# The Financial Crisis and Restoring Retirement Security

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Testimony before the Committee on Education and Labor
U.S. House of Representatives

February 24, 2009

Chairman Miller, Ranking Member McKeon, and members of the Committee, thank you for inviting me to testify this morning about the lessons we've learned about our current 401(k) system in the wake of the financial crisis and ideas on how to strengthen our retirement security.

My name is Alicia Munnell, and I am Director of the Center for Retirement Research at Boston College. The Center investigates anything that affects how much money people will have in retirement: we study public and private pensions, the Social Security system, and individual decisions about saving and work.

**Even before the financial crisis, we have been concerned about the ability of 401(k) plans to provide secure retirement income.**[1]

They were not designed for that role. When 401(k) plans came on the scene in the early 1980s, they were viewed mainly as supplements to employer-funded pension and profit-sharing plans. Since 401(k) participants were presumed to have their basic retirement income security needs covered by an employer-funded plan and Social Security, they were given substantial discretion over 401(k) choices.

Today most workers with pension coverage have a 401(k) as their primary or only plan (see Figure 1). Yet 401(k)s still operate under the old rules. Workers continue to have almost complete discretion over whether to participate, how much to contribute, how to invest, and how and when to withdraw the funds. Evidence indicates that people make mistakes at every step along the way. They don't join the plan, they don't contribute enough; they don't diversify their holdings; they over invest in company stock; they take out money when they switch jobs; and they don't annuitize at retirement.

Policymakers came to recognize the challenges inherent in 401(k) plans – and building on studies by behavioral economists that demonstrated the major role that inertia plays in how workers participate and invest – enacted the Pension Protection Act of 2006 (PPA).[2] The PPA encouraged automatic enrollment, fostered automatic increases in deferral rates, and broadened default investment options. This legislation has been helpful, but it is not a "cure all" for 401(k)s. And the PPA did not address the challenges that participants will face on the decumulation side, as they try to figure out the best way to draw down their assets in retirement.

The most telling failure of 401(k) plans is the modest balances that participants have accumulated. Based on reports from Vanguard and the new 2007 *Survey of Consumer Finances* (SCF), median 401(k) holdings for people 55-64 were only about $60,000 in 2007 when the stock market was at its peak.[3] A more complete – and more worrisome – picture of how risky retirement has become is captured in our National Retirement Risk Index, which projects the percent of households that will not be able to maintain their standard of living in retirement. This Index shows that the share of households unprepared for retirement jumped from 31 percent in 1983 to 44 percent in 2006. And the number rises to 61 percent explicitly factoring in health care expenses (see Figure 2).

My conclusion was that exclusive reliance on 401(k) plans was a catastrophe in the making. But I thought the dimensions of the problem would not become clear for another 10 or 15 years when large numbers of people retired reliant solely on Social Security and 401(k)s. Instead, the financial crisis has accelerated a reexamination of our retirement income system.

**The financial crisis – and its impact in the real economy – has highlighted the fragility of 401(k) plans as the sole supplement to Social Security.**

401(k) balances have dropped in value by about thirty percent; people are losing their jobs, resulting in fewer contributions and more hardship withdrawals; and companies under pressure are suspending their matching contributions.

Between October 9, 2007, the peak of the stock market, and October 9, 2008, the Wilshire 5000 declined by 42 percent.[4] Participants in 401(k) plans approaching retirement held about two-thirds of their balances in equities.[5] As a result, the market value of assets in 401(k)s/IRAs tumbled by about 30 percent (see Table 1). That decline means that the median 401(k) holdings for a person 55-64 went from around $60,000 in 2007 to roughly $42,000 at the end of 2008.[6]

The financial crisis has also severely damaged the real economy. Roughly 3.6 million people have lost their jobs.[7] People without jobs cannot contribute to 401(k) plans. And those with jobs increasingly are turning to their 401(k) plans for help. Hardship withdrawals (to cover the purchase of a primary residence, educational expenses, medical expenses, or general financial pressures) – while still at relatively low levels – have ticked up. According to data from Fidelity and Vanguard, to date roughly 2 percent of participants have made a hardship withdrawal.[8] My sense is that many more will tap their 401(k) before the recession is over.

