Prepared Testimony for the Hearing "Regulatory Barriers Facing Workers and Families Saving for Retirement"

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Mr. Chairman, Ranking Member Sablan, and Members of the Committee:

Thank you for the opportunity to testify on the important topic of retirement security. In my testimony today I would like to make six points:

1. The retirement landscape has changed enormously in recent decades, with the decline of defined benefit (DB) plans and the rise of defined contribution (DC) plans.

2. Too many Americans are unprepared for retirement, either lacking access to retirement plans or saving very little in them.

3. DC plans come with two sets of risks: (i) the market risk associated with investments with uncertain returns and (ii) the risk of making poor decisions. The first risk is inherent to DC plans and is the necessary flip-side of higher returns. The second risk reflects decisions by policymakers and may be reduced through effective policy design.

4. One poor decision many make is to not participate in a retirement savings plan. Congress has taken important steps to address this by making automatic enrollment in 401(k)s easier. Another natural step would be a proposal originally developed by the Heritage Foundation and the Brookings Institution to require businesses to offer opt-out Individual Retirement Account (IRA) plans. Absent affirmative Federal action, States and localities should, at least, have the opportunity to experiment with such plans.

5. Another poor decision is to make higher-fee, lower-return investments. This poor decision can be actively encouraged by retirement advisers who are not acting in their clients' best interest. Well-designed regulations, like the Department of Labor's (DOL's) conflict-of-interest rule (also known as the fiduciary rule) can both help middle-class savers and increase confidence in the system as a whole.

6. Reducing access to health insurance, as would result from the enactment of the American Health Care Act (AHCA), would increase financial insecurity for tens of millions of households—and make it harder for them to save for retirement.

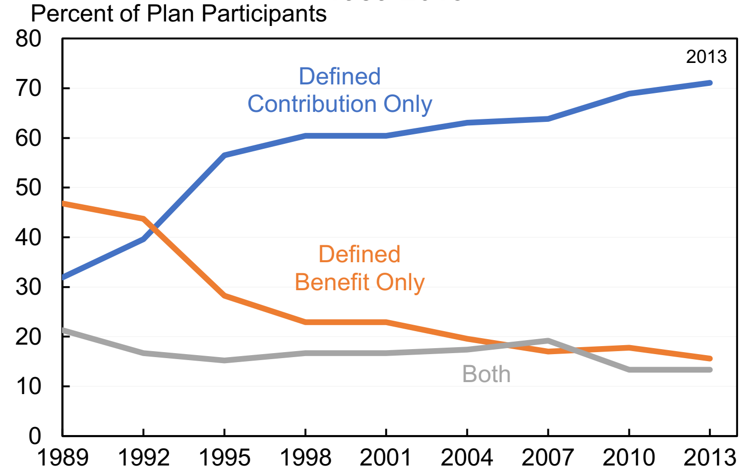
Let me now elaborate on these six points.

Point #1: The Retirement Landscape Has Changed Dramatically in Recent Years

Americans' retirement income comes from many sources. Social Security provides the basic foundation for retirement security through the provision of universal, guaranteed benefits. Building on that foundation, a system of tax-preferred retirement plans provides additional opportunities for savings explicitly designated for retirement. And finally, families accumulate additional private savings in a wide variety of financial and non-financial assets. For the middle class, the most important form taken by these additional savings is home equity.

While this landscape is familiar today, it is markedly different from the landscape that existed in the past. Though the overall share of workers participating in any type of retirement plan has shown little net change over the last 25 years, the share of workers covered by traditional, defined benefit (DB) pension plans—which offer a guaranteed income stream in retirement—has fallen sharply. Today, the majority of workers participating in a retirement plan at work are covered only by a defined contribution (DC) plan, such as a 401(k). As shown in Figure 1, the share of workers participating in a retirement plan who had a traditional pension fell from nearly 70 percent in 1989 to less than 30 percent in 2013. The share of participating workers with only a defined contribution plan increased from about 30 percent to about 70 percent.

