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"Federal Benefits: Are We Meeting Expectations"

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Mr. Chairman and members of the subcommittee, my name is Patrick Purcell and I am a specialist in income security with the Congressional Research Service. Thank you for inviting me to speak to you today about the Federal Employees' Retirement System and the Thrift Savings Plan.

CSRS and FERS

Retirement income for federal employees is provided through the Civil Service Retirement System (CSRS) and the Federal Employees' Retirement System (FERS). Most civilian federal employees who were hired before 1984 are covered by the CSRS, which is a defined benefit pension plan. Employees covered by CSRS do not pay Social Security taxes and are not eligible for Social Security benefits for their period of federal employment. Federal employees first hired in 1984 or later are covered by the FERS. All federal employees who are covered under FERS pay Social Security taxes and are eligible for Social Security benefits. Federal employees enrolled in either CSRS or FERS also may participate in the Thrift Savings Plan (TSP), which is a defined contribution plan. Only employees covered under FERS, however, are eligible for employer matching contributions to the TSP. Because the CSRS has been closed to new entrants for more than 20 years, and now covers less than a quarter of the federal workforce, this testimony focuses on the benefits provided under the Federal Employees' Retirement System.

Origin of the Federal Employees' Retirement System

Prior to enactment of the *Social Security Amendments of 1983* (P.L. 98-21), federal employees were not covered by Social Security. Federal employees were covered instead by the Civil Service Retirement System (CSRS), which was established in 1920. Because the Social Security system needed additional cash contributions to remain solvent, the 1983 Social Security amendments mandated coverage for civilian federal employees hired in 1984 or later.

Congress recognized, however, that Social Security provided some of the same benefits as CSRS. Moreover, enrolling federal workers in both plans would have required payroll deductions equal to more than 13% of employee pay. Consequently, Congress directed the development of a new federal employee retirement system with Social Security as the cornerstone and which would incorporate many features of the retirement programs typical among large employers in the private sector. The result of this effort was the *Federal Employees' Retirement System (FERS) Act of 1986*

(P.L. 99-335). FERS consists of three elements: (1) Social Security, (2) a traditional pension called the FERS basic retirement annuity, and (3) the Thrift Savings Plan.

Eligibility and Benefits under FERS

Two factors determine an employee's eligibility for a FERS retirement annuity: age and years of service. The amount of the worker's retirement annuity is determined by three factors: the number of years of service, the accrual rate at which benefits are earned for each year of service, and the salary base to which the accrual rate is applied.

Retirement Age and Years of Service under FERS

Federal employees are fully vested in the FERS basic retirement annuity after 5 years of service. A current or former federal employee with at least 5 years of service is eligible for a retirement annuity at age 62. A current or former federal employee with at least 20 years of service is eligible for a retirement annuity at age 60. The earliest age at which a worker can retire under FERS was 55 for workers born before 1948. The minimum retirement age under FERS for workers who reach age 55 in 2007 is 55 and 10 months, and it will reach age 57 for those born in 1970 or later. A worker who has reached the minimum retirement age and has completed at least 30 years of service can retire with an immediate, unreduced annuity.

An employee covered by FERS can retire with a *reduced* benefit at the minimum retirement age if he or she has completed at least 10 years of service. The retirement benefit is permanently reduced by 5% multiplied by the difference between 62 and the retiree's age at the time the annuity begins. For example, an employee with at least 10 years of service who retires at 55 would receive a pension benefit that is reduced by 35% below the amount that would be paid to an individual with the same salary and years of service who retired at age 62.

The basic retirement annuity under FERS is determined by multiplying three factors: the *salary base*, the *accrual rate*, and the number of *years of service*. The FERS *salary base* is the average of the employee's highest three consecutive years of base pay.[1] This is often called "high-3" pay.

The *accrual rate* is the pension benefit earned for each year of service, expressed as a percentage of the salary base. Under FERS, workers accrue retirement benefits at the rate of 1% per year. A worker with 30 years of service will have accrued a pension benefit equal to 30% of high-3 pay. For employees in FERS who have at least 20 years of service and who work until at least age 62, the accrual rate is 1.1% for each year of service.

