Statement of Ellen E. Schultz

before the

Committee on Finance

U.S. Senate

on

Retirement Savings 2.0: Updating Savings Policy for the Modern Economy

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Chairman Wyden, Ranking Member Hatch, Members of the Committee, thank you for inviting me.

As a journalist, I have closely followed retirement practices and policy since the later 1980s, for the most part as a reporter and editor at *The Wall Street Journal.* My work has been based largely on my analysis of regulatory filings, internal company memos, and documents that are rarely, if ever, examined by those evaluating the retirement system. And I speak today from that perspective.

You have asked me to comment on whether the tax breaks conferred on retirement plans—expenditures that will likely exceed $100 billion in 2014 – are achieving what Congress intended. Namely, are these costly expenditures helping most working Americans accrue assets adequate to prevent them falling into poverty in their old age and becoming a burden to their families and society?

Based on what I have documented and reported over the past 25 years, that has not been the case. The economic benefits of the tax-subsidies that support the retirement system have flowed largely to the highest-paid Americans, to employers, and the financial services industry The expenditures have done too little to improve the likelihood that most of working Americans will have adequate—or any—income (other than Social Security) when they can no longer work.

Keeping Defined Benefit Plans Effective

There is no question that defined benefit plans are generally preferable to 401(k) plans and have provided secure and adequate pension benefits to million of people – and they have the potential of providing fair benefits across the board.

Policymakers recognize the value of what defined benefit plans do: Employees are automatically enrolled, professionals manage the investments, and the delayed compensation is ordinarily paid out in retirement as a lifetime annuities that the retiree and spouse cannot outlive.

But over the past two decades, I've seen employers manage their pension plans more for the benefit of the shareholders than the participants, and this committee should explore how to ensure that pension plans continue to be the vehicles envisioned by Congress.

For one thing, employers moved away from the notion that assets in pension plans were essentially locked up for sole purpose of paying benefits to retirees. Among the practices documented in my book, *Retirement Heist*:

- Some employers, including Montgomery Ward, terminated their *healthy* pension plans and used the assets to pay creditors.
- Many, like Verizon, used the assets to finance downsizings, offering departing employees additional pension payouts in lieu of severance.
- Others, including DuPont, used pension assets to pay for retiree health benefits
- In less transparent maneuvers, companies sold pension assets in mergers and acquisitions, indirectly converting pension assets into cash.
- Employers took advantage of tax loopholes to carve out parts of the tax-subsidized pension plans for the rank-and-file to pay for supplemental executive pensions and deferred compensation for highly paid employees. The arrangements are called QSERPs, which stands for "qualified supplemental executive retirement plans." Using this technique, for example, Intel was able to move more than $200 million in unfunded obligations for deferred compensation for the top 3% to 5% of its workforce into the pension plan. Participants can later roll their QSERP into an IRA.

Employers' ability to treat pension plans like tax-sheltered piggy banks rendered pension plans less well funded, and more likely to fail. It also meant that employers had an incentive to cut pensions and freeze plans –even when the plans were healthy-- because doing so increased the assets available for the employer.

Meanwhile, employers had another incentive to cut pensions: New accounting rules required companies to report pension obligations to shareholders, and their effect on quarterly income. Though intended to increase transparency, the rule had the unintended effect of rewarding companies that cut pension benefits. Doing so generated immediate profits for shareholders, and increased the surplus assets available to the employer.

Another thing to consider when evaluating the effectiveness of tax subsidies for pension plan is that the risk landscape has changed. When ERISA was enacted, employers bore the risk in pension plans (investment, interest rate, mortality) in exchange for the tax subsidies. But employers learned that they can essentially transfer investment and interest rate risk to participants by cutting pension benefits. When pension plans suffered losses, many employers responded by cutting benefits. (Replacing pensions with 401(k)s, of course, transfers *all* risk to the participants). Lump sum payouts are another way to transfer investment and interest rate risk, as well as inflation risk and longevity risk to retirees.

Taking risk transfer even further, a growing number of companies, including General Motors and Verizon, are transferring certain pension obligations to insurance companies, which take over the task of making monthly payments to retirees.

Companies benefit from this "de-risking" strategy, and insurers welcome the assets and fees for managing them, but retirees potentially face solvency risk, because their pensions no longer enjoy the protections of the federal Pension Benefit Guaranty Corp., which steps in to pay pensions if a plan fails.

The concept of "de-risking" requires greater scrutiny to insure there are no replays of 1980s debacles, when companies terminated pension plans and turned the job of paying out pensions to insurers like Executive Life, which became insolvent, causing retirees to lose significant amounts of their pensions.

Even more disturbing, some companies are offering lump sum window "opportunities" to already retired individuals. The lump sum option typically has far less value than the annuity that is already being paid, and many of the people to whom this option is offered are in their late 70s and 80s and some of them will be suffering from diminished capacity. Those who take lump sums are exchanging a secure stream of payments they cannot outlive, and taking on the challenge of investing the money and making it last.

The effectiveness of tax subsidies in 401(k) Plans

With employers freezing and terminating their pensions, and offloading liabilities to insurance companies and individuals, 401(k)-style savings plans have become the primary vehicle for retirement savings. The problem is that although the U.S. Treasury foregoes billions of dollars every year to encourage retirement saving, the workers who most need a supplement to Social Security either get nothing or very little from these plans.

