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"Social Security Reform: Successes and Lessons Learned"

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Madame Chairwoman and members of the subcommittee, my name is Patrick Purcell and I am a specialist in pension issues with the Congressional Research Service. Thank you for inviting me to speak to you today about the Thrift Savings Plan for federal employees.

The Thrift Savings Plan is a retirement savings plan for federal employees and members of the uniformed services. It was authorized by Congress in the *Federal Employees' Retirement System Act of 1986* (P.L. 99-335). The Thrift Plan provides federal employees and members of the uniformed services with a tax-deferred savings vehicle similar to those provided by many employers in the private sector under section 401(k) of the Internal Revenue Code. The Thrift Plan was designed by Congress to be a key part of the retirement benefits for employees who are covered by the Federal Employees' Retirement System (FERS), which covers all federal employees hired on or after January 1, 1984.

## Origin of the Federal Employees' Retirement System

Prior to enactment of the *Social Security Amendments of 1983* (P.L. 98-21), federal employees were not covered by Social Security. Federal employees were covered instead by the Civil Service Retirement System (CSRS). Because the Social Security system needed additional cash contributions to remain solvent, the 1983 amendments mandated coverage for civilian federal employees hired in 1984 or later.

Congress recognized, however, that Social Security provided some of the same benefits as CSRS. Moreover, enrolling federal workers in both plans would have required payroll deductions equal to more than 13% of employee pay. Consequently, Congress directed the development of a new federal employee retirement system with Social Security as the cornerstone and which would incorporate many features of the retirement programs typical among large employers in the private sector. The result of this effort was the Federal Employees' Retirement System, or FERS. FERS consists of three elements: (1) Social Security, (2) a traditional pension called the FERS basic retirement annuity, and (3) the Thrift Savings Plan.

The Thrift Plan is administered by an independent government agency, the Federal Retirement Thrift Investment Board, which is charged in statute with operating the Thrift Plan prudently and solely in the interest of the participants and their beneficiaries.[1] The assets of the Thrift Plan are

[1] See 5 U.S.C. § 8472(h).

maintained in the Thrift Savings Fund, which invests the assets in accordance with participant instructions in five investment funds authorized by Congress to be included in the plan.

Federal employees who participate in FERS, or its predecessor, the Civil Service Retirement System (“CSRS”), and members of the uniformed services are eligible to join the Thrift Plan immediately upon being hired. Generally, FERS employees are those employees hired on or after January 1, 1984, while CSRS employees are employees hired before January 1, 1984, who have not elected to convert to FERS. Each group has different rules that govern contribution rates.

As of March 31, 2005, there were 3.4 million participants in the Thrift Plan, with approximately 2.5 million contributing to the plan.[2] Among employees covered by FERS, 86% of those eligible to participate in the Thrift Plan do so. Among CSRS employees, about two-thirds participate. Assets of the plan totaled $154 billion as of March 31. In terms of both assets and number of participants, the Thrift Savings Plan is the largest employer-sponsored retirement savings plan in the United States.

The Thrift Plan is legally a “defined contribution” plan. This means that it specifies how much an employee may contribute and how much the employing agency must contribute to each FERS employee’s account. The employee owns the account and his or her benefit is equal to the account balance, which can be taken as a lump-sum, an annuity, or a series of periodic withdrawals.

Contributions

In 2005, FERS employees can contribute as much as 15 percent of basic pay on a tax-deferred basis, up to the $14,000 maximum specified in section 402(g) of the Internal Revenue Code. Participants in FERS are entitled to receive employer matching contributions on the first five percent of pay that they contribute to the Thrift Plan.[3] Participants age 50 and older who are already contributing the maximum amount for which they are eligible are allowed to make supplemental tax-deferred “catch-up” contributions of up to $4,000 in 2005.

In 2005, CSRS employees and members of the uniformed services can contribute up to ten percent of basic pay on a tax-deferred basis, subject to the $14,000 maximum specified in the tax code. Members of the uniformed services also may contribute up to 100% of designated special pay, incentive pay, and bonuses to the Thrift Plan. Neither CSRS participants nor members of the uniformed services receive employer matching contributions because both CSRS and the military services provide pension benefits to career employees and career military personnel that are substantially larger as a percentage of career-average pay than the FERS basic retirement annuity.

All FERS participants receive from their employing agencies an automatic contribution equal to one percent of basic pay.[4] Participants may also transfer funds from a traditional individual retirement accounts (IRA) or another eligible employer plan into the Thrift Plan.

