Covering the Uncovered

Common Ground Recommendations to Expand Retirement Savings for American Workers

Working Report

Conversation on Coverage

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Foreword

Back in 2001, the Pension Rights Center decided to do something that had never been done before. We brought together stakeholders from a variety of perspectives to start a comprehensive initiative to find ways of increasing pension coverage for American workers. With coverage rates stalled at approximately 50 percent for the last quarter century, there was broad recognition of the need to address this pressing issue. So with an initial grant from the Ford Foundation, we convened an ambitious two-day policy dialogue on the subject among a balanced group of representatives from business, unions, retiree, women's, minority and consumer organizations, as well as from the professional and academic communities. We called this process the Conversation on Coverage. And right from the beginning, it built a strong sense of camaraderie among participants and produced numerous promising initial concepts aimed at increasing coverage.

The success of the first event led to the launch of the second stage of the Conversation on Coverage in May of 2003. Again, with a wide range of Sponsors (listed separately in the report), we brought together 45 individuals from a broad spectrum of stakeholders in the pension system, to build on the first Conversation's ideas and to focus their expertise on developing concrete ways of increasing coverage.

This Working Report is the culmination of the second stage of the Conversation on Coverage. It is the product of concentrated efforts among experts of strong and differing viewpoints to reach agreement on new approaches to expanding pension coverage and retirement savings for American workers – particularly among low and moderate-wage earners.

The participants in all three Working Groups went beyond their traditional, work-related positions and personal ideologies. Just as I set aside my traditional advocacy role for the Pension Rights Center, Working Group members also cast off their advocacy hats and donated collectively hundreds of hours of time and creativity to thinking outside the box, and developing new approaches to expanding coverage. These experts joined as individuals, not specifically as representatives of particular organizations. The conversations were off-the-record, so participants could let their hair down and participate freely, away from the glare and bright lights of the Washington public policy process.

The Working Groups took different approaches to expanding coverage: Working Group I looked at new defined benefit designs; Working Group II looked at ways of getting more individuals to save; and Working Group III designed a plan that might appeal to small businesses. Under the ground rules of the Conversation, and through the powerful leadership of the Working Group Co-Chairs, members focused on where they agreed, not on where they disagreed. They tried, as best as possible, to transcend personal and professional ideologies, to come together on common ground. They stayed focused only on addressing ways of increasing private retirement savings -- and steered clear of related issues, including Social Security, Medicare and Medicaid.

The success of this process may be best summed up by MetLife Vice President Melissa Kahn, Co-Chair of Working Group I, who said, "The Conversation has been a give-and-take like nothing else I've experienced in Washington…We worked hard, laughed hard, sometimes argued, but in the end, developed innovative approaches that we think hold the potential of expanding pensions and savings for millions of American workers."

Each Working Group did its job alone, without conferring with the other two during the year-long process – not because they were not interested in what the other groups were doing–but because of time constraints and the desire to maximize the flow of ideas within each Working Group. On some issues, Working Group outcomes were surprisingly similar. On other issues they reached differing conclusions and solutions. All recognized that the world is changing – that the global economy and pressures on employers and employees increase the challenges and the need for new solutions

This is called a Working Report because the products described are still works-in-progress. In their present form, as outlined in these reports, they are promising ideas that remain in varying degrees of completion. These recommendations were first released on July 22, 2004, at a National Policy Forum held at the National Press Club. More than 200 stakeholders representing the broad spectrum of interests and views on the private sector retirement system attended the one-day event. The National Policy Forum, thus, was the first "hearing" for the recommendations. Participants at the Forum had a chance to ask questions and propose changes – which are included, in summary form, at the back of each report.

We were honored that Senator Grassley provided the opening address for the National Policy Forum and to have other esteemed Members of Congress – Representatives Rob Andrew, Rob Portman and Earl Pomeroy–address the participants. This Working Report contains some of their ideas as well. In his opening statement, Senator Grassley said, "Working together, I know we can improve the retirement security of millions upon millions of Americans across the country. Working together, I am confident we can ultimately achieve the goal of pension coverage for all Americans."

Because of my role as a neutral facilitator of this process, I had the opportunity to sit on the sidelines of the Working Group deliberations and listen to a lot of great new ideas from some of the best minds in this country. I now have a much greater appreciation and understanding of the challenges facing businesses, and the balance that needs to be struck between both the needs of employers and employees in shaping policy proposals. I discovered how passionate and committed my colleagues are and found that when people come together for the common good it is indeed possible to find common ground. The Conversation on Coverage has been an incredible experience for everyone involved and it is not an overstatement to say that it has changed the way many of us think and how we approach issues.

The Working Groups are starting anew with some of the same people and with some new people as well, to keep the process going, to refine the existing proposals and to work out outstanding issues. The goal is to have numerous solid ideas produced by the end of the process in early 2006 that could lead to proposals and demonstration projects.

> "Working together, I know we can improve the retirement security of millions upon millions of Americans across the country. Working together I am confident that we can ultimately achieve the goal of pension coverage for all Americans."
>
> Senator Charles Grassley (R-IA), Chairman of the Senate Finance Committee, from his opening statement for the Conversation's National Policy Forum, July 2004.

I am greatly indebted to all who helped make this project so productive. I want to particularly thank the Ford Foundation that made this process possible. Also, I want to thank the Charles Stewart Mott Foundation, the Annie E. Casey Foundation and a range of organizational Sponsors and Co-Sponsors that supported the second stage of the Conversation, and the publishing of this report. I also want to thank profusely all of the Working Group members, the Steering Committee members and the staff of the Conversation on Coverage who have made this process such a success – and who are named on the acknowledgement page.

It is so rare to be able to say that we have been part of something that is truly going to make the world a better place. I truly believe that the Conversation, because of the goodwill and hard work of the individuals involved, is part of the solution, and will help in designing ideas that will enable millions of people to live more comfortably in retirement. It has been a magical process and I'm delighted to invite all of you to read the Working Report and join the larger public policy dialogue.

Karen D. Friedman
Director, Conversation on Coverage

Acknowledgements

The Pension Rights Center wishes to thank all those who made the second stage of the Conversation on Coverage, the National Policy Forum and the publishing of this report possible. First and foremost we want to thank the Ford Foundation for having the vision to support the first Conversation on Coverage and their continued support of this important initiative during the second stage. We also want to thank the Annie E. Casey Foundation and the Charles Stewart Mott Foundation for their support of the Conversation and the publication of this report.

We are also grateful to our organizational Sponsors and Co-Sponsors for their support of the second stage of the Conversation. Thanks to our Sponsors: AARP, AFL-CIO, ASPPA Pension Education and Research Foundation and MetLife; and to our Co-Sponsors: American Academy of Actuaries, American Benefits Institute, Fidelity Investments, Motorola, TIAA-CREF Institute and the Urban Institute.

We also want to thank the members of our Steering Committee who often gave us daily advice during this process on everything from the weightiest substantive matters to simple "word-smithing" to ensure that every document was balanced and reflected a diversity of opinions. Thanks especially to Martha Hutzelman who served as Chair of the Steering Committee and whose steady guidance helped shape the process. Thank you also to Michael Calabrese, David Certner, Lynn Dudley, Regina Jefferson, Randy Johnson, John Kimpel, Olena Lacy, Alicia Munnell, Shaun O'Brien and Virginia Reno for their tireless efforts.

We owe so much to the Co-Chairs of the process, some of whom doubled as Steering Committee members, who often heard from us several times a day during the process, and even afterward as the reports were being written, to shepherd this process to completion. We cannot thank the Co-Chairs enough as they served with time, patience and endurance. Thank you to Melissa Kahn and Norman Stein of Working Group I; Randy Johnson and Regina Jefferson of Working Group II; and Ian Lanoff and Pamela Perun of Working Group III.

We also want to offer a special thank you to all the other Working Group members who personally and collectively donated hundreds of hours to the Conversation on Coverage to create these recommendations and who gave so much of themselves to the process. Every individual was willing to serve in at least five to six all-day meetings and when the task demanded more, they were willing to serve more, as well as taking the time to edit these reports. For that, we want to thank Working Group I members: Phyllis Borzi, Ellen Bruce, David Certner, Charlie Cole, Pat Dilley, Lynn Dudley, Ron Gebhardtsbauer, Deene Goodlaw, Brian Graff, Nell Hennessy, Mike Johnston, Judy Mazo and Shaun O'Brien; and Working Group II members: Dean Baker, Michael Calabrese, Mark Iwry, Mike Kelso, John Kimpel, Lisa Mensah, Eric Rodriguez, Gene Steuerle and David Wray; and Working Group III members: Chris Bone, Doug Ell, Cathy Heron, Pat Humphlett, Leslie Kramerich, Bob Nagle, Carol Sears, Javier Silva, Christian Weller and Janice Winston.

We want to thank an array of staff and consultants without whom this process could never have happened. First a very special thank you to Lemuel Odell, the Conversation's Special Assistant and Logistics Manager, who coordinated every logistic for the year-long process, coordinated all the correspondence between all the Working Group members and supervised the editing and publishing of this report. This process could not have been done without him. We also owe an immense debt of gratitude to Robert England whose tireless reporting skills helped capture the minutes of all the meetings, enabling him to write all three Working Group reports and incorporate the edits of 45 Working Group members, additional Steering Committee members and Pension Rights Center staff. Robert's extraordinary skill as rapporteur and writer enabled the process to be captured on paper. A thank you to Bob Walker, Jane Smith and Sharon Morrissey who also helped with the editing process. Finally, we want to thank the members of the Pension Rights Center's Board of Directors who advised us throughout the process, particularly, Lisle Carter, Dan Halperin and Marion Mudd.

A special thank you also to Alicia Munnell, who along with Jamie Lee and Kevin Meme at the Center for Retirement Research at Boston College, wrote the "Update on Employer-Sponsored Pensions" for the National Policy Forum of the Conversation on Coverage on July 22, 2004. This paper was originally prepared for the 2001 Conversation on Coverage inaugural event. Both papers can be accessed at www.pensioncoverage.net

Introduction

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

Although there has been tremendous growth in the number of workplace retirement plans, the number of people covered by retirement plans, and the dollars invested for retirement, the percentage of American workers participating in a pension plan has remained at roughly 50 percent of private sector workers for the past two decades. With changes in the workplace and pressures of globalization, the task of increasing coverage has become even more complex and challenging.

The Conversation on Coverage is addressing this challenge. Working Group members of this initiative – experts on various areas of retirement policy – came together over a year-long period to develop creative approaches to increasing coverage. Working Group members set out to determine what policies have worked, where improvements can enhance coverage, what existing ideas have merit and should be promoted and what new ideas should be considered and further developed. These ambitious efforts, a veritable beehive of intellectual activity, led to the creation of a broad framework of exciting new ideas to expand coverage, including proposals for new types of retirement plans.

The Conversation on Coverage has sought throughout its work to develop and recommend proposals that would enjoy a broad appeal among all stakeholders in the private pension system. It has organized and facilitated conversations among people from a broad spectrum of competing interests and divergent views on how best to secure retirement income for working Americans, especially those with low and moderate incomes. The gratifying result of this effort to find common ground is that the second stage of the Conversation has produced initial drafts of proposals that enjoy wide support and which – when further refined and developed – can potentially advance coverage among a greater share of the working population.

Background: The Work Place and Retirement Benefits

The Working Groups began with the notion that, in order to expand coverage, one must first identify the segments of the working population where the biggest coverage gaps exist. In 2004, 59 percent of all full-time and part-time private sector American workers had access to a pension plan sponsored by the company where they worked, according to the Department of Labor. However, only about 50 percent, or 51.6 million workers, actually participated in these corporate pension plans out of a private sector workforce of 102.3 million.

The likelihood that a worker is covered by a workplace retirement plan varies according to income and age. Today, as was the case in the early 1980s, higher income workers and older employees with job tenure are likely to work at a company with a retirement benefit. However, low to moderate-income people and younger employees are less likely to have a retirement benefit. There is also a big gap in coverage rates between full-time and part-time workers. In 2004, full-time workers had a 60 percent coverage rate while part-time workers had only a 20 percent coverage rate according to the Department of Labor.

The likelihood that a worker will be covered by a retirement plan also varies by the size of the company at which he or she works. Companies with more than 500 workers are most likely to have a retirement plan. In medium and large companies, a good employee benefits package is seen as key to attracting and retaining skilled workers.

On the other hand, smaller companies are where there are the most workers without retirement benefits. For example, the participation rate for workers at small businesses – those with 99 or fewer workers – was only

37 percent in 2004, compared to 67 percent for workers at companies with 100 or more workers. One of the reasons coverage is lower among small businesses is that they have a higher worker turnover rate. In work places with high labor turnover there is usually lower employer and worker interest in benefits with a long-term horizon.

A higher level of part-time workers at small businesses also tends to reduce retirement coverage rates. Among the smallest businesses – those with less than 10 workers, 41 percent of the workers are part-time, according to the U.S. Census Bureau. By comparison, in slightly larger companies – those with 10 to 24 workers – the proportion of part-timers drops to 33 percent.

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

Overview of the Conversation on Coverage's Working Group Reports

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

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

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

The starting point for most members of the Working Groups was a belief in perpetuating the voluntary private retirement system while finding ways to expand it to include more workers. Even so, during the Working Group conversations, some members said they strongly preferred new mandates. In the end, however, the Working Groups concurred on the use of voluntary approaches.

The private, off-the record sessions gave the participants a chance to explore and debate different concepts without concern that they would suggest something that might meet with objection – whether practical, political or academic – before it had been more thoroughly vetted. It was a chance for the members of the Working Groups to let their intellectual hair down, explore ideas and share common understandings. Nothing was taken for granted. The general theme was to build on the successes of the existing system and to look for new ways to make the system work better and expand it to reach more workers.

The result of all these efforts is an impressive package of proposals that are likely to advance the coverage debate significantly. The Working Groups did not attempt to evaluate all retirement plan proposals. Instead, they chose to focus on the broad framework of new plans they designed together and which they felt had particular merit. Due to the broad diversity in the membership of each of the Working Groups, and the considerable time and energy devoted to the task, the ideas that have been recommended in this report emerge from this process with a stamp of approval that increases the odds they can eventually be perfected, piloted and adopted.

In the upcoming third stage of the Conversation on Coverage, the Working Groups will refine the proposals that were developed in the second stage. Where appropriate, Working Groups may develop a demonstration project for a given proposal. Following the approach in the second stage, the refinement process will bring together a diverse group of experts. The Working Groups intend to seek out research data on key points to help them flesh out the proposals they are continuing to develop and to move them closer to the point where they could become the basis for legislation, regulation, trial or implementation.

Key Recommendations of the Working Groups

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

Working Group I

The mission of this Working Group was to explore the development of new types of plans with a defined guaranteed benefit that would be attractive to employers who do not now sponsor a defined benefit plan. The group developed models for two such plans.

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

- **The Plain Old Pension Plan** (POPP) is a new variation on the traditional defined benefit plan that starts with a modest guaranteed benefit that employers can boost for any year and then reduce back to the basic benefit in future years. The POPP also has features to make an employer's funding obligation predictable than under current law. The normal form of the final benefit is an annuity and no lump sums are permitted.

Working Group II

The mission of this Working Group was to devise ways to increase the portion of the work force that is eligible to participate in a defined contribution plan and, where employees are eligible to participate, to increase the level of participation and the overall level of savings. Along with a number of ways to improve coverage in existing types of defined contribution plans, the group came up with the idea of a central clearinghouse plan, described below, to reach more workers.

- **The Retirement Investment Account** (RIA) Plan proposes the creation of a government-authorized, privately-run central clearinghouse to accept worker contributions to retirement savings accounts. These savings accounts would be designed for saving for an additional benefit above and beyond Social Security. This plan is aimed at providing more individual workers who do not now have a plan with access to a payroll-deduction retirement savings plan through their workplace. Employers who do not now offer plans can provide access to their workers for this plan without significant new burdens, since they will not have to administer the plan or take fiduciary responsibility for the investment choices of their employees.

Working Group III

The mission of this Working Group was to find ways, through new institutions and structures, to further the goal of increasing coverage and retirement savings. The group devised a new plan to be sponsored by financial institutions and that would be aimed at small businesses, where coverage rates are low.

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

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

Despite their common elements, the Working Groups came up with their proposals independently of one another and without consultation among the groups. Prior to July 22, 2004, when the proposals were unveiled, none of the members of any of the Working Groups had seen the recommendations of the other Working Groups. In the third stage of the Conversation on Coverage, members of each Working Group will have the opportunity to offer ideas and suggestions about the proposals of the other two Working Groups.

This Working Report contains a detailed discussion of each of the proposals and other recommendations that emerged from the Working Groups on July 22, 2004, preceded by an Executive Summary of each of the Working Group reports.

Understanding the Language in the Working Group Reports

In the individual reports that follow, the reader will encounter the frequent use of the term "generally agreed." It will help in understanding the recommendations that have been made to know how that term is defined when this report describes the outcome of the discussions within the Working Groups. The goal of each Working Group was to try to reach consensus. "Consensus" did not necessarily mean having 100 percent agreement by all members in each group at all times. There was an understanding by the Working Groups that if nearly all members agreed on something, then it would be fair to say that the group "generally agreed" on that point. By that, it is meant that there was only token opposition from a few members.

You will also note that there are other areas with varying degrees of agreement beyond the category of "general agreement." It was decided from the beginning that there would be no vote *per se*, as voting was seen as working against agreement and could be polarizing. The meetings were covered by officially-designated reporters, and the Co-Chairs frequently polled members for their views. The range of views, in fact, often did not fall into simple "for" or "against" categories. As people were making compromises, they might be "for" with a caveat, or "against" but with some reservation. And sometimes Working Group members compromised on one item if they thought it was for the greater goal of moving the proposal forward and possibly getting something else in return on another point or provision. Sometimes, rather than getting bogged down in contentious issues, the Working Group members agreed to list a range of options and to come back later to the issue if there were more time.

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

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

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

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

Robert Stowe England

Working Group One Report

Report on the Conversations and Recommendations of Working Group I

Working Group's Assignment

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

Co-Chairs:

Melissa Kahn
Norman Stein

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Executive Summary

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

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

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

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

- The proposed plan is a new kind of hybrid plan that takes the existing money purchase plan and adds a guaranteed account balance. The money purchase plan is a retirement savings plan financed by the employer through regular contributions based on a percentage of the compensation of each worker.
- The account of each participant is credited with an annual employer contribution.
- Benefits are funded by the employer, based on standardized and conservative funding assumptions; employees could also elect to contribute on a pretax basis.
- The plan guarantees the annual rate of return on participants' account balances.

"I think the Conversation has really been quite extraordinary . . . it has brought together a broad array of interests. Really most every expert that I've come across in my years of work in this business appears to be involved in this common endeavor."

Representative Earl Pomeroy (D-ND)
from his address at the Conversation's
National Policy Forum,
July 22, 2004.

- The employer invests the plan assets so employees do not self-direct the investments.
- The plan offers an annuity as the automatic payment option, but participants may also be offered as an alternative a lump sum equal to the amount credited to the participant's account.

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

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

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

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

Some of the proposals adopted may require changes in public policy and some may be pursued through demonstration projects. This will be determined in the third stage of the Conversation on Coverage.

The Mission

The mission of Working Group I was to develop proposals that would expand the aggregate number of workers covered by a plan that offers a defined benefit. A defined benefit plan is a retirement plan offered by an employer who is legally obligated to fund the plan's promise to provide a monthly retirement benefit to each eligible employee and surviving spouse based on years of service and earnings. (See plan type definitions pages 18-20 for more information.) The group generally agreed that expanded coverage would include providing coverage to employees at firms that previously did not have a plan with defined benefits, as well as extending coverage to groups of employees at firms with a defined benefit plan that were not previously covered by the plan.

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

Background

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

Meanwhile the proportion of workers with a defined contribution plan as their primary retirement plan rose sharply over the same period from seven percent to 27 percent, making the defined contribution plan the dominant type of plan in the workforce.[5] A defined contribution plan is an employer-sponsored retirement savings plan that accumulates assets from employee contributions and/or employer contributions. There is no specific promised benefit at retirement and the investment risk falls on each individual employee. In the 401(k) and 403(b) models now predominant (both defined contribution plans) employees determine how much they should save and often choose how to invest their retirement savings. (See definitions on pages 18-

20.) The employee's retirement income is based on the contributions made into the account and the accumulated earnings at retirement.

Federal pension data illustrate the extent of the decline in defined benefit plans and employees covered by such plans. The number of workers covered has declined and the number of plans has fallen sharply. According to a Congressional Research Service paper, the number of workers covered fell from 29.3 million in 1983 to just under 23 million in 1998. [6] At the same time, the number of plans fell from 175,000 to 56,400, with most of the loss of plans occurring among small businesses (those with 99 or fewer workers). The proportional decline has been greatest among small plans. Between 1983 and 1998, for example, the number of workers in small plans fell by a disturbing 65 percent, from 1.86 million to 648,000. That represented a loss of more than 1.21 million workers. For the biggest firms, however, there was an even greater decline, with only 5.8 million of workers enrolled in defined benefit plans. In 1983, the number of active participants in defined benefit plans at large companies stood at 28.1 million. By 1998, it had declined 21 percent to 22.3 million.[7]

The Pension Benefit Guaranty Corporation provides estimates on the number of plans and the number of participants and beneficiaries of those plans based on premiums that are paid to the agency. PBGC reports that in 2001, there were 22.35 million active workers[8] in plans insured by the agency, representing 19.7 percent of the 113.5 million private sector wage and salary workers. This represented a tiny drop in workers covered from 22.38 million in 2000.[9] In 2003, the number of single-employer plans fell to 29,512 from 31,229 the previous year. The number of multiemployer plans stood at 1,623 in 2003, down from 1,671 the previous year.[10]

The data suggest that while the defined contribution plan has become a more popular method for providing retirement benefits, it has not achieved the success that the defined benefit system enjoyed before the rise of the defined contribution plans, particularly 401(k) plans. And despite its relative decline, the defined benefit plan remains an important part of the employee benefits system, especially at larger firms. In 1998, for example, private sector defined benefit plans paid out $107.8 billion in benefits, mostly in the form of annuities disbursed from plan assets. They also purchased an additional $3.4 billion in annuities from commercial insurers.[11] Also, the defined benefit plan continues to be the plan of choice for federal, state and local government employees and for workers in the unionized sector of the economy.

The Advantages of Defined Benefit Plans

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

Participants in defined benefit plans also enjoy a further advantage in that the investment risk is shifted away from the employee and the normal form of pension benefit is usually in the form of a lifetime annuity in an amount that can be calculated from the formula in the plan. More importantly, as recently as 1997, fewer than 25 percent of participants in defined benefit plans even had an option to take benefits in a nonannuity form, such as a lump sum.[12] In addition, the benefits provided by defined benefit plans are federally guaranteed with insurance provided by the Pension Benefit Guaranty Corporation.

Providing the retirement income benefit as an annuity eliminates the longevity risk for the retiree; that is, the retiree does not have to worry about outliving the pension, since the pension is defined as an income stream to be provided throughout the retiree's life span. It also fully meets the goals of the substantial federal tax subsidy for qualified retirement plans by providing income only during the retirement years of the employee and his or her spouse, and cannot be dissipated after a pre-retirement termination of employment or accumulated as a tax-favored asset for the next generation.

