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SAVING SMARTLY FOR RETIREMENT: ARE AMERICANS BEING ENCOURAGED TO BREAK OPEN THE PIGGY BANK?

HEARING

BEFORE THE

SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

WASHINGTON, DC

JULY 16, 2008

Serial No. 110–32

Printed for the use of the Special Committee on Aging

Available via the World Wide Web: http://www.gpoaccess.gov/congress/index.html
U.S. GOVERNMENT PRINTING OFFICE

48–149 PDF WASHINGTON : 2009

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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ARE AMERICANS BEING ENCOURAGED TO BREAK OPEN THE PIGGY BANK?

WEDNESDAY, JULY 16, 2008

U.S. SENATE
SPECIAL COMMITTEE ON AGING
Washington, D.C.

The committee met, pursuant to notice, at 10:35 a.m., in room SD–562, Dirksen Senate Office Building, Hon. Herb Kohl (Chairman of the committee) presiding.

Present: Senators Kohl, Salazar, McCaskill, and Smith.

Also Present: Senator Schumer.

OPENING STATEMENT OF SENATOR HERB KOHL, CHAIRMAN

The CHAIRMAN. Good morning to one and all, and we thank you all for being here today.

This morning we are going to talk about saving smartly for retirement. Less than 30 years ago, Congress created a new type of savings plan, the 401(k), to help ensure Americans have adequate income in retirement. However, increasingly we are seeing 401(k) funds being treated as rainy day funds, as participants take out withdrawals and loans. Today, we will learn more about the financial repercussions of this practice and examine policies that can best promote the original purpose of 401(k)'s, namely the retention and the growth of retirement savings.

First, let us look at the numbers. According to the Employee Benefit Research Institute, nearly one in five 401(k) plan participants do have an outstanding loan. We will learn from Dr. Weller's testimony that loans and withdrawals are not only increasing in number, but that loan amounts are growing substantially as well. We can only expect that these trends will worsen as more people face economic hardships due to the housing and credit crises and, over the long term, contribute to America's already poor record on savings.

We need to be clear that we are not saying that all 401(k) loans and withdrawals are a bad thing. Research has shown that making loans and withdrawals available for legitimate purposes can help encourage people to participate in 401(k) plans. However, loans and withdrawals can be ill-advised for several reasons, and we believe that participants should be aware of the negative consequences they may have on their retirement savings.

Frankly, I believe that there are some ways of using 401(k) savings that are patently bad, such as the 401(k) debit card. By offering a 401(k) debit card, plans send the message that it is OK to use retirement savings for everyday purchases despite the fact that the high fees associated with its use will drastically diminish savings. When a participant can use his or her 401(k) plan to make casual, everyday purchases, like even buying a cup of coffee, clearly that is a gross distortion of the plan's intended use.

We are also concerned about the high fees many plans charge their participants. These fees can significantly reduce the amount of savings Americans have when they retire. Last fall, I held a hearing to consider the impact of these 401(k) fees and promote their disclosure. Following the hearing, I introduced a bill with Senator Harkin that would require all 401(k) plan managers to reveal to both the employers and workers how much they charge in administrative fees.

Considering the impact fees can have on savings over time, I am concerned about recent advertising campaigns that encourage Federal employees and retirees to move their retirement accounts out of the Federal Thrift Savings Program and into higher-fee accounts. The TSP has the lowest administrative costs of any retirement program in the country, and I believe that these misleading ads are a disservice to hard-working public servants. Therefore, yesterday I sent letters to the companies that we know are running these advertisements asking them to reexamine this practice.

In just a moment, we will hear from several experts and industry officials about how loans and withdrawals can be used more responsibly. We will also hear from the manager of the largest retirement savings plan, the TSP, about their policy on loans and withdrawals. Following today's hearing, I plan to introduce a bill with Senator Schumer that will prohibit the use of 401(k) debit cards and to set a limit on the number of loans a participant can take.

In closing, the bottom line of today's hearing is that 401(k) and similar defined contribution plans were created to ensure that people would have adequate savings for retirement, not as a source of credit to use casually. The Federal Government provides $325 billion in tax benefits over the next 5 years to encourage retirement savings each year. I believe we have a duty to make sure that they are used properly so that all Americans can have a secure retirement.

Let me turn now to Ranking Member Senator Gordon H. Smith for his comments.

[The prepared statement of Senator Kohl follows:]

OPENING STATEMENT OF SENATOR GORDON H. SMITH, RANKING MEMBER

Senator SMITH. Thank you, Mr. Chairman. Ladies and gentlemen, all of you, thank you for being here today and to our witnesses, we appreciate the contribution you are making by your testimony here before this committee.

These are tough times for American families. Gas and food prices are at record highs, and this makes it difficult for many families to fill up their cars and pay for essential groceries.

The current economic environment also makes it difficult for many families to pay their bills on time, or at all. Many people are faced with missing one or two payments that they have every intention of making up the next month, but the next thing you know, they are in a hole trying to dig their way out of debt and just do not have the cash to do it.

Given how common this scenario has become, I am not surprised that many Americans are looking to their retirement savings to help them make ends meet. Fidelity has seen an increase of 16 percent in 401(k) hardship withdrawals in comparing the first quarter of 2007 to 2008.

And according to a survey released in February by the Transamerica Center for Retirement Studies, at the end of last year, 18 percent of workers had loans outstanding from their plans, up from 11 percent in 2006.

Although I understand the reasons, this trend concerns me and us as tapping into 401(k) savings today can have a significant impact on one's level of income at retirement age.

According to Vanguard, an employee who takes out two loans totaling $30,000 from their 401(k) and pays them back in 5 years will have almost $40,000 less in their 401(k) after 30 years than an employee who takes no loans. Considering the median 401(k) account balance in 2006 was about $66,000, $40,000 is a lot of money.

This leads me to my final point, one I have made many times before: Americans need to save more for retirement. For most of us, our 401(k)'s will be our primary source of retirement savings, and $66,000 is certainly not enough money to retire on, especially if you take out another $40,000.

I have been working over the past few years on ways to help Americans increase their retirement savings. I am pleased that Mark Iwry and David John from the Retirement Security Project are with us today to share their perspective and ideas on this topic. Mark and David came up with the concept of the automatic IRA, which Senator Bingaman and I then developed into legislation. Our auto IRA bill would allow those employees not covered by a qualified retirement plan to save for retirement through automatic payroll deposit IRA's. The auto IRA bill is currently under consideration by the Senate, and I hope my colleagues will join me in pushing for its much needed passage.

Again, I thank you all for being here and look forward to this hearing.

Thank you, Mr. Chairman.

[The prepared statement of Senator Smith follows:]

The CHAIRMAN. Thank you, Senator Smith.

At this time, we are pleased to welcome our panel.

Our first witness will be Dr. Christian Weller. Dr. Weller is a Senior Fellow at the Center for American Progress and an Associate Professor of public policy at the University of Massachusetts in Boston. He is an expert on retirement income security and his work has been featured in numerous academic and popular publications.

Next we will be hearing from two witnesses who will share the joint time: Mark Iwry and David John. They are both principals with the Retirement Security Project.

Mr. Iwry is also a Senior Fellow at The Brookings Institution. Previously Mr. Iwry served as the Benefit Tax Counsel at the U.S. Treasury Department between 1995 and 2001 where he was responsible for tax and regulations relating to tax-qualified pension and 401(k) plans.

Mr. John is a Senior Research Fellow at The Heritage Foundation where he has written and lectured extensively on the importance of reforming our Nation's retirement system.

Next, we will be hearing from Gregory Long. Mr. Long is Executive Director of the Federal Retirement Thrift Investment Board, and he serves as the managing fiduciary of the Thrift Savings Plan, or TSP. The TSP is the largest defined contribution plan in the world, serving over 3.7 million current and former Federal employees and uniformed service members with over $200 billion in assets. Previously Mr. Long worked for CitiStreet and Putnam Investments.

Our next witness will be John Gannon. Mr. Gannon is the Senior Vice President for Investor Education at the Financial Industry Regulatory Authority, or FINRA. Previously he served as the Deputy Director of the Office of Investor Education and Assistance at the U.S. Security and Exchange Commission.

And finally, we will be hearing from Bruce Bent. Mr. Bent is the founder and Chairman of The Reserve and its sister company, Reserve Solutions. The Reserve manages over $120 billion in assets, making it the third largest family owned asset manager in the United States.

We welcome you all. We look forward to hearing from you and we would appreciate it if you would hold your testimony to 5 minutes. Mr. Weller?

STATEMENT OF CHRISTIAN E. WELLER, PH.D., ASSOCIATE PROFESSOR, DEPARTMENT OF PUBLIC POLICY AND PUBLIC AFFAIRS, UNIVERSITY OF MASSACHUSETTS BOSTON; AND SENIOR FELLOW, CENTER FOR AMERICAN PROGRESS ACTION FUND, WASHINGTON, DC

Dr. WELLER. Thank you very much, Chairman Kohl, Ranking Member Smith, for inviting me here to talk about 401(k) loans and trends in those loans and the causes of those loans.

I will make the point that demand for 401(k) loans is largely driven by economic necessities. The economic necessities are unemployment, bad health, and home ownership, especially during the housing boom. Now, as the housing crisis grips the country, more and more individuals are tapping their 401(k)'s to help smooth over the troubled economic times. But this means that families leveraged their retirement security to ease their present financial insecurity.

To counter this trend, policymakers must reduce the need for people to borrow. This will require substantial improvements to income growth for American families and a commitment to providing health and unemployment insurance to citizens who experience unexpected health expenditures and job loss.

Let me give you a little bit of background on 401(k) loans. When families encounter rising demands on their budgets such as medical emergency, a spell of unemployment, or higher cost for necessary items, including housing, they often turn to consumer loans to help them smooth over a rough patch. Workers who are covered by a 401(k) can borrow from their own savings. An account holder may borrow up to half of his or her retirement savings with no penalty as long as the loan is repaid within 5 years. The interest rate is low, typically 1 to 2 percent above the prime interest rate, but there are clear drawbacks. Once the money is out of the retirement account, it does not earn a rate of return. The low interest rate also means that you get low additions to retirement savings, and if you do not pay the loan, there are substantial penalties.

The impact of the 401(k) loans can be severe. We calculate in our paper that we are releasing today with the Center for American Progress some hypothetical examples. We find that if you take out $5,000 in loans as a typical worker, in the first 5 years of having such a loan, you can reduce your retirement savings by the end of your career by up to 22 percent depending on the various assumptions. That is a substantial reduction in retirement savings.

This reduction in retirement savings comes typically at a time when other retirement income is also going down. This is the case right now. Housing values have fallen at the fastest rate in more than 3 decades and financial markets have been in turmoil for a year now decimating existing retirement savings. At the same time, families are increasing their borrowing from 401(k) loans due the growing economic hardships.

We also find that 401(k) loans generally add to the total debt burden the families have. They do not substitute for other loans. 401(k) loans grew in total amount to $31 billion in 2004, the last year for which we have data, up from $6 billion in 1989, an increase of almost 400 percent. This reflects just simply the fact that more people have loans and have the access to those loans.

But it also means that borrowers are tapping out on other loans. What we find in particular is the 401(k) loan holders have typically median debt payments relative to income of 22.5 percent of their income, substantially higher for those who do not have those loans, 18 percent. This would not be the case if 401(k) loans substituted for other forms of debt.

There have been a number of important shifts in terms of demographic characteristics of who is taking out the loans. The differences between minorities and whites have been shrinking, meaning whites have been taking out loans faster than minorities over time. 401(k) loan holders also have gotten younger and they have also become more educated over time. So this is becoming increasingly a middle class phenomenon, if you will.

The reason why people borrow is because they have to. The primary reason we find is bad health. A spell of bad health increases having a loan by more than 50 percent. Also, home ownership, especially during the housing boom, has forced people to borrow more from their 401(k) loans. However, that comes at a cost. We find that home owners who have a 401(k) loan typically have higher mortgage payments, less equity, and are more likely to have an adjustable rate mortgage. That means basically home owners who are financially tapped out otherwise are now borrowing from their 401(k)'s to basically just afford the down payment in the housing boom period.

So the solution here for us at least is that we need to find ways to keep people from borrowing, from tapping into retirement income security. That means we need to strengthen income growth, but we also need to create a stronger social safety net so that people do not have to use their 401(k) plans as supplemental unemployment insurance or health insurance.

Thank you very much.

[The prepared statement of Dr. Weller follows:]

Robbing Tomorrow to Pay for Today

Testimony before the U.S. Senate Special Committee on Aging at the hearing on protecting and strengthening 401(k) retirement savings

July 16, 2008

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Introduction and Summary

Thank you very much, Chairman Kohl, Ranking Member Smith and members of the committee for inviting me to speak to you this morning.

My testimony will focus on trends in loans from 401(k) plans and the reasons for these loans over time.

Imagine that you or someone in your family who relied on you for financial help were faced with unexpected medical bills that you could not afford with your current income. Luckily, you have managed to save a nest egg for retirement through your 401(k) plan, the most common defined-contribution retirement savings plan in the United States today, and you can simply borrow against that to keep the bill collectors at bay. Since the money is yours, there is no approval. You may borrow up to half of your retirement savings with no penalty so long as you pay it back within 5 years. Even better, the interest rate on these borrowed funds is lower than those on many other loans.

However, while the money is out of your retirement account you are not receiving an investment return. You are also paying yourself a below market rate of interest, which means that as a lender to yourself you are not being paid in full. And should you fail to pay the loan back you will have to pay taxes on the monies and pay a 10 percent penalty on top of that. Finally, the interest payments you are paying yourself are helping to grow your retirement savings, but you have paid them in after-tax dollars, and will have to pay taxes on that "gain" again when you retire and receive money from the account.

Given the significant downsides to 401(k)-type loans, why do people take them? Families take these loans because they are either uninsured or underinsured for the risks they face. Over the past few years, families looked for new ways to bridge the gap between slow income growth and rapidly rising prices, especially for houses, but also for food, energy, and health care. This search more often than not led them to household credit, but as families amassed ever-larger amounts of household debt they sometimes also sought out additional financial resources, such as their retirement plans.

Now, as the housing crisis grips the country, more and more individuals are tapping their 401(k)s. Most defined-contribution (DC) plans allow individuals to borrow from their 401(k)s. At the same time, these plans have become more widespread.[1] The result is that families leverage their future retirement security to ease their present financial insecurity.

To reduce the likelihood of workers leveraging their retirement to cover current catastrophes, policymakers must reduce the need for people to borrow. Policy solutions will require substantial improvements to income growth for America's families, and a commitment to providing health and unemployment insurance to citizens who experience unexpected health expenditures and job loss. To understand the need for such policy actions, this report considers the evidence on loans drawn from DC plans from 1989 to 2004, the last year for which complete data are available. The data show the following.

- Even with a fairly modest loan amount of $5,000 in 2008 dollars, a worker's retirement savings could be substantially reduced. For instance, a 401(k) plan participant who takes a loan to smooth over an economic rough patch, and makes only the loan payments, reduces their total retirement savings between 13 percent and 22 percent.

- Loans from DC plans have risen sharply. Over a period of 15 years, loans against retirement savings accounts increased almost fivefold in inflation-adjusted terms, to $31 billion in 2004, up from $6 billion in 1989—an increase of almost 400 percent. This reflects in large part the fact that many more people save for their retirement with defined-contribution plans and thus have access to these loans.

- Despite beneficial interest rates, loans from DC plans add to the overall debt burden and do not seem to substitute for other forms of debt. 401(k) plan participants who borrowed from their DC plans had median debt payments relative to income equal to 22.5 percent after 1995, while those who did not borrow paid only 18.0 percent. This difference in debt payments relative to income, 4.5 percentage points, had grown from 0.6 percentage points between 1989 and 1995.

- There have been important changes by demographic characteristics. Over the period under examination, borrowers from their 401(k)s were more equal by race and ethnicity. Loans among white 401(k) plan participants have become relatively more likely than among their African-American or Hispanic counterparts. Also, families with DC loans have gotten younger and have become more concentrated among families with high school degrees.

- The evidence shows that middle-class families in particular rely on their retirement savings accounts to provide them with easily accessible loans. This is particularly true when families buy a home, experience a spell of unemployment, and are burdened by bad health.

- There is no link between loans from DC plans and conspicuous consumption. If anything, families which exhibit a positive attitude toward borrowing for conspicuous consumption are underrepresented among families with loans from DC plans that were used for the purchase of goods and services.

The data point the way for current trends. As the economy slows, people are losing their jobs, and wage gains are falling behind sharply higher prices for energy, health care, transportation, and food. Families need to find ways to smooth themselves over the current rough patch even more so than in 2004, the endpoint of our analysis of the available data. With other venues to borrow money, particularly home equity lines, closed off due to lower house prices, tighter credit standards, and slower income growth, families are turning increasingly to the easily accessible loans from their 401(k) plans. The data through 2004 is a harbinger of the erosion in retirement security to come as families are economically squeezed from all sides.

The Basics: Loans from 401(k)-Type Plans

Over time, more people have DC plans and more people with DC plans can borrow from their DC plans. Specifically, among families with 401(k) plan participants between the ages of 25 and 64, the share with a DC plan increased to 39.7 percent in 2004 from 25.2 percent in 1989. During the same period, the share of families with a DC plan who could borrow from their DC plan rose to 72.2 percent from 60.5 percent.[2,3]

These trends show that an ever-growing share of families had access to DC loans, but there are good reasons to believe that the number of people with such loans has increased. In fact, previous researchers have found some indications for growth of DC loans. For instance, Annika Sunden and Brian Surette found in 2000 that the share of families that have a DC loan outstanding rose to 5.3 percent in 1998 from 2.1 percent in 1992.[4] More recently, the Employee Benefit Research Institute reported that an average of 18 percent of people with a 401(k) plan had a loan outstanding in 2006, compared to 19 percent in 2005, 18 percent in 2000 and in 1996.[5] Because the share of people with a 401(k) plan has also risen at the same time, more people and a greater share of the entire population had such loans over this 10-year period.

One of the reasons for the growth of people with these loans is that a loan from a 401(k) is easy and convenient for the borrower. The borrower acts like a bank to himself or herself, albeit within some limits.[6] People with a 401(k)-type plan can borrow $50,000 or one half of the vested balance from the account, whichever is lower. Any loan has to be repaid within 5 years or less, except for loans that have been taken out for the first-time purchase of a home and can be repaid over a period of up to 15 years.

The interest rates on these loans are generally very favorable. For instance, in 1996, it was "found that about 70 percent of the 401(k) plans that allow[ed] borrowing charge[d] an interest rate equal or less than the prime rate plus one percentage point, while less than 10 percent charge[d] and interest rate equal to the local bank's lending rate."[7] The repayment of the loan is not tax deductible, though, and neither are the interest payments unless the loan is secured by the primary residence.

Borrowers can incur penalties if they do not repay the loan to their 401(k)-type plan. Borrowers may leave a job before the final payments are due or they fail to make the agreed upon payments during the term of the loan. If this happens, the outstanding loan amount is considered a taxable distribution from the 401(k)-type plan. In particular, if the borrower is less than 59-and-one-half years of age, they will have to pay income tax on the outstanding loan amount plus an additional 10 percent as excise tax. If they are older than 59 and one-half, they are no longer subject to the excise tax, but still have to pay the income tax.

Over time, the U.S. Internal Revenue Service has clarified some rules, especially with respect to the timing of loan repayments. The IRS clarified some of the rules governing loans from 401(k) plans. Specifically, employers are permitted to give employees a grace period before the outstanding loan balance becomes a taxable income to the employee.

This grace period may not extend beyond the last day of the calendar quarter following the quarter during which the last payment was due.

Also, employers can increase the required installments to repay the loan according to the original schedule after employees return from leaves of absence. In addition, the new rules also clarify how much of the original loan is considered taxable when more than the maximum amount is borrowed. Furthermore, having more than two loans a year is considered a distribution subject to income taxes and a 10 percent excise tax. For those in military service, payments must resume after the end of the service, and the loan must be paid off by the end of its original term plus the period of military service. All of these changes became effective for loans made on or after January 01, 2004.[8]

Loans from Retirement Savings Plans Can Substantially Reduce Retirement Income

The basics of borrowing from a 401(k) plan highlight the dichotomous nature of loans from one's own retirement savings accounts. On the one hand, such loans are easily accessible and thus can reduce financial insecurities. On the other hand, these loans can also exacerbate current and future financial insecurity. They carry the risk of substantial tax penalties if the borrower fails to repay the loan in time due to job loss or other unforeseen circumstances. And repaying such a loan may mean that a worker is saving less for retirement than they otherwise would have, which can mean less retirement income in the future.

We calculate a few hypothetical examples to simulate the reduction in retirement savings that could come about as a result of a worker taking out a pension loan to the amount of $5,000 in 2008 dollars.[9] How much a 401(k) plan participant loses in terms of retirement savings, if anything, from taking out a loan against retirement savings depends on a number of factors, specifically:

- The interest rate charged for the loan.
- The interest rate earned on savings.
- Whether the borrower keeps up with contributions to the retirement savings plan in addition to repaying the loan.
- When the loan is taken out.

If the interest rate on the loan is less than the rate of return on the DC retirement savings plan, then the worker loses money because lending to oneself is less profitable than investing in stocks and bonds. But if the worker continues to make contributions to the 401(k) plan, then they will more quickly fill the hole that was created by taking out the loan. Finally, if a worker takes out a DC loan toward the end of a career, then the 401(k) plan has had more years to build up retirement savings and fewer years of compound interest to lose on the loan amount that is taken out.

We generate a range of simulations to illustrate these aspects. First, we allow the interest rate on the loan to vary, equaling 7.8 percent, 7.3 percent, or 8.3 percent. Over the past 10 years—from 1997 to 2007—the prime rate, to which interest rates on DC loans are often tied, has averaged 6.8 percent.[10] Thus, our interest rate assumptions reflect an implicit assumption that interest rates on DC loans are equal to prime plus 1 percent.

Second, we assume that the loan is taken out after 5 years, 10 years, or 15 years. And third, we model the outcomes when either a worker makes or foregoes additional contributions. For the case of additional contributions, we assume that the worker makes only the loan payments, or makes the same amount of payments that would have been made if there hadn't been a loan—whichever is larger—or makes the loan payments and continues to contribute the original saving amount.

The simulations illustrate the basic facts about borrowing from one's own DC retirement savings accounts. In particular, lower loan interest rates mean larger losses, and later start dates of a loan translate into smaller losses, as do additional contributions.

Even with a fairly modest loan amount of $5,000 in 2008 dollars, a worker's retirement savings could be substantially reduced. For instance, if the worker only makes the loan payments—which could be a reasonable assumption if the worker took out the loan to smooth over an economic rough patch—then total retirement savings are reduced between 1 percent and 22 percent (Table 1). The exact reduction depends on the loan interest rate, on the timing of the loan, and the level of additional contributions made outside of the loan repayment. Lower interest rates, earlier loans, and fewer additional contributions reduce retirement savings more than higher loan interest rates, later loans, and larger additional contributions.[11]

It is important to realize, though, that simulation scenarios that assume large additional contributions are probably not very realistic. As our analysis further below shows, many families take out loans because demands on their incomes have increased due to a spell of unemployment, bad health, or the purchase of a home. It thus seems unrealistic to assume that a large share of families with DC loans will continue to make their original contributions while also repaying their DC loans.

Table 1
Losses of Retirement Savings from Borrowing from a Retirement Savings Account

	Loan taken after 5 years		Loan taken after 10 years		Loan taken after 15 years	
	Account balance in year 35	Percent of no-loan balance	Account balance in year 35	Percent of no-loan balance	Account balance in year 35	Percent of no-loan balance
No loan	835,458					
Make loan payments						
7.3 percent loan	651,997	78.0	692,886	82.9	724,632	86.7
7.8 percent loan	653,020	78.2	693,642	83.0	725,191	86.8
8.3 percent loan	654,048	78.3	694,402	83.1	725,754	86.9
Make the larger of either loan payments or contributions without loans						
7.3 percent loan	703,921	84.3	734,893	88.0	756,067	90.5
7.8 percent loan	704,385	84.3	735,236	88.0	756,288	90.5
8.3 percent loan	704,852	84.4	735,582	88.0	756,510	90.6
Continue to make contributions and repay the loan						
7.3 percent loan	831,543	99.5	832,563	99.7	833,318	99.7
7.8 percent loan	832,565	99.7	833,319	99.7	833,877	99.8
8.3 percent loan	833,594	99.8	834,080	99.8	834,439	99.9

Notes: Authors' calculations. See text for details on simulation and their assumptions. All account balances are in dollars. Ratios to no-loan balance are in percent. Dollar amounts are not adjusted for inflation. Nominal rate of return is 9.2 percent.

Workers who borrow from their own DC retirement savings may not have other options as they may encounter hard economic times. The numbers, though, make it clear that more financial security today is traded off against substantially less economic security in the future.

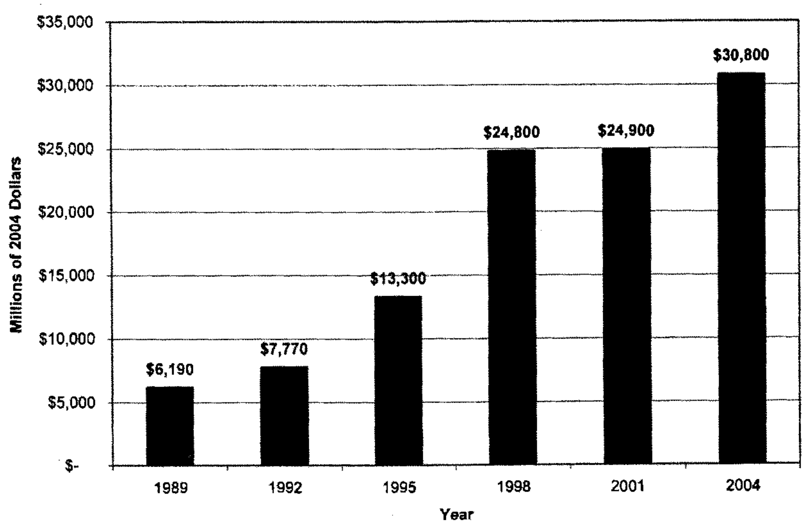
This is especially troublesome since many workers with DC plans are already at risk of substantially lower income in retirement. Researchers at the Center for Retirement Research at Boston College, for instance, calculate that 49 percent of early baby boomers born between 1946 and 1954 who also have a DC plan are at risk of not being able to maintain their standard of living in retirement. For late boomers, born between 1955 and 1964, the share of families at risk increases to 52 percent.[12] Thus, DC loans have serious ramifications for retirement income security since DC plans have increasingly become the only retirement savings plan for many workers.[13]

Loans from Retirement Savings Accounts Are Up Sharply, Contributing to Families' Financial Squeeze

Borrowing from one's own DC account is comparatively easy. As long as a DC plan permits it, there are only a few restrictions and, more importantly, there is only a limited loan application process involved. A family with one or more 401(k) plan participants may thus turn to borrowing from its own retirement account when getting a loan from a bank is impossible or too expensive to do.

This may explain the growth of the total amount of loans outstanding against retirement accounts over time (Figure 1). Over a period of 15 years, loans against DC retirement savings accounts increased almost fivefold in inflation-adjusted terms, to $31 billion in 2004, up from $6 billion in 1989—an increase of almost 400 percent.

Total 401(k) Loans, In 2004 Dollars



Source: Authors' calculations based on various years of Board of Governors, Federal Reserve System, Survey of Consumer Finances, Washington, DC: BOG. All figures are in millions of dollars. Dollar figures are adjusted for inflation using the CPI-U-RS.

This upward trend reflects in part larger loan amounts, at least after 1995. The inflation-adjusted amount of loans for the typical (median) family rose from $2,462 in 1995 to $4,000 in 2004, after declining in the preceding years (Table 2).[14] Similarly, the average loan amount grew by 61.3 percent from $4,912 in 1995 to $7,932 in 2004. At a time when other forms of consumer loans, particularly mortgages and home equity lines, became more readily available, families also sharply ramped up their borrowing from their retirement accounts. From 2001 to 2004 alone, the median loan amount increased by 25.2 percent and the average amount rose by 12.6 percent.

It is critical to keep in mind that the growth in outstanding loans reflects many more people with a DC loan over time. In particular, an increasing share of families have a DC plan and more people can borrow from their DC plans.[15]

Table 2
Loan Amounts for Families with Loans from Their DC Plans

Year	1989	1992	1995	1998	2001	2004
Median loan amount	4,398	2,636	2,462	3,478	3,195	4,000
Average loan amount	8,332	5,002	4,917	6,093	7,046	7,932

Source: In all instances, the demographic characteristics refer to the head of household. Inflation adjustments are done using the Bureau of Labor Statistics' CPI-U-RS. Notes: All amounts are in 2004 dollars. Only data for families with loans from their DC plans are considered. Only families between the ages of 25 and 64 are included.

Given this sharp increase in loans from DC plans, the immediate question arises: If families simply substituted loans from DC plans for more costly loans, then families with loans from DC plans should have lower debt payments relative to income than their counterparts.

This is clearly not the case. Families who had DC plans and who borrowed from these accounts had median debt payments relative to income equal to 22.5 percent after 1995, while families who did not borrow paid only 18.0 percent. Interestingly, the difference in debt payments relative to income between families with loans from DC accounts and those without loans grew from 0.6 percentage points in the early years to 4.5 percentage points in the later years (Table 3). Borrowing from DC plans thus added to the overall debt burden of families during the years, when other household debt also increased.

Table 3
Median Debt Payments Relative to Income, by Loans from DC Plans

	Families with loans from DC plans	Families without loans from DC plans
Before 1998	18.0	16.6
After 1995	22.5	17.2

Source: Authors' calculations based on various years of Board of Governors, Federal Reserve System, Survey of Consumer Finances, Washington, DC: BOG. Notes: All figures are in percent. Only data for families with DC plans are considered. Only families between the ages of 25 and 64 are included. In all instances, the demographic characteristics refer to the head of household.

More White Families, Younger Families, and Families with a High School Education Borrow from Their DC Plans

We determine whether a connection between demographic factors and loans from DC plans exists by examining two measures. First, we consider the distribution of family demographics for families with and without DC loans. We then calculate the ratio between the two distributions. A ratio greater than one indicates that families with particular demographic characteristics are overrepresented among families with loans from DC plans. A ratio of less than one indicates that a group is underrepresented.

Second, we consider the likelihood of borrowing from a retirement savings plan among families with specific demographic characteristics. In this way, we can gauge if families with certain characteristics are more or less likely than their counterparts to borrow from their DC plans, given that they have a DC plan.

The data show three interesting changes over time. First, African Americans, Hispanics, and other racial groups used to be substantially more likely to have loans from their DC plans than white families. After 1995, however, African-American families were the only families to be overrepresented in having a DC loan. In general, the chance of having a loan has become more equal by race and ethnicity after 1995.

Second, families with loans from their DC plans have become younger. Prior to 1998 the largest overrepresentation with respect to age occurred for families between the ages of 45 and 54. After 1995, the largest overrepresentation occurred for families between the ages of 35 and 33. Specifically, there were 17.9 percent more families in this age range among families with DC loans than among families without such loans. Also, once families in this age range had a DC plan, they had a probability of 13.8 percent of borrowing from it, higher than for any other age group, after 1995.

Third, families with DC loans have become more concentrated among families with high school degrees. After 1995, the largest overrepresentation occurred among families with high school degrees, while prior to 1998, all families with less than a college degree were about equally overrepresented among families with DC loans. See the table below for a complete breakdown of all three of our findings.

Table 4
Demographic Characteristics and Pension Loans

	1989-1995				1998-2004			
	Share among families with loans	**Share among families without loans**	**Ratio of families with loans to those without loans**	**Share of families with pension loan**	**Share among families with loans**	**Share among families without loans**	**Ratio of families with loans to those without loans**	**Share of families with pension loan**
Race/Ethnicity								
White	74.9	83.6	**0.9**	7.3	78.5	80.5	**1.0**	11.7
Black	14.4	8.5	**1.7**	13.1	13.1	10.7	**1.2**	14.3
Hispanic	6.4	4.5	**1.4**	11.1	5.0	5.1	**1.0**	11.8
Other	4.3	3.5	**1.3**	10.0	3.3	3.8	**0.9**	10.8
Age								
25-34	24.1	27.6	**.9**	7.2	19.8	22.6	**0.9**	10.6
35-44	37.2	35.0	**1.1**	8.6	39.0	33.0	**1.2**	13.8
45-54	30.7	25.3	**1.2**	9.7	29.8	28.3	**1.1**	12.5
55-64	8.1	12.2	**.7**	5.5	11.4	16.1	**0.7**	8.8
Education								
No HS or GED	5.9	5.4	**1.1**	8.2	4.5	4.6	**1.0**	11.6
HS or GED	28.6	27.4	**1.1**	8.5	34.5	26.2	**1.3**	15.2
Some college	22.8	20.3	**1.1**	9.0	20.8	18.7	**1.1**	13.1
College	43.1	46.9	**0.9**	7.5	40.2	50.5	**0.8**	9.8

Source: Authors' calculations based on various years of Board of Governors, Federal Reserve System, Survey of Consumer Finances, Washington, DC: BOG.
Notes: All figures (other than ratio) are in percent. Only families between the ages of 25 and 64 are included. In all instances, the demographic characteristics refer to the head of household.

401(k) Loans Smooth Bumps in the Road and Make Home Purchases Easier

When we consider the evidence on why families may have taken out loans from their DC retirement savings accounts, we find that homeownership but also unemployment spells and health care issues likely contributed to the rise in debt. That is, families typically borrow from their DC plans because they need to, not out of conspicuous consumption.

The primary reason for loans that were taken out against balances in DC plans were the purchase of goods and services, including consumer durables, such as refrigerators, but also services, such as financial advice. As our figures show further below, families borrowed money largely to purchase these often necessary goods and services since they had no other way of paying for them. In fact, loans for goods and services rose to about 45.3 percent in 2004 from about 36 percent in 1998 and 2001 (Table 5).

This rise in loans for purchasing goods and services between 2001 and 2004 came at the expense of loans for home purchases, which may reflect that mortgages became more readily available during that period of time. The share of DC loans that were taken out for home purchases dropped to 13.4 percent in 2004 from 24.4 percent in 2001. Families likely had to rely less on the easy access to this particular form of debt because there was comparatively easy access to mortgages and home equity lines.

In comparison, education and medical loans grew after 2001, when prices for both higher education and medical care once again rose sharply.[xvi] The increase in the share of loans for education and medical expenses rose by 4.8 percentage points between 2001 and 2004, from 6.7 percent in 2001 to 11.5 percent in 2004, thus compensating for approximately half of the decline in the share of loans for home purchases and improvements, data which is also reflected in the table below.

Table 5
Reasons for Loans from DC Retirement Savings Accounts

Loan Reason	1998	2001	2004
Home purchase	26.2	24.4	13.4
Home improvement	8.5	10.3	9.5
Vehicles	10.5	17.3	14.6
Goods and services	36.1	36.3	45.3
Investments and other real estate	2.7	5.0	5.7
Education, medical expenses and professional services	16.1	6.7	11.5

Source: In all instances, the demographic characteristics refer to the head of household. Authors' calculations based on various years of Board of Governors, Federal Reserve System, Survey of Consumer Finances, Washington, DC: BOG. Notes: All notes are in percent. Similar information is not publicly available prior to 1998. Only data for families with loans from their DC plans are considered. Only families between the ages of 25 and 64 are included.

Primarily, though, people borrow from their DC plans to purchase goods and services. This could reflect a drop in income due to a job loss or additional demands on household income due to health care needs or the purchase of a home. These effects may not be fully captured in the loan categories discussed above. For instance, a family in which one or two family members are in bad health may pay for their medical bills out of their income, but they may have to borrow from their DC plans to cover other large expenditures. We thus try to capture the potential effect of unemployment, health status, income, and homeownership on the likelihood of having a loan from a DC plan.

The figures indicate that there is a link between most of these events and the probability of a DC pension plan loan. For instance, there were 63.1 percent more families with an unemployed family member among families with loans than among families without loans prior to 1998. In the later years, the difference rose to 163.2 percent. Also, unemployed families were much more likely than employed ones to have a loan prior to 1998. The opposite, though, is true after 1995.

This, combined with the previous fact that unemployed families are disproportionately represented among families with DC loans, indicates that families experiencing a spell of unemployment after 1995 also had a lot more access to DC retirement savings accounts. This may simply reflect the fact that unemployment became a more long-term and more middle-class phenomenon after 2000.[xvii] Middle-class families tend to be more likely to have DC retirement savings accounts than lower-income ones, and thus have more ability to dip into their savings when they experience an unemployment spell. Consequently, unemployment tends to be associated with loans from DC plans, and it seems that unemployment has become more widespread among families with DC plans.

Having a family member in bad health also raises the likelihood of having a loan. Families with a family member in bad health were between 39.4 percent and 47.6 percent more likely than families in good health to have a loan after 1998, reflecting a growing difference by health status over time (Table 6). Also, families, with a member in bad health were more likely to borrow from their retirement savings accounts. After 1995, for example, roughly 16 percent of families with a family member in bad health had a loan, compared with only 11.0 percent for families in good health.

The figures by homeownership require a little more discussion because renters are actually somewhat disproportionately represented among families with loans. Once we look at homeowners and renters with DC retirement savings accounts, though, we see that homeowners are much more likely to borrow from their accounts. After 1995, 12.4 percent of homeowners borrowed from their retirement accounts, compared to 10.1 percent for renters. The table below details all of these trends.

Table 6
Economic Characteristics and Pension Loans

	1989-1995				1998-2004			
	Share among families with loans	Share among families without loans	Ratio of families with loans to those without loans	Share of families with pension loan	Share among families with loans	Share among families without loans	Ratio of families with loans to those without loans	Share of families with pension loan
Income								
Bottom Quintile	3.4	4.3	**0.8**	6.6	2.1	4.7	**0.5**	5.6
2nd Quintile	19.3	18.7	**1.0**	8.3	21.1	19.7	**1.1**	12.7
Middle Quintile	36.6	36.2	**1.0**	8.2	29.5	36.4	**0.8**	12.9
4th Quintile	36.9	34.9	**1.1**	8.5	35.5	35	**1.0**	12.1
Top Quintile	3.8	5.9	**0.6**	5.4	1.8	4.2	**0.4**	5.5
Housing Situation								
Renter	23.5	21.9	**1.1**	8.6	16.3	19.7	**0.8**	10.1
Owner	76.5	78.1	**1.0**	19.7	83.7	80.3	**1.0**	12.4
Employment								
Employed	83.0	81.1	**1.0**	8.3	82.9	82.2	**1.0**	12.0
Unemployed	2.0	1.2	**1.7**	12.7	2.0	0.8	**2.5**	4.7
Not in labor force	15.0	17.7	**0.9**	7.0	16.4	15.8	**1.0**	12.3
Health Status								
Missing	83.0	85.6	**1.0**	9.4	75.6	83.3	**0.9**	11.0
Poor Health								
1 person	13.0	12.1	**1.1**	10.7	20.9	14.2	**1.5**	16.7
2 people	3.1	2.3	**1.4**	13.3	3.5	2.5	**1.4**	15.9

Source: Authors' calculations based on various years of Board of Governors, Federal Reserve System, Survey of Consumer Finances, Washington, DC: BOG.
Notes: All figures (other than ratio) are in percent. Only families between the ages of 25 and 64 are included. In all instances, the demographic characteristics refer to the head of household, except for employment and health status. A family is characterized as unemployment if the head of household, his or her spouse, or both are unemployed. The data indicate a family as having one person in bad health if the head of household or the spouse are in bad health.

