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Panel Session
Industry Perspectives

Robert Pozen, Joel M. Dickson, F. Gregory Ahern,
Frederick L. A. Grauer, and Shaun Mathews

Robert Pozen

Thank you for inviting me to this very august group of economists as one of the so-called industry representatives. I thought that it might be useful to look at some of the practical issues from our perspective in two main areas: the investment-management side and the service side.

On the investment-management side, there are basically three main alternatives. You can have centralized fund investing, you can have index funds, or you can have some sort of active management. On the first alternative, I share many of the concerns that Martin Feldstein has articulated earlier in this meeting. I have been involved with the private administration of various defined-benefit plans, and you would be surprised how much pressure is brought to bear on these plans even in the private sphere. The standard response to avoid these pressures is reliance only on index funds, but these also raise concerns.

For the record, I want to say that Fidelity manages over $23 billion in retail index funds. We are the second biggest retail provider of index funds, so we are seriously involved with that aspect of money management. Nevertheless, I am actually quite concerned about a world in which huge numbers of people and huge amounts of money wind up in Standard and Poor's 500 funds. There is a clear free-rider problem on active research posed by index funds. They do not do any research on stocks or companies, so they have no idea about whether the prices of stocks in the index are appropriate. Index funds basically rely on active managers to set ap-

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propriate prices for index stocks: they are simply parasites living off active research.

This absence of securities research—the core characteristic of index funds—raises fundamental questions about their effect on the capital allocation function of the stock market. If more and more index money is invested without looking at the stocks or the companies, then capital may not go to those companies that are the best users of that capital. Moreover, the popularity of the Standard and Poor's 500 index tends to disfavor smaller and mid-size companies. For example, will there be a disparity in ability to raise capital between the 490th and the 510th company on the Standard and Poor's list? It is easy to argue that we should simply shift to broader indexes, such as the Wilshire 5000. However, these broader indexes have attracted relatively little investor interest or support.

When I consider the alternative of active management, I am attracted by the structure of the proposal from Fred Goldberg and Michael Graetz. Their proposal contemplates a default option for those who do not want to choose an active manager plus a "contract-out" procedure for those who want to use a private money manager. I support a strong default option because it may be difficult to educate all citizens about the range of fund options.

In thinking about how to design a low-cost, highly structured default option for those taxpayers who do not want to make investment choices, I would suggest that we look to what we call *lifestyle funds*. Lifestyle funds are ones where the mix of stocks and bonds changes automatically as the investor cohort ages. For example, when investors are twenty-five, the lifestyle fund has 80 percent stocks and 20 percent bonds; then, as they get to forty-five, the mix shifts to 40 percent bonds and 60 percent stocks; and, as they get toward retirement, the mix shifts to a majority of bonds. Such lifestyle funds are much simpler than even the government thrift plan, which offers participants several options to choose from.

I think that you need a strong default option because many members of Congress seem quite concerned about whether all citizens will know enough to make intelligent investment choices. With the lifestyle funds, we can meet these concerns—if a citizen does nothing, then he or she will be given an appropriate mix of stocks and bonds, which will be changed automatically over time.

As for the contract-out procedure for those who want to choose a private money manager, I would suggest that we use as a model the Department of Labor's safe harbor under section 404(c) of the Employee Retirement Income Security Act (ERISA). This safe harbor relieves the employer of liability for specific investments chosen by participants if certain conditions are met. Most important, a qualified investment manager must offer participants at least three different investment options. One must be a money market fund or stable-value account such as a bank

deposit or insurance account with guaranteed return. A second must be some type of high-quality bond fund. And the third must be some sort of diversified stock fund. Having three options is just the minimum; there can be more investment alternatives. Moreover, the safe harbor requires participants to receive educational materials about how to choose among these investment alternatives.

I would be concerned about a contract-out procedure that would be thrown open to any vendor regardless of qualification and would allow a vendor to offer only one investment option (such as individual Venezuelan stocks). It is this type of high-risk investment that is likely to produce political repercussions. By contrast, when you explain the 404(c) model to most people in Washington, they think that it is reasonable. It has the advantage of being used successfully in the context of defined-contribution plans.

Now, on the service side, I like the idea of having the IRS do as much as possible and using the present system for collecting social security contributions. However, I think that there still are a lot of questions about how often private money managers would receive contract-out monies and how they would actually get these monies. In my view, allowing a participant to choose only one private manager and transferring the money only once per year are probably the two most important features in terms of cost drivers. Costs would be too high if a financial institution received $12 a week, divided among four different mutual funds. A weekly contribution of $12 would equal $624 per year, which is close to 2 percent of the average social security contribution per year.

I think that many people are underestimating the cost of marketing, enrollment, and education for the contract-out procedure. On the other hand, if we have a system constructed with a default option, I am not at all worried if people wind up paying fees to investment managers that are higher than those currently charged by the federal thrift plan. Some investors may want a broad range of investment options plus other extras and may very well be willing to pay more for these. I am not bothered by this possibility as long as we have a strong default option and good disclosure by private money managers competing for contract-out business.

