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Chairman Brown, Ranking Member Toomey and members of the subcommittee—thank you for the opportunity to address you today on the topic of low-income workers and saving for retirement.

My name is Stephen Utkus, and I am director of the Vanguard Center for Retirement Research and a member of the leadership team of Vanguard's institutional retirement services business. At Vanguard, we manage more than $2 trillion in assets for tens of millions of U.S. investors—both for employees in workplace retirement plans and for individuals managing their savings on their own or with financial advisers. Our mission is "to take a stand for all investors, treat them fairly and give them the best chance for investment success." We are in particular known for our efforts to drive down the cost of retirement saving and investing. All other things equal, lowering the cost of investing is one of the critical levers that individuals and institutions have in order to improve retirement security.

We applaud the subcommittee for its focus on today's topic, the particular challenges facing low-income workers preparing for retirement. As you may know, having low lifetime earnings is a risk factor for being financially unprepared for retirement. To paraphrase one team of researchers in the field of retirement security, those who are financially vulnerable in their working years are more likely to be financially vulnerable in their retirement years.[1] So dedicating more attention to understanding this at-risk group is a particularly worthwhile goal.

The broader question of retirement security

Before considering the case of low-income workers, I believe a useful first step is to establish some perspective on a broader question—retirement security for the entire U.S. population. As you may know, there are varied estimates of retirement preparation in the U.S. One group of studies emphasizes that about half of Americans are "on track" for a financially secure retirement, while the other half are not. This is a "glass half full, glass half empty" view. Other studies suggest that 70 to 75 percent of Americans are likely to have the resources they need to maintain their standard of living in retirement. In light of this body of research, it is possible to maintain that anywhere from half to three-quarters of Americans are "retirement ready." The reason for these differences is that retirement security estimates are long-term forecasts based on varying assumptions and methodologies. These differences help explain why there is an ongoing and active debate on a fundamental policy question, Is there a retirement crisis in America—or not?[2]

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[1] See Brigitte Madrian, Olivia S. Mitchell and Beth J. Soldo, *Redefining Retirement: How Will the Boomers Fare?*, Oxford University Press, 2007, for a selection of papers on retirement preparation. This citation is to Robert Haveman, Karen Holden, Barbara L. Wolfe and Andrei Romanov, "The Sufficiency of Retirement Savings: Comparing Cohorts at the Time of Retirement," in that same volume, pp. 36-69.

[2] Alicia Munnell, Anthony Webb, and Francesca Golub-Sass, "The National Retirement Risk Index: An Update," Boston College Center for Retirement Research, Issue Brief 12-20, 2012. Jack VanDerhei, "All or Nothing? An Expanded Perspective on Retirement Readiness," EBRI Notes, Employee Benefit Research Institute, Washington, DC, 33:11, 2012. David A. Love, Paul A. Smith and Lucy C. McNair, "A New Look at the Wealth Adequacy of Older U.S. Households," *Review of Income and Wealth,* 54(4): 616-642, 2008. Michael Hurd and Susan Rohwedder, "Economic Preparation for Retirement," in David Wise, editor, *Investigations in the Economics of Aging,* University of Chicago Press, 2012. William Gale, John Karl Scholz, and Ananth Seshadri, "Are All Americans Saving Optimally for Retirement?," working paper, 2009, and John Karl Scholz, Ananth Seshadri, and Surachai Khitatrakun, "Are Americans Saving Optimally for Retirement?," *Journal of Political Economy*, 114(4): 607-643, 2006.

Having assessed studies like these over many years, I would encourage policymakers to avoid a simple, two-part "glass half full, glass half empty" view of retirement, and instead think about a three-part model. First, there is clearly a population, at least half of all Americans, and possibly larger, who are "on track" in their retirement planning. Second, there is also a group, probably at least a quarter of Americans, who are clearly "at risk" for retirement security. Many of the "at risk" workers have low incomes and lack the ability to accumulate meaningful private retirement savings. And third, there is an intermediate group, as a rough rule of thumb a quarter of Americans, who are "partially prepared." They have made some effort to accumulate private assets and savings for retirement, yet they will need to do more to close retirement shortfalls—whether that means saving more of their income while working or working for a longer period.[3]

Two types of low-income workers

A starting point for the conversation on low-income workers is to establish some baseline or terms of reference. The Census Bureau reports that in 2012, median income for households under age 65 was just over $57,000, meaning that half of working-age households earned above this amount and half below. About one-fifth of working-age households earned less than $24,000 per year in 2012, a narrow definition of "low-income worker," and one-third earned less than $40,000 per year in 2012, a more expansive definition of the group.[4]

Low-income workers likely fall within each of the three retirement readiness groups I described. Some will be "retirement ready," some will be "at risk," and others "partly ready."

