Common Sense Solutions to Increase Retirement Saving

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What I'll Cover

- Automatic retirement savings plans
- Saver's Credit
- Saving tax refunds
- Reforming asset tests
- About The Retirement Security Project

Auto 401(k)

Pro-saving defaults in employment-based retirement savings plans

401(k) Focus: The Big Picture

- Defined benefit decline, 401(k) expansion
- The question isn’t DB or DC, but specific design features
- Valuable DB attributes can be implanted in DC plans
  - Automatic coverage through employer nonmatching funding
  - Professional investment management
  - Protection of employees from investment risk (no upside)
  - Preservation of assets for retirement
  - Lifetime guaranteed income to manage longevity risk

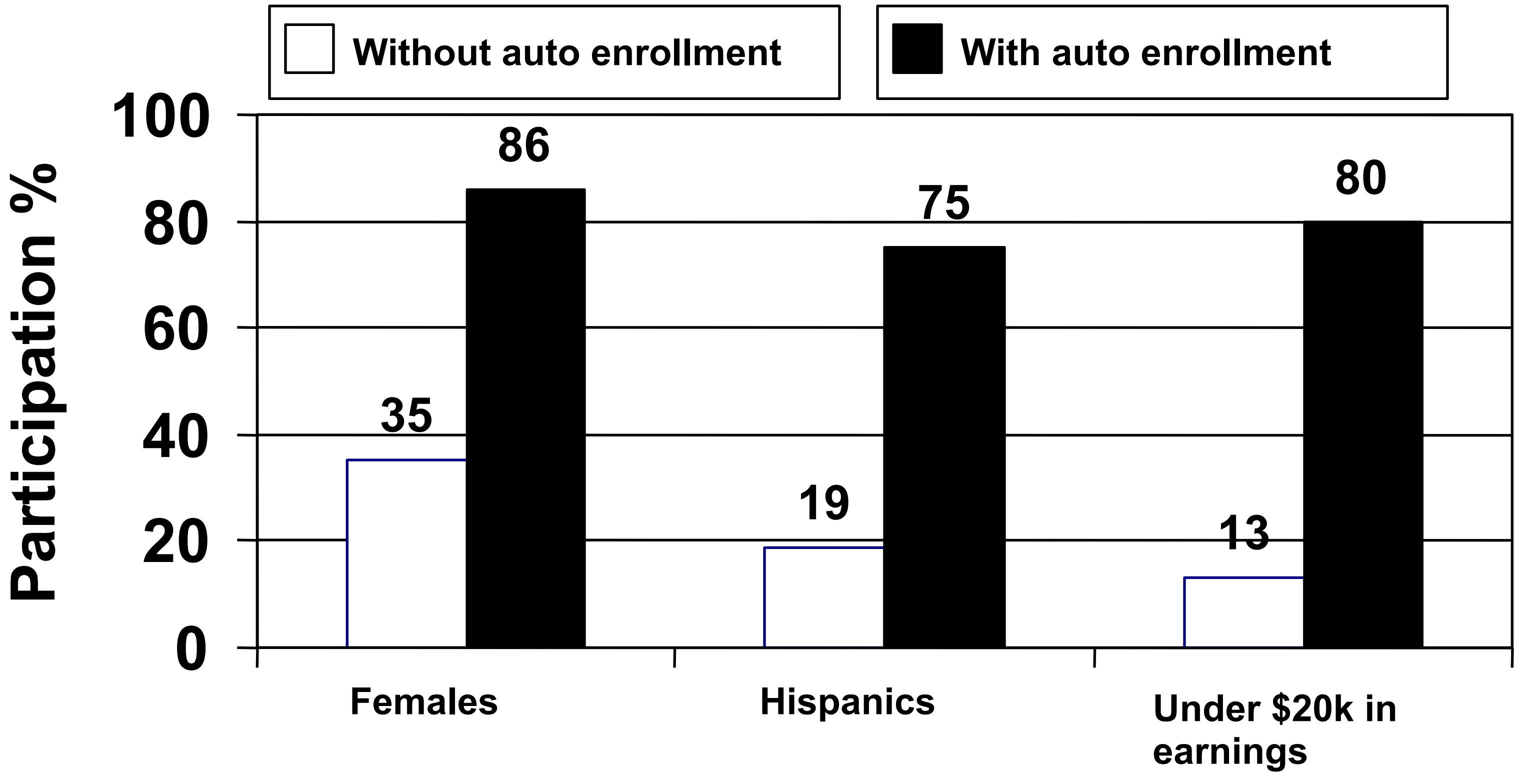
Where We Are Now

- Traditional 401(k)
  - One-fourth to one-third of eligibles don't participate
  - Widespread under-diversification
    - Money market, company stock
- Employee must actively–
  - Elect to participate
  - Decide contribution rate
  - Decide how to invest

Where We Could Be

- "Auto" 401(k)
  - Near full participation
  - Higher contribution levels
  - Sound asset allocation for greater accumulations
  - Disciplined rebalancing of investments
- Inertia is overcome
  - Auto enrollment
  - Auto escalation
  - Auto investment

Impact of 401(k) Auto Enrollment



Actual results for employees with between 3 and 15 months tenure. Study by Professor Brigitte Madrian, University of Pennsylvania's Wharton School, and Dennis Shea, United Health Group.

Source: Madrian and Shea

What’s Permitted?

