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RETIREMENT (IN)SECURITY: EXAMINING THE RETIREMENT SAVINGS DEFICIT

HEARING

BEFORE THE

SUBCOMMITTEE ON
ECONOMIC POLICY

OF THE

COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

SECOND SESSION

ON

EXAMINING THE CURRENT GAP BETWEEN WHAT AMERICANS WILL NEED FOR RETIREMENT AND WHAT THEY ARE ON TRACK TO SAVE, REVIEWING THE SIZE AND SCOPE OF THIS GAP AND HOW THE RECENT ECONOMIC CRISIS AND OTHER ECONOMIC FACTORS HAVE IMPACTED THIS DEFICIT AND AMERICANS' RETIREMENT SAVINGS AND SECURITY

MARCH 28, 2012

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C O N T E N T S

WEDNESDAY, MARCH 28, 2012

WITNESSES

Additional Material Supplied for the Record

RETIREMENT (IN)SECURITY: EXAMINING THE RETIREMENT SAVINGS DEFICIT

WEDNESDAY, MARCH 28, 2012

U.S. SENATE,
SUBCOMMITTEE ON ECONOMIC POLICY,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Subcommittee convened at 2:32 p.m., in room 538, Dirksen Senate Office Building, Hon. Jon Tester, Chairman of the Subcommittee, presiding.

OPENING STATEMENT OF CHAIRMAN JON TESTER

Senator TESTER. I want to call to order this hearing of the Economic Policy Subcommittee, a hearing titled, "Retirement Security," or maybe I should say "Insecurity: Examining the Retirement Savings Deficit."

I look forward to hearing from our witnesses this afternoon about the retirement savings deficit in America, that is, the shortfall between what Americans are saving for retirement and what they will need to live comfortably in retirement.

The facts are a bit unsettling. The most often cited studies peg the size of this deficit in the trillions of dollars. Only 14 percent of the folks are confident that they will have enough money to live comfortably in retirement. The majority of working adults, more than 75 million workers, do not participate in any private retirement savings plan at all, and according to a recent report from one of our witnesses, the majority of American workers has not even tried to calculate how much they will need to save for retirement.

For some time, trends have indicated that Americans have been saving less, participating less in retirement savings plans, and living longer. We cannot escape our demographics, and we know that the retirement of the Baby Boomers will place additional strains on Social Security and Medicare.

But we find ourselves confronting an even greater retirement security challenge today. In 2008, the financial crisis, the economic meltdown that followed, and the decline in housing values have, not surprisingly, widened the retirement savings gap and aggravated many Americans' sense of insecurity about retirement. Workers unable to find jobs due to the weak economy do not contribute to employer-provided retirement plans, reducing future retirement income and security. Market conditions not only impacted retirement assets and accumulation, but also hurt enrollment in retirement savings plans. And the bursting of the housing bubble effectively ended our ability to rely on the ever-increasing home values to provide retirement security.

The implications of the economic crisis for workers are clear. Americans must work longer, save more, or spend less in retirement in order to retire with sufficient retirement savings.

We spend an awful lot of time here in the Senate focused on how to reduce our deficit and strengthen Social Security and Medicare, but the bottom line is that regardless of any potential changes to these programs, Americans are simply not saving enough for retirement.

Since 2008, we have taken steps to improve the economy and restore confidence in capital markets, but we still have work to do to address this retirement savings challenge. And before that savings deficit grows much further, we have an opportune moment to take a closer look at this issue. We will examine the retirement savings gap, its nature and scope, and what the major trends are. We will consider the impact of the economic crisis on workers' savings and security and what the economic impact is of the growing retirement savings gap on capital and labor markets. And we will see how workers have responded and what that means about what we can expect as the Baby Boomer generation heads into retirement and better understand what some of the more effective and efficient strategies are to encourage greater retirement savings so that workers can confidently take retirement planning into their own hands.

It is a complicated issue, but today's hearing really gives us a chance to look more closely at a critical issue of retirement savings and security in hopes that we can all come away with a keener sense of the scope, scale of the problem, and come to grips with it.

With that, I turn it over to my friend, Senator Vitter, for his opening statement.

STATEMENT OF SENATOR DAVID VITTER

Senator VITTER. Thank you, Senator Tester, for calling this hearing. It certainly is a very, very important topic. And welcome and thanks to all of our witnesses. I look forward to mostly listening and I appreciate you all being here and offering your thoughts.

This is a very serious concern and a very serious challenge and I would invite you all to offer your thoughts on as wide a range of helpful areas as possible, certainly including the following. I am concerned, along with others, that one real and significant impact of the Fed's prolonged zero interest rate policy is a real hit on retirees and others who depend on that sort of investment and interest income, if you all could comment on that.

Certainly, any thoughts you have on Social Security reform. We need Social Security reform, first of all, to ensure the continued viability and solvency of the system, but I also think we need expanded flexibility and some new models and new options to offer folks who are in their working years now to build toward retirement.

And finally, tax policy and what we can do in the tax area. Some obvious examples, like increasing IRA limits, but there are other things, as well, and I would invite any ideas you have in that area.

And with that, I will be all ears and look forward to your comments. Thank you.

Senator TESTER. Thank you, Senator Vitter.

I would like to welcome our witnesses, a distinguished panel of scholar and experts on retirement issues, and I want to thank you for your willingness to testify this afternoon.