The benefit of having an automatic annuity in a defined benefit plan has, however, been eroded in recent years as more plans have opted to offer lump sums as an option and employees have chosen to take lump sums instead of annuities. In 2000, for example, 43 percent could take their benefit as a full or partial lump sum.[13]

Problems Facing Defined Benefit Plans

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

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

Employers who regularly make required contributions into their pension plans to meet future obligations can still fall short of the funding goal due to changes in the value of assets in the financial markets and due to changes in the prevailing interest rate used to evaluate liabilities. Changes in the benchmark interest rates, for example, may result in reported funding deficiencies for plans that had been previously well-funded.[14]

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

The volatility in actual funding requirements can cause serious cash-flow problems for employers. This volatility also shows up on employers' financial statements, as accounting standards require that pension assets and liabilities be recorded both on the income statement and the balance sheet. That can have a serious impact on employers' cost of capital. Proposals under consideration by the accounting profession for market value reporting would increase the volatility on a company's financial statement by disallowing the use of some techniques that smooth, or even out, the value of assets and liabilities for accounting purposes (e.g. when assets are unusually high, smoothing will lower them somewhat; when they are unusually low, smoothing will increase them somewhat), making plan funding more predictable and less volatile.

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

How Much Benefit for the Owners and/or Senior Management? One of the concerns about devising new defined benefit plans is not peculiar to this type of plan, but applies to all plans. Since most large and medium-sized employers have some type of employer-sponsored pension plan, most of the expansion that could occur is among small businesses. In these businesses, the owner and senior management are likely to be part of the plan that is offered, according to several members of the working group, and they would expect to receive a very large share of the pension benefits that would be financed in the plan.

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

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

How the Working Group Went About Its Assignment

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

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

The group began its work by reviewing several defined benefit or hybrid plan proposals that were included in a binder given to all working group members. Hybrid plans have some of the characteristics of both a defined contribution and a defined benefit plan. (See Definitions of Plan Types on pages 18-20.) The group considered hybrid plans that would, at a minimum, offer a standard annual contribution by the employer (which might be waived occasionally) and would also offer a specified rate of return for the accumulated funds in the account that would be guaranteed by the employer or a financial institution or company that offers the plan.

The group devised a set of criteria[15] for reviewing proposals for new types of plans and also for reviewing proposals for tax incentives and other ideas to make existing defined benefit plans more attractive to employers and employees.

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

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

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

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

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

The Group Expresses Interest in DB-K Plans

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

The Working Group identified several potential benefits of a DB-K. It would allow employers to offer in one plan a defined benefit based on pay and length of service, as well as a retirement savings plan. It would provide a 'safe harbor' for the defined benefit plan where the employer provides a minimum benefit formula for all eligible employees, such as one percent of final average compensation times up to 20 years of service. Employers who provide this minimum benefit would be deemed to have met the requirements of the nondiscrimination rules, including the rules applicable to 401(k) plans – giving them a safe harbor from those rules. This would eliminate the need to do costly nondiscrimination testing[16] required by the Internal Revenue Code. It would allow employers to imaginatively combine the best features of defined benefit plans and 401(k) plans.

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

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

The member who had introduced the original DB-K Proposal No. 3 suggested that the group replace the cash balance option with a new hybrid: the Guaranteed Account Plan, an adaptation of the money purchase plan, a defined contribution plan. The money purchase plan is a retirement savings plan financed by the employer through regular contributions based on a percentage of the compensation of each worker. (See Definitions of Plan Types on pages 18-20 for more information on money purchase plans.)[18]

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

The Working Group members generally supported the broad conceptual design of these two proposals.

Members also generally agreed on a number of key building blocks of design elements for each of the plans with reservations on some aspects of the design for the two plans.

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

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

The Guaranteed Account Plan

Areas of Broad Agreement on the Design of GAP

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

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

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

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

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

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

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

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

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

How Long Employees Work to Vest in Retirement Benefit. An employee is said to be "vested" in a pension when the employee becomes entitled to the benefits of the plan, including employer contributions to a plan and their earnings. The time until a benefit is vested is defined under guidelines set forth in federal pension law.[19] The Working Group generally agreed to propose that GAP would allow employers to offer one of two types of vesting for plan participants. One choice would be to vest in the entire benefit balance all at once after three years from the date of employment, an approach called cliff vesting. The group also generally agreed to allow for gradual vesting over a six-year period. Under this approach the portion of the benefit in the plan that is vested rises each year and reaches 100 percent after six years. The vesting options under GAP are the same as those that apply now for 401(k) plans and are more generous than the rules governing traditional defined benefit plans. Shortening the vesting requirement benefits employees.

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

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

The proposed funding rules for GAP reduce the amount of time the employer has to close the funding gap, compared to traditional defined benefit plans.[21] This makes it more likely plans will close their underfunding gap after they experience losses. The increase in the maximum contribution allows employers to make additional contributions in good years when the company can afford those contributions and, thus, make it better prepared for lean years, when the employer may find it difficult to make required contributions.

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

Joint and Survivor Annuity. The Working Group generally agreed that the normal benefit offered at retirement would be a joint and survivor annuity (or a single-life annuity for unmarried participants), based on the value of the participant's account at retirement. That means the value of a participant's account would be used to purchase a commercially annuity, reasonably priced, that would be issued jointly to the plan participant and spouse and that the spouse would continue to receive the annuity should the plan participant die. Employers would be able to decide whether or not their plans would offer lump sums. However, if a participant decided he or she preferred to take a lump sum, spousal consent would be required to change the distribution from the normal requirement that it be a joint and survivor annuity. Spousal consent for a lump sum is currently required for money purchase plans, as well as for defined benefit plans.[23]

A GAP with a 401(k) Feature. The Working Group generally agreed that a GAP could also include a 401(k) feature. Employees could, under such plans, make elective contributions[24] to the GAP or the 401(k) plan.

Employer Matching Contributions. The Working Group generally agreed that employers could make matching contributions to the GAP when employees made contributions to a plan including a 401(k) feature. The Working Group agreed this should be allowed in accordance with current Tax Code requirements for matching contributions, including safe harbor rules.[25]

Calculation of Lump Sum. When employees in a defined benefit plan leave a company before retirement and they are vested in a defined benefit pension plan, they frequently receive a lump sum payment. Current pension rules governing defined benefit plans, including cash balance plans, require a complicated calculation[26] to arrive at the value of the lump sum. The group generally agreed that rather than applying the complicated rules that now affect cash balance plans, that individuals would simply receive the balance credited to their accounts, using the rules that apply to defined contribution plans. Members stated this would be fair to employees and to employers and would simplify administration.

GAP Design Elements with Some, But Not General Agreement

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

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

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

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

Pension Benefit Guaranty Corporation Insurance. Defined benefit plans in the private sector are insured by the Pension Benefit Guaranty Corporation in Washington, D.C. When underfunded pension plans are terminated, the plan assets are transferred to the PBGC and the agency takes over the payment of pension benefits.[27] The agency guarantees pension benefits at normal retirement age and most early retirement benefits. The agency provides a maximum benefit guarantee, which is adjusted every year and is $3,801.17 per month for 2005 for workers who retire at age 65.[28]

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

Most of the Working Group also supported charging a lower $5 premium per member in a GAP. By contrast, the flat rate premium for single-employer defined benefit plans is $19 per member per year. (In early 2005 PBGC proposed raising the flat-rate premium to $30 as part of an effort to strengthen its finances.) Plans that are underfunded have to pay an additional adjustable rate premium.[29] A lower premium was recommended to mitigate one of the objections that employers have to adopting defined benefit plans; namely, the cost of pension insurance premiums. Most, but not all, members of the group believed that the lower premium for GAP would not represent risk to the PBGC because of the low risk of a GAP benefit default.

Higher Contribution Limits and Maximum Annual Annuity Benefits. Under the Internal Revenue Code, employers can contribute more annually for high-paid older employees into defined benefit plans[30] every year than they can with defined contribution plans. The Working Group discussed whether or not GAP, which is a hybrid plan, should have the contribution limits specified for defined benefit plans or those for defined contribution plans.[31] The contribution limits for defined benefit plans are generally more favorable to older workers, which the group anticipated would often be business owners and higher-paid workers of businesses that adopted a GAP.

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

The Working Group mostly agreed that GAP could use 5.5 percent as the interest rate for converting the annuity to a lump sum for purposes of the maximum defined benefit limit. The Working Group also mostly

> "The Conversation on Coverage is a spectacular initiative...with the laudable goal of finding common ground at a time when there are so many divisions..."
>
> Representative Robert Andrews (D-NJ) from his address at the Conversation's National Policy Forum, July 22, 2004.

agreed that if Congress were to change the law to provide a new interest rate assumption, the new interest rate assumption would apply to GAP.[32]

Four Policy Areas Linked in Discussions about GAP

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

- **Minimum guaranteed rate of return on account balances.**
- **Maximum benefits allowed for higher-paid and older workers.**
- **Minimum employer contribution credits for all workers.**
- **Flexible testing methods for nondiscrimination.**[33]

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

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

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

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

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

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

Larger Contributions for Older Workers in Top Heavy Plans. It was proposed to require a contribution minimum of 5 percent of compensation for all workers, regardless of age, in top heavy plans, which are plans[34] where key employees have amassed benefits greater than 60 percent of the entire pool of benefits. Tax Code regulations require top heavy plans to make minimum contributions to all employees. Most small business retirement plans eventually become top heavy because the compensation of key employees is higher and because there is more turnover among other employees. This turnover means fewer of them accumulate benefits.

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

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

Flexible Approaches to Nondiscrimination Testing. Congress requires all qualified retirement plans to satisfy nondiscrimination rules, which are intended to ensure that such plans do not overly favor highly-compensated employees over other employees. The group engaged in lively discussions about whether GAP should import the nondiscrimination rules applicable to defined contribution plans, including complex testing methods known as age-weighting or cross-testing.[35]

In a nutshell, cross-tested methodologies allow employers to contribute substantially more (as a percentage of pay) to older plan participants, without violating the nondiscrimination rules – even if most of the older employees are highly compensated.[36] This methodology is based on the premise that a contribution to an older plan participant is inherently less valuable than the same contribution to a younger plan participant since the latter contribution will have more time to accumulate investment returns. Small firms whose owners and other favored employees were older than rank-and-file employees often used cross-testing methodologies to favor those employees. Recent variations on cross-testing methodologies allow some firms to deny the benefits of cross-testing to older rank-and-file employees by creating subgroups of participants for nondiscrimination testing, provided they contribute at least a minimum five percent of pay contribution on behalf all rank-and-file employees. (Plans that use these methodologies are sometimes called new comparability plans.) [37]

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

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

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

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

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

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

Minimum Contribution Requirements for Nondiscrimination Safe Harbor. The members of the Working Group discussed what minimum level of contributions would be required to allow employers to avoid nondiscrimination tests.[38] Several potential arrangements were discussed: a minimum contribution for a stand-alone GAP, a minimum for a combined GAP with a 401(k) feature, and a minimum for a top-heavy GAP either alone or in combination with a 401(k). No agreement was reached on this point.

Converting from an Existing Plan to a GAP. In recent years some employers who converted their traditional defined benefit pension plans to cash balance plans encountered charges of age discrimination. Some employers were criticized for the method they used in calculating how the value of the benefit accrued under the traditional plan was determined and transferred to an opening balance in the cash balance plan.[39] As a result of strong objections that were raised, cash balance plans encountered legal and political obstacles that have yet to be resolved. To avoid the problems encountered by cash balance plans, the Working Group considered whether or not it should bar an employer with a traditional defined benefit plan from converting to a GAP.[40] Several members opposed allowing a conversion to a GAP from a traditional plan. Some members warned, however, that if a conversion to a GAP is disallowed that employers might instead convert to a defined contribution plan, a less desirable outcome than converting to a GAP, according to most group members.

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

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

The Plain Old Pension Plan

Areas of Broad Agreement on the Design of POPP

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

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

- The plan is a simple, easy-to-understand traditional defined benefit plan that provides a modest basic benefit to allay employer concerns about funding the plan.
- The final basic benefit is based on a percentage (as low as one percent) of an employee's career average pay multiplied by the number of years of service.

- The plan would allow employers to fund bonus benefits in any given year or years that would raise the final benefit without having the bonus benefits become part of the permanent benefit structure.
- The plan would permit, but not require, a generous past service credit that would be attractive to small business owners.
- All benefits from the plan would be paid in the form of an annuity. Lump sum distributions would not be permitted.

Basic Plan Benefit. The basic plan benefit would accrue at one percent a year of the career average income times the number of years of service. To make the calculations simpler, plans could rely on tables published annually by the Treasury Department or the Pension Benefit Guaranty Corporation that would be expressed as a table using age and compensation to determine the contribution each year. The amounts set forth in the table would be determined by the governmental agency using very conservative actuarial assumptions. Employers would calculate each year's required contribution by aggregating the contributions on the table for each participant. Some members of the Working Group suggested that the government publish the actuarial tables required in this plan every 5 years instead of annually. The actuarial assumptions in the tables would be conservative, to make funding shortfalls unlikely.

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

Vesting. An employee is said to be "vested" in a pension when the employee becomes entitled to the benefits of the plan, including employer contributions to a plan and their earnings. The time until a benefit is vested is defined for most plans under guidelines set forth in federal pension law.[41] As modified, this proposal would allow for either three-year cliff vesting or two- to six-year graded vesting. With cliff vesting the participant becomes entitled to the benefit balance that has accrued all at once after three years from the date the participant joined the plan. Under graded vesting, the portion of the benefit in the plan that is vested rises in equal portions each year until it reaches 100 percent after the graded vesting period. Vesting would only count service from the date POPP was adopted unless the employer chose to count years prior to adoption of POPP.

Past Service Credit. The plan allows for past service credit for as many years as the employer would like. The past service credit would have to be amortized; that is, funded in regular installments over a seven-year period.[42] Likewise, employees would accrue the past service credit over a seven-year period. An employer could give past service credit for benefit purposes without giving vesting credit for those years.

Bonus Benefit. In years when the investments in the plan do very well, in years when the company's profits are strong, or at any other time, the employer may give a bonus benefit to employees without committing to a permanent benefit increase. For example, in good years employees could accrue a benefit of two percent of compensation instead of one percent. Or, the employer might increase the benefit by the cost-of-living, and such COLAs would be treated as a bonus benefit for the years they covered.[43] Past service credit could also be given for a bonus benefit.

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

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

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

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

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

Pension Benefit Guaranty Corporation Insurance. The plan would be insured by the PBGC and would pay $5 premiums, lower than those paid by traditional pension plans. When plans are terminated, the plan assets are transferred to the PBGC and the agency takes over the payment of pension benefits.[44] The agency guarantees pension benefits at normal retirement age and most early retirement benefits.[45] The agency provides a maximum benefit guarantee, which is adjusted every year and is $3, 801.17 per month for 2005 for workers who retire at age 65.[46] By contrast, the flat rate premium for single employer defined benefit plans is $19 per member per year. (The PBGC in early 2005 proposed raising the flat rate premium to $30 as part of an effort to strengthen its finances.) Plans that are underfunded have to pay an additional adjustable rate premium.[47] A lower premium was recommended to mitigate one of the objections that employers have to adopting defined benefit plans; namely, the cost of pension insurance premiums.

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

Conversion to Traditional Defined Benefit Plan. The plan could be amended at any time to become a more traditional defined benefit plan. The converted plan would be permitted to use all available nondiscrimination testing methodologies available to regular defined benefit plans.[48] After conversion, the employer would adopt its own actuarial assumptions and run the converted plan like a traditional defined benefit plan, including provide a minimum benefit to all workers eligible to participate if the plan is top heavy.[49]

Tax Credit. As proposed, the plan would allow employers a tax credit equal to five percent of the contributions made to fund benefits for non-highly compensated employees[50] for a period of five years. The credit would be recaptured by the Internal Revenue Service if the employer terminates the plan within five years. This provision would help employers cover the costs of providing the benefits to all workers, including part-time workers who are not seasonal workers.

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

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

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

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

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

Tax Incentives for Expanded Coverage

The Working Group submitted ideas for tax incentives that would encourage employers to maintain or extend defined benefit plan coverage to more employees. These included ideas to reward companies for retaining a defined benefit plan, ideas for adopting specific provisions that would expand coverage, as well as incentives to start-up new defined benefit plans.

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

Tax Credits Generally Supported by the Working Group:

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

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

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

Tax Credits With Some Support by the Working Group:

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

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

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

No Use of Permitted Disparity. The Working Group considered a suggestion that a tax credit be provided to an employer that did not use nondiscrimination testing methods that permit disparity.[51] The group was divided on whether or not to support a tax credit for this prohibition.

What Can Be Done Next

The Conversation on Coverage in its next stage will consider what further steps it can take to promote coverage through adaptations of the two new major plan designs – GAP and POPP – to emerge from Working Group I. The participants of the Working Group will concentrate on refining the outstanding issues of GAP to develop a fully-formed proposal, as well as complete development of the POPP proposal. The Conversation will examine the feasibility of potentially launching a demonstration project in which a plan, like POPP, might be marketed through financial institutions.

Definitions of Plan Types

Defined Benefit Plan

A defined benefit plan is a pension other than an individual account plan that provides a regular monthly income after retirement that is determined according to a formula. It is not dependent on the actual contributions made to the plan or investment performance of the plan's assets. Benefits typically are determined based on a fraction[52] of a worker's average earnings (either career earnings or certain high earnings years at the end of the worker's tenure), or a flat dollar amount multiplied by the number of years worked for the employer. For example, a defined benefit plan might offer employees a monthly retirement benefit equal to one percent of average compensation a year multiplied times the number of years worked. In this instance, if a worker averaging $40,000 a year worked 20 years, he or she would earn one percent of $40,000 or $400 multiplied by 20 or $800 a month ($9,600 a year). In the alternative, a plan might promise a benefit of $40 per month times the number of years worked. If a worker put in 20 years of service, he or she would also receive $800 a month or $9,600 a year. The maximum benefit payable by a defined benefit plan in 2005 is $170,000 a year.

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

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

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

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

Defined Contribution Plan

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

In most defined contribution plans, workers receive their benefits as lump sums when they leave their jobs. They may either roll over the account balance to an IRA or a new employer plan or use the money for other, nonretirement purposes. Defined contribution plans, other than money purchase plans (discussed below) are not required to offer annuity payouts and most do not. Upon retirement, an employee has an accumulated retirement savings that he or she will have to decide how to manage. The retiree has to decide whether to take part or all of the assets as an annuity, if that is an option. Or, perhaps the retiree may choose to set up a schedule of regular withdrawals. The retiree also has to decide how to invest the assets in retirement, including whether to change the asset allocation. With the 401(k), there are minimum distribution rules, which dictate a minimum withdrawal each year beginning at the age of 70?. Defined contribution plans, unlike defined benefit plans, are not insured by the Pension Benefit Guaranty Corporation.

Hybrid Plan

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

Cash Balance Plan

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

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

Money Purchase Plan

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

Appendix A

DB-K Proposals Considered by the Group

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

DB-K Proposal No. 1. Under this proposed plan[53] from the American Society of Pension Actuaries, there would be a single trust established for both the 401(k) and either a traditional defined benefit plan or a cash balance plan. However, the trust would have strict recordkeeping requirements whereby the assets of each of the defined benefit and 401(k) components of the plan would be accounted for separately. Accordingly, for example, any excess assets associated with the defined benefit portion of the plan could not be used for purposes of employer contribution requirements to the 401(k) portion of the plan.

An advocate of this proposal suggested that many employers would likely choose a cash balance design over a traditional defined benefit plan for the defined benefit portion of the plan. The cash balance plan is a hybrid plan in which the employer credits contributions to a hypothetical account for each employee and guarantees a rate of return on money deemed to be allocated to those hypothetical accounts. (See definitions of plan types on pages 18-20 for information on cash balance plans.) The accumulated balance is converted to an annuity for payment at retirement age, but is typically made available as a lump sum payment.

In order for employers to take full advantage of the concept, the ASPA proposal would require under the defined benefit portion of the plan a minimum benefit formula for eligible employees of one percent of final average compensation times up to 20 years of service. The proposal would offer employers a cash balance design option instead of a traditional defined benefit design. For the cash balance design alternative, the proposal contemplates that employers would credit an annual contribution for eligible employees to their hypothetical cash balance accounts equal to five percent of compensation. However, the proposal also permits employers to increase contribution levels for older workers on a graduated basis so that the plan more closely mirrors the increased benefit values for older workers provided under a traditional defined benefit plan.[54] The plan also offered employers the choice of making a minimum contribution of five percent of pay to both the defined benefit and defined contribution side of the plan. The ASPA DB-K would also allow for additional accruals to the defined benefit arm of the plan based on what portion of income is contributed from compensation to the 401(k) side of the plan. In other words, employers could match employee contributions to the 401(k) plan by enriching the defined benefit side of the plan. There was considerable interest among members of the group in the plan, although there was some concern it might be an expensive plan, especially the graduated cash balance benefit.

DB-K Proposal No. 2. The Principal DB-K plan was similar to the ASPA DB-K plan. However, it offered only a traditional defined benefit plan and not a cash balance option. The traditional defined benefit portion of the plan was designed to provide a worker who put in 20 years of service an income equal to 25 percent of career average pay. It also offered an option where the benefit could also accrue at a higher rate over ten years.

DB-K Proposal No. 3. The DB-Plus Plan from the American Academy of Actuaries would allow employees to make pre-tax contributions to the defined benefit side of the plan. It would also allow for employer matches to employee contributions to the defined benefit side of the plan. Supporters of the DB-K Plus plan would seek legislative or regulatory clarification on current rules that would allow for employers who sponsor the plan to offer a higher rate of return for funds in the defined benefit side than is currently available under Internal Revenue Service rules to solve the so-called 'whipsaw' problem.[55] The plan would also allow for tax credits for contributions on behalf of low-income employees to be deposited into the plan. [56] The plan encourages employers to set up an automatic default election that would put new employees into the plan with automatic contributions of one percent to six percent of pay (with increases when salaries increased) unless the employee affirmatively requests otherwise. The DB-K Plus also allows for distributions beginning at age 59½ even without termination of employment. Allowing distributions at age 59½ would allow members to have a phased retirement beginning at that age. The PBGC would insure all of the benefits of the DB-K Plus, as long as it was funded appropriately. Some members were concerned that because both the defined benefit plan and the 401(k) are in a single trust, it could mean that the PBGC would be deemed to have guaranteed the 401(k) side of the combination. Others raised concerns that the proposal would allow excess assets associated with the defined benefit component of the plan to be used to offset the cost of employer contributions under the 401(k) component of the plan.

Appendix B

Proposals Considered and Not Endorsed

Risk-Splitting Defined Benefit Plans. After its May 2003 meeting, the group formed a subgroup on risk-splitting. Several suggestions to share the risk of market performance between the employer and the employees were advanced for consideration. A proposal was considered for guaranteeing only 75 percent[57] of the final benefit liability. Under this approach, the employee would share some of the risk associated with the funding obligation for 25 percent of the benefit, while the employer still retained responsibility for 75 percent. The group generally did not support any of the risk-splitting proposals. Those objecting stated such an approach would put additional burdens on the Pension Benefit Guaranty Corporation (PBGC), which insures defined benefit plans. The PBGC would face the difficult task of determining how much of the benefit should be paid if a plan is terminated and taken over by the agency. One member said that Congress would not be receptive to the idea of transferring risk to employees.

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

SAFE Proposal. SAFE stands for The Secure Assets for Employees Plan, which was introduced as legislation in 1997 by Rep. Nancy Johnson (R-CT) and Rep. Earl Pomeroy (D-ND).[58] This plan was designed to provide a minimum defined benefit that would be 100 percent funded.[59] It would be funded either by an individual retirement annuity or through a trust. SAFE sought to reduce the regulatory burden on employers, to reduce uncertainty about potential unfunded liabilities and to give employers more flexibility in managing the plan than is possible with traditional defined benefit plans.[60] Members of the group discussed the proposal but declined to endorse it. [61] Members suggested that the group should come up with new proposals and not revisit previous proposals. Some members, noting the group's greater interest in other proposals, cautioned against possibly supporting too many proposals. Some group members also expressed concern that SAFE permitted designs under which business owners could capture too much of the plan's aggregate benefits.

