Covering the Uncovered

FINAL REPORT OF THE CONVERSATION ON COVERAGE

COMMON GROUND PROPOSALS TO EXPAND RETIREMENT SAVINGS FOR AMERICAN WORKERS

Outcomes from an Unprecedented Six-Year Public Policy Initiative

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Supporters

The Conversation on Coverage is an unprecedented national public policy initiative convened by the Pension Rights Center and supported by:

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Foreword

The Conversation on Coverage is an amazing success story that demonstrates that, when individuals of differing perspectives come together with passion, commitment and a shared mission, solutions can be found and real change can be set into motion.

This Final Report is the culmination of years of hard work and perseverance by more than 45 experts who were brought together in three Working Groups to develop common ground recommendations on ways to increase pensions and retirement savings for American workers. The first versions of these proposals were developed over an 18-month period in the Second Stage of the Conversation and were released in the summer of 2004. Then the Working Group members, many of whom have been involved in the Conversation from the beginning, intensified their efforts in the Third Stage of this initiative to refine these recommendations, which are included in their final form in this document, *Covering the Uncovered: The Final Report of the Conversation on Coverage.*

The Conversation on Coverage is unlike any other initiative in the retirement arena in its composition, its duration, its focus, and its accomplishments. The Conversation set for itself the ambitious mission of creating new proposals to increase pensions and retirement savings for American workers – particularly targeting low- and moderate-income wage earners. Under the powerful leadership of the Conversation's Co-Chairs, the Working Groups devoted collectively hundreds of hours at all-day meetings, subgroup meetings, telephone conferences and in e-mail exchanges to develop carefully constructed common ground proposals aimed at balancing the interests of, and being attractive to, employers, financial institutions and employees. The fact that each Working Group succeeded in its mission is no small feat when you take into account that many of the Working Group members have been, at times, on opposite sides of issues in their roles outside of this common ground process.

That has been the magic of the Conversation. It has allowed people of differing viewpoints and ideologies to get to know each other, air their differences, and find ways of reaching agreement in off-the-record conversations – all outside the glare of the Washington policy process. This teamwork was possible because everyone was committed to the same goal: getting more people covered by pensions or retirement savings plans so they can have more money to live on in retirement.

The Conversation process was exciting, but it also had its challenges. There were times when Group members, after resolving many issues easily, would reach a stalemate on a topic on which members had strong and divergent views. Rather than being stymied by these impasses, the Co-Chairs and Conversation staff would work together to develop new approaches, such as convening smaller focused subgroup meetings, conducting additional research, or bringing in outside experts. When consensus could not be reached, the members would list options for how a matter could be resolved later when these plans are further developed or implemented. In this way, unresolved issues did not impede the Groups' progress.

This report should be viewed as a living document, an array of well-developed, detailed proposals that hold the promise of truly increasing coverage, but that still have room to breathe and grow in the public policy

and implementation process. The proposals are substantive and well-conceived, but, by virtue of the fact they were created in a compromise process, they are good approaches – not necessarily perfect products.

As the neutral facilitator of this process, I had the privilege and opportunity of sitting in on the Working Group deliberations and listening to intellectually stimulating ideas and discussions from some of the brightest minds in the country. Thanks to these discussions, and the push and pull that led to a variety of decisions, I now have a much greater appreciation and understanding of the challenges facing businesses and the need to strike a balance between the needs of employers and employees in shaping policy proposals. I discovered how committed my colleagues are, and found that when people come together for the common good, it is indeed possible to find common ground. The Conversation has been a rewarding process for everyone involved and it is not an overstatement to say that it has changed the way many of us think and how we approach issues, building camaraderie and trust that will continue beyond the Conversation.

I am greatly indebted to the Conversation's foundation and organizational supporters, Co-Chairs, Working Group members, Steering Committee and the staff, all of whom have made this process such a success (see Acknowledgements).

It is rare to be able to say that we have been part of something that is truly going to make the world a better place. I sincerely believe that the Conversation on Coverage – because of the goodwill, perseverance and talent of the individuals involved – is part of the solution and has helped in designing and promoting ideas that will enable millions of people to live more comfortably in retirement. The Conversation has been an incredible experience, and I am delighted to invite all of you to read the Final Report and join in the larger public policy dialogue.

Karen D. Friedman Director, Conversation on Coverage May 2007

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Acknowledgements

The Pension Rights Center wishes to thank all those who have made the Conversation on Coverage such a successful initiative. The Conversation has been in every way a collective enterprise that worked so well because of the involvement, expertise, and shared commitment of so many individuals and organizations.

First and foremost, we want to thank the Ford Foundation whose vision helped turn the Conversation on Coverage from an idea into a reality. The Ford Foundation has supported the Conversation on Coverage from the beginning and has made the development of these final recommendations possible. We also would like to thank the Annie E. Casey Foundation, which supported the Second and Third Stages of this initiative. In addition, we would like to acknowledge the previous support of the Charles Stewart Mott Foundation and the W.K. Kellogg Foundation, which helped us build the framework for this initiative.

We are also extremely grateful to the organizational supporters that have made the Third Stage of the Conversation on Coverage and the publication of this report possible. Thank you to: *Platinum Sponsors* – AARP, MetLife, and Nationwide; *Sponsors* – ASPPA Pension Education and Research Foundation, the Employee Benefit Research Institute, Fidelity Investments, the International Association of Machinists and Aerospace Workers, the National Committee to Preserve Social Security and Medicare, Prudential Financial, the Retirement Security Project, the U.S. Chamber of Commerce, and Vanguard; *Co-Sponsors* – the AFL-CIO, the American Academy of Actuaries, the American Benefits Institute, and the American Council of Life Insurers. Also, thanks to Motorola, TIAA-CREF and the Urban Institute for co-sponsoring the Second Stage of the Conversation on Coverage.

The members of the Steering Committee have provided unfailing support and guidance to ensure that the documents and the process have been balanced and reflect a diversity of opinions. Thanks especially to Steering Committee Chair Martha Hutzelman who tirelessly provided advice and guidance for the process and gave ongoing assistance to the Conversation on Coverage staff. Thanks also to the other terrific members of the Steering Committee – David Certner, Lynn Dudley, Regina Jefferson, Randy L. Johnson, Leslie Kramerich, Olena Berg Lacy, Lisa Mensah, Alicia Munnell, Shaun O'Brien, Virginia Reno, and Carol Sears — who took part in ongoing meetings and helped provide technical and process-related advice and editing on a regular basis.

We owe so much to the Working Group Co-Chairs of the Third Stage of the Conversation for leading the process with patience, endurance and grace. The Co-Chairs devoted enormous time and energy to the process, often consulting with Conversation staff on a daily basis to devise strategies to move the deliberations forward, edit material and shepherd this process to completion. Thank you to Melissa Kahn and Norman Stein who have been Co-Chairs of Working Group I since 2003; Michael Calabrese and John Kimpel, the Co-Chairs of Working Group II; and the four Co-Chairs of Working Group III: Maria Freese, Cathy Heron, Ian Lanoff, and Pamela Perun.

We also want to give a special thank you to all the Working Group members who gave so much of themselves to develop and refine these recommendations. All these individuals attended dozens of meetings and

provided technical edits to the reports and recommendations. We thank the following: Working Group I: Beth Almeida, Phyllis Borzi, Ellen Bruce, David Certner, Charles Cole, Patricia Dilley, Lynn Dudley, Ron Gebhardtsbauer, Deene Goodlaw, Brian Graff, Dan Halperin, Mike Johnston, Judy Mazo, Shaun O'Brien, and Jack VanDerhei. Working Group II: Dean Baker, Michael Beresik, Lynn Franzoi, Luisa Grillo-Chope, J. Mark Iwry, Lynn Jacobs, Regina Jefferson, Lisa Mensah, C. Eugene Steuerle, and Aliya Wong. Working Group III: Christopher Bone, Michael Fanning, Bridget Flynn, Leslie Kramerich, Claire McCusker, Colleen Medill, Robert Nagle, Sue Palmer, Carol Sears, Laurie Shultz, Stephen Utkus, and Christian Weller. We salute all of you!

Thanks to Dallas Salisbury and the Employee Benefit Research Institute for enabling Jack VanDerhei to use EBRI models and data to conduct a survey of the marketability and potential adequacy of Working Group I proposals. And thanks to Brian Graff for allowing the Conversation to send the survey to the membership of the American Society of Pension Professionals and Actuaries.

Also we want to thank Second Stage participants, who were not able to continue into the Third Stage but, who helped create the interim recommendations that led to the final recommendations: John Ameriks, Kenneth Cohen, Douglas Ell, Nell Hennessey, Pat Humphlett, Randy Johnson, Michael Kelso, Diane Oakley, Robert Patrician, Eric Rodriguez, Javier Silva, Dick Wartman, Janice Winston, and David Wray.

Thanks also to Alicia Munnell and her team at the Center for Retirement Research at Boston College for reviewing statistics for the Final Report and preparing *Private Pensions: Coverage and Benefit Trends*, a comprehensive paper created for the launch of the Conversation in 2001 and updated for the Second Stage in 2004.

And finally, we would like to recognize the Conversation staff and consultants who contributed so much. First and foremost, enormous gratitude must be paid to Robert England, the "storyteller" of the Conversation who has captured the minutes of every meeting since the first day of the process back in 2001, who helped create the Discussion Guides and who wrote the reports, integrating the edits of the Working Group members and Conversation staff. And a special thanks to Joellen Leavelle, the Conversation's Communications Coordinator and Logistics Manager who patiently and heroically worked with the Conversation's Director, organizing the process, editing materials, keeping communications flowing, scheduling countless meetings, keeping the details straight – and somehow managed to stay calm through it all. The Third Stage could not have happened without her. And finally thank you to Nancy Hwa, Kyle Garrett and Kathe Reusing who pitched in, along with other Pension Rights Center staff, as needed.

Thanks to all for a job well done.

X Acknowledgements

Introduction and Executive Summary

The Conversation on Coverage was launched in July 2001 when 75 retirement experts of varying perspectives came together at a two-day conference to address the pressing question: How do we expand pensions and savings for the millions of Americans, particularly low- and moderate wage-earners, who do not have income outside of Social Security to support them in retirement? With coverage rates stalled at approximately 50 percent for the last quarter-century, there was broad recognition that something needed to be done to address this critical issue. The event built a strong sense of camaraderie among participants and produced numerous promising initial concepts to increase coverage.

Spurred by the success of the first event, the Pension Rights Center, which convened this initiative, launched the Second Stage of the Conversation on Coverage in 2003. The Conversation established three Working Groups, with more than 45 experts of diverse backgrounds, who met intensively over an 18-month period to develop the first iterations of specific approaches to increase coverage. The Conversation on Coverage released these interim recommendations on July 22, 2004, at the National Policy Forum at the National Press Club (for more information, see www.conversationoncoverage.org).

In May 2005, the Conversation launched the Third Stage of its deliberations to refine the interim recommendations. The Working Groups were reconvened, with some new members, and they devoted collectively hundreds of hours in day-long meetings and telephone conferences to address an array of unresolved substantive issues and develop their detailed final recommendations. These ambitious efforts – a veritable bee-hive of intellectual activity – led to the development of four common ground proposals that are aimed at expanding guaranteed pensions, increasing retirement savings by individuals, and expanding coverage among small businesses. They all include elements that the Groups thought would be attractive to employers, financial institutions and employees. These proposals, completed in early 2007, are summarized below and described in detail in the three Working Group reports that follow.

Summary of the Final Working Group Recommendations

Four promising ideas for new types of retirement plans emerged from the Groups.

Working Group I

Working Group I's primary mission was to expand coverage by encouraging new forms of defined benefit plans or plans that have salient defined benefit features. To achieve this mission, the Group developed two plans:

The Guaranteed Account Plan (GAP)

GAP is a new hybrid plan that features individual accounts funded by employers with minimum guaranteed returns on employees' balances. In this plan, the employer credits a

contribution to an individual's account based on a percentage of the employee's pay and then guarantees the return on the contributions. The employer assumes the risk of investing the money to obtain the promised rate of return. The basic benefit is paid as a lifetime annuity that begins at the time of retirement, with a guaranteed survivor annuity for spouses.

Key features of GAP:

- Under GAP, each participant's guaranteed account is credited with an annual contribution based on a percentage of pay.
- The GAP credits each employee's account with a guaranteed annual rate of return, which can be a fixed interest rate or a variable rate of return.
- The employer funds the benefits, based on standardized conservative funding assumptions.
- The sponsor of GAP will employ professional asset managers to invest plan assets.
- A GAP could be designed to permit additional voluntary pre-tax contributions by employees, either to the GAP account or to another type of individual account plan.
- Under GAP, the normal payment option is an annuity (joint and survivor annuity for married participants). The employer can, however, design a GAP to offer alternative forms of benefits, including lump-sum payments.
- GAP has a unique Side-Car Trust to increase funding flexibility while insuring security for the promised benefits.
- The Pension Benefit Guaranty Corporation (PBGC)ⁱ would insure GAP accounts.
- The GAP will be subject to a lower PBGC premium than other defined benefit plans, reflecting the requirement that the employer fund the GAP on the basis of mandated conservative assumptions.
- The GAP permits generous past-service credits, which should appeal to small-business owners.

The Plain Old Pension Plan (POPP)

POPP is a new and simplified version of a basic traditional defined benefit pension plan that is easy for employers to create, fund, and administer. This is an employer-funded plan that starts with a modest guaranteed benefit to allay employer concerns about committing to large future pension funding obligations. The basic benefit is based on a percentage of an employee's career-average pay and is paid to the employee as an annuity with a guaranteed survivor annuity for spouses of married participants. One important feature of the plan enables companies to provide bonus benefits in good years and to scale back to the basic benefit formula in leaner years.

Key features of POPP:

- POPP is a simple, easy-to-understand traditional defined benefit plan that provides a modest basic benefit (as low as one percent of average compensation per year).
- Employer contributions are based on published government tables that will make it easier for employers to know how much money they will need to contribute and help reduce some of the funding volatility.

- POPP's vesting rules are more generous to employees than rules governing traditional defined benefit plans.
- POPP allows employers to fund special bonus benefits in any given year, which will raise employees' final pension benefits. This means that employers can increase benefits in years when they have good financial performance and provide only the basic benefit in years when the company does not perform as well.
- Employers can design plans to permit a generous past-service credit, which should be attractive to many small business owners.
- All benefits from the plan would be paid in the form of an annuity. Lump-sum distributions would not be permitted (except for very small amounts).

Both GAP and POPP incorporate funding rules that should substantially reduce the fluctuation from year to year in the employer's annual contribution to the plan and should, thus, make the plans more attractive to employers than currently available defined benefit plans.

See the Working Group I report for a full description of the building blocks of the GAP and POPP plans and other recommendations of the Group.

Working Group II

The mission of Working Group II was to develop new incentives and proposals to encourage more individual workers in the private sector to save – not only those who do not have an employer plan, but also those who may not be eligible for their employer's plan or who may not have chosen to participate. The Group focused on expanding coverage for low- and moderate-income workers who are least likely to have access to a plan. The Group had a short-term track to recommend incremental steps to encourage more individuals to participate in existing 401(k) plans and a long-term track to develop a proposal for a new clearinghouse to administer lifetime portable accounts.

The Retirement Investment Account (RIA)

The Group's primary achievement was the development of a proposal for a new plan, the Retirement Investment Account:

The RIA establishes a new national clearinghouse structure to administer portable lifetime individual accounts. This proposed structure is designed to provide an easy and efficient way for workers who are not covered by a plan to save for retirement and enable them to keep their account whenever they change jobs and lack employer plan coverage.

Key features of the RIA plan:

• The plan establishes a government-sponsored central Clearinghouse that would contract out the investments of funds to the private sector, in an approach such as that taken by the Thrift Savings Plan.

- The Clearinghouse would be set up to receive contributions from employees through payroll deductions facilitated by the employer in amounts indicated by employees.
- All eligible workers will be automatically enrolled unless they opt out.
- Self-employed individuals and contract workers can contribute when they file their quarterly taxes.
- All workers not covered or eligible to contribute to an employer-sponsored retirement savings plan, in which employees contribute, would be eligible for the RIA.
- Participant contributions will automatically be placed in a default investment.
- Participants who opt out of the automatic investment will have a limited choice of investment options.
- The RIA would be portable so that workers can maintain their RIA as they move from one employer to another and transfer amounts to and from 401(k) or IRA accounts.
- Tax credits could be added to the plan to encourage incentives for low- and moderate income wage earners.

See the Working Group II report for a full description of the building blocks of the plan and other recommendations of the Group.

Working Group III

Working Group III's mission was to create new approaches to increase pension coverage among small businesses where the coverage rates are lowest. To achieve this mission, the Group developed a new plan, the Model T, a simple plan that is meant to be attractive to small businesses and their employees.

The Model T Plan

The Model T is a simplified multiple employer payroll deduction plan offered by financial institutions to small businesses.

Key features of the Model T plan:

- A third-party financial institution runs the plan and takes on many of the administrative functions.
- Once an employer signs up with a financial institution, both the employer and employees will be able to make contributions to the plan.
- All employees full-time and part-time are eligible to participate. The self-employed and independent contractors can contribute on their own.
- Employees contribute through payroll deduction provided by participating employers.
- Employer contributions are voluntary but innovations in the plan design are aimed at encouraging employers to contribute on behalf of all employees in the plan.
- Funds are invested in simplified investment options that are consistent with the U.S. Department of Labor's default investment regulations.
- A recommended "Standardized Performance Report," produced annually by financial institutions that offer the plan, will help employers (and employees) compare fees, services, and investment performance of the plan on an apples-to-apples basis.

Understanding the Working Groups and the Process

The Conversation's Steering Committee (see Appendix A) and staff developed ground rules that have underpinned the deliberations of the Working Groups. Members were asked to participate as individuals, not as representatives of their organizations. They were asked to transcend, as much as possible, their personal and professional ideologies in the name of finding common ground solutions. Likewise, the Pension Rights Center cast aside its traditional advocacy role and served as a neutral facilitator in the process. All of the Conversation's deliberations were off the record and individuals were asked not to discuss the deliberations outside of the meetings, enabling participants to express their views freely. Working Group members were instructed to focus on where they agreed rather than where they disagreed. They were also asked to focus only on ways of increasing private retirement savings — not to address related issues such as Social Security, Supplemental Security Income, Medicare, and Medicaid.

To help facilitate the process in the Third Stage of the initiative, the Conversation on Coverage staff prepared elaborate Discussion Guides that the Co-Chairs used to ensure there was identifiable progress made at each of their day-long meetings and telephone conferences. These Discussion Guides summarized what had been accomplished at previous meetings and outlined key unresolved issues and ways of addressing them. The starting point for most members in their deliberations was a belief in perpetuating the voluntary retirement system, while finding ways of expanding it to include new workers and trying to ensure that any new proposals would complement, not undermine, the existing system.

Before the release of this report, members of the three Working Groups previewed their draft recommendations to one another so that all members would have a chance to hear about the details of proposals from the other Groups and make comments and suggestions. The Group also previewed their recommendations at off-the-record briefings with congressional committee and government agency staff in late 2006 and early 2007 to answer questions and hear responses and suggestions regarding the plans. Some of their comments will be taken into consideration in the implementation phase. (See Appendix B for some of the questions and comments that were made by congressional committee and government agency staff.)

Throughout the process, the Conversation has sought to develop and recommend proposals that would enjoy a broad appeal among all stakeholders in the private system. These proposals were shaped by hard work and passion in a give-and-take process that produced proposals and concepts that took into account a broad spectrum of views. Due to this broad diversity in the membership of the Working Groups and considerable time and energy devoted to this task, the ideas that have been recommended in this Final Report emerge from this process with increased odds that they can be adopted and implemented, advancing the coverage debate significantly.

Understanding the Language in the Report

The goal of each Working Group was to reach consensus on the design elements of the various proposals. However, by "consensus" we did not mean that 100 percent of the members all agreed on a particular issue.

There was an understanding by each Group that if nearly all the members agreed on something then it would be termed in the report as "general agreement." When views were mixed, that is indicated as well, and often the minority view is discussed in the rationale. It was decided at the beginning of the process that there would be no voting, per se, as this was seen as being potentially polarizing. When there were sticking points, the Working Group members either tried to reach resolution or provide options that could be decided later in the public policy process.

Understanding the Coverage Issue

The Working Groups began with the notion that, in order to expand coverage and participation, one must first identify the segments of the working population where the biggest coverage gaps exist. To that end, the Working Groups collected the statistical data set forth in this section. In addition to the data described in this section, the Working Groups also relied on data and findings from several studies that shed light on the coverage issue and that were written for the Conversation on Coverage.^{III}

The Department of Labor's National Compensation Survey – which surveys more than 10,000 private-sector employers, in reveals that in 2006, 60 percent of all full-time and part-time private-sector American workers had access to a retirement plan sponsored by the company where they worked. However, only 51 percent, or 53.6 million workers out of 110 million private-sector workers, participated in these corporate retirement plans.

Another study called the Current Population Survey^v has found a declining trend in coverage and participation rates. In 2005, for example, the survey found that only 55 percent of full-time and part-time private sector workers worked at firms that sponsored a retirement plan. Of those, only 45 percent participated in an employer-sponsored plan.^{vi} This compares with a 60 percent employer sponsorship rate and 50 percent employee participation rate in 2000.^{vii}

While the divergence in coverage and participation rates found in government statistics raises some questions about which numbers are correct, both surveys remain consistent with past findings that half the private-sector work force is not participating in a private retirement plan. viii

The likelihood that a worker will be covered by a workplace retirement plan varies according to income and age. Today, higher income workers and older employees with job tenure are more likely to work at a company with a retirement benefit. However, low- to moderate-income workers and younger employees are less likely to have a retirement plan. For example, while 58 percent of workers aged 55 to 64 participated in a retirement plan in 2005, only 42 percent of workers aged 25 to 34 participated, according to a Congressional Research Service analysis of the Current Population Survey. And, while 70 percent of the highest earnings quartile participated in a retirement plan, only 28 percent of the lowest earnings quartile participated in a plan.*

There is also a big gap in coverage rates between full-time and part-time workers. In 2005, 52 percent of full-time workers participated in a retirement plan, while only 24 percent of part-time workers participated, according to CRS analysis of the Current Population Survey.xi

The likelihood that a worker will participate in a retirement plan also varies by the size of the company. Companies with more than 100 workers are more likely to have a retirement plan. In these medium and large companies, a good employee benefits package is seen as key to attracting and retaining skilled workers.

On the other hand, one finds the largest share of workers without retirement benefits at smaller companies. The participation rate for full-time workers at businesses with 100 or more workers was 65 percent in 2005, while it was 45 percent at firms with 25 to 99 workers and only 25 percent at firms with fewer than 25 employees.** One of the reasons coverage is lower among small businesses is that they have a higher worker turnover rate. In work places with high labor turnover there is usually lower employer and worker interest in benefits with a long-term horizon.

The data also suggests that a higher level of part-time workers at small businesses also reduces overall retirement participation rates, since part-time workers as a group have lower coverage rates. Among the smallest businesses – those with fewer than 10 workers, 41 percent of the workers are part-time, according to the U.S. Census Bureau. By comparison, in slightly larger companies – those with 10 to 24 workers – the proportion of part-timers drops to 33 percent.