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[2] See **Table 1** for complete Thrift Savings Plan enrollment statistics.
[3] The formula for agency matching contributions is specified in law at (5 U.S.C. § 8432(c)).
[4] Basic pay is defined in statute at (5 U.S.C. § 8401(4)).

Investment Options

As provided for in statute, Thrift Plan participants are offered five investment funds. Participants may allocate their contributions among any or all of the five investment funds, and they may reallocate their account balance among the five investment funds. The four funds that invest in private-sector securities are all index funds. These funds purchase securities in the same proportion as they are represented in an index of stocks or bonds, rather than through the decisions of an investment manager. Index funds have lower administrative costs than actively-managed funds, and because they purchase securities in the same proportion as they are represented in an index, there is little or no opportunity for the purchase of securities by the fund to be influenced by third parties who might benefit from having the fund invest in particular companies or sectors of the economy.
The five funds in the Thrift Plan are:

- the *Government Securities Investment Fund*, (the "G Fund"). This fund invests exclusively in U.S. Treasury Securities and other securities backed by the full faith and credit of the United States. Over the period from 1988 through 2004, the "G" fund earned an average annual rate of return of 6.6%.[5]

- the *Fixed Income Investment Fund*, (the "F Fund"). This fund invests in a bond index fund that tracks the performance of the Shearson Lehman Brothers Aggregate (SLBA) bond index. These securities consist of government bonds, corporate bonds, and mortgage-backed securities. From 1988 through 2004, the "F" fund earned an average annual rate of return of 7.7%.

- the *Common Stock Index Investment Fund* (the "C Fund"). This fund invests in stocks of the corporations that are represented in the *Standard and Poor's 500* index in the same proportion as they are represented in that index. During the period from 1988 through 2004, the "C" fund earned an average annual rate of return of 12.0%.

- the *Small Capitalization Stock Index Investment Fund* (the "S Fund"). This fund invests in the stocks of small and medium-sized companies incorporated in the United States. Stocks in this fund are held in the same proportion as they are represented in the *Wilshire 4500* stock index. The average annual rate of return on the *Wilshire 4500* from 1988 through 2004 was 12.7%

- the *International Stock Index Investment Fund* (the "I Fund"). This fund invests in the common stocks of foreign corporations represented in the Morgan Stanley Capital Investment EAFE (Europe, Australia-Asia, Far East) index. The average annual rate of return on the EAFE Index from 1988 through 2004 was 6.1%

The Thrift Board has contracted with Barclays Global Investors to manage the index funds in which the F, C, S, and I Fund assets are invested. The contracts for each fund are open to competitive bids by qualified investment managers every three to five years.

[5] See **Table 2** for annual rates of return from 1988 through 2004.

Participant Vesting

Thrift Plan participants are immediately vested in all of their own contributions and investment earnings on those contributions.[6] Participants also are immediately vested in agency matching contributions made to their accounts and attributable earnings. In order to be vested in the agency automatic (1%) contributions, a FERS employee must have either 2 or 3 years of service as described in section 8432(g) of title 5 of the U.S. Code. FERS employees who are not vested and who separate from the federal government forfeit all agency automatic contributions and attributable earnings. Forfeited funds, consisting primarily of monies forfeited pursuant to 8432(g), totaled $10,822,000 in 2004 and $7,824,000 in 2003. By law, these funds are used to pay accrued administrative expenses of the Thrift Plan. If the forfeited funds are not sufficient to meet all administrative expenses, earnings on participant investments are then charged for administrative costs. In its most recent annual report, the plan reported administrative costs of six basis points, or six-hundredths of 1%. Thus, the administrative expenses of the Thrift Plan are about 60 cents for each $1,000 invested.[7]

Participant Accounts

The Thrift Plan maintains individual accounts for each participant. Participant accounts are credited with the participant's contributions, agency automatic and matching contributions, and charged with withdrawals. The value of the participant's account reflects the number of shares and the daily share prices of the funds in which it is invested. Administrative expenses are a component of the share price calculation. The benefit to which a participant is entitled is the participant's vested account. Thrift Plan participants can receive account-balance information and conduct transactions by automated telephone service or on the Thrift Plan's web site.[8]

Participant Loans

Participants may borrow from their accounts. There are two types of Plan loans: general purpose and residential. General purpose loans can be obtained for any purpose, with a repayment period from 1 to 5 years. Residential loans can be obtained for the purpose of purchasing a primary residence, with a repayment period from 1 to 15 years. Participant loans may only be taken from participant contributions and attributable earnings. The minimum loan amount is $1,000. The interest rate for loans is the "G Fund" interest rate at the time the loan agreement is issued by the Plan's record keeper. The rate is fixed at this level for the life of each loan. Interest earned on loans is allocated to the participant account upon repayment. Participants whose loans are in default have until the end of the following calendar quarter to pay the overdue amount. If not repaid by that time, the loan plus accrued interest is treated as a taxable distribution to the plan participant, which may be subject to the 10% penalty on retirement plan distributions made before age 59½.

