, is that government policy on funding rules can come and go. But in the U.S. retirement system, with its blend of both private- and public-sector elements, it is difficult for government policy to overcome fundamental changes occurring in the private marketplace. Brad Belt, the former head of the PBGC, put it well. To paraphrase his remarks, he said while the PPA did improve the funding of DB pensions and the fiscal position of the PBGC, it did nothing to reverse the long-term, marketplace trend away from DB plans. I believe it's an irreversible trend.

Of course, this is not to say that existing DB plans will suddenly disappear, or that they won't be valuable for a segment of the U.S. workforce. Many tens of millions will still rely on private-sector pension plans, and $2 trillion has been set aside to help pay promised benefits. Plan sponsors will still need help designing, administering, and managing investments for their DB program.

Yet looking to the past, I don't believe it's an overstatement to say that the PPA marks the end of the defined benefit era. It is also an implicit recognition of the limitation of government action in the face of powerful market forces.

The Present

What about the present? Here the PPA teaches us a different lesson: Government policy and private action can often work hand in hand, in a beneficial way, to help improve and enhance our collective welfare.

In my mind, one of the strengths of the PPA is how it codifies into law the recent success of the automatic or autopilot 401(k). As you may know, over a decade ago, behavioral economists began working with private-sector employers, studying the behavior of 401(k) plan participants. In this real-world laboratory, they discovered that while many employees did a reasonably good job of planning for the future, others struggled with important savings and investment decisions.

This collaboration led, in 1997, to the first IRS regulations encouraging automatic enrollment. If some participants were subject to procrastination and inertia, and never got around to joining their 401(k)

savings plan, better to use inertia instead to their benefit: enroll them automatically, and let them quit if they wanted to.

Employers began to experiment with automatic enrollment. But soon the drawbacks were apparent: automatic enrollment produced many small accounts, with contribution rates set at low rates like 3 percent. The money was mostly invested inappropriately in a conservative money market fund or GIC (guaranteed investment contract). Automatic enrollment was clearly a failure if all it did was produce small account balances invested in cash.

Here again, private-sector ingenuity and the research community came together, with the program we all know today as the autopilot 401(k). Combine automatic enrollment with automatic deferral increases, and invest the participant's account in a sensible balanced or life-cycle[1] account. That was an integrated solution that solved the earlier problems of automatic enrollment.

Some of the early adopters of these types of programs were at Vanguard. In such plans, enrollment rates for new hires were typically low, on the order of 30 percent or 40 percent. Now they range from 80 percent to 100 percent, depending on the plan. Often, novice investors invested too conservatively, given their lack of experience, or just invested in the highest-returning fund. Today, 80 percent or more of those novices remain invested in well-diversified life-cycle or balanced funds, designed by Vanguard's investment professionals and selected by the sponsor.

One of the great accomplishments of the PPA was to recognize this innovation in the private sector and to codify it in the law. Hence, the automatic enrollment safe harbor you are all familiar with, plus the new law and regulations on default fund investing, and the section on investment advice.

This is really a transformation in our collective thinking about defined contribution plans. We once thought every employee would be his or her own investment manager. We know today that while many employees want to exercise choice, others are just confused or overwhelmed by it. With the PPA, Congress has come to recognize that policy must serve two audiences: the engaged decision-maker, and the reluctant saver and investor.

So in terms of the present, the PPA is about codifying best practice from the private sector, and strengthening and encouraging that practice through legislation.

The Future

One way to think about the PPA is to recognize that it is Congress's final word on the private retirement system as the baby boom enters retirement. As you know, the first of the boomers turned 60 last year[2], and they become eligible for early Social Security next year, in 2008. We're unlikely to see any fundamental change to the principles governing private-sector retirement plans as the boomers approach and enter retirement.

And what does the PPA tell us about the future? Simply, it says that the era of defined benefit plans is drawing to a close, and the future rests on the success of the participant-directed defined contribution plan. As I noted earlier, this is not to say that private-sector DB plans will not remain important for millions of participants. DB plans will continue to provide valuable benefits to a segment of the U.S. workforce for the foreseeable future. At Vanguard, we serve such plans as an administrator and an investment manager.

But the PPA sends a different message about the future: It's time to draw to a close the national debate over DB versus DC plans. We must recognize that our future is not about that historic debate, but about how to optimize and enhance the performance of DC plans in the future.

There are many in Washington who will rue this message. In some political circles and in the media, DB plans have always been viewed as safe and generous, and with DC plans positioned as risky and meager. But in my view, this is a misreading of history and the facts. Today, the median payout to a retiree from a private DB plan is $6,800 per year, according to the Congressional Research Service. That's a meaningful benefit but not the tens of thousands of dollars a year that we sometimes imagine. We forget that the highest DB benefit only goes to those employees who work for a generous employer and who can remain on the job at the same company for 25 or 30 years. But few Americans are so lucky. They change jobs, they are laid off, their employer can't afford to be very generous—DB pensions aren't risk-free. They have real-world risks.

DC plans also have their risks: failing to participate, failing to save adequately, and failing to build a well-diversified portfolio. But as I mentioned, the PPA gives us a path forward for addressing these problems. Make no mistake, our future is about a participant-directed defined contribution world —on the one hand, giving tools and services to active decision-makers so they can make their own choices; and on the other, setting defaults and features optimally so that reluctant decision-makers also end up on the path to retirement security.

Yes, there are still many issues to debate about defined contribution plans in the future. You know some of the issues: fee and cost disclosure, better advice rules, questions about noncovered workers with no retirement plan. But while we will work on these and other issues in the years ahead, it seems to me that the PPA gives us the long-term vision: The participant-directed defined contribution plan is and will remain the cornerstone of the private-sector retirement system for the foreseeable future. And with this framework in place for the private pension system, Congress can turn to the daunting question of entitlement reform in Social Security and Medicare—the topics that now move to the top of the national retirement agenda, as Federal Reserve Chairman Bernanke pointed out recently.

Conclusion

Past, present, future. The PPA shores up the DB system of the past; it codifies into law current best practices for DC plans; and it offers us a guide path to the future centered on the defined contribution plan. As I said earlier, PPA marks the end of one era, and the beginning of another.

And in that new era, we see participant-directed defined contribution plans not as a threat but an opportunity. We see the private sector and public policy working together to improve retirement results for current and future generations in a defined contribution world. We see the future not as dangerous, but as a period of strengthened retirement security for today's participants and generations to come.

And in all of this, we see the PPA playing a pivotal role, laying the groundwork for our future success and setting out a vision of the future for our individual and collective retirement security.

Thank you again for your efforts in working on pension issues, on the PPA, and on retirement policy. And thank you for your attention this afternoon.

Endnotes

[1] Life-cycle funds are subject to the risks associated with their underlying funds. Diversification does not ensure a profit or protect against a loss in a declining market.

[2] If you take withdrawals from a qualified retirement plan before age 59-1/2, you may have to pay ordinary income tax plus a 10 percent federal penalty tax.

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