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

Coverage and Participation Rates at Firms with Retirement Plans

There is considerable potential to raise participation rates even at firms that currently offer workers the opportunity to save for retirement in a 401(k) plan. One study found that only 66 percent of workers who are eligible participate in 401(k) plans.xiii The study also found that when these firms adopt automatic enrollment, participation rises to 92 percent of eligible employees.xiv Automatic enrollment occurs when employers automatically enroll into a retirement saving plan all new hires and existing eligible employees who are not participating. Employees have to choose to opt out of participation under automatic enrollment.

In September 2005 the Department of Labor calculated the impact of automatic enrollment in its proposed rule on default investment options.* In 2002 only five percent of employers had adopted automatic enrollment. The Department of Labor estimated that in the near future 35 to 45 percent of employers will adopt automatic enrollment. The department estimated in its proposed rule that plans that adopt automatic enrollment raise participation rates to a level between 70 percent to 90 percent and that if one-third or more of employers adopt automatic enrollment, it will raise overall 401(k) participation rates from 72 percent to between 75 and 77 percent.* Higher employee contributions are also likely to raise overall employer matching contributions.*

There is also room to add coverage and participation by targeting the groups of workers at companies that sponsor plans who are not eligible to participate in those plans. This includes workers who have not been

employed long enough to be eligible, as well as those who do not work enough hours to be eligible, as well as other categories of workers that the employer chooses to exclude.

The Conversation on Coverage proposals in this Final Report offer a variety of ways to expand pensions and retirement savings to more workers and can, when implemented, go a long way toward reducing the coverage gap.

Robert Stowe England Rapporteur and Writer, Conversation on Coverage

Endnotes for Introduction

The Pension Benefit Guaranty Corporation was created by Congress in 1974 as part of the Employee Retirement Income Security Act (ERISA). It covers private sector defined benefit plans and is financed by premiums paid by employers. When plans are terminated, PBGC takes over the management of their assets and the payment of benefits to retirees.

"The Thrift Savings Plan is a retirement savings plan for federal civilian employees.

"Four papers have been completed to assist the efforts of the Conversation on Coverage and can be found at the following web site: www.conversationoncoverage.org. The four papers are as follows:

- "Private Pensions: Coverage and Benefit Trends," by Alicia H. Munnell and Annika Sundén with the assistance of Elisabeth Lidstone, Center for Retirement Research, Boston College, July 2001.
- "Working Paper on Multiple Employer Pension Plans," by Fiona M. Wright, 2003.
- "Confronting the Pension Coverage Challenge," by Leslie B. Kramerich, May 2003.
- "An Update on Employer Sponsored Pensions," by Alicia H. Munnell, Jamie Lee, and Kevin Meme, Center for Retirement Research, Boston College, July 2004.

"National Compensation Survey, Bureau of Labor Statistics. Survey from March 2006 can be found at http://www.bls.gov/ncs/ebs/sp/ebsm0004.pdf.

'In recent years there has been a divergence in participation rates as reported by various agencies of the federal government. *The Current Population Survey*, jointly sponsored by the Census Bureau and the Bureau of Labor Statistics, has been showing a steady decline since 2000. At the same time, however, the *National Compensation Survey* of the Bureau of Labor Statistics has been showing an increase in participation from 49 percent in 2003 to 51 percent in 2006. The National Compensation Survey has been considered authoritative by some because the reporting is done by employers, who might be assumed to be better informed about coverage and participation. Yet, the trends in *the Current Population Survey* are consistent with the trends found in the Federal Reserve Board's *Survey of Consumer Finances*, which has reported that participation fell from 50 percent of workers in 2001 to 48 percent in 2004.

"Patrick Purcell, "Pension Sponsorship and Participation: Summary of Recent Trends," (Washington, D.C.: Congressional Research Service, August 31, 2006), Table 2, page 6. The coverage data is based on a CRS analysis of the data from the Census Bureau's Survey Current Population Survey for the years 1990, 1995, and 2000 to 2005.

viiIbid.

viiThe Center for Retirement Research at Boston College has done several analyses of pension trends over time and has compared different data sets. Alicia H. Munnell and Pamela Perun ("An Update on Private Pensions," Issue in Brief Number 50, August 2006) document that pension participation rates have been essentially stuck at about 50 percent of the private-sector workforce for the past quarter-century. Geoffrey Sanzenbacher ("Estimating Pension Coverage Using Different Data Sets," Issue in Brief Number 51, August 2006) compares several major data sets and finds that the overall levels of participation and long-term trends are similar; again, they all show participation rates of roughly 50 percent.

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ixPatrick Purcell, CRS, Ibid, Table 5, p. 11.
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*Ibid, Table 7, p. 14.

xiIbid, Table 2, p. 6.

xiiIbid, Table 3, p. 8.

xiii"The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions on 401(k) Contributions at Retirement," Issue Brief No. 283, Employee Benefit Research Institute, Washington, D.C., 2005.

xivIbid.

^{xv}Default Investment Alternatives Under Participant Directed Individual Account Plans; Proposed Rule, Employee Benefits Security Administration, Federal Register, September 17, 2006 (v. 71, no. 187), pp. 56806-56824.

xviIbid, p. 56819.

xviiEmployer matching contributions could rise between \$700 million and \$1.3 billion annually under the default investment regulation. Ibid, p. 56820.

Definitions of Plan Types

This is a glossary explaining many of the terms used in *Covering the Uncovered*.

Defined Benefit Plan

A defined benefit plan is a pension other than an individual account plan that provides a regular monthly income after retirement that is determined according to a formula. It is not dependent on the actual contributions made to the plan or investment performance of the plan's assets. Benefits typically are determined based on a fraction of a worker's average earnings (either over the course of the worker's career or over the course of certain highearning years at the end of the worker's tenure), or a flat dollar amount multiplied by the number of years worked for the employer. For example, a defined benefit plan might offer employees a monthly retirement benefit equal to one percent of average compensation a year multiplied times the number of years worked. For example, if a worker earning \$40,000 a year accrues a pension of one percent or \$400 a year toward an annuity, then after 30 years, the individual has accumulated a pension of 30 multiplied by \$400 or \$12,000 a year. That is an annuity income of \$1,000 a month. In the alternative, a plan might promise a benefit of \$40 per month multiplied by the number of years worked. If a worker put in 20 years of service, he or she would also receive \$800 a month or \$9,600 a year. The maximum benefit payable by a defined benefit plan in 2007 is \$180,000 a year.

Some newer defined benefit plan designs provide benefits that mimic the appearance of defined contribution plans, reporting benefits as a lump-sum account balance (see cash balance plans below). Private-sector defined benefit pension plans must provide annuities as the default form of benefit. The annuities offered are either single-life annuities for unmarried participants or joint and 50 percent survivor annuities for married participants. The annuity from a defined benefit plan helps retirees (and their surviving spouses) by assuring them of a regular income based on a set formula for the rest of their lives.

Not all retirees receive their defined benefit as a regular monthly stream of income, known as an annuity. Instead, some employers allow retirees to receive their accumulated benefit as a lump sum (with the consent of their spouses). If a retiree elects to take a lump sum, where it is allowed, that retiree is responsible for deciding how to manage and invest those funds, as well as when and how much to pay out as income. In a defined benefit plan, the worker does not have to make decisions about how to invest assets contributed by the employer into the plan. The employer is responsible for determining the amount of contributions needed to fund the promised benefits, making those contributions each year, investing the assets in such a way they will earn a sufficient return to provide for the funds needed to pay the promised benefit, and making up for any shortfall in the assets. Most benefits provided by private defined benefit plans are guaranteed by the federal pension insurance program managed by the Pension Benefit Guaranty Corporation. The maximum insured annual benefit for 2007 is \$49,500.

Defined Contribution Plan

A defined contribution plan is one that provides workers with an individual account and pays out benefits equal to contributions to the account and net investment earnings on the contributions. The 401(k) plan is the most well-known example of this type of plan. In a 401(k) plan, contributions can be made by the employer or the worker, and employers often match employee contributions; that is, they provide an additional contribution tied to the amount of contribution the employee

makes. In some defined contribution plans – typically 401(k) plans – employees must decide how to allocate all or part of their account balances among a set menu of investment options selected by the employer (e.g., among various mutual funds and employer stock).

In other kinds of defined contribution plans – such as profit sharing, money purchase, and employee stock ownership plans - contributions are made by the employer. In these plans, the employer often invests the money in the employees' accounts. In most defined contribution plans, workers receive their benefits as lump sums when they leave their jobs. They may either roll over the account balance to an IRA or a new employer plan or use the money for other, nonretirement purposes. Defined contribution plans, other than money purchase plans (discussed below) are not required to offer annuity payouts and most do not. Upon retirement, an employee has accumulated retirement savings that he or she will have to decide how to manage. The retiree has to decide whether to take part or all of the assets as an annuity, if that is an option. Or, perhaps the retiree may choose to set up a schedule of regular withdrawals. The retiree also has to decide how to invest the assets in retirement, including whether to change the asset allocation. With the 401(k), there are minimum distribution rules, which dictate a minimum withdrawal each year beginning at the age of 70-1/2. Defined contribution plans, unlike defined benefit plans, are not insured by the Pension Benefit Guaranty Corporation.

Hybrid Plan

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

Cash Balance Plan

A cash balance plan is a defined benefit plan that defines the benefit as a stated account balance. In a typical cash balance plan, each worker is credited

on a periodic basis with a pay credit, a percentage of one's earnings, and an interest credit, which sets the rate of return for the account balance for that year. The interest rate can be either a fixed rate or a variable rate. Although cash balance benefits are reported as individual account balances, these accounts are only hypothetical. Workers' benefit amounts are unrelated to the employer's actual cash contributions to the plan and unrelated to the actual investment performance of plan assets. The benefit is based on the accumulated amount credited to each employee's account. As with all defined benefit plans, employers must offer employees the option of taking the benefit as an annuity as the default form of benefit.

Money Purchase Plan

The money purchase plan is an employer-sponsored defined contribution plan that allows employers to contribute a set percentage of compensation for workers into the plan with a maximum annual contribution of \$45,000 in 2007. This is the maximum for all defined contribution plans and, thus, is not a unique design element of the money purchase plan. Once an employer establishes a contribution level, the amount in subsequent contributions must be maintained until the employer makes a formal, prospective pronouncement that the contribution will be decreased or discontinued. Thus, contributions are made whether or not the business has a profit, which differentiates the money purchase plan from a profitsharing plan, where contributions are made to employees' accounts at the discretion of employers, usually when there are profits. Unlike other defined contribution plans, money purchase plans must provide joint and survivor annuities for married participants and single life annuities for unmarried participants.

SIMPLE

SIMPLE is an acronym for Savings Incentive Match Plan for Employees. The two basic types –

12 Definitions of Plan Types

SIMPLE IRAs and SIMPLE 401(k)s – are employer-sponsored retirement plans that are available to small employers with no more than 100 employees, as well as self-employed people. A SIMPLE IRA plan is an IRA-based plan that gives small employers a highly simplified method to offer employees an opportunity to make contributions toward their retirement. It involves no annual reports to the IRS, no lengthy plan document, no need for IRS approvals or determination letters, no nondiscrimination testing, and no trust for the employer to administer. Under a SIMPLE IRA plan, employees may choose to make salary-reduction contributions and the employer makes either matching or nonelective contributions. (A nonelective contribution is a type of contribution an employer chooses to make to each eligible employee's account, whether or not the employee makes a salary-reduction contribution.) All contributions from employers and employees are made directly to an Individual Retirement Account or Individual Retirement Annuity (IRA) set up for each employee. The employer may choose to have all of the IRAs established at the same financial institution. (See IRS Publication 560, IRS Publication 590 and IRS Notice 98-4 for detailed information on SIMPLE IRA plans.)



Mission

Working Group I was charged with expanding coverage by encouraging new forms of defined benefit plans and new types of hybrid plans that contain many of the salient features of defined benefit plans.

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Mission

Working Group I was charged with expanding coverage by encouraging new forms of defined benefit plans or new types of hybrid plans that contain many of the salient features of defined benefit plans. The Group, as a secondary mission, also sought to find ways to help stop the further erosion of the number of workers covered by defined benefit plans. (For more information on defined benefit plans and hybrid plans, see Definitions of Plan Types on page 11.)

Background

Members of Working Group I unanimously agreed that defined benefit plans are among the most efficient and effective mechanisms for providing a reliable stream of retirement benefits to employees of all income levels. While there has been a decline in the number of workers covered by defined benefit plans, the Group wanted to find ways to encourage, preserve, and promote the features of these plans. The Group's challenge was to design plans that would be attractive to employees while overcoming some of the challenges faced by employers in setting up and preserving these types of plans.

To address its mission, the Group first identified those features of defined benefit plans that make them attractive to employees. These features include the fact that defined benefit plans are employer-funded and that the investment risk is placed on the employer and not the employee. Key defined benefit plan features also include protection for spouses through survivor annuities, and the fact that these plans generally pay out benefits in a lifetime income stream – to ensure that neither the retiree or nor the retiree's spouse can outlive their assets (see the Advantages of Defined Benefit Plans sidebar).

The Working Group members then looked at why companies are increasingly moving away from sponsoring defined benefit pension plans, which were once the preferred pension arrangement at most large companies and many smaller ones. The Group identified the chief disincentives as (1) the volatile and unpredictable funding requirements; (2) the lack of attractive, easy defined benefit designs that can be marketed by financial institutions to small- or medium-sized businesses; (3) and finally, the perception among businesses that their employees do not value or understand these defined benefit plans and would prefer 401(k) plans.

Taking these factors and concerns into account, the members of Working Group I developed two new types of employer-paid, employer-guaranteed plans that incorporate features that represent both employer and employee interests. The plans are: the Guaranteed Account Plan (GAP), which is a hybrid plan, (i.e., a plan that combines many of the attractive features of the defined benefit plan with the familiarity and simplicity of the defined contribution plan); and the Plain Old Pension Plan (POPP), which is a simplified traditional career-average defined benefit plan.

THE GUARANTEED ACCOUNT PLAN (GAP)

GAP is a new hybrid plan that features individual accounts funded by the employer with minimum guaranteed returns on employees' balances. In this plan the employer credits a

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contribution to an individual's account based on a percentage of that employee's pay and then guarantees the return on the contributions. The employer assumes the risk of investing the money to obtain the specified promised rate of return. The basic benefit is paid as a lifetime annuity that begins at the time of retirement with a guaranteed spousal survivor annuity.

THE PLAIN OLD PENSION PLAN (POPP)

POPP is a new and simplified version of a basic traditional defined benefit pension plan that is easy for employees to understand and easy for employers to fund. This is an employer-funded plan that starts with a modest guaranteed benefit to allay employer concerns about committing to large future pension funding obligations. The basic benefit is based on a percentage of the employee's career-average pay and is paid to the employee as an annuity with a guaranteed spousal survivor benefit. One important feature of the plan enables companies to provide bonus benefits in good years and scale back to the basic benefit formula in leaner years.

Both GAP and POPP incorporate funding rules that substantially reduce the fluctuation from year to year in the employer's annual contribution to the plan and should, thus, make the plans more attractive to employers than currently available defined benefit formats.

In the wake of declining pension plan sponsorship, the Working Group believes that GAP and POPP should be marketed as alternative pension plans, particularly for small- and medium-sized businesses, although they are available for employers of any size. These plans could potentially offer valuable lifetime guaranteed benefits to millions of American employees.

This report describes in detail the design features of GAP and POPP, presented as building blocks of the overall plans. In addition to developing GAP and POPP, the Group also considered other ideas to encourage employers to adopt certain types of defined benefit plans that would increase coverage. Ultimately, the Group endorsed the idea of focused tax credits that would increase coverage in defined benefit plans. The report concludes with a discussion of these tax credit ideas.

How the Group Went about Its Assignment

Working Group I, like the other two Working Groups, was first formed in 2003 at the start of the Second Stage of the Conversation on Coverage. The original 15 members of the Group developed a list of criteria for reviewing proposals for new types of defined benefit and hybrid plans and also for reviewing proposals for tax incentives and other ideas to make defined benefit plans more attractive. In a nutshell, the Group generally agreed that proposals should be attractive to employers and employees, make good public policy sense, and be regarded as marketable by the financial institutions and consultants who would sell them.

The Group then began its substantive work by reviewing several defined benefit and hybrid proposals. The Group also looked at proposals that combine a defined benefit with a 401(k), so-called DB-K plans. From this work, the Group developed the first iterations of the GAP and the POPP proposals – which were

The Advantages of Defined Benefit Plans

efined benefit plans are often seen to have a number of inherent advantages over the most prevalent defined contribution plans for rank-and-file workers. Significantly, all or most of the contributions are made by the employers. Also, the burden of determining how much to save, the responsibility for investing those assets, and the investment risk are all shifted away from the employee on to the employer.

Employees in defined benefit plans also have the advantage that their guaranteed benefits are generally paid out as a lifetime annuity in an amount that can be calculated from the specific formula in the plan. Providing the retirement income benefit as an annuity eliminates the longevity risk for the retiree; that is, the retiree does not have to worry about outliving the pension, since it is paid out as an income stream throughout the retiree's life span.xvii Also, should a company go bankrupt, and not be able to meet its pension obligations, defined benefit plans are insured by the Pension Benefit Guaranty Corporation.

In addition, defined benefit plans offer protections to spouses by providing a joint and survivor annuity as the normal form of benefit. This means that there is a guaranteed annuity for the spouse should the participant die either while working or in retirement. This benefit will automatically be paid to a spouse unless he or she signs away the right to receive this benefit.

released in the interim Working Report titled Covering the Uncovered: Common Ground Recommendations to Expand Retirement Savings for American Workers. (For a full description of the Working Group Second Stage process, see the Working Report at www.conversationoncoverage.org.)

In May of 2005, the Working Group, with some new members, began the Third Stage of deliberations of the Conversation to review and address issues left unresolved in the interim reports. The deliberations continued through 2006. The members of Working Group I collectively put in hundreds of hours in more than a dozen full and subgroup meetings. The Group sought to reconcile and coordinate the interests of employees and employers and financial institutions. To reach consensus, members of the Group often engaged in spirited discussion and sought to understand and conceptualize issues from a variety of perspectives. As a result, the proposals reflect resolution of issues that may be different from those that any one group member might have decided had he or she developed the proposal alone.

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The Guaranteed Account Plan (GAP)

MAJOR DESIGN FEATURES AND KEY ADVANTAGES

The major features and key advantages of GAP are described below. This presentation highlights the appeal of particular design features and provides more detailed descriptions of the design for various elements of the plan.

CONCEPT AND BUILDING BLOCKS

The Concept

GAP is a new kind of easy-to-understand hybrid plan, which combines individual accounts with employer funding and guarantees on investment performance. The basic form of benefit under GAP is a lifetime annuity, with a guaranteed spousal survivor benefit.

The Group's basic idea was that an individual account plan, with employer funding and employer-guaranteed rates of return, could replicate many of the advantages of traditional defined benefit plans, particularly if the basic form of benefit was a lifetime annuity, with a survivor benefit for a participant's spouse. The Group also thought that such a plan could be attractive to small businesses if two conditions were met: first, if they could promise the owners and other valued employees of such businesses a significant retirement benefit; and, second, if the employer could rely on predictable and stable contribution obligations over the plan's life. The Group believed that both of these conditions could be satisfied in a plan that would also provide meaningful guaranteed benefits to lower- and middle-income employees.

Working Group I members recognized that GAP would, in many respects, resemble a cash balance plan (see Definition of Plan Types on page 11). The Group, however, wanted a hybrid plan that avoided the legal and conversion issues that surrounded cash balance plans at the time of the Group's deliberations. Through some reverse engineering, the Group designed GAP as a mirror image of the cash balance plan. Rather than start with a defined benefit plan that has notional accounts (the way a cash balance plan works), GAP instead starts with the regulatory framework for money purchase pension plans, a type of defined contribution plan that is employer-funded and that provides participants with an annuity benefit at retirement. The Group then added employer guarantees to the money purchase plan blueprint and developed workable funding rules for this new hybrid design.

Building Block 1

The employer provides all employees with an across-the-board contribution based on a percentage of salary.

The employee's account is credited with annual contributions, called pay credits, which may, but need not be, a uniform percentage of each employee's compensation. The proposed GAP framework does not specify a minimum contribution level, except in cases where employers want to take advantage of complex rules that allow them to better reward higher-paid employees (see Building Blocks 7 and 8 for more details on contribution limits and permitted nondiscrimination tests).

Rationale: The Group discussed the pros and cons of requiring the same contribution level for all employees. While many in the Working Group agreed that it would be ideal for employers to adopt GAPs with uniform contribution limits, the group also recognized that GAP would compete with other types of plans, particularly 401(k) plans, and various other forms of defined contribution plans that allow the employer to provide a higher percentage pay credit for owner and management employees. In order to encourage employers to adopt GAPs and offer their employees the benefits of an employer-funded plan with employer-guaranteed investment returns, the Group generally agreed that GAP would have to permit employers to design plans that provide better benefits for owners and management employees if they wished – as long as they provide minimum contributions for rank-and-file employees in some situations.

Building Block 2

Each year the employer credits the employee's GAP account with an annual rate of return, which can be a guaranteed fixed interest rate or a variable rate of return.

With this building block, GAP tries to accomplish two goals. It requires employers to provide at least a modest guaranteed rate of return. However, it also gives employers flexibility in setting a higher fixed rate or a variable rate of return (such as a return tied to an equity or bond index) on account balances.

- A fixed rate of return. GAP must provide a rate of return of at least three percent a year.
- A variable rate of return. If the employer uses a variable rate of return, GAP must guarantee that the account balance at the time of payment will be at least equal to a cumulative three percent rate of return. Thus, when a plan provides a variable rate of return, the employee will receive the higher of the two amounts: the actual account balance, reflecting the variable rate of return, or an alternate account balance with a three percent rate of return.
- In addition, if GAP provides a variable rate of return, it must also provide employees with the right, at a specified age, to shift to a fixed rate of return at the time of the election. The Group has not determined the age at which the employee should be permitted to make this election or the mechanics of the election.

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Employers would be permitted, if they so chose, to design a GAP that gives employees a choice of a fixed rate of return or a variable rate of return.

Rationale: While the Group initially considered whether a GAP plan sponsor should be required to provide a specific minimum benefit for all employees, the members ultimately decided that the employer should have the flexibility to set benefits at a level that fits its compensation and employee retirement goals. While GAP does not set a minimum contribution level, it does require a minimum rate of return.

