



Testimony

**Statement of
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The Effects of Recent Turmoil in Financial Markets on Retirement Security

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

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Chairman Miller, Ranking Member McKeon, thank you for inviting me to testify this afternoon about the effects of the crisis in financial markets on pensions and retirement security.

Turmoil in Financial Markets

Financial markets have experienced substantial stress for over a year. The turmoil emanated from the bursting of the housing bubble, which led to substantial losses on mortgage loans and mortgage-related securities. In part because the mortgage-related securities are complex and in part because future rates of defaults on the individual mortgages underlying those securities are hard to predict, financial markets have had difficulty gauging the magnitude of the losses on the securities. That opacity, in turn, has made it difficult to evaluate the financial condition of the institutions holding them.

Those problems have contributed to a broader collapse in confidence, leading to a general pullback from all types of risky lending. Financial institutions have become increasingly unwilling to lend to one another, creating stress in the interbank market for short-term loans that became particularly severe over the past several weeks. The issuance of corporate debt plummeted in the third quarter, and the commercial paper market has also been hit hard. Bank lending, which has thus far remained relatively strong, will likely be severely curtailed by the difficulties that banks are facing in raising capital. The general collapse in confidence is reflected in significant increases in risk spreads (or the difference between the interest rates charged on risky assets and those on Treasury securities). For example, the spread between the interest rate on corporate bonds with the lowest risk (AAA-rated bonds) and the interest rate on Treasury securities has risen by more than a percentage point since the middle of last year.

In sum, recent developments in financial markets represent a severe credit crunch, which could have devastating effects on the U.S. and world economies. In response, the Congress recently enacted a financial rescue package that, among other things, creates the Troubled Assets Relief Program (TARP), under which the Secretary of the Treasury is authorized to purchase, insure, hold, and sell a wide variety of financial instruments. The Congressional Budget Office (CBO) analyzed many aspects of that program in recent testimony before the House Budget Committee.¹

The turmoil in financial markets has affected many aspects of the economy, including pensions. The most direct effect on pensions is through the prices of financial assets such as corporate equities and bonds. The Standard & Poor's 500 stock market index, for example, has fallen by more than 25 percent over the past year as the outlook for the economy and corporate profits has worsened.

1. Statement of Peter R. Orszag, Director, Congressional Budget Office, before the House Committee on the Budget, *Federal Responses to Market Turmoil* (September 24, 2008).

Because the majority of pension assets are held in equities, drops in stock prices have had a significant adverse effect on pension plans.² Data from the Federal Reserve suggest that the decline in the value of financial assets cost pension funds (private-sector and public-sector combined) roughly \$1 trillion—almost 10 percent of their assets—from the second quarter of 2007 to the second quarter of 2008 (the latest period for which data are available), and there has been a significant further drop in asset prices since then.

Private-Sector Pension Plans

The two principal types of pension plans are defined-benefit plans and defined-contribution plans. Over the past several decades, the private-sector pension system has shifted dramatically toward defined-contribution plans, such as 401(k) plans.

Defined-Benefit Pension Plans

In a defined-benefit pension plan, benefits are specified by a fixed formula unrelated to the value of the pension fund. The sponsor of the plan is generally responsible for financing the benefits and must therefore make larger contributions when the value of the assets held by the pension fund declines. By CBO's estimates, the value of the assets held by defined-benefit plans has declined by roughly 15 percent over the past year.

Because of the way the obligations of the plans are calculated, their funding position (that is, the relationship between their assets and liabilities) is also affected by the level of interest rates. Because payments will extend far in the future, the amount of funding today necessary to make those payments is adjusted for the time value of money by "discounting" them using certain interest rates. Those rates have increased over the past year, lowering the discounted value of plans' liabilities by roughly 5 percent to 10 percent and partially offsetting the drop in asset values.³ Overall, according to CBO's estimates, defined-benefit plans' assets net of liabilities may have decreased by 5 percent to 10 percent over the past year.

