

# INTELLIGENCE

“Personal retirement accounts should be familiar to federal employees because you already have something similar, called the Thrift Savings Plan.”

—George W. Bush  
(Feb. 2, 2005)

## Voluntary Personal Accounts and the TSP

By Dick Schreitmueller

**T**HOSE WORDS in the president’s State of the Union address caught my full attention. That’s because I’d been present at the creation of the federal employees’ Thrift Savings Plan (TSP) as a Senate staffer in 1985, just 20 years ago, and watched President Reagan sign it into law a year later.

Today, the TSP is the nation’s largest 401(k)-type plan, with 3.4 million participants and \$152 billion of assets. Now another president wants to use that plan as a model for Social Security voluntary personal accounts (VPAs) that would be available to more than 100 million workers.

You might wonder what’s so special about the TSP. The answer lies in the TSP’s management and investment structure, which offers a practical way for the government to insulate common stock investing from political influence and pressure.

Inside the Beltway, the TSP is widely viewed as a winner, and has been virtually free of criticism since its inception. The general public probably would like a government agency to manage VPAs, following the example of the TSP, instead of using Wall Street firms, banks, or insurance companies; the White House says that such an arrangement “should lay to rest any suggestion that we’re thinking of privatizing the Social Security system.”

Record-keeping issues are also very important because Social Security covers a

# NT DESIGN



great many tiny employers and uneducated workers, who can't all be expected to deal with complex choices and procedures. Moreover, the president insisted long ago that his personal accounts plan must be voluntary. This could be a major complication if workers had to make many choices, or small employers had to handle workers with VPAs differently, or the government had to operate two parallel systems for workers with and without VPAs. But the White House team found ways around such obstacles, designing the VPA program to be:

- simple for the government to manage, keeping costs down;
- simple for employers to handle, using the existing Social Security tax collection procedures;
- simple for workers to understand, having very few decisions to make.

The president's proposal has its flaws, perhaps fatal ones. At this writing, any Social Security reform remains stalled as some legislators deny that the program really, really has a problem. Others note that Bush's plan doesn't purport to improve the program's long-range finances, and still others object to the transition financing and other implications of the Bush proposal. Still, if the president can sell anything resembling his VPA proposal to Congress, the thoughtful design features explained below will have played a major part. ▶

**TABLE 1**

## Operating Structures of the TSP and the Voluntary Personal Accounts Program

	<b>THRIFT SAVINGS PLAN</b>	<b>SOCIAL SECURITY PERSONAL ACCOUNTS</b>	<b>COMMENTS ON VPA STRUCTURE</b>
<b>Role of employer</b>	Each federal agency enrolls its employees, sends in contributions allocated to employees for each pay period, and conducts training and education on the plan.	Employer has no role in VPAs.	Employers just keep paying Social Security taxes for all workers, doing nothing different for those who have elected VPAs.
<b>Role of managing agency</b>	<p>Operates outside the executive branch; must act solely in the interests of participants.</p> <p>Contracts with outside firms or agencies to invest funds, keep records, handle transactions, provide annuities, and produce training and communications material.</p> <p>Collects contributions from federal agencies.</p> <p>Communicates directly with employees about their fund balances, all transactions, and allocation of new and existing investments.</p>	<p>Same structure as in the TSP.</p> <p>Contracts out the same kinds of tasks as in the TSP.</p> <p>Communicates directly with workers and beneficiaries about enrollment, account balances, investment options, death benefits, annuities.</p> <p>Allocates workers' payroll taxes between Social Security and VPA funds.</p>	<p>As in the TSP, the managing agency's board members, once appointed, are totally independent of White House control. This includes policies, regulations, budgets, and tenure of board members.</p> <p>The TSP provides a good model for use of the Internet and other technology, although administrative needs for VPAs would differ substantially.</p> <p>Administration of VPAs would have to be closely coordinated with Social Security.</p>
<b>System for record keeping and administration</b>	System performs daily updates of account balances and transactions, as in a 401(k) plan.	System will make an estimated allocation of ongoing payroll taxes to Social Security and the VPA investment funds, then update workers' accounts when individual wage data are available.	VPA system will use data that employers report for the current Social Security program, plus separate records of investment options elected by workers who have VPAs.
<b>Investment options *</b>	<p>Three stock index funds, for large, small, and overseas companies.</p> <p>Corporate bond index fund.</p> <p>Stable value fund using government securities that mature in one day.</p> <p>Life-cycle option that blends the five funds, gradually shifting money from stocks to bonds as a worker gets older.</p>	<p>Five funds like those in the TSP, plus a life-cycle option.</p> <p>Special government securities fund crediting interest at a 3 percent real rate. This is the break-even return needed to avoid gain or loss from electing a VPA.</p> <p>Life-cycle option is the default option.</p>	The break-even 3 percent real rate of return is net after expenses, so the special government securities would have a gross annual return of a little above 3 percent.