After lengthy discussion, and several subgroup meetings, the Group decided to give plan sponsors the choices outlined above on the rate of return so that GAP could either provide employees with the security of a predictable fixed rate or provide employees with an opportunity to earn higher returns in a stock index with some protection against sudden declines in value because of variable rates. The Group regarded the minimum guarantee for variable rates as essential for employee retirement security. In discussions, members of the Group observed that most equity or bond indexes would pay, over the course of an extended period of time, a cumulative return that would generally exceed the three percent minimum alternative return.¹⁷

The Working Group also spent many hours discussing how large the minimum fixed guarantee would be. Some in the Group initially wanted a higher rate of return than three percent but others argued if that were the case, employers would then likely choose a variable rate of return that the Group expected to be lower than the minimum fixed rate – which would defeat the purpose of the guarantee. Some members of the Group suggested that employers who chose a variable rate of return could be required to choose among indices that are expected to return more than three percent, but the complexity of implementing such a requirement was thought to be considerable. In any event, because business owners themselves, as well as other higher-paid employees would also be adversely affected by a low rate of return, there would be considerable incentive for employers to provide a competitive rate of return, whether as a fixed rate or a variable rate.

Building Block 3

GAP has shorter vesting than most traditional pension plans to assure that more shortterm workers earn a retirement benefit.

GAP has vesting rules – that is, rules that govern how long employees have to work before they are entitled to the benefits in a retirement plan – that are more generous than rules governing traditional defined benefit plans.

Contributions (and interest on those contributions) from the employer can be vested in one of two ways: six-year graded vesting or cliff vesting after three years. Graded vesting means the vesting occurs gradually and steadily. Cliff vesting means that 100 percent of the account balance plus returns are vested after completion of a specific number of years, which, in the case of GAP, is three years.

GAP's vesting rules for employer-provided benefits are identical to the vesting requirements that apply to "top-heavy plans" and to employer-matching contributions to 401(k) plans. In addition, as part of the Pension Protection Act of 2006, Congress extended these rules to all defined contribution plans and required three-year cliff vesting for cash balance plans.

Building Block 4

GAP is portable with other retirement plans because its basic benefit is an account balance.

Employees can choose to keep their balance with their employer or roll it over to other qualified retirement plans. Portability helps ensure that the GAP benefit will grow and be reserved for retirement income.

Building Block 5

GAP can include a 401(k) feature, which allows employees to make contributions to the plan above and beyond the employer contributions.

GAP can be designed to permit employees to make voluntary contributions on a pre-tax basis. Employers can match the employee contribution, just as in a 401(k) plan. So, GAP has a two-in-one appeal. The employee contribution and employer matching features follow current Internal Revenue Code requirements governing 401(k) plans.

• The employer could design an elective deferral feature to permit employees to contribute to their GAP account, a separate section 401(k) plan, or the employee's choice of the two. Because the employer is making a contribution, GAP would satisfy section 401(k) non-discrimination safe-harbor testing.

Rationale: These provisions were included to allow employers to combine GAP with a voluntary savings plan to meet a frequent request of plan sponsors. This would also make the plan more attractive to workers, who will have a way to add to their retirement benefit by electing to contribute part of their compensation to the 401(k) feature on a regular basis.

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Building Block 6

GAP allows for generous past-service credit to make it more appealing to owners and older employees who have been at a company for a long time.

Here's how the past-service credit works:

- GAP can provide for up to seven years of past-service credit. An employee could earn up to one year of past-service credit for each year of actual GAP participation. Thus, it would take seven years to earn the maximum seven years of past-service credit. The employer is required to fully fund past-service credits in the year in which it is earned. Thus, funding for the maximum seven years of past-service credit occurs over the first seven years of a GAP's life.
- All employees including low- and moderate-income workers, as well as highly-compensated employees—receive past-service credit on the same basis. Further, when past-service credit is allowed, the period of past service can count toward the vesting requirements of the plan.

Rationale: Experience suggests that permitting generous past-service credits – where employees get pension credit for years worked prior to the establishment of the plan – is a strong incentive for employers to establish plans, since such credits will help the long-tenured employees that firms most want to benefit. Current regulations generally limit past-service credits to five years in the case of a small business.

Building Block 7

GAP permits significant contributions for senior employees in exchange for making a higher contribution for all employees.

In cases where an employer wants to contribute more for senior, higher-paid workers, GAP has a trade-off: It allows employers to choose to follow the tax rules of defined benefit plans, which permit employers to make larger contributions for older workers than the rules generally applicable to money purchase pension and other defined contribution plans. However, in return for this higher contribution limit, employers would have to provide a contribution of at least 6.5 percent of compensation to all employees, regardless of age. This is a win-win for rank-and-file employees and for the older key employees that the employer wants to benefit.

Rationale: The Group devoted many hours of discussion in both the large group meetings and in subgroup meetings to balance the interests of employers and employees. Some members wanted to maximize benefits for owners and/or highly paid employees while others wanted to ensure that if this occurs, rank-and-file workers are not short-changed in the level of benefits they were able to obtain in the bargain. As a compromise, the Group decided that, in exchange for giving employers an opportunity to provide higher contribution levels in GAP than they could under a defined contribution plan, employers would have to

provide a 6.5 percent "gateway" (i.e., minimum) contribution of each eligible worker's compensation into a GAP account. This is a higher contribution rate than is now required under current rules governing defined contribution plans.

Building Block 8

Employers can use the more flexible defined contribution methodologies to test contribution formulas for nondiscrimination.

Rationale: Congress requires all qualified retirement plans to perform nondiscrimination tests to ensure that the plans do not provide a disproportionate share of the benefits to high-paid workers over low-paid workers. Under methodologies permissible under Treasury regulations, it is possible to design a defined contribution plan that provides substantially higher annual contributions for selected highly-compensated employees. One methodology permits a plan to provide relatively higher contributions for older employees. A second, more complex methodology (using "rate groups"), permits higher contributions for select higher paid employees, regardless of age. The regulations generally require defined contribution plans that use a form of the latter method to provide either a 5 percent or 7.5 percent gateway contribution for non-highly compensated employees.*

The Group determined that an employer using "rate group" testing methodologies should have to provide a minimum contribution for non-highly compensated employees. After discussion, the Group settled on a 6.5 percent minimum contribution for plans using such testing methodologies.

Building Block 9

GAP funding rules provide for predictable and easy funding.

GAP rules are designed to allay a key concern of employers regarding traditional defined benefit plans – the unpredictability of the annual contribution employers have to make to keep the plan full funded. With GAP, a plan sponsor will determine required funding in accordance with standardized and conservative interest rates and other actuarial assumptions. If a GAP becomes underfunded, the employer will have a five-year period to amortize the shortfall.

Here are the basic funding rules:

- The plan sponsor funds each year's additions to employee GAP accounts based on standardized and conservative assumptions.
- When the plan becomes underfunded, the funding gap has to be remedied over a five-year period, which is shorter than would be required under a traditional defined benefit plan and, thus, seen as better protection of workers' earned benefits.

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• Employers can fund a GAP up to 150 percent of its target liability, the same as for defined benefit plans after the Pension Protection Act of 2006. Employers can contribute additional money to an associated Side-Car Trust, as described in the next Building Block (see Appendix C for a case study illustrating the funding method over a seven-year period).

Rationale: The Working Group wanted to establish rules that would reduce contribution volatility and thereby provide employers with better control of annual cash flows to their retirement plan, and at the same time provide a strong degree of benefit security to participants. While there may appear to be tension between these goals, the requirement that plans use conservative actuarial assumptions advances both goals. In addition, the Group anticipates that some employers will use funding strategies that will substantially decrease the likelihood that a plan will ever become even moderately underfunded due to investment performance. The use of the Side-Car Trust, in conjunction with the generous overall full funding limit for the actual plan trust, will provide employers with ample opportunity to advance fund a GAP in good years and hedge against problems that might arise in down years in a firm's business cycle.

Building Block 10

GAP has a unique Side-Car Trust to increase funding flexibility while insuring security for the promised benefits.

To encourage the creation of a financial buffer against down business cycles and market declines, GAP allows employers to set up a Side-Car Trust to build up reserves that could be used to close funding gaps, to fund benefit increases, or simply to meet the employer's normal funding obligations. The Side-Car Trust is set up to operate alongside GAP. The employer would receive a current corporate income tax deduction for contributions made to the Side-Car Trust.

- Sponsors could make tax-deductible contributions into the Side-Car Trust and gains within the trust would not be taxed at the time of the gain.
- Further, there would be no restrictions on transfers from the Side-Car Trust to GAP (aside from the 150 percent funding limit). An employer would be allowed to use funds in the Side-Car Trust to satisfy its normal funding obligation.
- Transfers from the Side-Car Trust to GAP could be made tax-free. Sponsors could withdraw funds from the Side-Car Trust for any reason, but only when the GAP is at least 110 percent funded.
- Shortfalls in GAP funding have to be made up within five years and funds from the Side-Car Trust would be required to be transferred to the plan until the GAP's funding ratio was at least 110 percent.
- Employer withdrawals from the Side-Car Trust would be subject to income tax and a 12 percent excise tax, which is both lower and simpler than the excise tax applied to reversions from existing defined benefit plans.

Rationale: The suggestion for a Side-Car Trust came out of efforts to provide employers with an incentive to keep plans well-funded and create a buffer of funding that could be applied to the plan in difficult

years or during market declines. It was noted by Working Group members that under current law, some employers are unwilling to fund the plan above current plan liabilities because, if an employer wishes to recover all or part of the surplus, the employer must pay both high transaction costs and a high excise tax. On the other hand, other members of the Working Group have a favorable view of current law because, by reducing the incentive for employers to access surplus assets, it helps preserve a cushion against market downturns and increases the odds that employers will improve benefits. The Side-Car Trust vehicle was seen as a compromise position to encourage employers to put aside assets that could, if needed, be used in the future without unnecessarily encouraging employers to withdraw assets from the plan itself.

Reaching a compromise on the amount of the reversion tax (corporate tax rate plus 12 percent excise tax) was one of the most contentious and technically challenging issues the Working Group faced in both the Second and Third Stages of the Conversation on Coverage process. While many members did not want to weaken current protections represented by the reversion tax in existing pension plans, they agreed that designing a different approach for GAP would encourage employers to adopt these plans and effectively provide the plans with a rainy-day fund.

In setting the reversion excise tax at 12 percent (on top of the corporate income tax) the Group chose a rate that was seen by some members of the Group as high enough to recapture, on a rough justice basis, the tax benefits that were realized by making a contribution to the Side-Car Trust. The Group used financial modeling to determine the excise tax's ability to recover the benefits of tax deferral under various timelines as well as assumptions about tax rates and rates of return on investment. The Group was aware that the effective rate of return on investments, particularly for owners of small businesses, is at historic lows, which means that an excise tax may not have to be set high to recover the benefits employers realized from the tax deferral of contributions to a plan or to a Side-Car Trust. The financial modeling suggested that the 12 percent tax would generally more than recover those tax benefits unless an employer left assets in the Side-Car Trust for a decade or more. The Group further believed that most GAP sponsors would not "game the system" if they had to leave assets in the Side-Car Trust for a decade or more to derive meaningful tax benefits, and that in any event, there would be a public benefit if GAP were maintained for more than a decade.

The Side-Car Trust is a feature specifically designed for GAP, in conjunction with other features, to make the plan more attractive than other plans on the market.

Building Block 11

The normal form of benefit in a GAP is a lifetime annuity, with a 75 percent survivor benefit for the spouse. An employer may, however, design a plan to provide alternative forms of benefits, including a lump-sum benefit.

Rationale: These provisions were added to ensure that employers would offer a lifetime monthly benefit as the normal form of benefit, even though GAP is based on an account balance. In other words, GAP adopts and adapts rules that now apply to traditional defined benefit plans. 401(k) plans and some other

defined contribution plans do not require this type of payment. Under current law, the automatic form of benefit under a defined benefit plan is called a joint and survivor annuity. Unless an employee and his or her spouse agree in writing to reject this survivor's option, the retiree's benefit will generally be actuarially reduced to ensure that if the participant dies the spouse can receive a lifetime benefit – usually equal to 50 percent of what the retiree was receiving. The Group believed that the GAP should provide a 75 percent survivor benefit rather than a 50 percent survivor benefit, because in the typical case the survivor will need more than 50 percent of the payments that were made while the participant was alive. The Pension Protection Act of 2006 requires that plans offer a 75 percent survivor annuity as an alternative to the 50 percent survivor annuity.^{xi}

Building Block 12

GAP accounts will be insured by the Pension Benefit Guaranty Corporation (PBGC) at a reduced \$5 annual premium.

Because the benefits are guaranteed, account balances in GAP will be insured by the PBGC. However, because of the strict and conservative funding rules, the premium will be \$5, much lower than the premium charged for traditional defined benefit plans. The idea is that the conservative funding approach required under GAP would expose PBGC to lower risk.

The next steps required to implement GAP are discussed at the end of this Working Group I report, following the discussion of the POPP.

The Plain Old Pension Plan (POPP)

MAJOR DESIGN FEATURES AND KEY ADVANTAGES

As described at the beginning of this Working Group report, POPP is a straightforward career-average defined benefit plan that simplifies funding rules and administration while providing the employer with an opportunity to vary benefit accruals from year to year without formal plan amendments. POPP also permits employers to provide generous past-service benefits, which should make the plan attractive to firms that wish to provide meaningful benefits to employees with long tenures at the time of plan adoption. These features should make POPP an appealing option for small- and medium-sized firms that would like to offer their employees the security of a defined benefit plan.

Below are the major features and key advantages of POPP. This presentation highlights the appeal of particular design features and provides a more detailed description of various elements of the plan.

With these features, the Group reached agreement on the key design elements of POPP. Of course, further work is needed to work out all the details of the plan for the future.

CONCEPT AND BUILDING BLOCKS

POPP is a simplified traditional defined benefit plan that is easy to understand.

POPP is a simplified traditional defined benefit plan that provides a modest basic benefit to allay employer concerns about committing to large future pension funding obligations. The basic benefit is based on a percentage of an employee's career-average pay, which can be as low as one percent, multiplied by the number of years of service, which would be paid to the employee as monthly income starting at the point of retirement. Put another way, an employee's final benefit is the sum of each year's basic benefits – the percentage of their pay for that year.

• **Multiple Employer POPP.** The Group thought that the POPP could also work in a multiple employer context in which a single financial institution could offer the same plan to several companies, investing the assets together.

Building Block 1

POPP'S eligibility rules are designed to expand coverage for workers.

POPP covers more members of an employer's workforce than traditional defined benefit or defined contribution plans. This includes most part-time employees, if they work regularly throughout the year.

• Eligibility Rules. The plan would cover all employees who meet the minimum service requirements, including part-time employees. The minimum service requirement is at least one year of work and the employee must be at least 21 years old. If someone is hired at age 18, for example, the plan could require him or her to wait until age 21 to become a participant in the plan. Employers would not be required to cover seasonal employees but could, if they wished. Thus, the plan would typically cover a secretary who worked one day a week, but not a college student who worked for the summer. If the employer has separate lines of business, the plan could be adopted for one line of business only.

Rationale: By including part-time workers, the POPP casts a wider coverage net. By giving employers flexibility to exclude seasonal workers, however, it allows employers to exclude workers who do not have a regular and permanent relationship to the firm. Employer flexibility is further enhanced by allowing employers to offer the plan for only one line of business.

Building Block 2

POPP's vesting rules are more generous than rules governing traditional defined benefit plans.

Contributions to POPP from the employer can be vested in one of two ways: six-year graded vesting or cliff vesting after three years. Graded vesting means the vesting occurs gradually and steadily. Cliff vesting means that employees earn a nonforfeitable right to 100 percent of their benefits at retirement after a specified number of years, which under POPP is three years.

Statistics on Defined Benefit <u>Plans</u>

The defined benefit plan was once the dominant pension plan in the private sector and the public sector. However, even though it has retained much of its prominence in federal, state and local government employee retirement plans, it has lost ground in the private sector. Due to a variety of factors, including competitive pressures, globalization, changing views about retirement benefits by corporations, and the lack of appreciation of the defined benefit plans by many employees, the defined benefit plan is no longer the preeminent method of providing retirement income for private-sector employees. The plan's dominant position eroded within a single generation, as the proportion of the private-sector workforce covered by a defined benefit plan was cut in half from 39 percent in 1980 to 19 percent in 2003.xviii According to a government survey of employers, 21 percent of private sector workers had access to a defined benefit plan in 2005, while 20 percent actually participated in a defined benefit plan.xix

Meanwhile the proportion of workers with a defined contribution plan as their primary retirement plan rose sharply over the same period from eight percent to 31 percent, making the defined contribution plan the dominant type of plan in the workforce. **

Federal pension data illustrates the extent of the decline in the number of defined benefit plans and employees covered by such plans. According to the Pension Benefit Guaranty Corporation, the number of insured defined benefit plants fell from continued on page 30

continued from page 29

114,396 in 1985 to 30,336 in 2005. The sharp decline was primarily a result of the termination of a large number of small plans. Between 1985 and 2005, xxii the number of single-employer defined benefit plans with 100 or fewer workers fell from 90,061 to 17,997, an 80 percent decline.xxiii The number of large defined benefit plans fell from 22,147 to 10,772, a decline of 51 percent.xxiii In recent years, several large pension plans have been terminated and others have been "frozen" so that participants no longer accrue pension benefits.

There has been a similar decline in the total number of workers covered and the share of private-sector workers covered by a defined benefit plan. In 1980, for example, 27.42 million private workers representing 35 percent of the 78.35 million private sector workforce were covered by a defined benefit plan. xxiv In 2003, by comparison, 21.26 million workers representing 18.5 percent of the work force of 114.92 million private sector workers were covered. xxv

The data suggests that while the defined contribution plan has become a more popular method for providing retirement benefits, it has not achieved the degree of success that the defined benefit system enjoyed before the rise of the defined contribution plans, particularly 401(k) plans. And despite its relative decline, the defined benefit plan remains an important part of the employee benefits system, especially at larger firms. Also, the defined benefit plan continues to be the plan of choice for federal, state and local government employees and for workers in the unionized sector of the economy.

• Faster Vesting. The POPP vesting rules for employer-provided benefits are identical to the vesting requirements for top-heavy plans and for employer matching contributions to 401(k) plans: six-year graded vesting or cliff vesting after three years. (The Pension Protection Act of 2006 has extended these vesting rules to all defined contribution plans, and has also extended three-year cliff vesting to cash balance plans.) The vesting options are thus more generous than the rules that still govern traditional defined benefit plans. Vesting would only count service from the date POPP was adopted unless the employer chose to count years prior to adoption of POPP.

Building Block 3

POPP gives employers flexibility to provide bigger benefits in any given year without fear of being locked in to offering a bigger benefit every year.

POPP allows employers to fund bonus benefits in any given year or years that would raise the final benefit without having the bonus benefits become part of the permanent benefit structure. This means that employers can increase benefits in years when they have good financial performance, and provide only the basic benefit in years when the company does not perform as well.

The POPP bonus benefit can work as follows:

- The employer may give a bonus benefit to employees without committing to a permanent increase.
- Or, the employer might increase the benefit by the cost-ofliving, and such COLAs would be treated as a bonus benefit for the years they covered.
- A bonus benefit would raise the final annuity in the plan. For example, if a worker earned \$50,000 per year from an employer, that employee would accrue a basic benefit of an annuity on retirement of \$500 (one percent of \$50,000) for that year. If the employer gave a bonus benefit of an additional two percent for that year, then the employee would accrue a benefit of \$1,500 (one percent basic benefit plus two percent bonus benefit equals three percent of

\$50,000 for that year). The employee's final benefit would be the sum of each of the annual accruals, including both basic benefits and bonus benefits for the years of service.

• These provisions give the employer the opportunity to improve benefits on an annual basis in good years without having to maintain those benefits going forward. Thus, the employer could return to the basic one percent benefit the following year. The decision on year-to-year benefit changes can be done administratively. That is, the bonuses could be done by board of directors' resolution and a participant announcement each year rather than a formal amendment of the plan.

Rationale: By providing plans with the opportunity to improve benefits in good years without requiring that these additional benefits become permanent, POPP gives employers greater flexibility in providing benefits when they can afford it and improves the chances workers will earn bonus benefits.

Building Block 4

POPP allows for generous past-service credit to make it more appealing to owners and older employees who have been at a company for a long time.

The plan would permit employers to provide as much past-service credit as they would like to employees for all or part of the years they served in the company prior to the establishment of the plan. This means that all employees would get extra benefit credit for years worked before the plan started—which is an appealing feature for small business owners. All of the past-service credit would be earned and funded on a pro-rata basis over seven years from the year it was adopted.

Here are the rules for past service:

- The past-service credit would be amortized, that is funded in regular installments, over a seven-year period from the date adopted.
- Employees would earn the past-service credit over the same seven year period (if, for instance, the company decided to give seven years of past credit, the employee would work one year in the future, to earn benefit credit for one year in the past).

The past-service credits make the plan very attractive to businesses that previously did not have a plan with any kind of defined benefit.

Rationale: Experience shows that permitting generous past-service credits is a strong incentive for employers to establish plans, since credits will help the long-tenured employees that firms most want to benefit. Because these benefits could be subjected to future vesting, the employer would be able to use them as a retention device for continued service by employees, although the employer could credit past service for vesting as well.

Building Block 5

Employers can offer a plan that allows voluntary employee contributions to increase the final POPP benefit.

An employer can design a POPP that permits employees to make pre-tax salary-reduction contributions to increase their retirement benefit. Benefits would be determined using the same actuarial tables as the employer. (See information in Appendix D on tables and funding rules, as well information in the next building block on how the funding works.) This allows the best of both worlds. While POPP is primarily an employer-funded plan, which is appealing to low-income workers, those who can afford to can contribute more money. Employee contributions in the POPP would not be able to exceed annual employee deferral contribution limits set by the law, which is \$15,500 in 2007.xii

• **Contributory DB Conversion to POPP.** An employer with a contributory defined benefit plan, where contributions are post-tax, could convert to a POPP and employee contributions would be pre-tax.

Rationale: These provisions give the employee the opportunity to improve their retirement benefit, either through a contribution to the POPP to improve their defined benefit – or by contributing to a 401(k) plan with individual accounts. The employee-deferral contribution limits would apply to all of the employee's pre-tax contributions to POPP and to all plans for the year.

Building Block 6

POPP provides for predictable and easy funding.

Contributions will be made under conservative actuarial assumptions using government-authorized tables. This would simplify administration and allay employer concerns about the potential volatility of the funding liability.

- **Basic Benefit.** The final basic benefit is based on a percentage as low as one percent of an employee's career-average pay multiplied by the years of service.
- Treasury Tables Published Annually. The annual contribution for each participant would be determined in accordance with tables on key actuarial variables for mortality and interest rates published annually by the U.S. Department of Treasury, which would set a contribution amount per dollar of benefit based on the participant's age in each particular year. The amounts set forth in the tables would be determined using conservative actuarial assumptions, to reduce the possibility of funding shortfalls. Employers would calculate each year's required contribution by aggregating the contributions on the table for each participant. Some members of the Working Group suggested that the government publish the actuarial tables required in this plan every five years instead of annually.
- Examples of How Funding Works. Tables to illustrate how the plan will be funded are located in Appendix D.

• **Smoothing of Investment Losses.** The plan would be subject to periodic actuarial valuations, primarily to assess investment experience since mortality and interest rates would be covered automatically under tables. Investment experience would be smoothed by using a five-year rolling average of the asset valuation (or, if less, the number of years since the plan was established). Investment shortfalls are to be funded in installments over seven years.