SMART Proposal. SMART stands for a Secure Money Annuity or Retirement Trust Plan, which was introduced by the Clinton Administration in February 1998 as a hybrid plan designed for business with fewer than 100 employees. Like the SAFE proposal, the SMART would offer a minimum guaranteed benefit at retirement[62] with the potential for additional investment return if the assets perform above the base 5 percent benchmark.[63] It would also be funded by an annuity or a trust. Members of the group discussed the proposal but declined to endorse it. [64] As with the SAFE, members were in favor of new proposals rather than revisiting previous proposals.

Improved Cash Balance Plans. The group discussed ways to make cash balance plans more attractive. Cash balance plans have been criticized for discriminating against older workers at some companies that switched from a traditional defined benefit plan to a cash balance plan. While some members strongly opposed cash balance conversions, there was some interest in cash balance plans that are started *de novo* by a company that previously did not have a defined benefit plan. Proposals to make cash balance plans more attractive included reduced insurance premiums for fully-funded cash balance plans and other ideas.[65] Despite interest in this challenge, the effort to improve cash balance plans was eventually set aside, largely because some court decisions and regulatory issues had clouded the outlook for such plans and strong political opposition had emerged to the plans.

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

Other Ideas Listed in the Binders. The group also briefly reviewed other proposals from a list included in the binder and chose not to consider further any of those plans for endorsement. One proposal considered was by Ted Groom and John Shoven to eliminate most of the federal rules governing pension plans, including nondiscrimination rules, as well as pension insurance and the Pension Benefit Guaranty Corporation. It was suggested by Groom and Shoven that more employers would offer plans if there were fewer rules governing them. The group also briefly discussed, but did not support, a proposal identified as the Individual Advantage Plan from Jim Davis of Milliman & Robertson that would allow workers the choice of the greater of a cash balance or a traditional formula.[66]

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

Appendix C

Contribution Calculations for the Guaranteed Account Plan

Case Study Showing Funding Method Over a Seven-Year Period

Synopsis of funding calculation:

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

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

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

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

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

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

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

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

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

(10) Maximum funding calculation (maximum deduction):

(a) Calculate 1.5 times the amount in (7)
(b) Subtract the amount in (2) from the amount in (10)(a). If this is a positive number, this is the most the employer can contribute on a deductible basis. If this is zero or a negative number, the maximum deduction is zero (i.e., the full funding limit).

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

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

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

Case Study

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

Year 1: Total participant compensation is $1,000,000
Normal cost = $60,000

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

GABs as of valuation date: $60,000.

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

Minimum funding: $60,000

Maximum funding: $90,000

Employer's actual contribution: $60,000

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

Normal cost = $66,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,100,000)

Actual earnings since last valuation date: $2,392 (about 4%)

Total value of assets as of the valuation date (before current year contribution is made): $62,392

The guaranteed return for this valuation period on the GABs from the prior valuation date: $3,000

GABs as of valuation date (excluding current year's contribution): $63,000 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $608 (i.e., assets minus pre-contribution GABs). This would be worth $776 in 5 years under the plan's guaranteed rate of 5%.

Amortization payment for shortfall: $140 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $66,140

Sum of GABs as of valuation date (including current year's contribution): $129,000

Shortfall on 100% funding: $66,608 (i.e., $129,000 minus $62,392)

Minimum funding amount: $66,140 (i.e., the lesser of the normal cost plus]payment or the 100% funding shortfall)

150% x GABs: $193,500

Maximum funding is: $131,108 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $66,500

Year 3: Total participant compensation is $1,340,000.

Normal cost = $80,400. This is determined by calculating the hypothetical contribution for this year (6% x $1,340,000)

Actual earnings since last valuation date: $1,154 (only a 1% rate of return).

Total value of assets as of the valuation date (before current year contribution is made): $130,045

The guaranteed return for this valuation period on the GABs from the prior valuation date: $6,450

GABs as of valuation date (excluding current year's contribution): $135,450 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $5,405 (i.e., assets minus pre-contribution GABs). This would be worth $6,897 in 5 years under the plan's guaranteed rate of 5%.
Amortization payment for shortfall: $1,248 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $81,648

Sum of GABs as of valuation date (including current year's contribution): $215,850

Shortfall on 100% funding: $85,805 (i.e., $215,850 minus $130,045)

Minimum funding amount: $81,648 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall)

150% x GABs: $323,775

Maximum funding is: $193,730 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $82,000
Year 4: Total participant compensation is $1,500,000.

Normal cost = $90,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,500,000)

Actual earnings since last valuation date: -$3,908 (a negative rate of return).

Total value of assets as of the valuation date (before current year contribution is made): $208,137

The guaranteed return for this valuation period on the GABs from the prior valuation date: $10,792.50

GABs as of valuation date (excluding current year's contribution): $226,643 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $18,505 (i.e., assets minus pre-contribution GABs). This would be worth $23,618 in 5 years under the plan's guaranteed rate of 5%.

Amortization payment for shortfall: $4,274 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $94,274

Sum of GABs as of valuation date (including current year's contribution): $316,643
Shortfall on 100% funding: $108,506 (i.e., $316,643 minus $208,137)

Minimum funding amount: $94,274 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall)

150% x GABs: $474,964

Maximum funding is: $266,827 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $99,000

Year 5: Total participant compensation is $1,400,000.

Normal cost = $84,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,400,000)

Actual earnings since last valuation date: $17,224 (6% rate).

Total value of assets as of the valuation date (before current year contribution is made): $324,362

The guaranteed return for this valuation period on the GABs from the prior valuation date: $15,832

GABs as of valuation date (excluding current year's contribution): $332,475 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $8,113 (i.e., assets minus pre-contribution GABs). This would be worth $10,355 in 5 years under the plan's guaranteed rate of 5%.

Amortization payment for shortfall: $1,874 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $85,874

Sum of GABs as of valuation date (including current year's contribution): $416,475

Shortfall on 100% funding: $92,113 (i.e., $416,475 minus $324,362)

Minimum funding amount: $85,874 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall)

150% x GABs: $624,712
Maximum funding is: $300,350 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $100,000

Year 6: Total participant compensation is $1,600,000.

Normal cost = $96,000. This is determined by calculating the hypothetical contribution for this year (6% x $1,400,000)

Actual earnings since last valuation date: $36,368 (9% rate).

Total value of assets as of the valuation date (before current year contribution is made): $460,729

The guaranteed return for this valuation period on the GABs from the prior valuation date: $20,824

GABs as of valuation date (excluding current year's contribution): $437,298 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $0 (the plan is now running at an experience gain)

Amortization payment for shortfall: $0 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $96,000

Sum of GABs as of valuation date (including current year's contribution): $533,298

Shortfall on 100% funding: $72,569 (i.e., $533,298 minus $460,729)

Minimum funding amount: $72,569 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall); the plan will have to be brought to full funding this year

150% x GABs: $799,948

Maximum funding is: $339,219 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $200,000 (Things are going well, the employer puts in extra for a rainy day and to get a bigger deduction)

Year 7: Total participant compensation is $2,000,000. Normal cost = $120,000. This is determined by calculating the hypothetical contribution for this year (6% x $2,000,000)

Actual earnings since last valuation date: $31,009 (5% rate).

Total value of assets as of the valuation date (before current year contribution is made): $691,738

The guaranteed return for this valuation period on the GABs from the prior valuation date: $26,665

GABs as of valuation date (excluding current year's contribution): $559,963 (i.e., the GABs as of the prior valuation date plus the guaranteed return on those GABs).

Shortfall: $0 (the plan is still running at an experience gain)

Amortization payment for shortfall: $0 (round to nearest $1), based on a 5-year amortization period

Normal cost plus amortization payment: $120,000

Sum of GABs as of valuation date (including current year's contribution): $679,963

Shortfall on 100% funding: $0 (i.e., assets exceed the GABs)

Minimum funding amount: $0 (i.e., the lesser of the normal cost plus amortization payment or the 100% funding shortfall)

150% x GABs: $1,019,945

Maximum funding is: $328,207 (i.e., 150% x GABs minus assets as of valuation date)

Employer's actual contribution: $0

Appendix D

Contribution Calculations for the Plain Old Pension Plan

Compensation Age	$30,000/year	$60,000/year	$100,000/year	$200,000/year
30	$585	$1,170	$1,950	$3,900
40	$960	$1,920	$3,200	$6,400
50	$1,584	$3,168	$5,280	$10,560
55	$2,043	$4,086	$6,810	$13,620
60	$2,666	$5,333	$8,888	$17,776
65	$3,537	$7,074	$11,790	$23,580

Mortality Assumption: 1994 Group Annuity Mortality table projected to 2002*
Interest Rate Assumption: 5%
Plan Formula: 'A lifetime pension = 1% times current compensation at age 65, payable monthly

**This is the mortality table required by IRS to calculate minimum lump sums from pension plans.*

Endnotes

[1]Traditionally defined benefit plans were designed to provide workers with a replacement income that, when combined with Social Security, would be sufficient enough to maintain their standard of living. However, some defined benefit plans are not designed to provide a replacement rate sufficient to maintain a worker's standard of living. Instead, they may be designed to provide supplementary income with a predictable income stream to add a worker's retirement income. For this reason, employees with a defined benefit plan will still need to assess how much they need in retirement and how determine much they may need to save to provide a sufficient replacement income beyond the income that will be available from Social Security and a stream of income from a defined benefit plan.)

[2]The normal benefit is an annuity, but many defined benefit plans offer a lump sum or other payout options. If a retiree does not elect an annuity, then the retiree is faced with the task of managing the lump sum over his or her retirement years. Increasingly, retirees from defined benefit plans can also select a lump sum option. In 2000, 45 percent of full-time private sector employees worked at firms with defined benefit plans offered a lump sum option, according to the Bureau of Labor Statistics. To the extent that retirees select a lump sum option, they must then also devise a plan for managing those assets during retirement.

[3]Private sector pensions insured by the Pension Benefit Guaranty Corporation are guaranteed up the statutory limits, now roughly about $44,000 if the benefit starts at age 65.

[4]From Department of Labor data for 2000 and 2001, as reported in Constantijn W. A. Panis, "Annuities and Retirement Satisfaction," Pension Research Council Working Paper PRC WP 2003-19, The Wharton School, University of Pennsylvania, mimeo, 2003, p. 8.

[5]Ibid..

[6]Patrick J. Purcell, "Pensions and Retirement Savings Plans: Sponsorship and Participation," (Washington, D.C. Congressional Research Service, October 22, 2003), p. 5.

[7]Ibid.

[8]Pension Benefit Guaranty Corporation, Pension Insurance Data Book, April 2004, Table S-33, p. 57.

[9]Ibid.

[10]Ibid, Table S-31, p. 55 and Table M-6 on p. 84.

[11]U.S. Department of Labor, Pension and Welfare Benefits Administration (now the Employee Benefits Security Administration), Abstract of 1998 Form 5500 Annual Reports, Private Pension Plan Bulletin, Number 11 (Winter 2001-2002).

[12]U.S. Bureau of Labor Statistics, Employee Benefits in Medium and Large Private Establishments, 1997, Bulletin 2517 (Washington, D.C.: U.S. Department of Labor, September 1999), Table 133, p. 107.

[13]U.S. Department of Labor, Bureau of Labor Statistics, National Compensation Survey: Employee Benefits in Private Industry in the United States, 2000, Bulletin 2555, January 2003, p. 66, Table 78.

[14]The 30-year treasury rate is used for calculation of the deficit reduction contribution and certain other purposes. In recent years Congress has provided temporary relief from the 30-year Treasury rate as the standard for calculating the benefit obligation. For plan years 2004 and 2005, employers can use a corporate bond rate.

[15]For employers, the group generally agreed that the following criteria should be considered: reduced regulation, low administrative costs, low contribution costs, high benefits for owners and officers, attractiveness to prospective employees, designs that are helpful in retaining current employees, designs with tax benefits to the company and owner, designs with contribution flexibility for the owners. For employees, the group generally agreed the following criteria should be considered: low costs and high returns, protection against investment risk, control over assets, portability of assets, protection against longevity risk, protection against inflation, tax benefits, psychological benefits of owning assets, simplicity and fairness for employees, and the adequacy of benefits provided under the proposal. From a public policy standpoint: effectiveness of the revenue dollars spent, and the degree to which savings are preserved for retirement rather than withdrawn earlier for other purposes. Proposals were also judged on how well they could be sold to Congress, employers and employees. They were also judged on how marketable they might be by financial institutions and benefits consultants.

[16]Nondiscrimination testing is required under Internal Revenue Service rules to ensure that highly compensated employees do not derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.

[17]On the contribution issue, the group explored the possibility that a combined 3 percent employer contribution for all employees to the defined benefit and defined contribution side of the plan would be sufficient to avoid nondiscrimination testing and top heavy rules.

[18]There was also support for providing a joint and survivor annuity on the 401(k) side, and for distributions as early as 59 ? years old on the defined benefit side to make it easier for workers to engage in phased retirement.

[19]The chief federal pension law is the Employee Retirement Income Security Act of 1974, often referred to as ERISA.

[20]As explained by the staff of the Joint Economic Committee in 2003 (See reference at the end), the full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent (for 2003) of the plan's current liability (including the current liability normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets (i.e., the average fair market value over a period of years). However, the full funding limit may not be less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full funding limit may be based on projected true benefits including future salary increases. The full funding limit based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter, but is slated to be reinstated in plan years beginning in 2010. Thus. in 2004 and thereafter, until 2010, the full funding limit is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the value of the plan's assets, but in no case less than the excess, if any, of 90 percent of the plan's current liability over the actuarial value of plan assets, as described above. Reference: "Present Law and Background Relating to the Funding Rules For Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation (PBGC)," Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and

Means on April 30, 2003, prepared by the Staff of the Joint Committee on Taxation, April 29, 2003.

[21]Traditional pension plans have to make up unfunded balances, according to descriptions prepared by the staff of the Joint Committee on Taxation in April 29, 2003 (See reference at the end), there are two categories of old unfunded liabilities (those that occurred prior to the plan year just ended). The employer has to calculate a current contribution required to amortize the unfunded liability for each of these two categories. The first amount is, in general, the amount necessary to amortize the unfunded old liability under the plan in equal annual installments until fully amortized over a fixed period of 18 plan years, beginning with the first plan year that starts after December 31, 1987. The second amount is, in general, the amount needed to amortize the additional old unfunded liability over a period of 12 years, beginning with the first plan year that starts after December 31, 1994. In addition, plans have to make a contribution for any new unfunded liability that occurs in the year just ended. If the plan is less than 60 percent funded, the employer must contribute 30 percent of the new unfunded liability into the plan. The applicable percentage decreases by .40 of one percentage point for each percentage point by which the plan's current liability percentage exceeds 60 percent. Reference: ("Present Law and Background Relating to the Funding Rules For Employer-Sponsored Defined Benefit Plans and the Financial Position of the Pension Benefit Guaranty Corporation (PBGC)," Scheduled for a Public Hearing Before the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means on April 30, 2003, prepared by the Staff of the Joint Committee on Taxation, April 29, 2003.

[22]Making the past service credit available to all employees would be deemed to satisfy the nondiscrimination requirements.

[23]However, if the plan is a profit-sharing, 401(k) or stock purchase plan, current law states the plan is not required to offer an annuity provided the spouse receives 100 percent of the account balance of the employee dies while covered by the plan. The law also states that if the plan does not offer an annuity and the employee does not die while covered by the plan, the employee can withdraw the account balance as a lump sum or other non-annuity payment without spousal consent when the employee leaves the plan.

[24]Elective contributions are contributions voluntarily made by employees into a retirement savings plan or pension plan.

[25]Under one safe harbor, the nondiscrimination test would be satisfied if the employer contributed 100 percent of an employee's contribution up to 3 percent of compensation and 50 percent an employee's contribution up to an additional 2 percent of compensation.

[26]The calculation for lump sums in all defined benefit plans occurs though a two-step process. This process presents special issues, however, when the plan in question is not a traditional defined benefit plan but is, instead, a plan whose benefit is an account balance. Several courts have held that the above-described procedure must be used to determine lump sum values for cash balance plans. The manner in which this is done is to credit interest through an employee's retirement age, convert the resulting retirement-age balance to an annuity, and then determine the present value of that annuity. Generally speaking, if the plan's crediting rate is higher than the statutory benchmark interest rate, the lump sum amount will be higher than the participant's balance in his account. Thus, a cash balance plan is not permitted to pay the account balance in these circumstances. This phenomenon has been called whip-saw.

[27]PBGC guarantees "basic benefits" earned before your plan ended, which include (1) pension benefits at normal retirement age, (2) most early retirement benefits, (3) disability benefits for disabilities that occurred before the plan was terminated, and (4) certain benefits for survivors of plan participants. PBGC does not guarantee health care, vacation pay, or severance pay.

[28]PBGC's maximum benefit guarantee is set each year under provisions of ERISA. For pension plans ending in 2004, the maximum guaranteed amount is $3,698.86 per month ($44,386.32 per year) for workers who retire at age 65. This guarantee amount is lower if you begin receiving payments from PBGC before age 65 or if your pension includes benefits for a survivor or other beneficiary. The guarantee amount may be higher if you retire after age 65 or if you are over age 65 and receiving benefits when the plan terminates.

[29]Underfunded single-employer plans pay an additional variable-rate premium of $9 for every $1,000 (or fraction thereof) of unfunded vested benefits. The proposed GAP would have the variable rate premium would be phased in for the first five years as follows: 20 percent for year 1, 40 percent for year 2, 60 percent for year 3, 80 percent for year 4 and 100 percent for year 5.

[30]The limits for contributions and benefits are within section 415 of the Internal Revenue Code. For defined contribution plans, the current annual contribution limit is currently $41,000 a year for 2004. For defined benefit plans, employers can contribute each year toward providing a maximum benefit at retirement of $165,000. However, employers face maximum tax deduction limits, too, that can limit the amount that can be contributed in any given year into defined benefit plans.

[31]The Tax Code sets the rules for converting the maximum allowable annuity into a lump sum for purposes of applying the maximum benefit limit applicable to defined benefit plans. Under that limit, defined benefit plans can pay no more than $165,000 a year as an annual retirement benefit. At the time the Working Group was meeting, the Tax Code required that plans use the 30-year Treasury rate for converting the annuity benefit into a lump sum for this purpose. Treasury has discontinued issuing 30-year bonds and the 30-year rate has declined considerably in recent years. This has meant that lump sums based on the 30-year interest rate assumption have been sharply higher than in the past.

[32]In fact, Congress in April 2004 passed a law to temporarily replace the 30-year Treasury rate with a 5.5 percent interest rate for two years (2004 and 2005) for purposes of calculating the maximum defined benefit limit.

[33]Nondiscrimination testing is required under the Tax Code to ensure that highly compensated employees do not derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is the Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.

[34]Plans are top heavy when key employees amass benefits greater than 60 percent of the entire pool of benefits. A key employee is any employee who during the plan year was: (1) an officer of the employer who received more than $130,000 (adjusted for cost of living) in compensation from the employer, (2) a 5 percent owners of the employer, or (3) a one percent owner who received more than $150,000.

[35]The name “cross-testing” refers to the rationale for these rules. The rationale is as follows: the present value of annual accruals in traditional defined benefit plans is larger for an older employee than a younger employee. For example, if a 25-year old employee and a 60-year old employee are each promised an annuity benefit of $1 at age 65, the employer must make a larger contribution for the older employee than for the younger employee because there will be less time for the contribution to earn interest. Treasury Regulations permit a defined contribution plan to test an allocation to an employee’s account as if it were a defined benefit with a present value equal to the contribution. Thus, the contribution is “cross-tested” as if it were a benefit under a defined benefit plan.

[36]The maximum contribution, however, is limited to $41,000 annually, under section 415 of the Internal Revenue Code.

[37]Current treasury regulations permit some plans to use new comparability testing methods only if they provide a 5% “gateway” contribution for all plan participants.

[38]Nondiscrimination testing is required under Internal Revenue Service rules to ensure that highly compensated employees do not derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.

[39]In some cases, it required some older workers to work several years before the balance in their cash balance account rose from the initial balance in the account at the time of the transition. This period in which no new benefits were added has been described as a period of wear away.

[40]The Working Group also discussed whether or not an employer should be required to wait two years after terminating a traditional defined benefit plan before being allowed to start a GAP. The members disagreed on this suggestion, with some noting that employers might instead terminated a defined benefit plan and adopt a defined contribution plan.

[41]The chief federal pension law is the Employee Retirement Income Security Act of 1974, often referred to as ERISA.

[42]The past service credit would be calculated by adding one-seventh of the past service career average compensation to the employee’s current compensation. For example, if an employee has always earned $20,000 per year and is entitled to 14 years of past service, the employee will be treated as earning $60,000 for the first X years of the plan for purposes of calculating the contribution. In this example, the employer could decide that only 50 percent past service credit is given, so the employee would only be deemed to earn $40,000 for those years. An employee who leaves before the full 7-year amortization period will only received the accrued past service credit that has vested on termination date. The reason for this is that, if pension benefits are viewed as deferred wages, the benefits earned after he plan is in effect are part of the bargained for package, but past service credit would be a windfall. Seven years of service for full accrual would encourage employees to give past service credit as a retention device.

[43]For example, an employer can tell an employee that his or her benefit at 65 was increased by 3percent, which translates into an additional accrual on this year’s salary equal to, for example, 1 percent.

[44]If a POPP were terminated and fully funded, the employer would have the option of keeping the plan and paying out benefits when due or transferring the benefit obligations and assets to the PBGC. If the employer transfers the benefit obligation and assets to the PBGC, annuitization would no longer be required, as PBGC would pay the benefit guaranteed under its authority, and lump sums would no longer be allowed.

[45]PBGC guarantees "basic benefits" earned before your plan ended, which include (1) pension benefits at normal retirement age, (2) most early retirement benefits, (3) disability benefits for disabilities that occurred before the plan was terminated, and (4) certain benefits for survivors of plan participants. PBGC does not guarantee health care, vacation pay, or severance pay.

[46]PBGC's maximum benefit guarantee is set each year under provisions of ERISA. For pension plans ending in 2004, the maximum guaranteed amount is $3,698.86 per month ($44,386.32 per year) for workers who retire at age 65. This guarantee amount is lower if you begin receiving payments from PBGC before age 65 or if your pension includes benefits for a survivor or other beneficiary. The guarantee amount may be higher if you retire after age 65 or if you are over age 65 and receiving benefits when the plan ends.

[47]Underfunded single-employer plans pay an additional variable-rate premium of $9 for every $1,000 (or fraction thereof) of unfunded vested benefits. The proposed POPP would have the variable rate would be phased in for the first five years as follows: 20 percent for year 1, 40 percent for year 2, 60 percent for year 3, 80 percent for year 4 and 100 percent for year 5.

[48]The plan could use cross-testing, permitted disparity and any other formulas permitted under Section 401(a) (4).

[49]A plan is top heavy when key employees amass benefits greater than 60 percent of the entire pool of benefits. A key employee is any employee who during the plan year was: (1) an officer of the employer who received more than $130,000 (adjusted for cost of living) in compensation from the employer, (2) a 5 percent owners of the employer, or (3) a one percent owner who received more than $150,000.

[50]Highly compensated employees are those who earn at least $90,000 a year.

[51]Under the Tax Code plans that meet the minimum contribution requirements of a safe harbor plan to avoid nondiscrimination testing must still also fall within the bounds of permitted disparity.

[52]The accrual rate is the percentage of final salary or final average salary which builds up for each year of service or membership of a defined benefit plan. For example, the plan may specify a retirement benefit of 1.5 per cent of final average salary for each year of service. The annual accrual rate, therefore, is 1.5 per cent (of final average salary). Can also be referred to as benefit scale.