Finally, as the recession gains momentum, companies under severe earnings pressure have announced a suspension of their 401(k) matches. This response mirrored what happened in the wake of the 2001 recession when many large companies stopped matching employee contributions. Once again the automobile companies led the way with Ford and General Motors suspending the match for their salaried employees. But suspensions have also occurred at Kodak, FedEx, US Steel and many other companies. We track these announcements and estimate to date that about 1.6 percent of 401(k) participants have lost their 401(k) match (see Figure 3). The seriousness of the current suspensions depends on whether more firms follow suit and whether the suspensions are a temporary or permanent phenomenon. If, as was the case in the wake of the 2001 recession, the suspensions are temporary, the effects will probably be modest. On the other hand, if these suspensions lead to a permanent decline of the employer match, significantly fewer people will participate – especially among the lower paid – and people will end up with noticeably less retirement income.

**Some older workers can absorb the shock of the financial crisis by working longer. And working longer should be an important component of responding to the crisis and for strengthening our retirement income system.**

Even before the financial collapse, we have argued that people need to work longer.[9] The reason is that the retirement system is contracting and people are living longer. At any given age, Social Security benefits will replace a smaller fraction of pre-retirement earnings than in the past because 1) the Full Retirement Age is moving from 65 to 67, which is equivalent to an across-the-board cut; 2) Medicare premiums, which are automatically deducted from Social Security benefits, are slated to increase sharply; and 3) the taxation of Social Security benefits under the personal income tax will move further down the income distribution, as the exemption amounts in the tax code are not indexed to wage growth or inflation (see Figure 4). In addition, as noted above, balances in 401(k) plans are modest, and people save virtually nothing outside of employer-sponsored plans. While the retirement system is contracting, life expectancy is increasing. For men, life expectancy at 65 was 14.7 years in 1980 and is expected to be 17.5 years in 2030.[10] For women, the comparable numbers are 18.7 years and 21.1 years.

Older workers, whose 401(k) balances have been decimated by the financial crisis, have three options: they can save more, they can live on less in retirement, or they can work longer. Saving enough to offset the impact of the financial collapse is virtually impossible.[11] Reducing an already modest retirement income further is undesirable. So the only real option is to keep working. And that is apparently what many have decided to do. The employment statistics are dramatic. A greater percentage of men age 55 and older are working today than at the peak of the expansion in late 2007 (see Figure 5). This pattern is in sharp contrast to that of younger workers, where the employment rate is over 4 percentage points lower than at the cyclical peak.

Working longer is a powerful antidote to both the immediate crisis and the long-run contraction of the retirement income system. It directly increases current income; it avoids the actuarial reduction in Social Security benefits; it allows people to contribute more to their 401(k) plans; and it shortens the period of retirement. Working longer alone, however, will not ensure security for older Americans.

**To avoid a repeat of the current crisis, we also need to shore up our retirement income system. This task requires avoiding further reductions in Social Security and introducing a new tier of retirement income.**

The collapse of 401(k) plans during the recent financial crisis has highlighted the importance of Social Security as the backbone of our retirement income system. While Social Security faces a shortfall over the next 75 years because of the aging of the population, it has been almost totally unaffected by our current economic woes. The Social Security Administration continues to send out monthly checks, which while modest, are a predictable source of income that people can count on. Moreover, these benefits are a really special type of income because they are adjusted each year for changes in the cost of living and they continue for as long as the recipient lives. As

discussed above, Social Security will replace less of pre-retirement earnings in the future than it has in the past. Any further reductions would put millions of future retirees at risk. My view is that, with little else to rely on, Americans will be willing to pay higher taxes to maintain this extremely successful program.

Stabilizing Social Security is not enough, however. We also need to consider a new tier of retirement income. This tier would help bolster retirement security both for low-wage workers facing declining Social Security replacement rates and for middle- and upper-wage workers who increasingly rely on 401(k) plans as their only supplement to Social Security (see Figure 6).