Those developments have probably left private-sector defined-benefit pension plans' obligations exceeding their assets by a greater amount than last year. That circum-

2. One important question is whether the current value of stocks represents a temporary dip or a permanent adjustment to a new, lower value. Economists have not resolved empirically the question of whether stocks depart only temporarily from some relatively stable average. However, some evidence suggests that stock prices tend to revert to a more stable long-run value after particularly sharp declines. See, for example, James M. Poterba and Lawrence Summers, "Mean Reversion in Stock Prices," *Journal of Financial Economics*, vol. 22, no. 1 (1988), pp. 27–59; Eugene Fama and Kenneth French, "Permanent and Temporary Components of Stock Prices," *Journal of Political Economy*, vol. 96, no. 2 (1988), pp. 246–273; and Jeremy J. Siegel, *Stocks for the Long Run* (New York: McGraw Hill, 2007).

3. That calculation is based on the yields on corporate debt rated A or higher, which have increased over the year, according to several indexes.

stance could force employers to raise contributions to help trim the shortfall, reducing the cash that they have available for investment, hiring, or distribution to shareholders. However, such funding requirements are sensitive to future asset prices, which are highly uncertain given the turmoil in financial markets.

Defined-Contribution Pension Plans

Changes in asset prices have also affected the value of assets in defined-contribution pension plans. In those plans, the resources available to workers upon retirement depend directly on the value of assets in their plan account. Defined-contribution plans apparently are more heavily weighted toward stocks than defined-benefit plans are; over two-thirds of the assets in defined-contribution plans are invested in equities (either directly or through mutual funds). Because of that heavy emphasis on equities, the value of assets in defined-contribution plans may have declined by slightly more than that of assets in defined-benefit plans. To the extent households view balances in defined-contribution plans as part of their overall portfolio of wealth, a decline in those balances could lead people to reduce or delay purchases of goods and services. As described below, it could also lead some workers to delay their retirement.

State and Local Pension Plans

Public pension plans have also been affected by market developments. According to data from the Federal Reserve, for example, the assets held by state and local governments' pension plans declined by more than \$300 billion between the second quarter of 2007 and the second quarter of 2008.⁴ The composition of public-sector funds mimics that of corporate pension funds. Overall, about 60 percent of the assets in public pension funds are invested in equities, 30 percent in domestic fixed-income securities, 5 percent in real estate, and the remaining 5 percent in alternatives.⁵

Even before the current downturn, concerns had been raised about the funding levels of some public-sector pension plans. According to the most recent survey of public pension funds by the National Association of State Retirement Administrators, plans accounting for about 85 percent of the assets had funded ratios of 86 percent, on average.⁶ (Funded ratios measure the degree to which assets and future contributions match current and future liabilities.) Some analysts have expressed concerns that reported funded ratios may be inflated because some public pension plans use relatively high discount rates when computing their future liabilities. The 20 largest public pension plans, which account for about half of all assets in such plans, have funded ratios of about 90 percent on average, but some smaller plans have funded ratios

4. Federal Reserve, Flow of Funds Accounts of the United States, Table L. 119, "State and Local Government Employee Retirement Funds," September 18, 2008, available at www.federalreserve.gov/releases/Z1/Current/z1r-4.pdf.

5. Alternatives include private equity, hedge funds, currency, commodities, and cash.

6. See Public Fund Survey, "Actuarial Funding Levels," (2007), available at www.publicfundsurvey.org/publicfundsurvey/index.htm.

below 60 percent. Smaller plans, particularly those with lower funded ratios, may have a more difficult time weathering the decline in asset values.

Funded ratios have been steadily declining in recent years. In 2000, about 90 percent of public pension plans had funded ratios greater than 80 percent.⁷ By 2006, that share had decreased to about 40 percent (though, again, a much larger share of large plans have funded ratios above 80 percent). Lower returns caused by a declining market and the economic slowdown, which will translate into lower corporate and personal income tax revenues, will exacerbate the downward trend in funded ratios.