First, Mr. Calabrese is a Senior Research Fellow affiliated with the asset-building program at the New America Foundation located right here in Washington, D.C. Previously, Mr. Calabrese served as General Counsel of the Congressional Joint Economic Committee, Director of the Domestic Policy Programs at the Center for National Policy, and as a pension employee benefits counsel at the national AFL–CIO. Welcome, Mr. Calabrese.

Next, we have Dr. VanDerhei, who is a Research Director of the Employee Benefit Research Institute, EBRI, a Washington-based private, nonprofit organization conducting public policy research and education on economic security and employee benefits. He is also the Director of both the EBRI Defined Contribution and Participant Behavior Research Program and the EBRI Retirement Security Research Program. Welcome, Mr. VanDerhei.

And last but certainly not least, we have Mr. Rickards, and he is the Senior Managing Director of Tangent Capital Partners, an investment bank based in New York specializing in alternative asset management solutions. He is a counselor, economist, and investment advisor with 35 years of experience with several firms, including Citibank, RBS, Long-Term Capital Management, and Caxton Associates, and I want to welcome you, Mr. Rickards.

Each witness will have 5 minutes for oral statements and their written testimony will be made a part of the record in its complete.

So with that, Mr. Calabrese, would you please get us started.

STATEMENT OF MICHAEL CALABRESE, SENIOR RESEARCH FELLOW, NEW AMERICA FOUNDATION

Mr. CALABRESE. OK. Good afternoon. Thank you, Mr. Chairman and Senator Vitter, for this opportunity to testify. It is great to see that this Subcommittee is taking up this important topic.

There is no question that a widening retirement savings gap is creating widespread insecurity. Most individuals are simply not saving enough over their working life to supplement the meager benefits that they will receive from Social Security.

One barometer, the National Retirement Risk Index, indicates that a majority, 51 percent, of working-age households are at risk of not having enough retirement income to maintain their pre-retirement level of consumption. Most worrisome are adults over 45. The index shows 41 percent of early Boomers and 48 percent of late Boomers are at risk.

These shortfalls represent the cumulative trillions that the Chairman mentioned. They estimated a couple of years ago a $6.6 trillion retirement income deficit, which is according to the Center for Retirement Research, which created the index. This $6.6 trillion is roughly $22,000 per capita and represents the present value of the saving and investment shortfall needed to ensure, on average, retirement security for every American.

What accounts for this enormous savings gap? I believe America's real retirement security crisis is not Social Security solvency or the many big firms terminating or freezing their traditional pension plans. The larger problem is that a majority of working adults do not participate in any retirement saving plan, whether a traditional pension, 401(k), or IRA. Participation in employer-sponsored plans peaked in the late 1970s and appears to be at its lowest level in more than 30 years. Employer-sponsored plans cover fewer than half of all private sector workers, leaving a projected majority of Boomers possibly more dependent on Social Security than their parents' generation is today.

Coverage and participation rates are also strikingly lower among workers who are low-income, young, work part-time, or work at small firms. The result of excluding half the Nation from automatic workplace saving is that nearly two-thirds of those 65 and older rely on Social Security for a majority of their income and 40 percent rely on Social Security for 90 percent or more of their income, a dependency ratio that is even greater for widows.

Not surprisingly, the lowest earning 40 percent of working adults are accumulating very little in the way of financial assets. Elderly and the lowest-income quintile receive, on average, only about 5 percent of their income from either pension or assets. And because retirees with low career earnings receive minimal Social Security benefits, about a third of the elderly on Social Security fall below the individual poverty line.

So how are America's seniors coping with this savings deficit? For those 65 and older, rising income from remaining in or reentering the workforce is replacing steadily declining income from nonpension assets. Since the mid-1980s, the share of income for Americans 65 and older coming from wages has doubled, while the share from asset income has plummeted to about 12 percent, the lowest level in half a century.

This trend toward more wage income for seniors seems to confirm opinion surveys showing that a steadily growing portion of the workforce will at least try to continue to work at least part-time beyond normal retirement age. And while working past age 65 or 70 may not seem so bad to us, according to a McKinsey study, in 2007, nearly half of all Boomers were working in physically demanding jobs, including 18 percent in construction and production jobs, and another 14 percent in physically demanding service sector jobs, such as police, fire, and food production. Only 21 percent of Boomers are professionals.

While remaining employed will help compensate for rising disparity in ownership of income-producing assets, it will also impact labor markets by potentially reducing the availability of work opportunity and rising real wages for younger workers.

The single most important thing policymakers can do to narrow this retirement savings gap is facilitate access to automated payroll deduction savings plans accessible to all. The fact that so few workers save regularly in IRAs reinforces what demonstration projects in asset building among low-income families have found, that it is not primarily access to savings accounts that spur participation, but what I call the four "I"s: Inclusion, incentives, infrastructure, and inertia.

So I will just wrap up by explaining what I mean by this. By inclusion, I mean eligibility and design criteria that allow every working adult not currently able to participate in a qualified employer plan to contribute. We need stronger tax incentives for saving that are more targeted toward lower-income earners who find it most difficult to save and whose savings actually add to net national saving. We need an account-based infrastructure that enables every worker to save by automated payroll deduction and facilitates career-long account portability. And finally, we need default options that convert myopia into positive inertia through automatic enrollment and payroll deduction, automatic escalation, automatic asset allocation, automatic rollovers, and automatic annuitization.