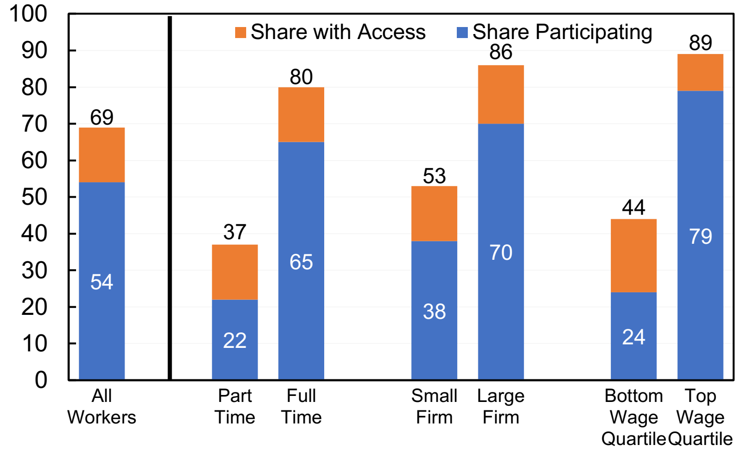
Figure 1: Retirement Plan Participants by Plan Type, 1989-2013



Source: Boston College Center for Retirement Research; author's calculations.

This dramatic transition from defined benefit to defined contribution plans has affected only those covered by a retirement plan at work. However, only about half of the workforce has coverage. Most of those without coverage lack access to any workplace retirement plan. Access and participation rates vary significantly by the demographic and economic characteristics of workers, with access and participation particularly low for part-time workers, workers at smaller firms, and low-wage workers, as shown in Figure 2. In addition, access and participation rates are lower for younger workers, Latino workers, and workers with fewer years of education.

Figure 2: Retirement Plan Access and Participation, 2016



Note: A small firm has fewer than 100 employess and a large firm has 100 or more employees.
Source: Bureau of Labor Statistics, Employee Benefits Survey.

<u>Point #2: Too Many Americans Are Unprepared for Retirement</u>

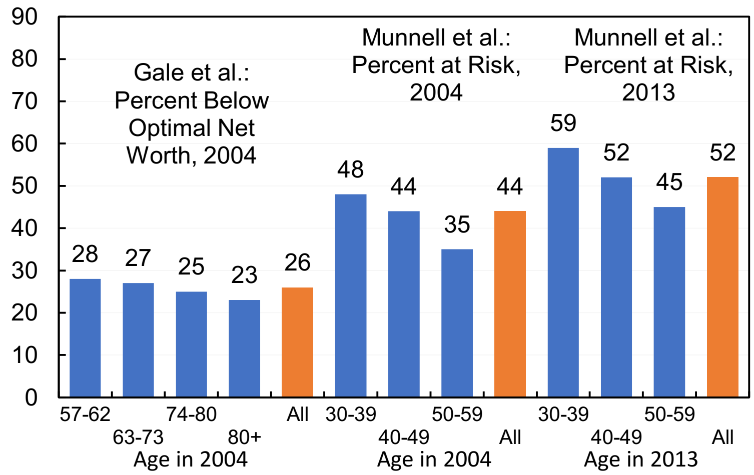
Retirement savings coverage is not an end in itself. Rather, coverage is a tool to help Americans achieve a secure retirement. And even among the population that has coverage, the amount of money saved for retirement is often very low. According to the 2013 Survey of Consumer Finances (the most recent data published by the Federal Reserve), about 40 percent of households with head age 55-64 had no retirement savings accounts, and among households with head age 55-64 and retirement accounts the median balance was about $100,000.

In addition to saving through employer plans, Americans also save through tax-advantaged Individual Retirement Accounts (IRAs). IRAs are particularly important for older Americans, many of whom roll over workplace retirement plans to an IRA upon separation from their employers. Since their creation in 1974, IRAs have grown to hold more than $7 trillion of retirement wealth—most of which derives from rollovers from workplace retirement plans—and now account for nearly one-third of all retirement assets. In addition, IRAs serve a critical role in the retirement landscape, as they offer tax incentives for saving to workers without access to a plan at work, including workers at small businesses or those working part-time.

From an economic perspective, the question of retirement readiness relates to the household's ability to enjoy a standard of living in retirement commensurate with that enjoyed during working years. Achieving a constant standard of living means that different households need to save different amounts; there is no single amount of savings that can guarantee a secure retirement.

