MINUTES OF THE MEETING OF THE BOARD MEMBERS

June 19, 2007

Andrew M. Saul, Chairman of the Federal Retirement Thrift Investment Board, convened a meeting of the Board members on June 19, 2007, at 9:00 a.m., Eastern Time. The meeting was open to the public at the Board's offices at 1250 H Street, N.W., Washington, D.C. In attendance were Thomas A. Fink of Alaska, member; by telephone, Terrence A. Duffy of Illinois, member; by telephone, Gordon J. Whiting of New York, member; Gregory T. Long, Executive Director; Thomas K. Emswiler, Secretary and General Counsel; Mark A. Hagerty, Chief Information Officer; Pamela-Jeanne Moran, Director, Participant Services; James B. Petrick, Chief Financial Officer; Tracey A. Ray, Chief Investment Officer; and Thomas J. Trabucco, Director, External Affairs.

1. Approval of the minutes of the May 22, 2007 Board member meeting.

Chairman Saul entertained a motion for approval of the minutes of the May 22, 2007 Board member meeting. The following motion was made, seconded, and adopted without objection:

> MOTION: That the minutes of the Board member meeting held on May 22, 2007, be approved.

2. Thrift Savings Plan activity report by the Executive Director.

a. Miscellaneous Matters.

Mr. Long noted that he would make recommendations pertaining to automatically enrolling new participants in the TSP, to making an age appropriate L Fund the default fund for new participants, and adding a Roth 401(k) option. He introduced Veronica Mance from the Office of Product Development and thanked her for her contributions to developing these recommendations.

Mr. Long stated that the Government Accountability Office had issued its report on the Agency and that the report had raised only minor issues: the GAO concluded that the Agency currently leases too much space and that Board members should participate in more Board meetings by telephone rather than personally appear. We will send our response to the GAO next week.

Mr. Long reported that he had spoken with Brian Whiting of the New York USO and that the Agency would be doing outreach with that organization. Ms. Moran reported on another outreach effort to the uniformed services. She noted that she would meet with representatives from the Consumer Federation of America (CFA) regarding its military saves program. The CFA is a non-profit organization that operates under a memorandum of understanding with Office of the Under Secretary of Defense (Personnel & Readiness). Its mission is to persuade service members to reduce debt and to save more, including saving through the TSP. Mr. Long and Chairman Saul stated this is very good news because it may be a vehicle to increase TSP participation among the members of the uniformed services.

a. Monthly Participation Activity.

Mr. Long reviewed the report on TSP statistics. See "Thrift Savings Fund Statistics" (attached). He noted that the TSP has grown by almost $6 billion in one month and that investment returns were all positive. The FERS participation rate increased slightly and the total number of participants exceeds 3.7 million. Uniformed service participation continued its slow and steady growth with the overall participation rate increasing from 25 to 25.6 percent. The number of loans outstanding is unchanged.

b. Monthly Investment Performance Report.

Ms. Ray reviewed the June 8, 2007 memorandum (attached), on the performance of the G, F, C, S, I, and L Funds during May 2007.

She noted that tracking error was minimal with the exception of the I Fund due to a fair value adjustment. Tracking error for the year is very small. Trading costs were low in May. The S Fund was the best performer in May and is also the best performer for the year-to-date. The G Fund rate for June increased to 5 percent. All L Funds continue to outperform the G and F Funds. The income fund has outperformed the G Fund since inception. The percentage of FERS participants with balances in the L Funds increased from 13 to 14 percent and the percentage of uniformed service participants with balances in the L Funds increased from 15 to 16 percent. Over $21 billion is invested in the L Funds and over 500,000 participants invest in the L Funds.

Chairman Saul commented that the Wall Street Journal had reported that lifecycle funds were becoming an important component of 401(k) plans. This shows that our plan is up to date and that it is a well thought out plan. Mr. Long agreed and added that the L funds are doing exactly what they are supposed to do. Several studies predict that lifecycle funds will become the default funds for most plans as well as the biggest asset holder. Mr. Saul commented that the L Funds cover the entire equity and debt markets very well.

C. Legislative Report.

Mr. Trabucco discussed his paper entitled "Background and Basis for Federal Retirement Thrift Investment Board Position Against Using TSP Investments to Advance Political Objectives and/or Social Goals" (attached). He reported that Congress designed the TSP to operate free of political/social considerations and to operate solely in the interest of the participants and beneficiaries. His paper is intended to respectfully advise Congress that we believe the plan was designed properly and that Congress should continue to allow it to function in this manner.

Chairman Saul asked Mr. Trabucco to summarize the bills pending in Congress. The Senate bill combines an Iran Energy Sector Free fund with a sense of Congress that the TSP should offer a terror-free international investment option and a Darfur free investment option. Bills introduced in the House separate these proposals. Some of these proposals are directed exclusively at the TSP and others are aimed at all pension plans and specify that divestment would not constitute a fiduciary breach.