- Treasury/IRS
  - Permits automatic enrollment
  - Revenue Rulings
    - Require advance notice, opt-out rights
    - Balanced fund example, but it must be prudent
    - 401(k) regulations confirm
- “Iwry letter”
  - Explicit IRS comfort that 401(k), 403(b) plans can
    - Use auto enrollment with any % contribution as default
    - Escalate contribution % (such as 1% a year)
    - Escalate contribution % based on pay raises or bonuses

Importance of Escalation

- Many participants stay at initial deferral rate
- Experienced plan sponsors have recognized importance of offering escalation
  - Automatic up-tick each year (employee can opt out)
  - One-time ‘check-the-box’ option for employee to elect to have his deferral percentage increased every year

Why Now?

- Continued decline of DB pensions
  - Freezes, conversions
  - Prompting new emphasis on 401(k) adequacy
- 401(k) participation may be declining: 3/4 to 2/3
- Persistent nature of “eligible non-participants”
- Post-Enron/WorldCom diversification concerns
- Increased pressure on ADP
  - HCEs can contribution much more
    - 1990: ca. $8,000; 1993: ca. $9,000
    - 2001: $10,500
    - 2006: $15,000 (or $20,000 if age 50+)
  - Bottom-up leveling restricted

Auto Enrollment Benefits Employers

- ADP results improve as “zeros” are defaulted into participating
  - Lower-income employees get additional “match” through Saver’s Credit
- Set initial automatic contribution at higher level and/or use escalation
  - For more dramatic increase, apply to existing employees
  - Interaction with eligibility waiting period
- Variations
  - Active decision, other enrollment strategies

Importance of Automatic Investment

- Why automatic investment?
  - Auto enrollment requires default investment
  - Self-direction is a burden for many
  - Too many choices can discourage participation
  - Too many invest unwisely
  - Investment education is good but insufficient
- What are the options?
  - Stable value is common, but presents asset allocation concerns
  - Managed accounts
  - Balanced funds
  - Life style (risk-based) or Life cycle (target retirement date) funds

How We Get There

- Wide bipartisan support for encouraging "auto" adoption through legislation
  - Give greater fiduciary comfort for well designed default investments, e.g., balanced funds, life cycle funds, managed accounts
    - Labor Dept to propose regulations as well
  - Clarify federal ERISA preemption of state law to permit AE
  - Allow brief grace period for automatically enrolled employees to opt out and receive penalty-free refund of their contributions
  - Some would explore possible non-discrimination changes
  - Could incorporate key features in Federal Thrift Savings Plan

Saver's Credit

Encouraging retirement saving by middle and lower income earners through reform of existing upside-down pension tax incentives

Saver's Credit: Where We Are Now

- Non-refundable tax credit for saving by moderate and low income earners
- Provides matching tax credit for 401(k), IRA, other employee contributions to plans
- Credit is 10% to 50% on contributions of up to $2,000, depending on income
- Expires after 2006

Where We Should Be: Extension and Expansion

- Make the credit rate 50 percent for all eligible households
- Make the credit refundable for workers with no federal income tax liability
  - Consider restructuring it as an actual match rather than an implicit match
- Make more middle income earners eligible for the credit
- Make the credit permanent

Saver's Credit: Impact of Expansion, Extension

- Five million tax filers claimed the Saver's Credit in each of 2002 and 2003
- Improvements could make the credit available to 59 million filers
- Saving from this cohort tends to be new saving, versus asset shifting

Saving Tax Refunds: Where We Are Now

- IRS permits direct deposit of tax refund on an all-or-nothing basis
- Most refunds, including direct deposits,are not saved
- $200 billion+ in refunds each year

Saving Tax Refunds: Where We Should Be

IRS adds an option to allow tax filers to split refund among accounts

- Would enable direct deposit of part of refund to saving account

- Savings portion could be directed to IRA

Saving Tax Refunds: How We Get There

- Change IRS systems and Form 1040 to permit direct refund by direct deposit to more than one account
- Encourage financial institutions to offer low-cost IRAs to receive refunds
- Encourage households to save at time of tax preparation

Asset Tests in Means-Tested Programs: Where We Are Now

- Means-tested public assistance programs (Medicaid, Food Stamps, etc.) often include IRA and/or 401(k) assets in eligibility tests
- LMI earners are discouraged from saving insofar as it jeopardizes eligibility for assistance during hardship

Asset Tests: Where We Should Be

- Encourage and preserve retirement saving by LMI workers
- Remove punitive treatment of retirement saving
- Reduce strain on post-retirement means-tested programs

Impact of Revising Asset Tests

- Treating LMI households' 401(k) and IRA balances like DB benefits -- i.e., disregarding them in measuring assets that count against eligibility for assistance -- can
  - Increase the number of seniors able to maintain an adequate standard of living in retirement
  - Reduce poverty among elderly households
  - Protect and therefore encourage retirement savings that are not merely shifted balances

About The Retirement Security Project

- Nonpartisan, nonprofit public policy initiative
- Focused on making it easier for middle and lower income earners to save for retirement and increasing their incentives to save
- Supported by The Pew Charitable Trusts
  - In cooperation with Georgetown University’s Public Policy Institute and the Brookings Institution
- Led by principals: Peter Orszag, Bill Gale, Mark Iwry

Operating Across Three Worlds

- Academic/research
- Policy
- Private sector outreach

Our Charter

- Promote increased retirement saving, especially among middle and lower income earners
- Research, write, and distribute policy briefs
- Focus on real world outcomes/implications of proposals
  - Empirical research on the effects of particular interventions
  - Outreach to private sector stakeholders in the retirement system
- Inform, assist, and advise policymakers
- Encourage private sector actions
  - Constructive automatic features in 401(k) design
  - Expanded retirement savings for middle and lower income earners

In Summary

- Public policy should expand coverage and encourage participation in the employment-based retirement saving system
- Public policy should target financial incentives to lower and middle income earners make it easier for them to save
- Common sense reforms can significantly affect retirement saving behavior among middle and lower income earners