[6] To "vest" in a benefit is to gain a legally enforceable right to receive it.
[7] See **Table 3** for the Thrift Savings Plan's assets, income, and expenses in 2004 and 2003.
[8] The URL of the Thrift Savings Plan web site is www.tsp.gov.

Benefit Payments

After leaving service, participants may elect benefit withdrawals in the form of a partial withdrawal or a full withdrawal as a single payment, a series of payments, or a life annuity. Participants may choose to combine any two, or all three, of the available withdrawal options. The Board has contracted with the Metropolitan Life Insurance Company to provide annuity products to Thrift Plan participants. The contract to issue Thrift Plan annuities is open to competitive bids every three to five years.

The Federal Retirement Thrift Investment Board

The Federal Retirement Thrift Investment Board was established by the FERS Act of 1986.[9] The Board is responsible for developing the investment policies of the Thrift Plan and overseeing the management of the plan, which is under the day-to-day direction of an Executive Director appointed by the Board.

Three of the five members of the Board — including the Chairman — are appointed by the President. The President chooses a fourth member of the Board in consultation with the Speaker of the House and the House Minority Leader and a fifth member in consultation with the Majority and Minority Leaders of the Senate. Members of the Board serve 4-year terms and all nominations are subject to Senate confirmation. The law requires that all nominees to the Board must be individuals with "substantial experience and expertise in the management of financial investments and pension benefit plans."[10]

The authorizing legislation that established the Thrift Board defines the Board's authority and responsibilities, and provides for substantial independence of the Board from political pressures.

Authority

The Thrift Board has the authority to:

- Appoint the Executive Director of the Thrift Plan;
- Remove the Executive Director for cause (This requires 4 votes of the 5-member Board.);
- Establish investment policies for the Thrift Plan;
- Instruct the Director to take whatever actions the Board deems appropriate to carry out the policies it establishes;
- Submit to the Congress legislative proposals relating to its responsibilities under federal law.

[9] See 5 U.S.C. § 8472.
[10] See 5 U.S.C. § 8472(d).

Independence

Members of the Board are nominated by the President and confirmed by the Senate, but once confirmed they cannot be removed from their 4-year terms without good cause. The selection and nomination process are designed to assure that Members of the Board are individuals who are supported by the President and Congress. They serve in times of good behavior, rather than at the pleasure of the President or Congress, assuring that they can carry out the responsibilities of their positions without of removal from office. The Federal Retirement Thrift Investment Board receives no appropriations from Congress. Administrative expenses are paid through agency-automatic contributions forfeited by employees who leave federal service before they have vested and charges against participant accounts.

Responsibility

The law requires that the members of the Board shall discharge their responsibilities solely in the interest of participants and beneficiaries. In practice, this means that the investment policies and management practices of the fund are evaluated by the Board exclusively in reference to the efficient and prudent management of the Fund's assets. This exclusive responsibility serves to further insulate the Board from pressures to adopt investment policies or management practices that might not be in the long-term interest of preserving and increasing the security and investment performance of the Fund's assets.

Oversight

To assure that the Members of the Thrift Board remain aware of the interests and concerns of Thrift Plan participants and beneficiaries, the authorizing legislation established the Employee Thrift Advisory Council. This 14-member council is appointed by the Chairman of the Thrift Board and must include representatives of federal employee and Postal Service labor organizations, managerial employees, supervisory employees, female employees, senior executives, and annuitants.

All fiduciaries of the plan, including members of the Thrift Board are required by law to be bonded.[11] The Secretary of Labor is authorized by law to investigate any suspected breach of duty by a fiduciary of the plan. The financial statements of the Thrift Board are audited regularly by an independent accounting firm. Congressional oversight of the Thrift Plan is performed by the House Committee on Government Reform and the Senate Committee on Homeland Security and Governmental Affairs.