Putting together a complete picture of households' retirement readiness requires a significant amount of work to collect all of the relevant data and some fairly heroic assumptions. And there is no single right way to do it. Fortunately, numerous researchers have attempted the feat. Unfortunately, as one might expect, they have come to rather different answers.

Figure 3: Retirement Adequacy Comparison, Select Measures



Source: Gale et al. (2009); Munnell et al. (2017)

Figure 3 summarizes the results of two groups of researchers who have tackled this question. The first set of bars present the results of the economists William Gale, Karl Scholz, and Ananth Seshadri (2009). This group built a life-cycle model and used that model to compute optimal wealth targets for every household according to the model's assumptions. They then compared each household's actual wealth to its calculated target wealth. They found that roughly 25 percent of households were below their target wealth levels and that younger households were slightly less likely to achieve their optimal wealth target. Among households with wealth below their target, the median deficit was about $32,000.

Researchers at the Boston College Center for Retirement Research, led by Alicia Munnell, took a different approach and computed projected replacement rates and target replacement rates for each household using data from the Survey of Consumer Finances (Munnell et al. 2017). They then used these computations to construct a retirement risk index, which they update every three years when the Federal Reserve releases new survey results. In their most recent update, using data for 2013, they estimate that 45 percent of households with head aged 50 to 59 are at risk of an insecure retirement. They define a household to be at risk if its projected replacement rate is more than 10 percent below its target replacement rate. These results are shown in the bars at the far right of the figure. The same approach using data for 2004 yielded a slightly more optimistic assessment of adequacy, with only about 35 percent of households at risk. The 2004 results are slightly closer to the results found by Gale, Scholz, and Seshadri for that year and are shown in the middle panel of the figure.

In either set of results, tens of millions of Americans are unprepared for retirement. Moreover, the results from Munnell et al. show that, when measured consistently, retirement savings inadequacy has grown over time.

Point #3: DC Plans Come with Two Sets of Risks: (i) Market Risk and (ii) Poor Decision Risk

DC plans have a number of advantages that, along with generous tax subsidies, have made them increasingly popular over time. These include greater portability and transparency. But DC plans come with two sets of risks.

The first risk is market risk: returns on DC plans are uncertain—and can even be negative. A person retiring in 2008 faced much worse market conditions than someone retiring in 2006, for example. This risk, however, is the compensation for the higher average returns in these retirement accounts. And it is also a transparent way to account for the risk that gets shifted to employers, taxpayers, and (in some cases) workers under traditional DB plans. This risk could be eliminated if workers invested entirely in Treasury bills, but that would entail a tradeoff against higher returns.

The second set of risks is the risk of making poor decisions. DC plans require a set of decisions at every step of the process. The first decision is whether or not to participate in the plan at the outset. A second decision is how to invest one's savings. A third decision is what to do with the balances upon retirement and, generally, conversion to an IRA. A final decision is how to withdraw the balances over time, whether in a lump sum, in an annuity, or in some other fashion. There is compelling economic evidence that when confronting these complicated decisions, individuals have limited resources in terms of time and attention, often make choices that do not adequately consider the long run, and, since many face these decisions only once in their lives, are often stymied by their complexity.

The second set of risks can be mitigated by effective public policy and regulation that will both help increase returns to savers and increase their confidence in the retirement system. Such regulation need not reduce choices but should help people make better choices by default—with the option of making whatever other choices they want if they so choose.

In my next two points I will discuss two important ways that regulation can help reduce the unnecessary risk of bad decisions faced by retirement savers.

Point #4: Access to Retirement Plans with Auto-Enrollment Can Help Address the Poor Decision Not to Participate in a Retirement Plan

Economists have extensively documented the evidence that many people fail to sign up for 401(k) plans, in many cases leaving money on the table from employer matches and tax incentives. A simple mechanism can help address this: auto-enrollment in 401(k) plans, whereby individuals are defaulted into a retirement savings plan but can choose to opt out. Such a policy gives people complete freedom to participate or not—and for some, not participating will be the right choice. But establishing an auto-enrollment program changes the default, leading more people to save instead of not to save.