\* TSP investment options include certain new features taking effect later in 2005.

## Management and Investment Structure

Table 1 outlines the operating structure proposed for the VPA program. This is similar to the structure of the TSP, shown alongside for comparison.

Administration and record keeping are centralized, as in a 401(k) plan, not scattered like millions of individual retirement accounts (IRAs). In creating the TSP, Congress explicitly rejected the “retail” approach used by IRAs as too costly and cumbersome for a single plan covering millions of workers. The resulting economies of scale hold down administrative costs.

An independent government agency controls the plan and its investments, operating almost entirely outside the executive branch. The private-sector investments use index funds, tightly controlled by statute so that Uncle Sam can't play favorites by picking stocks or timing the market. And workers have only a few investment choices. The central agency can readily create educational tools and programs to make the plan transparent and encourage informed decision-making.

The TSP structure was designed to insulate management and investments from political interference. Future legislation could change this structure to inject political values, but that seems unlikely in the foreseeable future. The VPA program structure would have the same characteristics.

## Other Features of VPAs

Table 2 briefly outlines the contributions, benefits, and other features of the VPA program. (Features of the TSP, not shown in the table, are quite different.)

Contributions to VPAs are computed by the government, not reported by employers as one might expect. Employers pay normal Social Security taxes, from which the government diverts contributions for workers who have a VPA by using a simple formula, which is 4 percent of taxable wages, capped at a dollar amount (\$1,000 initially) in any year. The Social Security program now takes many months to post earnings credits to individuals, and it isn't clear exactly how the Bush plan intends to credit contributions or investment earnings in a timely manner.

Workers with VPAs have an offset that reduces their Social Security benefits. The offset is the amount of annuity that could be provided from a hypothetical account earning a 3 percent real rate of return. A worker whose VPA actually earns more than a 3 percent real rate of return comes out ahead, while one who earns less than the 3 percent break-even rate comes out behind.

The Bush plan technically won't let workers drop out after they join, but it lets workers effectively drop out for as long as they wish. They can do this by investing in a government securities fund that credits the break-even interest rate, so that the individual neither gains nor loses by having a VPA.

Converting all account balances to annuities, regardless of amount, has definite advantages but might be hard to sell politically.

Workers are not allowed to have loans, hardship withdrawals, or other access to their VPA funds before retirement. It makes sense for VPAs not to let workers take money out, but specific hardship cases could eventually make Congress consider bending this rule.

Assets in a VPA must be converted to an annuity at retirement if needed to bring the Social Security benefit up to the poverty level. Converting all account balances to annuities, regardless of amount, has definite

advantages but might be hard to sell politically. That is, the public might not appreciate better annuity rates and greater financial security as much as they would like freedom of choice. Under the Bush plan, retirees who draw down their account balances too rapidly may find that their ultimate benefits are at the poverty level.

## Lessons From Abroad

Many other nations' social insurance systems have introduced voluntary personal accounts programs, designed many different ways. From these we can get an idea of what has worked and what has not.

Most of these plans are truly privatized, giving workers a wide range of choices among privately managed investment funds and products. Following are highlights of a few prominent VPA plans in other nations, illustrating what can go wrong.

■ Singapore has the oldest VPA plan, in effect since 1955. Workers are able to withdraw assets before retirement in many situations instead of preserving their savings for retirement. As a result, retirement benefits are often inadequate, yet costs are high, with workers contributing 33 percent of payroll.

■ Chile has had VPAs since 1981, with reasonably good results. Investment performance for the first 15 years was very good, thanks to surging prices for stocks and bonds. Over the past 10 years, investment performance has been more volatile, and many investment managers have gone out of business. Also, fees for administration and insurance have been very high (2.3 percent of payroll), financial firms have been criticized for selling unsuitable investment products, and only about 60 percent of workers participate because of widespread evasion.

■ Britain began allowing individual workers to have VPAs in 1988. After misleading sales information in the 1990s led unsophisticated workers to buy inappropriate savings products, financial firms had to repay billions of pounds to individuals. Since then, large numbers of employees with VPAs have rejoined the state pension system.

