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# PRIVATE-SECTOR RETIREMENT SAVINGS PLANS: WHAT DOES THE FUTURE HOLD?

## JOINT HEARING

OF THE

## COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS

AND THE

## COMMITTEE ON FINANCE
## UNITED STATES SENATE

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

ON

EXAMINING A LONG-TERM PERSPECTIVE ON THE FUTURE OF OUR NATION'S RETIREMENT PLANS IN THE PRIVATE SECTOR

MARCH 15, 2005

Printed for the use of the Committee on Health, Education, Labor, and Pensions

U.S. GOVERNMENT PRINTING OFFICE

20–164 PDF WASHINGTON : 2005

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
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# PRIVATE-SECTOR RETIREMENT SAVINGS PLANS: WHAT DOES THE FUTURE HOLD?

**TUESDAY, MARCH 15, 2005**

U.S. SENATE,
COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS,
AND COMMITTEE ON FINANCE,
*Washington, DC.*

The committees met jointly, pursuant to notice, at 9:30 a.m., in room SD-G50, Dirksen Senate Office Building, Senator Enzi [Chairman of the Committee on Health, Education, Labor, and Pensions] presiding.

Present: Senators Enzi, Hatch, Grassley, Thomas, Burr, Kennedy, and Reed.

## OPENING STATEMENT OF SENATOR ENZI

The CHAIRMAN. It is 9:30. We would like to start on time. I will call this hearing to order.

I want to welcome you to this joint forum, conducted by the Senate Finance and the Health, Education, Labor, and Pensions Committee. I think it is historic. Chairman Grassley and I believe that Congress should be proactive on the future of our Nation. Today we will be taking a long-term perspective on the future of our Nation's retirement plans in the private sector.

Our Nation is facing a changing workforce that is growing older and becoming more adaptable as workers are changing careers more frequently, and therefore changing companies more frequently. In addition, many companies face global market pressure.

This forum is to address many of these issues, to collect as much information as possible in as short a period of time from as many experts as possible, so that we can be proactive toward helping workers and employers design retirement security plans for the future. We do not want just a short-term fix, we want to fix it. I believe fervently that we must save defined benefit plans so that employers and employees will have this valuable option in the future. The HELP and Finance Committees are committed to enacting responsible, comprehensive pension reforms this year that will stabilize the defined benefit system, that will strengthen the PBGC, and that will reduce the Agency's deficit.

We will accomplish these things this year, which means there is a long-range future for defined benefit and defined contribution plans for us to be discussing here today.

I also have a particular interest in how we can provide more small business employees with retirement benefit coverage and how small business owners can provide retirement benefit plans.

I appreciate everybody's attendance, and look forward to the roundtable discussion.

Chairman Grassley.

## OPENING STATEMENT OF SENATOR GRASSLEY

Senator GRASSLEY. Thank you very much. First of all, Senator Baucus will be along in a little while, but in the meantime I want to put a statement in the record from Senator Baucus.

[The prepared statement of Senator Baucus follows:]

### PREPARED STATEMENT OF SENATOR BAUCUS

Thank you, Chairman Enzi and Chairman Grassley, for holding this forum on the future of employer-sponsored retirement plans. I am pleased to be here with Senator Kennedy and other members of our two committees, to learn from the stakeholders who have joined us today.

Winston Churchill said: "It is always wise to look ahead, but difficult to look further than you can see." Retirement savings is a long-term challenge ahead. Today we try to see into that long term, to see as far as we can see.

Two weeks ago, the Finance Committee held a hearing on the financial status of the Pension Benefit Guarantee Corporation, and the administration's funding proposal for defined benefit plans. It was a timely hearing about a difficult subject that we have to address in the next few months.

But today we get to climb above those immediate concerns and lift our eyes to the challenges of the future.

Not the least of these challenges will be accelerating global competition. We have to work to create an environment where we can compete successfully on the global stage.

But in doing so, we must remember why success matters. Success matters so that American workers can have a good life, so that Americans who work hard can share in the success of this country. It is thus important to see the future through the lens of benefits for workers. And that is why we are here today.

James Thurber said, "It is better to know some of the questions than all of the answers." Then we are on the right track with this forum. We have thought-provoking questions to focus our discussion, and a diverse group of experienced individuals here to join us in our exploration.

I expect that we will hear different opinions not only of how the future will look, but how it should look. In other words, when we leave today, I expect that we will have more questions than answers. And that will be a good thing.

I look forward to today's far-sighted discussion. And then I look forward to tackling the challenges that we will see.

Senator GRASSLEY. For my part, I welcome all the participants, all of you as experts for your insight on the future of private retirement plan systems, and I particularly welcome Dan Houston of Principal Financial from my home State of Iowa.

It seems to me that all of you people bring a wealth of information and experience and insight to this meeting, a perspective on how things operate out there in the real world, and you are all here today because of sharing one common goal, improving our private retirement system and the retirement security of Americans everywhere. So I thank you for participating.

This is a year in which retirement security, thank God, has come very much to the forefront of our national dialogue, and with the baby boom generation on the cusp of retirement, this dialogue could not have been more timely.

For his part, the President has advanced the dialogue by bringing to the forefront ways to strengthen and improve Social Secu-

rity, but we all know that security retirement depends on a heck lot more than Social Security, employment based retirement plans and private savings, our other two critical legs of our three-legged retirement stool. So here today we are going to focus attention on those other two legs. We will focus our attention not just on where we are today but where we should be going.

Too often here in Congress we find ourselves responding to the latest crisis or doing damage control. This is an opportunity to be ahead of the curve, and I am pleased also that we are holding this hearing jointly with Senator Baucus and Senator Kennedy and our two committees, because we have had great success in recent years working retirement security in a bipartisan way. In the 1990s we passed a series of bipartisan pension reforms that brought new life to our private retirement system, and we have to work on those successes of the past, and so we look forward to this forum being a part of our foundation for doing that.

Thank you, Mr. Chairman.

[The prepared statement of Senator Grassley follows:]

PREPARED STATEMENT OF SENATOR GRASSLEY

Good morning, I want to begin by extending a very warm welcome to all of the participants—many of whom have come from far away, including Dan Houston [how-stin] from Principal Financial in my home State of Iowa—to share their insights on the future of our private retirement plan system.

The people we have in this room really are the experts. They bring a wealth of experience and insight. They bring a perspective on how things operate in the "real world" outside of the beltway. And they all are here today because they share one common goal—improving our private retirement system and the retirement security of Americans everywhere.

Thank you to all of you for making time to be here today.

This is a year in which retirement security has taken a central place in our national dialogue. With the baby boom generation on the cusp of retirement, this dialogue could not be more timely. For his part, the President has advanced this dialogue by asking us to look at ways to strengthen and modernize Social Security. But we all know that a secure retirement depends on more than just Social Security. Employment-based retirement plans and private savings are the other two critical legs of our three-legged retirement stool.

Here today, we will focus attention on those other two legs. And we will focus our attention not just on where we are today, but where we should be going tomorrow. Too often, here in Congress, we find ourselves responding to the latest crisis, or trying to do "damage control" when we become aware that problems exist.

Today, we have an opportunity to get out of "reactive mode" and look proactively to the future. I am pleased also to be here today with Chairman Enzi and Senator Baucus and Senator Kennedy. We all know that the only way to get things done in the United States Senate is to work together.

We've had great success in recent years working on retirement security in a bipartisan manner. In the 1990's, we passed a series of bipartisan pension reforms that began to breathe new life into our private retirement system.

In the bipartisan 2001 tax relief bill, we enacted a bipartisan and far-reaching set of retirement savings reforms. This year, I hope we can work together in a bipartisan way to strengthen Social Security. At the same time, I hope we can work on a "next generation" of retirement reforms, including:

- making the 2001 retirement savings reforms permanent;
- protecting workers' retirement plan benefits by making sure that pension plans are fully funded and that 401(k) participants have the right to diversify out of company stock; and
- expanding savings opportunities for all Americans.

And as we look farther into the future here today, I hope that we can continue to work in a bipartisan spirit on these issues, so that we can confront head-on the challenges that we know are sure to lie ahead.

The CHAIRMAN. Thank you.

Senator Kennedy.

OPENING STATEMENT OF SENATOR KENNEDY

Senator KENNEDY. Thank you very much, Mr. Chairman. I want to thank Senator Enzi and Senator Grassley, as well as Senator Baucus for bringing us all together.

We have to let our wonderful witnesses know today that we hope you are on your toes because Senator Enzi has filled out ERISA forms—[Laughter]— himself, and he is a trained and skilled auditor. So he is at a particular advantage over the rest of us here today. He said he just cannot wait to get into the facts and figures of the challenge. Well, he will have a pleasant day if that is what he is really looking forward to.

I want to thank all of our great experts and old friends who have joined with us for the discussion of the future of private pensions.

Retirement security is a critical issue for all Americans, as we all know. The national debate now under way is questioning all aspects of our current system which is founded, as Senator Grassley has mentioned, on a three-legged stool of private pension, Social Security and private savings. The private savings rate is at its lowest level in more than 40 years. We know wages are stagnant, and it is related to savings, related to wages.

The President is proposing to change the structure of Social Security. This makes insuring a private pension, I believe, all the more important. Despite our efforts in Congress over the years to secure retirement from private pensions still remains a remote goal for too many Americans.

The statistics tell the story. Our economy is still weak, and compounding the problem, only half of American workers have a pension plan at work, a proportion that has failed to improve over the past 30 years. Pension coverage is even less adequate for women, minorities, and employees in small businesses. As the chairman pointed out, the pension system as a whole is increasingly shifting to require workers to bear more and more risk. Today only 1 in 5 workers have a defined benefit plan, and the defined contribution plans and individual retirement accounts have an increasing role in our retirement policy.

In theory, the defined contribution plans and IRAs can provide a comfortable retirement, but experience shows this is not happening. Half of the workers 55 or older who have a retirement account have less than $55,000 in their 401(k)s or IRAs, not nearly enough to live on in retirement.

There are other problems with the defined contribution plans. Nearly 30 percent of the employees eligible to participate in 401(k) plans do not do so. Many of those who do are at risk of over investing in stock of the company that they work for. Retirees also bear the risk of outliving their money; an unforeseen medical emergency or drop in the stock market can be devastating.

As we look to the future we must also find ways to meet the new challenges of a changing economy, workforce and the effects of increased globalization on benefits for employers and retirees. Manufacturing jobs are being lost to competition overseas. Such jobs long provided good wages, good pensions, retiree health benefits, but today's low wage jobs, service sector jobs, part-time jobs, often do not.

Other changes also influence our policy. Employees are more likely to change jobs or work part time. And increasing numbers of women are entering the workforce. These workers should not be left behind in earning a pension.

Overall the Nation's retirement policy needs to better reflect our values of fairness and equality. People who have worked hard all their lives should not have to live in poverty. Surely the janitor who cleans the office tower has as much right to retire in dignity as the CEO in the corner office. Retirement security for every employee is good policy for our society, good policy for our economy as well.

We have much to do and I look forward to hearing from the experts here today the most effective ways to build a strong pension system for the future.

Thank you, chairman.

The CHAIRMAN. Thank you very much.

Today's forum will proceed in a different manner than typical Senate hearings. The primary purpose of this forum is to hear from you, the participants, and get your discussion on the long-term evolution of the private sector retirement benefit plans. Accordingly, today's format will be a roundtable. There will be no official oral statements made by the participants. However, any of the participants can submit statements that will be part of the record if you desire. That can even be based on something you may not have gotten to say today that you want to turn in to us.

So if any of you would like to answer a question that is being asked by us, or would like to respond to a comment made by one of your colleagues, just stand your nameplate on end—I am hoping they are sturdy enough to do that—and that will be an indication that you want to speak, and I will call on you according to your raised nameplate. Occasionally we will vary the format to fit the discussion or to pursue something in particular.

Before we begin the discussion, I would like to introduce our distinguished panel of participants. I want to thank them for their efforts to get here, and then also to change the schedule to accommodate our schedule so that we could be doing both budget and White House meetings and a number of other things.

First we have Cynthia Bowers, who is the Vice President of Compensation & Benefits for Smurfit-Stone Container Corporation; David Certner, the Director of the Federal Affairs for AARP; Kevin Covert, the Vice President and Deputy General Counsel for Honeywell; Mark Dunbar, President of Dunbar, Bender & Zapf, Inc.; Glenn English, the CEO of the National Rural Electric Cooperative Association; Karen Friedman, the Director of Policy Strategies, Pension Rights Center; Don Fuerst, the Worldwide Partner of Mercer Human Resource Consulting; Douglas Garrison, the Manager of Global Benefits Design of Exxon-Mobil; Ron Gebhardtsbauer, Senior Pension Fellow for the American Academy of Actuaries, another number person; C. Robert Henrikson, the President of MetLife; Dan Houston, the Senior Vice President of Principal Financial; John Kimpel, the Senior Vice President and Deputy General Counsel of Fidelity Investments; William McNabb, the Managing Director of Client Relationship Group, Vanguard.

Dallas Salisbury will be joining us later. He is the President and CEO of Employee Benefits Research Institute. The change in schedule affected that.

Pamela Schutz, the President and CEO of Retirement Income and Investments, of Genworth Financial. Gene Sperling will—oh, he is here, glad you were able to shift your schedule around too—Senior Fellow for the Center for American Progress; and Richard Trumka, the Secretary-Treasurer of the AFL-CIO.

We will begin with question No. 1. Our purpose for convening this forum today is to find out what the private sector initiatives for retirement benefits will look like 20 or 30 years from now. This will help us in Congress to fashion private pension laws accordingly. The three questions that we have asked participants to consider are:

(1) How will private sector retirement savings and pension plans evolve 20 years in the future and beyond? Question (2), How will our Nation's changing workforce affect the development of the retirement benefit plans and to what extent will our aging population, the need for portability of plans and the adequacy and coverage of plans for workers determine the future of private sector retirement savings and pension plans? And finally, what role will global competitiveness and U.S. companies' ability to compete in the global market, as well as to retain workers, determine the development of the private sector retirement savings and pensions?

To start the discussion, I would like to direct everyone's attention to Chart No. 10 from the Bureau of Labor Statistics Occupational Outlook Handbook. The chart shows that certain industries such as the service sector professional and office support will increase dramatically in the coming years. Gone are the days when a worker stayed at one company for his entire life. I have read that today's student will have up to 14 different occupations, and 10 of those jobs have not even been invented yet.

How will the companies adapt to this changing workforce structure?

Will companies be able to increase participation of workers in retirement benefit plans?

In addition, what structure will retirement plans develop to allow for changing careers of future employees?

That is probably a big enough bite, and there are probably some other places you want to go anyway, so we will begin. Does anyone want to throw out some answers? We are desperately searching for answers.

Senator GRASSLEY. If you knew how much we got paid per minute, you would not waste a minute. [Laughter.]

The CHAIRMAN. Mr. Certner?

## STATEMENT OF DAVID CERTNER, DIRECTOR, FEDERAL AFFAIRS, AARP

Mr. CERTNER. I guess I would want to just make one beginning comment on this. It seems pretty clear that with the changes in the workforce you are going to have a much smaller population of younger workers coming on board, and from our perspective, we think that part of that gap will need to be filled with the increasing number of older workers that we have in this country.

So we think that looking at the future you are going to see—and we have already seen this trend in the last few years somewhat—and up-tick in the number of older workers who either want to remain, employers want them to remain or who choose to remain in the workforce, some because they need the money, but many because they want to stay active. We think it is going to be important that as we look at the benefit structure in the future that is very accommodating to making sure that older workers want to stay on, and we encourage older workers to stay in the workforce because we are going to need those older workers in order I think to keep this economy running.

The CHAIRMAN. Mr. English?

**STATEMENT OF GLENN ENGLISH, CEO, NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION**

Mr. ENGLISH. Mr. Chairman, I think that we are somewhat unique as I understand it in this whole matter in that we are a multiple employer group. Electric cooperatives are in 47 States across the country. There are some 950 cooperatives who are part of our overall program. Our defined benefit program has been in existence since 1948; our defined contribution plan has been in existence since 1967. Our plan allows all of our members to participate even though they are very small electric cooperatives, and as such, they are able to pool their resources and share the risk, exposure if you would. It also is a way in which it gives them portability. They can move between cooperatives, move between States and retain this.

As far as looking to the future and what we might be able to contribute, geographically we are in about 83 percent of all the counties in the United States. As cooperatives we are actually owned by the people who use the electric power that are generated by electric cooperatives.

What we think is a possibility for the future is that we may open up our program to every member of the electric cooperatives, so you could have small businesses and 83 percent of the counties in the United States who would participate in this overall benefit plan, multiple employer plan. We think that that is a way in which a lot of small businesses in particular could offer this kind of a program, a defined benefit, defined contribution to their employees, and be able to afford it, and be able to share the risk that is involved. We have total assets for roughly 60,000 employees right now of $7 billion, and as I have mentioned, it has worked extremely well for us and is continuing to do so today.

What we would be troubled by is anything that would restrict multiple employers from working together in this kind of a plan, and we would hope that in the future it would be made easier. There are some contradictions in the law, both from a standpoint of ERISA and the IRS that make this more difficult. So as throwing out a suggestion, an idea, Mr. Chairman, I would suggest that that is one that the committee may want to examine, particularly for smaller communities and rural areas in this country.

The CHAIRMAN. Thank you. It would be helpful, and you probably already have written down those restrictions and ways that it can be made easier to share with us.

Mr. ENGLISH. We will submit that for the record, Mr. Chairman.

The CHAIRMAN. Thank you.

I believe Ms. Bowers was next. Ms. Bowers.

**STATEMENT OF CYNTHIA S. BOWERS, VICE PRESIDENT OF COMPENSATION & BENEFITS, SMURFIT-STONE CONTAINER CORPORATION**

Ms. BOWERS. Smurfit-Stone is a leading packing company. We employ about 27,000 employees. We have about 400 employees in Iowa. We have about 600 employees in Massachusetts, and about 500 employees in Montana, Missoula, Montana.

We are a large employer in a lot of small cities, and I am really concerned about the future of pensions because I am not a benefit actuary, I am not an attorney. I am the person in the company that has to justify to our senior management that defined benefits are what is good for the company and what is good for employees. When you speak about the three-legged stool, we really do have a three-legged stool in our country for Social Security income, but a couple of those legs are getting wobblier and wobblier every year.

We have 401(k) plans, defined contribution as well as defined benefit plans, but in our 401(k) plan our salaried employees about two-thirds participate in that. I wish it were 100 percent but it is only two-thirds. More unfortunate is that our hourly workforce, only one-third of our hourly employees participate in our 401(k) plan, and that is with significant company matches. On our salaried program we match 70 cents on the dollar and with 50 cents on a dollar for hourly employees, and it is still not enough to entice employees to save on their own.

So if we have an opportunity to strengthen and to make sure that defined benefit plans are in place in the future, that is what I would like to ensure.

The problem is, is that what we are encountering today and what we see in the future is that the cost of maintaining these programs are going to become increasingly overburdensome to our company. In the last 4 years we have contributed over $500 million to our pension trust, and we have a goal of staying at a 90 percent funding target, but if we continue to see what is happening on the forefront, we believe that our costs will more than double. I tell you, I am a pretty good person in trying to persuade people, but I do not know if I can persuade my management to double our costs, because we are diverting other business opportunities that we could be putting that revenue toward and putting it toward our pension plan.

My concern is to how to keep the system viable, healthy and there in the long haul.

[The prepared statement of Ms. Bowers follows:]

PREPARED STATEMENT OF CYNTHIA BOWERS

Chairman Enzi and Grassley, Ranking Members Kennedy and Baucus, I am pleased to provide the Senate Health, Education, Labor, and Pensions Committee and the Senate Finance Committee with a formal submission summarizing the comments made in the open forum on March 15, 2005. These comments are submitted on behalf of my company, Smurfit-Stone Container Corporation.

Smurfit Stone Container Corporation (SSCC) is a leader in the packaging industry employing over 35,000 employees throughout North America with an $8 billion revenue base. Our company's multiple Single Defined Benefit Plans cover approxi-

mately 25,000 active U.S. employees, 16,000 retirees and approximately 9,000 terminated vested employees in almost every State, including almost 400 employees in IA, 500 in Montana, 600 in Massachusetts. We also have approximately 4,000 in union multiemployer trust plans. Both my company's management and employees support retaining defined benefit plans as a central component to retirement security.

We cannot look to the future of pension plans without recognizing the three major components of any individual's retirement income stream. Our employees have the ability to retire with three separate income streams: defined benefit plan, 401K savings plan and social security. Given the current state of affairs on pension plans and their future viability, it is uncertain as to how long companies such as SSCC can continue significant contributions into a pension trust under some of the proposals before Congress.

For example, the Administration's proposal for reform of the Defined Benefit Plan system could more than double our cost of compliance with funding requirements, thus reducing cash flow available to continue reinvesting in our business which is required to remain competitive in today's global marketplace. As a mature industry with long-term defined benefit commitments and capital intensive investments, altering the funding rules can have a major impact.

Over the last 4 years we have invested almost $500 million in our pension fund and expect to make a similar investment over the next 4 years. We have a capital budget of between $225 and $275 million per year. The Administration's pension reform provisions will virtually eliminate our capital reinvestment capability.

The fundamental issue is that Americans, on their own don't save enough for the future. On a national average savings are trending toward depression-era levels around 1 percent of earnings. According to American Benefits Council the average person would have to save 7 percent of earnings over their career in order to amass enough savings for a stable retirement. Our company's 401K savings plan reflects the general savings trend of the country. For hourly employees only ⅓ contribute, even though they can get company-matching contributions.

So, if there is no evidence that people are motivated to save on their own for retirement, and companies are overly burdened with the type of proposals before Congress today, the future looks bleak. In time, companies will be forced to cease offering defined plans to an even greater extent than already reflected in the last 10 years, as the number of pension plans have decreased by 60 percent.

This situation will inevitably harm Americans as defined benefit plans provided a source of income to individuals who may not have otherwise saved for retirement. Without this guaranteed income, Americans will become more reliant upon Social Security income as a primary source, thus further burdening a system that is under duress. This loss of income will have a severe impact on the quality of life of many Americans.

Smurfit Stone is a responsible company. Over the last 5 years, we have been between 90 percent and 98 percent funded in our pension plan and have followed existing law in providing the level of contributions in advance of requirements, despite strong market pressures slowing industry growth. Any new funding requirements should not be based upon the perceived financial strength or weakness of a plan sponsor. Funding requirements should be based upon quantitative targets and objectives consistently applied to all plan sponsors.

We are concerned that legitimate efforts to assure long-term sustainability and viability of the PBGC may in fact lead to a precipitous decline in affordability, reliability and predictability in maintaining defined benefit plans. Our 35,000 employees would be severely disadvantaged from receiving future benefits if the Administration's proposal were to pass as currently constructed.

Rather than helping secure the future of our defined benefit plan, assumptions embedded in the yield curve methodology would create unnecessary financial burdens that could lead to reduced future reliance on a predictable retirement income. An actuarially-sound replacement of the 30-year Treasury rate with a 4-year weighted average of the long-term corporate bond rate would address these concerns.

Utilizing the 4-year weighted average of the long-term corporate bond rate with some sort of smoothing would provide more predictability. In addition, this option is transparent and provides an accurate rate base, it steers a middle course between what is earned and what is owed. Imposing a 90-day smoothing concept into a yield curve places undue short-term pressures on companies for a long-term condition. The reason we encourage 30-year mortgages is to encourage purchasing of homes. If home owners had to pay a disproportionate amount of the cost up front, rather than over a longer term, fewer homes would be affordable. Likewise, we need to allow companies who are voluntarily providing long-term benefits to employees to

spread a long-term cost over a longer period of time and not be subject to short-term volatility.

New proposals for funding targets, contribution requirements, deduction limits, benefit restrictions and increased premiums will in fact jeopardize our company's ability to continue to offer a defined benefit plan for new employees. Providing for predictability and reducing volatility in funding plans can be achieved with existing smoothing mechanisms for assets and interest rates.

Eliminating tax deductions for over funded plans is a short-term revenue benefit to the Treasury at the expense of longer-term opportunities to actually enhance the viability of pension funds while helping strengthening a company's position in the marketplace.

I am pleased to present these views and contribute to the debate so that we can find a means by which defined benefit plans can continue to be offered by companies for their employees with a degree of predictability and encouragement rather than penalties for being in a growth cycle, recessionary market or specific debt condition. Losing our defined benefit plans as a retirement benefit could seriously affect our ability to attract the talent necessary to successfully grow and prosper as a company.

Thank you for the consideration of these comments.

The CHAIRMAN. Thank you.

Mr. Gebhardtsbauer.

**STATEMENT OF RON GEBHARDTSBAUER, SENIOR PENSION FELLOW, AMERICAN ACADEMY OF ACTUARIES**

Mr. GEBHARDTSBAUER. Thank you. One of the things we have seen is that the future demographics are going to be very different than the demographics in the past. In the 1970s we have baby boomers coming in, women coming into the workforce. So DB plans were developed in the past, and they are going to be very different in the future because of different demographics. Back then there was so much labor coming in that it made sense for a pension plan to have people retiring at early ages and incenting people to come in at early ages, and retiring at early ages like 55. But in the future the supply of the labor is going to shrink a lot after the baby boomers leave.

So as you were talking about, we need ways in which to encourage people to continue working. And DB plans are very flexible. If the law allows they can just do about anything you want, and we have tried all kinds of things in the last 5, 10 years like cash balance plans, hybrid plans. There is a new idea called DBK that would take some of the futures of DB plans and bring in the ideas of some 401(k) ideas so that it is simpler, the employees can sort of follow it. Another advantage of the 401(k) is that the employer actually has to sell it to the employees, and the more they sell the lower income employees into it, the more the higher income employees can participate. So there are all kinds of new ideas that are coming along.

But we cannot do the DBK idea, for instance. People are very uncertain about whether they can do this cash balance idea. Companies have had it for a long time but now the rules are kind of uncertain. So again, a lot of the criticisms that people are having of DB plans, for instance, that they do not work for a mobile workforce, actually you can modify the traditional DB plan into something that does make sense for a mobile workforce. For instance, the cash balance idea is something that gives the same amount to everybody so that it is good for people who are in and out, it is good for women who are in and out of the workforce. But it is difficult to come up with these new ideas when the rules are kind of tight.

In the world that we have today where we need to make these changes to be able to compete, then the rules need to be flexible enough so that we can make some of these changes to our DB plans, and either the rules need to be flexible or when a new idea comes up we need rules that can change, so that Congress can be responsive and quickly change to some of the new ideas.

So those are some of the things I think would be valuable to enable DB plans to change for the workforce of tomorrow.

The CHAIRMAN. Thank you.

Mr. Trumka.

**STATEMENT OF RICHARD TRUMKA, SECRETARY-TREASURER, AFL-CIO**

Mr. TRUMKA. Thank you, Mr. Chairman. I think it bears worth stating at the beginning that pension and pension security cannot be addressed in a vacuum, that all the other policies that we are dealing with or all the other challenges that we are seeing in the country affect dramatically workers' pension plans and savings. And I will refer to things like the budget deficit, the trade deficit, outsourcing, the stagnation of wages. All of those things affect, one, the ability of companies to provide pensions and two, the ability of workers to force savings or to have savings.

Having said that and restating the obvious, I guess I would say the following. Unless there is a change in current policies and the current business environment, some retirement plan trends will continue. The share of private sector workers participating in defined benefit plans will continue to decline following a quarter century trend. In 1979 we had 39 percent of workers who had a defined benefit plan. Today it is only 21 percent. Retirement plan participation will likely remain flat at 50 percent of the workforce as it has over the past 2 decades, and participation has remained flat even though we have seen a shift away from DB plans to DC plans, and it is not clear right now that any of the simplification reforms and the increases in contribution limits enacted in the mid 1990s will have any meaningful effect on the coverage. I think fewer workers will be receiving annuities in retirement. Defined contribution plans do not offer those annuities, so we will see fewer of those happening.

And as more plans allow workers to take lump sums, I think workers will begin to use their retirement savings accounts for purposes other than retirement income, all of which are dangerous when we are looking for our retirement security.

I would also point out, Mr. Chairman, that when it came to defined benefit plans, a union that I came out of, the United Mine Workers, had one of the first if not the first. It was signed in 1947. It was a multiemployer plan, and I would just like to remind everybody the purpose for that plan. Back then many of the mines that the Nation's miners worked in were small mines, employing 25, 30, 35 or 40 people. Those mines would come into business and go out of business every 2 or 3 years. The employers would leave their employees without any retirement. As a result of that we needed a mechanism to be able to harness that existence of those small entries and exits out of the mining industry. The defined benefit plan, particularly the multiemployer benefit plan, was the perfect vehicle

because you had portability and you could take your benefits from company to company. As Mr. English said, we need to have the flexibility to be able to combine those and to have more people join into those plans so that we can share the risk even further so that we have professional management of those plans in a meaningful way.

I would also say, Mr. Chairman, that we really do have to grapple with a series of touch questions when it comes to things like 401(k)s or other forms of savings. What will happen to the low and middle income workers? How effective are employers' plans at helping workers manager their accounts? Will middle income people even have enough retirement?

Only 50 percent of workers have any kind of a savings account, retirement savings accounts, and their average amount, as Senator Kennedy said, is about $55,000. If you convert that out that comes out to about $230 a month in savings, which is not likely to be able to support people very long out into the future.

All of those things are important to us, so when we look at things I guess we would say that we really need to protect workers' pensions by making funding rules work for single-employer or multiemployer defined benefit plans. We think we have to enact rules that will strengthen pension funding and promote employer sponsorship of single-employer defined benefit plans, and we have to give multiemployer plan trustees and the relevant bargaining parties additional tools to protect their pension plans.

Also one subject I would really like to touch on just briefly is to protect workers' 401(k)s when employers file for bankruptcy. We just had a lot of talk on the Hill about bankruptcy and a bill passed. But while workers' wages get a priority, they only get a priority to $4,500. That is a number that has not been moved in decades. That low priority cap affects how much workers can get back in missed 401 contributions and in stolen 401(k) money. The other thing that we really need to look at in bankruptcy is to make 401(k) participant claims for security and pension fraud a priority claim in bankruptcy. As it is right now, you do not see that happening. They get to the end of the line. This kind of problem could be solved in the future by giving 401(k) plans and plan participants priority in bankruptcy for fraud and breach of fiduciary duty claims arising out of their holdings in stock or anything else.

Those are just a few of the things, Mr. Chairman. I would like to submit for you additional items that can be done to help retirement security.

[The prepared statement of Mr. Trumka follows:]

SUPPLEMENTAL STATEMENT OF RICHARD L. TRUMKA

Mr. Chairman and members of the committee, thank you for the opportunity to present these additional views on the future of private-sector retirement plans.

**Tax Policy and Retirement Plans**

One roundtable participant suggested that replacing the Federal income tax with a consumption tax would have a beneficial impact on national saving. While there was no follow-up discussion, it is important to note the potentially large negative impact such a shift could have on private retirement plans. This issue is particularly relevant since President Bush has appointed an Advisory Panel on Federal Tax Reform to consider fundamental changes in the tax system and submit recommendations for reform by July 31, 2005.

As a 2001 Congressional Research Service report noted, "[w]ith both defined benefit and defined contribution plans, the typical consumption tax eliminates all pecuniary incentives for employer sponsored pension plans."[1] Such a fundamental shift in the tax system "could cause a sharp reduction or a wholesale elimination of existing pension plans."[2]

The elimination of job-based retirement plans clearly would undermine the national policy objectives underlying the current job-based retirement plan system, with particularly negative consequences for many low- and middle-income Americans. Current tax code nondiscrimination and coverage rules governing employment-based defined benefit and defined contribution plans act to increase retirement benefits and savings among low- and middle-income workers. Further, as was noted by several hearing participants, the payroll deduction feature of 401(k)'s and similar retirement savings plans is very important, a point strongly supported by comparisons to the very low participation rates in Individual Retirement Accounts.

At a minimum, any discussion of fundamental tax reform must include a thorough analysis of its impact on pensions and retirement savings plans. Unfortunately, this relationship has been given scant attention in the past. As the Department of Labor's Advisory Council on Employee Welfare and Pension Benefit Plans concluded in 1996, "the complex and far-reaching implications of fundamental tax reform for the Nation's retirement and pension system have not been given adequate attention or analysis through existing policy channels, either in Congress or in the Executive Branch, especially given the complexity of the issues and uncertainty that surrounds them."[3] It remains to be seen whether these issues will be given the due they deserve in the upcoming tax reform debate.

**Retirement Savings**

One focus of discussion at the hearing was developing effective ways to get more Americans to save and to save more for retirement. Many people, as I stated at the hearing, simply do not make enough money to save much or at all for retirement. In fact, many families have trouble paying for basic items and services. For example, the Economic Policy Institute (EPI) has found that 3 in 10 (29 percent) families with pre-teen children have insufficient incomes to cover a basic family budget in their communities, excluding any level of savings for retirement, education or even emergencies.[4] The EPI study was based on a budget of necessities, like food, housing, transportation, childcare and medical care. In other words, many families do not have sufficient income to maintain a safe and decent standard of living. For them, the lack of adequate retirement savings (or any savings at all) is not a result of consuming too much, the favorite explanation of some commentators, but instead a symptom of an economy and a labor market that do not provide them with enough to meet basic needs.

**Pension Funding**

Although not a focus of the roundtable discussion, I and other participants raised serious concerns about the implications of certain proposed changes to the pension funding rules for the future of defined benefit pension plans. In particular, changes that would result in greater volatility in the pension funding requirements—no matter how intellectually elegant they may seem to some—are likely to drive many employers to freeze or terminate their existing plans, with an ultimate negative effect on Americans' pension security.

Specifically, legislation proposed by President Bush and others would eliminate many of the features of the current funding rules designed to make funding requirements more predictable by tempering interest rate and asset value volatility. Under these approaches, liabilities would be measured using market or near-market interest rates and assets would be marked to market values. Also, interest rates used to measure liabilities would be taken from a yield curve based on the duration of the liabilities, increasing the liabilities for companies with older participant and beneficiary populations. The stated reasons for these changes are protecting the Pension Benefit Guaranty Corporation (PBGC) and improving pension security.

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[1] Steven Maguire, Congressional Research Service, "Consumption Taxes and the Level and Composition of Saving," updated Jan. 11, 2001, p. 7.

[2] Report of the Working Group on the Impact of Alternative Tax Proposals on ERISA Employer-Sponsored Plans, 1996 Advisory Council on Employee Welfare and Pension Benefit Plans, U.S. Dept. of Labor, Nov. 13, 1996.

[3] Report of the Working Group on the Impact of Alternative Tax Proposals on ERISA Employer-Sponsored Plans.

[4] Heather Boushey, et al., Economic Policy Institute, *Hardships in America: The Real Story of Working Families* (2001). The report focused on families with one or two adults and one to three children under 12.

This radically new approach to plan funding likely will have effects opposite those intended by its supporters. Volatility in required contributions is a major concern to plan sponsors, with three out of five employers listing volatility as a top threat to defined benefit plans, in one survey. In an environment in which the playing field already is tilted significantly in favor of defined contribution plans, the shift to a yield curve based on near-market rates likely will induce more employers to freeze or terminate their defined benefit plans and make it even less likely employers will create new defined benefit plans. This outcome will hardly benefit the PBGC, the premium payer base of which will be reduced, or workers, whose pension benefits will be cut.

It is the view of the AFL-CIO that pension security can be improved without introducing the harmful effects of volatile funding requirements. A proposal by Dr. Christian Weller at the Center for American Progress illustrates this point. He has shown that funding rules based on long-term interest rate averages both decrease funding volatility and improve plan funding levels. A key benefit of Dr. Weller's approach is that the funding rules become more pro cyclical, "lowering the burden during bad economic times and increasing it during good economic times, when employers are best able to contribute to their pension plans." Attached is testimony he recently gave to the House Committee on Ways and Means Subcommittee on Select Revenue Measures addressing these issues in greater detail. Policymakers should seek out these kinds of win-win proposals to build greater retirement security.

On a separate but related matter, policymakers need to give multiemployer pension plan trustees and the relevant bargaining parties additional tools to protect their pension plans. Current rules do not provide the flexibility needed to protect pension plans until it is too late.

The CHAIRMAN. Thank you. I appreciate it.

Mr. Kimpel.

**STATEMENT OF JOHN KIMPEL, SENIOR VICE PRESIDENT AND DEPUTY GENERAL COUNSEL, FIDELITY INVESTMENTS**

Mr. KIMPEL. Thank you. I would like to take a slightly different tack and talk about what I am most concerned about looking at 20 years. It is not the pension system itself, but rather the extent to which retirement savings will increasingly be eaten up by health care costs. We estimate that a couple retiring today will need at least $175,000 to cover that couple's out-of-pocket medical expenses. I do not think the issue is DB versus DC or annuitization versus nonannuitization. Those are important issues, but the real issue, in our judgment, is regardless of how much people are saving today, they are not saving enough to cover the massive health care costs that they will be confronting 20 years out from now, and unless and until we focus on that and figure out ways to integrate health care savings with retirement savings we will not be saving enough.

The CHAIRMAN. Thank you.

Ms. Schutz.

**STATEMENT OF PAMELA S. SCHUTZ, PRESIDENT AND CEO, RETIREMENT INCOME AND INVESTMENTS, GENWORTH FINANCIAL**

Ms. SCHUTZ. Thank you very much. I represent an insurance company, Genworth Financial, and I will come at this from a little bit different angle.

We see the landscape is very much changing, and that the burden for guaranteed retirement income shifting more to the individual. You see that with the decline in defined benefit plans, that guaranteed paycheck for life that people had, and exacerbated by the fact that Americans are living longer. The defined contribution plans do not offer those guarantees. They do not substitute a de-

fined benefit plan. They do not guarantee for investment risk and longevity risk.

So what we see is insurance companies being able to step in and fill some of that vacuum and gap to give people peace of mind, a paycheck for life, because that is what they do. They pool investment and longevity risk. So we see the insured defined contribution plan concept and annuitization becoming more and more important and valuable as we look ahead in retirement savings and security.

[The prepared statement of Ms. Schutz follows:]

PREPARED STATEMENT OF PAMELA SCHUTZ

Thank you for organizing this important forum and inviting me to participate on behalf of Genworth Financial. With 15 million valued customers, more than 5,000 skilled professionals, and more than $103 billion in assets (as of December 31, 2004), we are one of the world's largest insurance organizations. We serve three major customer needs: protection, retirement income and investments, and mortgage insurance.

INTRODUCTION TO THE PROBLEM

Helping Americans improve their ability to enjoy a financially secure retirement is one of the most challenging domestic issues faced by this Congress. Americans are spending a greater portion of their lifetimes in retirement than previous generations. Today, more than half of all workers retire before their 62nd birthday, and the average retiree can expect to spend approximately one-fourth of his or her life in retirement. Retirement is also the most difficult financial planning exercise that the average individual will face in his or her lifetime because the stakes are so high—the potential consequence of making a mistake is to live the last years of one's life in poverty.

A comprehensive retirement income system should be built to deliver results on all facets of the "Three-Legged Stool": Government Social Security, employer sponsored plans, and individual personal savings. As the focus of this forum is the trend in employer sponsored plans, it is important to recognize the degree to which the burden of assuring an adequate retirement income is shifting to the individual, who typically has not been given the tools to meet this challenge. This shifting to the individual of responsibility for a financially adequate retirement will continue as long as the availability of traditional Defined Benefit (DB) plans continues to decline. Employees are faced with a loss of guaranteed income during retirement and they have limited options in replacing that "paycheck" for life.

Further exacerbating the problem of achieving an adequate retirement income is the simple fact that Americans are living longer. A longer life is something to be thankful for, but it means that we each will need income that will match that longer lifespan. Today, 50 percent of healthy 65-year-old women will live past age 85. In fact, one in three will live past age 90 and one in 10 will live past age 95. In addition, women spend even more time in retirement than men and are less likely to have participated in employer sponsored retirement plans. Forty-four percent of female workers lack a pension from any employer, compared to 36 percent for male workers. These factors mean that both men and women face a difficult challenge in managing their savings during retirement years.

THE LACK OF GUARANTEES FOR THE INDIVIDUAL

At the center of the challenges and concerns individuals have about their retirement security is the lack of guarantees, in particular the lack of a guaranteed income that will last regardless of how long the individual lives and no matter how the stock market performs.

In their current design, Defined Contribution (DC) plans do not replace the guarantees that are associated with a traditional DB plan. There is no guaranteed minimum income, there is no guarantee that the retirement income will last a lifetime, and there is no guarantee on the performance of the individual's overall retirement portfolio. Without these guarantees, the employee is faced with having to mitigate six key retirement risks on his or her own. These six key risks are:

- long-term rate of return risk (will your assets perform as expected),
- inflation risk (will your returns outpace inflation),
- excess withdrawal rate risk (how much can you safely withdraw),

- point-in-time risk (can you weather a down market at the time of retirement),
- longevity risk (will you outlive your assets), and
- health care risks (will your income stream support rising healthcare costs).

POTENTIAL SOLUTIONS

Life insurance companies are in a unique position to help employees manage these risks by partnering with DC plan sponsors and mutual fund companies. Life insurance companies can pool longevity and investment risks across a large number of participants—thereby providing guarantees at the individual participant level. These guarantees are provided by financial institutions that are highly regulated by the States to assure that individuals receive the benefits they have been promised.

There is widespread recognition that the purchase of income annuities, "annuitization," at the point of retirement would help mitigate some of these risks. It is a common practice for life insurance companies to:

- convert an account balance into a guaranteed income stream that will last a lifetime,
- offer guaranteed payouts over the life of a single individual or the life of the individual and his or her spouse,
- increase a fixed payout stream for an expected inflation rate,
- guarantee that payments will continue for a minimum period whether the individual lives or dies, and
- allow the individual to participate in equity market performance.

As a consequence, an emerging market is developing in what Genworth calls "Insured Defined Contribution" plans. Insurance companies like Genworth, MetLife, and others are building new annuity products that allow sponsors to offer defined benefit investment options to their employees within a 401(k) plan. The importance of an Insured DC option is that the individual throughout his or her working career, without having to wait until retirement, is able to determine with certainty how much guaranteed lifetime income his or her current 401(k) account balance will buy at a future retirement date.

An Insured DC option can be made portable, thereby addressing the issues created by an increasingly mobile workforce. In addition, some designs can be structured to provide upside potential through equity participation in order to offset the risk of inflation. Our consumer research into the Insured DC option has indicated significant interest on behalf of 401(k) participants. Here are the highlights of our findings:

- 69 percent of participants age 25–34 would invest in an Insured DC offering if given the opportunity, 70 percent of all participants would do so.
- 23 percent of those who say they would invest in an Insured DC option would increase their contributions to their 401(k) plan if able to participate in such an option.
- 54 percent of the individuals who choose not to participate in their employer's 401(k) plan would participate in the plan if an Insured DC option was available.
- 95 percent of participants found the guaranteed minimum income for life feature of an Insured DC option attractive (63 percent said very attractive).
- 93 percent of participants said portability of the Insured DC guarantee was attractive (53 percent said very attractive).

THE NEED FOR EDUCATION

A key predicate to successfully managing the risks that Americans face in retirement is making sure that they understand those risks. Most Americans have not had the opportunity to prepare for the responsibility they will face at retirement. Financial planners report confusion about retirement planning and many working people do not understand how to convert assets into enough income to cover a lifetime of non-discretionary expenditures. This conversion of account balance into lifetime income at a future retirement date is a very sophisticated calculation. In order for Americans to understand the dynamics of this retirement reality, we as a country must address the significant education gap that exists today.

The following simple question illustrates the complexity in this area: If you were 65 today and were to retire today, would you feel wealthier if you had $500,000 in your 401(k) plan or had a pension guaranteed to pay you and your spouse $32,500 per year for the rest of your lives? It becomes a harder question to answer when given the added information that many advisors would say that no more than $20,000 should be withdrawn annually from a $500,000 balanced fund in order to be reasonably assured that the money will last 30 years. However, even at this safe

withdrawal rate, there is no longevity or investment performance guarantee, so it is still possible to outlive this money.

To help Americans understand the retirement security issues they face and the solutions available to them, retirement education needs to focus on three components:

- the basics of personal finance, including the discipline of saving, starting to save early in your working life, and the value of compound interest,
- the conversion of savings into a reliable income stream, and
- the value of guaranteed income, a "paycheck for life," and the benefit of pooling longevity and investment risk with others.

While many valuable financial education initiatives have been undertaken in recent years by both the public and private sectors, more can and should be done.

THE IMPORTANCE OF LIFE CONTINGENT ANNUITIES

One of the most important, and often least understood, sources of financial risk comes from uncertainty about how long one will live. According to a 2001 study by the Society of Actuaries, 67 percent of retired women and 55 percent of retired men underestimated the average life expectancy of a 65-year-old. This uncertainty means that there is a real risk of experiencing a reduction in living standard at older ages, even if one has tried to prepare for retirement. Saving is not enough; one must also be a careful manager of one's savings. Individuals should be encouraged to manage their savings during retirement in a manner that accommodates their daily needs, but also ensures that their savings will not be exhausted when they have more years to live. This is why life contingent annuities are so important.

An annuity that continues to make payments for as long as you live (often called a "life contingent" annuity) is an affordable, powerful retirement tool that allows individuals to manage many of their personal retirement risks. The life contingent annuity is a combination of investment expertise and insurance that gives individuals the ability to insure against the financial risks of retirement by pooling their assets, and their financial risks, with a large number of other policyholders.

For many individuals, guaranteed lifetime income payments from an annuity may be the most effective way to ensure that retirement savings will not be depleted during their life. Outside Social Security and employer sponsored DB plans, only an annuity can guarantee that an individual will receive regular, guaranteed income payments for as long as he or she lives.

A life contingent annuity is designed specifically to address the financial planning problem of guaranteeing that individuals will not outlive their income no matter how long they live. The annuity can be designed to give consumers the flexibility to transform accumulated savings—both savings inside an employer plan and those accumulated outside of a plan—into a variety of forms of guaranteed streams of retirement income based on each individual's needs.

Annuities have a variety of features and options that allow individuals to provide for their own retirement needs and to provide for a spouse or heirs after death The payment stream itself can take a variety of forms depending on the individual's needs. It can guarantee payments over a person's life (a life contingent annuity), over two peoples' lives (called a joint and survivor annuity), over a specified period (called a period certain annuity), or over a life or lives with a minimum period of payments guaranteed, e.g., 10 years (called a certain and life annuity). Annuities that combine life contingencies with period certain features are particularly attractive because they protect against longevity risk while at the same time providing the ability to bequeath amounts to heirs (either in a lump sum or as continued periodic payments) upon a death during the period certain.

Annuity payment streams can be designed to make fixed income payments (called a fixed annuity), or can be designed to protect against inflation by making payments that increase or decrease with market performance (called a variable annuity). Some variable annuity products also guarantee minimum income levels while providing the upside potential of the equity markets, thereby protecting against investment risk in addition to inflation and longevity risk.

The key point is that life contingent annuities, in whatever flavor may best suit a particular individual's circumstances, provide individuals with the guarantee of an income stream that will continue throughout their retirement years, no matter how long they live.

CONCLUSION

The combination of more and improved retirement education, the growth of Insured DC options in employer plans, and encouraging more individuals to manage retirement risk through life contingent annuities would benefit the Three-Legged

Stool: employers would have a predictable and stable funding vehicle for the retirement benefits they offer and have employees that value and appreciate the benefits offered; employees would have an option for guaranteed retirement income for life and would be motivated to begin addressing the concern earlier in their working lives; and the government would have the other two legs of the stool helping to bear the load of retirement security.

Once again, we appreciate being included in this timely forum and look forward to discussing the many different alternatives available to resolve some of these critical retirement savings and income issues faced by our country.