Conclusion

The Thrift Savings Plan is an efficient provider of retirement savings accounts to the federal workforce. It has achieved high participation rates and low administrative costs. The Thrift Plan is a key component of federal employees' retirement benefits. This is especially true for workers in the middle and upper ranges of the federal pay scale who would be unlikely to achieve adequate retirement income from just Social Security, the FERS basic annuity, and the

[11] A "fiduciary" is a person in a position of trust or confidence with regard to the property of another. A "bond" is form of insurance against the potential malfeasance of a plan fiduciary.

government's automatic contribution of 1% of pay to the plan. Later this year, the Thrift Plan will begin to offer life-cycle funds that will allow employees to have their investments re-balanced with a greater weight toward corporate and government bonds as they approach retirement age, thus protecting their accumulated assets from a sudden downturn in the stock market just as they are about to retire.

This concludes my testimony and I would be happy to answer any questions that members of the subcommittee might have.

## Table 1. Thrift Savings Fund Statistics

| Fund balances, in millions | March 2005 | | February 2005 | | January 2005 | |
|---|---|---|---|---|---|---|
| "G" Fund | 61,060 | *40%* | 60,066 | *39%* | 59,760 | *40%* |
| "F" Fund | 10,079 | *7%* | 10,222 | *7%* | 10,279 | *7%* |
| "C" Fund | 64,368 | *41%* | 65,589 | *42%* | 64,163 | *42%* |
| "S" Fund | 9,847 | *6%* | 10,028 | *7%* | 9,681 | *6%* |
| "I" Fund | 8,678 | *6%* | 8,325 | *5%* | 7,451 | *5%* |
| **Total** | **$154,032** | ***100%*** | **154,230** | ***100%*** | **151,334** | ***100%*** |
| **Twelve-month returns** | | | | | | |
| "G"Fund | 4.45% | | 4.36% | | 4.38% | |
| "F" Fund | 1.17% | | 2.36% | | 4.07% | |
| "C" Fund | 6.76% | | 6.99% | | 6.24% | |
| "S" Fund | 7.95% | | 10.42% | | 10.14% | |
| "I" Fund | 14.96% | | 18.64% | | 16.22% | |
| **Participants (thousands)** | | | | | | |
| FERS, contributing | 1,539 | | 1,543 | | 1,553 | |
| FERS, agency 1% only | 243 | | 237 | | 234 | |
| FERS participation rate | 86.4% | | 86.7% | | 86.9% | |
| FERS, without agency 1% | 71 | | 63 | | 55 | |
| Total FERS with contributions | 1,853 | | 1,843 | | 1,842 | |
| CSRS contributing | 449 | | 454 | | 465 | |
| Uniformed services | 476 | | 478 | | 458 | |
| Participants, not contributing | 661 | | 663 | | 657 | |
| Total TSP participants | 3,439 | | 3,438 | | 3,422 | |
| **Loans outstanding** | | | | | | |
| Number | 859,386 | | 872,240 | | 883,357 | |
| Amount (millions of $) | $4,908 | | $4,969 | | $5,033 | |

**Source**: Federal Retirement Thrift Investment Board.

## Table 2. Annual Rates of Return for Thrift Savings Plan Funds

| Year | G Fund | C Fund | F Fund | S Fund | I Fund |
|---|---|---|---|---|---|
| 1988 | 8.8% | 11.8% | 3.6% | 20.5% | 26.1% |
| 1989 | 8.8% | 31.0% | 13.9% | 23.9% | 10.0% |
| 1990 | 8.9% | -3.2% | 8.0% | -13.6% | -23.6% |
| 1991 | 8.1% | 30.8% | 15.7% | 43.5% | 12.2% |
| 1992 | 7.2% | 7.7% | 7.2% | 11.9% | -12.2% |
| 1993 | 6.1% | 10.1% | 9.5% | 14.6% | 32.7% |
| 1994 | 7.2% | 1.3% | -3.0% | -2.7% | 7.8% |
| 1995 | 7.0% | 37.4% | 18.3% | 33.5% | 11.3% |
| 1996 | 6.8% | 22.8% | 3.7% | 17.2% | 6.1% |
| 1997 | 6.8% | 33.2% | 9.6% | 25.7% | 1.5% |
| 1998 | 5.7% | 28.4% | 8.7% | 8.6% | 20.1% |
| 1999 | 6.0% | 21.0% | -0.8% | 35.5% | 26.7% |
| 2000 | 6.4% | -9.1% | 11.7% | -15.8% | -14.2% |
| 2001 | 5.4% | -11.9% | 8.6% | -2.2% | -15.4% |
| 2002 | 5.0% | -22.1% | 10.3% | -18.1% | -16.0% |
| 2003 | 4.1% | 28.5% | 4.1% | 42.9% | 37.9% |
| 2004 | 4.3% | 10.8% | 4.3% | 18.0% | 20.0% |
| **1988-2004** | **6.6%** | **12.0%** | **7.7%** | **12.7%** | **6.1%** |