The goal of this additional tier would be to replace about 20 percent of pre-retirement income. To accomplish the goal, participation should be mandatory, participants should have no access to money before retirement, and benefits should be paid as annuities. The system should be funded and reside as much as possible in the private sector. As we have just learned, funded and pay-as-you-go systems are subject to different kinds of risks, so such an approach would allow us to diversify the risks.

Moving beyond principles is difficult. The challenge hinges on the tradeoff between lifetime returns and the required contribution. Equities offer a higher return, but they also bring greater risk, as we have just seen. Relying on equities therefore creates two types of problems. First, replacement rates will vary dramatically depending on the performance of the stock market over the period when the participant is working and accumulating assets. Some cohorts of retirees will get a lot, and others will end up with little. Second, as the recent financial crisis highlights, values can drop precipitously just as participants are approaching retirement. A sharp drop in retirement balances upsets people's plans, even if the drops merely offset a lifetime of high returns. The net result is inadequate retirement saving.

The natural response is to think about trying to protect people by offering guarantees. The problem is that low rates of guarantee – 2 percent or 3 percent inflation-adjusted – would have done nothing to protect workers over the last 84 years. The reason is that no retiring cohort would have earned less than 3.8 percent on a portfolio of equities, so low guarantees would never have kicked in. Only high guarantees – like 6 percent – would have had any impact, but standard finance theory says such guarantees are not possible, as long as the guarantor shares the market's aversion to risk.

Perhaps the best we can do is a tier modeled on the Federal Thrift Savings Plan with sensible target date funds. Such an approach would avoid unnecessary risks, such as investing in a single stock or holding too large a share in equities just prior to retirement. But it would be nice to think a little more about guarantees and risk sharing.

**In any case, the message that I want to leave is that we need *more* organized retirement saving. A declining Social Security system and fragile 401(k) plans will not be enough for future retirees.**

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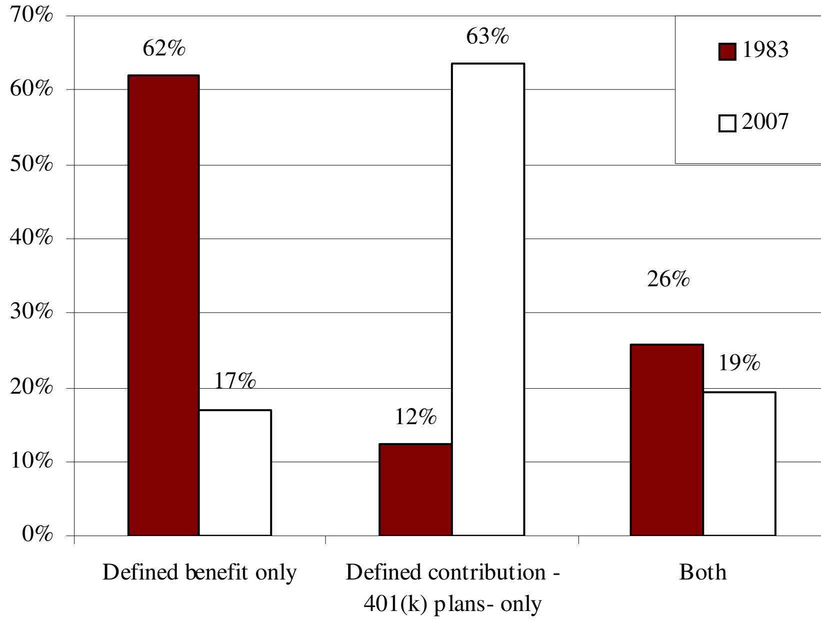
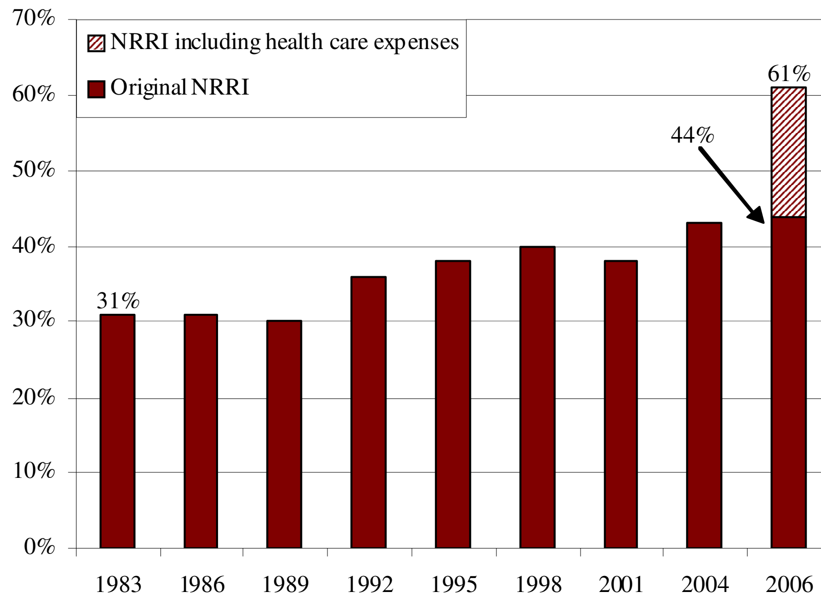
Figure 1. *Percent of Workers with Pension Coverage by Type of Plan from SCF, 1983 and 2007*




