STATEMENT OF

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SUBCOMMITTEE ON THE FEDERAL WORKFORCE, POSTAL SERVICE, AND THE DISTRICT OF COLUMBIA

HOUSE COMMITTEE ON OVERSIGHT AND GOVERNMENT REFORM

ON

MANAGING THE THRIFT SAVINGS PLAN TO THRIVE

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Mr. Chairman and Members of the Subcommittee: My name is J. David Cox, Sr., and I am the National Secretary-Treasurer of the American Federation of Government Employees, AFL-CIO (AFGE), the largest federal employee union representing more than 600,000 workers in agencies throughout the nation and around the world. I thank you for the opportunity to testify today on issues related to the policies, regulations, and administration of the Thrift Savings Program (TSP).

The Thrift Savings Plan Enhancement Act of 2009

The enactment of the Thrift Savings Plan Enhancement Act of 2009 effected many changes for the TSP, including immediate agency contributions and automatic enrollment for new employees, as well as the opportunity for spouse beneficiaries to maintain a TSP account in their own names and receive a federal employee death benefit into a TSP account. The law also directed the program to establish Roth-type TSP accounts as an option for participants, and authorized the TSP to offer a so-called "mutual fund window" to allow participants to invest some of the TSP money in mutual funds that are not part of the current fund options.

AFGE supported passage of the Thrift Savings Plan Enhancement Act, but we did not support all elements of it. We strongly supported immediate agency contributions, because there was no policy or technical rationale for delaying the opportunity for federal employees to receive the benefit of government matching contributions or the one percent of salary deposit. The former delay in receiving these benefits cost federal employees months of investment gains and AFGE was happy to see this unjustifiable delay corrected. AFGE also supported automatic enrollment for new employees. Although the notion of effectively "reducing" new employees' salaries by three percent without their affirmative consent was somewhat controversial, we believed that the cost of foregoing the extra four percent of salary that failure to enroll would entail was too high a price to pay. The government match of the three percent of salary savings, as well as the automatic extra one percent, form a crucial part of federal employee compensation. We surveyed our members and although some expressed misgivings about automatic enrollment, the majority believed that as long as there was ample opportunity to decline enrollment, that having the "default" action to be enrollment was the preferred policy option.

We believe that it will be important for the TSP to undertake a serious education effort with regard to the costs and benefits of the new Roth-type TSP accounts. Our analysis suggests that relatively few AFGE members would be better off choosing to receive their government match into a Roth-type account, and it will be important that they are fully aware of the differences between the two kinds of savings vehicles. No one likes to pay taxes, and it may seem to many that not having to pay taxes on withdrawals in retirement will be a "better deal" than being able to make tax-free deposits now and paying taxes later. For the majority of federal employees, that may be a very costly mistake. Nevertheless, we recognize that for some federal employees, the establishment of Roth-type accounts in the TSP will be advantageous, and for that reason AFGE supported their becoming an option in the program.

The Question of a Mutual Fund "Window" in the TSP

Establishing a mutual fund "window" in the TSP, however, was another story. AFGE opposed the mutual fund window because we firmly believe that the current collection of investment options within the program is close to optimal. We believe that in almost every case, federal employees who would choose to utilize this mutual fund window would lower their overall rate of return on their savings, not only by exposing themselves to unnecessary risk, but also by paying the large fees and "load" charges that mutual funds impose on investors. Further, it is not the practice in large private or public sector defined contribution programs to allow participants to have such a "window" largely because it imposes such large and unnecessary risk and expense.

One of the main virtues of the TSP is its extraordinarily low administrative costs. Private mutual funds impose on their investors a wide array of fees and "expenses" such as sales loads, deferred sales charges, redemption fees, exchange fees, annual account fees, purchase fees, management fees, distribution fees, and other "expenses." Although these fees and practices must be disclosed in the fund's prospectus, few people actually read this kind of fine print, and those who do rarely understand it, and can be shocked to learn later how much of their investment and profit is lost to such fees. This is not to say that the investment management companies that sell mutual funds do not deserve to make a living; AFGE does not begrudge them the reimbursement of their costs, the commissions for their salespeople, or even their profits (as long as they are reasonable). But we are quite pleased that federal employees are able to enjoy an extremely wide range of investment opportunities that cost them very little in administrative overhead. Indeed, the TSP as currently constituted offers its participants virtually every investment opportunity at truly minimal cost.