The important question, though, is whether homeowners who borrowed from their DC plans face better or worse financial conditions. Specifically, we can imagine two situations when prospective homeowners dip into their retirement savings to buy a house. First, a DC loan may allow a family over a threshold down payment for a first home, or allow them in some other way to buy a home that they otherwise couldn't "afford," or perhaps permit them to buy their home on terms better than those prevalent in the market.

If the first case scenario is prevalent, we should find that homeowners with DC plans are generally more financially stretched than their counterparts without DC plans. This could manifest itself in less home equity, a greater share of adjustable-rate mortgages, higher mortgage payments relative to income, and lower home values relative to income. By comparison, if the second scenario is more prevalent, homeowners with loans from their DC plans should be financially more secure, at least with respect to their residential real estate assets.

We discover in our analysis that homeowners with DC loans tend to be in a more precarious financial situation than the ones without such loans. Homeowners with DC loans have less home equity, $44,627, than homeowners without a DC loan, $69,000—a telling difference of 54.5 percent—for the years 1998 to 2004. In fact, this difference has widened from 28.0 percent between 1989 and 1995.

Similar gaps, at least after 1995, exist for all other measures. Homeowners who borrow from their DC plan tend to have higher mortgage payments relative to income, own less home relative to income, and have a substantially higher probability of borrowing with an adjustable-rate mortgage compared to homeowners who do not have a loan from their DC plan . For example, the difference in the likelihood of having an adjustable-rate mortgage is 17.7 percent for homeowners with a loan from their DC plan compared to only 11.1 percent for homeowners without such a loan.

Homeowners with DC loans also tend to be in a financially more precarious situation than their counterparts. This suggests that a loan from a DC plan allows families who otherwise would not have been able to afford a home to purchase one, although this increased leverage comes at a cost. DC loans do not seem to be used to negotiate better financial terms, for example by offering a larger down payment. The table below details our findings.

Table 7
The Link between Loans from DC Plans and Homeowners' Finances

Variable	Time period	Family has a loan from their DC plan	Family has no loan from their DC plan
Median home equity (in 2004 dollars)	Before 1998	46,167	59,091
	After 1995	44,627	69,000
Median mortgage payment relative to income (in percent)	Before 1998	14.5	12.1
	After 1995	13.9	12.5
Median home value relative to income (in percent)	Before 1998	183.2	174.3
	After 1995	161.8	181.2
Share of homeowners with ARM (in percent)	After 1995	17.7	11.1

Source: In all instances, the demographic characteristics refer to the head of household. Authors' calculations based on various years of Board of Governors, Federal Reserve System, Survey of Consumer Finances, Washington, DC: BOG. Notes: Only data for home owning families with a DC plan are considered. The figures change only marginally, when all home owning families are considered. Only families between the ages of 25 and 64 are included.

Finally, the link between income and DC retirement account loans is not as straightforward as one might assume. Generally speaking, families in the middle 60 percent of income distribution are disproportionately represented among families with pension loans. These families are also more likely to borrow from their retirement accounts, when they have one, compared to low-income and high-income families. That is, loans from retirement savings accounts are more a middle-class phenomenon than a low-income one (Table 6).

The evidence shows that middle-class families use their retirement savings to provide them with easily accessible loans. This is particularly true when families buy a home, experience a spell of unemployment, or are burdened by bad health.

Loans from DC Plans Not Linked to Conspicuous Consumption

Alternatively, families with DC pension plan loans (especially those used for goods and services, the largest reason for such loans) may be more prone to conspicuous consumption than other families. We consider a number of variables, which measure families' attitudes toward saving and debt.[xviii]

We then see if they are systematically linked to the probability of having a loan outstanding that was used for goods and services, if they have a loan in general, and if so, how much they borrowed.

If anything, families that exhibit a propensity for debt and for borrowing to finance conspicuous consumption are underrepresented among families, who have loans outstanding that were used to purchase goods and services. Only 28.6 percent of families, for instance, with such loans between 1998 and 2004, are considered aggressive borrowers—the smallest group. In comparison, conservative borrowers made up 33.1 percent of families with loans against DC plans that were taken out to finance purchases of goods and services (Table 8).

In addition, 77.0 percent of families in this category did not think it was a good idea to borrow to finance a vacation, a fur coat, or jewelry, and only 23.1 percent did. Finally, families in this category are evenly split between savers and non-savers. There is no evidence that families exhibiting a positive attitude toward debt, particularly for conspicuous consumption, are the driving factor behind loans against DC plans that were borrowed to finance purchases of goods and services.

In addition, the amounts borrowed by families, who are less likely to save and show a greater acceptance of borrowing for conspicuous consumptions, tend to be smaller in absolute terms and relative to income than for other families. For instance, the median loan amount relative to income for aggressive borrowers was 4.2 percent, well below the relative outstanding loan amount of moderate and conservative borrowers. Similarly, families indicating that they are less likely to save and more prone to borrow have actually smaller outstanding loan amounts, both in absolute terms and relative to income (Table 8).

Another way of thinking about this is to consider if the general attitudes of those who had DC loans for goods and services differed from those who had DC loans for other purposes and from those who had no DC loans. The data suggest that those families taking out DC loans for goods and services were actually more careful borrowers than other families. In particular, only 28.6 percent of families with a DC loan for goods and services fall into the "aggressive borrower" category, as compared with 36.6 percent of families with DC loans for other purposes and 32.0 percent for families who had no DC loans.

What's more, there is no difference among these three groups of families with respect to the proportion of families self-identified as conspicuous consumers. It is only with respect to families' attitudes toward saving that there is a clear difference. Families with DC loans are less likely to be identified as savers, which may reflect their inability to save due to low income relative to their expenditures and not necessarily their desire to save.

There is thus no indication that loans from DC plans were primarily driven by a desire for conspicuous consumption, but rather they seem to reflect economic necessities (Table 9).

Table 8
Families with DC Loans for Goods and Services:
Personal Attitudes Toward Debt and Saving, 1998-2004

	Borrower Type			Conspicuous Consumption		Saver	
	Aggressive	Moderate	Conservative	Yes	No	No	Yes
Share among families (in percent)	28.6	38.3	33.1	23.1	77.0	49.1	50.9
Median loan amount (in 2004 dollars)	3,000	4,000	2,898	1,598	3,200	2,319	4,047
Ratio of median loan amount to income (in percent)	4.0	5.7	5.1	3.2	5.5	4.8	5.2

Source: Authors' calculations based on various years of Board of Governors, Federal Reserve System, Survey of Consumer Finances, Washington, DC: BOG.
Notes: Aggressive borrowers believe it is a good idea to buy goods on an installment plan, moderates believe is it both good and bad, conservatives believe it is a bad idea. Conspicuous consumers believe it is okay to borrow for jewelry, furs, or vacation purchases. Only families who have DB loans and who stated that they used the loan to finance goods and services are included. Only families between the ages of 25 and 64 are included. In all instances, the demographic characteristics refer to the head of household.

Table 9
Comparison of Attitudes of Families with DC Loans for Goods and Services with Those Without

	Percentage of aggressive borrowers	Average conspicuous consumption score	Average saver score
Family has DC loan for goods and services	28.6	0.8	0.5
Family has DC loan, but not for goods and services	36.6	0.8	0.6
Family has no DC loan from their DC plan	32.0	0.8	0.7

Source: Authors' calculations based on various years of Board of Governors, Federal Reserve System, Survey of Consumer Finances, Washington, DC: BOG. Notes: Aggressive borrowers believe it is a good idea to buy goods on an installment plan, moderates believe is it both good and bad, conservatives believe it is a bad idea. Conspicuous consumers believe it is okay to borrow for jewelry, furs, or vacation purchases. Only families who have DC loans and who stated that they used the loan to finance goods and services are included. Only families between the ages of 25 and 64 are included. In all instances, the demographic characteristics refer to the head of household.

No Change in Sight

The U.S. economy is currently experiencing a serious slowdown in terms of economic growth. And the labor market is responding in kind (after seven years of flat wage gains after adjusting for inflation) alongside tighter credit and less access to some forms of credit due to lower house prices. The available data indeed indicate that people are apparently increasing their DC loans in recent years. Specifically, a Transamerica Center for Retirement Studies survey showed an 11 percent increase in people with DC loans in 2007 over 2006.

In comparison, JP Morgan Chase & Co. analysts surveyed 350 DC plans nationwide and found a 7 percent increase in the second half of 2007. [xix] In addition, the giant fund manager Fidelity reported a small increase in loans in December 2007. Only Vanguard, another large fund manager, reported no change in outstanding DC loans.[xx] Also, DC loans at Great West Retirement Services, one of the largest retirement plan administrators, rose by almost 15 percent from 2006 to 2007.[xxi]

Another possibility is to look at hardship withdrawals, for which we do not have data from the Survey of Consumer Finances. There is again some indication that such withdrawals have risen in recent years. For example, Great West Retirement Services saw a 20 percent increase in hardship withdrawals in January 2007 compared to one year earlier.[xxii] Fidelity also saw a 17 percent surge in withdrawals in 2007, with record numbers in December.[xxiii]

Often DC loans are growing despite efforts by employers to discourage such loans. These efforts include limiting the number of loans or adding fees. For example, according to Hewitt Associates, a consulting firm, nearly 80 percent of plans charged loan-origination fees in 2007, up from 63 percent in 2001.[xxiv]

DC loans primarily seem to be rising because demand for credit is growing amid less access to other forms of household debt due to tighter credit standards and lower house prices in the wake of the U.S. housing and global credit crises.[xxv] For instance, in the Transamerica study, a survey of 2,000 full-time employees found that 29 percent of those who borrowed in 2007 took the loan to pay off debt, up from 27 percent in 2006. Also, since 2006 more than half of all 401(k) plans experienced an increase in loans and withdrawals in regions that have seen the highest increase in foreclosure rates, including the Midwest, South Atlantic, and Southwest.[xxvi]

Conclusion

Over the past decade, households have often turned to household debt to cover the gap between rising household expenditures due to sharply higher prices and weak income growth. Loans from defined contribution retirement savings plans have provided easily accessible credit to fill this gap. Families often turn to these DC loans when facing unemployment, medical care costs, and greater expenditures due to homeownership.

Consequently, the existing evidence suggests that families may increase their borrowing from their DC loans again in the current economic slowdown. Slower income growth and rising unemployment occurred at the same time as still much higher prices, especially for energy, food, education, and health care. At the same time, access to other forms of credit, particularly mortgages, has decreased due to tighter credit standards and lower house prices.

Increased borrowing from DC loans, though, will lower retirement income security. Depending on how many loans are taken out, when the loan is borrowed, and how quickly it is repaid, a DC loan can reduce retirement income security, possibly by more than 20 percent.

The policy solution must be to reduce the need for people to borrow against their DC retirement savings accounts. Given that people borrow at least to some degree to cover the cost of an unemployment spell and for medical care, such policy approaches could encompass improved unemployment insurance benefits and greater health insurance coverage.

Appendix:

Tables

Table A1
Breakdown of Families with DC Plans and the Ability to Borrow from Them

Demographic characteristic	Share of families with DC plans		Share of families who can borrow from their DC plans	
	1989-1995	1998-2004	Before 1998	After 1995
Total	29.1	40.5	64.3	75.1
Race/Ethnicity				
White	32.4	44.1	64.5	74.6
Black	20.0	32.9	67.3	78.3
Hispanic	17.0	22.5	62.8	77.1
Other	22.7	39.6	56.2	73.6
Income				
Bottom quintile	5.5	8.8	57.6	59.2
2nd Quintile	21.7	31.2	59.9	65.6
Middle Quintile	37.0	52.2	60.6	76.0
4th Quintile	49.4	62.7	70.8	81.3
Top Quintile	47.9	53.3	68.1	77.2
Age				
25-34	27.7	38.3	66.7	72.5
35-44	33.2	45.5	61.8	78.9
45-54	33.2	41.8	68.9	74.4
55-64	19.0	33.3	56.4	71.8
Education				
No high school/GED	10.4	15.8	53.9	66.6
High school/GED	25.2	35.9	63.1	73.7
Some college	32.7	40.1	64.3	74.8
College	38.9	51.8	66.3	76.7
Housing situation				
Renter	17.7	24.2	61.9	70.0
Owner	35.5	48.2	65.0	76.3
Employment				
Employed	36.0	47.9	64.7	75.7
Unemployed	7.3	16.8	53.0	63.7
Not in labor force	17.3	24.7	63.3	72.9
Health status				
None	35.1	44.8	67.3	75.9
1 person in bad health	18.8	29.0	56.4	72.5
2 people in bad health	15.8	22.5	61.6	65.1

Notes: All figures are in percent. Only families between the ages of 25 and 64 are included. In all instances, the demographic characteristics refer to the head of household, except for unemployment and health status. A family is characterized as unemployed if the head of household, his or her spouse, or both are unemployed. The data indicate a family as having one person in bad health if the head of household or the spouse are in bad health. Authors' calculations based on various years of Board of Governors, Federal Reserve System, Survey of Consumer Finances, Washington, DC: BOG.

Survey questions

The data set that we are using, the Federal Reserve's Survey of Consumer Finances, includes several questions regarding families' attitudes toward saving and debt. We use three of them here.

First, we use a general question that addresses a family's attitude towards debt.[xxvii] In particular, the survey asks the following question:

"In general, do you think it is a good idea or a bad idea for people to buy things on the installment plan?"

The SCF allows for three possible answers:

- Good idea
- Good in some ways, bad in others
- Bad idea

We consequently group respondents, with a DC plan, into these three categories and see if families who think that borrowing on an installment plan is a good idea are more likely to have a loan outstanding and have larger amounts of loans outstanding than families who do not think that this is a good idea. Families who answer that it is a good idea are considered aggressive borrowers, those who chose the second answers are labeled moderate borrowers, and those that indicated that they thought it was a bad idea are termed conservative borrowers.

Second, we use a few specific follow-up questions regarding people's attitude toward debt. In particular, the SCF asks if it is okay to borrow for certain consumption items. Since our goal here is to find a measure that captures a family's attitude toward conspicuous consumption, we use the follow two questions:

"[Do you] feel it is all right for someone like yourself to borrow money....

....to cover the expenses of a vacation trip?
....to finance the purchase of a fur coat or jewelry?"

In each case, the survey allows only for a yes/no answer. We summarize the answers to these two questions, such that a family is considered prone to conspicuous consumption if they answered yes to either one of these two questions.

Third, we use a question that addresses a family's general attitude toward saving. Specifically, the SCF asks the following question:

"Which of the following statements comes closest to describing your saving habits?

- Don't save—usually spend more than income
- Don't save—usually spend about as much as income

- Save whatever is left over at the end of the month—no regular plan
- Save income of one family member, spend the other
- Spend regular income, save other income
- Save regularly by putting money aside each month."

Due to data limitations, we group the answers into two groups. Families are considered savers if they chose of the last three answers and non-savers otherwise.

We consider the connection between people's attitudes and the probability that loans from a DC plan were used for conspicuous consumption. The loan category that is thus of most importance to us is loans from DC plans that were used to purchase goods and services. We first consider the distribution of attitudes among families in this loan category. Then, we consider the loan amounts, both in absolute terms and relative to income.

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Endnotes

[1] All data refer to employer-based retirement savings plans and not individual accounts, such as IRAs. IRAs do not offer loan options.
[2] Authors' calculations based on Board of Governors, Federal Reserve System, Survey of Consumer Finances, Washington, DC: BOG. Data include families with DC plans from current and past jobs.
[3] See the appendix for additional detail on the demographic breakdown of families with DC plans and with the ability to borrow from their DC plans.
[4] A. Sunden and B. Surette, "Households' Borrowing from 401(k) Plans," paper presented at the Second Annual Joint Conference of the Retirement Research Consortium, "The Outlook for Retirement Income," May 17-18, 2000, Washington, DC.
[5] J. VanDerhei, S. Holden, C. Copeland, and L. Alonso, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2006," EBRI Issue Brief No. 308 (Washington, D.C.: Employee Benefit Research Institute, 2007).
[6] General Accounting Office, "401(k) Pension Plans: Loan Provisions Enhance Participation But May Affect Income Security for Some" (Washington, DC: GAO, 1997).
[7] GAO (1997) citing Buck Consultants, "401(k) Plans: Employer Practices and Policies" (, New York, NY: Buck Consultants, 1996).
[8] J. Geisel, "IRS Offers New 401(k) Loan Guidance," *Business Insurance* 34 (32) (2000): 1.
[9] We make the following constant assumptions. Earnings grow at 3.9 percent per year, starting from Social Security's average wages of $40,307 in 2008. We assume a constant contribution rate equal to 6 percent of earnings for a total of 35 years. Once a loan is taken out, it takes 5 years to repay the loan. The average rate of return on a person's account is 9.2 percent, reflecting the historical difference between the prime rate and a mixed portfolio rate of return.
[10] Calculations based on Board of Governors, Federal Reserve System, Release H.15 Selected Interest Rates (, Washington, DC: BOG, 2008).
[11] The General Accounting Office, now renamed the Government Accountability Office, estimated in 1997, under a different set of assumptions, that loans against retirement savings accounts could reduce retirement income by between 2 percent and 28 percent. See GAO, "401(k) Pension Plans: Loan Provisions Enhance Participation But May Affect Income Security for Some" (Washington, D.C.: General Accounting Office, 1997). Also, Munnell and Sunden (2004) estimate that a loan equal to 50 percent of the accumulated account balance taken out at age 40 and repaid over 5 years could reduce the accumulated savings by I percent to 16 percent, depending on the assumptions made about additional contributions.
[12] Center for Retirement Research, "Retirements at Risk: A New National Retirement Risk Index" (Boston, MA: Center for Retirement Research at Boston College, 2006).
[13] O. Sorokina, A. Webb, and A. Muldoon, "Pension Wealth and Income: 1992, 1998, and 2004," CRR Issue in Brief 8-1 (Boston, MA: Center for Retirement Research at Boston College, 2008).
[14] Although loan amounts are comparatively large in 1989, this reflects substantially fewer families with loans. For one, a lot fewer families had DC plans than in later years and a much smaller share of them could even borrow from their retirement savings plans.
[15] See the appendix for detailed demographic breakdowns of these trends.
[xvi] C. Weller, and D. Douglas, "One Nation Under Debt," *Challenge* 50 (1) (2007): 54-75.
[xvii] A. Stettner and S. Allegretto, "The Rising Stakes of Job Loss: Stubborn Long-Term Joblessness amid Falling Unemployment Rates," EPI Briefing Paper No. 162 (Washington, D.C.: Economic Policy Institute, 2005).
[xviii] See the appendix for a discussion of the survey questions.
[xix] E. Laise and C. Karmin, "Despite Costs, More People Raid 401(k)s for Cash," *Wall Street Journal*, February 28, 2008.
[xx] J.W. Elphinstone , "More Are Tapping 401(k) Funds to Make Ends Meet," *Associated Press*, March 10, 2008, available at http://www.courierpress.com/news/2008/Feb/24/borrowing-against-the-future-more-americans-tap/.
[xxi] C. Dugas, "401(k)s Tapped to Save Homes," *USA Today*, March 10, 2008.
[xxii].Ibid.
[xxiii] J.W. Elphinstone, "More Are Tapping 401(k) Funds to Make Ends Meet."

[xxiv] E. Laise, and C. Karmin, "Despite Costs, More People Raid 401(k)s for Cash"; C. Dugas, "401(k)s Tapped to Save Homes"; J.W. Elphinstone , "More Are Tapping 401(k) Funds to Make Ends Meet."
[xxv] J. Mincer, "401(k) Loans: At Your Own Risk – Borrowing Rises a Bit Despite Long-Term Danger," *Wall Street Journal,* October 6, 2007.
[xxvi] E. Laise, and C. Karmin, "Despite Costs, More People Raid 401(k)s for Cash."
[xxvii] Questions regarding debt attitudes are only available from 1995 forward. We use data from 1998 forward and then only by combining years to make the results comparable across attitude measures and to make sure that we have sufficient observations in each category.

The CHAIRMAN. Thank you for your testimony, Mr. Weller.
Mr. Iwry, Mr. John?

STATEMENT OF J. MARK IWRY, PRINCIPAL, THE RETIREMENT SECURITY PROJECT, NONRESIDENT SENIOR FELLOW, THE BROOKINGS INSTITUTION; AND DAVID C. JOHN, PRINCIPAL, THE RETIREMENT SECURITY PROJECT, SENIOR RESEARCH FELLOW, THE HERITAGE FOUNDATION, WASHINGTON, DC

Mr. IWRY. Mr. Chairman, Senator Smith, I am Mark Iwry with The Brookings Institution. This is my colleague, David John with The Heritage Foundation. We are both principals of the nonpartisan Retirement Security Project, and we are pleased to appear together essentially as a single witness before you today to emphasize the importance in this area in particular of an approach that transcends traditional partisan and ideological divisions.

We would like to present our views jointly on savings, including the automatic IRA proposal that you, Senator Smith, and Senator Bingaman have introduced as the lead cosponsors, and on the leakage issue that is the main topic of this hearing.

Senator Smith, you have already described the problem of inadequate saving, as have you, Mr. Chairman. We recognize that adequate retirement security and adequate saving require not only increasing saving, which David John will discuss in connection with the automatic IRA, but preserving savings that have already been done so that they do not leak out of the pension system by being consumed prematurely.

Often the discussion of pension leakage focuses on loans and hardship withdrawals. But in a system that is increasingly dominated by 401(k) plans that are funded by voluntary employee contributions, many people may be reluctant to contribute unless they know they can have at least limited access to their savings if they have a critical need. And the employer that is sponsoring the 401(k) traditionally has had an interest in encouraging those voluntary contributions and therefore an interest in allowing loans and hardships as a kind of liquidity carrot for people to participate in the plan because broad participation enables the employer to pass the nondiscrimination standards and enables the top people to contribute more to the plan.

Things are changing. 401(k)'s are coming of age. Sponsors are no longer uniformly interested in getting rid of accounts for terminated employees. And automatic enrollment—that is, putting people in the plan automatically unless they opt out—is transforming the 401(k) landscape in a way that is very potentially relevant to this leakage issue. This may mean that plan sponsors, because they have higher participation through automatic enrollment, will be less concerned about using access to savings as an inducement to broader participation and can sponsor K plans that limit leakage, that use automatic or behavioral strategies to reduce the occasions when people take lump sums from the plan in particular after they leave employment.

Accordingly, at least as a first step, it may be worth exploring whether sponsors are willing to engage in a best practice of allowing lump sums on termination of employment only if they are directly rolled over to another employer plan or IRA or the departing employee has reached a specified age, such as 55 or 65 unless the employee can demonstrate a hardship and a need for the immediate access to the funds, such as extended unemployment. This would fall between the defined benefit approach to post-employment leakage and the current 401(k) practice. We would be happy to discuss our specific proposals, including the need for a leakage policy after retirement, that is, more annuities and lifetime income in 401(k) plans during your question and answers.

David?

Mr. JOHN. The other source of leakage that should concern both this committee and the Nation as a whole is the money that never got put in the plan in the first place. And this comes basically from two sources. One is the fact that roughly 78 million workers are employed in the U.S. by a company that does not offer any form of retirement savings plan at all, and other workers will have employment with these companies maybe as an interlude between jobs with companies that do offer this sort of retirement savings plan.

In response, as Senator Smith has mentioned, Mark and I developed the automatic IRA. The automatic IRA would probably affect roughly 40 million out of the 78 million workers. It is designed as a simple, low-cost, low-burden option for the employer and a simple low-cost savings option for the worker. It is crafted to discourage employers from moving from a 401(k) plan down to an auto IRA. As a matter of fact, it is actually crafted exactly the opposite: to encourage people to start with an auto IRA and move up to a simple or a 401(k).

I will close by citing a study by Prudential Insurance Company. They found that 8 in 10 employees were very interested in the auto IRA, and they said, "In fact, the more employees learned about the auto IRA, the more they were interested in it."

Now, this same study also surveyed about 200 smaller employers, the ones who had offered this, and they found that 8 in 10 businesses believed that the design overcomes their concern and support the adoption of the auto IRA. Again, the more they heard about it, the more they liked it.

Further, they discovered that roughly 54 percent of eligible employees would be creating new savings rather than moving savings around.

We think that leakage is a very serious problem, and we appreciate the fact that you are addressing that in this hearing. But at the same time, we need to look at both sources of leakage, both out of existing plans and, as I say, the money that never got there in the first place.

Thank you.

[The prepared statement of Mr. Iwry and Mr. John follows:]

The Retirement Security Project RSP

The Heritage Foundation
LEADERSHIP FOR AMERICA

CONGRESSIONAL TESTIMONY

PROTECTING AND STRENGTHENING RETIREMENT SAVINGS

Strategies to Reduce Leakage in 401(k)s and Expand Saving Through Automatic IRAs

Testimony Before the
Special Committee on Aging
United States Senate

July 16, 2008

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PROTECTING AND STRENGTHENING RETIREMENT SAVINGS

Strategies to Reduce Leakage in 401(k)s and Expand Saving Through Automatic IRAs

Testimony before the Special Committee on Aging United States Senate

July 16, 2008

Chairman Kohl, Ranking Member Smith, and Members of the Committee, we appreciate the opportunity to testify before you.[1] We are submitting our testimony as a single joint statement because we believe strongly in the need for a common strategy to preserve and expand retirement savings in a manner that transcends ideological and partisan differences.

The topic of the Committee's hearing today, "Saving Smartly for Retirement: Are Americans Being Encouraged to Break Open the Piggy Bank?", reflects the dual aspect of this issue. Effective policy needs to focus both on saving -- the accumulation of assets -- and on the preservation of those assets to provide security in retirement. In fact, these two objectives are, to some degree, at odds with one another.

Accordingly, our testimony consists of two parts. First, as the Committee has requested, we address the issue of preservation of savings in 401(k) and similar employer-sponsored retirement plans (pages 2-14, below). Our testimony on this topic seeks to place the issue in a broader, relevant context; briefly summarizes certain recent efforts to limit pension "leakage," and offers a number of recommendations.

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The Retirement Security Project is supported by The Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution.

The views expressed in this testimony are those of the two witnesses and the Retirement Security Project, but should not be attributed to The Heritage Foundation, the Brookings Institution, Georgetown University's Public Policy Institute, The Pew Charitable Trusts, or any other organization.

Next we address the need to expand saving by promoting broader participation and coverage (pages 14-28, below). We give special attention to the bipartisan bill introduced by Senator Smith and Senator Bingaman – S. 2167, The Automatic IRA Act, which had its genesis in our joint proposal to expand retirement savings for small business workers.[2] We are pleased by the positive responses the proposal has received and are grateful to you and Senator Bingaman and your other cosponsors in the Senate and the House, for introducing and sponsoring it. We also are grateful to our colleagues, including those in government and in various stakeholder organizations, who have contributed to the proposal.[3]

I. Inadequate Saving and the Problem of Pension Leakage

Life expectancies are lengthening, and the nation's demographic profile is growing older. With individuals living longer and spending more years in retirement, and with the number of retirees increasing relative to the number of workers, we have a diminishing ratio of workers actively supporting a growing number of retirees. At the same time, the traditional bedrock of the employer pension system, the DB plan, is declining at an accelerating rate. Yet today's households have done too little to accumulate savings in 401(k)s or IRAs, partly because millions of them don't have the opportunity to do so at work. Fully half the working families in the United States lack any employer-sponsored retirement savings plan. In percentage terms, employer-provided pension coverage has been essentially stagnant for decades.

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[2] The second part of this testimony is based on a more detailed proposal the witnesses have set forth in a series of research and policy papers (see, e.g., Retirement Security Project Publication No. 2007-2 "Pursuing Universal Retirement Security through Automatic IRAs") which are available at *www.retirementsecurityproject.org*. **(Major portions of this testimony – nearly all of the second part, on the Automatic IRA proposal -- are taken verbatim (though without quotation marks) from the witnesses' research and policy papers cited above and from testimony the witnesses have submitted to the U.S. House of Representatives.** See Iwry and John, "Pursuing Universal Retirement Security Through Automatic IRAs," Testimony before the Subcommittee on Select Revenue Measures, Committee on Ways and Means, United States House of Representatives, June 26, 2008.) As noted, the proposal has been introduced in the 110th Congress as the "Automatic IRA Act of 2007", S. 1141, sponsored by Senator Jeff Bingaman (D-NM) and the Ranking Member of this Committee, Senator Gordon Smith (R-OR), and H.R. 2167, sponsored by Rep. Richard Neal (D-MA) and Rep. Phil English (R-PA), together with additional cosponsors in the Senate and the House.

[3] See http://www.retirementsecurityproject.org/pubs/File/AutoIRAQuoteSheetFinal7.6.07.pdf. Crenshaw, Albert, "Automatic IRAs – a Quick Fix for Workers Without Pensions?" Washington Post, February 19, 2006; "The Way to Save" Editorial, New York Times, February 20, 2006; Bernard, Tara, "Groups Propose Payroll Deductions for IRAs," The Wall Street Journal, February 16, 2006; Editorial, Newsday, February 22, 2006; Marketwatch.com (February 16, 2006); Lambro, Donald, "A Broader Retirement Plan," The Washington Times, April 12, 2007; "Another Black Eye for H&R Block" Editorial, New York Times, March 18, 2006; Quinn, Jane Bryant, "A Nest Egg for Low Earners," Newsweek, February 26, 2007; Commission on the Regulation of U.S. Capital Markets in the 21st Century, Report and Recommendations, March 2007. The automatic IRA proposal emerged as one of the leading recommendations of the 2006 National Summit on Retirement Savings (Saver Summit).

These facts, a national saving rate that has been declining steadily since the 1980s, and the inability of Social Security to pay increased benefits through its current structure, make inadequate retirement saving a major national problem.

Retirement savings are meaningful only if both accumulated in adequate amounts and preserved for use in retirement (or for certain other limited purposes that serve to enhance long-term economic security). Retirement savings do not serve their principal purpose – the purpose for which our private pension system is tax-subsidized -- if consumed prematurely or diverted to uses that do not contribute to retirement security. Evidence suggests that significant amounts of retirement savings have "leaked" out of the private pension system, largely because they have been distributed from employer plans without being either used to support the plan participant in retirement or rolled over to another retirement plan (employer-sponsored or IRA).[4]

Leakage in Context

It is helpful to view traditional forms of pension "leakage" in the larger context. There are several possible reasons why the initial contribution of funds to a 401(k) or IRA might not actually be increasing retirement security or savings.

- For one thing, the household might be accumulating credit card, consumer, or other debt outside (or within) the plan. When determining net saving, this would offset retirement plan contributions.

- Second, a given contribution to a retirement savings plan might be accompanied by a reduction in other saving activity (for example, by shifting other accumulated assets to the plan or by reducing the amount of current income that otherwise would have been saved in other forms or vehicles).

- Third, tax expenditures designed to promote plan contributions represent public dissaving that must be taken into account in determining net national saving (private plus public).

- Fourth, excessive fees and expenses might be viewed as a form of "leakage" to the extent that they eat away at plan account balances.

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[4] See, e.g., L. Burman, N. Coe and W. Gale, "Lump Sum Distributions from Pension Plans: Recent Evidence and Issues for Policy and Research," National Tax Journal, Vol. LII, No. 3:553-562 (Sept. 1999) and the other sources cited in note 1 of W. Gale and M. Dworsky, "Effects of Public Policies on the Disposition of Lump-Sum Distributions: Rational and Behavioral Influences," (Center for Retirement Research, Boston College, 2006). See also Government Accountability Office, "401(k) Pension Plans: Loan Provisions Enhance Participation But May Affect Income Security for Some" (October 1, 1997) ("GAO 1997 Report").

All of these factors affect the net amount of saving, if any, resulting from contributions to plans. Unfortunately, the evidence on these issues is quite limited.[5]

Loans and Hardship Withdrawals May Not Be the Main Causes of Leakage

Much conventional discussion of pension "leakage" focuses on plan loans and withdrawals of benefits "in service" (while individuals are still actively employed), such as hardship withdrawals.[6] We submit that this focus is somewhat misdirected. The vast majority of 401(k) plan loans are repaid (albeit after causing some reduction in future benefits because, for example, the employee's contributions to the plan are suspended or earnings on her account balance are reduced), and it is not clear that "in-service" withdrawals have been very large as a percentage of account balances or have gone far beyond hardship situations that may represent reasonable uses of the funds.

In fact, we have a reasonably restrictive policy regarding withdrawals (including loans) during employment by the plan sponsor, but a much looser policy regarding withdrawals after termination of employment. It won't matter how tightly we lock the front door of the barn if the horses are free to run out the back.

Moreover, it is not at all clear that plans such as 401(k)s, which seek to induce voluntary employee contributions, should be discouraged from offering loans and hardship withdrawals.[7] (Loans generally are preferable to withdrawals because

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[5] See, however, Eric M. Engen and William G. Gale, "The Effects of 401(k) Plans on Household Wealth: Differences Across Earnings Groups," Working Paper 8032 (Cambridge, Mass.: National Bureau of Economic Research, December 2000)

[6] The rules applicable to tax–qualified plans under the Internal Revenue Code of 1986, as amended (the "Code" or "IRC") and plans governed by ERISA (the Employee Retirement Income Security Act of 1974, as amended) govern the circumstances in which 401(k), defined benefit, and other types of plans may or must distribute retirement benefits to plan participants, both before and after termination of employment. The Code also prescribes a detailed regime under which plans are permitted to make loans to participants. As a practical matter, the types of plans that offer loans are defined contribution 401(k) plans, and the data suggest that loans are offered by a majority of 401(k) plans, but by no means all. In general, participants may borrow up to the lesser of $50,000 or half of their vested account balance. (If half the vested account balance is less than $10,000, they can borrow up to $10,000.) Loans must be repaid within five years, except that loans used to acquire the participant's principal residence may be repaid over a longer period. In general, loans that violate these and certain other rules as well as outstanding loans that are not repaid are deemed to be taxable distributions from the plan. Code section 72(p).

[7] Different types of qualified plans have different rules governing withdrawals and distributions of contributions and associated earnings. Section 401(k) plan contributions elected by employees on a pretax basis (typically by salary reduction) generally may be distributed to the employees only after age 59 ½, upon severance from employment, death, or disability, plan termination, or upon the employee's financial hardship. The 401(k) regulations detail the restrictions on in-service withdrawals based on financial hardship. A hardship withdrawal will not be permitted unless it is "made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the financial need." Treasury Regulations section 1.401(k)-1(d)(3)(i). This generally means that "the need may not be relieved from other resources reasonably available to" the employee, including other assets and plan loans. Treasury Regulations section 1.401(k)-1(d)(3)(iv)(C)(4), (E)(1). Thus, employees generally must exhaust their ability to take plan loans before resorting to hardship withdrawals.

plan loans commonly are repaid, whereas there is no general provision for repayment of actual withdrawals, hardship or otherwise.) To encourage voluntary employee contributions in the first place, the liquidity these features provide may be needed to make many employees feel sufficiently comfortable that they could access their retirement savings if they really needed to.

As a result, there is a tension between the goal of inducing contributions and the goal of preserving them for retirement. What is the minimum liquidity or access needed to maximize employee contributions? An optimal strategy may well be to provide just enough access – during employment and after – for employees to feel that they could withdraw their contributions if they really had to (e.g., in an emergency or other hardship). Employees' willingness to contribute may not be highly sensitive to the exact degree of access a plan provides beyond basic access through loans or minimal hardship withdrawals. Once the employee starts saving in a 401(k), the benefits of retaining the funds in the plan or another tax-qualified plan and allowing them to grow on a tax-deferred basis tend to become increasingly evident to the employee.

This may be why some plans have adopted the practice of requiring employees to demonstrate financial hardship in order to obtain a loan. In an effort to strike the balance between inducing participation and reducing leakage, these plans have imposed the same standards on loans that they would in order to obtain a hardship withdrawal.

Thus, there has been evidence in the past that

- a large majority of 401(k) participants are in plans offering loans (85 percent of the EBRI/ICI database in 2006),[8]
- 401(k) plans that offer loans have higher participation than other plans and their participants tend to contribute more[9],
- a relatively limited percentage of participants take advantage of the ability to take loans[10], and

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The Code also imposes an additional 10% tax on premature withdrawals from qualified plans and IRAs. Withdrawals subject to the additional tax are essentially those that are paid before age 59 ½ and are not in annuity form, not rolled over, not on account of death or disability, not paid after termination of employment following age 55, and not exempted under certain other exceptions relating to special purposes such as IRA withdrawals for higher education or purchase of a home. Code section 72(t).

[8] Employee Benefit Research Institute (EBRI) Issue Brief No. 308 (August 2007), "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2006," page 19.

[9] GAO 1997 Report.

[10] EBRI Issue Brief No. 308, page 19.

- "[o]verall, loans from 401(k) plans tend to be small, with the vast majority of 401(k) participants in all age groups having no loan at all."[11]

Should Every Job Change Trigger a 401(k) Distribution Opportunity?

What we should perhaps be questioning – more than the availability of plan loans and hardship withdrawals -- is the assumption in the 401(k) universe that termination from a particular employer (as opposed to retirement from employment generally in one's sixties or later) should automatically be treated as a distribution event. In the traditional labor market assumed by traditional DB pension plans -- in which employees are expected typically to remain at a single company for their entire career -- termination of employment and retirement are synonymous. However, the well known reality in today's labor market is that the average employee changes jobs multiple times in a career[12], so the vast majority of job changes occur pre-retirement.

It follows that most job changes should not be seen as occasions to pay retirement benefits to the individual (as opposed to retaining the benefits in the plan or transferring them to a new employer's plan or IRA). Yet over the years, it has been common for employees changing jobs to receive lump-sum payments from 401(k) and similar plans. In general, the smaller this lump-sum distribution, the less likely it is to be saved by being transferred ("rolled over") to another employer plan or to an IRA.[13] In fact, data suggest that, as of 1996, the median lump-sum distribution was $5,000, and a sizable majority of defined contribution plan participants who received a lump-sum distribution of $5,000 or less did not roll it over to a qualified plan or IRA. See GAO 1997 Report. Accordingly, it may well be that payouts triggered on termination of employment have resulted in far more leakage than loans and in-service withdrawals.

Indeed, the leakage that does result from loans appears to be caused mostly by 401(k) plan provisions that permit distributions upon termination of employment. Loans from 401(k) plans typically are repaid by payroll deduction. The same is not necessarily true of loans from section 403(b) tax-sheltered annuities (which do not involve the same close connection between the individual and the employer and its payroll system) or section 457 deferred compensation plans of state and local governments (which are exempt from ERISA). To the extent that

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[11] Ibid.

[12] The data report the total number of jobs held by those who were born in 1957-1964 (late baby boomers). When these workers were between ages 18 and 42, they held on average between 10 and 11 jobs. Nearly two thirds of these jobs were held from ages 18 to 27. Data from the Bureau of Labor Statistics' National Longitudinal Survey of Youth 1979. See www.bls.gov/news.release/nlsoy.t01.htm for more details.

