Final Report and Recommendations by the

Mini-Conference on Incentives to Increase Retirement Savings By Individuals and Through Employment-Based Retirement Plans

July 12, 2005
Mini-conference held at the headquarters of the
National Rural Electric Cooperative Association
Arlington, Virginia

110 attendees representing large and small employers (both private and public sector), unions, rural cooperatives, academia, benefits and compensation professionals and members of the public

Sponsored by:
American Benefits Council
ERISA Industry Committee
Employee Benefit Research Institute
International Foundation of Employee Benefit Plans
National Rural Electric Cooperative Association
WorldatWork

Priority Issue #1

The White House Conference on Aging should support policies that promote the expansion of defined benefit pension plans as an important benefit that both offers retirement income and facilitates orderly planning particularly for older workers and their employers.

Background

A defined benefit pension plan (DB plan) is an arrangement that provides a retirement benefit calculated according to a specific formula set out in the plan document. Contributions to single-employer DB plans are made by the employer who bears the risk of investment. A defined benefit is required to be offered in the form of an annuity but may provide the option of a lump sum. DB plans provide employees funded retirement benefits that are not dependent on their ability or inclination to save nor on the fluctuations of the financial markets before, at, or after retirement. For employers, DB plans are a means of attracting and retaining employees and are an important element of workforce management.

Barriers to Implementation and Maintenance of Defined Benefit Pension Plans:

Increased Regulation and the Cost of Administration: Employee benefit plans are subject to over 2,000 pages of statutes and over 4,500 pages of regulations. DB plans consume the bulk of these directives. The complexity of excessive regulation is a significant barrier to implementing and maintaining DB plans since sponsors are subject to significant expenses in order to maintain actuarial, accounting, communication, and administrative consultants and legal counsel necessary for compliance. Increased complexity makes it more difficult for employees to understand the intrinsic value of DB plans and DB plan sponsors often face significant competitive disadvantages against companies not sponsoring DB plans. As the regulatory barriers increase, DB plans have become endangered. In 2004, for example, only 26,000 plans covered 17 percent of the private workforce compared to 1978 when 128,000 DB plans covered 41 percent.

Predictability of Funding Requirements: By far, the most critical factors in determining required contributions to defined benefit plans are the interest rates mandated by statute (e.g., 30-year Treasury bonds or corporate bond rates) that fluctuate widely from year to year. Since DB plans are long-term commitments, employers depend upon the ability to average mandated rates over a four-year period to "smooth" volatile interest rate fluctuations. As an additional safeguard, employers can accumulate credits for excess plan contributions in "rich" years to offset the inability to fund a plan in other years (e.g., credit balances). The inability to smooth fluctuations in required contributions would be a considerable barrier to implementing or maintaining DB plans because stability and predictability are critical to sponsorship of such long-term financial commitments.

Lack of Transparency and Relevance to Plan Participants: Few workers can calculate their traditional defined retirement benefit at different stages of their careers. Newer hybrid defined benefit plans express the benefit as if it were a savings plan so participants understand their benefit at any time. Hybrid plans also provide greater benefit portability to the growing number of employees who do not spend their entire careers with one employer. While hybrid arrangements have been around for almost two decades, their validity has been questioned by a single court case contradicting other courts that have validated the plans. Unless the law clarifies that hybrid plans are valid arrangements, the legal limbo will continue to be a significant barrier to transparency, portability, and relevance of the benefits offered by defined benefit plans.

Increased Worker Mobility: Many workers would like to continue working on a reduced basis past "early" and even "normal" retirement age, especially since they are likely to live longer than earlier generations and may outlive their retirement assets. Current law places significant barriers on older workers who wish to continue working on a "phased retirement" basis.

