American Benefits Council

HEARING SUMMARY

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DATE:	June 14, 2005
HEARING:	The Role of the Financial Markets in Social Security Reform
COMMITTEE:	Subcommittee on Securities and Investment of the Senate Committee on Banking, Housing, and Urban Affairs
WITNESSES:	Gary Amelio (Executive Director, Federal Thrift Retirement Savings Board), Francis Enderle (Chief Investment Advisor, Barclays Global Investors), Francis Cavanaugh (Consultant, Public Finance Consulting), Mike Tanner (Director, Project on Social Security Choice, The CATO Institute), David John (Research Fellow, The Heritage Foundation) Jason Furman (Adjunct Professor, Wagner Graduate School of Public Service, New York University)

On June 14th, the Subcommittee on Securities and Investment of the Senate Committee on Banking, Housing, and Urban Affairs held a hearing entitled "The Role of the Financial Markets in Social Security Reform." The committee received testimony from a single panel of witnesses that included Gary Amelio (Executive Director, Federal Thrift Retirement Savings Board), Francis Enderle (Chief Investment Advisor, Barclays Global Investors), Francis Cavanaugh (Consultant, Public Finance Consulting), Mike Tanner (Director, Project on Social Security Choice, The CATO Institute), David John (Research Fellow, The Heritage Foundation), and Jason Furman (Adjunct Professor, Wagner Graduate School of Public Service, New York University). Chairman Hagel (R-NE) and Senators Dodd (D-CT) and Sununu (R-NH) attended most of the hearing, and Senator Reed (D-RI) attended the Q&A session. Full copies of the testimony and opening statements can be obtained at:

http://banking.senate.gov/index.cfm?Fuseaction=Hearings.Detail&HearingID=161

Opening Statements
Chairman Hagel noted the importance of the Social Security system and expressed concern over the future financial problems facing the program. He stressed that the purpose of the hearing was to better understand the risks, administration, and structure of a personal account system (as included in various Social Security reform proposals) and how such accounts would affect financial markets. Using the Federal Thrift Savings Plan (TSP) as a potential model for reform, he focused on its costs, available investment options, and structure, questioning whether it could be effectively adapted to fit Social Security reform.

Ranking Minority Member Dodd stated that although he favored reform, the Bush Administration's reform proposal is flawed. He explained the harms that would result from diverting Social Security funds to private accounts, including exacerbating insolvency concerns, increasing the national debt, and forcing a decrease in benefits. He suggested that core principles for successful reform are maintaining the current structure and creating more private saving incentives through the tax code.

Witness Testimony
Gary Amelio. Mr. Amelio limited his testimony to the structure and functioning of TSP and did not comment on any of the reform proposals. He said that TSP has garnered confidence among federal employees because funds are managed by a fiduciary board independent of political and social interests. The structure of the plan -- simple and limited investment options that track market indices and are passively managed -- have led to low administrative costs (around six basis points). Finally, he noted that TSP will soon be adding lifecycle funds that will change composition over the lifetime of the participant, matching changing individual needs.

Francis Enderle. Mr. Enderle described the investment philosophy behind managing defined contribution accounts and TSP accounts, allowing for reliable and low cost investing. He stressed that administrative costs for the TSP are minimized because there are only five investment options available. Several practices additionally reduce costs, including tracking indices and internally matching and offsetting buy and sell decisions to reduce market costs. He recommended that Social Security personal accounts should provide a limited number of index portfolios because they reliably capture returns of asset classes, have low management fees, and have low transaction costs. He also suggested allowing the type of lifecycle funds TSP is introducing.

Mr. Cavanaugh. Mr. Cavanaugh agued that adopting the TSP model for Social Security reform would not be feasible and he believed the Administration's investment return and cost estimates are far too optimistic. He suggested adopting a trust fund proposal instead, where the federal government would invest part of the Social Security trust fund in equities. He asserted that private accounts would prove too costly to administer for small businesses, just as 401(k) services are too expensive for private industry to administer for small businesses. He argued that the expense ratio for even the largest small business would be 300 basis points, and this figure would only be higher for smaller companies. There are several differences between TSP and Social Security that he said would make Social Security costs more significant, including the fact that TSP is administered by only one employer, TSP is balanced every day, and communications would be too difficult for a plan as large as Social Security. Furthermore, he stressed that credits to individual accounts would be delayed by 22 months after payday and political pressure would eventually lead to permitting withdrawals from accounts.