The CHAIRMAN. Thank you.

Ms. Friedman.

**STATEMENT OF KAREN FRIEDMAN, DIRECTOR OF POLICY STRATEGIES, PENSION RIGHTS CENTER**

Ms. FRIEDMAN. Hi. Thank you very much for enabling us to be here today.

I wanted to say a few things first from the Pension Rights Center's perspective when you are looking 20 years in the future. Certainly we need to take into account that there is a changing workforce. We want to make sure that while there is a shift from defined benefit plans to more individual account plans, that we do as much as we can to keep defined benefit plans, recognizing that employers have a real role to play in providing retirement income to people of all income levels, and I want to start with that.

What I wanted to emphasize today, and many people around the table actually know about this, the Pension Rights Center has convened a national public policy dialogue over the last 3 years with several of the people around the room, MetLife, AARP, the AFL-CIO, Fidelity, the American Academy of Actuaries, are all cosponsors of this initiative called the Conversation on Coverage. I know Dallas has been an advisor. We are working with Principal. Vanguard has just joined one of our working groups.

The Conversation on Coverage is a forward-thinking forum to address the very questions that you are asking today. We have been looking at how do we increase coverage for the 50 percent of the working population that now has no pensions or savings to supplement Social Security. We assume that that challenge is going to get even greater in the years forward. The great thing about the Conversation—and I can say this because I am just the neutral facilitator and am not part of the working groups, and John Kimpel is one of our co-chairs right there—the Conversation has come up with—and I am not going to go into it now, but I would be happy to a little bit later—has come up with the kinds of innovative solutions that Ron was talking about.

Working Group 1 looked at how do we increase coverage through defined benefit plans, and looked at new forms of hybrids, even looked at DBK proposals but also looked at a new kind of proposal called a gap, which actually starts with a money purchase structure.

Working Group 2 looked at ways of encouraging savings both by making it easier for people to participate in 401(k) plans, but also came up with a new structure for a centralized system of individual accounts about Social Security.

Senator Enzi, you talked about the challenges to small business. Working Group 3 looked exactly at that challenge and came up with what they called a new Model-T plan, which is essentially a

new kind of multiple employer plan that would be marketed through financial institutions to small employers, possibly in a small community, and we are going to be looking to do a demonstration project on that.

So I just want to point out that the Conversation on Coverage has put out some initial recommendations, and we are going to be working to refine those over the next year.

The CHAIRMAN. Thank you.

Mr. Covert.

**STATEMENT OF KEVIN M. COVERT, VICE PRESIDENT AND DEPUTY GENERAL COUNSEL, HONEYWELL**

Mr. COVERT. Thank you, Mr. Chairman. I would like to spend a couple minutes coming at this a little less from a policy perspective and a little more from a real world employer perspective company that actually sponsors these plans. Honeywell is a multinational company with 108,000 employees, 60,000 in the U.S. We provide both defined contribution 401(k) plans and defined benefit plans to all of our U.S. employees.

We actually believe that is the proper mix, to encourage both the DC plans giving employees the opportunity to invest their own money and share in the largesse of a growing economy and good times, but also to provide benefit plans where you provide a safety net for employees in their retirement.

Unfortunately, when we look into our crystal ball we see a world of almost exclusively defined contribution plans 20 years from now. We already see it with our colleagues in the Fortune 100 companies, huge companies with large U.S. populations that have frozen their plans on the DB side, Tyco, Time-Warner, Xerox, Sears, Rockwell, IBM. The list is large and it covers an awful lot of employees.

As an employer we see the reason for that being twofold, first the funding issues. What CEOs and CFOs need in this global economy is predictability. We cannot survive with our competitors either in the U.S. or globally if we have huge volatility swings on funding requirements because as you all know, we do not plan for 2005 in 2005. We plan for 2005 in the year 2000. That is how we manage our cash. That is how we manage our capital outlays, research and development and so forth.

Second, we have perverse incentives. In a system whereby we ratchet funding requirements and PBGC premiums in lean economic times, forcing companies that would rather stay in the system out of the system, and yet in good economic times there are all types of restrictions to companies being able to put excess money, when they have it available, into their plans, so that when lean times come their plans are adequately funded.

The other obstacle we see ongoing is uncertainty. Most large employers like Honeywell have hybrid plans of one type or another that cover some of their population. Because of the District Court decision in Illinois, that has had a very detrimental freezing effect on companies in terms of willingness to adopt new plans and to maintain their plans. That was the reason given by IBM for why they froze their plan. They got hit with a huge judgment. They were concerned about it, and they could not very well go to their

CEO and say, well, we are just going to maintain this plan and let that potential liability spiral up.

So we as employers need to know that the plans we sponsor are legal. If we do not have that certainty, I as a general counsel advising my CEO cannot go to him and say, well, I think we should continue to let these plans go, continue to bring new employees in, continue to accrue benefits in them with no guarantee that we are not going to get hit with a multibillion dollar judgment down the road.

Thank you.

The CHAIRMAN. Thank you.

Mr. Dunbar.

**STATEMENT OF MARK K. DUNBAR, PRESIDENT, DUNBAR, BENDER & ZAPF, INC.**

Mr DUNBAR. My presence here, I think I am one of the few that represent small employers. My company is a small plan sponsor, and I also do a lot of work with small employers. I am actually a pension actuary, so I am one of the few here that has that hat on.

Some of the comments that have been made I think are clearly from a large plan perspective. I think with the small employer, I think one of the first comments I would make is that the small employer needs to have control. So they are going to be more interested in a plan design where they have the flexibility that they need to be in or out. The ability to fund, as Kevin mentioned, is important, to be able to fund in good years and not have a huge requirement in bad years. So that flexibility is there in both small and large plans.

I think one of the prior comments was about the DBK concept. We have seen interest in the small employers in cash balance type arrangements. Obviously, the legal uncertainty is of concern. One of the other problems with the cash balance on the small employer is the requirement to tag lump sums to GATT rates and whipsaw, if any of you are familiar with whipsaw. That restricts the interest rate that you can credit on a cash balance and that is a deterrent to these types of plans for the employees. With the larger employers, they tend to get around that by not offering lump sums, but on the small employer that is not an option. So that is a big issue.

If Congress could address the cash balance issues and look at the type of designs like the defined benefit (k) arrangements, I think that would make the defined benefit area more attractive to the small employer.

When we talk to a lot of our small employers, they are willing to commit to a small level fixed contribution, for example, safe harbor 401(k)s with a 3 percent fixed contribution. Many small employers are willing to agree to that, knowing that they can change it in a future year if they need to. So they are willing to commit to a low level and then put more in if they have a good year. I think that if that arrangement was there on the defined benefit side also, it would increase the interest in that type of arrangement.

Other issues, a lot of your small employers, again, you are taking dollars away from other sides. If there was incentive for them to put plans in, even initially, that would help at least not have an

expense. I think often with our small employers getting hit with document costs over and over again as we have to resubmit documents is an issue. From the small employer employees, talking about participation rates, you have in the code now some saver credit dollars that go to low-paid employees. If you could increase those dollar limit numbers to hit more employees, I think that would help with getting your low-end employees in at the early years. Once employees are into a plan they tend to stay in and continue to contribute. It is getting those 20- to 30-year-olds in the plans at an early age that is difficult. They tend to have other uses for their dollars as to "what am I doing this weekend?" So if you could find a way to give those low-paid employees incentive, it is meaningful.

Thank you.

The CHAIRMAN. Thank you. Do you feel a tremendous burden representing 90 percent of the businesses in the United States?

Mr. COVERT. I do. I do. [Laughter.]

The CHAIRMAN. Thank you.

Mr. Henrikson.

**STATEMENT OF C. ROBERT HENRIKSON, PRESIDENT, METLIFE**

Mr. HENRIKSON. Yes. First I would like to—it strikes me listening to everyone speak that I would like to thank everybody for this opportunity because for those of us who have been—and most of us have in one way or another—in the pension business all our lives, this is a unique opportunity.

One of the things I think you will notice is that despite the fact everyone comes from a little bit different place and a position looking at these problems, the language will be very similar and I do not think you are going to find a lot of disagreements on the major issues.

One of the things I wanted to mention about the three-legged stool is that I remember being part of the Council for Economic Development back 7 or 8 years ago studying this very problem. On my first meeting—and I was going to be good and not say anything until the conversation got going—and the opening statement was by the chairman at the time, "One of the things we need to have in our opening page is a statement that basically says 'This generation needs to learn how to save for their retirement like we did.'"

And I came out of my seat because I think certainly the people in that room, no one was living a retirement based on what they had saved, I will tell you that, basically a group of CEOs. [Laughter.]

So one of the things about the three-legged stool that I would say—and certainly this experience with my parents—the most important thing about the three-legged stool is that two parts of that stool, two legs of that stool produce an income off of which people live. After all, that is what most people live off of, income. If you ask them why their status is what it is or why they send their kids to the schools they do or where they live or what kind of home they buy and whatnot, it is based on their income. The three-legged stool, certainly in my dad's situation, the day he retired the biggest paycheck he got every month was from his defined benefit pension

plan. He was a middle income person, worked for many years at one company. The second biggest payment he got was his Social Security check. And then he had his savings which he watched like a hawk for the rest of his life because he was worried about it. He did not live off of it.

A few years went by and before you knew it his largest paycheck was the Social Security paycheck because it had been indexed for upward prices and so forth, then the pension plan, and he was still watching his savings, scared to death the older he got that he was going to somehow lose that bag of cash.

What we are asking employees to do today, my point is, we are asking people to do something that has never been asked of people before in the history of the United States. We are basically asking them to fund and finance the rest of their lives dependent on how much they save, what kind of investment decisions they make, and then the big challenge is how do you manage that money after you are retired, such that it can provide you an income that you can live off of? It is very, very difficult.

The biggest thing that—to tackle what a couple of other people have said—the biggest thing lost in terms of security when the employers go out of the defined benefit business is a mortality pool. That mortality pool makes it possible for someone to not have to worry how long they are going to live. This is something that cannot be self-insured. It has been provided by defined benefit plans for years. It certainly is provided by Social Security, and now with a defined contribution system, to Pam's point, someone is going to have to encourage people to understand what the value of being part of the mortality pool is, and that is a very, very big issue.

In terms of defined benefit plans I would just say we have business with many of the Fortune 100 companies in the United States. Unfortunately, I think the traditional defined benefit plan at the large end of the marketplace the cat is out of the bag. The employer has agonized over decisions to get out of the defined benefit plan. It was not an easy decision for them to make. To think of them reversing that decision at this point, I think is very difficult to envision.

The small plan, the small employer, one of the great things about a defined benefit plan is that the employer who has worked to build that business and may not have been able to afford a retirement plan in the early years, can reach back in time to give themselves and their employees past service credit on the defined benefit system. And for that reason I think that defined benefit plans might grow in the small business community.

[The prepared statement of Mr. Henrikson follows:]

PREPARED STATEMENT OF C. ROBERT HENRIKSON

Our Nation is at a retirement crossroads and the next decade will prove to be critical for the long term retirement security of individuals.

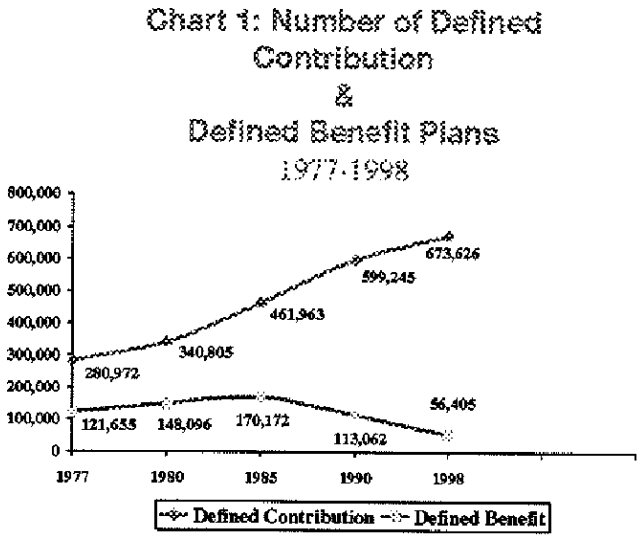
By now most of us are aware that many Americans have not saved enough for retirement. There are other factors at work that are compounding the problem. First, we are living longer than at any time in our Nation's history. Second, fewer and fewer people will be able to rely on the security and guarantee of a fixed level of lifetime income afforded by traditional pension plans. We expect that over the coming decades, especially as the Baby Boomer generation enters their retirement years, these factors will become even more pronounced. The convergence of these

factors has created the real possibility that many retirees will outlive their retirement assets or be forced to adjust their lifestyles and standard of living.

To better understand the magnitude of the problem the country faces, a discussion of the demographic and market forces that have led us to this point is instructive. Research results that speak to people's overall retirement preparedness will be highlighted and we will review some of the risks that are unique to retirees. Finally, one important solution to the need for lifetime retirement income—annuities—will be discussed and we will share with you some of the new product innovations that allow individuals to convert their nest egg into a guaranteed stream of income that they cannot outlive.

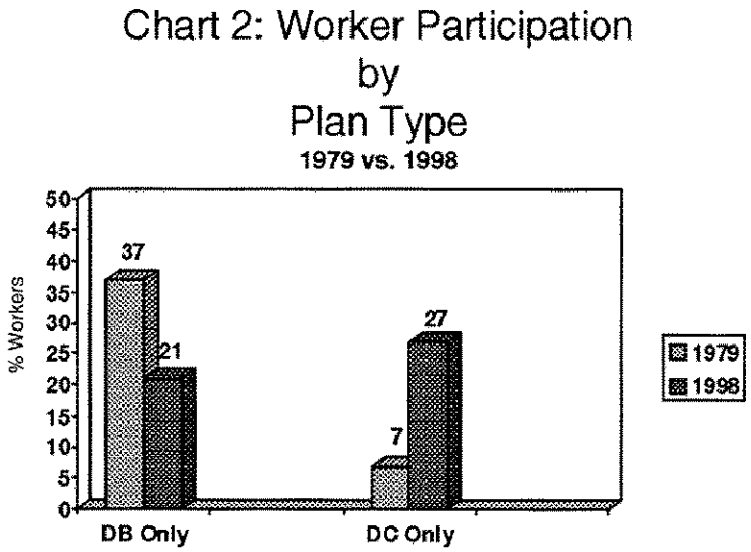
The Impending Retirement Crisis

The looming crisis facing us today is not one that happened overnight. We have slowly been evolving to this point over the last 20 years as the burden of saving for retirement has been steadily shifting to the individual. Over that time the number of defined contribution plans (DC) has been accelerating rapidly while the number of defined benefit programs (DB), with their guarantee of lifetime income, has been steadily decreasing. This trend will likely continue over the coming decades as defined benefit plans continue to face an uncertain future (see Chart 1):




Source: Department of Labor

The Department of Labor, in a Government Accountability Office (GAO) study released in July 2003, reported that the percentage of workers who participated in a primary defined benefit plan fell by 16 percentage points while the percentage participating in a primary defined contribution rose by 20 percentage points (see Chart 2):



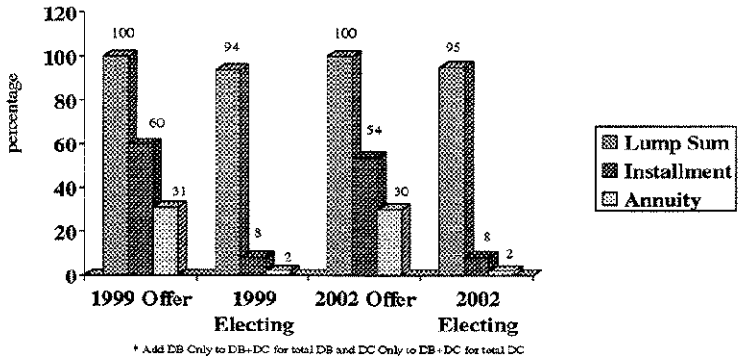

Source: Department of Labor; GAO report on private pensions July 2003

The PBGC estimated that the number of active employees covered by a traditional single employer defined benefit pension plan was 10.5 million in 2000, down from the peak of 22.2 million in 1988. Of note is the fact that half of today's plans allow employees to take their distribution in a lump sum rather than as a lifetime monthly paycheck. We believe the movement away from traditional pension plans will have a significant adverse impact on Baby Boomers' retirement security over the next 20 years.

The shift away from traditional defined benefit plans has put increasing pressure on retirement savings plans such as 401(k)s to be the primary source of retirement income. With it comes a tremendous challenge for our citizens as they are being asked to determine largely on their own to how much to save, how to invest that money wisely and how to prudently draw down their savings so they are not depleted prematurely. Although retirement savings levels are insufficient for many workers to enjoy a comfortable retirement, the larger issue is how those retirement savings will be managed in retirement so that they last a retiree's lifetime.

So what choices are people making at the point of retirement? In its report on private pensions, the GAO analyzed the types of pay-outs workers actually received at retirement from defined benefit and defined contribution plans. The analysis covered the period 1992–2000. They found that retirees in greater numbers are selecting benefits in a form other than a guaranteed lifetime payment (i.e., annuities). An increasing proportion of more recent retirees chose to directly roll over lump sum benefits into an IRA or to leave their assets in the plan. From 1992–1994 retirees choosing either of these options represented about 32 percent but grew to 47 percent by 1998–2000. Clearly, much of this can be explained by the shift toward defined contribution plans, less than one-third of which offer an annuity option. But the report went on to state that a growing percentage of retirees who reported having a choice among benefit pay-out options chose pay-outs other than annuities. An analysis conducted by the Employee Benefit Research Institute (EBRI) supports the GAO findings. All indications are that when given the choice to replicate the benefit provided by a traditional pension (i.e., an annuity), few individuals are making that choice (see Chart 3):

Chart 3: Payment Forms and Selection




Source: EBRI Analysis of 1992,1995 and 1998 Survey of Consumer Finances

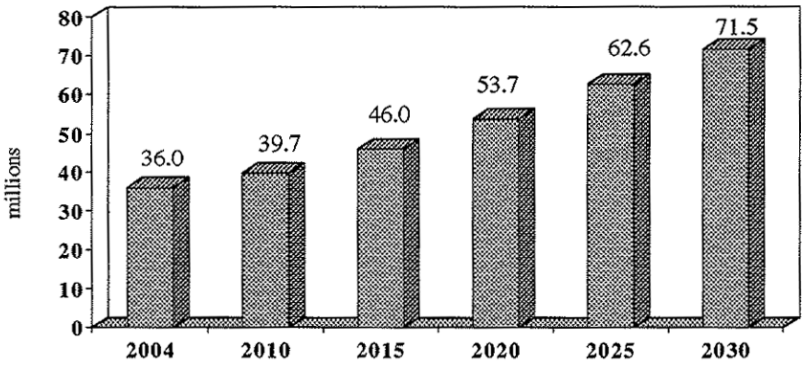
There are a number of reasons why people are choosing distribution options other than annuities. The two most significant reasons, however, are the lack of familiarity with longevity risk and not fully understanding how much their retirement savings are worth in terms of an income stream.

Given the clear trend away from traditional pensions, people will be relying on programs such as 401(k) plans that do not provide the same guarantee of benefits. They will be largely left on their own to replicate the security previously provided by defined benefit plans—security that was created by teams of actuaries, pension experts, investment professionals, benefit consultants, accountants, attorneys, and by the government through the protection offered by the Pension Benefit Guaranty Corporation. Stripped of this expertise and protection, employees need our help.

Consumer Preparedness

Increases in life expectancy, greater responsibility falling to the individual and the financial challenges faced by government supported programs are creating a period of great risk with regard to retirement security. This triple threat is magnified exponentially when you factor in that the 36 million Americans over the age of 65 will grow to 72 million 25 years from now. If that sounds far off, consider that the first Baby Boomers will reach the traditional retirement age of 65 in just 6 years (see Chart 4):

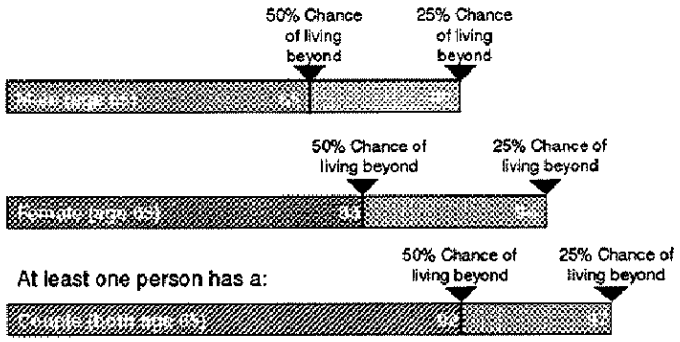
Chart 4: The 65+ Population is Growing Rapidly




Source: U.S. Census Bureau

So how prepared for retirement are these millions of people? In June 2003, MetLife created the Retirement Income IQ test. Twelve hundred men and women in the survey between 56 and 65 years of age and within 5 years of retiring were asked 15 questions to assess their level of retirement preparedness. Ninety-five percent of the respondents failed the test and the average score was 33 on a scale of 100 points. Perhaps most disturbing was the misunderstanding surrounding how long people will live. A 65-year-old man has a 50 percent chance of living beyond his average life expectancy. That's what average life expectancy means—about half the population will live past that point and the other half won't. Yet when we posed that question to 1,200 individuals, the majority of them thought there was only a 25 percent or less likelihood of living beyond average life expectancy. Only 16 percent of respondents replied correctly that a 65-year-old couple have a 25 percent chance that one of them will live beyond age 97 (see Chart 5):

## Chart 5: People Underestimate the Time Spent in Retirement




Source: Society of Actuaries 2000 Annuity Male and Female Tables

Respondents also underestimated how much money experts recommend they need for retirement and they overestimated the recommended rate at which they can safely withdraw from savings to help make their money last throughout their retirement. Over one-third believe they can safely withdraw 7 percent from their savings annually, even though planning professionals suggest limiting annual withdrawals to no more than 4 percent. When you combine underestimating longevity with these other findings, the picture becomes very unsettling.

The results from the Retirement Income IQ are corroborated by many other industry studies. EBRI's 2004 Retirement Confidence Survey notes that less than one-half of workers have even done a basic retirement calculation. Other results of note from this survey include:

- Approximately one-third of respondents are not confident of having enough money to live comfortably in retirement.
- One out of six workers said that they were not too or not at all confident of having enough money to take care of basic expenses in retirement.
- Nearly 4 out of 10 workers believe they will need seventy percent or less of their pre-retirement income while retired, a sharp contrast to the 90 percent to 100 percent that some financial experts estimate individuals will need.
- 66 percent of all workers have given little or no thought as to how they will manage their money in retirement so that it doesn't run out.

MetLife's 2004 Employee Benefits Trend Study found that nearly half of workers rank "outliving their assets" as their greatest fear. More than half of Baby Boomer employees ages 41 to 60 describe themselves as "behind schedule" in saving for retirement, with 28 percent reporting that they are "significantly behind" and an additional 27 percent described themselves as "somewhat behind." Only 3 percent have reportedly reached their goals. Other results of note from the survey include:

- Nearly half of all those surveyed report that they manage their finances by living paycheck-to-paycheck.
- Young workers between the ages of 21 and 30 are the most unprepared, with nearly half lacking retirement goals and/or savings.

What is the answer? Individuals must receive better retirement planning education. It is our belief that the most successful programs are those that are made available through the workplace and then targeted to employees at various life stages (e.g., singles, established families, pre-retirees, and retirees). Beyond that, we believe individuals must receive investment advice so they understand how to maximize their retirement dollars. We also need to shift the conversation from retirement *assets* to focus on retirement *income* and offer tools to make this happen. Even those who have built a relatively large nest egg do not know how much income that

nest egg will produce throughout their retirement. In short, Americans don't know what their savings are really worth.

Risks in Retirement

Once they reach retirement, there are certain risks people face that they did not have to confront during their working years.

A significant concern for retirees and pre-retirees alike is **inflation.** According to EBRI's 2003 Retirement Risk Study, over half of retirees and nearly two-thirds of pre-retirees are *very* or *somewhat* concerned that they will not be able to maintain the value of their savings and investments relative to inflation. In addition, pre-retirees expressed a greater concern than retirees over the possibility of not having enough money to pay for good health care (58 percent of pre-retirees are *very* or *somewhat* concerned as opposed to 43 percent of retirees). Pre-retirees are also more concerned about their ability to pay for quality long-term care.

**Market volatility** is another risk that can have a unique impact on retirees. Recent stock market experience has taught us all how quickly and how adversely our savings can be affected when exposed to a bear market. But for people who are still saving they have the benefit of time on their side and have a reasonable expectation of seeing their assets return to or even surpass pre-downturn levels. However, for retirees market downturns can have a devastating impact, especially early on in their retirement years. Too often people rely on averages and base their planning (if any) on the assumption that their account will return the average. They research the historical market returns, plan to withdraw an amount less than the historical average return and then feel confident their money will last them well into their retirement years. However, a market downturn in retirement can have a much greater impact on a retiree's nest egg if they are taking withdrawals than if they are simply saving and still have time to recover from any stock market losses. Using average returns while planning is dangerous because the market does not earn averages in any given year and once you withdraw in a down market, you realize losses never to be recovered.

However, we believe that the biggest risk facing retirees is longevity. An earlier graph illustrated the average life expectancies for males, females and couples. When we shared these statistics with consumers most expressed shock and some even disbelief. But the numbers are accurate and, as we continue to make advances in medicine and adopt healthier, more active lifestyles, life expectancy will stretch out even longer.

The reason we believe longevity is the greatest retirement risk retirees face is because it is the only risk an individual cannot manage on his or her own. Market risk can be alleviated somewhat through asset allocation and inflation risk can be addressed by investing in growth equities or inflation indexed bonds. Not only is longevity the one risk individuals cannot manage by themselves, it actually exacerbates these other two risks by increasing the length of time individuals are exposed to them.

Managing Longevity Risk

How long one individual will live is extremely uncertain. People can take a guess as to how long they are going to live . . . plan so that their retirement assets last the right amount of time . . . and then hope that they haven't miscalculated their life expectancy. Fortunately, there is a better way to manage life expectancy. Join a mortality pool and ensure that you will not outlive your retirement assets.

The pooling concept is a powerful one that's at the heart of all insurance products and defined benefit plans. Longevity is a small risk for the sponsors of large defined benefit pension plans since the "law of large numbers" permits them to fund for the average life expectancy of the entire group of retirees. When a large group of retirees is pooled together, the retiree who lives a long time is offset by the retiree who dies early.

By contrast, individuals cannot self-insure the risk of outliving their money because they cannot accurately predict how long they will live. Whereas an individual can decrease his investment risk by changing his investment strategy, there is no way that an individual can, on his own, reduce his longevity risk. The only way that an individual can manage this risk is by converting his savings to an annuity. With annuities, a retiree can manage longevity risk and may choose to keep some portion of investment risk (along with its potential return) through a variable income annuity. Or a retiree can manage both longevity and investment risk with a fixed income annuity. An income annuity, also known as an immediate or payout annuity, is an insurance product that converts a sum of money into a stream of income that is guaranteed to last throughout the lifetime of the policyholder.

The Next Generation of Retirement Income Solutions

In the coming decades, we believe that annuities will be a critical part of the solution to helping people turn their nest egg into guaranteed lifetime income in retirement. Market research indicates that there is greater receptivity to annuities once their benefits are explained. Furthermore, we are beginning to see more innovative product designs that are intended to meet the needs of today's—as well as future—retirees. Companies such as MetLife are helping to revolutionize how employees prepare for the 20, 30 or even 40 years that they will live in retirement. The insurance industry has introduced some of its most innovative retirement products during the past 2 years. This "new generation" of income annuities—which are supported by a range of educational programs and tools—allow individuals to convert their nest egg into guaranteed income that they can't outlive. To reflect the needs of today's retirees and the retirees of the future, income annuities have become more flexible, more affordable and portable, while retaining the product's core value of guaranteed lifetime income.

One recently introduced income annuity is a type of longevity insurance—designed to generate income starting at a later age when an individual's retirement savings may be running out. The individual may elect to receive the monthly income from the product, for example, on his or her 85th birthday—the average life expectancy for Americans who have reached age 65—or at any point during an individual's retirement. Since the individual would typically buy this income annuity between the ages of 55 and 65, she is deferring the income start date 20 or even 30 years into the future. It allows her to set aside a smaller portion of her retirement savings in order to generate a steady stream of guaranteed income in the later years when many of us need it most. It also allows her to manage her remaining retirement assets to a limited time horizon.

Insurers are also introducing income annuity products that are targeted to a younger audience. These new products allow employees to create their own "personal pension." Offered as a complement to, or as an option within, a 401(k) plan this type of product is unique in that—unlike traditional savings vehicles—every contribution an individual makes is immediately converted to a specific future income benefit that is guaranteed to last a lifetime. This is similar to a defined benefit plan. The product is also portable so workers can take it with them when they switch jobs. The need for portability is clearly important since, as reported in the National Longitudinal Survey of Youth, the average Baby Boomer held 10 jobs by the age of 36.

We are also seeing more income annuity products that offer liquidity options that allow purchasers to access money in an emergency and inflation options that link benefit increases to changes in the CPI. In addition, products are offering features (e.g., more investment choices, transfers, and rebalancing) that provide individuals with the flexibility and control that they are used to seeing within their 401(k) plans.

During the last Congress, the House Ways and Means Committee marked up legislation that takes important steps in educating individuals about the value of income annuities by including a targeted income tax exclusion for retirement plan distributions taken in the form of annuity payments. The bill also contained important fiduciary safe harbors for employers that offer a specific annuity or IRA at the time of distribution, which will encourage employers to offer annuities to 401(k) plan participants. Finally, a new pension bill to be introduced in the near future not only includes these provisions but also recognizes the value of longevity insurance by excluding the amount of money used to purchase such insurance from the required minimum distribution rules.

We believe that a concentrated effort to educate consumers about the benefits of annuities, coupled with legislative proposals, will go a long way in helping us meet and overcome the retirement crisis facing the country.

The CHAIRMAN. Thank you.

Mr. Garrison.

## STATEMENT OF DOUGLAS GARRISON, MANAGER, GLOBAL BENEFITS DESIGN, EXXON-MOBIL

Mr. GARRISON. Thank you, Mr. Chairman. I applaud the committees for this forum. I think this is, as Mr. Henrikson said, it is a very useful opportunity to share ideas among ourselves with the different perspectives that we have.

The point I would like to make would be to rise a little bit above some of the details, and my sense is that what we fundamentally face is a need for retirement security 20 years out. That need is going to be high considering the proportions of unprepared baby boomers that we have, the extended life spans, the increasing cost of health care, the limits on Social Security and the like. I think there is no doubt that the need for retirement security is going to be there.

I would like to point out that I think business objectives that are served by retirement plans are still there. Some of us in the company that I work for, Exxon-Mobil, has both a DB and a DC plan. I am also the chair of the ERISA Industry Committee and represent approximately 120 large employers. Many of our companies believe that our business objectives are well served by retirement plans. We attract and retain people. We enhance productivity. We reinforce corporate culture. We reward long service. We facilitate the renewal of the workforce. These are corporate objectives that are served by retirement plans, and I think those corporate objectives will continue to exist 20 years out.

In terms of the plans themselves, they are going to be shaped, in my opinion, by the business needs, by employee wants and desires, what the employees are looking for, by the regulatory environment and by the technology and sophistication of the industry.

I would like to point out that I believe there are a number of advantages of employment linked plans, primarily the discipline in the accumulation phase, as well as in the discipline in the spend down phase. In my company, for example, we have approximately 96 or 97 percent of our eligible people participate in the DC plan. We have designed it really to induce participation. You do not get any match if you do not put 6 percent of your own contributions in, and folks get matched dollar for dollar for that 6 or 7 percent. It is a very high cost that you pay if you do not choose to participate.

There are a number of other very innovative ideas out in the marketplace today in terms of automatic participation and increasing percentages of contributions as pay goes up, which I think the employer can provide some discipline to help promote the sense among participants, employees, of the need to set aside resources for their retirement.

I guess the key question for me is the degree to which policymakers will facilitate the creation of plans that cover more workers while enabling plan sponsors to retain the flexibility to stay competitive.

I think we need, as others have mentioned this morning, stable and predictable ground rules. I think we need nationally more interest in saving for retirement among workers, and we probably need a longer time horizon among plan sponsors and investors.

Thank you.

The CHAIRMAN. Thank you.

Mr. Fuerst.

**STATEMENT OF DON FUERST, WORLDWIDE PARTNER, MERCER HUMAN RESOURCE CONSULTING**

Mr. FUERST. Thank you, Senator. I share the belief of a number of people that we need diversified assets to really secure retirement. Like an investment portfolio that needs to be diversified to provide real security, financial assets in retirement need to be diversified. The three-legged stool needs three strong legs.

The problem that we see demonstrated by the chart behind you is that one of those legs have been declining for a large number of our Americans, and my work as a consultant to large companies, helping them design and finance these, I would echo the comments that others have made earlier, it is difficult to justify to senior management why they are taking on the cost of these benefits. An even more challenging situation is to try to explain to a company that does not have a defined benefit plan why they might want to add one for the benefit of their employees.

They can recognize many of the benefits, that defined benefit plans generally provide universal coverage for everyone, that they provide a relatively uniform benefit for most employees, that there is no leakage from the plan through early withdrawals and loans, that they can offer special benefits when they have layoffs, window benefits or past service benefits as others have mentioned, that the longevity pooling resulting from defined benefit plans can create an enormous amount of value.

But they also recognize that they are taking on an enormous amount of risk with that plan, and that the risk is not justified in many of their viewpoints. The volatility of contributions is an enormous problem for financial executives today to justify that.

Many of them were very happy in the 1990s when we had what we called funding holidays. In retrospect, those funding holidays were very detrimental to the long-term security of the plans. We need major revisions in the funding rules of these plans that will enhance both the solvency of the plans but also the predictability of the contributions. Both of those elements are extremely important.

We need greater certainty about the legality of these plans. There are many innovative ideas about how to design new pension plans that respond to the needs of a mobile workforce, but most of those right now are under an enormous cloud of uncertainty about the legal aspects, and companies are not willing to implement these new plan designs that would enhance portability and the mobile workforce when they see enormous legal risk to those plans.

Finally, there is just very little incentive or even appreciation for many employees, particularly young employees because of the deferred nature of these benefits. We need more incentives for companies to adopt these plans and more incentives to make the plans attractive to employees. We have had enormous creativity with respect to savings plans and defined contribution plans over the past 30 years. Employees can put money into these plans on a pretax or after-tax basis. They can now even have the flexibility of taking their tax benefit when they put the money in or when we take the money out. We now have plans that can provide tax-free income in retirement.

We have a lot of creativity in the design of defined contribution plans through issues like automatic enrollment or investment funds that automatically change asset allocation throughout an employee's career, but we cannot make those types of innovative changes in pension plans today because of the uncertainty under the law. We need more incentives for employers to first of all be clear that these are legal and to provide a financial incentive.

I would suggest a couple ideas. For instance, perhaps a tax credit for a company that maintained both a defined benefit and a defined contribution plan to encourage the diversity of that financial security. To employees to make the plans more attractive, the ability to get tax-free income from a retirement plan. An exemption from taxation of a portion of the benefit paid as a lifetime income to an individual would create enormous grass roots supports for these plans. Employees would be demanding from their employers that they establish a plan that would provide that type of income to them. So these are the kind of changes that we need to reverse some of the trends that we have seen over the past 20 years.

The CHAIRMAN. Thank you.

Mr. McNabb.

**STATEMENT OF WILLIAM MCNABB, MANAGING DIRECTOR, CLIENT RELATIONSHIP GROUP, VANGUARD**

Mr. MCNABB. Thank you, Mr. Chairman.

At Vanguard we deal with a huge array of different types of investors including IRA investors, defined benefit plan sponsors, as well as defined contribution plan sponsors. And as we talk to them and due research amongst them in terms of where they see the future going and where they would like to see the future going, what actually strikes us is the commonality that you hear among them even though you are dealing with very different constituencies.

Among the plan sponsors, be they large or small, the two common themes we hear, and we have heard this from some of the other panel members, are plan sponsors need to know what their benefit programs are going to cost, that that need for specific knowledge around the cost of the program is very important. The advent of 401(k) plans really in the early 1980s when many of us began in that business, was that was a big part of it was the cost was known. You could predict year from year from year what the cost was going to be, and I think that was a lot of the attraction to corporate CFOs, and again, you have heard that from some of your other members.

The other issue that rises among plan sponsors, whether they are large or small, is this whole mobility of the workforce that you referenced in your opening comments, the fact that people are going to have 10 or 12 jobs, portability becomes a very important concept.

It is really to that end, when you look at sponsors as well as individual investors who may be in IRAs, the themes that come across are common. One is portability, the ability to move from one kind of plan to another. If you think about our system today we have 401(k) plans, 403(b)(7) plans, 457 plans, 401(a) plans, SEP IRAs, simple IRAs, simple 401(k), etc, and it is very complex. And how you move, what the rules are to move from one plan to another are

very arcane. So the whole concept of portability and simplification is something that really resonates with investors, again, whether they are small businesses or large corporations.

The other big theme we keep hearing is we have to do things to make it easier for people to invest, and again, people have referenced some of these programs, the auto enrollment or the auto increase programs that you mentioned in your opening. Auto increase, we have some experience with that. We have 200 plan sponsors covering about half a million workers today where there is an auto increase component in the plan. And we have seen among those plans the average savings rate go up in the last 12 months about 1½ percent, so those are the kind of programs that seem to work.

What we hear from sponsors and participants is, what are the incentives to do that? It is not necessarily tax credits or financial incentives, but it may be—it may take the form of fiduciary relief in terms of if we structure a plan a certain way, will we have some level of fiduciary protection? I would reference on the fiduciary side, several years ago, 404(c), the interpretive bulletin came out for 404(c), and I think again many of us here worked with that. What that did, for those of you not familiar with it, is it gave plan sponsors of defined contribution plans a certain level of fiduciary protection.

If you want to see how positive a legislative change can be, you could look at 401(k) plans before 404(c), 401(k) plans after, and what you see is a huge increase in participation rates and a huge level of increased diversification. We think those same kind of principles could apply in terms of portability, the auto savings programs and so forth.

So as we think forward, looking out 20 years, what you would hope would happen is rather than building a more and more complex system, we would actually strip away some of the legacy systems and make a simpler more incentivized system for people to save.

The CHAIRMAN. Thank you.

Mr. Sperling.

## STATEMENT OF GENE SPERLING, SENIOR FELLOW, CENTER FOR AMERICAN PROGRESS

Mr. SPERLING. Thank you very much, Senator. The statistic that Senator Kennedy gave at the beginning about the median being $50,000 is actually in some ways too optimistic. That is for those who have those savings. Over half of people 55 to 59, over half have less than $10,000. I mean that is a stunning statistic. Over half of all Americans 55-59 have less than $10,000 in a 401(k) or IRA, which seems to me pretty clear we either have to be or together both increasing the role of defined benefits and finding out how that can be more viable.

But I guess I want to concentrate my comments on how we should be making the 401(k) model more targeted to actually doing what I consider to be our goals for having incentives, which is to increase our private savings rate, to increase retirement security among the second and third leg of our retirement system.

Our system today of incentives could not be more upside down. We have one system essentially for encouraging savings in our country, tax deductibility. When tax deductibility is your only incentive for savings, it turns our progressive tax system on its head. So when Senator Kennedy talked about the CEO and the person who might be cleaning their office, the person cleaning their office, if they can somehow manage to save a dollar gets a 10 percent deduction. The CEO gets 35 percent deduction. Now, what in a sense happens is we have a system in which we are giving the least incentive to those who need the most help saving and the most incentive to people who need the least help.

What is very clear is that we have incentives now. We spend hundreds of billions of dollars over a decade incentivizing people to shift savings, well-off people to shift savings from nonpreferred savings to tax-preferred savings. We are not doing that to increase our private savings rate. And I think that we need to take a look at whether this notion of just providing incentives through tax deductibility makes sense because what is happening now is that it is an upside down system. It is funny, if you are a public servant like myself, not that I am a well-off person, but you make a little bit more savings you can really feel it. When you are really struggling, there is very little for you. When you start to make a little you can get a SEP IRA, the world comes at you. You get 35 percent deductions. You get 401(k) matches. We have a very divided society right now, and I see that division as going greater.

I think we need to think about how we can use what we know works best and use public policy to encourage it. What we know works well is when people have money automatically dedicated, where they have a significant match for them. How significant that match might be is important. It may need to be quite a lot higher for more low-income people who we now do the least for.

So the question is how could we do this? My view is that we should be moving toward a kind of a universal 401(k), where in a sense every single American at all times will essentially have the model that the people in the very best or most generous plans that we have heard get. In other words, any time a person invests a dollar who is middle income, that they could get a tax credit for that dollar.

Now, we had a small step with the saver's credit but it is a tiny step. It is not refundable. It does not go up to cover that many people. We are trying to do this on the cheap. Were we to do a system, were we to give a tax credit, a refundable tax credit for low income people that might be 2 to 1 and a 1 to 1 credit for more moderate or middle income people, we would be turning our tax incentive right side up. We would be putting the greatest number of incentives to the people who need it most.

I will just very quickly say what that would do. One, it would actually leverage private savings to the degree the government was giving a dollar in tax incentives, it would only be going to the degree it was targeting people who were not saving now. Therefore rather than the embarrassing statistic we saw in the New York Times, which is that the amount that we were giving away in tax incentives was more than our overall private savings rate, we

would be targeting incentives to leveraging additional private savings.

Second, the automatic 401(k) models are good, but a company has to provide it. If you had a generous tax incentive it would make it more easy for companies to want to provide a deductibility option if they knew their employees were going to get a significant match. It would make it easier for private sector employees to give an attractive match if the government was sharing in that, and they would have an incentive to do that to the degree that it helped fix their—made it easier for them to meet their nondiscrimination rules.

For the part-time contingent workforce right now when they drop off they have no pension and they have no incentive to keep their pension. So one of the things we have not talked about is that most people cash out. But if people could roll over into a universal 401(k), where even as they worked part time or even as they were home for child care, they could still get a matching incentive, that would encourage more people to do this.

So I really think we need to think very seriously about our incentive system and turning this upside down system around so that our tax incentives are targeted to the people who are not saving now instead of just encouraging people to shift savings from one account to the other.

The CHAIRMAN. Thank you. I want to reiterate that if others of you—I am going to take two more people to speak, Mr. Houston and Mr. Salisbury, and then we will move on to another question. I know a lot of you have some additional comments. Hopefully you will share those with us.

Senator Grassley had to leave to go to the White House and have some discussions there that include some retirement, and——

Senator KENNEDY. I hope not mine. [Laughter.]

The CHAIRMAN. I think it includes yours. [Laughter.]

And Senator Kennedy has some obligations on the floor so he will have to leave shortly. Senator Reed has already been here. Senator Burr is here, Senator Hatch, Senator Thomas. We appreciate all of you being here and know that you have staff that was here before you came, and there are other members of both committees that have staff here that have been collecting your comments and that will be doing some additional research. We actually do not do all of our own research, and they will provide us with some summaries and help us to get through this issue.

We will continue on this question for two more people, and then move on to a second question. Mr. Houston.

**STATEMENT OF DAN HOUSTON, SENIOR VICE PRESIDENT, PRINCIPAL FINANCIAL**

Mr. HOUSTON. First let me just say it is an honor to have the opportunity to have an open discussion on these very important issues.

The Principal Financial Group has about 40,000 small- to medium-size customers. About 1 out of 11 small employers with fewer than 100 employees have their retirement benefits with the Principal Financial Group, which is about 3 million American workers. This week at the end of the week I will be in Tucson with the Inc.

500 group. It is the 500 fastest growing companies. And if it is anything like it was last year, what they would tell you is top of mind for them is growing their businesses; the second is capital formation; third is health care like we heard earlier; and the fourth one would be around retirement benefits. With these small employers they typically will talk about how onerous some of the rules are as it relates to compliance and being in compliance as a small employer. So again, if the question is, are there things we can do to simplify retirement rules and regulations, I think it would be well received by small- to medium-size businesses, and again, we can submit that, Chairman, for your review, some ideas that we have in this area.

Mr. McNabb spoke at Vanguard about what can happen locally to help better increase pension coverage, and again, we have similar experience in that when we put salaried employees with small- to medium-size group employees with one-on-one meetings we can see participation go from 75 percent to 90 percent. We can see average deferrals increase by 1½ to 2 percent. I would also tell you that when we can sign them up for auto enrollment and step up, they will start at 4 percent and end up at 8 percent. And again, I think Mr. Salisbury would comment that if we can get American workers to save between 10 and 15 percent we can reduce pension liability significantly.

And that really leads me to my last point, and that is I do not think we can forget the responsibility the American workers have to do a better job. They simply are not saving enough, and no matter how much policy we develop, if a young worker is not putting away 10 to 15 percent of their salary from the day they start employment, they simply will not adequately fund for retirement. And again, if they were at that level, they would not need the fallback position of a defined benefit program.

Thank you.

The CHAIRMAN. Thank you.

Mr. Salisbury.

**STATEMENT OF DALLAS SALISBURY, PRESIDENT AND CEO, EMPLOYEE BENEFITS RESEARCH INSTITUTE**

Mr. SALISBURY. Senator, thank you very much, and I appreciate being here.

Just to build on the comments others have made with a slight twist, and the last one is I think that part of what we are seeing is if we look at today's retired population, about 22 percent have pension income from a private defined benefit plan, and that is actually lower than it was as recently as 10 years ago. If we look at that in replacement of those now retired, about 21 percent of their income for public and private sector retirees comes from an annuity income from a pension. That is projected for late boomers, if the system simply stays as it is, to decline to 10 percent. If the system continues to have employers eliminate new employees from those plans, which by our estimates occurred in at least 20 percent of defined benefit plans within the last 12 months, then those numbers are going to be even lower.

If we look at what is happening then, the trend lines, as Mr. Trumka and others have said, can be expected to continue, most

Americans, frankly, have always been on their own other than Social Security. And if we look at current retirees, Social Security is providing 38 percent income replacement, for the generation of late boomers it is projected to provide 31 percent income replacement.

Savings plans and defined benefit plans, as other speakers have noted, but defined benefit plans, importantly, have moved away from the traditional annuity provision. Over 25 percent of existing plans in the defined benefit realm are now cash balance. I am only aware of one that does not offer lump sum distributions. In those that do offer them, about 98 percent of participants choose a lump sum. Of the other 75 percent of existing private defined benefit plans, half now offer lump sum distributions, and depending on what survey you look at, between 67 and 97 percent choose the lump sum distribution.

So if there are two things in this realm that Congress needs to focus on, I would suggest they did in this last legislative round, one is the tremendous importance of financial literacy education and getting basic education and savings education into our schools early, and doing better, as Rob noted, with future generations making the effort to save than past generations did. And the data makes clear that past generations did not.

Second, it is longevity education. That has been described by people here vis-a-vis annuities, but the sad fact of the data is individuals, when given the choice between an annuity and a lump sum, do not select annuities. And a large part from our retirement confidence survey research that is indicated by the fact that most Americans today think they will die far sooner than statistically they are likely to live. In other words, the general population believes when we use the term "life expectancy"—which most in this room know means average, 50 percent will live beyond that—most Americans think life expectancy means that is the longest I am going to live.

So my dad, now 91, still getting that defined benefit pension check, who thought he would be dead about 20 years ago because of childhood diseases and other things, his only income beyond Social Security is now that pension check. It was always smaller than Social Security. For 25 years it was a fraction of income from selling off their primary residence and other assets, but now it is the only thing they have. If it had been left to my parents at the time they retired, "Do you want an annuity or a lump sum," my father tells me, as a former life insurance man, he would have selected the lump sum distribution because he did not think it would in the long-term mean anything to him.