■ Sweden started its VPA plan in 1991 by letting workers choose among some 600 funds, which confused many workers. A low-cost index fund was the default option, without many takers at first. But after years of poor results in the other funds, many workers tired of trying to beat the market and elected to

**TABLE 2**

## Other Features of the Social Security Personal Accounts Program

FEATURE		COMMENTS
<b>Eligibility to contribute</b>	Workers born after 1949 first become eligible to enroll during 2009-2011, depending on age. Once enrolled, a worker must keep contributing to the VPA.	Workers born before 1950 are excluded. Phase-in of eligibility spreads the start-up efforts and costs over three years.
<b>Amount of contributions</b>	Contribution is 4 percent of taxable wages with a dollar cap of \$1,000 in 2009, plus \$100 each year, indexed to average wages.	The cap is intended eventually to reach 4 percent of the Social Security wage base (\$90,000 in 2005), but no schedule of cap increases is specified after 2015.
<b>Offset to basic Social Security benefit</b>	The Social Security benefit of a retiree who has a VPA is offset by the amount of inflation-indexed annuity that could be provided from a hypothetical account that earned a 3 percent real rate of return.	The offset does not apply to disability benefits before retirement age or benefits to young survivors.
<b>Open seasons for investments</b>	Open seasons are available to change investment options, apparently once a year.	
<b>Ability of worker to drop out of the plan</b>	Workers technically can't drop out, but they can get the same result by electing to contribute to the government securities fund and earn the break-even interest rate of 3 percent plus the rate of inflation.	
<b>Expense charges</b>	Estimated rate is 0.3 percent of assets.	This expense rate is only a rough estimate because the plan has unique administrative requirements. Most of the expenses are for record keeping.
<b>Loans before retirement</b>	Not permitted.	Loans are costly to administer even when they can be repaid by payroll deductions, which don't fit into the proposed administrative methods for VPAs.
<b>Withdrawal of funds before retirement</b>	Not permitted.	
<b>Death benefits before retirement</b>	The account balance is paid to a beneficiary.	
<b>Annuities at retirement</b>	Account balance must be used to buy an annuity to the extent that a retiree's Social Security benefit is below the poverty level. Retiree can take any additional funds in a lump sum or phased withdrawals indexed to life expectancy.	The poverty level in 2005 is \$9,570 of annual income for an individual, \$12,830 for a couple.  The government will take the lead in providing annuities for the VPA program, but details of the annuity arrangement are not specified.

invest in the index fund.

■ Poland has had a VPA plan only since 1999. Because of poor plan design and controls, many so-called sales agents were able to collect fraudulent commissions.

The White House's plan avoids major pitfalls noted above by keeping the plan design simple, centralizing administrative, educational, and investment functions with a low-cost index-fund arrangement, and not permitting access to funds before retirement.

### Concluding Observations

Many VPA features are copied from Model 2 in the 2001 report of the President's Commission to Strengthen Social Security. Few people bothered to criticize that report in detail at the time, but the president's political opponents now find some features of VPAs to be highly objectionable.

■ *Transition financing:* The president's plan uses a "carve-out" approach, diverting some Social Security taxes to VPAs and requiring large Treasury loans in order to continue paying traditional benefits. Eventually, the VPA program's offsets kick in, reducing traditional Social Security benefits and permitting repayment of such loans.

Some critics prefer an "add-on" design, leaving the current program more or less intact and adding a new layer of personal accounts on top. In debating these two approaches, each side claims that its way does not add new long-term costs or obligations, while the other way does.

But there's no doubt that VPAs call for issuing large volumes of Treasury bonds over the next few decades. Note that some VPA assets will be invested in Treasury securities, reducing the strain on cash flow during the transition.

■ *Partial advance funding:* The TSP introduced an element of true advance funding into the federal employee retirement program, which formerly had held only Treasury bonds as assets. In the same way, VPAs will gradually shift some Social Security program assets from Treasury securities, which have no economic reality for a federal program, to privately issued stocks and bonds that represent claims on revenue from outside the government. As a result, Social Security will no longer have to rely totally on future taxes as a source of revenue to pay all its benefits, and the program's financial solvency will be less dependent on the vagaries of future demographics such as birth rates and life spans. Inevitably, changing Social Security from an essentially unfunded program to one partly funded with private securities will make heavy demands on cash flow during the transition, but it eventually will reduce unfunded obligations.

■ *Risks and rewards:* Bush's plan may be a "risky scheme," as Al Gore called it a few years ago, but it has potential rewards and safeguards. Over the long run, stocks have consistently outperformed other investments, with the main risks being lack of diversification and poor timing. The president's plan uses index funds, which are highly diversified, and it offers a lifestyle option that moves assets from stocks to bonds over the years before

retirement. The shift out of stocks protects against retiring when stock values are bottoming out. Meanwhile, the shift into bonds gives some protection against retiring when annuity rates are at their worst, i.e., when long-term interest rates are low and bond values are peaking.