Then we get to the cost of administrative servicing. Many fund sponsors provide a very high level of customer support—for example, twenty-four-hour phone service, consolidated reports, and Internet tools. Problem resolution itself is an expensive service. Again, I am not worried if we have a strong default option and good disclosure from a number of qualified financial institutions. If someone does not demand a lot of service and wants to pay very low fees, he or she can stay with the default option. If someone wants more services, then he or she can consider the cost-benefit trade-off offered by various private money managers.

Finally, on implementing any new system for individual accounts under

social security, I think that it is a good idea to have something like a three-year transition for several reasons. One is that it will take time for the government to build the new system and make all the proper connections to the old system. A transition period allows time to educate people about the available choices in the new system. A transition period also allows time for accounts to build up to a reasonable size. Given the number of young people who have part-time and summer jobs, you can have very small account sizes. I think that it might be useful to have a rule requiring a minimum account size of $2,000 or $5,000 before someone could contract out. Otherwise, it would be possible to have people invest $29 in a fund, which would not be economical.

Joel M. Dickson

A broad consensus has developed regarding the need to reform the U.S. social security system. As part of this national debate, numerous proposals have been advanced that would provide participants with the ability to direct some of their social security investments through individual accounts. Unfortunately, to date, little attention has been given to the administrative costs of running these new accounts. This conference will likely provide an important platform as administrative-cost considerations begin to be integrated with the design proposals.

The costs of any particular proposal will vary depending on its characteristics. However, existing retirement-savings-plan options—namely, 401(k)s and IRAs—can provide some guidance on the costs of and trade-offs in servicing social security accounts. Record keeping for 401(k) plans is a very transaction-intensive business where two different groups must be serviced: the plan sponsor and the participants. There are multiple pay periods and multiple sources of funds (e.g., employee pretax contributions, employee after-tax contributions, employer matching contributions) that must be tracked separately. There is also a lot of flexibility in plan design, making each plan unique in terms of investment choice, plan provisions, and required services. In short, a typical 401(k) plan's costs are quite expensive. However, financial services firms have one important tool at their disposal: voluntary selection. Firms can decide whether they want to provide services for a given provider, thereby targeting those plans whose asset-based revenue can pay for its servicing costs. In a universal social security plan, providers would likely lose this ability to select their client base.

Although there is no such thing as a typical 401(k) plan, some parameters can be placed around the major cost areas. Overall, servicing a 401(k) plan probably costs on the order of $100 per participant year, depending on the plan's complexity and the range of services offered. A reasonable

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estimate of the servicing costs—that is, the systems, staff, and array of services needed to interact with both the employer and the employee—may represent about 50 percent of that total cost. Another significant portion of the costs can be accounted for by transaction processing (e.g., plan contributions, exchanges, withdrawals, loans) and ongoing research and development of new services needed to attract and retain clients. All other plan expenses, including participant education, statement mailings, and miscellaneous other expenses, may account for just about 20 percent of the total cost. These costs simply represent the ongoing costs of servicing the accounts. One-time start-up costs would also need to be accounted for in any overall pricing model, and these marketing and plan conversion costs can be considerable.

Providing services to an IRA is generally less complex and, hence, less costly than providing them to a 401(k) plan. With an IRA, a financial services provider is interacting with only one client—the account owner. This relationship is less transaction intensive, with fewer reporting requirements than exist under the ERISA-based 401(k) structure. In addition, providers retain some ability to select their client base through the institution of minimum account balances, account-maintenance fees for small accounts, and targeted marketing to "profitable" shareholders. Overall, ongoing servicing costs probably run about $30 per year. In addition, first-year costs associated with attracting a new account might represent an additional $40 in order to cover phone calls, account setup, and literature fulfillment.

The wide range of ongoing administrative costs within existing IRA and 401(k) models provides the ability to identify areas of cost savings. In particular, four general questions need to be addressed in evaluating the potential administrative costs of any individual account proposal: Who does the record keeping, who are the clients being serviced, how often are the accounts valued, and what are the types and frequency of allowable transactions by participants?

Centralized or decentralized record keeping is probably the most important issue to address. If it is determined that individual financial services companies should provide record-keeping services, the reporting-requirements transaction activity will likely be more complex than with current IRAs. This would be especially true if firms would have to interact with both the employer and the employee. However, these accounts would probably be less complex than a 401(k) plan because it would be a more standardized program. With decentralized record keeping, administrative costs will naturally be higher because thousands of different marketing, education, and advertising programs will have to be developed and tailored to that particular institution. Service enhancements and the constant competition to retain and attract clients will also lead to generally higher costs.

