Testimony on "The State of U.S. Retirement Security: Can the Middle Class Afford to Retire?"

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Thank you, Chairman Merkley and members of the Senate Banking Committee's Subcommittee on Economic Policy for the opportunity to testify today. My name is Robbie Hiltonsmith, policy analyst at Dēmos, a public policy organization working for an America where we all have an equal say in our democracy and an equal chance in our economy. I am happy to be here today to testify on the state of U.S. retirement security, because though retirement security is one of the lynchpins of economic security for the middle class, it is also proving sorely elusive for the majority of Americans. One of the major reasons for this brewing retirement security crisis is the inadequacy and inefficiency of defined contribution plans. These plans, which include 401(k)-type plans and IRAs,[1] are the primary ways for most workers to supplement Social Security retirement income, and it is on the inherent problems with these plans that I will focus my testimony.

According to the National Compensation Survey (NCS), less than two-thirds of all private sector workers in the U.S. (64 percent) were covered by any workplace retirement plan in 2012, and just 49 percent of all such workers participated in their employer plan.[2] However, the retirement security crisis isn't just limited to the half of workers who don't participate; even many of those who are actively saving for retirement are at risk as well, because most U.S. workers participating in a workplace retirement plan are covered only by an individual-account, 401(k)-type plan. These plans place nearly all of the risk on workers, who face the very real possibilities of losing their savings in a stock market plunge or of outliving their retirement savings. Even worse, 401(k)s often have high, hidden investment management, administration, and trading fees that can eat into their returns, making saving for retirement even more difficult. Though 401(k)s have only become the primary retirement savings vehicle for workers in the past three decades, the inadequacies of these plans are already showing in retirement savings data: nationally, as of 2010, 40% of households ages 55-64, the first cohort of workers to be forced to rely on the 401(k), had nothing saved for retirement, and the median retirements savings among those with any was just $100,000.[3] These stark figures, along with many others, show that the fees and risks mean that 401(k)s are make them unsuitable to be U.S. workers' primary supplement to Social Security in retirement.

So, what risks, in particular, does being forced to depend on a 401(k) for the bulk of one's retirement income force workers to shoulder? Retirement experts generally agree that there are five major types of risk that 401(k) participants bear. Savers risk losing their savings to poor investment decisions, which experts term investment risk; high fees and low contributions (contribution risk); or a turbulent market (market risk); they also risk outliving their retirement savings (longevity risk); and being forced to, or unwisely choosing to, withdraw from or borrow against their savings (leakage risk). Though many 401(k) proponents believe the private retirement market can and will mitigate these risks, the continued inadequacy of Americans' retirement savings after nearly three decades of the 401(k) suggest otherwise.

The financial crisis and following recession of the past few years has made the magnitude of the effect of market risk on 401(k) retirement savings crystal clear. During the stock market plunge of 2008 and 2009, 401(k)s and IRAs lost a total of $2 trillion dollars in value, while the average 401(k)-holder lost over 1/3 of his or her savings.[4] Retiring during a market downturn generally means either doing so with vastly reduced retirement savings, which—though retirees' balances may later recover—can certainly affect potential retirees' long- and short-term financial planning, or lead them to postpone retirement, which in turn prevents younger workers from entering the labor force and worsens the already high youth unemployment that accompanies such downturns. Just how large of an impact can market cycles have on 401(k) balances? By our calculations, if an average worker with retirement savings had retired at the height of the last big stock market surge in 2000, he or she would have had over 50 percent more to live on during retirement than if she had retired in the depths of the last recession in 2009.

Another problem with 401(k)s is investment risk—the possibility of participants making poor investment decisions. Though the freedom to choose one's own investments is lauded as a benefit of 401(k)s, in fact, most actual Americans are extremely ill-equipped to choose among often inscrutable investment choices. For example, in one study, 84 percent of retirement plan participants thought that higher mutual fund fees guaranteed better performance[5], even though multiple studies have shown that there is no relationship between the two. 401(k) participants, despite years of advice from their investment advisors, generally have no idea how to balance their portfolios, often adopting an all-or-nothing approach to risk. 21 percent of participants have more than 80 percent of their assets in stocks and other risky assets, far too much for any but young savers. Another 38 percent have none invested in stocks, a far-too-conservative allocation for any age.[6] Individualized investing might seem to conform to our nation's idealized vision of freedom and individual choice, in reality, leaving the investment decisions up to financial market professionals would result in higher returns and lower risk.

Longevity risk, or the possibility that retirees outlive their retirement savings, is increasingly worrisome as high-income Americans continue to live longer. Though most know that life expectancies are on the rise, it's still impossible to know exactly how long we, individually, will live. When surveyed, individuals, generally, underestimate their own probabilities of living to an old age[7]. 401(k)s, by their very nature, simply provide a fixed sum to live off of in retirement; ensuring that sum lasts the rest of one's life would require exact knowledge of one's exact date of death, a grisly and impossible prospect. Investment options such as annuities, which can mitigate longevity risk, remain both prohibitively expensive and are often extremely complex. The most efficient way to eliminate longevity risk is to pool such risk among a wide swath of the country, similar to the approach taken by the Affordable Care Act. Unfortunately, the structure of the current 401(k) system makes it nearly impossible to do so.

