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Building Savings and Retirement Security in the Wake of Crisis

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World Affairs Council of St. Louis

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Thank you, for that generous introduction and welcome to St. Louis. I grew up on the banks of the Mississippi, about 675 miles south of here, and I always have been fond of this great river city.

It is an honor to speak before the World Affairs Council. The promotion of understanding, engagement, and leadership in world affairs has never been more important, and I applaud your efforts to connect interested Americans with vital global issues.

My topic tonight is managing the financial future in a changing global environment—with an emphasis on retirement security.

As I survey the retirement landscape in September 2015—seven years after the most jarring events of the great financial crisis—there are four themes that I want to touch upon tonight:

- How pension systems are changing around the world;

- The state of retirement security in the United States today;
- How savers and regulators have reacted to the financial crisis;
- And—most important—how we can improve our retirement security by expanding coverage and promoting a culture of saving.

At the outset, I should tell you that I am a student of history and language. Public policy challenges are best understood with a bit of context. Let me share with you some of the history of retirement plans.

"Retirement" is in many ways a relatively recent term and concept. Its French root means to "draw back," and the term was first used with respect to leaving an occupation only in the mid-seventeenth century.

This is not surprising. In societies built around agriculture and handicrafts—that is, for 49 of the 50 centuries of recorded human history—workers didn't anticipate an extended period of leisure after their working years.

Life expectancies weren't that long, and the elderly tended to live in extended households where they could contribute even as their strength and skills declined. Your "retirement plan" consisted of your land, tools, skills, relationship with family and community, and whatever you could put by to save for later.

The exception tended to be the military. Scholars cite the armies of ancient Rome as the first to have pensions. When Augustus established the Roman Empire, he created a pension plan that, in outline, would look familiar even today.

Service of 20 to 25 years qualified a legionnaire for a lump sum that could produce an income in excess of two-thirds of a laborer's earnings.

So, too, in China—soldiers tended to have retirement plans long before others. It's not hard to see why a society—any society—would have a strong incentive to provide for older soldiers rather than leaving them destitute, angry—and armed.

Nonetheless, while retirement as a distinct financial goal may be quite recent, saving and thrift have long been central moral themes in societies around the world.

In the *Book of Genesis*, we read of the need to store up in years of feast to survive years of famine.

Aesop's well-known fable of the ant and the grasshopper dates from the seventh century B.C. and teaches that "it is best to prepare for the days of necessity."

In innumerable ways, in society after society, this identical moral has been passed from generation to generation to stress the importance of saving.

“For Age and Want save while you may,” wrote our own Benjamin Franklin in *Poor Richard’s Almanack*. “No morning Sun lasts a whole day.”

In Japan, schoolchildren still learn about Ninomiya Kinjiro, a nineteenth century agrarian reformer who preached “diligence, thrift, and saving.” For decades, schools in Japan were decorated with statutes of a studious boy carrying a bundle of firewood, honoring Ninomiya’s saying: “Work hard, spend little. Gather much firewood, but burn little.”

The teachings of Confucius, in the fifth century B.C., emphasized frugality and social cohesion. Official Confucianism took a dim view of private wealth, but encouraged saving as a moral imperative and as a means of providing for the community.

Families took primary responsibility for care of the elderly, but the community was expected to help out as needed. Confucius wrote: “Let the old people live good lives, let those in working age contribute to the society, and let children be well-educated.”

Long before banks or investment funds, communal granaries and savings societies helped villagers meet emergencies and fund one another’s new enterprises.

The Industrial Revolution changed the nature of work, and ultimately of society and the nature of retirement. Craft work was supplanted by industrial-scale work for wages, while life expectancies increased.

So in the nineteenth century, both private and public pension systems emerged to help support aged workers who could no longer keep up with the pace of work in factories or offices. In the United States, the American Express Company formed the first private-sector pension plan in 1875, followed in 1880 by the Baltimore and Ohio Railroad Company.

The concept caught on in a few industries—railroads, banks, and public utilities—but didn’t spread more widely. Until the 1930s, more than half of older American men were in the workforce.

The Depression and World War II fundamentally changed the picture. In 1935, Congress created Social Security—a national program for retirees, which soon extended benefits to dependents and survivors. And World War II’s wage controls and tax incentives fueled the growth of private-sector pension plans.

The vast majority of these plans offered “defined benefits,” where the employer and plan bore the risk of delivering on the promise of a regular pension payment for life. And government retirement systems often were created on a “pay as you go” basis.

In recent decades, those models have come under intense pressure.

Changing demographics have made pay-as-you-go government-provided retirement systems increasingly unsustainable. Created during a period of rapid population growth, these systems initially had a large number of workers supporting a smaller number of retirees.

When population growth slows, the pool of retirees grows faster than the pool of workers supporting them, undermining the finances of these systems.

Employer-sponsored defined benefit plans, meanwhile, have faced funding pressures as well. DB plans also have proven more expensive—and their costs more volatile—than many employers anticipated.

