The Retirement Security Project

CONGRESSIONAL TESTIMONY

PROTECTING AND STRENGTHENING RETIREMENT SAVINGS

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

**Testimony Before the
Special Committee on Aging
United States Senate**

July 16, 2008

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

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

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

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

I. Inadequate Saving and the Problem of Pension Leakage

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

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

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

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

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

Leakage in Context

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Thus, there has been evidence in the past that

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

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

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

[9] GAO 1997 Report.

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

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

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

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

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

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

[11] Ibid.

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

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

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

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

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

Limiting Leakage from Post-Termination Distributions

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

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

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

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

Direct Rollovers, Mandatory Withholding, and Automatic Rollover of Cashouts

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Reducing Leakage During Retirement

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

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

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

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

Leakage from Defined Benefit Plans

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

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

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

The Role of Education

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

Two Approaches We Would Not Endorse

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

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

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

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

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

II. The Automatic IRA

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

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

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

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

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

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

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

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

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

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

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

The Basic Problem

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

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

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

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

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

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

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

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

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

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

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

The Automatic IRA

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

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

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

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

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

The Prudential research concluded,

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

How the Automatic IRA Would Work

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

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

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

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

[34] Id. at 20.

Little or No Cost to Employers

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

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

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

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

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

(4) select investments for employee contributions,

(5) select among IRA providers, or

(6) set up IRAs for employees.

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

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

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

Tax Credit for Employers that Serve as Conduit for Employee Contributions

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

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

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

Direct Deposit and Automatic Fund Transfers

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

Employees Covered

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

Portability of Savings Through Choice of Roth or Traditional IRA

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

Expanding Saving through Automatic Features

Obstacles to Participation

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

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

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

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

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

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

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

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

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

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

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

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

Compliance

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

Making a Saving Vehicle Available To Everyone

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

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

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

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

A Low-Cost Standard Automatic Account

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

Automatic Investment Fund Choice

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

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

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

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

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

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

Employers Protected from Risk of Fiduciary Liability

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

The Importance of Protecting Employer Plans

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

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

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

Encouraging Contributions by the Self-Employed and Independent Contractors

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

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

Matching Deposits as a Financial Incentive

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

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

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

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

Guaranteed Lifetime Income

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

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

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

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

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

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

Conclusion

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

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

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

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

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

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

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

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

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

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

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

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

J. Mark Iwry

Mark Iwry (pronounced "Eevry") is a Nonresident Senior Fellow at the Brookings Institution, a Principal of the Retirement Security Project, Research Professor at Georgetown University, and Of Counsel to the law firm of Sullivan & Cromwell LLP, where he specializes in pensions, compensation and benefits. He was Benefits Tax Counsel at the U.S. Treasury Department from 1995 to 2001, serving as the principal Executive Branch official directly responsible for tax policy and regulation relating to the Nation's qualified pension and 401(k) plans, employer-sponsored health plans, and other employee benefits.

Recently named one of the 100 Most Influential People in Finance (*Treasury and Risk* Magazine, June 2008), Mr. Iwry has often testified before congressional committees – formerly representing the Treasury and Executive Branch and, since leaving government, testifying as an independent expert -- and State legislatures. He has advised numerous Senators and Members of Congress on both sides of the aisle, five Presidential campaigns (2004 and 2008), GAO, other federal agencies, State officials and legislators, foreign government agencies and officials (including the United Kingdom and Israel), AARP, and other private-sector organizations on retirement savings, and has served as an expert witness in federal litigation. He was formerly a partner in the law firm of Covington & Burling, chair of the D.C. Bar Employee Benefits Committee, a member of the White House Task Force on Health Care Reform, and has addressed several hundred professional, industry, policy and academic conferences. Mr. Iwry co-edited the book, "Aging Gracefully: Ideas to Improve Retirement Security in America" (Century Fdn. Press, 2006)(with William Gale and Peter Orszag); the automatic IRA proposal he has co-authored through the Retirement Security Project has been introduced as a bill in Congress, and the proposals he has co-authored to leverage State resources to expand pension coverage have been introduced as bills in several States.

