Retirement Savings Modernization Act

Sen. Pat Toomey (R-Pa.) and Sen. Tim Scott (R-S.C.)

The Problem: American Workers With 401(k) Plans Lack Access to Diversified Investment Portfolios

Until the 1970s, most Americans working in the private sector would collect retirement benefits from traditional pension plans that paid out “defined" amounts. Today, however, the vast majority of American private sector workers rely on defined contribution plans, such as 401(k)s, to save for retirement. These investment vehicles have shifted responsibility for ensuring an adequate amount is saved from the employer to the worker.

Nearly seven times as many Americans are now enrolled in defined contribution (“DC”) plans compared to defined benefit (“DB”) pension plans. And yet, DC plans underperform DB plans, largely because DB plans diversify investments across the full range of asset classes—just like most sophisticated institutional investors. A full 89% of public DB pension plans like CalPERS and the Illinois State Board of Investment incorporate exposure to private equity, which is now the highest returning asset class in public pension portfolios (median annualized return of 15.1% over the past 10 years).

Such diversification reflects market realities. Since 2005, private company growth has significantly outpaced public company growth by value. A recent study estimated that a target date fund diversified with the asset classes that DB plans frequently use—private equity, hedge funds, and real estate—would increase a participant’s balance at retirement by 17% and reduce expected losses in an economic downturn.

The proposed Retirement Savings Modernization Act gives 401(k) savers the same access as pension plan savers to diversified and alternative retirement plan options, helping to strengthen retirement security and improve financial returns for private sector workers.

Background

Under the Employee Retirement Income Security Act of 1974 (“ERISA”), retirement plan sponsors, advisers, and managers have a sole duty to act exclusively in the financial interest of a plan participant, making them a “fiduciary.” ERISA’s “prudent man” standard requires fiduciaries, among other things, to select investments with care, remove imprudent investments promptly, defray reasonable expenses of the plan, and diversify investments “so as to minimize the risk of large losses.” If plan fiduciaries are found in breach of these duties, they can be held personally liable for losses.

The legal risks are greater for DC plans than DB plans since DB plans will always pay out the promised level of benefits regardless of investment performance barring insolvency. DC plan participants receive no such promise, thus fiduciaries, fearful of litigation risk, are excessively cautious about investing in assets outside of a traditional mix of stocks, bonds, and cash equivalents. As a result, instead of offering the best investment, plan fiduciaries often offer investments that retirement savers can only fully understand. Contrast this with DB plans, which put nearly one of every five dollars in alternative asset classes like private equity.

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The Solution: Retirement Savings Modernization Act

The Retirement Savings Modernization Act amends ERISA to clarify that retirement plan sponsors may offer DC or DB plans that are prudently diversified across all asset classes, including both traditional and alternative assets.

More specifically, the Retirement Savings Modernization Act:

1. Clarifies that plan fiduciaries may select investment options that include a range of asset classes, including private equity. Nothing in ERISA currently limits the asset classes that may be included in a plan; this amendment makes clear that Congress intends to let investment professionals determine the appropriate range of asset classes.

2. Protects ERISA's fiduciary standard. A unanimous U.S. Supreme Court has affirmed that ERISA's fiduciary duties are "the highest known to the law." Fiduciaries must still select investments through a prudent process, and the bill explicitly does not create a safe harbor from a fiduciary's legal duties.

3. Promotes the prudent diversification of retirement savings plans. The bill does not require that plan participants have access to specific asset classes, but it provides fiduciaries with the tools to better ensure diversification.