Many public pension plans use actuarial methods that will mute the effects of recent changes in asset values on funded status. One of those methods is “smoothing,” or valuing current assets on the basis of averages over recent years, rather than on current market values. That method generally causes the reported valuations to lag behind the market; in the current environment, it can cause reported valuations to be higher than current market values.

Although the laws governing state and local pension plans vary, significant drops in funded ratios could trigger requirements for higher contributions to the plans from state and local coffers or from public-sector employees at a time when tax collections are also waning.

Households’ Assets and Retirement Behavior

Asset prices affect households not only through pension plans but also through their other holdings. Although most households have few assets outside retirement plans, those assets are still substantial in the aggregate. In 2006, income from assets outside retirement plans provided almost as much income for households with elderly members as pensions did: Pensions provided 18 percent of the aggregate income for the population age 65 and older, and asset income accounted for 15 percent.⁸ Social Security provided 37 percent, on average; and earnings, 28 percent.

The shares of income coming from pensions and asset income vary widely across the income distribution, however (see Figure 1). Among households with elderly members, those in the lowest income quintile obtained only 4 percent of their aggregate income from pensions and just 3 percent from asset income. At the other end of the distribution, households in the highest quintile received 18 percent of their income from pensions and 21 percent from asset income.

7. Statement of Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security, Government Accountability Office, before the Joint Economic Committee, published as Government Accountability Office, *State and Local Government Pension Plans: Current Structure and Funded Status*, GAO-08-983T (July 10, 2008).

8. Federal Interagency Forum on Aging-Related Statistics, *Older Americans 2008: Key Indicators of Well-Being*, available at agingstats.gov/agingstatsdotnet/Main_Site/Data/Data_2008.aspx.

Some people on the verge of retirement might respond to a decline in financial markets by working longer. In 2006, 36 percent of people age 65 and older were in families with earnings; that share could rise somewhat over the next few years, both because of underlying trends in the labor market and because of the recent turmoil in financial markets.

Older workers' participation in the labor force decreased during the 1970s and early 1980s but has increased since then (see Figure 2). The labor force participation rate of workers 55 to 64 years old, for example, fell from about 62 percent in 1970 to 54 percent in 1986 and then rose steadily, to nearly 64 percent in 2007.⁹ The rate for workers age 65 and older followed a similar pattern and is at nearly the same level today as it was in 1970. Moreover, the fraction of people age 55 and older who work full time grew from about 22 percent in 1990 to nearly 30 percent in 2007 (see Figure 3).

Studies that have examined the impact of the stock market boom of the 1990s and the subsequent decline of the early 2000s on retirement decisions show mixed results. One paper, for example, found no evidence of an increase in the retirement age among people in households owning stocks after the stock market decline of 2000.¹⁰ Another paper, however, showed that survey respondents who held corporate equity immediately prior to the bull market of the 1990s retired, on average, 7 months earlier than other respondents.¹¹

Mitigating Financial Market Risks

Although severe stresses in financial markets almost inevitably cause wrenching adjustments by workers and employers, the risks can be attenuated by sensibly designing pension plans. For example, although workers enrolled in defined-contribution plans may not be able to avoid bearing the risks associated with broad price changes in financial markets, they can avoid unnecessary risks associated with a lack of diversification. Such unnecessary risks can arise, for example, by overweighting portfolios with individual stocks rather than diversified index funds.

9. Based on data from the Current Population Survey compiled by the Department of Commerce's Bureau of Labor Statistics, available at www.bls.gov/data/#employment.

10. Courtney C. Coile and Phillip B. Levine, "Bulls, Bears, and Retirement Behavior," *Industrial and Labor Relations Review*, vol. 59, no. 3 (April 2006), pp. 408–429, available at digitalcommons.ilr.cornell.edu/cgi/viewcontent.cgi?article=1218&context=ilrreview.