[53]If the DB-K has a cash balance plan instead of a traditional defined benefit plan, the plan would require a 2 percent minimum contribution for workers under age 30, 4 percent for workers ages 30 to 40, 6 percent for workers ages 40 to 50, and 8 percent for those over age 50. Or, the plan could have a safe harbor if there is a combined 5 percent of pay contributed to both the defined benefit and defined contribution side of the plan.

[54]This alternative would provide a safe harbor from nondiscrimination testing for plans where the employer contributed 2 percent for employees under age 30, 4 percent for employees age 31 to 39, 6 percent for employees 40 to 49, and 8 percent for employees 50 and over.

[55]It has been suggested that IRS Notice 96-8 makes it difficult to provide a rate of return higher than the Treasury rate for employee contributions in a defined benefit plan. Since employees can get a higher return in their 401(k) plans, they would have little incentive

to voluntarily contribute to a DB-K plan if the return were going to be less. This could be done if policymakers clarified that Section 411(a)(7)(A)(i) of the Internal Revenue Code would apply to DB-K plans and, thus, allow the defined benefit plan to provide a market rate of return.

[56]In the Economic Growth Tax Relief and Reconciliation Act of 2001 (EGTRRA), Section 25B provides for a tax credit to match contributions from low-income employees into a defined contribution plan. The DB-K Plus proposal would make these credits available for a tax credit match for employee contributions to the defined benefit side of the DB-K Plus plan.

[57]The group also considered an approach that would guarantee only those benefits that had been in place for at least 10 years. The group also considered an approach that would set higher premiums for insurance from the Pension Benefit Guaranty Corporation (PBGC) for plans that have higher allocations to equities. Typically equities, over time, earn more than bonds; however, earnings can be very volatile. Reducing the equity exposure would reduce volatility in the pension funding obligation, a key employer concern that was identified by the group as impeding the implementation of defined benefit plans.

[58]The Secure Assets for Employees Plan Act was numbered H.R. 1656 and introduced in the House of Representatives on May 16, 1997.

[59]In the case of a SAFE Trust, the employer would be liable for additional contributions in years when returns in participant account did not earn 5 percent. SAFE plans would not be insured by the Pension Benefit Guaranty Corporation.

[60]Employers would fund the plan with contributions of 1, 2 or 3 percent of pay for each year they worked. In lean years the corporation could scale back the contribution to 1 or 2 percent. Individuals could also reap higher benefits than the minimum 5 percent return on funds in their accounts of the investments performed better than 5 percent.

[61]One objection to the SAFE plan was that its past service provision made it too rich for an IRA.

[62]Employees would be credited with either 1 percent or 2 percent of their salary for each year that worked, with 3 percent possible for the first five years of the plan.

[63]In the case of a SMART Trust, the employer would be liable for additional contributions in years when returns in participant accounts did not earn 5 percent. The employer who chose the SMART Trust would pay reduced premiums to the Pension Benefit Guaranty Corporation, which would guaranty the minimum benefit for the Trust. SMART Annuity plans would not pay a premium and the benefit would not be guaranteed by PBGC.

[64]One objection to the SMART plan was that it did not relax nondiscrimination rules, but simply provided a safe harbor.

[65]The group was asked to consider ways to solve the age-discrimination issues and the problems associated with whipsaw, which is a situation where an employee can get a benefit after leaving an employer that is higher than the employee's account balance.

[66]The Individual Advantage Plan was developed as a way to deal with cash balance conversions, but was also touted as a way for new plans to deal with older workers. One member said that he doubted anyone would start up a new plan that gave such a choice.

Questions & Ideas

Questions and Ideas from the National Policy Forum Working Group I

The Conversation on Coverage held a National Policy Forum on the proposals from this Working Group and others at the National Press Club on July 22, 2004. As part of that forum, people attending were invited to participate in break-out sessions to discuss the GAP and POPP proposals put forth by Working Group I. This section summarizes some of the questions, comments and suggestions addressed during the break-out session.

Many members of the Working Group were present to respond to questions and to take comments for the upcoming refinement and implementation phases of the Conversation on Coverage. Some of the responses below expand on comments made at the break-out session in order to provide background and context. It should be noted that while the Working Group spent a year on developing these proposals, this was a brief opportunity for those attending the conference to comment on them. Except for those on Working Group I, this was the first time the proposals were made public. The members of the other two Working Groups, for example, had not seen the proposals prior to the National Policy Forum. Those attending were invited to submit questions by card. Unfortunately, the group was unable to address all the questions submitted. A list of the questions that were not read for a response can be found in the footnote to this sentence. These questions will be looked at in the refinement and implementation phase.

Questions and Answers

Q. Is funding fixed on both the GAP and POPP – that is, are the assumptions used to calculate contributions specified? What happens if investment returns are higher or lower than the plans require?

A. Yes, the funding is fixed for both proposals. In the case of POPP, the contributions are higher than what would be required under current law for the same level of benefits because the funding assumptions are conservative. By specifying that the return on the accounts will be five percent, it will be easier for financial institutions to assure employers that they can meet that goal. It is expected that financial institutions will respond to POPP by offering products that can meet the five percent return. POPP allows employers to average performance over a ten-year period to smooth the results. Losses are made up over a five-year period. In the case of both POPP and GAP, plans are likely to use stable value types of investments, which are investments designed to produce a guaranteed rate of return, such as five percent. Some of them, however, can be variable tied to an index to match a similar guarantee in either POPP or GAP.

Q. Are there design elements in these plans that could be adopted by existing defined benefit plans to address problems in funding that they face?

A. The proposals that were developed by the Working Group were not designed to fix problems of existing defined benefit plans. They were, instead, designed to encourage those employers without a defined benefit plan to offer one of the two new proposed plans as a way of providing a plan that has a guaranteed benefit.

Q. Did the members of the Working Group consider that companies without a defined benefit plan might not want to assume the risk associated with the two proposals because the potential benefit to the

employer (providing a plan with a guaranteed benefit) was outweighed by the level of risk that would come with adopting the plan?

A. When members of the Working Group were designing both GAP and POPP, it was done partly with an understanding that employers would be able to transfer much of the risk for the guaranteed return to financial institutions. The risk would not be formally transferred. However, it is expected that financial institutions will offer employers products in which the plan can invest, and these products will provide the required return on assets that the plan specifies. To the extent employers are able to find the products that are tailored to meet the requirements of these plans – such as guaranteed interest contracts – the employer will have transferred most of the risk of managing the assets in the plan to a financial institution. Thus, the employer has a new benefit to attract and retain workers while minimizing the exposure of the company to market risks.

Q. POPP requires that the benefit be annuitized. GAP does not require the benefit to be annuitized. Did you consider requiring part of GAP to be annuitized? For both plans, would a requirement to annuitize present a problem for employers, since the private market is inefficient and such annuities might be expensive?

A. During the Working Group's discussions on GAP, there was a proposal to mandate that part of the benefit be paid as an annuity. The group did not reach agreement to support this approach. It was seen by those opposing it, as making GAP less attractive to employers. Opponents of a mandated annuity also noted that some retirees might not need an annuity because of other resources and, thus, might prefer a lump sum. Under the GAP proposal, employers could, of course, voluntarily offer an annuity option with GAP.

The Working Group also discussed whether institutions such as the Pension Benefit Guaranty Corporation should take on a new responsibility for paying out annuities for POPP, but the group did not reach agreement on this point. It was argued by those who supported this approach that it would be more cost effective if a single government institution took on the responsibility of paying annuities, the normal form of benefit for a defined benefit plan. This would avoid the likely higher cost of annuities that employers would pay if they bought insurance on their own.

Q. Why did you choose the GAP plan as a proposal instead of a floor offset cash balance plan?

A. The Working Group decided not to take on cash balance plan designs because of political and legal issues surrounding them. Instead, it reverse engineered a similar concept by taking a defined contribution type plan, the money purchase plan, and guaranteeing the return on balances in the plan.

Q. Will the design of the plan complicate your recommendation that it be insured by the PBGC?

A. Not necessarily. However, it will require legislation if either GAP and POPP are to be insured by the PBGC.

Q: What happens when a worker leaves a job before retirement and the sum is rolled over into a new vehicle?

A: POPP does not allow lump sum rollovers for early terminations. In the case of GAP, if a worker leaves a company with a GAP plan and asks for a lump sum rollover, he or she would no longer be able to earn the plan's guaranteed rate of return on the balance that was taken out.

Suggestions for Improving the Proposals:

Suggestion: You should allow a lump sum with the POPP. If a person leaves a job before retirement age, that person would be able to invest the balance and get a higher final benefit. It would also give them a chance to compensate for the fact that the plan is a career average benefit and not a final average pay benefit.

Response: Your suggestion regarding the lump sum would not likely lead to a higher benefit when a person is ready to retire. Here's why: if the balance that would have been taken out is instead left in the plan, it will continue to earn at the investment rate of return on which the plan operates. It does not simply sit there and remain the same balance. By contrast, if a person took the lump sum out and invested it and was able to earn the same rate of return as the plan, then the person would have the same retirement benefit. However, it is unlikely that a person who invests on his or her own would earn a higher return than the rate of return that the plan would earn over the intervening years. Thus, it is more likely that a person would have a higher benefit if he or she left it in the plan until retirement age.

Suggestion: Instead of having the PBGC insure the benefit for either POPP or GAP, why not just suspend interest credits if the company goes bankrupt or if it cannot catch up after an investment loss?

Response: There is a value to employees knowing that the plan is guaranteed by the PBGC. Because the funding restrictions are tight, the exposure for PBGC is reduced. Further, many in the Working Group conditioned their support of both POPP and GAP on their being insured by the PBGC.

Suggestion: Retirement plan proposals should be considered in terms of their relationship to the overall economy. The Conversation on Coverage should seek the input of financial economists on whether shifting more of the benefit package from wages to retirement benefits would result in additional costs. It would help to look at the experience of countries like Singapore, where saving is mandatory, and the United Kingdom, which supplements its social security program with a mandatory supplementary pension.

Response: Clearly, we need to research the economic implications of the proposals and the experiences of other retirement systems in the implementation phase of the Conversation on Coverage.

Suggestion: It would help if you were to provide examples of minimum funding rules and how the maximum deductible and accounting works for both POPP and GAP.

Response: The Working Group has worked out examples and they are included in this report as Appendix C (GAP) on page 36 and Appendix D (POPP) on page 44 of the report for Working Group I.

Suggestion: Why not recommend GAP for large employers?

Response: The GAP might be appropriate for larger employers. If the employer had a previously existing defined benefit plan, it would require terminating the plan and fully vesting the benefits of people who were in the plan. It was not the intent of the group to offer proposals that might have the effect of prompting employers with existing plans to terminate them. If, however, a larger employer currently has only a defined contribution plan, the Working Group generally agreed that such employers should be given the opportunity to add a GAP or POPP as a companion benefit to the defined contribution plan.

Suggestion: Why not design a plan that is divided into two parts to address the different needs of different age groups? One part would be a 401(k) for people in their 20s and 30s. Another part would be a defined benefit plan for people in their 40s and 50s. As people age at the firm, they could be transferred from the 401(k) part of the plan to the defined benefit part.

Response: The Working Group discussed such a proposal, but was unable to agree on this approach. Of course, an employer could have both types of plans, although that is not likely to happen at small- to mid-sized businesses.

Suggestion: How do you get around the paperwork hassles for smaller employers, along with the costs of having to hire actuaries?

Response: In the case of POPP, to the extent that the employer chooses a plan with simplified funding rules, conservative assumptions, published tables, and to the extent that the financial institutions provide the investment products to match the guaranteed return or benefit, the employer would not have to employ an actuary. The GAP plan, however, would require an actuary.

Suggestion: The two proposals do not represent new ideas, but appear to be different versions of the deferred annuity plan whereby the employer buys a piece of an annuity each year from a responsible insurance company. Why not add a deferred annuity option to an existing 401(k) plan?

Response: One could, of course, add an annuity option to an existing 401(k) plan. As for the proposals reflecting prior ideas, in some sense there are no new ideas in this area. So, it is no surprise that some proposals are "back to the future."

Questions Submitted on Cards:

The following questions were submitted on cards, but were not specifically addressed during the break-out session:

What can be done to continue coverage of workers in existing defined benefit plans, especially in light of freezes, terminations, and closing of participation to new workers?

How would you avoid the cash balance transition issue in converting a final pay defined benefit plan to a POPP?

Do you envision direct rollovers between POPP plans?

It seems to me that the funding rules and methods assume that conservative funding with existing rules works. Are you assuming that the maximum deductible limits go away?

For companies subject to Financial Accounting Standard 87 or international accounting rules, did you evaluate what the difference would be between the POPP funding and the accounting charge?

In the GAP, do you need to buy an annuity from an insurance company?

So long as the environment is chaotic, do you think people out of the system will get in, even if there are new plans?

Does the Working Group think that nothing will be fixed unless employer risk is lowered? (Lower risk could mean risk sharing or investing more in bonds.)

Does the group think that lower employer risk means lower benefit levels?

Is there a basis for estimating the coverage increase each of the two plans, POPP and GAP?

Working Group Two Report

Report on the Conversations and Recommendations of Working Group II

Working Group's Assignment

Answer This Question:
How do we increase coverage and retirement savings by providing new incentives to encourage employees to save for themselves, as well as incentives for employers to contribute increased amounts for employees in low tax brackets?

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Executive Summary

The proportion of workers who participate in workplace retirement plans has remained at or near 50 percent for many years, despite a number of efforts by Congress and successive Administrations to adopt policies intended to expand coverage. One of the goals of Working Group II was to look for ways to expand participation to include substantially more of the uncovered half of the workforce and to increase the level of saving by those who do participate. The group was especially focused on low and moderate income workers – those who are most likely to lack coverage by a workplace retirement plan.

The group set out to expand coverage and saving by offering to support proposals that are intended to do the following:

- Prompt more employers to offer access to retirement savings plans.
- Expand the number of workers who are eligible to participate in an existing employer-sponsored retirement plan.
- Increase the overall level of saving by workers in workplace retirement savings plans, especially among those who save the least – low and moderate income workers.

The group began as a collection of members with a great deal of expertise on the key issues before them, but with very diverse and strongly-held views. Over the course of more than half a dozen meetings of the entire group and additional subgroup meetings, the members hammered out a consensus in areas where members held common ground, often exceeding the expectations of its members concerning the degree to which agreement could be reached.

> "Think about the dramatic change we could make in the lives of people right now, who only have a modest income, if we could get them saving for retirement. That would give people peace of mind in their retirement years."
>
> Representative Rob Portman (R-OH) from his address at the Conversation's National Policy Forum, July 22, 2004.

The Retirement Investment Account Plan

The group's chief accomplishment was to reach general agreement on the broad outlines of a new centralized broadly-based savings account, the Retirement Investment Account Plan or RIA. This plan is targeted toward workers at companies that do not currently have a retirement plan, as well as workers at firms where there is a retirement plan, but where some workers are not eligible to participate. Further, the vehicle is designed to provide an additional source of retirement income on top of the benefits provided by the Social Security system

Members of the group supported the RIA because it was believed that this approach offers great promise in providing access to retirement saving for a substantial portion of uncovered workers. One of the reasons the proposed plan will be helpful is because it removes most of the administrative burden of sponsoring a plan, a key concern of employers who do not currently sponsor a plan. By giving employees access to a workplace retirement system, it is also likely to dramatically increase the chances that workers will contribute toward retirement savings and enhance their retirement income beyond the Social Security benefit.

As this report will show, much work was put into the details of a potential RIA plan and much progress was made on many building blocks of the system. Even where there was not general agreement on the details, there was often agreement on the framework in which the details could be resolved.

The group generally agreed on the following broad outlines of the RIA plan:

- **Accounts Will Be Managed By a Central Clearinghouse.** The RIA plan will be offered through a government-authorized central clearinghouse that would be run by the private sector.
- **Contributions Can Be Made Through Payroll Deductions.** The system would be set up to receive contributions from employees through payroll deductions by the employer of amounts indicated by employees. The system would also be able to receive contributions by employers.
- **How the Infrastructure Will Work.** The employer will send the employee and employer contributions to the U.S. Treasury, and the Treasury, in turn, will forward contributions to the central clearinghouse.
- **Participant Contributions Made in a Default Investment.** Contributions to the RIA plan will be placed in a default investment pool that will be a balanced, diversified fund, which could also be a lifestyle or life cycle fund.
- **Participants Can Select From Simplified Investment Choices.** Participants who wish to choose investments beyond the default choice will have a simplified choice of investment options chosen by the clearinghouse.

Policies to Expand Coverage in All Retirement Savings Plans

The members of the group also supported a number of initiatives they felt would increase the level of participation and the retirement saving by and for workers at companies where there is already a workplace retirement plan. These include:

- **Automatic Enrollment.** The group generally supported continuing the policy whereby employers voluntarily offer automatic enrollment to new hires as a way to prompt workers to contribute regularly to their accounts in the plan.
- **Automatic Rollovers.** The group generally supported designating the Thrift Savings Plan – an employer-sponsored saving plan for federal government employees – as a central national receptacle for rollovers for accounts with balances from $1,000 to $5,000 for employees who leave a firm. This policy would make it easier for many employers to roll over such sums and would likely preserve retirement savings for more workers.
- **Default Investment Mix.** The group generally agreed to support a change in federal pension law to provide a safe harbor that would allow employers to voluntarily offer employees a default investment option which would automatically place their contributions in a balanced, diversified fund that could be a lifestyle or life cycle fund.
- **Saver's Credit.** The members generally agreed to support an extension and expansion of the Saver's Credit, which provides 10 to 50 percent government matches for individual contributions of low and moderate income workers. The program is slated to sunset in 2007.
- **Financial Education.** The group generally supported a proposal to encourage high schools and colleges to provide basic financial education, including education on retirement saving and health care finances.

The Mission

The mission of Working Group II was to review and discuss proposals to increase the portion of the work force that participates in a workplace retirement saving plan, as well as to increase the level of overall retirement savings in plans. The group was also asked to review and discuss incentives for employers to contribute increased amounts for employees in lower tax brackets.

Principles and Standards

Members of the Working Group generally agreed on a list of principles and standards by which it would evaluate proposals. The principles include:

- The effort would be collaborative while inviting diverse thinking. It would focus on workers with incomes below the median, especially low-income workers, and it would consider the unintended consequences of proposals.

- Proposals should be efficient to administer and simple to communicate to workers and have a nationally consistent set of rules.
- Proposals should be judged on whether they are economically efficient and feasible, both in the short-term and the long-term, as well as whether or not they involve minimal interference in economic, investment and labor markets.
- Proposals should be judged on whether or not they offer flexible terms and rules for both employees and employers.
- Proposals should be politically viable, both in the short-term and the long-term.
- Proposals should be judged on whether or not they enhance retirement income security for all U.S. citizens.
- Proposals, when considered in total, should be equitable in their benefits and contributions. They should be equitable 'horizontally' (meaning that it affects people the same whether or not they have access to an employer-sponsored plan), as well as when viewed 'vertically' (meaning across all income levels).

Background

The goal of providing a retirement plan for all workers is an ambitious one. In 2004, for example, only about 59 percent of American workers had access to a retirement plan sponsored by their employer, according to the Bureau of Labor Statistics. A majority of these workers – about 50 percent – have access to a defined contribution retirement savings plan, such as the 401(k) plan. [1]

Employees participating in a defined contribution plan often save by determining what portion of their wages is to be taken from their regular pay and contributed to their plan. Employers often match those contributions. Workers who participate in defined contribution plans usually have the responsibility of determining how much they expect they will need to save for retirement and how much they would like to contribute out of each pay period. Workers also are often given choices among several investment options within a plan. When they retire, workers with defined contribution plans received lump sum distributions and, therefore, have to decide how to manage the accumulated savings to provide income across their retirement years.

Some of the areas where improvements can be made in coverage can be found in some of the details of the employer surveys of coverage in different segments of the workplace population. Medium and large businesses (100 employees or more) had a participation rate of 67 percent, while small businesses (99 or fewer workers) had a participation rate of 37 percent.[2] Further, the participation rate for all full-time workers of all private sector businesses was 60 percent, significantly higher than the 20 percent for all part-time workers.[3]

Expanding participation in workplace plans is important for other reasons. It appears to be the best way to increase retirement saving. If one looks at federal income tax return data, the proportion of filers who claim an IRA or Keogh deduction has been both fairly modest and steadily declining over time. From a peak of 16.2 percent in 1986, it fell to 3.5 percent in 2000 and 2001.[4] In contrast, the participation rate in workplace plans is 66.2 percent of those eligible for 401(k) plans (a population of workers that represents 32.6 percent of the private sector workforce).[5]

Increasingly, important decisions that will affect retirement income tend to fall on the shoulders of individual workers. If more workers are to be able to save for retirement, more of them need to have access to and participate in a workplace retirement savings plan. Potential opportunities to increase the proportion of the workforce with access to a retirement saving, and potential opportunities to increase participation by those already covered can be created in several ways, include the following:

- Employers who have plans can make it easier for more workers to participate in those plans.
- Employers who do not have retirement plans, which are predominantly in the small business sector, can sponsor plans. (Working Group III has focused its efforts on developing a proposal for the small business sector).
- Incentives, such as tax credits for employees and/or employers, as well as government contributions into accounts, can increase the level of overall saving in existing retirement plans.
- Beyond this, the government can create new saving vehicles that will be more attractive to smaller employers, as well as self-employed and contract workers.

- Employers who do not have retirement plans can facilitate access for its employees to new kinds of centralized savings vehicles that might be created.
- Government can also devise programs and incentives that target lower-income workers.
- Finally, efforts can be made to provide opportunities for financial education in high school and college so that more workers better understand the need to save for retirement and health care expenses, and also to be better prepared to plan for their future needs.

How the Working Group Went About Its Assignment

To meet the challenges set out above, Working Group II decided initially to focus on ways to increase overall saving in existing plans, and ways to expand access to employer-sponsored retirement saving plans to more workers. The group also looked at tax-based incentives, including tax credits and tax deductions.

The group looked at the existing Saver Credit program to see how it might be expanded and made permanent. It also looked at a range of incentives and ideas for improving coverage and saving – including automatic enrollment, default investment choices, and financial education – and reached agreement on a number of them. This is discussed in Section II of this report.

Working Group II also examined ideas for setting up a new type of savings account program that would be patterned after the 401(k) plan, but would be more widely available to workers and even non-workers. The group devoted considerable time to developing general agreement on the broad outline for a new individual account system named the Retirement Investment Account or RIA. The group examined how government credits and contributions might play a role in promoting retirement saving by low and moderate income workers, especially those who presently are not enrolled in an employer-sponsored plan.

Members were invited to express their opinions about the incentives and proposals to increase saving and coverage, as well as the broad outline of the RIA. The group sought to reach consensus on as many points as they could. At times, the group was unanimous or nearly-unanimous in supporting or rejecting a given point. In this instance, the group was said to have "generally agreed" or "generally disagreed" on that point. At other times, the group found substantial agreement, while there was minor opposition. At other times, the opposition might be strong. When the group disagreed on a point or provision, members were invited to offer different options that might address that particular issue. Members of the group were assured that strong opposition would be noted in the report.

SECTION I: The Retirement Investment Account Plan

Working Group II's primary accomplishment was its success in reaching general agreement on many of the broad outlines of a proposed new retirement vehicle, which the group named the Retirement Investment Account or RIA.

The Retirement Investment Account Plan at a Glance

The group generally agreed that the Retirement Investment Account would be offered through a new privately-run, centralized infrastructure overseen by the federal government. This system is designed to expand pension coverage and provide a benefit above and beyond the Social Security benefit. The areas of general agreement are described below.

The RIA and the new infrastructure are designed to make it possible to have a savings account vehicle potentially available to all workers, whether full-time, part-time, self-employed or contingent workers. Importantly, the RIA could potentially provide coverage to workers who are not currently covered by a retirement savings plan. The potential for a broadly-based centralized system to boost retirement savings has long been a hope for those who would like to see the United States create a means whereby all working Americans could participate in a payroll-withholding retirement scheme.