Second, vis-a-vis the trend line of if we do have additional change, two issues that Congress is dealing with or has on its table where, as other speakers have noted, it could fundamentally change or determine what the world looks like 20 years from now. One relates to accounting treatment, and in the congressional sense last year the Congress dealt with the interest rate for funding purposes, and the debate was between the yield curve proposals of the administration, which matched what the Financial Accounting Standards Board is talking about doing, or allowing pension funds, defined benefit plans to continue to be funded with so-called

smoothing, assuming midline for the future. We have historical experience now on what this does to the defined benefit system.

In Great Britain over the last 12 months, 65 percent of defined benefit pension plans have been frozen against new entrants because of FAS 17 and the move in the United Kingdom to mark to market accounting similar to the yield curve. That may or may not mean you want to do it. But if that is the direction public policy and accounting policy goes, it is predictable that most of the remaining defined benefit system for future workers will go away.

The second is cash balance clarity. As has been noted, whether one loves them or hates them, wants them or does not want them, the effect of an absence of regulatory clarity is day in and day out leading to the closing down for future workers of cash balance defined benefit plans. So the absence of clarity is essentially a decision that one wants them to disappear. We do not lobby. We do not take positions. I am not saying you should feel one thing or the other.

I will just emphasize that in terms of whether those late boomers manage to get 10 percent replacement from defined benefit plans or zero is largely in the hands of the Congress today vis-a-vis the combination of the accounting issue and the cash balance clarity issue. On stock options and other issues, there have been issues of do you tell FASB what to do? This is one where if the private regulation takes place, then the fate of defined benefit plans, if it follows what it has in the United Kingdom, will fundamentally change the trend lines on the charts behind you, and defined benefit plans will markedly be, if you will, gone 20 years from now.

Finally, in terms of that long-term trend I just underline where I started. The education point, is with longevity increases and with individuals needing to contemplate. In my case I used the longevity calculators. I have an aunt who is 105. My father is 91, my mother is 88, and individuals in my family have lived into their 80s for over 100 years. The calculators tell me 103. I want to find an insurance company to take that risk. [Laughter.] But it requires trust, and it is the one thing I would underline. One of the reasons individuals today take a lump sum instead of an annuity is because of an absence of trust that their employer will still be there, an absence of trust that their employer will keep the promise. The reason they tend, based on research, to not buy annuities is an absence of willingness to trust that the offering insurance company will be there 40 or 50 or 60 years from now.

So while we talk about short-term, one of the most important issues vis-a-vis education as well, and legislating, is trying to figure out how vis-a-vis that 20-year margin to bring trust back into the system so that the public will think about longevity risk.

Thank you.

The CHAIRMAN. Thank you very much. I have to cut off discussion on that and will reiterate that if any of you want to expand on your comments or provide us with information or counterpoints that has been brought up, it would be very helpful. We have had a truckload of information, and one advantage to this format is that we have been able to get information from a lot more people than we would be able to do in a hearing.

I am going to switch gears a little bit and go to a different question because we do not operate in a vacuum. There is little doubt that the global marketplace has a broad effect on U.S. companies that are planning for the future. Today many companies do have overseas operations. I know one in Cowley, Wyoming—anybody here know where Cowley, Wyoming is? The mayor there told me that I could say that he lives a half a block from downtown and a block and a half from out of town. [Laughter.] But he runs a little overseas operation that provides lamps, those tubular great lamps that go in the front of big office buildings, and he ships those all over the world. So all sizes of business have this problem too, and they are in competition with companies in other parts of the world. Many of the bigger companies have overseas operations, and therefore have retirement pension and benefit plans in those countries as well.

How do overseas private sector pension and benefit plans and initiatives affect the U.S. companies' decision on retirement benefits for their workers? How do we expect this to change in the long-term for U.S. workers? What are the international implications here? Anybody want to start us off? Yes, Mr. Salisbury?

Mr. SALISBURY. I will just add off of the UK experience in talking to consultants in companies that because of the changes in the United Kingdom have chosen to terminate or freeze their defined benefit plans in the UK. That has ended up feeding decisions to make changes in their U.S. plans as well, and it has basically made it—their choice of words—easier to rationalize recent decisions to not make the defined benefit plan available here to new hires because it will no longer be available in the United Kingdom. The two nations in the world with the strongest defined benefit systems up until last year were the United Kingdom and the United States.

So I think as we see change in other countries taking place, the International Accounting Standards Board is expected to extend FAS 17 to all nations, and with that change, we are likely to see a world pressure in that direction of more freezings of existing defined benefit plans.

The CHAIRMAN. Before we go to—we will do Mr. English, and I think that Senator Hatch has had a question that he wants to kind of throw out here too as a result of the discussion.

Mr. English.

Mr. ENGLISH. Thank you, Mr. Chairman. I think—and I am following up a little bit on the point that Dallas was making. There is a difference, I think, as we look at this issue, between those who are offering service, those that are in competition and those that are not. That may start having a dramatic impact with regard to this entire issue. Ours is a service industry. You are not going to go overseas and get electric power and bring it in to rural America. We are not going to be in competition. A lot of small business in this country is not going to be in competition, unlike the example that you used, Senator. They are not going to be in competition overseas.

There may be something of a watershed that develops here between small business, those who in the service industries that do not face competition overseas and those that do. It is going to be an interesting reversal if you have greater benefits in people living

in rural American and small towns and in small businesses than you do in some of the largest corporations in this country. But I think you could very well see that take place.

Also there is a difference with regard to the employees themselves. It is not unusual still in rural America to see employees stay with one company throughout their entire history as an employee. Certainly with electrical operatives, most of our employees do in fact stay with the same electric cooperative, live in the same small town throughout their history. And this defined benefit program and the defined contributions that have been in existence for our employees for so long obviously is—we are reaching a point in which they may in fact be better off in retirement than many of those who live with some of those more generous contributions that are made from a wage salary standpoint in some large corporations.

So it may be that we are seeing a reversal now for those of us who come from small towns and rural communities. We see this as a wonderful thing that is developing, because if you want to live well and you want to have good defined benefits and defined contributions over an extended period of time, you better move to rural America. Cities cannot give it to you anymore because most of their businesses are in competition overseas, and they simply cannot afford that particular benefit. That may be a bit extreme but you know it is an interesting development that may come about as a result of this.

Again, I would make the point that what has stopped people in small businesses and particularly those in rural communities is they simply have not had the resources to put together a defined benefit program, and certainly they cannot maintain it. They cannot take care of it. They cannot have that kind of expense and certainly do not have that level of sophistication.

Again, we would strongly urge that you look at the multiple employer approach as a way in which you can pool those kinds of resources and offer those kinds of benefits to people in small business in this country, and particularly those who may not be in competition overseas.

Thank you, Senator.

The CHAIRMAN. Of course we are always tempted to make some comments about the comments, but I will withhold.

We do have the extreme pleasure of having Senator Hatch here, who not only serves on the Health, Education, Labor and Pensions Committee, but he is also on the Finance Committee. So he is the joint person at the joint meeting. And it is kind of historic that our two committees are working well together to come up with some solutions. And so the man that holds it together.

Senator HATCH. The joint person on the joint committee who feels disjointed about this subject. [Laughter.]

I would just like to ask you what new tools or savings plans are needed to get new entrants into the labor force to start saving early on in their careers? Somebody may have answered this before because I was not here earlier, but I would like to have you take a crack at that. What are some of the tools that would help us in that area?

The CHAIRMAN. Mr. Henrikson.

Mr. HENRIKSON. Yes, I will take it. It has been discussed to some degree. I think the strongest statement which also tells us a little bit about what is being expected of employees, I think is what I would call an automatic enrollment approach. In other words, if you can get people to have as the default option that they are part of a plan, that would have a great effect.

The problem, however, one of the things that is sort of implicit in that is if employees need to have an automatic enrollment program to take advantage of something that might give them an immediate 50 or 75 percent return on their money, we are asking those same employees to make decisions after they start to build money, relative to their mix of stocks and bonds and so forth and so on, and then at retirement, as if crossing 65 were sort of crossing a finish line, that is the beginning of the most difficult time they are going to have.

In a syndicated column not too long ago it just struck me. Someone said, "Now that 401(k) plan participants are comfortable income averaging in to the marketplace, what they really need to do is as markets go up and down, they should learn to save more when the stock market declines. They should be value averaging in." What this says to the retiree, of course, is that you ought to learn how to value average out. If the market goes down, simply live off of less every month if you are taking periodic withdrawals.

So saving is great. It is great to have increased savings, but the question is, are the savings going to turn into a secure retirement income?

Senator HATCH. Thank you. Anybody else?

The CHAIRMAN. Mr. Trumka.

Mr. TRUMKA. I want to go back to a point I made at the beginning. First of all, none of the pension stuff is done in a vacuum, so Mr. Houston said that young people are not saving enough money. There is a reason for that. Many of them cannot save money and will not ever be able to save money. They have stagnant wages. They have health care costs that are going off the chart. They have an educational system that they may have to pay back school loans. Many of them in industries like steel or airlines are living on wages that they were paid in 1980. Inflation has gone beyond them. They cannot save. That is why defined benefit plans are so absolutely essential in all of this.

And it all ties together because you take the manufacturing crisis that we are seeing. We have lost 3,000 manufacturing jobs. Most of those jobs were high paying jobs that provided pension benefits. They are not there right now. You take a trade bill that is not enforced with China. They manipulate their currency. They give an employer a 45 percent advantage by going offshore and manufacturing in China. They will go offshore for 45 percent. The trade bill is not enforced in other areas. It gives them another 40 percent because they do not enforce their child labor laws, their prison labor laws. That gives them another incentive to go offshore, take the jobs away that take the pensions and the means to provide those pensions with them. You take a tax code that rewards people for going offshore. That also affects the ability, and that is how globalization has tied into all of this stuff.

Well, I cannot get past one other thing, Mr. Chairman, we have talked about, and I want to come back to this. We have talked about clarifying one area of the cash balance plan. We would agree with the status of cash balance plan needs to be clarified, but because they play a valuable role in retirement security under the right conditions, but we also want to emphasize that that needs to be accompanied by protections, that needs to be accompanied by protections for older, long service workers and cash balance conversions because you wake up one morning and you think you have a plan that is going to give you 30, 40 percent of your retirement income, is going to replace that, and you find out that it has not done that. And so you end up too late to be able to save more. So they need to be protected as well.

All these things tie together. We believe that defined benefit plans are very, very important for young workers and old workers because many workers in this country, young, middle age and approaching your retirement, cannot save. Let me repeat that again. Many workers in this country cannot save. It is not a matter of wanting to or not wanting to. They cannot because their economic circumstances will not allow them to do that.

The CHAIRMAN. Senator Hatch's question has touched off quite a run here. I am going to ask everybody to keep their comments under 2 minutes so that we can get more comments and perhaps some other questions.

Mr. Covert.

Mr. COVERT. Thank you, Mr. Chairman.

First of all, to address Senator Hatch's comments, obviously auto enrollment would be helpful. Plan design incentives for employers that increase the match, thereby drawing more people, incentivizing them to come into the system. And also investment education, the ability to provide investment education to employees without employers having to worry about whether or not they are going to get sued for violating ERISA.

To answer the chairman's question, we have operations in 98 foreign countries. The pension systems in those 98 foreign countries are a patchwork to say the least. Some countries like France have mandated social plans like our Social Security system, and that is how defined benefit pensions are delivered. Other countries like the UK have a similar system to ours. The same with Canada.

The reason why a lot of employers, including Honeywell, have frozen their plans in those countries is over regulation. You have these perverse rules where if you close a facility or consolidate facilities or even do legal tax restructurings of your subsidiaries, that can trigger funding obligations on the employer on what they call a wind up basis, a termination basis, in our parlance, essentially forcing an employer with a plan that is already adequately funded to contribute basically double what they would ordinarily otherwise have to contribute even though nothing in reality has happened to the overall solvency of the plan, from Honeywell's perspective.

So what we do internationally does not really impact what we see in the United States. However, I guess what I would say is to the extent more and more of our competitors do not have the cost associated with maintaining defined benefit plans, there is obviously pressure on us because we need to be smarter and more com-

petitive with that pension burden that we have. We are committed to staying in the system, but that is the types of things that we look at, so even though what we do in the UK for example does not impact what our thinking is in terms of U.S. pension plans, overall it is a global company and we have to budget and plan around cash flow, capital investment and so forth. A company like Honeywell that provides defined benefit plans to its employees is at a disadvantage against companies that do not provide defined benefit plans.

The CHAIRMAN. Thank you.

Mr. Gebhardtsbauer.

Mr. GEBHARDTSBAUER. Thank you.

Senator Hatch asked how can we get more people into these retirement plans, and automatic enrollment has been talked about, so that you are in unless you elect out. Another way that it has been discussed to do all these decisions right at your date of hire so that you do not see your big paycheck and after you enroll you have a smaller paycheck, so bring them in in the beginning, but some of the rules make it difficult to bring people in right away because of the participation rates. The people at the low end are maybe not as likely to be as good.

One other thought that I have is also in the area of DB versus DC. Originally the 401(k) plan was seen as the supplement plan, and so it was understandable that not everybody would be in the 401(k) plan because was in the DB plan, and so the way we have moved in the past 10 years is toward less DB plans. In fact, that slide in the middle behind Senator Enzi, the green line going up is the 401(k) participation rates, so you will see when ERISA was passed in the mid 1970s there were really none of them, and now I guess it is around 40 percent of the workforce is covered by 401(k)s. Whereas DB plans used to be at 40 percent and now they are down below 20 percent.

I happen to know these numbers because I did the slide. [Laughter.] My glasses are not this good. [Laughter.] And the red line is something called the money purchase plan. That was sort of a DC plan, but it is pretty much where everybody was involved and was covered in the DC plan. It is a money purchase plan. And you will see that it is going down. It is below 10 percent and it may go away.

One of the reasons why DB plans and money purchase plans are going away is because, as some other people I think, Don, mentioned, we have been very creative at improving the rules for 401(k) plans so that everybody wants to get into the 401(k) plans. And we have not kept the DB rules up. We have not kept the money purchase rules up. We have not improved them, and it is getting harder and harder to have a DB plan, as Dallas was mentioning, for many reasons. These DB plans were the ones that covered everybody, and we are moving to a world maybe if there is no DBs, maybe there will just be 401(k)s, and so maybe we need to tighten up some of the 401(k) rules.

Right now the rule to encourage more participation in a 401(k) is done through—if you get 70 percent of your lower income employees participating in the 401(k), then 100 percent of your higher income employees can participate. So the American Academy of Ac-

tuaries, where I work, does not actually take a position, but one area where you could do, is you could change that 70 percent rule. Not everybody is going to like that rule, so there will be people pro and con around the table maybe on this. But maybe you could raise the 70 percent to 80 percent, saying you need to have 80 percent of your lower income employees participating in order to get 100 percent of your higher paid people participating.

Another area would be in how much the contribution is, so you would not only want someone to contribute, but you want someone to contribute more, and so if there are ways to change the rules so you could get more contributions from the less highly compensated people.

A slightly different topic—I apologize. I will just make this really quick because I may be going over my 2 minutes. This is a new topic, that whenever Congress wants to do something good, the budget rules make it difficult, so Congress has actually tied its hands through the budget rules, the cash rules. Whenever they create a rule to come up with some of these new great ideas that Karen has brought up or I think Mark and Don and Gene, in order to get more companies to have pension plans, in order to get more people participating, that means more deductions today, meaning less tax today. So of course that is a negative and so your cash budgeting reflects that. But it is not a total escape from taxation because eventually this money that went into the pension plan eventually comes out, and so it is not escaping tax, it is not tax exempt. It is tax deferred, so eventually the government gets the taxes back when the distribution is made when you are retired.

So in fact that is actually a good thing because actually we need taxes more in the future than we need right now, so one way to untie Congress's hands would be to not only have a cash budget to score all your changes on a cash rule, but also to have some sort of accrual rule accounting, so that you reflect the good things that are way out there in the future. More people are going to have pensions and more people are going to get taxed on their pensions out there in the future, and somehow bring that in today. So everybody says that is very difficult to do, but actually we have a rule already called the Credit Act of 1990 that affects education loans. So the government eventually gets the money back 30 years from now, and they actually bring that into the budget. So it would be great to untie Congress's hands so that it could score things like more pension coverage as a good thing, not a bad thing.

The CHAIRMAN. Thank you.

Mr. Sperling.

Mr. SPERLING. Senator Hatch I will start with an anecdote some of us live through. If you go from a campaign into the White House, which is campaign young people are probably the worst savers. They are a transient group, risk takers. They come into the White House or into the government and suddenly you have this Thrift Savings Plan. And you get virtually a dollar to dollar match on your Thrift account. It is very interesting. You watch a lot of people who never thought about saving at all, but when they are given the opportunity to have it deducted right out of their paycheck and get that significant of a match, it is interesting how many turn to savers.

Now, Dallas's charts we would show you, it still does not quite work for a lot of the lower income types, people making lower incomes. But I think that what you are hearing here is there is a lot of studies that first of all say if people were automatically put on, or as Ron is saying, even right from day one, that people very rarely choose to move out of it.

Second though, the question is—and I think Mr. Garrison talked about with his company—that you really have to give a strong incentive to get people to save. So the question is how could we replicate this among around the workforce, and I think we do have the ability, through our tax code, to do more. I mean we give people $1,000 tax credit for having a child, and you get it every single year. You could have a refundable credit that goes to people, and you can make it quite generous in the IDA model at lower incomes, but if you did that, you would be doing something. One, you would be encouraging more employers to allow automatic deduction if it helped them meet the 70 percent rule. So imagine if you have a tax credit that encourages employers to allow all their lower and moderate income workers to automatically deduct money out—and they are telling them, look, if you are lower income, you may get a $2 to $1 match or dollar to dollar match. That is a fairly significant incentive. When the person leaves—young people right now, even if they started savings they usually just cash out. So the second part of the question really should be how to get them to start to save and how not to get them to just cash out as soon as they leave their job.

So I think we are having this whole discussion within the Social Security context which is dividing us, but this context of how we could use refundable tax credit and incentives to get people essentially a universal 401(k) that they feel like they can always contribute a dollar and get that match, so it is not just the lucky few who find themselves in the TSP, but something we could do for all workers, I think really is the future and I think it is an area where one could have a lot of common ground around a savings and ownership agenda.

The CHAIRMAN. Mr. Houston.

Mr. HOUSTON. I will keep this under 2 minutes. I think we could search for a long time to try to find the silver bullet on what we could do, Senator Hatch, to increase participation and encourage participation, and I suspect whether it is Chile or Australia or Hong Kong, where there is required contributions, that is probably where we will need to end up. Again, I do not think a required contribution is a bad thing.

I think one thing you would have to step back from, in responding to Mr. Trumka, is whether or not we truly are over consuming in this country, of which I am a strong proponent that we are. We consume way more than we can afford and the resulting factor is we have very little left to save. I do not know if we have drifted up too highly, what our standard of living is, but in a global workforce, as we continue to move these jobs around the world, I think increasingly, whether it is for health care expenditures, retirement for DB, DC, wages, whatever the case is, we will be head to head in competition with a global workforce which will cause us to reconsider priorities around consumption versus savings.

That rural electric angle, I like that one. That has potential maybe on job safety. [Laughter.]

Thank you.

Senator HATCH. Let me interrupt you on that, because one of the questions I have—and it relates to Mr. Trumka's comments as well—are defined benefit plans sustainable as they are shrinking—which is to say that the average age is rising and there are more retirees than there are active workers?

Mr. HOUSTON. Again, I think it has been hit on from a couple of different angles. One is the very large multinationals have been able to grind it out and maintain their position to still be a sponsor of a defined benefit program, although we are making it increasingly challenging to do so because of some of the uncertainty around defined benefit legislation. For the very small private corporations, who are small private practices, there is a real growth, an emerging market there. There is a fairly high take up rate among those 55-year-olds with a half a dozen other employees who would very much welcome the opportunity to support a defined benefit plan.

But if we are talking about small to medium size companies, 25 employees to a thousand, there is very little appetite to take on the liability of the required funding levels for defined benefit, and most of them would tell you that something that has variable contributions, profit sharing, 401(k), discretionary match is the preferred plan design. Again, as I mentioned earlier, to the degree we can reduce the burdensome compliance nature of the small employers, I think the take-up rate would be higher.

The CHAIRMAN. Mr. Kimpel.

Mr. KIMPEL. Thank you. I will be quick. I just want to make one point in response to Senator Hatch's first question. I fully agree with Mr. Henrikson's remarks about auto enrollment, but I do not think auto enrollment in and of itself solves the problem. Mr. McNabb earlier made reference to Section 404(c). One of the problems with auto enrollment, which the law now allows is that if it is automatically enrolled the money defaults into a particular investment option under the plan. What virtually every employer does today because of 404(c) is they default to a money market fund, which in terms of long-term saving is not the right thing to do.

What we need is a fairly simple legislative fix that would enable employers to match automatic enrollment with a default to a life cycle fund, where there would be appropriate diversified asset allocation based on the participant's age that would change over the course of his or her career.

The CHAIRMAN. Thank you.

Ms. Schutz.

Ms. SCHUTZ. Thank you. To your question on what are the tools available, education is a real fundamental gap, and I see it on really three levels. One is savings and the value of compounded interest and earnings, and the lack of awareness and literacy around that. The second is the lack of understanding of how much in savings is required to create an income stream for retirement. I do not think most individuals understand that and the math. And the third area is the value of guaranteed income sources, annuitization

being one of those, in that an individual can lay off risk to an insurance company or the employer for longevity, for long-term earnings rates, timing risk in the market.

I think that there is really a fundamental education gap today that needs to be filled.

The CHAIRMAN. Thank you.

Ms. Friedman.

Ms. FRIEDMAN. Thank you. I think my remarks are going to kind of be an amalgamation of what a lot of people are talking about.

In response to your question, Senator Hatch, certainly the kinds of solutions that people are recommending today, automatic enrollment and other kind of automatic devices in 401(k) plans are very important. But I want to reiterate what Rich Trumka said, which is for a lot of people, they just cannot save. It is great if people could put away 20 percent of their income, but people are being asked to save for everything now, for their education and their health savings accounts and their medical savings accounts, and we have to have something that takes some of the risks out of people's investments. And that is why we feel strongly that defined benefit plans still have to be encouraged.

You were talking about education, Pamela. One of the things that I have been thinking about—and again, I am not sure how this is done—but, you know, Dallas is part of ASEC, which is the American Savings Education Council, and they have had a whole campaign to educate people about the importance of individual savings. It seems to me that people in this room could work together to do a campaign to educate employers and employees about the importance of defined benefit plans as a way of addressing those issues.

There are also—and I said this at the beginning of my comments and it has been reflected throughout the day—that there is now an exploration of different kinds of hybrid plans that take into account the best parts of defined benefit plans in terms of the employer puts the money in and assumes the risk, and they are guaranteed, with some of the best features of 401(k) plans like portability and transparency. I do want to say, because I have heard this a lot today and I know that this is way beyond the purview of this, but if we are going to resolve the cash balance situation we have to do so in a way that balances the interests of both employees and employers, and particularly takes into account adequate transition benefits for older workers in those situations. But we are certainly willing to look at interesting new plan designs.

The CHAIRMAN. Thank you.

Mr. Covert, you had your sign up and you put it down.

Mr. COVERT. I spoke already. Thank you.

The CHAIRMAN. Thank you.

Ms. Bowers.

Ms. BOWERS. Thank you, Senator.

Senator Hatch, you are asking two wonderful questions. Today the savings rate of the average American, as you are hearing, is somewhere between 1 percent and 3 percent. I heard 3 percent, and then when you factor out the Microsoft dividend returns I have heard that it is down to 1 percent on NPR.

People are not saving. What can we do to encourage them to save? There are a lot of techniques that we can do, but in the long run what will people have to save to replace defined benefit plans should they be removed from an offering in most employers? That is a big question and that is going to be a difficult area to replace. I think everyone in this room would agree that if we can find ways to keep defined benefit plans as being something that employers want to offer their employees and to continue these plans, that is what we should work toward.

Unfortunately, right now we are getting a lot of pressure. We can give you lots of different ways. Through the Treasury Department's support of the yield curve, we are finding that that creates volatility in the way we have to predict our contributions for our plans that a lot of companies will not be able to move forward without some type of stable smoothing that we have today. So we need to continue the relief that we have today.

We have pressures from companies that are looking at their ability to fund their pension plans and also be able to fund other business opportunities and having to make some tough decisions on where they need to put their moneys. Do they put their moneys in trying to grow their business, or do they put their moneys in trying to maintain their pension trust? How long will it be until we are able to get some kind of stability in those contributions?

I reported earlier this morning, my company, Smurfit-Stone, which is a large company throughout the United States with 27,000 employees and about 60,000 people that participate in our defined benefit plan, we are placed under continued pressure to make sure we keep our funding at an adequate level. And there are some proposals out today that would require us to fund at even higher levels. We are funded at about a 90 percent funding, and if we were to be required to fund at 100 percent, our contributions would be increasing by double what we are paying today or even more so over the future.

So if we want to be able to maintain the ability for defined benefit plans, we have got to have some stability in those plans, we need to have some relief on how we can project what our costs are. And all these benefit programs are looking at what happens 10, 20, 30 years into the future. We cannot try to solve that problem by taking a snapshot in today's time and trying to fix it with short-term limited time basis of fixing this problem. This is something that we have to look at over the long haul to make sure that we have a solution that people can live with, that the average American is not going to be compromised. Today the average American is not saving enough to replace what will be lost if defined benefit plans are not maintained in this country.

Thank you, Senator.

The CHAIRMAN. Thank you.

Mr. Fuerst.

Mr. FUERST. Thank you, Senator. With regard to increasing participation in these plans, there are many innovative solutions that have been recommended by several people. All of these will help. Frankly, I think we have done a reasonably good job. If you look at the chart again behind you, 30 years ago we did not have 401(k)

plans. We have created enormous assets through these plans and IRA plans.

But over that same time period, where these plans have increased enormously, if you look at the net savings of Americans, in 1980 it was approximately 10 percent. It was down to under 2 percent in 2003 and even lower last year according to preliminary reports. We are not saving despite the fact that employer sponsored plans are increasing significantly and people are contributing to those plans. Yet they are dissaving in other areas. At the same time that they might put a contribution into a 401(k) plan, they are refinancing their house, taking equity out and spending that.

Consumption has been enormous in the United States, consumption growth in the past 10 years. The consumer led the economic boom throughout the late 1990s, and through the recession it was consumer spending that helped moderate the degree of the recession that we had in the early 2000s.

The problem is not so much participation in employer sponsored plans. The tax incentives are there to get people to get the tax deduction of pretax contributions to these plans, but on the other side there is no incentive for them to save overall. There is in fact a—because our tax system is based on income rather than consumption, there is an incentive to reduce your taxable income but still spend as much as you can. If you really wanted to look at a very different approach to the whole system—and I know that this has been discussed to some extent—a consumption-related tax rather than an income-related tax would enormously encourage savings. It would have a lot of other impacts also that you certainly have to consider, but it would enormously impact savings.

With regard to the global competitive issue, I think that companies that compete on a global market are concerned about their total compensation cost, not just their benefit cost or their salaries. They make a decision on where to produce goods based on their total cost. We may make a decision on how to allocate that total cost between benefits and direct compensation, but it is the total cost that really drives it. If our employees in America want to allocate more toward benefits, we can work that out within a total cost consideration.

The real concern though on the global market is being able to predict what that is and knowing how volatile your costs are going to be. Our problem with respect to pension benefits is the volatility of the cost, not the level of the cost. Pensions are actually a very efficient way of delivering compensation to our employees. It is the volatility that is uncertain.

That goes also to the comment that was made about is the defined benefit system sustainable? It is if we have better rules about controlling this volatility. During the late 1990s companies had significant benefit cost for pension plans. People were accruing more and more benefits each year. Yet we were precluded from funding those. In fact, if we put money into a pension plan to fund those costs, we would have to pay an excise tax when we were at that level. The funding target that says if you have assets greater than your liabilities, that you cannot make a deductible contribution, really puts 100 percent funding as a ceiling to the plan, not as a target. And if we are going to have volatile markets we have to

have funding allowable above that level also. If companies were able to make a consistent contribution every year, we would not have some of the funding problems with these plans that we have today.

Thank you.

The CHAIRMAN. Thank you.

Mr. Certner.

Mr. CERTNER. Thank you. I want to address the question on getting more people to save, and I think one of the ways we have seen that has been most successful to get people to save is through a salary reduction arrangement. I think that shows why the Thrift Savings Plans and 401(k) plans, for example, have been much better at getting people to save than something like an IRA. People just do not have the money, as Mr. Trumka and others have said, to save, and certainly if it is not coming directly out of their paycheck every 2 weeks, the chances of them having a lump sum of money to put in at the end of the year are much more nonexistent particularly for people at the lower and middle ends. We know that they prefer to save by having the money taken directly out of their paycheck. So having a 401(k) or a Thrift Savings Plan available for everyone would I think essentially be a good goal for this country.

I mean right now you only have an advantage of being able to do that if you are with an employer who has that kind of arrangement, and I think if we could make a standard in this country that no matter where you worked you would have some kind of a salary reduction arrangement, that that money would be going somewhere, whether it be an employer plan or even to your own individual IRA, you would be able to get more savings.

You would be able to encourage that by building also on the saver's credit that we have right now. We have employer matches that encourage to get in, but we also have now the saver's tax credit that encourages people at the lower end, and hopefully if we can raise that a little bit more to middle income earners, so you would have both a salary reduction arrangement with a matching contribution. We know that that is at least an effective tool to begin to get people in. Others have talked about other tools like automatic enrollment. Again, we know that boosts participation way up, almost close to 100 percent in many circumstances.

But that only gets us part of the way there. That only just gets the money in to people's accounts. We also need to make sure we keep that money from coming out. What we see now is a significant amount of leakage from the system in the form of lump sums or cash-outs pre-retirement. So just getting the money in is not going to help if we have the money come right out. So you need either auto enrollment, better financial literacy, to make sure that people keep that money in the retirement income stream and do not just see this as another savings pot that they are going to dip in immediately when they need a car, need a vacation, or even do things like send their kids to college. Those are all useful things if you are going to be buying a house and sending your kid to college, but it means you are not going to have any money for retirement either. We need to make sure that we encourage this money for retirement savings not just savings in general.

Another point on the cash balance arrangements that were talked about, we think it would be very important to get certainty into this other kind of plan option, and we have said for years we needed to have that certainty come along with the protections for those, all the workers who were in the old system for so many years, and we think that could provide another type of plan option, but again, you have that same lump sum problem you need to deal with.

I also want to note—and I think some others have—that we do have another problem here with high health care costs in this country, and I think you see high health care costs squeezing out retirement costs. Health care is a need we have now, and both employers and employees need to make those payments now, and so the retirement income needs falls behind that. So higher and higher health care costs both squeeze out the employers' and the employees' ability to contribute money for retirement income. So keeping health care costs down I think would help very much on the retirement side as well.

The CHAIRMAN. We are also in charge of keeping health care costs down, so we will do some other forums on that too. Good point.

Senator HATCH. Not doing too well, however. [Laughter.]

The CHAIRMAN. We have exceeded our allotted time, so I will allow Mr. Henrikson, Mr. Garrison and Mr. Dunbar to add their comments, and then we will have to close.

Senator HATCH. Mr. Chairman, I am going to have to leave. I apologize for leaving without getting all of these answers, but I will pay attention to you. These are big problems, and of course I think this has been a very stimulating panel. I just want to thank all of you for taking time to be here with us. It has been very stimulating to me. I just wish I could have been here a little bit earlier. But we are grateful to you, and frankly, if you will forgive me, I am going to have to slip out. I know the chairman will keep good track of these things.

The CHAIRMAN. Thanks for being here.

Mr. Henrikson.

Mr. HENRIKSON. I have three quick comments to make it short. One of the things, mortality pooling, I had mentioned it earlier, the other side of mortality pooling which was emphasized, someone had said before that defined benefit plans are extremely efficient. One of the reasons they are so efficient is that mortality gains, that is, when someone dies early, are retained in the plan to help pay the benefits for people who live a long time. So if you have defined benefit plans, not to put a damper on anything—and I have no problem with hybrid plans—but when you start adding features to defined benefit plans like take the money with you, leave the money to your heirs, portability and so forth, the efficiency per dollar to benefit is lost to a great degree. So you cannot take money out of the system that previously was held in the system and not feel the brunt of that.

To put it another way, for an individual to save and have anywhere near, less a high probability that they will be able to use that money for the rest of their lives, they would have to save probably about 30 percent more to overcome the value of mortality

gains if they go into a pool. I would make that point. I did not mean to sound difficult or convoluted on that. But I do not care what kind of a plan it is, whether it is Social Security, whether it is a defined benefit plan, take mortality gains out of the system and it costs a lot of money.

The other thing I would say, just in terms of a default option on DC, it is kind of odd to us that have been in the business for years, DC plans were around a long time before there was any option for employees to have different investment options. So whether they were profit-sharing plans that said zero to 15 percent of covered compensation not to exceed profits, that went into your account and then that account was managed by the trustees, similar to the way it was in a defined benefit plan. So I just would point out that it is sort of odd that we then make it hard for people to have a default option that is broad based.

I am sorry Senator Hatch left, but I would just make a comment. He asked if plans are sustainable. In some businesses it is very difficult. If you look at a company that is in a manufacturing business that has 6 or 7 times more retirees than actives, and perhaps even more important than that, they are not even in the same business that those legacy employees are in, and that is going to be very, very difficult. So when you are talking about exporting your expertise in the benefits arena, for example, across the ocean to another country, you probably would not want to replicate that problem.

The CHAIRMAN. Thank you.

Mr. Garrison.

Mr. GARRISON. Just two quick points, Mr. Chairman. With respect to the global issue, we at Exxon-Mobil, look at it in terms of a total remuneration package. That is to say some portion of the compensation is going to be paid as cash and some portion may be put away in terms of a retirement program. I think what we are really arguing about here or discussing is the proportion that is dedicated to retirement security as opposed to current consumption in terms of cash. I think we have flexibility. Certainly there are issues associated with change from one State to another, but ultimately I think what the panel may be recommending is that we need more of an emphasis on the retirement savings component of the total package and perhaps less on the total consumption or the current consumption.

With respect to Senator Hatch's question, I think an additional point, which will not solve all the problems, is that we need more of a culture of savings in this country. I think in our particular company we preach from day one as new employees come in about the three-legged stool and the shared financial responsibility, so that it is implicit in the employee that he or she is going to help contribute toward their retirement, and they understand that is expected of them, that is part of the culture of the company, and I guess I would say that we make it easy for them to do the right thing by having an attractive match that they would forego if they do not choose to participate.

But I do think that the culture and the discipline of private employers to incent people and to gently encourage them to do what they need to do should not be overstated.

The CHAIRMAN. Thank you.

And our final word from Mr. Dunbar.

Mr DUNBAR. Just again wanted to hit just the small employer perspective on this, but a lot of small employers delay putting plans in until they have the resources to put money aside. They are going to look at defined contribution plans first. I think a lot of the comments around the room have been that your lower paid employees cannot afford to defer. I think we see that in the small employer, especially if the intent is to try to give incentive for the small employer to put plans in and look at defined benefit plans as an option. Then the regulatory environment has to be cleaned up a little bit so that it is not as onerous, because right now it is onerous as far as the burdens regulatory wise.

I think you also need to build some flexibility into defined benefit plans so that they can have some flexibility on funding. As far as incentives to employers to put plans in and incentives for employees to defer, I think those have been kicked around.

Last comment, lump sums. The small employer, they almost have to have lump sums built into their plan because when that small employer retires that plan is going to disappear, so it would be very difficult not to have lump sums built into those plans. I think you could restrict possibly the rollover of that money so that employees do not have access, you know, maybe make it more onerous for people to just take money out for different possibilities, but I do think lump sums have to be there for small employers.

Thank you.

The CHAIRMAN. Thank you very much. I want to thank everybody for their participation. I know there are other comments out there. I am still inviting you to submit those along with any other information you think would be helpful to the committees. On my global question, one of the things that struck me during the discussion is that we in the United States expect to be paid the highest and have the highest benefits, but we want to buy cheapest. Somehow there seems to be a little bit of a conflict there.

I wish we could go on with this.

I would want to mention that Mr. Brad Belt, who is the Executive Director of the PBGC has spent the morning with us. He is over there on the side, and I very much appreciate him listening to your comments as well. It is not often that we get that kind of participation from somebody directly involved in the process, and quite often agencies show up, do their testifying and leave. But he has been here the whole time, and that is worth mentioning.

As you can tell from the discussion today the private sector initiatives on retirement and security benefits are evolving. The defined benefit system is clearly a worthwhile retirement security plan for both workers and their companies. In addition, the rise of defined contribution plans are expected to become an even greater part of the private sector retirement security system. As the changing demographics, the greater need for portability of retirement plans and the globalization of our economy continues, Congress should take these into consideration as we draft current and future laws affecting the private sector retirement benefit plans. Today was just the first of a comprehensive look at the long-term future that we are going to need.

Again, I want to thank all the participants. I know you had to rearrange your schedules dramatically to be here and then to coincide with our little earlier opening. We will leave the hearing record open for 10 days for questions from members as well as additional responses you might want to make.

Thank you very much for being at the hearing, and I appreciate the great participation of people watching too.

[Additional material follows:]

## ADDITIONAL MATERIAL

PRINCIPAL FINANCIAL GROUP,
DES MOINES, IOWA 50392,
*March 25,* 2005.

Hon. MICHAEL B. ENZI,
*Chairman,*
*Committee on Health, Education, Labor, and Pensions,*
*U.S. Senate,*
*Washington, DC 20510-6300.*

DEAR MR. CHAIRMAN: Thank you for the opportunity to appear before you and the members of your committee and the Senate Finance Committee at the joint forum entitled, "Private-Sector Retirement Plans: What Does the Future Hold?" I found the exchange of ideas and opinions to be stimulating and hope it helps as you and the committee members work through the many facets of retirement issues and opportunities.

At the forum, I was asked to provide comments on ways to simplify the rules for small employers. It is my opinion that employers are hesitant to sponsor retirement plans because they feel the administration and recordkeeping of the plan will be too costly, find compliance with pension legislation and regulations too confusing, and have concerns about fiduciary liability. They are also concerned with the fact that some employees may not be able to save as much as they would like because other employees choose not to participate in saving for their own retirement. This is especially true for smaller employers, i.e. those with less than 100 employees.

The Principal Financial Group knows the small- to medium-sized business market as well as anyone. To help encourage more growing employers to sponsor a retirement plan for their employees, Principal provides the following plan design suggestions that would simplify the administration, fiduciary liability, nondiscrimination, government reporting, and plan document requirements of a traditional 401(k) plan while at the same time providing meaningful benefits for their employees. This design option would only be available for employers with less than 100 employees. We offer the following suggestions:

**Administration and Nondiscrimination Testing**

Over the last 15–20 years, numerous pension laws have been enacted that added overlapping rules in an attempt to raise revenue and limit abusive plan situations. These rules merely created more administrative complexity and administrative/recordkeeping burdens with only incremental assurance rank and file employees are treated fairly. The limits include the IRC § 402(g) salary deferral limits, IRC § 415 contribution limits, IRC § 401(k)/(m) tests, IRC § 401(a)(17) compensation limit, IRC § 401(a)(4) nondiscrimination rules and IRC § 410(b) coverage tests, as well as the top heavy rules added in the early 1980s. In addition, there is the overall deduction limit of IRC § 404 that further restricts contributions to employer sponsored plans. In place of this myriad of complex and overlapping or redundant rules, Principal suggests a very straightforward approach to simplify 401(k) plan rules for smaller employers by establishing just two overall restrictions to meet:

- Employee salary deferrals will be limited to the current § 402(g) dollar limit, indexed to $14,000 in 2005.
- Any employer match will be capped at one third of the § 402(g) dollar limit or $4,667 in 2005.

Under these simplified rules, employees would be automatically enrolled in the plan 401(k) no later than the start of the second pay period after their date of hire. Automatic deferral rates could be set by the employer at any reasonable rate between 1–6 percent of pay, with reasonable annual automatic increases of 1 percent per year up to 6 percent of pay maximum. There would be no other entry or coverage requirements. Top heavy rules would not apply and all participants would be 100 percent vested, further reducing the administration burden.

Contributions will be portable and can be transferred to any other 401(a), 403(b) or 457 contribution plan.

If desired, the employer may also decide to make profit sharing contributions to the plan participant. The employee would have the flexibility to use any of the currently acceptable forms of allocation methods (pay-to-pay, integrated, age-weighted and comparability). The ability to make these additional contributions will allow employers the needed flexibility to design a plan that better meets the needs of all their participants but if they do so, any additional contributions would be subject to coverage, nondiscrimination, vesting and other rules and to restrictions such as compensation and contribution time limits.

**Fiduciary Rules Under ERISA**

ERISA provides very important protection for plan participants and under our simplified plan design approach Principal wants to ensure plan sponsors continue to be held to very strict fiduciary standards. We offer these suggestions to provide sponsors with minimum fiduciary standards that must be followed for plans to remain in compliance with ERISA. These include:

- Absent employee direction, the default of all contributions to a Lifestyle fund corresponding to an employee's normal retirement age of 65 is required.
- All ERISA § 404(c) rules must be met for participant-directed accounts.
- Annual employee statements must be provided in print or acceptable electronic means and must include:

1.Contributions summary
2. Account balance and projected normal retirement benefit
3. Access to (print and electronic):
   - Fund performance
   - Fund performance benchmarks
   - Fund summaries/prospectuses
   - Fund manager information
   - Fund management fees
   - Employee education tools such as retirement calculators, asset allocation models, deferral calculators, investment quizzes and benefit projections
4. Employee summary plan descriptions must be provided upon entry or every 5 years unless the plan is amended more frequently. These may be provided in print or acceptable electronic means.

**Government Reports**

There would be a simplified government report for this type of plan. It would be an annual registration statement similar to the current form 5500R filed with the IRS/DOL and would contain the plan data of the 5500R as well as basic information on the plan's assets, types of investment funds and a summary of contributions made and benefits paid for the year.

Copies of this simplified report must be made available to participants upon request.

**Plan Documents**

The IRS will provide guidance on required wording for this simplified 401(k) plan. In addition, plan documents must be written only on a pre-approved IRS prototype.

Again, thank you for the opportunity to appear and to offer these additional comments. If you have further questions, please do not hesitate to contact me.

Sincerely,

DANIEL J. HOUSTON,
*Sr. Vice President,*
*Principal Financial Group,*
*Retirement and Investment Services.*

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STATEMENT OF CHRISTIAN E. WELLER, PH.D.

(The following is testimony on the President's Proposal for Single-Employer Pension Funding Reform before the U.S. House of Representatives' Committee on Ways and Means' Subcommittee on Select Revenue Measures, March 08, 2005, Securing Retirement Income Security Through Sensible Funding Rules.)

Thank you very much, Chairman Camp and Ranking Member McNulty, for inviting me here today to testify on proposed rule changes regarding single-employer defined benefit plans. Retirement income security occupies much of the public policy debate these days. While most of the attention is focused on attempts to privatize Social Security, the security of defined benefit pension plans is also in the balance. Pensions have received a lot of attention recently since falling interest rates and stock prices left DB plans with fewer funds than they need to cover all promised benefits. In extreme cases, pension plans were terminated, leaving workers with substantially fewer benefits than they had expected and resulting in shortfalls at the Pension Benefit Guaranty Corporation (PBGC).

Public policy can address the problems plaguing defined benefit pension plans through sensible reforms. In considering these reforms it is important to keep the following goals in mind:

1. Maintain the security of pension benefits;
2. Promote and sustain sponsorship of defined benefit plans; and
3. Maintain the ability of the PBGC to support DB plans.

The administration recently proposed a set of rule changes for single employer DB plans. Characteristic of the crucial aspects of this proposal is a greater tendency to link pension fund assets and liabilities to the market. Such a move would fail the goals for public policy reform. By increasing the volatility of pension funding, employers would have very strong incentives to terminate their existing pension plans, further lowering retirement income security for workers.

A closer look at pension funding and proposed rule changes shows the following:

• Current funding rules are counter-cyclical. Employers are required to contribute more to pension plans during bad economic times than during good times.

• The administration proposal would exacerbate the counter-cyclicality of pension funding and increase the uncertainty associated with pension plans. Employers would likely terminate their plans instead of absorbing the additional costs associated with attempts to reduce funding volatility by investing solely in bonds.

• Alternative funding rules could provide for greater leeway in averaging fluctuations in pension funding over the course of a business cycle and improve the outlook for pensions. This process is called "smoothing."

• As a result of smoothing, the burden on the PBGC would be reduced through better-funded pension plans. Employers would benefit as pension funding would become less counter-cyclical, lowering the burden during bad economic times and increasing it during good economic times, when employers are best able to contribute to their pension plans.

**Plan Sponsorship Linked to Counter-Cyclical Funding Volatility**

Changes in the way pensions are regulated will inevitably affect employer behavior. Employers are mainly concerned with unpredictable demands for outlays for their pension plans (Hewitt, 2003) This is typically more important than other issues, such as simplifications to the rules. Changes in funding contributions arise, when the funding status of a plan changes. For instance, a deterioration of a plan's funding status would increase the financial demands on employers in two ways. For one, they would have to make additional contributions to their plans, as is discussed below, and second, they may have to pay higher insurance premiums to the PBGC. Typically, the size of additional contributions can easily dwarf the size of additional insurance premiums. The primary focus should thus be on the determinants of funding contributions. If changes in funding rules lead to more volatility in the funding status of pension plans and thus to increased uncertainty about employers' future obligations to their plans, employers would become more likely to terminate their plans than is currently the case.

In a defined benefit (DB) pension plan, the employee is guaranteed a fixed benefit upon retirement, usually based on years of service, age and either final earnings or a benefit multiplier. Accrued benefits for private sector DB plans are insured, up to certain limits, by the Pension Benefit Guaranty Corporation (PBGC), which is funded by insurance premiums from employers with DB pensions as well as investment income and assets from terminated pension plans.

Although DB pension coverage has declined for some time, millions of employees and their families still depend on this benefit. The share of private sector workers with a DB plan has declined from 39 percent in 1975 to 21 percent in 2004 (PWBA, 1998; BLS, 2004). By 2002, the last year for which data are available, more than 34 million beneficiaries could still expect to receive some benefits from DB pensions (PBGC, 2003).

The funding of a DB plan's liabilities (promised benefits) is usually the employer's responsibility. Up until 2000, many employers could not contribute more to their plans, as their pensions were well funded due to the strong stock market performance and rising interest rates. However, after 2000, pension funds faced large shortfalls and employers sponsoring them had to contribute large amounts to their pension plans. Many large firms with pension plans have faced persistent shortfalls. PBGC (2004) estimated that the combined shortfall of all single-employer DB plans as of September 2004 was $450 billion. Consequently, firms had to contribute new money to their plans. For instance, 90 percent of DB plans offered by companies included in the S&P 500 index showed a loss. When contributions rose, corporate earnings were often adversely affected, although some firms passed the additional costs on to consumers in the form of higher prices (Kristof, 2003). In extreme cases, the demand on employers' resources from the weak economy and pension plan underfunding contributed to corporate bankruptcies and plan terminations. The PBGC took over plans from Bethlehem Steel, LTV Steel, National Steel, TWA, U.S. Airways and Polaroid, among others. All of these terminations were among the 10 largest since 1974, totaling $8.5 billion in claims and covering 263,861 participants (PBGC, 2003).

Even though the PBGC insures benefits, it does so only within limits. By statute, PBGC's insurance is capped, currently at $45,600 per year for a retiree at age 65 under the agency's single-employer pension insurance program. This maximum, though, is reduced for early retirement benefits. Other reductions are taken for survivorship and disability benefits and recent benefit improvements. Beneficiaries can also not accrue further benefits after the plan has been terminated. Hence, a plan termination leaves workers with less retirement security than expected.