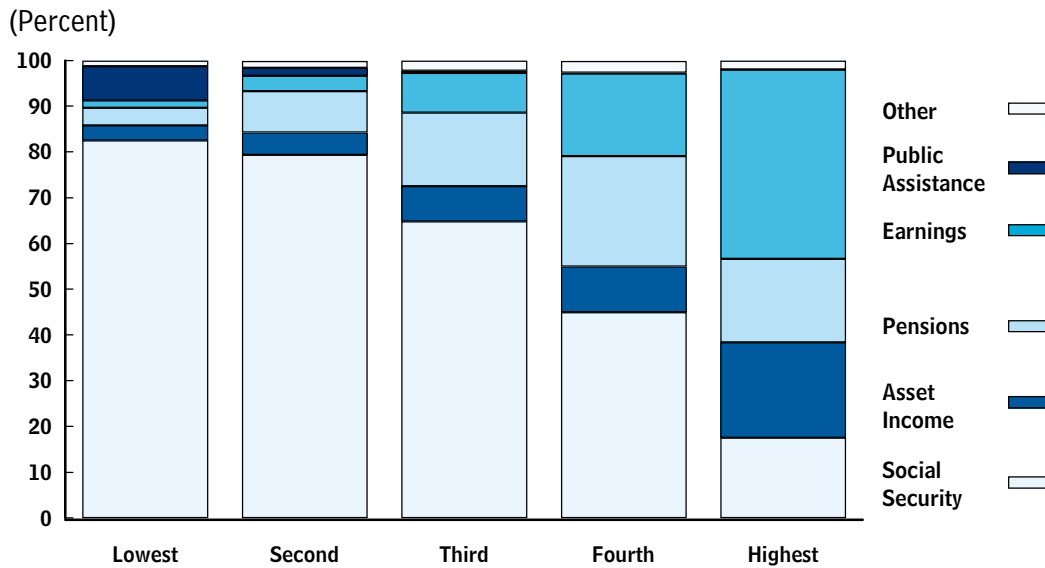
11. Julia Lynn Coronado and Maria G. Perozek, "Wealth Effects and the Consumption of Leisure: Retirement Decisions During the Stock Market Boom of the 1990s," FEDS Working Paper No. 2003-20 (Federal Reserve Board, May 2003), available at ssrn.com/abstract=419721.

In recent years, many firms have adopted automatic enrollment in defined-contribution pension plans.¹² Such automatic enrollment dramatically increases participation rates, especially for subgroups such as workers with low income, for whom participation is otherwise very low. Perhaps of more relevance to a discussion of financial market risks, however, the Pension Protection Act of 2006 requires that the allocation of assets by automatic-enrollment pension plans meet certain criteria that protect against excessive risk for participants. As a result, pension assets for automatically enrolled workers tend to be weighted toward more-diversified portfolios. Such protections against nondiversified investment portfolios can help avoid excessive exposure to financial market risks. By design, however, workers in defined-contribution plans must inevitably bear the risks associated with broad market fluctuations.

12. See, for example, William E. Nesmith, Stephen P. Utkus, and Jean A. Young, "Measuring the Effectiveness of Automatic Enrollment," Vanguard Center for Retirement Research, vol. 31 (2007).

Figure 1.