Chairman Saul stated that he believes it is important that the Board take a very strong stand that politics must be kept out of the TSP. It's not in the participants' best interest to use their investments to make social or political statements—that would be totally contrary to how the plan was set-up and would be a bad precedent. Mr. Duffy and Mr. Whiting concurred. Mr. Fink stated that he supported the position but that he wouldn't oppose such legislation if it was a national policy rather than targeted at the TSP. He believes that if economic sanctions could stop these terrible practices without the necessity of going to war that we should support such measures. Mr. Trabucco stated that he felt Mr. Fink was arguing that the government should make certain investments illegal and that the proposed bills were too narrow in focus. Chairman Saul added that a perfect example would be Cuba where it is illegal for any U.S. citizen to buy Cuban products or to invest in Cuba. We would of course comply with such a law, but we object to singling out the TSP to advance political objectives.

Mr. Duffy remarked that the proposals would be using the TSP as a stalking-horse. Mr. Long added that there is a big difference between requiring state defined-benefit plans to divest and requiring a 401(k) plan (like the TSP) to divest. Requiring a state defined-benefit plan to divest does not reduce the benefit to participants. It's very different for a 401(k) plan.

Chairman Saul requested a "Sense of the Board" resolution that would stress that the TSP must operate free of politics. Mr. Fink reiterated that the resolution should state that the TSP should not be singled out but that if a national economic policy could avoid a war we would not want to stand in the way of such a decision. Mr. Duffy added that we must be careful in what we express because we don't want to make a political statement that Congress could cite as the TSP's endorsement of a particular action.

Ms. Ray than commented on the Ennis Knupp report on how divesting from the Sudan would affect the TSP. She added that we are all sympathetic to these issues but we must be guided solely by what is best for TSP participants. Modern Portfolio Theory (MPT) demonstrates that divestment would expose TSP participants to greater risk. MPT holds that as the number of securities held increases then risk decreases. By excluding stocks in a divestment then risk increases. In other words, divestment increases risks.

Barclays has a $1 billion Sudan free fund. Our I Fund is $25 billion. We will lose tremendous liquidity if we went into the Sudan free fund.

Annual costs would increase 5 basis points or $12.5 million on a $220 billion fund. In addition, the divestment costs would be between $12 and $44 million. Annual recurring costs would be approximately $12.5 million and the fund's performance relative to the benchmark could be plus or minus 50 basis points. In fact, over the past five years, a BGI Sudan-free index would have underperformed the EAFE by $34 million per year. Mr. Long summarized by saying divestment would cost participants significant amounts both initially and on an on-going basis.

Chairman Saul asked about the cost of the other divestment proposals. He was told that it would be more complicated, costly, and would increase risk. But, since there aren't any Iran energy free or terror free funds to benchmark against, we cannot provide a good estimate of the total cost to participants.

3. Recommendations on Automatic enrollment, changing the default fund, and establishing a Roth feature.

Mr. Long provided his analysis and recommendations on automatic enrollment, changing the default fund, and establishing a Roth feature. See attached June 14, 2007 memorandum. He recommended submitting proposed legislation to automatically enroll new employees, to change the default from the G Fund to an age-appropriate L Fund, and to take no action on adding a Roth feature.

These recommendations were based on an analysis of the Pension Protection Act, interface with industry, discussions with think tanks, the employing agencies, and the Employee Thrift Advisory Council (ETAC). We also did a thorough analysis of the cost of each proposal.

Automatic enrollment would enroll all new employees and members of the uniformed services in the TSP at a three percent contribution rate unless they affirmatively elected otherwise. Afterwards, they would have 90 days to elect to stop contributions and have their money refunded penalty free. Beyond 90 days, a participant could still elect to stop or modify contributions but regular withdrawal rules would apply.

Approximately two-thirds of respondents to the recent survey of TSP participants wanted automatic enrollment and the ETAC endorsed the proposal. Chairman Saul asked whether the uniformed service representative favored automatic enrollment and was told that she did. Mr. Duffy asked whether these options would be clearly explained to new hires. He was told that the proposal was modeled on the rules applicable to Federal Employee Group Life Insurance so that personnel offices would be familiar with the procedures and so that it could be easily added to the regular briefings the employing agencies provide to new hires.