There is evidence that the effects of auto-enrollment can be quite large. For example, economists James Choi, David Laibson, and Brigitte Madrian (2004) found that when companies implemented automatic 401(k) enrollment, participation rates were more than 50 percentage points higher after six months on the job. This difference was persistent over time, remaining more than 30 percentage points higher after three years.

In the Pension Protection Act of 2006, Congress took important steps to enable companies to establish auto-enrollment for their employees, with appropriate protections under the Employee Retirement Income Security Act of 1974 (ERISA). Since then, such auto-enrollment plans have increased rapidly. Analysis published by the Bureau of Labor Statistics found that in 2009-10, 25 percent of establishments with savings and thrift plans had at least one plan with automatic enrollment (Butrica and Karamcheva 2015).

This welcome trend, however, is of little benefit to the roughly one-third of Americans who have no access to a retirement savings plan through their employers. In 2006, the Brookings Institution and the Heritage Foundation teamed up to develop a proposal for these households that would require firms to establish an automatic IRA for their employees that would default employees into retirement savings while giving them the choice to opt out. Under the plan, small businesses would get a tax credit to cover the relatively minimal administrative costs associated with running the system.

Federal legislation on automatic IRAs would be welcome. In the absence of Federal legislation, a number of States and localities— California, Oregon, Illinois, Maryland and Connecticut—have enacted laws to establish such plans. A substantial barrier to the establishment of such payroll deduction savings programs by States has been ERISA. ERISA defines its scope of coverage—which includes any retirement plan "established or maintained" by an employer—quite broadly, such that only minimal involvement or action by the employer is needed to place a plan under ERISA. As such, state payroll deduction savings programs could plausibly be read as requiring employers to create ERISA plans, since they would be mandated to (a) automatically enroll employees and (b) deduct from payrolls to send on to the plan.

However, triggering ERISA coverage would effectively undermine States' plans, because ERISA explicitly places the regulation of covered plans as a matter of Federal law and preempts any and all state laws governing covered plans. As the Department of Labor has noted, in addition to subjecting plans to a number of statutory and regulatory requirements (e.g. disclosure, restrictions of certain transactions, etc.), "if a state program requires private employers to take actions that effectively cause those employers to establish ERISA-covered plans, the [S]tate law underlying the program would likely be preempted. Similarly, if the [S]tate-sponsored program itself were deemed to be an ERISA plan, ERISA would likely preempt any state law that mandates private-sector employers to enroll their employees in that program" (81 FR 92640).

To remove this impediment, the Department of Labor proposed (in November 2015) and finalized (in August 2016) a rule creating a "safe harbor" from ERISA preemption for State payroll deduction savings programs that meet a number of criteria. On December 20, 2016, in response to interest from cities like Seattle, Philadelphia, and New York City, DOL further extended the safe harbor to cover plans established by large political subdivisions (i.e. counties or cities) within States that lack a statewide retirement savings program for private workers.

On April 13, President Trump signed into law H. J. Res. 67, nullifying the Obama Administration's expansion of the safe harbor to localities under the provisions of the Congressional Review Act (CRA). The House and the Senate have both passed H. J. Res. 66, rescinding the underlying August 2016 final rule; the President is expected to sign it in the near future.

This legislation will chill State experimentation in this critical area, increase uncertainty, and impede an effort that would have increased retirement security for a large number of Americans. The CRA resolutions would increase uncertainty for States seeking to establish auto-IRA programs but would not necessarily prohibit them from doing so. (The pilot phase of Oregon's plan, for example, is still scheduled to be operational by the summer of 2017.) One of the main issues is whether the State plans are judged to be "completely voluntary," one of the conditions necessary for ERISA exemption. The 2016 rulemaking explicitly changed the threshold from "completely voluntary" to "voluntary" and clarified that automatic enrollment provisions would be permitted. It is possible that auto-enrollment plans would still be deemed "completely voluntary" under the original 1975 DOL regulation, but overturning the 2016 rule would increase the uncertainty on this point, discouraging more States from experimenting with this critical tool for increasing retirement security for Americans without access to a workplace retirement savings program.