To discuss the magnitude of recent pension plan shortfalls, it is important to understand the mechanics of pension plan funding. A plan's funding status depends on how assets compare to current liabilities. Current liabilities are the sum of payments to current retirees and of benefits that workers have already earned. In earnings-based plans, future benefits are forecast given reasonable assumptions about life expectancy, inflation and other relevant demographic and economic variables. Based on these forecasts, pension plans determine how much in assets they need to fund benefits payable in the future. Thus, they assume how much interest they expect to earn on their assets. The higher this interest rate is, the fewer assets are needed today. It is in a plan sponsor's interest to assume a high interest rate since this would lower the amount of assets required to be set aside to pay benefits. To avoid abuse, regulators set a range of interest rates that pension plans can choose from in calculating current liability. Pension plans must choose an interest rate that is between 90 percent and 105 percent of the 4-year weighted average of the 30-year Treasury bond yield. [1]

A pension plan's funding status is then determined by looking at the ratio of the plan's assets to its liabilities. Plans can choose a number of options to value their assets, although many large plans use fair market valuation. Assets are evaluated at prices for which the assets could be sold on the valuation date.

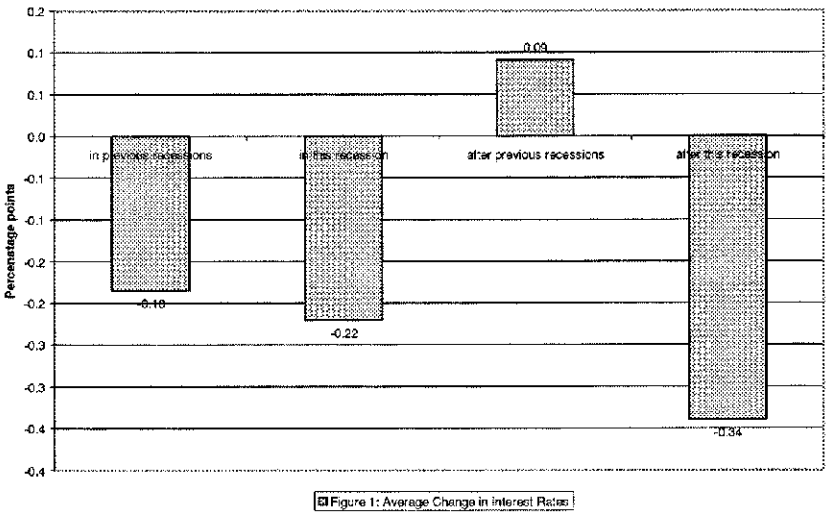
By the nature of funding rules, pension plan funding is tied to changes in interest rates and stock prices. The main problem is that both of these tend to decline around the time of a recession, when corporate earnings are also declining.[2] From 1927 to 2001, there were a total of 12 recessions. Only in one recession, from 1973 to 1975, did interest rates not decline. The stock market is a forward looking indicator. Typically, the stock market peaks about a year before a recession starts and continues to decline in a recession. On average, stock prices are about 7 percent lower in the year after a business cycle peaks than before. That is, pension plans are losing with their assets before and during a recession, which brings additional pressures due to lower corporate earnings and lower interest rates that translate into a higher valuation of a plan's liabilities.

The recent recession posed a particular challenge since stock prices fell sharply and interest rates stayed lower, and lower longer, than in prior recessions (Weller and Baker, 2005). From the start of the recession in March 2001 to the end of 2002, the stock market fell by 25 percent. From its peak in August of 2000 to its low point in February 2003, the stock market lost 44 percent of its value. At the same time that the stock market sustained severe losses, interest rates declined more and stayed low for a longer period than on average in previous recessions (figure 1). In this recession, the treasury rate declined by 0.22 percentage points, slightly above the average of 0.19 percentage points for prior recessions. However, in the first year of a recovery, interest rates generally rise by 0.10 percentage points, whereas they fell by another 0.34 percentage points in this recovery. Thus, in this recovery employers did not see the usual help in funding their pensions that would come from rising interest rates.

[1] The Pension Funding Equity Act of 2004 required that plan sponsors use a discount rate between 90 percent and 100 percent of a 4-year weighted average of a blend of investment-grade corporate bond yields for plan years beginning after December 31, 2003, and before January 1, 2006.

[2] Interest rates refer to the long-term treasury bond rate and total rates of return refer to the year-on-year change in the stock market plus the dividend yield. Stock market data are for the S&P500.

Figure 1: Average Change in Interest Rates




The problem of falling asset prices and declining interest rates in the recent recession was further exacerbated by the fact that companies had not built up more reserves during the prior expansion. This can be traced back to two aspects of the current regulatory system. First, if a pension plan reaches a certain funding threshold, the employer either no longer has to contribute or has to contribute only minimal amounts. Second, there are regulatory disincentives to contribute more to a pension plan when it is already fully funded. If pension plans are fully funded, employers face excise taxes on their contributions to the tune of 50 percent. On top of that, they can no longer deduct their pension contributions from their tax liabilities. The contribution limit beyond which further contributions are discouraged by the tax code is 100 percent of current liabilities. Thus, largely due to beneficial financial market trends—rising interest rates and higher stock prices—the average funding ratio of PBGC insured pension plans jumped from 116 percent in 1999 to 145 percent in 2000 (PBGC, 2003). However, for many plans, this reserve was insufficient to weather the crisis that followed as the stock market bubble burst and the liability discount rate sunk to and remained at historically low levels. In 2002, 74,138 new beneficiaries started receiving payments from PBGC, compared to 40,473 new beneficiaries in 2001 and only 11,091 in 2000 (PBGC, 2003).

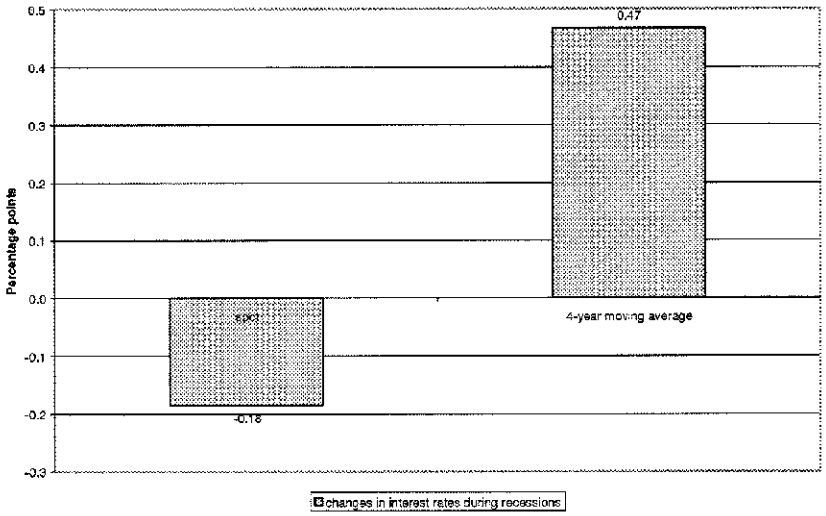
**Administration Proposal Will Exacerbate Funding Problems**

The administration recently released its own proposal to reform funding rules, among other changes to the pension system (DOL, 2005). Funding burdens are already counter-cyclical, requiring employers who sponsor DB plans to contribute more during bad times than during good times. The administration's proposal could exacerbate this volatility in addition to the overall costs of some plans. First, the current rules require the use of a 4-year weighted average of the 30-year Treasury bond rate to determine current liabilities. The administration is proposing to eliminate the 4-year weighted average and to replace the single treasury rate with a range of bond rates, the so-called yield curve. This would mean that liabilities—future benefits—that come due at different future dates are discounted by different interest rates. For example, a benefit that is due in 10 years will be discounted by the interest rate on corporate bonds with 10-year maturity; a benefit that is due in 5 years will be discounted by the 5-year rate, a benefit in 15 years by the 15-year rate and so on. The applicable rates would be averaged over 90 days, instead of 4 years. Second, the administration proposes that all assets be valued at fair market value, thus eliminating the current option to average stock price fluctuations over short periods of time. If these changes are enacted, plan sponsors worried about the predictability of their future contributions would have strong incentives to abandon their plans.

The administration's proposal would raise the costs of mature plans immediately. Employers who have a disproportionate number of older workers, e.g. in well established industries, will face rising costs from the administration's yield curve proposal. This is because older workers are likely to retire sooner than younger workers and their benefits will have to be paid out sooner than those for younger workers. The discount rate is tied to corporate bonds with shorter maturities. Those interest rates are lower than those for corporate bonds with longer maturities. A lower discount rate translates into a higher liability and higher cost for the employer. According to estimates by the Employment Policy Foundation (2005), the liabilities for workers 55 and older could increase by 3.5 percent and the liabilities for workers between 50 and 54 could rise by 2.0 percent. This would particularly hurt the struggling manufacturing sector. That is, the administration's proposal would fall short of the first goal to secure existing benefits.

In addition to raising the costs for some plans, the administration's proposal on changes to the interest rate would exacerbate cyclical fluctuations, just like the use of fair market value for assets does, as already discussed.[3] Employers would become more likely to see larger contributions during bad economic times, mainly because the smoothing of interest rates over even the minimal period of time of 4 years is eliminated. From the 1930s to the present, the spot interest rate for long-term Treasury bonds would have declined by an average of 0.18 percentage points during recessions. In comparison, though, the 4-year weighted average of the long-term Treasury bond rate would have risen by 0.47 percentage points. The fact that the discount rate is on average 0.65 percentage points higher with smoothing than without means that employers face fewer demands on their cash flow when they can least afford them. However, it also means that they face higher funding obligations during good years, when they can actually afford them.

**Figure 2: Changes in Interest Rates During Recessions, With and Without Averaging**



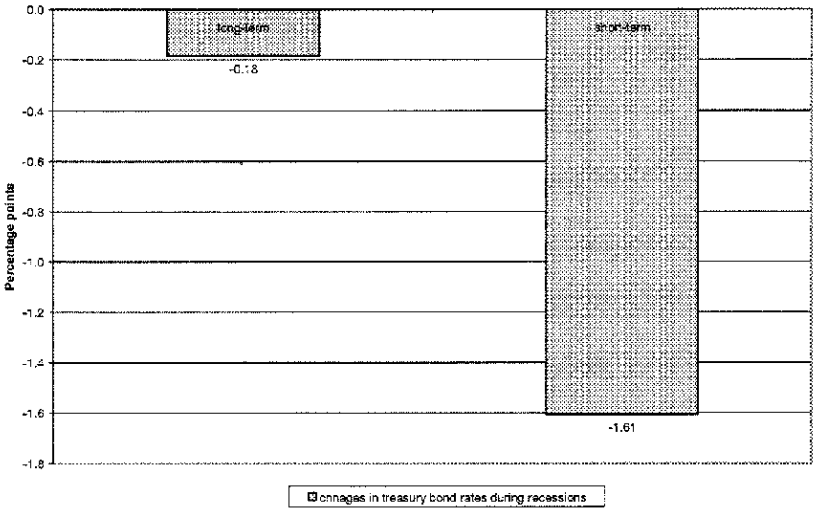

The use of a yield curve, using a variety of interest rates with different maturities for separate liabilities, would also exacerbate the funding burden during economic downturns, especially for pension plans with a more mature workforce. Specifically, the spread between short-term and long-term interest rates tends to rise during recessions, largely because short-term interest rates tend to fall faster than long-term interest rates. Short-term Treasury interest rates, in this case for 3-month bills and bonds, have typically declined by 1.6 percent during recessions (figure 3). This is an increase that is almost eight times as large as the average decline of long-term Treasury bond rates during recessions. During a recession, employers with an older

[3] Employers could theoretically insulate themselves from these fluctuations by matching assets to liabilities. However, such a "bonds only" strategy would substantially raise the costs for employers to provide this benefit and thus give another strong disincentive to abandon their plans.

labor force will see their costs rise much more rapidly than employers with a younger workforce.

The use of a yield curve would increase the volatility of pension contributions for employers, thus providing an incentive to terminate DB plans. That is, the administration's proposal falls short of the second goal to maintain and strengthen future benefit security.

Figure 3: Changes in Long-Term vs. Short-Term Treasury Bond Rates During Recessions




## Immunization Not a Viable Alternative

Fluctuations in liabilities and assets can lead to changes in the funding status of pension plans. When interest rates and asset prices fall, plans can become underfunded. The administration's proposal would increase the volatility of the future funding status of a DB plan. Employers could theoretically respond to this surge in volatility by matching assets and liabilities by investing in bonds that reflect the maturity of a pension plan's liabilities. This process is also referred to as immunization.

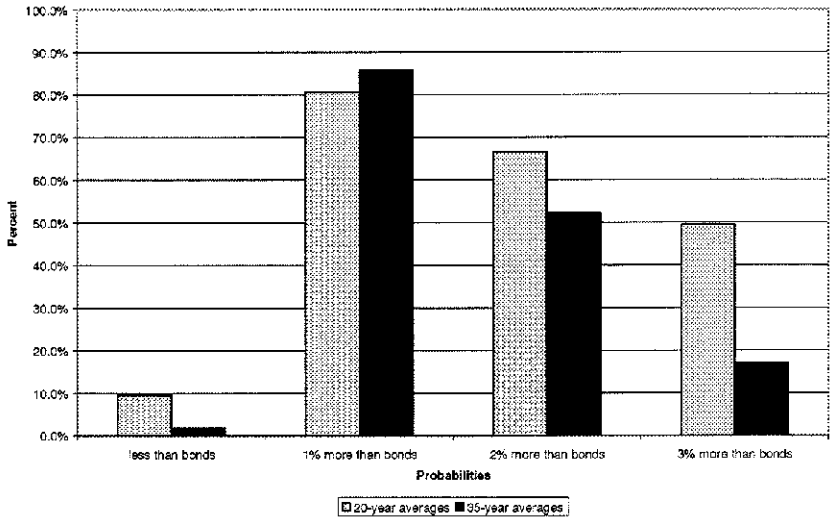
To understand how immunization works, consider the way a pension plan's liabilities would be calculated under the administration's proposal. Future benefit payments would be discounted by the interest rates that would apply for treasury bonds with the same maturity as the benefit obligation. To finance new obligations, pension plans have to purchase additional assets. To avoid fluctuations in funding status under the administration's proposal, pension plans could purchase a corporate bond with the same maturity and thus the same interest rate as the maturity of the benefit obligations (Bodie, 2005). As a result, assets would theoretically be matched to the liabilities and the two could not move apart over time. Underfunding would thus be reduced.[4]

Although the logic of immunization is appealing, it has one major drawback, aside from the potential complexity of implementation, that would ultimately hurt pension beneficiaries substantially. Immunization would significantly raise the costs of pension plans for plan sponsors. Typically plans diversify their assets between different types of securities, largely bonds and stocks. By doing so, plans can expect to earn a higher rate of return over the long-run than they could by merely investing in bonds, while reducing the risks. Through immunization, plans would eliminate the added earnings from investing in stocks. This loss can be severe. Over 20-year or even 35-year periods, the chance of a typical mixed portfolio of a pension plan—60 percent stocks and 40 percent bonds—is unlikely to perform worse than bonds. The chance that a mixed portfolio will on average see a rate of return that is at least 1 percentage point higher than a pure corporate bond allocation is more than 80

[4] Perfect matching would likely not be possible since the administration's proposal allows for discount rates to be smoothed over 90 days.

percent (figure 4). The chance of seeing a rate of return that is at least 3 percentage points greater is 50 percent over 20-year periods and 17 percent over 35-year periods. These are the potential earnings that pension plans would give up through immunization. This loss of earnings would require an offset from higher employer contributions to their pension plans.[5] As costs of pension plans would rise, employers would have again a strong incentive to abandon their plans.

Figure 4: Performance of Mixed Portfolios over 20 and 35 Year Periods




Notes: Data are based on S&P 500 and corporate bonds (AAA) from 1919 to 2004. Sources are TradeTools.com, Shiller (2000), and BOG (2005).

However, if pension plans do not immunize, they can face market fluctuations from investing in stocks. Uncharacteristically large fluctuations in the stock market substantially contributed to the decline in pension funding after 2000. This leads to two questions. First, who should bear this risk, and second, is there another way to handle the risk exposure of pension plans, which does not increase the volatility of pension plan funding for employers and thus does not raise the specter of plan terminations? The answer to the first question is that pension plans are better equipped than individuals to handle market risks. The answer to the second question is detailed in the next section.

Pension plans are better equipped than individuals to handle the risks associated with investing for retirement. However, if funding rule changes provide employers with strong incentives to terminate their DB plans, individuals would have to increase their efforts to save for retirement through private accounts, such as 401(k)s or IRAs, to maintain the same level of retirement income. Even if individuals invest prudently, they still face large market fluctuations. Some workers would thus retire with substantially less retirement income than they were counting on, while others would do better than expected, depending on how well the market did during their lifetime (Weller, 2005). The problem is that individuals can often not wait for the market to improve again since many of the reasons for retirement, such as deteriorating health, will likely get worse with age. In contrast, pension plans are going concerns that can expect additional income as they pay out benefits for the foreseeable future. Because pension plans generally do not have to liquidate their assets on a given date, they can, at least to some degree, wait for markets to improve. After all, this is the logic behind using an average interest rate to calculate pension plan liabilities. Thus, pension plans are much better equipped than individuals to withstand the risks associated with investing in stocks.

[5] Mixed portfolios will not always do better than pure bond portfolios. There is a chance that stock market fluctuations are large and it takes long periods of time for stocks to recover those losses (Weller, 2005).

As a result of the administration's proposal, pension plans would be faced with an unappealing choice. They would either face increased volatility in their pension contributions or the costs of funding their pension plans would rise substantially. In either case, employers would have strong incentives to reduce their commitments to their employees through their DB pension plans and shift the risks of saving for retirement onto their employees. While pension plans are better equipped than individuals to handle long-term fluctuations in the stock market, the question still remains whether there are alternative funding rules that could help to reduce the volatility of pension contributions for employers and lower the incentives to terminate pension plans, without jeopardizing the security of pension benefits now and in the future. The answer is yes and the details are provided in the next section.

**More Smoothing Improves Benefit Security**

The problem as described above is that, under current funding rules, employers are more likely to have to make contributions to their pension plans when times are bad. When times are bad, more employers are unable to make payments to their pension plans. Therefore, pension terminations spike and the burden on the PBGC grows. The rules proposed by the administration would exacerbate this problem, while also raising the costs for employers with an older workforce. However, it is possible to change the funding rules, so that benefits are protected, employers have more certainty associated with the funding of their pension plans, and the PBGC will end up with fewer terminations.

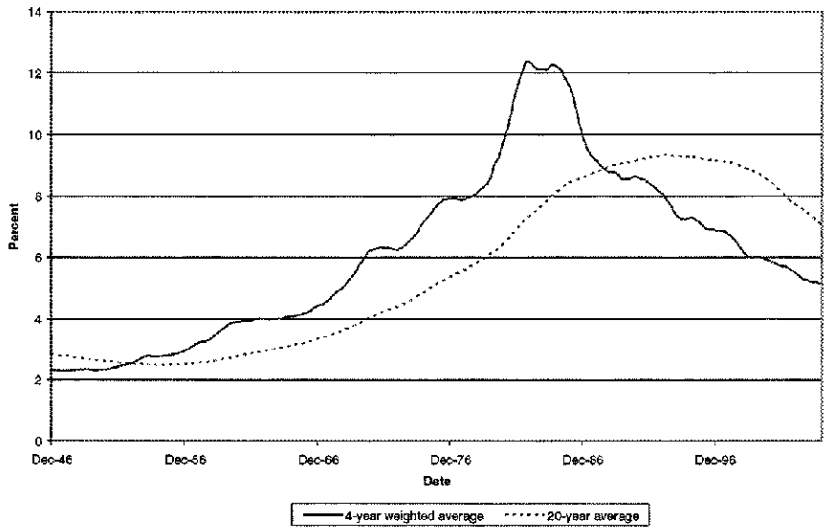
The basic premise underlying these funding rules is that they should be more procyclical, allowing employers to contribute more during good times and contribute less during bad times, when they can least afford it.

Such an approach is also more consistent with the nature of a pension plan than the administration's approach. The proposals laid out here give a clearer summary view of how well a pension plan is prepared for mastering the challenges of the medium-term future, when it is expected to pay benefits. By comparison, the administration's proposal to move towards a process of "marking to market" provides only a snapshot of the pension plan at the time of valuation. This is a consistent and accurate view only if it is assumed that the pension plan will terminate shortly after valuation. Under all other circumstances, the assumptions are too volatile to provide an accurate glimpse of the plan's future.

Three funding rule changes seem especially relevant. First, one way to reduce the cyclicality of pension funding is to use a long-term average of the benchmark interest rate, e.g., a 20-year average. This would substantially reduce the volatility of calculating pension fund liabilities and it would de-couple funding requirements from the fluctuations of the business cycle, since the period over which the interest rate is averaged is longer than any business cycle. A 20-year period is also a much closer match to the average duration of pension plan liabilities. Moreover, because interest rates have recently been so low, the longer-term average would be higher than even the 4-year weighted average. Thus, switching to a longer-term average could give plan sponsors some funding relief in the immediate future, while also improving funding certainty over the long term.[6]

[6] One of the reasons for changing pension funding rules is that the 30-year treasury bond rate is no longer an appropriate bench mark because the treasury has stopped issuing these bonds. It appears reasonable to use the 10-year Treasury bond rate instead. The benchmark rate is supposed to be risk free and reflect the long-term nature of pension liabilities. Both the 10-year and the 30-year treasury bond reflect the most secure assets. The 10-year treasury bond yield reflects the long-term nature of pension liabilities. The Federal Government will have outstanding debt that is likely to grow. Its financing instrument with the longest maturity is the 10-year Treasury bond. Thus, its yield reflects the long-term nature of the Federal debt. Further, data on the 10-year Treasury bond rates are available since 1953—longer than for the 30-year treasury, which was introduced in 1977.

Figure 5: Interest Rate Averages




Second, to mirror the rule change for liabilities, one can also use a 20-year smoothing for stock prices (Weller and Baker, 2005).[7] This process essentially assumes that stocks will adjust towards a long-run average over a long enough period of time. If stock prices are above long-term averages with respect to corporate earnings, they are discounted with the assumption that the adjustment process will take 20 years. The same holds when stocks are too low.

Lastly, one of the problems associated with the recent funding crisis was that pension plans had not built up enough reserves to weather the storm that ensued after 2000. The administration has recognized this problem and has proposed that employers would be permitted to contribute to their plans even after they meet the full funding target. However, many employers already could have contributed more to their pension plans if they had wanted to during the 1990s (Ghilarducci and Sun, 2005). Hence, the lack of a cushion was to some degree the unwillingness of employers to increase the funding status of their plans, even when times were good. Therefore, a proposal to require companies to fund up to 120 percent of liabilities over a period of 30 years seems reasonable.[8]

The effects of these rule changes on a hypothetical plan can be simulated.[9] To evaluate their effect, though, two questions should be asked. First, does the contribution pattern become less cyclical? Second, does the funding status of a plan weaken because of the rule changes? The changes in the funding status are evaluated using the ratio of assets at fair market value to current liabilities at the 4-year weighted average of the long-term Treasury rate. In addition, the probability of falling below a funding status of 75 percent is calculated.

The alternative rules would have maintained or reduced the burden on plan sponsors compared to the baseline (table 1). That is, on average, employers would have had to contribute less, especially during bad economic times. Using a smoother discount rate would have resulted in contribution holidays from 1998 to 2002 (model (2)); the alternative asset valuation method would have resulted in a contribution holiday after 1999 until 2002 (model (3)); and the requirement of contributions up to 120 percent of current liabilities would have meant no contribution holiday during this 5-year period, but contributions would have been equal or less compared to the baseline model (model (4)). When all three changes are in place, the fund

[7] At the same time that more smoothing is allowed, the current practice of credit balances is eliminated.

[8] The baseline assumes normal cost contributions up to 100 percent.

[9] The technical details of the simulation from Weller and Baker (2005) can be found in the appendix.

would have enjoyed contribution holidays for all 5 years (model (5)), reflecting the build-up of sufficient reserves during the preceding good years.[10]

To see this, the long-term performance of the alternative funding rules is tested, using the past 50 years as an example (table 2). From 1952 to 2002, average contributions would have been approximately the same under all scenarios, or sometimes a little bit less than under the baseline.

However, plans would have built up more reserves due to the funding rule changes. In each case, the CL funding ratio would have been higher than under the baseline scenario. That is, evaluated at current rules, the security of pensions would have improved. Also, in almost all cases, the chance of the funding ratio falling below 75 percent is reduced compared to the baseline (table 2). This again highlights the improved security of pension benefits under the new set of benefits.

To test whether the proposed rules would make pension funding less counter-cyclical, contributions during recessions and non-recessions are considered. From 1952 to 2002, only the alternative asset assumptions would have lowered the contributions during the recessions compared to the baseline model. But for the period from 1980 to 2002, all models would have lowered contributions during recessions. Thus, during the past 2 decades, employers would have enjoyed more predictability in the funding of their pension plans.

[10] The easing of the funding burden during the 5 years from 1998 to 2002 was a result of substantial build-ups in reserves and thus did not reduce the funding adequacy and the security of benefits. The current liability (CL) funding ratio would have been higher in each case than under the baseline (table 1).

*Table 1: Funding Status of Model Pension Plan with Different Funding Rules*

| | Baseline model | Model (2) | Model (3) | Model (4) | Model (5) |
|---|---|---|---|---|---|
| Discount rate for liabilities. | 4-year weighted average of long-term Treasury bond yield. | 20-year average of long-term Treasury bond yield. | 4-year weighted average of long-term Treasury bond yield. | 4-year weighted average of long-term Treasury bond yield. | 20-year average of long-term Treasury bond yield. |
| Asset assumptions | Fair market value | Fair market value | Adjustments for level and ROR on stocks, and long-term average interest rate for bonds. | Fair market value | Adjustments for level and ROR on stocks, and long-term average interest rate for bonds. |
| Contribution limit | 100 percent | 100 percent | 100 percent | 120 percent | 120 percent |

| | Contribution as share of salary | CL funding ratio | Contribution as share of salary | CL funding ratio | Contribution as share of salary | CL funding ratio | Contribution as share of salary | CL funding ratio | Contribution as share of salary | CL funding ratio |
|---|---|---|---|---|---|---|---|---|---|---|
| 1998 | 0.0 | 100.7 | 0.0 | 119.7 | 8.3 | 137.1 | 3.3 | 97.7 | 0.0 | 243.1 |
| 1999 | 4.8 | 98.2 | 0.0 | 117.6 | 6.7 | 142.2 | 3.1 | 97.8 | 0.0 | 253.5 |
| 2000 | 0.0 | 101.9 | 0.0 | 118.7 | 0.0 | 149.7 | 2.2 | 100.1 | 0.0 | 255.2 |
| 2001 | 3.6 | 87.6 | 0.0 | 102.7 | 0.0 | 131.0 | 3.6 | 87.5 | 0.0 | 220.6 |
| 2002 | 6.0 | 76.4 | 0.0 | 87.6 | 0.0 | 113.2 | 6.0 | 76.3 | 0.0 | 188.3 |

Notes: All figures are in percent. Source is Weller and Baker (2005).

## *Table 2: Summary Measures for Different Funding Rules, 1952 to 2002*

| | Baseline model | Model (2) | Model (3) | Model (4) | Model (5) |
|---|---|---|---|---|---|
| Discount rate for liabilities. | 4-year weighted average of long-term treasury bond yield. | 20-year average of long-term treasury bond yield. | 4-year weighted average of long-term treasury bond yield. | 4-year weighted average of long-term treasury bond yield. | 20-year average of long-term treasury bond yield |
| Asset assumptions | Fair market value | Fair market value | Adjustments for level and ROR on stocks, and long-term average interest rate for bonds. | Fair market value | Adjustments for level and ROR on stocks, and long-term average interest rate for bonds |
| Contribution limit | 100 percent | 100 percent | 100 percent | 120 percent | 120 percent |

| | Avg. cont. to salary | Avg. fund. Ratio | Prob. of less than 75% | Avg. cont. to salary | Avg. fund. ratio | Prob. of less than 75% | Avg. cont. to salary | Avg. fund. ratio | Prob. of less than 75% | Avg. cont. to salary | Avg. fund. ratio | Prob. of less than 75% | Avg. cont. to salary | Avg. fund. ratio | Prob. of less than 75% |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1952-2002 | 2.6 | 98.6 | 4.1 | 2.0 | 116.6 | 3.4 | 2.7 | 101.1 | 0.7 | 2.4 | 109.1 | 3.0 | 2.5 | 137.2 | 7.7 |
| | (2.7) | (13.6) | | (2.7) | (28.1) | | 3.0 | (13.9) | | (1.5) | (18.1) | | (3.4) | (38.7) | |
| 1980-2002 | 3.0 | 100.3 | 9.5 | 0.0 | 144.4 | 106 | 2.8 | 102.6 | 0.1 | 1.7 | 115.4 | 4.6 | 0.0 | 176.2 | 0.0 |
| | (3.5) | (19.3) | | 0.0 | (16.9) | | (3.4) | (18.7) | (1.6) | (23.9) | | 0.0 | (14.5) | | |

Notes: All figures are in percent. Figures in parentheses are standard deviations.

## *Table 3: Contributions during Recessions and Non-Recessions*

| | Baseline model | | Model (2) | | Model (3) | | Model (4) | | Model (5) | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Recession | Non-recession | Recession | Non-recession | Recession | Non-recession | Recession | Non-recession | Recession | Non-Recession |
| 1952-2002 | 2.2 | 2.8 | 2.5 | 1.8 | 1.7 | 3.2 | 2.6 | 2.2 | 3.4 | 1.8 |
| 1980-2002 | 2.0 | 3.4 | 0.0 | 0.0 | 0.7 | 3.8 | 1.8 | 1.6 | 0.0 | 0.0 |

Note: All figures are in percent.

There are clear benefits from implementing more smoothing in pension funding rules. Employers would gain predictability in the funding of their pension plans, while the funding status of pension plans would generally improve. Thus, employees would enjoy greater security of their benefits and the PBGC would ultimately see a reduction in the probability of plan terminations.

This proposal would also introduce funding rules that are more consistent with the going concern nature of pension plans. Using long-term averages assumes that pension funds will buy and sell securities, and that these transactions will occur at different interest rates. The time frames over which the smoothing occurs are generally consistent with the typical duration of pension liabilities. The proposals laid out here give a clearer summary view of how well a pension plan is prepared for mastering the challenges of the medium-term future, when it is expected to pay benefits.

Numerous proposals, including the administration's, have recognized the benefits and the consistency of smoothing in funding rules for the future well-being of pension plans. However, such proposals allow for more smoothing on the plan contribution side, rather than on the asset and liability valuation side (DOL, 2005; Towers Perrin, 2005). This still leaves the problem that "marking to market" does not provide an accurate view of how well the plan is prepared for the future. Furthermore, even those who propose more smoothing of contributions don't necessarily believe that it will actually work. When introducing the administration's plan, Secretary of Labor Elaine Chao was quoted as saying in the New York Times on January 30, 2005, that workers will "pressure their employer to more adequately fund the underfunded pension plans." Secretary Chao's comments indicate that the administration is counting on the large volatility of pension funding that would result from its new funding rules to scare workers into demanding more pension contributions from their employers. That is, regardless of the funding rules, employers may be forced to increase pension contributions to stave off employee dissatisfaction. However, this may only be a short-term phenomenon. Because the funding status of a pension plan would become more volatile, the contribution demands from employees at one point in time may become quickly obsolete as asset prices and interest rates change. The result would be frustration on the part of employees and large short-term pressures on employers, with the likely result that more and more employers would abandon their pension plans. Instead, the proposal laid out here would provide employees with a more accurate picture of the long-term health of their pension plans and stabilize the contribution stream of employers to their pension plans.

**Conclusion**

After 2000, defined benefit pension plans experienced severe underfunding. While the magnitude of the problem was unprecedented, the combination of the underlying factors was not. Employers should expect a regular recurrence of declining interest rates and asset prices during a recession. Current funding rules reflect this regularity and the administration's proposal to change these funding rules will not make the problem better, but exacerbate the counter-cyclical volatility of pension funding. Thus, the administration's proposal falls short of the standards laid out in the introduction. It would reduce the chance that future benefits will be maintained and it could jeopardize the pension security in well established pension plans through higher costs.

Instead of increasing the volatility of pension funding, which would drive more employers to terminate their pension plans, there are rule changes that would allow for more smoothing of pension liabilities and assets and thus stabilize pension funding. Empirical results show that this would result in more stable employer contributions to pension plans and to higher average funding ratios. Employers would benefit from greater certainty about the future of their pension plans, while employees and the PBGC would benefit from greater security of pension benefits. Thus, these alternatives would meet all three goals of sensible funding rule changes. They would secure existing benefits, help to maintain benefit security in the future, without unduly burdening the PBGC.

Thank you very much for this opportunity to present my views on pension funding rules. I am looking forward to your questions.

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**Appendix: Technical Details of Pension Model**

The basic simulation model referenced here is developed in Weller and Baker (2005).

*Asset Valuation Method*

First, the difference between market price and trend price is calculated for the current period:

$$\left(\frac{P_t}{\overline{P}_t}\right) = \frac{P_t}{\overline{E}_t(\overline{P/E})} = \frac{P_t}{\overline{E}_{t-1}(1+\hat{E})(\overline{P/E})} \qquad (1)$$

where $P$ is the current market price as measured by the S&P 500 index and $\overline{P}$ is the trend price. The trend price is equal to the trend earnings, $\overline{E}$, times the long-term average price to earnings ratio, $(\overline{P/E})$, since 1927 of 15.3. Further, the trend earnings in period $t$ are equal to the trend earnings in the previous period after having grown at the long-term average earnings growth rate, $\hat{E}$, of 5.0 percent.

Next, it is assumed that the difference between market price and trend price disappears over a period of 20 years, which generates an adjustment factor, AF, to the market price of stocks of:

$$AF_t = \left(\frac{1}{1 - r_t}\right) \tag{2}$$

where the adjustment rate, r, is defined as:

$$r_t = \ln\left(\frac{\overline{P}_t}{P_t}\right) / 20 * 100 \tag{2'}$$

such that the adjusted price, P*, is described by:

$$P^*_t = P_t AF_t \tag{2''}$$

Since the expected rate of return to stocks is the sum of the rate of capital appreciation and the dividend yield—dividends relative to market price—the adjustment made to the price also affects the expected dividend yield, such that the adjusted dividend yield is equal to the ratio of dividends, D, to the adjusted market price, P*.

We also assume that the difference between the actuarial value and fair market value disappears after 20 years, and that assets other than stocks earn the same long-term interest rate as for liabilities plus 50 basis points.

*Basic Pension Plan Design*

The number of workers is assumed to have been 10,000 in 1952, equally distributed from age 20 to 65, with 80 percent of workers blue collar and 20 percent white collar, labor force growth equal to 1 percent annually, and annual wage growth equal to 3 percent. Assumed attrition is 5 percent, equally distributed, and the number of vested workers is proportional to that of job leavers. We use the age earnings profile for blue- and white-collar workers from Engen et al. (1999).

Retirement benefits are based on average final pay, with retirement benefits equaling 1 percent of the average of the last 5 years of earnings for each year of service, with 5 years of vesting, and no ancillary benefits. Current liabilities are then calculated using the unit credit method. Assets are held in stocks and bonds. From 1952 to 2002, the pension plan's asset allocation into equities is equal to the share of directly held corporate equities out of assets for all pension plans (BoG, 2003). The rate of return earned on stocks is set equal to the increase in the S&P 500 plus the dividend yield, and the rate of return on bonds is equal to the treasury rate plus 50 basis points.

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FMR CORPORATION,
BOSTON, MA 02109,
*March 24, 2005.*

Hon. MICHAEL B. ENZI,
*Chairman,*
*Committee on Health, Education, Labor, and Pensions,*
*Washington, DC 20510–6350.*

Hon. EDWARD M. KENNEDY,
*Ranking Member,*
*Committee on Health, Education, Labor, and Pensions,*
*Washington, DC 20510–6350.*

Hon. CHARLES GRASSLEY,
*Chairman,*
*Committee on Finance,*
*Washington, DC 20510–6350.*

Hon. MAX BAUCUS,
*Ranking Member,*
*Committee on Finance,*
*Washington, DC 20510–6350.*

**Re: Joint Hearing on Private-Sector Retirement Savings Plans**

DEAR CHAIRMAN ENZI, CHAIRMAN GRASSLEY, SENATOR KENNEDY AND SENATOR BAUCUS: Thank you for the opportunity to participate in the recent joint forum, "Private-Sector Retirement Savings Plans: What Does the Future Hold?," held by the Senate Committees on Finance and Health, Education, Labor and Pensions (HELP). I found the hearing to be quite productive and look forward to working with you and your staffs regarding the important issues surrounding the need for Americans to better prepare for their retirement.

Three issues raised at the hearing merit additional attention, and I would like to offer the enclosed written materials for your review. These issues are as follows:

**Savings for Retiree Medical Expenses.** As I stated at the hearing, Fidelity estimated in 2003 that a couple retiring in 2004 at age 65 would need to have accumulated at least $175,000 in savings at that time to fund out-of-pocket medical expenses in retirement, notwithstanding Medicare coverage (including the prescription drug benefit) available to retirees at that age. We believe very few retirees, even those who have participated in an employer-sponsored defined benefit or defined contribution plan, will be adequately prepared to pay for these enormous retiree medical costs. We therefore believe much more needs to be done to educate workers about these expected costs and to offer them appropriate vehicles in which to save for these costs while they are still working.

To provide further information on this issue for the committees, I have attached a white paper prepared by Fidelity on the subject titled "Retiree Health Care Accounts: The Next Step Toward a Workable Solution."

• **Lifecycle Funds.** As I stated in the hearing, the current Department of Labor regulations under ERISA § 404(c) provide no fiduciary liability protection for employers with regard to the investment option to which accounts are defaulted when participants make no affirmative investment election. As a consequence, most employers designate a money market fund as the default fund instead of a more appropriate lifecycle or similar fund. This problem is exacerbated in the case of plans that provide automatic enrollment since those plans, by definition, result in a higher number of participants being allocated to the default fund. We believe a simple solution to this problem would be an amendment to § 404(c) that provides a shield from fiduciary liability when a properly-designed lifecycle or similar fund is designated as the default investment option.

To provide further information on this issue to the committees, I have attached two white papers prepared by Fidelity on this topic, entitled, "The Case for Age-Based Lifecycle Investing" and "Putting Lifecycle Investing Theory into Practice."

• **Longevity Risk and Lifetime Income Planning.** Many of the participants in the hearing highlighted the importance of the risk in retirement income planning and the beneficial consequences of annuitization. Fidelity likewise recognizes the importance of longevity risk, but we also recognize the importance of other risks in retirement income planning with regard to which annuitization may have a less than beneficial effect, including inflation risk and issuer risk. To encourage retirement planning, Fidelity has developed tools that allow retirees to better determine the appropriate level to annuitize their retirement income, taking into account all of the relevant risks. We therefore urge Congress to proceed cautiously with regard to the issue of providing incentives to retirees to annuitize their retirement income stream to assure that all of the relevant risks are balanced.

To provide further information on this issue to the committees, I have attached a white paper prepared by Fidelity on this topic entitled "Lifetime Income Planning."

I would be happy to discuss any of these issues at greater length with you or your staffs. Again, thank you for offering me the opportunity to participate in the joint hearing.

Sincerely yours,

JOHN M. KIMPEL,
*Senior Vice President and*
*Deputy General Counsel.*

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PREPARED STATEMENT OF SENATOR THOMAS

As public attention has recently been drawn to the subject of retirement security and the discussion that has ensued over the government's role of providing Social Security benefits, I'm very glad that we're taking the time here to address at least some of the role of the private sector. While I still believe that ultimately responsibility for an individual's retirement lies largely with the individual—as illustrated by my introduction of the SAVE initiative last week—to the extent that private employers choose to provide pension benefits for their workers, those benefits should

be reliable. In other words, it's extremely important that we have an effective, well-regulated—but not overregulated—system. I very much appreciate the time each of you has taken to be here today to discuss this important issue.

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QUESTION OF SENATOR THOMAS

*Question*. As we look at what makes a good pension system, I think we have to remember that private pensions are entirely voluntary and that employers can either offer them or not. Hopefully, most will want to offer them to attract and retain the best employees. That said, we must be careful going forward that we do not hamstring employers that try to offer these plans. It is incredibly important that we strike the right balance between protecting the employee and keeping employer compliance simple and straightforward. What are your suggestions for striking and maintaining this delicate balance?

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NATIONAL RURAL ELECTRIC COOPERATIVE ASSOCIATION,
*March 25, 2005.*

Hon. MIKE ENZI,
*Chairman,*
*Committee on Health, Education, Labor, and Pensions,*
Hon. EDWARD M. KENNEDY,
*Ranking Member,*
*Committee on Health, Education, Labor, and Pensions,*
Hon. CHARLES GRASSLEY,
*Chairman,*
*Committee on Finance,*
Hon. MAX BAUCUS,
*Ranking Member,*
*Committee on Finance,*
*U.S. Senate,*
*Washington, DC 20510–6350.*

**Re: "Private-Sector Retirement Savings Plans: What Does the Future Hold?" Additional Submission for the Record Highlighting Challenges for "Multiple Employer" Plans**

DEAR CHAIRMAN ENZI, CHAIRMAN GRASSLEY, SENATOR KENNEDY AND SENATOR BAUCUS: Thank you once again for inviting me to participate in last week's Senate Forum dedicated to examining the future of private-sector retirement savings plans. We at NRECA appreciate the opportunity to continue our strong working relationship with the committees on these important issues that impact over 55,000 of our members' employees alone.

As you know, NRECA sponsors both a Defined Benefit (DB) multiple employer pension plan, and, a Defined Contribution (DC) multiple employer pension plan (401(k) Plan) under § 413(c) of the Internal Revenue Code (collectively, the "Plans") for our members' employees. NRECA is the primary source of retirement savings services for the Cooperative community, with 77 percent of NRECA's member systems offering the DB Plan, 84 percent offering the 401(k) Plan, and 74 percent offering both plans.

During the Forum, I stated that while we believe our story is a success that should be shared and encouraged, administering and participating in a "multiple employer" plan does not come without significant challenges. Further, I described how the "multiple employer" plan structure is often overlooked or is an afterthought in legislative proposals, resulting in an unclear legal and regulatory environment that increases financial risks to both plan sponsors and participating employers. The Administration's DB pension proposal to determine a plan's funding target or liability based on a company's credit rating is the latest example of this—Administration officials have publicly admitted that they never considered "multiple employer" plans in developing their proposal, which simply does not work in that context.

Chairman Enzi asked that I describe some other "multiple employer" issues for the record as the committees continue to examine legislative proposals to preserve and enhance the private retirement savings system for the future, and I do so here:

1. Under current law, the Internal Revenue Service (IRS) has established the Employee Plans Compliance Resolution System (EPCRS) to enable an employer that maintains a plan that has experienced a problem with an applicable Code require-

ment to correct the problem and simultaneously preserve the tax benefits available for employers and employees.

The ECPRS system permits plan sponsors to correct qualification failures and thereby continue to provide their employees with retirement benefits on a tax-favored basis. One component of the EPCRS is the Audit Closing Agreement Program (Audit CAP), which permits a plan sponsor to pay a sanction and correct a plan failure while the plan is under audit.

Under Audit CAP, any penalty is a negotiated percentage of the amount of taxes that would be owed if the plan were disqualified. For a "multiple employer" plan, this could mean that the penalty would be based on the assets of the entire plan, even where for example, an operational error relates solely to a plan sponsor's treatment of just one participating employer's part of the plan.

We believe this is a disincentive for small employers to work together, to leverage group purchasing power and economies of scale, to create "multiple employer" pension plan arrangements. While NRECA has never been subject to Audit CAP, we believe that the Congress should provide clear direction to the IRS that in the "multiple employer" context, this concept must be refined. That is, in situations where a violation is solely attributable to the participation of fewer than all participating employers, any negotiated percentage of taxes that would be owed if the plan were disqualified should only be based on the portion of the plan attributable to those particular employers and should not be based on the other parts of the plan attributable to the other employers.

2. Section 4010 of ERISA requires notification to the PBGC for plans with unfunded vested benefits that exceed $50 million (the $50 million section 4010 gateway test). Significant employer identification, plan information, and financial information must be included in the PBGC filing. While the PBGC notification requirement was clearly intended to apply only to large companies, the number of plans subject to the 4010 filing has greatly increased in recent years due to historically low interest rates.

The PBGC is interpreting the statute to apply the $50 million threshold to a "multiple employer" plan in total, even if for each individual employer participating in the plan there is no question that the value of unfunded vested benefits is well below $50 million. These reporting requirements place an unnecessary and unreasonable burden on all employers, but particularly small employers participating in a "multiple employer" plan.

We believe this is a disincentive for small employers to work together, to leverage group purchasing power and economies of scale, to create "multiple employer" pension plan arrangements.

We hope to continue our work with the committees to address these kinds of issues so that "multiple employer" plans continue to be a viable vehicle for companies committed to doing the right thing—providing meaningful retirement benefits to their employees. If you have any questions, please feel free to have your staff contact me or Chris Stephen here in my office at 703–907–6026.

Sincerely,

GLENN ENGLISH,
*Chief Executive Officer.*

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## PREPARED STATEMENT OF CONVERSATION ON COVERAGE

### INTRODUCTION

The private sector retirement system in the United States is in many ways a great success story, providing much-needed benefits in addition to basic Social Security benefits for millions of older Americans. But millions of others, who will be equally in need of a supplement to Social Security, are left out of the system.

Although there has been tremendous growth in the number of workplace retirement plans, the number of people covered by retirement plans, and the dollars invested for retirement, the percentage of American workers participating in a pension plan has remained at roughly 50 percent of private sector workers for the past 2 decades.

The retirement plan coverage locomotive is stalled and is not gaining ground. This is true despite an intensive debate for more than a decade on how to improve coverage and the emergence of many innovative policy recommendations. Suggestions have been put forward by Presidents, Members of Congress, business groups, employee advocates, pension specialists, and professors. Some suggestions for simplifying rules and establishing new types of retirement plans have been made into law. The new plans have prompted some employers who had not previously offered plans

to do so, while some new rules have prompted employers to offer an existing plan to more employees.

The Conversation on Coverage was envisioned as a vehicle to bring together retirement plan experts representing a wide diversity of viewpoints in an effort to reach common ground on recommendations to increase the rate of retirement plan coverage of American workers.

There remains a clear need for new ideas to increase coverage, especially those aimed at raising coverage rates among low- and moderate-income workers.

**Background: The Work Place and Retirement Benefits Today**

In 2004, 59 percent of all full-time and part-time private sector American workers had access to a pension plan sponsored by the company where they worked, according to the Department of Labor. However, only about 50 percent of all workers actually participated in these corporate pension plans.

In 2004 total enrollment in the private sector plans was 51.6 million of the 102.3 million private sector workers, the Department of Labor reports.

Today, as was the case in the early 1980s, higher income workers and older employees with job tenure are likely to work at a company with a retirement benefit. However, low- to moderate-income people and younger employees are less likely to have a retirement benefit. There is also a big gap between full-time workers, who have a 53 percent coverage rate, and part-time workers, who have an 18 percent coverage rate, according to the Department of Labor.

Companies with more than 500 workers are most likely to have a retirement plan. In medium and large companies, a good employee benefits package is seen as key to attracting and retaining skilled workers.