Rationale: POPP was designed to simplify the funding rules and reduce employer concerns about the plan developing large unfunded liabilities that might overwhelm a small business. Conservative and consistently applied funding assumptions make the calculation of the annual contribution simpler, while also making funding more predictable and less variable from year to year. The use of smoothing**ii will reduce the volatility of differences between actual investment experience and the assumptions reflected on the government tables.

Building Block 7

The retirement benefit from a POPP must be paid out as an annuity.

All benefits from the plan would be paid in the form of a qualified joint and survivor annuity. Lump-sum distributions would not be permitted except when the benefit is worth less than \$5,000. Benefits for terminated employees could be transferred to the PBGC for future payout to further simplify administration.

• **Distributions from 401(k) Feature.** The 401(k) feature cannot be paid out as a lump sum and is instead to be applied toward increasing the annuity benefit with an additional pre-tax contribution, and not for separate investments by the participant.

Rationale: Requiring that the benefit be taken only as an annuity ensures that the purpose of the POPP is preserved; that is, that the plan provides retirement security through lifetime benefits. If the employer wishes to provide employees with a straight savings plan, they can sponsor a 401(k) plan in addition to the POPP as an alternative to allowing employees to augment their benefits through elective POPP contributions.

• **Small Balances and Cash-Outs.** A plan could be designed to permit an employee to elect a lump-sum distribution if the present value of his or her benefit at retirement age is less than \$5,000. The plan, however, could not require the employee to take a lump sum unless the benefit has a present value of less than \$1,000. A participant may rollover a lump-sum payment to an IRA. Notwithstanding the above, if a benefit is transferred to the PBGC, the PBGC may make payments in accordance with its normal rules. (See discussion in Building Block 8 about participants in terminated plans.)

Rationale: These cash-out provisions were designed to minimize small balance issues associated with the requirement that the benefit be given as an annuity, while also allowing even small accumulated benefits to be preserved until retirement.

• **No Minimum Benefit.** POPP does not require a minimum top-heavy benefit even if the plan becomes top heavy.

Rationale: Because POPP provides the same level of benefits for all employees, the possibility for discrimination in favor of key or highly-paid employees is negligible. Indeed, if a POPP becomes top heavy, it will generally be because of turnover and not because the benefit formula is skewed to the highly paid.xiv Thus, the Group did not think that the plan needed to provide a minimum benefit in excess of a plan's basic benefit, even if the plan did become top heavy.

Building Block 8

POPP is insured by the Pension Benefit Guaranty Corporation and employers will pay lower premiums for this insurance.

POPP would be insured by the PBGC and employers would pay a premium of \$5 per participant per year, lower than the cost charged traditional plans.

• Benefits Transferable to PBGC for Plan Terminations. When a plan terminates, benefits of terminated participants could be transferred to the PBGC. Or they could be held in the plan for distribution as an annuity at retirement age.

Rationale: A lower PBGC premium was recommended to mitigate one of the objections that employers have to adopting defined benefit plans: namely, the cost of pension insurance premiums. Lower premiums are justified because POPP's conservative actuarial assumptions, coupled with its stringent funding of past service credit, minimizes the risk of loss to the agency.

• **Participants in Terminated Plans.** Under the proposed plan design, the benefits of terminated participants could be transferred to the PBGC. Or benefits could be held in the plan for distribution at retirement age. To reduce the burden of employees with small balances, the plan could allow for cashing out those with a benefit worth \$1,000 or less.

Rationale: These provisions are designed to preserve as much of a retirement benefit as possible and to ensure that the benefit is paid out as an annuity, while giving employers some relief from the burdens associated with maintaining balances worth \$1,000 or less.

Building Block 9

If the plan is terminated, there is no reversion of any surplus assets to the employer.

Under this provision, the excess would be used to increase benefits of current employees to compensate them for the lost opportunity to accrue more benefits. The surplus could also be used to increase benefits for retirees.

These provisions give employees the benefit of surpluses in terminated plans. Some members of the Working Group objected to the proposed reversion rules and suggested instead that the plan be governed by existing reversion rules.

Rationale: If surplus assets arise because of strong investment performance, many of the Group thought those benefits should accrue to the employees.

Building Block 10

An employer can convert POPP to a traditional defined benefit plan at any time.

Nondiscrimination Issues. POPP could be amended to convert it to a traditional defined benefit plan. The converted plan would be permitted to use all available nondiscrimination testing methodologies available to regular defined benefit plans. After conversion, the employer would fund and run the converted plan as a traditional defined benefit plan, including providing a minimum benefit to all workers eligible to participate if the plan is top heavy.

Rationale: These provisions allow employers to upgrade POPP to a regular defined benefit plan. This provision would be useful if the employer merges with an employer with a regular defined benefit plan or decides that it wants more complex features in its plan.

Building Block 11

Employers are eligible for a tax credit for funding POPP pensions for workers who are not highly compensated.

Employer Tax Credit. POPP would allow employers a tax credit equal to five percent of the contributions made to fund the benefits for non-highly compensated employees for a period of five years. The credit would be recaptured by the Internal Revenue Service if the employer terminates the plan within five years. This provision would help employers cover the costs of providing the benefits to all workers, including eligible part-time workers. The tax credit for POPP could be similar to a temporary tax credit that was offered on contributions to Payroll Stock Ownership Plans.

Rationale: These provisions are designed to make the plan more attractive to employers and, in the process, encourage more widespread adoption and a consequent expansion of coverage.

Employee Tax Credit. The Working Group generally agreed that POPP should provide an employee tax credit similar to the Saver's Credit.

Rationale: This provision would encourage more employees to make additional contributions to the plan and, thus, improve the final benefit.

The next steps required to implement POPP are discussed following the discussion below of other ideas supported by the Working Group.

Other Ideas Supported by Working Group I

Tax Credit Ideas

The Group discussed developing new kinds of tax credits to encourage increased coverage in defined benefit plans. Below are three broad concepts the Group recommends.

- **Immediate Vesting.** Give employers a tax credit to provide immediate vesting of benefits.
- 100 Percent Coverage of Employees in a Single Line of Business. Give employers a tax credit for providing this level of coverage. Some thought a credit should be given only to employers that meet this benchmark; others thought it could be structured for less. There was no agreement exactly on how that should be done.
- Reduction of the 1,000 Hours Requirement for Plan Participation and Benefit Accrual/Allocation. Reduce from 1,000 to 500 hours the threshold for making part-time workers eligible for a defined benefit plan. At the same, employers could exclude seasonal workers.

All of the suggestions above need further exploration.

What's Next for GAP, POPP and Implementation Strategies

Survey of GAP and POPP

The Working Group is preparing surveys of pension plan advisers on the potential appeal of both GAP and POPP. The survey is being conducted by the Employee Benefit Research Institute^{xv} (EBRI) and is being sent to the membership of the American Society of Pension Professionals and Actuaries^{xvi} (ASPPA). The survey was developed after submitting descriptions of both GAP and POPP to a focus group made up of ASPPA members. The survey should help determine whether employers have an interest in GAP and POPP and what the likely impact on both coverage and eventual retirement income would be if these plans were introduced into the marketplace. The results of these surveys will be available later in 2007 or early 2008.

Task Forces for the Implementation of GAP and POPP

The Working Groups will set up two task forces among its members and outside experts to determine the best way of moving GAP and POPP forward.

Implementation of GAP

The Working Group believes that GAP has many novel design features that work together to create an attractive plan — including the plan's simplified funding rules, the availability of a Side-Car Trust, and

the choice between defined benefit and defined contribution plan maximum limits on contributions and benefits. These features taken together may make GAP more appealing than traditional defined benefit plans or cash balance plans. In addition, the group believes that GAP has important participant protections not available in cash balance plans, including the larger survivor annuity and the guaranteed rate of return on account balances.

Many of the features of GAP are not consistent with current law. The Working Group task force will determine how to move this proposal forward to facilitate the unique benefits and rules for GAP which were created to work together to offer a unique blend of benefits for employers and employees (see Appendix E for information on GAP and current law).

Implementation of POPP

At its heart, the POPP is a simplified career-average pay defined benefit plan. An employer can today adopt such a plan, but the plan would not have some of the flexibility or other benefits of the POPP — for example, the ability to have discretionary bonus benefits, to provide more generous past-service credit, or to pay a reduced PBGC premium. The employer would also be left to the complex funding mechanisms mandated by current law, which was modified by the Pension Protection Act of 2006. Moreover, the POPP provides social benefits by requiring broader coverage than required by a traditional plan and by allowing employees to make elective contributions that would purchase a benefit in the form of an annuity, with a better basic survivor benefit for the spouse of the participant. The POPP task force will determine how to move forward the unique benefits and rules of this plan (see Appendix F for information on the interplay between POPP and current law).

Development of Demonstration Project to Test GAP and POPP

The Group will also explore the feasibility of setting up projects to test POPP and GAP – especially after the surveys and modeling are completed to determine the level of interest in both plan types. There was also a suggestion to explore ways that government agencies might be able to provide exemptions so that POPP and GAP could be tested among a specific group of employers to determine the potential to increase coverage through the marketing of these new forms of plans.

Endnotes

¹ For employers the Group generally agreed that the following criteria should be considered: reduced regulation, low administrative costs, low contribution costs, high benefits for owners and officers, attractiveness to prospective employees, designs with tax benefits to the company and owners, designs with contribution flexibility for the owners. For employees, the Group generally agreed the following criteria should be considered: low costs in terms of contributions and high returns on assets in the plan, protection against investment risk, employee control over assets, portability of assets, protection against longevity risk, protection against inflation, tax benefits, psychological benefits of owning assets, simplicity and fairness for employees, and the adequacy of benefits provided under the proposal. From *Covering the Uncovered: Common Ground Recommendations to Expand Retirement Savings for American Workers*, Working Report of the Conversation on Coverage, 2005, p. 6.

"For more information on the DB-K and hybrid plans the Group discussed, see *Covering the Uncovered: Common Ground Recommendations to Expand Retirement Savings for American Workers*, Working Report of the Conversation on Coverage, 2005, p. 7.

There were two issues regarding cash balance plans: Most members of the group believed that cash balance controversy arose from conversions of traditional defined benefit plans into cash balance plans, which some in the Group believed led to a reduction in their expected benefits. The group agreed that employers should not be able to convert an existing defined benefit plan into a GAP. The second concern involved some of the legal and conceptual problems that cash balance plans encountered because they tried to marry a hybrid structure to the regulatory regime governing defined benefit plans. The group believed that these problems were largely avoidable if it started with a regulatory structure designed for defined contribution plans, rather than defined benefit plans, and worked from there.

^{iv} The three percent minimum guarantee was adopted as an underlying protection that is more predictable and secure than an index guarantee. Indices go down as well as up, and can have long periods of underperformance, as they did from 2000 to 2004.

^v An employee is said to be "vested" in a pension when the employee becomes entitled to the benefits of the plan, including employer contributions to a plan and their earnings. The time until a benefit is vested is defined under guidelines set forth in the chief federal pension law, the Employee Retirement Income Security Act (ERISA) of 1974 as amended.

¹⁷ Plans are top-heavy when key employees amass benefits (vested and unvested) greater than 60 percent of the entire pool of benefits. A key employee is any employee who during the plan year was: (1) an employee who is a five percent owner of the employer; (2) an employee who is a one percent owner and who earned more than \$150,000; (3) any officers of the employer company; and (4) any employees earning more than \$130,000 (adjusted for the cost of living). Additional requirements apply to top-heavy plans, such as more rapid vesting schedules and minimum contributions for plan participants who are not key employees.

A contribution arrangement of an employer-sponsored retirement plan under which participants can choose to set aside part of their pretax compensation as a contribution to the plan. These are also known as "salary-deferral" or "salary-reduction contributions."

viii Section 415 of the Internal Revenue Code provides outer limits on the size of contributions that can be made to a defined contribution plan, and on the size of benefits that can be accrued over a career in a defined benefit plan. For defined contribution plans, the contribution limit for 2007 is \$45,000, plus an additional \$5,000 "catch-up" contribution for employees at least 50 years of age. The limit is an aggregate limit for employer and employee contributions, combined. For defined benefit plans, Section 415 provides that the maximum annual annuity benefit that can be paid is \$180,000 annually, beginning at age 62. The annual contribution necessary to fund this benefit varies with factors such as the age of the employee, the period of time the employee has participated in the plan, and the age at which the employee will retire. For an older participant in a recently adopted plan, however, the benefit limit might effectively permit a contribution well in excess of \$100,000 per year.

ix A highly-compensated employee is a term in the Revenue Code that describes any employee who either (1) owned more than five percent of the company during the current or preceding year or (2) received compensation in excess of \$80,000 (indexed) in the preceding year and, if the employer elects, was in the top 20 percent in annual compensation.

*The 7.5 percent gateway applies when the employer uses a combination of a defined contribution and a defined benefit plan. Older favored employees would participate in the defined benefit plan (and perhaps defined contribution plan as well). The use of the defined benefit plan permits the employee to accrue a benefit restricted by the section 415 limits for defined benefit plans, which for older employees will generally permit the employee to earn a larger annual benefit than the employee could in a defined contribution plan, where the limit on employer and employee contributions for 2007 is \$45,000, with an additional \$5,000 catch-up contribution for employees who are at least 50.

xi If someone chooses the 75 percent option, the lifetime benefit of the participant will be reduced accordingly.

These are the 402(g) limits of the Internal Revenue Code that apply to employee deferrals into retirement savings plans such as SIMPLE, 401(k), 403(b), and 457(b) plans.

^{xiii} The investment return built into the charts is a constant. The employer's actual investment experience will be done on an average return basis over five years, rather than on annual results, to reduce volatility in contributions. The employer's investment experience will alter the contributions from those published in the tables. If the investments outperform the assumed rate, then the employer gets a contribution holiday. If the investments underperform, then the employer has to contribute more.

xiv In effect, POPP has adopted the minimum benefit formula for defined contribution plans where the employer has to contribute the same rate he has contributed for key employees.

^{xv} Jack L. VanDerhei, EBRI Fellow and a member of Working Group I, is developing the survey and will run the results of the survey through EBRI's computer simulation models.

xvi Brian H. Graff, the executive director and chief executive officer of ASPPA and a member of Working Group I, has made the membership of ASPPA available for the survey by EBRI for the Conversation on Coverage.

svii The benefit of having a lifetime annuity in a defined benefit plan has, however, been eroded in recent years as more plans have opted to offer lump sums as a pay-out option, and many employees have chosen to take lump sums instead of an annuity. In 1997, fewer than 25 percent of defined benefit plan participants even had an option to take benefits in a lump sum, but in 2003 48 percent of all private-sector workers could take their benefit as a full or partial lump sum. This data is from U.S. Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in Private Industry in the United States, 2003," Bulletin 2577 (Washington, D.C.: U.S. Department of Labor: October 2005, Table 47, p. 62.

xviii From Department of Labor Form 5500 data, as reported in Marric Buessing and Mauricio Soto, "The State of Private Pensions: Current 5500 Data," Issue in Brief 42, Center for Retirement Research at Boston College, Appendix Table E4.

xix U.S. Department of Labor, Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2006," (Washington, D.C.: U.S. Department of Labor, August 2006), Table 1, p. 6 and Table 2, p. 7. Web site: http://stats.bls.gov/ncs/ebs/sp/ebsm0004.pdf

xx Buessing and Soto, Appendix Table E4.

xxi Pension Benefit Guaranty Corporation, Pension Insurance Data Book 2005, Table S-31, p. 58.

xxii Ibid.

xxiii Ibid.

xxivIbid., Table S-33, p. 60.

xxv Ibid.



Mission

The Working Group sought to develop new incentives and proposals to encourage more individual private-sector workers to save for retirement – particularly focusing on low- and moderate-income workers who are least likely to have access to a plan.

Working Group II Members

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Members

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J. Mark Iwry
Lynn Jacobs
Regina Jefferson
Lisa Mensah
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Mission

The mission of Working Group II was to develop new incentives and proposals to encourage more individual workers in the private sector to save – not only those who do not have an employer plan, but also those who may not be eligible for their employer's plan or who may not have chosen to participate. The Group focused on expanding coverage for low- and moderate-income workers, who are least likely to have access to a plan.

Background

The target population for the Working Group II proposals is substantial – more than half the private-sector workforce. In 2005, only 55 percent, or 52.5 million, of the 95.7 million full- and part-time employees in the private sector worked at companies that sponsor a retirement plan, according to the Current Population Survey. Not all workers at companies that sponsor plans are eligible to participate in the plan. Some of those eligible to participate do not participate. In 2005, only 45 percent, or 43.1 million, of all private-sector workers were participating in a plan. This leaves a target population of 52.7 million workers who either have no access to a plan or are not participating in a plan.

To achieve its mission, Working Group II has taken two policy tracks:

- **First Track: Short Term.** The Group sought to take **incremental steps** to improve coverage and participation in the near term by developing incentives for employers to expand coverage and for individuals to participate in 401(k) plans. Among the ideas endorsed by the Group are automatic enrollment and expansion of the Saver's Credit iii (these ideas are discussed at the end of the report).
- Second Track: Long Term. As its primary accomplishment, the Group developed a proposal for a new national Clearinghouse structure to administer portable lifetime individual accounts the Retirement Investment Account (RIA) plan. This proposed structure, in which eligible individuals can save either through payroll deduction or direct contributions, is designed to provide an easy and efficient way for workers who are not covered by a plan to save for retirement and to be able keep their account whenever they change jobs and lack employer-plan coverage. With the addition of tax credits, the RIA plan can be made to be more attractive to lower-income workers and help increase participation and savings.

How the Group Went About Its Assignment

The Working Group brought together a range of experts with widely different backgrounds to develop proposals to expand coverage. In the beginning of the process (in the Second Stage from 2003-2004), the Working Group met initially to develop the principles^{iv} that would guide their work. The Group agreed, for example, to support developing incentives and approaches that would prompt more employers to offer access to plans, as well as increase the overall level of retirement savings, particularly among low-wage workers. The Group then reviewed an array of proposals to help inform their work to develop initial concepts that would increase incremental coverage in already-existing 401(k) plans (see www.conversationoncover-

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age.org for the interim report on the Conversation on Coverage, published in May 2005). The proposals designed to increase coverage in existing plans became the starting point for the building blocks of the Group's chief proposal, the Retirement Investment Account.

In the Third Stage of the Conversation on Coverage (2005-2006), the Group focused on resolving outstanding issues regarding the operating framework of the RIA plan. This effort was greatly assisted by bringing in experts to discuss in detail how financial institutions currently manage the investment of a large base of employees in plans with a range of investment options. These experts explained how costs can be kept down, and how small businesses with SIMPLE^v plans can handle contributions and fund choices without a payroll vendor. The insights gained in this effort helped the Working Group further refine the RIA plan and find consensus on a number of issues. The Group also spent a number of meetings developing guiding principles for the design of expanded tax credits that can apply to the RIA as well as other employer plans. In total, in the Third Stage, the Group met in more than a dozen full and subgroup meetings as well as by phone. When the Group was unable to devise details of a particular part of the plan design, the Group set forth guiding principles for a resolution of the issues or offered a choice among alternative solutions.

The Retirement Investment Account Plan (RIA)

The Building Blocks of the RIA Plan

A closer examination of the design elements demonstrates how each piece works to make the whole plan more effective. Below are descriptions of the RIA's major building blocks with an explanation of why the Working Group chose a particular design or approach.

Building Block 1

The plan will be administered by a national government-authorized Central Clearing-house, which allows for lifetime portable accounts for workers.

The advantages and features of the Clearinghouse approach are as follows:

• **Portability across Employers.** Plan accounts are portable so that workers can contribute to the plan as they move from one workplace to another and find themselves uncovered by a contributory employer-sponsored plan (that is, a plan in which employees contribute their own money). In addition, plan accounts would be fully portable with those employer-sponsored plans that agree to accept rollovers, and with IRAs. Thus, workers could move accumulations from plan accounts to employer-sponsored retirement plans and vice versa in accordance with existing rules and arrangements.

Employers would be able to roll over funds from a terminated employee to an RIA when the account balance does not exceed \$5,000 and the employee does not make an explicit election. Presently, employers must roll over these amounts into IRAs.

- Employers Have a Limited Role of Facilitating Contributions. The employer's role is limited to providing eligible participants with the ability to contribute to the RIA through payroll deduction. The system will be set up to receive contributions from employees through payroll deductions in amounts indicated by employees on W-4 forms. The employer will be required to send the employee contributions to the Central Clearinghouse. After receiving the funds, the Central Clearinghouse will notify the U.S. Treasury of funds it has received for each individual with an account.
- **Private Sector Invests the Money.** In an approach like the Thrift Savings Plan^{vi} (a retirement savings plan for federal civilian workers), the Clearinghouse would contract the investment of funds out to the private sector. Competition for fund managers in the private sector would allow the Clearinghouse to locate providers with lower-cost funds and good service records. Moreover, competition for administrative functions provided by the private sector is expected to help the Clearinghouse keep down costs. The Clearinghouse will have clout when it negotiates with providers because of its size and its status as a government-sponsored entity.
- **Employee Advantages**. As described above, employees can maintain a single lifetime account for themselves where they work, even when they are in between jobs or self-employed. They can put money into the RIA whenever they are not covered by an employer-sponsored contributory retirement plan.
- **Education and Marketing.** The Clearinghouse will be responsible for educating workers about the existence of the RIA plan, how it works, and the need to save.

Rationale: The national Central Clearinghouse approach to make accounts portable across employers – as they are all administered in one place – will lower the cost of administration and result in savings for participants.

Building Block 2

The plan has broad employee eligibility rules for the uncovered to significantly boost coverage.

The RIA plan is designed to provide a retirement savings vehicle for all workers not covered by or eligible to participate in a contributory workplace retirement savings plan. To reach the broadest possible share of the target population of uncovered workers, eligibility for the RIA is open to any wage earner who is not eligible to contribute to any kind of employer-sponsored retirement savings plan or whose employer does not offer such a plan. This approach has the potential of making important strides toward the goal of closing the coverage gap. While some members supported making the plan available to all workers, it was agreed that the RIA should be restricted to uncovered workers because (1) uncovered workers are the target population under the Group's mission; and (2) the Group did not want the RIA to discourage employers from retaining their own retirement savings plans – or discourage them from starting up a new plan.

The target population of uncovered workers is defined as broadly as possible to be sure all uncovered workers have an opportunity to save for retirement through payroll deduction. The eligibility rules recognize that large segments of the working population are not covered: contract workers, contingent workers, part-time workers, on-call workers, or workers who are under other types of alternative working arrangements. For example, the Bureau of Labor Statistics counted 10.3 million workers or 7.4 percent of the private workforce in 2005 who were independent contract workers. In addition, there are many contingent workers whose jobs by definition are not expected to last, a group estimated in 2005 to represent between 2.2 percent to 4.9 percent of total employment. These workers are eligible for the RIA, as explained below. Groups of employees who are eligible for the RIA are specifically identified in the proposed plan design to better clarify who is covered.

• Targeted Employee Eligibility Groups. The RIA is open to any wage earner who is not eligible to contribute to any kind of employer-sponsored retirement savings plan.