In the interest of a harmonious outcome, the majority of the group supported making the program voluntary, although a number of members strongly favored making it mandatory. There was also support for providing a means for workers to contribute directly to the central clearinghouse without going through payroll deduction. This could include making contributions when filing annual income tax returns.

The elemenets of the plan include:

Central Clearinghouse. A government-authorized central clearinghouse will handle contributions from employees into accounts in the RIA plan. The members generally agreed that the government will contract some or all of the services provided by the central clearinghouse to the private sector.

Employer Facilitates Contributions. Employers will voluntarily help facilitate contributions from employees to the RIA plan, but do not have to become involved as plan sponsors; i.e., sponsors of the RIA retirement plan. Thus, they do not have to assume the responsibilities, fiduciary liabilities, and other burdens of being a plan sponsor for the RIA plan.

Employee Contributions. Employees will indicate the level or amount of contributions they would like to have deducted from their wages on a regular basis on a revised W-4 form. The employer will transfer to the U.S. Treasury the amount that an employee has elected to contribute to the RIA plan when the employer submits regular tax payments. Treasury, in turn, will forward contributions as soon as possible to the clearinghouse.

Employer Contributions. Employers can also make contributions and matches of employee contributions[6] to the RIA. The employer contributions, too, are sent along to the U.S. Treasury and forwarded as soon as possible to the clearinghouse.

Default Investment Mix. Contributions to the RIA system will automatically be placed into a default investment in a balanced, diversified fund which could also be a lifestyle or life cycle fund.

Investment Choices. For participants who wish to make a choice other than the default investment mix, there will be a simplified offering of investment options chosen by the clearinghouse.

Government Credits and Matches. The RIA plan is set up in a way that would make it possible to offer government contributions and matches of employee contributions, as well as government tax credits. The group, however, while supporting government matches and tax credits in a general way, did not agree on a specific program.

Offered in Conjunction With Other Plans. Employers at firms that already sponsor 401(k) and other retirement saving plans can also offer their employees access to the RIA plans. The target group, however, consists of workers who are not covered by or are ineligible to participate in an employer-sponsored plan.

Contribution Limits. The group set limits on participant and employer contributions and matches at levels that are designed to prevent the RIA plan from undermining the success and appeal of the 401(k) plan, the SIMPLE,[7] and other defined contribution plans.

Members of the group looked at initiatives that members felt would be beneficial without consideration for their budgetary impact and acknowledge that whatever program that might be proposed would be dependent on the federal budget available at the time.

The Design Elements of the RIA Plan

The group devoted many hours to discussing the details of how the RIA plan would work and how it would fit into the array of existing retirement plans without detracting from any of them. The group was able to reach some agreement on some of the design elements, but was divided on other elements, sometimes strongly divided. Each of the broad design elements of the RIA plan are presented below, along with the outcome of the group's discussions.

The Infrastructure for the RIA Plan

The group discussed what type of infrastructure would work best to make the RIA plan accessible to employees, while reducing the potential burden on employers. The group also examined what would be needed in the infrastructure to implement potential government matches and tax credits for individuals.

Areas of General Agreement:

The RIA Will Be Run Through a Central Clearinghouse. The group generally agreed that contributions from employees and employers to the RIA plan will flow into a government-authorized central clearinghouse. This infrastructure would allow employees to have a portable plan, to the extent that a future employer also participates in the RIA plan, and to the extent other flexible methods are found for employees to contribute directly.

The Central Clearinghouse Will Be Privately Run. The group generally agreed that the government-authorized central clearinghouse would be run by the private sector. This approach was taken so that the RIA plan would not be seen by critics as creating a big government bureaucracy.

Employees Will Indicate Contributions on W-4 Forms. The group generally agreed that employees would indicate what amount of their regular pay and compensation would be earmarked as a contribution to the RIA plan.

Employer Will Remit Contributions to U.S. Treasury. The group agreed that employers will remit the employee-designated contributions to the U.S. Treasury. The group agreed that the employer also will send employer contributions to U.S. Treasury and will not remit directly to the clearinghouse.

The U.S. Treasury Will Transfer Contributions to the Central Clearinghouse. The group generally agreed that the U.S. Treasury will forward contributions remitted by the employer to the central clearinghouse. The group deferred any decisions on how this should be done or how quickly it should occur, but generally favored an approach that transferred the funds in a timely manner.

The Clearinghouse Will Credit Contributions Received from the U.S. Treasury. The group generally agreed that the clearinghouse will credit employee and employer contributions in designated individual accounts, as funds are sent to it by the U.S. Treasury.

Areas Where Views Differed:

Government Oversight Agency. The group discussed which agency would oversee the clearinghouse, but members decided that the proposal for the RIA plan should not get detailed.

Who Is Eligible to Participate?

The group discussed whether or not to include several groups of workers: those under the age of 21, part-time workers, contingent workers, contract workers, the self-employed, household workers, and non-working spouses. Currently, workers from these groups are often excluded from required coverage for most retirement savings plans sponsored by employers. Excluding them helps employers meet nondiscrimination requirements. Self-employed workers do have access to existing tax-preferred retirement savings plans, such as the SEP, Keogh, IRA, and SIMPLE IRA and SIMPLE 401(k).[8]

Areas of General Agreement:

All Wage Earners Eligible to Contribute. The group generally agreed that the RIA plan should be open to all Americans who earn an income. There were some, however, who did not agree. Some members preferred to limit access to the RIA plan to workers earning at least $5,000 a year. Some opposed to opening the RIA plan to all workers said they were concerned that it might set up a system that would collapse from having to administer millions of tiny accounts.

Self-Employed Can Participate in RIA plan. The group generally agreed that the participation of the self-employed would not be affected by whether or not employers are required to make the system accessible to employees through payroll deductions. The reason is that the self-employed could include their contribution into the RIA plan when they send the IRS their quarterly income taxes. One member suggested that participation of the self-employed be limited to those who earn at least $1,250 a quarter, which would maintain the $5,000 a year minimum income level for participation.

Areas Where Views Differed:

Direct Contributions By Employees. The group discussed how individuals might contribute to the RIA plan if they are not able to contribute through payroll deductions arranged by their employer. The group failed to reach agreement on how this might be done. However, there were several suggestions that were offered.

One member of the group suggested that an alternative method of contributing should be set up that would allow workers to make contributions to the clearinghouse when they file their income taxes every year. Another member suggested that workers be allowed to designate a portion or all of their refund as a contribution into the RIA plan.

Non-Working Spouses. The group could not reach agreement on whether or not non-working spouses should be allowed to contribute to a RIA plan, as is now allowed with IRA's.

Some in the group maintained that non-working spouses already have access to IRAs and that allowing them to participate in the RIA plan would make the system unnecessarily complicated. One member suggested, and others agreed, that the proposal remain silent about spouses but provide that it will be open to all citizens with earned income, which arguably would include what is allowed for contributions to IRA's by default. When spouses contribute to IRA's they are deemed to be self-employed with no reported income. Others in the group contended that explicitly offering the RIA to unemployed spouses would assist them in preparing for retirement.

Investment Options

The group discussed whether or not participants could be automatically enrolled in the plan, whether there might be a default investment choice, and whether there might be additional investment options in the plan.

Areas of General Agreement:

Automatic Enrollment. The group agreed that employers would be allowed to provide automatic enrollment. With this approach, a new employee would have to choose not to enroll. Otherwise he or she would be enrolled in the RIA plan.

Automatic Investment in Default Balanced Fund. The group generally agreed that if employees do not elect to choose an investment option(s), their contributions to the RIA plan would automatically go to a balanced,[9] diversified fund, which could be a lifestyle-oriented fund.[10] A balanced fund is a common name for an investment fund that invests significant portions of its assets in each of the major investment asset classes: shares or equities, real property, fixed interest investments and cash. Lifestyle funds are one type of balanced fund that allocates funds between different classes of investments based on the participant's age and risk tolerance, and which sometimes automatically adjusts the allocation as a person ages, becoming more conservative over time.

The group's recommendation regarding the default choice reflects a growing trend in the 401(k) system in favor of a default choice of a balance fund or lifestyle fund. When a default option is offered, a member said, about 75 percent of workers usually accept the default investment.

Clearinghouse Will Select Simplified Investment Options. The group generally agreed participants could elect to make a choice among one or more of a simplified offering of fund options. The group also generally agreed to let the choice of investment options to be determined by the clearinghouse.

One member suggested that the range of choices should be limited to the types of choices offered in the Thrift Savings Plan.[11] Another member suggested even fewer options: a balanced fund, an equity fund, and a short-term interest fund. One member suggested that some people may want a safer investment, such as Treasury bills or bonds. One member supported keeping contributions in the default investment in a balanced fund until the balance had reached a minimum level, which was not specified.

Employee and Employer Contribution Limits

All defined contribution plans, including the 401(k), have contribution limits that affect how much employees and employers can contribute. Such limits are put in place partly to reduce the drain on government revenues and partly to assure that owners and high wage earners do not take too great a portion of the overall tax benefits provided to retirement savings plans.

Over the years Congress has developed a range of simpler defined contribution plans with different sets of contribution limits than the popular 401(k). As new types of plans have been introduced, lawmakers have consciously tried to design them so that they do not work to undermine the success of existing plan designs.

Areas of General Agreement:

Why the RIA Has Contribution Limits. The group agreed that the RIA plan should have contribution limits for employee and employer contributions. The contribution limits would accomplish two things:

Limits could help assure that higher-paid employees and business owners do not disproportionally benefit from the RIA plan.

The limits could be kept low enough to prevent the proposed RIA plan from prompting employers to terminate their existing defined contribution plan, such as a 401(k) plan. The group supported the view that the RIA plan should not undermine existing plans or prompt them to be terminated. Plans like the 401(k) are seen to be helpful in increasing overall saving because they often feature employer-matching contributions to encourage workers to contribute. This feature, in turn, prompts workers to save who might not be inclined to save in a system without matches, supporters of the 401(k) plan contend. If an employer terminates a 401(k) plan because the RIA has similar contribution limits (which means the employer gets the same outcome in terms of benefit), it might reduce overall saving for retirement by the rank and file, according to supporters of the 401(k) plan.

Contribution Limits Should Be Lower Than Those For the 401(k) Plan. The group agreed that the contribution limits should be set lower than those for the 401(k).

One member explained his support for lower limits as follows: If new savings vehicles are set with limits that are too high, it would be a disincentive for small business owners to offer an employer-sponsored plan. Employers would instead offer workers access to the RIA plan. One member said that his business would drop its 401(k) plans "in a heartbeat" if the RIA plan were created with the same contribution limits as a 401(k). The reason is that the employer would no longer have to sponsor a retirement plan, educate workers about saving and offer matching contributions to get more of the lower-paid workers to contribute so that the plan could pass nondiscrimination tests.

Participant contributions to 401(k) plans are called elective deferrals in the Tax Code. For 2005, the limit was raised from $13,000 to $14,000. Similarly, the limit on the salary deferrals[12] was raised from $13,000 to $14,000 for 457 plans[13] of state and local governments and tax-exempt organizations. For SIMPLE plans, either SIMPLE IRAs or SIMPLE 401(k) s, the limit was increased from $9,000 to $10,000. IRA contribution limits for 2005, by comparison, rose from $3,000 to $4,000.

Participant Contribution Limits Set at $5,000 to $6,500. The group generally agreed that participant contribution limits should be limited to somewhere between $5,000 and $6,500. This contribution limit level would position the RIA plan in a niche below the 401(k) plan ($14,000 limit) and the SIMPLE ($10,000 limits), but above the IRA ($4,000 limit).

Employer Contribution Limit Set at $4,000. The group generally agreed that voluntary employer contributions could be allowed to the RIA plan and that such contributions should be limited to $4,000 a year. The RIA contribution limit would position the plan in a niche below the 401(k)'s $14,000 limit and also below the SIMPLE's $10,000 limit.

Employers Can Choose a Nondiscrimination Safe Harbor for Contributions. The group generally agreed to support a nondiscrimination safe harbor from having to conduct nondiscrimination tests. The safe harbor can be achieved in one of two ways:

- The employer contributes two percent of pay into the RIA accounts of all workers.
- The employer contributes a match of $1 for each $1 contributed by an employee into a RIA account for the first two percent of pay, followed by an employer match of 50 cents for each $1 contributed by an employee for the next two percent of pay.

Withdrawals and Distributions from Accounts in the RIA Plan

The group discussed when rules should apply for pre-retirement withdrawals for either loans or hardship, when changing jobs, when withdrawals can begin without penalty, and what rules would govern those withdrawals.

Areas of General Agreement:

Plan Allows Hardship Withdrawals, Does Not Allow Pre-Retirement Loans. The group generally agreed that the RIA plan would not allow loans on balances in the plan, but would allow for hardship withdrawals under tight rules. By contrast, in 401(k) plans, participants can take out loans against their balances and can have hardship withdrawals.

Loans were opposed because they would add to the administrative burden of the plan for the central clearinghouse. Further, some argued that it may be difficult to get the loan prepaid because the RIA plan is not an employer-sponsored plan where the employer can arrange for payroll deductions to repay the loan. Finally, it was argued that loans would add difficult complications to implementing potential government tax credits. One member, however, strongly opposed a prohibition against loans, stating that the RIA plan should not be inferior to a 401(k) plan. This member further contended that loans could be repaid through payroll deductions.

Those in support of allowing hardship withdrawals under rules at least as stringent as those for 401(k) plans, noted that it was important for low and moderate income savers to know that they could have access to their savings if they had an emergency. Otherwise, some would not contribute to the RIA plan or might contribute less if no pre-retirement hardship withdrawals were allowed.

No Need to Withdraw Funds When Employees Change Jobs. The group generally agreed there was no need for employees to withdraw funds due to a plan termination by the employer or because an employee changes job, since the RIA plan is associated with a central clearinghouse. Even if an employee's new employer does not participate in the RIA plan, the funds in the account can continue to enjoy gains from its investments. Also, contributions could potentially be continued directly to the government when participants file their annual income tax return.

No Early Withdrawals of Government Contributions. The group generally agreed that government contributions or matches to accounts in the RIA plan could not be withdrawn at all before participants are eligible to withdraw employee and employer contributions without penalty. This prohibition was supported because it would assure that government contributions would go toward supporting participants in retirement and not for pre-retirement living expenses. (See section on Government Contributions)

Withdrawal Rules Made Consistent for Government, Employer, and Employee. The group, while disagreeing on what the retirement age should be, did agree to make the age uniform for all sources of contributions – individual, employer and government – to avoid administrative complications if one source of funds faced special age restrictions.

Roll Over Accounts Will Maintain Restrictions on Government Contributions. The group generally agreed that the prohibition against early withdrawal of government contributions would apply to funds from an account in the RIA plan that are rolled over to another retirement saving plan. (See discussion on Government Contributions).

Areas Where Views Differed:

Age When Withdrawals Can Be Made Without Penalty. The group was unable to agree on what age a participant could begin to withdraw funds from an account in the RIA plan without a penalty for early withdrawal. While the group was agreed that the age should be the same for all contributions – individual, employer and government – the group was divided into two groups about when the retirement age should be set for withdrawals. Some members preferred setting the age at 59½, which is the age when participants can begin to withdraw from a 401(k) plan without penalty. Other members, however, preferred setting the retirement age the same as those for Social Security, where retirees can begin to collect a reduced benefit at age 62, and those born in 1940 can collect the full retirement age benefit at 65 and 6 months in 2005 (although the age will increase gradually for later birth cohorts until it reaches 67 in 2027 for those born in 1960).

Those who favored withdrawals without penalties at age 59½ said that the RIA plan should not be designed to be inferior to the 401(k) plan. The members preferring a later retirement age argued that it would preserve the government contribution until retirement age. Group members favoring a higher uniform age argued

> "I think the Conversation has really been quite extraordinary . . . it has brought together a broad array of interests. Really most every expert that I've come across in my years of work in this business appears to be involved in this common endeavor."
>
> Representative Earl Pomeroy (D-ND) from his address at the Conversation's National Policy Forum, July 22, 2004.

that a higher age for withdrawals without penalty could still allow for early withdrawals without a penalty due to disability, using the disability rules as defined by the Social Security Administration.

Rollover Rules. The group left unresolved the question of whether or not age restrictions set for the RIA plan might apply to funds that were rolled over from a RIA plan to another retirement savings plan. While the group did support the idea that government funds could not be withdrawn until retirement age as defined in the RIA plan, it was not decided whether or not the age at which funds can be withdrawn without penalty, if different, would be transferred to the rollover account in another retirement plan.

Tax Credits, Including Government Matching Deposits

The group discussed ways to encourage employees to contribute to RIA accounts by using an array of tax credit approaches. A tax credit is a direct reduction in the tax payment that would otherwise be required from a taxpayer. There were three kinds of tax credits that the Working Group thought merited discussion and which could prompt employees to contribute more to the RIA plan:

1. Refundable tax credit: An income tax credit is "refundable" if it is designed so that it could result in a refund (i.e., a payment from the Treasury to the taxpayer). The refund payment can take the form of either a check from the Treasury to the taxpayer or a direct deposit by the Treasury to the taxpayer's bank account. Whether paid by check or direct deposit, the refund can be used any way the taxpayer wishes; the taxpayer could choose to spend it or save it.

A refundable tax credit first reduces or eliminates the amount of income tax that the taxpayer might otherwise owe (if any). If the credit exceeds the person's income tax liability, the excess is paid to the person (by check or direct deposit) as a tax refund.

> ***Example:*** Taxpayer owes $200 in income tax and is eligible for a $300 refundable tax credit. The credit first wipes out the $200 tax liability. The remaining $100 of the credit is refunded to the taxpayer.
>
> If, instead of $300, the credit had been only $150, it would have reduced the taxpayer's income tax liability from $200 to $50. In that case, the taxpayer would have paid $50 in tax and would not have received any refund.

2. Nonrefundable tax credit: An income tax credit is "nonrefundable" if it is designed so that it cannot result in a refund. A nonrefundable tax credit reduces or eliminates the amount of income tax that the taxpayer might otherwise owe. But if the nonrefundable credit exceeds (and therefore eliminates) the person's income tax liability, the excess is not refunded to the person. The same result – no refund – also applies if the person never had any income tax liability in the first place. Therefore, a nonrefundable credit is of no value to a low-income person who owes no income tax.

The Saver's Credit (discussed in detail on pages 55-56) is an example of a nonrefundable credit. If someone whose income is $50,000 or less (in the case of a married couple; $25,000 for a single person) contributes to a 401(k), another employer plan, or an IRA, then they get a tax credit equal to a percentage of their contribution, but only up to the amount of their tax liability (which is what makes it nonrefundable). The percentage of the contribution that generates a credit may be 10%, 20%, or 50%, depending on the taxpayer's income. The amount of the credit is limited to $1,000 for individuals, $2,000 for married couples.

Because the Saver's Credit is nonrefundable, it fails to reach some 50 million households who would otherwise qualify for it because their income is low enough but who receive nothing from the program because they have no income tax liability. The group discussed expanding the Saver's Credit by making it refundable in order to make it valuable to most of the lower-income households that it was designed to benefit.

> ***Example:*** taxpayer owes $200 in income tax and is eligible for a $300 nonrefundable tax credit. The credit wipes out the $200 tax liability. The remaining $100 of the credit is not refunded to the taxpayer; it simply disappears (or perhaps, if the rules governing the credit permit, the excess might be carried forward or back to reduce the taxpayer's income tax liability in a later or earlier year).

3. Direct government deposit of refundable tax credit: A refundable tax credit could be designed so that any refund is deposited directly into the taxpayer's RIA account in order to ensure that it is saved (rather than the refund being paid to the taxpayer as a check or direct deposit to their bank account, which, in either case, could be spent for any purpose instead of being saved). The group had various questions about this approach, as discussed below.

Areas of General Agreement:

Employers Might Be Allowed to Contribute to RIA Accounts. The group discussed whether employers (not merely employees or other individuals) should be allowed to contribute to the RIA. Most members favored this, although some raised concerns about whether this would ultimately threaten the viability of employer-sponsored plans and complicate the application of nondiscrimination standards. The group also generally agreed that, if employers contributed to the RIA, the government could match those contributions by contributing additional amounts to the RIA. (Costs were not part of the discussion in this round of the Conversation.)

Start-Up Subsidy for the RIA System. The group generally supported providing a start-up tax subsidy to get the infrastructure of the RIA plan up and running and able to sustain itself. (Again, costs were not factored yet into the discussion).

Areas Where Views Differed:

Government Can Offer Refundable Tax Credits. There was strong support, but not general agreement for the government to strengthen the RIA by offering tax credits that could be spent by individuals – as opposed to limiting government credits to only direct *contributions* into individual accounts within the RIA plan. Supporters of this approach noted that workers might be more inclined to put money into an RIA if they know that, in return, they will get a government match in the form of a check from the Treasury as cash. One member strongly supported the view that tax credits paid out in cash refunds (by check) to individuals would be more likely to increase overall saving for retirement. However, some members objected to this approach because they felt that if government matches went directly into RIA accounts instead of into the hands of employees, it would better serve the goal of promoting retirement savings. By this, they mean that the total amount of saving would be higher if the refund, too, went into the RIA account and was not paid out.

Government Credits and Matches Deposited Only in RIA Accounts. There was considerable support, but not general agreement, for depositing into the RIA plan account all government contributions and matches of employee contributions made to either the RIA or 401(k). Some of those who supported this approach said it would avoid administrative complications for the 401(k) system, such as trying to track down a former employee a year later when a government contribution arrived. Government matches, likely to be based on income levels, could not be made until an individual has filed an annual income tax return. Some members strongly opposed having government funds go only to the RIA plan, claiming it would undermine the 401(k) system. Another member favored having government matches deposited in either the 401(k) or the RIA.

Government Can Offer Matches and Tax Credits. Some members of the group supported a policy of both government contributions into individual RIAs, as well as tax credits that could be spent by individuals. The group as a whole, however, did not generally agree to support this approach. Members supporting an approach that would combine both a match and a tax credit, also recommended making it more attractive to choose the government match to be deposited into a RIA, rather than receive a check from the government that can be spent any way individuals wish. For example, a participant could choose between two options: (1) the government could deposit $500 into an account for a participant who contributed $1,000 to a RIA; or, (2) an employee who contributed $1,000 to a RIA could receive a $250 tax credit to be spent any way an individual chooses.

Can Employers Count Government Contributions for 401(k) Nondiscrimination Testing? The group did not support a suggestion to allow employers to take into account government contributions to RIAs for their employees when they conduct nondiscrimination tests for their 401(k) Plans. One member who objected to this approach said it would lead to fewer employer contributions to 401(k) plans, and recommended instead a tax credit for employers who make contributions to low-income workers that are above the level required under nondiscrimination rules.

Government Seed Money and Super Matches. Most of the members agreed that tax incentives, such as small contributions for some or all RIA accounts in the system, would be helpful. However, supporters of tax incentives did not agree on which incentives to support. Some members favored direct contributions to RIAs for workers making less than $40,000. Other members favored a super match for initial contributions that would benefit lower income workers, such as offering a supermatch for the first $5,000 of lifetime savings. Members of the group recognized that these types of programs could be relatively costly, and acknowledged that whatever program that might be proposed, would be affected by budgetary constraints.

Tax Credits for Employers. There was some support for a suggestion to provide tax credits for employers who made contributions or matches that are above and beyond the levels employers are required to contribute to meet nondiscrimination rules and tests. However, the group deferred discussion on this point and was unable to address the subject again due to time constraints. Similarly, the group failed to reach agreement on supporting a tax credit for employers who contributed a higher percentage of pay to low paid workers than is contributed on behalf of all workers.