A principal architect of the Saver's Credit to expand 401(k) and IRA coverage (claimed annually on 5.3 million tax returns) and the "SIMPLE" 401(k)-type plan (covering an estimated 3 million workers), Mr. Iwry directed Treasury's formulation and implementation of an integrated strategy to increase retirement saving by defining, approving and promoting 401(k) automatic enrollment as well as automatic rollover to curtail pension leakage. He has also been centrally involved in initiating or orchestrating many other significant improvements and simplifications of the nation's pension and health care systems, including development of the Presidential "Universal Savings Accounts" proposal (1999-2000), and strengthening oversight of the PBGC by its Board of Directors.

While in government, Mr. Iwry was widely recognized for his work to expand coverage while simplifying and rationalizing benefits law and regulation. He received the Secretary of the Treasury's Exceptional Service Award "[i]n recognition of his outstanding leadership and accomplishments ….Widely respected as Treasury's benefits and pension expert, Mr. Iwry excelled at building coalitions of diverse interests…." At Treasury, he drew upon a wide spectrum of private sector advice, held town hall meetings around the country, and received a special IRS (Office of Chief Counsel) award "[i]n recognition of the collegial working relationship you have fostered between [Treasury] and the IRS Office of Chief Counsel and of your many contributions to our nation's tax system."

Mr. Iwry's views are often reported in the major media and trade press. He is an honors graduate of Harvard College and Harvard Law School, has a Masters in Public Policy from Harvard's Kennedy School of Government, is a member of the bar of the US Supreme Court, a Fellow of the American College of Employee Benefits Counsel, and is listed in *Who's Who*; *Best Lawyers in America; Washington, DC Super Lawyers,* etc.

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David John, Principal to the Retirement Security Project and a Senior Research Fellow with the Thomas A. Roe Institute for Economic Policy Studies at the Heritage Foundation. He has been involved in Washington's top policy debates for almost 30 years and he continues that career as Heritage's lead analyst on issues relating to pensions, financial institutions, asset building, and Social Security reform. He has also commented on corporate governance and financial literacy.

John has written and lectured extensively on the importance of reforming the nation's retirement system. During this time, he has testified before a number of House and Senate committees on subjects ranging from Social Security and pension reform to improving the nation's flood insurance program. In 2001, he testified before the President's Commission to Strengthen Social Security, providing detailed analysis of how personal retirement accounts could be structured and regulated. John also testified before the House Budget Committee's Task Force on Social Security, explaining what the costs of transitioning to a system of Social Security personal retirement accounts might be as compared to the cost of running the current program.

In addition, John has testified before the House Ways and Means Committee on issues such as steps that should be taken to improve Social Security for women and minorities, how to increase the information that the public can receive about Social Security programs, and how the United Kingdom's pension system operates. He also testified before both the Senate Special Committee on Aging and the House Education and the Workforce Committee on proposals to strengthen the funding of defined benefit pension plans.

John has been published and quoted extensively in many major publications, including the Wall Street Journal, Financial Times, Washington Post, New York Times, Chicago Tribune, Los Angeles Times, Philadelphia Inquirer, Washington Times, Forbes, Business Week, and USA Today. He has also appeared on CBS News, NBC News, CNN, MSNBC, the Fox News Channel, BBC radio, and many other national and syndicated radio and television shows.

John came to The Heritage Foundation from the office of Rep. Mark Sanford, R-S.C. John was the lead author of Rep. Sanford's plan to reform Social Security by setting up a system of personal retirement accounts. John's Capitol Hill service also includes stints in the offices of Reps. Matt Rinaldo, R-N.J., and Rep. Doug Barnard Jr., D-Ga. While working for Barnard, John helped write one of the first bills that would have eliminated restrictions on banks to sell securities and insurance. He also authored a bill in 1981 that restarted the national commemorative coin program.

In the private sector, John was a Vice President specializing in public policy development at The Chase Manhattan Bank in New York. In addition, he worked for three years as Director of Legislative Affairs at the National Association of Federal Credit Unions, and worked as a senior legislative consultant for the Washington law firm of Manatt, Phelps & Phillips.
John earned a bachelor's degree in journalism, an MBA in finance, and a master's degrees in economics from the University of Georgia in Athens.