**Sources**: www.tsp.gov, www.wilshire.com, www.msci.com.
**Note**: Rates of return for the C, G, and F funds are shown net of TSP expenses.

## Table 3. Financial Statements of the Thrift Savings Fund
## Statements of Net Assets Available for Benefits
## as of December 31, 2004 and 2003

*(In thousands)*

| | 2004 | 2003 |
|---|---|---|
| **ASSETS:** | | |
| Investments, at fair value: | | |
| U.S. Government Securities Investment Fund | $ 56,670,880 | $ 51,121,034 |
| Barclays U.S. Debt Index Fund | 9,732,943 | 10,071,287 |
| Barclays Equity Index Fund | 63,218,611 | 54,303,506 |
| Barclays Extended Market Index Fund | 9,644,143 | 5,622,444 |
| Barclays EAFE Index Fund | 7,021,069 | 2,211,875 |
| Participant loans | 5,105,715 | 5,130,170 |
| **Total investments** | **151,393,361** | **128,460,316** |
| Receivables: | | |
| Employer contributions | 166,045 | 151,497 |
| Participant contributions | 507,034 | 446,574 |
| Total receivables | 673,079 | 598,071 |
| Fixed assets, total: | 41,839 | 39,715 |
| Other assets | 5,460 | 11,236 |
| **Total assets** | **152,113,739** | **129,109,338** |
| **LIABILITIES:** | | |
| Total liabilities | 99,984 | 179,216 |
| Funds restricted for the purchase of Fiduciary Insurance | (4,829) | (4,978) |
| **Net Assets Available for Benefits** | **$ 152,008,926** | **$ 128,925,144** |

**Source**: Financial statements of the Thrift Savings Plan [ http://www.tsp.gov/forms/financial-stmt.pdf ].

## Table 3, continued. Financial Statements of the Thrift Savings Fund Statements of Changes in Net Assets Available for Benefits, Years ended December 31, 2003 and 2004

*(In thousands)*

| | 2004 | 2003 |
|---|---|---|
| **ADDITIONS:** | | |
| Investment income (loss): | | |
| U.S. Government Securities Investment Fund | $ 2,346,104 | $ 2,074,004 |
| Net appreciation (depreciation) in fair value of Barclays funds: | | |
| Barclays U.S. Debt Index Fund | 408,397 | 455,956 |
| Barclays Equity Index Fund | 6,115,843 | 11,316,657 |
| Barclays Extended Market Index Fund | 1,249,934 | 914,990 |
| Barclays EAFE Index Fund | 870,403 | 358,102 |
| Interest income on participant loans | 237,684 | 222,422 |
| Asset Manager rebates | 1,778 | 1,616 |
| Less investment expenses | (4,503) | (3,708) |
| Net investment income (loss) | 11,225,640 | 15,340,039 |
| Contributions: | | |
| Participant | 11,980,077 | 10,366,123 |
| Employer | 4,238,199 | 3,887,260 |
| Total contributions | 16,218,276 | 14,253,383 |
| **Total additions** | **27,443,916** | **29,593,422** |
| **DEDUCTIONS:** | | |
| Benefits paid to participants | 4,110,891 | 2,774,685 |
| Administrative expenses | 91,896 | 75,038 |
| Participant loans declared taxable distributions | 157,496 | 130,559 |
| Total deductions | 4,360,283 | 2,980,282 |
| Change in funds restricted for the purchase of Fiduciary Insurance | 149 | 375 |
| Net increase | 23,083,782 | 26,613,515 |
| **NET ASSETS AVAILABLE FOR BENEFITS:** | | |
| **Beginning of year** | **128,925,144** | **102,311,629** |
| **End of year** | **$152,008,926** | **$ 128,925,144** |

**Source**: Financial statements of the Thrift Savings Plan [ http://www.tsp.gov/forms/financial-stmt.pdf ].