The Group defined this to include the following specific groups:

- Any worker in a company that does not have a retirement plan.
- Any worker whose employer has a 401(k) plan or other contributory defined contribution
 plan in which the worker is not eligible to participate either because the worker has not met
 participation criteria or because the worker is a member of an excluded group.
- Any worker who is covered only by a non-contributory plan that is, a plan in which only employers contribute, such as a defined benefit plan, a cash balance plan or a profit-sharing plan would be eligible for payroll deduction into an RIA.
- The Plan Removes Eligibility Restrictions. The RIA is free of a number of restrictions to eligibility that can be found in some workplace plans. For example, there is no minimum income eligibility requirement (although contributions cannot exceed wage income). There is no age restriction. Part-time and seasonal workers are eligible. Contingent workers are eligible. Contract workers, sole proprietors, and other self-employed individuals are eligible. Leased employees would generally be provided access through the companies that lease them to an employer.
- Treatment of Spousal Contributions. The general consensus was that, at least in the early stages, only wage earners could participate and spousal participation could be added later in the process.

The Group had a lengthy discussion on this topic with many perspectives presented. Those in favor of spousal accounts said that spouses who work in the home should be valued, and spouses should be able to take advantage of the RIA plan's portability features and benefit from the lifetime account concept. It was also noted that women have the highest poverty rates in retirement and could benefit from saving. Those opposed to spousal accounts argued that if non-working spouses were to contribute to the plan, it would add administrative burdens because payroll deduction, a critical component of the RIA proposal, would be unavailable. It was also noted that a non-working spouse can already participate in a spousal Individual Retirement Account.

Building Block 3

Self-employed individuals can open accounts and contribute directly, while all workers can contribute when income taxes are filed.

Self-employed individual workers, including contract workers, can open accounts and send contributions directly to the Clearinghouse. Additionally, the Group agreed that any worker could contribute at the time income taxes are filed. The decision to allow self-employed workers and contract workers to contribute was made because such workers could not contribute through payroll deduction and it would fulfill the goal of the Group to reach as many workers as possible. The decision to allow all workers to contribute when filing income taxes was made partly to increase the opportunities for saving, especially to take advantage of refunds.

- **Self-employed individuals** can send quarterly contributions to the Clearinghouse when they send their quarterly taxes to the Internal Revenue Service (IRS). This would, of course, involve writing a separate check. The Clearinghouse would notify the IRS of contributions it has received.
- **Individuals**, whether self-employed or not, can also contribute to an RIA account through direct deposit by the IRS of part or all of their income tax refunds, as designated when they file their income tax returns. The IRS would forward the funds to the Clearinghouse.

Rationale: While the Group recognized that the RIA would be most efficient for those with payroll deduction access, they also wanted to include self-employed people, such as contract workers, to ensure that these important sectors of the workforce are covered by the plan, thereby increasing its coverage potential.

Building Block 4

Eligible workers will be automatically enrolled in the RIA and contributions placed into a default investment. For employees who wish to choose, there will be three additional investment options.

Automatic enrollment was endorsed as a way to ensure that more eligible employees would participate. Research has found that when employees are automatically enrolled into an employer-sponsored retirement plan, between 70 to 90 percent of those enrolled remain in the plan and do not opt out.^x

• **Default Investment.** Employee contributions to the plan will be placed in a default investment pool that could be a diversified balanced fund^{xi} or a life cycle fund.^{xii} The Clearinghouse will develop the default investment, which will be consistent with the investment options specified in the Department of Labor's default investment regulations.

Rationale: If there is a default investment, the great majority of workers will likely stay with the default, as past behavior has shown. In 401(k) plans, the default fund has often been an option, such

as a money market account, with very low risk and which preserves the principal. Often workers, especially lower-income workers, choose these low-risk options and thereby are not able to benefit from the higher returns of a diversified investment approach that includes a mixture of asset classes, including equities and fixed-income securities. By having an asset-allocated automatic default, workers are likely to have more accumulated savings when they retire.

• Clearinghouse Chooses a Single Default Option. The Clearinghouse will decide what the default option should be.

Rationale: Having a single default option meets the plan's goal of keeping the system simple in order to make it cost efficient and thereby save on administration costs.

• Limit of Three Additional Investment Options. The Group agreed that the plan should be limited to three options beyond the default option for participants who choose to opt out of the default. Additional investment options can include a bond index fund and Treasury Inflation-Protected Securities. In addition, there should be at least one investment choice that is low risk and preserves the principal, since low-income workers tend to be more risk adverse and may not participate if there is no low-risk option. Participants who choose to invest in the low-risk option will be periodically automatically redirected to the default option and will have to opt out each time if they wish to stay in the low-risk investment option.

Rationale: The Group identified a number of reasons for limiting the investment choices to three options beyond the default option. The choice of three options was based partly on ERISA's rules on participant-directed accounts, which state that plans should offer employees at least three investment choices. The Group's decision came after a meeting with experts on operations from financial institutions. The meeting helped the Group to better understand how costs increase with additional investment options. Fewer investment options would reduce the administrative costs (such as processing and call center costs) for the Clearinghouse, which would translate into savings for participants. The Group agreed with the experts that it is less costly to do daily valuations rather than monthly ones, and that the system should be made as paperless as possible. The Group further supported the direct deposit of funds by employers because it is more cost-effective than having funds sent separately.

Building Block 5

Employers are required to provide access to the RIA plan to all employees who are not covered by an employer-sponsored retirement savings plan.

Under the design of the RIA plan, all employers are required to offer workers the opportunity to participate in the RIA if they are not covered by an employer-sponsored contributory retirement plan.

This building block was chosen to be part of the plan design to make sure that all workers not now covered would have the opportunity to save for retirement through payroll deduction.xiii Under this provision

employers must offer access to all groups of eligible workers, which are identified in Building Block 2. The Group discussed at length whether or not an employer must offer the plan to uncovered workers and concluded that the potential burden on employers would be negligible, based an examination of current practices among employers both with and without payroll firms who handle their business.

Further, it was felt that if the plan did not require employers to provide access to uncovered workers, the full potential for reaching uncovered workers would not be realized. At the same time, the Group was aware that for some very small employers, there may be a need for an exemption to the rule that employers must provide access. Here are the requirements for employers:

- **Uncovered Workers.** Employers that do not sponsor a defined contribution retirement plan would be required to offer all eligible employees the opportunity to contribute to an RIA through payroll deduction. Employers who do sponsor a defined contribution retirement plan will be required to offer employees who are ineligible for the company plan a chance to contribute to an RIA through payroll deduction.
- Automatic Enrollment. Employers will automatically enroll all employees who are eligible to participate. Employees can still opt out of participation when employers automatically enroll them.
 - Exemption from Automatic Enrollment for Very Small Employers. While the Group did not recommend a specific design for the exemption, the Group agreed that any exemption that is drawn up should be tied to the number of workers at the firm. Exemptions should be based on size limitations already in the law, so that new regulations would not have to be issued specifically for this exemption. Members suggested the following potential exemption thresholds to consider: (i) a size restriction like the one for COBRAxiv (Consolidated Omnibus Budget Reconciliation Act), which affects health insurance; (ii) employers with 10 or fewer workers; or (iii) employers with four or fewer workers. The exemption should affect a very small share of the workforce. Members were opposed to setting the exemption so high that it would allow too many employers to opt out of the requirement to provide employees the opportunity to make payroll deduction contributions to the RIA.
 - Employer Tax Credit to Encourage Automatic Enrollment. The Group supported the concept of a modest employer tax credit for employers that are included within the automatic enrollment exemption. The tax credit was supported as an incentive to encourage employers to offer their employees the opportunity to contribute to the RIA through payroll deduction.

Rationale: Automatic enrollment and payroll deduction may be impractical for some very small businesses that do not electronically process payroll. Recognizing this reality, the members of the Working Group agreed to leave open the possibility of providing a very narrowly-constructed exemption that would apply to only a small portion of the workforce.

• Flow of Funds from the Employer. The Group explored how financial institutions handle retirement plan contributions from employees to gain insights into how to structure the

Clearinghouse. From conversations with experts on plan operations, the Group came up with a number of recommendations for handling the flow of funds to the Clearinghouse. Contributions for the current year to the RIA could flow from the employer to the Clearinghouse through the employer's payroll vendor. For employers who do not have a payroll vendor, the Clearinghouse could provide web-based services to handle the transfer of funds and associated recordkeeping. Such a web-based mechanism for contributions would allow employers to transmit to the Clearinghouse a list of employees and deduction amounts, which could then transfer funds from the employer's bank account. Funds would flow from the Clearinghouse into private-sector investment funds (an illustration of the Funding Process Flow can be found in Appendix G).

Building Block 6

Contribution limits should be set at an amount that is less than the limits for employersponsored plans but higher than that for IRAs.

The RIA plan design does not include specific recommendations for employee contribution limits. However, the Group agreed that there should be guidance on where those limits would be set. In principle, it was agreed that the limits should be set at an amount that is less than the limits for employer-sponsored plans but higher than that for IRAs. Below are the principles the Group agreed should govern decisions on where the limits should be set in relation to employer-sponsored retirement savings plans.

- **Guidance for Setting Limits.** In principle, employee contribution limits should be set at levels higher than those for IRAs but lower than the limits for the SIMPLE.
- **Contribution Percentage.** The members of the Working Group agreed the plan will enroll employees at a target of five to six percent of pay, which was identified as an appropriate level of saving for retirement. However, the Group also agreed the contribution percentage of pay could be lower if research were to show that a higher percentage level would lead employees to opt out of the plan.

Rationale: The recommendation for contribution limits was set at levels that the Group agreed were not likely to detract from the appeal of an employer-sponsored plan, but high enough to make the RIA more attractive than the IRA.

Building Block 7

The plan will not initially provide for employer contributions; this approach eliminates the need for nondiscrimination rules.

The Group delibrately set down rules governing the plan in such a way that it would not detract from the appeal of employer-sponsored plans, recognizing the value of 401(k) plans that use matching

contributions to expand participation and increase savings for a broad spectrum of employees. While there were some members who supported employer contributions, the Group generally agreed to prohibit employer contributions.

• **Nondiscrimination Rules Not Required.** Employer-sponsored plans are governed by nondiscrimination regulations and tests. These were set up to prompt employers to design their plans in such a way that more benefits would be spread across rank-and-file workers instead of being too concentrated among owners and top executives. Without employer contributions, and with a high auto-enrollment contribution rate, the RIA plan will not require a nondiscrimination regulatory regime.

Rationale: It was felt that employer contributions would, for example, complicate the ability of an employer to pass nondiscrimination tests in other plans if the match encouraged workers to contribute only to the RIA plan. Those who opposed employer contributions also said that allowing employer contributions in an RIA would increase the risk of employers dropping existing plans in favor of an RIA. They also noted that such contributions would require an appropriate regulatory regime to meet nondiscrimination concerns, which would greatly complicate the plan, increase costs for the Clearinghouse, and add to administrative burdens on employers.

Building Block 8

The plan will have essentially the same tax treatment that now governs traditional IRAs and 401(k) plans.

This tax treatment would include the following:

- **Pre-Tax Contributions.** Like 401(k) and traditional IRA contributions, employee contributions to the RIA plan would be made on a pre-tax basis.
- **Tax-Exempt Earnings.** Like a 401(k) plan and a traditional IRA, the assets in the RIA plan would grow tax-free.
- **Taxable Distributions.** Like 401(k) and traditional IRA distributions, RIA distributions would be fully taxable as income to the participant when made.
- **Coordination of Limits.** Although RIA contribution limits would be lower than 401(k) plan limits (see Building Block 7), they would be coordinated with the contribution limits for 401(k) plans. For example, RIA participants who subsequently participated in a 401(k) plan later in the same year would have their RIA contributions taken into account when applying the annual employee deferral contribution limits set by the law (in the same manner that these limits apply to workers who participate in two 401(k) plans in the same year).

Rationale: The RIA has the same tax treatment as other plans, giving workers a deduction for contributions, allowing capital gains without taxation, and deferring taxation until there are withdrawals. This gives the RIA the same tax appeal as other plans and because it does not add additional preferences, it does not have a competitive edge over employer plans, achieving one of the goals of the Working Group.

Building Block 9

A refundable^{xvi} federal matching tax credit can help encourage more workers to save for retirement through the RIA plan.

The Working Group determined that while the RIA plan could function without tax credits, the credits would provide strong incentives to encourage low- and moderate-income workers to save. The Working Group agreed that an initial specified amount of savings by employees would be matched by a tax credit for low- and moderate- income workers. The contributor's eligibility for the tax credit would be reconciled annually through the tax return process.

Today's federal income tax deduction for qualified retirement saving provides no incentive at all for tens of millions of low-earning households who pay the 15.3 percent payroll tax, but who do not have current income tax liability to offset. Even middle-income taxpayers in the 10- and 15-percent tax brackets receive a weak subsidy compared to the deduction for taxpayers earning more than \$200,000 a year, who are typically in the 35 percent federal income tax bracket.

Members spent a considerable amount of time discussing how a tax credit regime might be designed for the RIA plan with the expectation that whatever tax credits were approved for the RIA plan would, like the Saver's Credit, also apply to all employer-sponsored retirement savings plans.

- Two Policy Goals for the Design of the Tax Credit. The Group tried to construct the guiding principles for a tax credit that would reach the targeted group. In addition, members sought to design a credit that would be workable; that is, it would prompt more low- and moderate-income workers to contribute, while also being easy for participants to understand and uncomplicated for employers, the Clearinghouse and the IRS. There were two key goals the Group had in mind as it discussed how to design the tax credit:
 - Target Credit to Low- and Moderate-Income Workers. The tax credit should be structured to reach the targeted population without further rewarding those who already benefit greatly from retirement savings tax expenditures.
 - Credit Must Be Deposited into a Retirement Savings Account. It is preferred public policy to require that the matching tax credit be deposited into a retirement savings account and not be made available to spend on current consumption by the participant. Members supported

this approach because they preferred that the credit add to overall saving for retirement rather than being spent immediately.

- Policy Challenges Associated with Deposited Tax Credit. While the Group agreed that the tax credit should be directly deposited into a retirement savings account, they were unable to agree on how to design the credit so that this goal could be accomplished. During the discussion the following key points were made:
 - Concerns about Complexity and Delays. There were concerns that if the tax credit went directly into an account, there could be administrative complexity for employers and the IRS, since an individual's income eligibility for the credit may not be known until the following year (see the discussion on eligibility for tax credit below). For this reason, there could be considerable delays in depositing the credit to an individual's account, delaying the time when it would be earning a return.
 - Concerns about Where to Deposit the Credit. Even if administrative complexities could be resolved, there were also unresolved questions about where to deposit the credit if it were limited to deposits in retirement accounts only. These concerns arise because the Working Group envisioned that the tax credit, like the Saver's Credit, would be available to all contributory retirement savings plans. For those with only an RIA, it would obviously be deposited there. But what about those in 401(k) plans? Employers might not want to facilitate the deposit of a tax credit into their 401(k) plans, some members argued, especially if the delay resulted in plans receiving deposits for former employees, which would add administrative burdens to the employer.
 - Concerns about Early Withdrawals of Tax Credit. Members were also concerned that participants might take early withdrawals of the tax credit and spend them for non-retirement purposes. It was suggested there could be restrictions and penalties on withdrawing the tax credit. However, such restrictions would require three separate tracking "buckets" for the administrator: one for all contributions, another for the tax credit, and a third for earnings on the tax credit. There was concern that this would increase administrative costs.
 - Plan May Need to Allow for a Flexible, Refundable Tax Credit. The complications associated with penalties for early withdrawal, administrative complexity, and delays in depositing the credit led some in the Group to conclude that, while it is preferable that the refundable tax credit be automatically saved, in the end, it might be appropriate to make the refundable tax credit available to employees to spend as they wish in order to have a workable tax credit design. Some argued that, for lower-income individuals, receiving money back would provide an additional incentive to save.
- Match Rate and Income Caps for the Tax Credit. Members discussed how a tax credit match might help prompt more low- and moderate-income workers to save. Based on studies of the saving experience of employees in response to various employer matches, the Group generally agreed to the following:

- Match Rate Should Be Sufficient to Generate a Good Response. The percentage match for contributions should be a strong one; that is, higher rather than lower. Members agreed it would be preferable to apply a higher matching rate to a lower amount of initial saving rather than apply a lower matching rate to a higher level of saving. Support for a higher match rate was based on studies, such as one by H&R Block***iii, which found a match at the 50 percent level prompts a significantly higher percentage of workers to make a contribution, while lower matching rates prompt lower response levels.
- Example of Suitable Match Rate and Income Cap. An illustrative example of a match/income cap combination that the Group favored would be one with a match level up to 50 percent applied to a lower portion of income, such as the first \$2,000 as opposed to a lower match rate, such as 10 percent applied a larger amount of income, such as the first \$10,000.
- Ways to Limit the Credit to Low- and Moderate-Income Workers. Members of the Group discussed how they could design a tax credit so that it would benefit primarily, or even solely, this target population. The Saver's Credit, for example, applies to couples filing jointly who earn below \$52,000. While the Group was unable to design the details of a structure that would limit the tax credit, the following agreements and observations were made:
 - **No Income Cliffs.** Members generally agreed that in no case should the design of the tax credit have income cliffs; that is, it should not be structured so that someone would be eligible at \$50,000 and not eligible at \$50,001.
 - **Phase-Out Design.** The Group discussed the feasibility of having a gradual phase-out of the tax credit for households with incomes between \$50,000 and \$60,000 per year. There was concern, however, that with a phase-out that affected more than a small portion of workers, one would not know one's income until the year ended. That uncertainty was seen as potentially leading some workers to decide not to participate at the beginning of the year.
 - **Credit for All Workers.** One member proposed providing the tax credit to all workers to eliminate uncertainty about qualifying for the credit for current year contributions. Providing the tax credit to all workers, while simplifying administration and uncertainty over eligibility, would be more costly in terms of lost tax revenues. Furthermore, some of the tax credit would be earned by households that have no need of additional tax subsidies to save.

To reduce the cost of the credit, it was suggested that the tax credit be given to all households, but recaptured by adjusting the overall marginal income tax rate for households with incomes of \$60,000 or more. With adjustments in the overall income tax rate schedule, one can attain approximately the same level of progressivity as one can attain with a phase-out. However, the distribution of benefits and taxes would not be exactly the same. It was seen as politically and technically difficult to adjust income tax rates to compensate for the effects of the tax credit on higher income earners if the RIA proposal were part of a pension reform package only.

However, if it were part of a broader tax package, it would be easier politically and technically to incorporate the adjustments into the broader bill.

• Limits on Eligibility for Tax Credits. This approach was taken to deter affluent families and family-owned businesses from taking advantage of the rules and receiving credits on unearned income. Thus, the following rules apply: (i) The amount of any savings eligible for a matching tax credit cannot exceed earned income. (ii) An employee must be at least 16 years old and not a dependent to be eligible for the tax credit.

Building Block 10

Rules governing withdrawals seek to keep the plan simple, while also seeking to preserve assets as much as possible for use in a participant's retirement years.

The Group agreed on some provisions on distributions that are similar to current rules governing 401(k) plans. However, in other cases, the RIA plan disallows some 401(k) options on distributions.

- **Retirement Age.** The Group agreed to apply to the plan the basic retirement age rules of current federal pension law and regulation for 401(k)s. Under this approach, workers who save in retirement saving plans cannot withdraw funds free of an early withdrawal tax until they reach age 59½. When participants reach age 59½, they can withdraw part or all of the funds in the account and pay tax at their income tax rate. Some members supported a requirement that tax credits and their earnings be kept in the plan until a worker reaches Social Security retirement age. The members agreed the normal retirement age be set at 59½ for all contributions, whether from the employee or the government (via tax credits) or the employer, if and when they might be allowed.
- Hardship Allowed. Early withdrawals for hardships are allowed under simple rules that reduce the administrative burden for the Clearinghouse. The RIA plan will require, as under 401(k) plans, that the borrower has taken all other available funds and has no money from other sources. The rules will also require that those who apply will document that the requirements have been met. There would be no review of the hardship claim by the plan, and the participant would not have to substantiate the claim.

Rationale: Policymakers in Washington have devised retirement savings plans with rules designed to preserve the savings until a worker is close to normal retirement age. However, low- and moderate-income earners are often reluctant to save in a retirement plan if they cannot have access to those funds for emergencies during their working years. Since the RIA was designed to close the retirement plan coverage gap among low- and moderate-income workers, the Group felt it was important to provide for some way for workers to tap their savings for hardships.

• **No Loans.** The RIA plan does not allow participants to take out loans on the balances in their accounts. Allowing loans from RIAs was seen as a costly feature that would be difficult to implement,

since the Clearinghouse would not be able to arrange for loan repayments via payroll deductions from compensation.

- No Forced Withdrawals When Changing Jobs. Under the RIA plan, as is the case in most employer-sponsored plans, there is no requirement to withdraw funds when an employee changes jobs.
- **Rollovers.** As noted in Building Block 1, the plan provides that accounts can be rolled over into employer-sponsored retirement savings plans and IRAs and vice versa. Automatic default rollovers from other plans for sums up to \$5,000 could be rolled over to an RIA instead of an IRA.
- **Government Tax Credits.** The Group was unable to resolve how it would treat early withdrawals of tax credits. Members supported a prohibition against early withdrawals of government tax credits deposited into plan accounts. This prohibition would also apply to withdrawals that are rolled over into another plan, such as a 401(k) or IRA, since early withdrawals are allowed from those accounts. Some members opposed tracking and treating tax credits differently, as it would create complexity and increase costs to the plan.
 - Possible Resolution. Two options were proposed to simplify the rollover rules. (i) Prohibit Rollover of Government Funds. Prohibit workers from withdrawing or rolling over the portion of their RIA account balance attributable to government credits to employer-sponsored plans and IRAs, which would then permit withdrawals. (ii) No Tax Credit Restrictions. Adopt the same rollover rules that apply to 401(k)s and allow rollovers from the RIA into an IRA, with no restriction on tax credits that are rolled over in the process.
 - Hardship Withdrawals and Tax Credits. Early hardship withdrawals of tax credits posed another policy dilemma for the Group. While the Group was not able to resolve this, one possible option was identified: treat early withdrawals of the tax credit for hardships the same way that 401(k) plans treat early withdrawals; that is, add a 10 percent tax penalty on top of the income tax that might be owed when a withdrawal is made.

Building Block 11

An independent governing body will oversee the operations of the Clearinghouse and act as a fiduciary.

The oversight body would act as the chief fiduciary for the plan. One of the responsibilities of the Clearinghouse will be to educate workers about the need to save and about the availability of the RIA – so people will find out how easy it is to save.

- **Central Record Keeper.** The Clearinghouse is a national central record keeper and general administrator for the RIA plan. It is a government-sponsored body that would contract out fund management and some administrative duties.
- **Fiduciary Oversight Body.** One possible governance model to consider is the one that governs the Thrift Savings Plan (TSP). The TSP has an oversight board and contracts out investment options to the private sector. The Group also identified as another possible approach the Social Security Administration's governance model, which has a Board of Trustees appointed according to statutory requirements.
- Minimal Fiduciary Rules for Employers. Given the automatic enrollment design of the RIA plan and the role of the Clearinghouse, the employer's fiduciary obligations would be limited. Nevertheless, the Working Group felt strongly that the plan should retain basic protections for participants. These protections would include requiring that employee contributions be forwarded by the employer in a timely manner. It would also include minimal disclosure rules, such as information to help participants make a decision about whether to opt out of the automatic enrollment and whether to go along with the default investment or make a different investment choice.