Mike Tanner. Mr. Tanner commended the committee for considering the operation and structure of individual accounts and argued that private investment would lead to greater returns than the current system. To maintain simplicity and low costs, he recommended that the Treasury administer a plan initially including a small number of broadly diversified funds modeled after TSP investment choices. Later, a larger number of investment options should be allowed, modeled after 401(k) plans. Reform goals should include simplicity, balancing permissible risk and return, low costs, and limited employer and government involvement.

David John. Mr. John supported adopting private retirement accounts using the current payroll tax system. He suggested using private fund managers for the accounts, providing several initial investment choices (similar to those offered in TSP) that provide different mixes between stocks and bonds, and setting a default lifecycle investment option. He cited an estimated fee cost between 19 and 35 basis points for workers contributing two percent of annual gross earnings.

Jason Furman. Mr. Furman stressed certain problems with personal account systems, arguing that such reform proposals would increase the number of tasks performed as part of Social Security administration, increasing administrative costs tenfold. Establishing and administering accounts would require increased government staffing, potentially leading to a new agency half the size of the IRS. He estimated that returns for many participants would be lower than other reform proposals because of increased administrative costs and expressed concern over the effect the resulting increased debt would have on financial markets, anticipating either increased interest rates, decreased stock prices, or both.

Member's Questions and Comments
Chairman Hagel. Chairman Hagel focused on the feasibility of individual accounts and began by asking Mr. Amelio how TSP has kept fees so low and whether Social Security could be administered at a similarly low cost. Mr. Amelio attributed the low fees to the large size of assets held, the small number of index fund investment options offered, and self administration. Although he refused to comment on reform proposals, he did note that increasing the participant base, collecting contributions, and opening different payroll offices would increase administrative costs. Mr. Enderle added that asset management costs depend entirely on how many funds are offered and how large the accounts are.

In response to Mr. Cavanaugh's discussion of withdrawals and the associated costs, Chairman Hagel emphasized that Social Security withdrawals have never been an issue in the past, and because the Administration's proposal would not allow loans or withdrawals, they should not be a factor in the reform decision.

Chairman Hagel also asked the panel for reform alternatives to personal accounts and expressed concern over how reform would affect financial markets and future generations. The panel responded that the alternatives include several choices, namely increasing taxes, decreasing benefits, or government investing. The panel was split over how large of an effect individual account investing would have on asset prices, stability, and liquidity as well as the national debt and Social Security solvency and over whether such effects would be negative.

Senator Dodd. Senator Dodd expressed disapproval with several aspects of individual accounts, suggesting Congress ask the 401(k) services industry whether administration would be feasible. He expressed concern over the cost of offering a number of investment options, the delay before crediting accounts, and who would administer the fund. In response, Mr. Tanner recommended that the federal government serve as a centralized collection point, using a money market account until funds can be transferred to individual accounts. Senator Dodd wanted further information on the effect reform would have on disability and survivor benefits.

Senator Sununu. Senator Sununu defended the individual account reform proposals, disagreeing with Mr. Cavanaugh on whether it would be cost effective to administer a program for small businesses. He likened administration of the system to that of tax withholdings, which has not proven too costly for small businesses. He favored limiting the investment options available to achieve the same economies of scale as TSP.

Senator Sununu questioned whether investors actually follow a lifecycle model of investing. Mr. Amelio responded that investors are both too conservative and too risky simultaneously and usually are not on the efficient risk/return frontier. Finally, Senator Sununu pointed out that political pressure has not led to many investment choices under TSP, rebutting the suggestion that individual account reform would be forced to offer many costly investment choices.

Senator Reed. Senator Reed expressed concern over several aspects of reform that would lead to increased administrative costs, including allowing withdrawals or loans without regular standards, allowing investment in individual stocks, and creating a multi-tier system allowing greater investment choice at certain points. He asked about the advantages and disadvantages of the government trust fund alternative. Mr. Cavanaugh responded that the advantages were many, ncluding higher returns and diversification along with lower costs, and the only disadvantage would be government stock ownership.