These problems have become ever more apparent over the years. And they have prompted a profound shift in the U.S. private sector away from “traditional pensions.” In their place, employers have tended to adopt a different model—the “defined contribution” or “DC” approach of 401(k) and other plans. In this model, a retiree’s ultimate benefits are determined not by a formula set by the employer, but by the savings and investment earnings accumulated during that worker’s career.

In the United States, DC plans are popular with workers and employers. They empower individuals to build savings over their working lives. They convey ownership of retirement assets to workers. They are transparent. They are portable and accrue value throughout a participant’s working life.

These developments in the United States are familiar—but they mirror the experiences of many other societies struggling to sustain their pension systems. Between 2007 and 2012, virtually every developed country around the world instituted pension reform measures of some type.

As part of those reforms, more countries have begun to examine defined contribution systems and to consider how to design them in a way that takes into account each country’s particular history, culture, economic constraints, and political preferences.

Some countries are using DC plans to supplement or replace government or occupational retirement schemes. Others are considering how DC features can fit into their existing plans. Japan has even adopted the term “Japan-version 401(k)” to describe its DC plans.

ICI is a global organization, and in my work I visit many countries and talk to many policymakers. They often exhibit keen interest in the United States’ experience with 401(k)s and other DC plans, and express admiration for the sizable pool of retirement assets—14.4 *trillion* dollars as of the first quarter this year—that American savers have amassed in DC plans and individual retirement accounts, or IRAs.

It’s a bit of a shock to come back from those trips and be reminded that many U.S. commentators and legislators view the shift to a 401(k)-based retirement system in the private sector as, well, a disaster. Critics claim that America faces a “retirement crisis” that can only be addressed by sweeping, radical government actions.

This is a case where, well, distance lends perspective—because overseas admirers of our 401(k) system have a more accurate view than stay-at-home critics.

Based on research by ICI and others—based on the deep involvement of ICI's member mutual funds with the 401(k) system—and based on the input we've received from workers who are actually participating in plans, we believe that the trend toward 401(k) has strengthened Americans' prospects for secure retirement.

To be sure, the 401(k) system has gaps and deficiencies that need to be addressed—and I'll come back to those. But on the whole, Americans' preparedness for retirement is better today than it has ever been before.

Skeptical? Let me give you some data.

Retirement assets per household at the end of 2014 were more than seven times greater than they were in 1975, even after adjusting for inflation. Today's households enjoy significantly greater assets earmarked for retirement than their counterparts did when defined benefit plans were much more prevalent.

1975 was before 401(k) plans were even invented. In the eyes of many 401(k) critics, that was a time when most workers were covered by defined benefit pension plans. But this idea of a "golden age"—when every retiree got a gold watch and a traditional pension—is a myth.

In fact, more retirees receive more income from private-sector retirement plans today than in 1975. In 2013, 33 percent of retirees received income from private-sector retirement plans—up by more than half from 1975. And the median income received by those retirees, in constant dollars, has risen by more than one-third.

Don't credit these changes entirely to 401(k) plans. For most households, however, employer-sponsored retirement plans are crucial.

Some critics argue that, as 401(k) plans claim a larger share of retirement planning, we will not be able to sustain the progress we have seen.

Consider, however, that today's workers in their forties are the first cohort who will spend their full career in a 401(k)-based system. Studies conducted by ICI and the Employee Benefit Research Institute show that these workers can save enough to replace substantial amounts of their working income in retirement. Similarly, scholars at MIT, Dartmouth, and Harvard support the conclusion that personal saving accounts like the 401(k) will increase wealth at retirement for future retirees at all income levels.

The financial crisis of 2008 was a remarkable "stress test" for 401(k)s. But unlike other parts of the financial system, 401(k)s did well by most retirement savers.

In 2008, the value of large-cap stocks fell by 37 percent. If you go back to 1825—almost two centuries—you will find only one year with larger annual losses, and that was 1931. 2008 was a terrible year for investors—including 401(k) participants and IRA savers.

But 401(k) participants generally stayed the course. They kept contributing to their plans, and they didn't radically change their investment mix. When markets came back in 2009 and 2010, those participants were there to enjoy the gains.

By year-end 2013, the average account balance of "consistent participants"—401(k) savers who have been in the same plan since 2007—was up by 86 percent from 2007. That's a compound average annual growth rate of 10.9 percent over those six years—even including the steep drop of 2008.

These results are no accident. The "slow and steady" design of 401(k) plans helps limit the impact of investment shocks. 401(k)s tend to suppress the sort of bad investor behavior—such as trying to time the market—that can really damage long-term returns.

Contributions from every paycheck helps workers invest in a style known as "dollar-cost averaging"—buying funds or other assets on a regular schedule, rather than chasing prices as they rise and fall. And the long-term nature of retirement savings encourages workers to keep their investments in place during market turbulence.

As Poor Richard preached, "Save and have." "A penny saved is two pence clear."

Today's retirement system has many strengths. But it also has gaps and areas for improvement—areas that we can address through sound public policy. Such reforms must build upon strengths of the system we have—not strive to replace it.

As a start, we must preserve what's working well. That means shoring up Social Security and protecting the private-sector, voluntary nature of the employment-based system.