While the actual costs would depend on the ultimate individual account

structure, a reasonable assumption for a bare-bones model might be an ongoing cost of $50 per participant year with decentralized record keeping. Given this figure, what are the business implications for providing these accounts? Consider an individual earning $30,000 in social security income (which is above the mean social security income level) with 2 percent contributed to an individual account, and assume that the first-year cost of establishing the account is $40. A low-cost provider charging expenses of thirty basis points (0.3 percent) would generate first-year revenue of about $1.80 (0.3 percent × 2 percent × $30,000) but would incur costs of roughly $90.

Under the commonly proposed 2 percent individual account model, the break-even period for this example would be nearly twenty-five years, assuming an 8 percent nominal return and a 5 percent real return. On a stand-alone basis, this is not a particularly attractive business proposition, especially if firms would not be able to choose their client base. In short, asset-based revenue would not cover operating costs unless other fees—like low balance fees—could be used. Even if firms generated 1 percent in asset-based fees, the break-even period would still be on the order of a decade. Two general conclusions can be drawn from this example. First, a number of providers might choose not to offer individual accounts if only 2 percentage points of payroll taxes were used to fund the accounts because of the substantial start-up costs. In addition, the firms for which the accounts would be the most attractive are those that can generate significant asset-based revenue over a relatively short time horizon—that is, higher-cost providers that, all else equal, would provide lower returns to the system's participants.

Costs could be lowered dramatically by adopting centralized record keeping, although this approach may also decrease investment flexibility and service development. In particular, with a single record-keeping system, significant economies of scale and scope are available. For example, there would be a need for only one coordinated education program and one set of marketing initiatives. In addition, error reconciliation is much simpler, and no conflicts would result from trying to move accounts between different financial services providers.

One way in which to reduce client-servicing costs would be to develop a way of getting either the employer or the employee out of the picture. Because the individual accounts would likely be owned and controlled by the employee, it might make sense to eliminate any employer involvement that is required in servicing the individual account. One approach might be to direct the individual account investment through an individual's tax forms; that is, use the IRS as a conduit for account contributions. In this way, the account is based on social security wages, which are already detailed on individual W-2 forms, requiring no further employer involvement. Even an individual account proposal with decentralized record

keeping could lower costs by using the tax-filing process to allocate contributions. However, the combination of centralized record keeping and minimal involvement by employers would dramatically lower overall costs.

One often-overlooked consideration is the valuation period of the account, which can significantly alter administrative-cost calculations. There are two general industry models: daily valuation and periodic valuation. With periodic valuation (e.g., monthly or quarterly), there is an overall trust account that represents the employer-sponsored plan and is reconciled on a regular basis. Participants own shares in the trust. This is a fairly straightforward approach because all that is required is to reconcile the trust's investments and then allocate this pool of money to participants on the basis of their ownership shares in the trust.

Daily valuation works in the reverse direction. That is, the reconciliation process begins by auditing each participant's account on a daily basis. These individual accounts must then be aggregated and reconciled at the trust level. This is a much more complex and expensive process than periodic valuation. As a ballpark estimate, monthly or quarterly valuation (and associated transaction activity) would probably reduce administrative costs by one-quarter to one-third relative to daily valuation. However, this approach would make more sense with centralized record keeping and limited investment choice because much of the cost savings would be eliminated by using existing mutual funds—which are daily valued and subject to many different dividend-distribution schedules—in a periodic valuation system.

The final area of potential cost savings would be in limiting transaction activity. Factors that would lower administrative costs would be limits on exchanges and contributions, no ability to make withdrawals before retirement or to take loans, and limited investment options. As with many of the other factors discussed, limited investment options probably work better within a centralized record-keeping framework. However, even without centralized record keeping, there are ways in which to limit transactions, such as limiting investment to a series of so-called lifestyle funds, as others have suggested.

In summary, financial services firms have considerable experience managing individual accounts and understand many of the cost considerations needed to evaluate alternative proposals for social security reform. Although the key decision might well be whether to employ centralized or decentralized record keeping for the accounts, there are many other factors that would significantly affect overall administrative costs. In particular, the number of relationships needed to ensure the accuracy of the account information, the valuation frequency of the accounts, and the degree of flexibility offered in terms of available services and transaction capability would all affect the costs associated with providing and servicing a social security system with individual accounts.

F. Gregory Ahern

I would preface my comments by saying that the paper that was presented earlier today by Goldberg and Graetz is one that tracks some of the remarks that I was going to make, so, in the interest of not being repetitive, I will offer only a few brief comments.

First, the real challenge when you look at individual social security accounts is the fact that you are talking about a market that would ultimately be five times bigger than the 401(k) market is today. It would involve 140 million individual accounts. At State Street, we have been actively involved with the issue of social security reform for a couple of years now. We have operated under a set of principles regarding what we think is relevant not only from a political standpoint—because you have to build political support—but also from the national policy standpoint. The first of these is that you have to protect current retirees and the soon to be retired from benefit cuts. Any new program has to be phased in very gradually.