Small businesses (with 99 or fewer workers) often face a different workforce situation. With a high worker turnover rate, there may be less employer or worker interest in benefits with a long-term horizon. Smaller companies are where there are the most workers without retirement benefits. Among firms with 100 or more workers, the participation rate in retirement plans was 65 percent, compared with 35 percent for employees at small businesses.

Some of the lower coverage rates among small businesses is due to the fact that small businesses are more likely to have part-time workers—and part-time workers, as noted, are more likely to be without retirement plan coverage. Among the smallest businesses—those with less than 10 workers, 41 percent of the workers are part-time, according to the U.S. Census Bureau. By comparison, in slightly larger companies—those with 10 to 24 workers—the proportion of part-timers drops to 33 percent.

An overall coverage rate of 50 percent at any one time does not mean that half the work force *never* has coverage. The likelihood that a single individual will be covered increases with age.

**Overview of the Conversation on Coverage's Working Group Reports**

The Conversation on Coverage tackled the issue of expanding coverage in its first gathering in July 2001. That event produced a number of innovative concepts, and a commitment among the diverse constituencies that care about pension issues to find ways to work together to improve pension coverage.

The second phase of the Conversation on Coverage began in early 2003 with the establishment of a Steering Committee and the creation of three Working Groups, each with its own assignment, and each with members representing a broad range of views and expertise in retirement issues. Members of these groups met for an intensive series of day-long meetings during the period from May 2003 through February 2004. The groups each had five or six full sessions, numerous subgroup meetings, and extensive further communications by telephone and e-mail.

The 45 experts on the three Working Groups represented a wide diversity of viewpoints. They came from businesses large and small, from academia, from the legal and employee benefits professions, from the union movement, from retiree and women's organizations, and from insurance and investment companies. They worked together many hours to find common ground. Starting from different points on the ideological spectrum, they ultimately came together to reach agreement.

The starting point for most members of the Working Groups was a belief in perpetuating the voluntary private retirement system while finding ways to expand it to include more workers. Along the way, some members said they preferred new mandates; but, the Working Groups in the end reached a consensus on voluntary approaches.

The private, off-the-record sessions gave the participants a chance to explore and debate different concepts without concern that they would suggest something that might meet with objection—whether practical, political or academic—before it had

been more thoroughly vetted. It was a chance to let their intellectual hair down, explore ideas and share common understandings. Nothing was taken for granted. The general theme was to build on the successes of the existing system and to look for new ways to make it work better and to reach more workers.

The result of all these efforts is an impressive package of proposals that are likely to advance the coverage debate significantly. The synthesis of thinking among members of the group is now offered for consideration and deliberation by others, including workers, employers, Members of Congress and the general public. The Working Groups did not attempt to evaluate all retirement plan proposals. Instead, they chose to focus on the broad framework of new plans they helped design and which they felt had particular merit. Due to the broad diversity in the membership of each of the Working Groups, and the considerable time and energy devoted to the task, the ideas that have been recommended in this report emerge from this process with a stamp of approval that increases the odds they can eventually be perfected, piloted and adopted.

**Key Recommendations of the Working Groups**

Four new promising ideas for new types of retirement plans emerged from the Working Groups. They are summarized below.

• **The Guaranteed Annuity Plan (GAP)** takes an employer-funded defined contribution plan, the money purchase plan, and adds new twists: the employer guarantees the rate of return on account balances of workers. The money purchase plan is a retirement savings plan financed by the employer through regular contributions based on a percentage of the compensation of each worker. GAP also provides higher contribution limits. The normal form of GAP's final benefit is an annuity, although employers can offer lump sums. (Working Group I)

• **The Plain Old Pension Plan (POPP)** is a new variation on the traditional defined benefit plan that starts with a modest guaranteed benefit that employers can boost in any year and then reduce back to the basic benefit in future years. It makes an employer's funding obligation more predictable. The normal form of the final benefit is an annuity and no lump sums are allowed. (Working Group I)

• **The Retirement Investment Account (RIA) Plan** proposes the creation of a government-authorized, privately-run central clearinghouse to accept contributions from all workers at all businesses. Employers will not have to administer the plan or take fiduciary responsibility for the investment choices of their employees. This plan is aimed at providing more individual workers with access to a payroll-deduction retirement saving plan through their workplace. (Working Group II)

**The Model T Plan** is a proposed multiple-employer plan that can be offered by financial institutions, such as banks, insurance companies, brokerage firms and mutual fund companies. The institutions will administer the plans and assume fiduciary liability for a simplified array of investment choices in the plan. This plan is likely to expand coverage by encouraging more small businesses to offer a plan to their workers. (Working Group III)

These proposals have several common elements. They reduce and/or transfer administration costs away from employers and reduce employer worries about the costs of funding the plan. They expand the number of workers eligible to participate in a plan. They also provide more opportunities to provide benefits—and in some instances—increase the level of benefits for low- and moderate-income workers. In addition, the proposals create approaches that are more appealing to the small and medium-sized businesses where coverage is the lowest.

This report contains a detailed discussion of each of these proposals and other recommendations that emerged from the Working Groups, preceded by an Executive Summary for each of the Working Group reports.

**Understanding the Language in the Working Group Reports**

In the individual reports that follow, the reader will come across the frequent use of the term "generally agreed." It will help in understanding the recommendations that have been made to know how that term is defined for purposes of this report. The goal of the group was to try to reach consensus. "Consensus" did not necessarily mean having 100 percent agreement by all parties at all times. There was an understanding by the Working Groups that if nearly all members agreed on something, then it would be fair to say that the group "generally agreed." By that, it is meant that there was only token opposition from a few members, usually no more than two.

Beyond the area of "general agreement," you will also note that there are other areas with varying degrees of agreement. It was decided from the beginning that there would be no vote *per se*, as voting was seen as working against agreement and could be polarizing. The meetings were covered by officially-designated report-

ers, and the co-chairs frequently polled members for their views. The range of views, in fact, often did not fall into simple "for" or "against" categories. As people were making compromises, they might be "for" with a caveat, or "against" but with some reservation. And sometimes Working Group members compromised on one item if they thought it was for the greater goal of moving the proposal forward and possibly getting something else in return on other ideas. Sometimes, rather than get bogged down in contentious issues, the Working Group members agreed to list a range of options and to come back later to the issue if there were more time.

There are times in the report when it helps to know what level of agreement existed, since there is a fairly large range of possible levels of agreement between no agreement and "general agreement." Thus, the reader will encounter such descriptions as "the majority" favored a given view. Or, "most" members supported an approach. When views were more evenly divided or diverged in ways that were difficult to tally, the text is likely to say that "the group was divided" on this issue.

Efforts are made to include minority views, especially when they are strongly expressed or held. So, even when there may be "general agreement" on a point, the reader might find that "a few" or "some" members held a different point of view. Sometimes, when there was disagreement, the report offers suggestions offered by members for addressing the issue at hand.

It is important to understand the context in which these new proposals are being offered. They are not considered finished concepts, but initial recommendations. It is hoped that these proposals will prompt a host of constructive suggestions for improving them, as well as even more new ideas for expanding coverage.

Lastly, these reports also contain comments and suggestions about the recommendations voiced by participants in the Conversation on Coverage's July 2004 National Policy Forum.

ROBERT STOWE ENGLAND

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## REPORT ON THE CONVERSATIONS AND RECOMMENDATIONS OF WORKING GROUP I

### WORKING GROUP'S ASSIGNMENT

### ANSWER THIS QUESTION

How do we increase coverage by encouraging incentives for both traditional and new forms of defined benefit plans?

FEBRUARY 7, 2005

Co-Chairs: Melissa Kahn and Norman Stein

Working Group Members: Phyllis Borzi, Ellen Bruce, David Certner, Charles Cole, Patricia Dilley, Lynn Dudley, Ron Gebhardtsbauer, Deene Goodlaw, Brian Graff, Nell Hennessy, Mike Johnston, Judy Mazo, Shaun O'Brien, and Bob Patrician

### EXECUTIVE SUMMARY

The Working Group held a series of meetings between May and November of 2003 to discuss ways to increase the number of workers in the workforce who work at companies that offer a defined benefit plan. Such plans typically promise a benefit that provides a guaranteed stream of income for life after retirement. Defined benefit plans are funded by the employer and the promised benefit level does not depend on the actual performance of the plan assets. An increase in workers covered by a defined benefit plan can be achieved both by encouraging employers that already sponsor defined benefit plans to extend coverage to more of their workers and by efforts or policies that prompt more employers to offer a defined benefit plan.

Defined benefit plans have several advantages for employees. Since employers fund the plan, employees do not have to determine how much they need to save to receive a defined benefit at retirement. Nor do they need to make contributions to receive the benefit.[1] The employer, and not the employee, bears the market risk associated with investment performance. The employer, and not the employee, decides how to invest the income and reallocate assets over time. And, to the extent that retirees take their distribution in the form of a lifetime annuity, they are relieved of the task of creating a budget for drawing down over time the funds in a lump sum, as well as deciding how to manage and invest the funds after retirement age.[2] Further, retirement income provided by defined benefit plans is federally guaranteed[3] with coverage provided by the Federal Pension Benefit Guaranty Corporation.

The members of the Working Group reviewed recent proposals for new types of defined benefit plans that were designed to appeal to employers who currently do

not offer a defined benefit plan (See Appendices A and B). They looked at traditional plan designs and new types of plan designs that contain features of defined benefit plans. After reviewing those suggested approaches, the Working Group put together the basic outlines of two new proposals—the Guaranteed Account Plan (GAP) and the Plain Old Pension Plan (POPP)—aimed at employers who may be interested in sponsoring a defined benefit plan but who are also wary of the liabilities and burdens associated with traditional pension plans.

**Guaranteed Account Plan.** The Working Group generally agreed on the key design features of this proposed plan, listed below.

• The proposed plan is a new kind of hybrid plan that takes the existing money purchase plan and adds a guaranteed account balance. The money purchase plan is a retirement savings plan financed by the employer through regular contributions based on a percentage of the compensation of each worker.

• The account of each participant is credited with an annual employer contribution.

• Benefits are funded by the employer, based on standardized and conservative funding assumptions; employees could also elect to contribute on a pre-tax basis.

• The plan guarantees the annual rate of return on participants' account balances.

• The employer invests the plan assets so employees do not self-direct the investments.

• The plan offers an annuity as the automatic payment option, but participants may also be offered as an alternative a lump sum equal to the amount credited to the participant's account.

With this basic design, GAP transfers from the employee to the employer the risks associated with choosing appropriate investments, as well as the financial market risk of how well investments perform.

**The Plain Old Pension Plan.** The Working Group generally agreed on the key design features of this proposed plan, which are listed below.

• The plan is a simple, easy-to-understand traditional defined benefit plan that provides a modest basic benefit to allay employer concerns about funding the plan.

• The final basic benefit is based on a percentage (as low as 1 percent) of an employee's career average pay multiplied by the number of years of service.

• The plan would allow employers to fund bonus benefits in any given year or years that would raise the final benefit without having the bonus benefits become part of the permanent benefit structure.

• The plan would permit, but not require, a generous past service credit that would be attractive to small business owners.

• All benefits from the plan would be paid in the form of an annuity. Lump sum distributions would not be permitted.

**Tax Credit Provisions.** The Working Group also supported a number of tax credit provisions that would encourage employers to adopt and maintain a defined benefit plan, as well as to expand the number of workers covered by a defined benefit pension plan.

Some of the proposals adopted may require changes in public policy and some may be pursued through demonstration projects. This will be determined in a refinement and implementation stage in 2005.

THE MISSION

The mission of Working Group I was to develop proposals that would expand the aggregate number of workers covered by a plan that offers a defined benefit. A defined benefit plan is a retirement plan offered by an employer who is legally obligated to fund the plan's promise to provide a monthly retirement benefit to each eligible employee and surviving spouse based on years of service and earnings. (See box on plan type definitions page TK for more information on types of plans.) The group generally agreed that expanded coverage would include providing coverage to employees at firms that previously did not have a plan with defined benefits, as well as extending coverage to groups of employees at firms with a defined benefit plan that were not previously covered by the plan.

The Working Group also sought to find ways to help prevent further erosion of the number of workers currently covered by defined benefit plans. To support this goal, the group generally agreed to support proposals that would encourage employers who currently sponsor defined benefit plans to continue sponsoring such plans. The group also generally agreed it should not support proposals that might discourage employers who sponsor defined benefit plans from continuing to do so. This approach was seen as being similar to physicians who take the Hippocratic Oath: "First, do no harm."

BACKGROUND

The defined benefit plan is no longer the preeminent and preferred method of providing retirement income for employees. The plan's dominant position has been eroded in a single generation, as the proportion of the private sector workforce covered by a defined benefit plan was cut in half from 38 percent in 1978[4] to 19 percent in 1998.[5]

Meanwhile the proportion of workers with a defined contribution plan as their primary retirement plan rose sharply over the same period from 7 percent to 27 percent, making the defined contribution plan the dominant type of plan in the workforce.[6] A defined contribution plan is an employer-sponsored retirement savings plan that accumulates assets from employee contributions and/or employer contributions. There is no specific promised benefit at retirement and the investment risk falls on each individual employee. In the 401(k) and 403(b) models now predominant (both defined contribution plans) employees determine how much they should save and often choose how to invest their retirement savings. (See box on plan type definitions for more information on plan types on page TK.) The employee's retirement income is based on the contributions made into the account and the accumulated earnings at retirement.

Federal pension data illustrate the extent of the decline in defined benefit plans and employees covered by such plans. The number of workers covered has declined and the number of plans has fallen sharply. According to a Congressional Research Service paper, the number of workers covered fell from 29.3 million in 1983 to just under 23 million in 1998.[7] At the same time, the number of plans fell from 175,000 to 56,400, with most of the loss of plans occurring among small businesses (those with 99 or fewer workers). The proportional decline has been greatest among small plans. Between 1983 and 1998, for example, the number of workers in small plans fell by a disturbing 65 percent, from 1.86 million to 648,000. That represented a loss of more than 1.21 million workers. For the biggest firms, however, there was an even greater decline: with only 5.8 million of workers enrolled in defined benefit plans. In 1983, the number of active participants in defined benefit plans at large companies stood at 28.1 million. By 1998, it had declined 21 percent to 22.3 million.[8]

The Pension Benefit Guaranty Corporation provides estimates on the number of plans and the number of participants and beneficiaries of those plans based on premiums that are paid to the agency. PBGC reports that in 2001, there were 22.35 million active workers in plans insured by the agency, representing 19.7 percent of the 113.5 million private sector wage and salary workers.[9] This represented a tiny drop in workers covered from 22.38 million in 2000.[10] In 2003, the number of single-employer plans fell to 29,512 from 31,229 the previous year. The number of multi-employer plans stood at 1,623 in 2003, down from 1,671 the previous year.[11]

The data suggest that while the defined contribution plan has become a more popular method for providing retirement benefits, it has not achieved the success that the defined benefit system enjoyed before the rise of the defined contribution plans, particularly 401(k) plans. And despite its relative decline, the defined benefit plan remains an important part of the employee benefits system, especially at larger firms. In 1998, for example, private sector defined benefit plans paid out $107.8 billion in benefits, mostly in the form of annuities disbursed from plan assets. They also purchased an additional $3.4 billion in annuities from commercial insurers.[12] Also, the defined benefit plan continues to be the plan of choice for Federal, State and local government employees and for workers in the unionized sector of the economy.

THE ADVANTAGES OF DEFINED BENEFIT PLANS

Defined benefit plans are often seen to have a number of inherent advantages for rank and file workers. Significantly, all or almost all the contributions are made by the employer. Thus, the burden of determining how much to save and how to invest those assets is shifted away from the employee to the employer or, in a negotiated plan, to the bargaining table.

Participants in defined benefit plans also enjoy a further advantage in that the investment risk is shifted away from the employee and the normal form of pension benefit is usually in the form of a lifetime annuity in an amount that can be calculated from the formula in the plan. More importantly, as recently as 1997, fewer than 25 percent of participants in defined benefit plans even had an option to take benefits in a non-annuity form, such as a lump sum.[13] In addition, the benefits provided by defined benefit plans are federally guaranteed with insurance provided by the Pension Benefit Guaranty Corporation.

Providing the retirement income benefit as an annuity eliminates the longevity risk for the retiree; that is, the retiree does not have to worry about outliving the

pension, since the pension is defined as an income stream to be provided throughout the retiree's life span. It also fully meets the goals of the substantial Federal tax subsidy for qualified retirement plans by providing income only during the retirement years of the employee and his or her spouse, and cannot be dissipated after a pre-retirement termination of employment or accumulated as a tax-favored asset for the next generation.

The benefit of having an automatic annuity in a defined benefit plan has, however, been eroded in recent years as more plans have opted to offer lump sums as an option and employees have chosen to take lump sums instead of annuities. In 2000, for example, 43 percent could take their benefit as a full or partial lump sum.[14]

PROBLEMS FACING DEFINED BENEFIT PLANS

In order to develop new plan designs and fashion new incentives to attract employers to the defined benefit form, the group felt it was important to understand the reasons for the decline of defined benefit plans. Thus, the group explored the reasons why defined benefit plans now have less appeal to employers and, in some cases, to employees.

**The Employer's Uncertainty about the Pension Liability.** Many members of the group agreed that defined benefit plans have become less popular because of the unpredictability of the annual contribution employers have to make to keep their plans fully funded under Federal pension laws. Such contributions are based on a series of actuarial calculations that take into consideration the promised benefits for workers, the value of assets currently in the plan, the expected rate of return that assets in the plan will likely earn in the future, and actuarial assumptions such as mortality rates and the rate of employee turnover that bear on the cost of benefit liabilities.

Employers who regularly make required contributions into their pension plans to meet future obligations can still fall short of the funding goal due to changes in the value of assets in the financial markets and due to changes in the prevailing interest rate used to evaluate liabilities. Changes in the benchmark interest rates, for example, may result in reported funding deficiencies for previously well-funded plans.[15]

In recent years, declining interest rates have required employers to contribute larger sums of money. The required contribution was also increased because the value of assets in many plans declined substantially in 2000, 2001, and 2002. These year-to-year changes can make the amount of the funding obligation—the amount the employer needs to put aside now to pay benefits later—rise and fall dramatically. Thus, swings in interest rates and the market value of assets can make the funding obligation volatile. This volatility has been a key concern of employers, since it can require companies to divert financial resources needed to run the company into the pension plan. Requirements for large contributions often come when the company may not be profitable and when the failure to invest in the future of the company can weaken its prospects for success or even survival. Funding shortfalls are not always predictable since they may arise from market forces not within the employer's control.

The volatility in actual funding requirements can cause serious cash-flow problems for employers. This volatility also shows up on employers' financial statements, as accounting standards require that pension assets and liabilities be recorded both on the income statement and the balance sheet. That can have a serious impact on employers' cost of capital. Proposals under consideration by the accounting profession for "mark-to-market" reporting would heighten that accounting volatility by disallowing the use of some actuarial smoothing techniques used to value assets and liabilities for accounting purposes.

**Employees Do Not Always Value Defined Benefit Plans.** The group generally agreed that one of the reasons that employers do not consider adopting defined benefit plans is that employees do not ask for them or appreciate them. Indeed, younger employees, who may expect to change jobs several times, may see a 401(k) or defined contribution plan as more valuable, since they know what assets are in their individual account and can see the assets grow over time through regular statements from the plan. However, the group also generally agreed that employees have lately shown more interest in plans that accrue funds at a regular pace with a guaranteed rate of return in response to the performance of the financial markets from 2000 to early 2003, when many employees saw the value of their 401(k) accounts plummet.

**How Much Benefit for the Owners and/or Senior Management?** One of the concerns about devising new defined benefit plans is not peculiar to this type of

plan, but applies to all plans. Since most large and medium-sized employers have some type of employer-sponsored pension plan, most of the expansion that could occur is among small businesses. In these businesses, the owner and senior management are likely to be part of the plan that is offered, according to several members of the working group, and would expect to receive a very large share of the pension benefits that would be financed in the plan.

People who are in the business of selling defined contribution plans, such as 401(k) plans, and profit-sharing plans—both popular among small and medium-sized employers—report that the owner and/or senior management of very small businesses normally expect to receive as much as 60 to 70 percent of the benefit. According to those who market plans, there is a tipping point for the owner and/or senior management when it is easier for the owner to simply take a similar amount of money out of the company without any tax deduction at all and set it aside for retirement outside of any qualified pension plan. Some members of the group felt this reality of the marketplace creates an obstacle to expanding coverage. While coverage can be said to be increased if more small businesses adopt plans, this may not be significant if most of the benefit goes to higher paid workers while rank-and-file employees do not receive meaningful benefits.

Members of the group disagreed on where new plans should set the dividing line between the portion of the retirement benefits provided to the owners and highly paid managerial employees and benefits for regular employees. Some members of the group were concerned that potential plan designs that directed too little of the contribution to owners and other highly paid employees may not be attractive enough to employers to prompt them to sign up for the plan. Others were concerned that little would be gained if new plans merely benefit owners and senior management with few benefits for the rank and file of the work force.

## HOW THE WORKING GROUP WENT ABOUT ITS ASSIGNMENT

The members of the Working Group held six meetings and several subgroup meetings between May and November, 2003. In the initial meetings the group reviewed a number of proposals for new types of plans that promised a defined benefit.

Members were invited to express their opinions about proposals and the group sought to reach consensus on as many points as it could. Due to the nature of the process of the Conversation on Coverage, members of the group often "took off their advocacy hats" and often started from a position in the "middle" in an effort to find places where they could generally agree. At times the group was unanimous or nearly-unanimous in supporting or rejecting a given point. In this instance, the group was said to have "generally agreed" or "generally disagreed" on that point. At other times, the group found substantial agreement, but not unanimity. Sometimes the opposition was strong. When the group disagreed on a point or provision, members were invited to offer different options that might address a particular issue. This report reflects those differing opinions and varying viewpoints.

The group began its work by reviewing several defined benefit or hybrid plan proposals that were included in a binder that was given to all working group members. Hybrid plans have some of the characteristics of both a defined contribution and a defined benefit plan. (See Definitions of Plan Types at on page TK.) The group considered hybrid plans that would, at a minimum, offer a standard annual contribution by the employer (which might be waived occasionally) and a specified rate of return for the accumulated funds in the account that would be guaranteed by the employer or a financial institution or company that offers the plan.

The group devised a set of criteria[16] for reviewing proposals for new types of plans and also for reviewing proposals for tax incentives and other ideas to make existing defined benefit plans more attractive to employers and employees.

The group generally agreed that proposals should be attractive to employers and employees, make good public policy sense, and be regarded as marketable by the financial institutions and consultants who would have to sell them to employers.

For employers, the group generally agreed that the following criteria should be considered: reduced regulation, low administrative costs, low contribution costs, high benefits for owners and officers, attractiveness to prospective employees, designs that are helpful in retaining current employees, designs with tax benefits to the company and owner, designs with contribution flexibility for the owners.

For employees, the group generally agreed the following criteria should be considered: low costs in terms of contributions and high returns on assets in the plan, protection against investment risk, employee control over assets, portability of assets, protection against longevity risk, protection against inflation, tax benefits, psychological benefits of owning assets, simplicity and fairness for employees, and the adequacy of benefits provided under the proposal.

From a public policy standpoint, the members generally agreed that proposals should be measured by the effectiveness of the revenue dollars spent, and the degree to which savings are preserved for retirement rather than withdrawn earlier for other purposes. Proposals were also judged on how well they could be sold to Congress, employers and employees. They were also judged on how marketable they might be by financial institutions and benefits consultants.

The group generally agreed that the target employer market for the proposals they reviewed would be small and medium-sized businesses. Some members, however, hoped that some of the proposals that the group reviewed and eventually favored would also appeal to large businesses that may or may not have a defined benefit plan.

THE GROUP EXPRESSES INTEREST IN DB-K PLANS

Early in its conversations the Working Group expressed a preference for supporting some type of DB-K plan, with the DB referring to defined benefit and the K referring to a 401(k) plan. A DB-K plan would be, then, a defined benefit plan with a 401(k) feature. The idea behind such plans is to combine two goals into one plan: one side of the plan would provide a more secure benefit based on a guaranteed rate of return while the other side of the plan, the 401(k), would give employees a way to save for retirement through contributions that are excluded from taxable income.

The Working Group identified several potential benefits of a DB-K. It would allow employers to offer in one plan a defined benefit based on pay and length of service, as well as a retirement savings plan. It would provide a "safe harbor" for the defined benefit plan where the employer provides a minimum benefit formula for all eligible employees, such as 1 percent of final average compensation times up to 20 years of service. Employers who provide this minimum benefit would be deemed to have met the requirements of the nondiscrimination rules, including the rules applicable to 401(k) plans—giving them a safe harbor from those rules. This would eliminate the need to do costly nondiscrimination testing[17] required by the Internal Revenue Code. It would allow employers to imaginatively combine the best features of defined benefit plans and 401(k) plans.

The group generally agreed to support the overall concept of a DB-K plan that would have a guaranteed benefit in one arm and a 401(k) feature in the other arm. The group, however, did not generally support any one of the three plans it reviewed. The three DB-K proposals that were discussed are described in Appendix A.

The Working Group at one point expressed interest in DB-K Proposal No. 1, which had one arm that could be either a traditional defined benefit plan or a cash balance plan. The Working Group was interested in improving on the basic features offered in DB-K Proposal No. 1 to make it more attractive for both employers and employees. The group was interested, for example, in finding ways to make it less costly for the employer by reducing the minimum required contribution.[18] The Working Group generally agreed that employers would be more likely to adopt such plans if they were less costly. The group was also interested, for example, in allowing for withdrawals at age 59½ instead of normal retirement age to make phased retirement possible at that age, as is already possible in 401(k) plans.[19]

The member who had introduced the original DB-K Proposal No. 3 suggested that the group replace the cash balance option with a new hybrid: the Guaranteed Account Plan, an adaptation of the money purchase plan, a defined contribution plan. The money purchase plan is a retirement savings plan financed by the employer through regular contributions based on a percentage of the compensation of each worker. (See definitions of plan types on page TK for more information on money purchase plans.)

**Working Group Offers Two Plans for Consideration**

After reviewing a number of pre-existing potential designs for new types of plans with defined benefits, the Working Group settled on two proposals: the Guaranteed Account Plan (GAP) and the Plain Old Pension Plan (POPP), whose designs are described below.

The Working Group members generally supported the broad conceptual design of these two proposals. Members also generally agreed on a number of key building blocks of design elements for each of the plans with reservations on some aspects of the design for the two plans.

In some key provisions, members could not reach agreement on single provisions alone without considering their impact as a whole (see section in this report on Working Group I within the discussion of GAP titled Four Policy Areas Linked in Discussions). Some members said they wanted to be sure that the package of provisions as a whole would provide lower paid workers a sufficient share of the benefits

in return for the greater flexibility and higher benefit the plan would allow higher paid employees.

The Working Group generally supported POPP on a broad conceptual level, and there was agreement on some of its potential provisions. However, on some provisions there was disagreement. Those areas of agreement and disagreement are discussed later in this report. In some cases there are options offered for resolving issues and points of dispute.

## THE GUARANTEED ACCOUNT PLAN

### AREAS OF BROAD AGREEMENT ON THE DESIGN OF GAP

The Working Group reached general agreement on some of the key design elements of the proposed Guaranteed Account Plan. These elements are discussed here as individual building blocks of the overall plan.

**Basic Plan Design of GAP.** The group unanimously agreed on the following basic design points.

- The proposed plan is a money purchase plan with a guaranteed account balance.
- The employer credits the account of each participant with an annual contribution.
- Benefits are funded by the employer, based on standardized and conservative funding assumptions.
- Employees can also elect to contribute on a pre-tax basis.
- The employer guarantees the annual rate of return on the assets in participant accounts.
- The employer invests the plan assets in the accounts and, thus, the employees do not self-direct the investments.
- The plan offers an annuity as the automatic payment option.
- Participants may also be offered as an alternative to an annuity a lump sum equal to the amount credited to the participant's account.

With this basic design, GAP transfers from the employee to the employer the risks associated with choosing appropriate investments, as well as the financial market risk of how well investments perform and annuity purchase rates at any given time. The group did not agree on such elements as what the annual guaranteed rate of return should be and what limits should be placed on employer and employee contributions to control the extent to which highly paid employees might disproportionately benefit from the plan.

One member strongly objected to GAP on the grounds that it was a defined contribution plan with a guarantee and not a true defined benefit plan and, thus, fell outside the group's mission. Nevertheless, there was general agreement among members to support the broad outlines of GAP, while views differed on key provisions. Members who supported the proposal stated it preserved some of the best elements of defined benefit plans and avoided the legal controversies surrounding cash balance plans.

**How Some Compromises Were Reached.** In the consensus that emerged in support of key design features of the GAP, many members of the group expressed concern that some of the legislative and regulatory changes made over the years have allowed too much leakage of accumulated benefits that should be saved for retirement. Some members also expressed concerns that Congress and Federal Agencies have been far too willing to allow plans to favor higher paid employees in terms of contributions and benefits. As a practical compromise, some members agreed to retain in proposed new plans, like GAP, many of what they considered to be "bad" features of current law as a practical compromise.

This was done in response to the contention that if one were to tighten existing rules for the new proposed plan, employers would be less likely to adopt the proposed plan and might either drop their current defined benefit plan in favor of the new proposed plan, or move to a defined contribution plan.

For example, many of the members would have preferred to recommend that the GAP disallow any lump sums except for the smallest accounts. However, since employers already have a lump sum option in their defined benefit plan, it was difficult to support tougher rules for GAP. As the point illustrates, the outcome on some key points on which agreement was reached was not entirely satisfactory to some concerned members. However, they decided as a practical reality they had to preserve incentives to keep employers in existing defined benefit plans. Thus, even where members supported new various provisions in GAP, they made a point of noting that it was not an ideal structure to deliver retirement benefits and that, given the constraints of current law, it was the best compromise they could make.

With the above caveats, below are the areas where there was general agreement:

**How Long Employees Work to Vest in Retirement Benefit.** An employee is said to be "vested" in a pension when the employee becomes entitled to the benefits of the plan, including employer contributions to a plan and their earnings. The time until a benefit is vested is defined under guidelines set forth in Federal pension law.[20] The Working Group generally agreed to propose that GAP would allow employers to offer one of two types of vesting for plan participants. One choice would be to vest in the entire benefit balance all at once after 3 years from the date of employment, an approach called cliff vesting. The group also generally agreed to allow for gradual vesting over a 6-year period. Under this approach the portion of the benefit in the plan that is vested rises each year and reaches 100 percent after 6 years. The vesting options under GAP are the same as those that apply now for 401(k) plans and are more generous than the rules governing traditional defined benefit plans. Shortening the vesting requirement benefits employees.

**Simplified Funding Rules.** Most defined benefit plans have a complicated set of rules that govern how much in new funding an employer has to contribute each year. When the total assets in a plan fall below a level that would make it difficult to meet the future benefit obligation, employers are required to close the funding gap. There are also limits on the maximum amount that can be contributed in a given year. The Working Group sought to simplify the rules in order to make GAP more appealing to employers.

The Working Group generally agreed that the employer be required to fund the plan in a manner designed to assure that plan assets are at all times adequate to meet current obligations. When the funding level of the plan falls below what it will need to meet future obligations, the plan has to schedule additional contributions to make up the amount. The Working Group generally agreed that when the plan becomes underfunded due to market performance of the assets in the plan, the gap should be closed over a 5-year period, which is shorter than would be required under a traditional defined benefit plan and, thus, seen as better protection of workers' earned benefits. The employer would also be allowed to make additional contributions above those required that could raise the level of assets in the plan to 150 percent of its current liability.[21] This is a higher limit than current law.

The proposed funding rules for GAP reduce the amount of time the employer has to close the funding gap, compared to traditional defined benefit plans.[22] This makes it more likely plans will close their underfunding gap after they experience losses. The increase in the maximum contribution allows employers to make additional contributions in good years when the company can afford those contributions and, thus, make it better prepared for lean years, when the employer may find it difficult to make required contributions.

**Increased Credit for Past Service.** Members stated that plan designs that allow for past service credit may be more appealing to older employers. This feature would allow employers who have not yet set up a defined benefit plan to do so and then make contributions for the years employees worked before the plan was set up and, thus, help provide a better benefit at retirement. The Working Group generally agreed that GAP could provide for up to 7 years of past service credit. The credit would be earned 1 year at a time for all the years of prior service credit. Thus, it would take 7 years to allow for sufficient employer contributions to cover 7 years of past service credit. All employees—including low and moderate income workers, as well as highly-compensated employees—would be eligible for the increased credit for past service.[23] Consequently, the grant of past service credit would be deemed to satisfy the nondiscrimination requirements. Further, the Working Group agreed that when past service credit is allowed, it would count toward the vesting requirements of the plan.

**Joint and Survivor Annuity.** The Working Group generally agreed that the normal benefit offered at retirement would be a joint and survivor annuity (or a single-life annuity for unmarried participants), based on the value of the participant's account at retirement. That means the value of a participant's account would be used to purchase a commercially annuity, reasonably priced, that would be issued jointly to the plan participant and spouse and that the spouse would continue to receive the annuity should the plan participant die. Employers would be able to decide whether or not their plans would offer lump sums. However, if a participant decided he or she preferred to take a lump sum, spousal consent would be required to change the distribution from the normal requirement that it be a joint and survivor annuity. Spousal consent for a lump sum is currently required for money purchase plans, as well as for defined benefit plans.[24]

**A GAP with a 401(k) Feature.** The Working Group generally agreed that a GAP could also include a 401(k) feature. Employees could, under such plans, make elective contributions[25] to the GAP or the 401(k) plan.

**Employer Matching Contributions.** The Working Group generally agreed that employers could make matching contributions to the GAP when employees made contributions to a plan including a 401(k) feature. The Working Group agreed this should be allowed in accordance with current Tax Code requirements for matching contributions, including safe harbor rules.[26]

**Caluclation of Lump Sum.** When employees in a defined benefit plan leave a company before retirement and they are vested in a defined benefit pension plan, they frequently receive a lump sum payment. Current pension rules governing defined benefit plans, including cash balance plans, require a complicated calculation[27] to arrive at the value of the lump sum. The group generally agreed that rather than applying the complicated rules that now affect cash balance plans, that individuals would simply receive the balance credited to their accounts, using the rules that apply to defined contribution plans. Members stated this would be fair to employees and to employers and would simplify administration.

GAP DESIGN ELEMENTS WITH SOME, BUT NOT GENERAL AGREEMENT

**Rules Governing Terminations of a GAP with Surplus.** The Tax Code contains provisions that penalize companies when they terminate overfunded pension plans. Under the proposed GAP, if employers guarantee a specific rate of return, such as 3 percent, and the plan's assets experience higher returns, the plan will accumulate surplus assets (to the extent the funding method does not fully correct for the mismatch). An employer may wish to take a reversion on a portion of those assets. A reversion occurs when an employer terminates a plan to take out excess pension assets.

There was strong support, but not general agreement, for the following suggestions:

- *20 Percent Excise Tax on Reversions up to 130 Percent*. Employers could terminate a GAP and take the surpluses or amounts in the plan and pay a 20 percent excise tax for amounts that are up to 30 percent above the 100 percent level of account balances.
- *50 Percent Excise Tax on Reversions Above 130 Percent*. If, however, the surplus is greater than 130 percent of account balances, the employer would have to pay a 50 percent excise tax on the portion above 130 percent.

This feature was thought by members to make GAP more attractive to employers who might otherwise wish to avoid taking on the risk of guaranteeing the rate of return on account balances. This approach, one member said, would be more lenient than current law, but would not give employers "a complete [free] pass." Nevertheless, several members strongly objected to a reduced excise tax for part of the surplus. They argued that without a significant penalty, companies would be tempted to take the surpluses and terminate plans.

**Pension Benefit Guaranty Corporation Insurance.** Defined benefit plans in the private sector are insured by the Pension Benefit Guaranty Corporation in Washington, D.C. When underfunded pension plans are terminated, the plan assets are transferred to the PBGC and the agency takes over the payment of pension benefits. The agency guarantees pension benefits at normal retirement age and most early retirement benefits.[28] The agency provides a maximum benefit guarantee, which is adjusted every year and is $3,801.17 per month for 2005 for workers who retire at age 65.[29]

Most of the Working Group members supported a suggestion that GAP be insured by the PBGC. One member was strongly opposed to the guarantee, arguing that PBGC guarantees were inappropriate for a plan that was not a true defined benefit plan, but a defined contribution plan with a guaranteed rate of return.

Most of the Working Group also supported charging a lower $5 premium per member in a GAP. By contrast, the flat rate premium for single-employer defined benefit plans is $19 per member per year. (In early 2005 PBGC proposed raising the flat-rate premium to $30 as part of an effort to strengthen its finances.) Plans that are underfunded have to pay an additional adjustable rate premium.[30] A lower premium was recommended to mitigate one of the objections that employers have to adopting defined benefit plans; namely, the cost of pension insurance premiums. Most, but not all, members of the group believed that the lower premium for GAP would not represent risk to the PBGC because of the low risk of a GAP benefit default.

**Higher Contribution Limits and Maximum Annual Annuity Benefits.** Under the Internal Revenue Code, employers can contribute more annually for high-paid older employees into defined benefit plans every year than they can with defined contribution plans.[31] The Working Group discussed whether or not GAP, which is a hybrid plan, should have the contribution limits specified for defined benefit plans or those for defined contribution plans.[32] The contribution limits for de-

fined benefit plans are generally more favorable to older workers, which the group anticipated would often be business owners and higher-paid workers of businesses that adopted a GAP.

A majority of the group's members agreed that employers should be given a choice of whether to use defined benefit or defined contribution limits. However, some members strongly objected to this provision as providing too much of a potential benefit to owners and top executives, who are often older than the average rank-and-file worker.

The Working Group mostly agreed that GAP could use 5.5 percent as the interest rate for converting the annuity to a lump sum for purposes of the maximum defined benefit limit. The Working Group also mostly agreed that if Congress were to change the law to provide a new interest rate assumption, the new interest rate assumption would apply to GAP.[33]

**Four Policy Areas Linked in Discussions About GAP**

As members discussed what provisions to approve for GAP, four key issues were frequently tied together in the conversations:

- **Minimum guaranteed rate of return on account balances.**
- **Maximum benefits allowed for higher paid and older workers.**
- **Minimum employer contribution credits for all workers.**
- **Flexible testing methods for nondiscrimination.**[34]

There were varying levels of agreement on each of these areas. In addition, members generally agreed that whatever design the GAP proposal would have in the end would depend heavily on the combination of these four provisions. Some members suggested that it would not be possible to decide what was appropriate for each of these plan design elements in isolation without knowing what the other three would be.

A driving concern for some was a desire to be sure that lower paid workers were able to obtain a sufficient share of the benefits in return for the greater flexibility and higher benefits the plan would allow higher paid employees. For others, the concern was that employers be given sufficient flexibility and higher contribution and benefit levels in return for minimum contributions to all workers and guaranteed rates of return on account balances.

The four issues revolve around complicated rules of the Tax Code governing whether or not retirement plans are "qualified," that is, whether plans generate favorable tax benefits for the employer and employees. Those benefits, generally, are as follows: immediate tax deductions for employer contributions, deferral of income recognition for employees until benefits are distributed, and tax exempt status for the plan's funding vehicle. The most important of those rules are the complex provisions on when plans are considered to discriminate too much in favor of highly-paid employees and, thus, invalidate the tax qualified status of the plan.

**Minimum Guaranteed Annual Rate of Return on Account Balances.** The minimum guaranteed rate of return is a key provision since it makes the money purchase plan, a defined contribution plan, a hybrid plan with defined benefit characteristics.

The Working Group generally agreed that the rate of return could be either a fixed rate or a variable rate, meaning that it is tied to a market indicator or index. It was suggested by one advocate for the plan that the minimum be set at a 3 percent annual rate of return. That would mean that account balances in the account would be credited with at least a 3 percent gain each year. The Working Group could not agree on an appropriate fixed rate of return. The Working Group, however, generally agreed that if the rate of return were variable, it should still be the same for all employees at any given time.

Some members of the Working Group felt that the 3 percent minimum return was unreasonably low and does not provide adequate benefits for rank and file workers. These members preferred a 5 percent guaranteed rate of return. Some members argued that because higher-paid employees would be able to contribute more under the higher contribution limits and more flexible nondiscrimination tests of the GAP, they would take too great a share of the potential benefits under the plan. Other members said that if the plan required a 5 percent rate of return, more employers who adopted the GAP would probably opt for a variable rate to avoid this requirement.

**Larger Contributions for Older Workers in Top Heavy Plans.** It was proposed to require a contribution minimum of 5 percent of compensation for all workers regardless of age, in top heavy plans,[35] which are plans where key employees have amassed benefits greater than 60 percent of the entire pool of benefits. Tax Code regulations require top heavy plans to make minimum contributions to all employees. Most small business retirement plans eventually become top heavy because

the compensation of key employees is higher and because there is more turnover among other employees. This turnover means fewer of them accumulate benefits.

The group also considered a second option for top heavy plans that would allow for higher contributions to older workers and lower contributions to younger workers. Supporters of this option said it would give employers more flexibility in designing plans to meet the age demographics of their work forces. The proposed formula was as follows: Workers age 30 or under would receive contributions equal to 3 percent of compensation. Workers age 30 but not over age 50 would receive 5 percent of compensation. Workers over age 50 would receive 7 percent of compensation.

The Working Group was divided on whether to support the option to provide higher contribution minimums for older workers. Some members who were opposed said that the low annual rate of return on account balances would harm younger workers. Some members who supported higher contribution rates for older workers noted that the plan would still be subject to nondiscrimination testing.

**Flexible Approaches to Nondiscrimination Testing.** Congress requires all qualified retirement plans to satisfy nondiscrimination rules, which are intended to ensure that such plans do not overly favor highly-compensated employees over other employees. The group engaged in lively discussions about whether GAP should import the nondiscrimination rules applicable to defined contribution plans, including complex testing methods known as age-weighting or cross-testing.[36]

In a nutshell, cross-tested methodologies allow employers to contribute substantially more (as a percentage of pay) to older plan participants, without violating the nondiscrimination rules—even if most of the older employees are highly compensated.[37] This methodology is based on the premise that a contribution to an older plan participant is inherently less valuable than the same contribution to a younger plan participant since the latter contribution will have more time to accumulate investment returns. Small firms whose owners and other favored employees were older than rank-and-file employees often used cross-testing methodologies to favor those employees. Recent variations on cross-testing methodologies allow some firms to deny the benefits of cross-testing to older rank-and-file employees by creating subgroups of participants for nondiscrimination testing, provided they contribute at least a minimum 5 percent of pay contribution on behalf all rank-and-file employees. (Plans that use these methodologies are sometimes called new comparability plans.)[38]

Some members of the group believed that GAP should be able to use age-weighting methodologies to prevent GAP from being at a competitive marketing disadvantage compared to defined contribution plans. Other group members argued that these methodologies were highly technical ways of directing benefits to highly compensated employees and should either not be permitted in GAP or only permitted if plans using them were required to direct additional benefits to lower-paid employees.

The group had a lively discussion on this issue, with group members articulating various views. Most of the members of the group agreed that subjecting GAP to more exacting nondiscrimination rules than those applicable to defined contribution plans would essentially mean that employers would not adopt them. One group member observed that more than 75 percent of new defined contribution plans were using cross-testing and new comparability methodologies. Moreover, the Department of Treasury, after lengthy consideration, adopted new regulations that provided minimum contribution requirements for many new comparability plans. These same rules, including the minimum contribution requirements, would apply to GAP. People who expressed this view also noted that if policy demanded limiting cross-testing methodologies, they should be limited for defined contribution plans as well as GAP and that this was an issue that was outside the Conversation on Coverage's focus on creating new plans. These group members also suggested that there would, in fact, be fewer plans if cross-testing methodologies were limited generally.

A few members of the group argued that GAP's features would attract employer interest regardless of whether or not cross-testing methodologies are available, particularly given that older highly-paid individuals could earn larger benefits in GAP than in a defined contribution plans. These members said that since a key objective of the Conversation on Coverage is to focus on rank-and-file employees, GAP should be designed in a manner that directs meaningful levels of benefits to such employees.

The group generally agreed that the use of cross-testing methodologies be conditioned on the employer providing a higher minimum benefit than would be provided for a non-cross-tested GAP. For example, under current regulation, the minimum contribution for cross-tested defined benefit plans is 5 percent. Consequently cross-testing methodologies would only be permitted for a GAP if the employer made a 5 percent minimum gateway contribution for all employees.

The group also discussed what minimum "gateway" contribution percentage made to all employees would be appropriate for a safe harbor from nondiscrimination rules if the employer wanted to use the higher defined benefit plan maximum contribution rules. A majority of the group supported allowing cross testing only if the employer contributed 6 percent of pay gateway contribution for all employees in the plan.

Some members said they would be willing to support allowing cross-testing methodologies for the designated minimum gateway contribution levels above if the GAP plan also provided that the minimum annual rate of return on account balances was higher than 3 percent.

**Minimum Contribution Requirements for Nondiscrimination Safe Harbor.** The members of the Working Group discussed what minimum level of contributions would be required to allow employers to avoid nondiscrimination tests.[39] Several potential arrangements were discussed: a minimum contribution for a standalone GAP, a minimum for a combined GAP with a 401(k) feature, and a minimum for a top-heavy GAP either alone or in combination with a 401(k). No agreement was reached on this point.

**Converting from an Existing Plan to a GAP.** In recent years some employers who converted their traditional defined benefit pension plans to cash balance plans encountered charges of age discrimination. Some employers were criticized for the method they used in calculating how the value of the benefit accrued under the traditional plan was determined and transferred to an opening balance in the cash balance plan.[40] As a result of strong objections that were raised, cash balance plans encountered legal and political obstacles that have yet to be resolved. To avoid the problems encountered by cash balance plans, the Working Group considered whether or not it should bar an employer with a traditional defined benefit plan from converting to a GAP.[41] Several members opposed allowing a conversion to a GAP from a traditional plan. Some members warned, however, that if a conversion to a GAP is disallowed that employers might instead convert to a defined contribution plan, a less desirable outcome than converting to a GAP, according to most group members.

The Working Group also considered whether or not to allow an employer to convert a cash balance plan to a GAP. There were some who favored allowing such a conversion provided the cash balance plan had not previously been converted from a traditional pension plan and provided the GAP were not started up by an employer following the termination of a converted cash balance plan.

The Working Group discussed whether or not it should prohibit the adoption of a GAP by a company that freezes an existing traditional defined benefit plan. There were some who opposed allowing a freeze and new GAP, unless the change was part of an agreement negotiated by a union. Some members suggested that such a prohibition might lead employers to adopt a defined contribution plan after freezing a traditional plan.

## THE PLAIN OLD PENSION PLAN

### Areas of Broad Agreement on the Design of POPP

The Plain Old Pension Plan proposal was originally introduced by a member of the group and later revised by that member and presented again to the group for discussion. In some cases, discussions surrounding issues that arose with GAP also proved helpful in discussing the provisions of POPP.

The Working Group generally agreed to the components of the plan as spelled out in this section. The basic design elements are as follows:

- The plan is a simple, easy-to-understand traditional defined benefit plan that provides a modest basic benefit to allay employer concerns about funding the plan.
- The final basic benefit is based on a percentage (as low as 1 percent) of an employee's career average pay multiplied by the number of years of service.
- The plan would allow employers to fund bonus benefits in any given year or years that would raise the final benefit without having the bonus benefits become part of the permanent benefit structure.
- The plan would permit, but not require, a generous past service credit that would be attractive to small business owners.
- All benefits from the plan would be paid in the form of an annuity. Lump sum distributions would not be permitted.

