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BEFORE THE
HOUSE SUBCOMMITTEE ON DOMESTIC AND INTERNATIONAL MONETARY POLICY, TRADE AND TECHNOLOGY

Good morning Chairman Pryce and Members of the Subcommittee. My name is Gary Amelio. I am the Executive Director of the Federal Retirement Thrift Investment Board and, as such, the managing fiduciary of the Thrift Savings Plan, or TSP, for Federal employees and members of the uniformed services. I welcome this opportunity to appear before the Subcommittee on behalf of the Board.

You have invited my testimony as part of your review of large individual account programs in the United States and other countries. Your purpose is to consider individual account approaches for Social Security. Although the Board has expressed no view regarding any proposals to change Social Security, our experience with the TSP may provide some useful information for the Subcommittee. The relevant issues include plan structure, governance, benefits, communications, and investments. I am pleased to describe how the TSP functions in each of these areas and to discuss how the Congress addressed important TSP issues in the Federal Employees' Retirement System Act of 1986 (FERSA).

The TSP is a voluntary savings and investment plan that allows Federal and Postal employees (and, since 2002, members of the uniformed services) to accumulate savings for their retirement. It offers employees of the Federal Government the same types of savings and tax benefits that many private corporations offer their employees under Internal Revenue Code section 401(k) retirement plans. The TSP currently has approximately 3.4 million individual accounts. The Thrift Savings Fund has grown to $155 billion. Each month, participants add more than $1.4 billion in new contributions. Participants may invest in any individual, combination, or all of five investment funds; transfer their monies among the funds; apply for loans from their accounts; transfer money into their accounts from other eligible employee plans or individual retirement accounts; and receive distributions under several withdrawal options. TSP administrative expenses are borne by the participants, not by the taxpayers.

The Government-wide Federal Employees' Retirement System (FERS) employee participation rate is 86.4 percent. TSP participation by Civil Service Retirement System (CSRS) employees is currently about 66 percent. Additionally, after only three years, nearly half a million members of the uniformed services also now have TSP accounts.

PLAN STRUCTURE

Employees who are covered by FERS, CSRS, or members of the uniformed services contribute via payroll allotment to the TSP. The maximum percentages they may contribute are prescribed by law. These limits are scheduled to increase next year to $15,000 annually for most employees and $20,000 annually for those age 50 and over.

FERS employees receive an automatic contribution to their TSP accounts, paid by their employing agency, which is equal to one percent of their basic pay each pay period. Their employing agency also matches the first five percent of basic pay contributed -- dollar-for-dollar on the first three percent and fifty cents on the dollar for the next two percent. CSRS employees and members of the uniformed services receive the same tax benefits as FERS employees, but receive no automatic or matching contributions from their agencies.

GOVERNANCE AND ADMINISTRATION

The TSP is administered by the Federal Retirement Thrift Investment Board, which was established as an independent Federal agency under FERSA. There are approximately 90 employees of the Agency. Governance is carried out by six individuals who serve as fiduciaries of the Plan. Five are part-time presidential appointees (confirmed by the Senate) who serve four-year terms, and the sixth is a full-time Executive Director. The latter is selected by the appointees and serves an indefinite term. Each of these persons is required by FERSA to have “substantial experience, training, and expertise in the management of financial investments and pension benefit plans.” 5 U.S.C.

э 8472(d). With input from the Executive Director and Agency staff, the Board members collectively establish the policies under which the TSP operates and furnish general oversight. The Executive Director carries out the policies established by the Board members and otherwise acts as the full-time chief executive of the Agency. The Board and the Executive Director convene monthly in meetings open to the public to deliberate policies, practices, and performance.

FERSA provides that all monies in the Thrift Savings Fund are held in trust for the benefit of the participants and their beneficiaries. As fiduciaries, the Executive Director and the Board members are required to act prudently and solely in the interest of TSP participants and their beneficiaries. This fiduciary responsibility gives the Board a unique status among Government agencies.

Congress wisely established this fiduciary structure because it recognized that all Plan funds belong to the participants, not the Government, and thus must be managed for them independent of political or social considerations.

The Conference Report on FERSA, House Report 99-606, dated May 16, 1986, states in the Joint Explanatory Statement of the Committee of Conference:

> Concerns over the specter of political involvement in the thrift plan management seem to focus on two distinct issues. One, the Board, composed of Presidential

appointees, could be susceptible to pressure from an Administration. Two, the Congress might be tempted to use the large pool of thrift money for political purposes. Neither case would be likely to occur given present legal and constitutional restraints.

The Board members and employees are subject to strict fiduciary rules. They must invest the money and manage the funds solely for the benefit of the participants. A breach of these responsibilities would make the fiduciaries civilly and criminally liable.