Second, there are two big questions regarding individual accounts: Can they be made to work for low-income workers, and can you organize them in such a way as to address the time lag between contributions and the crediting of individual accounts? We think that there are acceptable answers to both these questions. Many of the ideas that look attractive to us at State Street have been touched on in the papers presented at this conference. We think that a realistic program of individual accounts with some right of ownership requires a low-cost structure. We also agree with the notion that the program will require a safety-net element (perhaps with a defined-benefit first-tier part) and keep survivor and disability benefits intact as well.

Third, we agree that you have to work off the existing tax and data codes already available: the IRS/Treasury, Social Security Administration (SSA), or some combination of both. You need to use a centralized record keeper in order to make this work. And, more important, you need to keep it simple, particularly in the early years, whether you call it an *incubation account* or a *cash-balance account.* The only realistic way in which to get individual accounts off the ground is to be able to provide something that people can afford, at least in the initial years. An evolutionary model, which has been discussed here today, would involve a cash-balance approach with unitized investment and ownership rights that really would have to be tracked back in the reconciliation process. That is, the money would remain in the cash-balance account until the payroll-tax receipts had been allocated to individual contributors. And, when that has been completed (which, in an ideal world, would be a year to eighteen months

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but realistically might take even longer), the money could go into either an individual investment account with a lifestyle approach, modeled in a way that is similar to what Bob Pozen was describing, or into a default option offering three basic funds. If you use the lifestyle model, then asset allocation would depend only on the age of the contributor.

I think that the accounts need to reach a certain level either in terms of assets or in terms of age before you can allow people to roll out into a program with many vendors and a high level of service. Before doing this, the account system must be allowed to build up assets to a point at which costs as a fraction of assets are reasonable. If the basis-points approach for allocating costs is used, you want to be able to cross-subsidize smaller accounts without imposing exorbitant fees on larger accounts. You also want to begin to add the bells-and-whistles service features that have become common in the 401(k) business today. All these features require a large asset base over which to spread costs. As the system matures, it could become similar to the 401(k) world with which we are all familiar today.

What do I mean by *starting simply?* I am talking about one statement per year, no loans, as well as perhaps a single annual contribution, distribution only on death or retirement, and some reasonable way to manage call volume. At least in our experience, call volume is the single biggest driver in terms of costs after the education component. For example, if you established 140 million accounts tomorrow, a very conservative estimate is that you would have to handle 150–175 million inquiries per year. Even if you are able to use Internet technology or some other automated system, that is still a staggering volume of calls and inquiries with which to deal. In terms of education, I assume that we will rely on the government and the media to provide the bulk of the service, particularly in the beginning. The need for education and its cost can be mitigated to some degree by having the incubation-account approach, which really is automatic, as well as a simple default option.

I feel that allocating costs according to account assets (the basis-points approach) is the only way to go. In terms of total costs, you are looking at a minimum of $25–$30 per account, and that number could range up to $75–$100; charging fees on the basis of total costs is just not going to work with this kind of system. With the basis-points approach, you get the cross-subsidization effect, which has got political elements to recognize, but I think that it is probably the fairest way to go. And, as you know, from a seller's standpoint, all participants get the same returns as long as they are in either the level 1 unitized account or a level 2 individual account.

To summarize, individual accounts can be made to work; you need to begin simply, and you need to use an evolutionary approach. If you align investment choice and service features with the growth in balances, you

can make a really good case for evolving to the 401(k) model three to five years down the road.

Frederick L. A. Grauer

The U.S. social security system may be reformed in the near future. One change proposed is that participants in the system direct the investment of their social security account. Administrative costs of self-directed investing, such as accounting, safekeeping, reporting, phone servicing, managing, and transacting, affect the design of the system itself. Under a budget constraint, the greater are these administrative costs, the fewer investment choices would be available. Since administrative costs may have substantial fixed costs and thus exhibit economies of scale, the optimal set of investment choices may be small.

The discussions at the conference envision a social security system that is either defined benefit (DB), like the current system, or defined contribution (DC), or a hybrid. Almost by definition, the investments behind a DB plan cannot be self-directed. Participant-directed investing is a feature of a DC system. A conventional DC system, under which benefits equal contributions plus (or minus) the participant's investment success (or failure), cannot assure funding of a predefined benefit. If social security were converted entirely to a DC system, there would be no assured social safety net.

If a hybrid is contemplated where a social safety net is provided in the form of a defined benefit and, in addition, a DC plan is also provided, the DB portion must be invested according to a policy designed to ensure funding of those benefits.[1] The DC portion may be invested according to each participant's policy. Of course, the need to reform the social security system arises in part because the investment policy currently followed does not ensure funding of the defined benefit. Conversion to a DC system will not solve this problem. A social safety net and self-directed investing are incompatible.

The administrative costs of investment choice are relevant if social security is to move in whole or in part to a DC system.