At the end of my testimony, I also mention some other options for encouraging saving across the lifetime, such as children's savings accounts, but I will stop there. Thank you.

Senator TESTER. Thank you, Mr. Calabrese.

Dr. VanDerhei.

STATEMENT OF JACK VANDERHEI, PH.D., DIRECTOR OF RESEARCH, EMPLOYEE BENEFIT RESEARCH INSTITUTE

Mr. VANDERHEI. Mr. Chairman, Mr. Ranking Member, Members of the Subcommittee, I am Jack VanDerhei, Research Director of the Employee Benefit Research Institute. EBRI is a nonpartisan institute that has been conducting original research on retirement and health benefits for the past 34 years. EBRI does not take policy positions and does not lobby.

My testimony today will focus on the size of Americans' retirement saving gap, the extent to which its deficit has been impacted by economic conditions over the past several years, and the most effective strategies to encourage and facilitate greater savings for retirement. The testimony draws on extensive research conducted by EBRI on these topics over the past 13 years with its Retirement Security Projection Model as well as annual analysis of behavior of tens of millions of individual participants from tens of thousands of 401(k) plans dating back in some cases as far as 1996.

Measuring retirement income adequacy is an extremely important and complex topic, and EBRI started to provide this type of measurement in the late 1990s. Figure 1 of my written testimony shows that when we modeled the Baby Boomers and Gen Xers earlier this year, 43 to 44 percent of the households were projected to be at risk of not having adequate retirement income for even basic retirement expenses plus uninsured health care costs. Even though this number is quite large, the good news is that it is five to 8 percentage points lower than what we found in 2003. It would be my pleasure to explain in more detail later why American households are better off today than they were 9 years ago, even after the financial and real estate market crises in 2008 and 2009.

Who is most at risk? Figure 2 in my testimony shows that, not surprisingly, lower-income households are much more likely to be at risk for insufficient retirement income. The 2012 baseline at-risk ratings for early Boomers range from 87 percent for the lowest-income households to only 13 percent for the highest-income households.

Figure 4 shows the conditional average retirement income deficits by age, family status, and gender for Baby Boomers and Gen Xers. The average individual conditional deficit number ranges from approximately $70,000 for families to $95,000 for single females and $105,000 for single females. In aggregate terms, that would be $4.3 trillion for all Baby Boomers and Gen Xers in 2012.

Last year, EBRI published a report analyzing the percentage of U.S. households who became at risk of insufficient retirement income as a result of the financial market and real estate market crisis in 2008 and 2009. As one would expect, the answer to this question depends to a large extent on the size of the account balance the household had in defined contribution plans and/or IRAs as well as their relative exposure to fluctuations in the housing market. The resulting percentages of households that would not have been at risk without the 2008–2009 crisis that ended up at risk varies from a low of 3.8 percent to a high of 14.3 percent.

It is difficult to imagine any voluntary strategy more effective at dealing with retirement income security than increasing the likelihood of eligibility in a qualified retirement plan. Figure 8 of my written testimony shows the importance of defined benefit plans for retirement income adequacy, and Figure 9 shows a similar analysis for 401(k) plans. We see that the number of future years the workers are eligible for participation in a defined contribution plan makes a tremendous difference in their at-risk ratings, even after adjusting for the worker's income quartile. When the results for Gen Xers were aggregated across all income categories, those with no future years of eligibility are simulated to run short of money 61 percent of the time, whereas those with 20 or more years of future eligibility would only experience this situation 18 percent of the time.

EBRI research has shown repeatedly the traditional type of 401(k) plan under current tax incentives has the potential to generate a sum that, when combined with Social Security benefits, would replace a sizable portion of the employee's pre-retirement income for those with continuous coverage. Our research has also shown that the automatic enrollment type of 401(k) plan, when combined with automatic escalation provisions, appears to have the potential to produce even larger retirement accumulations for most of those covered by such plans.

Recently, however, there have been proposals to modify the existing tax incentives for defined contribution plans by either capping the annual contributions or changing the before-tax nature of employee and employer contributions in exchange for a Government-matching contribution. In September of 2011, the Senate Finance Committee held a hearing that focused to a large extent on the second type of proposal. EBRI presented preliminary evidence at that time of the possible impact of such a proposal on future 401(k) accumulations.

In recent months, results from two surveys have allowed EBRI to more precisely model these effects in view of a specific proposal, and last week, we published our new results showing the average percentage reductions in 401(k) account balances at retirement age due to expected modifications of plan sponsors and participants in response to this proposal. Figure 17 in my written testimony shows a 22 percent reduction in 401(k) balances at retirement for those currently 26 to 35 in the lowest-income quartile, and those are the ones who are most at risk for insufficient retirement income.

The results are even more dramatic for small plans. Figure 18 in my testimony shows the average reduction for the lowest-income quartile in the two smallest plan size categories are 36 and 40 percent.

In conclusion, given that the financial fate of future generations of retirees appears to be so strongly tied to whether they are eligible to participate in employer-sponsored retirement plans, the logic of modifying either completely or marginally the incentive structure of employees and/or employers for defined contributions plans at this time needs to be thoroughly examined. The potential increase of at-risk percentages resulting from either employer modifications to existing plans or a substantial portion of low-income households decreasing or eliminating future contributions to savings plans needs to be analyzed carefully when considering the overall impact of such proposals.

Thank you, and I look forward to your questions.

Senator TESTER. Thank you, Dr. VanDerhei.