Members of the group acknowledge that much more discussion is necessary to flesh out the options under government matches and tax credits. The group, as well, acknowledged that in the next stage of the Conversation, it would be helpful to have research to provide the costs of any of these proposals to the Treasury. The group generally decided that whatever tax credits would apply to the RIA should also apply to other employer-sponsored plans to ensure that there are not lopsided incentives favoring the RIA over employer-sponsored plans.

Should Employers Be Required to Provide Access to the RIA Plan?

The working group discussed whether or not to recommend that employers be *required* to transfer contributions from employees who wanted to participate in the RIA plan. Members of the group were asked whether or not they supported making the RIA plan mandatory in any or all of the following instances: (1) for workers at companies that do not offer employer-sponsored retirement plans, (2) for workers at companies that do sponsor plans who are *not* eligible to participate in those plans, and (3) for workers at companies that sponsor plans and who *are* eligible to participate in the plans.

After discussion, the majority supported making access voluntary on the part of the employer to garner business support for the RIA plan. However, there were two members who felt strongly that the RIA plan should be mandatory for all workers, regardless of whether their employer offered a plan, while two other members supported making it mandatory only for workers who do not now have access to a retirement plan. The majority, however, supported making access to the RIA voluntary on the part of the employer. Some members suggested that ways should be found to allow workers to contribute directly to the RIA, such as allow employees to direct tax refunds to be deposited in a RIA plan account.

Those who supported a voluntary RIA plan gave a range of reasons for their views. One member said he was against government mandates because they tend to discourage job formation and generally lead employers to reclassify workers into contract employees. In addition, the member said, mandates place a burden on small businesses. Another member argued that the burden of handling contributions would be far more onerous than some opponents realized. He noted that in his view it was employers, not the government, who do a great deal of the work involved with administering the Social Security system. Likewise, employers are the ones who will make the RIA plan work.

Those who supported making access to the RIA plan required for employers felt strongly about the importance of this proposed provision. One member said that the need to provide retirement savings opportunities to half the workforce without a plan is so great that it would justify making access to it mandatory for employers. If it were required, the member suggested that the next step would be to launch a massive educational program to convince more workers to participate. Another member supporting mandatory access said the burden on business would be trivial. One member said that if the program was not required, it might be better to devote available resources to expanding the Saver's Credit to get more workers participating in a retirement savings plan.

Next Steps: A Pilot RIA

Some members of the group supported a program to introduce the RIA plan on a pilot basis to demonstrate how it can help increase saving and how it can work along side existing employer-sponsored plans. The experience from a pilot, it was suggested, might demonstrate that the RIA plan does not impose an unworkable burden on employers. If this were to be demonstrated, it could lead to support for requiring all employers to offer access to the RIA plan, one member contended. Some members questioned whether it was feasible to do a pilot RIA, claiming it would be difficult to execute a pilot without new legislation and regulatory rules in place. One member was strongly opposed to a pilot, claiming that a pilot plan would be expensive to do, negating the low-cost advantage of the RIA.

SECTION II: Proposals to Increase Saving in Retirement Plans

The Working Group discussed a number of tax incentives, regulatory changes and other approaches designed to increase the number of workers covered in an already existing defined contribution plan, as well as to increase the amount of money saved and invested through the plan. They also looked at ways to increase coverage among low and moderate income workers who currently are either not in a plan or who save little through the plan in which they are enrolled.

Automatic Enrollment

When workers are hired, some employers automatically enroll them in the 401(k) or other defined contribution plan unless the worker specifically requests on government forms that he or she would not wish to participate in the plan. The group discussed whether or not this should be mandated and whether special incentives should be provided to encourage more companies to adopt automatic enrollment.

The group discussed whether or not employers who have an automatic enrollment program could automatically place employee and employer contributions in a balanced fund, including a lifestyle fund. The group also examined whether special incentives, such as changes in fiduciary rules, should be provided to encourage more companies to place workers in a default investment mix. Many employers who have automatic enrollment presently allocate by default the funds in the account to a money market or other low-risk, fixed income fund. However, some employers also already allocate available funds by default to balanced funds. Others may be reluctant to allocate by default to balanced funds because of concerns about fiduciary liability for the choices of participants in the plan, in a situation when the participant did not chose the investment, except by default.

Areas of General Agreement:

Automatic Enrollment of Workers. The group generally agreed that more employers should be encouraged to voluntarily offer automatic enrollment but that it should *not* be mandated by law. It was suggested that during the implementation phase of the Conversation on Coverage that a study be conducted of incentives to encourage automatic enrollment.

Safe Harbor for Default Investment into a Balanced Fund. The group generally agreed that employers should be given a safe harbor from fiduciary liability[14] when they direct the funds of an employee who has not made a choice among investment options into a balanced, diversified fund, including a lifestyle fund. Some members noted that it might be difficult to get Congress and/or regulators to support a safe harbor for such an approach, since such safe harbors are based on the assumption that the participant chooses the investment.

Automatic Rollovers

The group discussed whether or not employers should automatically place rollover funds of $1,000 to $5,000 from workers who have left the company, in an investment other than a money market fund or low-return investment. When workers leave a company, employers are allowed to pay out employee balances up to $5,000. Balances between $1,000 and $5,000, if paid from the plans, are automatically rolled over into an Individual Retirement Account or IRA unless the employee designates to the contrary.[15] Employees also can elect to take the money out of their retirement accounts.[16]

Areas of General Agreement:

Invest Rollovers for Better Earnings. The group generally agreed that when employees leave a company and are eligible for payouts of sums up to $5,000, it is important that amounts saved be retained for retirement purposes and not be spent on current needs.[17] The group also generally agreed that it is important that rollovers of sums between $1,000 and $5,000 be invested in a way that will earn the best risk-adjusted return for the worker.

Roll Over Small Balances to the Thrift Savings Plan or IRA. The group generally agreed that it would be helpful if there were a single national destination for rollovers that any employer could use to transfer rollovers. This would make it easier for employers to roll over the sums and encourage employees to save the funds for retirement. The employers would no longer have to choose an IRA, if they did not wish to do so, or if they found it to be a burden.

The group discussed whether or not to roll over funds to the Pension Benefit Guaranty Corporation or to the Thrift Savings Plan[18] which is a retirement savings plan for federal government civilian and uniformed workers. Some members of Congress have suggested designating the PBGC as a recipient for rollover funds. However, the group generally agreed that the Thrift Savings Plan would be the preferred destination. In addition, the group generally agreed that employers should be allowed to choose between rolling over small balances to the Thrift Savings Plan and rolling them over to an IRA.

The choice of the TSP as a destination for small balances was seen as helping alleviate concerns by the employer about choosing an IRA for a departing employee who fails to make a choice for the rollover. Some members in the group supported the proposal to roll over small balances to the TSP. Other members of the group, however, preferred to keep the option of allowing employers to roll over the small balances into an IRA. The group reached agreement to allow either one or the other.

Expand Saver's Credit

Currently, low and moderate income workers can receive a Saver's Credit up to $1,000 to encourage saving in a retirement saving plan. Enacted into law[19] in 2001, the Saver's Credit was first available in 2002 and is slated to end in 2007. The Saver's Credit can reduce the federal income tax a worker pays dollar for dollar. The amount of credit that one can receive is based on one's contributions into an IRA, 401(k), and other retirement saving plans. [20]

The amount of credit[21] available ranges from 10 percent to 50 percent, depending on adjusted gross income and filing status. Lower income workers are eligible for a higher credit. For married couples filing jointly, the credit is available on incomes $50,000 and under. For single people and married couples filing separately, the credit is available on incomes up to $25,000. In practice, most of the benefits have been paid out in 10 percent credits for couples filing jointly who earn between $35,000 and $50,000.

The Saver's Credit is not refundable. That is, if someone does not owe any taxes, then they cannot receive the credit in cash. The credit can only go towards reducing an existing tax liability. Although there are 57 million workers within the income brackets covered by the Saver's Credit, only about 20 percent are eligible to receive any benefit.[22] In this group only about 3.5 million have actually received a Saver's Credit by contributing to an eligible savings plan, and most have received only a 10 percent or 20 percent match.[23] Contributions are made to a 401(k) and rarely an IRA.[24] Only about one tenth of one-percent received a 50 percent match on a $2,000 contribution.[25]

The members discussed whether or not the Saver's Credit had increased coverage or saving. Members disagreed on how successful the Saver's Credit has been in promoting either goal. One member estimated that the program cost $10 billion in tax revenues. Members of the group generally agreed that it would be helpful to get detailed information on how the program has worked in its initial implementation, in order to evaluate what changes might improve coverage or saving for retirement.

Areas of General Agreement:

Extend the Saver's Credit Beyond 2007. The group generally agreed that the Saver's Credit program should be extended beyond its sunset in 2007.

Make the Tax Credit Refundable. The group generally agreed that the tax credit should be refundable so that more workers could enjoy the benefits. This means that workers who do not have a tax liability sufficient to cover the tax credit would be eligible to receive a payment for the part not covered by a tax liability. This means that if they owed, say, $200 in taxes and were eligible for a $300 credit, they would receive a payment for $100. Supporters stated that refundable tax credits are desirable because they promote greater saving by more workers. Some of those supporting a refundable credit expressed a preference for depositing the refundable portion into a retirement savings account rather than sending payments to eligible recipients.

There were some objections, too, to a refundable tax credit. One member was concerned about compliance issues, such as possible fraud. One member stated that refundable tax credits are less efficient in promoting saving than government matches. The member noted that $1 match would result in $2 of savings. A $1 tax credit might, however, only prompt $1 of saving if the tax credit is spent. There was also a concern that the government would impose costly complications that might be difficult to administer.[26]

Areas Where Views Differed:

Make the Saver's Program Permanent? The group was unable to agree on making the Saver's program permanent.

Raise the Percentage Match and Income Levels. The group discussed a variety of ways to raise the percentage of the credit available at various income levels. They also supported workers earning higher incomes than allowed currently be eligible for the credit. While the group *did not* generally agree on a new income schedule at which different percentage credits would apply, there was strong support for raising the tax credit to 75 percent for couples filing jointly who earn up to $40,000, with the credit phasing down to 50 percent for couples earning $50,000, and then phasing down to zero for couples earning $60,000. For singles and couples filing separately, the income limits would be half the level for couples filing jointly.[27]

Offer a Government Match for Employee Contributions? The group also discussed a government match for individual and employer contributions. There was support for a government match, but some members were unsure about one would devise a method for determining the match, and how the funds would be transferred into the plan. The issue is complicated by lack of an infrastructure for transferring the funds. It is also complicated by the fact that the government match could not be transferred into an account until after a worker making a contribution filed income taxes, at which time the worker's annual adjusted gross income would be known.

Employer Tax Incentives for Matching Contributions by Employers

Currently, employers are not eligible for tax credits or other tax incentives for making matching contributions to employees. The group discussed whether or not it was better to offer tax credits to employers or employees in order to help increase overall saving. They also discussed whether or not tax credits to employers or employees would offer the greater net gain in saving. Or, to put it another way, which would offer the biggest savings bang for the tax credit buck? The group also discussed whether or not tax credits for employers should be limited to small businesses, and whether credits should be offered only for contributions to the accounts of workers below a certain income level.

Areas Where Views Differed:

Employer Tax Credit. There was strong support, but not general agreement, for a suggestion to provide an employer tax credit that rewarded employer contributions or matches, provided it was tightly targeted at lower-paid workers in both large and small businesses.

There were concerns about how a tax credit would work, even among supporters of tax credits for employers. One member said that contributions would have to be 'high quality,' in the sense that they were provided only for employer contributions that were made almost entirely on behalf of the targeted low-income workers.[28] Some who supported a tax credit in principle worried how it might work in practice. One member who strongly opposed any type of employer tax credit said it is not true that this approach gives a greater bang for the tax credit buck. He claimed that if employees can get an additional tax credit if the employer matches the employee's contribution, it would have a similar affect on net retirement savings as providing a tax credit to the employer.

Members Offer Several Suggestions for Tax Credits. The group discussed several options for designing an employer credit without deciding to generally support any one of them. One member suggested a credit for employer contributions that are above and beyond what was needed to satisfy nondiscrimination tests.[29]

One member suggested a 50 percent tax credit to employers for contributions to non-highly-compensated employees.[30] One alternative was to offer a credit to employers for contributions to workers earning up to $40,000 or $50,000.[31] One member proposed making the employer credit a complementary part of the Saver's Credit, which is directed at employees. In this instance, the credit would be only for contributions above and beyond what an employer makes to the work force generally.[32]

The group discussed whether or not an employer tax credit might be limited because the targeted group of small business includes some companies without a big tax liability. To reach this group, it was suggested that any employer credit also be refundable and spendable.[33]

Intelli-Match Proposal to Benefit Low, Moderate Wage Earners

The group discussed the Intelli-Match proposal[34] that would provide a higher proportionate match or contribution to low and moderate income workers than it provides to workers in general.

Before employers could set up an Intelli-Match proposal, Congress would have to pass legislation to grant employers a safe harbor on nondiscrimination tests, since some workers would receive matching contributions at a higher percentage of pay than others. There are existing safe harbors which would allow employers to do this; however, they also require immediate vesting, which may be inconsistent with the business requirements of some employers. For this reason, the Intelli-Match proposal had a provision that employers would not have to provide for immediate vesting[35] to the employer match. This would reduce the overall cost of an Intelli-Match program for employers.

Areas of General Agreement:

The group generally agreed to support an adjustment in the terms of the safe harbor to make defined contribution plans more flexible for employers in return for a higher targeted match for workers earning up to $50,000.

Areas Where Views Differed:

The group did not agree on the provision in the Intelli-Match proposal that would eliminate immediate vesting, although it supported the broader concept, as noted above, that the employer would be given some additional flexibility in return for a higher match for low and moderate income workers.

Payroll Deduction IRAs

The group discussed ways to expand the availability of payroll deduction IRAs, including requiring employers to offer them at firms that do not have a retirement savings plan, as well as requiring employers who have a retirement plan to offer the payroll deduction IRA to workers who are not eligible to participate in that plan.

Under current law[36] employers are allowed to provide employees with the opportunity for making contributions to an IRA through payroll deductions. In 2005 employees are able to contribute up to $4,000 a year to a payroll deduction IRA, while workers over 50 can contribute an additional $500 directly to the bank.

Areas of General Agreement:

The group generally agreed that it would be desirable to expand payroll deduction IRAs.

Areas Where Views Differed:

The group was divided on this issue and did not agree to require employers to offer the payroll deduction IRA. As an alternative, some members suggested that workers be allowed to contribute part or all of their refund to an IRA when they file their annual tax returns.

Reducing the Risk in Defined Contribution Plans

The group considered several proposals that were designed to reduce the market risk that may occur when investment returns perform below historic averages for an extended period. A period of low returns can be of special concern if this occurs when workers are nearing retirement.

Areas of General Agreement:

Government-Issued Retirement Bonds. The Group generally supported encouraging employers to offer inflation-adjusted retirement savings bonds as an investment option in their plans. The group identified Treasury Inflation-Indexed Securities (TIPS) as a potential candidate for this option.

Areas Where Views Differed:

Government Insurance for Defined Contribution Plans. It was proposed that the government insure the difference between a career average return on investments, and the actual return on investment in a worker's account at the time of their retirement, death or disability. The group did not endorse any form of government insurance for contributions or investments in defined contribution plans.

Combination Defined Contribution/Cash Balance Offset Plan. The group decided against considering a proposal with a defined benefit[37] component, as it was seen to be within the scope of Working Group I on defined benefit plans and not within the scope the assignment set for Working Group II. A proposal had been submitted to recommend adding a cash balance plan to a 401(k) in order to assure that a portion of the retirement saving would have a guaranteed return no matter what happens to the markets.

Raising the 70 Percent Coverage Requirement

Under tax law, 70 percent of employees must participate in a retirement plan in order for the plan to qualify as nondiscriminatory.[38] In addition, plans can exclude from this calculation employees who work less than 1,000 hours a year. Some members suggested that it might be possible to increase the required level of coverage to some level above 70 percent of workers. The group also considered whether or not to recommend that employers be required to include more part-time and contingent workers to the standard required to be nondiscriminatory.

Areas of General Agreement:

The group generally agreed there should be more study of the impact of raising coverage above 70 percent and increasing part-time coverage.

Areas Where Views Differed:

The group was unable to reach agreement on supporting either raising the 70 percent level or increasing the number of part-time and contingent workers. There was strong disagreement over the proposal to increase the number of part-time and contingent workers. Some members said that the group needed data to demonstrate the impact of both approaches to determine which would be more effective, while others were willing to support these approaches without more data.

Other Proposals:

Areas of General Agreement:

Improving Financial Education and Literacy. The group generally agreed to support instruction on financial literacy for high school and college students. However, the group did not recommend making it a requirement for graduation, as one member had suggested.

Tightening Coverage Rules. While not making any specific recommendations, the group generally supported the proposition that coverage rules should be tightened. However, the group also generally agreed that more studies are needed to measure the impact of various proposals before endorsing them.

Endnotes

[1]U.S. Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2004,",November 2004, Table 1, p. 5. From the web site at http://stats.bls.gov/ncs/ebs/sp/ebsm0002.pdf. The survey does not include workers employed by state and local governments, the federal government or the military.

[2]U.S. Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2004,",November 2004, Table 2, p. 6. From the web site at http://stats.bls.gov/ncs/ebs/sp/ebsm0002.pdf. The survey does not include workers employed by state and local governments, the federal government or the military.

[3]Ibid.

[4]U.S. Department of the Treasury, Internal Revenue Service, Statistics of Income Bulletin, (Winter 1984-1985, Winter 1986-1987, Winter 1990-1991, Winter 1993-1994, Winter Fall 1995, Winter Spring 1996, Fall 2001, and Winter 2002-2003).

[5]Craig Copeland, "Retirement Plan Participation and Features, and the Standard of Living of Americans 55 or Older," EBRI Issue Brief Number 248 (Washington, D.C.: Employee Benefit Research Institute, August 2002), Figure 2, p. 8.

[6]The W-4 is the form the IRS requires to be filled out by new employees for tracking payroll taxes and deductions.

[7]SIMPLE IRAs and SIMPLE 401(k)s are available to small business with less than 100 employees, as well as self-employed people. SIMPLE stands for Savings Incentive Match Plan for Employees.

[8]SIMPLE IRAs and SIMPLE 401(k)s are available to small business with less than 100 employees, as well as self-employed people. SIMPLE stands for Savings Incentive Match Plan for Employees.

[9]A balanced fund aims to produce high rates of return over the medium to long-term. In terms of risk levels, a balanced fund usually occupies a middle position. It is more volatile than a fund with primarily cash and fixed interest investments. It is less volatile than a fund which invests only in equities and real property.

[10]In a Lifestyle Fund, the choices about how much to put into equities, bonds and cash are based on the risk tolerance of the investors and the investor's goals. Lifestyle Funds allow an investor to put all the assets in a single fund and not have to review or revise those investments. The fund periodically adjusts the allocation and gradually becomes increasingly more conservative as the investor moves toward retirement age.

[11]The Thrift Savings Plan offers only a handful of few investment options, which is generally seen to make it easier for participants to use and make decisions about investing. The TSP offers, for example, the following five choices: a Government Securities Investment (G) Fund, a Fixed Income Index Investment (F) Fund, a Common Stock Index Investment (C) Fund, a Small Capitalization Stock Index Investment (S) Fund, and an International Stock Index Investment (I) Fund.

[12]Some pension plans refer to the contribution made into the plan as a salary deferral because it reduces the amount of income that is counted for taxation purposes, while deferring taxes on that income until it is withdrawn later.

[13]SIMPLE IRAs and SIMPLE 401(k)s are available to small business with less than 100 employees, as well as self-employed people. SIMPLE stands for Savings Incentive Match Plan for Employees.

[14]Internal Revenue Code 404(c) requires a participant to make a choice in order to give employers a safe harbor from fiduciary liability for the participant's choice.

[15]Congress required employers to rollover sums for departing employees who do not make a choice in the Economic Growth and Tax Relief Reconciliation Act of 2001. Implementation of the policy cannot begin until Treasury issues regulations affecting the rollovers.

[16]If employees withdraw their money from a 401(k) account after leaving and job and do not deposit into an IRA or another 401(k) at their next job, they will owe taxes on the withdrawal, including a 10 percent penalty tax on amounts withdrawn before age 55.

[17]Congress required employers to rollover sums by for departing employees who do not make a choice in the Economic Growth and Tax Relief Reconciliation Act of 2001. Implementation of the policy can not begin until Treasury issues regulations affecting the rollovers.

[18]The Thrift Savings Plan offers only a handful of few investment options, which is generally seen to make it easier for participants to use and make decisions about investing. The TSP offers, for example, the following five choices: a Government Securities Investment (G) Fund, a Fixed Income Index Investment (F) Fund, a Common Stock Index Investment (C) Fund, a Small Capitalization Stock Index Investment (S) Fund, and an International Stock Index Investment (I) Fund.

[19]The Saver's Credit was part of the Economic Growth and Tax Relief Reconciliation Act of 2001.

[20]Saver's Credit also available for contributions to 403(b) plans, 457 governmental plans, SIMPLE 401(k) plans or SIMPLE IRA's.

[21]For married couples filing jointly, workers with income up to $30,000 are eligible for a 50 percent Saver's Credit for their contributions into a saving plan. Married couples earning $30,001 to $32,500 are eligible for a 20 percent credit, and married couples filing jointly earning $32,501 to $50,000 are eligible for a 10 percent credit. Those earning over $50,000 are not eligible for a credit. For single people or married people filing separately, the Saver's Credit is available for 50 percent of contributions for workers with incomes up to $15,000. Workers with incomes $15,001 and $16,250 can obtain a 20 percent Saver's Credit. Single workers and married people filing separately who earn between $16,251 and $25,000 can receive a 10 percent Saver's Credit on contributions. Slightly different earnings levels qualify a head of household: (50 percent for incomes up to $22,500; 20 percent for incomes $22,501 to $24,375; and 10 percent of incomes $24,376 to $37,500).

[22]Data provided by former Treasury official Mark Iwry.

[23]Ibid.

[24]Ibid.

[25]Ibid.

[26]A proposal to make the refundable amounts made available by a special savings bond payable on retirement and not through a tax credit has been made by Senator Jeff Bingaman (D-New Mexico.)

[27]For singles and couples filing separately, there was support for raising the credit to 75 percent for those earning up to $20,000. The credit would be gradually phased down to 50 percent for those earning $25,000. It would then be gradually phased out to zero for those earning $30,000.

[28]The member who proposed this suggestion said the definition of 'high quality' would have to be further refined.

[29]Nondiscrimination testing is required under Internal Revenue Service rules to ensure that highly compensated employees do not

derive a much greater benefit from a qualified plan than non-highly compensated employees. There are two broad tests. One is Actual Deferred Percentage (ADP) Test which measures the rate at which employees elect to make contributions. The other is the Actual Contribution Percentage (ACP) Test that measures the rate of employer matching and after-tax contributions.

[30]Non-highly-paid employees are those earn less than $90,000. Highly compensated employees earn $90,000 or more.

[31]In this proposal, employer contributions would have to meet "a certain quality of coverage" standard in order to qualify for the 50 percent tax credit, such as requiring that the first dollar of coverage awarded by employers would reach the target population within a given range. Companies would not qualify if they integrated their benefits into Social Security or if they engaged in cross testing to meet nondiscrimination testing requirements. Credit would be made for matching and automatic contributions. On matching contributions, employers had to provide at least a 20 percent match. On automatic contributions, the level would have to be 1 percent or 2 percent of pay. The credit was capped at 3 percent of pay for the employer contribution. It could also be provided for a 1 percent non-elective, 2 percent match. The target was low-income people, not just small business workers.

[32]The employer credit would be allowed made for employer contributions to workers earning less than $30,000, and be applied to contributions 1 percent or 2 percent of wages above the percentage contribution levels the employer was providing to all employees.

