STATEMENT
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PRINCIPAL
STATE STREET GLOBAL ADVISORS

Mr. Chairman, members of the committee, thank you for the opportunity to appear before you today. My name is James Phalen, and I am a principal at State Street Global Advisors, the investment management division of the State Street Corporation of Boston.

Overall, the State Street Corporation today holds some $4.4 trillion in customers assets in custody and we directly manage $458 billion in customer funds -the bulk of these in retirement assets. My job at State Street Global Advisors is to oversee our defined contribution retirement plan business - through which we service three million individual retirement accounts.

State Street's Chairman and Chief Executive Officer, Marshall N. Carter, has been engaged in the continuing national debate about how best to revitalize and re-secure Social Security for a number of years now and we at State Street stand willing to help you in your efforts in any way that we can.

As Congress considers the possibility of creating an individual investment account option within the context of Social Security, my purpose here today is not to offer a specific proposal for such a system.

It is, rather, to share with you some lessons from our experience in the defined contribution business in the hope that some of those lessons will be useful to you as you contemplate whether to establish individual accounts as part of the Social Security system.

But let me be clear. We at State Street do believe that creating individual accounts in connection with Social Security would provide an historic opportunity for millions of working Americans. Families who have never owned financial assets or directly benefited from the growth of our nation's dynamic financial markets would begin do so.

Such a reform would also create an enhanced awareness among all American taxpayers that they are saving for their own retirement security.

Principles for Engaging Individual Accounts In Any Social Security Solution

But if individual investment accounts are to be considered as an element of reform - we at State Street also believe that there are some real constraints on how they might be implemented.

- First, they must be strictly regulated and fees must be kept low by intense competition.

- Second, the assets must be soundly invested and diversified across stocks, bonds and other instruments and adjusted to suit a retiree's age and risk profile.

- To keep costs down, investment options must be minimal in the initial years of implementation - with a quite limited number of investment choices - similar to the Federal Employees Retirement System.

- Finally, such accounts must not impose heavy new costs or administrative burdens on employers -- especially small businesses.

Technical and Administrative Challenges

In addition to these basic principles, there are also a series of demanding technical and administrative hurdles that must be addressed if the individual account option is to meet the test of economic and political viability.

As a company, a trust bank that does accounting for millions of accounts, we at State Street take the issue of practicality very seriously.

And when we talk about a universal program like Social Security - which must meet the needs of all Americans -the purely technical aspects of record-keeping, accounting, and investment management for something over 150 million people, is really daunting.

Let me give you some statistics to illustrate the scope of this challenge:

- 7 million U.S. employers still file their tax information on paper.

- Now, while full electronic reporting of these records is mandated -in theory - by 1999, total compliance could well stretch into the next century.

- More than 30 million employees farm workers, part-time employees and others -- have taxable income of less than $5,000 annually.

- If an individual account investment option involved 2% of payroll, these people would be depositing just $100 a year--barely $5 per pay period into an individual investment account. Even at 5% of salary directed into an investment account, their annual contributions could be just $250 or less.

- There is also a long time-lag -up to 18 months, longer in some cases -- between collection and reporting of individual FICA taxes.

- Employers collect every pay-day, but they only report individual's contributions annually. Processing of this data by the IRS and SSA takes more time - before individual FICA contributions could be broken out and directed toward investments.

- A system of individual investment accounts would have to "piggy-back" on these existing information flows - in order to avoid heavy new costs for small employers.

Far from being a huge "bonanza" for Wall Street or financial service firms, as some have charged - taking on the task of record-keeping, reporting and managing millions of individually tiny accounts would test the capabilities of even the most sophisticated financial companies.

Nonetheless, we at State Street believe that in the United States today we have the experience, the technical know-how, and the financial infrastructure to meet these challenges and create a system of individual retirement security accounts for all working Americans.

If the Congress were to choose to establish such accounts, the possible approaches range from creating a basic structure with no investment choice for the individual and few account options to establishing an elaborate structure that offers a full range of services and choices similiar to the most advanced defined contribution plans.

The most sophisticated defined contribution plans permit account-holders to make contributions each pay period, to shift their investments to any one of dozens, even hundreds of investment options including mutual funds, stocks, bonds and money markets.