Two comments are offered. First, the administrative costs of investment choice will be different depending on whether one is building a system from scratch or modifying an existing system. The analyses offered at the conference have carefully examined the administrative-cost functions of large private-sector servicers of DC employee retirement plans. The conclusions are of the form, If the social security system adopts the private-

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1. There is, of course, some debate as to whether a society can self-insure and deliver a defined benefit for certain.

sector administrative model, then the administrative costs of the system should approximate those of large private providers, which have been estimated to be in the range of 75–150 basis points of assets administered.

The implicit assumption is that adoption of the private model involves either the replication (duplication) of an existing system or the allocation of all historical costs of the existing system if the existing system is used, including the costs of building it in the first place and the marketing costs of asset gathering. What has not been examined is the incremental cost of modifying existing systems to provide a social security subaccount.

It is common practice for private providers to customize their systems to meet their customers' needs. Costs of modifying existing systems will depend on the nature of the modifications. The modifications could be made quite standard across different systems if the SSA specified standard investment choices and standard interfaces to itself, the IRS, and payroll servicers. Simple and uniform standards would reduce the costs of modification substantially. The true incremental administrative cost of a social security subaccount would be a fraction of the cost of building an existing system from scratch. As an added benefit, the integration of the social security account into participants' retirement reports can only enhance the quality of their retirement planning. At the conference, I suggested that the average incremental administrative cost at full funding of adding a social security account to existing DC or IRA systems could be as low as 5 basis points. This may be low, but surely 75–150 basis points for a redundant system is high.

A problem exists with the modification approach—lack of universal coverage. Approximately 50 percent of working Americans are currently covered by DC plans and/or IRAs. Significant growth in coverage remains as DC-plan formations extend into the public sector and to companies with fewer than fifty employees. Over the next five years, covered American workers should exceed 60 percent.

Several low-cost approaches to expanding coverage must be considered. The simplest approach for those not covered by a DC plan or an IRA would be to maintain existing DB coverage under social security—no change, no harm. Another approach would involve the creation of a national DC-investment-pooled account without participant direction that would have a more aggressive investment policy than social security currently; that is, it would include stocks in its policy mix. Still another approach would contemplate a DC account or an IRA equivalent to the so-called lifeline account used in the regulated utility industry to assure minimum service access for those not able to afford regular service. Such an approach should involve incentives for DC-plan sponsors to extend coverage to nonemployees or financial institutions to create lifeline IRAs.

The administrative costs of privatizing investment choice should be sub-

stantially reduced through modification rather than replication of existing private delivery systems. Cost-effective alternative approaches probably exist to address shortfalls in universal coverage. To hold modification (vs. replication) hostage to uniform universal coverage is tantamount to forced cross-subsidization.

The second comment focuses on investment choice itself. If the existence of administrative costs implies limited investment choice, what are the best, limited choices to offer social security participants? This kind of question inevitably elicits heated debate. The existence of administrative costs forces the issue, however.

The last fifty years of academic research has witnessed significant growth in investment wisdom. Markowitz (1952) demonstrated the power of cross-sectional diversification to control risk and improve the reward-to-risk ratio on investments. Samuelson (1965) showed how intertemporal diversification reduced risk and why buy-and-hold investing dominates market timing. Sharpe (1991) emphasized that the costs of investing were the key determinant of the average active investor underperforming the market—an argument in favor of index funds. Brinson, Hood, and Beebower (1986) showed that the asset-allocation decision—the choice of what mixture of stocks, bonds, and cash to hold in a portfolio—"explained" more than 90 percent of realized pension portfolio risk and return. In other words, asset-class selection is more important than security selection for long-term portfolio performance.

This wisdom suggests the desirable scope of investment choice within social security—a set of low-cost, buy-and-hold, diversified stock, bond, and cash portfolios. What we cannot afford is high turnover, actively managed funds. Index funds would be appropriate; sector funds and funds that place big bets on a handful of stocks would not be allowed.

These types of investment choices greatly simplify the question of what are the best investment options for the DC portion of social security. Investment choices limited to indexed stocks and bonds with infrequent trading intervals (yearly, perhaps) would dramatically lower administrative costs and significantly increase the prospects for investment performance over the long run.

In summary, the incremental cost of modifying existing DC or IRA administrative systems to support a simple social security subaccount must be analyzed before committing to the replication of existing administrative systems. Alternative approaches to the coverage of those not covered under existing DC or IRA plans must be evaluated in order to determine whether the cost-effective expansion of social security DC coverage is possible. Cross-subsidization should be avoided. Finally, both administrative costs and investment performance are improved if we heed the investment wisdom of our time: diversify within and across markets, invest for the long term, and mind costs.

Shaun Mathews

I prepared some formal remarks for today, but I will not use all of them because much of the substance has already been discussed in earlier sessions. Aetna has been analyzing these issues over the last twelve months primarily from the public policy side with a major consideration being a "customer perspective."