Point #5: A Well-Tailored Rule to Require Advisers to Act in Their Clients' Interest Can Promote Retirement Security

Another important area where regulation can help people make better decisions to promote retirement security is the conflict-of-interest rule, also known as the fiduciary rule. This rule, which was finalized by the Department of Labor in April 2016, requires retirement advisers to serve as fiduciaries, acting in the best interest of their clients. The Trump Administration has since delayed the implementation date to June and opened a process for further changes to the underlying rule. Such changes would reduce the return on retirement savings, potentially transferring billions of dollars from middle-class savers to financial institutions.

Because the tax code subsidizes retirement savings, the government has an important role to play in ensuring their safety and security. The conflict-of-interest rule built on earlier efforts to provide basic protections for American pension and retirement benefits, going all the way back to ERISA in 1974. Notably, neither ERISA nor the conflict-of-interest rule applies to investments outside of the subsidized and regulated retirement system.

When people leave their employers, they have to make one of the most important and complicated financial decisions of their lives: whether and how to roll over their retirement savings into an IRA. One challenge was that under the old rules advisers were held to different standards: advice from a 401(k) provider was required to be "prudent and loyal" to participants' interests—in other words, it had to meet a fiduciary standard. Brokers of IRAs, on the other hand, were merely required to "avoid conflicts." The definition of these conflicts was very narrow, allowing most brokers to receive a variety of conflicted payments—commissions, for instance—from the sellers of the products they recommended.

How much do these conflicts matter? A 2015 report I supervised as chairman of President Obama's Council of Economic Advisers, drawing on over a dozen peer-reviewed studies, estimated that the lower returns caused by conflicted advice amounted to $17 billion annually in IRAs alone (CEA 2015). Clients who received conflicted advice when rolling over at retirement could exhaust their savings five years earlier than they should have.

Many retirement advisers are honest, work hard to provide sound guidance, charge transparent fees, and offer solid recommendations. Emerging business models, including so-called "robo-advisers," harness technology to reduce costs and provide high-quality advice. But the brokers who make large commissions by providing conflicted advice have a powerful financial incentive to stifle these alternative models.

After receiving extensive input from the industry, the Obama Administration wrote the conflict-of-interest rule to include an exemption allowing a wide variety of payments to brokers as long as firms established strict safeguards against conflicted advice. The rule is more flexible and permissive than the approach taken by the United Kingdom, Australia, and other countries. Most major brokers chose to continue receiving compensation from the funds they recommend, but put in place procedures to reduce conflicts of interest and increase transparency. This is leading to a more competitive and diverse market for retirement advice, with benefits for consumers and brokers alike.

Even with this careful design, the rule still created compliance costs: an estimated $5 billion upfront, along with $1.5 billion annually thereafter. But the goal of sensible regulation should be to maximize net benefits, not to minimize gross costs. The boon to consumers of minimizing conflicted advice is considerably larger than the upfront costs, and it will grow over time as more assets come under the rule's purview.

Critically, much of the expense of the new consumer protections reflects one-time transition costs as firms developed new approaches to providing advice with fewer harmful conflicts of interest. As a result, the net benefits of continued implementation of the consumer protections are even larger than those estimated at the time the protections were announced.

Undoing the conflict-of-interest rule could reduce costs for some industry actors. But the flip-side would be higher fees and worse returns for American savers—along with an additional set of transition costs as the industry adapts once again.

Point #6: Health Insecurity Increases Retirement Insecurity

Finally, I want to briefly mention that perhaps the most consequential policy issue for retirement savers that this Congress has considered this year is the American Health Care Act (AHCA). The Congressional Budget Office (CBO) estimated that the version of AHCA originally introduced in the House would result in 24 million people losing health insurance due to a combination of regulatory changes (like eliminating the individual responsibility to purchase insurance) and an $880 billion reduction to Medicaid over the next decade. (CBO has not yet provided an updated estimate for the revised version of the AHCA passed by the House on May 4.) Moreover, CBO has documented that the legislation would result in increases in out-of-pocket costs for many households—particularly for older households and for those with lower incomes.

The net effect of this legislation would be to reduce effective after-tax incomes for tens of millions of households, increasing their financial insecurity and causing them to cut back on a wide range of activities—including retirement savings. As such, this legislation has the potential to increase retirement insecurity along with its other costs in terms of worse health outcomes and greater financial insecurity.

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