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Congress Should Add Auto-Enrollment to the Thrift Savings Plan, But Resist Interfering in Its Investment Choices

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Congress will improve the retirement security of millions of federal workers if it agrees to add auto-enrollment to the Thrift Savings Plan (TSP), a part of the federal government's employee retirement system. Under auto-enrollment, a worker participates in TSP unless he or she opts out of it. Last year, the Federal Retirement Thrift Investment Board (FRTIB), which manages TSP and has a fiduciary responsibility to ensure that TSP operates solely for the benefit of federal workers, voted to ask Congress for the authority to automatically enroll new and returning workers into TSP. The recommendation also has the support of TSP's Employee Thrift Advisory Council. Establishing auto-enrollment would especially help military personnel, whose participation rate in TSP is well below that of civilian employees.

On July 16, 2008, the House Oversight Committee agreed to H.R. 6500, which would implement this request. However, the committee made a serious error by retaining the "G" Fund as the automatic investment option. As discussed below, the "G" Fund practically guarantees that workers will not be able to save enough for a secure retirement. Instead, Congress should follow the FRTIB's recommendation and establish the "L" Fund as an automatic investment option.

Congress would, however, undermine federal workers' retirement security if it acts to limit TSP enrollees' investment options. A number of legislators have expressed support for proposals that would require TSP and other pension plans to stop investing in companies that do business in Sudan or Iran, and others want the program to establish a "corporate responsibility" investment option. At the same time, the FRTIB also voted to strongly oppose any such legislation. These proposals would cost federal workers millions of dollars that should be going to fund their retirements and introduce politics into a program that has been solely dedicated to improving the retirement incomes of federal workers.

How the TSP Works. The TSP is one element of the Federal Employees' Retirement System, managing over $200 billion of retirement savings for about 3.7 million federal civilian employees and military personnel. Since its creation in 1986, TSP has grown from one fund that invested in federal government bonds to five individual funds and a "lifestyle portfolio" that includes investments in all five funds. TSP members control how their retirement savings are invested and have the ability to move their savings between the funds at will.

At the end of 2006, 38 percent of TSP's assets were invested in an S&P 500 stock index fund,

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while 36 percent were invested in government bonds, 11 percent in an international stock index fund, 9 percent in a small and medium sized company fund, and 6 percent in a bond index fund. Funds have been added to TSP slowly, with the government bond fund opening in April 1987, the stock and bond index funds in January 1988, and the international stock index and the small cap funds in May 2001. The lifestyle portfolios incorporating various proportions of the five funds appeared in August 2005.

TSP administrative fees are extremely low, averaging about 30 cents for every $1,000 invested (3 basis points) in 2006. This is artificially low, because federal agencies absorb some of the administrative costs, but as a result, federal employees receive one of the best bargains in retirement investing. Management of the funds is contracted out to private sector investment managers based on a periodic bidding process. Currently, all of the funds except for the government bond fund are managed by Barclays Global Investors.

A key factor in TSP's success is the limited number of funds that it makes available to members. Research shows that many participants in 401(k) plans become confused when their plan offers too many investment choices. Too many funds can actually reduce participation.

TSP's one weakness is that unless a worker designates another investment choice, his or her money goes into a government bond index fund (G Fund). While this is a safe choice that has almost no chance of losing money, it also will not earn nearly enough for a comfortable retirement income. The FRTIB proposes to address this weakness by making the lifestyle fund (L Fund) the automatic investment choice for members who do not choose to actively manage their funds and to move to automatically enroll federal workers at a certain investment amount unless they actively choose not to join.

Auto-Enrollment: An Important Improvement. Auto-enrollment is perhaps the single most important improvement to retirement savings plans for many years, and adding it to TSP will help federal employees to achieve retirement security. Under the current TSP structure, a worker who is considering enrolling must make several decisions that he or she may not feel qualified to make. These include how much to save and what investments to choose. Faced with important decisions that could cause a loss if the wrong choice is made, many workers simply do nothing. As a result, they do not save, and their retirements will be less secure.

Under auto-enrollment, the situation would be reversed. Unless the worker chooses otherwise, he or she would be automatically enrolled in TSP, contribute a set proportion of income, and invest in the retirement fund (the L Fund) that is most likely to produce a suitable level of retirement savings. The worker will still have the right to change any of those decisions, but in this case, inertia works to his or her benefit, increasing the worker's retirement security. Studies of auto-enrollment in 401(k) plans show that participation rates reach and exceed 80 to 85 percent of the workforce for all groups, including lower income workers, younger workers, women, and minorities. Without auto-enrollment, members of these groups are the least likely to save for retirement and the most likely to need additional retirement income beyond that provided by Social Security.