These systems permit account holders virtually unlimited access to their accounts via telephone or the Internet.

They allow for loans against account balances and permit early withdrawals, annuity payouts and lump sum rollovers to IRAs. In most plans, statements are mailed to account holders on a quarterly basis and in some cases monthly.

The most difficult decisions for participants is determining how much to save and how to invest that savings.

Such plans require complex tax reporting, discrimination testing and extensive communications with account holders concerning investment and contribution options and asset allocation.

Plan sponsors typically spend considerable time and money to educate their account holders so that they make informed investment and contribution decisions given their age and investment goals.

One of the clearest lessons from America's defined contribution plan experience is that the more choice offered to account-holders, the more complex the system of individual accounts -- the more expensive the system.

Partly for that reason, when considering a system of individual accounts linked to Social Security, I would caution you on a structure in the early years that offers extensive choice since it is choice more than anything that drives up the cost of fund administration.

And choice, in the early years of such a program when account balances would be quite small -- would frankly offer limited value to account holders.

In this respect, the experience our country has had with defined contribution plans is instructive.

The 401(k) Experience

In the early 1980s, typical 401k) accounts had relatively low balances. Back then, most account holders had limited investment choice, they received infrequent statements and were restricted on how often they could change their investment options.

But through the years, as defined contribution account balances have grown, account-holders have increased their demand for more choice and flexibility.

Today, 401(k) balances in the U.S. exceed $1 trillion and the average 401(k) account balance is more than $25,000.

With such amounts, choice has more value; investors can tailor their investments to meet their retirement planning needs and the total annual cost as a percentage of the account balance is relatively low - indeed, very low in the best plans.

One of the best examples of how funds can be practically pooled, then invested in market-based options

-- and at a reasonable cost -- is the Thrift Savings Plan of the Federal Employees Retirement System.

TSP now covers 2.3 million federal employees -including almost all members of Congress, the Administration and their staffs. While not the largest pension plan in America, the program held assets of $58 billion at the end of last year.

The TSP plan, which offers three basic investment options - a Treasury bond fund, a stock fund and a bond index fund - has provided median returns of about 8.5% -- **net of fees --** since its inception.

It enjoys a very low administrative overhead of about 1/10th of 1%. In financial jargon that's ten "basis points." In plain English, that's a dime a year on every $100 invested.

Now, we've also had the benefit in this country of the experience of thousands of 401(k) plans -- and their accompanying 457, 403(B) plans for the public sector. An estimated 32 million Americans held more than $1 trillion through these plans by the end of 1996.

The number of 401(k)s has grown from 68,000 in 1988 to more than 220,000 by 1996- with rising participation rates and more sophisticated investment patterns over time through employee education.

The best, most-cost effective 401(k) plans are generally established by large corporations. They offer participants not only investment management, but trust/trustee accounting, employee communications and a tremendous amount of investor education.

In fact, the trend in the industry is towards increased services - often including daily valuation of your funds, phone-centers on an 800 number that work 24 hours a day. And investment choices have grown from four options several years ago to generally eight options now.

Some companies, like Exxon, have been able to keep their administrative cost to as low as 1/20th of one percent -- five basis points - a nickel per year for each $100 invested -- by offering only a limited number of broadly-based funds.

We see the average, passively managed or "indexed" 401(k) plan, incurring a cost to the participants of only 15 to 20 basis points - 20 cents per year or less per $100 invested.

As for the average actively managed 401(k), where they are actually picking stocks, costs for the best plans run in the 50 to 60 basis point range - just over half a dollar a year for each $100 invested.

I don't mean to suggest that 401(k)-plans are any kind of panacea, because unlike Social Security, they are not universal.

Many part-timers have no access to them. Some allow lump-sum withdrawals or excessive loans- which undermine the purpose of retirement finance.

But the 401(k) experience does offer one clear lesson for us in thinking about how individual investment accounts might play a role in revitalizing Social Security.

The lesson is that ***large institutions have the bargaining power to drive down administrative overhead costs and increase services for members***.

The bargaining power of the trustees or administrators who might contract out some Social Security funds to investment managers would, clearly, be enormous. Competition would tend to keep fees razor-thin, just as we've seen in every other aspect of the financial services industry.