**Basic Plan Benefit.** The basic plan benefit would accrue at 1 percent a year of the career average income times the number of years of service. To make the calculations simpler, plans could rely on tables published annually by the Treasury Department or the Pension Benefit Guaranty Corporation that would be expressed as

a table using age and compensation to determine the contribution each year. The amounts set forth in the table would be determined by the governmental agency using very conservative actuarial assumptions. Employers would calculate each year's required contribution by aggregating the contributions on the table for each participant. Some members of the Working Group suggested that the government publish the actuarial tables required in this plan every 5 years instead of annually. The actuarial assumptions in the tables would be conservative, to make funding shortfalls unlikely.

**Employees Covered.** The plan would cover all employees who meet the minimum service requirements, including part-time employees. Employers would not be required to cover seasonal employees (but could, if they wished). Thus, the plan would typically cover a secretary who worked 3 days a week, but not a college student working for the summer. If the employer has separate lines of business, the plan could be adopted for one line of business only.

**Vesting.** An employee is said to be "vested" in a pension when the employee becomes entitled to the benefits of the plan, including employer contributions to a plan and their earnings. The time until a benefit is vested is defined for most plans under guidelines set forth in Federal pension law.[42] As modified, this proposal would allow for either 3-year cliff vesting or 2- to 6-year graded vesting. With cliff vesting the participant becomes entitled to the benefit balance that has accrued all at once after 3 years from the date the participant joined the plan. Under graded vesting, the portion of the benefit in the plan that is vested rises in equal portions each year until it reaches 100 percent after the graded vesting period. Vesting would only count service from the date POPP was adopted unless the employer chose to count years prior to adoption of POPP.

**Past Service Credit.** The plan allows for past service credit for as many years as the employer would like. The past service credit would have to be amortized; that is, funded in regular installments over a 7-year period. Likewise, employees would accrue the past service credit over a 7-year period.[43] An employer could give past service credit for benefit purposes without giving vesting credit for those years.

**Bonus Benefit.** In years when the investments in the plan do very well, in years when the company's profits are strong, or at any other time, the employer may give a bonus benefit to employees without committing to a permanent benefit increase. For example, in good years employees could accrue a benefit of 2 percent of compensation instead of 1 percent. Or, the employer might increase the benefit by the cost-of-living, and such COLAs would be treated as a bonus benefit for the years they covered.[44] Past service credit could also be given for a bonus benefit.

**Minimum Benefit.** There would be no required minimum benefit even if the plan is top heavy because the minimum benefit is built into the benefit formula, which provides the same level of benefits for all employees.

**401(k) Feature.** The plan could contain a 401(k) feature. Participants could "buy" more retirement income through contributions using the Government tables to determine the cost. Or, the employer could offer a separate 401(k) plan with an employer match for employee contributions and profit sharing contributions that would be invested in the traditional 401(k) investments.

**Simplified Funding Rules.** POPP was designed to simplify the funding rules and reduce employer concerns about the plan developing large unfunded liabilities that might overwhelm a small business. For this reason, the plan will allow for an approach that will smooth changes in actuarial assumptions, as well as gains and losses in the assets held in the plan. As proposed, the plan would be subject to periodic actuarial valuations, primarily to assess investment experience since mortality and interest rates would be covered automatically under tables. Investment experience would be smoothed by using a 10-year rolling average of the asset valuation (or, if less, the number of years since the plan was established). Investment shortfalls would be funded in installments over 5 years. However, the use of conservative actuarial assumptions is likely to significantly reduce the chances that plans will have funding shortfalls.

**Joint and Survivor Annuity.** The plan was designed to have withdrawals from the plan be made only in the form of a qualified joint and survivor annuity. Lump sums would not be allowed.

**Terminated Participants.** Under the proposed plan design, the benefits of terminated participants could be transferred to the Pension Benefit Guaranty Corporation, the Federal Agency that insures pension benefits—or held in the plan for distribution at retirement age.

**Pension Benefit Guaranty Corporation Insurance.** The plan would be insured by the PBGC and would pay $5 premiums, lower than those paid by traditional pension plans. When plans are terminated, the plan assets are transferred to the PBGC and the agency takes over the payment of pension benefits.[45] The

agency guarantees pension benefits at normal retirement age and most early retirement benefits.[46] The agency provides a maximum benefit guarantee, which is adjusted every year and is $3,801.17 per month for 2005 for workers who retire at age 65.[47] By contrast, the flat rate premium for single employer defined benefit plans is $19 per member per year. (The PBGC in early 2005 proposed raising the flat rate premium to $30 as part of an effort to strengthen its finances.) Plans that are underfunded have to pay an additional adjustable rate premium.[48] A lower premium was recommended to mitigate one of the objections that employers have to adopt defined benefit plans; namely, the cost of pension insurance premiums.

**Plan Termination.** If the plan is terminated, there would be no reversion of any surplus assets to the employer. Under current law, overfunded plans can be terminated and a portion of the surplus can be transferred to the employer who sponsored the plan. The process of transferring the funds back to the employer is called a reversion. Under this provision, the excess would be used to increase benefits of current employees to compensate them for the lost opportunity to accrue more benefits and could also be used to increase benefits for retirees. Some members of the Working Group objected to the proposed reversion rules and suggested instead that the plan be governed by existing reversion rules.

**Conversion to Traditional Defined Benefit Plan.** The plan could be amended at any time to become a more traditional defined benefit plan. The converted plan would be permitted to use all available nondiscrimination testing methodologies available to regular defined benefit plans.[49] After conversion, the employer would adopt its own actuarial assumptions and run the converted plan like a traditional defined benefit plan, including provide a minimum benefit to all workers eligible to participate if the plan is top heavy.[50]

**Tax Credit.** As proposed, the plan would allow employers a tax credit equal to 5 percent of the contributions made to fund benefits for non-highly compensated employees[51] for a period of 5 years. The credit would be recaptured by the Internal Revenue Service if the employer terminates the plan within 5 years. This provision would help employers cover the costs of providing the benefits to all workers, including part-time workers who are not seasonal workers.

The Working Group generally agreed that the tax credit should be higher than 5 percent and should be similar to the level of the Saver Credit, which provides a 50 percent credit for contributions up to $2,000. Members also said the tax credit for POPP could be similar to a temporary tax credit that was offered on contributions to PAYSOPS, Payroll Stock Ownership Plans.

Some members of the Working Group were worried that the tax credit might be an incentive for an employer to convert a more generous traditional defined benefit plan to a POPP. A member suggested that the tax credit be limited to the first 5 years of the plan.

**Required Legislative Changes.** The proposed provisions of POPP are mostly available under current law. However, legislation would be needed to authorize the PBGC to issue contribution tables, to operate terminated, sufficient plans, and to act as a clearinghouse for rolled over or transferred benefits. Legislation would also be needed to permit a 401(k) feature in a defined benefit plan, and enact the tax credit for contributions for non-highly compensated employees.

The Working Group discussed POPP and its proposed provisions and generally agreed that the plan had attractive features and that they should offer it as a plan to be considered by employers, employees, consultants, plan providers and policymakers. The Working Group also agreed that the plan would garner more attention from potential employers and plan providers if the required legislative changes were enacted by Congress.

Several members expressed doubt that Congress would be interested in supporting a new type of defined benefit plan. One member suggested that while Congress might not be receptive to the idea of supporting a new defined benefit plan, it was helpful nevertheless for the Working Group to put forward an idea that the members generally agreed had merit. Some members remained skeptical that POPP was sufficiently attractive to employers and some questioned whether it would be marketed by financial institutions and other prototype plan providers. One member said that the proposed benefit based on 1 percent of income might be too low to attract the enthusiasm of employees.

### TAX INCENTIVES FOR EXPANDED COVERAGE

The Working Group submitted ideas for tax incentives that would encourage employers to maintain or extend defined benefit plan coverage to more employees. These included ideas to reward companies for retaining a defined benefit plan, ideas

for adopting specific provisions that would expand coverage, as well as incentives to start-up new defined benefit plans.

The members considered 13 tax credit ideas and adopted some and rejected others.

Tax Credits Generally Supported by the Working Group

**Immediate Vesting.** The Working Group generally supported giving employers a tax credit to provide immediate vesting of benefits.

**100 Percent Coverage of Employees in a Single Line of Business.** The Working Group generally supported tax credits for this goal.

**Reduction of the 1,000 Hours Requirement for Plan Participation and Benefit Accrual/Allocation.** The Working Group generally supported the idea of reducing the requirement to 500 hours for part-time workers. They also agreed that seasonal workers could be excluded from the 500-hours requirement.

Tax Credits With Some Support by the Working Group

**Establishment and Maintenance of a Defined Benefit Plan.** The Working Group discussed several options for rewarding employers for establishing and maintaining a defined benefit plan. One member proposed giving employers a tax credit equal to the cost of PBGC premiums every 5th and 10th year. Other members thought this would be too expensive.

**Defined Benefit Plans Providing an Annuity Option Only.** There was support within the Working Group for tax credits for plans that provide that benefits be offered only as an annuity, provided there was a threshold level for the requirement. Some supported a policy of exempting balances of $50,000 from the annuity requirement, while others suggested that the group should not set a dollar amount but ask the Department of Labor, PBGC, and Treasury to determine a level below which there is not a viable annuity market. Members supporting this provision said that the PBGC might be encouraged to offer annuities not provided by commercial users. One member, however, questioned the appropriateness of providing tax credits to employers "to lock up the money" of employees and recommended instead that employees be given the tax credit for taking their benefit as an annuity.

**Plans Not Permitting Pre-Retirement Age Distributions.** There was support in the Working Group for tax credits for plans that adopted this prohibition, with an exception for benefits worth less than $5,000. It was seen as supporting the goal of building more assets for retirement. One member suggested that rollovers for those who leave a company before retirement be made to an IRA that restricted the final benefit to an annuity. One member, however, questioned the appropriateness of giving tax credits to employers to limit options for employees.

**No Use of Permitted Disparity.** The Working Group considered a suggestion that a tax credit be provided to an employer that did not use nondiscrimination testing methods that permit disparity.[52] The group was divided on whether or not to support a tax credit for this prohibition.

WHAT CAN BE DONE NEXT

The Conversation on Coverage in its next phase will consider what further steps it can take to promote coverage through adaptations of the two major new plan designs—GAP and POPP—to emerge from the Working Group. It could consider demonstration projects for an adaptation of the proposed two new plan types that would be allowable under current law in order to build support for making legislative changes to enact statutory changes to provide for a fuller range of provisions for the two proposed plans. These demonstration projects might help in refining the plans and help build support among potential plan providers for marketing the plans.

**Definitions of Plan Types**

**Defined Benefit Plan**

A defined benefit plan is a pension other than an individual account plan that provides a regular monthly income after retirement that is determined according to a formula. It is not dependent on the actual contributions made to the plan or investment performance of the plan's assets. Benefits typically are determine based on a fraction[53] of a worker's average earnings (either career earnings or certain high earnings years at the end of the worker's tenure) or a flat dollar amount multiplied by the number of years worked for the employer. For example, a defined benefit plan might offer employees a monthly retirement benefit equal to 1 percent of average compensation a year multiplied times the number of years worked. In this instance, if a worker averaging $40,000 a year worked 20 years, he or she would earn 1 percent of $40,000 or $400 multiplied by 20 or $800 a month ($9,600 a year). In the alternative, a plan might promise a benefit of $40 per month times the num-

ber of years worked. If a worker put in 20 years of service, he or she would also receive $800 a month or $9,600 a year. The maximum benefit payable by a defined benefit plan in 2005 is $170,000 a year.

Some newer defined benefit plan designs provide benefits that mimic the appearance of defined contribution plans, reporting benefits as a lump sum account balance. (See Cash Balance Plans below)

Private sector defined benefit pension plans must provide annuities—either single life annuities for unmarried participants or joint and 50 percent survivor annuities for married participants—as the default form of benefit. The annuity from a defined benefit plan helps retirees (and their surviving spouses) by assuring them of a regular income based on a set formula for the rest of their lives.

Not all retirees receive their defined benefit as a regular monthly stream of income, known as an annuity. Instead, some employers allow retirees to receive their accumulated benefit as a lump sum (with the consent of their spouses). If a retiree elects to take a lump sum where it is allowed, that retiree is responsible for deciding how to manage and invest those funds, as well as when and how much to pay out as an income.

In a defined benefit plan, the worker does not have to make decisions about how to invest assets contributed by the employer into the plan. The employer is responsible for determining the amount of contributions needed to fund the promised benefits, making those contributions each year, investing the assets in such a way they will earn a sufficient return to provide for the funds needed to pay the promised benefit, and making up for any shortfall in the assets. Most benefits provided by defined benefit plans are guaranteed by the Federal pension insurance program managed by the Pension Benefit Guaranty Corporation. The maximum insured annual benefit for 2005 is $45,614.

**Defined Contribution Plan**

A defined contribution plan is one that provides workers with an individual account and pays out benefits equal to contributions to the account and net investment earnings on the contributions. The 401(k) plan is the most well-known example of this type of plan. In a 401(k) plan, contributions can be made by the employer or the worker and employers often "match" employee contributions; that is, they provide an additional contribution tied to the amount of contribution the employee makes. In some defined contribution plans—typically 401(k) plans—employees must decide how to allocate all or part of their account balances among a set menu of investment options selected by the employer (e.g., among various mutual funds and employer stock). In other kinds of defined contribution plans—such as profit sharing, money purchase, and employee stock ownership plans—contributions are made by the employer. In these plans, the employer often invests the money in the employees' accounts.

In most defined contribution plans, workers receive their benefits as lump sums when they leave their jobs. They may either roll over the account balance to an IRA or a new employer plan or use the money for other, nonretirement purposes. Defined contribution plans, other than money purchase plans (discussed below) are not required to offer annuity payouts and most do not. Upon retirement, an employee has an accumulated retirement savings that he or she will have to decide how to manage. The retiree has to decide whether to take part or all of the assets as an annuity, if that is an option. Or, perhaps the retiree may chose to set up a schedule of regular withdrawals. The retiree also has to decide how to invest the assets in retirement, including whether to change the asset allocation. With the 401(k), there are minimum distribution rules, which dictate a minimum withdrawal each year beginning at the age of 70½. Defined contribution plans, unlike defined benefit plans, are not insured by the Pension Benefit Guaranty Corporation.

**Hybrid Plan**

A hybrid plan has characteristics of both defined benefit plans and defined contribution plans. The most common hybrid plan is the cash balance plan.

**Cash Balance Plan**

A cash balance plan is a defined benefit plan that defines the benefit as a stated account balance. In a typical cash balance plan, each worker is credited on a periodic basis with a **pay credit**, a percentage of one's earnings, and an **interest credit**, which sets the rate of return for the account balance for that year. The interest rate can be either a fixed rate or a variable rate. Although cash balance benefits are reported as individual account balances, these accounts are only hypothetical. Workers' benefit amounts are unrelated to the employer's actual cash contributions to the plan and unrelated to the actual investment performance of plan assets. The benefit is based on the accumulated amount credited to each employee's account.

As with all defined benefit plans, employers must offer employees the option of taking the benefit as an annuity as the default form of benefit.

**Money Purchase Plan**

The money purchase plan is an employer-sponsored defined contribution plan that allows employers to contribute a set percentage of compensation for workers into the plan with a maximum annual contribution of $42,000 in 2005. This is the maximum for all defined contribution plans and, thus, is not a unique design element of the money purchase plan. Once an employer establishes a contribution level, the amount in subsequent contributions must be maintained until the employer makes a formal, prospective pronouncement that the contribution will be decreased or discontinued. Thus, contributions are made whether or not the business has a profit, which differentiates the money purchase plan from a profit-sharing plan, where contributions are made to employees' accounts at the discretion of employers, usually when there are profits. Unlike other defined contribution plans, money purchase plans must provide joint and survivor annuities for married participants and single life annuities for unmarried participants.

## APPENDIX A

### DB-K PROPOSALS CONSIDERED BY THE GROUP

Three DB-K proposals were considered by the group, one from the American Society of Pension Actuaries (ASPA), one from the American Academy of Actuaries (AAA) and one from The Principal Financial Group. The proposals share common design features. Each provided both a defined benefit formula and the opportunity for workers to make tax-deductible contributions from their wages and salaries to a defined contribution plan. Each plan provided a minimum defined benefit to all participants. All of the plans are designed to avoid nondiscrimination testing if they promise minimum benefits, and the plans have simplified rules for funding the defined benefit portion of the plan.

**DB-K Proposal No. 1.** Under this proposed plan[54] from the American Society of Pension Actuaries, there would be a single trust established for both the 401(k) and either a traditional defined benefit plan or a cash balance plan. However, the trust would have strict recordkeeping requirements whereby the assets of each of the defined benefit and 401(k) components of the plan would be accounted for separately. Accordingly, for example, any excess assets associated with the defined benefit portion of the plan could not be used for purposes of employer contribution requirements to the 401(k) portion of the plan.

An advocate of this proposal suggested that many employers would likely choose a cash balance design over a traditional defined benefit plan for the defined benefit portion of the plan. The cash balance plan is a hybrid plan in which the employer credits contributions to a hypothetical account for each employee and guarantees a rate of return on money deemed to be allocated to those hypothetical accounts. (See description of plan types on page TK for information on cash balance plans.) The accumulated balance is converted to an annuity for payment at retirement age, but is typically made available as a lump sum payment.

In order for employers to take full advantage of the concept, the ASPA proposal would require under the defined benefit portion of the plan a minimum benefit formula for eligible employees of 1 percent of final average compensation times up to 20 years of service. The proposal would offer employers a cash balance design option instead of a traditional defined benefit design. For the cash balance design alternative, the proposal contemplates that employers would credit an annual contribution for eligible employees to their hypothetical cash balance accounts equal to 5 percent of compensation. However, the proposal also permits employers to increase contribution levels for older workers on a graduated basis so that the plan more closely mirrors the increased benefit values for older workers provided under a traditional defined benefit plan.[55] The plan also offered employers the choice of making a minimum contribution of 5 percent of pay to both the defined benefit and defined contribution side of the plan. The ASPA DB-K would also allow for additional accruals to the defined benefit arm of the plan based on what portion of income is contributed from compensation to the 401(k) side of the plan. In other words, employers could match employee contributions to the 401(k) plan by enriching the defined benefit side of the plan. There was considerable interest among members of the group in the plan, although there was some concern it might be an expensive plan, especially the graduated cash balance benefit.

**DB-K Proposal No. 2.** The Principal DB-K plan was similar to the ASPA DB-K plan. However, it offered only a traditional defined benefit plan and not a cash balance option. The traditional defined benefit portion of the plan was designed to

provide a worker who put in 20 years of service an income equal to 25 percent of career average pay. It also offered an option where the benefit could also accrue at a higher rate over 10 years.

**DB-K Proposal No. 3.** The DB-Plus Plan from the American Academy of Actuaries would allow employees to make pre-tax contributions to the defined benefit side of the plan. It would also allow for employer matches to employee contributions to the defined benefit side of the plan. Supporters of the DB-K Plus plan would seek legislative or regulatory clarification on current rules that would allow for employers who sponsor the plan to offer a higher rate of return for funds in the defined benefit side than is currently available under Internal Revenue Service rules to solve the so-called "whipsaw" problem.[56] The plan would also allow for tax credits for contributions on behalf of low-income employees to be deposited into the plan.[57] The plan encourages employers to set up an automatic default election that would put new employees into the plan with automatic contributions of 1 percent to 6 percent of pay (with increases when salaries increased) unless the employee affirmatively requests otherwise. The DB-K Plus also allows for distributions beginning at age 59½ even without termination of employment. Allowing distributions at age 59½ would allow members to have a phased retirement beginning at that age. The PBGC would insure all of the benefits of the DB-K Plus, as long as it was funded appropriately. Some members were concerned that because both the defined benefit plan and the 401(k) are in a single trust, it could mean that the PBGC would be deemed to have guaranteed the 401(k) side of the combination. Others raised concerns that the proposal would allow excess assets associated with the defined benefit component of the plan to be used to offset the cost of employer contributions under the 401(k) component of the plan.

## APPENDIX B

### PROPOSALS CONSIDERED AND NOT ENDORSED

**Risk-Splitting Defined Benefit Plans.** After its May 2003 meeting, the group formed a subgroup on risk-splitting. Several suggestions to share the risk of market performance between the employer and the employees were advanced for consideration. A proposal was considered for guaranteeing only 75 percent of the final benefit liability. Under this approach, the employee would share some of the risk associated with the funding obligation for 25 percent of the benefit, while the employer still retained responsibility for 75 percent.[58] The group generally did not support any of the risk-splitting proposals. Those objecting stated such an approach would put additional burdens on the Pension Benefit Guaranty Corporation (PBGC), which insures defined benefit plans. The PBGC would face the difficult task of determining how much of the benefit should be paid if a plan is terminated and taken over by the agency. One member said that Congress would not be receptive to the idea of transferring risk to employees.

Some members suggested that risk-splitting raises a question about whether employees should also share in some of the gains if a plan over-performs, and also whether employees should have a role in selecting investments. One member suggested it would be difficult to determine how much of a plan's underfunding was due to poor market performance and how much was due to the employer failing to make regular, adequate annual contributions. There was also concern about the complexity of the risk-splitting proposals before the group. Finally, some suggested that risk-splitting could already be accomplished by an employer sponsoring both a defined benefit plan and a defined contribution plan. While some members of the group believed that the concept of risk-splitting had some merit, no one suggested it should be listed as a group recommendation.

**SAFE Proposal.** SAFE stands for The Secure Assets for Employees Plan, which was introduced as legislation in 1997 by Rep. Nancy Johnson (R-CT) and Rep. Earl Pomeroy (D-ND).[59] This plan was designed to provide a minimum defined benefit that would be 100 percent funded.[60] It would be funded either by an individual retirement annuity or through a trust. SAFE sought to reduce the regulatory burden on employers, to reduce uncertainty about potential unfunded liabilities and to give employers more flexibility in managing the plan than is possible with traditional defined benefit plans.[61] Members of the group discussed the proposal but declined to endorse it.[62] Members suggested that the group should come up with new proposals and not revisit previous proposals. Some members, noting the group's greater interest in other proposals, cautioned against possibly supporting too many proposals. Some group members also expressed concern that SAFE permitted designs under which business owners could capture too much of the plan's aggregate benefits.

**SMART Proposal.** SMART stands for a Secure Money Annuity or Retirement Trust Plan, which was introduced by the Clinton Administration in February 1998

as a hybrid plan designed for business with fewer than 100 employees. Like the SAFE proposal, the SMART would offer a minimum guaranteed benefit at retirement[63] with the potential for additional investment return if the assets perform above the base 5 percent benchmark.[64] It would also be funded by an annuity or a trust. Members of the group discussed the proposal but declined to endorse it.[65] As with the SAFE, members were in favor of new proposals rather than revisiting previous proposals.

**Improved Cash Balance Plans.** The group discussed ways to make cash balance plans more attractive. Cash balance plans have been criticized for discriminating against older workers at some companies that switched from a traditional defined benefit plan to a cash balance plan. While some members strongly opposed cash balance conversions, there was some interest in cash balance plans that are started de novo by a company that previously did not have a defined benefit plan. Proposals to make cash balance plans more attractive included reduced insurance premiums for fully-funded cash balance plans and other ideas.[66] Despite interest in this challenge, the effort to improve cash balance plans was eventually set aside, largely because some court decisions and regulatory issues had clouded the outlook for such plans and strong political opposition had emerged to the plans.

**A List of Incentives to Improve Coverage at Defined Benefit Plans.** The group decided to create a list of tax incentives that would encourage desired behavior with respect to defined benefit plans, including such ideas as supporting tax credits for employers who expand pension coverage to part-time workers. The ideas the group supported are discussed earlier in this report.

**Other Ideas Listed in the Binders.** The group also briefly reviewed other proposals from a list included in the binder and chose not to consider further any of those plans for endorsement. One proposal considered was by Ted Groom and John Shoven to eliminate most of the Federal rules governing pension plans, including nondiscrimination rules, as well as pension insurance and the Pension Benefit Guaranty Corporation. It was suggested by Groom and Shoven that more employers would offer plans if there were fewer rules governing them. The group also briefly discussed, but did not support, a proposal identified as the Individual Advantage Plan from Jim Davis of Milliman & Robertson that would allow workers the choice of the greater of a cash balance or a traditional formula.[67]

**Other Ideas Proposed by Members.** The working group also considered ideas proposed by its members during its discussions. One member proposed eliminating the lump sum option for defined benefit plans. Increasingly, workers have chosen to take lump sums instead of an annuity, which provides a stream of monthly payments that continue as long as the annuitant lives. This idea was seen by some as being beyond the scope of the group's mission to expand coverage. The suggestion was also criticized because it can be costly for small businesses to purchase individual annuities, which might lead some small businesses to switch from a defined benefit plan to defined contribution plans. One member suggested that lump sums could be deposited into a central clearinghouse and, thus, avoid the high costs of purchasing individual annuities. There was some support for this approach, with one member suggesting that the PBGC could be the clearinghouse. The group, however, did not further refine the proposal.

## APPENDIX C

### CONTRIBUTION CALCULATIONS FOR THE GUARANTEED ACCOUNT PLAN

### Case Study Showing Funding Method Over a 7-Year Period

*Synopsis of Funding Calculation*

(1) Calculate total of hypothetical contributions for the plan year.

(2) Calculate the value of the assets as of the valuation date, before any current contribution is added.

(3) Calculate the sum of the Guaranteed Account Balances (GABs) as of the valuation date (excluding (1)).

(4) Subtract (3) from (2). If this is a positive number, there has been an earnings gain. If this is a negative number, there has been an earnings shortfall.

(5) If (4) is a net loss, calculate the amount that the earnings shortfall would be worth in 5 years (including the current year) under the plan's guaranteed rate of return (assume current year guarantee if the rate can fluctuate).

(6) Calculate the amount that would be required to be contributed as of the valuation date to amortize the amount in (5) over the 5-year period.

(7) Calculate the aggregate GABs as of the valuation date, including the amount in (1).

(8) Subtract the amount in (2) from the amount in (7). This is the unfunded portion of the GABs. If (2) is larger than (7), the GABs are fully funded, and this amount is zero.

(9) Minimum funding: The lesser of: (a) the amount in (1) plus the amount in (6), or (b) the amount in (8).

(10) Maximum funding calculation (maximum deduction):

(a) Calculate 1.5 times the amount in (7).

(b) Subtract the amount in (2) from the amount in (10)(a). If this is a positive number, this is the most the employer can contribute on a deductible basis. If this is zero or a negative number, the maximum deduction is zero (i.e., the full funding limit).

(11) Limitations on funding assumptions: pre-retirement discounts for turnover and mortality not permitted, no salary scale assumptions.

(12) Plan is a money purchase plan for IRC § 412 purposes, but is subject to the special minimum funding requirements stated above. Therefore, there would be no quarterly contribution requirement under IRC § 412(m).

(13) When calculating the aggregate Guaranteed Account Balances, a participant's account must be limited to the maximum lump sum permitted under IRC § 415(b) if the account were to be distributed as of the valuation date.

**Case Study**

A GAP is established which promises a 6 percent hypothetical contribution, and a 5 percent guaranteed rate of return. Contribution is allocable as of the last day of the plan year.

Year 1: Total participant compensation is $1,000,000.

Normal cost = $60,000.

(This is the total compensation times the hypothetical contribution rate. There were no prior year contributions, so no guaranteed return for the first year.)

GABs as of valuation date: $60,000.

No earnings shortfall because the plan does not have any experience on the first valuation date.

Minimum funding: $60,000.

Maximum funding: $90,000.

Employer's actual contribution: $60,000.

Year 2: Total participant compensation is $1,100,000.

Normal cost = $66,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,100,000).

Actual earnings since last valuation date: $2,392 (about 4%).

Total value of assets as of the valuation date (before current year contribution is made): $62,392.

The guaranteed return for this valuation period on the GABs from the prior valuation date: $3,000.

GABs as of valuation date (excluding current year's contribution): $63,000 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $608 (i.e., assets minus pre-contribution GABs). This would be worth $776 in 5 years under the plan's guaranteed rate of 5%.

Amortization payment for shortfall: $140 (round to nearest $1), based on a 5-year amortization period.

Normal cost plus amortization payment: $66,140.

Sum of GABs as of valuation date (including current year's contribution): $129,000 Shortfall on 100% funding: $66,608 (i.e., $129,000 minus $62,392).

Minimum funding amount: $66,140 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall).

150% x GABs: $193,500.

Maximum funding is: $131,108 (i.e., 150% x GABs minus assets as of valuation date).

Employer's actual contribution: $66,500.

Year 3: Total participant compensation is $1,340,000.

Normal cost = $80,400. This is determined by calculating the hypothetical contribution for this year (6% x $1,340,000).

Actual earnings since last valuation date: $1,154 (only a 1% rate of return).

Total value of assets as of the valuation date (before current year contribution is made): $130,045.

The guaranteed return for this valuation period on the GABs from the prior valuation date: $6,450.

GABs as of valuation date (excluding current year's contribution): $135,450 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $5,405 (i.e., assets minus pre-contribution GABs). This would be worth $6,897 in 5 years under the plan's guaranteed rate of 5%.

Amortization payment for shortfall: $1,248 (round to nearest $1), based on a 5-year amortization period.

Normal cost plus amortization payment: $81,648.

Sum of GABs as of valuation date (including current year's contribution): $215,850 Shortfall on 100% funding: $85,805 (i.e., $215,850 minus $130,045).

Minimum funding amount: $81,648 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall).

150% x GABs: $323,775.

Maximum funding is: $193,730 (i.e., 150% x GABs minus assets as of valuation date).

Employer's actual contribution: $82,000.

Year 5: Total participant compensation is $1,400,000.

Normal cost = $84,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,400,000).

Actual earnings since last valuation date: $17,224 (6% rate).

Total value of assets as of the valuation date (before current year contribution is made): $324,362.

The guaranteed return for this valuation period on the GABs from the prior valuation date: $15,832.

GABs as of valuation date (excluding current year's contribution): $332,475 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $8,113 (i.e., assets minus pre-contribution GABs). This would be worth $10,355 in 5 years under the plan's guaranteed rate of 5%.

Amortization payment for shortfall: $1,874 (round to nearest $1), based on a 5-year amortization period.

Normal cost plus amortization payment: $85,874.

Sum of GABs as of valuation date (including current year's contribution): $416,475 Shortfall on 100% funding: $92,113 (i.e., $416,475 minus $324,362).

Minimum funding amount: $85,874 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall).

150% x GABs: $624,712.

Maximum funding is: $300,350 (i.e., 150% x GABs minus assets as of valuation date) Employer's actual contribution: $100,000.

Year 6: Total participant compensation is $1,600,000.

Normal cost = $96,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,400,000).

Actual earnings since last valuation date: $36,368 (9% rate).

Total value of assets as of the valuation date (before current year contribution is made): $460,729.

The guaranteed return for this valuation period on the GABs from the prior valuation date: $20,824.

GABs as of valuation date (excluding current year's contribution): $437,298 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $0 (the plan is now running at an experience gain).

Amortization payment for shortfall: $0 (round to nearest $1), based on a 5-year amortization period.

Normal cost plus amortization payment: $96,000.

Sum of GABs as of valuation date (including current year's contribution): $533,298 Shortfall on 100% funding: $72,569 (i.e., $533,298 minus $460,729).

Minimum funding amount: $72,569 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall); the plan will have to be brought to full funding this year.

150% x GABs: $799,948.

Maximum funding is: $339,219 (i.e., 150% x GABs minus assets as of valuation date).

Employer's actual contribution: $200,000 (Things are going well, the employer puts in extra for a rainy day and to get a bigger deduction).

Year 7: Total participant compensation is $2,000,000.

Normal cost = $120,000. This is determined by calculating the hypothetical contribution for this year (6% x $2,000,000).

Actual earnings since last valuation date: $31,009 (5% rate).

Total value of assets as of the valuation date (before current year contribution is made): $691,738.

The guaranteed return for this valuation period on the GABs from the prior valuation date: $26,665.

GABs as of valuation date (excluding current year's contribution): $559,963 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $0 (the plan is still running at an experience gain).

Amortization payment for shortfall: $0 (round to nearest $1), based on a 5-year amortization period.

Normal cost plus amortization payment: $120,000.

Sum of GABs as of valuation date (including current year's contribution): $679,963 Shortfall on 100% funding: $0 (i.e., assets exceed the GABs).

Minimum funding amount: $0 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall).

150% x GABs: $1,019,945.

Maximum funding is: $328,207 (i.e., 150% x GABs minus assets as of valuation date).

Employer's actual contribution: $0.

APPENDIX D

*CONTRIBUTION CALCULATIONS FOR THE PLAIN OLD PENSION PLAN*

| Compensation → Age ↓ | $30,000/year | $60,000/year | $100,000/year | $200,000/year |
|---|---|---|---|---|
| 30 | $585 | $1,170 | $1,950 | $3,900 |
| 40 | $960 | $1,920 | $3,200 | $6,400 |
| 50 | $1,584 | $3,168 | $5,280 | $10,560 |
| 55 | $2,043 | $4,086 | $6,810 | $13,620 |
| 60 | $2,666 | $5,333 | $8,888 | $17,776 |
| 65 | $3,537 | $7,074 | $11,790 | $23,580 |

Mortality Assumption: 1994 Group Annuity Mortality table projected to 2002*
Interest Rate Assumption: 5%
Plan Formula: A lifetime pension = 1 percent times current compensation at age 65, payable monthly.
*This is the mortality table required by IRS to calculate minimum lump sums from pension plans.

**Endnotes**

[1] Traditionally defined benefit plans were designed to provide workers with a replacement income that, when combined with Social Security, would be sufficient enough to maintain their standard of living. However, some defined benefit plans are not designed to provide a replacement rate sufficient to maintain a worker's standard of living. Instead, they may be designed to provide supplementary income with a predictable income stream to add a worker's retirement income. For this reason, employees with a defined benefit plan will still need assess how much they need in retirement and how determine much they may need to save to provide a sufficient replacement income beyond the income that will be available from Social Security and a stream of income from a defined benefit plan.

[2] The normal benefit is an annuity, but many defined benefit plans offer a lump sum or other payout options. If a retiree does not elect an annuity, then the retiree is faced with the task of managing the lump sum over one's retirement years. Increasingly, retirees from defined benefit plans can also select a lump sum option. In 2000, 45 percent of full-time private sector employees worked at firms with defined benefit plans offered a lump sum option, according to the Bureau of Labor Statistics. To the extent that retirees select a lump sum option, they must then also devise a plan for managing those assets during retirement.

[3] Private sector pensions insured by the Pension Benefit Guaranty Corporation are guaranteed up the statutory limits, now roughly about $44,000 if the benefit starts at age 65.

[4] From Department of Labor data for 2000 and 2001, as reported in Constantijn W. A. Panis, "Annuities and Retirement Satisfaction," Pension Research Council Working Paper PRC WP 2003-19, The Wharton School, University of Pennsylvania, mimeo, 2003, p. 8.

[5] U.S. Bureau of Labor Statistics, *Employee Benefits in State and Local Governments*, 1998, Bulletin 2531 (Washington, D.C.: U.S. Department of Labor, December 2000, Table 1, p.5.

[6] Panis, p. 8.

[7] Patrick J. Purcell, "Pensions and Retirement Savings Plans: Sponsorship and Participation," (Washington, D.C. Congressional Research Service, October 22, 2003), p. 5.
[8] Ibid.
[9] Pension Benefit Guaranty Corporation, Pension Insurance Data Book, April 2004, Table S-33, p. 57.
[10] Ibid.
[11] Ibid, Table S-31, p. 55 and Table M-6 on p. 84.
[12] U.S. Department of Labor, Pension and Welfare Benefits Administration (now the Employee Benefits Security Administration), Abstract of 1998 Form 5500 Annual Reports, Private Pension Plan Bulletin, Number 11 (Winter 2001–2002).
[13] U.S. Bureau of Labor Statistics, Employee Benefits in Medium and Large Private Establishments, 1997, Bulletin 2517 (Washington, D.C.: U.S. Department of Labor, September 1999), Table 133, p. 107.
[14] U.S. Department of Labor, Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, 2000, Bulletin 2555, January 2003, p. 66, Table 78.
[15] The 30-year treasury rate is used for calculation of the deficit reduction contribution and certain other purposes. In recent years Congress has provided temporary relief from the 30-year Treasury rate as the standard for calculating the benefit obligation. For plan years 2004 and 2005, employers can use a corporate bond rate.
[16] For employers, the group generally agreed that the following criteria should be considered: reduced regulation, low administrative costs, low contribution costs, high benefits for owners and officers, attractiveness to prospective employees, designs that are helpful in retaining current employees, designs with tax benefits to the company and owner, designs with contribution flexibility for the owners. For employees, the group generally agreed the following criteria should be considered: low costs and high returns, protection against investment risk, control over assets, portability of assets, protection against longevity risk, protection against inflation, tax benefits, psychological benefits of owning assets, simplicity and fairness for employees, and the adequacy of benefits provided under the proposal. From a public policy standpoint: effectiveness of the revenue dollars spent, and the degree to which savings are preserved for retirement rather than withdrawn earlier for other purposes. Proposals were also judged on how well they could be sold to Congress, employers and employees. They were also judged on how marketable they might be by financial institutions and benefits consultants.
[17] Nondiscrimination testing is required under Internal Revenue Service rules to ensure that highly compensated employees do not derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.
[18] On the contribution issue, the group explored the possibility that a combined 3 percent employer contribution for all employees to the defined benefit and defined contribution side of the plan would be sufficient to avoid nondiscrimination testing and top heavy rules.
[19] There was also support for providing a joint and survivor annuity on the 401(k) side, and for distributions as early as 59½ years old on the defined benefit side to make it easier for workers to engage in phased retirement.
[20] The chief Federal pension law is the Employee Retirement Income Security Act of 1974, often referred to as ERISA.
[21] As explained by the staff of the Joint Economic Committee in 2003 (See reference at the end), the full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent (for 2003) of the plan's current liability (including the current liability normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets (i.e., the average fair market value over a period of years). However, the full funding limit may not be less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full funding limit may be based on projected true benefits including future salary increases. The full funding limit based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter, but is slated to be reinstated in plan years beginning in 2010. Thus, in 2004 and thereafter, until 2010, the full funding limit is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the value of the plan's assets, but in no case less

than the excess, if any, of 90 percent of the plan's current liability over the actuarial value of plan assets, as described above. Reference: "Present Law and Background Relating to the Funding Rules For Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation (PBGC)," Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on April 30, 2003, prepared by the Staff of the Joint Committee on Taxation, April 29, 2003.

[22] Traditional pension plans have to make up unfunded balances, according to descriptions prepared by the staff of the Joint Committee on Taxation in April 29, 2003 (See reference at the end), there are two categories of old unfunded liabilities (those that occurred prior to the plan year just ended). The employer has to calculate a current contribution required to amortize the unfunded liability for each of these two categories. The first amount is, in general, the amount necessary to amortize the unfunded old liability under the plan in equal annual installments until fully amortized over a fixed period of 18 plan years, beginning with the first plan year that starts after December 31, 1987. The second amount is, in general, the amount needed to amortize the additional old unfunded liability over a period of 12 years, beginning with the first plan year that starts after December 31, 1994. In addition, plans have to make a contribution for any new unfunded liability that occurs in the year just ended. If the plan is less than 60 percent funded, the employer must contribute 30 percent of the new unfunded liability into the plan. The applicable percentage decreases by .40 of 1 percentage point for each percentage point by which the plan's current liability percentage exceeds 60 percent. Reference: "Present Law and Background Relating to the Funding Rules For Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation (PBGC)," Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on April 30, 2003, prepared by the Staff of the Joint Committee on Taxation, April 29, 2003.

[23] Making the past service credit available to all employees would be deemed to satisfy the nondiscrimination requirements.

[24] However, if the plan is a profit-sharing, 401(k) or stock purchase plan, current law states the plan is not required to offer an annuity provided the spouse receives 100 percent of the account balance if the employee dies while covered by the plan. The law also states that if the plan does not offer an annuity and the employee does not die while covered by the plan, the employee can withdraw the account balance as a lump sum or other non-annuity payment without spousal consent when the employee leaves the plan.

[25] Elective contributions are contributions voluntarily made by employees into a retirement savings plan or pension plan.

[26] Under one safe harbor, the nondiscrimination test would be satisfied if the employer contributed 100 percent of an employee's contribution up to 3 percent of compensation and 50 percent an employee's contribution up to an additional 2 percent of compensation.

[27] The calculation for lump sums in all defined benefit plans occurs through a two-step process. This process presents special issues, however, when the plan in question is not a traditional defined benefit plan but is, instead, a plan whose benefit is an account balance. Several courts have held that the above-described procedure must be used to determine lump sum values for cash balance plans. The manner in which this is done is to credit interest through an employee's retirement age, convert the resulting retirement-age balance to an annuity, and then determine the present value of that annuity. Generally speaking, if the plan's crediting rate is higher than the statutory benchmark interest rate, the lump sum amount will be higher than the participant's balance in his account. Thus, a cash balance plan is not permitted to pay the account balance in these circumstances. This phenomenon has been called whip-saw.

[28] PBGC guarantees "basic benefits" earned before your plan ended, which include (1) pension benefits at normal retirement age, (2) most early retirement benefits, (3) disability benefits for disabilities that occurred before the plan was terminated, and (4) certain benefits for survivors of plan participants. PBGC does not guarantee health care, vacation pay, or severance pay.

[29] PBGC's maximum benefit guarantee is set each year under provisions of ERISA. For pension plans ending in 2004, the maximum guaranteed amount is $3,698.86 per month ($44,386.32 per year) for workers who retire at age 65. This guarantee amount is lower if you begin receiving payments from PBGC before age 65 or if your pension includes benefits for a survivor or other beneficiary. The guarantee amount may be higher if you retire after age 65 or if you are over age 65 and receiving benefits when the plan terminates.

[30] Underfunded single-employer plans pay an additional variable-rate premium of $9 for every $1,000 (or fraction thereof) of unfunded vested benefits. The proposed GAP would have the variable rate premium would be phased in for the first 5 years as follows: 20 percent for year 1, 40 percent for year 2, 60 percent for year 3, 80 percent for year 4 and 100 percent for year 5.

[31] The limits for contributions and benefits are within section 415 of the Internal Revenue Code. For defined contribution plans, the current annual contribution limit is currently $41,000 a year for 2004. For defined benefit plans, employers can contribute each year toward providing a maximum benefit at retirement of $165,000. However, employers face maximum tax deduction limits, too, that can limit the amount that can be contributed in any given year into defined benefit plans.

[32] The Tax Code sets the rules for converting the maximum allowable annuity into a lump sum for purposes of applying the maximum benefit limit applicable to defined benefit plans. Under that limit, defined benefit plans can pay no more than $165,000 a year as an annual retirement benefit. At the time the Working Group was meeting, the Tax Code required that plans use the 30-year Treasury rate for converting the annuity benefit into a lump sum for this purpose. Treasury has discontinued issuing 30-year bonds and the 30-year rate has declined considerably in recent years. This has meant that lump sums based on the 30-year interest rate assumption have been sharply higher than in the past.

[33] In fact, Congress in April 2004 passed a law to temporarily replace the 30-year Treasury rate with a 5.5 percent interest rate for 2 years (2004 and 2005) for purposes of calculating the maximum defined benefit limit.

[34] Nondiscrimination testing is required under the Tax Code to ensure that highly compensated employees do not derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is the Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.

[35] Plans are top heavy when key employees amass benefits greater than 60 percent of the entire pool of benefits. A key employee is any employee who during the plan year was: (1) an officer of the employer who received more than $130,000 (adjusted for cost of living) in compensation from the employer, (2) a 5 percent owner of the employer, or (3) a 1 percent owner who received more than $150,000.

[36] The name "cross-testing" refers to the rationale for these rules. The rationale is as follows: the present value of annual accruals in traditional defined benefit plans is larger for an older employee than a younger employee. For example, if a 25-year old employee and a 60-year old employee are each promised an annuity benefit of $1 at age 65, the employer must make a larger contribution for the older employee than for the younger employee because there will be less time for the contribution to earn interest. Treasury regulations permit a defined contribution plan to test an allocation to an employee's account as if it were a defined benefit with a present value equal to the contribution. Thus, the contribution is "cross-tested" as if it were a benefit under a defined benefit plan.

[37] The maximum contribution, however, is limited to $41,000 annually, under section 415 of the Internal Revenue Code.

[38] Current treasury regulations permit some plans to use new comparability testing methods only if they provide a 5 percent "gateway" contribution for all plan participants.

[39] Nondiscrimination testing is required under Internal Revenue Service rules to ensure that highly compensated employees do not derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.

[40] In some cases, it required some older workers to work several years before the balance in their cash balance account rose from the initial balance in the account at the time of the transition. This period in which no new benefits were added has been described as a period of wear away.

[41] The Working Group also discussed whether or not an employer should be required to wait 2 years after terminating a traditional defined benefit plan before being allowed to start a GAP. The members disagreed on this suggestion, with some noting that employers might instead terminate a defined benefit plan and adopt a defined contribution plan.

[42] The chief Federal pension law is the Employee Retirement Income Security Act of 1974, often referred to as ERISA.

[43] The past service credit would be calculated by adding 1/7 of the past service career average compensation to the employee's current compensation. For example, if an employee has always earned $20,000 per year and is entitled to 14 years of past service, the employee will be treated as earning $60,000 for the first X years of the plan for purposes of calculating the contribution. In this example, the employer could decide that only 50 percent past service credit is given, so the employee would only be deemed to earn $40,000 for those years. An employee who leaves before the full 7-year amortization period will only received the accrued past service credit that has vested on termination date. The reason for this is that, if pension benefits are viewed as deferred wages, the benefits earned after he plan is in effect are part of the bargained for package, but past service credit would be a windfall. Seven years of service for full accrual would encourage employees to give past service credit as a retention device.

[44] For example, an employer can tell an employee that his or her benefit at 65 was increased by 3 percent, which translates into an additional accrual on this year's salary equal to, for example, 1 percent.

[45] If a POPP were terminated and fully funded, the employer would have the option of keeping the plan and paying out benefits when due or transferring the benefit obligations and assets to the PBGC. If the employer transfers the benefit obligation and assets to the PBGC, annuitization would no longer be required, as PBGC would pay the benefit guaranteed under its authority, and lump sums would no longer be allowed.

[46] PBGC guarantees "basic benefits" earned before your plan ended, which include (1) pension benefits at normal retirement age, (2) most early retirement benefits, (3) disability benefits for disabilities that occurred before the plan was terminated, and (4) certain benefits for survivors of plan participants. PBGC does not guarantee health care, vacation pay, or severance pay.

[47] PBGC's maximum benefit guarantee is set each year under provisions of ERISA. For pension plans ending in 2004, the maximum guaranteed amount is $3,698.86 per month ($44,386.32 per year) for workers who retire at age 65. This guarantee amount is lower if you begin receiving payments from PBGC before age 65 or if your pension includes benefits for a survivor or other beneficiary. The guarantee amount may be higher if you retire after age 65 or if you are over age 65 and receiving benefits when the plan ends.

[48] Underfunded single-employer plans pay an additional variable-rate premium of $9 for every $1,000 (or fraction thereof) of unfunded vested benefits. The proposed POPP would have the variable rate would be phased in for the first 5 years as follows: 20 percent for year 1, 40 percent for year 2, 60 percent for year 3, 80 percent for year 4 and 100 percent for year 5.

[49] The plan could use cross-testing, permitted disparity and any other formulas permitted under Section 401(a)(4).

[50] A plan is top heavy when key employees amass benefits greater than 60 percent of the entire pool of benefits. A key employee is any employee who during the plan year was: (1) an officer of the employer who received more than $130,000 (adjusted for cost of living) in compensation from the employer, (2) a 5 percent owner of the employer, or (3) a 1 percent owner who received more than $150,000.

[51] Highly compensated employees are those who earn at least $90,000 a year.