I should probably tell you a little about Aetna because, as I listened to the group talk about other countries' plans today, I realize that Aetna provides retirement plans in all these countries. We are in Chile, Argentina, Mexico, Canada, New Zealand, and Australia (to name a few), and, in the United States, we provide retirement plans for all the markets and tax codes. We do 401(k) business and are a very large player in the small to mid-size end of the business. We provide retirement plans for primary and secondary education and a lot of university systems and do a lot of work with governments and municipalities as well as some individual investment products: annuities, IRAs, and mutual funds. We sell products in two structures: in a mutual fund structure, like all the folks around the table, but also in an annuity/insurance wrapper for both retirement accumulation and payout.

We do a lot of things; we have a lot of different customers and many different constituencies we have to think about. Our president, Tom McInerney, has been very involved in the National Savers' Summit. Working with a few of you, he has spent a lot of time on CSIS (the Center for Strategic and International Studies), and we can keep coming back to a fundamental question: Isn't this all about a national retirement policy? And we keep wanting to take the discussion back to the "three legs of the stool": employer system, private savings, and social security.

When we start to look at issues like private accounts, we always ask this question: What problem are we trying to solve? And it is very hard sometimes to have, in my opinion, a good debate around the private accounts without knowing what problem you are trying to solve. For example: Is this about program solvency? Or is this about transferring cost and risk to the private sector? Is it about expanded access? I have heard a few people today talk about piggybacking the employer system. Are we attempting to move retirement plans down to the smaller end of the market? Or is it some combination of all those things? An informed discussion ultimately involves making decisions around some of these questions.

When we talk to plan sponsors, as a few of you have suggested today, there are a lot of concerns, particularly in the 401(k) market. It is not

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just about social security or getting involved in one more administrative responsibility as an employer. It is also about ERISA concerns; it is about fiduciary liability. In my mind, given the capacity of payroll and record-keeping systems today, this liability question is as important to address as is the question of administration. How might this connect to the current regulatory system in the 401(k) market? I think that there is a lot of noise around administration because it is easier to understand. But, if you are the fiduciary or the trustee of a plan, you worry about this. That is what a lot of our employers say to us. At the same time, a lot of our plan participants tell us that they are concerned about the solvency of the social security system. From a participant perspective, how do you restore some of the confidence in the system?

And, last but not least, we do lots and lots of work with financial advisers who also are very interested in this issue. Whenever they talk to their customers about financial planning and savings for retirement, social security is an integral part of these discussions and plays an important role in establishing a plan.

So there are lots of different issues from a constituency perspective. We talked about the three model alternatives: working off the current tax system; individual directed accounts; and the employee-based system. In my mind, each of these has strengths and weaknesses that must be debated in the context of what problems we are trying to solve. I believe that it is important to look at the strengths and weaknesses in the context of how we service our customers today. At Aetna, we break down the services that we provide into six components: money collection, plan administration, participant record keeping, investment management, participant education, and participant services. We have already discussed today how much or how little of that you can choose to provide and how that affects the cost of providing service. Again, each of the options for implementing private accounts has different effects on these service components.

Without looking at every nuance, let us look at a couple of examples. We talked earlier today about the option of "piggybacking" private accounts onto existing defined-contribution plans. All the companies here today already provide a great deal of participant education in support of the retirement plans that they provide to sponsors. In this regard, if private accounts were enacted, assuming that transitional and fiduciary concerns have been addressed, there is a possibility of leveraging operating structures already in place for defined-contribution plans. This issue of education in the context of private accounts is very important as we find 70–80 percent of our individual customers want information to help in planning for retirement and making the appropriate risk-adjusted investment choices. One cannot overlook this need for help in establishing a system of private accounts because of the potential risk of suboptimizing the long-term social objectives.

Another consideration: recognizing all the complexity and cost of ad-

ministering small accounts, I have been struck by the discussion of making "once-a-year" deposits into individual accounts. Being a proponent of dollar cost averaging, I would suggest that you look at market returns over the last thirty years and consider what happens when you are out of the market the best thirty days over the last thirty years—a huge difference in returns.

The next thing that I would mention is that I think that the idea of using lifestyle accounts for individual accounts is interesting. One of the options that the Clinton administration has just put forth is a "negative election" option for 401(k) plans. Under negative election, the employer can decide that all employees will participate in the 401(k) plan unless they expressly opt out. Some of our sponsors have actually used negative election in their plans and have used our asset-allocation funds for these deposits. Also note that asset-allocation funds cost more than indexing as it involves making certain sector-rebalancing decisions on a regular basis. But, as someone said earlier today, 80–90 percent of returns come from asset-allocation decisions.

In closing, I believe that the amount of choice that you give people in terms of controlling their private accounts and/or making investment decisions has a lot to do with who bears the risk at the back-end or payout phase of the retirement account. If the account is going to continue to be linked to a concept of providing a minimum level of income (e.g., an annuity), this "safety-net" concept must be linked with the choices provided in establishing and managing private accounts. Otherwise, there is a risk that future balances will not reach the levels anticipated and/or necessary to meet the minimum income needs in retirement.

