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The Future of Retirement

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Paul Schott Stevens
President and CEO, Investment Company Institute

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Thank you, Mellody [Hobson, president of Ariel Investments], and thanks to Evelyn [Dilsaver, moderator and former president and CEO of Charles Schwab Investment Management] and the Commonwealth Club for sponsoring today's event. It is a great honor indeed to appear on this stage, which has hosted so many distinguished speakers addressing issues that are critical to our nation.

Mellody and I share a deep, long-standing interest in Americans' retirement security and the plans that promote it. The funds that the Investment Company Institute represents—including Ariel's funds—are designed and managed to help American families meet their financial goals, and for many Americans, their number one financial goal is a secure retirement.

Now, the research that Mellody just described indicates that we face many challenges in helping Americans reach that goal. Ariel's work clearly indicates a need for better financial education across the population.

But do these findings undercut the strength of the 401(k) system itself? Do they support the conventional wisdom among some academics and journalists that the shift over the past 30 years toward 401(k)s and other defined contribution (DC) retirement plans has been harmful to Americans' retirement security?

No, they do not. That conventional wisdom is wrong.

To the contrary, the trend toward 401(k) has strengthened Americans' prospects for secure retirement. We base that statement on research…on our members' deep involvement with the 401(k) system…and on the input we've received from workers who are actually participating in plans.

The 401(k) fits the needs of American companies and workers, today and tomorrow. It's flexible and evolves to meet those needs as our society and workforce change. And just as important, Americans have confidence in the 401(k) system and the role it plays in securing their financial futures.

Am I arguing that the 401(k) system has reached a state of perfection?

No, certainly not.

Just as Mellody has, I will offer proposals today to make this system even stronger. As Americans increasingly depend upon 401(k)s, individual retirement accounts (IRAs), and other DC savings plans in their efforts to achieve retirement security, we need to build upon the 401(k).

Before I offer those ideas, let me spend a few minutes laying out some facts about today's retirement system.

First—despite the financial crisis—Americans had accumulated $18.5 trillion in retirement assets as of the middle of 2012. That's more than one-third of all household financial assets in the United States.

Second, our private-sector retirement system—both traditional pensions and DC plans—is providing more benefits to more people. Yes, you heard me right—more benefits to more people.

Conventional wisdom would have you believe that there was once a “golden age of the golden watch,” when most American workers were covered by defined benefit (DB) pension plans—and that private-sector retirement benefits have declined since that time.

In fact, the share of retirees who receive retirement income from private-sector plans rose by almost half from 1975 to 2010, from 21 percent to 31 percent. And the median benefit rose by almost one-third, after adjusting for inflation—thanks to both improvements in DB pensions and the growth of 401(k) plans.

A third underreported fact is that 401(k)s can help workers to accumulate enough assets to provide substantial income replacement.

Today’s 40-year-olds are the first cohort of workers 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 replace a substantial portion of their working income in retirement from their accumulated 401(k) assets.

Many distinguished economists have reached similar conclusions. For example, James Poterba of MIT, Steven Venti of Dartmouth, and David Wise of Harvard conclude, “the advent of personal account saving will increase wealth at retirement for future retirees across the lifetime earnings spectrum.” [1]

What are the factors that make 401(k)s and similar DC plans so well suited for today’s workforce? I would single out three elements:

- portability;
- ownership; and
- innovation.

Americans are a mobile workforce, and it’s not unusual for them to move from job to job—even career to career. That puts a premium on retirement benefits that are portable—that can travel with a worker throughout his or her lifetime.

Portability reflects the second key characteristic—ownership.

The holder of a 401(k) account owns actual assets—not a promise of future benefits. 401(k) participants have full rights to their own contributions and the investment earnings on those, subject only to the tax rules that encourage workers to preserve their savings for retirement.

Let’s be frank—owning and investing one’s own assets brings risks. No one needs reminding that the average 401(k) balance fell by more than one-quarter in the crisis markets of 2008.

But the design of 401(k) plans helps limit the impact of investment shocks and mitigate risks. Workers invest paycheck-by-paycheck in accounts that tend to be diversified.

Beginning in 2008, in the teeth of the financial crisis, ICI started surveying recordkeepers of 401(k) plans to understand how 401(k) participants have behaved. We have found a remarkable commitment to stay the course: even in the depths of the bear market, fewer than 4 percent of savers quit contributing, and fewer than one in seven switched asset allocations.

As a result, these 401(k) savers were poised to catch the upswing when stock markets recovered. With market gains and new contributions, 401(k) assets have risen 49 percent since 2008.

The third factor that makes 401(k) plans particularly well suited to today’s workplace is innovation.

Employers can use automatic enrollment to get more workers into plans—a key innovation that uses workers’ inertia to boost, rather than depress, saving.

They can use auto-escalation of workers’ contribution rates, to increase savings rates as workers focus more on retirement needs.

And employers or workers can choose to invest 401(k) savings in target date funds—innovative funds that allocate savings between stocks and bonds based on workers’ retirement horizon, and rebalance those holdings as markets move and savers age. These funds provide diversification and keep 401(k) participants exposed to growth assets, even when individuals express less willingness to take financial risk.

In short, the recent developments in 401(k) plans have helped these investors avoid over-reaction to the financial crisis—

overreaction that could hurt their retirement security decades from now.

Innovation has had another benefit: it's created new services for participants—for example, daily balances, website tools, and call centers. And even as the services have improved, we know that fees for mutual funds—which account for half of 401(k) assets—have fallen. It's clear that 401(k) plan sponsors and participants are sensitive to fees, and that market pressures have been driving these fees down for years.