If you're still paying 18 percent for your credit card, you'll probably want to look around. There are a lot of 7 or 8 percent cards out there. The same kind of thing would happen to these administrative services.

I cite these best practices - and these price-cutting competitive pressures - not as explicit models -- but as strong evidence that a system of individual investment accounts within the Social Security context could be undertaken at quite reasonable costs.

An Evolutionary Approach

One option for initiating a system of individual investment accounts might be to take some of the lessons from the evolution of the defined contribution business and create what amounts to an evolutionary model: one that starts modestly and over time expands into a larger, more sophisticated structure with more choice.

Under this evolutionary approach, you could begin with a very simple administrative system that maintains accounts for every worker paying FICA taxes.

It would, of course, be necessary to fully automate the flow of contribution data from SSA to a record keeping system. It is imperative that the SSA be able to automate the flow of individual account records on a timely basis.

Initially, the account balance updates might only be done annually but the longer-term solution should entail more frequent updates.

Although there are similarities between Defined Contribution retirement accounts and the concept of individual investment accounts within Social Security, the record keeping and administration requirements to maintain an individual SSA account would actually be simpler in many ways than for today's 401(k) accounts.

With individual SSA accounts, there would be no need to maintain multiple sources of funds, employer match criteria, loan administration, merger/acquisition changes, integration to nonqualified plans, and plan discrimination testing.

All of these features add significantly to the cost of the 401(k) administration. None would apply to individual investment accounts linked to Social Security.

Other factors that will significantly influence the cost of administration are the design of any potential individual account option including the number of investment options, the method for selecting these options and the service features available -all of which are major cost drivers.

For example, service features such as frequency of statements, method of access (voice response, internet, customer service) as well as distribution options (annuities, roll-over, etc.) will significantly affect system costs in the near term- when balances are small.

Over time, of course, as account balances grow, these costs will decline as a percentage of rising pools of assets.

A Possible Design

Using commercially available technology, a system could be designed to meet the requirements of an individual account system.

It could be a custom-designed solution built specifically to meet the requirements of individual accounts linked to Social Security.

Essentially, it would be a stripped-down version of a defined contribution system but a system that needs to ultimately support the entire labor force, more than 130 million people at present.

The record keeping service itself could be subcontracted to several firms chosen by competitive bid, or, operated by the SSA, or by a well-established government service organization such as the Federal Reserve Bank.

The qualifications would include previous experience handling large-scale, high-volume, highly-automated data processing and service applications.

The cost for administration would, of course, vary widely depending upon the program's design.

If there were to be a desire to provide on "Day One" for service that is comparable to the most sophisticated 401(k) plans, such a system would be relatively expensive.

That is especially true when measured as a percentage of the likely account balances in the first years of a system of Social Security-linked individual accounts.

Remember the average 401(k) account today is over $25,000. In the first year of individual accounts linked to Social Security, the typical account balance would probably be less than $500.

With average 401(k) balances 50 times greater than the average SSA account on year one, 401(k) accounts can support much higher expenses.

An interesting note, however, is that the actual per account cost to support the SSA accounts will be significantly less than the 401(k) account though not 50 times less.

Therefore, if the policy is to pursue the individual account option with account holders paying the administrative expense, the design requirements must consider the average account size.

Options and service features should be very basic in the early years and, as balances grow, the assets will support the costs associated with more choice and services.

Again, this is what happened in the 401(k) experience and we think it makes sense here.

Conclusions

Based on our preliminary analysis we are confident:

- Individual Account scenarios linked to Social Security are, indeed, feasible.
- Solutions can be designed to meet the record-keeping and administrative needs.

- Private sector and government entities are available with the experience to handle large scale technology service applications.

- If we align investment choice and service features with the growth in balances the expenses can be paid for by the account holder -without sacrificing the benefits that higher market-based returns would bring.

Mr. Chairman, members of the committee, if you decide as a matter of policy that the American people would benefit from individual accounts, I believe strongly that America has the experience, the capability, and the financial services infrastructure to meet the challenge.

We also believe that this would be in the best interests of all Americans - and most of all of working and middle class families who would be enabled to build real, personal, inheritable wealth.

At State Street, we will be pleased to assist you in whatever way we can.

Thank you and I would welcome any questions you may have.

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