Mr. Rickards.

STATEMENT OF JAMES G. RICKARDS, SENIOR MANAGING DIRECTOR, TANGENT CAPITAL PARTNERS, LLC

Mr. RICKARDS. Mr. Chairman and Mr. Ranking Member and Members of the Subcommittee, thank you for inviting me to testify today, and I appreciate this opportunity to speak to you on a subject of the utmost importance to the U.S. economy.

A significant portion of income security for retirees comes from earnings on savings. While savings themselves are important, it is the earnings on the savings compounded over decades that makes the difference between a comfortable retirement and barely getting by. Since retirees properly favor safe investments, such as certificates of deposit and money market funds, over risky investments, such as stocks, it follows that Federal Reserve interest rate policy is a key determinant of the adequacy of retirement income security.

The Federal Reserve lowered interest rates to zero in December 2008 and rates have remained at that level ever since. The Fed has declared an intention to keep short-term interest rates near zero through late 2014. Keeping rates near zero for 6 years is unprecedented. It should come as no surprise that an unprecedented policy should have unprecedented results.

There is evidence that the Fed's policy is leaving the U.S. economy worse off when compared to a more normalized interest rate regime. Some of these deleterious effects on retirement income security include the following.

The zero rate policy represents a wealth transfer from retirees and savers to banks and leveraged investors. The zero rate policy deprives retirees of income and depletes their net worth through inflation. This lost purchasing power exceeds $400 billion per year and cumulatively exceeds $1 trillion since 2007.

The zero rate policy is designed to inject inflation into the U.S. economy. However, it signals the opposite. It signals the Fed's fear of deflation. Americans understand this signal and hoard savings, even at painfully low rates.

The Fed's zero rate policy is designed to keep nominal interest rates below inflation, a condition called "negative real rates." This is intended to cause lending and spending, as the real cost of borrowing is negative. For savers, the opposite is true. When real returns are negative, the value of savings erodes. This is a non legislated tax on savers. The Fed's policy says to savers, in effect, if you want a positive return, invest in stocks. This gun to the head of savers ignores the relative riskiness of stocks versus bank accounts. Stocks are volatile, subject to crashes, and not right for many retirees. To the extent many are forced to invest in stocks, a new bubble is being created.

Solutions are straightforward. The Fed should raise interest rates immediately by one-half of 1 percent and signal that other rate increases will be coming. The Treasury should signal that they support the Fed's move and support a strong dollar, as well. The Fed and Treasury should commit to facilitate the conversion of savings into private sector investment by closing or breaking up too-big-to-fail banks. This will facilitate the creation of clean new banks capable of making commercial loans to small businesses and entrepreneurs.

The result over time would be to replace a consumption and debt-driven economy with an investment-driven economy that rewards prudence and protects the real value of the hard-earned assets of retirees. It is false to suppose that monetary policy is a choice between encouraging savings, which reduces aggregate demand, and discouraging savings to increase aggregate demand. In a well-functioning banking system, savings can be a source of real returns for savers and a source of aggregate demand through investment.

As late as the 1980s, money-center banks operating through syndicates made 7-year commercial loans to finance massive private sector investments in projects like the Alaska pipeline, new fleets of Boeing 747 aircraft, and other critical infrastructure. These projects were financed with the savings of everyday Americans, including retirees. Savers received a positive return on their money.

Today, the United States does not have a well functioning banking system because of regulatory failures by the Fed. The conveyor belt between savings and investment provided by the banks is broken. With the repeal of Glass-Steagall in 1999 and derivatives regulation in 2000, the door was opened to break down traditional lending functions and allow banks to become leverage machines for securitization and proprietary trading. Securitization breaks the bond between lender and borrower because the bank cares only about selling the loans, not collecting on them at maturity. This destroys the incentive to allocate capital to the most productive long-term uses. Productive private sector investment and capital formation have been the victims.

It is not too late to turn back from the Fed's inflationary policies and restore the link between savings and investment. The path to improved income security for retirees consists of raising interest rates in stages to provide positive real returns to savers, breaking up too-big-to-fail banks that pose systemic risk, offering real price stability. Two percent inflation is not benign, it is cancerous.

The United States is mired in a swamp of seemingly unpayable debt. In these circumstances, there are only three ways out: Default, inflation, and growth. The first is unthinkable. The second is the current path that the Fed is pursuing in stealth. The third is the traditional path of the American people. Growth does not begin with consumption. It begins with investment.

America's retirees are ready, willing, and able to provide the savings needed to fuel investment and growth. All they ask in return is stable money, positive returns, and a friendly investment climate. The Fed's policy of money printing and negative returns is anathema to investment and growth. Until the Fed's war on savers is ended, income security for retirees will be an illusion.

Thank you for this opportunity to testify and I look forward to any questions.

Senator TESTER. Well, thank you, Mr. Rickards. I thank you and thank all of the panelists for their testimony and insights. It is very much appreciated.

I would ask the Clerk to put 7 minutes on the clock, if you might. I think we will have enough time to get through most all the questions that folks have.

I am going to start with a 30,000-foot perspective of the problem of retirement security and it goes to all of you, to help us get a broad picture of the savings deficit. Clearly, one of the biggest challenges is the fact that so many Americans are not asking themselves the question about how much am I going to need when I get to retirement. And they may not be asking other questions along with that as they go forth. And so ignorance may be bliss, but I doubt it. How can we get Americans to start asking themselves the question about retirement savings and how much are they going to need for the future, and we will start with you, Mr. Calabrese.