Source: Author's calculations based on the 2007 SCF.

Figure 2. *The National Retirement Risk Index, 1983-2006 and 2006 Explicitly Incorporating Health Care*



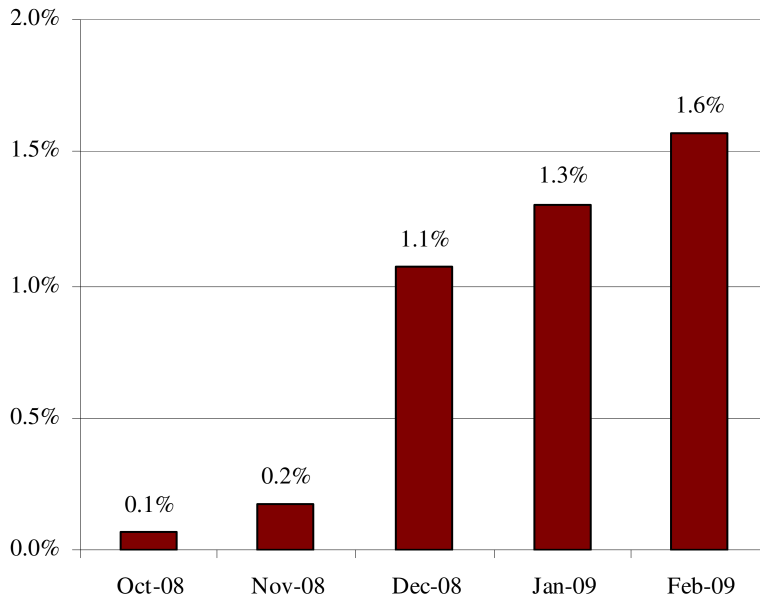

Sources: Munnell, Golub-Sass, and Webb (2007); and Munnell et al. (2008).

Table 1. *Equity Declines October 9, 2007 – October 9, 2008 in Retirement Plans, Trillions of Dollars*

| Type of Plan | 10/9/2007 | 10/9/2008 | Decline |
|---|---|---|---|
| Defined contribution plans | $4.7 | $2.7 | $2.0 |
| IRAs | 2.0 | 1.1 | 0.8 |
| Private defined contribution plans | 2.6 | 1.5 | 1.1 |
| Federal government plan[a] | 0.2 | 0.1 | 0.1 |
| Defined benefit plans | 4.2 | 2.4 | 1.7 |
| Private defined benefit plans | 1.8 | 1.0 | 0.7 |
| State and local plans | 2.4 | 1.4 | 1.0 |
| Total | 8.8 | 5.1 | 3.7 |