[13] See, e.g., L. Burman, N. Coe and W. Gale, "Lump Sum Distributions from Pension Plans: Recent Evidence and Issues for Policy and Research," National Tax Journal, Vol. LII, No. 3:553-562 (Sept. 1999) and the other sources cited in note 1 of W. Gale and M. Dworsky, "Effects of Public Policies on the Disposition of Lump-Sum Distributions: Rational and Behavioral Influences," (Center for Retirement Research, Boston College, 2006).

any plan making loans requires them to be repaid via automatic payroll deduction, the likelihood of default is reduced. Therefore, this method (or automatic debit of the individual's personal financial account) should be encouraged as part of a plan loan program.

However, the payroll deduction repayment process is interrupted if the employee's employment terminates. A loan outstanding at that point often ceases to be repaid and is offset against the account balance being paid out. It is deemed to be a distribution from the account and, unless rolled over, leaks out of the tax-qualified saving system. In fact, in the case of a corporate spinoff, numerous employees with outstanding loans may be transferred from one employer and its 401(k) plan to another, and this may result in extensive leakage.

Fortunately, such deemed distributions can be avoided. First, the former employer could allow outstanding loans upon termination of employment to continue to be repaid (for example, by automatic debit of the individual's personal financial account). Second, the former employer could allow or require outstanding loans to be rolled over to the plan of a new employer (if there is a new employer sponsoring a plan that offers loans and if the new plan sponsor concurs). We suggest that sponsors of 401(k) plans offering loans be encouraged to adopt one or both of these policies to reduce leakage after termination of employment.

Limiting Leakage from Post-Termination Distributions

More broadly than these specific measures, as the decline of traditional pension plans moves the 401(k) onto center stage as the only or main retirement plan for most employees who have one, it is time to rethink 401(k) distribution policies and practices. This should occur as part of the rapid transformation of the 401(k) system from the less effective "do it yourself" model (which developed somewhat haphazardly when 401(k)s were viewed very much as merely supplemental plans) to an the "automatic" 401(k) that incorporates, by design, features more closely resembling an actual pension program. The enrollment and contribution phases of 401(k) saving are benefiting from automatic (default) enrollment and automatic escalation of contributions.[14] Similarly, the investment phase is benefiting from the introduction of sensible automatic (default) investments such as managed accounts and asset-allocated qualified default investment alternatives.[15]

[14] William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," (The Retirement Security Project, Policy Brief No. 2005-1; available at www.retirementsecurityproject.org)

[15] William G. Gale and J. Mark Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices" (The Retirement Security Project, Policy Brief No. 2005-4; available at www.retirementsecurityproject.org).

Like the enrollment, contribution and investment phases of the 401(k), the distribution or payout phase can also be reformed using "behavioral" strategies. These take into account the impact on human behavior of factors other than pure financial maximization – such as inertia, simplicity (or complexity), ease and convenience (or difficulty and inconvenience), transaction costs, the manner in which choices and issues are framed or structured for the individual, and the like. Indeed, two such behavioral strategies have already begun to be used in the distribution phase in an effort to reduce leakage. Both strategies reflect the view that, in the case of post-termination-of-employment payouts, the culprit is not the lump sum distribution per se, but those pre-retirement-age lump sum payouts that are neither retained in the former employer's plan nor rolled over to a new employer's plan or an IRA.

Direct Rollovers, Mandatory Withholding, and Automatic Rollover of Cashouts

The first of these strategies, enacted by Congress in 1992, requires qualified plans to offer participants the option of taking a tax-free rollover of benefits in the form of a "direct" rollover (i.e., a transfer of benefits that generally does not pass through the hands of the participant) if the participant gives the distributing plan the name of a receiving employer plan or IRA. While departing employees generally are permitted to leave their benefits in the former employer's plan, these direct rollover rules require those who opt for a lump-sum payout to have the distributing plan directly roll it over to another plan or IRA or else subject it to mandatory 20% Federal income tax withholding.[16]

There is evidence suggesting that these direct rollover and mandatory withholding rules have promoted portability and have reduced cashouts and hence leakage.[17] In addition, beginning in 2005, qualified plans have been required to implement an automatic or default rollover strategy for small pre-retirement payouts in a further effort to reduce involuntary cashouts and thus limit leakage of assets from the retirement system.

For years, account balances of up to $5,000 could be involuntarily "cashed out," that is, paid to departing employees without their consent, and these payments were the least likely to be preserved for retirement. In 2000, however, a Treasury-IRS ruling permitted retirement plan sponsors to transfer such amounts to an IRA established for any departing employee who did not affirmatively elect any other disposition of the funds. A year later Congress mandated such automatic rollover to IRAs for distributions between $1,000 and $5,000.

[16] Code Sections 401(a)(31), 3405(c).

[17] See Gale and Dworsky, op. cit., pp. 10, 12.

Under this legislation, which took effect in 2005, plan sponsors may no longer force cash-out distributions of more than $1,000 on departing employees. Instead plans must follow employees' instructions either to transfer the funds to another plan or an IRA, pay the funds directly to the employee, or keep the funds in the plan if the plan permits that option. The individual thus has the choice to preserve or consume the retirement savings, but, if the individual makes no other choice, the default is preservation—either in the employer's plan, if the employer so chooses, or in an IRA that the employer opens for the employee. The employee must also be notified that, if the payout is automatically rolled over to an IRA, he or she may then roll it over to another IRA of his or her choice.

Automatic rollover was designed to have a potentially valuable byproduct, namely, broader utilization of IRAs. Currently, only about 1 in 10 of those who are eligible to open and contribute to an IRA on a tax-preferred basis actually do so. Like enrolling in a 401(k), opening an IRA requires individuals to overcome inertia and to navigate through a number of decisions (in this case, choosing among a vast number of financial institutions and investments). Automatic rollover instead calls upon the employer to take the initiative to set up an IRA and choose investments on the employee's behalf, again unless the employee chooses to do so. The intended result is not only to preserve the assets within the tax-favored retirement plan universe, but also to create an expanding infrastructure of portable, low-cost individual accounts for the millions of workers who have no IRAs but who are covered at some point in their careers by an employer-sponsored retirement plan.

Automatic rollover thus has the potential to help achieve a far broader expansion of retirement plan coverage for middle- and lower-income households. Indeed, this broader agenda is explicitly reflected in the automatic rollover legislation, which directs the Treasury and Labor Departments to consider providing special relief for the use of low-cost IRAs. However, thus far, it appears that the majority of plans have opted to eliminate involuntary cashouts in excess of $1,000 and retain the assets rather than setting up IRAs for departing employees and rolling over the small payouts to the IRAs.

Eventually, Congress might consider whether leakage could be further limited by extending automatic rollover to a wider array of distributions. However, any such expansion would need to be examined carefully. An automatic or default arrangement generally already applies to benefits in excess of $5,000: they remain in the employer plan unless the employee explicitly elects otherwise. (Involuntary cashouts of these benefits are not permitted.)

Potential Best Practices Limiting Automatic Payout Every Time an Employee Changes Jobs

This default for benefits exceeding $5,000 appears to be relatively weak, however, as terminating employees tend to override it. Accordingly, at least as a first step, it may be worth exploring whether plan sponsors would be willing to engage in a "best practice" of allowing lump-sum distributions upon termination of employment only if (i) they are directly rolled over to another employer plan or IRA, (ii) the departing employee has reached a specified retirement age (such as 60 or 65), or (iii) the departing employee can demonstrate a hardship under standards similar to those that apply to active employees (but perhaps including sustained unemployment).[18]

Such an approach would fall somewhere between the current 401(k) practice of allowing lump-sum distributions whenever employees change jobs and the common practice in traditional DBs of prohibiting lump sum distributions or limiting them to former employees who have reached a specified age between 55 and 65. It would also be modeled to some degree on the approach reflected in the current-law 10 percent penalty imposed on early withdrawals that are neither rolled over nor paid as an annuity and that are paid before age 59 ½ and before termination of employment after age 55.

A variation of this approach might limit it to the portion of each employee's account balance attributable to employer contributions (and associated earnings). A more stringent distribution policy limited to employer contributions (often comprising a quarter or a third of the total account balance) would avoid employee complaints about locking up "their money". If limited also to future contributions, it would avoid running afoul of the anti-cutback rules that generally protect employees from retroactive changes to the regime governing past contributions. Such an approach also would avoid giving rise to possible employee complaints about changing the rules of the game after they had contributed in reliance on the ability to withdraw employer matching contributions in specified circumstances.[19]

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[18] Before considering such an approach, some plan sponsors might want explicit confirmation from the regulators that it would not run afoul of the plan qualification rules or ERISA.

[19] When it comes to in-service withdrawals, it is somewhat ironic that the plan qualification standards permit plan sponsors to subject employer contributions to a distribution regime that is in many circumstances far more lax than that applicable to employee contributions (other than the relatively infrequent after-tax employee contributions, which can be freely withdrawn). As a practical matter, many if not most 401(k) plans extend the hardship withdrawal regime to employer as well as employee pre-tax or salary reduction contributions. However, in rulings issued 37 and 40 years ago, the IRS permitted employer contributions to be withdrawn before termination of employment once the employee has five years of plan participation or once the contributions have remained in the plan for two years. See Revenue Ruling 71-295, 1971-2 C.B. 184; Revenue Ruling 68-24, 1968-1 C.B. 150. Policy in this area is too important to be governed by old revenue rulings, which are not subject to public notice and comment and involve no congressional consideration.

Is there any reason to expect that plan sponsors would have an interest in tightening their plan distribution policies in this way? Perhaps not, but we would not reject the possibility out of hand.

First, the world has changed somewhat since the days when plan sponsors were more uniformly inclined to rid themselves of accounts for terminated vested participants. Employers now seem to be of two minds about this. While some are still inclined to avoid administering account balances for former employees, others are interested in saving provider fees by maximizing their plan's assets under management. These employers may be in a natural alliance with 401(k) financial providers and recordkeeper organizations that have financial incentives to retain and maximize their assets under management. On the other hand, cost structures for many financial providers appear to be driven more by average account size than by aggregate assets.

Second, would such a transformation of 401(k) distribution policy run up against the 401(k) sponsor's traditional interest in maximizing performance on the 401(k) nondiscrimination tests? Would tighter distributions fly in the face of the employer's interest in providing sufficient liquidity to induce moderate- and lower-income employees to participate in order to improve nondiscrimination results, which in turn permits higher tax-preferred contributions by the more highly paid executives and owners who are the company's decisionmakers? Perhaps not in the age of automatic enrollment, which is increasingly prevalent in 401(k) plans.

By drawing moderate- and lower-income employees into the plan, automatic enrollment solves much of the nondiscrimination problem for 401(k) sponsors. It might also make employees somewhat less sensitive to the liquidity issue. Employees' tendency to go along with the default of enrolling in the plan seems highly unlikely to be reversed by a tighter distribution regime for employee contributions and even less likely to be reversed by a tighter distribution regime that is limited to employer contributions. Moreover, plan sponsors that allow automatically enrolled employees to change their minds and withdraw their contributions pursuant to the 90-day permissible withdrawal rules might be more willing to consider experimenting with a tighter distribution policy and perhaps tighter loan and hardship withdrawal policies (such as a policy that limits loans or hardship withdrawals to employee – as opposed to employer -- contributions). If such a policy turned out to discourage participation or create significant employee relations problems, the sponsor could relax or reverse the policy.

Reducing Leakage During Retirement

The problem of leakage is not confined to the pre-retirement phase. Leakage can result also from lump sum payouts made when or after a participant reaches retirement age if they are used to purchase a boat or a recreational vehicle or are otherwise quickly consumed.

It is challenging for individuals and households to manage their assets to last a lifetime of uncertain duration, especially given the risks not only of longevity and mortality but also of investment underperformance, inflation, possible credit risk, and unexpected financial demands or foreshortened earning capacity due to illness or disability (including need for long term care). Longevity risk can be pooled through annuities and similar products (including longevity insurance), and other methods are available to help manage the risks and make the money last.[20] However, few employees elect annuities from 401(k) plans or even from defined benefit plans that adopt the cash balance or other hybrid format. One reason is that these plans frame the benefit (and thus participants' perceptions and expectations) as an account balance and thus a presumptive lump sum that can be very enticing for workers considering major purchases. As we have suggested elsewhere, a potential counterweight might be to require such plans to state all benefits not only as an account balance but also, alternately, as an annuity or stream of regular income to help individuals think of their benefits as a monthly "pension paycheck". A similar technique could be extended to plan loans and withdrawals by showing the worker what taking such a loan or withdrawal would do to reduce his or her retirement income.

The financial services industry is developing a variety of innovative products and features to address these concerns. Products are needed that would provide lifetime guaranteed income at reasonable cost in ways that are more flexible and more responsive to the needs of moderate- and lower-income families than most traditional annuity products.

In addition, with our co-authors, Bill Gale and Lina Walker, we have proposed a behavioral strategy to encourage retirees to try out regular lifetime income.[21] We and others are developing a number of other possible approaches in this area as well, including educational initiatives that seek new and more effective ways of thinking about and presenting the issue.

Leakage from Defined Benefit Plans

Pension leakage is not limited to 401(k) and other individual account plans. While defined benefit plans prohibit in-service withdrawals, cash balance and other hybrid DB plans pay lump sums upon termination of employment, as noted. These plans could delay payments to terminated employees until retirement age (with respect to future accruals), as DB plans traditionally have done. A likely concern about such a tightening of distribution practices would be the loss of pension portability, but an exception could be made for lump sums that are directly rolled over to another plan or IRA. Other concerns that would likely be raised by any such approach would include the potential for adverse reaction

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[21] William G. Gale, J. Mark Iwry, David C. John, and Lina Walker, "Increasing Annuitization in 401(k) Plans with Automatic Trial Income," (The Retirement Security Project, Policy Brief No. 2008-2; available at www.retirementsecurityproject.org)

from employees and the complexity introduced by maintaining two distribution regimes, one for "old money" and the other for "new money".

The Role of Education

We believe it is important to provide effective education for actual and possible plan participants and IRA owners regarding the need to save, planning for one's financial future and retirement, investing, and financial literacy in general. Much of this may be necessary or helpful to counteract the marketing and culture of easy credit and indebtedness. However, we believe that educational efforts, while essential, are ultimately insufficient. In order to work, saving strategies need to include practical, action-oriented, behavioral measures that are effective in shaping and changing behavior.

Two Approaches We Would Not Endorse

Before turning to the second part of our testimony, proposing a broad strategy to expand saving, we note two strategies that we would not consider advisable.

One proposal often raised in connection with the leakage issue would be to increase the 10% additional tax that is intended to discourage premature withdrawals. In our view, the existing 10% penalty serves a purpose as a disincentive to take pre-retirement lump sum payouts without rolling them over, and as an attention-getting device to discourage such payouts. It is especially useful in providing a financial disincentive for those who would otherwise owe no tax on the withdrawal, as well as for IRAs, which, unlike 401(k)s, do not flatly prohibit distributions before certain times or events.

However, increasing the 10% penalty might not significantly increase its deterrent or attention-getting power, but could readily increase the amount of benefit forfeited by those typically lower-income individuals who are desperate for the cash and will therefore take the withdrawals in any event. Those who are less educated, less affluent, and less likely to analyze and calculate the tax consequences in advance of their decision will be more likely to take the cash withdrawal and lose more of their savings without any commensurate benefit to them or society.

Another initiative that concerns us is the 401(k) loan debit card. We share the concern of others that, in the interest of limiting leakage as a matter of public policy, borrowing from tax-qualified retirement savings plans should not be made too easy. We recognize that those who would offer such a product might claim certain advantages for it, such as the ability to continue repaying a loan without regard to changes in employment and perhaps the possibility of reducing other, higher-interest credit card debt. However, we remain concerned that the effect on plan participants is unknown and potentially harmful, as the ease with which card holders might borrow from the plan could lead them down a "slippery slope" of borrowing. In fact, the linking of such a card to a 401(k) plan could be read by employees to imply an employer endorsement of a behavior pattern that involves continual borrowing from the plan in the absence of hardship and even for purposes of routine consumption.

Because we believe that ease, convenience, and minimization of transaction costs can have a significant effect on behavior, we worry that a debit card for 401(k) borrowing might function as an effective behavioral strategy for dissaving rather than saving. Some would argue that the root of the leakage problem and the broader problem of inadequate saving is an economy and a culture that have gone too far in promoting easy credit and indebtedness; but that is a more general issue beyond the scope of this testimony.

II. The Automatic IRA

With the looming retirement security crisis facing our country, policy-makers from both parties are focused on ways to strengthen pensions and increase savings. Our proposal for automatic IRAs would provide a relatively simple, cost-effective way to increase retirement security for the 78 million Americans working for employers (usually small businesses) that do not offer a retirement plan.[22] It would enable these employees to save for retirement by allowing them to have their employers regularly transfer amounts from their paycheck to an IRA.

These people – half of our workforce – have no effective way to save at work. Research and experience both point to a simple and effective solution, which your bill, Senator Smith, calls the "automatic IRA."

We are by no means suggesting that the automatic IRA proposal is the only step that should be taken to expand retirement savings for small business workers or others. In fact, we have long believed in the primacy of employer-sponsored retirement plans as vehicles for pension coverage, and the first part of our testimony today includes recommendations for enhancing the preservation of assets in those plans.[23] Additionally, the Retirement Security Project continues

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[22] Craig Copeland, "Employment-Based Retirement Plan Participation: Geographic Differences and Trends, 2005: Employee Benefit Research Institute Issue Brief No. 311," November 2007, Figure 1, p. 7. An additional 16 million workers either are not eligible for their employer's plan or are eligible but fail to participate.

[23] We have previously written and testified before Congress on various aspects of employer-sponsored retirement plans. David John has written and testified about the funding problems faced by defined benefit pension plans and about the United Kingdom's pension situation. Mark Iwry led the Executive Branch efforts in the 1990s to develop the SIMPLE plan for small business, the startup tax credit for small employers that adopt new plans, and the saver's credit for moderate- and lower-income workers, as well as the Executive Branch initiatives to define, approve and promote 401(k) automatic enrollment, automatic rollover to restrict pension leakage, and automatic 401(k) features generally. See also William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Saver's Credit" (The Retirement Security Project, Policy Brief No. 2005-2; available at www.retirementsecurityproject.org).

to advocate strongly for the expansion of pension coverage through automatic features in 401(k) and similar retirement savings plans[24] and for several other initiatives designed to expand retirement security, especially for the moderate- and lower-income households that comprise a majority of the U.S. population.[25]

Making saving easier by making it automatic has been shown to be remarkably effective at boosting participation in 401(k) plans, but roughly half of U.S. workers are not offered a 401(k) or any other type of employer-sponsored plan. We would extend the benefits of automatic saving to a far wider array of the population by combining several key elements of our current system: payroll deposit saving, automatic enrollment, low-cost, diversified default investments, and IRAs.

The automatic IRA approach would offer most employees not covered by an employer-sponsored retirement plan the opportunity to save through the powerful mechanism of regular payroll deposits that continue automatically. The employer's administrative functions are minimal and should involve no out of pocket cost. In addition, the arrangement is market-oriented and realistic: it uses a well established and familiar vehicle, IRAs, provided by the same banks, mutual funds, insurance carriers, brokerage firms, credit unions, and other private financial institutions that currently provide them. As a fallback, if individuals or employers could not find an acceptable IRA on the market, they would be able to use ready-made, low-cost automatic IRA accounts provided by a consortium or pool of private-sector financial institutions or another nonprofit or government-contracted entity that contracts out asset management and other functions to the private sector.

[24] William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Automatic 401(k): A Simple Way to Strengthen Retirement Savings," (The Retirement Security Project, Policy Brief No. 2005-1; available at www.retirementsecurityproject.org); William G. Gale and J. Mark Iwry, "Automatic Investment: Improving 401(k) Portfolio Investment Choices" (The Retirement Security Project, Policy Brief No. 2005-4; available at www.retirementsecurityproject.org).

See also the description of the joint AARP, FINRA, Retirement Security Project "Retirement Made Simpler" campaign, below.

[25] See, for example, the following (all of which are available at www.retirementsecurityproject.org): J. Mark Iwry, William Gale, and Peter Orszag, "The Potential Effects of Retirement Security Project Proposals on Private and National Saving: Exploratory Calculations," Retirement Security Project Policy Brief No. 2006-2; Peter Orszag and Eric Rodriguez, "Retirement for Latinos: Bolstering Coverage, Savings and Adequacy," Retirement Security Project Policy Brief No. 2005-7; William G. Gale, J. Mark Iwry and Peter R. Orszag, "The Saver's Credit," Retirement Security Project Policy Brief No. 2005-2; J. Mark Iwry, "Using Tax Refunds to Increase Savings and Retirement Security," Retirement Security Project Policy Brief No. 2005-9; Peter Orszag, "Protecting Low-Income Families' Savings: How Retirement Accounts Are Treated in Means-Tested Programs and Steps to Remove Barriers to Retirement Saving," Retirement Security Project Policy Brief No. 2005-6.

The Basic Problem

In 2004 half of all households headed by adults aged 55 to 59 had $13,000 or less in an employer-based 401(k)-type plan or tax-preferred saving plan account.[26] The U.S. personal saving rate has declined steadily over the last two decades, to the point where it recently dropped below and currently hovers just above zero percent.[27]

Moreover, traditional corporate defined benefit pension plans are declining, and few expect Social Security to provide increased benefits in the future. The households that tend to be in the best financial position to confront retirement are the 41 percent of the workforce that participate in an employer-sponsored retirement plan.[28]

The most vulnerable employees are those lacking access to an employer-sponsored plan. In a survey conducted by AARP with 700 private sector workers at companies with 10-250 employees that do *not* offer a 401(k) or some other retirement plan, fewer than half of these workers without access to an employer plan said they had taken the following actions: Saved money in a non-retirement account (45%); Saved money in a retirement account (35%); Read articles or other information about retirement (35%); Talked with friends, relatives, and/or coworkers about retirement (31%); Used a retirement calculator (14%).[29]

Generally, the rate of participation (those who contribute as a percentage of those who are eligible) for 401(k) plans is on the order of 7 or 8 out of 10. An increasing share of plans are including automatic features that make saving easier and raise participation, often to levels exceeding 9 out of 10. While more can and should be done to expand 401(k) and other employer plan coverage,[30] the fraction of the workforce that is covered by employer plans has hovered around half for at least three decades. The uncovered employees have no effective way to save at work. IRAs do not cover enough people because many fail to exercise the initiative required to make the decisions and take the actions necessary to save in an IRA. More broadly, many people find it too difficult or lack the financial sophistication to plan for retirement and defer consumption. As a result, only about 1 in 10 eligible individuals contributes to an IRA.

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[26] Even among those households that had savings in 401(k)s and IRAs, the median account balance was only $69,000. Authors' calculations using the 2004 Survey of Consumer Finances.

[27] As measured in the 2007 National Income and Product Accounts, the personal saving rate is 0.5 percent of disposable income. See www.bea.gov/bea/dn/nipaweb/Nipa-Frb.asp for more details.

[28] Copeland, EBRI Issue Brief No. 299, Figure 1, page 7. Similar but updated figures for 2006 are available in the Employee Benefit Research Institute Issue Brief 311.

[29] Thayer, Colette, "Automatic IRAs: Worker Attitudes and the Likelihood of Participation," April 2007.

[30] See William G. Gale, J. Mark Iwry, and Spencer Walters, The Pension Protection Act of 2006 and the Unfinished Agenda. (Retirement Security Project Publication No. 2007-1, April 2007).

While IRAs hold more assets that employer-sponsored plans, most of those assets were not contributed directly to IRAs but came from tax-free rollovers of savings accumulated in employer-sponsored plans. (A June 2008 GAO Report[31] notes that, as of 2004, IRAs held about $3.5 trillion in assets, compared to $1.9 trillion in employer-sponsored defined benefit ("DB") pension plans and $2.6 trillion in employer-sponsored 401(k) and other defined contribution ("DC") plans. More recent data suggest that these relationships have not changed fundamentally.)

As evidenced by the dramatic difference in participation rates noted earlier, employer plans have been a far more effective means of generating participation and contributions than the opportunity to contribute to a non-workplace-based ("standalone") IRA. This is attributable to employer contributions (matching and nonmatching), the power of regular payroll deduction that automatically continues making regular small contributions, automatic enrollment, default investments and other automatic (default) features, employer-provided education and encouragement to save, economies of scale associated with group saving arrangements, peer group reinforcement, and other factors.

The Automatic IRA

The Automatic IRA legislation is designed to overcome the obstacles to saving in IRAs. It would give the uncovered half of our workforce an easy, effective way to save through automatic enrollment into payroll deposit IRAs. The AARP-commissioned study shows that workers at companies that would be covered by automatic IRAs favor the automatic IRA concept and are likely to participate: Over seven in ten (71%) of those without access to an employer-provided retirement savings plan agree that "employers who do not offer a 401(k) or other retirement plan should be required by law to offer workers the option to regularly save a part of their paycheck in an individual retirement account" and nearly eight in ten (79%) of those without access say they would be likely to participate if their company offered them the option to regularly save a part of their paycheck in an IRA through payroll deduction.

Very similar results were obtained in a study conducted by Prudential Insurance Company, titled "Saving for Retirement at Work: Employee and Business Reactions to an Automatic IRA Concept". The Prudential research found that eight in ten employees were interested in the proposed automatic IRA. The study reported, "Employees are positive in their reaction to the Automatic IRA, both in concept and after learning the specific details. *In fact, the more*

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[31] Report of the Government Accountability Office ("GAO") to the Committee titled "Individual Retirement Accounts: Government Actions Could Encourage More Employers to Offer IRAs to Employees" (GAO-08-590, June 2008) (the "GAO Report").

employees learn about the Automatic IRA, the more they are interested in it." [original emphasis][32]

In addition, the Prudential study surveyed more than 200 small employers. It found that "Eight in 10 businesses believe the design overcomes their concerns, and support the adoption of the Automatic IRA. . . . The more they heard about its features, the more they liked it."[33]

The Prudential research concluded,

> **"The Automatic IRA can generate "new" savings, rather than merely shifting savings from one vehicle to another. Of the 80% of employees who were "very/somewhat" interested in the Automatic IRA, 68% believe it will generate real additional savings. Projecting this rate to all eligible employees suggests that new savings might be gained by about 54% of eligible employees."[34]**

How the Automatic IRA Would Work

The automatic IRA approach is intended to help households overcome the barriers to saving by building on the successful use in 401(k) plans of automatic features which encourage employees toward sensible decisions while allowing them to make alternative choices. The automatic IRA would feature direct payroll deposits to a low-cost, diversified IRA. Employers above a certain size (e.g., 10 employees) that have been in business for at least two years but that still do not sponsor any plan for their employees would be called upon to offer employees this payroll-deduction saving option. The automatic IRA would apply many of the lessons learned from 401(k) plans so that more workers could enjoy automated saving to build assets – without imposing any significant burden on employers. Employers that do not sponsor plans for their employees could facilitate saving – without sponsoring a plan, without making employer matching contributions, and without complying with plan qualification or fiduciary standards. They would simply offer to act as a conduit, remitting a portion of employees' pay to an IRA, preferably by direct deposit, at little or no cost to the employer.

The automatic IRA is also designed to address the concern that financial providers have found it less profitable to serve groups of people with a small average account size. The proposal would provide a backstop arrangement contracted to the private sector that would give an option to any employee groups that the financial services industry is not currently interested in serving.

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[32] Prudential Insurance Company of America, "Saving for Retirement at Work: Employee and Business Reactions to an Automatic IRA Concept," page 19.

[33] Id. at 20. Prudential stated that "to obtain unbiased objective reactions to the ability of the concept to meet their established concerns about retirement programs and specific needs for the future," it did not tell employers until the last part of the survey that the proposal would require, not merely permit, certain employers to adopt automatic IRAs. (The optional approach to payroll deposit IRAs has been tried and has resoundingly failed. Payroll deposit IRAs have been permitted for at least a decade, and were publicized by the U.S. Treasury and Labor Departments in the 1990s, but virtually no employers have adopted them.)

[34] Id. at 20.

Little or No Cost to Employers

Direct deposit to IRAs is not new. In the late 1990s, Congress, the IRS, and the Department of Labor all encouraged employers not ready or willing to sponsor a retirement plan to at least offer their employees the opportunity to contribute to IRAs through payroll deduction.[35] However, employers generally did not respond to this option. As noted, few employers have ever adopted direct deposit or payroll-deduction IRAs – at least in a way that actively encourages employees to take advantage of the arrangement.

With this experience in mind, your bill proposes a new strategy designed to induce employers to offer, and employees to take up, direct deposit or payroll deposit saving. For many if not most employers, offering direct deposit or payroll deduction IRAs would involve little or no cost. The employer would not be maintaining a retirement plan, and employer contributions would be neither required nor permitted. Firms would *not* be required to

(1) comply with plan qualification or ERISA[36] rules,

(2) establish or maintain a trust to hold assets,

(3) determine whether employees are actually eligible to contribute to an IRA or are complying with the limits on contributions,

(4) select investments for employee contributions,

(5) select among IRA providers, or

(6) set up IRAs for employees.

Employers would be required simply to allow employees to make a payroll-deduction deposit to IRAs. This dovetails with what employers are already required to do by way of withholding income (and payroll) tax from employees' pay (based partly on employee elections on IRS Form W-4) and remitting those amounts to the federal tax deposit system.

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[35] In the Conference Report to the Tax Reform Act of 1997, Congress stated that "employers that choose not to sponsor a retirement plan should be encouraged to set up a payroll deduction [IRA] system to help employees save for retirement by making payroll-deduction contributions to their IRAs" and encouraged the Secretary of the Treasury to "continue his efforts to publicize the availability of these payroll deduction IRAs" (H.R. Rep. No. 220, 105th Cong., 1st Sess. 775 [1997]). IRS and Labor guidance was given in IRS Announcement 99-2, "Payroll Deduction IRAs," and Department of Labor Interpretive Bulletin 99-1 (June 18, 1999), 29 C.F.R. 2509.99-1(b).

[36] Employee Retirement Income Security Act of 1974, as amended.

Tax Credit for Employers that Serve as Conduit for Employee Contributions

Firms that do not provide employees a qualified retirement plan, such as a pension, profit-sharing, or 401(k) plan, would be given a temporary tax credit to establish automatic IRAs. The tax credit would be available to a firm for the first two years in which it offered payroll deposit saving to an IRA and would be designed to avoid competing with the tax credit available under current law to small businesses that adopt a new employer-sponsored retirement plan. Also, it would be available both to those employers required to offer payroll deposit and to very small or new firms that are not required to but do so voluntarily.

Tax Credit for Employers that Adopt a New Employer-Sponsored Retirement Plan

Under current law, an employer with 100 or fewer employees that starts a new retirement plan for the first time can generally claim a tax credit for startup costs. The credit equals 50 percent of the cost of establishing and administering the plan (including educating employees about the plan) up to $500 per employer per year for three years. To maintain employer incentives to adopt an employer plan, the automatic IRA tax credit would be lower, e.g. $25 per employee enrolled, capped at $250 in the aggregate per employer. Employers could not claim both the new plan startup credit and the proposed automatic IRA credit.

Direct Deposit and Automatic Fund Transfers

The automatic IRA would capitalize on automated or electronic fund transfers. Many employers retain an outside service provider to manage payroll, including withholding, federal tax deposits, and direct deposit of paychecks to accounts designated by employees or contractors. For the numerous firms that already offer their workers direct deposit, direct deposit to an IRA would entail no additional cost, even in the short term. A large proportion of the employers that still process their payroll by hand would be exempted under the exception for very small employers. As a result, our proposal focuses chiefly on those employers that already use electronic payroll but have not used the same technology to provide employees a convenient retirement saving opportunity. Employers that do not use electronic payroll would have the option of "piggybacking" the payroll deposits to IRAs onto the federal tax deposits they currently make, whether online, by mail, or by delivery to the local bank.

Employees Covered

Employees eligible for the automatic IRA would include those who have worked for the employer on a regular basis (including part-time) for a specified period of time and whose employment there is expected to continue. Employers would not be required to offer automatic IRAs to employees who are already covered by a retirement plan or are excludable from coverage (such as recently-hired employees, those who work less than 1,000 hours a year, union-represented employees or nonresident aliens without US source income) under the qualified plan rules. Accordingly, the proposal is not intended to apply to employers that offer 401(k), SIMPLE, pension or other qualified retirement plans to their employees.[37]

Portability of Savings Through Choice of Roth or Traditional IRA

Like a 401(k) contribution, the amount elected by the employee as a salary reduction contribution generally would be tax-favored. It either would be a contribution to a Roth IRA, which receives tax-favored treatment upon distribution, or a "pre-tax" contribution to a traditional, tax-deductible IRA. To spare households the need to undertake the comparative analysis of Roth versus traditional IRA, one or the other would be the default or presumptive choice. Of course, presented with an automatic or standard option, many households will simply go along with it, while others will consider whether to choose the other alternative. Accordingly, the automatic approach strikes a balance between simplicity and individual choice. In either case, the use of IRAs maximizes portability of savings. IRAs generally continue in existence without regard to changes in the owner's employment status and, in general, are freely transferable by rollover to other IRAs or qualified plans.

Expanding Saving through Automatic Features

Obstacles to Participation

Today, individuals who want to save in an IRA must make a variety of decisions to open an account. In addition, they must overcome a natural tendency to delay making important decisions until the last minute. At least five key questions are involved:

- whether to participate at all;
- which financial institution to use to open an IRA (or, if they have an IRA already, whether to use it or open a new one);
- whether the IRA should be a traditional or Roth IRA;
- how much to contribute to the IRA; and
- how to invest the IRA.

These obstacles can be overcome by making participation easier and more automatic.

[37] The only exception would be an employer that sponsored a retirement plan but excluded a major portion of its workforce – for example, excluding an entire division or subsidiary that is not union-represented or foreign – in which case the employer would be required to offer payroll deposit saving to the rest of the workforce.

Automatic Enrollment or an Explicit "Up or Down" Employee Election

Automatic enrollment (more often applied to newly hired employees but now increasingly applied to both new hires and other employees) has produced dramatic increases in 401(k) participation.[38] In view of the basic similarities between employee payroll-deduction saving in a 401(k) and under a direct deposit IRA arrangement, the law should, at a minimum, permit employers to automatically enroll employees in direct deposit IRAs.

However, simply allowing employers to use automatic enrollment with direct deposit IRAs may not be enough. Requiring employers to use automatic enrollment in conjunction with the payroll deduction IRAs (with a tax credit and legal protections) likely would increase participation dramatically while preserving employee choice. However, a workforce that presumably has not shown sufficient demand for a retirement plan to induce the employer to offer one might react unfavorably to being automatically enrolled in direct deposit savings without a matching contribution. In addition, some small business owners who work with all of their employees closely each day might regard automatic enrollment as unnecessary.

Accordingly, automatic enrollment would be the presumptive or standard enrollment method, but employers could opt out of it in favor of an alternative approach, which is in effect a variation on automatic enrollment. The alternative requires all eligible employees to submit an election that explicitly either accepts or declines payroll deposit to an IRA. Requiring an "up or down" election picks up many who would otherwise fail to participate because they do not complete and return the enrollment form due to procrastination, inertia, inability to decide on investments or level of contribution, and the like.[39] Any employee who fails to comply with the election requirement is automatically enrolled. In either case, to maximize participation, employers receive a standard enrollment module reflecting current best practices in enrollment procedures.[40]

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[38] Brigitte Madrian and Dennis Shea, "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior," Quarterly Journal of Economics 116, no. 4 (November 2001): 1149-87; and James Choi and others, "Defined Contribution Pensions: Plan Rules, Participant Decisions, and the Path of Least Resistance," in Tax Policy and the Economy, vol. 16, edited by James Poterba (Cambridge, Mass.: MIT Press, 2002), pp. 67-113. See also Sarah Holden and Jack VanDerhei, "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Accumulations at Retirement," Employee Benefit Research Institute Issue Brief No. 283 (July 2005).

[39] James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick, "Optimal Defaults and Active Decisions," NBER Working Paper No. 11074 (January 2005).

[40] A national website could provide firms these standard enrollment and election forms, as well as provide an opportunity to promote employee education and best practices as they evolve, such as automatic enrollment and potentially, lifetime guaranteed income.

In addition, employees like automatic enrollment. Retirement Made Simpler -- a coalition of advocacy, regulatory and policy organizations, including AARP, the Financial Industry Regulatory Authority (FINRA), and the Retirement Security Project (RSP) – was launched to encourage employers to help their employees be better prepared financially for retirement. Retirement Made Simpler recently released a survey on employee satisfaction with automatic enrollment. The survey, a first of its kind, reached out to employees who work at firms that use automatic enrollment. The results are striking. Of these employees, 97% agreed that they were satisfied with automatic enrollment, and 74% of them were "very satisfied." Agreement that automatic 401(k) has helped them start saving for retirement earlier than planned is 85%, with 62% at "Strongly agree". And agreement that automatic enrollment has made saving for retirement easy is 95%, with 71% at "Strongly agree." Even among those who opted out of their company's 401(k) plan, a full 79% were glad their company offered automatic enrollment to employees.

Compliance

Whether using automatic enrollment or explicit "up or down" elections from employees, employers would be required to obtain a written (including electronic) election from each nonparticipating employee. That way, no one would be left out by reason of inertia. If the employer chose to use automatic enrollment, the notice would also inform employees of that feature (including the automatic contribution level and investment and the procedure for opting out), and the employer's records would need to show that employees who failed to submit an election were in fact participating in the payroll deduction saving. Employers would be required to certify annually to the IRS that they were in compliance with the payroll deposit saving requirements.[41]

Making a Saving Vehicle Available To Everyone

Under the automatic IRA, individuals who wish to direct their contributions to a specific IRA can do so. To make this happen, the employer has two choices:

- remitting all employee contributions in the first instance to IRAs at a single private financial institution (chosen by the employer), from which employees can transfer the contributions, without cost, to their own IRA, or

[41] This might be done in conjunction with the existing IRS Form W-3 that employers file annually to transmit Forms W-2 to the government. Failure to offer payroll deposit saving would ultimately be backed up by an excise tax similar to (but much lower than) that imposed for employer violations of the COBRA health care continuation coverage requirements. The intent is that employers would never have to pay such an excise tax; it is simply a deterrent to noncompliance, accompanied by a rather forgiving array of exceptions, opportunities for correction, and relief for unintentional noncompliance that is generally patterned after the corresponding COBRA provisions. Compare Code Section 4980B.

- if the employer or employees could not find an IRA provider willing to serve their market for an acceptably low fee, or if the employer preferred not to designate a particular financial institution for provide IRAs for employees, employers and employees would have access to a standard fallback IRA account, as described below.[42]

A Low-Cost Standard Automatic Account

The fallback arrangement, which might take the form of an industry consortium or nonprofit organization, would make a standard IRA account automatically available to receive direct deposit contributions from employees. These accounts would be maintained and operated by private financial institutions under contract with the federal government. By contrast to the wide-open array of investment options provided in most current IRAs (which can be daunting for many savers) and the high (and costlier) level of customer service provided in many 401(k) plans, the standard account would provide only a few investment options (to maximize economies of scale and reduce cost). It would permit individuals to change their investments only once or twice a year, and would emphasize transparency of investment and other fees and expenses. Like the investment options under the federal Thrift Savings Plan for federal employees, it is contemplated that costs could be minimized, for example, through the use of passive investments such as index funds provided and managed by private financial institutions or other private-sector investments that are similarly low-cost. This would not limit anyone's choices: individuals who preferred other IRA investments could simply continue contributing to an IRA outside the context of these proposed new arrangements.