[33]One member described both the refundable and nonrefundable tax credits as "spendable" tax credits to differentiate them from contributions deposited into an account by the government.

[33]One possible Intelli-Match approach would be to provide a 100 percent match for employee contributions up to $2,000 or 4 percent, whichever is greater. A worker earning $100,000 could contribute up to $4,000 and receive a $4,000 match. A worker earning $20,000, however, might contribute $2,000 even though that would represent 10 percent of the worker's salary. Even so, the worker would still get a $2,000 match. The proposal would also provide a tax credit to the employer for the amount of employer match contributed to people making less than $50,000 that is above the percentage match give to owners and highly-compensated employees.

[34]An employee is said to be "vested" in a pension when the employee becomes entitled to the benefits of the plan, including employer contributions to a plan and their earnings.

[35]In 1975 the Department of Labor issue a regulation describing the circumstances under which the use of an employer payroll deduction program for forwarding employee monies to an individual retirement account (IRA) will not constitute an employee pension benefit plan subject to Title I of the Employee Retirement Income Security Act (ERISA) of 1974. Further, as part of the conference report on the Taxpayer Relief Act of 1997, Congress expressed its view that "employers that choose not to sponsor a retirement plan should be encouraged to set up a payroll deduction system to help employees save for retirement by making payroll deduction contributions to their IRAs." (H.R. Rep. No. 220, 10th Congress, 1st Session at 755, 1997).

[36]Defined benefit type plans are retirement plans offered by employers who promise to fund and provide a monthly retirement benefit to each eligible employee based on years of service and earnings.

[37]Internal Revenue Code Section 410(b).

Questions & Answers

Questions and Ideas from the National Policy Forum Working Group II

The Conversation on Coverage sponsored a National Policy Forum on the proposals from three working Groups, including Working Group II, at the National Press Club on July 22, 2004. This section summarizes some of the questions, comments and suggestions addressed during the break-out session for Working Group II.

Many members of the Working Group were present to respond to questions about the Retirement Investment Account (RIA) plan and other recommendations from this report and to take comments for the upcoming refinement and implementation phases of the Conversation on Coverage. Some of the responses below expand on comments made at the break-out session in order to provide background and context.

Questions and Answers

Q. What was the target population for the RIA plan?

A. The Working Group was concerned about individuals who did not have access to a plan either because their employer did not sponsor one or because they were ineligible to participate in an existing plan. In addition, the group targeted its efforts at finding ways to get low- and moderate-income people covered by a plan – either an existing plan type or the proposed RIA plan.

Q. What could be done to prevent the RIA from threatening existing 401(k) plans? And was the Working Group in favor of designing the plan so that it would not undermine the 401(k) plan?

A. The Working Group consciously designed the RIA plan so that it would not undermine existing employer-sponsored plans. For example, it set contribution limits lower than the limits for the 401(k) plan and the SIMPLE plan, but higher than the limits for IRAs. The plan also has fewer investment options and more restrictions on withdrawals than the 401(k) plan to simplify it and make it less expensive to administer. One member, however, supported giving the RIA plan to the same contribution limits as the 401(k) plan.

Q. Would it not be better to improve the 401(k) plan than to add a new type of plan?

A. The Working Group spent a good deal of time looking at ways to improve existing plans so that more workers would be covered, and those suggestions are included in this report. However, members felt that improving the 401(k) plan would not do enough to expand coverage because many workers are at companies without a 401(k) plan while others work for an employer with a 401(k) plan, but are not be eligible to participate.

Q. Did the Working Group discuss spousal protections and what protections would the RIA provide for spouses?

A. The Working Group discussed the idea of allowing spouses to contribute to separate accounts in the RIA plan as they can now do with IRAs, but did not reach agreement to specifically state that the plan would have this provision. However, several members agreed that the group should remain silent about spouses but state that the plan will be open to all citizens with earned income. This approach, it was argued, would include what is now allowed for spousal contributions to IRAs by default. That's because when spouses contribute to IRAs, they are deemed to be self-employed with no reported income. The group did not, however, address the issue of spousal rights to funds in accounts.

Q. Did the Working Group give any thought to which government agency should run the clearing house? And how many entities would be involved?
A. The Working Group agreed during its discussions that the RIA will be offered through a government-authorized clearinghouse that would be administered by the private sector. The details of how it would be operated are to be worked out in the refinement and implementation phase of the Conversation on Coverage.

Q. Can the default investment option in the RIA plan give weight to investments based on the age of the participant?

A. Yes. The default investment is in a balanced fund and the choices can include a life cycle fund, which is one that allocates funds based on the age of the participant.

Q. What sort of research data would be helpful in the next phase?

A. One group member suggested that behavioral economics would be helpful, especially studies that might reveal at what level a refundable tax credit match might prompt the most low income workers to make a contribution to a retirement plan in order to get the match. Another member said he would like to see research that could explain why people who are eligible to participate choose not to participate in employer-sponsored retirement savings plans. A member said she would like a survey of employers to determine whether or not they think it is worth the time to teach employees about finances.

Q. Given its potential appeal, should not employers be required to offer access to the RIA plan?

A. The members of the Working Group discussed at length whether or not employers should be required to offer access to the plan and ultimately, the group did not agree to require it to be mandatory, even though some of its members favored that approach.

One member of the group said during the break-out that he favored making it mandatory to offer access to the RIA plan in order to ensure that everyone is covered and also to make sure the plan is portable. Another member noted that employers have a strong negative reaction to making anything mandatory and this opposition would make it difficult to get Congress to adopt a mandatory plan. One member of the group said during the break-out, that making the RIA mandatory would undermine the existing employer-sponsored defined contribution plan system as employers with 401(k)'s would drop them in favor of an RIA plan.

Suggestions and Responses

Some suggestions do not have a response because none was offered during the break-out session.

Suggestion: Members from all three Working Groups should discuss the differences between their plans and why different approaches were taken to similar policy challenges. For example, the Model T Plan proposal from Working Group III allows for loans on account balances, but does not allow for hardship withdrawals – while the RIA plan from Working Group II allows for hardship withdrawals, but does not allow for loans.

Suggestion: Research should be done on how many people would be covered by the RIA plan and what design options would give it the widest enrollment. There should be a survey of the financial industry to see how much interest there would be in selling the plan once it is set up. There should also be a survey of the legal issues that might be involved with setting up the RIA plan.

Suggestion: The Working Group should give consideration to a more distinctive name than RIA. It is too similar to IRA and, thus, subject to confusion with an IRA.

Suggestion: Consideration should be given to how to help savers and investors allocate their savings for best results without having to learn a lot about economics and finance.

Response: One person suggested that technology could provide a solution to this challenge. A group member said that some of those in attendance might come up with some suggestions in the area of automatically managing investments after reading the details of the report.

Suggestion: Mandate automatic enrollment in 401(k) plans and other defined contribution plans.

Response: The Working Group generally supported the concept of automatic enrollment, but did not reach a consensus that it should be mandated. One group member noted that there are industries with high worker turnover where automatic enrollment would make it very hard for employers to pass nondiscrimination tests.

Working Group Three Report

Report on the Conversations and Recommendations of Working Group III

Working Group's Assignment

Answer This Question:
How do we increase coverage and retirement savings
through new institutions and structures?

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Executive Summary

Working Group III's goal was to explore and consider what role new institutions and structures might play in expanding the portion of the workforce covered by pension plans. After due consideration, the group chose to examine the role that financial institutions could play in increasing coverage, particularly among small businesses. Only about 35 percent of employees at small businesses (those with 99 or fewer workers) participate in a workplace retirement savings plan. The group also wanted to find ways to expand coverage for part-time workers. This group represents an even greater area of need since only 18 percent of part-time workers participate in a workplace retirement savings plan. Further, since small businesses employ more part-time workers, the effort to reach small businesses would potentially expand coverage for part-timers.

The group also recognized that workers are much more likely to save if they have a way to save through their employer. When such plans are offered, participation rates are high across the board, even if there is no employer match. One reason is that savings can be regularly deducted from a worker's pay check. In addition, once a decision to save is made, it continues automatically.

After reviewing a range of proposals aimed at reaching the target group, the Working Group decided to take the bold step of offering its own clean-slate proposal to reach the masses of uncovered workers. Taking a leaf from Henry Ford's highly successful strategy of designing a car for the masses, the group decided to name its plan the Model T. The new Henry Ford's who would put together retirement plans for the masses would be executives at regulated financial institutions: banks, insurance companies, brokerage firms, and mutual funds.

The Model T would have these features:

- All employees – full-time, part-time, contingent workers and even independent contractors [1] – would be eligible to participate if an employer agreed to be part of a plan. This is a striking departure from existing rules that allow employers to limit which employees might be eligible for such plans as the 401(k).
- Regulated financial institutions could be authorized to offer a simplified plan to groups of employers. This could include insurance companies, banks, brokerage companies and mutual funds.

> "Unless we make some significant changes in our retirement system today, three decades from now we will almost certainly have a system where we have a whole new class of impoverished retirees. We will either spend a relatively paltry amount of money now and dramatically reduce the number of retirees with no means of support other than Social Security or we will spend a lot of money later on down the line when we have tens of millions of retirees with nothing but Social Security."
>
> Representative Robert Andrews (D-NJ) from his address at the Conversation's National Policy Forum, July 22, 2004.

- The group generally agreed that there should be only three to five investment options and that they would include model portfolios that would be conservative, moderate and aggressive.
- Employers would be able to automatically enroll workers.
- If workers enrolled in a Model T plan make no choice among investments, the employer could designate that their contributions be invested in a mix of options that would be appropriate for their age and expected date of retirement.

Small businesses would be more likely to offer such plans because two of the chief reasons they say they currently avoid plans would be eliminated. First, the plan would be administered by the financial institution that provides it. Secondly, the employer would no longer be potentially liable as a fiduciary for the investment choices of employees.

Employers would be allowed to contribute to the plan, but would not be required to contribute. This, too, would address a concern by small businesses whose managers and owners worry that the business is too precarious and profits too uncertain to commit to employer contributions.

While tax credits for employer and employee contributions were seen as helpful, they were not deemed to be essential for the plan.

The Working Group supported giving sponsoring institutions flexibility to design plans to be marketed to employers in a specific region or city or even industry. This approach would make the Model T more appealing because it could meet the marketing needs of some financial institutions. For example, a bank in Peoria, Illinois could offer the plan to businesses in the Peoria area. The plan could also be targeted toward business categories, such as a Mississippi insurance company offering a plan for Mississippi construction and building trade groups.

Mission

The broad mandate of Working Group III was to find new institutions and structures to increase the portion of the workforce covered by a retirement saving plan and to raise the level of retirement savings. The members of the group looked at the role that financial institutions could play in providing new approaches that target workers employed by small businesses, where coverage and saving are much lower than in mid-sized and large businesses.

The group generally agreed they should try to develop broad outlines for a new plan they named the Model T plan, which would be a simplified, low-cost multiple employer retirement savings plan that could be sponsored by financial institutions, such as banks, insurance companies, mutual fund companies, and brokerage firms. The group set out to design the elements of the plan that explain how it might work to attract plan providers and employers. In working on the design elements of the plan, the group sought to find agreement on as many areas as possible and, where a consensus could not be developed, to identify areas where more work needed to be done.

Background

According to the Bureau of Labor Statistics, different segments of the workplace population have widely differing participation rates. The participation rate is 67 percent in medium and large businesses (100 employees or more). However, the participation rate was only 37 percent among small businesses (99 or fewer workers).[3] There is an ever sharper divide in participation rates between full-time (60 percent) and part-time workers (20 percent).[4]

Getting small business owners to sponsor plans is difficult, but not impossible. According to the 2003 Small Employer Retirement Survey (SERS) by the Employee Benefit Research Institute, 29 percent said they were likely to start a plan in the next two years.[5] At the same time, 68 percent said they were not likely to start a plan.[6] This represents a sharp decline in the number of small businesses that are likely to start a retirement plan in recent years. In 1998, for example, 42 percent of small business owners said they were likely to start a plan in the next two years, while 56 percent reported they were not likely.

The survey looked at a number of factors that could improve the chances that small businesses would offer a plan. It found that 73 percent of small businesses were more likely to start a plan if it did not require employer contributions, 67 percent were more likely to start a plan if the employer could get tax credits for start-up costs, 57 percent were more likely to start a plan [7] if the plan had reduced administrative requirements, and 55 percent were more likely to start a plan if it offered easy-to-understand information about the plan. Fiduciary responsibility is another stumbling block to employers sponsoring plans.

These data suggest that a plan that has the following attributes would likely prompt a good deal of interest among small business employers: a plan that offers discretionary contributions on the part of the employer, is easy to administer, reduces fiduciary liability for the choices of employees, provides tax credits for start-up costs, and is easy to understand.

Employer-sponsored pension plans still appear to be the best way to motivate workers to save for retirement. The federal income tax return data indicate that the proportion of filers who claim an IRA or Keogh deduction has been both fairly modest and steadily declining over time. From a peak of 16.2 percent in 1986, it fell to 3.5 percent in 2000 and 2001. [8] By contrast, the participation rate in workplace plans is 66.2 percent of those eligible for 401(k) plans (a population of workers that represents 32.6 percent of the private sector workforce). [9]

How the Working Group Went About Its Assignment

Working Group III first examined a range of existing proposals aimed at employees of small businesses. Instead of recommending any of those proposals, the group instead decided to start with a clean slate and design the broad outlines of a new proposal for a simplified multiple employer[10] or group plan that would be offered to small businesses by financial institutions.

In taking this approach, the group was also responding to a recommendation from the first Conversation on Coverage in 2001 to examine new types of model group pension plans that would enable groups of unrelated small employers to pool resources, thereby reducing administrative costs and fiduciary liability. [11]

Taking a leaf from Henry Ford's Model T, which became the symbol of affordable transportation for the masses, the group named its new plan the Model T multiple employer plan. It was the group's hope that it could be an inexpensive and accessible savings vehicle that could provide pensions to tens of thousands of workers in small companies.

Under the Model T plan approach the plan providers – banks, insurance companies, brokerage companies, and mutual fund companies – would assume fiduciary liability for the investment choices in the plan and would shoulder administration duties for the plans. The transfer of these two responsibilities from the employer to the plan provider was seen by the group as a means of addressing two of the key objections by small businesses to starting a new defined contribution plan. In addition, the simplicity of the proposal was seen as addressing another key concern of both small business employers and employees.

The Model T Plan at a Glance

The group generally agreed on the following broad outlines of the Model T plan.

Multiple-Employer Plan. It will be a multiple-employer defined contribution group or pooled plan and not an aggregation of individual retirement accounts.

Workplace Plan. The Model T will be offered by an employer to employees and independent contractors of the firm.

Administration by Third Party Provider. The administration of the plan would be the responsibility of the plan provider – a financial institution – and not the employer.

Financial Institutions Would Offer the Plan. Regulated financial institutions – banks, insurance companies, brokerage firms and mutual fund companies – would be authorized to offer the Model T plan, in much the same way the Internal Revenue Code now authorizes certain types of financial institutions and corporations to offer IRAs. The authorized institutions would market the plan to employers.

Limited Investment Choices. The group generally agreed that Model T plans would be required to offer a limited choice of three to five options that would consist of model portfolios and/or lifestyle funds, with the possibility of a guaranteed return investment option. The choices would be designed to make them easy for the employer and employee to understand.

Fiduciary Liability Transferred to Third Party Provider. The fiduciary responsibility for the investment choices will be transferred from the employer to the plan provider.

Default Investment Mix Option. Plan providers will have the option of offering participants in the plan the choice of selecting a default mix of investments based on a lifestyle fund or a model portfolio. [12]

Employee and Employer Contributions. Once an employer signs up with a plan provider, both the employer and employees will be able to contribute to the plan.

Securities and Exchange Commission Is Lead Regulator. While the Internal Revenue Service and the Department of Labor would play an important role in the regulation of the Model T plan, the Securities and Exchange Commission would take a leading role in the regulation and oversight of fiduciary and investment matters.

The Building Blocks of the Model T Plan

The group discussed in detail how the plan might be structured and what policies would govern the various elements of the plan. In many cases, the Group was able to reach a consensus, but in others there were varying opinions, or dissenting opinions. The outcome of the discussions of the various elements is presented below.

Building Block No. 1: Plan Providers

The group discussed potential plan providers to offer the plan to employers. This included banks, insurance companies, mutual fund companies, brokerage firms, and various financial intermediaries.

Areas of Agreement:

Regulated Financial Institutions Can Offer the Plan. The group generally agreed the regulated financial institutions can sponsor the Model T plan. This would include banks, insurance companies, brokerage firms and mutual fund companies. A number of members indicated they thought that a simplified Model T plan might be attractive to banks, which have not been as active in offering retirement plans as other financial institutions.

Plans Can Target Regions and Groups. The group generally agreed that plan providers could offer plans that are targeted to employers in a specific geographical or regional area or targeted at employers in specific categories of business and industry.

Authorized Providers. The group generally agreed to support a regulatory approach that is similar to the Internal Revenue Code provisions that govern who can offer IRAs. [13] These regulations would set out the procedures for designating which financial institutions would be authorized to provide the plan to employers. They also generally agreed that the process would be open to eligible financial institutions already regulated by a federal or state agency. This would include banks, insurance companies, brokerage firms, and mutual fund companies.

Brokers and Intermediaries. The group discussed whether or not brokers or intermediaries could pool contributions from self-employed individuals and forward them to a regulated financial institution plan provider. The discussion included such potential intermediaries as organizations representing freelance workers. It was generally agreed that an organization could be allowed to facilitate signing up its members in a plan offered by a financial institution.

Areas Where Views Differed:

Authorization Dependent on Target Participation by Low-Income Workers. There was a proposal by one member that the authority of financial institutions to offer the Model T be dependent on the ability of the plan provider to market the plan in such a way that a designated portion of the workers covered by the plan – perhaps 20 percent – would be low-income workers. This would follow the approach taken in the Community Reinvestment Act (CRA) toward regulating depository institutions. The group was divided on whether or not to support a CRA-type approach to licensing. One member who objected said it would increase the cost of the plan by increasing the level of detail in administering it. One member supported the use of the CRA-type approach by institutions offering the Model T but did not want to make it part of the eligibility requirements for a financial institution seeking to offer a plan. One member suggested that a study be made of 529 college saving plans[14] with CRA-type requirements to see if something could be adapted to suit the eligibility requirements for the Model T plan.

Commissions for Brokers and Intermediaries. The group also discussed whether organizations or even brokerage firms could pool contributions from a group of workers or small employers for a commission. The group could not agree, however, on whether organizations could earn fees for their work as facilitators.

Professional Employment Organizations. One member suggested that professional employment organizations or PEOs that lease out employees be authorized to offer the Model T to the employees they lease out to businesses. However, the group did not generally agree to support allowing PEOs to be plan sponsors.

Building Block No. 2: Employee Participation in the Plan

The group discussed which of a given company's employees would be eligible to participate in the plan and whether or not employers should be allowed to automatically enroll workers when they are hired.

Areas of Agreement:

All Employees Eligible to Contribute. The group generally agreed that once an employer agrees to participate in a Model T plan offered by a financial institution, then all employees will be eligible to contribute to the plan. This will include full-time workers, part-time workers, contingent workers and independent contractors. As noted above, there was interest in having organizations facilitate contributions from various groups of workers, including the self-employed.

Automatic Enrollment. The group generally agreed that an employer participating in a Model T plan could adopt the option of automatically enrolling a new hire into the plan unless the employee indicated otherwise.

Areas Where Views Differed:

Limits on Employee Contributions. The group deferred discussion on setting contribution limits for employees and/or employers to the next phase of the Conversation on Coverage, with the assumption that the limits would be in keeping with the limits for other defined contribution plans.

Building Block No. 3: Employer Contributions to the Plan

The group discussed whether or not employers could contribute to the Model T plan and whether, in fact, employers might be required to contribute.

Areas of Agreement:

Employer Contributions Allowed. The group agreed that employers would be able to contribute to the Model T plan.

Areas Where Views Differed:

Mandatory or Voluntary Contributions. The group discussed whether or not employer contributions would be made mandatory, but remained divided on this issue. There was strong opposition to mandatory contributions. One member said that if employer contributions were made mandatory, then it would create a barrier for signing up employers to be part of the Model T plan. Another member noted studies – such as the annual Small Employer Retirement Survey (SERS) by the Employee Benefit Research Institute – that have found that small business employers would be more likely to offer a retirement saving plan if employer contributions were entirely discretionary. [15]

Some members were strongly in favor of mandating employer contributions. One member who supported a mandate said that if there is no mandate for the Model T plan, he did not see how it would differ very much from an IRA. A member who opposed mandatory contributions said that the Model T would still be a different plan because it would allow for employer contributions to the plan. One member suggested as a compromise, a flexible policy rule in which employers would be required to contribute in x years out of five, depending on whether or not there are profits. Another member suggested requiring the employer to contribute one percent of compensation if the employee puts in four percent of compensation. One member suggested that the Model T allow for reverse match contributions, where the employer contributes first and the employee matches the employer contributions.

Building Block No. 4: Investment Options in the Plan

The group discussed how many investment options and what types of investments should be included in the Model T plan.

Areas of Agreement:

Simplified Investment Options. The group generally agreed that the plan should offer at least three investment options, but no more than five options. The members also generally agreed that the choices should include at least three model portfolios or lifestyle funds: conservative, moderate, and aggressive.

Default Investment Mix. The group generally agreed that when employees fail to make choices on their own, plan providers should be allowed to offer participants at firms that join the plan a default mix of investment options based on lifestyle or life cycle funds – or model portfolios representing the basic asset classes.

Areas Where Views Differed:

Additional Investment Options. The group discussed including an investment option that would provide a guaranteed rate of return. Although several in the group strongly supported such an option as key to encouraging low-income workers to participate, the group did not reach agreement that this should be a required investment option.

Government Definitions of Investment Options. The group discussed having the government define what should be in an investment option, but could not reach agreement.

Two Tiers or One? The group discussed whether or not financial institutions might have two models or tiers to offer employers: (1) a simplified incubator model plus (2) a full-fledged plan with more investment options. Those who supported the concept of two-tiered plans argued that employers could begin with the simplified incubator plan and then move on to a traditional qualified plan offered by the institution offering the incubator plan – or any other institution – when they were ready. The suggestion was made out of concern that the simplified plan might not be profitable for plan providers and, thus, might fail to enlist their enthusiastic marketing of the plan. Members explained that the Model T might not be as profitable in the beginning because it would consist of a lot of accounts, each with very small balances.

The group was divided on this proposal. Some supported an approach with two plan options, a simplified incubator and a full-fledged plan, while others supported a single, simplified Model T plan. Members supporting a single Model T plan argued that while the Model T might not prove to be as profitable initially as the financial institution might wish, account balances would grow over time, increasing the plan's profitability. Further, employers could mature into one of the whole range of existing single employer plans when they are ready for more investment options and more bells and whistles in their plan.

Government Sponsored Start-Up Plan. The group discussed whether or not the government should sponsor a Model T plan for those employers with many small accounts – clients whose business would not be profitable for financial institutions that provide Model T plans. The group was divided on whether or not there should be a government start-up plan. A member who opposed a government plan said it would be difficult for the government to start up a plan. Furthermore, it was suggested that the financial institutions interested in sponsoring Model T plans would be opposed to it. Members supporting a government start-up plan, how-

> "It's great to see people coming together to set aside their specific differences in the interest of the common good. And the common good is expanding retirement savings, which is good for the economy and good for the worker."
>
> Representative Rob Portman (R-OH) from his address at the Conversation's National Policy Forum, July 22, 2004.

ever, continued to strongly support this approach. One asked why financial institutions would be opposed, since the government plan would be only for unprofitable accounts. A member opposing a government plan said it would "get tricky" to devise a way for employers to move from the government plan to a private sector plan.