Mr. Long explained that the recommended initial three percent contribution rate was based on the fact that FERS matches 100 percent up to three percent and on trends in the industry. He added that we would like flexibility in the legislation to allow us to increase this rate to four or five percent if doing so was prudent in order to allow new participants to benefit from the 50 percent match on these additional contributions. The cost to modify the TSP's recordkeeping system to implement this proposal would be between one-half and 1 million dollars. We estimate approximately $100,000 in communication costs and about $150,000 in additional staffing costs at our call centers. Based on the ability to ensure that more Federal employees and members of the uniformed services are better prepared for retirement, Mr. Long concluded that the merits of this proposal outweighed its costs.

Mr. Long then discussed changing the default fund from the G Fund to an age appropriate L Fund. Respondents to the TSP participant survey favored changing the default fund to an L Fund by a margin of 2 -1. The industry is also trending toward this option and using an L Fund is consistent with the Department of Labor regulations on default funds that apply to private-sector plans.

We analyzed the activity of new hires during the period 2004-2007 as part of this recommendation. During this period, forty-eight percent took no action and remained 100 percent invested in the G Fund. Sixty-two percent of these participants were under 40 years old. The G Fund is not the correct fund for a long term retirement investment. The Employee Thrift Advisory Council supported this proposal without objection.

It would cost about $200,000 to modify the TSP record keeping system to change the default fund but we would incur no additional communication costs if this was done in conjunction with automatic enrollment and $75,000 if done as a stand alone project. Mr. Long concluded by recommending that the Board adopt this proposal.

Mr. Long then discussed adding a Roth 401(k) feature. The Roth feature was first authorized for private sector plans in 2006. However, the authorization was set to expire in 2010. Even though the Pension Protection Act made the authorization permanent, relatively few private sector plans have added this feature. Consequently, we lack adequate data to make a recommendation on adding a Roth feature. Additionally, the cost of adding a Roth feature would be significant (more than $10 million). Educating TSP participants would require a significant communication and education campaign. Adding a Roth feature would significantly increase the number and duration of calls at our service centers and discussing a Roth feature is beyond the current skill level of the participant service representatives. Mr. Long recommended that the Board defer consideration of a Roth feature until we have more data from which to determine if adding a Roth feature is in the best interest of TSP participants.

Mr. Fink stated that while he supported making an age appropriate lifecycle fund the default fund and deferring consideration of a Roth feature, he did not support automatic enrollment. He was concerned that many new employees cannot afford to contribute three percent of their pay to the TSP. Consequently, he could not support a proposal that required participants to opt out.

Mr. Long explained that an employee could opt out before the first TSP contribution was taken from the employee's pay and that this proposal would only apply to employees who made no TSP election. Mr. Long stated that studies show that the vast majority of employees who were automatically enrolled in private sector plans stayed in. The proposal would overcome the inertia of employees who don't initially elect to contribute to the TSP and therefore never or significantly delay contributing to the TSP. Chairman Saul added that those who are really financially strapped will opt out; this proposal doesn't trap them. It educates them to focus on retirement and to make a mature choice. Mr. Long stated that the ETAC representatives said it was common for their members to state that they wished someone had forced them to start saving sooner. Mr. Duffy said that he agreed 100 percent; he has talked with a significant number of people who didn't start early and regret it. The proposal gives individuals the opportunity to invest in a very successful plan with minimal education effort—it is the right thing to do.

Mr. Fink stated that he could not support automatic enrollment and moved that the motion on these proposals be expressed in a manner that would allow him to oppose automatic enrollment but favor changing the default fund and deferring consideration on adding a Roth feature.

A discussion ensued on the ability of new employees to opt out before any TSP contributions were deducted from their pay and on the ninety day period following the first contribution to stop TSP contributions and to withdraw any TSP contributions penalty free. Outside of this ninety day period, a participant could still stop TSP contributions at any time, but normal withdrawal rules would then apply. Chairman Saul stated that automatic enrollment forces new employees to make a mature choice: start saving for retirement now or suffer in their post-retirement days. He added that this proposal makes tremendous sense. Mr. Duffy stated that starting saving two or three percent of pay won't affect or change their current lifestyle one bit. But it will give them the opportunity to begin participating in a very successful plan. Mr. Whiting added that he supported all three recommendations. Mr. Fink reiterated that he wanted the motion split so that he could oppose automatic enrollment but favor changing the default fund and deferring consideration on adding a Roth feature. His motion was not seconded.

Chairman Saul entertained a motion for approval of the Executive Director's recommendations. The following motion was made, seconded, and adopted by a vote of three to one:

> Motion: That the FRTIB should (1) pursue legislation that would require civilian Federal agencies and uniformed service branches to automatically enroll newly hired (and rehired) TSP-eligible employees and service members, unless the employee/member makes an affirmative election not to participate; (2)pursue legislation that would change the TSP default fund from the G Fund to an age-appropriate L Fund for all newly enrolled participants; and (3) continue to review private sector experience with the Roth 401(k) feature and reexamine the merits of adding such a feature within the next two years.