Members of Congress, congressional staff, federal law enforcement officers and firefighters accrue benefits at higher rates than do other federal employees. Under FERS, Members of Congress, congressional staff, law enforcement officers, and firefighters accrue pension benefits at the rate of 1.7% per year for their first 20 years of service and 1.0% per year for years of service after the 20th

[1] This calculation is based on nominal or "current dollars" rather than indexed or "constant dollars."

year. These accrual rates yield a pension equal to 34% of the FERS salary base after 20 years of service and 44% after 30 years of service.

Early Retirement, Social Security and the "FERS Supplement"

Because Social Security retirement benefits cannot begin before age 62, Congress included in FERS a temporary supplemental benefit for workers who retire before age 62. This benefit, the "FERS supplement" is paid to workers who retire at the minimum retirement age or older with at least 30 years of service or at age 60 with at least 20 years of service. The supplement is equal to the estimated Social Security benefit for which the worker will become eligible at age 62, but is based *only* on the portion of Social Security payments that are attributable to the worker's years of federal employment. It is paid only until age 62, regardless of whether the retiree chooses to apply for Social Security at 62.

Cost-of-living Adjustments (COLAs)

Cost-of-living adjustments, or COLAs, protect the purchasing power of retirement benefits from being eroded by inflation. COLAs in the Civil Service Retirement System are equal to the change in the Consumer Price Index for Urban Wage and Clerical Workers (CPI-W). As a cost-control measure, when the FERS Act was passed, Congress provided for limited COLAs for the FERS basic retirement annuity. Under FERS, the basic annuity is fully indexed if inflation is under 2% per year and partially indexed if inflation exceeds 2%. If the CPI-W increases by up to 2%, then the FERS monthly benefit amount increases by the same percentage. If the CPI-W increases by 2% to 3%, the FERS annuity increases by 2%. If the CPI-W increases by more than 3%, the FERS annuity increases by the rise in the CPI-W minus one percentage point. As a further restraint on the costs associated with COLAs, FERS provides COLAs only to retirees who are age 62 or older, annuitants of any age who are retired by reason of disability, and to survivor annuitants of any age.

Employer and Employee Contributions toward the FERS Annuity

Federal agencies and their employees prefund the FERS basic retirement annuity through required contributions to the Civil Service Retirement and Disability Fund (CSRDF). By providing a continuous source of budget authority, the trust fund allows benefits to be paid on time, regardless of any delays that Congress may experience in passing its annual appropriations bills. Prefunding pension obligations also requires federal agencies to recognize the full cost of their personnel when requesting annual appropriations from Congress.

Workers covered by FERS are required to contribute 0.8% of pay to the Civil Service Retirement and Disability Fund toward the cost of their future pensions. Federal employees covered by FERS also pay Social Security taxes of 6.2% on salary up to the maximum taxable wage base ($97,500 in 2007). Members of Congress contribute 1.3% of salary to the CSRDF. Members of Congress also pay Social Security taxes. In FY2006, employee contributions to CSRS and FERS totaled $3.7 billion, equal to 4.2% of the total income of the fund.

Federal agencies contribute an amount equal to approximately 11.2% of payroll to the CSRDF, which is part of their annual appropriations from Congress. The CSRDF is required by law to invest all of its assets in U.S. Treasury bonds or other securities backed by the full faith and credit of the United States Government.

The other major sources of revenue to the CSRDF are agency contributions, contributions of the U.S. Postal Service on behalf of its employees, interest on the federal bonds held by the fund, and a transfer from the general revenues of the U.S. Treasury. This transfer is necessary because the costs of the older of the two federal retirement programs, CSRS, are not fully covered by employee and agency contributions. FERS benefits are required by law to be fully funded by the sum of contributions from employees and their employing agencies and interest earned by those contributions.