At first blush, the fact that 401(k)s allow account-holders to make early withdrawals or take out loans against account assets to pay for unexpected expenses might seem to be an advantage of such plans, helping individuals to smooth out life's little financial curveballs and potholes. However, the flipside of allowing these early withdrawals/loans are that they present another risk--commonly referred to as leakage risk--to adequate retirement savings. Leakage can significantly damage workers' retirement prospects, particularly those of younger workers, who lose decades of compounded returns when they withdraw, cash out or borrow. According to Vanguard, one of the largest 401(k) providers, 3.7% of participants younger than age 60 withdrew an average of 29% of their total 401(k) balance in 2010[8]; Even more alarmingly, 18% of all 401(k) participants, and 23% of all participants with incomes less than $30,000, had a loan outstanding at the end of the year. Ten percent of these loans, Vanguard says, are never repaid, significantly affecting retirement savings, and the interest lost during the loan period reduces account balances for repaid and unpaid loans alike. The GAO estimates that such withdrawals and loans (including between-job cashouts) sapped nearly $84 billion from retirement accounts in 2006, a number which surely rose during the recent recession.[9] Between-job leakage is actually responsible for the lion's share of this leakage, as significant pluralities of workers simply cash out their retirement plans when leaving a job, particularly younger workers. A recent AON study found that 59% of Millennials, and 46% of Gen Xers, cashed out their 401(k)s each time they changed jobs[10].

Finally, perhaps the largest 401(k) risk is contribution risk: the risk that workers contribute too little to their retirement over the course of their lifetimes. Workers contribute too little to 401(k)s for three main reasons: either they're simply not earning enough, they don't trust 401(k)s and the financial markets in general, or simply don't have the financial literacy to understand how plans work or how much to contribute. Employees themselves believe the first reason, lack of income, is the also the largest, and decades of stagnant wages would seem to lend credence to their claim. In a 2007 poll, 56 percent of respondents said that the reason they were not saving for retirement was because they couldn't afford to save[11]. Figures on contribution rates by race confirm this claim; those for Latinos and African-Americans, who have lower average incomes, trail significantly behind higher income whites and Asian-Americans. [12]

The variety of fees charged by the funds in which 401(k) assets are invested can, too, make it even more difficult to contribute enough to individual retirement accounts. These fees, though often seemingly innocuous single-digit percentages, actually add significantly to the risk that workers are unable to save enough for retirement. According to our research, these fees can actually consume 30 percent or more of the gross (or before-fee) returns earned by savers' investments. Over a lifetime, these fees can add up to a significant chunk of workers' savings. According to our model, fees can cost an average household nearly $155,000, in fees or lost returns, effectively reducing the size of their nest egg by over 30 percent. How are mutual funds able to take such a large cut for their services? Mainstream economic theory provides a simple answer. When consumers of a product, such as mutual funds, do not have enough information or education to choose rationally among competing products, suppliers (funds) can charge higher prices. And that's precisely what happens: undereducated and overworked 401(k)-holders often do not choose wisely amongst the limited menu of often opaque and seemingly-identical mutual funds that their 401(k) provides. Employers, too, often lack expertise: employees in charge of many firms' 401(k)s only administer the plans part time, and thus often do not have the knowledge necessary to choose amongst nearly identical 401(k) plans, or the incentive or power to push for a plan switch if their firm's plan is on the higher end of the cost spectrum. And unfortunately, many IRA brokers and 401(k) financial advisors take advantage of this lack of knowledge by pushing higher-fee plans on savers and employers, because they are not required to look out for the best interests of their clients, and are in fact often incentivized to push such high fee plans because they receive part of their compensation from the fees generated by the plans they sell.

Though it has been difficult to quantify the losses due to “excessive” fees, in large part because of the lack of publicly available data on fees charged by 401(k) plans, recent research has shown large losses due to both savers’ and plan sponsors’ lack of knowledge and poor advice from plan investment advisors. One study estimates that savers lose an average of nearly 1% in returns due to poor choices by plan fiduciaries, in part likely due to poor or conflicting advice received from their plan financial advisors.[13] These losses could be partially or entirely mitigated by requiring financial advisors for 401(k)-type plans give advice in their clients’ best interest.

The 401k’s plethora of risks and excessive fees make a convincing case for what many critics have been saying for decades: this national experiment in 401(k)-based “do-it-yourself-retirement” has been, and will continue to be, a failure. A new system to replace 401(k)s is urgently needed. All hardworking Americans need a safe, low-cost secure account to save for retirement, one that can also provide a lifetime stream of income when they retire; in other words, an account that protects workers from the severe risks and high costs of 401(k)-type plans.

References

[1] I use "401(k)" or "401(k)-type plan" as a shorthand to refer collectively to the many types of similar employer-based individual retirement plans, including 401(k)s, 403(b)s, 457s, and Keoghs.
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