Proposed Solutions:

- Eliminate barriers to and encourage long-term and predictable funding of defined benefit plans by permitting reasonable techniques for averaging or smoothing of contribution requirements over a four year period.
- Permit reasonable use of credit balances and smoothing of asset values in meeting funding obligations.
- Encourage plan sponsors to increase contributions to plans during favorable economic times in order to reduce funding pressures during economic downturns, in particular by eliminating tax penalties for making "excess" contributions.
- Validate that hybrid arrangements are lawful.
- Establish "clearinghouse" model plans (similar to multi-employer plans used in collective bargaining arrangements) so that workers who change jobs frequently and their employers (including those that do not directly sponsor a plan) can voluntarily contribute to one portable defined benefit or defined contribution plan.
- Eliminate the barriers in pension law that prevent older workers from choosing "phased retirement" and employers from contracting with former employees after they retire.

Priority Issue # 2

The White House Conference on Aging should support policies that allow and encourage individuals to participate more readily and effectively in 401(k) and other defined contribution retirement savings plans.

Barriers to Implementation of and Participation in Defined Contribution Plans:

Lack of Sufficient Financial Literacy: Defined contribution plans are employer-sponsored arrangements (such as 401(k) and 403(b) plans) in which the benefit at retirement consists of the cumulative contributions made to the plan plus any earnings. Often, most of the money in these plans comes from compensation the employee elects to contribute. The employee decides how to invest the money in the choices offered by the plan. Many employees strive to make informed economic and financial decisions but are not always skillful in planning for the future. Some never elect to contribute to the plan in the first place.

Obstacles to Automatic Enrollment: Studies show that automatic enrollment, under which employees automatically participate in defined contribution plans unless they opt out, significantly increases participation in these plans. Particularly among low- and moderate-income workers, automatic enrollment typically raises employee 401(k) participation rates from the 60-65 percent range to the 85 percent plus range (Choi et al, *National Tax Journal*, June 2004). Other automatic features such as systematic increases in contributions (unless the employee opts out) and allocation of contributions into appropriate investment funds can greatly increase the assets accumulated for retirement.

Although current law allows employers to implement automatic enrollment features, a number of significant obstacles remain and some employers are therefore hesitant to adopt these designs. Under existing guidance, the employer may not rely on the relief provided by ERISA Section 404(c) (which places legal responsibility with the participants for investment performance in employee-directed defined contribution plans) for automatic enrollment plans with default investments. Moreover, sufficient regulatory guidance has not been provided to employers on selecting a default investment that complies with fiduciary responsibilities. Thus, many employers choose low-risk or risk-free investments, that consequently have low returns for the workers. Finally, certain state wage withholding laws potentially complicate automatic enrollment by prohibiting withholding from the workers' wages without their affirmative consent.

The current barriers could be addressed through appropriate regulatory guidance concerning default investments and also legislative clarification that state wage withholding laws do not prohibit automatic enrollment. In addition, employers would have an incentive to implement automatic enrollment if "safe harbors" were developed to avoid complex and costly testing requirements. In addition, greater efforts to promote financial literacy and knowledge about retirement income needs will permit individuals to more readily and effectively save for retirement.

<u>Proposed Solutions:</u>

- Encourage employers, through clarifying legislation or regulatory guidance, to implement defined contribution plans that automatically do the following unless the workers opts out:
    - Enroll workers in the plan and increase contributions over time
    - Allocate contributions to an appropriate default fund
- Provide incentives to employers to implement automatic enrollment through the use of safe harbors that will reduce administrative costs
- Clarify that state wage withholding laws do not prohibit automatic enrollment
- Clarify that default contributions may be made to a wider range of investments
- Promote knowledge about retirement income needs by encouraging employers to facilitate financial literacy programs
- Create a national emphasis in our educational system on the value of saving and on retirement income needs, through such means as making financial literacy a criteria for high school graduation

<u>Priority Issue #3</u>

The White House Conference on Aging should promote policies that help control health care costs and make possible the funding of retiree health care needs.