Automatic Investment Fund Choice

The IRAs selected by employees or employers from among those offered by private financial institutions as well as the fallback standard IRAs would provide low-cost professional asset management to millions of savers, with a view to improving their aggregate investment results. To that end, these IRAs would offer an automatic or default investment fund (generally similar, at least initially, to the kinds of investments described as "Qualified Default Investment Alternatives" in Department of Labor regulations)[43] for all deposits unless the individual chose otherwise. This automatic investment choice could be a highly diversified "target asset allocation" or "life-cycle" fund comprised of a mix of equities and fixed

[42] Morever, nothing would prevent an employer willing to do so from following employee directions as is ordinarily done when employers make direct deposits of paychecks to accounts specified by employees..

[43] "Default Investment Alternatives Under Participant Directed Individual Account Plans; Final Rule," Department of Labor Employee Benefits Security Administration, Federal Register (Vol. 72, No. 205), October 24, 2007. See also letter from J. Mark Iwry, Principal, Retirement Security Project, to Department of Labor Employee Benefits Security Administration, dated November 13, 2006 (available at www.retirementsecurityproject.org), commenting on the Department's proposed regulations.

income or stable value investments, and probably relying heavily on index funds or other cost-minimizing approaches. It could also make available some elements of guarantee against loss of principal, in exchange for a limited reduction in the rate of return.

One approach to minimize cost and maximize simplicity might be a temporary, short-term default investment in a guaranteed, principal-preserving option such as a bank certificate of deposit or other fixed income vehicle. Such a default would apply, if at all, only until account balances grew large enough to make them more self-sustaining.

Because it is desirable to maintain a degree of flexibility in order to accommodate and reflect market creativity, best practices, and the evolving consensus of expert financial advice over time, the proposed legislation would not fully specify the automatic investment. General statutory guidelines would be fleshed out at the administrative level after a process of extensive consultation with private-sector investment experts. In addition, the IRAs employees or employers select from private financial institutions would also offer at least a few investment alternatives, consistent with normal market practice, but would not be limited to any prescribed array of investment options.

Employers Protected from Risk of Fiduciary Liability

Employers making payroll deposits would be insulated from potential liability or fiduciary responsibility with respect to the manner in which direct deposits are invested in automatic IRAs, even if the IRA provider is selected by the employer. Nor would employers be exposed to potential liability with respect to any employee's choice of IRA provider or type of IRA. This protection of employers would be facilitated by regulatory designation of standard investment types that reduces the need for continuous professional investment advice. In addition, employers could avoid responsibility even for the selection of an IRA provider for their employees by specifying the government-contracted fallback automatic IRA (or, if the employer wished to, allowing each employee to specify his or her preferred IRA provider).

The Importance of Protecting Employer Plans

The automatic IRA proposal is designed carefully to avoid competing with or crowding out employer plans. Probably the most important protection for employer plans is the use of IRAs, which have maximum permitted contribution levels of $5,000 (with an additional $1,000 if the contributor is age 50 or older). This is sufficient to meet the demand for saving by millions of households but not high enough to satisfy the appetite for tax-favored saving of business owners or decision-makers, who can contribute up to $15,500 of their own salary to a 401(k) (or $20,500 if age 50 or older) plus matching or nonmatching employer contributions that can bring the total annual 401(k) contributions on their behalf to

$46,000 a year.[44] In addition, by design, the employer tax credit for providing access to automatic IRAs is significantly less than the small employer tax credit for sponsoring a new 401(k), SIMPLE or other retirement plan.

In fact, the automatic IRA is designed to actually promote more employer plans. First, any employer that wants to match its employees' contributions must adopt a qualified plan or SIMPLE; to preserve that incentive, the automatic IRA does not allow employer contributions. Second, any small business owner or decisionmaker who wants to save more than $5,000 or $6,000 a year on a tax-favored basis would have an incentive to adopt a SIMPLE or 401(k). Finally, the automatic IRA gives consultants, third-party administrators, financial institutions, and other plan providers a new way to penetrate the small business pension market with 401(k)s, SIMPLEs and other tax-favored employer plans. Because these plans can now be purchased at very low cost, it would seem natural for many small businesses – especially those whose owner would like to save more or to match employees' saving – to graduate from payroll deduction saving and complete the journey to a qualified plan.

Encouraging Contributions by the Self-Employed and Independent Contractors

For the self-employed and others who have no employer, regular contributions to IRAs would be facilitated in four principal ways:

- Expanding access to automatic debit arrangements, including through professional and trade associations that could help arrange for automatic debit and direct deposit to IRAs. Automatic debit essentially replicates the power of payroll deduction insofar as it continues automatically once the individual has chosen to initiate it.
- Extending the payroll deposit option to many independent contractors through direct deposit with firms from which they receive regular payments (without affecting the individual's status as an independent contractor);
- Enabling taxpayers to direct the IRS to make direct deposit of a portion of their income tax refunds to an IRA (which became possible for the first time last year); and
- Allowing the self-employed to transmit IRA deposits with their quarterly estimated income taxes.

Matching Deposits as a Financial Incentive

A powerful financial incentive for direct deposit saving by those who are not in the higher tax brackets (and who therefore derive little benefit from a tax

[44] The IRA and 401(k) contribution limits (as well as the limits applicable to SIMPLE plans) are indexed for cost-of-living.

deduction or exclusion) would be a matching deposit to their payroll deposit IRA. By increasing assets under management, a match would also increase private financial institutions' interest in providing IRAs. One means of delivering such a matching deposit would be via the financial institution that provides the payroll deposit IRA. For example, the first $500 contributed to an IRA by an individual who is eligible to make deductible contributions to an IRA might be matched by the private IRA provider on a dollar-for-dollar basis, and the next $1,000 of contributions might be matched at the rate of 50 cents on the dollar. The financial provider would be reimbursed for its matching contributions through federal income tax credits.[45]

Evidence from a randomized experiment involving matched contributions to IRAs suggests that a simple matching deposit to an IRA can make individuals significantly more likely to contribute and more likely to contribute larger amounts.[46] Matching contributions – similar to those provided by most 401(k) plan sponsors – not only would help induce individuals to contribute directly from their own pay, but also, if the match were automatically deposited in the IRA, would add to the amount saved in the IRA. The use of matching deposits would require procedures to prevent gaming – contributing to induce the matching deposit, then quickly withdrawing those contributions to retain the use of those funds.[47]

Guaranteed Lifetime Income

The automatic IRA could also serve as a natural platform or proving ground for best practices in retirement savings, possibly including, over time, an expanded use of lifetime guaranteed income. There is reason to believe that many households with savings but no lifetime income stream to supplement Social Security would be better off if they converted a portion of their savings to (appropriately priced) guaranteed income. Yet most are reluctant to do so. The same automatic strategy used to promote enrollment and sensible investment could encourage more workers to obtain the security of an annuity or other guaranteed lifetime income, including perhaps "longevity insurance" that provides a deferred annuity beginning at age 80 or 85, for example. The attractiveness of lifetime income options is increasing as providers offer more features that are responsive to consumer concerns (such as death benefits, cash surrender

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[45] This raises a number of issues. For further discussion, see discussion of proposed reforms of the Saver's Credit, e.g., William G. Gale, J. Mark Iwry, and Peter R. Orszag, "The Saver's Credit: Expanding Retirement Savings for Middle- and Lower-Income Americans" (Retirement Security Project Publication No. 2005-02, March 2005).

[46] Esther Duflo, William Gale, Jeffrey Liebman, Peter Orszag, and Emmanuel Saez, "Saving Incentives for Low- and Middle-Income Families: Evidence from a Field Experiment with H&R Block" (Retirement Security Project, May 2005).

[47] Among the possible approaches would be to place matching deposits in a separate sub-account subject to tight withdrawal rules and to impose a financial penalty on early withdrawals of matched contributions.

options, and products combining guaranteed minimum benefits with potential for growth). The uniform default investment and the backstop automatic IRA for any employees who cannot find an appropriate IRA in the market may lend themselves to exploring means of encouraging greater use of low-cost guaranteed income in IRAs generally as well as in 401(k) and other employer plans.[48]

As former Chair of the Council of Economic Advisers Laura Tyson pointed out in a Wall Street Journal op-ed article endorsing the automatic IRA, "[j]ust as the Automatic 401(k) and Automatic IRA would help to ensure that employees have enough retirement savings, automatic guaranteed lifetime income would help to ensure that they do not outlive their savings"[49] and have an income stream they can count on.

Conclusion

American households have a compelling need to increase their personal saving, especially for long-term needs such as retirement. To that end, effective policy must focus both on the accumulation of assets and on the preservation of those assets to provide security in retirement.

Accordingly, this testimony addresses both preservation and accumulation. It first addresses preservation of savings in 401(k) and similar employer-sponsored retirement plans, including recent efforts to limit pension "leakage" and recommendations regarding future strategies. Next the testimony summarizes a strategy to make accumulation of savings more automatic – hence easier, more convenient, and more likely to occur. By adapting to the IRA universe practices and arrangements that have proven successful in promoting 401(k) participation, the automatic IRA approach holds considerable promise of expanding retirement saving for millions of workers.

This bipartisan, cross-ideological automatic IRA proposal put forward in S. 1141 has elicited favorable responses from across the political spectrum. As Congressional Budget Office Director Peter Orszag recently stated, "I do sense

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[48] Accordingly, S. 1141 and H.R. 2167 require a joint study by the Labor and Treasury Departments of the feasibility and desirability of promoting the use of low-cost annuities, longevity insurance, or other guaranteed lifetime income arrangements in automatic IRAs, including consideration of – (i) appropriate means of arranging for, or encouraging, individuals to receive at least a portion of their distributions in some form of low-cost guaranteed lifetime income, and (ii) issues presented by possible additional differences in, or uniformity of, provisions governing different IRAs. Section 4(b)(1)(B). The bills also would provide for a joint study of the feasibility and desirability of extending to automatic IRAs spousal consent requirements similar to, or based on, those that apply under the Federal employees' Thrift Savings Plan, including consideration of whether modifications of such requirements are necessary to apply them to automatic IRAs. Section 4(b)(1)(A).

[49] Laura D'Andrea Tyson, "Some No-Brainer Savings Ideas," Wall Street Journal, October 30, 2007, page A-18.

that there is significant bipartisan support for this kind of approach."[50] Indeed, support has come from both the Chair of the Council of Economic Advisers under President Clinton and the Chair of the Council of Economic Advisers under President Reagan, from the New York Times editorial page and the Washington Times' chief political correspondent.[51]

Similar types of proposals have been introduced by Senate Finance Committee Chairman Max Baucus and advanced by the Commission on the Regulation of U.S. Capital Markets in the 21st Century, an Independent Bipartisan Commission Established by the U.S. Chamber of Commerce, while the automatic IRA proposal itself has been supported or has been the subject of favorable comment by a variety of other groups and individuals including AARP, Marketwatch, Newsday, Jane Bryant Quinn, and the 2006 National Summit on Retirement Savings.[52]

Chairman Kohl, Ranking Member Smith, and Members of the Committee, we appreciate the opportunity to testify before the Committee and would be happy to respond to any questions.

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[50] Presentation at the Retirement Security Project conference on "The Automatic Revolution" at the National Press Club, Washington, D.C., June 10, 2008.

[51] The former Chair of President Clinton's Council of Economic Advisers, Laura Tyson, has stated that the "Automatic IRA would help to ensure that employees have enough retirement savings," (Wall Street Journal, Oct. 30, 2007), and the former Chair of President Reagan's Council of Economic Advisers, Professor Martin Feldstein, has said, "I am a great enthusiast of automatic enrollment IRAs. I think as a policy it's a no-brainer. I think the legislation should be enacted. I can't imagine why there would be any significant opposition from political players on either side of the aisle." Presentation at the Retirement Security Project conference on "The Automatic Revolution" at the National Press Club, Washington, D.C., June 10, 2008.

The New York Times has stated, in an editorial, "The best idea yet developed for making savings universal is an I.R.A. that is funded with automatic direct deposits from a paycheck. . . . Congress should pass legislation to establish auto-I.R.A.'s, and the president should sign it." (New York Times, editorial, March 18, 2006). The **Washington Times' chief political correspondent, Donald Lambro, has said, "The savings rate in our country . . . is abysmal. This [the Automatic IRA] would dramatically turn that rate around, helping millions to build wealth and some measure of retirement security." (Washington Times, April 12, 2007.)**

[52] See n. 3, above, and www.retirementsecurityproject.org.

The CHAIRMAN. Thank you, gentlemen.

We would like to hear from Mr. Long at this point.

STATEMENT OF GREGORY T. LONG, EXECUTIVE DIRECTOR, FEDERAL RETIREMENT THRIFT INVESTMENT BOARD, WASHINGTON, DC

Mr. LONG. Chairman Kohl, Ranking Member Smith and members of the committee, my name is Greg Long. I am the Executive Director of the Federal Retirement Thrift Investment Board and, as such, the managing fiduciary of the Thrift Savings Plan for Federal employees. I welcome the opportunity to appear before your committee to discuss the TSP loan and in-service withdrawal programs.

I commend the committee's efforts to focus public attention on protecting and strengthening retirement savings programs, especially with regard to those participants who might engage in unnecessary borrowing or indiscriminate early withdrawals. The board's own experience over the past 20 years shows that a close attention and a willingness to adjust in these areas is critical to ensure a good balance between the goals of achieving participants' long-term retirement goals and meeting their short-term needs.

In 1988, TSP participants who contributed their own funds were first permitted to borrow for four specific purposes: medical expenses, education, financial hardship, or to purchase a primary residence. Documentation to demonstrate the loan's purpose was required. Participants could have a maximum of two loans outstanding. Like 401(k) plans, TSP loans were subject to restrictions found in the Internal Revenue Code and in regulations issued by the IRS. As with similar loan programs in 401(k) plans, our loan is intended to encourage employees to voluntarily contribute their own funds by allowing limited access to those funds when necessary.

After 8 years of administrative experience, the board identified three areas that required improvement. First, the four purposes were viewed by some as overly restrictive. Second, the documentation process, which for a worldwide plan like the TSP, was of necessity conducted over long distances by mail, was administratively difficult. Finally, some participants with financial difficulties were already overwhelmed by debt. They required debt relief in order to get their heads above water.

The board worked with the Congress and Senator Ted Stevens in particular, who is widely regarded as the father of the TSP, to resolve these issues in legislation. As a result of the Thrift Savings Plan Act of 1996, the board was permitted to offer general purpose loans requiring no documentation. Additionally, in-service withdrawals for financial hardship and for those who attained age 59 and a half were allowed for the first time.

As expected, loan activity increased. Between 1997 and 2003, the number of participants with loans increased from 219,000 to 554,000. Although we cannot demonstrate any direct connection, the FERS participation rate increased from 82.9 to 86.9 percent during the same period.

The TSP loan program was again modified in 2004. The need for this change was identified a year earlier when the board implemented a new daily valued record keeping system. A relatively small number of participants were found to be borrowing slightly larger amounts over and over again in an apparent attempt to supplement their basic pay. A review of this practice found that one participant had used the program to borrow 31 times.

As the board was implementing a new record keeping system in 2003, this serial borrowing caused significant administrative problems. In July 1904, after careful study and a review of private sector practices, the board implemented three changes: a $50 loan fee, a 60-day waiting period between loans, and a limit of just one general purpose and one primary residential loan at any time.

We view these changes, which we continue to employ today, as highly effective. A total of 353,000 new TSP loans were disbursed during 2003. In 2005, that number dropped to 192,000. The overall number of loans, which was rapidly approaching 1 million, has steadily declined.

Meanwhile, the total average monthly contribution per participant has continued to steadily increase, from $432 per month in 2005 to $497 per month in 2008.

Unlike the changes that characterize the 20-year history of the TSP loan program, the in-service withdrawal program, which first became available in 1997, has had only one major change. Originally, like loans, hardship required documentation. As with loans, the board found this requirement to be administratively burdensome. Therefore, with the introduction of the new record keeping system, participants were permitted to self-certify their hardship conditions. However, I would like to point out that in addition to the tax consequences, participants are also restricted from making employee contributions and therefore from receiving matching contributions for 6 months after taking a financial hardship withdrawal. Therefore, there are deterrents built into the program.

Finally, I have also provided the committee with copies of our 2008 edition of Highlights, which is our newsletter. The feature article of this newsletter, which is published on our website, is being sent to participants. The key article is called “Look Before You Leap.” I would like to explain why I found it necessary to issue such a caution to participants.

Earlier this year, I stepped out of the board’s office in downtown Washington and I saw a bus stop billboard that urged Federal employees to transfer their “old” TSP accounts—I put that in quotes—to the advertising sponsor’s IRA. Shortly thereafter, a second advertising campaign, which is similarly targeted, told readers that their TSP accounts would retire.

I am here today to advise that after 21 years, the TSP is still young and vigorous. It is not getting old and it does not intend to retire. Thanks to the wisdom of Senator Stevens and other congressional authors, it will continue to follow the timeless principle of tracking broad market performance while adding value for participants via very low administrative expenses.

And our participants recognize the value of the TSP. Last year, over 20,00 checks came in for a total of $478 million rolled into the TSP from private sector 401(k) and IRA accounts.

Thank you for the opportunity to testify. I would be pleased to respond to any questions.

[The prepared statement of Mr. Long follows:]

STATEMENT OF GREGORY T. LONG
EXECUTIVE DIRECTOR, FEDERAL RETIREMENT
THRIFT INVESTMENT BOARD
BEFORE THE SPECIAL COMMITTEE ON AGING
OF THE UNITED STATES SENATE
JULY 16, 2008

Chairman Kohl, Ranking Member Smith, and members of the Committee, my name is Greg Long. I am the Executive Director of the Federal Retirement Thrift Investment Board and, as such, the managing fiduciary of the Thrift Savings Plan for Federal employees. I welcome the opportunity to appear before your Committee to discuss the TSP loan and in-service withdrawal programs.

I commend the Committee's efforts to focus public attention on protecting and strengthening retirement savings programs, especially with regard to those participants who might engage in unnecessary borrowing or indiscriminate early withdrawals. The Board's own experience over the past twenty years shows that close attention and a willingness to adjust in these areas is essential to ensure a good balance between achieving participants' long-term retirement goals and meeting their short-term needs.

In 1988, TSP participants who voluntarily contributed their own funds were first permitted to borrow for four specific purposes: medical expenses, education, financial hardship, or to purchase a primary residence. Documentation to demonstrate the loan's purpose was required. Participants could have a maximum of two loans outstanding. Like 401(k) plans, TSP loans were subject to restrictions found in the Internal Revenue Code and in regulations issued by the Internal Revenue Service. As with similar loan programs in 401(k) plans, our loan program is intended to encourage employees to voluntarily contribute their own funds by allowing limited access to those funds when necessary.

After eight years of administrative experience, the Board identified three areas that required improvement. First, the four purposes were viewed by some as overly restrictive since many seemingly legitimate needs (such as expenses associated with adoption) did not automatically qualify for a loan. Second, the documentation process – which for a world-wide plan like the TSP was of necessity conducted over long distances by mail – was time-consuming and administratively difficult. Finally, some participants with financial difficulties were already overwhelmed by debt. They required debt relief in order to get their heads above water and to move forward.

The Board worked with the Congress and Senator Ted Stevens in particular -- who is widely regarded as the father of the TSP – to resolve these issues in legislation. As a result of the Thrift Savings Plan Act of 1996, the Board was permitted to offer general purpose loans requiring no documentation. Additionally, in-service withdrawals for financial hardship or for those who have attained age 59 ½ were allowed for the first time.

As expected, loan activity increased when these changes were implemented. Between 1997 and 2003, the number of participants with loans increased from 219,208 to 554,057. Although we cannot demonstrate any direct connection, the FERS participation rate increased from 82.9% to 86.9% during the same time period.

Interestingly, during this growth in the number of loans, the value of outstanding loan amounts as a percent of total TSP assets remained at 3% for three years and then topped-out at just 4%. Thus, while many more participants were borrowing for more purposes, the percentage of assets that remained fully invested for the long term was not significantly reduced. This was because of the continued growth of contributions and the strong investment returns from the markets during the late 1990's.

The TSP loan program was modified again in 2004. The need for this change was identified a year earlier when the Board implemented a new daily-valued record keeping system for the TSP. A relatively small number of participants were found to be borrowing slightly larger amounts over and over again in an apparent attempt to continuously supplement their basic pay. A review of this practice found that one participant had used the program to borrow a total of 31 times.

As originally implemented, the TSP loan program was viewed as a benefit of participation. In order to encourage voluntary contributions by employees, loans were available to all eligible participants without an application fee or processing charge. Interest is calculated at the Government Securities Investment (G) Fund interest rate during the month of application. While this simple design met original needs, it allowed for this frequent borrowing of relatively small amounts. As the Board was implementing the new record keeping system in 2003, this "serial borrowing" caused significant administrative problems. In July 2004, after careful study and review of private sector practices, the Board implemented three changes: a $50 loan fee, a 60-day waiting period between loans, and a limit of just one general purpose and one primary residence loan at any time.

We view these changes, which we continue to employ today, as highly effective. A total of 353,716 new TSP loans were disbursed during 2003, which was the last full year of operations under the old rules. After the transition year, 2004, the number of new loans issued declined to 192,757 in 2005. The overall number of loans, which was rapidly approaching one million, began to decline. The average amount borrowed for general purpose loans increased, as did the percentage of residential loans. However, the average loan balance relative to the average account balance has not trended up.

After reaching a high point of 4% in 2003, outstanding loan dollars as a percent of assets fell back to 3% and has held steady since then. Meanwhile, the total average monthly contribution per participant has continued to steadily increase -- $432 in 2005, $474 in 2006, $492 in 2007, and $497 thus far in 2008.

Unlike the changes which characterize the 20 year history of the TSP loan program, the in-service withdrawal program, which first became available in 1997, has only had one major administrative change. Originally, like loans, financial hardship in-service withdrawals, which allowed participants to withdraw their own funds in times of genuine financial need, required documentation. As with loans, the Board found this requirement to be both restrictive and administratively burdensome. Therefore, with the introduction of the new record keeping system in 2003, participants were permitted to self-certify their hardship conditions. However, I would like to point out that in addition to the tax consequences associated with a withdrawal, participants are also restricted from making employee contributions (and therefore receiving matching contributions) for six months after taking a financial hardship withdrawal. Therefore, there are deterrents built into the program to discourage participants from acting indiscriminately.

Data on TSP hardship withdrawals do show an increase after we transitioned to hardship self-certification and the new loan rules. However, growth between 2005 and 2007 was relatively small, and data thus far for 2008 indicates no increase in utilization over last year. The average amount of a hardship withdrawal in 2007 ($8,081) trailed the average general purpose loan ($12,087) and residential loan ($18,793) amounts, as well as the average size of an age-based withdrawal ($55,476). Clearly, the negative aspects of hardship withdrawals have made them the least attractive option for participants.

Although utilization has been steady, through design and careful administration, we believe this program continues to meet an important need. Our education materials urge participants to fully recognize the adverse consequences of early withdrawal, and to consider borrowing if that option is available to them. We have provided copies of our Loan and In-Service Withdrawal booklets for review by the Committee. We have also provided copies of our January and July 2004 *Highlights*, the TSP newsletter, which we used to introduce the loan changes.

The age-based in-service withdrawal program is intended to allow individuals who reach their retirement age – 59 ½ under the Federal tax code – to access their funds as they transition into retirement. This program continues to achieve this goal, and changes have not been required.

Finally, I have also provided the Committee with copies of our July 2008 edition of the *Highlights*. The feature article of this newsletter, which was just published on our Web site, www.tsp.gov, and is being sent to participants who receive their quarterly statements by mail, is entitled "Look before you leap!" I would like to explain why I found it necessary to issue such a caution to our participants.

Earlier this year, I stepped out of the Board's office in downtown Washington and saw a bus stop billboard urging Federal employees to transfer their "old" TSP accounts to the advertising sponsor's IRA. Shortly thereafter, a second advertising campaign, similarly targeted, told readers that their TSP accounts would "retire."

I'm here today to advise that after 21 years, the TSP is still young and vigorous. It isn't getting old. And, it does not intend to retire. Thanks to the wisdom of Senator Stevens and other Congressional authors, it will continue to follow the timeless principle of tracking broad market performance while adding value for participants via very low administrative expenses. And our participants recognize the value of the TSP. Last year, we accepted more than 20,700 checks totaling over $478 million in funds being rolled over into the TSP from private sector 401(k) and IRA accounts.

Separated participants may leave their funds on account if they wish. Nearly one million separated employees have chosen to do so. Those participants who would like to transfer their retirement savings from the TSP to an IRA are welcome to do so. But no one should move their funds from the TSP out of a concern that the TSP is old or retired.

All of our communications efforts encourage informed decision making. "Look before you leap!" gives our participants the information they need to resist the lure of misinformed advertisers and to make an informed decision.

In closing, I would again like to recognize the ongoing work by this Committee to protect and strengthen savings for retirement. Especially in a difficult economic environment, employees require consistent encouragement to save, and good information to make sound choices. Your hearing today advances both of these goals. Thank you for the opportunity to testify. I would be pleased to respond to any questions you may have.

The CHAIRMAN. Thank you very much, Mr. Long.

Now we will hear from Mr. Gannon.

STATEMENT OF JOHN GANNON, SENIOR VICE PRESIDENT, OFFICE OF INVESTOR EDUCATION, FINANCIAL INDUSTRY REGULATORY AUTHORITY, WASHINGTON, DC

Mr. GANNON. Mr. Chairman and members of the committee, I am John Gannon, Senior Vice President for Investor Education at the Financial Industry Regulatory Authority. As the largest non governmental regulator for the country's securities firms, FINRA's top priority is to ensure fair markets for American investors.

On behalf of FINRA, I would like to thank you for the opportunity to testify on such an important topic. You have my written testimony, so this morning I would like to highlight what we at FINRA view as emerging threats to a secure retirement.

For today's investors, especially those close to retirement, the number of hurdles on the road to financial security is growing every day. The cost of living is up. Home prices are down, and credit has dried up. Financial institutions that once seemed invincible have failed or are in trouble.

The Washington Post reports that nearly three out of five middle class retirees will likely run out of money if they do not change their spending habits. Supporting that is a recent AARP study citing the personal bankruptcy filings for middle-aged Americans has risen by more than 50 percent since the 1990's.

When people feel pinched for cash, they often choose risky ways to make ends meet. In fact Fidelity, T. Rowe Price, and Vanguard have reported significant increases in 401(k) hardship withdrawals since last year. A recent Wall Street Journal Harris Interactive Survey found that about one-quarter of adults actively planning for retirement have prematurely withdrawn money from their retirement investments.

Also feeding into this anxiety or unscrupulous financial professionals, many of them unregistered. They push investments that promise security, but too often they end in financial ruin.

At FINRA, we believe that the first line of defense for every investor is education. That is why we are focused on teaching investors about the importance of retirement savings and the consequences of early withdrawals from 401(k)'s. FINRA is focused in two ways to help protect investors and teach them in these uncertain times. First, we use surveillance and enforcement tools to detect and deter abusive sales practices. Second, we do everything we can to educate investors to help them make the best financial decisions.

I would like to highlight two areas of concern today: early retirement scams and 401(k) debit cards.

As you know, section 72(t) of the IRS Code permits penalty-free early withdrawals from company-sponsored plans before the age of 59 and a half. Some financial advisors tout 72(t) as a loophole that allows investors to retire early by withdrawing assets and reinvesting them. Investors are often promised unrealistically high returns, but are rarely told about the down side of those investments.

One case in particular comes to mind. A few years ago, a 57-year-old retiree from Belton, MO was promised that his 72(t) investment would earn 9 percent. He was persuaded to invest $1 million in retirement savings into two variable annuities, and 7 months later, $225,000 of his principal was gone. But that was just the beginning. Eventually he lost over $450,000 due to the negligence and fraud on the part of his broker.

More recently, FINRA sanctioned two securities firms, Citigroup and Securities America, for misleading investors in this way. They were fined $5.5 million and ordered to pay $26 million in restitution to hundreds of former Bell South and Exxon Mobil employees. In both cases, the firms were onsite targeting employees at their work places. Given the aging U.S. demographic, we are likely to see even more investors victimized in this way. FINRA will continue to take action where investors are treated improperly.

Another potential threat to a secure retirement is the relatively new 401(k) debit card. In May, FINRA published an investor alert outlining the dangers of 401(k) debit cards, and we hope investors heed our warnings.

Investors can use a debit card to borrow directly from their 401(k) account for any purpose, but as they spend it, they may wipe out a good portion of their retirement savings. Taking money out of your retirement savings, even for a short period of time, can be disastrous.

FINRA has developed a number of tools that focus on building and protecting retirement savings.

First, we have our 401(k) Learning Center on our website, finra.org. Here we explain everything from 401(k) enrollment to the risks of cashing out before retirement.

FINRA has also teamed up with the Retirement Securities Project and AARP to establish Retirement Made Simpler, an effort to use automatic features such as automatic enrollment, to increase participation in 401(k) plans.

We issue investor alerts, warning about early retirement pitches and products that could be harmful and we offer online tools to help employers check out early retirement sales people and avoid potential scams.

Mr. Chairman, FINRA appreciates the opportunity to testify. We look forward to working with the committee, the SEC, and other regulators to expand Americans' financial knowledge and to help them build a secure retirement. I would be happy to answer any questions.

Thank you.

[The prepared statement of Mr. Gannon follows:]

FINRA™
Financial Industry Regulatory Authority

Testimony
of
John Gannon
Senior Vice President, Office of Investor Education
Financial Industry Regulatory Authority

Before the
Special Committee on Aging
United States Senate

July 16, 2008

Mr. Chairman and Members of the Committee, I am John Gannon, Senior Vice President for Investor Education with the Financial Industry Regulatory Authority, or FINRA. On behalf of FINRA, I'd like to thank you for the opportunity to testify today. FINRA and the FINRA Investor Education Foundation are committed to expanding the knowledge and confidence of all Americans wishing to build a more secure financial future through saving and investing, and we share your interest in protecting those savings and investments.

FINRA and the FINRA Investor Education Foundation

FINRA is the largest non-governmental regulator for all securities firms doing business in the United States. FINRA was created in 2007 through the consolidation of NASD and the Member Regulation, Enforcement and Arbitration divisions of the New York Stock Exchange. FINRA touches virtually every aspect of the securities business—from registering and educating all industry participants to examining securities firms; writing rules; enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities, and administering the largest dispute resolution forum for investors and registered firms. All told, FINRA oversees 5,000 brokerage firms, about 172,000 branch offices and more than 676,000 registered securities representatives.

FINRA believes investor protection begins with education. Using the Internet, the media and public forums, we help investors build their financial knowledge and provide them with essential tools to better understand the markets and basic principles of saving and investing. We issue educational materials to alert investors to potential problems and provide "plain English" explanations of products and processes. We have developed a variety of interactive tools for investors to use in making financial decisions. We conduct public education events to reach out to investors.

In addition to the investor education activities of FINRA itself, the FINRA Investor Education Foundation (FINRA Foundation) is the largest foundation in the United States dedicated to investor education. Its mission is to provide underserved Americans with the knowledge, skills and tools necessary for financial success throughout life. To further this mission, the Foundation awards grants to fund educational programs and research aimed at segments of the public who could benefit from additional resources. Since the FINRA Foundation's inception in December 2003, it has approved more than $31 million in financial education and investor protection initiatives through a combination of grants and targeted projects. Many of those projects target underserved segments of the population, including a particular focus on senior investors and military personnel and their families so that they are able to avoid fraudulent and inappropriate products and sales pitches and manage their money with confidence.

Current Financial Environment

A recent study by AARP found that in 2007 more than 1 in 5 debtors were over the age of 55, compared with 1 in 10 back in 1991. The study also found that the rate of personal bankruptcy filings among those ages 45 to 54 had jumped by more than 48 percent from 1991 to 2007. For those ages 55 to 64, the rate rose by 150 percent—and for those ages 75 to 84, by 433 percent. These are very disturbing numbers by any measure. But they represent the hard realities of today's financial environment for many Americans, especially when combined with the rising costs of food and fuel, declines and volatility in the housing and financial markets. And they represent a challenge for policy makers and regulators.

In tough financial times, many people feel pinched for cash—and some may search for different, often risky ways to make ends meet, or to maintain a certain lifestyle. Troubling trends include trading in insurance policies in transactions known as "life settlements," tapping the home equity through reverse mortgages, and today's topic –leveraging or prematurely depleting retirement savings.

At FINRA, we are concerned that some investors may be risking one of their most valuable assets in an effort to raise cash—including those in or near retirement, who may not have time to recover their losses. And unfortunately, some unscrupulous financial professionals—many of them unregistered—feed into this investor anxiety, pushing strategies and products that promise to provide balance and safety, but that often end up haunting an investor for a lifetime.

Early Withdrawals of Retirement Savings
There is no doubt that Americans are increasingly making early withdrawals of their retirement savings. Fidelity Investments reported a 17 percent increase in 401(k) hardship withdrawals last year, and T. Rowe Price reported a 10 percent increase. The number of 401(k) loans is also on the rise. In 2006, 11 percent of investors took loans from their plan. In 2007, the number of loans jumped to 18 percent.

These numbers serve as a warning sign, demanding extra vigilance on the part of regulators. FINRA is paying particularly close attention to products and strategies that allow investors to easily tap their retirement savings prematurely. We are concerned that some financial advisers have started advocating the use of retirement accounts as a way to address their clients' current cash problems or to recommend unsuitable investments or strategies for those funds while promising unrealistic returns.

But from FINRA's perspective, protecting investors today is made more complicated because there are many products that may be suitable for some investors, but are very unsuitable for others. If it were simply a matter of banning certain products, our job would be very easy. But we know that even products like variable annuities, which create issues when sold to the wrong people, can have legitimate value for some investors. At FINRA, we've taken a two-pronged approach to help protect investors in these unsteady times.

First, we use our surveillance and enforcement tools to detect and deter abusive sales practices, especially those aimed at seniors. Second, we do everything we can to educate investors to help them make the best financial decisions for their unique situation.

I'd like to highlight two areas of concern for you today. The first involves early retirement account withdrawals. The second is the relatively new phenomenon of 401(k) debit cards. Both are troublesome because they may make it easy—too easy—for investors to unlock retirement savings before they really need it.

Early Retirement Seminar Scams
Section 72(t) of the IRS code permits penalty-free early withdrawals from company-sponsored plans before the age of 59 ½. What we are seeing is that some financial advisers tout Section 72(t) as a "loophole" that allows investors to retire early by withdrawing assets through a series of substantially equal periodic payments and reinvesting in products that offer higher rates of return.

In some cases, the financial advisers may promise that the investments will generate returns high enough to allow the investor to maintain a standard of living that is equal to or even higher than they have while working. However, the promised rate of return is often unrealistically high, and investors are often not told about the potential downside to these investments, including the potential for total depletion of their retirement savings. Many times victims entrust a broker with the entire cash proceeds of their retirement accounts—forfeiting their right to receive a lifetime monthly benefit under their company's pension plan.

In recent cases, FINRA fined two securities firms (Citigroup and Securities America) $5.5 million and ordered them to pay $26 million in restitution related to this type of early retirement investment scheme. Given the aging U.S. demographic, this is a problem that is likely to grow and we are watching firms very closely to make sure investors are treated properly.

401(k) Debit Cards
In addition, there is a relatively new way investors are accessing funds from their retirement plans—the 401(k) debit card, which is like a debit and credit card rolled into one. It acts like a

debit card because it allows investors to access and spend their own money, rather than someone else's. But it also acts like a credit card because investors need to repay their balances over time.

FINRA published an Investor Alert outlining the pros and cons of 401(k) debit cards in May—and we hope investors heed our warnings. The pitfalls of theses debit cards are many.

Investors use a 401(k) debit card to borrow directly from their 401(k) account. Consumers can use the funds for any purpose and usually don't have to explain why they need the money or how they intend to spend it. But as they spend it, the potential is very high that they may wipe out a good portion of their retirement savings in the process. There can be significant tax liabilities, lost opportunity costs and even exposure to creditors of funds borrowed from retirement accounts if the investor ultimately has to declare bankruptcy.

If that weren't enough of a deterrent, the cards also charge interest and fees. The interest rate is usually tied to the prime rate, but a portion of that interest, as well as any fees, are paid to the card vendor. In addition to these finance charges, there may be set-up fees, annual fees and cash advance fees—so individuals should think long and hard before they sign up.

Taking money out of your retirement savings, even for a short period of time, can have enormous repercussions for your retirement security. The results can be disastrous if you never put that money back.

FINRA Investor Education Initiatives and Tools
As mentioned above, at FINRA, we believe the first line of defense in protecting investors is education. In support of that belief, FINRA and the FINRA Investor Education Foundation have developed a variety of tools and resources to educate investors about the importance of retirement savings and the potential impacts of early withdrawals, to encourage retirement savings and to assist investors in avoiding scams. Several of those efforts are outlined below:

- **401(k) Learning Center**
  To help investors of all ages with retirement savings, FINRA has developed an online 401(k) Learning Center, which is available on our Web site at *www.finra.org/investorinformation.* The center walks visitors through everything from the enrollment process, to the role of risk and reward when making allocation decisions, to issues of portability and the risks posed by cashing out of a 401(k) plan before retirement.

- **Investor Alerts**
  In addition, we regularly publish Investor Alerts to highlight issues, trends, pitches and products where we see danger of jeopardizing the secure financial future of U.S. investors. Several of our recent alerts have dealt specifically with retirement savings issues, notably *401(k) Debit Cards – Think Before You Swipe; Look Before You Leave: Don't Be Misled By Early Retirement Investment Pitches That Promise Too Much; Weathering Tough Financial Times—The Long-term Costs of Quick Cash, Think Twice Before Cashing Out Your 401(k), and Putting Too Much Stock in Your Company—A 401(k) Problem.*

- **Resources to Guard Against Early Retirement Seminar Scams**
  To assist employers and employees in guarding against early retirement seminar scams, FINRA introduced two online resources earlier this year. The resource for companies, *Help Your Employees Achieve Their Retirement Dream: Tips for Spotting Early Retirement Scams*, offers tips on how to evaluate the financial professionals involved in early retirement seminars and the seminar materials such as invitations, slides, handouts and scripts. Company representatives may also refer early retirement seminar materials

to FINRA for review if they have concerns. FINRA staff will review all seminar materials referred and inform the company whether the materials are consistent with applicable FINRA standards. A second resource, *Early Retirement Seminars 101: Smart Tips for Spotting Retirement Scams*, alerts employees to the pitfalls of early retirement schemes. FINRA has worked with both the Society of Human resources Management and the International Foundation of Employee Benefit Plans to ensure broad dissemination of these resources.