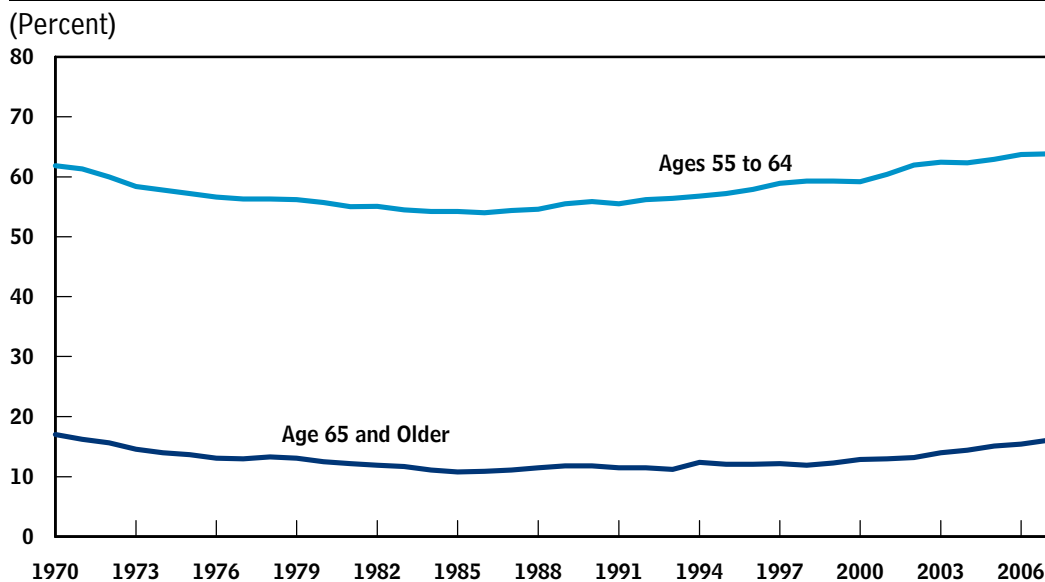
Sources of Income for People Age 65 and Older, by Income Quintile, 2006



Source: Congressional Budget Office based on data from the Federal Interagency Forum on Aging-Related Statistics, *Older Americans 2008: Key Indicators of Well-Being*.

Figure 2.

Percentage of Older People Participating in the Labor Force, 1970 to 2007

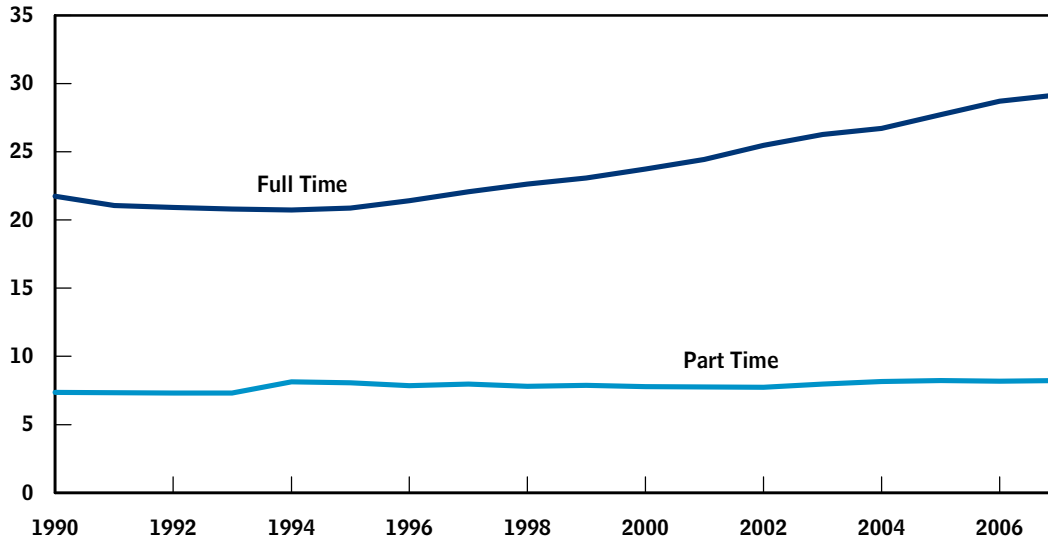


Source: Congressional Budget Office based on data from the Bureau of Labor Statistics.

Figure 3.

Percentage of People Age 55 and Older Working Full- or Part-Time, 1990 to 2007

(Percent)



Source: Congressional Budget Office based on data from the Bureau of Labor Statistics.