There is no real benefit to be had for a TSP participant to choose to invest in a private mutual fund rather than one or a combination of current TSP funds. That is the bottom line. Mutual fund fees can eat up half or more of an investor's returns over time. If someone were to invest $10,000 in a private mutual fund and keep it for 30 years with a six percent annual rate of return, that $10,000 would turn into $57, 434 with no fees. But with a two percent annual fee, the investor would only have $31,330 over the 30 years. The difference in rate of return in this example is 45.5%. And the assumption of a two percent annual fee is modest; many mutual funds charge various fees that exceed this amount. Although the TSP could negotiate favorable terms from the mutual funds that could sell in the "window," as this simple numerical example shows, the current TSP funds are a far better deal. The TSP investor would bear some administrative costs, but the amount would actually be quite close to $57,000, and the $25,000 or $26,000 is an enormous sum and an enormous benefit of the current investment options.

Unless the TSP is able to negotiate with the investment management companies that sell mutual funds a set of administrative costs, fees, and profits that are as low as the current fund options' costs, then AFGE believes that it is not in the best interest of the plan's participants to pursue the mutual fund "window" option. Because the plan's administrators are required, as part of their fiduciary responsibilities, to act solely in the interests of participants, AFGE believes that the TSP should not exercise its authority under the law to create the mutual fund "window."

Allowing Deposits of Unused Annual Leave into TSP

An important issue left unaddressed in the Thrift Savings Plan Enhancement Act was a change to Title 5 which allows federal employees to deposit the dollar value of unused annual leave into their TSP accounts. Internal Revenue Service (IRS) rules allow private sector employees who have unused paid time off that exceeds their employer's carryover limit to contribute that money into their 401(k) accounts as long as the employee would be eligible to receive the dollar value of the unused leave in a lump sum at retirement. Federal employees' unused sick leave cannot be converted into a lump sum payment at retirement, but unused annual leave can. Federal employees are forced to "use or lose" annual leave, that is, they are subject to limits on the amount of annual leave they can "bank" or carry over from year to year. And when federal employees retire, they are eligible to receive in a lump sum the dollar value of any unused annual leave they have accumulated and accrued. Unfortunately, in order for federal employees to be able to take advantage of the current IRS rules regarding the deposit of the dollar value of unused paid leave into their TSP accounts, Congress must amend the current law. AFGE urges lawmakers to make this important change so that federal employees have the same opportunities for retirement savings as their counterparts in the private sector and state and local governments.

The Employee Thrift Advisory Committee (ETAC)

When Congress was working to develop the Federal Employees Retirement System (FERS), AFGE worked hard to make sure that the legislation would require the establishment of an employee advisory committee for the TSP so that the concerns of the employees who finance the bulk of the plan's assets would be heard and considered. The law that was enacted did provide for such a forum, and I am happy to report that the Employee Thrift Advisory Committee (ETAC) has operated effectively as a means of facilitating pre-decisional employee input on a wide range of administrative and regulatory issues. It has also served to keep federal employees informed of impending changes and helped its constituent organizations to educate our members on how to make the most of their opportunities under the law. We also believe that both federal employees and the Federal Retirement Thrift Investment Board (FRTIB) have benefited immensely from the unions' ability to help determine the policy direction of the TSP through the ETAC. Indeed, the ETAC works so well for both employees and the TSP program itself that AFGE is working to establish a similar employee advisory committee for the Federal Employees Health Benefits Program (FEHBP), which lacks any means for federal employee input. We firmly believe that with the establishment of an ETAC-like advisory structure for FEHBP it might be possible for that program to begin to attain some of the virtues of the TSP with regard to efficiency, transparency, and accountability.

Restricting the Number of Free Interfund Transfers in TSP

In 2008, the TSP issued a new regulation that restricted TSP participants to two free interfund transfers per month. The new regulation was a response to the finding that the "frequent trading" activities of a small group of TSP participants were creating significant costs for the program as a whole and lowered overall rates of return to all of the affected funds. Most of the "frequent trading" has occurred in the I Fund (International Fund). The FRTIB's internal analysis concluded that trading in the I fund in 2006 cost *all* of the participants in the fund 0.08% of the return they would have received otherwise. To put this into perspective, in 2006, the total expense ratio of the entire TSP – all its overhead and administrative costs put together – costs only three basis points.