Incremental Steps

Considerable gains in participation and overall retirement savings can be made by expanding participation in existing plans. The Group considered and reviewed several proposals designed to expand coverage incrementally, and generally agreed to support several of them. Below are the details:

- Automatic Enrollment into Employer Plans. This means when workers are hired by an employer that sponsors a 401(k) or similar plan, they are automatically enrolled in the plan and the employer therefore begins to transfer a portion of the worker's pay into the plan every pay period. It can also mean that current workers not enrolled are automatically enrolled. In the case of both new hires and current workers, if an employee does not want to be enrolled, the employee gives the employer notice that the employee wants to opt out of automatic enrollment. Automatic enrollment tends to significantly increase the number and percentage of eligible workers who participate in an employer-sponsored plan. The Pension Protection Act of 2006 enables employers to automatically enroll eligible new employees and non-participating employees. Under the law workers must be given a chance to decide not to participate.
- Automatic Escalation of the Contribution as Share of Pay. Employers should be encouraged to not only automatically set the contribution rate for employees who do not opt out, but also to raise the rate automatically in subsequent years unless the worker chooses to opt out of such automatic escalation. The Pension Protection Act of 2006 encourages such escalation to the extent that it makes escalation a condition of a 401(k) nondiscrimination safe harbor available to plan sponsors. The Act states that employers can automatically enroll new workers and non-participating employees at three percent of pay, and escalate the percentage of pay contribution to four percent in the second year, five percent in the third year, and six percent in the fourth year. Under the Act, the contribution rate of pay is capped at 10 percent.

State-Based Strategies for Expanding Coverage

orking Group II was also interested in exploring the design of other approaches that use state public employees retirement plans, rather than a national clearinghouse, to promote retirement savings for workers not covered by an employer-sponsored plan.

The Group spoke with experts to learn about new approaches that would enlist the efforts of state governments, in partnership with financial institutions, to promote worker participation in 401(k) plans, SIMPLE plans, or payroll deduction IRAs.**

In Washington State, the Economic Opportunity Institute, a public policy think tank, has been promoting a proposal to establish Washington Voluntary Retirement Accounts. The central clearinghouse for the program is the state retirement system, which administers the public employee plan for the state. The idea is that the state retirement system would contract with one or more private-sector providers to offer employees in the state the opportunity to save.

There are two tiers to the system. In the first tier, employers would be required to make payroll-deduction IRAs available to all employees without a plan (the requirement that employers offer the IRAs to all eligible employees was tested in focus groups among Washington State employers). In the second tier, employers could choose to offer 401(k) plans or SIMPLE plans to their employees.

There are many other states considering such approaches (including Maryland, Michigan, and Vermont).xiii In September 2006, Conversation on Coverage staff and some of the Working Group members attended a conference called "State Solutions: Universal Retirement Savings" to lend their expertise and learn more about these efforts. xxiv The discussions on state-based approaches helped reinforce Working Group II's belief in the importance of the employer's role in providing access to the plan, as well as shed light on the broad bipartisan appeal of plans aimed at closing the gap in coverage. The Group was interested in how these approaches demonstrate the way states can act as laboratories for developing new policies that might find application nationwide.

- Preempt State Laws on Written Employee Consent. Encourage automatic enrollment by affirming that, to the extent necessary to permit automatic enrollment, ERISA preempts state laws that prevent deductions from employee pay without the advance written consent of the employee. The Pension Protection Act of 2006 addresses this issue.
- Allow Unwinding of Automatic Enrollment Very Early Without Penalty. Allow plan sponsors to "unwind" the contributions made by employees through automatic enrollment within three to six months after automatic enrollment occurred so that plans could give employees their money back without regard to the restrictions of 401(k) plan withdrawals or the 10 percent early withdrawal tax that would ordinarily apply. The Pension Protection Act of 2006 addresses this issue.
- Reduce Employer Fiduciary Liability. Reduce the potential fiduciary liability of plan sponsors of participant-directed retirement savings plans when they specify default investment options that allocate assets in a diversified manner among several asset classes, such as managed accounts, life cycle funds, and balanced funds. The Pension Protection Act of 2006 addresses this issue.
- Make the Saver's Credit Permanent. The Saver's Credit provides a tax credit of 10-50 percent of 401(k) or IRA contributions up to \$2,000 a year. The credit is aimed at lowand moderate-income workers whose income is \$52,000 or less. The Saver's Credit was originally set to expire at the end of 2006. The Working Group supported making the credit permanent, which was accomplished with the Pension Protection Act of 2006.

• Expand the Saver's Credit and Make it Refundable. All of those who are eligible for the Saver's Credit should be eligible for the 50 percent credit rate (i.e., the 10 percent and 20 percent rates should be eliminated). The Saver's Credit should be refundable. Both changes conform to the design of the Saver's Credit as it was originally proposed.xix

What's Next

The Conversation on Coverage will put together a task force of Working Group members, and potentially other interested parties, to determine the appropriate future course of action for moving forward with the RIA. The Group would determine how the remaining details of the proposal would be resolved, including how the governance of the system would be structured, as well as potentially the type of tax credit regimen that would apply to the RIA. Since this proposal cannot be implemented under current law, the Group would determine appropriate future steps.

There are also likely to be opportunities for RIA-type plans in states to test how a new type of clearinghouse approach might work. See sidebar on state-based strategies for expanding coverage on the previous page.

Endnotes

¹ Congressional Research Service analysis of the Current Population Survey of March 2005. Data reported in following source document: Patrick Purcell, "Pension Sponsorship and Participation: Summary of Recent Trends," Updated August 31, 2006, Congressional Research Service, Table 2, p. 6.

ii Ibid.

iii The Saver's Credit was part of the Economic Growth and Tax Relief Reconciliation Act of 2001. It was made permanent in the Pension Protection Act of 2006.

iv Principles and Standards. Members of the Working Group generally agreed on a list of principles and standards by which it would evaluate proposals. The principles included: The effort would be collaborative while inviting diverse thinking. It would focus on workers with incomes below the median, especially low-income workers, and it would consider the unintended consequences of proposals. Proposals should be efficient to administer and simple to communicate to workers and have a nationally consistent set of rules. Proposals should be politically viable, both in the short term and the long term. Proposals, when considered in total, should be equitable in their benefits and contributions. They should be equitable "horizontally" (meaning that it affects people the same whether or not they have access to an employer-sponsored plan), as well as when viewed "vertically" (meaning across all income levels). Proposals would be judged on whether they are economically efficient and feasible, both in the short term and the long term, as well as whether or not they involve minimal interference in economic, investment and labor markets. Proposals would be judged on whether or not they offer flexible terms and rules for both employees and employers.

^v SIMPLE IRAs and SIMPLE 401(k)s are employer-sponsored retirement plans that are available to small business with fewer than 100 employees, as well as self-employed people. SIMPLE stands for Savings Incentive Match Plan for Employees.

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

vii Bureau of Labor Statistics, "Contingent and Alternative Employment Arrangements, February 2005," Press Release dated July 27, 2005, p.1. This document can be found at http://stats.bls.gov/news.release/conemp.nr0.htm.

viii Ibid, pp. 1 and 4.

^{ix} For a description of the split refund referred to here, see J. Mark Iwry, "Using Tax Refunds to Increase Savings and Retirement Security" (Retirement Security Project Policy Brief No. 2006-9 (Nov. 2005).

* Employee Benefit Security Administration, Department of Labor, Proposed Default Investment Alternatives Under Participant Directed Individual Account Plans; *Federal Register*: September 27, 2006 (Volume 71, Number 187), From the Federal Register Online via GPO Access (wais.access.gpo.gov), p. 56818.

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

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

wiii Questions have been raised from time to time as to how the RIA proposal compares or relates to the automatic IRA proposal developed by Working Group member Mark Iwry and his coauthor. (J. Mark Iwry and David C. John, "Pursuing Universal Retirement Security Through Automatic IRAs," Retirement Security Project working paper dated February 12, 2006 and Testimony Before the Subcommittee on Long-Term Growth and Debt Reduction, Committee on Finance, United States Senate (June 29, 2006).) Because its members include pension and retirement savings experts, the Group's work, including the RIA proposal, naturally has drawn upon separate work that they and others have done, including the automatic IRA proposal and the Universal Savings Accounts proposed by President Clinton in 1999. However, the RIA and automatic IRA are by no means identical: Building Blocks 2, 3 and 5 and their component elements are generally the same as the automatic IRA proposal, for example, while other aspects of the RIA proposal differ from the automatic IRA.

xiv Congress passed the landmark Consolidated Omnibus Budget Reconciliation Act (COBRA) health benefit provisions in 1986. The law amends the Employee Retirement Income Security Act (ERISA), the Internal Revenue Code, and the Public Health Service Act to provide continuation of group health coverage that otherwise would be terminated. COBRA contains provisions giving certain former employees, retirees, spouses and dependent children the right to temporary continuation of health coverage at group rates.

xv A refundable tax credit is one of three approaches that the government might take to support employee contributions to the RIA. The three are as follows: (1) direct government contributions and matches into the RIA account; (2) a cash refundable tax credit; and (3) a non-cash refundable tax credit. A cash refundable tax credit is one where the recipient can receive the full value of the credit regardless of whether or not they have an income tax liability. A non-cash refundable tax credit is one where the recipient can receive only the value of the tax credit that is

equal to the recipient's tax liability. One member described both the refundable and nonrefundable tax credits as "spendable" tax credits to differentiate them from contributions from the government that are deposited into a savings account.

xvi The tax credits in the Saver's Credit are available up to \$52,000 for married couples, \$26,000 for singles, and \$39,000 for heads of household. The credit rate ranges from 50 percent for the lowest income brackets to 10 percent for the highest income brackets. People whose incomes are above the income levels stated above do not qualify for the credit.

xvii 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." Washington, D.C.: The Retirement Security Project, sponsored by Pew Charitable Trusts in partnership with Georgetown University's Public Policy Institute and the Brookings Institution, No. 2005-5, May 2005.

xviii The Saver's Credit provides 10 to 50 percent government matches for individual contributions of low and moderate income workers. For more details, see section titled "Expand Saver's Credit" in the interim report, *Covering the Uncovered, Common Ground Recommendations to Expand Retirement Savings for American Workers*, Working Report, May 2005, pp. 55-56.

xixThese are the 402(g) limits of the Internal Revenue Code that apply to employee deferrals into retirement savings plans such as SIMPLE, 401(k), 403(b), and 457 plans.

xx Information on state-based approaches can be found in articles and congressional testimony by J. Mark Iwry, "State K: A strategy for Using State-Assisted Savings to Expand Private Pension Coverage," testimony before the Subcommittee on Long-term Growth and Debt Reduction, Senate Committee on Finance, June 29, 2006.

xxi The Washington State Universal Savings Account proposal has been developed and promoted by the Economic Opportunity Institute's Executive Director John Burbank and Policy Director Marilyn Watkins. The Washington proposal was first inspired by a paper written by Working Group member Dean Baker, Co-Director of the Center for Economic and Policy Research. Mark Iwry, a Working Group member who is a Nonresident Senior Fellow at the Brookings Institution, proposed state-based savings approaches to Maryland, Michigan, Vermont and other states and provided extensive policy and strategic consultation and legislative drafting to Washington, suggesting frameworks to ensure these approaches are consistent with federal law.

washington Voluntary Retirement Accounts program development has been funded by both the House and Senate budgets in the state of Washington. To learn more, visit http://www.eoionline.org/Policy-WVA.htm.

xxiiiIn Michigan, the Governor embraced the concept of a state-based universal 401(k) in her 2006 State of the Union address; In Maryland the House of Delegates unanimously passed a bill to explore the feasibility of implementing such a program. See J. Mark Iwry, "Growing Private Pensions: A Supporting Role for the States," Tax Management Compensation Planning Journal, December 1, 2006.

xxiv The conference was hosted by the Economic Opportunity Institute; the Economic Analysis and Research Network; and J. Mark Iwry, nonresident Senior Fellow, the Brookings Institution. It was funded by AARP, the Retirement Research Foundation, the Heinz Family Philanthropies, Economic Policy Institute and WISER.



Mission

The mission of Working Group III was to create new approaches to increase pension coverage among small businesses where the coverage rates are lowest.

Working Group III Members

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Mission

The mission of Working Group III was to create new approaches to increase pension coverage among small businesses where the coverage rates are lowest.

Background

The Working Group focused on ways of encouraging small businesses to adopt retirement savings plans. The reason the Group chose this focus is because small businesses represent the fastest growing employment sector in the economy and the one that has the largest block of workers without a workplace retirement plan. Fewer small employers sponsor plans, and as a result, a lower portion of workers in small businesses, compared to workers in medium and large businesses, participate in employer retirement plans. (See sidebar on Small Business Plan Coverage Rates.) Studies show that small businesses would be more likely to start a plan if administrative costs, complexities, and fiduciary responsibilities were reduced and if employer contributions were voluntary. The Group also acknowledged that more had to be done to encourage employees to participate in employer-based plans.

From the beginning, the Group sought to create a plan that would overcome many of the obstacles faced by small businesses in setting up plans. Taking a page from Henry Ford's Model T, which became a symbol of affordable transportation for the masses, the Group decided to create its own clean-slate proposal which they named the Model T plan. This plan is an inexpensive and accessible savings vehicle that could be sold and marketed to small employers. Because it is designed to be sold as a multiple employer plan, it could be a potentially efficient way of reaching numerous small businesses at once, creating momentum toward increasing coverage. It should also lend itself to effective marketing techniques.

The Model T Plan at a Glance

The Model T is a simplified, multiple employer payroll deduction plan offered by financial institutions.

Here are the basic features of the plan:

- Third party financial institutions would run the plan and take on many of the administrative functions.
- Once an employer signs up with the financial institution, both the employer and employees will be
 able to make contributions to the plan.
- All employees full-time, part-time, and contingent workers would be eligible to participate if an employer agreed to be part of a plan. The self-employed and independent contractors can contribute on their own.
- Employees contribute through payroll deduction provided by participating employers.
- Employer contributions are voluntary but there are innovations in the plan design aimed at encouraging employers to contribute on behalf of all employees in the plan.

Small Business Plan Coverage Rates

ccording to the Bureau of Labor Statistics, different segments of the workplace population have widely differing coverage rates and participation rates. The coverage rate is 78 percent for medium and large businesses (100 employees or more). However, the coverage rate is only 44 percent among small businesses (99 or fewer workers). The participation rate is 67 percent in medium and large businesses, while it is 37 percent at small businesses. There is an even sharper divide in coverage rates for full-time (69 percent) workers versus part-time workers (29 percent). The same goes for participation rates for full-time (60 percent) versus part-time workers (21 percent). Small businesses are more likely to have larger numbers of part-time workers.

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

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

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

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

- Funds are automatically placed in investment options that are consistent with the U.S. Department of Labor's default investment regulation.
- The Model T has a recommended "Standardized Performance Report," which will help employers and employees compare fees, services and investment performance of the plan on an apples-to-apples basis.

The Model T Plan could be marketed in an innovative, community-based Demonstration Project.

The Group designed the Model T to be as simple as possible with the notion that the proposed plan could potentially be tested in a community-based demonstration project in the future. Such an idea could be modeled after other successful programs, such as "Cleveland Saves," which is a broad-based community effort aimed at encouraging people to save. The Working Group believes that the Model T could help increase coverage among small businesses, if this low-cost plan is effectively marketed by financial institutions to employers and their employees. Depending on research and interest among financial institutions, employers and employees, the Group will explore the feasibility of launching the plan in a particular community or among associations for employers.

How the Group Went About Its Assignment

The Working Group began as a collection of members who each had a great deal of expertise in retirement savings

plan design and ways to increase coverage, but with diverse views. Over the course of three years, and dozens of meetings, the members hammered out a consensus in areas where they had common ground.

When Working Group III members started their deliberations in the Second Stage of the Conversation in 2003, they first examined a range of existing proposals aimed at expanding coverage in small businesses. Rather than using the features of these proposals to design their plan, the Group instead chose to start with a clean slate and designed the broad outlines of a new simplified multiple employer plan. In taking this initial approach, the Group was responding to a suggestion from the first Conversation on Coverage event in 2001 to examine new types of model group pension plans that would enable groups of unrelated small employers to pool resources, thereby reducing administrative costs and potentially reducing fiduciary responsibility.

The Group ultimately decided to design the simplest plan possible to make future implementation easier. In the Third Stage, from 2005 -2006, the Group devoted dozens of meetings to seeking resolutions on the building blocks of the plan, sometimes bringing in outside experts on fiduciary issues and plan design to address particular areas where agreement was hard to reach. To help facilitate discussions, the Conversation staff developed intensive Discussion Guides which presented specific unresolved issues and options for the Group to explore in order to resolve these issues. When the Group was unable to reach consensus on specific details of a particular part of the plan design, the Group developed guiding principles or offered a choice among alternative solutions. The Group decided to leave some of the finer points of the plan design to the financial institutions that will market the plan.

The Model T Plan

The Building Blocks of the Model T Plan

The design of Model T can be best described as a souped-up SIMPLE IRA^{III} with a few additional elements of a qualified plan. (See Definitions of Plan Types on page 11.) The Group primarily favored the SIMPLE plan design for the Model T because the regulatory framework is less complex and fits the plan's characteristics as designed by the Group. However, members of the Group also supported provisions and design elements of the Model T because they deemed them appropriate for the plan, without regard to whether or not they fit into a specific regulatory framework. The Group strived to develop a better, simpler and more attractive plan than the alternatives now available – one that can be marketed to employers, financial institutions and employees. The Group believes that promoting the Model T as a multiple employer plan will help increase the marketability of the plan and lead to increased coverage in the small-business sector.

This section provides a closer examination of the design elements of the plan and demonstrates how each piece works to make the whole plan effective. This section includes an explanation of why the Working Group chose a particular approach.

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The Plan will be offered by regulated financial institutions to small employers.

The Group agreed that any financial institution regulated by a federal or state agency would be eligible to sponsor a Model T. This includes banks, insurance companies, brokerage firms and mutual fund companies.^{iv}

Plans Can Target Regions and Groups. Model T providers can offer plans that are targeted to employers in a specific geographical or regional area or can target employers in specific segments or categories of business and industry. For example, a financial institution in St. Louis could offer the plan to all small businesses in the St. Louis area.

Building Block 2

The Model T will cover all W-2 employees of a participating employer.

The Working Group agreed that they wanted all employees working for an employer to be eligible to participate in the plan. This approach was taken to better reach the target audience of low- and moderate-income wage earners. After looking at ways to ensure that all workers were covered, it was decided that the best approach was to designate any employee at a participating employer who receives a W-2 form as eligible to participate in the plan. There is no limit on eligibility based on age, income, or time on the job. Part-time and seasonal workers are eligible.

While some in the Group argued that there should be an income floor like the SIMPLE IRA, the Group decided against this approach because it would limit eligibility. One member was concerned that without such a floor, employers might not be willing to provide non-discretionary contributions for employees.

Given the Working Group's decision to include the widest possible definition of wage earners, the Group agreed that financial institutions might need some relief in dealing with small balances, especially among small employers that have a high degree of turnover among their workers. The Group decided that financial institutions could cash out balances of \$1,000 or less, consistent with common practice today, when an employee leaves a company or reaches the age for distribution.

Self-Employed and Independent Contractors Eligible to Participate. Eligibility to participate in the Model T plan is not restricted to just W-2 workers. Independent contract workers can also participate by contributing directly to the financial institution as though they were an employee of a sole proprietor business. Self-employed workers can also participate and contribute directly to the financial institution.

Rationale: The Group decided that in exchange for simplicity – transferring most of the administrative burdens from the employer to the financial institution – the Model T should provide the widest coverage possible to reach the target population of low-and moderate-income wage earners.

The Model T will use automatic enrollment to expand coverage.

The Working Group supports the idea of employers automatically enrolling all eligible workers rather than offering workers the opportunity to enroll and then waiting for them to make an affirmative decision to enroll in the plan. The Group ultimately decided to make automatic enrollment a required part of the plan.

Rationale: Studies have shown that automatic enrollment dramatically increases participation rates in a plan. For example, the Employee Benefit Research Institute (EBRI) found that 66 percent of eligible workers at year-end 2000 were participants in 401(k) plans. However, immediately after adding automatic enrollment to the model, the participation rate rose to 92 percent of eligible workers. Additionally, an EBRI survey of Americans found that 66 percent of workers who do not contribute to their employer's retirement plan say they would stay in such a plan if their employer automatically enrolled them in one.

Building Block 4

Financial institutions can offer automatic escalation of contributions in plans they offer.

Members agreed that after employees are enrolled at an initial percentage of pay, it would be desirable to escalate the percentage of pay contribution until it reaches a designated goal. However, due to concern that automatic escalation might lead some low- and moderate-income workers to opt out of the plan, the Group decided it should not mandate automatic escalation.

The Group ultimately decided to allow the following:

- Financial institutions offering the Model T will decide whether or not to have automatic escalation, which, if offered, should include an opt-out provision.
- Financial institutions will also decide how to structure automatic escalation, including the initial deferral percentage, the target escalation and the pace at which the escalation will occur.

Rationale: While the Group recognized the importance of potentially providing automatic escalation of contributions in the plan, in light of the small size of the Model T, the Group preferred to give financial institutions the flexibility to offer or not offer automatic escalation, based on market demand.

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The Model T will be launched with limited investment options based on the type of default investment options approved by the Department of Labor.

Initially, under the plan design, the plan will offer only investments that are contained in the Department of Labor's proposed Default Investment Regulation^{vii} issued in September 2006. As described in the next building block, financial institutions will be able to add other investment options. The proposed regulations include the following classes of investments as appropriate defaults:

- A target date (life-cycle) fund with a mixture of equity and fixed income exposures based on a
 participant's age, target retirement date or life expectancy;
- A fund with a mixture of equity and fixed-income exposures consistent with a target level of risk
 appropriate for participants of the plan as a whole, such as a balanced fund; and
- An allocation of an individual's assets by an investment management service that includes a mixture of equity and fixed income exposures offered through investment alternatives under the plan.

Rationale: The Group spent many meetings discussing which investments should be included in the plan. Originally the Group recommended the plan be launched with three to five investment options. But in the name of simplicity and efficiency, the Group generally agreed to launch the plan with these limited investment options. The Group believed limiting investment options to those that have been generally approved by the Department of Labor will simplify choices and, in doing so, help reduce the fiduciary burden on employers.

Building Block 6

Financial institutions can later add other investment choices beyond the initial options.

There was support for allowing financial institutions in subsequent years to add additional investment options beyond the default options – including such options as conservative, moderate and aggressive model portfolios, as well as an option with a guaranteed rate of return. Some in the Group felt that the lack of additional choices might be a disincentive for some employees to participate. Additional investments options could be added later to Model T plans if financial institutions chose to do so – or if research supported the need for additional choices to attract employees to the plan.