According to the Center for Retirement Research, only about half of private sector workers participate in a workplace retirement plan, and roughly one-third of households reach their sixties with no retirement plans at all.

The reality is that a disproportionate amount of the tax expenditure ends up benefitting affluent employees who are already saving. Two-thirds of the value of tax expenditures for retirement savings plans goes to households in the top income quintile, according to the Urban-Brookings Tax Policy Center.

Many blame low savings rates on the behavior of low and middle income workers: failing to contribute, or contributing too little, making poor investment choices, or cashing out what little they have accumulated to pay for pressing needs like health care, rent, college tuition, and home attendants for their elderly parents.

But there are also other reasons. For example, millions of workers who are excluded altogether from participation in their employer's retirement plans. Although 401(k)s and other retirement plans are supposed to be made available to the broad base of employees, and not just a select group, employers are permitted to exclude 30% of workers for any reason, and even more if they follow certain rules. They can exclude workers in certain divisions, or geographic areas and job classifications. They may also exclude those who work fewer than 1,000 hours in a 12-month period, which can effectively eliminate part-timers and seasonal workers; people under age 21, and workers covered by collective bargaining agreements.

Excluding low-paid workers who are not likely to contribute or contribute very little makes it easier for the retirement plans to pass discrimination tests, which compare the contributions of low-paid to those of high paid, to ensure that the plan doesn't unfairly benefit the top echelon. If too few of the lower paid participate, and contribute too little, a plan can appear discriminatory, which can bring down the maximum amount the high-paid can contribute. One way to ensure that low participation by lower paid workers doesn't make the plan appear discriminatory is to exclude many of them altogether.

One example in my book is Hugo Boss, a company that makes high-end clothing. For years, the company excluded workers in its warehouse in Midway, Georgia, from the 401(k) plan that it offered to the 232 employees and managers at its Cleveland headquarters. Low participation and contributions from the low-paid warehouse workers, mostly minority women, would have cause the plan to fail the discrimination tests. When that happens, the limits on what the highest paid employees can contribute are lower than the statutory maximum, which currently is $17,500 plus a $5,500 catch-up contribution for those 50 and over.

Thus, those who need savings incentives the most are shut out of plans to ensure that those who need help the least can contribute the maximum amount.

A recurring theme I've seen since the '80s is that many employers want to maintain the plans primarily for the benefit of their higher paid employees, and with the help of benefits consulting firms, use increasingly complex maneuvers to sidestep the discrimination rules and skew benefits to the highly paid. These include segregating lower-paid workers in separate but unequal plans, and providing larger contributions to higher-paid workers, a nearly universal practice common in pension plans, called "permitted disparity." Younger and lower-income workers are also more likely to forfeit employer contributions because they don't remain on the job long enough to vest.

Employers have persistently sought relief from discrimination rules, and lobbied successfully for the automatic enrollment provision included in the Pension Protection Act, which become effective in 2007. Although sold as a way to improve participation among the low-paid, who are automatically enrolled in a plan, the benefit to employers is that merely by providing automatic enrollment (even if workers opt out), and making a modest matching contribution to an employee's account, the plans don't have to prove that they are benefiting lower paid employees.

It remains to be seen whether auto-enrollment will provide a meaningful benefit for the low-paid. Employees can drop out at any time, aren't required to contribute, can use the plan as a piggy bank for immediate spending needs, and must work for three years before they vest in the employer contributions. Meanwhile, only *non-excluded* employees are auto-enrolled, and employers can continue to take advantage of "permitted disparity" to provide richer contributions to the highest paid employees in the plans.

Looking ahead

Using tax breaks as carrots to encourage savings is potentially a good thing , but more scrutiny is needed to determine how to structure them to work more efficiently.

For example, the increase in 401(k) limits in 2001 (and indexed to inflation) has not significantly increased the number of retirement plans or the percentage of people participating. [Currently, the maximum combined employer-employee contribution to a 401(k) is $52,000.]

A rollback of contribution levels, or at least a freeze at the current level might be something to consider. According to the GAO, only a small percentage of workers contribute the maximum to their plans. Contribution ceilings do not jeopardize the ability of more affluent employees to save on a tax deferred basis. Many of the highest paid participate in deferred compensation plans that enable them to save significant amounts above the contribution limits. Savings in these parallel 401(k)s receive employer contributions, can be invested in virtual versions of the same funds available in the 401(k), and enjoy grow tax deferred growth.

In any discussion of tax expenditures, it would be illuminating to measure revenue loss attributable to the billions of dollars that highly paid employees set aside each year in deferred compensation plans and supplemental executive pensions plans, which at some companies exceed the amounts owed regular workers.

And we need more information from employers.

To get a clearer view of who benefits from tax-payer subsidized retirement plans, employers should once again be required to submit Schedule T of the Form 5500, which for each plan shows:

Total employees
Total number of excluded workers,
Number of excluded workers by classification:

* work fewer than 1,000 hours a year
* worked less than one year
* under 21
* location (excluded division/unit)
* job category
* collectively bargained

Total participants in the plan
Number of participants with anything in their accounts

Demographic data would also be helpful when evaluating who benefits from qualified plans. Employers could be required to disclose the race, gender and ages of both participants and excluded employees.

Thanks you for your time. I'd be glad to answer any questions.