AFGE supported the imposition of restrictions, but would have preferred a slightly higher maximum. We were persuaded, however, that it was not in the best interest of participants to continue the policy of unlimited free interfund transfers. It was difficult to know for sure what the costs would be for the continuation of the former policy because foreign markets are closed by the time that the I Fund's orders are received each day. Since the trades are executed the next day, when foreign markets re-open, the prices were often different from what they were when the trade order was made. But all differences in prices between when I Fund trades are ordered and when they are executed are charged to the whole Fund, not to the individual participants who bought and sold. That is why the activities of a few were having a negative impact on the returns experienced by the I Fund as a whole. Differences in price between the time when an order is made and executed can affect any of the Funds that hold equities, but the large time differences between the eastern U.S. and many foreign markets have had the largest impact.

Another source of cost for frequent trading had to do with the fact that stock and bond trades settle three days after the trade date – that is when the money actually changes hands. The way the TSP operates allows TSP participants to credit proceeds from sales the next day, and it is up to the investment manager to bridge the divide. Again, the peculiarities of the I Fund make it more expensive to accomplish this task than for the other Funds that trade in private equities.

In response to the market-timing scandals among private mutual fund firms in 2002, the Securities and Exchange Commission (SEC) started allowing them to charge redemption fees to customers when they could show that the fees were in the best overall interest of a fund (as opposed to the best interests of individual fund holders). Instead of imposing redemption fees, the FRTIB issued a regulatory restriction to the number of interfund transfers permitted in a given month. When the regulation was first proposed, AFGE offered the following comment:

> *We do not question the FRTIB's contention that the frequent trading activity of a small minority of the TSP population, especially in and out of the I Fund, imposes large costs upon the system as a whole. We recognize that the policy of allowing unlimited numbers of free trades is not the practice of any large mutual fund company or defined-contribution retirement plan in either the public or private sector. Further, we understand that the process of effecting international sales and purchases of fund shares sometimes takes days, and that when frequent traders exploit this fact, they sometimes do so at a cost to their fellow I fund*

shareholders who realize a lower rate of return than they would in the absence of frequent trading.

We believe that the FTRIB's proposal is unnecessarily restrictive with respect to the problems it seeks to address and the costs it seeks to minimize. We believe that a more reasonable change would be to restrict TSP participants to four free interfund trades per calendar month, with unlimited interfund trades into the G-Fund. In addition, we believe that the FTRIB should follow the practice of many private financial services and mutual fund companies, and rather than disallow more than two interfund transfers per month, charge traders a fee of two percent of the value of the trade for all interfund trades that exceed this number. We have considered the FRTIB's claim that it would be too cumbersome and costly to track trading activities and assess this fee, but we believe the trade-off is worthwhile. Numerous AFGE members have expressed their support for charging the full cost of excessive interfund transfers to individual traders. We believe that not only will this serve as a disincentive to imprudent, high-risk behavior, it will either minimize or even eliminate the adverse impact of frequent trading on those who refrain from the practice.

Nevertheless, the FRTIB chose to retain its original proposal of limiting participants to two interfund transfers per month, while maintaining the ability to make unlimited transfers into the G Fund. AFGE understands that this regulation was issued to fulfill what the Board understood to be its fiduciary responsibility to the plan as a whole.

The TSP and Questions of Inherently Governmental Work

In the last decade, the TSP has outsourced several information technology and record-keeping functions and virtually all of its expansions of work. As the agency contemplates how it will staff the new requirements from the Thrift Savings Plan Enhancement Act, we are hopeful that they will be scrupulous in making sure not only that they follow the law that requires them to hire federal employees for all inherently governmental and near-inherently governmental work, but also that they consider carefully what TSP work may have been improperly contracted out in the past, and act to bring it back in-house. The TSP should not only work to insource inherently governmental work that was wrongly outsourced, but should also insource work that is closely related to inherently governmental work as well as contracted out work that could be performed by federal employees at less cost to the agency. Finally, we believe it should be a high priority of the agency to maintain in-house capacity in every area and function that the agency needs on an ongoing basis. This is not only an operational and security imperative, but it is also prudent from a fiduciary responsibility perspective.

Conclusion

AFGE is grateful for the Subcommittee's attention to issues surrounding the operation and policy of the TSP. We believe that the agency has made prudent decisions regarding the program, has acted in good faith by treating the ETAC with respect, and has upheld high standards for accountability, transparency, and responsiveness. We urge the Subcommittee to enact legislation that would allow federal employees to deposit the dollar value of unused annual leave into their TSP accounts. Finally, we ask that the Subcommittee continue to hold the agency accountable for its adherence to federal laws concerning government performance of inherently governmental work and work that is closely connected to inherently governmental work. This concludes my statement. I will be happy to answer any questions members of the Subcommittee may have.