- **Retirement Made Simpler**
  In addition, we have teamed with the Retirement Security Project and AARP to establish "Retirement Made Simpler," an effort to increase participation rates among employees whose companies offer 401(k) plans. A recent brief issued by the Employee Benefit Research Institute (EBRI) notes that almost one-third of recently hired employees who are eligible to participate in their company's defined contribution plan do not participate, and participation rates for employees earning less than $20,000 a year is even lower. A number of academic studies have found that changing the default option to require workers to opt out of, rather than opt into participation in 401(k) plans raises participation rates to more than 90 percent. The goal of the Retirement Made Simpler collaboration is to encourage employers to adopt automatic enrollment and other so-called "automatic" 401(k) features options, in whole or in part.

- **Investor Protection Campaign for Older Americans**
  FINRA Investor Education Foundation-funded research unveiled in July 2006 shattered the stereotypes of senior investment fraud victims. The study revealed a fraud victim profile that was counterintuitive in many respects, as well as influence tactics used by fraudsters that were sophisticated and highly effective. These findings forced regulators and senior advocates alike to rethink how best to approach the challenge of equipping older investors with the tools and information they need to thwart fraudsters touting investment scams.

  In response, the FINRA Investor Education Foundation mounted a research-based, social change campaign designed to reduce the incidence of investment fraud among investors ages 55 and over. Earlier this year, the Foundation launched a pilot campaign to test social norm messages and intervention strategies that positively influence the behavior of older investors to decrease the likelihood that they will become victims of investment fraud. The pilot campaign was developed by the FINRA Investor Education Foundation, in collaboration with AARP, Washington State Department of Financial Institutions, Florida Office of Financial Regulation and noted experts in the fields of fraud and persuasion.

  The FINRA Investor Education Foundation's investor protection campaign seeks protect older investors from investment fraud by helping them to:

  Recognize that they are vulnerable to financial fraud;

  Identify persuasion techniques; and

  Reduce risky behaviors by asking questions and checking information.

  More information on the campaign, as well as additional financial education materials specifically aimed at the senior investor, are available on a website created by the FINRA Foundation: <u>www.SaveAndInvest.org/55plus</u>.

Conclusion

The need for retirement savings is greater than ever before, but people are tapping into that money with unprecedented frequency. We at FINRA are doing what we can to add to the chorus of voices trying to improve and increase retirement savings and combat the trend of using those savings before retirement except as a strategy of last resort. Through the means described above, we try to ensure that before investors withdraw funds from their retirement savings, they know the many good reasons to keep those savings intact. As we pointed out in a recent Investor Alert, people should at least consider the following before prematurely tapping into their retirement savings:

- **Tax Liability**—Unless you're over the age of 59 ½, you will not only have to pay income taxes on the amount you withdraw, but you will also be subject to a 10% tax penalty. In most cases, your employer will withhold 20% in federal taxes, so the amount you receive will be significantly lower than the amount you requested.

- **Opportunity Costs**—The repercussions of withdrawing funds from your 401(k) could be enormous in terms of lost growth opportunity. For example, let's assume you are 30 years old, and have a 401(k) balance of $20,000. If you leave that money alone, and your account averages a 6% rate of return over the next 32 years, your balance at retirement will be $129,068 when you're 62—even if you do not make any additional contributions during that time. If you take it out, you'll have nothing. Even if you have a shorter time horizon, you will forgo significant savings opportunities by taking money out of your 401(k). For a 45-year-old, that $20,000 will grow to $53,855 in 17 years.

- **Opening Assets to Creditors**—Under the Bankruptcy Abuse Protection and Consumer Protection Act of 2005, your creditors cannot touch your 401(k) balance or similar retirement savings account—even if, as a last resort, you file for bankruptcy protection. Balances in traditional and Roth IRAs are also protected up to a limit of $1 million. But if you take money out of your retirement plan through a loan or a hardship or regular withdrawal, your creditors can go after that sum.

If investors really need access to their retirement funds early, they should be aware that borrowing from a 401(k) may be a better option than taking a withdrawal. Depending on a plan's terms, investors may be able to borrow at a lower rate from their accounts than they could from a bank or other lender, and they won't have to pay taxes on the proceeds of that loan as they would with a withdrawal. Investors should pay back the loan, however, before it is treated as a withdrawal.

Again, FINRA appreciates the opportunity to testify on these important issues today. I'd be happy to take any questions you may have.

The CHAIRMAN. Thank you very much, Mr. Gannon.

Finally, we will hear from Mr. Bent.

STATEMENT OF BRUCE R. BENT, FOUNDER AND CHAIRMAN OF THE RESERVE, NEW YORK, NY

Mr. BENT. Chairman Kohl, Ranking Member Smith, and distinguished members of the committee, my name is Bruce Bent. I am the Chairman of The Reserve, the leading cash management specialist for institutional and individual investors. I am also Chairman of Reserve Solutions, a sister company. Reserve companies currently manage over $125 billion.

The Reserve is best known as the creator of the money market mutual fund. We wanted a product that would provide a return that reflects actual money market interest rates while providing safety of principal, liquidity, and a high degree of safety. As we all know now, the money market fund has been extremely successful with nearly $4 trillion invested in it. I say that for purposes of identification.

I am here today to discuss ReservePlus, the qualified pension plan administrative services that we provide. ReservePlus was created to help address the challenges of increasing participation by lower income and younger workers who traditionally do not participate because they feel they cannot afford to lose access to their earnings.

To begin, ReservePlus does not approve loan requests, establish or interpret loan policies, and is not a plan fiduciary. We are simply a software processor. Our service is made available only to participants who have been directed to us by plan administrators in accordance with their employer's policy. Once a participant's request has been approved, they direct the plan administrator to transfer their money into a loan account within their plan. The amount in that account is then invested in a Reserve money market mutual fund. Participants may then access the amount of their account using checks or a debit card.

Each ReservePlus participant is provided with materials containing a description of the service, its operation, and associated charges. The committee has been provided with copies of these disclosures.

The account opening fee averages $75 and the subsequent annual maintenance fee ranges from $25 to $50, charges that typically apply to both conventional loan programs and ReservePlus and are paid to the plan administrators, not Reserve. As is usual with plastic-based transactions, there is a $2 fee for cash advances but no fee for purchases by check or card. In addition, the plan participants pay themselves an interest rate of the prime rate and a service fee to ReservePlus which ranges from 2.9 to 3.25 percent on loan balances actually utilized.

The average loan balance for participants in plans utilizing ReservePlus is approximately 35 percent less than the average loan balance for all plan participants, specifically $4,800 versus $7,200. Our default rate is 2.2 percent, and we have been unable to determine what the industry average default rate is.

ReservePlus is different from traditional loan programs because participants may establish an account without actually withdrawing funds. A traditional loan actually forces money out of a plan by requiring a participant to withdraw the entire amount approved immediately in a lump sum. With ReservePlus, the participant's funds remain within the plan, continuing to earn sheltered investment returns until the participant withdraws them. The participant may withdraw as little or as much as needed at any time, up to the amount approved by their employer. There is no lump sum withdrawal requirement. When participants know they have access to their money, they contribute more into the plan and take less out of the plan. At the end of the day, participants accumulate greater overall retirement savings using ReservePlus services over conventional loan processing.

Participants with ReservePlus services are also less likely to default on their plan loans when they leave the job. Industry practice for traditional loans requires them to be repaid through payroll deductions. As a result, employees that are terminated, resign, or retire are no longer able to continue repaying their loans via payroll deductions. In these circumstances, plans utilizing traditional loan processing typically give a participant only 90 days or less to repay all outstanding loans.

A participant who is unable to repay the outstanding balance will incur a taxable distribution, subject to regular city, State, and Federal income taxes, and an additional 10 percent penalty if they are under the age of 59 and a half. Obviously, the participant's retirement savings will also be reduced by the amount of the default. This instant repayment requirement in traditional plans is a significant deterrent to employees joining a plan because it comes at a time that the participants are least able to afford it. This is not so with ReservePlus.

Unlike traditional loan programs, ReservePlus is not dependent on payroll deduction and allows participants to continue making their regular payments even after they leave their employer. Given the increasingly mobile workforce, this feature of ReservePlus helps safeguard participants' retirement savings. ReservePlus also allows participants to prepay in advance, in whole or in part, at any time and to reduce the amount available in their loan account at any time, unlike traditional loan processing through payroll.

We designed ReservePlus with several concrete advantages to plan participants over traditional loans. I share your concerns for America's seniors and for hard-working Americans like my parents, a postal employee and a school cafeteria worker. I am very proud of the innovations ReservePlus offers to participants in overcoming many shortcomings of the prevailing practices that encourage workers, regardless of income level, to participate in retirement plans to the maximum level as soon as they are eligible.

Thank you for your time. Again, I am happy to answer your questions.

[The prepared statement of Mr. Bent follows:]

TESTIMONY OF BRUCE R. BENT
FOUNDER AND CHAIRMAN OF THE RESERVE
BEFORE THE
SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE

July 16, 2008

Introduction

Chairman Kohl, Ranking Member Smith, and distinguished members of the Committee, my name is Bruce R. Bent. I am the Chairman of The Reserve, the leading cash management specialist for institutional and individual investors and I am also Chairman of Reserve Solutions a sister company. Reserve companies currently manage over $125 billion in assets.

The Reserve is best known as the creator of the money market mutual fund. We wanted a product that would provide a return that reflects actual money market interest rates while providing safety of principal, liquidity and a high degree of safety. As we all now know, the money market fund has been extremely successful with nearly $4 trillion now invested. This for purposes of identification.

I am here today to discuss ReservePlus the Qualified Pension Plan Administration service we provide. ReservePlus was created to help address the challenge of increasing participation by lower income and younger workers who traditionally don't because they feel they cannot afford to lose access to their earnings.

Overview of ReservePlus

To begin, ReservePlus does not approve loan requests, establish or interpret loan policies and is not a plan fiduciary, we are simply a processor. Our service is made available only to participants who have been directed to us by the plan administrator in accordance with their employer's policies.

Once a participant's request has been approved, they direct the plan administrator to transfer their money into a loan account within their plan. The amount in that account is then invested in a Reserve money market mutual fund. Participants may then access the amount in their account using checks or a debit card.

Each ReservePlus participant is provided with materials containing a description of the service, its operation and associated charges. The Committee has been provided with copies of these disclosure documents.

The account opening fee averages $75 and the subsequent annual maintenance fee ranges from $25 to $50, charges that typically apply to both conventional loan programs and ReservePlus and are paid to the plan administrators, not Reserve. As is usual with plastic based transactions, there is a $2 fee for cash advances but no fee for purchases by check or card. In addition, the plan participants pay themselves an interest rate of the prime rate and a service fee to ReservePlus which ranges from 2.90% to 3.25% on loan balances actually utilized.

Benefits of ReservePlus over Traditional Loans

The average loan balance for participants in plans utilizing ReservePlus is approximately 30% **less** than the average loan balance for all plan participants, i.e., $4800 versus $7000. Our default rate is 2.2%; we have been unable to determine the industry average.

ReservePlus is different from traditional programs because participants may establish an account without actually withdrawing funds. Traditional loans actually force money out of the plan by requiring a participant to withdraw the entire approved amount immediately in a lump sum. With ReservePlus, the participant's funds remains in the plan, continuing to earn sheltered investment returns until the participant withdraws them. The participant may withdraw as little or as much as needed at any time, up to the amount approved by their employer. There is no lump sum withdrawal requirement. When participants know they have access to their money, they contribute more into the plan and take less out of the plan,. At the end of the day, participants accumulate greater overall retirement savings using the ReservePlus service over conventional loan processing.

Participants with ReservePlus services are also less likely to default on their plan loans when they leave their jobs. The industry practice for traditional loans requires them to be repaid through payroll deductions. As a result, employees that are terminated, resign, or retire are no longer able to continue repaying their loans. In these circumstances, plans utilizing traditional processing typically give a participant only 90 days or less to repay all outstanding balances.

A participant who is unable to repay the outstanding balance will incur a taxable distribution subject to regular city, state and federal income taxes and an additional 10% penalty if they are under age 59½. Obviously the participant's retirement savings will also be reduced by the amount of the default. This instant repayment requirement in traditional plans is a significant deterrent to employees joining a plan because it comes at a time that participants are least able to afford it. Not so with ReservePlus.

Unlike traditional loan programs, ReservePlus is not dependent on payroll deduction and allows participants to continue making their regular payments even after they leave their employer. Given the increasingly mobile workforce, this feature of ReservePlus helps safeguard participants' retirement savings. ReservePlus also allows participants to prepay advances in whole or in part at anytime, and to reduce the amount available in their loan account at any time unlike traditional loan processing through payroll.

Conclusion

We designed ReservePlus with several concrete advantages to plan participants over traditional loans. I share your concern for America's seniors and for hardworking Americans like my parents, a postal employee and a school cafeteria worker, in meeting their retirement income needs. I am very proud of the innovations ReservePlus offers to participants in overcoming many shortcomings of the prevailing practices thereby encouraging all workers regardless of income level to participate in a retirement plan to the maximum level as soon as they are eligible.

Thank you for your time. I would be happy to answer any questions you may have.

The CHAIRMAN. Thank you very much, Mr. Bent.

We will turn now to my colleague, the ranking member, Senator Smith, for his questions, and then we will turn to Senator Salazar and Senator McCaskill. Senator Smith?

Senator SMITH. Thank you, Mr. Chairman. Gentlemen, all of you, your testimony has been excellent.

I wonder, Mark and David, as you have gone out with your very bipartisan proposal on automatic IRA's, I think you both commented that the more people know, the more they warm up to it. I assume I heard you correctly.

Mr. JOHN. You did, yes.

Senator SMITH. You know, obviously we are here because we have a real dilemma. We have a national savings problem. We have a demographic bubble with the baby boom generation getting ready to retire and insufficient preparation for retirement. We are looking for what we can best do to facilitate the retirement of elder Americans.

I am wondering in your opinion, any of you, which is worse? Plan loans or hardship withdrawals? What is the most destructive thing that could be done to one's 401(k) plan?

Mr. IWRY. Senator Smith, the loan at least is repaid. The withdrawal is not generally repaid.

And worse than either of those, if I may, is actually the lump sum that is distributed or offered to a participant each time they change jobs, leaving a 401(k) plan. We probably have more leakage coming from lump sums paid out between jobs than we do from the more restrictive loan and hardship withdrawal regimes that apply while the person is employed. So that is the area that I think we need to question as the highest priority. Do we really want to be offering the money to a participant every time he or she changes from one 401(k) sponsor to another rather than having an affordable, seamless savings system?

Senator SMITH. Clearly, plan loans and hardship withdrawals are designed to provide liquidity as an inducement for people to enroll in the first place. I think you have all made that clear. But if you go to an automatic enrollment system, do we need those kinds of inducements? Where do we draw this line? That is really what I am getting at.

Mr. IWRY. I think it is a great question. It is a balancing. The employer is trying to induce participation by offering enough liquidity so people feel they can get that money if they really desperately need it. But we should leave that door open only a crack, and an automatic enrollment plan gets that kind of participation probably with less need for liquidity as an inducement. Therefore, the employer should feel freer and we would hope policymakers would feel freer to narrow that opening to reduce the access because we do not need it as much in the modern auto enrolled 401(k) universe. So I think your policies of restricting leakage, as I understand them, looking carefully at whether we can restrict leakage some more, are timely.

Senator SMITH. Several of you have commented that the more people know, the more comfortable they are. Are we at the Federal Government level, the Department of Labor, Department of the

Treasury doing enough to educate people so that they understand and feel they can get involved?

Mr. GANNON. Senator, there is always more that can be done with educating investors about 401(k)'s and other retirement savings vehicles. We are constantly trying to strive to get the information that is out there into as many hands as we can. I mean, that is why we work through the FINRA Financial Investor Education Foundation to give grants to organizations such as libraries so that the information can get into every community. There needs to be much more done with that.

Also, information has to be available at the time that people need it. So that means when they are going to get a loan from their 401(k), is the education available at that point? Is it available when they are taking a hardship withdrawal? Is it available when they are making financial decisions with respect to their financial savings?

Senator SMITH. The last question, Mr. Chairman. It seems that in Congress we like to speak and act as though the cycles of supply and demand do not exist, and we can repeal them, that market corrections and cycles in our economy, we can somehow control. We have never been able to do that. But that certainly has been the history in Congress. As much as we would like times always to be good, we have had bad times in the past since the introduction of the 401(k). Is this down cycle different in terms of the leakage you are seeing?

Dr. WELLER. So far the data is not out. We will not firmly know until next year when we get the new data from the Federal Reserve.

It does not look at all that different from what we have seen from the recent surveys. It does not look all that different. We expect the numbers to increase, the loan amounts, the number of people who have those loans, but those are clearly tied to both the availability of health insurance and the availability of unemployment insurance and other savings. And in that regard, the current downturn is different because people now have much more debt than they used to.

Right now for the first quarter of 2008, with a record amount of 132 percent of disposable income, that is the highest number we have ever seen. Personal debt to income has risen four times faster than it did during the 1990's. So now there is less fall-back position for families. So that makes it different, but generally I think the factors that drive people into a loan are not that different from previous loans. Again, it is the lack of savings to smooth you over a rough patch, either health insurance or unemployment insurance.

Mr. IWRY. Senator, obviously, we trust this too will pass, but in the meanwhile, we should be doing everything we can to help people keep their savings for the long term when better times are here.

Senator SMITH. Thank you, Mr. Chairman. I would be pleased to be added as a cosponsor of your bill.

The CHAIRMAN. Thank you very much, Senator Smith.

Before I turn it over to Senator Salazar, I just want to make one statement and ask a single question for all of you. Companies like Karsten Manufacturing, which is the maker of the Ping golf products, which we all familiar with, do not allow any loans on their plan and still they boast a 92 percent participation rate, significantly because they have a very generous matching fund provision in terms of company contributions.

So if we have generous matching funds and if we have automatic enrollment and we do not allow people to opt out, in many ways is that the most desirable kind of a plan that we would like to see? What do you think, Mr. Weller?

Dr. WELLER. There is a number of ways of, obviously, increasing both participation and contributions. Matches are a big part in terms of at least increasing contributions. They do not do that much in terms of participation. But automatic enrollment is certainly one way of going.

I also want to add something to the liquidity option that was discussed here. Yes, the evidence from the past shows that if you have the loan option, hardship withdrawal option, it does increase contributions, but over time, the evidence seems to suggest that that effect has diminished, at least according to our research.

So I think that other factors such as automatic enrollment and employer matches are a much better way of increasing participation and to wealth and ultimately that goes in line with what Mark said in terms of restricting the access to loans.

Mr. JOHN. For us, the short answer is yes, and when it comes right down to it, education is a key, but plan design we have found actually is much more of a determinant of success. And I think this is one case where that shows that.

The CHAIRMAN. Mr. Long and then Mr. Bent.

Mr. LONG. I have viewed loans as a necessary evil, necessary to encourage participation. As automatic enrollment becomes more popular and at some point used within the TSP and as matching becomes more lucrative, the necessity of loans starts to decrease.

The CHAIRMAN. Mr. Bent?

Mr. BENT. Several weeks ago I learned of a person that resigned from their job because they had no access to their 401(k). An example of unintended consequences of restricted access. So maybe a little bit more flexibility would be helpful.

The CHAIRMAN. Mr. Gannon?

Mr. GANNON. Well, to give you an example, obviously we believe strongly in auto enrollment, auto escalation because we work with the Retirement Securities Project to promote those efforts with medium-sized employees. To give you an example, at FINRA we established auto enrollment in 1997. Our participation rate went from 75 percent to over 97 percent, and you see that time and time again when employers move to auto enrollment and auto escalation features. There is little down side to using those features.

I am concerned about loans. I am even more concerned about debit cards because I believe they will lead to current consumption. You should not be using your 401(k) to buy pizzas and lattes, and that is the only reason I think you would use a plastic card.

The CHAIRMAN. Thank you, Mr. Gannon.

Senator Salazar?

Senator Salazar. Thank you very much, Chairman Kohl, and Ranking Member Smith, for holding this important hearing, Saving

Smartly for Retirement. That is a very important subject and something that I am glad Senator Kohl has decided to put a focus on.

What I would like you to comment on for me is the current economic circumstance and what you might paint out to be what could be a parade of horribles happening with people's retirement accounts and 401(k)'s. We all know the statistics related to what is happening with fuel and $4 a gallon gas. We know the hardship that people are facing with respect to home ownership, given the housing crisis that we are seeing across America. We know what is happening with the huge escalating costs in higher education, and we know what is happening with health care costs for Americans. People may disagree whether we are in a recession or not, but I do not think there is any disagreement that there are a lot of Americans who are facing tremendous hardship.

So when you have that kind of hardship and you are feeling that kind of economic pain, you start looking to those potential assets that you have to help you through these hard times. And so whether it is taking loans from your 401(k) or maybe taking an early withdrawal from your 401(k), what is the parade of horribles here? If the economic times continue to be as painful as they are, I think, in the last several months, if they continue to exacerbate, what is going to happen to the saving smartly for retirement?

Dr. WELLER. Well, I think when it comes to the current economic situation, it is important to understand that the down turn in the housing market and the stock market has made a bad situation worse. It was not like we had this wonderful economy before 2007 and everything was going well. On the contrary. The labor market was weak. People had to borrow a lot of money. That made them very vulnerable to the current economic downturn, and that is exactly what we are seeing at this point. People already had very few savings. They were highly leveraged. So they are losing their homes. Their home equity is dropping. At this point, people own the smallest share of the homes that we have on record; 46 percent of their home is actually their own.

So I think the parade of horribles at this point means we are going to see more foreclosures. We are going to see more bankruptcies. We have seen an 80 percent increase in the bankruptcy rate, 90 percent in bankruptcy filings since 2006. So that is the first line of defense. We are going to see massive foreclosures and defaults and that is going to continue.

The second part is we are going to see people struggling with higher costs of living and that ultimately means less retirement savings. And on top of that, because we are in a weak economy, employers are cutting back on the benefits that people have traditionally relied on to make ends meet just as in retirement savings and health insurance.

So ultimately what that adds up to is that we see a big drop down in financial security and ultimately in retirement income security. Again, it is a little too early at this point to come up with complete numbers, but we already saw a big drop in retirement income security from 2001 to 2004, and we expect that to continue as we get the new data for 2007.

Senator SALAZAR. Let me ask you this question and the other panelists may follow up on that. Given that reality which you described I think very well, what then should we in the U.S. Senate be thinking about doing to deal with some of the consequences of the economic hard times that we are in?

Dr. WELLER. Well, I think you need to think about three things. The first one is to increase incomes where we can through improved earned income tax credits and other measures along those lines, promote savings through a saver credit, refundable saver credit preferably, along those lines, to have a real wealth-building strategy, and ultimately what I call an efficiency policy to shelter families from the effects of rapidly rising prices, for instance, for health care, for our energy, and other things. That means broader energy efficiency, more efficiency in the health care system. I think those are the general three directions to go in in terms of policy.

Senator SALAZAR. Mark or David?

Mr. IWRY. Senator, we can very much focus on the fact that this downturn will not last forever, and it will not be the last downturn that we will see. So I think one of the things that the Senate should do is keep the Nation's eye on the long term and focus on the solutions to the potential parade of horribles, ways to prevent it.

I think Mr. Weller put it well. We need to make it easier for people to save and to not make it too easy for them to withdraw their money. Expanding the savers credit, making it refundable, is key. The automatic IRA proposal that Senator Smith and Senator Bingaman have been lead cosponsors on is key. There is a reason why that has been endorsed by both a former chairman of the Council of Economic Advisers for President Reagan and for President Clinton, Marty Feldstein, Laura Tyson, respectively, why it has been endorsed by the New York Times on its editorial page and by the Washington Times chief political correspondent, and other bipartisan endorsements.

And we need to make sure that the parade of horribles does not include easy access to carefully built-up retirement savings through a flood of things like debit cards or other devices that make it overly easy for people to undo all the hard work they have done in building up their savings.

Senator SALAZAR. I have about 50 seconds here. So does anybody else want to comment?

Mr. GANNON. Yes, Senator. More than 10,000 Americans are turning 60 every day and I think that is the difference with the economic down-climb we are seeing now, is that people are needing their money from their retirement savings. If you are 25 and there is an economic downturn, time is on your side to recover from that, but if you need to take withdrawals today for the near future, it is a much more difficult situation for you. Either you are going to have to continue working or you are going to have to live on less income.

And we need to address better ways to make sure that people understand how to withdraw money from their retirement savings. There is much investor education that has been done about saving for retirement. There has been little done to teach people about what are the best ways to withdraw, how to use annuitization to enhance your ability to keep that money for your entire retirement period.

Senator SALAZAR. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Senator Salazar.

Senator McCaskill?

Senator MCCASKILL. Thank you, Mr. Chairman.

I come from a State where one of our most treasured values is common sense, and it defies common sense that giving Americans plastic is a way to increase savings. It just does not make sense to me, Mr. Bent.

I would like to ask you about your relationships with the employers in these plans. Your debit cards are around because they are profitable, I assume, for your company.

Mr. BENT. Not yet, but one would hope so, yes.

Senator MCCASKILL. And how long have you been doing this?

Mr. BENT. I guess we have been working on this for about 7 years now.

Senator MCCASKILL. 7 years? And your company has not been profitable yet?

Mr. BENT. No, it has not.

Senator MCCASKILL. I assume that the reason the employers—your testimony was that you really are like a passive processor.

Mr. BENT. That is correct.

Senator MCCASKILL. That these people are being directed to you.

Mr. BENT. Correct.

Senator MCCASKILL. Well, what is the motivation of these fiduciary employers to direct people to you? Why would they want to do that?

Mr. BENT. Because it encourages people to come into the plan. It encourages people to stay in the plan if they loose their job.

Senator MCCASKILL. And they are making money.

Mr. BENT. I am sorry?

Senator MCCASKILL. And they are going to make money.

Mr. BENT. Who is going to make money?

Senator MCCASKILL. The employer gets part of the money. Right?

Mr. BENT. No, no, no.

Senator MCCASKILL. They do not get anything?

Mr. BENT. Of course, not.

Senator MCCASKILL. I thought I heard in your testimony that they get part of the fees.

Mr. BENT. No, no, not at all. Not at all. That is the plan administrator.

Senator MCCASKILL. OK. Well, so what you are saying is the fiduciary duty that these plans have—they see giving their participants a debit card to access the money as within their fiduciary responsibility, and that is why they are turning to your—

Mr. BENT. What we are finding statistically is more people are willing to participate because they feel they will have access to their money in time of need. In fact, what we are seeing is that there is less money being borrowed through our program than there is through a conventional program. In a conventional program, what you have to do is anticipate an entire need and you take all that money out of the plan at one time. That is not the case with us.

Senator McCASKILL. OK. Well, I know you have testified that when they have a debit card, they contribute more into the plan and take less out of the plan.

Mr. BENT. Correct.

Senator McCASKILL. I would sure like the backup for that.

Mr. BENT. Fine.

Senator McCASKILL. That is hard for me to believe.

And you are saying that they are accumulating greater overall retirement savings by having a debit card that they can go and buy a latte with it?

Mr. BENT. I think that is a gross exaggeration. If you look at the data that is provided by the other people on the panel, irresponsible loans amount to very little of the whole thing, of all the loans that are taken from the plan. So I would not extrapolate some gratuitous comment from some other commentator up here on that.

It is psychological. When we started the money funds, we went to the brokerage houses and we said to them, we want you to take your clients' balances and give them to us, put them in a money market fund. And the reaction of the brokerage houses was, you are out of your mind. That is the essence of profit that comes to the brokerage house.

As a result, we had to fight to get into the brokerage houses. Today there is over $3 trillion that is invested in money market funds from brokerage houses because, in fact, the clients of the brokerage houses leave more money there because they know they have access even though they don't use it.

The second step we took in the money market funds is by opening checking accounts against the accounts. So then the brokerage houses said to us, you are truly out of your mind because this way they are going to take the money out of here and it will not be within the brokerage house. What happened is more money came into the plan.

Finally, a debit card was attached to the access of money market funds within brokerage houses, and indeed, more money came in.

So it is a psychological thing. It is not a question that people use it. It is a question that they know that they can get to it.

Senator McCASKILL. Well, I have just got to tell you I am not aware that the advantages of credit cards and debit cards have led to savings. Every experience I have had in my life is counter-intuitive to that. And I would like the backup for these claims—

Mr. BENT. I would be more than pleased to do that.

Senator McCASKILL [continuing]. That people are saving more because they can charge.

Now, let me ask you a specific question, and if it is your testimony that the plans have no profit motive whatsoever to turn people to your program and that you are just a passive processor, I am assuming you are out selling this concept to people.

Mr. BENT. We try.

Senator McCASKILL. Let us assume hypothetically that somebody takes out $7,000 worth, which is the average amount of a loan that is being taken out right now. Let us assume someone owes you $7,000 on one of these debit cards and they lose their job. What is the interest rate they are going to pay on that right now?

Mr. BENT. They pay 7.9 percent, 5 percent of which goes back to their plan, 2.9 percent is paid to The Reserve.

Senator MCCASKILL. Total.

Mr. BENT. Total.

Senator MCCASKILL. So you are only collecting 2.9 percent on this debt.

Mr. BENT. That is correct.

Senator MCCASKILL. Well, you are never going to make money.

Mr. BENT. Bless you.

Senator MCCASKILL. So it is not prime plus 2.9.

Mr. BENT. It is prime plus 2.9.

Senator MCCASKILL. What is the total amount of interest they are paying right now?

Mr. BENT. 7.9 percent. I think what you are missing is the fact that it is their own money. So what I am doing is I am administering the loan. I am not lending money to them.

Senator MCCASKILL. But I am talking about if they owe the money, if they have spent the money, what are they paying?

Mr. BENT. They owe it to themselves. They are paying 7.9 percent.

Senator MCCASKILL. And how long will it go before they get a penalty from the IRS for using that money or have to pay extra taxes?

Mr. BENT. Well, if they do not use ReservePlus and they go to the conventional—

Senator MCCASKILL. I understand. If they use ReservePlus I am asking.

Mr. BENT. If they use ReservePlus, they can stay there for 5 years and pay back their loan.

Senator MCCASKILL. What happens in 5 years if they have not paid it back?

Mr. BENT. The same as what happens under a conventional loan.

Senator MCCASKILL. I understand. But instead of having a deadline of 90 days, they always have the 5-year deadline which they have with your money with the debit card or they have with a conventional loan. It is a 5-year limit.

Mr. BENT. Correct.

Senator MCCASKILL. And do you think they all understand that clearly?

Mr. BENT. It is the same as it is with a conventional loan. There is nothing different.

Senator MCCASKILL. Well, I understand, but with most credit cards you do not have to pay them back in 5 years.

Do you think that most people understand that on that amount, the total is going to go significantly up in 5 years?

Mr. BENT. Senator, I think you are confusing credit cards and this access to your savings.

Senator MCCASKILL. I think the consuming public is going to confuse credit cards and access to these savings because it feels and walks like a duck.

Mr. BENT. My apologies for not being able to convey this to you, but it is their money. It is not my money. I am not lending them money. Whether they go through The Reserve plan or a traditional plan, if they default on the loan, what happens is that then they will pay taxes on it. I am not changing the law. That is not within my power.

Senator MCCASKILL. I understand.

Mr. BENT. I am strictly an administrator.

Senator MCCASKILL. Thank you, Mr. Bent.

The CHAIRMAN. Thank you, Senator McCaskill.

Before we turn to Senator Schumer, one question for you, Mr. Long. You testified that you were concerned about recent ads urging TSP participants to roll their accounts over into higher fee IRA's. I agree with your concern, and I am calling on these companies to stop running ads that portray TSP as "irrelevant or outdated."

Can you share with us why you think these ads are misleading and why most participants would want to stay in the TSP?

Mr. LONG. The ads that I saw, one of which suggested that you should leave when you are retired or when your TSP account retires, or the other one was referring to your old TSP accounts. TSP accounts are not old and TSP accounts do not retire. People who leave the Federal service are welcome to leave their retirement funds with us and we actually encourage them to do so because the TSP has one very big advantage over virtually all private sector plans, that is, a tremendously attractive fee structure. And so, yes, I was not pleased when I saw ads that suggested that TSP was old or retired.

The CHAIRMAN. Thank you very much.

Senator Schumer?

Senator SCHUMER. Thank you, Mr. Chairman. I appreciate your letting me attend this hearing because this is an issue I have been involved with for a long time.

In the 104th Congress, whenever that was—what are we now? The 110th? So about 12 or 13 years ago. Anyway, I was in the House, so it was before 1998. I read about a bank doing this. I think it was BankOne. And I was really upset because I think that savings is so important and there is so much pressure on people in today's society to spend, spend, spend and not to save. And here we had set up in Congress this great device, the 401(k), which encourages people to save, and to allow you to just go with your debit card and take money out of your 401(k) was a big mistake, given everything that has happened here.

And you can make the arguments, as Mr. Bent ably does, about the free market and all of that, but you know, we are not in the 1890's anymore. I think doing things to encourage people to save for their future makes a great deal of sense.

Anyway, I introduced the legislation then, and much to my surprise, BankOne withdrew the product. So I figured this issue was over. And when you called this hearing, I was not even aware that Mr. Bent's bank was doing this. I said, I am coming and I am going to introduce legislation with you, Mr. Chairman, to deal with this issue. And I appreciate your invitation and I appreciate we are doing this because to me it makes a great deal of sense.

And, Mr. Bent, I know you say it is their money. It is their money. There are penalties. But people scrounge to get that money into the 401(k), whether it is theirs or their employers. It is hard and we should not make it easy to take it out. I mean, there are unusual circumstances. God forbid a terrible illness. No one would say wait for your retirement if you need money for a terrible illness. On the other hand, if there is an impulse to buy a flat screen TV and take many out of your 401(k), I think there should be barriers, and there certainly are not barriers with an ATM card.

So I am supporting this legislation.

I missed your testimony, Mr. Bent, but do you have another argument other than, "It is their money?" What about savings? What about the idea that it is easy in this society to have short-term gratification patterns and hard to have long-term gratification patterns? We provide other incentives for people to save either for their retirement or other things. It is not a flat tax code that says consumption and savings get the same. I for one would like to see greater incentives for people to save.

Just give me your general view. And I understand your right as a capitalist to go ahead and do this—

Mr. BENT. Thank you.

Senator SCHUMER [continuing]. In free market America. You understand our right to say this is bad policy and—no offense to you—

Mr. BENT. Absolutely.

Senator SCHUMER [continuing]. We ought to change it.

But just give me your view a little bit about what I said, about the difficulty for people saving in today's society, that one of the great problems with America is we do not save enough, that we should have incentives for savings and not to simply consume. Some would argue that we are in the present recession because we like to stuff our face. We export less than we import. We save less than we borrow. We consume more than we produce.

And it is one of the great problems in America. And in a small way, what you are doing here would exacerbate that. Tell me what you think.

Mr. BENT. I think you are wrong. We are in a situation—you asked.

Senator SCHUMER. I do not mind.

Mr. BENT. We are in a situation where lots of people who are younger and lower income do not participate in the 401(k). The idea of having to opt out of an automatic enrollment is great. We put that in in our plan as soon as it was possible.

But that being said, you still have a situation where people want to have access to their money. My argument, that it is their money and they should have access to it. But I am not talking about that. I am talking about encouraging people to come into the plan and save more and borrow less because of the access. It is psychological. They do not use it, as evidenced by the fact that our average loan is lower. It is 35 percent lower than a traditional loan.

And the clincher with our program.

Senator Schumer. You are saying your plan encourages savings.

Mr. BENT. That is correct. It encourages participation and it encourages—how can you argue against that? If they are taking less money out—

Senator SCHUMER. Because you are making the argument that if your plan was not available, people would go into their 401(k)'s in another way, and that is just not going to be the case. Practical logic tells you when you can just use it as a credit card or debit card, it is a lot different than if you have to go through a whole lengthy process to do it.

Lots of people buy on impulse and regret buying what they bought on impulse the next week.

Mr. BENT. If you would like to go to Fidelity right now and you want to take out a conventional loan, you go click, click, click, click. The check is in the mail.

Senator SCHUMER. Maybe we should not allow that either. That is not a good argument. I mean, to say other people do something that is not good—

Mr. BENT. No. What I am saying is that you are trying to paint my product as something evil. It is not. It encourages people to participate in 401k's and we do not alter borrowing restrictions.

Senator SCHUMER. I am not saying it is evil. I am saying it discourages savings, encourages consumption.

Mr. BENT. We can debate it forever but the facts are it does not.

The final thing is when someone loses their job, under a conventional plan they have to pay their money back in 90 days. That is not the case with ReservePlus. You can continue to make payments for 5 years. It is a major advantage.

Senator SCHUMER. But every withdrawal is a new loan, each one with its own fees and everything else. Right? So in other words, if you got one big loan of $5,000 or you used your credit card and did 10 different withdrawals of $500 each, would you not pay many more fees in your situation?

Mr. BENT. No, not at all. If you go back to BankOne, in the BankOne situation where they had the 401(k) access, the money came out in a lump sum. It was immediately outside the plan, and therefore, any interest that the people earned on that money before they actually consumed it was outside of the plan. So one, conventional plans incent people to take out monies in a lump sum. Mine does not. Because conventional plans force people to anticipate needs and withdraws lump sums so that any interest that they earn on the money they take out, would be taxed immediately. Under ReservePlus it is not the earnings remain tax deferred within their plan.

Senator SCHUMER. But there are new fees under yours each time.

Mr. BENT. No, no, no. I am working up to it.

What we do is we move from the conventional corpus of the fund, your retirement fund, which is stocks, bonds, although that has not been a great place over the last 8 years, and you go into a money market account. The money market account is within the plan. So I have $50,000 in the plan and I think I am going to need $5,000 it moves from the stock and bonds, into the loan part of the plan, which is invested in a money market fund. But it is still within the plan. You pay no fees. You pay a fee if you want to sign up for the loan, but that goes to the TPA administrator. That is true whether it is a conventional loan or ReservePlus processing.

So you are now into the money market account. Let us say, you access $50 at a time or $500 at a time. There are no additional fees. Nothing. Effectively you pay—

Senator SCHUMER. What if you increase the money in that money market fund by $500 at a time? You say you take $5,000. You have set aside $5,000 out of your $50,000. What if you only set aside $500 and then you set aside another $500 and you set aside another $500?

Mr. BENT. No fees.

Senator SCHUMER. No?

Mr. BENT. Not from me, no. Not at all.

Senator SCHUMER. I am not sure that is—OK. That is not my understanding.

Mr. BENT. Well, your understanding is wrong.

Senator SCHUMER. OK.

How about Mr. Iwry? Do you have something to say here?

Mr. IWRY. Yes. I think you are right, Senator. An individual can take out more than one loan.

Senator SCHUMER. Right.

Mr. IWRY. And the limits on the total amount of loans do look to how much you have outstanding on a look-back basis, but that does not mean that you cannot take out what you need—

Senator SCHUMER. Another loan with additional fees.

Mr. IWRY [continuing]. Then take another loan out. Right.

Senator SCHUMER. Is he wrong?

Mr. IWRY. So you can do that—

Mr. BENT. Oh, he is right. He is agreeing with me, not you.