<u>Barriers:</u>

Persistent and Unsustainable Cost Increases: The persistent and unsustainable double-digit increase in health care costs remains a major factor eroding retiree coverage. According to the 2004 Kaiser/HRET Survey of Employer-Sponsored Health Benefits, the share of employers (with 200 or more employees) offering retiree health coverage fell from 66 percent in 1988 to 36 percent in 2004. Retiree health costs increased by an estimated 12.7 percent from 2003 to 2004 according to a recent report by Kaiser and Hewitt Associates, significantly outpacing inflation or wage growth for the same period and running slightly higher than the annual increase in active employee health costs. While employers continue to bear substantial costs, retirees are assuming an increasing percentage and many now pay the full premium.

Expanding and Unrestricted Participant Care Requirements: Numerous factors contribute to the health care affordability crisis, particularly for retirees. Some factors are difficult to influence such as the "Baby Boom" generation's increasing health care needs as it reaches retirement age or health consumers' expectations, regardless of cost, that services be immediately available. Another significant factor is the lack of uniform measures of the quality and efficiency of health care services. Without such measures, large health care purchasers, such as governments, employers and health plans, often waste health care dollars on unnecessary or ineffective care.

Need for Quality and Efficiency Measures: Quality and efficiency measures would also assist consumers in selecting care. Government, employer and health plan purchasers would be able to reward providers who consistently deliver appropriate care. These "value-based purchasing" or "pay-for-performance" efforts involve numerous stakeholders in the health system. They are, however, unlikely to succeed without the federal government, the largest of all health purchasers, moving to adopt this approach over the next several years.

Little Savings for Future Health Care Needs: In addition, while a small percentage of Americans will leave employment with retiree health coverage, fewer still are saving while actively employed for their future health care needs. Nor do the appropriate tax-advantaged savings vehicles yet exist to help them. According to the Employee Benefit Research Institute (EBRI), each individual who expects to live to age 85 and who retires without health care coverage will need $223,000 for costs not covered by Medicare. (EBRI Issue Brief No. 254, *Retiree Health Benefits: Savings Needed to Fund Health Care in Retirement*, Feb. 2003.) This figure does not include coverage costs for those retiring prior to age 65 Medicare eligibility.

Tax-Advantaged Savings Vehicles Required: Those attempting to save for their retiree health care needs face additional hurdles. For example, funds accumulated in 401(k) plans or traditional Individual Retirement Accounts (IRAs) are taxed at distribution, requiring retirees to pay after-tax dollars for health insurance premiums or other medical expenses. These could be financed by pre-tax spending if these costs were incurred during working years. The tax code also contains no provisions to directly encourage lifelong savings for individual future health care needs through tax-advantaged savings vehicles, similar to 401(k) plans, IRAs, or 529 college savings plans. Finally, newly authorized Health Savings Accounts (HSAs) potentially could help more Americans save for retiree health expenses, but strict limits on annual contribution amounts prohibit sufficient savings accumulation for post-employment health costs.

Proposed Solutions:

- Promote the development of health care quality outcome measures
- Promote the disclosure of health provider outcomes so that individual, employer, health plan and government purchasers can make decisions based upon quality, cost and efficiency of care
- Establish flexible tax-advantaged retiree medical savings vehicles
- Establish medical savings vehicles for retiree health needs that apply equally to all individuals regardless of employment status
- Permit individuals to accumulate additional funds within their employer-sponsored retirement savings account, or Individual Retirement Account, and to reallocate existing balances in these arrangements for retiree health care purposes
- Modify flexible spending accounts to encourage individuals to save for retiree health care needs by eliminating the so-called “use it or lose it” rule
- Eliminate disincentives for employers to establish or contribute to retiree medical savings vehicles due to restrictive interpretations of the Age Discrimination in Employment Act
- Allow individuals and employers to direct a portion of their retirement savings plan contributions to a subaccount that could be withdrawn on a tax-free basis after retirement to pay for qualified medical expenses