Total Cost of FERS Benefits

Actuaries calculate the cost of pension programs in terms of "normal cost." The normal cost of a pension plan is the level percentage of payroll that must to be set aside each year to fund the expected pension benefits that will be paid to all members of an employee group and their surviving dependents. Normal cost is based on estimates of attrition and mortality among the workforce, and estimates of future interest rates, salary increases, and inflation-based COLAs for retirees.

The Office of Personnel Management (OPM) has estimated the normal cost of the FERS basic annuity at 12% of payroll. Federal law requires agencies to contribute an amount equal to the normal cost of FERS minus employee contributions to the program, which are equal to 0.8% of payroll. Consequently, the normal cost of the FERS basic annuity to the federal government is equal to 11.2% of payroll. The federal government has three other mandatory costs for employees covered by FERS. Social Security taxes are 6.2% of payroll on both the employee and the employer up to the maximum taxable amount of earnings ($97,500 in 2007). All agencies automatically contribute an amount equal to 1% of employee pay to the TSP. Agencies also make matching contributions to the TSP. The normal cost of FERS to the federal government is therefore at least 18.4% of pay for the average employee. Federal matching payments to the TSP can add up to 4 percentage points to this total, depending on an employee's voluntary contributions.

The Thrift Savings Plan: An Integral Component of FERS

The Thrift Savings Plan (TSP) is a retirement savings plan similar to the "401(k)" plans provided by many employers in the private sector.[2] As of July 2007, the Thrift Savings Plan held more than $225 billion in assets and 3.7 million participants among the federal civilian workforce, the uniformed services, and former employees who continued to hold retirement assets in the TSP.

In 2007, federal employees under age 50 can contribute up to $15,500 to the TSP.[3] Employees age 50 and older can contribute an additional $5,000. For all federal workers covered by FERS, the

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[2] "401(k)" refers to the section of the Internal Revenue Code that authorizes deferral of income taxes on contributions to retirement savings plans.

[3] The annual limit on contributions is set in law at §402(g) of the Internal Revenue Code.

agency at which they are employed contributes an amount equal to 1% of the employee's base pay to the TSP, whether or not the employee chooses to contribute anything to the plan. In addition to the employing agency's automatic contribution of 1% of pay, employers covered by FERS receive dollar-for-dollar employer matching contributions on the first 3% of pay that they contribute and a 50% match on the next 2% they contribute, for a maximum employer contribution of 5% of pay.[4] Contributions to the TSP are made on a pre-tax basis, and the contributions and investment earnings are free from income taxes until the money is withdrawn from the account. All TSP participants are immediately vested in their contributions to the plan, all federal matching contributions, and any growth in the value of their investment from interest, dividends, and capital gains. They are fully vested in the 1% agency automatic contributions to the TSP after three years (two years for congressional employees and executive branch political appointees).

Federal employees are eligible to contribute to the Thrift Savings Plan immediately upon being hired, and they may transfer funds from an individual retirement account (IRA) or another employer's 401(k) plan into the TSP. Of the 3.7 million individuals with TSP accounts, approximately 2.9 million are currently contributing to the plan. Among current federal employees covered by FERS, 86% of those eligible to contribute in the Thrift Plan do so. In terms of both assets and number of participants, the Thrift Savings Plan is the largest employer-sponsored retirement savings plan in the United States.

The Thrift Savings Plan is administered by an independent government agency, the Federal Retirement Thrift Investment Board, which is charged in statute with operating the Thrift Plan prudently and *solely in the interest of the participants and their beneficiaries*.[5] The assets of the TSP are maintained in the Thrift Savings Fund, which invests the assets in accordance with participant instructions in five investment funds authorized by Congress to be included in the plan. TSP accounts are individually owned by the participants in the TSP in the same way that 401(k) accounts are owned by workers in the private sector.