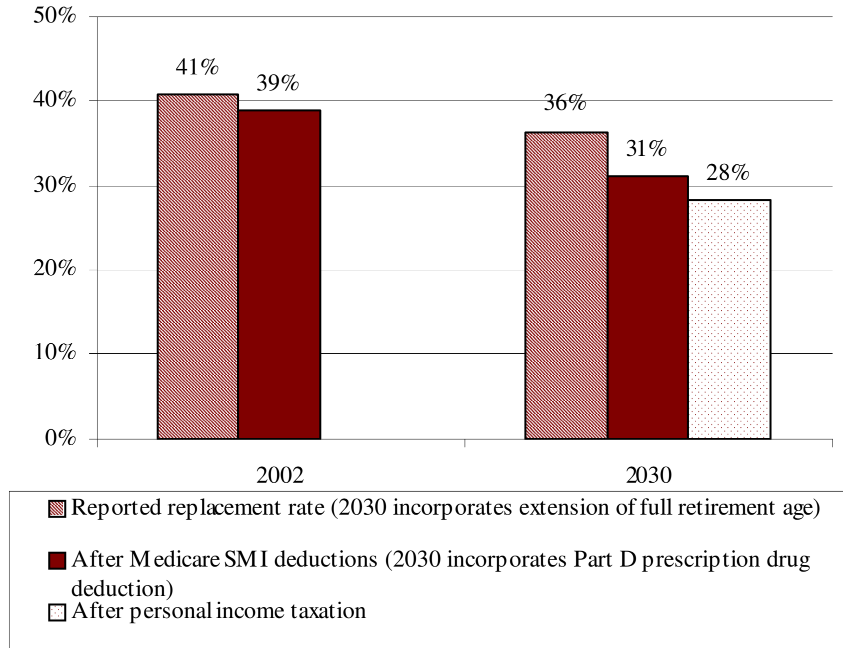
[a]The federal government holdings are those in the Thrift Savings Plan.
Note: Figures may not add to totals due to rounding. Also, this figure varies slightly from that in Munnell and Muldoon (2008) due to changes in the way the Flow of Funds estimates equity holdings and the valuations of firms' market value. Further details can be found in U.S. Board of Governors of the Federal Reserve System (2008).
Source: Author's updates based on Munnell and Muldoon (2008).

Figure 3. *Cumulative Percentage of Private-Sector Defined Contribution Plan Participants Affected by Suspension of Employer Match, 2008-2009*



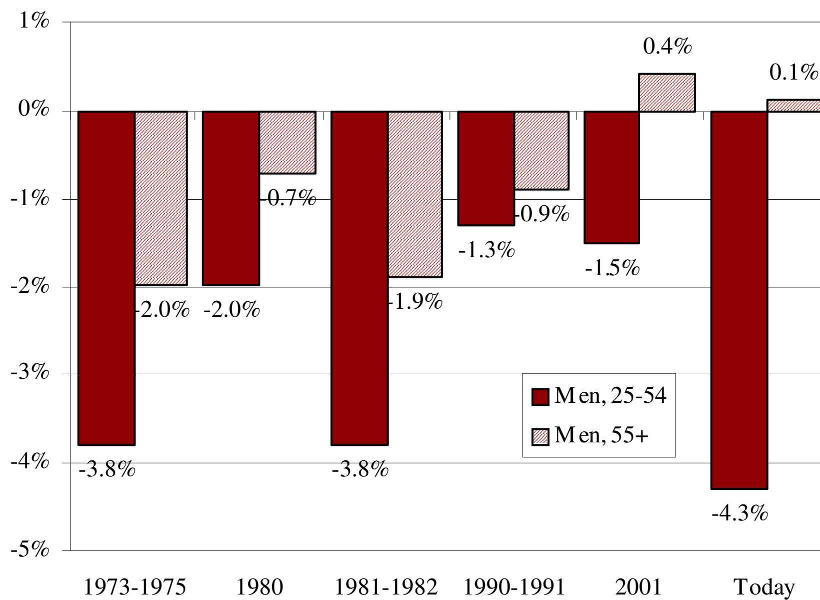

Note: Most participation data are for plan year 2006 – the most recent Form 5500 data available.
Sources: Author's estimates based on U.S. Department of Labor (2006); newspaper articles; and personal communication with companies.