A unique two-tiered contribution limit regime would encourage employers to contribute on behalf of employees.

The Group devoted a considerable amount of discussion time to the issue of contribution limits that would be attractive to employers and employees, as well as setting limits that would more likely lead employers to contribute to the Model T Plan. The Group decided that in order to encourage employers to both participate in the plan and provide an employer contribution, the Model T would have an innovative two-tiered contribution limit structure, with a lower limit set at \$8,000 and the higher limit set at \$12,000.

Contribution Limits. The two limits are set to be higher than IRA limits but lower than 401(k) limits.

- **\$8,000 Lower Limit:** If an employer does not want to make a matching or non-discretionary contribution, then the plan has an \$8,000 limit which the Group set at a level between an IRA and a SIMPLE. This was structured to ensure that the lower limit Model T would be more appealing than an IRA, but would not compete with SIMPLE plans that require a matching contribution.
- **\$12,000 Higher Limit:** If the employer is willing to give an across-the-board contribution to all workers, the contribution limit could be \$12,000, higher than a SIMPLE, but lower than a 401(k). Thus, employers can be rewarded with a higher contribution limit for their own contributions (and those of key employees) if they:
 - Provide a 100 percent match to employee contributions up to four percent of pay.
 - Or, contribute \$750 for each employee with a W-2.

Annual Decision on Employer Limit. The employer can determine on a year-to-year basis whether or not to choose the lower contribution limit or the higher contribution limit – allowing employers the flexibility to provide employer contributions/matches in good business years and to scale back at other times.

Immediate Vesting. Employees are 100 percent immediately vested when contributions are made either by the employer or employee. The Group discussed a possible vesting schedule of two years, which would match the provisions on automatic enrollment in the Pension Protection Act. Ultimately, however, the Group decided to keep 100 percent immediate vesting to simplify administration.

Contribution Levels Indexed. The Group also decided that the contribution limits at both levels would be adjusted as contribution limits move up for the IRA, SIMPLE, and 401(k) to keep the Model T in its relative position. In addition, the Group agreed that the non-discretionary contribution amount of \$750 for the higher limit option would be indexed for inflation.

Employee/Employer Contribution Limits. The Group decided that employers that have a Model T are prohibited from having other plans. Keeping that in mind, the joint employer/employee contribution

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limits would be \$24,000, and there is no need for complex joint-contribution limits, which take into account other plans.

No Catch-Up Contributions. The Group opposed both catch-up and Roth contributions as part of the Model T. Although some members argued strenuously that catch-up contributions would appeal to owners, the sense of the Group was that for simplicity's sake, they should not be allowed in the Model T.

Rationale: There was a lot of discussion about the issue of contribution limits and how they should be addressed. Members of the Group expressed their view that the spread between the \$8,000 lower limit and the \$12,000 higher limit was significant, and could be an enticement for employer contributions. Also, Working Group members pointed out that, when employers do contribute, employees win because they get a 100 percent match that is higher than a SIMPLE and is immediately vested.

Building Block 8

Nondiscrimination testing does not apply to the Model T.

Safe Harbor Plan at the \$12,000 Level. As described above, the Model T was created as a safe harbor plan by ensuring that if employers and key employees want to take advantage of higher contribution levels they must ensure that the same benefit formula applies to all employees. A safe harbor approach assures benefits are provided to all eligible workers and thereby meets the goal of nondiscrimination testing.

No Testing at the \$8,000 Level. There was some concern among some Group members that with a lack of required employer contributions at the \$8,000 level, the plan could just become a higher-limit payroll deduction IRA that would favor higher-paid employees. While the Group recognized these concerns, there was general agreement that the mandatory automatic enrollment with escalation features would help ensure that most workers of all income-levels would benefit from participation in Model T plans. They also were optimistic that employers, with the added inducement of the higher contribution limits, would choose to make employer contributions and/or matches.

Building Block 9

The employer is assisted in its fiduciary responsibilities by the simplicity of the plan and by an annual performance report that will be provided by financial institutions.

From the beginning of its deliberations, Working Group III sought to find a way to transfer some of the fiduciary responsibilities from the employer to the financial institution. Members saw employer concerns about fiduciary responsibility as a barrier for small businesses to enroll their employees into a retirement savings plan.

Under ERISA, fiduciaries are those who exercise control over the plan's management. Typically, the employer that sponsors the plan assumes the role of the fiduciary on a number of activities including choosing and monitoring the plan service providers, choosing and monitoring investment options and defaults, approving and monitoring fees charged to participants as well as an array of administrative and other duties.

Studies show that many small businesses are hesitant to take on these fiduciary responsibilities out of concern about their potential liability if the plan is not administered properly or an investment option performs poorly. Some fiduciary experts say that many small employers do not have the time needed to perform the due diligence and monitoring that is required.

As described below, the Group spent many full-day meetings, working to address these issues. The Group was able to resolve most of the fiduciary issues relatively quickly, but on one key issue, ongoing monitoring of plan investments, the Group discovered that transferring these fiduciary duties away from employers posed a bevy of other complex issues. The Group ended up keeping the monitoring duties with the employer but hoped to mitigate the burdens of this task by simplifying the investments and requiring financial institutions to provide employers with annual reports on performance, fees and services, as explained below.

The fiduciary duties allocated to employers under the Model T are as follows:

- The employer is responsible for choosing the financial institution and the initial selection of investment options. The Group recognized that these duties should continue to fall on the shoulders of employers. This responsibility includes choosing a reliable financial institution and evaluating the investment options in the plan, as well its fees and services. While the financial institution will offer products to the employer, the employer is the fiduciary with respect to choosing among them. Given that the Model T includes limited investment options, this should make the employer's duties simpler in this regard. As noted earlier, these investments will follow Department of Labor guidance on selecting default investment options.
- The employer is responsible for remitting participant data and contributions in a timely manner to the financial institution. If the financial institution allows funds to be taken directly from employer checking accounts by electronic transfer through Automated Clearing House (ACH),^{xi} the employer is still responsible, under current law, for transferring data on salary deferral (names of employees, income, contribution, change in status, etc.). In larger plans, the third party payroll provider is responsible for forwarding contributions and employee data to the financial institution once it is received. The financial institution is then responsible for most of the administrative duties under the plan as described in Building Block 10.
- The employer is responsible for ongoing monitoring of investment options, fees and services. While the Group decided to keep the employer in this role, the members thought the decision to offer only default investments would simplify the ongoing monitoring in the future because rather than monitoring many options, employers would only monitor one investment option.

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- The Working Group has recommended the development of an innovative Standardized Performance Report to be disseminated by financial institutions to employers as a way to help employers monitor ongoing investments. The Group recommended that the Department of Labor devise a standardized format for the annual performance data that would allow employers to compare the fees, services and investment performance of the plan on an apples-to-apples basis. The information provided by the financial institution would be provided in a format that would enable a small business, such as the owner of Betty's Beauty Shop, to decide whether or not to retain the provider or ask that some of the investment options be changed. The Group thought this report could be helpful to employers not just in the Model T but also others in the small plan universe. The Report could also be made available to employees.
- The Group also recommended that there be further examination of other regulatory regimes to address the ongoing monitoring issue. See discussion below under Potential New Regimes for Ongoing Monitoring.

Rationale: Ongoing monitoring was one of the thorniest issues discussed by the Group. As mentioned above, the Group devoted entire meetings, and numerous subgroup meetings, to finding ways of potentially transferring the responsibility now on employers to financial institutions. However, all the options reviewed by the Group raised practical and legal obstacles that left the Group unable to determine a satisfactory method in the short-term for transferring these duties.

The problem with transferring fiduciary responsibility to the financial institution for ongoing monitoring is that it potentially puts the financial institution into a position of "self-dealing," in violation of the prohibited transaction rules of the Employee Retirement Income Security Act.* For instance, if a financial institution decided to change investment options in the plan, it could be deemed to have engaged in self-dealing since some options might have higher fees than other investments and could be perceived as benefiting the institution, rather than the participant.

To address this issue the Group reviewed numerous options and brought in experts on fiduciary issues to explain issues and options. For instance, the Working Group discussed the potential for an independent fiduciary to oversee the monitoring functions. But this raised questions about how the independent fiduciaries would be regulated and what standards would apply. Concerns were raised that hiring an independent fiduciary would be costly. Also, some members of the Group noted that, if the financial institutions paid for this service, there would be questions about how independent these fiduciaries would be. One suggestion was to have a single fiduciary hired by all the employers in a Model T in one particular community (see options described below).

Potential New Regimes for Ongoing Monitoring

The Group looked at a variety of ways to transfer the fiduciary responsibility for ongoing monitoring from the employer to a third party, thereby making the Model T more attractive to

small businesses. To the extent that a way could be found to transfer fiduciary duty for the Model T, it might also work for all plans aimed at small businesses and, thus, help improve coverage in this important sector.

Based on what has been learned from its efforts to find a way to transfer fiduciary duty to a third party, the Group recommends the following ideas for further exploration:

- Reviewing what other countries are doing to relieve employers of fiduciary duties. In Australia, for example, a third party, not the employer, is the fiduciary. To assure that participant interests are protected, the regulatory authorities in Australia have a strict licensing process for trustees and regulators, who go on site to monitor the trustees closely on a regular basis. (See Appendix H on Fiduciary Regulation in Australia.)
- Examining whether there could be a cost-effective system of independent fiduciaries, with appropriate regulation developed in the United States
- Investigating the viability of a per se prudence approach which could mean that there would be a
 government stamp of approval on certain types of investments which could be adopted by financial
 institutions.

Rationale: The Group successfully designed a simplified plan that would potentially reduce some fiduciary responsibilities on the employer. However, the members recognized that the task of developing a regime to enable the transfer of the bulk of fiduciary duties away from employers to third party entities was broader than the scope of designing the Model T and needed further examination in the public policy arena. The Group considers the development of the Standardized Performance Report an important tool that can help employers and employees compare the performance, fees, and services of plans. But, the Group also strongly recommends that efforts continue to examine ways to relieve small employers of fiduciary duties so that they will be more willing to sponsor plans.

Building Block 10

The financial institution assumes most administrative responsibilities, thereby reducing the potential burden on the employer.

Working Group members developed a regime in which most administrative duties were transferred from the employer to the financial institution. Except for the first item below, the vast array of administrative duties, as noted below, are transferred to the financial institution.

• The employer provides the financial institution key information. The employer is responsible for sending the financial institution information about employees, including eligibility and employment status. The employer provides the financial institution with the deferral percentage from the pay of each worker (plus the compensation per employee for each pay period), plus the matches and contributions from the employer.

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- The financial institution maintains basic records. The financial institution maintains participant records and account balances. It also processes requests from employees and handles loans.
- The financial institution monitors contributions and matches. The Working Group discussed ways to simplify the administration of the plan for both employers and financial institutions, given the complexities that might arise from having two contribution limits and given the ability of employers to indicate each year whether they would choose the \$8,000 limit or the \$12,000 limit. To better handle decisions on these potential choices, employers would indicate each year one of the following to the financial institution:
 - No match (contributions limited to \$8,000 deferral).
 - 100 percent match with 100 percent vesting up to four percent of compensation (\$12,000 deferral permitted).
 - An across-the-board contribution of at least \$750 (\$12,000 deferral permitted).

A standard form could be used by employers, who would check which of the above three choices applied to the plan during the coming year and forward the form to the financial institution. The financial institution would then monitor contributions to ensure no employee exceeded the limits for the year.

When the employer chooses the maximum contribution each year, the financial institution will notify the employees of the limit for the coming year. The financial institution will return excess contributions for participants who exceed the contribution limit. The financial institution will monitor to see that employer matches and contributions are contributed into participant accounts in those years in which the employer chooses the higher \$12,000 contribution limit. The flat rate contribution of \$750 or more can be sent in all at once or in quarterly installments.

The financial institution provides Model T participants the disclosure and communications documents required by law. These could include the following items: the prospectus and enrollment material, Summary Plan Document, Summary Annual Report, and annual benefit statement.

Building Block 11

Early withdrawal rules are designed to encourage the preservation of retirement saving in Model T accounts.

The Working Group sought to develop rules governing pre-retirement distributions that would simplify administration and keep down costs. The rules are also designed to preserve savings through the Model T for retirement, as much as possible.

Loans and Hardship Withdrawals

The Group considered whether or not to offer loans and hardship withdrawals, two options commonly found in 401(k) plans. These options are particularly attractive to lower-income savers, who might not save at all or as much if they knew they could not gain access to those savings in the event of financial emergency.

- No Hardship Withdrawals. Hardship withdrawals were rejected because of the difficulty in setting up criteria for eligibility and the administrative expense of implementation. Opposition was also partly based on the fact that it would be difficult for a financial institution to know for certain if there was a genuine hardship. Instead, it was argued, those with such needs could simply borrow the funds they required.
- Financial Institutions Decide Whether to Offer Loans. The Group decided to allow loans after agreeing that the low-income target audience would be particularly wary of a plan that required them to relinquish control of savings until they reached retirement age. The decision on whether or not to offer loans would be made by the financial institution. A loan provision would bring the Model T under the qualified plan rules.
- **Loan Limits.** There was general agreement that, where loans are made available, workers would be limited to one loan at a time with a maximum of five years to pay it back. The loan cannot exceed 50 percent of the account balance or \$50,000, whichever is smaller. Finally, borrowers cannot obtain subsequent loans until the prior loan is paid in full.

Withdrawals and Rollovers after Leaving Employment

The Working Group considered what policies would govern balances in the plan when employees were terminated from an employer who participated in a Model T Plan. The Group's goal was to preserve income for retirement as much as possible. In addition, members wanted to give the Model T much of the flexibility that is currently available to participants in 401(k) plans in order to make the Model T attractive to employees.

- **No Lump-Sum Withdrawals at Termination.** The Model T prohibits cash-out or lump-sum withdrawals that are not rolled over when one leaves employment, except for cash-outs of small balances under \$1,000.
- Option to Keep Balance in Plan to Retirement. After leaving a company, former employees can also opt to leave part or all of the balance in their account in the Model T until the former employee reaches retirement eligibility age.
- **Rollover Options.** Any participant who leaves a company can roll over 100 percent of the balance into another IRA or Model T Plan.

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Distribution rules after age 59½ offer the potential for a lifetime stream of income.

The Group sought to forge a policy that would reserve half the balance of the accumulated Model T account for an annuity or a series of installment payments that would provide income across the expected lifetime of the retiree. While approving the broad goal of a lifetime income stream in retirement, the Group was unable to agree on a specific policy for the reasons explained below. The Group instead decided to initially leave decisions on distribution rules to the financial institution, keeping open the possibility of further changes in what types of distributions would be allowed and how to define the normal form of retirement benefit.

Retirement Age at 59½. The Working Group considered a range of retirement age options, from 59½ to 62 to the Social Security retirement age, currently rising gradually to 67. Given the fact that lower- and middle-income workers may need to retire earlier than higher-income workers for a variety of reasons, and to keep the Model T consistent with the rules governing 401(k) plans, the Group agreed to set 59½ years as the minimum age one must attain to be eligible to receive the normal form of benefit, regardless of how that benefit is ultimately designed.

Lump-Sum Distributions. While agreement could not be reached on how best to preserve half the accumulated balance for income spread out over the life of the participant, the Group was able to reach agreement that up to 50 percent of the account balance could be withdrawn as a lump sum at or after age $59\frac{1}{2}$. The Group also supported allowing those who continue to work beyond $59\frac{1}{2}$ to take up to 50 percent of the account balance at retirement age. Allowing the distribution of half of the income to be taken at age $59\frac{1}{2}$ for those who continue work gives participants the option of phasing into retirement.

Annuities and Installment Payments. As noted above, the Group supported in concept the idea of requiring participants to take at least 50 percent of the balance in the plan at the time of retirement as an annuity. Or, alternatively, 50 percent of the balance could be paid out in installment payments designed to cover the expected lifespan of the participants. This second option was added so that financial institutions without a life insurance affiliate could offer the Model T plan. Finally, the Group agreed that if participants so wished, they could take out 100 percent of entire balance at retirement as an annuity.

• Employee Concerns about Annuities. The Group supported in concept a policy that would reserve half the accumulated balance for an annuity and/or a series of installment payments spread out over the expected lifespan of the retiree. The desire to provide a lifetime income in retirement, however, came up against other concerns. First, members noted that the total accumulated savings might not be high and that annuities are more costly for those with smaller sums to annuitize. Secondly, some members noted that retirees may need a lump sum for urgent medical treatments, or other financial emergencies. A single provision requiring annuitization would not be flexible enough to cover a wide range of participant needs, some members argued.

• Financial Institution Concerns about Annuities. The Group suggested that if annuities are required, many financial institutions might not offer Model T plans, either because they do not have an insurance affiliate or because they think annuities are too costly for smaller sums and, thus, not an attractive option to offer participants.

Normal Form of Retirement Benefit. Given the goal of preserving 50 percent for a stream of lifetime earnings and the concerns raised by annuities, the Group was unable to settle on a specific policy regarding the normal form of retirement benefit, beyond allowing for the withdrawal of 50 percent as a lump sum upon reaching retirement age. Instead, the Group agreed that the financial institution should decide what the normal form of retirement benefit is, within the broad outlines suggested by the Working Group. Thus, the normal form of retirement benefit could be designed to include any or all of the following:

- An annuity of 100 percent of the balance.
- A schedule of payments of 100 percent of the balance.
- Up to a 50 percent lump sum plus a 50 percent annuity.
- Up to a 50 percent lump sum plus a 50 percent schedule of payments arrangement.
- Up to a 50 percent lump sum with 50 percent left in the plan; e.g., for phased retirement.

Focus Groups. The Group agreed that questions about how best to handle distributions should be presented to informal focus groups of employers, employees, and financial institutions. The findings from this effort could then be used to make further alterations in the distribution rules for the Model T. It was also suggested that some financial institutions might be interested in conducting some of the informal focus groups of employers and/or employees.

Additional Research. In view of the uncertainties about how financial institutions would view requirements to provide an annuity or schedule of payments, members supported additional research, if practicable, to determine if it is feasible to require that an annuity or schedule of payments be part of the normal form of benefit, or if the distribution rules should be altered from the current decision to leave the choice up to financial institutions, but limit the choices financial institutions can make, as noted above. There is also some interest in further exploring the idea of collective annuitization, such as allowing participants to finance an annuity through the Pension Benefit Guaranty Corporation or Thrift Savings Plan, or a similar institution, as well as directly in the private market.

Mandatory Withdrawals. The current law governing 401(k) plans that requires mandatory withdrawals beginning at age $70\frac{1}{2}$ would also apply to the Model T Plan.

Spousal Consent. The current rules governing spousal consent would apply to any distributions from the Model T, including a joint and survivor requirement for any annuity that might be part of the final plan design.

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What's Next?

At the conclusion of the Third Stage of the Conversation on Coverage, the Working Group agreed to set up task forces to continue the work of refining, advancing, and potentially testing the Model T concept in a demonstration project.

- **Focus Group Task Force.** The Group agreed that members should form a task force to explore ways to organize focus groups to review the plan design of the Model T, particularly in the area of distributions and investment options.
- **Implementation Task Force.** The Conversation on Coverage will put together a task force to determine what steps are necessary to make the Model T into a reality. There are only two provisions that are inconsistent with current law, the two-tiered contribution regime and the ability for a SIMPLE-type plan to provide loans.
- **Demonstration Feasibility Task Force.** The Group agreed that there should be a task force set up to explore the feasibility of setting up a demonstration project for the Model T.
- Task Force for Developing the Standardized Performance Report. Working Group members will explore the idea of developing this tool with other experts and appropriate government officials.

Endnotes

ⁱCovering the Uncovered, Common Ground Recommendations to Expand Retirement Savings for American Workers, A Working Report (Washington, D.C.: Pension Rights Center, May 2005), pp. 64-78.

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

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

^{iv} The Group supported a regulatory approach for the Model T that is similar to the Internal Revenue Code provisions that govern who can offer IRAs. These regulations set out the procedures for designating which financial institutions would be authorized to provide the plan to employers.

^v Sarah Holden and Jack VanDerhei, "The Influence of Automatic Enrollment, Catch-Up, and IRA Contributions of 401(k) Accumulations at Retirement," Issue Brief No. 283 (Washington, D.C: Employee Benefit Research Institute, 2005), p. 4

vi Ruth Helman, Dallas Salisbury, Variny Paladino and Craig Copeland, "Encouraging Workers to Save: The 2005 Retirement Confidence Survey", Issue Brief No. 280 (Washington, D.C.: Employee Benefit Research Institution, April 2005), p. 8.

vii "Default Investment Alternatives Under Participant Directed Individual Account Plans; Proposed Rule," Employee Benefits Security Administration, *Federal Register*, September 17, 2006 (v. 71, no. 187), pp. 56806-56824.

viii Minutes of Working Group III Meeting of January 24, 2006, p. 3. Description of fiduciary duties taken from summary of comments by Roberta Ufford, partner at Groom Law Group in Washington, D.C.

ix Automated Clearing House (ACH). The ACH system of the U.S. Federal Reserve Bank that provides electronic funds transfer between banks. It is used for all kinds of fund transfer transactions, including direct deposit of paychecks and monthly debits for routine payments to vendors. The ACH is separate and distinct from the various bank card networks that process credit card transactions. ACH operations are done in a batch mode, which can take up to 72 hours before the money is actually transmitted. A return notification is sent if there are insufficient funds in the account.

*Section 406 of ERISA and Section 4975(c)(1) of the Internal Revenue Service Code relate to prohibited transactions and self-dealing. These rules prohibit, among other things, transactions in which a fiduciary to a plan deals with the assets of a plan in his own interest or for his own account.

xi U.S. Bureau of Labor Statistics, "National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2006, "published August 2006, Table 1, p. 6. From the web site at http://www.bls.gov/ncs/ebs/sp/ebsm0004.pdf.

- xii Ibid, Table 2, p 7.
- xiii Ibid, Table 1, p. 6.
- xiv Ibid. Table 2, p. 7.
- xv Seven percent were very likely to start a plan in the next two years, while 22 percent were somewhat likely. Source: Employee Benefit Research Institute, "The 2003 Small Employer Retirement Survey (SERS) Summary of Findings" (Washington, D.C.: EBRI, June, 2003), p. 2.
 - xvi Twenty-five percent were not too likely to start a plan in the next two years, while 43 percent were not at all likely. Source: Ibid.
 - xvii Ibid.
- xviii U.S. Department of the Treasury, Internal Revenue Service, *Statistics of Income Bulletin*, (Winter 1984-1985, Winter 1986-1987, Winter 1990-1991, Winter 1993-1994, Winter Fall 1995, Winter Spring 1996, Fall 2001, and Winter 2002-2003).
- xix Craig Copeland, "Retirement Plan Participation and Features, and the Standard of Living of Americans 55 or Older," EBRI Issue Brief Number 248 (Washington, D.C.: Employee Benefit Research Institute, August 2002), Figure 2, p. 8.

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Appendix A: Steering Committee and Working Group Members

Steering Committee

Steering Committee members participated as individuals and not as representatives of their organizations.