[3] See James M. Poterba, "Retirement Security in an Aging Population," NBER Working Paper 19930, National Bureau of Economic Research, Cambridge, MA, 2014, for a discussion of heterogeneity of retirement preparation. Jack VanDerhei, 2012, cited above, also discusses relative degrees of preparation.
[4] Carmen DeNavas-Walt, Bernadette D. Proctor, and Jessica C. Smith, "Income, Poverty and Health Insurance Coverage in the United States: 2012," U.S. Census Bureau, Washington, D.C., 2013. Quintile and bottom-third working age incomes were interpolated from working-age distributions.

Yet as I mentioned at the outset of this testimony, the empirical evidence does suggest that the lower a worker's earnings, the greater the likelihood that the work will be "at risk" or "partially prepared" for retirement.

As we consider the prospects for low-income workers, I believe it is helpful to think about low-income workers in terms of two groups. First there are those workers who will remain at the lowest economic rungs for their working career, whom I will call "low lifetime earnings" workers, and who have the greatest chance of being in the "at risk" category. Then there are workers who, while having a low income today, are likely to see earnings rise over time. I'll refer to this latter group as "low current income" workers. These workers, as their earnings grow, will have greater chances for private retirement savings to supplement Social Security and reduce their chances of being "at risk."

Workers with low lifetime earnings

For workers with low lifetime earnings, Social Security remains the bedrock of financial security in retirement. Social Security's benefit structure is progressive, meaning that lower income workers receive a higher replacement income (as a fraction of their wages during their working years) than do better-paid workers. Thus one critical way to strengthen retirement security for low-income workers is to ensure that Social Security is on a fiscally sustainable footing for the long run.

In addition, many Social Security reform proposals advanced in recent years, while often trimming benefits for better-off retirees, include reforms to expand benefits for low-income workers. Acting through Social Security has several advantages. It will directly reduce retirement risks for workers with low lifetime earnings and their surviving spouses. It recognizes that many of these households lack the discretionary income to generate private resources for retirement—and when they do save for the future, any savings they accumulate are likely to be devoted to emergency needs, home purchase, or debt reduction, not retirement. And it also acknowledges that the existing Social Security system is an efficient and targeted way to improve outcomes among these households.

Workers with low current incomes

A second group of low-income workers are those with low current incomes today but with rising income prospects for the future. For individuals in this group, as their incomes grow, Social Security benefits will come to represent a smaller fraction of their retirement resources, and the need for private retirement savings increases.

Several important developments in the defined contribution (DC) system have emerged in recent years designed to improve retirement outcomes among these workers. Our annual statistical publication *How America Saves* and our other research studies can be helpful in understanding these developments. Today, the majority of new hires into private-sector DC plans are automatically enrolled. The striking benefit of automatic enrollment is that it encourages substantially higher plan participation rates among young and low-income workers and among minorities—traditional low- or non-saver groups. Automatic enrollment, often combined with an automatic savings escalation feature, continues to disseminate in the private DC system as a result of the reforms enacted by Congress.[5]

[5]"How America Saves 2013: A Report on Vanguard 2012 Defined Contribution Data," Vanguard Center for Retirement Research, Malvern, PA, 2013. Cynthia A. Pagliaro and Stephen P. Utkus, "Diversity and defined contribution plans: The role of automatic plan features," Vanguard Center for Retirement Research, Malvern, PA, 2011. William E. Nessmith, Stephen P. Utkus, and Jean A. Young, "Measuring the effectiveness of automatic enrollment," Vanguard Center for Retirement Research, Malvern, PA, 2007.

One concern about automatic savings programs is that they are only available to those workers who are offered a DC plan at work. On this front, there have been encouraging new findings from researchers at the Social Security Administration and Small Business Administration, who estimate that now 7 out of 10 private-sector workers are covered by a retirement plan at work. This is higher than previous estimates because it relies not on worker surveys, but on a more accurate, data source: workers' own W-2 forms submitted to the IRS. Plan coverage remains lowest among the smallest firms—those with fewer than 50 employees.[6]

A second important development within DC plans has been the rising importance of automatic investment programs. Participant-directed DC plans have been traditionally criticized because they placed the burden of investment decision-making on often inexperienced or unsophisticated workers. However, the landscape has changed considerably—so much so that within five years, we estimate that the majority of 401(k) and other DC plan participants will be leaving investment decision-making to professional money managers chosen by their employer. In effect, the pendulum on investment decision-making has swung, and fewer workers are being called upon to undertake complex portfolio decisions within their retirement accounts.