Investment Options

As provided for in statute, TSP participants are offered five investment funds. Participants may allocate their contributions among any or all of the five investment funds, and they may reallocate their account balance among the five funds. One fund invests exclusively in U.S. government securities and the other four funds invest in private-sector stocks and bonds. The four funds that invest in private-sector securities are all index funds. These funds purchase securities in the same proportion as they are represented in an index of stocks or bonds, rather than through the decisions of an investment manager. Index funds have lower administrative costs than actively-managed funds, and because they purchase securities in the same proportion as they are represented in an index, there is little or no opportunity for the purchase of securities by the fund to be influenced by third parties who might benefit from having the fund invest in particular companies or sectors of the economy. In its annual report for 2006, the plan reported administrative costs of $81 million and

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[4] The formula for agency matching contributions is specified in law at (5 U.S.C. § 8432(c)).

[5] See 5 U.S.C. § 8472(h).

assets of $206 billion. Thus, the administrative expenses of the Thrift Plan were about 40 cents for each $1,000 invested.

The Thrift Board has contracted with Barclays Global Investors to manage the index funds in which TSP assets are invested. The five funds in the Thrift Plan are:

- the *Government Securities Investment Fund*, (the "G Fund"). The G fund invests only in U.S. Treasury Securities and other securities backed by the full faith and credit of the United States.

- the *Fixed Income Investment Fund*, (the "F Fund"). The F fund invests in a bond index fund that tracks the performance of the Shearson Lehman Brothers Aggregate (SLBA) bond index, consisting of government bonds, corporate bonds, and mortgage-backed securities.

- the *Common Stock Index Investment Fund* (the "C Fund"). The C fund invests in stocks of the corporations that are represented in the *Standard and Poor's 500* index in the same proportion as they are represented in that index.

- the *Small Capitalization Stock Index Investment Fund* (the "S Fund"). The S fund invests in the stocks of small and medium-sized companies incorporated in the United States. Stocks in this fund are held in the same proportion as they are represented in the *Wilshire 4500* index.

- the *International Stock Index Investment Fund* (the "I Fund"). The I fund invests in the stocks of foreign corporations represented in the Morgan Stanley Capital Investment EAFE (Europe, Australia-Asia, Far East) index.

In 2005, the TSP added five new "lifecycle" funds, which invest in the five authorized TSP funds in allocations that are based on the employee's expected date of retirement. These "L" funds include an income fund and four funds that allocate investments based on expected retirement dates of 2010, 2020, 2030, and 2040. By allocating assets based on expected date of retirement, the worker's assets are gradually moved from higher-returning but more volatile investments when they are young to lower-returning but more stable investments as they approach retirement age.

<u>Participant Loans</u>

Participants may borrow from their accounts. There are two types of Plan loans: general purpose and residential. General purpose loans can be obtained for any purpose, with a repayment period from 1 to 5 years. Residential loans can be obtained for the purpose of purchasing a primary residence, with a repayment period from 1 to 15 years. Participant loans may only be taken from participant contributions and attributable earnings. The minimum loan amount is $1,000. The interest rate for loans is the "G Fund" interest rate at the time the loan agreement is issued by the Plan's record keeper. The rate is fixed at this level for the life of each loan. Interest earned on loans is allocated to the participant account upon repayment. Participants whose loans are in default have until the end of the following calendar quarter to pay the overdue amount. If not repaid by that time, the loan plus accrued interest is treated as a taxable distribution to the plan participant, which may be subject to the 10% penalty on retirement plan distributions made before age 59½.

Benefit Payments

After leaving service, participants may elect benefit withdrawals in the form of a partial withdrawal or a full withdrawal as a single payment, a series of payments, or a life annuity. Participants may choose to combine any two, or all three, of the available withdrawal options. The Board has contracted with the Metropolitan Life Insurance Company to provide annuity products to Thrift Plan participants. The contract to issue Thrift Plan annuities is open to competitive bids every three to five years.

Communication and Education

The Thrift Board communicates with plan participants to help them better understand the investment choices, benefits, and administration of the TSP. Employing agencies distribute information, including the *Summary of the Thrift Savings Plan for Federal Employees*, which provides a comprehensive description of the Plan, as well as booklets describing the loan program, withdrawal programs, and annuity options under the plan. The Thrift Board also issues a quarterly newsletter, *TSP Highlights,* and quarterly participant statements. Participants also can obtain their account balances from the TSP web site, request contribution allocations and interfund transfers or, in some cases, loans and withdrawals. The web site also provides various calculators that can be used as retirement planning tools. TSP Bulletins are issued regularly to inform agency personnel and payroll specialists of current operating procedures. The ThriftLine, the Board's toll-free automated voice response system, also provides both general plan and account-specific information.