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^{*} Titles reflect the individuals' affiliations at the time of the Third Stage deliberations

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Appendix B:

Q&A from Government Agency and Congressional Committee Staff

Q&A from Government Agency and Congressional Committee Staff

The Working Group Co-Chairs, accompanied by other Conversation on Coverage Working Group and Steering Committee members, gave off-the-record briefings to congressional committee and government agency staff to solicit their input on substantive and technical matters, as well as practical suggestions that could be relayed to Working Group members about the final recommendations.

The committee staff briefing took place in December 2006, and included staff members from the House Committee on Ways and Means, the then-House Committee on Education and the Workforce (now the House Committee on Education and Labor), the Joint Committee on Taxation, the Senate Committee on Finance and the Senate Health, Education, Labor and Pensions Committee. The governmental staff briefing took place in January 2007 and included staff from the Internal Revenue Service, the Treasury Department, the Pension Benefit Guaranty Corporation and the Department of Labor. The following members of the Conversation on Coverage participated in the briefings: Director Karen Friedman and Steering Committee Chair Martha Hutzelman; the Co-Chairs of Working Group I, Norman Stein and Melissa Kahn, Working Group I member Brian Graff; the Co-Chairs of Working Group II, John Kimpel and Michael Calabrese, Working Group II member Mark Iwry; and Co-Chairs of Working Group III, Maria Freese, Ian Lanoff and Cathy Heron.

Below are some of the questions, answers, comments, and suggestions that emerged from those meetings. Since these briefings were off the record and comments were not for attribution, neither the questioners nor the respondents are identified.

Working Group I

KEY QUESTIONS AND COMMENTS ON GAP AND POPP

Question: Is GAP a defined benefit plan or a defined contribution plan?

Answer: There was a debate within the Working Group about whether to call the GAP a defined benefit plan or a defined contribution plan – since it has features of both. The Group decided to take the primary regulatory structure for the money purchase plan and make adjustments to it. One Working Group member at the briefing suggested that it would be called a GAP or be placed in whatever category the regulatory agencies decided to place it.

The important distinction is that while the cash balance plan was an effort to make a defined contribution plan out of a defined benefit plan, the Group wanted to make the GAP account a modified defined benefit plan within the confines of a defined contribution plan (thereby avoiding the controversial issues surrounding cash balance plans at the time of the Group's deliberations).

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Question: Are GAP accounts notional or real?

Answer: This issue is philosophical and academic in nature. What is important to employees is not whether the accounts are notional or real, but whether the employer puts in the money to ensure that they deliver on the guaranteed benefit employees expect, based on the plan formula. However, Working Group I members had long discussions about whether the GAP plan account is an actual or notional account. At one briefing, a Working Group member said the GAP account is an actual account, overlaying the money purchase account, which is credited with the return guaranteed in the plan. Another Working Group member believes that GAP is really a hypothetical account using the money purchase regulatory structure. But, where there is an account, unlike the situation with a defined contribution plan or a money purchase plan, the account in GAP could be underfunded (or potentially overfunded) at any given moment.

INVESTMENTS IN GAP AND POPP

Question: Are the investments in GAP matched up with the guaranteed rate of return or can employers invest in equities?

Answer: The investments in a GAP plan would not have to be placed in bonds that are matched to the fixed rate of return or a variable rate index. If employers invested in risky investments and lost, they would be responsible for making up any shortfall. The anticipation is that there would be investment instruments available in the marketplace designed to reduce that risk.

Question: How do you ensure that there are investment vehicles to provide the returns indicated in POPP, taking into account the contribution tables used in the description of the plan? Are there are going to be situations where the contributions indicated would not keep the plan 100 percent funded? What is the back up?

Answer: The contribution tables chart in question was based on a five percent rate of return for contributions to the plan (see Appendix D). One Working Group member said that it might be better to use a four percent rate of return, noting that the Working Group had been told that in some states insurance commissioners would not allow insurance companies to guarantee a five percent rate of return. Another Working Group member said the assumption for POPP is that there would be an investment product, a GIC (Guaranteed Investment Contract) or other investment vehicle. It would not necessarily be insured. Just like under GAP, if there was a shortfall due to poor investment performance, the plan sponsor would have to bring the plan up to full funding fairly quickly. In some ways the POPP is telling employers if they do not want volatility in their pension obligation, they will have to make larger contributions and invest conservatively.

Question: If GAP or POPP are using simplified and conservative actuarial assumptions, will either plan require a higher annual contribution than a cash balance plan? If so, will small businesses respond favorably to this?

Answer: Members of the Working Group I noted that many business owners want the deduction employers get for making the higher contributions. Also, the employers may be concerned that the plan may run

into trouble further down the road from being underfunded. The design of each plan is meant to strike the right balance between potentially higher contribution levels and predictable contributions with reduced volatility. The rules for the GAP were developed by Working Group I in advance of the Pension Protection Act of 2006. Since the new law has tightened up the funding rules, the disparity between the two sets of rules is not as great as when the Working Group drafted the GAP proposal. Also, the GAP recognizes "experience adjustments," meaning that employers may have to contribute more upfront, but may be able to reduce contributions if the plan's investments do well.

Question: Do GAP and POPP lend themselves to a model document?

Answer: Absolutely. In terms of design features, there are only a few choices on a practical basis that employers would have to make with GAP. POPP also lends itself to a prototype document. The Working Group members also believe that there is a reasonable chance that GAP and POPP would be attractive to insurance companies to market as ready-to-go plans.

POPP CONTRIBUTION RATES

Question: Does everyone in POPP get the same minimum contribution rate? Does it apply to bonuses? Can benefits increase with years of service?

Answer: Under POPP, there is a uniform contribution for all employees. However, there could be a disparity if an employer gives past service credits, in which case there would be double contributions in years when past service is granted. The same principle applies to GAP when past service is granted. If you were given three years of credit for prior service, you would give double contributions in those years. The rules would require that that everyone with prior service for those years receive the same double credit.

CHOICE OF LIMITS

Question: Do employers get to choose which limits to use – the defined benefit limits or the defined contribution limits? Once they have chosen, can employers change their minds? Wouldn't key employees who are older choose defined benefit limits, while younger employees would choose defined contribution limits?

Answer: Employers must select only one set of limits as part of the plan design. This decision would be based on everyone in the plan. Once the employer makes that decision, it is irrevocable.

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Working Group II

KEY QUESTIONS AND COMMENTS ON THE RETIREMENT INVESTMENT ACCOUNT

EMPLOYER'S RESPONSIBILITIES

Question: What are the employer's administrative responsibilities?

Answer: The employer's obligation is limited to making payroll deduction available to employees, and making sure the contributions go to the Clearinghouse. For the employer, it is no different than the obligation to transmit income and taxes to the government. One Working Group II member said it was best not to think of the employer as offering "anything." He said it was just adding an additional box under the W-4 form.

BENEFIT OF CLEARINGHOUSE

Question: How important is the Clearinghouse as opposed to having the employer choose a single provider for many accounts?

Answer: The Group came to the Clearinghouse idea in order to relieve the employer of several responsibilities, including the selection of a service provider, which would involve fiduciary liability. This allows everything to be done automatically for workers, and would be particularly advantageous for low-income workers, some of whom do not have bank accounts.

Question: Was there any consideration given by the Working Group to requiring these payments be paid out as a stream of income or as an annuity?

Answer: The Group discussed the fact that if you have an infrastructure that is as broad and as standardized as the RIA, and if you have accounts with a national platform, there is an opportunity to encourage annuitization on a broad scale. While the Group reached general agreement on annuitization as a goal, it did not have time to try to figure out how this would be done through a federally-sponsored clearinghouse.

POTENTIAL COMPETITION WITH EXISTING PLANS

Question: It seems that having the limit set at a level between the IRA and SIMPLE limits could act as an incentive for some employers who are sponsoring a 401(k) plan to decide to get rid of it. By terminating the 401(k) plan and replacing it with an RIA, the employer could save on the administrative costs of the 401(k), get rid of the match, and use the savings to reward the people the company cares most about giving them an extra \$15,000 or \$20,000 in cash or nonqualified benefits outside the RIA. Has the Group looked at or modeled the economic incentives that might influence employers who have 401(k) plans?

Answer: The Group did discuss the incentives that might be created by having a contribution limit higher than an IRA. While the majority supported these higher limits, there was a strong minority view in favor of keeping the limits no greater than the IRA limits. The majority of the Group believed that if they increased the contribution limit a few thousand dollars above the IRA, it would not cause employers to abandon their qualified plans. A Working Group member noted that there is no employer contribution with the RIA, which makes it less likely the employer could take care of the preferred workers in any particular way. There was a comment that only those who had a defined benefit plan but not a 401(k) plan could contribute to the RIA.

Question: Won't the tax credits proposed by the Group cost a lot?

Answer: The Group developed ideas for the expanded tax credit but has not yet developed the cost estimates. The Group was focused on what kinds of tax structures would make sense to encourage savings among the targeted population. But the RIA can be launched first without the credits.

Question: Can an individual both have an RIA and an IRA?

Answer: The Group looked at the RIA as an efficient way to save. Some Working Group members thought that if employees had an RIA they should not be able to contribute to an IRA. There were others who thought, just like a 401(k) plan, they should. There were many who thought that the limits should at least be integrated with the IRA.

Working Group III

KEY QUESTIONS AND COMMENTS ON THE MODEL T

PLAN LOANS

Question: The Model T does not allow hardship withdrawals but it does allow for loans. What happens if an employee does not repay the loan?

Answer: If the loan is not repaid, it would be deemed a distribution. It was noted the same problem already exists in plans that offer loans. It was further noted that under the Model T, it would be up to the financial institution to decide whether or not to offer loans.

FIDUCIARY ISSUES

Comment from Government Staff: If fiduciary rules are an impediment to plans being set up by small employers, there is a way to structure a product from a service-provider perspective. There might be some predefined investment options that would not create the kinds of conflicts of interest that the Working Group

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faced with trying to transfer the fiduciary duties from employers to financial institutions. The Group might explore the potential for this and other approaches.

FEASIBILITY OF A DEMONSTRATION PROJECT

Question from the Working Group to Government Officials: Is there is a way to establish a demonstration project in a particular community and work with the relevant agencies to make it happen? If a demonstration project is granted, is it possible to ensure that it is not just as a temporary measure, but one that could continue for the companies and employees involved?

Answer: One government official said that part of the challenge would be to find an institution to define a particular product they would be willing to market to a test group. He said that the government could discuss options with the Working Group about the potential levels of public involvement that might minimize liability for employers. He said it be worth exploring how some safe harbor might be constructed.

Question from the Working Group to Government Officials: Members of the Working Group noted they had also considered hiring certified independent fiduciaries, but could not figure out to do it. Is there a certification process or some sort for these experts?

Answer: A government official stated that the agencies look at whether independent fiduciaries have the expertise needed but there is not a certification process.

Question from the Working Group to Government Official: What could be done in the context of a demonstration project to transfer fiduciary liability from the employer to a third party? Is there something that could be set up as a structure within existing practices?

Answer: A government official said that there might be frameworks that could be explored. If there are prohibited transaction issues, the framework would require an independent fiduciary. In addition, there could be an exploration of pre-defined investments with someone certifying that the investments are prudent and appropriate. (This was discussed within the Working Group, but some members were concerned that the government has never intervened in determining whether an investment is "prudent.")

GENERAL QUESTIONS ON THE CONVERSATION ON COVERAGE

Question: Would the combination of all four proposals from the Working Groups together achieve universal coverage?

Answer: The goal of the Conversation on Coverage was to develop common ground solutions to increase coverage; the goal was never to achieve universal coverage. The goal of each Working Group was different: Working Group I's goal was to expand guaranteed benefits; Working Group II's goal was to get more individuals to save; and Working Group III's goal was to expand coverage among small businesses.

The Groups also worked to ensure that their proposals were consistent with continuing the voluntary employer-based system.

Question: Do all the proposals work together?

Answer: While there may be certain elements of proposals that are similar, the Working Groups all worked independently of one another. (In fact, the first time the Working Groups got to hear each other's proposals was in July 2004, when the interim recommendations were released.) The proposals were never intended to work as separate parts that fit together. In the end, there could be four separate proposals or a proposal that merged some of the best features of the proposals. The key is to recognize that these are common ground approaches. Decisions on various building blocks in the proposals were reached because they appealed to either employers, employees or financial institutions. And many provisions were compromises reached after long discussions.

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Appendix C: Contribution Calculations for the Guaranteed Account Plan

Contribution Calculations for the Guaranteed Account Plan

CASE STUDY SHOWING FUNDING METHOD OVER A SEVEN-YEAR PERIOD

Synopsis of funding calculation:

- (1) Calculate total of hypothetical contributions for the plan year
- (2) Calculate the value of the assets as of the valuation date, before any current contribution is added
- (3) Calculate the sum of the Guaranteed Account Balances (GABs) as of the valuation date (excluding (1))
- (4) Subtract (3) from (2). If this is a positive number, there has been an earnings gain. If this is a negative number, there has been an earnings shortfall.
- (5) If (4) is a net loss, calculate the amount that the earnings shortfall would be worth in five years (including the current year) under the plan's guaranteed rate of return (assume current year guarantee if the rate can fluctuate).
- (6) Calculate the amount that would be required to be contributed as of the valuation date to amortize the amount in (5) over the five-year period.
- (7) Calculate the aggregate GABs as of the valuation date, including the amount in (1).
- (8) Subtract the amount in (2) from the amount in (7). This is the unfunded portion of the GABs. If (2) is larger than (7), the GABs are fully funded, and this amount is zero.
- (9) Minimum funding: The lesser of: (a) the amount in (1) plus the amount in (6), or (b) the amount in (8).
- (10) Maximum funding calculation (maximum deduction):
 - (a) Calculate 1.5 times the amount in (7)
- (b) Subtract the amount in (2) from the amount in (10)(a). If this is a positive number, this is the most the employer can contribute on a deductible basis. If this is zero or a negative number, the maximum deduction is zero (i.e., the full funding limit).
- (11) Limitations on funding assumptions: pre-retirement discounts for turnover and mortality not permitted, no salary scale assumptions.
- (12) Plan is a money purchase plan for IRC §412 purposes, but is subject to the special minimum funding requirements stated above. Therefore, there would be no quarterly contribution requirement under IRC §412(m).

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

CASE STUDY

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

Year 1: Total participant compensation is \$1,000,000

Normal cost = \$60,000

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

GABs as of valuation date: \$60,000.

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

Minimum funding: \$60,000

Maximum funding: \$90,000

Employer's actual contribution: \$60,000

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

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

Actual earnings since last valuation date: \$2,392 (about four percent)

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

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

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

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

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

Normal cost plus amortization payment: \$66,140

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

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

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

150 percent x GABs: \$193,500

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

Employer's actual contribution: \$66,500

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

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

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

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

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

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

Shortfall: \$5,405 (i.e., assets minus pre-contribution GABs). This would be worth \$6,897 in five years under the plan's guaranteed rate of five percent.

Amortization payment for shortfall: \$1,248 (round to nearest dollar), based on a five-year amortization period

Normal cost plus amortization payment: \$81,648

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

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

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

150 percent x GABs: \$323,775

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

Employer's actual contribution: \$82,000

Year 4: Total participant compensation is \$1,500,000.

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

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

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

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

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

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

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

Normal cost plus amortization payment: \$94,274

Sum of GABs as of valuation date (including current year's contribution): \$316,643

Shortfall on 100 percent funding: \$108,506 (i.e., \$316,643 minus \$208,137)

Minimum funding amount: \$94,274 (i.e., the lesser of the normal cost plus amortization payment or one hundred percent funding shortfall)

150 percent x GABs: \$474,964

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

Employer's actual contribution: \$99,000

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

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

Actual earnings since last valuation date: \$17,224 (six percent rate).

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

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

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

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

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

Normal cost plus amortization payment: \$85,874

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

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

Minimum funding amount: \$85,874 (i.e., the lesser of the normal cost plus amortization payment or the one hundred percent funding shortfall)

150 percent x GABs: \$624,712

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

Employer's actual contribution: \$100,000

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

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

Actual earnings since last valuation date: \$36,368 (nine percent rate).

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

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

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

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

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

Normal cost plus amortization payment: \$96,000

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

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

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

150 percent x GABs: \$799,948

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

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

Year 7: Total participant compensation is \$2,000,000.

Normal cost = \$120,000. This is determined by calculating the hypothetical contribution for this year (six percent x \$2,000,000)

Actual earnings since last valuation date: \$31,009 (five percent rate).

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

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

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

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

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

Normal cost plus amortization payment: \$120,000

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

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

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

150 percent x GABs: \$1,019,945

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

Employer's actual contribution: \$0

Appendix D: Sample Calculations for the Plain Old Pension Plan

Sample Calculations for the Plain Old Pension Plan

CONTRIBUTION CALCULATIONS

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

Assumptions for Contribution Calculations

- 1997 Group Annuity Mortality table projected to 2002.
- Interest rate assumption of five percent.
- Plan formula: A lifetime pension equals one percent times current compensation at age 65, payable monthly.

BENEFIT CALCULATIONS

COMPENSATION AGE	\$30,000/YEAR	\$60,000/YEAR	\$100,000/YEAR	\$200,000/YEAR
30	\$10,500/year	\$21,000/year	\$35,000/year	\$70,000/year
40	\$7,500/year	\$15,000/year	\$25,000/year	\$50,000/year
50	\$4,500/year	\$9,000/year	\$15,000/year	\$30,000/year
55	\$3,000/year	\$6,000/year	\$10,000/year	\$20,000/year

Assumptions for Benefit Calculations

- Participant remains in plan from entry date to retirement.
- No increase in compensation.

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Appendix E: Interplay between GAP and Current Law

Interplay between GAP and Current Law

GAP Provisions Inconsistent with Current Law

- Lower PBGC Premium
- · Choice of Defined Benefit or Defined Contribution Plan Limit
- Gateway Contribution to Use Defined Benefit Limit
- Gateway Contribution for Certain Nondiscrimination Testing Methodologies
- Special 401(k) Provisions
- Requirements for Rate of Return on Account Balances
- Simplified Funding Rules
- Side-Car Trust Rules
- Accelerated Minimum Vesting Rule
- Special Past-Service Benefit Rules
- Default Benefit Includes 75 Percent Spousal Survivor Annuity

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Appendix F: Interplay between POPP and Current Law

Interplay between POPP and Current Law

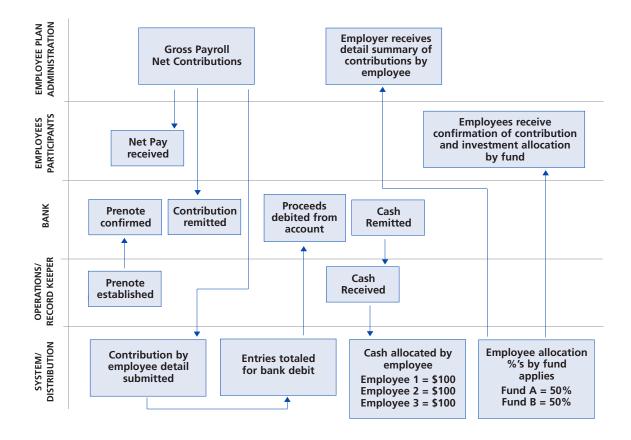
POPP Provisions Inconsistent with Current Law

- Accelerated Minimum Vesting Rule
- · Ability to Provide Annual Bonus Benefits at Discretion of Employer
- Special Past-Service Benefit Credit
- Voluntary Employee Contribution Feature/401(k) Account
- Special Simplified Funding Method, Including Development of Contribution Charts
- Mandatory Annuity Benefit Requirement (except for small lump-sum amounts)
- No Top-Heavy Minimum Benefit Requirement
- Reduced PBGC Premium
- No Reversion of Excess Assets to Employer
- Tax Credit for Non-Highly Compensated Employees

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Appendix G: Electronic Funding Process

Electronic Funding Process



- Employer or Plan Manager submits a request to establish an Electronic Funds Transfer (EFT) between their employer's bank and the Operations record keeping bank.
- A prenote transmission is sent to test the instructions (prenote transactions are \$0.00 dollar transmissions required to test the connection and instructions).
- Employer or Plan Manager calculates gross payroll and net contributions.
- Employee receives net pay.
- Details for employee's contributions are submitted by the employer or plan manager to the operations record keeper.
- Entries are totaled for bank debit from the employer's account.
- Contributions are remitted electronically by the employer's bank.
- Proceeds are debited from the bank account.
- Cash is electronically remitted to the operations record keeper (via EFT).
- Operations record keeper receives cash and the system allocates the proceeds according to details previously supplied by the employer or plan manager.
- The employee allocation percentages by fund are applied.
- Employer receives a detailed summary of contributions by each employee as confirmation (no investment selections/allocations are made visible to the employer to protect the employees privacy).

• Employee receives confirmation of contributions and investment allocation by fund.

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Appendix H: Fiduciary Regulation in Australia

Fiduciary Regulation in Australia

A member of Working Group III suggested that the Group might want to look at how Australia regulates its superannuation plans to see if there were arrangements that might be applicable to the Model T plan. The Group was interested in Australia's regulatory model because it assigns fiduciary responsibility to a financial institution trustee and not to the employer. Members of Working Group III have, from the beginning, hoped to design a new type of plan that would relieve the employer of fiduciary responsibility for the ongoing monitoring of investments options, fees, and services.

A decidedly different menu of qualified plans is offered in Australia. Among the kinds of plans that might be relevant to the design of the Model T are corporate master trusts, which are offered by large financial institutions on a group basis, and multiple-employer industry funds.

The Australian model of retirement plan regulation has strict oversight of plans and a rigorous licensing process for trustees, who act as the fiduciaries for the plans. Trustees are generally appointed – either by the sponsoring organizations (an employer, employer association or trade union) – or by a parent financial institution. In some instances, member-representative trustees are elected by members rather than appointed by a trade union. Since trustees act as fiduciaries, the employer does not have fiduciary liability for the investment options, fees, and services of the plan. The trustees "are in the regulatory cross hairs," says Dr. Brad Pragnell, Director, Policy and Best Practice for the Association of Superannuation Funds in Australia.

The appointment of trustees to be fiduciaries, the careful licensing process, and the heightened oversight are potential features that might be adopted in the United States, although it would require the creation of a different regulatory structure. For example, there is a stringent process in Australia to become a designated trustee and there are on-site visits to the trustee's location every six to twelve months from regulators. While employers have less responsibility, the effect of the higher regulatory burden on operations of funds might increase the costs compared to the situation in the United States. The government licensing process for trustees, if adopted in the United States, might also apply to other types of plans besides the Model T.

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ⁱFollowing up on this suggestion to look into fiduciary regulation in Australia, a telephone conference call was arranged with Dr. Brad Pragnell, Director, Policy and Best Practice for the Association of Superannuation Funds in Australia. During the conversation Dr. Pragnell explained the basics of the Australian system and how it might potentially apply to the U.S. system and whether there would be any relevance to the work of Working Group III in particular. The following people participated in the telephone conference: Robert England, Karen Friedman, and Martha Hutzelman.

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