Senator SCHUMER. No, he is not.

Mr. BENT. Yes, he is.

Senator SCHUMER. Who are you agreeing with, Mr. Iwry? [Laughter.]

Mr. IWRY. I am agreeing with you, Senator.

Senator MCCASKILL. Smart guy.

Mr. BENT. What did I say that was wrong? I am sorry. I misunderstood what you said then.

Mr. IWRY. The Senator I think is making the point that a person who does not have a credit card or a debit card access to loans can also take out only as much as she might need, and if she needs more, can then take out another loan for an additional amount.

Mr. BENT. But there are fees charged for each time you do it under the TPA fee structure right now. That is what his question was. I do not have those fees. So you are wrong.

Senator SCHUMER. OK. Let me go on here.

Let us a do a comparison here. Maybe this will bring some of this to light, although this is a slightly different issue.

You contain a comparison because you talk about the average loan amount of a Reserve loan compared to a regular loan, and you say the average amount is different. Right?

Mr. BENT. Correct. Lower.

Senator SCHUMER. But to compare the products, we need to make a different comparison. So let us take two people with the same income and a plan balance who each take out $8,000. OK? Now, the first person takes out $8,000, puts the money in a bank, and spends $2,000 each quarter for a year, and then repays the loan within 5 years. The second person puts $8,000 in a ReservePlus account and withdraws $2,000 each quarter for a year and then repays the loan within 5 years. So that is the apple-to-apple comparison. Fundamentally, these people are the same.

Now, but because each withdrawal under your plan is considered a separate loan with a separate fee, plus the setup fees, is the second person not worse off, or are they the same?

Mr. BENT. No. They are better off with mine.

Senator SCHUMER. Why?

Mr. BENT. Because, No. 1, there are additional fees for each advance because there is only one loan.

No. 2, with a conventional loan you take the money out and you put it in a bank and any interest you earn you pay taxes immediately.

Senator SCHUMER. So you are saying a person in your Reserve account just pays one fee.

Mr. BENT. Correct.

Senator SCHUMER. Mr. Iwry?

Mr. IWRY. Senator, if I may, the fees that would be charged on a normal plan loan depend on the particulars of that plan.

Senator SCHUMER. Of course.

Mr. IWRY. And in many cases, there would be very little fee charged by the plan. There are lots of large 401(k) plans in which there is only a nominal fee that is charged.

Senator SCHUMER. Is your fee nominal?

Mr. BENT. My fee is nonexistent. It depends what the TPA charges.

Senator SCHUMER. No. But you did say you charge a fee.

Mr. BENT. No. The fee is for the amount that is utilized. So there is no fee for opening up a loan account.

Senator SCHUMER. Opening up that money market account.

Mr. BENT. Correct.

Senator SCHUMER. That is what you said. But there is a fee each time you borrow against the money market account.

Mr. BENT. No, no.

Senator SCHUMER. No fee at all.

Mr. BENT. No.

Senator SCHUMER. So this is fee-free?

Mr. BENT. It is fee-free relative to what you are saying, and in addition—

Senator SCHUMER. But is it fee-free, period? What fees do people pay?

Mr. BENT. They pay the TPA, the plan administrator. They pay him—I think we said—average $75. That does not go to me. It goes to the plan administrator. If the plan administrator sets up—

Senator SCHUMER. And you get no fee at all. Your company gets no fee for any of this, aside from your annual? I am talking about fees each time they take out a loan.

Mr. BENT. No, there is not. Plus, what he ignored was the fact—

Senator SCHUMER. I think we have a—

Mr. IWRY. Senator?

Senator SCHUMER. Let Mr. Iwry. Go ahead.

Mr. IWRY. Senator—

Mr. BENT [continuing]. The interest that is earned—am I speaking or is he?

Senator SCHUMER. Mr. Bent and then Mr. Iwry.

Mr. BENT. OK. The interest that is earned when the money comes out in a conventional loan is taxed immediately. With

ReservePlus it is not. Under the scenario that you outlined, the person is better off under my plan than they are in a conventional plan.

Senator SCHUMER. Go ahead, Mr. Iwry.

Mr. IWRY. Mr. Bent's written statement says that the plan participants pay a service fee to ReservePlus, which ranges from 2.9 percent to 3.25 percent.

Senator Schumer. Yes. What is that?

Mr. IWRY. On loan balances actually utilized.

Mr. BENT. Exactly.

Senator SCHUMER. But that is what we are saying.

Mr. BENT. It is not a transaction fee.

Senator SCHUMER. OK, but they pay a fee.

Mr. BENT. Of course. [Laughter.]

Of course. There is a difference. There is a substantial difference.

The CHAIRMAN. Senator Schumer, you have done great.

Senator SCHUMER. Thank you, Mr. Chairman. Thank you.

The CHAIRMAN. Do you want to make a comment?

Senator MCCASKILL. Well, I wanted to ask a question.

I am confused. If anyone is not confused at this point, they have not been listening. [Laughter.]

What I do not understand is how you have the ability to call this fund still as part of the fund. What you are saying is legally they are setting aside part of their money and putting it on one of your money markets.

Mr. BENT. Which they can do in a conventional plan today.

Senator MCCASKILL. I get that. I get that. But you are saying the difference is it is still part of the fund.

Mr. BENT. Correct.

Senator MCCASKILL. And that there are no penalties that inure to them, none of that.

Mr. BENT. Absolutely.

Senator MCCASKILL. Then why is it that you get 5 years if they quit and the loans only get 90 days? You are saying that if they leave their job, they do not have to repay it in 90 days. You are saying that if they leave their job, they do not have any penalty. They have up to 5 years to pay themselves back without having to endure the penalties.

Well, if it is still part of the fund, if you are still considering this part of their fund, what is the legal—maybe it is not an artifice. It feels like an artifice. What is the legal artifice that allows you to remain part of that of fund for purposes of a 5-year payback and not have the 90 days?

Mr. BENT. Take the 401(k) fund. Divide it into two parts. In the fund you have a conventional investment fund and you have the part the beneficiary has decided that they want to have that as an access loan fund for them. It is within the plan. If they leave their employer tomorrow and they have not used anything in that loan fund, no harm, no foul. Zero. They do not owe anything to themselves. They do not owe anything to me. There is no fee. There is nothing. It is all within the plan.

Senator MCCASKILL. But what if they do owe? You have testified that the benefit of your plan over a conventional loan is the reason everyone is dying to get these debit cards because they are going to be—they are saving money money—is because they do not have to worry about the 90- day payback. What legal basis are you using to say you do not have to pay it back in 90 days?

Mr. BENT. You have fund A and fund B within the retirement plan. One is conventional, stocks, bonds. The other one you have designated as a loan fund. It is all within the plan. You have not used any of it.

Now you use some of it. Arbitrarily you use $5,000. OK?

Senator MCCASKILL. Right.

Mr. BENT. You now have the $5,000 out. It is a loan. You have used it for whatever you use it for—

Senator MCCASKILL. Right.

Mr. BENT [continuing]. Medical expenses, so on and so forth.

You then lose your job.

Senator MCCASKILL. Right.

Mr. BENT. Under a conventional loan policy, tradition if you will, you have 90 days to pay it back to your fund. The employer could choose to have it paid back over 5 years, but they do not. Traditionally they do not because they want to get it off their books.

Under my program, what I will do is I will accept payments from those people to pay back their loan to themselves, and they do not have this cataclysmic event of losing their job and having to pay the loan back in 90 days.

Senator MCCASKILL. I understand. So this is the choice, a business choice, of your company. There is no legal requirement they pay it back to their fund. Their employer just wants it back that quickly. And you do not care if they take longer.

Mr. BENT. Paraphrasing, yes, correct.

Senator MCCASKILL. Thank you, Mr. Chairman.

The CHAIRMAN. Well, we thank you. Senator McCaskill, Senator Schumer, and all the members of the committee. I believe we have again brought to the surface the importance of retirement programs, and the importance of the 401(k). We need to shore it up, and to be certain that it is used for the right purposes, this is important to our country. And we will be following up with you and with legislation toward that end.

You have been very good today. Your testimony has really advanced, I believe, the cause, and we appreciate your being here. We appreciate all of you for being here today.

And this hearing is adjourned.

[Whereupon, at 11:55 a.m., the hearing was adjourned.]

APPENDIX

PENSION RIGHTS CENTER

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WASHINGTON, DC 20036
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WWW.PENSIONRIGHTS.ORG

STATEMENT OF THE PENSION RIGHTS CENTER

ON

"SAVING SMARTLY FOR RETIREMENT: ARE AMERICANS BEING ENCOURAGED TO BREAK OPEN THE PIGGY BANK?"

BEFORE THE UNITED STATES SENATE SPECIAL COMMITTEE ON AGING

**WASHINGTON, D.C.
JULY 16, 2008**

The Pension Rights Center—the nation's only consumer organization dedicated solely to protecting and promoting the retirement security of American workers, retirees and their families—commends the Senate Aging Committee for holding this aptly-named hearing "Saving Smartly for Retirement. Are Americans Being Encouraged to Break Open the Piggy Bank?"

The hearing could not be more timely as many American families, faced with the stresses and strains of an uncertain economy, have to decide whether to save for retirement or take the money out of their 401(k) plans to help pay for the rising costs of food, fuel, health care and housing costs. But raiding a 401(k) plan is at best a short-term, stop-gap response to these financial pressures and could lead to long-term financial devastation. Breaking open the piggy bank today will mean that all too many individuals are robbing themselves of needed future retirement income to supplement Social Security, leaving themselves vulnerable to retiring with inadequate income. Our hope is that today's hearing will start a dialogue on the extent to which employees should be able to access 401(k) funds before retirement.

Let's start with some history. There was a time when most large and medium-sized American businesses sponsored *real* pension plans, which provided employees with a guaranteed lifetime benefit when they retired. In such plans, employees could not withdraw benefits before they retired and plan loan programs were virtually non-existent.

In this universe, defined contribution plans—such as today's 401(k) plans—were usually supplemental retirement plans, the savings leg on the proverbial three-legged stool of retirement preparation. It thus made some sense for our legal rules to permit employers to provide some pre-retirement access to account balances through loans and in-service withdrawals, since many employees were not dependent on these plans for the majority of their retirement income. Moreover, as 401(k) plans increasingly came onto the scene, advocates for withdrawals argued forcefully that employees would be reluctant to contribute to such plans unless they had some emergency access to their money.

But the landscape of retirement savings has undergone seismic change during the last two decades. In 1983, 63 percent of private sector workers had defined benefit plans and 12 percent had defined contribution plans. In 2004, this was totally reversed: 63% had defined contribution plans (primarily 401(k) plans) and only 20 percent had defined benefit plans. What this means is that for millions of people, their 401(k) plan accumulations will be their only source of retirement income other than Social Security. The issues with respect to whether 401(k) plans will provide adequate retirement income are legion and well-documented. These plans require working people to decide whether to contribute, and if so, how much. They require them to properly manage their investments. And they require retirees to figure out how to make their savings last throughout their retirement.

In recent years, there has been a movement to address some of these issues by making 401(k) plans look more like defined benefit plans by adopting automatic enrollment and automatic escalation features and providing default investments. But these features will be ineffective if policymakers do not address the very real problem that all too many workers are withdrawing their 401(k) money for non-retirement purposes.

Unfortunately, both market forces and misguided policy have compounded rather than ameliorated the problems of leakage. An employee can now access 401(k) plans to pay medical bills, to pay for a child's education, to help purchase a home, to address other financial hardships, and for any reason at all when he or she change jobs. In fact, according to the Profit Sharing/401(k) Council of America 87.5 percent of 401(k) plans in 2006 allowed participants to take loans and of the plans allowing loans, 84 percent offer loans for any reason. Ultimately, it is low and moderate wage earners who will be most hurt by taking out the money early. They will have to pay back the money in after-tax dollars. Also in a struggling economy, a worker who has taken a loan but loses her job will face the additional pressures of having to repay the loan or face substantial taxes and penalties.

So should Congress simply shut the door on pre-retirement withdrawals and loans? If this Committee were writing on a clean slate—reinventing the 401(k) plan so as to make it a less imperfect retirement savings vehicle—we would urge you to support a zero tolerance for pre-retirement access to 401(k) accounts. While this might mean that some employees would not contribute quite as much to their 401(k) plans, it would also mean that what they did contribute would be there for retirement.

However, you are not writing on a clean slate. Changes to the rules would be regarded as unexpected and unfair by workers who made contributions under a prior set of rules and expectations. We also recognize that there are some reasonable policy arguments to permit employees to have some pre-retirement access to their contributions. The pre-retirement economic stresses that people are facing are real. However, we think there are better solutions than asking Peter to pay Paul, which is exactly what happens when policymakers effectively encourage people to invade their retirement accounts to meet immediate financial concerns. (It goes without saying that we very much oppose the latest market "initiative," the 401(k) debit card.)

As you continue to examine these critically-important issues of pre-retirement withdrawals, it is important to remember that 401(k) plans, as the beneficiaries of a very sizeable tax subsidy, are partially supported by *all* American taxpayers (including those who do not contribute to these plans). The challenge is to ensure that this tax subsidy promotes enhanced retirement income security for all Americans. We commend the Senate Aging Committee for starting this important dialogue.

Statement for the Record
on Behalf of Hewitt Associates LLC

Before

U.S. Senate
Special Committee on Aging

Hearing on

"Saving Smartly for Retirement: Are Americans Being
Encouraged to Break Open the Piggy Bank?"

July 16, 2008

By

Alison Borland, FSA, EA
and
Frank McArdle, Ph.D.

Executive Summary

As one of the world's premier human resource companies, Hewitt Associates LLC is a leading retirement consultancy and the largest independent 401(k) record keeper for employer-sponsored retirement plans in the United States. We have deep experience both designing and administering 401(k) plans for our clients and have insights and meaningful data on the saving behaviors of more than 4.7 million defined contribution plan participants.

In our database of large employer plans, 98 percent of plans provide access to loans. Other research shows that participants in these plans contribute up to 35 percent more if a loan provision is available.[1] If repaid, a loan can be an effective means to meet short-term financial needs when the participant maintains pre-loan contribution levels, thus generally preserving retirement income. Hewitt's research shows that 85 percent of participants with outstanding loans do continue to make their pre-loan contributions. Of the 15 percent who decrease contributions, the average reduction is 5.8 percent of pay. Currently, 22 percent of active participants in our database have outstanding loans with an average balance of $7,800. For purposes of accumulating retirement savings, loans are far superior to withdrawals, which permanently reduce retirement savings and subject the participant to significant tax penalties.

Trend data over the last six years show that loan participation, average loan balances, and outstanding principal as a percentage of account balance have remained largely unchanged. Perhaps in response to recent economic pressures, thus far in 2008 we are seeing an increase in loans granted of approximately 1 percent. If a participant defaults on a loan, it effectively becomes a withdrawal, depleting both retirement principal and future earning power. Fortunately, only 1 percent of loans end in a taxable distribution. After adjusting for participants who are terminating their employment, only 0.2 percent of active employees default on their loans.

Establishing disciplined lending criteria and providing educational material on the consequences of failing to meet loan commitments are important steps toward preserving retirement savings. Hewitt shares the Committee's concern with the recent experimentation with retirement plan debit cards. These instruments make frequent borrowing too easy and limit the opportunities to inform and educate.

More than 90 percent of plans offer hardship withdrawals or other in-service withdrawals based on age or disability. While we would not encourage hardship withdrawals, they serve as an important source of emergency funds for immediate and extreme financial need when other sources have been exhausted. While withdrawals are a far greater threat to achieving an adequate retirement nest egg, fewer than 1.5 percent of participants in Hewitt's database took a hardship withdrawal in 2007. Of the 5.4 percent of active participants who did take withdrawals of any type, 78 percent were in-service withdrawals, which can be a reasonable mechanism for beginning to take distributions after age 59½ to ease into full retirement. With respect to terminated participants, 45 percent elected a cash distribution and most likely paid income tax penalties rather than maintaining the tax-deferred status. This is especially true of younger workers with lower plan balances. In fact, nearly three-quarters of participants with balances below $10,000 cashed out their retirement plan balance. Job changes often play a significant role in depleting retirement savings, when accumulated balances are not rolled over.

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[1] GAO Report to the Chairman, Special Committee on Aging, and the Honorable Judd Gregg, U.S. Senate, 401(k) Pension Plans: Loan Provisions Enhance Participation but May Affect Income Security for Some, October 1997.

Keeping retirement savings in tax-deferred instruments, and thus avoiding unnecessary penalties, is smart saving. However, which retirement vehicle a participant chooses can also make a real difference. In 2006, the $3 trillion U.S. private defined contribution (DC) market accepted $268 billion in rollovers from qualified plan participants. It also transferred $195 billion from private qualified DC plans to individual retirement accounts (IRAs), which held more than $4 trillion in assets.[2]

What many participants fail to realize is that if they have access to a 401(k) plan with institutional pricing of investment options, such a plan may be the best retirement plan vehicle for them. Contrary to the advertising and public relations blitz by the retail IRA industry, mid- to large-sized employer 401(k) plans can often provide lower-cost and higher-value options. Using conservative assumptions and typical account balances, our calculations show that a 35-year-old who is an average saver who moves her $33,000 balance from her company plan to a retail IRA could lose $37,681 or 9 percent (or more) relative to what she would otherwise have when distributions are required at age 70 had she remained invested in the 401(k) plan. If she is an active saver who contributed at 8 percent per year over the course of her career, and she moved her $101,808 balance to an IRA at age 35, she could lose $116,250 or more. Using a larger fee differential, more typical for very large 401(k) plans, this difference would increase to $244,078, representing a loss of 18 percent of the total accumulated balance.

Are Americans saving smartly? Certainly the majority of defined contribution plan participants are avoiding loans and especially hardship withdrawals, although this trend could conceivably change to some extent if economic conditions worsen. Most Americans know to use a tax-deferred investment vehicle, but hidden fees can unwittingly eat away at even a well-planned nest egg. Americans need and deserve clear and unambiguous information on their options and the financial consequences of choosing a given option.

[2] Source: Cerulli Associates

Hewitt Statement

Mr. Chairman and Members of the Committee, thank you for the opportunity to submit this statement for the record of this important hearing, which continues the major work the Committee undertook last fall to explore the nature of 401(k) fees and the need for greater disclosure.

Hewitt Associates LLC is a global human resources outsourcing and consulting company providing services to major employers in 33 countries. We employ 23,000 associates worldwide. Headquartered in Lincolnshire, Illinois, we serve clients nationwide out of offices in 30 states. We have a presence in many of the states represented by the Members of this Committee. Hewitt is the largest 401(k) independent record keeper for employer-sponsored 401(k) retirement plans in the United States. We provide defined contribution (DC) services to large employers representing 4.7 million participants. As an independent record keeper, we do not have affiliations with investment management firms.

The role of today's companies in preparing their workforces for retirement has never been more challenging. We applaud the Committee's interest in examining some of the critical issues surrounding the effective use and potential misuse of 401(k) savings plans.

My name is Alison Borland, FSA, EA, and I am the Defined Contribution Consulting Practice Leader for Hewitt. Frank McArdle, Ph.D., manages Hewitt's Washington, D.C. Research Office. Together, we would like to address two key concerns of the Committee regarding the potential for 401(k) plan participants to unknowingly drain their future retirement savings:

I. We will discuss the use of plan loans and withdrawals from retirement plans, the educational materials provided to participants who are considering a loan or a withdrawal, and the disclosure of all fees or penalties associated with the loan or the withdrawal.

II. Next, we will examine the potential long-term impact on the participant's future retirement savings of taking money out of the 401(k) plan and moving it to retail IRAs or other products. Using reasonable assumptions, we will demonstrate the cumulative effect of moving from a lower-cost retirement plan environment to a higher-cost environment.

I. Loans From Retirement Plans

Based on our research and experience, Hewitt supports the availability of 401(k) loans when disciplined lending criteria and payback provisions exist. Additionally, appropriate education must be provided to ensure participants are aware of, and fully understand, the risk of default and the implication to their long-term retirement security.

Research indicates that the availability of both loan and withdrawal options increases the overall participation and savings rates among participants by reducing the perceived risk in the event of an emergency. In a study for this Committee, the GAO found that "Plans that allow borrowing have a somewhat higher proportion of employees participating than other plans, all other factors being equal. In addition to employer matching, allowing borrowing increases participation among eligible employees, especially lower-income employees. Allowing pension-plan borrowing also significantly affects how much employees contribute. Participants in plans that allow borrowing contribute, on average, 35 percent more to their pension accounts than participants in plans that do not allow borrowing."[3]

[3] GAO Report to the Chairman, Special Committee on Aging, and the Honorable Judd Gregg, U.S. Senate, 401(k) Pension Plans: Loan Provisions Enhance Participation but May Affect Income Security for Some, October 1997.

Our current findings indicate that taking out a 401(k) loan does not usually result in a decrease in contributions. In fact, the vast majority of participants who borrow from their 401(k) continue contributing to the plan at the same rate they were contributing before initiating the loan, in addition to making loan payments. Therefore, once the loans are repaid, we find that retirement income is generally preserved. For purposes of accumulating retirement savings, loans are far superior to withdrawals, which permanently reduce retirement savings and subject the participant to significant tax penalties.

Nevertheless, we share the Committee's concern about the use of debit cards to borrow funds from retirement accounts. In our opinion, debit cards undermine the disciplined criteria we believe are necessary to preserve savings for retirement. Debit cards make it too easy to use a 401(k) like a checking account and preclude the financial modeling and thoughtful consideration that should accompany any decision to initiate a 401(k) loan.

Prevalence of Loan Provisions and Frequency of Loans
Based on our experience administering benefits for 4.7 million DC plan participants and research on hundreds of 401(k) plan designs, we find that in aggregate:

- Virtually all large plans offer participants an option to apply for a loan. Ninety-eight percent of large plans offer participants loan access. Among that group, 99 percent offer general purpose loans and 77 percent offer home loans.

- Twenty-two percent of the active participants in our database have outstanding loans. The average balance of such loans is $7,800.

- According to trend data over the last six years, loan participation, average balance of loans, and outstanding principal as a percentage of balance have remained largely unchanged. Our early data for 2008 suggests approximately a 1 percent increase in loan participation.

Table 1
401(k) Participation and Outstanding Balance Trends 2002–2007

Year	Participants With Loans	Average Outstanding Principal	Outstanding Principal as a Percentage of Balance
2002	22.4%	$7,113	20.5%
2003	22.1%	$7,364	18.8%
2004	23.0%	$7,336	18.5%
2005	22.4%	$7,962	18.6%
2006	21.8%	$8,144	18.3%
2007	22.3%	$7,828	19.6%

Chart 1a: Percentage of Participants Taking Loans or Withdrawals from 2002 to 2007

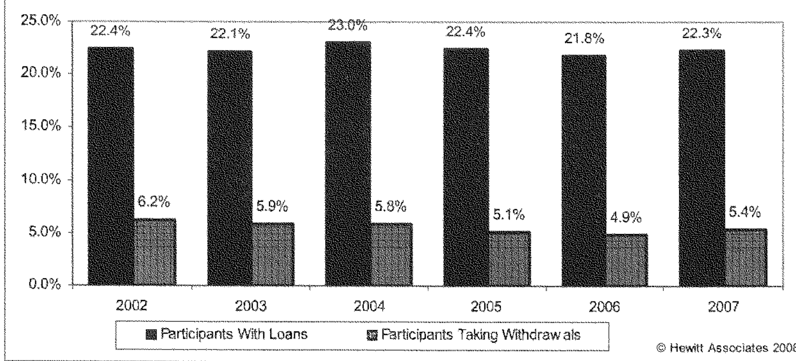
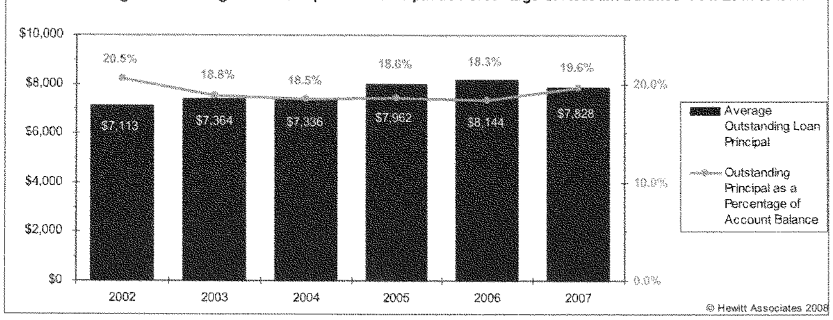


Chart 1b: Average Outstanding Loan Principal and Principal as Percentage of Account Balance from 2002 to 2007



Participant Savings Behavior After Receiving a Loan

Hewitt has been conducting its own research on the impact of 401(k) loans on long-term retirement income. Here, we present both aggregate data as well as data arrayed by age and salary.

- Only 1 percent of loans terminate as taxable distributions, and those are mainly the result of terminations of employment. Specifically, only 0.2 percent of active employees with loans had taxable distributions in the form of unpaid loans, versus 26.7 percent of terminated employees with loans. The risk of default significantly increases upon termination of employment because loan provisions generally require immediate repayment of the loan.

- Overall, our research found that the vast majority of participants did not decrease or suspend contributions to the plan after they received a loan. By continuing to save and paying back their loan with interest, they were able to preserve their total retirement asset potential. On a 401(k) loan, the borrower effectively pays interest back to his or her own account.[4] Of the 401(k) plan participants who have an

[4] As a result, depending on the rate of interest charged on the loan in comparison to the overall investment rate of return during the period the loan is outstanding, some borrowers may even realize a smaller amount of additional growth than if they had not taken a loan.

outstanding loan, only 15 percent suspended or reduced their contributions to the plan, most likely reflecting the situations where the decrease is warranted due to extenuating circumstances. In general, younger workers were more likely to reduce or suspend contributions. Chart 2 and Chart 3 show the percentage of participants who maintain or reduce their contributions after taking out a loan, by age and salary, respectively.

Chart 2: Percentage of Participants Who Maintain or Reduce Contributions After Taking Out a Loan—By Age

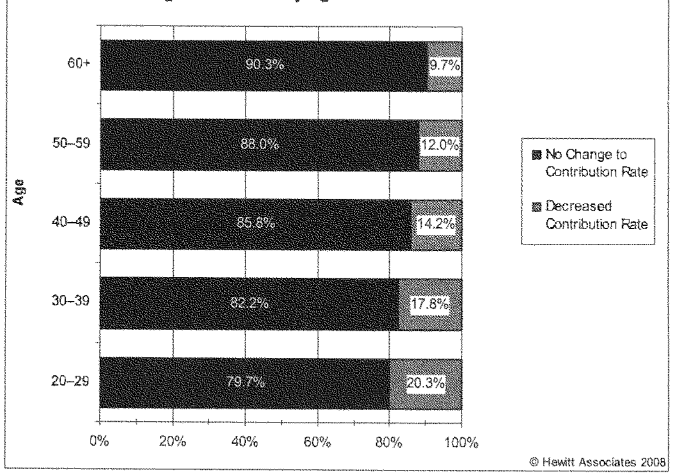
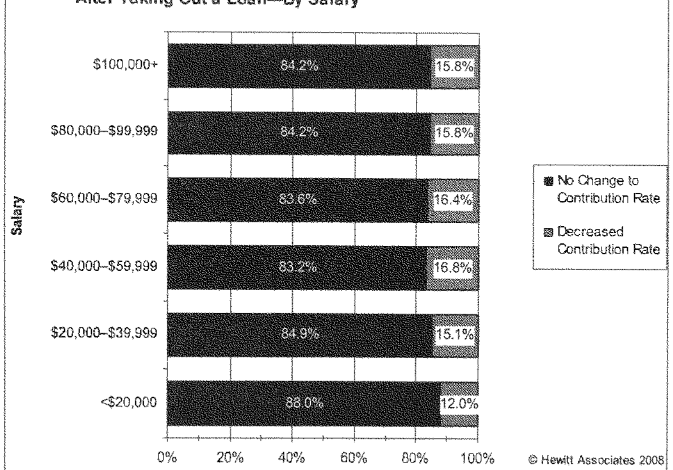


Chart 3: Percentage of Participants Who Maintain or Reduce Contributions After Taking Out a Loan—By Salary



- Of the minority of participants who do decrease their contribution rates, the average decrease is 5.8 percent of pay. Table 2 shows the average decrease in contribution rates among those borrowers who decreased their contribution, by age, and Table 3 shows the average decrease in contribution rates among those borrowers who reduced contribution rates, by salary.

Table 2
Percentage of Participants With Loans Who Decreased Contribution Rates and Average Decrease in Contribution Rates—By Age

Age	Percentage of Participants Decreasing Contribution Rates (including those who stopped contributing)	Average Percentage of Pay Decrease After Taking a Loan
20–29	20.3%	−5.1%
30–39	17.8%	−5.4%
40–49	14.2%	−5.7%
50–59	12.0%	−6.9%
60+	9.7%	−8.3%

Table 3
Percentage of Participants With Loans Who Decreased Contribution Rates and Average Decrease in Contribution Rates—By Salary

Salary	Percentage of Participants Decreasing Contribution Rates (including those who stopped contributing)	Average Percentage of Pay Decrease After Taking a Loan
<$20,000	12.0%	−7.0%
$20,000–$39,999	15.1%	−5.3%
$40,000–$59,999	16.8%	−6.0%
$60,000–$79,999	16.4%	−6.5%
$80,000–$99,999	15.8%	−6.3%
$100,000+	15.8%	−7.0%

One possible explanation for why the vast majority of those taking loans continue their retirement plan contributions may be the effectiveness of information and educational materials they are provided when they apply for a loan. This information generally includes an explanation of the tax consequences and the potential loss of retirement income if the loans are not repaid or if contributions decrease or cease while the loan is outstanding. In our opinion, the most significant risk of a debit card approach is that this education would not be available to plan participants prior to each use of the debit card as a reminder of the risks associated with failing to preserve retirement principal. The decision would be too fast and too easy. An employee might even get the impression that the availability of a debit card is condoning, or at the very least not discouraging, frequent loans.

Communicating Loan Provisions

Informational materials are provided to participants in a number of ways. They are contained in the Summary Plan Descriptions (SPDs) and vary by employer based on the provisions of their plans. Among large employers, this material is generally available to each participant both online and in printed form.

SPDs contain detailed information about loan types and lending limits, disbursements, interest and repayments, loan sources, and the impact on investment fund balances. Hewitt also provides a modeling tool to help participants evaluate the impact of taking a loan or withdrawal from the plan.

For Hewitt employees, our own online site provides a prominent link to a resource titled "The Consequences of Taking a Loan." It is intended to make applicants aware of tax consequences and the potential for loss of retirement income, including a list of alternative sources to consider in lieu of taking a loan. This communication is key to supporting participant understanding of the risks associated with loans and to underscoring the importance of repaying the loans in a timely fashion. While loans can be a valuable financial tool, they should not be undertaken without a consideration of both the alternatives and potential consequences.

Charging a modest fee for a loan is common practice. Seventy-nine percent of large plans charge a loan origination fee, and the median fee is $50. Thirty-four percent of large plans have an annual maintenance fee, and the median fee is $24. These fees are designed to cover the administrative costs associated with loans and, in our experience, are communicated to participants prior to taking a loan. Because there is a real cost to administering the loan, we believe it is a fair practice to charge those taking a loan rather than spread the cost to all plan participants in the general administration fees.

Hardship Distributions and Other Types of Withdrawals

More than 90 percent of 401(k) plans have some provision for hardship or other in-service withdrawals. As a plan design consideration, including these options can increase the participation rate in the plans in general. When participants understand that they will be able to access funds in an emergency, they are often more likely to save. In cases of emergency, hardship withdrawals may be the only viable answer for participants.

While we would not encourage these distributions, we understand that they may be necessary in some instances. We provide educational materials and tools that our participants can use to determine their best option when considering a loan, a withdrawal, or other sources of funds outside their 401(k) plan. If available, loans are usually a better option than withdrawals to meet short-term needs while protecting long-term retirement savings. Alternatives outside the plan may offer even better solutions. We encourage our clients to provide this type of decision support to their own participants.

Hardship distribution policies vary by company, but typically a participant must provide documentation of an immediate and extreme financial need. In most cases, the participant must incur (but not pay for) the expense before requesting the withdrawal. Then, the withdrawal must be used to pay that specific expense—plus expenses related to any federal, state, or local income taxes or penalties reasonably anticipated as a result of the withdrawal.

The following are common criteria for allowing a hardship distribution in 401(k) plans:

- Costs directly related to buying a primary residence (excluding mortgage payments)
- Payments necessary to prevent eviction from your primary residence or foreclosure on the mortgage on that residence
- Medical care expenses meeting the IRS definition of deductible expenses
- Payment of postsecondary tuition, related educational fees, or room and board expenses
- The next semester or quarter of postsecondary education costs directly incurred by the participant, or the participant's spouse, children, or dependents (as defined by the Internal Revenue Code)
- Funeral expenses for the participant's spouse, dependents, or parents
- Repair of unforeseen damage to the primary residence that is not compensated for by insurance

In addition to hardship withdrawals, 90 percent of plans allow for in-service withdrawals based on age, and some offer withdrawals upon eligibility for long-term disability. In-service withdrawals offered at age 59½ can be valuable tools for both employers and employees who are looking for ways to gradually phase into retirement. That said, as a matter of retirement planning policy, we are concerned that some employees could take in-service withdrawals as a result of pressure to roll over assets into a retail IRA, which can result in erosion of the value of the account. This phenomenon is discussed in greater detail below.

Participant Behavior With Respect to Withdrawals

Overall, our research shows that 5.4 percent of active participants took withdrawals in 2007, compared to 4.9 percent in 2006. Of these participants, 26 percent took hardship withdrawals and 78 percent took in-service withdrawals in 2007 (a small percentage took both types, so the numbers add up to more than 100 percent). This means that fewer than 1.5 percent of participants took a hardship withdrawal in 2007. Clearly, hardship withdrawals significantly diminish retirement assets and the value is not replenished. Employers should seek to keep the utilization of withdrawals low.

With respect to withdrawals by terminated participants, our research shows that only 55 percent of departing participants are rolling over these assets while 45 percent are taking cash withdrawals (and we assume paying penalties) upon distribution. That said, when we look at the assets leaving the plan, 85 percent of the assets are rolling over. This implies that cashing out occurs with participants holding relatively smaller balances, typically younger employees. In fact, when the balance is below $10,000, nearly three-quarters of participants take their balance in cash. Even this relatively smaller savings amount can significantly detract from long-term retirement savings goals, especially when individuals change jobs and cash out several times.

Communication Implications of Withdrawals

Hewitt always suggests maintaining retirement funds in a tax-deferred instrument versus obtaining a cash payout. The main goal here is to ensure that the savings remain dedicated to retirement and are not used for short-term cash needs. Modeling tools are an effective way to quantify the impact of withdrawals to increase awareness of the risks of in-service distributions.

Total cash distributions upon termination, Hewitt is working with plan sponsors to both encourage employees to stay in the 401(k) plan upon termination of employment and improve the rollover process without additional cost to either the plan or the former employee in the event the participant chooses a rollover. We have recently begun partnering with a company that provides an online tool to inform terminating employees of their options, and to simplify and expedite the rollover process.

Of course, both withdrawals and loans that are not repaid result in an opportunity lost by reducing the value of future earnings. When a participant defaults on a loan, the entire balance of the loan is unavailable for retirement. If not repaid, a loan has the same effect as a hardship withdrawal on retirement savings. Fortunately, our data shows that only 1 percent of loans default, but those that do represent a very real risk.

To understand the effects of these decisions, consider the following example that is similar to one that Hewitt provides to employees considering taking a loan or a withdrawal. Each of these three hypothetical employees is the same age, and contributed to and invested their 401(k) the same way during their employment.

Scenario	Action	Consequence
Michele needs cash to pay for some uncovered medical bills.	She finds alternative means of funding and does not take out a loan or a withdrawal.	At age 65, Michele has earned **$350,984** for retirement.
Anthony decides to buy his first house at age 35. He needs funds for the down payment.	He takes out a $10,000 loan but fails to make any loan payments and the loan is defaulted.	At age 65, Anthony has earned **$274,861** for retirement. *His $10,000 defaulted loan cost $76,123 in unrealized savings.*
Sandra decides to go back to college at age 45. She needs extra money to cover tuition and fees.	She takes a withdrawal for $35,000.	At age 65, Sandra has earned **$215,545** for retirement. *Her $35,000 withdrawal cost $135,439 in unrealized savings.*

II. Potential Impact on Retirement Income of Rollovers From a Low-Fee Qualified Retirement Plan to a Higher-Fee Rollover IRA

In 2006, the $3 trillion U.S. private DC market accepted contributions of $268 billion from qualified plan participants. It also transferred $195 billion from private qualified DC plans to IRAs, which held more than $4 trillion in assets[5]. Hewitt alone processed more than 150,000 rollovers for participants, totaling more than $16 billion in assets. Across the industry, there are signals that some financial services firms are viewing this transfer of wealth as one of the most potentially lucrative opportunities in recent history. What is at stake is the overall financial security of the U.S. retiree population.

Rollover products vary considerably in type and fees. Following are some typical types of programs, but there are many variations and other options.

- Some rollovers provided by mutual fund companies are simply retail mutual fund purchases—with load fees and ongoing asset management fees depending on product(s) selected. These are the most common rollover/account types that investors access.

- With managed accounts, the load fees are generally waived. Institutionally priced funds are commonly used, and the consumer is charged an annual asset-based fee of 50 to 200 basis points (0.50 percent to 2.00 percent) based on asset size, in addition to the fund expenses themselves. In these programs, an advisor or advisory service selects specific funds and determines asset allocation. Often minimum investment amounts are required—thus, these types of accounts are less prevalent and used more by investors with higher account balances.

- IRA rollover annuities generally have up-front commission sales as well as ongoing fees.

In our opinion, 401(k) plan participants are at far greater risk of falling short in their retirement savings if they roll over their plan balances to a retail account IRA compared to a mid- to large-sized company 401(k) plan. This is because retail IRAs typically charge higher fees than are charged for investments within the 401(k) plan. Press reports suggest that in some cases, unsuspecting employees have suffered devastating losses after being lured by the promise of high investment returns.[6]

The retail industry is waging a media and public relations blitz to convince participants that rollovers are the wise move when the employee terminates employment. However, Hewitt believes it is often the best choice to keep assets in a mid- to large-sized company 401(k) plan to take advantage of lower-cost and higher-value investment options often available through these institutional plans. We are encouraging plan

[5] Source: Cerulli Associates
[6] Mara Der Hovanesian, "Ruined by 401[k] Predators," ***BusinessWeek***, July 3, 2008. http://biz.yahoo.com/bizwk/080703/0828b4092000132397.html?.v=1

sponsors to educate their employees on the value of their 401(k) plans and the potentially significant negative impact of moving toward higher-fee IRAs. A typical IRA could cost substantially more in fees than a mid- to large-sized company 401(k) plan, thus directly reducing employees' retirement savings.

The following hypothetical example demonstrates the impact on retirement income if a participant moves from a lower-fee 401(k) plan environment to a higher-fee retail environment, using reasonable assumptions of fee differentials (based on our experience and research) and balances typical of similar employees in our database.