The structure of the funds themselves prevents political manipulation. The Government Securities Investment Fund is invested in nonmarketable special issues of the Treasury pegged to a certain average interest rate. The Fixed Income Investment Fund is composed of guaranteed investment contracts, certificates of deposits or other fixed instruments in which the Board contracts with insurance companies, banks and the like to provide it with a fixed rate of return over a specified period of time. The Board would have no knowledge of the specific investments.

Finally, the stock index fund is one in which a common stock index such as Standard & Poor’s 500 or Wilshire’s 5000 is used as the mechanism to allocate investments from the fund to various stocks.

. . . .

The investment approach chosen by the conferees is patterned after corporate, state and local government, and the few existing Federal pension funds. Political manipulation is unlikely and would be unlawful.

As to the issue of Congress tampering with the thrift funds, the inherent nature of a thrift plan precludes that possibility. Unlike a defined benefit plan where an employer essentially promises a certain benefit, a thrift plan is an employee savings plan. In other words, the employees own the money. The money, in essence, is held in trust for the employee and managed and invested on the employee’s behalf until the employee is eligible to receive it. This arrangement confers upon the employee property and other legal rights to the contributions and their earnings. Whether the money is invested in Government or private

> securities is immaterial with respect to employee ownership. The employee owns it and it cannot be tampered with by any entity including Congress.

H.R. Conf. Rep. No. 99-606, at 136-37 (1986), _reprinted in_ 1986 U.S.C.C.A.N. 1508, 1519-20.

In keeping with the intent of Congress that the Plan be administered in accordance with fiduciary standards derived from those applicable to private sector employee benefit plans -- as distinct from the usual administration of an executive branch agency -- Congress exempted the Board from the normal budget and appropriations processes and the legislative and budget clearance processes of the Office of Management and Budget. The Plan's independence is critical to ensure the fiduciary accountability envisioned by FERSA. So long as the Plan is managed by the fiduciaries named in FERSA (the members of the Board and the Executive Director) in accordance with the statute's strict fiduciary standards, Federal employees and members of the uniformed services can be confident that their retirement savings will not be subject to political or other priorities which might otherwise be imposed by these clearance processes.

FERSA protects the Thrift Savings Fund through more than just the independent fiduciary governance by the Board members and the Executive Director. Additional safeguards to protect TSP participants include the provisions in FERSA relating to (1) the role of the Secretary of Labor in establishing a program of fiduciary compliance audits; (2) the requirement that the Board contract with a private accounting firm to conduct an annual audit of the TSP on the basis of generally accepted accounting principles; and (3) the participation of the 15-member Employee Thrift Advisory Council, which includes representatives of the major Federal and Postal unions, other employee organizations, and the uniformed services.

The Board has benefited greatly from hundreds of audits conducted by the Department of Labor over the past seventeen years. These audits, which have covered every aspect of the TSP, are reported to the Congress annually under the Inspector General Act of 1978, as amended.

The accounting firm retained by the Board has conducted annual reviews as required. The result has been eighteen unqualified audit opinions.

The Advisory Council meets with the Executive Director and advises on investment policy and the administration of the TSP. These meetings are very helpful in providing the Board with insights into employee needs, attitudes, and reactions to the various programs undertaken by the Board.

The TSP also benefits from the cooperation of every agency and service in the Federal establishment. Although the Board is an independent body, successful administration of the TSP is highly dependent upon all Federal agencies and the uniformed services, which have direct responsibilities under FERSA for the administration of the TSP.

PLAN SERVICES AND BENEFITS

Employees and service members who participate in the TSP are served primarily by the personnel, payroll, and other administrative employees in their own agencies. The agencies are responsible for distributing TSP materials, providing employee counseling, and accurately and timely transmitting participant and employer contributions and necessary records to the TSP record keeper. TSP record keeping services are currently provided by the National Finance Center (NFC), which is part of the Department of Agriculture. The TSP Service Office in New Orleans performs a wide variety of services for TSP participants.

In addition, the TSP maintains parallel call centers at NFC in New Orleans, Louisiana, and in Cumberland, Maryland. Participants with questions may call a toll-free number which routes calls to participant service representatives at one of these sites. Further, we maintain a primary data center and a back-up data center.

Actively employed participants may borrow their own contributions and earnings from their accounts according to rules established by the Executive Director and regulations of the Internal Revenue Service. Participants repay the loans, with interest, and the money is reinvested in their TSP accounts. A $50 fee is charged to cover the costs of loan processing.

The other major benefit program is the TSP withdrawal program. Participants may withdraw funds from their TSP accounts before separation after reaching age 592 or in cases of financial hardship. Upon separation, a participant may:

- withdraw his or her account balance in a single payment (and have the TSP transfer all or part of the payment to an Individual Retirement Account (IRA) or other eligible retirement plan);
- withdraw his or her account balance in a series of monthly payments (and, in certain cases, have the TSP transfer all or part of each payment to an IRA or other eligible retirement plan);
- receive a life annuity; or
- keep his or her account in the TSP, subject to certain limits.