Figure 4. *Social Security Replacement Rates for Average Earner Retiring at Age 65, 2002 and 2030*



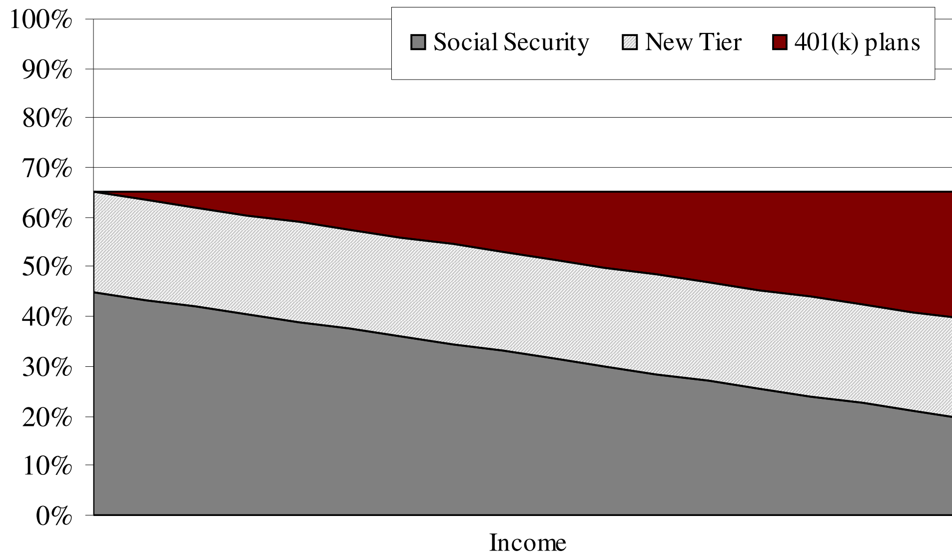

Source: Author's updates based on Munnell (2003).

Figure 5. *Change in Employment to Population Ratio, Men Aged 25-54 and 55 and Older, Recent Recessions and Today*




Note: Data are seasonally adjusted. "Today" covers the period from December 2007-January 2009.
Sources: Author's updates based on Munnell, Muldoon, and Sass (2009).

Figure 6. *Additional Tier of Funded, Privately-Managed Retirement Saving*




Source: Author's illustration.

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[1] Munnell and Sundén (2004).
[2] See, for example, Madrian and Shea (2001) and Choi, Laibson and Madrian (2004).
[3] Vanguard (2008); and U.S. Board of Governors of the Federal Reserve System (2007). Focusing on only 401(k) balances understates accumulations because participants often roll money into Individual Retirement Accounts (IRAs). According to the 2007 SCF, median 401(k)/IRA balances for working individuals age 55-64 were $78,000.
[4] As a result, the value of equities in pension accounts declined by almost $4.0 trillion (Munnell and Muldoon 2008). Individuals were sheltered from the immediate impact of the $1.7 trillion of losses in defined benefit plans. But they did experience a direct hit on the $2.0 trillion in losses that occurred in 401(k)s and IRAs.
[5] Fidelity Investments (2007); and Vanguard (2008).
[6] Author's calculations based on U.S. Board of Governors of the Federal Reserve System (2007); and Wilshire Associates (2008).
[7] U.S. Bureau of Labor Statistics (2009).
[8] Fidelity (2009); and Vanguard Center for Retirement Research (2009).
[9] Munnell and Sass (2008).
[10] U.S. Social Security Administration (2008).
[11] For example, a person with eight years to retirement who had been on track to get 50 percent of his retirement income from financial assets would have to raise his saving rate from 6 percent to 21 percent to make up for the drop in the stock market.