A major reason for this development is the growing use of target-date funds within DC plans. Target-date funds are evolving within DC plans in two ways. First, plan sponsors, when implementing automatic enrollment, are overwhelmingly selecting target-date funds as their preferred default investment. Most sponsors have expressed a strong interest in a default investment program that reduces risk-taking as the participant approaches retirement. Second, in plans where participants are not automatically enrolled but instead make their own investment choices, sponsors are also introducing target-date funds as a way to streamline investment

[6] Irena Dushi, Howard M. Iams and Jules Lichtenstein, "Assessment of Retirement Plan Coverage by Firm Size, Using W-2 Tax Records," *Social Security Bulletin,* 71(2): 53-65, 2011.

decision-making by workers. Target-date funds simplify investment choices because they reorient decision-making away from detailed fund selection to the choice of a portfolio based on the year of retirement. Participants can thus focus on understanding the risks and costs of the investments they own at a very high level, and not concern themselves with complex portfolio construction questions. The old view of DC plans—that workers had to be their own money managers—is gradually receding from the landscape.[7]

The Importance of Costs

So far I have addressed both savings rates and investment decisions in DC plans. Yet at Vanguard we strongly believe that all employers and workers have a third lever for influencing retirement outcomes, both when accumulating savings and in the drawdown or retirement phase—namely, costs. All other things equal, the lower the costs that workers bear in their retirement programs, the larger the nest egg they will accumulate during their working years, and the longer the money will last when it is spent in retirement.

For retirement programs, costs come in two forms: recordkeeping costs, which include all expenses associated with operating a retirement plan, communicating it, and serving plan sponsors and participants; and investment costs, which include all expenses associated with money management for the plan. As a result of the plan sponsor fee disclosure regulations issued by the Department of Labor (DOL), combined with intense competition in the marketplace, both recordkeeping costs and investment costs are declining. On the administrative side, we are seeing substantial downward pressure on recordkeeping fees due to DOL disclosure regulations and competitive re-pricing efforts. On the investment side, we are experiencing a resurgence of

[7] Jean A. Young, "Target date fund adoption in 2013," Vanguard Center for Retirement Research, Malvern, PA, 2014.

interest in low-cost indexing strategies as sponsors look to ways to reduce DC plan investment costs and improve relative investment performance.

As one illustration of this latter point, among fast-growing target-date funds within DC plans, we now estimate that nearly 45 percent of target-date assets are passively invested (compared to 20 percent for the overall private DC system). An important part of this is the "Vanguard effect," where our emphasis on low-cost investing contributes to positive change in the marketplace. According to our internal calculations, we recently became the largest target-date investment manager for U.S. DC plans because of the growth of our low-cost, indexed target-date strategies.[8] But it is also a testament to our competitors who also provide index services to the DC marketplace. And it is of course directly due to the growing attention to plan investment costs among employers.

On the cost front, one worry has been that while mid- and large-sized companies can obtain investment management costs at competitive prices, small-company plans are at a disadvantage. In this vein we are excited about the recent launch of Vanguard Retirement Plan Access—where, with our partner Ascensus, we are bringing low-cost investing to small company retirement plans. As the marketplace continues to respond to regulatory reform and fee disclosure requirements, we anticipate ongoing scrutiny of plan costs, and in particular increased demand among small employers to obtain lower fees for their participants.

Conclusion

The U.S. retirement system can best be characterized as a hybrid, public-private partnership. From the public sector, Social Security, a mandatory and universal system, is used to

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[8] These Vanguard estimates, derived from market sources, include target-date strategies in mutual funds, commingled trusts and other investment vehicles used within DC plans.

provide a floor of income for most workers. It is augmented by Medicare, which pays for the majority of in-retirement medical costs, and Medicaid, which pays for a substantial proportion of long-term care costs. In the private sphere, government policy has encouraged the development of a robust system of supplemental, voluntary retirement plans that today cover about 7 in 10 private sector workers. Improvements in Social Security could be one way to address the concerns of workers with low lifetime earnings. For low-income workers with rising income prospects, automatic enrollment in the DC system is gradually expanding the benefits of these plans to workers who are covered by but not currently participating in their employer's plan.

As the subcommittee considers the issue of low-income workers, efforts to improve retirement outcomes should be evaluated from this holistic perspective. We would also encourage policymakers to consider a three-part model of retirement security, distinguishing among those who are likely to be "on track," "at risk," or "partially ready," and weighing policy prescriptions in terms of these distinct groups.