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Discussion Summary

Peter Diamond began by emphasizing a point made by Shaun Mathews of Aetna—that 40 percent of investors are self-directed and that 60 percent of investors want or need investment advice. He next offered a correction

of a point in Joel Dickson's presentation. Dickson had performed a calculation of the expected costs to a financial institution of managing the individual account of a representative individual in which he assigned the individual an annual income of $27,000—identified as the median income of workers covered by social security. Diamond pointed out that the $27,000 was a *mean,* not a *median,* figure and that the relevant number for the purposes of Dickson's calculation was actually mean *covered* earnings, which is $23,000. *Dickson* remarked that this change would support his point even more strongly. *Diamond* then suggested that the administrative cost figures from Dickson's presentation ($50 per participant year and $40 for initial setup) could be reconciled with Diamond's own $150 per participant year figure. His argument proceeded in several steps:

First, he noted that Dickson's costs included only record keeping, communication, and advertising and did not include fund management. Diamond suggested that fund management would add $10 per participant year. *Dickson* and *Estelle James* argued that this may not be the case, observing that $10 extra in costs may not translate into $10 extra in fees.

Second, *Diamond* observed that charges for adjustments necessitated by divorce were not included in Dickson's calculations but that they should be. He argued that, in any mandatory national individual account system, divorce-adjustment rules would likely be built into the charges and would not be up to the discretion of the fund manager. *Dickson* countered that this would likely be a small effect. He argued that, under a national, standardized system of mandatory individual accounts, provisions for divorce would be simple to administer. He noted that divorce is complicated for 401(k)s largely owing to the heterogeneity of 401(k) accounts. Any domestic-relations order that has to be qualified for a 401(k) under ERISA has to be qualified under the specific plan to which it is to be applied. Dickson argued that this would not be an issue under a national, standardized plan.

Finally, *Diamond* ventured that Vanguard has lower costs than the average investment-management firm and that therefore we should view Dickson's cost estimates as below the likely average cost of administering individual accounts. He suggested that, if the ratio of industry average charges to Vanguard's charges is multiplied by the $60 per participant year figure, it would likely bring the figure up to roughly $100—still below his estimate of $150 but much closer than Dickson's original $50 figure. *Dickson* countered that there is a difference between costs and charges and that, although Vanguard's charges were lower than average, their costs are likely not significantly different from average. *Diamond* recognized the distinction and argued that his adjustment to Dickson's figures to bring them up to industry average was still valid for charges.

Martin Feldstein raised two questions regarding Robert Pozen's discussion of a two-tiered system of individual accounts with a default option

and a more expensive plan for those who choose to opt out of the default option. Feldstein wondered (1) what would be the nature of the mechanism for collecting the extra fees from individuals in the "opt-out plan" and (2) whether people in the opt-out plan would enjoy a government guarantee/safety net on their returns (as individuals in a default plan are likely to enjoy under a politically feasible privatization proposal)? On the first point, *Pozen* noted that a centralized collection mechanism already exists. Discussion of the second point centered around what type of government guarantee/safety net, if any, should and/or would accompany the individual accounts. Pozen noted that his conception of the individual accounts did not include a government guarantee of returns at all, whether in the default option or in the opt-out plan. Further, he envisioned that individuals choosing the opt-out plan would receive a lower defined benefit (i.e., a pay-as-you-go benefit) than they would had they stayed in the default plan. *Feldstein* argued that, on the basis of the current discussions in Washington, it was possible that politically feasible reform options would have to include some form of government guarantee, perhaps a guarantee of a certain level of "all-in" social security benefits—that is, on the combined defined-benefit and defined-contribution amount. *Estelle James* argued that guaranteeing individuals who opt out would introduce a significant moral hazard problem. *Feldstein* countered that, nonetheless, a good deal of the politics involved in making individual accounts acceptable revolves around being able to guarantee that individuals will do at least as well under the reformed system as they would have under the status quo. *Pozen* opined that, if this is the political reality, the system will work only if the guarantee is applied *only* to the default package and if the default package is made very conservative. Individuals who opt out would forfeit their guarantee, and they must take that into account when deciding to opt out.

Robert Pozen argued that, in order to make the two-tiered approach (i.e., a default option and an opt-out plan, as specified above) most effective, it would be critical not to bundle the default accounts with 401(k)s. Keeping the low-cost, standardized default option separate from the opt-out plan, he suggested, would make a government guarantee (on the default tier only) more feasible. In addition, the availability of a low-cost default option would likely reduce the perceived need for regulation of fees and costs in the opt-out plan. That is, given that individuals have the option of staying in a very low-cost, guaranteed default plan, they should not be prohibited from going outside the plan and spending more money on a less restricted account. *Martin Feldstein* noted that the counterargument to this position is that clever advertising will lure innocent people to give up their guarantee and move into an opt-out plan with high fees; the individuals will invest badly and end up with only the pay-as-you-go piece at retirement, which is only a fraction of what they otherwise would

have received. Consequently, the argument goes, the opt-out plans ought to be subject to regulation regarding allowable types of investment. *Pozen* pointed out that this type of regulation is already embodied in the "404(c)" model, which mandates that the account manager provide at least three highly diversified investment options (a money market fund, a bond fund, and a stock fund), provide investor education, and meet various other requirements in order to be a "qualified provider." *Feldstein* wondered whether it might not be possible to extend the government guarantee to the opt-out plan if it were to operate under a 404(c)-type model. But *Pozen* argued that there would still be enough choice and risk to cause a serious moral hazard problem. *John Shoven* concurred, noting that, even under the 404(c) model, a government guarantee would essentially subsidize equity investment. *Kent Smetters* suggested that applying different tax rates to the different accounts could offset this effective subsidy. *Estelle James* and *Shoven* replied that this would be quite complicated.