[52] Under the Tax Code plans that meet the minimum contribution requirements of a safe harbor plan to avoid nondiscrimination testing must still also fall within the bounds of permitted disparity.

[53] The accrual rate is the percentage of final salary or final average salary which builds up for each year of service or membership of a defined benefit plan. For example, the plan may specify a retirement benefit of 1.5 percent of final average salary for each year of service. The annual accrual rate, therefore, is 1.5 percent (of final average salary). Can also be referred to as benefit scale.

[54] If the DB-K has a cash balance plan instead of a traditional defined benefit plan, the plan would require a 2 percent minimum contribution for workers under age 30, 4 percent for workers ages 30 to 40, 6 percent for workers ages 40 to 50, and 8 percent for those over age 50. Or, the plan could have a safe harbor if there is a combined 5 percent of pay contributed to both the defined benefit and defined contribution side of the plan.

[55] This alternative would provide a safe harbor from nondiscrimination testing for plans where the employer contributed 2 percent for employees under age 30, 4 percent for employees age 31 to 39, 6 percent for employees 40 to 49, and 8 percent for employees 50 and over.

[56] It has been suggested that IRS Notice 96-8 makes it difficult to provide a rate of return higher than the Treasury rate for employee contributions in a defined benefit plan. Since employees can get a higher return in their 401(k) plans, they would

have little incentive to voluntarily contribute to a DB-K plan if the return were going to be less. This could be done if policymakers clarified that Section 411(a)(7)(A)(i) of the Internal Revenue Code would apply to DB-K plans and, thus, allow the defined benefit plan to provide a market rate of return.

[57] In the Economic Growth Tax Relief and Reconciliation Act of 2001 (EGTRRA), Section 25B provides for a tax credit to match contributions from low-income employees into a defined contribution plan. The DB-K Plus proposal would make these credits available for a tax credit match for employee contributions to the defined benefit side of the DB-K Plus plan.

[58] The group also considered an approach that would guarantee only those benefits that had been in place for at least 10 years. The group also considered an approach that would set higher premiums for insurance from the Pension Benefit Guaranty Corporation (PBGC) for plans that have higher allocations to equities. Typically equities, over time, earn more than bonds; however, earnings can be very volatile. Reducing the equity exposure would reduce volatility in the pension funding obligation, a key employer concern that was identified by the group as impeding the implementation of defined benefit plans.

[59] The Secure Assets for Employees Plan Act was numbered H.R. 1656 and introduced in the House of Representatives on May 16, 1997.

[60] In the case of a SAFE Trust, the employer would be liable for additional contributions in years when returns in participant account did not earn 5 percent. SAFE plans would not be insured by the Pension Benefit Guaranty Corporation.

[61] Employers would fund the plan with contributions of 1, 2 or 3 percent of pay for each year they worked. In lean years the corporation could scale back the contribution to 1 or 2 percent. Individuals could also reap higher benefits than the minimum 5 percent return on funds in their accounts of the investments performed better than 5 percent.

[62] One objection to the SAFE plan was that its past service provision made it too rich for an IRA.

[63] Employees would be credited with either 1 percent or 2 percent of their salary for each year they worked, with 3 percent possible for the first 5 years of the plan.

[64] In the case of a SMART Trust, the employer would be liable for additional contributions in years when returns in participant accounts did not earn 5 percent. The employer who chose the SMART Trust would pay reduced premiums to the Pension Benefit Guaranty Corporation, which would guaranty the minimum benefit for the Trust. SMART Annuity plans would not pay a premium and the benefit would not be guaranteed by PBGC.

[65] One objection to the SMART plan was that it did not relax nondiscrimination rules, but simply provided a safe harbor.

[66] The group was asked to consider ways to solve the age-discrimination issues and the problems associated with whipsaw, which is a situation where an employee can get a benefit after leaving an employer that is higher than the employee's account balance.

[67] The Individual Advantage Plan was developed as a way to deal with cash balance conversions, but was also touted as a way for new plans to deal with older workers. One member said that he doubted anyone would start up a new plan that gave such a choice.

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## REPORT ON THE CONVERSATIONS AND RECOMMENDATIONS OF WORKING GROUP II

### WORKING GROUP'S ASSIGNMENT

### ANSWER THIS QUESTION

How do we increase coverage and retirement savings by providing new incentives to encourage employees to save for themselves, and incentives for employers to contribute increased amounts for employees in low tax brackets?

FEBRUARY 22, 2005

Co-Chairs: Regina Jefferson and Randy Johnson

Working Group Members: Dean Baker, Michael Calabrese, Kenneth Cohen, Mark Iwry, Michael Kelso, John Kimpel, Lisa Mensah, Diane Oakley, Eric Rodriguez, Eugene Steuerle, and David Wray

**Executive Summary**

The proportion of workers who participate in workplace retirement plans has remained at or near 50 percent for many years, despite a number of efforts by Con-

gress and successive Administrations to adopt policies intended to expand coverage. One of the goals of Working Group II was to look for ways to expand participation to include substantially more of the uncovered half of the workforce and to increase the level of saving by those who participate. The group was especially focused on low and moderate income workers—those who are most likely to lack coverage by a workplace retirement plan.

The group set out to expand coverage and saving by offering to support proposals that are intended to do the following:

- Prompt more employers to offer access to retirement savings plans.
- Expand the number of workers who are eligible to participate in an existing employer-sponsored retirement plan.
- Increase the overall level of saving by workers in workplace retirement savings plans, especially among those who save the least—low and moderate income workers.

The group began as a collection of members with a great deal of expertise on the key issues before them, but with very diverse and strongly-held views. Over the course of more than half a dozen meetings of the entire group and additional subgroup meetings, the members hammered out a consensus in areas where members held common ground, often outstripping the member expectations about the degree to which agreement could be reached.

**The Retirement Investment Account Plan**

The group's chief accomplishment was to reach general agreement on the broad outlines of a new centralized broadly-based savings account vehicle, the Retirement Investment Account Plan or MA. This plan is targeted at workers at companies that do not currently have a retirement plan, as well as workers at firms where there is a retirement plan, but where some workers are not eligible to participate.

Members of the group supported the MA because it was believed that this approach offers great promise in providing access to retirement saving for a substantial portion of uncovered workers. One of the reasons the proposed plan will be helpful is because it largely removes the administrative burden of sponsoring a plan, a key concern of employers who do not now sponsor a plan. By giving employees access to a workplace retirement system, it is likely to also dramatically increase the chances that workers will contribute toward retirement savings.

As this report will show, much work was put into the details of a potential MA plan and much progress was made on many building blocks of the system. Even where there was not a general agreement on the details, there was often agreement on the framework in which the details could be resolved.

The group generally agreed on the following broad outlines of the RIA plan:

- **Accounts Will Be Managed By a Central Clearinghouse.** The RIA plan will be offered through a government-authorized central clearinghouse that would be run by the private sector.
- **Contributions Can Be Made Through Payroll Deductions.** The system would be set up to receive contributions from employees through payroll deductions by the employer of amounts indicated by employees. The system would also be able to receive contributions by employers.
- **How the Infrastructure Will Work.** The employer will send the employee and employer contributions to the U.S. Treasury, and Treasury, in turn, will forward contributions to the central clearinghouse.
- **Participant Contributions Made in a Default Investment.** Contributions to the RIA plan will be placed in a default investment pool that will be a balanced, diversified fund which could also be a lifestyle or life cycle fund.
- **Participants Can Select From Simplified Investment Choices.** Participants who wish to choose investments beyond the default choice will have a simplified choice of investment options chosen by the clearinghouse.

**Policies to Expand Coverage in All Retirement Savings Plans**

The members of the group also supported a number of initiatives they felt would increase the level of participation and the level of retirement saving by and for workers at companies where there is already a workplace retirement plan. These include:

- **Automatic Enrollment.** The group generally supported continuing the policy whereby employers voluntarily offer automatic enrollment to new hires as a way to prompt workers to contribute regularly to their accounts in the plan.
- **Automatic Rollovers.** The group generally supported designating the Thrift Savings Plan—an employer-sponsored saving plan for Federal Government employees—as a central national receptacle for rollovers for accounts with balances from

$1,000 to $5,000 for employees who leave a firm. This policy would make it easier for many employers to roll over such sums and would likely preserve retirement savings for more workers.

• **Default Investment Mix.** The group generally agreed to support a change in Federal pension law to provide a safe harbor to allow employers to voluntarily offer employees a default investment option that would automatically place their contributions in a balance, diversified fund that could be a lifestyle or life cycle fund.

• **Saver's Credit.** The members generally agreed to support an extension and expansion of the Saver's Credit, which provides 10 to 50 percent government matches for individual contributions of low and moderate income workers. The program is slated to sunset in 2007.

• **Financial Education.** The group generally supported a proposal to encourage high schools and colleges to provide basic financial education, including education on retirement saving and health care finances.

**The Mission**

The mission of Working Group II was to review and discuss proposals to increase the portion of the work force that participates in a workplace retirement saving plan, as well as to increase the level of overall retirement savings in plans. The group also was asked to review and discuss incentives for employers to contribute increased amounts for employees in lower tax brackets.

**Principles and Standards**

Members of the Working Group generally agreed on a list of principles and standards by which it would evaluate proposals. The principles include:

• The effort would be collaborative while inviting diverse thinking. It would focus on workers with incomes below the median, especially low-income workers, and it would consider the unintended consequences of proposals.

• Proposals should be efficient to administer and simple to communicate to workers and have a nationally consistent set of rules.

• Proposals should be judged on whether they are economically efficient and feasible, both in the short-term and the long-term, as well as whether or not they involve minimal interference in economic, investment and labor markets.

• Proposals should be judged by whether or not they offer flexible terms and rules for both employees and employers.

• Proposals should be politically viable, both in the short-term and the long-term.

• Proposals should be judged on whether or not they enhance retirement income security for all U.S. citizens.

• Proposals, when considered in total, should be equitable in their benefits and contributions. They should be equitable "horizontally" (meaning that it affects people the same whether or not they have access to an employer-sponsored plan), as well as when viewed "vertically" (meaning across all income levels).

**Background**

The goal of providing a retirement plan for all workers is an ambitious one. In 2003, for example, only about 57 percent of American workers had access to a retirement plan sponsored by their employer, according to the Bureau of Labor Statistics. A majority of these workers—about 51 percent—have access to a defined contribution retirement savings plan, such as the 401(k) plan.[1]

Employees participating in a defined contribution plan often save by determining what portion of their wages is to be taken from their regular pay and contributed to their plan. Employers often match those contributions. Workers who participate in defined contribution plans usually have the responsibility of determining how much they expect they will need to save for retirement and how much they would like to contribute out of each pay period. Workers also often are given choices to make between several investment options within a plan. When they retire, workers with defined contribution plans received lump sum distributions and, therefore, have to decide how to manage the accumulated savings to provide income across their retirement years.

Some of the areas where improvements can be made in coverage can be found in some of the details of the employer surveys of coverage in different segments of the workplace population. Medium and large businesses (100 employees or more) had a participation rate of 65 percent, while small businesses (99 or fewer workers) had a participation rate of 35 percent.[2] Further, the participation rate for all full-time workers of all private sector businesses was 58 percent, significantly higher than the 18 percent for all part-time workers.[3]

Expanding participation in workplace plans is important for other reasons. It appears to be the best way to increase retirement saving. If one looks at Federal in-

come tax return data, the proportion of filers who claim an IRA or Keogh deduction has been both fairly modest and steadily declining over time. From a peak of 16.2 percent in 1986, it fell to 3.5 percent in 2000 and 2001.[4] In contrast, the participation rate in workplace plans is 66.2 percent of those eligible for 401(k) plans (a population of workers that represents 32.6 percent of the private sector workforce).[5]

Increasingly, important decisions that will affect retirement income fall on the shoulders of individual workers. If more workers are to be able to save for retirement, more of them need to have access to and participate in a workplace retirement savings plan. Potential opportunities to increase the proportion of the workforce with access to a retirement saving and potential opportunities to increase participation by those already covered can be created in several ways, include the following:

- Employers who have plans can make it easier for more workers to participate in those plans.
- Employers who do not have retirement plans, which are predominantly in the small business sector, can sponsor plans. (Working Group III has focused its efforts on developing a proposal for the small business sector).
- Incentives, such as tax credits for employees and/or employers, as well as government contributions into accounts, can increase the level of overall saving in existing retirement plans.
- Beyond this, the government can create new saving vehicles that will be more attractive to smaller employers and self-employed and contract workers.
- Employers who do not have retirement plans can facilitate access for its employees to new kinds of centralized savings vehicles that might be created.
- Government can also devise programs and incentives that target lower-income workers.
- Finally, efforts can be made to provide opportunities for financial education in high school and college so that more workers better understand the need to save for retirement and health care expenses and to be better prepared to plan for their future needs.

**How the Working Group Went About Its Assignment**

To meet the challenges set out above, Working Group II decided initially to focus on ways to increase overall saving in existing plans, and ways to expand access to employer-sponsored retirement saving plans to more workers. The group also looked at tax-based incentives, including tax credits and tax deductions.

The group looked at the existing Saver Credit program to see how it might be expanded and made permanent. It also looked at a range of incentives and ideas for improving coverage and saving—including automatic enrollment, default investment choices, and financial education—and reached agreement on a number of them. This is discussed in Section II of this report.

Working Group II also examined ideas for setting up a new type of savings account program that would be patterned after the 401(k) plan, but would be more widely available to workers and even non-workers. The group devoted considerable time to developing a general agreement on the broad outline for a new individual account system named the Retirement Investment Account or RIA. The group examined how government credits and contributions might play a role in promoting retirement saving by low and moderate income workers, especially those who presently are not enrolled in an employer-sponsored plan.

Members were invited to express their opinions about the incentives and proposals to increase saving and coverage, as well as the broad outline of the RIA. The group sought to reach consensus on as many points as they could. At times the group was unanimous or nearly-unanimous in supporting or rejecting a given point. In this instance, the group was said to have "generally agreed" or "generally disagreed" on that point. At other times, the group found substantial agreement, while there was minor opposition. At other times, the opposition might be strong. When the group disagreed on a point or provision, members were invited to offer different options that might address that particular issue. Members of the group were assured that strong opposition would be noted in the report.

## SECTION I: THE RETIREMENT INVESTMENT ACCOUNT PLAN

Working Group II's primary accomplishment was its success in reaching general agreement on many of the broad outlines of a proposed new retirement vehicle, which the group named the Retirement Investment Account or RIA.

**The Retirement Investment Account Plan at a Glance**

The group generally agreed that the Retirement Investment Account would be offered through a new privately-run, centralized infrastructure overseen by the Federal Government. The areas of general agreement are described below.

The RIA and the new infrastructure are designed to make it possible to have a savings account vehicle potentially available to all workers, whether full-time, part-time, self-employed or contingent workers. Importantly, the RIA could potentially provide coverage to workers who are not now covered by a retirement savings plan. The potential for a broadly-based centralized system to boost retirement savings has long been a hope for those who would like to see the United States create a means whereby all working Americans could participate in a payroll-withholding retirement scheme.

In the interest of a harmonious outcome, the majority of the group supported making the program voluntary, although a number of members strongly favored making it mandatory. There was support also for providing a means for workers to contribute directly to the central clearinghouse without going through payroll deduction. This could include making contributions when filing annual income tax returns.

- **Central Clearinghouse.** A government-authorized central clearinghouse will handle contributions from employees into accounts in the RIA plan. The members generally agreed that the government will contract some or all of the services provided by the central clearinghouse to the private sector.
- **Employer Facilitates Contributions.** Employers will voluntarily help facilitate contributions from employees to the RIA plan, but do not have to become involved as plan sponsors; i.e., sponsors of the RIA retirement plan. Thus, they do not have to assume the responsibilities, fiduciary liabilities, and other burdens of being a plan sponsor for the RIA plan.
- **Employee Contributions.** Employees will indicate the level or amount of contributions they would like to have deducted from their wages on a regular basis on a revised W-4 form.[6] The employer will transfer to the U.S. Treasury the amount an employee has elected to contribute to the RIA plan when the employer submits regular tax payments. Treasury, in turn, will forward contributions as soon as possible to the clearinghouse.
- **Employer Contributions.** Employers can also make contributions and matches of employee contributions to the RIA. The employer contributions, too, are sent along to the U.S. Treasury and forwarded as soon as possible to the clearinghouse.
- **Default Investment Mix.** Contributions to the RIA system automatically will be placed into a default investment in a balanced, diversified fund which could also be a lifestyle or life cycle fund.
- **Investment Choices.** For participants who wish to make a choice other than the default investment mix, there will be a simplified offering of investment options chosen by the clearinghouse.
- **Government Credits and Matches.** The RIA plan is set up in a way that would make it possible to offer government contributions and matches of employee contributions, as well as government tax credits. The group, however, while supporting government matches and tax credits in a general way, did not agree on a specific program.
- **Offered in Conjunction With Other Plans.** Employers at firms that already sponsor 401(k) and other retirement saving plans can also offer the workers access to the RIA plans. The target group, however, consists of workers who are not covered by or are ineligible to participate in an employer-sponsored plan.
- **Contribution Limits.** The group set limits on participant and employer contributions and matches at levels that are designed to prevent the RIA plan from undermining the success and appeal of the 401(k) plan, the SIMPLE,[7] and other defined contribution plans.

Members of the group looked at initiatives that members felt would be beneficial without consideration for their budgetary impact and acknowledge that whatever program that might be proposed would be dependent on the Federal budget available at the time.

**The Design Elements of the RIA Plan**

The group devoted many hours to discussing the details of how the RIA plan would work and how it would fit into the array of existing retirement plans without detracting from any of them. The group was able to reach some agreement on some of the design elements, but was divided on other elements, sometimes strongly di-

vided. Each of the broad design elements of the RIA plan are presented below, along with the outcome from the group's discussions.

**The Infrastructure for the RIA Plan**

The group discussed what type of infrastructure would work best to make the RIA plan accessible to employees, while reducing the potential burden on employers. The group also examined what would be needed in the infrastructure to implement potential government matches and tax credits for individuals.

*Areas of General Agreement*

**The RIA Will Be Run Through a Central Clearinghouse.** The group generally agreed contributions from employees and employers to the RIA plan will flow into a government-authorized central clearinghouse. This infrastructure would allow employees to have a portable plan, to the extent that a future employer also participates in the RIA plan, and to the extent other flexible methods were found for employees to contribute directly.

**The Central Clearinghouse Will Be Privately Run.** The group generally agreed that the government-authorized central clearinghouse would be run by the private sector. This approach was taken so that the RIA plan would not be seen by critics as creating a big government bureaucracy.

**Employees Will Indicate Contributions on W-4 Forms.** The group generally agreed that employees would indicate what amount of their regular pay and compensation would be earmarked as a contribution to the RIA plan.

**Employer Will Remit Contributions to U.S. Treasury.** The group generally agreed that employers will remit the employee-designated contributions to the U.S. Treasury. The group generally agreed that the employer also will send employer contributions to U.S. Treasury and will not remit directly to the clearinghouse.

**The U.S. Treasury Will Transfer Contributions to the Central Clearinghouse.** The group generally agreed that the U.S. Treasury will forward contributions remitted by the employer to the central clearinghouse. The group deferred any decisions on how this should be done or how quickly it should occur, but generally favored an approach that transferred the funds in a timely manner.

**The Clearinghouse Will Credit Contributions Received from the U.S. Treasury.** The group generally agreed that the clearinghouse will credit employee and employer contributions in designated individual accounts as funds are sent to it by the U.S. Treasury.

*Areas Where Views Differed*

**Government Oversight Agency.** The group discussed which agency would oversee the clearinghouse, but members decided that the proposal for the RIA plan should not get into that level of detail.

**Who Is Eligible to Participate?**

The group discussed whether or not to include several groups of workers: those under the age of 21, part-time workers, contingent workers, contract workers, the self-employed, household workers, and non-working spouses. Currently, workers from these groups are often excluded from required coverage for most retirement savings plans sponsored by employers. Excluding them helps employers meet nondiscrimination requirements. Self-employed workers do have access to existing tax-preferred retirement savings plans, such as the SIMPLE IRA.[8]

*Areas of General Agreement*

**All Wage Earners Eligible to Contribute.** The group generally agreed that the RIA plan should be open to all Americans who earn an income. There were some, however, who did not agree. Some members preferred to limit access to the RIA plan to workers earning at least $5,000 a year. Some opposed to opening the RIA plan to all workers said they were concerned that it might set up a system that would collapse from having to administer millions of tiny accounts.

**Self-Employed Can Participate in RIA plan.** The group generally agreed that the participation of the self-employed would not be affected by whether or not employers are required to make the system accessible to employees through payroll deductions. The reason is that the self-employed could include their contribution into the RIA plan when they send the IRS their quarterly income taxes. One member suggested that participation of self-employed be limited to those who earn at least $1,250 a quarter, which would maintain the $5,000 a year limit on participation.

*Areas Where Views Differed*

**Direct Contributions By Employees.** The group discussed how individuals might contribute to the RIA plan if they are not able to contribute through payroll

deductions arranged by their employer. The group failed to reach agreement on how this might be done. However, there were several suggestions that were offered.

One member of the group suggested that an alternative method of contributing be set up that would allow workers to make contributions to the clearinghouse when they file their income taxes every year. Another member suggested that workers be allowed to designate a portion or all of their refund as a contribution into the RIA plan.

**Non-Working Spouses.** The group could not reach general agreement on whether or not non-working spouses should be allowed to contribute to a RIA plan, as is now allowed with IRA's.

Some in the group maintained that non-working spouses already have access to IRAs and that allowing them to participate in the RIA plan would make the system unnecessarily complicated. One member suggested, and others agreed, that the proposal remain silent about spouses but provide that it will be open to all citizens with earned income, which arguably would include what is allowed for contributions to IRA's by default. When spouses contribute to IRA's they are deemed to be self-employed with no reported income. Others in the group contended that explicitly offering the RIA to unemployed spouses would assist them in preparing for retirement.

INVESTMENT OPTIONS

The group discussed whether or not participants could be automatically enrolled in the plan, whether there might be a default investment choice, and whether there might be additional investment options in the plan.

*Areas of General Agreement*

**Automatic Enrollment.** The group generally agreed that employers would be allowed to provide automatic enrollment. With this approach, a new employee would have to choose not to enroll. Otherwise he or she would be enrolled in the RIA plan.

**Automatic Investment in Default Balanced Fund.** The group generally agreed that if employees do not elect to choose an investment option(s), their contributions to the RIA plan would automatically go to a balanced,[9] diversified fund, which could be a lifestyle-oriented fund.[10] A balanced fund is a common name for an investment fund which invests significant portions of its assets in each of the major investment asset classes: shares or equities, real property, fixed interest investments and cash. Lifestyle funds are one type of balanced fund that allocates funds between different classes of investments based on the participant's age and risk tolerance, and sometimes automatically adjusts the allocation as a person ages, becoming more conservative over time.

The group's recommendation regarding the default choice reflects a growing trend in the 401(k) system in favor of a default choice of a balance fund or lifestyle fund. When a default option is offered, a member said, about 75 percent of workers usually accept the default investment.

**Clearinghouse Will Select Simplified Investment Options.** The group generally agreed participants could elect to make a choice among one or more of a simplified offering of fund options. The group also generally agreed to let the choice of investment options to be determined by the clearinghouse.

One member suggested that the range of choices should be limited to the types of choices offered in the Thrift Savings Plan.[11] Another member suggested even fewer options: a balanced fund, an equity fund, and a short-term interest fund. One member suggested that some people may want a safer investment, such as Treasury bills or bonds. One member supported keeping contributions in the default investment in a balanced fund until the balance had reached a minimum level, which was not specified.

**Employee and Employer Contribution Limits**

All defined contribution plans, including the 401(k), have contribution limits that affect how much employees and employers can contribute. Such limits are put in place partly to reduce the drain on government revenues and partly to assure that owners and high wage earners do not take too great a portion of the overall tax benefits provided to retirement savings plans.

Over the years Congress has developed a range of simpler defined contribution plans with different sets of contribution limits than the popular 401(k). As new types of plans have been introduced, lawmakers have consciously tried to design them so that they do not work to undermine the success of existing plan designs.

*Areas of General Agreement*

**Why the RIA Has Contribution Limits.** The group agreed that the RIA plan should have contribution limits for employee and employer contributions. The contribution limits would accomplish two things:

- Limits could help assure that higher paid employees and business owners do not disproportionally benefit from the MA plan.
- The limits could be kept low enough to prevent the proposed RIA plan from prompting employers to terminate their existing defined contribution plan, such as a 401(k). Such plans often feature employer matching contributions to encourage workers to contribute. This, in turn, increases the overall level of saving and encourages more workers to save.

**Contribution Limits Should Be Lower Than Those For the 401(k) Plan.** The group generally agreed that the contribution limits should be set lower than those for the 401(k).

One member explained his support for lower limits as follows: If new savings vehicles are set with limits that are too high, it would be a disincentive for small business owners to offer an employer-sponsored plan. Employers would instead offer workers access to the RIA plan. One member said that his business would drop its 401(k) plans "in a heartbeat" if the RIA plan were created with the same contribution limits as a 401(k). The reason is that the employer would no longer have to sponsor a retirement plan, educate workers about saving and offer matching contributions to get more of the lower paid workers to contribute so that the plan could pass nondiscrimination tests.

Participant contributions to 401(k) plans are called elective deferrals in the Tax Code. For 2005, the limit was raised from $13,000 to $14,000. Similarly, the limit on the salary deferrals [12] was raised from $13,000 to $14,000 for 457 plans of State and local governments and tax-exempt. For SIMPLE plans [13], either SIMPLE IRAs or SIMPLE 401(k)s, the limit was increased from $9,000 to $10,000. IRA contribution limits for 2005, by comparison, rose from $3,000 to $4,000.

**Participant Contribution Limits Set at $5,000 to $6,500.** The group generally agreed that participant contribution limits should be limited to somewhere between $5,000 and $6,500. This contribution limit level would position the RIA plan in a niche below the 401(k) plan ($14,000 limit) and the SIMPLE ($10,000 limits), but above the IRA ($4,000 limit).

**Employer Contribution Limit Set at $4,000.** The group generally agreed that voluntary employer contributions could be allowed to the RIA plan and that such contributions should be limited to $4,000 a year. The RIA contribution limit would position the plan in a niche below the 401(k)'s $14,000 limit and also below the SIMPLE's $10,000 limit.

**Employers Can Choose a Nondiscrimination Safe Harbor for Contributions.** The group generally agreed to support a nondiscrimination safe harbor from having to conduct nondiscrimination tests. The safe harbor can be achieved in one of two ways:

- The employer contributes 2 percent of pay into the RIA accounts of all workers.
- The employer contributes a match of $1 for each $1 contributed by an employee into a RIA account for the first 2 percent of pay, followed by an employer match of 50 cents for each $1 contributed by an employee for the next 2 percent of pay.

**Withdrawals and Distributions from Accounts in the RIA Plan**

The group discussed when rules should apply for pre-retirement withdrawals for either loans or hardship, when changing jobs, when withdrawals can begin without penalty, and what rules would govern those withdrawals.

*Areas of General Agreement*

**Plan Allows Hardship Withdrawals, Does Not Allow Pre-Retirement Loans.** The group generally agreed that the RIA plan would not allow loans on balances in the plan, but would allow for hardship withdrawals under tight rules. By contrast, in 401(k) plans, participants can take out loans against their balances and can have hardship withdrawals.

Loans were opposed because they would add to the administrative burden of the plan for the central clearinghouse. Further, some argued that it may be difficult to get the loan prepaid because the RIA plan is not an employer-sponsored plan where the employer can arrange for payroll deductions to repay the loan. Finally, it was argued that loans would add difficult complications to implementing potential government tax credits. One member, however, strongly opposed a prohibition against loans, stating that the RIA plan should not be inferior to a 401(k) plan. This member further contended that loans could be repaid through payroll deductions.

Those supporting allowing hardship withdrawals under rules at least as stringent as those for 401(k) plans noted that it was important for low and moderate income savers to know that they could have access to their savings if they had an emergency. Otherwise, some would not contribute to the RIA plan or might contribute less if no pre-retirement hardship withdrawals were allowed.

**No Need to Withdraw Funds When Employees Change Jobs.** The group generally agreed there was no need for employees to withdraw funds due to a plan termination by the employer or because an employee changes job, since the RIA plan is associated with a central clearinghouse. Even if an employee's new employer does not participate in the RIA plan, the funds in the account can continue to enjoy gains from its investments. Also, contributions could potentially be continued directly to the government when participants file their annual income tax return.

**No Early Withdrawals of Government Contributions.** The group generally agreed that government contributions or matches to accounts in the RIA plan could not be withdrawn at all before participants are eligible to withdraw employee and employer contributions without penalty. This prohibition was supported because it would assure that government contributions would go toward supporting participants in retirement and not for pre-retirement living expenses.

**Withdrawal Rules Made Consistent for Government, Employer, and Employee.** The group, while disagreeing on what retirement age should be, did agree to make the age uniform for all sources of contributions—individual, employer and government—to avoid administrative complications if one source of funds faced special age restrictions.

**Roll Over Accounts Will Maintain Restrictions on Government Contributions.** The group generally agreed that the prohibition against early withdrawal of government contributions would apply to funds from an account in the RIA plan that are rolled over to another retirement saving plan.

*Areas Where Views Differed*

**Age When Withdrawals Can Be Made Without Penalty.** The group was unable to agree on what age a participant could begin to withdraw funds from an account in the MA plan without a penalty for early withdrawal. While the group was agreed that the age should be the same for all contributions—individual, employer and government—the group was divided into two groups about when the retirement age should be set for withdrawals. Some members preferred setting the age at 59½, which is the age when participants can begin to withdraw from a 401(k) plan without penalty. Other members, however, preferred setting the retirement age the same as those for Social Security, where retirees can begin to collect a reduced benefit at age 62, and those born in 1940 can collect the full retirement age benefit at 65 and 6 months in 2005 (although the age will increase gradually for later birth cohorts until it reaches 67 in 2027 for those born in 1960).

Those who favored withdrawals without penalties at age 59½ said that the RIA plan should not be designed to be inferior to the 401(k) plan. The members preferring a later retirement age argued that it would preserve the government contribution until retirement age. Group members favoring a higher uniform age argued that a higher age for withdrawals without penalty could still allow for early withdrawals without a penalty due to disability, using the disability rules as defined by the Social Security Administration.

**Rollover Rules.** The group left unresolved whether or not age restrictions set for the RIA plan might apply to funds that were rolled over from a RIA plan to another retirement savings plan. While the group did support the idea the government funds could not be withdrawn until retirement age as defined in the MA plan, it was not decided whether or not the age at which funds can be withdrawn without penalty, if different, would be transferred to the rollover account in another retirement plan.

**Government Matches and Tax Credits**

The group discussed three governmental approaches to supporting employee contributions to the MA plan:

1. Direct government contributions to the RIA account (which might be characterized as a refundable tax credit, but one that is automatically deposited in the account);
2. A cash (spendable) refundable tax credit and
3. A nonrefundable tax credit.

A cash refundable tax credit (No. 2 above) gives the recipient the full value of the credit even if the credit exceeds his or her income tax liability. As a result, once the credit has eliminated any income tax liability the recipient might otherwise have had, any additional credit amount is paid to the individual in a check from the Treasury that can be used for any purpose.

A nonrefundable tax credit (No. 3 above) gives the recipient only the value of the tax credit up to the recipient's tax liability. For example, a nonrefundable tax credit—such as the Saver's Credit under current law—would not provide any saving incentive or benefit to a worker who pays payroll taxes but has no income tax liability. (The group ranked this last among the three approaches.)

By way of clarification, one member described both the refundable and nonrefundable tax credits (Nos. 2 and 3 above) as "spendable" tax credits to differentiate them from an automatic direct deposit of the credit by the government into an RIA account. A "spendable" credit is not automatically added to the individual's savings. Instead, to the extent that it wipes out the individual's income tax liability, it frees up other funds that would otherwise have been used to pay that tax. Such funds can then be used for any purpose; and to the extent that the credit is refundable and results in a check from the Treasury to the individual, the individual is, of course, free to use that for any purpose as well.

The group also discussed whether or not the government could provide start-up subsidies for the system, as well as tax credits for employers who made contributions to accounts above and beyond what would be required under nondiscrimination rules.

*Areas of General Agreement*

**Government Can Offer Matching Contributions to Accounts in RIA Plan.** The group generally agreed that government could match contributions made by employers to the RIA plan.

**Start-Up Subsidy for the System.** The group generally supported providing a start-up subsidy to get the infrastructure of the RIA plan up and running and able to sustain itself.

*Areas Where Views Differed*

**Government Can Offer Spendable Tax Credits.** There was strong support, but not general agreement that the government could support the RIA plan by offering "spendable" tax credits—that is either a cash refundable credit or a cash nonrefundable credit—as opposed to limiting government credits to direct contributions into individual accounts in the RIA plan. Supporters noted that allowing spendable tax credits gets money into the hands of savers to spend as they wish. One member strongly supported a view that spendable tax credits paid to individuals are more likely to increase overall saving for retirement. However, some members objected to this approach because they felt that if government matches went directly into RIA accounts instead of into the hands of employees, it would better serve the goal of promoting retirement savings.

**Government Credits and Matches Deposited Only in RIA Accounts.** There was considerable support, but not general agreement, for depositing into the RIA plan account all government contributions and matches of employee contributions for either the RIA or 401(k). Some of those who supported this approach said it would avoid administrative complications for the 401(k) system, such as trying to track down a former employee a year later when a government contribution arrived. Government matches, likely to be based on income levels, could not be made until an individual has filed an annual income tax return. Some members strongly opposed having government funds go only to the RIA plan, claiming it would undermine the 401(k) system. Another member favored having government matches be deposited in either the 401(k) or the RIA.

**Government Can Offer Matches and Tax Credits.** Some members of the group supported a policy of both government *contributions* into individual RIAs, as well as government *spendable tax credits*. The group as a whole, however, did not generally agree to support this approach. Members supporting an approach that would combine both a match and a tax credit also recommended making it more attractive to choose the government match to be deposited into a RIA rather than receive a spendable credit. For example, a participant could choose between two options: (1) the government could deposit $500 into an account for a participant who contributed $1,000 to a RIA; or, (2) an employee who contributed $1,000 to a RIA could receive a $250 spendable tax credit.

**Can Employers Count Government Contributions for 401(k) Nondiscrimination Testing?** The group did not support a suggestion to allow employers to take into account government contributions to RIAs for their employees when they conduct nondiscrimination tests for their 401(k) Plans. One member who objected to this approach said it would lead to fewer employer contributions to 401(k) plans and recommended instead a tax credit for employers who make contributions to low-income workers that are above the level required under nondiscrimination rules.

**Government Seed Money and Super Matches.** Most of the members agreed that tax incentives, such as small contributions for some or all RIA accounts in the system, would be helpful. However, supporters of tax incentives could not decide on which incentives to support. Some members favored direct contributions to RIAs for workers making less than $40,000. Other members favored a super match for initial contributions that would benefit lower income workers, such as offering a supermatch for the first $5,000 of lifetime savings. Members of the group recognized that these types of programs could be relatively costly, and acknowledged that whatever program that might be proposed would be dependent on the budget available at the time.

**Tax Credits for Employers.** There was some support for a suggestion to provide tax credits for employers who made contributions or matches that are above and beyond levels employers are required to contribute to meet nondiscrimination rules and tests. However, the group deferred discussion on this point and was unable to address the subject again due to time constraints. Similarly, the group failed to reach agreement on supporting a tax credit for employers who contributed a higher percentage of pay to low paid workers than is contributed on behalf of all workers.

**Should Employers Be Required to Provide Access to the RIA Plan?**

The working group discussed whether or not to recommend that employers be *required* to transfer contributions from employees who wanted to participate in the RIA plan. Members of the group were asked whether or not they supported making the MA plan mandatory in any or all of the following instances: (1) for workers at companies that do not offer employer-sponsored retirement plans, (2) for workers at companies that do sponsor plans who are *not* eligible to participate in those plans, and (3) for workers at companies that sponsor plans and who *are* eligible to participate in the plans.

After discussion, the majority supported making access voluntary on the part of the employer to garner business support for the RIA plan. However, there were two members who felt strongly that the MA plan should be mandatory in all three instances above, while two other members supported making it mandatory only for workers who do not now have access to a retirement plan. The majority, however, supported making access to the MA voluntary on the part of the employer. Some members suggested that ways should be found to allow workers to contribute directly to the RIA, such as directing tax refunds to be deposited in a MA plan account.

Those who supported a voluntary MA plan gave a range of reasons for their views. One member said he was against government mandates because they tend to discourage job formation and generally lead employers to reclassify workers into contract employees. In addition, the member said, mandates place a burden on small businesses. Another member argued that the burden of handling contributions would be far more onerous than some opponents realized. He noted that in his view it was employers, not the government, that do a great deal of the work involved with administering the Social Security system. Likewise, employers are the ones who will make the MA plan work.

Those who supported making access to the MA plan required for employers felt strongly about the importance of this proposed provision. One member said that the need to provide retirement savings opportunities to half the workforce without a plan is so great that it would justify making access to it mandatory for employers. If it were required, the member suggested that the next step would be to launch a massive educational program to convince more workers to participate. Another member supporting mandatory access said the burden on business would be trivial. One member said that if the program was not required, it might be better to devote available resources to expanding the Saver's Credit to get more workers participating in a retirement savings plan.

**Next Steps: A Pilot RIA**

Some members of the group supported a program to introduce the MA plan on a pilot basis to demonstrate how it can help increase saving and how it can work along side existing employer-sponsored plans. The experience from a pilot, it was suggested, might demonstrate that the RIA plan does not impose an unworkable burden on employers. If this were to be demonstrated, it could lead to support for requiring all employers to offer access to the MA plan, one member contended. Some members questioned whether it was feasible to do a pilot RIA, claiming it would be difficult to execute a pilot without new legislation and regulatory rules in place. One member was strongly opposed to a pilot, claiming that a pilot plan would be expensive to do, negating the low-cost advantage of the RIA.

SECTION II: PROPOSALS TO INCREASE SAVING IN RETIREMENT PLANS

The Working Group discussed a number of tax incentives, regulatory changes and other approaches designed to increase the number of workers covered in an already existing defined contribution plan, as well as to increase the amount of money saved and invested through the plan. They also looked at ways to increase coverage among low and moderate income workers who currently are either not in a plan or who save little through the plan in which they are enrolled.

**Automatic Enrollment**

When workers are hired, some employers automatically enroll them in the 401(k) or other defined contribution plan unless the worker specifically requests on government forms that he or she would not wish to participate in the plan. The group discussed whether or not this should be mandated. The group discussed whether special incentives should be provided to encourage more companies to adopt automatic enrollment.

The group discussed whether or not employers who have an automatic enrollment program could automatically place employee and employer contributions in a balanced fund, including a lifestyle fund. The group discussed whether special incentives, such as changes in fiduciary rules, should be provided to encourage more companies to place workers in a default investment mix. Many employers who have automatic enrollment presently allocate by default the funds in the account to a money market or other low-risk, fixed income fund. However, some employers also already allocate available funds by default to balanced funds. Others may be reluctant to allocate by default to balanced funds because of concerns about fiduciary liability for the choices of participants in the plan in a situation when the participant did not chose the investment, except by default.

*Areas of General Agreement*

**Automatic Enrollment of Workers.** The group generally agreed that more employers should be encouraged to voluntarily offer automatic enrollment but that it should not be mandated by law. Under this approach, an employee would have to choose not to enroll; otherwise, he or she would be enrolled in the company's retirement saving plan. It was suggested that during the implementation phase of the Conversation on Coverage that a study be conducted of incentives to encourage automatic enrollment.

**Safe Harbor for Default Investment Into A Balanced Fund.** The group generally agreed that employers should be given a safe harbor from fiduciary liability [14] when they direct the funds of an employee who has not made a choice among investment options into a balanced, diversified fund, including a lifestyle fund. Some members noted that it might be difficult to get Congress and/or regulators to support a safe harbor for such an approach, since such safe harbors are based on the assumption that the participant chooses the investment.

**Automatic Rollovers**

The group discussed whether or not employers should automatically place rollover funds of $1,000 to $5,000 from workers who have left the company in an investment other than a money market fund or low-return investment. When workers leave a company, employers are allowed to pay out employee balances up to $5,000. Balances between $1,000 and $5,000, if paid from the plans, are automatically rolled over into an Individual Retirement Account or IRA unless the employee designates to the contrary.[15] Employees also can elect to take the money out of their retirement accounts.[16]

*Areas of General Agreement*

**Invest Rollovers for Better Earnings.** The group generally agreed that when employees leave a company and are eligible for payouts of sums up to $5,000, it is important that amounts saved be retained for retirement purposes and not be spent on current needs.[17] The group also generally agreed that it is important that rollovers of sums between $1,000 and $5,000 be invested in a way that will earn the best risk-adjusted return for the worker.

**Roll Over Small Balances to the Thrift Savings Plan or IRA.** The group generally agreed that it would be helpful if there were a single national destination for rollovers that any employer could use to transfer rollovers. This would make it easier for employers to roll over the sums and encourage employees to save the funds for retirement. The employers would no longer have to choose an IRA, if they did not wish to do so, or if they found it to be a burden.

The group discussed whether or not to roll over funds to the Pension Benefit Guaranty Corporation or to the Thrift Savings Plan [18] which is a retirement savings

plan for Federal Government civilian and uniformed workers. Some members of Congress have suggested designating the PBGC as a recipient for rollover funds. However, the group generally agreed that the Thrift Savings Plan would be the preferred destination. In addition, the group generally agreed that employers be allowed to choose between rolling over small balances to the Thrift Savings Plan and rolling them over to an IRA.

The choice of the TSP as a destination for small balances was seen as helping alleviate concerns by the employer about choosing an IRA for a departing employee who fails to make a choice for the rollover. Some members in the group supported the proposal to roll over small balances to the TSP. Other members of the group, however, preferred to keep the option of allowing employers to roll over the small balances into an IRA. The group reached agreement to allow either one or the other.

**Expand Saver's Credit**

Currently, low and moderate income workers can receive a Saver's Credit up to $1,000 to encourage saving in a retirement saving plan. Enacted into law[19] in 2001, the Saver's Credit was first available in 2002 and is slated to end in 2007. The Saver's Credit can reduce the Federal income tax a worker pays dollar for dollar. The amount of credit that one can receive is based on one's contributions into an IRA, 401(k), and other retirement saving plans.[20]

The amount of credit available ranges from 10 percent to 50 percent, depending on adjusted gross income and filing status. Lower income workers are eligible for a higher credit.[21] For married couples filing jointly the credit is available on incomes $50,000 and under. For single people and married couples filing separately, the credit is available on incomes up to $25,000. In practice, most of the benefits have been paid out in 10 percent credits for couples filing jointly who earn between $35,000 and $50,000.

The Saver's Credit is not refundable. That is, if someone does not owe any taxes, then they can not receive the credit in cash. The credit can go only towards reducing an existing tax liability. Although there are 57 million workers within the income brackets covered by the Saver's Credit, only about 20 percent are eligible to receive any benefit.[22] In this group only about 3.5 million have actually received a Saver's Credit by contributing to an eligible savings plan, and most have received only a 10 percent or 20 percent match.[23] Contributions are made to a 401(k) and rarely an IRA.[24] Only about 1/10 of 1 percent received a 50 percent match on a $2,000 contribution.[25]

The members discussed whether or not the Saver's Credit had increased coverage or saving. Members disagreed on how successful the Saver's Credit has been in promoting either goal. One member estimated that the program cost $10 billion in tax revenues. Members of the group generally agreed that it would be helpful to get detailed information on how the program has worked in its initial implementation in order to evaluate what changes might improve coverage or saving for retirement.

*Areas of General Agreement*

**Extend the Saver's Credit Beyond 2007.** The group generally agreed that the Saver's Credit program should be extended beyond its sunset in 2007.

**Make the Tax Credit Refundable.** The group generally agreed to an approach that would make the tax credit refundable and spendable, so that more workers could enjoy the benefits. This means that workers who do not have a tax liability sufficient to cover the tax credit would be eligible to receive a payment for the part not covered by a tax liability. Supporters stated that refundable tax credits are desirable because they promote greater saving by more workers. Some of those supporting a refundable (spendable) credit expressed a preference for depositing the refundable (spendable) portion into a retirement savings account rather than sending payments to eligible recipients.

There were some objections, too, to a refundable (spendable) tax credit. One member was concerned about compliance issues, such as possible fraud. One member stated that refundable tax credits are less efficient in promoting saving than government matches. The member noted that $1 match would result in $2 of savings. A $1 tax credit might, however, only prompt $1 of saving if the tax credit is spent. There was also a concern that the government would impose costly complications that might be difficult to administer.[26]

*Areas Where Views Differed*

**Make the Saver's Program Permanent?** The group was unable to agree on making the Saver's program permanent.

**Raise the Percentage Match and Income Levels.** The group discussed a variety of ways to raise the percentage of the credit available at various income levels, as well as raising income levels eligible for a credit. While the group *did not* gen-

erally agree on a new income schedule at which different percentage credits would apply, there was strong support for raising the tax credit to 75 percent for couples filing jointly who earn up to $40,000, with the credit phasing down to 50 percent for couples earning $50,000, and then phasing down to zero for couples earning $60,000. For singles and couples filing separately, the income limits would be half the level for couples filing jointly.[27]

**Offer a Government Match for Employee Contributions?** The group also discussed a government match for individual and employer contributions. There was support for a government match, but some members were unsure about how one would devise a method for determining the match and how the funds would be transferred into the plan. The issue is complicated by lack of an infrastructure for transferring the funds. It is also complicated by the fact that the government match could not be transferred into an account until after a worker making a contribution filed income taxes, at which time the worker's annual adjusted gross income would be known.

### Employer Tax Incentives for Matching Contributions By Employers

Currently, employers are not eligible for tax credits or other tax incentives for making matching contributions to employees. The group discussed whether or not it was better to offer tax credits to employers or employees in order to help increase overall saving. They also discussed whether or not tax credits to employers or employees would offer the greater net gain in saving. Or, to put it another way, which would offer the biggest savings bang for the tax credit buck? The group also discussed whether or not tax credits for employers should be limited to small businesses and whether credits should be offered only for contributions to the accounts of workers below a certain income level.

*Areas Where Views Differed*

**Employer Tax Credit.** There was strong support, but not general agreement, for a suggestion to provide an employer tax credit that rewarded employer contributions or matches, provided it was tightly targeted at lower paid workers in both large and small business.

There were concerns about how a tax credit would work even among supporters of tax credits for employers. One member said that contributions would have to be "high quality," in the sense that they were provided only for employer contributions that were made nearly entirely on behalf of the targeted low-income workers.[28] Some who supported a tax credit in principle worried how it might work in practice. One member who strongly opposed any type of employer tax credit objected said it is not true that this approach gives a greater bang for the tax credit buck are not correct. He claimed that if employees can get an additional tax credit if the employer matches the employee's contribution, it would have a similar affect on net retirement savings as providing a tax credit to the employer.

**Members Offer Several Suggestions for Tax Credits.** The group discussed several options for designing an employer credit without deciding to generally support any one of them. One member suggested a credit for employer contributions that are above and beyond what was needed to satisfy nondiscrimination tests.[29]

One member suggested a 50 percent tax credit to employers for contributions to nonhighly-compensated employees.[30] One alternative was to offer a credit to employers for contributions to workers earning up to $40,000 or $50,000.[31] One member proposed making the employer credit a complementary part of the Saver's Credit, which is directed at employees. In this instance, the credit would be only for contributions above and beyond what an employer makes to the work force generally.[32]

The group discussed whether or not an employer tax credit might be limited because the targeted group of small business includes some companies without a big tax liability. To reach this group, it was suggested that any employer credit also be refundable and spendable.[33]

### Intelli-Match Proposal to Benefit Low, Moderate Wage Earners

The group discussed the Intelli-Match proposal[34] that would provide a higher proportionate match or contribution to low and moderate income workers than it provides to workers in general.