Participants may also elect a combination of these withdrawal options.

COMMUNICATIONS

The Agency maintains its communication program on a number of levels within the Federal establishment in order to achieve employee understanding of the investment choices, benefits, and the administration of the program. This is especially important given the voluntary nature of the Plan and the participants' degree of individual control over investments and benefits.

The communication effort is initiated by the Board for eligible individuals through the issuance of a "new account letter" to each new participant after the employing agency establishes his or her account. Employing agencies distribute program 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 for employees to review at the time they are examining those benefits. Investment information is provided by the TSP Fund Sheets and the Managing Your Account leaflet which discusses operations. Copies of these publications are also available on our Web site at www.tsp.gov or through the ThriftLine.

In addition, we issue materials related to specific events. For example, the *TSP Highlights* is a newsletter issued with the quarterly participant statement. Copies of the newsletters, which address topical items and convey rates of return, are provided on our Web site. Participants can also obtain their daily balances from the Web site, request contribution allocations and interfund transfers or, in some cases, loans and withdrawals, and use various calculators located there as convenient planning tools.

A TSP video is available explaining the basics of the TSP in an animated format. 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.

In connection with new Lifecycle funds we plan to introduce this summer, we will revise all of our communications materials and feature the benefits of the asset allocation approach used in "Life" funds as discussed below. We have budgeted $10 million for this major overhaul of our communications materials.

The Agency also conducts quarterly interagency meetings. These have proven to be an effective means of communicating program and systems requirements to Federal agency administrative personnel. These meetings also allow the TSP to hear and address representatives' concerns and to incorporate their suggestions in the establishment of TSP policies and operations.

INVESTMENT FUNDS

The TSP is a participant-directed plan. This means that each participant decides how the funds in his or her account are invested.

As initially prescribed by FERSA, participants could invest in three types of securities -- U.S. Treasury obligations, common stocks, and fixed income securities -- which differ considerably from one another in their investment characteristics. In 1996, on the Board's recommendation, Congress authorized two additional investment funds, which allow further diversification and potentially attractive long-term returns. The Small Capitalization Index Investment Fund and the International Stock Index Investment Fund were first offered in May 2001.

The Government Securities Investment (G) Fund is invested in short-term nonmarketable U.S. Treasury securities guaranteed by the full faith and credit of the U.S. Government. 5 U.S.C. ϶ 8438(b)(1)(A), (e). There is no possibility of loss of principal from default by the U.S. Government and thus no credit risk. These securities are similar to those issued to the Social Security trust funds and to other Federal trust funds. See 42 U.S.C. ϶ 401(d) (Social Security trust funds); 5 U.S.C. ϶ 8348(d) (Civil Service Retirement and Disability Fund).

The Fixed Income Index Investment (F) Fund, which by law must be invested in fixed income securities, is invested in a bond index fund, chosen by the Board to be the Lehman Brothers U.S. Aggregate (LBA) index. The LBA index represents a large and diversified group of investment grade securities in the major sectors of the U.S. bond markets: U.S. Government, corporate, and mortgage-related securities.

The Common Stock Index Investment (C) Fund must be invested in a portfolio designed to replicate the performance of an index that includes common stocks, the aggregate market value of which is a reasonably complete representation of the U.S. equity markets. The Board chose the Standard & Poor’s 500 (S&P 500) stock index in fulfillment of that requirement. The S&P 500 index consists of 500 stocks representing approximately 78 percent of the market value of the United States stock markets. The objective of the C Fund is to match the performance of that index.

The Small Capitalization Stock Index Investment (S) Fund must be invested in a portfolio designed to replicate the performance of an index that includes common stocks, the aggregate market value of which represents the U.S. equity markets, excluding the stocks that are held in the C Fund. The Board chose the Dow Jones Wilshire 4500 Completion index, which tracks the performance of the non-S&P 500 stocks in the U.S. stock market. The objective of the S Fund is to match the performance of the Wilshire 4500 index. The Wilshire 4500 index represents the remaining 22 percent of the market capitalization of the U.S. stock market. Thus, the S Fund and the C Fund combined cover virtually the entire U.S. stock market.

The International Stock Index Investment (I) Fund must be invested in a portfolio designed to track the performance of an index that includes common stocks, the aggregate market value of which represents the international equity markets, excluding the U.S. equity markets. The Board chose the Morgan Stanley EAFE

(Europe, Australasia, Far East) index, which tracks the overall performance of the major companies and industries in the European, Australian, and Asian stock markets. The objective of the I Fund is to match the performance of the EAFE index. The EAFE index was designed by Morgan Stanley Capital International (MSCI) to provide broad coverage of the stock markets in the 21 countries represented in the index.