Mr. CALABRESE. Well, of course, education——

Senator TESTER. I need you to turn your microphone on. Thank you.

Mr. CALABRESE. OK. It is. One thing, and I am sure Dr. VanDerhei will speak more about it, there has been an effort in the private sector to do an education campaign, which I think has been very useful, but, of course, it is not reaching far enough, obviously.

The better way would be to start in the schools, that really, we should find a way, and I do not know exactly how to do this, given the local character of education, whether there is some sort of Federal impetus for this or not, but we should really be building these days into middle and high school education some sort of financial literacy because there have been recent surveys done that show that the majority of American adults do not comprehend compound interest at all, cannot even calculate interest in many respects.

And so people just need to really understand these concepts better, and this is a much different world now than, say, 50 years ago, where you really do need to understand some of these things as a basic, you know, just to get by in life. And so I think building that financial literacy into a high school education would be a really important first step, in addition to the things that Jack had mentioned that the private sector is doing.

Senator TESTER. Dr. VanDerhei.

Mr. VANDERHEI. Well, I certainly agree with that. I do think it is very important, though, that the kind of information that people who have to make those decisions today—while I completely agree that for people still in the educational modality, they should get that type of training, but we have a situation today where only 42 percent of individuals that we have surveyed virtually every year for the past 20 have even attempted to make a guess at what they need for retirement.

This is becoming a very difficult type of assessment for many individuals as you realize. When people primarily had defined benefit plans and Social Security, it was relatively easy to figure out whether or not they were on track. Today, as more and more of them are going to defined contribution, they are ending up with a lump sum account balance and many of them have great difficulties trying to make the calculation of what would that lump sum buy me in terms of monthly income when I hit retirement age.

There are several proposals available as far as how one could go about doing that, but until we get to the point where, indeed, the vast majority of individuals do have that financial literacy, I think it is incumbent upon employers, providers, people in the public policy research section to try to come up with relatively easy to operate Web sites that could very quickly let somebody know whether or not they are on track, if they are not on track, how much more do they need to start saving each year, and let them do the "what if" scenarios between should I push back retirement age, should I increase my contribution today. Get something that is easy for people to understand so they will actually go and use it and start asking more questions.

Senator TESTER. OK. Mr. Rickards.

Mr. RICKARDS. Senator, the fellow panelists have mentioned various measures to encourage savings and design features to do that, such as automatic enrollment, and I applaud that. But your question, which is very straightforward, how much am I going to need, there are tried and true methods for calculating that. You go to your financial advisor. They say, how old are you? They come up with some life expectancy. They make some assumptions about returns, *et cetera,* and they can tell you how much you need to save to reach those goals.

The problem is, most of those assumptions are extremely flimsy, and to illustrate that point, imagine we are back in 1999 and asking your question, Senator, and someone who put their money in stocks and a 401(k) plan, and let us say someone else, not as financially literate, bought gold. The person who bought gold made 700 percent. The person who bought stocks made zero. Now, I am not projecting that into the future. I just put that point out there to illustrate that it is all in the assumptions, and until we have stable money and better Fed policy, I do not see how any investor can answer the question intelligently because we do not know what the dollars are going to be worth.

Senator TESTER. Good point. I just want to follow up just a little bit. You said that the models are out there, and this can apply to all of you because you know I am a farmer in my real life and I am not sure I would know how to determine how much money I am going to need when I retire, to be honest with you. Living in Big Sandy, Montana, is a whole heck of a lot different than living in Washington, D.C. And the costs it would cost me to live there and Washington, D.C., are different.

Are there actually models out there that if somebody was just out of college, and assuming they are going to live in the same area—which is a tough assumption right out of the shoot—that could tell you what is going to happen, because there are so many varying factors out there. There is inflation. There is energy prices. I mean, my goodness, there is just variance after variance and how can you predict somebody who is 21-years old, what they are going to need when they are 45 years down the road? Do you have any insight into that?

Mr. RICKARDS. The short answer is you cannot predict exactly, Senator, but you can engage in portfolio construction, pick assets, and diversify the assets in such a way that over long periods of time, they tend to track or perform well relative to various outcomes, some stocks, some bonds, some precious metals, some hard assets, *et cetera.* So you do not know the answer, but you try to prepare for all weather, so to speak.

Senator TESTER. Got you. All right. Would anybody else like to—Dr. VanDerhei.

Mr. VANDERHEI. Senator, I certainly agree with that. The important point, though, is you do not want to bury the individual in so much uncertainty that they are frozen from doing anything in the first place.

Senator TESTER. Right.

Mr. VANDERHEI. You want to get them into a situation where they start contributing, and hopefully as they get further down the process, get a much more accurate assessment of where they need to be.

Senator TESTER. OK.

Mr. CALABRESE. I would just say that what may be most important is if we could get this sort of automatic savings system, you know, if everybody had an automatic enrollment into a payroll deducted saving plan with the right defaults, because if your employer and the Government are saying—because they are defaulting you, they are saying, now, here is what you should be doing. So even if you are 23, they are starting you at 6 percent of your pay and escalating you, say, to 10 percent, well, that is giving you an idea that, yes, that is what the experts think you should be doing. And you may not know whether your income is going to double or triple over the next 30 or 40 years. You may not know where you are going to end up living. But if you can hit that benchmark which you ought to be defaulted into, you will be in pretty good shape.