Before employers could set up an Intelli-Match proposal, Congress would have to pass legislation to grant employers a safe harbor on nondiscrimination tests, since some workers would receive matching contributions at a higher percentage of pay than others. There are existing safe harbors that would allow employers to do this; however, they also require immediate vesting, which may be inconsistent with the business requirements of some employers. For this reason, the Intelli-Match proposal had a provision that employers would not have to provide for immediate vest-

ing[35] to the employer match. This would reduce the overall cost of an Intelli-Match program for employers.

*Areas of General Agreement*

The group generally agreed to support an adjustment in the terms of the safe harbor to make defined contribution plans more flexible for employers in return for a higher targeted match for workers earning up to $50,000.

*Areas Where Views Differed*

The group did not agree on the provision in the Intelli-Match proposal that would eliminate immediate vesting, although it supported the broader concept, as noted above, that the employer would be given some additional flexibility in return for a higher match for low and moderate income workers.

**Payroll Deduction IRAs**

The group discussed ways to expand the availability of payroll deduction IRAs, including requiring employers to offer them at firms that do not have a retirement savings plan, as well as requiring employers who have a retirement plan to offer the payroll deduction IRA to workers who are not eligible to participate in that plan.

Under current law[36] employers are allowed to provide employees with the opportunity for making contributions to an IRA through payroll deductions. In 2005 employees are able to contribute up to $4,000 a year to a payroll deduction IRA, while workers over 50 can contribute an additional $500 directly to the bank.

*Areas of General Agreement*

The group generally agreed that it would be desirable to expand payroll deduction IRAs.

*Areas Where Views Differed*

The group was divided on this issue and did not agree to require employers to offer the payroll deduction IRA. As an alternative, some members suggested that workers be allowed to contribute part or all of their refund to an IRA when they file their annual tax returns.

**Reducing the Risk in Defined Contribution Plans**

The group considered several proposals that were designed to reduce the market risk than may occur when investment returns perform below historic averages for an extended period. A period of low returns can be of special concern if this occurs when workers are nearing retirement.

*Areas of General Agreement*

**Government-Issued Retirement Bonds.** The Group generally supported encouraging employers to offer inflation-adjusted retirement savings bonds as an investment option in their plans. The group identified Treasury Inflation-Indexed Securities (TIPS) as a potential candidate for this option.

*Areas Where Views Differed*

**Government Insurance for Defined Contribution Plans.** It was proposed that the government insure the difference between a career average return on investments and the actual return on investment in a worker's account at the time of their retirement, death or disability. The group did not endorse any form of government insurance for contributions or investments in defined contribution plans.

**Combination Defined Contribution/Cash Balance Offset Plan.** The group decided against considering a proposal with a defined benefit component, as it was seen to be within the scope of Working Group I on defined benefit[37] plans and not within the scope of the assignment set for Working Group II. A proposal had been submitted to recommend adding a cash balance plan to a 401(k) in order to assure that a portion of the retirement saving would have a guaranteed return no matter what happens to the markets.

**Raising the 70 Percent Coverage Requirement**

Under tax law, 70 percent of employees must participate in a retirement plan in order for the plan to qualify as nondiscriminatory.[38] In addition, plans can exclude from this calculation employees who work less than 1,000 hours a year. Some members suggested that it might be possible to increase the required level of coverage to some level above 70 percent of workers. The group also considered whether or not to recommend that employers be required to include more part-time and contingent workers to the standard required to be nondiscriminatory.

*Areas of General Agreement*

The group generally agreed there should be more study of the impact of raising coverage above 70 percent and increasing part-time coverage.

*Areas Where Views Differed*

The group was unable to reach agreement agree on supporting either raising the 70 percent level or increasing the number of part-time and contingent workers. There was strong disagreement over the proposal to increase the number of part-time and contingent workers. Some members said that the group needed data to demonstrate the impact of both approaches to determine which would be more effective, while others were willing to support these approaches with more data.

**Other Proposals**

*Areas of General Agreement*

**Improving Financial Education and Literacy.** The group generally agreed to support instruction on financial literacy for high school and college students. However, the group did not recommend making it a requirement for graduation, as one member had suggested.

**Tightening Coverage Rules.** While not making any specific recommendations, the group generally supported the proposition that coverage rules should be tightened. However, the group also generally agreed that more studies are needed to measure the impact of various proposals before endorsing them.

**Endnotes**

[1] U.S. Department of Labor Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2003* (Washington, D.C.: Department of Labor, April 2004), Table 1, p. 3.

[2] U.S. Bureau of Labor Statistics, "Employee Benefits in the United States, 2003," News, UDSL: 03-489, September 17, 2003, Table 1, p. 3. From the web site at http://www.bis.gov/news.release/pdf/ebs2.pdf.

[3] Ibid.

[4] U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income Bulletin, (Winter 1984–1985, Winter 1986–1987, Winter 1990–1991, Winter 1993–1994, Winter Fall 1995, Winter Spring 1996, Fall 2001, and Winter 2002–2003).

[5] Craig Copeland, "Retirement Plan Participation and Features, and the Standard of Living of Americans 55 or Older," EBRI Issue Brief Number 248 (Washington, D.C.: Employee Benefit Research Institute, August 2002), Figure 2, p. 8.

[6] The W-4 is the form the IRS requires to be filled out by new employees for tracking payroll taxes and deductions.

[7] SIMPLE IRAs and SIMPLE 401(k)s are available to small business with less than 100 employees, as well as self-employed people. SIMPLE stands for Savings Incentive Match Plan for Employees.

[8] SIMPLE IRAs and SIMPLE 401(k)s are available to small business with less than 100 employees, as well as self-employed people. SIMPLE stands for Savings Incentive Match Plan for Employees.

[9] A balanced fund aims to produce high rates of return over the medium to long term. In terms of risk levels, a balanced fund usually occupies a middle position. It is more volatile than a fund with primarily cash and fixed interest investments. It is less volatile than a fund which invests only in equities and real property.

[10] In a Lifestyle Fund, the choices about how much to put into equities, bonds and cash are based on the risk tolerance of the investors and the investor's goals. Lifestyle Funds allow an investor to put all the assets in a single fund and not have to review or revise those investments. The fund periodically adjusts the allocation and gradually becomes increasingly more conservative as the investor moves toward retirement age.

[11] The Thrift Savings Plan offers only a handful of few investment options, which is generally seen to make it easier for participants to use and make decisions about investing. The TSP offers, for example, the following five choices: a Government Securities Investment (G) Fund, a Fixed Income Index Investment (F) Fund, a Common Stock Index Investment (C) Fund, a Small Capitalization Stock Index Investment (S) Fund, and an International Stock Index Investment (I) Fund.

[12] Some pension plans refer to the contribution made into the plan as a salary deferral because it reduces the amount of income that is counted for taxation purposes, while deferring taxes on that income until it is withdrawn later.

[13] SIMPLE IRAs and SIMPLE 401(k)s are available to small business with less than 100 employees, as well as self-employed people. SIMPLE stands for Savings Incentive Match Plan for Employees.

[14] Internal Revenue Code 404(c) requires a participant to make a choice in order to give employers a safe harbor from fiduciary liability for the participant's choice.
[15] Congress required employers to rollover sums for departing employees who do not make a choice in the Economic Growth and Tax Relief Reconciliation Act of 2001. Implementation of the policy cannot begin until Treasury issues regulations affecting the rollovers.
[16] If employees withdraw their money from a 401(k) account after leaving a job and do not deposit into an IRA or another 401(k) at their next job, they will owe taxes on the withdrawal, including a 10 percent penalty tax on amounts withdrawn before age 55.
[17] Congress required employers to rollover sums for departing employees who do not make a choice in the Economic Growth and Tax Relief Reconciliation Act of 2001. Implementation of the policy can not begin until Treasury issues regulations affecting the rollovers.
[18] The Thrift Savings Plan offers only a handful of few investment options, which is generally seen to make it easier for participants to use and make decisions about investing. The TSP offers, for example, the following five choices: a Government Securities Investment (G) Fund, a Fixed Income Index Investment (F) Fund, a Common Stock Index Investment (C) Fund, a Small Capitalization Stock Index Investment (S) Fund, and an International Stock Index Investment (I) Fund.
[19] The Saver's Credit was part of the Economic Growth and Tax Relief Reconciliation Act of 2001.
[20] Saver's Credit also available for contributions to 403(b) plans, 457 governmental plans, SIMPLE 401(k) plans or SIMPLE IRA's.
[21] For married couples filing jointly, workers with income up to $30,000 are eligible for a 50 percent Saver's Credit for their contributions into a saving plan. Married couples earning $30,001 to $32,500 are eligible for a 20 percent credit, and married couples filing jointly earning $32,501 to $50,000 are eligible for a 10 percent credit. Those earning over $50,000 are not eligible for a credit. For single people or married people filing separately, the Saver's Credit is available for 50 percent of contributions for workers with incomes up to $15,000. Workers with incomes $15,001 and $16,250 can obtain a 20 percent Saver's Credit. Single workers and married people filing separately who earn between $16,251 and $25,000 can receive a 10 percent Saver's Credit on contributions. Slightly different earnings levels qualify a head of household: (50 percent for incomes up to $22,500; 20 percent for incomes $22,501 to $24,375; and 10 percent of incomes $24,376 to $37,500).
[22] Data provided by former Treasury official Mark Iwry.
[23] Ibid.
[24] Ibid.
[25] Ibid.
[26] A proposal to make the refundable amounts made available by a special savings bond payable on retirement and not through a tax credit has been made by Senator Jeff Bingaman (D-New Mexico).
[27] For singles and couples filing separately, there was support for raising the credit to 75 percent for those earning up to $20,000. The credit would be gradually phased down to 50 percent for those earning $25,000. It would then be gradually phased out to zero for those earning $30,000.
[28] The member who proposed this suggestion said the definition of "high quality" would have to be further refined.
[29] Nondiscrimination testing is required under Internal Revenue Service rules to ensure that highly compensated employees do not derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.
[30] Non-highly-paid employees are those who earn less than $90,000. Highly compensated employees earn $90,000 or more.
[31] In this proposal, employer contributions would have to meet "a certain quality of coverage" standard in order to qualify for the 50 percent tax credit, such as requiring that the first dollar of coverage awarded by employers would reach the target population within a given range. Companies would not qualify if they integrated their benefits into Social Security or if they engaged in cross testing to meet nondiscrimination testing requirements. Credit would be made for matching and automatic contributions. On matching contributions, employers had to provide at least a 20 percent match. On automatic contributions, the level would have to be 1 percent or 2 percent of pay. The credit was capped at 3 percent of pay for the employer

contribution. It could also be provided for a 1 percent non-elective, 2 percent match. The target was low-income people, not just small business workers.

[32] The employer credit would be allowed made for employer contributions to workers earning less than $30,000, and be applied to contributions 1 percent or 2 percent of wages above the percentage contribution levels the employer was providing to all employees.

[33] One member described both the refundable and nonrefundable tax credits as "spendable" tax credits to differentiate them from contributions deposited into an account by the government.

[34] One possible Intelli-Match approach would be to provide a 100 percent match for employee contributions up to $2,000 or 4 percent, whichever is greater. A worker earning $100,000 could contribute up to $4,000 and receive a $4,000 match. A worker earning $20,000, however, might contribute $2,000 even though that would represent 10 percent of the worker's salary. Even so, the worker would still get a $2,000 match. The proposal would also provide a tax credit to the employer for the amount of employer match contributed to people making less than $50,000 that is above the percentage match give to owners and highly-compensated employees.

[35] An employee is said to be "vested" in a pension when the employee becomes entitled to the benefits of the plan, including employer contributions to a plan and their earnings.

[36] In 1975 the Department of Labor issued a regulation describing the circumstances under which the use of an employer payroll deduction program for forwarding employee monies to an individual retirement account (IRA) will not constitute an employee pension benefit plan subject to Title I of the Employee Retirement Income Security Act (ERISA) of 1974. Further, as part of the conference report on the Taxpayer Relief Act of 1997, Congress expressed its view that "employers that choose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs." (H.R. Rep. No. 220, 10th Congress, 1st Session at 755, 1997).

[37] Defined benefit type plans are retirement plans offered by employers who promise to fund and provide a monthly retirement benefit to each eligible employee based on years of service and earnings.

[38] Internal Revenue Code Section 410(b).

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## REPORT ON THE CONVERSATIONS AND RECOMMENDATIONS OF WORKING GROUP III

### WORKING GROUP'S ASSIGNMENT

### ANSWER THIS QUESTION

How do we increase coverage and retirement savings through new institutions and structures?

FEBRUARY 10, 2005

Co-Chairs: Ian Lanoff and Pamela Perun

Working Group Members: John Ameriks, Chris Bone, Doug Ell, Cathy Heron, Pat Humphlett, Leslie Kramerich, Robert Nagle, Carol Sears, Javier Silva, Dick Wartman, Christian Weller, and Janice Winston

### EXECUTIVE SUMMARY

Despite years of efforts to address the challenge, more than half the private sector work force does not participate in a retirement saving plan. Thus, employees are unlikely to accumulate any significant savings for their retirement years, which are likely to be very long as Americans continue to live longer. The workers who might be the most likely to experience poverty in old age are the same workers who are most likely to be without access to a retirement saving plan today.

Working Group III set out to do something about this uncovered group that needs the most attention. Its mission was to look for ways to enroll various financial institutions in new efforts to target the most important segment lacking coverage: small businesses. In this segment only 35 percent of employees participate in a workplace retirement savings plan. The group also wanted to reach part-time workers. This group represents an even greater area of need since only 18 percent of part-time workers participate in a workplace retirement savings plan.

The group also recognized that workers are much more likely to save if they have a way to save through their employer. When such plans are offered, participation

rates are high across the board, even if there is no employer match. One reason is that savings can be regularly deducted from a worker's pay check.

After reviewing a range of proposals aimed at reaching the target group, the Working Group decided to take the bold step of offering its own clean-slate proposal to reach the masses of uncovered workers. Taking a leaf from Henry Ford's highly successful strategy of designing a car for the masses, the group decided to name its plan the Model T. The new Henry Ford's would be executives at regulated financial institutions: banks, insurance companies, brokerage firms, and mutual funds.

• All employees—full-time, part-time, contingent workers and even independent contractors [1]—would be eligible to participate if an employer agreed to be part of a plan. This is a striking departure from existing rules that allow employers to limit which employees might be eligible for such plans as the 401(k).

• Regulated financial institutions could be authorized to offer a simplified plan to groups of employers.

This multiple employer plan could be targeted to a specific region. For example, a bank in Peoria, Illinois could offer the plan to businesses in the Peoria area. The plan could also be targeted toward business categories, such as a Mississippi insurance company offering a plan for Mississippi construction and building trade groups.

• The group generally agreed that there should be only three to five investment options and that they would include model portfolios that would be conservative, moderate and aggressive.

• Employers would also be able to automatically enroll workers.

• If workers make no choice among investments, the employer could designate that their contributions be invested in a mix of options that would be appropriate for their age and expected date of retirement.

Small businesses would be more likely to offer such plans because two of the chief reasons they say they currently avoid plans would be eliminated. The plan would be administered by the financial institution that provides it and the employer would no longer be potentially liable as a fiduciary for the investment choices of employees.

Employers would be allowed to contribute to the plan, but would not be required to contribute. This, too, would address a concern by small businesses whose managers and owners worry that the business is too precarious and profits too uncertain to commit to employer contributions.

While tax credits for employer and employee contributions were seen as helpful, they were not deemed to be essential for the plan.

**Mission**

The broad mandate of Working Group III was to find new institutions and structures to increase the portion of the workforce covered by a retirement saving plan and to raise the level of retirement savings. The members of the group looked at the role that financial institutions could play in providing new approaches that target workers employed by small businesses, where coverage and saving are much lower than in mid-sized and large businesses.

The group generally agreed they should try to develop broad outlines for a new plan they named the Model T plan, which would be a simplified, low-cost group retirement savings plan that could be sponsored by financial institutions, such as banks, insurance companies, mutual fund companies, and brokerage firms. The group set out to design the elements of the plan and how it might work to attract plan providers and employers. In working on the design elements of the plan, the group sought to find agreement on as many areas as possible and, where a consensus could not be developed, to identify areas where more work needed to be done.

**Background**

The goal of providing a retirement plan for all workers is an ambitious one. In 2003, for example, only about 57 percent of American workers had access to a retirement plan sponsored by their employer, according to Bureau of Labor Statistics. Of that group 20 percent have access to a defined benefit plan; that is, a plan that is generally funded by the employer and which usually provides a stream of income for life.[2]

The number of workers who actually participate in those plans is somewhat lower. Among all private sectors workers, 49 percent of full-time and part-time workers participated in an employer-sponsored retirement plan. That represented 50.5 million in a total private sector work force of 103.5 million in March 2003.[3]

The employer survey found that different segments of the workplace population have widely differing participation rates. The participation rate is 65 percent among the 45.9 million employed last year in medium and large businesses (100 employees

or more). However, the participation rate was only 35 percent among the 59.6 million employed last year by small businesses (99 or fewer workers).[4] There is an ever sharper divide in participation rates between full-time (58 percent) and part-time workers (18 percent).[5]

Getting small business owners to sponsor plans is difficult, but not impossible. According to the 2003 Small Employer Retirement Survey (SERS) by the Employee Benefit Research Institute, 29 percent said they were likely to start a plan in the next 2 years.[6] At the same time, 68 percent said they were not likely to start a plan.[7] This represents a sharp decline in the number of small businesses that are likely to start a retirement plan in recent years. In 1998, for example, 42 percent of small business owners said they were likely to start a plan in the next 2 years, while 56 percent reported they were not likely.

The survey looked at a number of factors that could improve the chances that small businesses would offer a plan. It found that 73 percent of small businesses were more likely to start a plan if it did not require employer contributions, 67 percent were more likely to start a plan if the employer could get tax credits for start-up costs, 57 percent were more likely to start a plan if the plan had reduced administrative requirements, and 55 percent were more likely to start a plan if it offered easy-to-understand information about the plan.[8] Fiduciary responsibility is another stumbling block to employers sponsoring plans.

These data suggest that a plan that has discretionary contributions on the part of the employer, is easy to administer, reduces fiduciary liability for the choices of employees, provides tax credits for start-up costs, and is easy to understand, would likely prompt a good deal of interest among small business employers.

Employer-sponsored pension plans still appear to be the best way to motivate workers to save for retirement. The Federal income tax return data indicate that the proportion of filers who claim an IRA or Keogh deduction has been both fairly modest and steadily declining over time. From a peak of 16.2 percent in 1986, it fell to 3.5 percent in 2000 and 2001.[9] By contrast, the participation rate in workplace plans is 66.2 percent of those eligible for 401(k) plans (a population of workers that represents 32.6 percent of the private sector workforce).[10]

**How the Working Group Went About Its Assignment**

Working Group III first examined a range of existing proposals aimed at employees of small businesses. Instead of recommending any of those proposals, the group instead decided to start with a clean slate and design the broad outlines of a new proposal for a simplified multiple employer[11] or group plan that would be offered to small businesses by financial institutions.

In taking this approach, the group was also responding to a recommendation from the first Conversation on Coverage in 2001 to examine new types of model group pension plans that would enable groups of unrelated small employers to pool resources, thereby reducing administrative costs and fiduciary liability.[12]

Taking a leaf from Henry Ford's Model T, which became the symbol of affordable transportation for the masses, the group named its new plan the Model T multiple employer plan. It was the group's hope that it could be an inexpensive and accessible savings vehicle that could provide pensions to tens of thousands of workers in small companies.

Under the Model T plan approach the plan providers—banks, insurance companies, brokerage companies, and mutual fund companies—would assume fiduciary liability for the investment choices in the plan and would shoulder administration duties for the plans. The transfer of these two responsibilities from the employer to the plan provider was seen by the group as a means of addressing these two of the key objections by small businesses to starting a new defined contribution plan. In addition, the simplicity of the proposal was seen as addressing another key concern of both small business employers and employees.

THE MODEL T PLAN AT A GLANCE

The group generally agreed on the following broad outlines of the Model T plan.

- **Multiple-Employer Plan.** It will be a multiple-employer defined contribution group or pooled plan and not an aggregation of individual retirement accounts.
- **Workplace Plan.** The Model T will be offered by an employer to employees and independent contractors of the firm.
- **Administration by Third Party Provider.** The administration of the plan would be the responsibility of the plan provider—a financial institution—and not the employer.
- **Financial Institutions Would Offer the Plan.** Regulated financial institutions—banks, insurance companies, brokerage firms and mutual fund companies—

would be authorized to offer the Model T plan, in much the same way the Internal Revenue Code now authorizes certain types of financial institutions and corporations to offer IRAs. The authorized institutions would market the plan to employers.

• **Limited Investment Choices.** The group generally agreed that Model T plans would be required to offer a limited choice of three to five options that would consist of model portfolios and/or lifestyle funds, with the possibility of a guaranteed return investment option. The choices would be designed to make them easy for the employer and employee to understand.

• **Fiduciary Liability Transferred to Third Party Provider.** The fiduciary responsibility for the investment choices will be transferred from the employer to the plan provider.

• **Default Investment Mix Option.** Plan providers will have the option of offering participants in the plan the option of choosing a default mix of investments based on a lifestyle fund or a model portfolio.[13]

• **Employee and Employer Contributions.** Once an employer signs up with a plan provider, both the employer and employees will be able to contribute to the plan.

• **Securities and Exchange Commission Is Lead Regulator.** While the Internal Revenue Service and the Department of Labor would play an important role in the regulation of the Model T plan, the Securities and Exchange Commission would take a leading role in the regulation and oversight of fiduciary and investment matters.

THE BUILDING BLOCKS OF THE MODEL T PLAN

The group discussed in detail how the plan might be structured and what policies would govern the various elements of the plan. In many cases, the group was able to reach a consensus, but in others there were varying opinions, or dissenting opinions. The outcome of the discussions of the various elements is presented below.

*Building Block No. 1*

**Plan Providers**

The group discussed potential plan providers to offer the plan to employers. This included banks, insurance companies, mutual fund companies, brokerage firms, and various financial intermediaries.

*Areas of Agreement*

**Regulated Financial Institutions Can Offer the Plan.** The group generally agreed the regulated financial institutions can sponsor the Model T plan. This would include banks, insurance companies, brokerage firms and mutual fund companies. A number of members indicated they thought that a simplified Model T plan might be attractive to banks, which have not been as active in offering retirement plans as other financial institutions.

**Plans Can Target Regions and Groups.** The group generally agreed that plan providers could offer plans that are targeted to employers in a specific geographical or regional area or targeted at employers in specific categories of business and industry.

**Authorized Providers.** The group generally agreed to support a regulatory approach that is similar to the Internal Revenue Code provisions governing who can offer IRAs[14] when designing regulations for designating which financial institutions would be authorized to provide the plan to employers. They also generally agreed that the process would be open to eligible financial institutions already regulated by a Federal or State Agency. This would include banks, insurance companies, brokerage firms, and mutual fund companies.

**Brokers and Intermediaries.** The group discussed whether or not brokers or intermediaries could pool contributions from self-employed individuals and forward them to a regulated financial institution plan provider. The discussion included such potential intermediaries as organizations representing freelance workers. It was generally agreed that an organization could be allowed to facilitate signing up its members in a plan offered by a financial institution.

*Areas Where Views Differed*

**Authorization Dependent on Target Participation by Low-Income Workers.** There was a proposal by one member that the authority of financial institutions to offer the Model T be dependent on the ability of the plan provider to market the plan in such a way that a designated portion of the workers covered by the plan—perhaps 20 percent—would be low-income workers. This would follow the approach taken in the Community Reinvestment Act (CRA) toward regulating depository institutions. The group was divided on whether or not to support a CRA-type ap-

proach to licensing. One member who objected said it would increase the cost of the plan by increasing the level of detail in administering it. One member supported the use of the CRA-type approach by institutions offering the Model T but did not want to make it part of the eligibility requirements for a financial institution seeking to offer a plan. One member suggested that a study be made of 529 college saving plans[15] with CRA-type requirements to see if something could be adapted to suit the eligibility requirements for the Model T plan.

**Commissions for Brokers and Intermediaries.** The group also discussed whether organizations or even brokerage firms could pool contributions from a group of workers or small employers for a commission. The group could not agree, however, on whether organizations could earn fees for their work as facilitators.

**Professional Employment Organizations.** One member suggested that professional employment organizations or PEOs that lease out employees be authorized to offer the Model T to the employees they lease out to businesses. However, the group did not generally agree to support allowing PEOs to be plan sponsors.

*Building Block No. 2*

**Employee Participation in the Plan**

The group discussed which of a given company's employees would be eligible to participate in the plan and whether or not employers should be allowed to automatically enroll workers when they are hired.

*Areas of Agreement*

**All Employees Eligible to Contribute.** The group generally agreed that once an employer agrees to participate in a Model T plan offered by a financial institution, then all employees will be eligible to contribute to the plan. This will include full-time workers, part-time workers, contingent workers and independent contractors. As noted above, there was interest in having organizations facilitate contributions from various groups of workers, including the self-employed.

**Automatic Enrollment.** The group generally agreed that an employer participating in a Model T plan could adopt the option of automatically enrolling a new hire into the plan unless the employee indicated otherwise.

*Areas Where Views Differed*

**Limits on Employee Contributions.** The group deferred discussion on setting contribution limits for employees and/or employers to the next phase of the Conversation on Coverage, with the assumption that the limits would be in keeping with the limits for other defined contribution plans.

*Building Block No. 3*

**Employer Contributions to the Plan**

The group discussed whether or not employers could contribute to the Model T plan and whether, in fact, employers might be required to contribute.

*Areas of Agreement*

**Employer Contributions Allowed.** The group generally agreed the employers would be able to contribute to the Model T plan.

*Areas Where Views Differed*

**Mandatory or Voluntary Contributions.** The group discussed whether or not employer contributions would be made mandatory, but remained divided on this issue. There was strong opposition to mandatory contributions. One member said that if employer contributions were made mandatory, then it would create a barrier for signing up employers to be part of the Model T plan. Another member noted studies—such as the annual Small Employer Retirement Survey (SERS) by the Employee Benefit Research Institute—that have found that small business employers would be more likely to offer a retirement saving plan if employer contributions were entirely discretionary.[16]

Some members were strongly in favor of mandating employer contributions. One member who supported a mandate said that if there is no mandate for the Model T plan, he did not see how it would differ very much from an IRA. A member who opposed mandatory contributions said that the Model T would still be a different plan because it would allow for employer contributions to the plan. One member suggested as a compromise a flexible policy rule in which employers would be required to contribute in x years out of five, depending on whether or not there are profits. Another member suggested requiring the employer to contribute 1 percent of compensation if the employee puts in 4 percent of compensation. One member

suggested that the Model T allow for reverse match contributions, where the employer contributes first and the employee matches the employer contributions.

*Building Block No. 4*

**Investment Options in the Plan**

The group discussed how many investment options and what types of investments should be included in the Model T plan.

*Areas of Agreement*

**Simplified Investment Options.** The group generally agreed that the plan should offer at least three investment options, but no more than five options. The members also generally agreed that the choices should include at least three model portfolios or lifestyle funds: conservative, moderate, and aggressive.

**Default Investment Mix.** The group generally agreed that when employees fail to make choices on their own, plan providers should be allowed to offer participants at firms that join the plan a default mix of investment options based on lifestyle or life cycle funds—or model portfolios representing the basic asset classes.

*Areas Where Views Differed*

**Additional Investment Options.** The group discussed including an investment option that would provide a guaranteed rate of return. Although several in the group strongly supported such an option as key to encouraging low-income workers to participate, the group did not reach agreement that this should be a required investment option.

**Government Definitions of Investment Options.** The group discussed having the government define exactly what should be in an investment option, but could not reach agreement on this point.

**Two Tiers or One?** The group discussed whether or not financial institutions might have two models or tiers to offer employers: (1) a simplified incubator model plus (2) a full-fledged plan with more investment options. Those who supported the concept of two-tiered plans argued that employers could begin with the simplified incubator plan and then move on to a traditional qualified plan offered by the institution offering the incubator plan—or any other institution—when they were ready. The suggestion was made out of concern that the simplified plan might not be profitable for plan providers and, thus, might fail to enlist their enthusiastic marketing of the plan. Members explained that the Model T might not be as profitable in the beginning because it would consist of a lot of accounts, each with very small balances.

The group was divided on this proposal. Some supported an approach with two plan options, a simplified incubator and a full-fledged plan, while others supported a single, simplified Model T plan. Members supporting a single Model T plan argued that while the Model T might not prove to be as profitable initially as the financial institution might wish, account balances would grow over time, increasing the plan's profitability. Further, employers could mature into one of the whole range of existing single employer plans when they are ready for more investment options and more bells and whistles in their plan.

**Government Sponsored Start-Up Plan.** The group discussed whether or not the government should sponsor a Model T plan for those employers with many small accounts, clients whose business would not be profitable for financial institutions that provide Model T plans. The group was divided on whether or not there should be a government start-up plan. A member who opposed a government plan said it would be difficult for the government to start up a plan. Further, it was suggested that the financial institutions that were interested in sponsoring Model T plans would be opposed to it. Members supporting a government start-up plan, however, continued to strongly support this approach. One asked why financial institutions would be opposed, since the government plan would be only for unprofitable accounts. A member opposing a government plan said it would "get tricky" to devise a way for employers to move from the government plan to a private sector plan.

*Building Block No. 5*

**Regulation and Oversight**

Since the Model T plan would transfer administration and fiduciary liability from the employer to the plan provider, it raised a number of questions about what regulatory regime would work best to keep the plan costs low while protecting participants. The group also looked at the question of who would have fiduciary liability for the investment choices in the plan and for any malfeasance and fraud that might occur. The group generally agreed that the employer would be relieved of fiduciary liability for the choice of investment options in the plan.

*Areas of Agreement*

**SEC is the Lead Regulator.** The group discussed what regulatory roles would be played by the Department of Labor, the Internal Revenue Service, and the Securities and Exchange Commission. The group discussed whether the SEC should enhance its role as fiduciary regulator over Model T plans above the level of scrutiny it applies for the non-pension related oversight that constitutes its regulatory focus. They also discussed whether or not the SEC should be the lead fiduciary regulator instead of the Department of Labor or IRS. The group generally agreed that the SEC should take the lead role in fiduciary regulation for the Model T. They also agreed that at the same time the IRS should be the guardian for tax rules while the Department of Labor would regulate the employer/employee relationship. The exact nature of the DoL's regulatory role was deferred for future consideration.

**SEC Will Regulate Model T Plans Offered By Banks and Insurance Companies.** The group discussed whether or not the SEC oversight would apply beyond brokerage firms and mutual funds to include banks and insurance companies, which are chiefly regulated by Federal banking authorities, as well as State banking and insurance authorities. One member noted that the SEC currently already regulates mutual funds offered by banks and variable annuities offered by insurance companies. Thus, the member explained, it is not a departure for the SEC to also regulate Model T retirement saving plans provided by banks and insurance companies. The group generally agreed that the SEC could be the fiduciary regulator for all providers of Model T plans.

**Paying for Plan Administration Costs.** The group discussed how administration costs would be paid. The group generally agreed that the sponsoring financial institutions could charge a fee for administration (in addition to the fee for investment management). They also generally agreed that the fee could optionally be borne by participants as a charge against earnings.

**Fees Should Be Low.** The group generally agreed that internal fees charged to manage funds, as well as administrative fees to manage the plan, should be low. Many in the group supported an approach that would keep fees below 100 basis points.[17]

*Areas Where Views Differed*

**SEC Will Regulate Fees.** Many in the group supported the view that the SEC would be responsible for regulating fees and determining what a reasonable fee might be. The SEC would also be responsible for determining whether or not there should be a cap on fees. This approach would expand the powers of the SEC, which currently oversees mutual funds, but does not regulate fees in mutual funds. However, the group did not generally agree to this approach. One member strongly objected to having the SEC set rates or caps for funds, stating that putting this in the proposal would "seriously derail" any effort to get support for the Model T plan. The member objecting also noted that if the Model T plan had caps, it would reduce the number of players in the market, while removing the cap would increase competition, which, in turn, would act to keep fees lower.

**Enhanced SEC Fiduciary Authority.** The group was divided over whether or not the SEC should enhance its fiduciary oversight for Model T plans. Some favored the current level of fiduciary scrutiny applied to brokerage firms and mutual funds as a way of streamlining regulation and keeping down costs. Others, however, felt that since the SEC was the lead regulator, it would have to take on some of the duties associated with the Department of Labor and some of the more extensive list of prohibited transaction rules under ERISA.[18]

**Study to Address Unresolved Fiduciary Issues.** The group generally agreed that a study should be undertaken to develop an outline for a regulatory regime for the Model T. For starters, the study could flesh out the duties of the various regulatory bodies, and address what enhanced fiduciary regulatory authority the SEC might have over Model T plans.

Among the unresolved issues is a question of whether or not any fiduciary liability would remain with the employer. Some suggested that the employer would retain fiduciary liability for choosing a Model T provider, even if it transfers to the plan provider the fiduciary liability for the investment choices offered in the plan. Some suggested that employers should face restrictions on who they might choose so "they could not hire their brother-in-law down the street," as one member put it.

There was also discussion about whether or not the plan provider might escape fiduciary liability for the choices in the plan, if it follows the required list of investment offerings. The group, however, did not reach agreement on a suggestion to remove fiduciary liability for plan providers who chose the recommended investment options. One member explained that a plan provider could simply offer the invest-

ment options of a business colleague or a relative rather than provide investment options that were managed for the sole interest of the plan participants.

*Building Block No. 6*

**Withdrawals and Distributions**

The group discussed under what terms and conditions employees could make pre-retirement withdrawals for hardship or as a loan. They also discussed the rules that would apply when employees leave an employer and the rules that would govern distributions of assets when a participant reaches retirement age.

*Areas of Agreement*

**Hardship Withdrawals Not Allowed.** The group generally agreed to disallow hardship withdrawals. This approach was taken partly because it would be difficult for plan providers to be able to determine if there was a genuine hardship. In addition, barring hardship withdrawals was seen as simplifying the plans, making them less expensive, and also encouraging workers to retain their accumulated balances until they are old enough to be eligible to take distributions.

**Loans Allowed Up to 50 Percent of Assets.** The group generally agreed that participants would be able to withdraw loans from their accumulated balances for amounts up to 50 percent of the value of the assets in their plan. They also generally agreed that if a participant defaulted, the loan would be treated as income and taxed. This approach was taken to provide some type of pre-retirement access to the assets in the plan. This approach was taken on the assumption that workers tend to contribute more and save more if they know they can withdraw some of the funds for an emergency. Loans were seen as preferable to hardship withdrawals, for the reasons noted above.

**Lump Sum Withdrawals at Age 59½.** The group generally agreed that participants could withdraw up to 50 percent of the value of the assets in the Model T plan beginning at age 59½, conforming to the age set for defined contribution plans generally, including 401(k) plans. If a participant has taken out loans and not repaid them, these loans would count toward the 50 percent maximum limit that could be withdrawn as a lump sum.

**Required Annuity on 50 Percent of Account Balance.** The group generally agreed that at least 50 percent of the account balance in the plan should be converted to an annuity or be subject to the current joint and survivor annuity rules. In addition, employees could elect at retirement to take out the entire balance as an annuity, with spousal consent.

**Rollover Rules.** The group generally agreed that a participant who leaves an employer can withdraw up to 50 percent of the balance or roll over the account into another Model T plan where he or she is eligible to contribute. A participant who leaves a company can also leave the remaining 50 percent in the account until age 59½. A participant would have to either leave the 50 percent balance designated for a future annuity in the plan or roll it over to a new Model T plan.

**No Maximum Age or Minimum Withdrawals.** The group generally agreed that there would be no maximum age at which time withdrawals would have to begin and no schedule of minimum annual withdrawals after that designated age. In 401(k) plans, for example, withdrawals must begin by age 70½ unless the employee is still working. If retired, annual withdrawals beginning at age 70½ are based on the life expectancy[19] of the participant—or the participant and his or her spouse, if married.

**Joint and Survivor Annuities.** The group generally agreed to apply existing law governing joint and survivor benefits to the Model T plan. That means the annuity would be issued jointly to the plan participant and spouse and that the spouse would continue to receive the annuity should the plan participant die. Plans would be able to decide whether or not they would allow the individual to take up to one-half of the balance at age 59½. If a participant decided he or she wanted to take 50 percent of the accumulated balance as a lump sum when it is offered, current law governing joint and survivor annuities would apply to the remaining amount in the plan.[20]

*Areas Where Views Differed*

**Other Types of Payment Schedules.** Some members suggested that participants be allowed to set up a regular withdrawal schedule timed to life expectancy for the annuity half of the benefit. Participants could, however, outlive the assumed time span for a schedule of payments, while annuities would make regular payments as long as a participant or surviving spouse lived, in the case of joint and survivor annuities.

**Government Managed Annuities.** One member suggested that balances dedicated to annuities be transferred to the Social Security Administration and that SSA could then issue the annuities. Or, alternatively, the Pension Benefit Guaranty Corporation could assume control of the balances dedicated to annuities and pay out the annuities beginning at retirement age. The group, however, declined to support this approach.

*Building Block No. 7*

**Tax Incentives and Provisions**

The group discussed whether or not there should be tax credits for employers, employees and plan providers, as well as tax subsidies for employers and providers. The group also discussed how contributions, gains and distributions would be treated for tax purposes.

*Areas of Agreement*

**Special Tax Treatment Not Essential.** The group generally agreed that while special additional tax benefits for contributions by employees and employers might be helpful, it was not essential for the Model T plan.

**Current Tax Preferences Favored.** The group generally agreed that the Model T should follow existing tax policy in key issues affecting contributions, earnings, capital gains, and distributions. Employee contributions would be excluded from income and, thus, income taxes. Employer contributions would be considered an expense against corporate income. Earnings, dividends and capital gains within the Model T plan would accumulate tax-free. Distributions and withdrawals from the plan would be taxed as part of ordinary income. Distributions upon separation from service upon termination of employment would be subject to the current withholding rules and a possible penalty if not rolled over to an IRA or another plan. Distributions that result from failure to repay a loan could be subject to the current early withdrawal penalty if made before age 59½.

**No Tax Subsidy for Plan Providers.** The group generally agreed that the Model T plan should not provide a start-up tax credit or subsidy for financial institutions that offer the plan to employers.

*Areas Where Views Differed*

**Tax Credits for Employer Contributions.** The group also discussed whether or not there should be tax credits for employers as an incentive for them to contribute to the plan or match employee contributions. While members generally agreed the tax credits for employers would be helpful, the group did not reach agreement on what types of credits would be appropriate. One member said it would be more difficult to get Congress to enact a law to set up the Model T, if it included tax credits for employer contributions. Another member, however, said that the plan should call for a tax credit, noting that one could not get a subsidy if one did not ask. The member also suggested allowing third parties to offer to match employee contributions for low-income workers.

**Super Deductions for Employers.** The group discussed a suggestion to give employers a super deduction, such as 110 percent, for contributions to the Model T plan. While some members supported this approach, the group did not reach general agreement on recommending this policy.

**Start-Up Tax Credit for Employer.** The group discussed whether or not small businesses should get tax credits for costs associated with starting up the plan, but could not agree on a recommended policy. Some members noted that the plan was provided by a third party, so start-up costs would be minimal. Other members noted, however, there would be some costs associated with setting up the plan and some members supported a credit for the first few years of the plan as an inducement to get small businesses to sign up with a plan provider. One member suggested a limited start-up credit.

**Tax Credits for Employees.** The group discussed whether or not to recommend refundable tax credits for employees to encourage contributions, expanding on the nonrefundable tax credits available through the Saver's Credit.[21] The group, however, did not generally agree to support this approach, although some members strongly favored it.

*Building Block No. 8*

**Marketing Considerations**

The group discussed how the plan might be marketed to assure that more small businesses would decide to participate.

*Areas of Agreement*

**Description of How the Model T Plan Differs.** The group generally supported providing a description of how the Model T differs from other retirement and saving plan types as a way to interest and eventually enlist financial institutions to provide the plan, as well as serving as a way to draw attention to the plan for employers who might wish to offer it to their employees.

**Demonstration Project.** The group generally supported exploring the possibility of a demonstration project to generate interest in the Model T plan. Such an effort could be modeled after such successful campaigns as "Cleveland Saves," which enlisted the Mayor and local banks in a public education campaign that included "personal trainers" who called up people and asked if they had saved anything that day. The Model T demonstration project could market a demonstration plan to small businesses and their employees in a given community.

*Areas Where Views Differed*

**Government Education Campaign.** There was discussion of having the government mount a public education campaign on the Model T plan so that financial institutions that offer them will not have to advertise them. Instead, individuals and small businesses would approach potential providers. This was seen as a way to reduce the cost of the plans and prompt financial institutions to offer them. The group, however, did not reach general agreement on supporting this approach.

**Endnotes**

[1] Independent contractors in this context refers to contract employees and freelancers, but does not include the employees of professional firms, such as lawyers and accountants, who advise or take on specific projects for companies.

[2] U.S. Department of Labor Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2003 (Washington, D.C.: Department of Labor, April 2004), Table 1, p. 3.

[3] U.S. Bureau of Labor Statistics. *National Compensation Survey: Employee Benefits in Private Industry in the United States, 2000*, Bulletin 2555 (Washington, D.C.: U.S. Department of Labor, January 2003), Table 1, p. 4. The 2000 survey of businesses represents an employed population of 107,538,277, 85,939,757 full-time and 21,598,520 part-time. The survey does not include workers employed by State and local governments, the Federal Government or the military.

[4] U.S. Bureau of Labor Statistics, "Employee Benefits in the United States, 2003," News, UDSL: 03-489, September 17, 2003, Table 1, p. 3. From the web site at http://www.bis.gov/news.release/pdf/ebs2/pdf.

[5] Ibid.

[6] Small businesses reported as follows: 7 percent were very likely to start a plan in the next 2 years, while 22 percent were somewhat likely. Source: Employee Benefit Research Institute, "The 2003 Small Employer Retirement Survey (SERS) Summary of Findings" (Washington, D.C.: EBRI, June, 2003), p. 2.

[7] Small businesses reported as follows: 25 percent were not too likely to start a plan in the next 2 years, while 43 percent were not at all likely. Source: Ibid.

[8] Ibid.

[9] U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income Bulletin, (Winter 1984–1985, Winter 1986–1987, Winter 1990–1991, Winter 1993–1994, Winter Fall 1995, Winter Spring 1996, Fall 2001, and Winter 2002–2003).

[10] Craig Copeland, "Retirement Plan Participation and Features, and the Standard of Living of Americans 55 or Older," EBRI Issue Brief Number 248 (Washington, D.C.: Employee Benefit Research Institute, August 2002), Figure 2, p. 8.

[11] Multiple employer plans (MEPPs) are controlled by a single plan document (for this reason they are technically classified as a type of single employer plan) and do not involve a collective bargaining agreement. The employers usually have some kind of connection short of common ownership ("controlled group" status), and the (typically employer) contributions are pooled in a single trust. Fiona Wright, "Working Paper on Pooled Multiple Employer Pension Plans", mimeo, May 2003.

[12] Leslie B. Kramerich, "Confronting the Pension Coverage Challenge," A Report on the Conversation on Coverage Convened by the Pension Rights Center, July 24–25, 2001, p. 42. From the web site at http://www.pensioncoverage.net/pdfs/whitepaper.pdf. The report discussed recommendations for pooled arrangements noting that these would be appealing to small businesses while also being a good vehicle for covering part-time and contingency workers.

[13] Lifestyle or life cycle funds allocate funds across the three main asset classes: equities, bonds and cash. For participants who wish to make a choice, there will be a simplified offering of fund options to be determined by the clearinghouse.

[14] The Internal Revenue Code's Section 408(a)(2) designates what institutions can offer an IRA (banks, credit unions and State corporations chartered by the commissioner of banking, and 401(n) defines what a bank is. Some non-bank financial organizations that offer IRA's often have affiliates that meet the definition of a bank. In addition, the trustee of an IRA can also be "a person other than a bank," but such a person or entity has to apply to the Commissioner of the Internal Revenue Service to demonstrate that it can "act within the acceptable rules of fiduciary conduct." The particulars for this requirements are spelled out in Treasury Regulations § 1.408-2(e)(6).

[15] So-called 529 plans are college savings programs established and administered by the States. They are named 529 Plans after the IRS code section that outlines the details of the plans.

[16] The 2003 Small Employer Retirement Survey found that 73 percent of small business would be more likely to start a plan if it did not require employer contributions.

[17] A basis point is one one-hundredth of a percentage point. Thus, 100 basis points equal 1 percentage point.

[18] The group did not explore in any detail what sort of prohibited transactions might be required in a fiduciary regime. The Employee Retirement Income Security Act (ERISA) of 1974, for example, sets forth a list of prohibited transactions to which employee benefit plans are subject. The Investment Company Act, which governs mutual funds and brokerage firms, also has a list of prohibited transactions, but not as extensive as ERISA.

[19] Withdrawals at age 70½ are based on life expectancy under a uniform IRS table or the joint life expectancy of the participant and his or her spouse if the spouse is more than 10 years younger than the participant.

[20] Since the Model T is a defined contribution plan, it follows current law applicable to such plans, but only on the portion that can be withdrawn as a lump sum, and only then if the plan does not offer an annuity on that portion. This policy is based on that fact that defined contribution plans are not required to offer an annuity provided the spouse receives 100 percent of the account balance if the employee dies while covered by the plan. However, current law also states that if the plan does not offer an annuity and the employee does not die while covered by the plan, the employee can withdraw the account balance as a lump sum or other non-annuity payment without spousal consent when the employee leaves the plan. Thus, if the plan offered an annuity on only 50 percent of the balance, then the lump sum could be taken out without spousal consent. However, if the plan offered an annuity on the entire balance, with the option of a lump sum on 50 percent, it would require spousal consent to take the benefit as a lump sum. Some members suggested that the process of obtaining consent for the annuity portion should be streamlined to reduce administrative costs, while others insisted that the current form of consent—a signature on paper—must be obtained to protect spousal rights.

[21] Enacted into law in 2001, the Saver's Credit was first available in 2002 and is slated to end in 2007. The Saver's Credit can reduce the Federal income tax a worker pays dollar for dollar. The amount of credit that one can receive is based on one's contributions into an IRA, 401(k), and other retirement saving plans. The Saver's Credit is part of the Economic Growth and Tax Relief Reconciliation Act of 2001. The Saver's Credit is also available for contributions to 403(b) plans, 457 governmental plans, SIMPLE 401(k) plans or SIMPLE IRA's. The Saver's Credit works as follows: For married couples filing jointly, workers with income up to $30,000 are eligible for a 50 percent Saver's Credit for their contributions into a saving plan. Married couples earning $30,001 to $32,500 are eligible for a 20 percent credit, and married couples filing jointly earning $32,501 to $50,000 are eligible for a 10 percent credit. Those earning over $50,000 are not eligible for a credit. For single people or married people filing separately, the Saver's Credit is available for 50 percent of contributions for workers with incomes up to $15,000. Workers with incomes between $15,001 and $16,250 can obtain a 20 percent Saver's Credit. Single workers and married people filing separately who earn between $16,251 and $25,000 can receive a 10 percent Saver's Credit on contributions. Slightly different earnings levels qualify a head of household: (50 percent for incomes up to $22,500; 20 percent for incomes $22,501 to $24,375; and 10 percent of incomes $24,376 to $37,500).

[Whereupon, at 11:44 a.m., the joint committee forum was adjourned.]

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