The Federal Retirement Thrift Investment Board

The Federal Retirement Thrift Investment Board was established by the FERS Act of 1986.[6] The Board is responsible for developing the investment policies of the Thrift Plan and overseeing the management of the plan, which is under the day-to-day direction of an Executive Director appointed by the Board. Three of the five members of the Board — including the Chairman — are appointed by the President. The President chooses a fourth member of the Board in consultation with the Speaker of the House and the House Minority Leader and a fifth member in consultation with the Majority and Minority Leaders of the Senate. Members of the Board serve 4-year terms and all nominations are subject to Senate confirmation. The law requires that all nominees to the Board must be individuals with "substantial experience and expertise in the management of financial investments and pension benefit plans."[7]

The authorizing legislation that established the Thrift Board defines the Board's authority and responsibilities, and provides for substantial independence of the Board from political pressures.

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[6] See 5 U.S.C. § 8472.

[7] See 5 U.S.C. § 8472(d).

Authority

The Thrift Board has the authority to:

- Appoint the Executive Director of the Thrift Plan;
- Remove the Executive Director for cause;
- Establish investment policies for the Thrift Plan;
- Instruct the Director to take whatever actions the Board deems appropriate to carry out the policies it establishes;
- Submit to the Congress legislative proposals relating to its responsibilities under federal law.

Independence

Members of the Board are nominated by the President and confirmed by the Senate, but once confirmed they cannot be removed from their 4-year terms without good cause. The selection and nomination process are designed to assure that Members of the Board are individuals who are supported by the President and Congress. They serve in times of good behavior, rather than at the pleasure of the President or Congress, assuring that they can carry out the responsibilities of their positions without risk of removal from office. The Federal Retirement Thrift Investment Board receives no appropriations from Congress. Administrative expenses are paid through agency-automatic contributions forfeited by employees who leave federal service before they have vested and charges against participant accounts.

Responsibility

The law requires that the members of the Board shall discharge their responsibilities solely in the interest of participants and beneficiaries. In practice, this means that the investment policies and management practices of the fund are evaluated by the Board exclusively in reference to the efficient and prudent management of the Fund's assets. This exclusive responsibility serves to further insulate the Board from pressures to adopt investment policies or management practices that might not be in the long-term interest of preserving and increasing the security and investment performance of the Fund's assets.

Oversight

To assure that the Members of the Thrift Board remain aware of the interests and concerns of Thrift Plan participants and beneficiaries, the authorizing legislation established the Employee Thrift Advisory Council. This 14-member council is appointed by the Chairman of the Thrift Board and must include representatives of federal employee and Postal Service labor organizations, managerial employees, supervisory employees, female employees, senior executives, and annuitants.

All fiduciaries of the plan, including members of the Thrift Board are required by law to be bonded.[8] The Secretary of Labor is authorized by law to investigate any suspected breach of duty by a fiduciary of the plan. The financial statements of the Thrift Board are audited regularly by an independent accounting firm. Congressional oversight of the Thrift Plan is performed by the House Committee on Oversight and Government Reform and the Senate Committee on Homeland Security and Governmental Affairs.

Legislation in the 110th Congress

TSP. The Federal Thrift Retirement Investment estimates that 86% of employees covered by FERS voluntarily contribute to the TSP. This is a high participation rate compared to private-sector 401(k) plans, in which participation rates of 70% to 75% are the norm. To boost participation rates, a growing number of employers in the private sector are adopting a policy of automatically enrolling new employees in their company 401(k) plan, with the option that those who wish to do so can drop out of the plan. The Thrift Board recently transmitted to Congress proposed legislation that would allow for automatic enrollment of new federal employees in the TSP. The contributions of those so enrolled would be diversified among the TSP's various investment funds.