In the case of TSP, auto-enrollment offers several advantages. While participation among civilian workers is already high, participation for military personnel is only about 25 percent. Under the FRTIB proposal, all workers, both new and returning, would be auto-enrolled at the time of employment and would contribute 3 percent of income to TSP. Those who decide not to participate would have 90 days to opt out and would receive their contributions back.

Equally as important, the FRTIB plan would change TSP's automatic investment option from the G Fund, which invests in government bonds, to the L Fund, a mixture of stocks, commercial bonds, and government bonds. The investment mix of the L Fund changes gradually and automatically over time based on when the individual worker plans to retire, shifting into more conservative investments as the worker ages. This serves to enable larger investment gains while the worker is younger and then to protect those gains from market volatility as the worker nears retirement age.

The difference between automatic investment

options is especially significant for younger workers. For the 12 months ending in May 2007, the G Fund had a rate of return of 4.92 percent, while the L Fund for those retiring after 2035 earned 20.92 percent and the L Fund for those retiring in the next few years earned 8.64 percent. Though the L Fund has a higher level of risk than the G Fund, the difference in rates of return, especially for younger workers who can and should bear more risk as they are decades away from the end of their working lives, could result in a much greater retirement income.

Mixing Retirement Savings and Foreign Policy. Early in the 110th Congress, Members of the House and Senate introduced three bills that threatened TSP's focus on improving federal employees' retirement security. Two were amended to drop language directly affecting TSP, passed the House by wide margins on July 31, and are now before the Senate. The third is unlikely to see further action. These bills may, however, presage future legislative initiatives.

Section 4(b) of the Darfur Accountability and Divestment Act (HR 180), introduced by Representative Barbara Lee (D–CA), would have required the Government Accountability Office (GAO) to "investigate the existence and extent of all Federal Retirement Thrift Investment Board investments in companies" identified as doing business in Sudan. That information would be reported to Congress annually. The clear intention was for Congress to use the information to pressure FRTIB to stop investing in those companies. This provision was deleted before the bill was considered by the House of Representatives.

Similarly, Section 7 of the initial version of the Iran Sanctions Enabling Act (H.R. 2347), introduced by Representative Barney Frank (D–MA), would have stated the sense of Congress that "the Federal Retirement Thrift Investment Board should initiate efforts to provide a terror-free international investment option among the funds of the Thrift Savings Fund" that would not invest in "the stock of companies that do business in any country the government of which the Secretary of State has determined… is a government that has repeatedly provided support for acts of international terrorism." While a sense of Congress resolution does not carry the force of law, FRTIB would have seen it as a threat to legislate if it failed to act. This provision also was deleted before the bill received House consideration.

Finally, Section 1(d) of Rep. Illeana Ros-Lehtinen's (R–FL) H.R. 1357, which also concerns pension investments in Iran, would have required TSP, "to the extent consistent with legal and fiduciary duties," to divest investments in any companies identified as having invested more than $20 million in Iran's energy sector since August 5, 1996, and Section 1(f) would have prohibited any future investment in those companies. H.R. 1357 has not been considered.

Raising Costs on Federal Workers. While the House removed TSP-related provisions of the two bills that it considered before passing them, they could be added back in the Senate or included in legislation allowing TSP to establish auto-enrollment. Such a move would complicate administration of the TSP, possibly raising fees, and take the first step in politicizing the investment of federal workers' retirement savings.

All of TSP's non-government bond investment choices are index funds directly related to stock indices that are widely available, extremely low cost, and simple to track. To a large extent, TSP's low administrative fees are due to using index funds that have been developed by firms such as S&P and Dow-Jones and that can be traded by computer. Reconfiguring these indices to remove certain companies is very expensive, especially if that list of companies changes regularly.

According to the consulting firm Ennis Knupp & Associates, reconfiguring TSP's I Fund (which invests in international stocks) to avoid investing in non-U.S. companies that do business in either Iran or Sudan would cost $30 million for the first year and another $12.5 million every year after that. This represents a doubling of the annual administrative cost of the fund, from 0.03 percent of assets to about 0.08 percent.

One reason for the high cost comes from the fact that most stock indices weight stocks listed in the index rather than treating them equally. For instance, TSP's S Fund, which is based upon the S&P 500 stock index, does not just invest equal

amounts in 500 selected stocks. Instead, the S&P 500 index is weighted by market float. Under market float weighting, the proportion of each stock's share of the index is equal to the number of shares that S&P determines are available for public trading times the stock price. In order to determine the value of the S&P 500 index at any point, this calculation is performed for all 500 stocks on the index and summed. In the case of the S Fund, the proportion of the fund invested in each company is the proportion of its market float to the total market float of all the 500 stocks contained in the index.