4. <u>Sense of the Board Regarding Using TSP Investments to Advance Political Objectives and/or Social Goals</u>.

In response to Chairman Saul's earlier request, Mr. Emswiler drafted and read the following for the Board's consideration:

Sense of the Board

When Congress created the TSP, it recognized that it might be tempted to use TSP assets for political purposes. To avoid such a possibility, it structured TSP investments in index funds that cover entire markets.

Legislation has been introduced that would use the TSP to address various meritorious causes. Such legislation would alter the TSP's fundamental structure and introduce social and political considerations into TSP investments.

The Federal Retirement Thrift Investment Board opposes all efforts to alter Congress's commitment and introduce political or social considerations into TSP investment policy.

Mr. Duffy and Mr. Whiting stated that they liked the resolution. Mr. Fink stated that while he didn't like it, he would vote in favor of it. He agreed that it's not in the best economic interest of TSP participants to limit investment choices, but stated that the resolution should acknowledge that Congress might be addressing a larger problem such as avoiding war. He stated that our view on the issue might be too narrow. Chairman Saul stated that we must take the narrow view. As TSP fiduciaries, the Board members must act solely in the interest of the participants. The Board members are not responsible for the best interest of the United States when they are acting as TSP fiduciaries. While he is sympathetic to the objectives of the proposed legislation, he could not support legislation that singles out the TSP. He added that we obviously would comply with any law enacted by Congress.

Chairman Saul entertained a motion for approval of the Sense of the Board resolution that was under consideration. The following resolution was made, seconded, and adopted without objection:

Sense of the Board

When Congress created the TSP, it recognized that it might be tempted to use TSP assets for political purposes. To avoid such a possibility, it structured TSP investments in index funds that cover entire markets.

Legislation has been introduced that would use the TSP to address various meritorious causes.

Such legislation would alter the TSP's fundamental structure and introduce social and political considerations into TSP investments.

The Federal Retirement Thrift Investment Board opposes all efforts to alter Congress's commitment and introduce political or social considerations into TSP investment policy.

Chairman Saul then asked Mr. Trabucco to ensure that the appropriate Congressional officials were made aware that Board had passed this resolution unanimously. Mr. Trabucco agreed to do so immediately.

5. Additional Matters.

Mr. Fink stated that several meetings previously he had asked whether plan administrative expenses were offset by forfeitures and loan fees. Mr. Petrick had answered his questions and he wanted to make the Board aware of the answers. The financial statement showed approximately $80 million in administrative expenses and $16 million in forfeitures. Loan fees are also used to offset expenses. Consequently, only $57 million was charged to the participants because the $80 million was offset by the $23 million in "other income." The three basis point charge is based on $57 million, not $80 million. Mr. Saul stated that another significant item was the credits we receive from Barclay's for managing four of the TSP's funds. Mr. Petrick stated that these credits do not offset administrative expenses but do enhance share prices. Mr. Long added that without forfeitures and loan fees the administrative charge in 2006 would have been four basis points. Chairman Saul asked what amount we expected to charge participants this year. Mr. Petrick said that we would not exceed last year's charge, but that he couldn't yet predict whether we will be able to round down to two basis points this year.

Mr. Fink then stated that the Board should reach a consensus and not just a majority before agreeing to change meeting dates. He would have liked to participate in last month's meeting, but it had been rescheduled for the one date he was not available.

Whereupon, there being no further business, the following motion was made, seconded, and adopted without objection and Chairman Saul adjourned the meeting at 10:40 a.m.

MOTION: That this meeting be adjourned.

Thomas K. Emswiler
Secretary

NOTE: Ace-Federal Reporters, Inc. made a verbatim transcript of this meeting.

Attachments

1. Thrift Savings Fund Statistics
2. May 2007 Performance Review - G, F, C, S, and I, and L Funds
3. Background and Basis for Federal Retirement Thrift Investment Board position Against Using TSP Investments to Advance Political Objectives and/or Social Goals
4. Recommendations on Automatic Enrollment, Default Funds, and Roth Account

Addendum to Minutes

The Honorable Alejandro M. Sanchez was unable to attend the June 19, 2007 Board member meeting due to a medical emergency. However, he wanted the minutes to note that, had he been present, he would have voted in favor of the following motion:

> That the FRTIB should (1) pursue legislation that would require civilian Federal agencies and uniformed service branches to automatically enroll newly hired (and rehired) TSP-eligible employees and service members, unless the employee/member makes an affirmative election not to participate; (2)pursue legislation that would change the TSP default fund from the G Fund to an age-appropriate L Fund for all newly enrolled participants; and (3) continue to review private sector experience with the Roth 401(k) feature and reexamine the merits of adding such a feature within the next two years.