The other thing which I should have mentioned earlier is another good starting point would be to reinstate the annual statement from Social Security, because we used to at least see, you know, get the thing in the mail each year, which we are not. And what would be a nice thing is if they could begin sending that either in addition or alternatively by email, they could include links to things like the Choose to Save retirement calculator that EBRI sponsors, because then you could actually connect people directly to these engines where they can begin doing these calculations.

Senator TESTER. Very good. Thank you.

Senator Vitter.

Senator VITTER. Thank you, Mr. Chairman, and thank you all again.

Is it clear that this problem is worsening long term when you factor out the recent recession and the current really sort economy? I assume that is an immediate factor. But to talk about long-term trends, you sort of have to back that out. So is it clear once you back that out that the problem is getting worse?

Mr. VANDERHEI. If I could, we did our first national assessment back in 2003 and updated it in 2010 and found actually a significant reduction in the percentage of households who were at risk, even though we had just gone through the 2008–2009 financial market crisis. The number one reason for that, and I realize this is something one needs to think about for a second, is that what group is most at risk? It is the low income.

There was something very, very valuable that happened between 2003 and 2010 and that was the Pension Protection Act in 2006. What it did was make automatic enrollment types of 401(k) plans much more popular for plan sponsors to adopt. And if you go back and look at the participation rates for the low-income individuals, again, the ones most at risk, you find situations where they virtually double, from being in the 40 percent range to the high-80 or low-90 percent range. What that one factor alone has done in projecting out future retirement income for the low-income has been absolutely phenomenal.

So if you go back pre-PPA, pre-2006, you have seen a marked improvement because of what the employers have done to help the low-income. But I will agree, if you go back and look just at the 2008 and 2009 years by themselves, certainly, the financial market and the real estate market crises have anywhere from 3 to 14 percentage points increased those that are considered to be at risk.

Going forward is actually dependent almost more than anything else on what happens with respect to uninsured health care in retirement. Nursing home costs, as I am sure you are aware, are a very, very large exposure. Families that get to retirement age with what seems to be an appropriate amount of financial resources, after one or two spells of expanded times in an expensive nursing home can very easily chew through those amounts.

Senator VITTER. Quickly, because I do not want to use up all my time, do you all have any other responses to my first question?

Mr. CALABRESE. Yes. Just to back up what Jack said is that the biggest change in participation in an employer plan over the past 30 years has simply been—you can see it almost percent by percent, is the shift from defined benefit to defined contribution, right, from traditional pension to 401(k), because what has happened is that although the overall participation rate at about 50 percent has been relatively level, the participation rate among the lowest third by income has fallen by about ten to 12 percentage points, and that is because when employers had traditional plans, they automatically put everybody into it and saved on their behalf. Now, you need to choose to save, and so the lower-wage workers are not doing that as much and that is really hurting the overall picture.

Senator VITTER. OK.

Mr. RICKARDS. And I would say Dr. VanDerhei's projections are certainly correct about the benefits of automatic enrollment. It increased participation, increased savings. I take far less comfort than he from how that will play out, because it all depends on long-term growth assumptions. Your savings do not do you any good if you are not going to get returns, and in sort of a hostile business environment, there is no reason to expect the future returns will match the past, and I think the 12-year stretch in the stock market from 1999 to 2011 bears that out.

Senator VITTER. OK. That sort of goes to my next question for Mr. Calabrese and Dr. VanDerhei. Have you done any calculation or do you have any comments about the impact of the Fed's zero interest rate policy, which is unprecedented, certainly, in terms of its longevity, on this problem?

Mr. VANDERHEI. Actually, right after we did our 2010 study, the Wall Street Journal called me up and asked me almost specifically the same question. Our baseline rate of return numbers were relatively high in a nominal sense compared to what you have today, 8.9 percent for equities and 6.3 percent for fixed income on a stochastic basis. The Wall Street Journal asked if we could lower that to a nominal 6 percent for equities and 2.4 percent for fixed income.

At that time, our at-risk percentages were 47 percent. Putting in this new low interest rate scenario that they wanted modeled increased the percentage of early Boomers from 47 percent all the way up to a situation where 59 percent of them would be at risk. So there would be a very large increase in those households that we would consider to be at risk because of that particular policy.

Senator VITTER. So that, you could say from that rough calculation, has roughly grown the problem 25 percent?

Mr. VANDERHEI. Correct.

Senator VITTER. OK. Mr. Calabrese, do you have any comment?

Mr. CALABRESE. Yes. I have no independent data on that. I would just note that, of course, a low interest rate policy would have a very differential effect depending on whether you are already retired or saving, particularly the older workers shifting assets into fixed income, because folks who are already retired, of course, have benefited from a bull market in bonds. But those who are shifting assets and new saving into fixed income, of course, are feeling that pinch.

Senator VITTER. OK. And probably the final question, this help, this improvement in terms of the changes that were made that encouraged a lot more automatic enrollment, what does that suggest about a logical next step to reasonably encourage even more automatic enrollment or similar gains in participation? What policy would reasonably be the next step?

Mr. VANDERHEI. It may be that you are in a period now where employers are still sorting out from a cost-benefit standpoint whether or not they want to go with automatic enrollment. The one thing you have to remember is that although the good news is you increase participation rates, the downside for employers is if you have a matching contribution, that means it is going to cost them more. And I think there are a lot of employers who are still waiting to see, perhaps looking at their competitors, perhaps looking at what these participants actually end up doing, whether they think automatic enrollment is correct for them from a business standpoint.