■ *Break-even interest rate:* Workers contributing to a VPA must earn more than a 3 percent real rate of return, net after inflation and expenses, to come out ahead. That's because the offset formula assumes a 3 percent investment return. To the extent they earn a real rate less than 3 percent, workers lose money by having a VPA.

The 3 percent interest assumption is a high hurdle to get over, perhaps too high. In the past 25 years, real long-term interest rates have often been over 3 percent, but earlier a rate of 2 percent was more realistic. The President's Commission used a 2 percent rate in its Model 2 plan, on which the Bush proposal is based.

Many people have calculated that young workers could get larger retirement benefits if their payroll tax contributions went into the stock market instead of Social Security. This was a major reason that the president said we need to enact VPAs, "to make the system a better deal for young workers." The 3 percent assumption is not very helpful in attaining this policy objective.



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## Why Did the TSP Use Index Funds?

The index fund proposal emerged from an informal conversation in the spring of 1985 between me and Jamie Cowen, a key Senate staffer who knew politics but not investments. We both had been scratching our heads, trying to find a good way for the plan to handle common stock investments. Others wanted to use IRAs as a model, letting employees choose among a vast number of investment managers, but we leaned toward a few centrally managed funds, if only they could be kept completely free of political influence.

But how could the fund managers avoid any pressure or tendency to invest in politically favored companies? Jamie got us halfway home when he remarked, "It's too bad there isn't a way to choose the stocks automatically." Right away the proverbial light bulb went on, and I replied, "There is a way, called an index fund. And that's how we'll do it."

Index funds, used mainly by large defined benefit pension funds at the time to reduce costs, were fairly new and got little respect. Nobody else on the congressional staffs had heard of them, and they weren't even mentioned by the investment experts at our public meetings and hearings throughout the legislative process.

But people caught on quickly. The stock index fund was in the Senate bill introduced in July 1985 (S. 1527), and the rest is history. I'm sure many of my actuarial colleagues would have come up with the same idea, and it just shows that Capitol Hill needs more actuaries.

By separating investments from politics, index funds overcame strong resistance in Congress and the White House to government management of common stock funds. Index funds had the added advantage of good investment performance. Today, some policy-makers who dislike personal accounts want to invest part of the Social Security trust funds in stock indexes, citing their record of success in the TSP.

—Dick Schreitmueller

Reducing the 3 percent rate makes a VPA more attractive because it raises net benefits after the offset. Unfortunately, that lower rate increases costs. Still, policy-makers who are proponents of VPAs may want to take another look at the interest assumption.

■ *Enrollment, investment options, and defaults:* Employee benefit planners have observed much inertia in workers asked to make a choice. An example in 1987 was the TSP, with only 40 percent of employees initially electing to contribute, despite a hefty employer match. On each \$1 contributed up to 3 percent of pay, the match was \$2 in the first three months and \$1 thereafter. Accordingly, many benefit plans today automatically enroll new employees unless they sign a form to opt out.

The White House indicates that the life-cycle option, investing in a mix of stocks and bonds depending on a worker's age, is the default investment choice for workers who fail to choose some other fund.

■ *Optional annuities:* The Bush plan requires annuities only in cases where a retiree's basic Social Security benefit falls below the poverty line. By making annuities optional above that line instead of mandatory as some suggest, the Bush plan provides freedom of choice in exchange for some disadvantages.

Explanations of payout options will be complicated and probably not well understood. Some retirees will outlive their savings and see a substantial decrease in their retirement income. Annuity rates will be unattractive because only the healthiest

people will elect to buy annuities. And men who really want to buy annuities may find they can get a better deal outside the plan, avoiding the plan's unisex rates and getting credit for their shorter average life span from private insurers.

Still, this feature of the Bush plan appeals to the vast majority of people who traditionally refuse to buy annuities and to some groups who are concerned that annuities discriminate against them because of their shorter average life spans.

■ *Social Security's collection system:* The current system for collecting and crediting Social Security tax contributions seems a bit primitive by 21st-century standards. A VPA program that interfaces with this system needs careful design and handling to avoid unacceptable errors and delays, such as commonly occur in Social Security record keeping.

Meanwhile, the TSP's administrative system has improved greatly in its brief lifetime, for example, in using the Internet to communicate with participants directly. In this respect, the TSP may serve as a good model for the much larger and older agency that administers Social Security and that may be asked to help meet the challenging new demands of a VPA program. ●

DICK SCHREITMUELLER, an actuary in Kensington, Md., helped design and launch the Thrift Savings Plan while working for the Senate Governmental Affairs Committee and the Federal Retirement Thrift Investment Board in 1985-87.