35-Year-Old Average Saver Scenario
Consider an average employee from our participant database who leaves a company at age 35 with an accumulated balance of $33,000 after saving 3% of pay for five years and receiving typical employer contributions. She rolls her balance into a typical retail IRA. Assuming she earns 8 percent before reflecting fees, she can expect a total balance of $366,424 at age 70, when she will be required to start taking distributions from the plan.

If she leaves her balance in a typical 401(k) with institutionally priced investments, with lower fees by 30 basis points (bps) compared to the retail IRA (a conservative assumption based on our experience), she can expect to accumulate $404,105 at age 70, an increase of $37,681 or 10 percent compared to the IRA option.

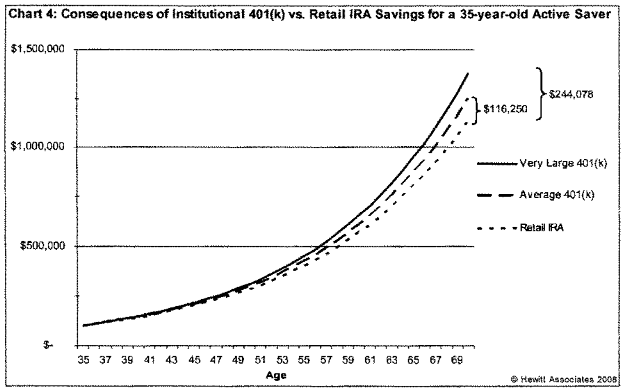
If she leaves her balance in a very large, efficient 401(k) with lower fees by 60 bps compared to the retail IRA (a realistic difference for the very large plan market), she can expect to accumulate $445,539 at age 70, an increase of $79,115 or 22 percent compared to the IRA option.

35-Year-Old Active Saver Scenario
Graph 4 depicts the consequences for an employee who leaves a company at age 35 with an accumulated balance of $101,808 after saving 8 percent of pay for ten years and receiving typical employer contributions. She rolls her balance into a typical retail IRA. Assuming she earns 8 percent before reflecting fees, she can expect a total balance of $1,130,451 at age 70, when she will be required to start taking distributions from the plan.

If she leaves her balance in a typical 401(k) with institutionally priced investments, she can expect to accumulate $1,246,700 at age 70, an increase of $116,250 or 10 percent compared to the IRA option.

If she leaves her balance in a very large, efficient 401(k), she can expect to accumulate $1,374,529 at age 70, an increase of $244,078 or 22 percent compared to the IRA option.

Chart 4: Consequences of Institutional 401(k) vs. Retail IRA Savings for a 35-year-old Active Saver



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In conclusion, Hewitt commends the Special Committee on Aging for its ongoing efforts to focus the spotlight on better disclosure of fees associated with retirement plan investments and on the impact on plan participants of taking preretirement loans or withdrawals from their 401(k) plan. We trust that the Committee's efforts will help foster awareness that there are better ways for employees to save more for retirement and make the most of what they save by preserving retirement principal in tax-deferred vehicles and taking advantage of the best investment options available to them at the lowest fees. In most cases, we believe those best options will be found within a qualified 401(k) plan.

We believe that federal agencies can also follow the Committee's lead by providing more public service announcements and guidance to participants on the factors employees should consider before taking a loan or withdrawal and when they are thinking about rolling over their 401(k) balances. In some cases, a rollover IRA could be the best choice for consolidating account balances from previous employers, but in many other cases, it may not be.

Hewitt would be honored to participate in any such effort to better educate participants, and we offer our data resources and expertise to the Committee in its continued efforts to ensure the adequacy of retirement savings in America. Thank you.

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July 16, 2008

The Honorable Herb Kohl
Chairman
Senate Committee on Aging
G31 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Gordon H. Smith
Ranking Member
Senate Committee on Aging
G31 Dirksen Senate Office Building
Washington, D.C. 20510

Re: Senate Aging Committee Hearing of July 16, 2008, "Saving Smartly for Retirement: Are Americans Being Encouraged to Break Open the Piggy Bank?"

Dear Senators Kohl and Smith:

We are pleased to respond to your request for information about how various countries around the world are addressing the challenge of reducing retirement plan leakage. Mercer is a leading global provider of consulting, outsourcing, and investment services, with 17,000 employees based in more than 40 countries working with clients to help solve their most complex retirement and other benefits and human capital issues, and we appreciate the opportunity to share some of our experience with you. We also stand ready to assist the Committee in whatever other ways would be helpful in its ongoing efforts to enhance retirement security for all Americans.

Our response includes:

- Findings of an informal survey of Mercer consultants in 11 countries/regions regarding what rules those countries have on the books to minimize or prevent retirement plan leakage.
- Background information on the mandatory and supplementary retirement programs in the countries referenced. This will provide additional context for the rules around retirement plan withdrawals and loans noted in the table.
- A recent Mercer article "Defined contribution plans: The challenge of achieving benefit adequacy." This will provide some background information on global retirement savings. The article reviews key elements of defined contribution structures around the world and some of the measures governments and plan sponsors are taking to help engage workers in building meaningful retirement savings.

We would be happy to discuss these materials and related policy issues further. If you have any questions, please contact me at 410-347-2867, or Geoff Manville of Mercer's Washington Resource Group at 202-263-3957.

Sincerely,

Barbara Marder

Barbara Marder
Global DC Consulting Leader and Worldwide Partner

Enclosures

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No	Country	Rules & Regulations - DC Plan Leakage
1	**Australia**	The main incentives in Australia to avoid leakage are: • Preservation - superannuation (pension) monies (employer and employee money) cannot be cashed out before the earlier of: retirement on or after age 60, reaching age 65, death or total and permanent disablement. There are exemptions for smaller draw downs prior to these events if the member can prove severe financial hardship or for specified events such as funeral costs and emergency medical treatment. • No loans, including loans for housing, can be made from a superannuation fund in Australia to a member. • The tax on superannuation contributions and earnings is 15%. That is considerably lower than the top marginal rate of 45%. In addition, the account based pension from which the member draws down to provide his/her post retirement income stream is tax free. • For low and middle income earners the government provides a "co-contribution". Thus, depending on the employee's income level, for every $1 the employee contributes each year to a superannuation fund the federal government contributes $1.50 up to a maximum of $1,500.
2	**Asia**	Early withdrawal and loan features are not very common for retirement schemes in Asia. From a cultural perspective, Asians prefer not to dip into their savings/ retirement plans until retirement. There are some countries which allow early withdrawals from retirement plans: • South Korea - common for their DB arrangements; vesting eligibility may restart following withdrawal. • Indonesia - only contributions but not investment returns. • Malaysia –only for certain purposes such as to finance home purchase (one house or replacement only), medical bills for critical illnesses, own or children's education fees; withdrawal limit of 30% of contributions. • Singapore - similar to Malaysia in principle, with restrictions on the purpose of the withdrawal and limits on the withdrawn amounts. • Hong Kong - only employee voluntary contributions may be withdrawn. Typical supplementary retirement arrangements in Asia provide lump sum cash payments on leaving service so, by default, this has meant that there is significant leakage of funds pre-retirement. Many Asian countries have been introducing mandatory/voluntary legislation to ensure preservation to retirement to try and limit this leakage from retirement savings. Some countries (China, South Korea, Taiwan) have recently introduced DC legislation requiring preservation to retirement and have added an annuity payment option at retirement in addition to the lump sum option.

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No	Country	Rules & Regulations – DC Plan Leakage
		Countries like Singapore and Malaysia are also currently considering promoting annuity options for the mandatory funds.
3	**Canada**	In Canada, retirement savings within registered Pension Plans cannot be accessed in any form during employment and rapidly become locked-in (i.e. inaccessible until retirement) upon cessation of employment, except for small amounts. Locking-in means that the money can only be accessed in the form of a life income stream (e.g. life annuity or other Canadian payout products that limit withdrawals so that there is always something left). There is a trend towards "unlocking" these savings at the moment of retirement, where individuals can unlock part or all of their savings. Currently, this is allowed in certain provinces as well as for plans that are federally regulated. For other forms of tax-assisted retirement savings, there is no locking-in feature - only administrative rules that the employer may put in place to limit withdrawals. These are typically penalties such as the loss of future employer contributions /matching for a certain period of time. Loans are permitted from certain plans for both the purchase of a house and for returning to school (under certain conditions), but there are limits on what amounts can be withdrawn and rules about repayment to the plan in order to avoid having the withdrawal taxed. Many recordkeepers have modeling tools on their website that show the impact to a plan participant of making such withdrawals so they can understand the implications.
4	**Denmark**	Pre-retirement withdrawals or loans are not allowed.
5	**Germany**	Earlier this year, the Government set new rules that would allow certain pension participants to take tax-favored lump-sum withdrawals for the purchase of a home or for buying a stake in a housing co-operative. There would be no limit on how much of one's fund may be withdrawn for housing.
6	**Ireland**	There is very little leakage in Ireland. No loans, no early withdrawals are allowed. The only way for retirement plan participants to get money out of the system is if a participant leaves a job with less than two years service, in which case a refund is payable subject to a tax penalty of 20%.
7	**Italy**	Leakage occurs in DC pension funds by way of advances. However, participants must be in the pension fund for at least 8 years before taking an advance (except for medical reasons) and the taxation is higher (except for medical reasons). These are the guidelines on advances:

No	Country	Rules & Regulations – DC Plan Leakage
		• At any moment for exceptional medical expenses: maximum 75% of the accrued capital taxed at 15% fixed rate. Under certain conditions a reduced tax rate is applicable, up to 9%. • Minimum of 8 years of participation in the fund for first house purchase: maximum 75% of the accrued capital taxed at 23% fixed rate. • Minimum of 8 years of participation in the fund for any other reason: maximum 30% of the accrued capital taxed at 23% fixed rate. Note that normally, pension benefits and lump sums are subject to a 15% withholding tax. This tax is reduced by 0.30% for each year after the fifteenth year of contribution to a supplementary pension fund, up to a maximum reduction of 6% - a small financial incentive for not touching pension funds.
8	**South Africa**	On leaving employment, other than at retirement, a participant may either preserve their accumulated assets or take the money in cash. Although cash withdrawals are taxed, for many lower income workers this rate of tax will be relatively low (<20%). Leakage is a material concern in South Africa where below age 40 the "rate of leakage" is around 90%. Admittedly the rate of preservation is higher where the amounts are more significant and is higher where the individual's income is higher. A practical complication in South Africa is that there is a very basic social security net in place. For example, unemployment benefits will stop 12 months after losing a job. Hence on leaving employment, individuals often need to ensure their retirement fund assets are available in case of pressing financial needs. Housing loans are permitted as are housing loan guarantees, where the participant's withdrawal benefit is used as collateral and is used to pay off the housing loan if the member leaves employment. Although these loans address an important social need they do lead to increased leakage since the member with a loan is basically forced to access their retirement benefits. The South African social security and retirement system is currently undergoing a reform process, and one of the principles endorsed is the need to have compulsory preservation. The details are yet to be finalized, but there has been some acceptance that some early access to retirement benefits may still be needed in the event of a loss of employment. Hence some integration of retirement benefit preservation with unemployment benefits will be required.

No	Country	Rules & Regulations - DC Plan Leakage
9	**Spain**	Withdrawals/loans are not allowed. However, according to the Spanish Law, the accrued funds can be paid before retirement age if the participant is under long term unemployment or serious illness situation.
10	**Switzerland**	Switzerland is by law almost "leakless" - primary features of the pension environment are: • A rather small state social security system. • A "medium sized" requirement for every employer to cover (almost) every employee for company pension benefits. • Substantial personal and company tax deductions for pension building in excess of the legal minimum. • Company has to pay at least 50% of the "whole package" (both in required part and excess part). • Accrued benefits vest 100% from day one. • Mandatory portability - generally participants MUST roll over accruals to a new employer plan on job change. • If a participant doesn't have a new employer, he or she MUST roll over accruals to a locked up retirement account. There are limited exceptions. • There is one substantial exception – participants can withdraw or pledge pension accruals for house purchase or mortgage security.
11	**United Kingdom**	Participants are effectively compelled to use 75% of their assets to secure an annuity (that has to be arranged no later than age 75). 25% of account value at retirement can be, and almost always is, taken as tax free cash - there are no restrictions on how this is used. The UK system is somewhat inflexible. Participants can't touch the money prior to retirement and cannot use funds as security against a loan. Despite the tax effectiveness of UK pensions, many individuals are not prepared to tie up capital in such an inflexible environment. The fact that once paid in, the money can't be withdrawn, is a major block to participation.

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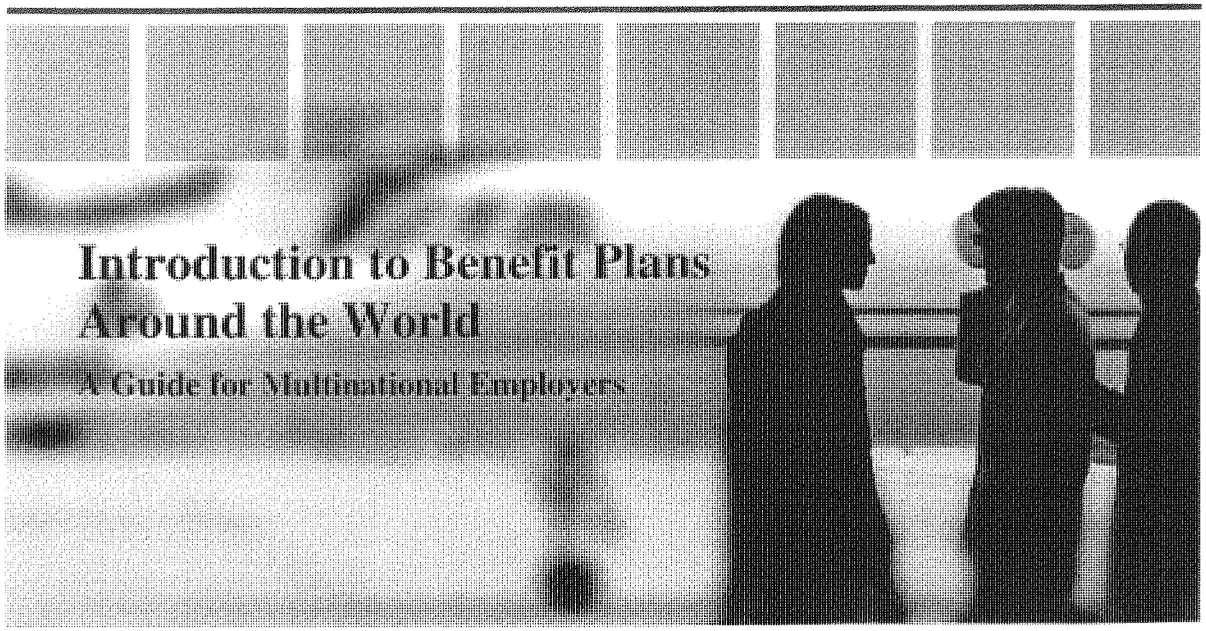
March 2008



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Country Snapshots

Definitions are below and Country Snapshots follow on next pages. This report covers all benefits except business travel accident, severance, and workers' compensation.

All Benefits

- Key Legislation: Recently approved or proposed key legislation on benefit plans with impact on employers.
- Mandatory Practice: Benefits provided from Social Security or mandatory employer-sponsored plan.
- MFR / MFS: Minimum Funding Requirement / Minimum Funding Standard
- Opportunities and Trends: Key changes in the benefit plan environment which present opportunities for employers.
- Prevalence: Indicates how commonly the plan is provided by multinational and local leading companies. Prevalence percentages are rough estimates based on Mercer consultants' experience working with these companies in the local market, and in some cases Mercer survey data.
- Threats and Restrictions: Key aspects of the benefit plan environment that restrict or threaten the establishment and/or management of a supplementary pension plan.
- Typical Market Practice: Describes typical, non-industry specific, general market practice for supplementary benefits provision and does not describe any sub-group differences in practice that may exist in each country. It includes multinational and local companies, various industries and company sizes, unless stated otherwise.

Retirement

- DB: Defined benefit retirement plan
- DC: Defined contribution retirement plan
- Executive only plans: Either a retirement plan exclusively for higher level employees or higher earning employees or higher contribution or defined benefit provided to this group through the same retirement plan as for other employees.
- Hybrid: Mixture of defined benefit and defined contribution features. Examples: A defined contribution plan which provides a guaranteed minimum defined benefit payment upon retirement; A defined contribution plan with benefit at retirement age equal to accumulated contributions plus interest or a fixed formula benefit, whichever benefit is higher; or Company typically provides DB plan for existing employees and DC plan for new hires (two separate plans).
- Mandatory Termination Indemnities: Lump sum payments which must be made by the company (or have been prefunded by the company possibly through an outside agency other than Social Security) when an employee retires.
- NRA: M / F: Normal Retirement Age: Male (age) / Female (age)
- SS salary ceiling or SSCC: Social Security salary ceiling
- Vesting: The acquisition by a plan member of an absolute right to an immediate or deferred benefit by fulfilling prescribed conditions, especially service requirements.

Medical, Sickness, Disability & Death

- AD&D: Accidental Death & Dismemberment
- Dependent Coverage: Describes whether the plan provides coverage for dependents. Dependent includes the spouse and dependent children, unless otherwise stated in a Country Snapshot.
- Inpatient: Services provided to individuals who are admitted to a hospital as a registered bed patient and is receiving services under direction of a physician for at least 24 hours.
- LTD: Long Term Disability
- Outpatient: Services provided to individuals who are admitted to a hospital or clinic for treatment that does not require an overnight stay.
- Rider: Indicates whether a benefit is financed as part of another policy. For instance, dental benefit may be a rider to the medical plan.
- Self-funded / Self-insured: Company finances the benefit internally (as opposed to using external insurance policy)
- STD: Short Term Disability
- TPD: Total Permanent Disability

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Australia

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	All companies	Social Security + Mandatory Superannuation Guarantee (SG) which can be DB or DC	PLAN NAME	Social Security + Mandatory Superannuation Guarantee (SG) which can be DB or DC
Typical Market Practice	Approximate: **% of multinational and local leading companies that provide supplementary benefits through same mandatory plan** 10%	In general, supplementary pension plans are provided mainly to management and higher-paid groups. Most DB plans are closed to new hires. Where open, eligibility upon date of hire.	PLAN ELIGIBILITY	In general, supplementary pension plans are provided mainly to management and higher-paid groups upon date of hire.
		65 Males / 65 Females	NORMAL RET. AGE	65 Males / 65 Females
		Typically 6 to 7 times final 3-year average salary after 40 years' service (inclusive of the mandatory SG). Lower benefit scales may apply to employees classified as "wage-earners"	BENEFIT FORMULA	Accumulation of contributions with interest.
		Included in retirement plan: Death: Yes. Disability: Yes.	DEATH & DISABILITY	Included in retirement plan: Death: Yes. Disability: Yes.
		Vesting benefit: Vesting periods now less common (i.e., most plans immediately vest). Benefit formula may be more generous on retirement after age 55.	VESTING	Vesting of employer contributions: Immediate full vesting.
	% of supplementary plans DB: 10% DC: 90% Hybrid: 0%	Typically 5% of salary (not counted towards the mandatory SG) from either pre-tax or past-tax salary, with additional voluntary contributions possible.	EMPLOYEE CONTRIBUTION	Not required, voluntary contributions possible.
		1% - 2% of earnings in addition to 9% mandatory contribution to SG.	EMPLOYER CONTRIBUTION	1% - 2% of earnings in addition to 9% mandatory contribution to SG.
		Stand-alone trust, master trust or industry fund.	FINANCING	Stand-alone trust, master trust or industry fund.
		Lump sum	FORM OF PAYMENT	Lump sum
	Executive only plans Not prevalent	Not prevalent	HYBRID ALTERNATIVES	Not prevalent
		Valuations: Formally every 3 years, informal valuations conducted more frequently Local accounting standard: AASB 119 (based on IAS 19)	OTHER	Employee investment choice: Yes "Choice of Fund" also applies from July 1, 2005

PENSION ENVIRONMENT

General Comments	Opportunities and Trends	Key Legislation (Recent or Proposed)

While this Snapshot is Mercer's understanding of current typical market practice, there are usually industry and geographical differences that should be taken into account if benchmarking or establishing a plan. Within the Retirement summary, Death & Disability excludes information on any death and/or disability benefits that may be provided outside the retirement plan. Copyright 2008 Mercer LLC. All rights reserved.

Australia

Retirement

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EMPLOYER PRACTICE

Prevalence	DB	DC
▪ Australia does not typically have supplementary plans in the sense that there is a separate plan. Instead about 10% of multinational and local leading companies provide supplementary benefits for higher-paid groups within the same (mandatory) superannuation plan as for other employees but through different membership categories. ▪ Many senior executives are "packaged", and superannuation is one component of that package. Senior executives can choose how much of that package is directed towards superannuation (other than for the minimum 9% SG). Even where there is a supplementary arrangement, it is not usually significantly higher than the 9% SG.	▪ Continuing trend towards master trusts and industry funds. Many employers have decided to wind-up their stand-alone trust because of increasing regulatory complexity and compliance costs. ▪ Most companies have shifted away from defined benefits. ▪ Mandated and voluntary choices. Flexible defined contribution plans – flexible contributions, insurance and investment choice, choice of fund.	▪ Sweeping changes to the superannuation system were effective as of July 1, 2007 including elimination of taxes on benefits taken after age 60, removal of "Reasonable Benefit Limits" and, new tax rates on Employment Termination Payments. These payments can no longer be transferred to a superannuation fund. Transitional rules apply until June 30, 2012. ▪ From July 1, 2008, legislated changes to the definition of salary for the purposes of mandated contributions to superannuation will increase many employers' costs. ▪ Also effective July 1, 2008, default funds must offer at least a minimum level of insurance on death for members under age 56.

While this Snapshot is Mercer's understanding of current typical market practice, there are usually industry and geographical differences that should be taken into account if benchmarking or establishing a plan. Within the Retirement summary, Death & Disability excludes information on any death and/or disability benefits that may be provided outside the retirement plan. Copyright 2008 Mercer LLC. All rights reserved.

Canada

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	All companies	Old Age Security (OAS) + Guaranteed Income Supplement (GIS) + Canada/Quebec Pension Plan (CPP/QPP)	PLAN NAME	All members receive DB only
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan** 80% **% of supplementary plans** DB: 50% DC: 15% Hybrid: 35% Hybrid means typically DB for existing employees, DC for new hires. **Executive only plans** Common, especially among larger companies	All full- and part-time employees, subject to a minimum service requirement. For part-time employees, a minimum earnings level requirement applies.	PLAN ELIGIBILITY	All full- and part-time employees, subject to a minimum service requirement. For part-time employees, a minimum earnings level requirement applies.
		65 Males / 65 Females	NORMAL RET. AGE	65 Males / 65 Females
		Typically up to 2% of final average earnings times years of service (65% of DB plans). Alternatives are career average earnings (15%) and flat benefit (20%) plans.	BENEFIT FORMULA	Accumulation of contributions with interest
		Included in retirement plan: Death: Yes. Disability: Varies.	DEATH & DISABILITY	Included in retirement plan: Death: Yes. Disability: No.
		Vesting benefit: Generally after 2 years of plan membership.	VESTING	Vesting of employer contributions: Generally after 2 years of plan membership.
		May be required (50% of plans), generally 3% - 7% of salary.	EMPLOYEE CONTRIBUTION	May be required, generally 3% - 7% of salary.
		Full cost of plan less any employee contributions.	EMPLOYER CONTRIBUTION	A match of employee contributions up to a maximum, or a fixed contribution, or both.
		Large employers: Trusts. Medium and small employers: Insurance policies or trusts.	FINANCING	Insurance policies or trusts.
		Choice of annuity or lump sum	FORM OF PAYMENT	Choice of annuity or lump sum
		Alternatives include sum of DB and DC, maximum DB or DC, flexible plans.	HYBRID ALTERNATIVES	Alternatives include sum of DB and DC, maximum DB or DC, flexible plans.
		Valuations: Required every 3 years. Some provinces require annual valuations when plans are less than fully funded. Local accounting standard: CICA 3461	OTHER	Employee investment choice: Yes

PENSION ENVIRONMENT

Threats and Restrictions

- Current legislative environment results in asymmetry with respect to surplus and deficits in DB plans.
- Companies wanting to make pension asset transfers, either in the context of sale or purchase activity, or for purpose of rationalizing or harmonizing their own plans, face uncertainty after a series of Court decisions.
- Potential inadequacy of DC benefits due to low interest rate environment.

Opportunities and Trends

- Employers are considering ways to improve retention features in DB plans such as removing early retirement subsidies and removing service caps.
- Phased retirement
- Trend towards DC continues, but the pace has slowed.
- Tax treatment of DC plans is more advantageous than a DB plan for younger employees; the tax treatment is neutral for older employees.
- Smaller companies may provide capital accumulation plans to avoid minimum provincial pension standards. These include: Registered retirement savings plans (RRSPs), Deferred profit sharing plans (DPSPs), and Employee profit sharing plans (EPSPs).

Key Legislation (Recent or Proposed)

- Effective January 1, 2008, updates to the Canada-US Tax Treaty will give mutual tax recognition of pension contributions.
- The list of provinces that have eliminated mandatory retirement grew in 2007 to include British Columbia, Newfoundland and Nova Scotia and continues to cause some employers to rethink plans for employees over age 65.

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China

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	All companies	Old Age Pension Insurance (DB and DC)	PLAN NAME	Old Age Pension Insurance (DB and DC)
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan** 39%	All employees. Probation period (typically 3 months) may apply. Age and service requirements usually not a plan feature.	PLAN ELIGIBILITY	Supplementary Retirement Plan (SRP): One year of service requirement (half of plans) Enterprise Annuity (EA): All employees, after probation period
		60 Males / 55 Females	NORMAL RET. AGE	60 Males / 55 Females
		1 to 2 times monthly salary for each year of service.	BENEFIT FORMULA	Accumulation of contributions with interest
	% of supplementary plans	Included in retirement plan: Death: Yes. Disability: Yes.	DEATH & DISABILITY	Included in retirement plan: Death: Yes. Disability: Yes.
	DB: 15%	Vesting benefit: No market data at this time.	VESTING	SRP: Typical vesting schedule is first vesting after 3 - 5 years of service and fully vested after 5 - 10 years of service. EA Plan: No typical practice yet; no vesting regulation.
	DC: 80%	Not required. None.	EMPLOYEE CONTRIBUTION	SRP: Not required. If required, 5% of salary or less. EA Plan: Required. Company + employee contributions not to exceed 1/6 of gross payroll of previous year.
	Hybrid: 5%	Full cost of plan	EMPLOYER CONTRIBUTION	SRP: 5% - 10% of salary. EA Plan: Company contributions not to exceed 1/12 of gross payroll of previous year.
	Executive only plans Not prevalent	Book reserve	FINANCING	SRP: Insurance policy (28% of plans); book reserve (28% of plans); social security institution (28% of plans). EA Plan: Must be trust arrangement.
		Lump sum	FORM OF PAYMENT	SRP: Lump sum. EA Plan: Choice of annuity or lump sum.
		Cash-balance plans	HYBRID ALTERNATIVES	Cash-balance plans
		Valuations: No requirement Local accounting standard: PRC GAAP	OTHER	Employee investment choice: Limited choice.

PENSION ENVIRONMENT

Threats and Restrictions	Opportunities and Trends	Key Legislation (Recent or Proposed)

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China

Retirement

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EMPLOYER PRACTICE

Prevalence	DB	DC
• Current Enterprise Annuity legislation does not provide guidance on tax relief for employee contributions. • Pension assets are managed in an immature and undeveloped capital market.	• The Government issued legislation in May 2004 on a DC voluntary occupational retirement scheme, termed Enterprise Annuity (EA). On August 2, 2005 the Government issued 37 licenses to EA service providers. As of November 19, 2007, an additional 24 licenses had been issued. • Over 60% of surveyed leading multinationals in China plan to implement an EA plan by 2008, and the EA taxation situation was identified as the most critical factor in affecting the decision as to whether to establish a plan.	• Regulations require that pre-EA supplemental pension (DB and DC plans) assets managed by the Bureau be transferred to licensed EA service providers before the end of 2007. Further detailed operation related rules are still not available in many cities/provinces (particularly Shanghai), and so the transferring progress has been insignificant. • New national law recognizing tax deductibility of contributions for Enterprise Annuity and premiums for supplementary medical insurance is in effect as of January 1, 2008. Limits up to which the contributions and premiums are tax deductible have not yet been specified.

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Denmark

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB	DC	
Mandatory Practice	All companies	National State Pension + ATP (Labor Market Additional Pension) + SP (Special savings Plan). SP is currently suspended until end of 2008. After 2008 the government will decide if the SP plan should be opened again.	PLAN NAME	All members receive DB only
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan** 98%	Not prevalent	PLAN ELIGIBILITY	All employees. Typically either immediately or after 3 months of service.
			NORMAL RET. AGE	65 Males / 65 Females
			BENEFIT FORMULA	Accumulation of contributions with interest.
	% of supplementary plans DB: 2% DC: 98% Hybrid: 0%		DEATH & DISABILITY	Included in retirement plan: Death: Yes. Disability: Yes.
			VESTING	Vesting of employer contribution: Immediate full vesting.
			EMPLOYEE CONTRIBUTION	Not required but depends on the pension policy of the company - contribution is typical 1/3 of total contribution (4% to 5% of base salary).
			EMPLOYER CONTRIBUTION	Typical 2/3 of total contribution (8% to 10% of base salary).
	Executive only plans Common		FINANCING	Insurance policy. Premiums for death and disability benefits are typically included in the pension contribution and so are health insurance and critical illness if those benefits are part of the plan. However, it is not untypical that some of these benefits are group benefits and can be in addition to the pension contribution and paid by employer.
			FORM OF PAYMENT	Typically the employee chooses a combination of lump sum and annuity.
			HYBRID ALTERNATIVES	Not prevalent
			OTHER	Employee investment choice: Yes

PENSION ENVIRONMENT

Threats and Restrictions

- The yield on investments has been falling over the years and puts pressure on the traditional savings with guaranteed payments. The number of pensioners has increased and pensioners are living longer. For pensioners with life long pensions, the pensions are paid out for more years. As the money for the extra payments is taken from the bonus of the entire pension fund population, it is expected that interest above the minimum guaranteed could be reduced for the entire pension fund population. For employees, more contributions need to be paid into the pension plan to have the expected pension income during the full retirement period.

Opportunities and Trends

- New investment products are being developed for both the choice of individual employees and for pension companies interested in offering investment products.
- New opportunities for investments, i.e., the savings investments can be separated from the benefit plan.
- Pension providers are reducing their costs, which gives opportunity for employers to spend the saved cost on other pension-related items.
- More flexibility and mobility in the transfer of a pension plan from one provider to another.

Key Legislation (Recent or Proposed)

- As of May 1, 2007 the statutory retirement age was increased from age 65 to age 67 (and from 60 to 62 for early retirement). This increase will be gradually implemented between 2024 and 2027. Given that company pension rules usually link the retirement age to the state retirement pension age, it is anticipated that many companies will modify their pension plan rules and will gradually change the ages for early and normal retirement in line with the state retirement age transition period.

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Germany

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	All companies	Social Security Retirement Insurance	PLAN NAME	All members receive DB only
Typical Market Practice	Approximate:	All full- and part-time employees, usually upon date of hire.	PLAN ELIGIBILITY	All full- and part-time employees, usually upon date of hire.
	% of multinational and local leading companies with a supplementary plan	65 Males / 65 Females	NORMAL RET. AGE	65 Males / 65 Females
		0.2% to 0.5% of salary below Social Security contribution ceiling (€ 63,600 for the western federal states and € 54,000 for the eastern federal states) plus 0.9% to 1.8% of salary above the ceiling multiplied by the number of years of service either on a final pay or career average basis.	BENEFIT FORMULA	DC plans effectively only possible as fully insured plans where premium determines insured benefit; premium typically 2% to 4% of covered pay up to Social Security ceiling (€ 63,600 for the western federal states and € 54,000 for the eastern federal states): most plans are hybrid plans
	90%	Included in retirement plan: Death: Yes – Survivor's benefit of 60% of disability or old age benefit. Disability: Yes – (Accrued) old-age benefit).	DEATH & DISABILITY	Included in retirement plan: Death: Yes – Survivor's benefit typically amounts to 60% of disability or old age benefit / Cash balance: Payment of (notional) account. Disability: Often, accrued old-age benefit.
	% of supplementary plans	Vesting benefit: 5 years of service + age 30	VESTING	Vesting of employer contributions: 5 years of service + age 30
	DB: 50%	Not required. None.	EMPLOYEE CONTRIBUTION	Not required, but varies by plan. Often requested within new plans, with employer matching contribution. Deferred compensation common for executives; offer mandatory for all employees up to a contribution of 4% of the SS salary ceiling.
	DC: 10% Hybrid: 40%	Full cost of plan	EMPLOYER CONTRIBUTION	General plan arrangements: 1.5% to 4% of salary below SS salary ceiling and 6% to 15% above ceiling, executives even more. Deferred compensation plans: Individual contributions.
	Executive only plans Common	Most popular method is a book reserve with or without segregated assets in contractual trust arrangements. Other methods include Support Funds, Pension Funds (Pensionskasse) and Direct Insurance.	FINANCING	Book reserve combined with employee accounts in separate funding vehicle (not part of the plan in legal terms but serves as security); Direct Insurance, Pensionskasse, Pensionsfonds or Support Funds combined with individual insurance policies.
		Annuity or lump sum with annuity predominant and combinations annuity/lump sums not uncommon.	FORM OF PAYMENT	Predominantly lump sums, annuities or combinations annuity/lump sums possible.
		Reinsured DB plan with defined contributions; level of benefits depending on the insurance benefits.	HYBRID ALTERNATIVES	DC plan with guaranteed minimum interest; insured plans ("Pensionskasse", direct insurance).
		Valuations: Annually. Local accounting standard: German Commercial Code (CC) but compliance with CC by using Tax Law standards (Teilwert-Methode). Trend is to move to IFRS.	OTHER	Valuations according to IAS 19 often necessary. Employee investment choice: Yes, but only in rare cases.

PENSION ENVIRONMENT

Threats and Restrictions

- A pure DC plan is still not possible (since the employer always retains parts of the investment risk); fully insured plans (and plans with Pensionskassen and Pensionsfonds) are still tax inefficient for contributions in excess of 4% of pay up to Social Security ceiling (any excess is fully taxable as income).

Opportunities and Trends

- Strong tendency from DB plans to DC-type hybrid plans, i.e., virtually all new plans are DC-type hybrid plans. Many DB plans are closed for new hires.
- Harmonization of pension plans: Conversion of past service from different pension plans into an initial building block in a cash-balance type hybrid plan; for future service there is only one valid cash balance-type hybrid plan.
- On going trend towards transferring a pension plan from book reserve to Contractual Trust Arrangement (and increasingly to Pensionsfonds).

Key Legislation (Recent or Proposed)

- Social Security normal retirement age will be increased gradually from 65 to 67 between 2012 and 2029.
- Reform of the German Company Pension Act (Betriebsrentengesetz – "BetrAVG"):
  - The age for legal vesting of employer-paid benefits has been reduced to 25 for promises given after December 31, 2008.
  - Premiums for deferred compensation are permanently exempted from social security contributions up to a contribution of 4% of the Social Security salary ceiling.

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Hong Kong

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	All companies	Mandatory Termination Indemnity (DB) payable on retirement known as a Long Service Payment	PLAN NAME	Mandatory Provident Fund (MPF)
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan**	Permanent full-time employees upon completion of probation period (1 to 3 months of service).	PLAN ELIGIBILITY	Following describes MPF top-up plans: All employees aged between 18 and 65 after completion of 60 days of service.
		60 Males / 60 Females	NORMAL RET. AGE	65 Males / 65 Females
		Multiple times Scheme Salary times Service, with the Multiple usually ranging from 1 to 3 for non-contributory schemes.	BENEFIT FORMULA	Accumulation of contributions with interest.
	80%	Included in retirement plan: Death: Yes. Disability: Yes.	DEATH & DISABILITY	Included in retirement plan: Death: Yes. Disability: Yes.
	% of supplementary plans	Withdrawal benefit is usually a proportion of the accrued retirement benefit depending on service. The full vesting period can vary substantially across schemes, from less than 10 years to 30 years.	VESTING	Mandatory Employer Contributions: Immediate full vesting. Voluntary Employer Contributions: Varies depending on employer's choice. 100% vesting after 10 years is typical.
	DB: 3% DC: 95% Hybrid: 2%	Non-contributory; if contributions required, normally at 5% of basic monthly salary.	EMPLOYEE CONTRIBUTION	5% mandatory contribution with monthly earnings capped at HK$20,000 to MPF. Voluntary contributions possible, with amount specified by employer in the scheme rules or flexible per employee's choice.
	Executive only plans	Full cost of plan less any employee contributions.	EMPLOYER CONTRIBUTION	Total contributions of 5% to 10% of basic monthly salary uncapped (inclusive of 5% mandatory contribution with monthly salary capped at HK$20,000). Contribution rate may vary by years of service or employee grade.
	Not prevalent	Trust arrangements. Master trusts (multi-employer pooled arrangements typically operated by insurance companies) are more common amongst small size employers.	FINANCING	Trust arrangements; majority are a master trust.
		Lump sum	FORM OF PAYMENT	Lump sum
		The greater of accumulated contribution balances and a multiple of service times salary.	HYBRID ALTERNATIVES	Not prevalent
		Valuations: Every 3 years if the scheme is solvent on a voluntary leaving service benefit basis; otherwise annual valuations are required. Local accounting standard: HKAS 19	OTHER	Employee investment choice: Yes (6-10 choices are typical)

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Hong Kong

Retirement (Cont'd)

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PENSION ENVIRONMENT

Threats and Restrictions

- Mandatory Long Service Payments/severance benefits, which are DB in nature, can be used to offset an employer-sponsored retirement benefit. This effectively creates a DB retirement benefit underpin in any employer-provided DC plan.

Opportunities and Trends

- The MPF was implemented in December 2000. A growing number of companies are starting to review their service provider's performance, in particular the investment performance. MPF arrangement is attracting more employee attention as MPF balances grow.
- Retirement plan benefits are more favorably taxed than cash compensation so salary sacrifice schemes are being considered by some employers.
- Increased sophistication of DC investment choices and member services.