Social Security provides the foundation of retirement security for almost all American workers—and for the majority, it may be the largest single income source in retirement. Yet, as Social Security celebrates its 80th birthday, the system faces a projected long-term imbalance. Absent action, by 2034 Social Security will be able to pay only 79 percent of the benefits it would provide if fully funded.

At ICI, we have no position on the mix of changes to benefit formulas, retirement ages, and revenues needed to put Social Security on a sound trajectory for the future. We do know that it is imperative to preserve Social Security as a universal, employment-based, progressive safety net for all Americans.

Preserving what works also means protecting the voluntary, private nature of employment-based retirement plans. Employers, financial services companies, and government regulators have worked together to foster a wide range of 401(k) plan innovations.

Payroll savings—employer matches—automatic enrollment—automatic escalation of contributions—target date funds—these and other features have evolved over the years from the desire of employers and their plan service providers to make 401(k) plans flexible and better adapted to meet workers' needs. We need to foster such innovation.

Further, we must preserve the ability of retirement savers to obtain the help and information they need to manage their accounts effectively.

We embrace the principle that all financial advisers should be held to act in the best interests of their clients. We also believe regulations must assure that financial advisers subject to this standard can still provide the help that retirement savers need so badly.

To build on the strengths of the system we have, we also must help make sure that every worker who needs and wants to save for retirement has the opportunity and incentives to do so. That means we must remove obstacles that prevent many employers—especially small businesses—from providing retirement plans to their workers.

Measures of this kind will create greater opportunities to save for millions of Americans.

For my final point, I want to move out of the realm of regulation and look at a broader landscape. I believe that if America is to have a brighter future and greater economic security—not just retirement security—we need to make a fundamental shift toward greater levels of saving.

Earlier in my remarks, I cited age-old wisdom on the importance of saving. But these nostrums are hardly outdated: no miracle of modern society has relieved us of responsibility for our own financial future. Thrift is no less important now than it was centuries ago.

No less important—but in many ways more difficult.

Every weekend, the *Financial Times* includes an ultra-glossy magazine supplement entitled, "How to Spend It." But nowhere in our media will you find anything urging thrift, frugality, or financial prudence—in short, about "How to Save It."

We are bombarded with messages that it's good to consume—to spend now, without delay. And in the form of credit cards, mortgages, home-equity lines, automobile loans, personal lines of credit, student loans, and more, we are freely handed the tools to front-load so very much of our consumption.

Consider two overwhelming trends in the 70 years since World War II: an emphasis on consumption as a major driver—if not the main driver—of economic growth, and a rapid expansion of the use of consumer credit.

Data tell the story. In 1950, household debt was almost precisely half of after-tax, or disposable, income.

In 1979, household debt exceeded income for the first time. Since 1984, the debt-to-income ratio has remained above 100 percent.

And by the end of 2007—as the financial crisis was getting underway—personal debt hit its all-time peak, at 185 percent of household after-tax income. Paying off a family's debt would require every dollar of its income for a full year, and then for a second year until November 6.

Maybe the financial crisis has prompted households to back away from high levels of debt. The latest figures show that the debt-to-income ratio is "only" about 154 percent now.

We must do better.

As a first step, our federal government could set a healthy example. The $8.0 trillion in debt that it has amassed since 2007, and the additional $8.0 trillion projected over the next decade, mean that our national leaders are a dismal embodiment of the cause of financial prudence. Helping our government live within its means—by putting our budgets on a path toward sustainable debt, if not balance—would send a signal that saving matters.

Second, we can preserve and build upon the incentives for saving that we already have. Tax reform looks increasingly likely, but some of the plans would sharply limit the system of tax deferral that's used to encourage retirement saving. A rational tax system should encourage saving and investment, and with them economic growth. Policymakers should find ways to create incentives for more private saving, whether for retirement or for other goals—not take incentives away.

We also need a national commitment to promote saving among young people, coupled with education to equip our future citizens in personal financial management. Few of us today work on our own cars, but many high schools still teach shop. They should be teaching instead how to manage credit and harness the power of compound interest—subjects we all must master.

Finally, we should have an honest national dialogue on the importance of changing from a culture focused on debt-fueled consumption to one that honors deferred gratification and long-term planning. We must foster institutions that encourage saving, make it easier, and make it more rewarding.

I invite you to reflect on the unique and extraordinary blessings that we enjoy as Americans.

We have taken this great land and its resources, and applied to them the energy, the creativity, and the can-do spirit of generations, native-born and immigrant, to build a prosperous and generous society.

As a result of that prosperity, we are able to provide a dignified old age for the vast majority of our citizens. Today's retirement system is delivering strong results for most workers. Compared to other nations, we have a substantial head start in building a sound, funded solution for the challenges of aging populations.

We must continue to pursue public policies that support that system. But we must each recognize as well that retirement security is critically a function of individual choice. At the end of the day, it is that array of personal decisions—to save paycheck by paycheck; to sign up for the 401(k); to invest carefully and wisely; to limit spending in favor of savings—that will determine one's own retirement outlook.

Public policy can create the tools to foster saving and financial security—but private choices will determine whether and how those tools are used. Happily, in the 401(k) system we see those tools being used, and used well. We need to keep up that good work.

Thank you for your time and attention.

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