Mr. RICKARDS. Senator, I would add, when you say automatic enrollment, my question would be, enrollment into what? I applaud automatic enrollment and the incentive to save, but if you are just going—and plan sponsors are extremely reluctant to offer any alternatives or any investments other than traditional stock/bond portfolios, and if those are going to be—if we are in the middle of another stock bubble, and my view is we are, that is another disappointment for investors. So unless there are some other things they can invest in, prudently managed, but precious metals, pools of hedge funds, things that are a little nontraditional, then they could just be setting up for another fall. All that savings and all that wealth could be wiped out in a stock market crash.

Senator VITTER. Thank you.

Senator TESTER. Thank you, Senator Vitter.

Senator Akaka.

STATEMENT OF SENATOR DANIEL K. AKAKA

Senator AKAKA. Thank you very much, Mr. Chairman, for holding this hearing. I would like to say aloha and welcome our witnesses to the hearing today.

As defined benefit pensions become less common and many families have little retirement savings, I am very concerned that many senior citizens will face financial insecurity as they age.

The current retirement system, signed by President Reagan in 1986, has served as a model for modern pensions, combining a small defined benefit, a 401(k)-style plan with matching contributions, and Social Security. Since that time, private sector pension participation has fallen dramatically. In my view, Congress must focus on addressing the nationwide retirement savings gap, shoring up systems that provide some guaranteed benefit to workers, and promoting individual savings.

As a longtime advocate for enhancing our Nation's financial literacy, I believe it is critical to ensure that people have the knowledge and support to effectively save for retirement. We must work with employers and the financial industry to educate employees and also to make it easier for the average American to save for his or her retirement.

This question is for Mr. Calabrese and Dr. VanDerhei. It is often a challenge to encourage employee participation in any retirement savings plan, especially for younger and lower-income employees. In 2009, Congress passed legislation to automatically enroll Federal employees in the Thrift Savings Plan unless they opt out. You both mentioned automatic enrollment in your testimony. I would like to hear more about how automatic enrollment helps individuals save for retirement.

Mr. CALABRESE. OK. Well——

Senator AKAKA. Mr. Calabrese.

Mr. CALABRESE. Right. I will start, and I know that Jack will be able to give an update on the data since they run a database of 401(k) plans that keeps track. But the most recent data I had seen was that of the roughly 45 percent of 401(k) plans that use automatic enrollment, they were seeing an improvement of about 30 percentage points in the overall participation rate. And of course when you are picking up people, you are picking up disproportionately the middle to lower range because the affluent have a very high participation rate to begin with. So it is very, very helpful.

There is a bit of a controversy, though, about the initial contribution rate, where it should be set, because about—the Wall Street Journal, for example, I think about a year ago had basically criticized the fact that the initial contribution rates for the majority of plans were set at 3 percent, and this was encouraged, in effect, by the Pension Protection Act, which in allowing this while giving a safe harbor cited 2 to 4 percent as the range. And so, really, we would agree with the Journal that 6 percent as an initial default contribution is much better, because actually, at 3 percent, a majority of workers, even if they are consistently saving, would not reach even 80 percent of their target for retirement income adequacy.

Senator AKAKA. Dr. VanDerhei.

Mr. VANDERHEI. Well, I certainly agree with most of that. We have seen a tremendous increase in the overall projected accumulations for 401(k) balances when they move from the old style voluntary system to the automatic enrollment.

I think the other question one wants to focus on is basically if you do start them at those relatively low default contribution rates, is there another procedure, such as automatic escalation, that is going to be valuable in getting people back to where they need to be long-term. There is, unfortunately, as mentioned, the upside that the participation rates especially among the low-income and the young increase substantially, but because of inertia, which works to the benefit of many employees—because once you put somebody in they are very unlikely to opt out—once you put somebody in at a particular contribution rate, they are also very unlikely to move from that on their own. And you have had this anchoring effect, and, in fact, many individuals on the upper income side would have been contributing at a higher rate had they voluntarily made that election as opposed to the automatic election.

But in terms of what is going on in the private sector among large sponsors, we now find 58 percent of large 401(k) sponsors have now moved to automatic enrollment and the other nice advantage about automatic enrollment in many cases is you get around the problem of allowing participants to necessarily direct their own investments. You find a substantial proportion of young individuals who will not put anything in equities. You find a substantial portion of the older people who have very, very high equity allocations. And you find still today, even after Enron, some people who will basically have almost all of their portfolios in company stock.

The reason automatic enrollment has worked so well, in addition to defaulting them in and defaulting their contribution, you also in most cases default them into usually a target date fund which is professionally managed and will have an age-appropriate asset allocation, and as the markets fluctuate, put them back to where at least professionals think the correct asset allocation should be.

Senator AKAKA. Thank you very much for your responses. Thank you, Mr. Chairman.

Senator AKAKA. Thank you, Senator Akaka.

This is a question for Mr. Calabrese. Your testimony highlights what the challenges are facing employees that work for small businesses. They may not have the staff, the resources, the time to craft, manage retirement plans for their workers like the larger companies do. Montana being a small business State, 75 percent of our workers work for companies that have less than 100 employees and many of those need to take retirement into their own hands.