This summer, the TSP will introduce Lifecycle Funds. The Lifecycle Funds will be invested in various combinations using the five existing TSP funds. Participants will benefit from having professionally designed asset allocation models available to optimize their investment performance by providing portfolios that are appropriate for their particular time horizon. This is known in the financial world as investing on the "efficient frontier." We are very excited by the prospect of providing these funds to participants this summer. We have just placed preliminary information regarding the Lifecycle Funds on our Web site, and will be issuing much more over the coming months.

One likely concern associated with a Federal agency's investing in equities is the potential for the Government to influence corporate governance questions and other issues submitted to stockholder votes. FERSA provides that the voting rights associated with the ownership of securities by the Thrift Savings Fund may not be exercised by the Board, other Government agencies, the

Executive Director, a Federal employee, Member of Congress, former Federal employees, or former Members of Congress. 5 U.S.C. э 8438(f). Barclays Global Investors (BGI), the manager of the C, S, and I Fund assets, has a fiduciary responsibility to vote company proxies solely in the interest of its funds' investors.

The fund assets held by the F, C, S, and I Funds are passively managed indexed funds; that is, they are invested in portfolios of assets in such a way as to reproduce market index returns. The philosophy of indexing is that, over the long term, it is difficult to improve upon the average return of the market. The investment management fees and trading costs incurred from passive management through indexing generally are substantially lower than those associated with active management. Passively managed index funds also preclude the possibility that political or other considerations might influence the selection of securities.

The manager of the assets held by the F, C, S, and I Funds has been selected through competitive bidding processes. Proposals from prospective asset managers were evaluated on objective criteria that included ability to track the relevant index, low trading costs, fiduciary record, experience, and fees.

The Board has contracts with BGI to manage the F, C, S, and I Fund assets. BGI is the largest investment manager of index funds in the United States, which had over $1.36 trillion in total assets under management as of December 31, 2004.

The centralized management of TSP investments was carefully considered in FERSA by Congress. According to the Joint Explanatory Statement of the Committee of Conference quoted earlier:

> Because of the many concerns raised, the conferees spent more time on this issue than any other. Proposals were made to decentralize the investment management and to give employees more choice by permitting them to choose their own financial institution in which to invest. While the conferees applaud the use of IRAs, they find such an approach for an employer-sponsored retirement program inappropriate. . . .
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> The conferees concur with the resolution of this issue as discussed in the Senate report (99-166) on this legislation:
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>> As an alternative the committee considered permitting any qualified institution to offer to employee[s] specific investment vehicles. However, the committee rejected that approach for a number of reasons. First, there are literally thousands of qualified institutions who would bombard employees with promotions for their services. The committee concluded that employees would not favor such an approach. Second, few, if any, private employers offer such an arrangement. Third, even qualified institutions go bankrupt occasionally and a substantial portion of an employee's retirement benefit could be wiped out. This is in contrast to the diversified fund approach which could easily survive a few bankruptcies. Fourth, it would be difficult to administer. Fifth, this "retail" or "voucher" approach would give up the economic advantage of this group's wholesale purchasing power derived from its large size,

> so that employees acting individually would
> get less for their money.

H.R. Rep. No. 99-606, at 137-38, reprinted in 1986 U.S.C.C.A.N. 1508, 1520-21.

INVESTMENT RETURNS

By law, TSP investment policies must provide for both prudent investments and low administrative costs. From the beginning of the G Fund's existence (April 1987) and the beginning of the F and C Funds' existence (January 1988) through December 31, 2004, the G, F, and C Funds have provided compound annual returns net of expenses of 6.7 percent, 7.7 percent, and 12.1 percent, respectively. The related BGI funds closely tracked their respective markets indexes throughout this period. Because the S and I Funds were introduced in May 2001, the Board has no long-term history for them. The indexes which they track, however, have produced compound annual returns of 11.9 percent and 5.6 percent, respectively, for the ten-year period ending December 2004.

In order to make the performance of the TSP funds more easily comparable, I have attached a chart which displays the growth of $100 invested in the underlying indexes for 20 years. The chart also includes the growth related to G Fund securities as well as inflation.

For calendar year 2004, the net Plan administrative expenses were .06 percent. This means that the 2004 net investment return to participants was reduced by approximately $.60 for each $1,000 of account balance. The expense ratio would be approximately .01 percent higher in the absence of account forfeitures, which offset expenses. These costs compare very favorably with typical private sector 401(k) service provider charges.

In summary, I believe that the Thrift Savings Plan has effectively and efficiently realized the numerous objectives Congress thoughtfully established for it nineteen years ago. To the extent that our experience is useful to the Subcommittee, I welcome the opportunity to provide any additional information you may require. I would be pleased to respond to any questions you or other members of the Subcommittee may have at this time.

Attachment