FERS. Federal employees contribute 0.8% of pay to the Civil Service Retirement and Disability Fund toward their FERS basic annuity. They become vested in this benefit after five years of service. Employees who leave the federal government and who leave their contributions in the CSRDF retain credit for their service and if they later are re-employed by the federal government, this prior period of federal service counts toward both the establishment of eligibility for a FERS annuity and in the computation of the annuity. Departing employees who withdraw their contributions forfeit their credit toward a FERS annuity. If they are later re-employed by the federal government, they are not permitted to re-deposit into the CSRDF the amounts that they had previously withdrawn. **H.R. 2533**, introduced by Representative Moran, would allow federal employees who were formerly employed by the federal government and who withdrew their contributions to the FERS basic retirement annuity upon their separation from service to redeposit those contributions, plus interest, to regain credit toward the FERS basic retirement annuity that they earned during their prior period of federal employment

CSRS. Federal employees with permanent appointments earn credit toward a retirement annuity under either CSRS or FERS whether they work full-time or part-time. Under FERS, the amount of the annuity is based on the pay applicable to the position in which the individual is employed and the computation of the retirement annuity is simply prorated for actual hours worked. Under regulations adopted by the Office of Personnel Management, however, the retirement annuities of workers covered by CSRS whose career includes a period of part-time work may be reduced not only through the pro-rating for reduced hours of work but also through the computation of the individual's high-three average pay. **H.R. 2780**, also introduced by Representative Moran, would change the computation of CSRS annuities for workers whose careers include a period of part-time work so that the annuity is prorated for hours worked and the average pay used in the

[8] A "fiduciary" is a person in a position of trust or confidence with regard to the property of another. A "bond" is form of insurance against the potential malfeasance of a plan fiduciary.

computation of the annuity is the pay applicable to the position in which the individual is employed. This would conform the computation of CSRS annuities for part-time workers to the process currently applied under FERS. H.R. 2780 also would allow CSRS retirees who worked part-time to apply for a re-computation of their annuity.

Conclusion

The pension benefits provided to federal employees compare favorably to those available to most workers in the private sector. Federal employees covered by the Federal Employees' Retirement System participate in Social Security, as do almost all employees in the private sector. However, federal employees also are covered by a defined benefit pension and they can participate in a tax-deferred retirement savings plan, a combination of benefits that is now relatively rare among employees in the private sector.

According to data collected by the Department of Labor, only 20% of workers in the private sector participated in a defined benefit plan in 2006 (See **Table 1**). The participation rate was 33% at establishments with 100 or more workers and just 9% at establishments with fewer than 100 workers. The Labor Department estimates that 43% of workers in the private sector participated in a 401(k)-type plan in 2006. The participation rate was 54% at establishments with 100 or more workers and 33% at establishments with fewer than 100 workers. While federal employees have the opportunity to participate in both a defined benefit pension plan and the TSP, only 15% of private-sector workers had both types of plan available to them in 2006, and just 12% of private-sector employees participated in both types of plan in 2006.

The FERS basic annuity is adjusted by a full or partial COLA every year for retirees age 62 and older. Private-sector pension plans typically do not provide automatic COLAs. According to the Bureau of Labor Statistics, only 7% of employees in private establishments who participate in a defined benefit pension plans were covered by plans that provide automatic post-retirement cost-of-living adjustments.

This concludes my testimony and I would be happy to answer any questions that members of the subcommittee might have.

Table 1. Percentage of Private-sector Employees Participating in Employer-Sponsored Retirement Plans in 2006

	Type of Retirement Plan		
	All Types	**Defined Benefit**	**Defined Contribution**
Establishment Size			
1 to 99 workers	37	9	33
100 or more workers	67	33	54
Work Schedule			
Full-time workers	60	23	51
Part-time workers	21	8	16
All workers	51	20	43

Notes: Some workers are in both types of plan, so the percentage with DB plan plus the percentage with DC plans will not add to the percentage with any type of plan. Data represent 105 million workers employed in the private sector in 2006.

Source: U.S. Department of Labor, National Compensation Survey.