Now, can 401(k)s still be better?

Of course.

Let me describe some ideas that will achieve three goals. We must:

- preserve the tax incentives that encourage employers to sponsor retirement plans and that enable workers to save for retirement;
- improve and expand DC savings plans for workers and retirees; and
- increase access to retirement savings opportunities for small businesses and individuals.

America's retirement system is built on Social Security, home ownership, private savings, IRAs, and employment-based plans—plans that are fueled in part by tax incentives for savings. So the first of my three goals is to preserve those tax incentives—or, as your physician might say, "First, do no harm."

Our nation faces severe fiscal challenges. Washington is in its fourth year of deficits exceeding $1 trillion. The "fiscal cliff" that looms on January 1, with sharp tax hikes and indiscriminate spending cuts, puts our budgetary challenge in stark relief.

As our leaders address these fiscal issues, however, they must not sacrifice the tax incentives that successfully encourage millions of Americans to accumulate savings toward retirement.

On this, Americans are solidly in agreement: in our 2011 survey, 85 percent of all U.S. households said they didn't want the tax advantages of DC accounts to be eliminated, and 83 percent opposed any reduction in employee contribution limits. And recent ICI research shows that savers across the income distribution benefit strongly from the deferred tax treatment of their 401(k) contributions.

In short: we need to point our federal government in the direction of greater thrift—without sacrificing the incentives that help millions of Americans save for their own financial futures.

Our second goal calls for building on the success of today's 401(k) plans by continuing the recent trend of innovation. Employers should be encouraged to use automatic enrollment, if it's appropriate for their employee base.

One unfortunate side effect of auto-enrollment is that many employers believe the government has endorsed 3 percent of pay as the "official" standard for 401(k) contributions. The fund industry supports encouraging employers to exercise greater flexibility.

We can also improve Americans' ability to make sound decisions about retirement savings and investing. Over the summer, you may have received a new disclosure from your own 401(k) detailing the fees for the plan and its investment options. The fund industry was an early supporter of those disclosures.

Now, we'd like to go further—by promoting electronic delivery of plan information, interactive educational tools, and materials to help workers research and understand their savings options.

These communications can be enhanced by providing workers with realistic projections of the income they can expect in retirement from their current and anticipated savings. Without such information, it's asking a lot to expect a 35-year-old to figure out how her saving and investment decisions now will affect the income she can expect three decades hence. These illustrations can directly address many of the uncertainties documented in Mellody's research, and provide a starting point for further planning and education.

As millions of Baby Boomers move into retirement, we can also give them greater flexibility in how they manage income from their retirement savings. Currently, retirees face stiff tax penalties unless they start taking money out of their plans after they turn 70½. We think the age for these required minimum distributions should be raised to 75 to reflect advances in life expectancy and retirees' desire to be responsible stewards of their retirement assets.

Our third goal is to make sure that every American who wants to save for retirement has access to the tools to do so, including tax incentives. Older workers already enjoy good coverage: four out of five households headed by a worker aged 55 to 64 own

retirement assets or expect a traditional pension. But there are gaps to be filled.

One particular area of concern is very small employers. While such companies have a number of options for savings plans today, none of those options work well for workplaces where the majority of workers are focused on saving for goals other than retirement—such as education, a home, or an emergency fund.

One approach to help these companies would be to create a new, simpler retirement plan. Such a plan would allow the workers who are focused on retirement saving to put away between $5,000 and $10,000 a year, tax-deferred, without the rules and costs more applicable to large plans.

We can also take steps to promote savings through IRAs. For a brief period in the 1980s, anyone with a job could make pretax contributions to an IRA. Today, anyone who wants to save through an IRA has to puzzle his way through a full-page chart published by the Internal Revenue Service to find out what he's eligible for.

In an ideal world, IRAs would be universal again—but that could cost the government a lot of revenue. Instead, regulators should simplify the rules and promote the availability of IRAs for millions of workers and their spouses. Meanwhile, Congress should help older savers by increasing the "catch-up" contributions for inflation.

There's one more item needed to strengthen our retirement system: we need to put Social Security on a sound financial footing. 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. But on its current course, Social Security is not going to be able to meet its future obligations. It is absolutely imperative to preserve Social Security as a universal, employment-based, progressive safety net for all Americans.

Let me just leave you with one last thought: the next time you hear a commentator criticizing the impact of 401(k) plans on Americans' retirement security, please keep in mind that the American people don't share that view.

In our latest survey, almost two-thirds of all households—and more than three-quarters of those that own IRAs or DC accounts—said they have a "very favorable" or "somewhat favorable" view of 401(k) and DC plans. And more than three-quarters of households with DC accounts or IRAs said they were "very confident" or "somewhat confident" that these accounts can help individuals meet their retirement goals. That is a striking degree of national consensus on a matter of such importance.

Americans face many economic challenges today, including the task of providing for a secure retirement. Meeting that goal requires thrift; it requires planning; it requires each of us to take responsibility for our future.

That's not easy, and we all know that many Americans need help—including more financial education—to meet their goals. Fortunately, building on the foundation of Social Security, today's employment-based system is moving to provide them with the means to save and invest, and the tools they need to meet their goals. Working together, America's employers, workers, plan providers, and government can continue to improve this flexible, innovative, and powerful system to the benefit of our nation.

Thank you. Mellody and I look forward to your questions.

endnotes

[1] Emphasis added. See "The Changing Landscape of Pensions in the United States," NBER Working Paper (September 2007), available at http://www.nber.org/papers/w13381.

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