Building Block No. 5: Regulation and Oversight

Since the Model T plan would transfer administration and fiduciary liability from the employer to the plan provider, it raised a number of questions about what regulatory regime would work best to keep the plan costs low while protecting participants.

The group also looked at the question of who would have fiduciary liability for the investment choices in the plan or in the case of malfeasance or fraud that might occur. The group generally agreed that the employer would be relieved of fiduciary liability for the choice of investment options in the plan.

Areas of Agreement:

SEC is the Lead Regulator. The group discussed what regulatory roles would be played by the Department of Labor, the Internal Revenue Service, and the Securities and Exchange Commission. The group discussed whether the SEC should enhance its role as fiduciary regulator over Model T plans, above the level of scrutiny it applies for the non-pension related oversight that constitutes its regulatory focus. They also discussed whether or not the SEC should be the lead fiduciary regulator instead of the Department of Labor or IRS. The group generally agreed that the SEC should take the lead role in fiduciary regulation for the Model T. They also agreed that at the same time the IRS should be the guardian for tax rules while the Department of Labor would regulate the employer/employee relationship. The exact nature of the DoL's regulatory role was deferred for future consideration.

SEC Will Regulate Model T Plans Offered By Banks and Insurance Companies. The group discussed whether or not the SEC oversight would apply beyond brokerage firms and mutual funds to include banks and insurance companies, which are chiefly regulated by federal banking authorities, as well as state banking and insurance authorities. One member noted that the SEC currently already regulates mutual funds offered by banks and variable annuities offered by insurance companies. Thus, the member explained, it is not a departure for the

SEC to also regulate Model T retirement saving plans provided by banks and insurance companies. The group generally agreed that the SEC could be the fiduciary regulator for all providers of Model T plans.

Paying for Plan Administration Costs. The group discussed how administration costs would be paid. The group generally agreed that the sponsoring financial institutions could charge a fee for administration (in addition to the fee for investment management). They also generally agreed that, as an option, the fee could be borne by participants as a charge against earnings.

Fees Should Be Low. The group generally agreed that internal fees charged to manage funds, as well as administrative fees to manage plans, should be low. Many in the group supported an approach that would keep fees below 100 basis points.[16]

Areas Where Views Differed:

SEC Will Regulate Fees. Many in the group supported the view that the SEC would be responsible for regulating fees and determining what a reasonable fee might be. The SEC would also be responsible for determining whether or not there should be a cap on fees. This approach would expand the powers of the SEC, which currently oversees mutual funds, but does not regulate fees in mutual funds. However, the group did not generally agree to this approach. One member strongly objected to having the SEC set rates or caps for funds, and further stated that putting this suggestion in the proposal would "seriously derail" any effort to get support for the Model T plan. The member objecting also noted that if the Model T plan had caps, it would reduce the number of players in the market; whereas, if there is no cap, it would increase competition, a development which would, in turn, help keep fees lower.

Enhanced SEC Fiduciary Authority. The group was divided over whether or not the SEC should enhance its fiduciary oversight for Model T plans. Some favored the current level of fiduciary scrutiny applied to brokerage firms and mutual funds as a way of streamlining regulation and keeping down costs. Others, however, felt that since the SEC was the lead regulator, it would have to take on some of the duties associated with the Department of Labor and some of the more extensive list of prohibited transaction rules under ERISA.[17]

Study to Address Unresolved Fiduciary Issues. The group generally agreed that a study should be undertaken to develop an outline for a regulatory regime for the Model T. For starters, the study could flesh out the duties of the various regulatory bodies, and address what enhanced fiduciary regulatory authority the SEC might have over Model T plans.

One unresolved issue concerns whether or not any fiduciary liability would remain with the employer. Some suggested that the employer would retain fiduciary liability for choosing a Model T provider, even if the employer transfers to the plan provider the fiduciary liability for the investment choices offered in the plan. Some suggested that employers should face restrictions on who they might choose so "they could not hire their brother-in-law down the street," as one member put it.

There was also discussion about whether or not the plan provider might escape fiduciary liability for the choices in the plan, if the provider follows the required list of investment offerings. The group, however, did not reach agreement on a suggestion to remove fiduciary liability for plan providers who chose the recommended investment options. One member explained that a plan provider could simply offer the investment options of a business colleague or a relative rather than provide investment options based on the sole interest of the plan participants.

Building Block No. 6: Withdrawals and Distributions

The group discussed under what terms and conditions employees could make pre-retirement withdrawals for hardship or a loan. They also discussed the rules that would apply when employees leave an employer, as well as the rules which would govern distributions of assets when a participant reaches retirement age.

Areas of Agreement:

Hardship Withdrawals Not Allowed. The group generally agreed to disallow hardship withdrawals. This approach was taken partly because it would be difficult for plan providers to be able to determine if there was a genuine hardship. In addition, barring hardship withdrawals was seen as simplifying the overall plan design, making the Model T less expensive. It was also seen as setting a policy that would encourage workers to retain their accumulated balances until they are old enough to be eligible to take distributions.

Loans Allowed Up to 50 Percent of Assets. The group generally agreed that participants would be able to withdraw loans from their accumulated balances for amounts up to 50 percent of the value of the assets in their plan. They also generally agreed that if a participant defaulted, the loan would be treated as income and would be taxed. This approach was taken to provide some type of pre-retirement access to the assets in the plan. This approach was taken on the assumption that workers tend to contribute more and save more if they know they can withdraw some of the funds for an emergency. Loans were seen as preferable to hardship withdrawals, for the reasons noted above.

Lump Sum Withdrawals at Age 59½. The group generally agreed that participants could withdraw up to 50 percent of the value of the assets in the Model T plan beginning at age 59½, conforming to the age set generally for withdrawals from defined contribution plans, including 401(k) plans. If a participant has taken out loans and not repaid them, these loans would count toward the 50 percent maximum limit that could be withdrawn as a lump sum.

Required Annuity on 50 Percent of Account Balance. The group generally agreed that at least 50 percent of the account balance in the plan should be converted to an annuity or be subject to the current joint and survivor annuity rules. In addition, employees could elect at retirement to take out the entire balance as an annuity, with spousal consent.

Rollover Rules. The group generally agreed that a participant who leaves an employer can withdraw up to 50 percent of the balance or roll over the account into another Model T plan where he or she is eligible to contribute. A participant who leaves a company can also leave the remaining 50 percent in the account until age 59½. A participant would have to either leave the 50 percent balance designated for a future annuity in the plan or roll it over to a new Model T plan.

No Maximum Age or Minimum Withdrawals. The group generally agreed that there would be no maximum age at which time withdrawals would have to begin and no schedule of minimum annual withdrawals after that designated age. In 401(k) plans, for example, withdrawals must begin by age 70½ unless the employee is still working. If retired, annual withdrawals beginning at age 70½ are based on the life expectancy [18] of the participant – or the participant and his or her spouse, if married.

Joint and Survivor Annuities. The group generally agreed to apply existing law governing joint and survivor benefits to the Model T plan. That means the annuity would be issued jointly to the plan participant and spouse. It would also mean that the spouse would continue to receive the annuity should the plan participant die before the spouse dies. Plans would be able to decide whether or not they would allow the individual to take up to one-half of the balance at age 59½. If a participant decided he or she wanted to take 50 percent of the accumulated balance as a lump sum when it is offered, current law governing joint and survivor annuities would apply to the remaining amount in the plan.[19]

Areas Where Views Differed:

Other Types of Payment Schedules. Some members suggested that for the annuity half of the benefit, participants should have the option of setting up a regular withdrawal schedule timed to life expectancy. This was seem by some as problematical since participants could outlive the assumed time span for a chosen schedule of payments, while annuities would make regular payments as long as a participant lived – or as long as a surviving spouse lived, in the case of joint and survivor annuities.

Government Managed Annuities. One member suggested that balances dedicated to annuities be transferred to the Social Security Administration and that SSA could then issue the annuities. Or, alternatively, the Pension Benefit Guaranty Corporation could assume control of the balances dedicated to annuities and pay out the annuities beginning at retirement age. The group, however, declined to support this approach.

Building Block No. 7: Tax Incentives and Provisions

The group discussed whether or not there should be tax credits for employers, employees and plan providers, as well as tax subsidies for employers and providers. The group also discussed how contributions, gains on assets and distributions of funds from the plan would be treated for tax purposes.

Areas of Agreement:

Special Tax Treatment Not Essential. The group generally agreed that while special additional tax benefits for contributions by employees and employers might be helpful, it was not essential for the Model T plan.

Current Tax Preferences Favored. The group generally agreed that the Model T should follow existing tax policy in key issues affecting contributions, earnings, capital gains, and distributions. Employee contributions would be excluded from income and, thus, income taxes. Employer contributions would be considered an expense against corporate income. Earnings, dividends and capital gains within the Model T plan would accumulate tax-free. Distributions and withdrawals from the plan would be taxed as part of ordinary income. Distributions at the time an employee separates from service upon termination of employment would be subject to the current withholding rules and would also be subject to a possible penalty if not rolled over to an IRA or another plan. Distributions that result from failure to repay a loan could be subject to the current early withdrawal penalty if made before age 59.

No Tax Subsidy for Plan Providers. The group agreed that the Model T plan should not provide a start-up tax credit or subsidy for financial institutions that offer the plan to employers.

Areas Where Views Differed:

Tax Credits for Employer Contributions. The group also discussed whether or not there should be tax credits for employers as an incentive for them to contribute to the plan or to match employee contributions. While members generally agreed the tax credits for employers would be helpful, the group did not reach agreement on what types of credits would be appropriate. One member said it would be more difficult to get Congress to enact a law to set up the Model T, if it included tax credits for employer contributions. Another member, however, said that the plan should call for a tax credit, noting that one could not get a subsidy if one did not ask. The member also suggested allowing third parties to offer to match employee contributions for low-income workers.

Super Deductions for Employers. The group discussed a suggestion to give employers a super deduction, such as 110 percent, for employer contributions to the Model T plan. While some members supported this approach, the group did not reach general agreement on recommending this policy.

Start-Up Tax Credit for Employer. The group discussed whether or not small businesses should get tax credits for costs associated with starting up the plan, but could not agree on a recommended policy. Some members noted that the plan was provided by a third party, so start-up costs would be minimal. Other members noted, however, that there would be some costs associated with setting up the plan and some members supported a credit for the first few years of the plan as an inducement to get small businesses to sign up with a plan provider. One member suggested a limited start-up credit.

Tax Credits for Employees. The group discussed whether or not to recommend refundable tax credits for employees to encourage contributions, expanding on the nonrefundable tax credits available through the Saver's Credit.[20] The group, however, did not generally agree to support this approach, although some members strongly favored it.

Building Block No. 8: Marketing Considerations

The group discussed how the plan might be marketed to assure that small businesses would decide to participate.

Areas of Agreement:

Description of How the Model T Plan Differs. The group generally supported providing a description of how the Model T differs from other retirement and saving plan types as a way to interest financial institutions in offering the plan. The comparison of the provisions of Model T with other available plans could also serve as a way to draw attention to the plan for employers who might wish to offer it to their employees.

Demonstration Project. The group generally supported exploring the possibility of a demonstration project to generate interest in the Model T plan. Such an effort could be modeled after such successful campaigns as "Cleveland Saves," which enlisted the Mayor and local banks in a public education campaign to encourage people to save. The Model T demonstration project could market a demonstration plan to small businesses and their employees in a given community.

Areas Where Views Differed:

Government Education Campaign. There was discussion about having the government mount a public education campaign on the Model T plan so that financial institutions which offer them will not have to advertise them. Instead, individuals and small businesses would approach potential providers. This strategy was seen as a way to reduce the cost of the plans and prompt financial institutions to offer them. The group, however, did not reach general agreement on supporting this approach.

Endnotes

[1]Independent contractors in this context refers to contract employees and freelancers, but does not include the employees of professional firms, such as lawyers and accountants, who advise or take on specific projects for companies.

[2]U.S. Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2004,"November 2004, Table 2, p. 6. From the web site at http://stats.bls.gov/ncs/ebs/sp/ebsm0002.pdf. The survey does not include workers employed by state and local governments, the federal government or the military.

[3]Ibid.

[4]Ibid.

[5]Small businesses reported as follows: 7 percent were very likely to start a plan in the next two years, while 22 percent were somewhat likely. Source: Employee Benefit Research Institute, "The 2003 Small Employer Retirement Survey (SERS) Summary of Findings" (Washington, D.C.: EBRI, June, 2003), p. 2.

[6] Small businesses reported as follows: 25 percent were not too likely to start a plan in the next two years, while 43 percent were not at all likely. Source: Ibid.

[7] Ibid.

[8] U.S. Department of the Treasury, Internal Revenue Service, S*tatistics of Income Bulletin*, (Winter 1984-1985, Winter 1986-1987, Winter 1990-1991, Winter 1993-1994, Winter Fall 1995, Winter Spring 1996, Fall 2001, and Winter 2002-2003).

[9] Craig Copeland, "Retirement Plan Participation and Features, and the Standard of Living of Americans 55 or Older," EBRI Issue Brief Number 248 (Washington, D.C.: Employee Benefit Research Institute, August 2002), Figure 2, p. 8.

[10]Multiple employer plans (MEPPs) are controlled by a single plan document (for this reason they are technically classified as a type of single employer plan) and do not involve a collective bargaining agreement. The employers usually have some kind of connection short of common ownership ("controlled group" status), and the (typically employer) contributions are pooled in a single trust. Fiona Wright, "Working Paper on Pooled Multiple Employer Pension Plans", mimeo, May 2003.

[11]Leslie B. Kramerich, "Confronting the Pension Coverage Challenge," A Report on the Conversation on Coverage Convened by the Pension Rights Center, July 24-25, 2001, p. 42. From the web site at http://www.pensioncoverage.net/pdfs/whitepaper.pdf. The report discussed recommendations for pooled arrangements noting that these would be appealing to small businesses while also being a good vehicle for covering part-time and contingency workers.

[12] In a Lifestyle Fund, the choices about how much to put into equities, bonds and cash are based on the risk tolerance of the investors and the investor's goals. Lifestyle Funds allow an investor to put all the assets in a single fund and not have to review or revise those investments. The fund periodically adjusts the allocation and gradually becomes increasingly more conservative as the investor moves toward retirement age.

[13]The Internal Revenue Code's Section 408(a)(2) designates what institutions can offer an IRA (banks, credit unions and state corporations chartered by the commissioner of banking, and 401(n) defines what a bank is. Some non-bank financial organizations that offer IRA's often have affiliates that meet the definition of a bank. In addition, the trustee of an IRA can also be "a person other than a bank," but such a person or entity has to apply to the Commissioner of the Internal Revenue Service to demonstrate that it can "act within the acceptable rules of fiduciary conduct." The particulars for this requirements are spelled out in Treasury Regulations § 1.408-2(e)(6).

[14] So-called 529 plans are college savings programs established and administered by the states. They are named 529 Plans after the IRS code section that outlines the details of the plans.

[15] The 2003 Small Employer Retirement Survey found that 73 percent of small business would be more likely to start a plan if it did not require employer contributions.

[16]A basis point is one one-hundredth of a percentage point. Thus, 100 basis points equal one percentage point.

[17]The group did not explore in any detail what sort of prohibited transactions might be required in a fiduciary regime. The Employee Retirement Income Security Act (ERISA) of 1974, for example, sets forth a list of prohibited transactions to which employee benefit plans are subject. The Investment Company Act, which governs mutual funds and brokerage firms, also has a list of prohibited transactions, but not as extensive as ERISA.

[18]Withdrawals at age 70 ? are based on life expectancy under a uniform IRS table or the joint life expectancy of the participant and his or her spouse if the spouse is more than 10 years younger than the participant.

[19]Since the Model T is a defined contribution plan, it follows current law applicable to such plans, but only on the portion that can be withdrawn as a lump sum, and only then if the plan does not offer an annuity on that portion. This policy is based on that fact that defined contribution plans are not required to offer an annuity provided the spouse receives 100 percent of the account balance if the employee dies while covered by the plan. However, current law also states that if the plan does not offer an annuity and the employee does not die while covered by the plan, the employee can withdraw the account balance as a lump sum or other non-annuity payment without spousal consent when the employee leaves the plan. Thus, if the plan offered an annuity on only 50 percent of the balance, then the lump sum could be taken out without spousal consent. However, if the plan offered an annuity on the entire balance, with the option of a lump sum on 50 percent, it would require spousal consent to take the benefit as a lump sum. Some members suggested that the process of obtaining consent for the annuity portion should be streamlined to reduce administrative costs, while others insisted that the current form of consent – a signature on paper – must be obtained to protect spousal rights.

[20]Enacted into law in 2001, the Saver's Credit was first available in 2002 and is slated to end in 2007. The Saver's Credit can reduce the federal income tax a worker pays dollar for dollar. The amount of credit that one can receive is based on one's contributions into an IRA, 401(k), and other retirement saving plans. The Saver's Credit is part of the Economic Growth and Tax Relief Reconciliation Act of 2001. The Saver's Credit is also available for contributions to 403(b) plans, 457 governmental plans, SIMPLE 401(k) plans or SIMPLE IRA's. The Saver's Credit works as follows: For married couples filing jointly, workers with income up to $30,000 are eligible for a 50 percent Saver's Credit for their contributions into a saving plan. Married couples earning $30,001 to $32,500 are eligible for a 20

percent credit, and married couples filing jointly earning $32,501 to $50,000 are eligible for a 10 percent credit. Those earning over $50,000 are not eligible for a credit. For single people or married people filing separately, the Saver's Credit is available for 50 percent of contributions for workers with incomes up to $15,000. Workers with incomes between $15,001 and $16,250 can obtain a 20 percent Saver's Credit. Single workers and married people filing separately who earn between $16,251 and $25,000 can receive a 10 percent Saver's Credit on contributions. Slightly different earnings levels qualify a head of household: (50 percent for incomes up to $22,500; 20 percent for incomes $22,501 to $24,375; and 10 percent of incomes $24,376 to $37,500).

Questions & Answers

Questions and Ideas from the National Policy Forum Working Group III

The Conversation on Coverage sponsored a National Policy Forum on the proposals from three working Groups, including Working Group III, at the National Press Club on July 22, 2004. This section summarizes some of the questions, comments and suggestions addressed during the break-out session for Working Group III.

Many members of the Working Group were present to respond to questions about the Model T Plan as proposed in this report and to take comments for the upcoming refinement and implementation phases of the Conversation on Coverage. Some of the responses below expand on comments made at the break-out session in order to provide background and context. A good deal of the time was spent explaining in more detail the building blocks that make up the plan and how the group arrived at its agreement on key provisions.

Questions and Answers

Q. What is going to be done to assure that people would have equal access to the plans? Would there be sanctions against employers who failed to make the plan available to all employees? The person raising this question pointed out the SEPs are marketed to a lot of employers who only use them for themselves instead of making them available to all employees.

A. The Working Group generally agreed that all workers would be eligible to participate in the plan. Members did not address of just how employers are supposed to make information about the opportunity to participate to all of its employees. The group also did not discuss whether or not to recommend sanctions for employers who failed to notify workers that they were eligible to participate. The group did, however, indicate that the design of the Model T Plan was intended to transfer most of the administration costs to the financial institutions that would offer the plan.

Q. Would people be drawn to the Model T Plan at the expense of better coverage in an existing plan – for example, moving from a 401(k) to a Model T? The person asking this question stated that, as designed, the plan allows employers to contribute $13,000 or more on their behalf, while not requiring that any money be contributed on behalf of non-full-time employees.

A. During their conversations, the Working Group discussed requiring employers to contribute to all employees a minimum amount in order to be eligible to sponsor in this plan, but did not reach agreement on this point. The current proposal has not yet developed contribution limits or determined how nondiscrimination rules might apply. Those issues can be addressed in the refinement and implementation phase. During their meetings, the Working Group discussed requiring the financial institution offering the plan market and administer it in such a way that a minimum percentage of those contributing would be low and moderate-income workers. The members of the group, however, did not generally agree to this approach.

Q. Why does the proposal for the Model T from Working Group III allow loans but not hardships, while the Retirement Investment Account proposal from Working Group II allows hardship withdrawals and not loans?

A. In both instances, the prohibitions were aimed at preventing leakage. In the case of Working Group II, it was felt that it would be difficult to arrange a repayment through payroll deduction because the plan would be administered by a central clearinghouse and the employer is not a plan sponsor, but merely give employees access to the plan. It would also complicate the very limited employer role envisioned by the plan design if the plan were to require employers to sending in loan repayments in addition to contributions. In the case of the Model T, it was felt that it would be difficult for an employer to decide whether a hardship existed when one was claimed. Loans were more attractive because, unlike hardship withdrawals, it was stated the there was the obligation to pay back the loan and the hope this would be done, thereby, preserving more funds for retirement.

Q. Why did the Working Group not offer a proposal that would get more people to save through IRAs?

A. Participation rates for employer-based plans are generally higher than participation rates in individual-type programs, such as IRAs. Further, the data suggest that employees tend participate at a higher level and to save more when they can deduct a portion of their regular pay on a pre-tax basis and have it go directly into the work-based plan. The Model T Plan would be more attractive than a payroll deduction IRA because it would have higher contribution limits and permit pre-tax contributions in all cases. In addition, it would be expected to have a limited list of investments. Employees would not face a choice among the very larger number of investments that might be available through an IRA – or even chose among a number of IRA providers. The fact the Model T Plan will have limited investment choices and providers was seen by the group has helping overcome the difficulty some face in making a choice when too many choices are offered in a plan.

Suggestions and Responses

Suggestion: Conduct a pilot of the Model T and target a community such as a group of churches, who would be exempt from the Employee Retirement Income Security Act, which would make it easier to do the pilot.

Response: This approach is a promising avenue for a pilot and it will be considered in the refinement and implementation phase of the Conversation on Coverage.

Suggestion: The investment choices in the plan should not include managed funds, which will have higher fees, but should include only index funds, which can capture the broad market and are typically operated with low fees.

Response: The Working Group generally agreed that the Model T Plan would be limited to 3 to 5 investment options that would consist of model portfolios and/or lifestyle funds, with the possibility of a guaranteed return investment options. Thus, there is already agreement that the fund would include managed funds. This does not mean the group was not concerned about fees or about having too many choices. The limit on investment options was designed to make the choices easier to understand and to address the difficulty of choosing when too many options are offered. As for fees, the Working Group did generally agree that internal fees charged to manage funds, as well as administrative fees to manage the plan should be low – with a common suggestion that they be kept below 100 basis points in the aggregate. However, the group did not generally agree to recommend that the Securities and Exchange Commission be given authority to regulate fees and determine whether or not fees were reasonable.

Suggestion: Require an employer to have a signature by all employees stating that they were given the opportunity to participate in the plan.

Suggestion: Perhaps it would be better to create a new plan that would be more like a junior 401(k) plan with simpler rules and choices than the proposed Model T plan. This would be helpful to a lot of employers who do not now have plans and might be interested in offering their first retirement savings plan.

Response: The Model T Plan could meet the needs of many employers who do not now have a retirement savings plan. To the extent that half of a participant's account balance can be taken as a lump sum, that half could be seen as a junior 401(k). The other half could be seen as a pension. The Working Group designed the plan with the hope that financial institutions would find it attractive and thus market it to employers. During their conversation, the Working Group discussed offering a two-tiered system – in which one tier would be an incubator plan and the other would be a more complex plan that would offer more options. This approach was seen by some as making the plan more attractive to financial institutions. However, the group was unable to agree on this approach. Those who did not support a two-tiered system with an incubator plan suggested that financial institutions would benefit by offering employers who were ready for it a more profitable single-employer plan, such as a 401(k) or SIMPLE.

Working Group One Members

All Working group members participated as individuals not as representatives of organizations.

The affiliations listed are those during the time that they participated on the Working Group, during the second stage of the Conversation on Coverage, from 2003-2004. Current affiliations (2005) are listed in parentheses.

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