Estelle James commented that the concern that a large percentage of the individual accounts would be extremely small during the initial period after reform may not be a serious problem, given that it would take several years for the necessary supporting systems (e.g., information systems) to be developed as well. She estimated that the development and implementation of information systems would take at least three to five years. During this time, accounts would be growing, and individuals could begin to think about and learn about different investment options. She also questioned Fred Grauer regarding the assumptions underlying his presentation and his claim that administrative costs for individual accounts could be as low as five basis points per account. Specifically, she questioned the compatibility of his assumptions that (1) many costs could be kept low by "piggybacking" (i.e., utilizing the infrastructure of existing defined-contribution and IRA systems for communications, record keeping, and disbursement of funds) and (2) custodial and managerial costs would be extremely low (based on the experience of the federal TSP). James suggested that the second assumption relies on maintaining a very small number of large pools while the first assumption implies many pools (associated with employers), some of which are small. *Grauer* agreed, noting that he envisioned approximately three types of funds (stock, bond, and cash) that every defined-contribution plan would offer. But *James* argued that there would be additional internal administration and communication costs that Grauer had not figured in, with respect to setting up and maintaining this new system.

James Poterba posed two questions to the panel regarding costs in the 401(k) market. First, he asked whether total costs to 401(k) participants had been rising recently, citing anecdotal and journalistic evidence that suggested such a trend. Poterba noted that the cost figures being discussed at the conference seemed lower than the figures he had heard from various

sources. Second, he asked whether there was a substantial difference in the *average* cost to participants in 401(k)s versus the costs of the *marginal* people currently coming into the system as it expands to a universal structure. He conjectured that some of the small firms that have recently come into the 401(k) market resembled less sophisticated, lower-income investors who would be brought into the system if it were to expand under a system of social security individual accounts.

Regarding the second question, *Robert Pozen* noted that financial institutions are currently offering to smaller firms a highly standardized and simple 401(k) option that is the type of cost model that he would suggest using for less sophisticated investors under a system of individual accounts. Pozen also noted, however, that detailed data do not yet exist on the trading-behavior or customer-service needs of these smaller firms relative to the total 401(k) population. Regarding the first question, Pozen pointed out that a significant driver of increased cost in 401(k)s has been increased demand for services and greater flexibility on the part of employers. He suggested that this escalation in demand for greater services has been quite substantial and that, in particular, large employers exert significant bargaining pressure to increase their level of services. *Estelle James* wondered why the firms do not bargain for lower fees. *Pozen* replied that they do bargain for lower fees but that benefits executives are especially concerned with delivering expanded services to their constituents. *Martin Feldstein* pointed out the implicit principal-agent issue in this dynamic—the benefits manager gets credit for delivering greater service but perhaps is not penalized for a slight increase in fees. *Joel Dickson* noted that mutual fund managers are prohibited by law from offering different fees to different customers but agreed that administrative fees for 401(k) management can differ and that, once fees are driven down to virtually zero, negotiations necessarily turn to other issues, such as services. *Shaun Mathews* commented that, in the small business market (fewer than one hundred lives), in which Aetna does most of its retirement business, retirement-plan costs are extremely small relative to the costs of other benefits programs, such as health care plans. Therefore, a slightly higher fee is not likely to seem an onerous burden in return for a higher level of service. He noted that, on average, Aetna offers these clients plans with a choice of six to twelve funds, of which the average participant chooses three or four, and 80 percent of participants call for customer service once per year or less. According to Mathews, Aetna's cost for administering such a plan is seventy to one hundred basis points, including distribution costs and taking into account the fact that some of the funds are active management (i.e., not index) funds.

Robert Pozen suggested that perhaps we should be concerned about the volume of funds that would be funneled into index funds under a social security system with individual accounts. He noted that, currently, compa-

nies added to the Standard and Poor's 500 get an immediate premium as a result of the high volume of investment already being diverted into index funds. *Martin Feldstein* suggested that, eventually, active investors would arbitrage this premium away. *Pozen* cautioned that we do not know the level of investment in index funds at which this trend begins to be a problem. *Joel Dickson* countered that Vanguard currently estimated net cash flow to index funds to be negative as a result of defined-benefit plans taking money out, despite the large inflow from defined-contribution plans.