When a company is removed from an index, as would have been required by the Darfur and Iran bills, it has to be replaced by another or the overall size of the index must shrink. In either case, the weightings of the stocks on the reconfigured index must be changed. This procedure is time-consuming and expensive.

Cutting out companies that invest in certain countries would radically change the focus of TSP. Given that the reason for making such a change is a foreign or political policy goal, rather than a pension fund's fiduciary duty to focus on maximizing a worker's retirement income, the result is that a worker's retirement money would be, by legal and fiduciary standards, misused. Though there are excellent political reasons for not investing in companies that do business in either Iran or Sudan, affecting foreign policy is not the purpose of either TSP or any other pension fund.

Any decision to inject politics into TSP investments could lead to a slippery slope. It is only a short step from requiring pension funds to base their investment decisions on foreign policy goals to basing them on short-term politics. This has actually happened in a number of state government employees' pension funds, where pension funds have been invested in factories that soon closed, public works projects that failed to produce profits, and similar projects that ended up causing significant losses for retirees.[1] TSP has been used exclusively to build federal workers' retirement security. It should not be used for any other purpose.

Don't Politicize TSP. In addition to efforts to force TSP to stop investing in companies that do business in Darfur or Iran, another bill would *require* TSP to offer a certain investment option to its members. The Federal Employees Responsible Investment Act (H.R. 2519), introduced by Representatives James Langevin (D–RI) and Chris Shays (R–CT) would require the TSP to offer a "corporate responsibility" investment option. According to Representative Langevin, this would be "a widely known stock index that only invests in stocks that meet strict financial and social responsibility criteria. These companies must meet standards including safe environmental practices, sound corporate governance, community involvement, and human rights worldwide."

This is the latest congressional attempt to create new TSP funds. In the last Congress, FRTIB successfully opposed legislation supported by almost 180 House Members that would have forced TSP to offer a stock index fund based on Real Estate Investment Trusts (REITs). It also opposed earlier attempts to prevent TSP from investing in companies that do business in particular countries.

The consulting firm Ennis Knupp & Associates has noted that it would be difficult to set up a "corporate responsibility" fund because of the difficulty in arriving at a consensus definition of what is and is not an acceptable business practice. The firm recommended against setting up such a fund.

Congress should leave choosing investment options to FRTIB. All of the funds in the TSP today were added only after being recommended by the FRTIB, which has a fiduciary responsibility to ensure that TSP operates solely for the benefit of federal workers. Wisely, the FRTIB has retained its exclusive focus on the retirement needs of its members, and it should continue to do so. In return, Congress should not attempt to force TSP to include any specific funds.

Conclusion. TSP is one of the most successful

1. For more information about state pension plan investments, see Daniel J. Mitchell, Ph.D., "Government-Controlled Investment: The Wrong Answer to the Wrong Question," Heritage Foundation *Backgrounder* No. 1841, April 11, 2005, at *www.heritage.org/Research/SocialSecurity/bg1841.cfm*.

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retirement investment vehicles ever created. In a large part, it has succeeded because its governing board considers only its members' need to build adequate retirement savings. As a result, federal employees today can have full confidence that their interests will come before whatever political winds are currently blowing in Washington.

Auto-enrollment, a policy recommended by that governing board, is one of the most effective ways to ensure that employees can adequately save for their retirements, and Congress should add this feature to TSP. At the same time, Congress should change TSP's automatic investment choice from the G Fund to the L Fund. Both changes are in the best interest of federal workers and will especially help those who need to save the most: younger workers, lower income workers, women, and minorities.

Congress should also resist attempts to use that legislation to modify TSP's investment choices. While there are good reasons to be concerned about Sudan and Iran, TSP is simply the wrong place to take action against those regimes. Similarly, Congress should avoid forcing the FRTIB to add any funds, regardless of whether they are ethical investment funds, sector funds (e.g., REIT funds), or any other choices that FRTIB has not requested.

The risk of injecting politics into TSP is that its focus will begin to shift from the needs of its members to short-term political goals and the agendas of particular industries or interest groups. Such a step would eventually lead to efforts to force TSP to invest in politically approved projects that do not earn adequate returns. Many state and local government employee retirement plans have been forced to make investments for political reasons, and most of them have sustained serious losses as a result. Retirement savings plans should encourage investment decisions that are solely in the best financial interest of retirees, not based on political or social goals, no matter how well-intended.

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