Key Legislation (Recent or Proposed)

- Definition of MPF Relevant Income on which MPF contributions are based to include housing allowance and other housing benefits with effect from January 18, 2008.
- The MPFA has drafted a proposal to allow workers a choice of MPF trustee. After a year with the employer's trustee, a participant would be free to switch trustees – for their own contributions only – as often as once a year. The proposal also includes a requirement for all MPF trustees to post all fund charges on the internet. A firm legislative timetable has yet to be released.
- The Mandatory Provident Fund Scheme Authority (MPFA) has opened discussions on allowing a 10% tax-exempt voluntary MPF contribution on. The plan would also raise the salary ceiling for mandatory contributions from HK$20,000 to HK$30,000

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Ireland

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	All companies	Pay-Related Social Insurance (PRSI) to provide a State pension from age 65	PLAN NAME	For employees not eligible to join a company plan, the employer must facilitate, but not necessarily contribute to a Personal Retirement Savings Account (PRSA).
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan** 100%	All employees (most plans), commonly at age 21 or 25. A minimum service requirement or probation period is often but not invariably required.	PLAN ELIGIBILITY	All employees (most plans), commonly at age 21 or 25. A minimum service requirement or probation period is often but not invariably required.
		65 Males / 65 Females although, in practice, many employees retire earlier. Senior executives often at 60 M / F.	NORMAL RET. AGE	65 Males / 65 Females although, in practice, employees can access retirement fund earlier.
		2/3[rds] of final pensionable salary after 40 years' service, i.e., an accrual rate of 1/60[th] of final pensionable salary for each year of service.	BENEFIT FORMULA	Accumulation of contributions with interest.
	% of supplementary plans DB: 37%	Included in retirement plan: Death: Yes. Disability: No; separate arrangement always.	DEATH & DISABILITY	Included in retirement plan: Death: Yes. Disability: No; separate arrangement always.
		Vesting benefit: Generally after 2 years in the plan, with a refund of member's contributions (with or without interest) being paid if employee withdraws before this time.	VESTING	Vesting of employer contributions: After 2 years of service, although some plans provide immediate vesting.
	DC: 38% Hybrid: 25%	Approximately 80% of plans have employee contributions. Typical is 5% of covered pay.	EMPLOYEE CONTRIBUTION	Required in majority of plans. 2% - 6% (average 4.1%) of covered pay.
	Hybrid means typically DB for existing employees, DC for new hires.	Usually balance of cost.	EMPLOYER CONTRIBUTION	4% to 10% (average 5.9%) of covered pay. PRSA: Employer contribution is possible but not typical.
		Trusts, using an external investment manager or pooled funds provided by investment managers / insurers.	FINANCING	Trusts, using pooled funds provided by external investment manager or insurance company. PRSA option also.
		Combination of annuity plus tax free lump sum	FORM OF PAYMENT	Combination of annuity plus tax free lump sum
	Executive only plans	Not prevalent	HYBRID ALTERNATIVES	Not prevalent
	Fairly common, but not universal	Valuations: Every 3 years, with an annual requirement to certify solvency on a minimum statutory basis. Local accounting standard: FRS 17/IAS 19.	OTHER	Employee investment choice: Yes, usually from a specified range of funds, but not invariably

PENSION ENVIRONMENT

Threats and Restrictions

- Stringent solvency requirements and onerous compliance burdens for DB plans.
- A significant number of plans in Ireland (approximately 20% - 30%) are currently under-funded on the minimum funding standard (MFS) and for these cases it is this statutory minimum funding requirement that is driving funding at present.
- Significant contributions are likely to continue because of the combined effect of minimum statutory funding requirements, increased longevity and low interest rates.

Opportunities and Trends

- Greater transparency of financial accounting reporting.
- Nearly 40% of DB schemes are closed to new members, and it is expected that this number will rise to 60% during 2006 - 2009 (May/June 2006 survey by Mercer). Few companies are closing their schemes entirely to existing members.
- In the Financial Services Sector, a number of significant employers have recently introduced DB/DC hybrid plans for new hires in response to significant union resistance to a proposed change to pure DC.

Key Legislation (Recent or Proposed)

- Mandatory pensions continue to be discussed, as more than 50% of employees have no supplementary provision. The government introduced a Green Paper on pension provision in October 2007. This is seeking views on the future shape of pension provision in Ireland. The consultation period runs until mid-2008 with legislation following at a later date.
- New disclosure regulations significantly extend the information that must be provided to DB scheme members from 2007 and DC scheme members from 2008.

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Italy

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	All companies	National Institute of Social Security (INPS) (old system) for people hired before January 1, 1996. Employees with less than 18 years of participation in Social Security system as of December 1995 accumulate pension benefits under DC INPS from January 1996. All employees are also eligible to the Mandatory Termination Indemnity plan – TFR. From 1 July 2007 and depending on the employee's decision, companies with more than 50 employees will pay all future accruals in a pension fund or to INPS. For employers with less than 50 employees, future TFR accruals may continue to be book reserved.	PLAN NAME	INPS (new system). Since January 1, 1996, all first employment in private sector and employees with less than 18 years of contribution to INPS on 12/1995 are covered by the DC INPS system. Additionally, all employees may join on a voluntary basis an industry-wide collective DC plan established for most business sector. However, for managers in the commercial sector, there is a mandatory participation in their industry-wide collective DC plan (FPDAC - Fondo Mario Negri). There are also companies offering additional arrangements (mostly DC) on top of prior schemes as described below.
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan** 25% **% of supplementary plans** DB: 0% DC: 100% Hybrid: 0% **Executive only plans** Common, especially among larger companies	Not prevalent	PLAN ELIGIBILITY	By category of employees (executives more prevalent than managers and professional)
			NORMAL RET. AGE	65 Males / 60 Females
			BENEFIT FORMULA	Accumulation of contributions with interest.
			DEATH & DISABILITY	Not prevalent. Each pension fund has the possibility to decide whether to provide death and/or disability benefits.
			VESTING	Vesting of employer contributions: Immediate full vesting.
			EMPLOYEE CONTRIBUTION	1% - 4% of annual gross salary.
			EMPLOYER CONTRIBUTION	Varies from 1% to 4%, most commonly matching the employee contribution.
			FINANCING	External pension fund
			FORM OF PAYMENT	Combination of annuity and lump sum or annuity only
			HYBRID ALTERNATIVES	Not prevalent
			OTHER	Some pension funds offer investment options for employees.

PENSION ENVIRONMENT

Threats and Restrictions

- The government is discussing the implementation of a minimum retirement age increase from age 57 to 58 in 2008 and gradually increasing to age 61 by 2013.
- The tax deductible limit for contributions paid into a pension fund (€ 5,165 annual ceiling) does not permit high salaried employees to build up a reasonable supplementary pension benefit.

Opportunities and Trends

- Due to the potential reduction in future Social Security benefit levels, there is a need for the younger generation to supplement the social pension.
- As a result of the TFR changes, companies are more interested in understanding the implication and advantages of setting up their own pension funds and/or looking for alternatives to the current industry-wide funds as a second choice for the employees.

Key Legislation (Recent or Proposed)

- TFR (statutory severance indemnity) is moving from being largely book reserved to being externally funded from July 1, 2007. The change will impact only upon future accruals. Tax Authorities have recently clarified that it will be possible to also transfer past accruals to pension funds without any taxation, if there is an agreement between employer and employees.

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Singapore

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	All companies	All members receive DC only	PLAN NAME	Central Provident Fund (CPF)
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan** Less than 5%	Not prevalent, although a few book reserve plans exist separate from the CPF.	PLAN ELIGIBILITY	Not prevalent, although a few tax approved plans exist separate from the CPF.
			NORMAL RET. AGE	62 Males / 62 Females (67 M / 67 F is Government's long-term objective but no legislation yet on this issue)
			BENEFIT FORMULA	Accumulation of contributions with interest.
			DEATH & DISABILITY	Accumulation of contributions with interest.
	% of supplementary plans DB: 40% DC: 60% Hybrid: Rare		VESTING	The few private pension plans that exist usually provide for a leaving service benefit based on a vesting scale according to length of service and applied to the accrued benefits.
			EMPLOYEE CONTRIBUTION	Not allowed for tax approved supplementary plans.
			EMPLOYER CONTRIBUTION	
			FINANCING	
			FORM OF PAYMENT	Usually lump sum
	Executive only plans Not prevalent		HYBRID ALTERNATIVES	Private plans can be a mix of DB and DC. DB benefit formulas may have an offset for employer CPF contributions.
			OTHER	Employee investment choice is available through an investment scheme.

PENSION ENVIRONMENT

Threats and Restrictions	Opportunities and Trends	Key Legislation (Recent or Proposed)
• Employers have been considering setting up plans to provide retirement benefits to their employees without Singaporean citizenship or permanent residency. These employees are ineligible to participate in the CPF Scheme. The most common response by companies in the market has been to pay cash in lieu of benefits.	• As a result of the decrease in CPF salary ceiling (currently SGD4,500/month), the increase in salary levels coupled with the tighter labor market, there is an increasing interest in using a Supplementary Pension Plan as a retention tool for employers in Singapore. Both tax approved and non-tax approved plans are available in the market.	• With effect from July 1, 2007, the government raised the employer's CPF contribution rate by 1.5%. For most workers aged 50 and below, this means the employer contribution will increase from 13% to 14.5%. Of this increase, 1% will go into the employees' Ordinary Account and 0.5% will go into the Medisave Account. • This will not apply to older low-wage workers, those who earn SGD1,500 per month or less and are also above 35 years old, as different measures have been taken. The government will implement a new Workfare Income Supplement Scheme (WIS) which should boost the take-home pay of these workers.

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South Africa

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Retirement

EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	Nil	None, but Government provides a State Old Age Pension (Pillar 1) on a means test basis.	PLAN NAME	All members receive DB only
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan**	Pension Fund: Some historic schemes still in operation. Typically not open to new employees	PLAN ELIGIBILITY	Pension Fund or Provident Fund: Full-time permanent employees upon date of hire.
		60 or 65 Males / 60 or 65 Females	NORMAL RET. AGE	60 Males / 60 Females
		2% of final salary for each year of pensionable service.	BENEFIT FORMULA	Accumulation of contributions with interest.
		Included in retirement plan: Death: Yes. Disability: Yes.	DEATH & DISABILITY	Included in retirement plan: Death: Yes. Disability: Yes.
	98%	Vesting benefit: Immediate full vesting.	VESTING	Vesting of contributions: Immediate full vesting.
	% of supplementary plans	Required. 6% to 7.5% (but most commonly 7.5%).	EMPLOYEE CONTRIBUTION	Pension Fund: Required. 5% to 7.5% with average 5.95% (lower employee rate applies mainly for unionized employees). Provident Fund: None, often non-contributory.
	DB: 15% DC: 83% Hybrid: 2%	Balance of plan cost – employer contributions subject to increase as closed membership ages	EMPLOYER CONTRIBUTION	5% - 13% of pensionable salary with average 9.95%, includes cost of insured group risk benefits and administration (lower contribution rate usually applies for unionized funds). For a non-contributory Provident Fund: 10% to 20% of pensionable salary and % includes risk and administration costs.
	Executive only plans	Only own scheme (no multi-employer or industry wide schemes operate on a DB basis). No unfunded plans (legislation requires funding).	FINANCING	Provident Funds on industry-wide basis are common for unionized staff. Smaller employers often join multi-employer ("umbrella") funds. Medium size employers operate own scheme. No unfunded plans (legislation requires funding).
	Not prevalent, few schemes that existed have generally been integrated into a main scheme.	Member can receive up to a maximum of 1/3rd of benefit as a lump sum; balance must be taken as an annuity	FORM OF PAYMENT	Provident Fund: Annuity or lump sum. Option of taking 100% in cash. Pension Fund: Retiree must take at least 2/3rd of benefit in form of pension (i.e., maximum 1/3rd in cash).
		Some DB scheme rules specify the employer contribution rate (i.e., no longer a balance of cost scheme).	HYBRID ALTERNATIVES	A few DC schemes have a DB underpin, but this relates to conversion from DB for existing members
		Valuations: Every 3 years Local accounting standard: AC116, which is similar to IAS 19	OTHER	Employee investment choice: Typically offered only to senior employee groups and is generally associated with life stage profiling as a default investment strategy.

PENSION ENVIRONMENT

Threats and Restrictions

- Impact of HIV/AIDS has increased significantly the cost of risk benefits in some schemes. In these cases, member's retirement savings have decreased and insufficient provision is being made for retirement.
- Pension Funds Second Amendment Act prescribes minimum benefits and also deals with the ownership of surplus. Employer is liable to fund at least prescribed minimum benefits on liquidation of the Fund.

Opportunities and Trends

- Smaller and medium sized employers are moving towards multi-employer funds ("umbrella schemes").
- Socially responsible investing (aimed at infrastructure development, job creation, etc.) is a key issue for Trustees to consider.
- DB Funds are unlikely to continue unless the Fund has large solvency reserves. (Most DB Funds are well funded)

Key Legislation (Recent or Proposed)

- Extensive changes are proposed to the existing Pension Funds Act, anticipated to become effective 2008 or later.

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Spain

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	All companies	Social Security	PLAN NAME	All members receive DB only
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan**	Qualified plans must be accessible to all employees with 2 years of service. Service requirement: No typical practice. Non-qualified plans: Sometimes requirement to be manager.	PLAN ELIGIBILITY	Qualified plans must be accessible to all employees with 2 years service. Service requirement: No typical practice. Non-qualified plans: Sometimes requirement to be manager.
		65 Males / 65 Females	NORMAL RET. AGE	65 Males / 65 Females
		There is no typical benefit formula.	BENEFIT FORMULA	Accumulation of contributions with interest.
	57%	Included in retirement plan: Death: Yes. Disability: Yes.	DEATH & DISABILITY	Included in retirement plan: Death before retirement: Yes. Disability: Yes.
	% of supplementary plans	Vesting benefit: Immediate full vesting in tax qualified plans. In case of tax non-qualified plan, 100% vesting usually between 1 and 10 years of service.	VESTING	Vesting of employer contributions: Immediate full vesting in qualified plans.
	DB: 9%	Not required. None.	EMPLOYEE CONTRIBUTION	Employee contributions are allowed in 58% of the plans. They are compulsory only in 44% of these 58%.
	DC: 78% Hybrid: 13%	Full cost of plan. Cost determination follows rules for external funding.	EMPLOYER CONTRIBUTION	No typical practice
	Executive only plans	Normally insurance policy.	FINANCING	All employee plans: Qualified pension fund more typical than insurance policy. Executive plans: Only insurance policy.
	Common for companies to provide additional benefits for higher-paid employees through supplementary DC or DB plans.	Choice of annuity or lump sum	FORM OF PAYMENT	Choice of annuity or lump sum
		Sometimes a company has a pure DC plan for all employees, plus a DB plan for managers which supplements the DC plan so that the sum of both plans achieves a defined benefit objective.	HYBRID ALTERNATIVES	Sometimes a company has a pure DC plan for all employees, plus a DB plan for managers which supplements the DC plan so that the sum of both plans achieves a defined benefit objective.
		Valuations: Annually. Local accounting standard: Follow external funding rules – require past service to be fully funded (qualified plan) or insured (non-qualified plan).	OTHER	Employee investment choice: No

PENSION ENVIRONMENT

Threats and Restrictions	Opportunities and Trends	Key Legislation (Recent or Proposed)
	• Law on Personal Income Tax, effective January 1, 2007: The law creates a new type of company retirement benefit plan ("plan de prevision social empresarial") which is a hybrid group life insurance based on the principles of employment qualified pension plans and the same tax treatment than employment qualified pension plans.	• Law 35/2006 on Personal Income Tax, effective January 1, 2007, modifies the taxation of qualified pension plans and group life insurance and clarifies the tax treatment of group risk insurance policies. • RD 439/2007, March 30, 2007, includes changes in the Regulations of the Pension Plans and Funds Law and the Regulations of the new Income Tax Law (Act 35/2006). Qualified Pension Plan Rules need to be modified by April 1, 2008 to adapt them to the new contribution limits, form of the benefits, new contingency (severe dependence and great dependence), etc.

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Switzerland

Retirement

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EMPLOYER PRACTICE

	Prevalence
Mandatory Practice	All companies
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan** 98% **% of supplementary plans** DB: 10% DC: 0% Hybrid: 90% **Executive only plans** Fairly common are top-hat pension plans and special arrangements for senior executives, with a variety of designs

DB		HYBRID
1st and 2nd Pillar of the Swiss Social Security system. Most Swiss pension plans provide mandatory 2nd Pillar and – often substantial – supplementary benefits in one pension plan.	PLAN NAME	1st and 2nd Pillar of the Swiss Social Security system. Most Swiss pension plans provide mandatory 2nd Pillar and – often substantial – supplementary benefits in one pension plan.
All employees from age 25 with salaries higher than CHF 19,890; no service requirement for retirement plan (age 18 with 3 months' service for death and disability benefits)	PLAN ELIGIBILITY	All employees from age 25 with salaries higher than CHF 19,890; no service requirement for retirement plan (age 18 with 3 months' service for death and disability benefits)
65 Males / 64 Females (2004 referendum rejected equalizing)	NORMAL RET. AGE	65 Males / 64 Females (2004 referendum rejected equalizing)
1.25% - 2.00% of insured salary for each year of service, containing mandatory as well as supplementary parts in one defined benefit.	BENEFIT FORMULA	Accumulation of contributions with interest (minimum interest rate guaranteed on mandatory retirement savings).
Included in retirement plan: Death: Yes. Disability: Yes.	DEATH & DISABILITY	Included in retirement plan: Death: Yes. Disability: Yes.
Vesting benefit: Immediate full vesting.	VESTING	Vesting benefit: Immediate full vesting.
Required in most Swiss pension funds. Ranges from 0% to 12% of insured salary, in some cases depending on age.	EMPLOYEE CONTRIBUTION	Required in most Swiss pension funds. Ranges from 0% to 12% of insured salary, in most cases depending on age.
3.5% to 25% of insured salaries (in some cases depending on age); employer contributions must amount to at least 50% of total contributions (average 62%).	EMPLOYER CONTRIBUTION	3.5% to 25% of insured salaries depending on age; employer contributions must amount to at least 50% of total contributions (average 62%).
Pension funds set up as separate legal entities, managed by boards with significant power over plan decisions. Fully reinsured multi-employer plans, self-insured with externally insured death and disability benefits or fully self-insured.	FINANCING	Pension funds set up as separate legal entities, managed by boards with significant power over plan decisions. Fully reinsured multi-employer plans, self-insured with externally insured death and disability benefits or fully self-insured.
Annuity option is mandatory for plans that comply with the legal minimum. Generally, choice of annuity or lump sum; top-hat plans pay usually only a lump sum.	FORM OF PAYMENT	Annuity option is mandatory for plans that comply with the legal minimum. Generally, choice of annuity or lump sum; top-hat plans pay usually only a lump sum.
DB plans define their retirement, death and disability benefits as % of last salaries (in rare cases of career average salaries)	DB ONLY PLAN	Not applicable.
Valuations: Generally annually (occasionally every 3 years). Local accounting standard: Swiss GAAP FER 26.	OTHER	Valuations: Generally annually (occasionally every 3 years). Local accounting standard: Swiss GAAP FER 26.

PENSION ENVIRONMENT

Threats and Restrictions

- In a pension fund, the employer has limited influence over plan governance as employee representatives have 50% of voting rights (only exception is pure supplementary plans with more than 50% employer contributions).
- Disability expenses have considerably increased during the past few years. As a consequence, new disability cases are more thoroughly analyzed in order to avoid misuse. If a pension fund has doubts about the federal disability insurance's certification of an employee's disability, they can now request an independent medical opinion before they are obliged to pay a disability pension.

Opportunities and Trends

- Several large Swiss pension funds have recently moved to change their main pension plans from DB to hybrid plans as of 2007. If acquired rights are granted, such a transition is feasible under Swiss law. During a transition period (2 to 5 years), grandfathering provisions will be applied for current employees. The main driver for this change was the fact that hybrid plans are more flexible to manage.

Key Legislation (Recent or Proposed)

- Proposal for restructuring supervisory authorities – reducing considerably the number of regional supervisory authorities and creating a more independent central authority. If the proposal is approved, pension plans will not be changed, but the formal approval processes for plan changes might change as some pension funds will have a new supervisory authority, e.g., the large collective foundations from insurance companies.
- As of January 2008, only auditors registered at the new supervisory authority (RAB/ASR) are authorized to audit Swiss Pension funds.

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United Kingdom

Retirement

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EMPLOYER PRACTICE

	Prevalence	DB		DC
Mandatory Practice	All companies	Basic State Pension (BSP) + State Second Pension (S2P) + Pension Credit.	PLAN NAME	All members receive DB only
Typical Market Practice	Approximate: **% of multinational and local leading companies with a supplementary plan** 100% **% supplementary plans** DB: 18% DC: 18% Hybrid: 64% Hybrid means typically DB for existing employees, DC for new hires. **Executive only plans** Common, benefits up to double basic plan accruals. Under new tax regime, unfunded plan or salary alternative (where benefits exceed £1.6m value*).	A typical DB salaried staff plan is contracted out of the state plan S2P. All employees, sometimes with a service requirement of 3 – 12 months.	PLAN ELIGIBILITY	Occupational schemes and personal pension plans. Eligibility varies but unless employer has an occupational pension scheme, the law requires the employer to offer access to a Stakeholder plan but does not require employer contribution.
		65 Males / 65 Females	NORMAL RET. AGE	65 Males / 65 Females
		Two thirds of final pensionable earnings salary after 40 years' service, i.e., an accrual rate of 1/60th of final pensionable earnings per year of service.	BENEFIT FORMULA	Accumulation of contributions with investment returns.
		Included in retirement plan: Death: Yes. Disability: Yes in majority of cases; practice varies as to whether the plan is used or salary continuation is provided by the employer.	DEATH & DISABILITY	Included in retirement plan: Death: Normally provided in conjunction; may be from a legally separate plan. Disability: Normally a separate plan if provided at all.
		Vesting benefit: From April 2006, 3 months.	VESTING	Increasingly immediate vesting – required under stakeholder/ personal plans. From April 2006, 3 months maximum.
		Typically 5% to 7% of base salary to a 1/60th scheme (many plans trending up, i.e., two years ago contributions were 3% to 5%). Most (not all) plans require a contribution.	EMPLOYEE CONTRIBUTION	Typically 2% - 5% of base salary. Most plans require a contribution. No legal requirement for a contribution and non-contributory plans do exist.
		Around 15% - 20% of base salary (1/60th final salary benefit). Current rates are higher due to past service funding deficits.	EMPLOYER CONTRIBUTION	4% - 10% base salary, formula related to level of employee contributions. Some employers use age-related scale as well.
		Method depends on the size of plan assets. Most sizeable plans have investment managers directing the assets.	FINANCING	Trust fund or a personal pension / stakeholder contract. Contract-based approaches becoming more common.
		Most plans allow around 25% of pension benefit to be taken as a tax-free lump sum. Remaining benefit as annuity.	FORM OF PAYMENT	25% lump sum, remaining benefit as annuity. Flexible forms of annuities are developing.
		Career-average schemes adopted by a significant minority of schemes. Typically accrued benefits linked to prices.	HYBRID ALTERNATIVES	Small number of schemes with various forms of guarantees; not common.
		Valuations: Every 3 years formal valuations. Annual "health check" reviews becoming a statutory requirement. Local accounting standard: FRS 17, IAS 19.	OTHER	Employee investment choice: Yes. Lifestyle option now common (equity based investment with automatic migration to bonds and cash over last 5-10 years).

PENSION ENVIRONMENT

Threats and Restrictions

- Significant power now lies with trustees and regulator.
- High taxation on any individual building up pension assets in excess of £1.6 million*

* For 2007/08 tax year.

Opportunities and Trends

- Re-financing of pension deficit by other borrowing to reduce PPF levies
- Reconsideration of DB investment strategy
- New tax rules increase flexibility over contributions and retirement planning, especially for DC
- Consider DC contribution adequacy
- Recent legislation means that pensions are now more important in mergers, acquisitions, corporate restructures
- Small but growing trend for employers to secure (or buy-out) the obligations of their closed DB schemes

Key Legislation (Recent or Proposed)

- Major tax reforms effective April 2006
- Age Discrimination legislation, effective December 1, 2006 for pension schemes
- The Pensions Act 2007 confirmed major reforms to state retirement provision, including a gradual increase in state pension age to 68 over the period 2024 – 2046. A new, quasi compulsory, savings plan referred to as 'personal accounts' is expected from 2012.
- Reduction in mandatory increases to defined benefits after an employee leaves.

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Retirement Perspective

Thought-provoking insights on retirement and pension issues facing multinational companies

Individual Article

Defined contribution plans: The challenge of achieving benefit adequacy

by Ben Facer and Amy Reynolds

Within a period of three years, 54 percent of defined benefit (DB) plans have barred new entrants; the value of defined contribution (DC) assets continues to grow, surpassing DB assets; and by next year, two-thirds of the 100 largest private employers will no longer offer DB benefits to employees. Australia in the late 1990s? The UK this decade? Brazil in the next five years?

Around the world the trend is consistent – movement away from the unpredictable funding and expense requirements of DB plans toward the cash-oriented simplicity of DC structures. As this domino effect is played out around the globe, what is the impact on the true aim of superannuation plans in Australia and pension plans elsewhere – the provision of an adequate retirement benefit for retired employees? Can the experiences of geographies that have a longer history with DC retirement vehicles be an effective indicator of what is to come for others? And let's not forget that moving from a DB to a DC structure does not eliminate risk and responsibility, but rather transfers it from plan sponsor to plan participants. Individual participants in DC plans hold much greater control, and responsibility for building an adequate retirement benefit, primarily through contributions and investment choices. But are employees effectively prepared to assume this control, and if not, what measures are governmental agencies and plan sponsors adopting to encourage them to prepare?

An adequate retirement benefit

A commonly held belief is that an adequate retirement income (including income from all sources, public and private) should be 65 percent of pre-retirement income, after taking into account taxes (which may differ pre- and post-retirement). With a DB plan, it is readily apparent what the full-career benefit will be, because the benefit is usually defined as a multiple of pre-retirement income. But this outcome is not as obvious in a DC structure, in which benefits are defined in terms of the contribution flow into the program, rather than the income distribution out at retirement. Comparing the typical target benefit levels of different countries is also challenging, due to differing tax treatments and levels of government-provided benefits.

There are several key components of building a retirement benefit:

1. **Contributions.** It has been shown that to build a retirement income of 60 percent to 65 percent of pre-retirement income, annual contributions in the order of 15 percent to 18 percent over a full career would be required. The range is sensitive to investment performance, but rarely are company contributions this high in modern DC plans. Hence, a significant contribution from employees is needed.
2. **Investment earnings.** Over a full working lifetime, modest increases in investment performance can yield considerable benefit increases, due to the compounding of returns.
3. **Length of contributions.** All other things being equal, doubling the contribution period more than doubles the resulting benefit. Hence, commencing contributions early in one's career can have a large impact on the ultimate benefit.

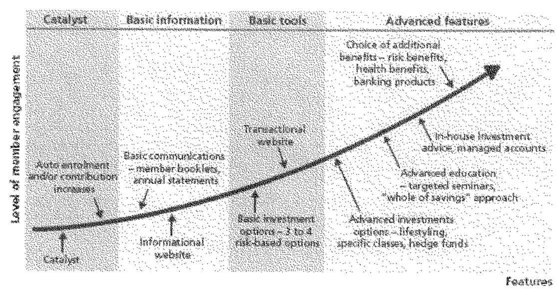
So why do many individuals contribute less, start contributing late, invest conservatively and retire early? For some the answer could be the availability of other personal assets. More often, however, it comes down to a lack of knowledge about the level of contributions needed to build an adequate retirement income and how to take control during the accumulation phase. In geographies where DC plans are emerging, the fact that their role serves as a secondary source of income may well have created a false sense of security, ultimately stunting savings rates. In the new DC world, there should be a greater sense of responsibility on the part of employers and trustees to provide the information, tools and knowledge to allow employees to take control more effectively and shape a secure retirement.

The evolution of DC systems and member engagement

How did the DC movement begin? Increased reliance on DC structures typically results from one of three catalysts:

- Legislative introduction of a compulsory savings plan, which is often structured as a DC plan. For example:
  - Award superannuation and the Superannuation Guarantee legislation in 1987 and 1992, respectively, in Australia
  - The DC law in Japan in 2001
  - KiwiSaver in New Zealand in 2007
  - Compulsory DC savings in Israel, commencing in 2008
- Corporate reaction to balance sheet and financing risks, such as occurred in Brazil in the 1990s and in the UK and the US more recently.
- Market reaction to the (expected) reduction in previously generous social security benefits, as is currently the case in many European countries.

The catalyst on its own, however, is rarely enough to generate sufficient employee engagement to produce more than a basic retirement benefit. Through analyzing the evolution of a number of DC systems around the world, we can identify the key features of these systems that have developed to enhance member engagement. The following figure illustrates in broad terms the factors that may characterize the evolutionary process of a DC system.



The progression of features on this graph will not necessarily occur in this order, and may, in part, be driven by the nature of the catalyst. When triggered by governmental action, features may be introduced simultaneously in an attempt to capitalize on a broader launch. For example, both the Japanese DC Law and the New Zealand KiwiSaver require auto enrolment, so introducing features simultaneously, because of the laws' significant effects on member engagement, outweighs any cost considerations. When a DC system is launched as a result of an employer's changing financial environment, the evolutionary process tends to be longer, more difficult and potentially less successful.

"Tools typically do not emphasize enough the importance of saving for retirement, in part due to fear of negative participant reaction, which only fuels inertia"

Several interesting conclusions may be drawn from this chart:

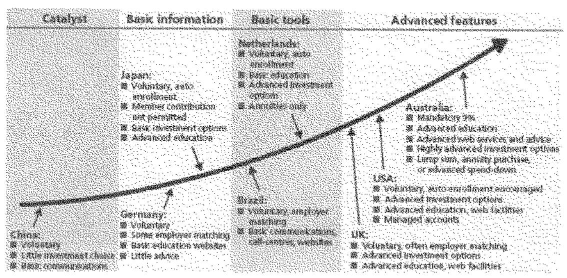
- Features that force member participation, such as legislation, automatic enrolment or automatic contribution increases, are an excellent starting point for creating an adequate DC system. However, the funding levels are typically far from the required 15 percent to 18 percent necessary to attain benefit adequacy. Additional voluntary contributions may be possible for the more highly paid populations, yet this will not avoid the inevitable division of the retired population into the "haves" and "have-nots."

- Informational features, such as basic communications and online information, will help employees understand the need for saving. However, without corresponding tools to engage employees, these features will not be fully effective. Equally important, these informational vehicles are rarely inspiring enough to compel employees to take action.

- Enhancing information with basic tools, such as broader investment choices or a transactional website, encourages employees to take ownership of their savings. Yet the tools typically do not emphasize enough the importance of saving for retirement, in part due to fear of negative participant reaction, which only fuels inertia.

- More advanced education, alternative investments and individual investment advice are the current "pinnacle" to strive for, in order to provide employees with the full range of knowledge and tools to tailor their savings to their own needs. Where the education curve is perceived to be too steep to be tolerable, the alternative approach of Managed Accounts has been introduced, primarily in the US, which we discuss further below.

The countries in which a DC system has been in place for many years, such as Australia and the US, have generally been fairly slow to develop services that aid member engagement. Particularly in the US, where legislative initiatives have only recently begun to address the issue, the failure to effectively educate the working population, despite significant attempts to do so, has been disappointing. Geographies that are just now entering the DC market are able to build on the ideas and technologies of others, and hence are likely to have a faster progression along the evolutionary scale.



In the chart above, we comment on the relative position of each country in the evolution of DC plans, not on the appropriateness of what is being offered. Some interesting observations arise from a closer examination of these specific countries:

- DC plans have existed in earnest in the US for nearly 30 years. Yet their position as a primary retirement vehicle is relatively new, gaining in popularity over the last five to seven years. While many of the tools necessary for an effective plan have existed for some time, there is still a strong sense of employer paternalism and "entitlement" to an employer-funded benefit among employees.

- In contrast, the Australian model has evolved over a shorter time period, spurred by the near demise of DB plans and legislation requiring a 9 percent employer contribution. The Australian approach offers the greatest level of control to participants, although its success is largely driven by legislation.

- Legislation is also driving the emergence of DC plans in China, although the high level of government-provided benefits limits the role for these plans. There and in the Netherlands, limited plan design and investment vehicles will make it difficult for DC plans to function as much more than a supplement.

- The impact of DC plans in Germany and Japan has also been constrained by legislative restrictions. In Germany, the tax effectiveness of contributions to DC plans is limited to 4 percent of salary, with salary further capped at the social security ceiling. While employers may be willing to make tax-ineffective contributions for executives, these limits significantly affect benefits for the broader population. In Japan, member contributions to DC plans are not permitted, severely limiting the potential for member engagement.

- As has been typical of a new entry to the DC world, China has little in the way of investment choice. But with 60 percent of employers indicating that they expect to switch to DC plans by 2008, we wouldn't expect this to last for too long. Germany, Japan and Brazil also currently offer only basic investment options and websites, but are also expected to advance quite quickly.

So what can be learned from the experiences of the countries discussed in this Perspective?

Counter to expectations, the evolution of DC plans through the plan features, as shown above, does not guarantee success. Attaining success with a DC plan, where success is defined as achieving a level of member engagement sufficient to provide an adequate retirement benefit for the majority of the population, seems to require some degree of compulsory contributions. Systems that began using a voluntary approach have gravitated over time to a minimum or default contribution level, or in some cases, to a mandatory rate.

Australia is probably the earliest example of a compulsory savings initiative, with the introduction of the 3 percent Award contributions in 1987 for employees covered by collective bargaining agreements. This was followed in 1992 by the Superannuation Guarantee for all employees, with employer contributions starting at 3 percent or 5 percent, depending upon the size of the company, and gradually increasing to 9 percent for all. While there has been continuing discussion within the government and the superannuation industry, compulsory employee contributions have not yet been introduced. The Superannuation Guarantee has gone a long way toward providing a basic level of retirement income for all employees; however, on its own, it cannot provide a truly adequate level of retirement income.

"Attaining success with a DC plan ... seems to require some degree of compulsory contributions"

Some late entrants into the DC arena are learning from their predecessors and moving quickly to compulsory savings. We mentioned earlier that Israel is introducing compulsory employer and employee contributions to DC plans beginning 2008. South Africa is also considering mandatory DC provision.

In countries with voluntary DC systems, an attempt has been made in some instances to eliminate the need for compulsory savings by encouraging participation through "matching" contributions, such as one-for-one, or lower, employer contributions. Initially perceived as a key driver of the savings level, experience reveals that employees will often make contributions barely sufficient to obtain the employer match, and sometimes not even that. It seems that this design is inadequate to lift member engagement to a level where making additional voluntary contributions is seriously considered.

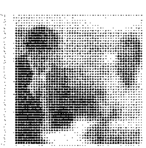
The relatively new but fast growing practice of an "auto-enrolment" or "opt-out" design eliminates the participant from the decision-making by automatically initiating contributions unless the participant takes action. In the US, auto-enrolment is now encouraged by law, and may well become the norm. The New Zealand "Kiwi Saver" system also adopts auto-enrolment, as do plans in the Netherlands and Japan.

Further, the UK government is planning to introduce a quasi-compulsory system for retirement savings beginning in 2012, referred to as "Personal Accounts." This system will require a 4 percent employee and a 3 percent employer contribution, with the government contributing a further 1 percent. Auto-enrolment will be a feature of Personal Accounts, and the government intends to encourage adoption of auto-enrolment by occupational plans in advance of the implementation of Personal Accounts.

Auto-enrolment is an effective tool but still leaves a portion of the workforce exposed. Younger individuals may set their contribution rate at a low level to ensure that cash is readily available for "more important" items, such as cars, property, or general spending. But the individual often may not increase his or her savings as these alternatives become less important. "Auto increase" is a strategy whereby a portion of salary increases are automatically redirected to a defined contribution plan as an increase in contribution rate, the idea being that this is "new money" that will not be missed. This strategy is encouraged in the US, and it will be interesting to see if it becomes more widespread.

"Auto increase" is a strategy whereby a portion of salary increases are automatically redirected to a DC plan as an increase in contribution rate"

While the use of automation and mandatory employee contributions is encouraging, and certainly allows for the accumulation of a basic benefit, there still remains no real incentive for individuals to appreciate what additional contributions might be required to provide an adequate retirement income, and how these contributions should be managed in both the accumulation and draw-down phases. This is where the advanced features that are becoming commonplace in countries such as the US and Australia, and to a lesser extent the UK, may be of great interest to others.



Enhancing features for greater participation

Advanced features typically start with the expansion of investment options. The Netherlands, the US and the UK all offer, in addition to the basic risk-based options, a number of "select your own" investment options. These will include many brand-name investment managers, offering both risk-based and single-asset class options. Experience has shown, however, that offering more vehicles does not assure greater diversification of participant accounts. In recent years, "lifestyle" or "lifecycle" funds have become popular, offering diversification with more aggressive asset allocation during an individual's younger years, and tapering to a more secure allocation as one approaches retirement. Many plans even offer individuals the option to choose the point of retirement (for investment purposes), and the period in which the asset allocation tapers off. Australia has taken these options a step further, also offering a range of alternative asset classes, such as emerging markets, hedge funds and specific infrastructure funds, and even direct investment in specific listed securities on the Australian Stock Exchange. These options are within reach of any individual, all within the plan.

But with these additional choices comes enhanced education. More advanced plans in countries such as Australia, the UK, the US and Japan, now include not only education about the specifics of the plan and its investment options, but also broader education on basic financial matters, such as budgeting and debt management as well as creating an entire savings picture in making contribution and investment decisions. The plan sponsor decision to rely on a DC approach seems to include a desire to elevate the financial acumen of the workforce.

Success in this effort is elusive, as plans are challenged to offer the technology to allow access to total wealth in line with the broader financial education that espouses that approach. In many cases, plans are restricted by legislation to adopt this approach and are required to keep concessionally taxed pension savings separate from other forms of saving. But this is not to say it cannot be done. Many large plans in Australia now offer links and discounts to banking products, health insurance products and other financial services to their members, including access to individual financial advice.

In some parts of the world, there is discussion around allowing individuals to use a limited amount of their pension savings as a deposit on their family home – the Swiss and Singaporean systems allow this already. And at the draw-down phase, plans in Australia are now considering the possibility of allowing access to savings, within the regulatory draw-down limits, via automated cash machines.

The US has an interesting alternative, or complement, to providing advice. In response to a low take-up rate for individual advice and a lack of consideration of it over time, "Managed Accounts" have developed. If the Managed Account investment option is chosen, information is provided to the individual's advisor around personal preferences and other savings, and the investment manager will set, rebalance and alter the individual's asset allocation over time to suit specific needs, without the member having to take action unless circumstances change.

> *"In the US ... in response to a low take-up rate for individual advice and lack of consideration over time, "Managed Accounts" have developed."*

A mandate: Educating and engaging the workforce

Despite the varying regulatory environments in which DC plans operate around the globe, the evolution of these programs is surprisingly consistent. While the need to save is universal, the process of leading the working public to actively participate in DC programs is arduous. The ultimate objective of universal worker engagement remains elusive.

We believe there is much to be learned from the experiences of others with regard to education, investment options, linked financial products, personal advice and other features. Clearly, these plans are evolving, with the optimal design yet to be developed. Looking beyond the legislative environments at the basic structures of these programs can provide insight into key features and practices – only some of which have been addressed here. In future editions of Global Retirement Perspective, we will review other key considerations, including plan governance structures and how a plan sponsor might develop communication and education strategies for building member engagement.

For multinationals that are looking to DC retirement plans as a key benefit component, the country trends described above should aid in decision making. Specifically, companies should:

- Review their existing plan against current local best practice
- Within local regulatory frameworks, adopt aspects of plans from more advanced countries that have had positive outcomes, ahead of local trends
- Update their plans when necessary to keep pace with changing trends and employee needs

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