The question is for you, and the other two can respond if they would like. How are small business employees and proprietors saving for retirement, or are they just simply not doing it?

Mr. CALABRESE. Yes. So, currently, the GAO had identified the categories of workers that are participating at very low rates, and in addition to the very young, very low income is people who work at small business. So a majority of small firms are not sponsoring these qualified retirement plans, and that is the reason that, you know, we have been suggesting that the automatic IRA concept is a very good one, because particular if you—you could exempt businesses that have fewer than, say, five or ten employees, but certainly anybody bigger than that, almost—more than 90 percent are using payroll services, for example. And we found that there are empty fields. They do paycheck deposit automatically, and it is just as easy to automate at marginal cost a saving into an automatic IRA without having to go jump through any of the regulatory hoops. You do the sponsor, an actual qualified plan.

Senator TESTER. So, and maybe I do not understand the automatic enrollment. I assume what you just said was automatic enrollment would happen for businesses over five or ten employees. The question I have, I guess, revolves around if there is extra money laying around, it usually goes to health care in a business, to try to provide them with that benefit. Would this have—look, we have got two problems here, and they may be like this. The automatic enrollment and the opportunity for increasing savings from retirement, all three of you said will work, assuming that the investment is put in the right spot. I guess the question is, has anybody done any analysis to see if this would have a negative or positive impact on a job market with it being another benefit? I hate to play the devil's advocate, but——

Mr. CALABRESE. Right. Right. Oh, sure. Well, it would depend what you require. The automatic IRA concept actually does not require employers to make any contribution.

Senator TESTER. OK.

Mr. CALABRESE. So there would really be no cost to them, and, in fact, the bipartisan bills that have been put in typically provide a small tax credit even to cover the payroll accounting expense——

Senator TESTER. Got you.

Mr. CALABRESE.——to the extent that there is one. And, in fact, some proponents of the automatic IRA would preclude employer contributions, although we think that employers should at least have the option to contribute.

Senator TESTER. Absolutely. OK.

I guess if you were going to—and you may repeat yourself on this, and that is fine—give me the top one or three things that you would do if you were sitting in my chair to help solve this problem, what would they be, and we will just go down the line. You first, Mr. Calabrese.

Mr. CALABRESE. OK. Well, the first, and this may not, unfortunately, not be squarely under your jurisdiction, is this notion of a universal automatic payroll deposit saving program that is accessible to every American worker. So, in other words, if your employer—you could exempt employers who are eligible, actually eligible to participate. So, for example, they have worked the year at a firm that sponsors a qualified plan, like a 401(k). But everyone else should be able to get into one of these portable career accounts, the automatic IRA idea.

Second, I mentioned children's savings accounts. I think if we start—and that would speak toward the literacy issue, as well. New America had a proposal which has been introduced as bipartisan legislation over the years, the ASPIRE Act for children's savings accounts. It starts them off with a $500 contribution. Ideally, you would have some tax incentives for families to contribute with the idea that that could grow by age 18 to really help pay for at least a State-level college education or to invest in a first home or to seed retirement saving.

And then the third thing is I think we need more initiatives to help bank the unbanked. So there was the proposal—there have actually been trials that began out in San Francisco, Bank on USA, for example, which the Treasury Department—the Obama administration had proposed to fund for a larger demonstration project. I do not believe that has happened yet. But that sort of thing is good to get people into the system.

Senator TESTER. OK. Dr. VanDerhei.

Mr. VANDERHEI. Well, I will give you three suggestions in no particular order. The first two deal with automatic enrollment, and almost by historical accident, we have ended up where we are today with respect to default contribution rates with automatic escalation being around 3 percent. If there was something the Government could do to help employers understand that going above 3 percent not only is more likely to help employees reach their goals, but is going to be sort of a safe harbor in terms of plan design, I think that would be ideal.

Another thing is with respect to automatic escalation. We did not really get a chance to go into that, but if you start people at a relatively low three or 6 percent and then put them in a program where automatically their contribution rates go up 1 percent per year until a specific level unless they opt out. Unfortunately, under today's safe harbors, the maximum you can allow that to go to automatically is 10 percent. I would dare say most financial professionals would say 10 percent from the employees plus perhaps a 3-percent match from the employer still is not going to be sufficient, especially in the low rate of return environment. And if you could allow those automatic escalation programs to continue beyond 10 percent, I think that would be great.

Third, risk management techniques at retirement. Again, I think so many individuals just use sort of a 50–50 chance of I will be OK if I have X dollars when I hit age 65. You have got longevity risk and you have got catastrophic health care risk that needs to be dealt with. There are many, many reasons, some legitimate and some perhaps not, that employers do not want to become involved in helping employees with the longevity risk. If you could have situations in which, for example, annuities or longevity insurance could be provided through the plan and employers would feel safe doing that, I think you would reach a situation where people have a much better cap on what they would need in terms of a prolonged lifespan.

Senator TESTER. OK. Mr. Rickards.

Mr. RICKARDS. Senator, I have three suggestions. The first, simply call upon the Fed to give us sound money, and the importance of that is money is how we count and make all these other decisions. We have heard talk today about target date funds, portfolio diversification, *et cetera,* and these all involve price signals and those price signals go into these complicated calculations. But without sound money, the price signal, the input and the output is all meaningless. So I would start there.

The second is a broader set of investment options. I certainly applaud automatic enrollment and things we have heard about today, but we need to get beyond traditional stocks and bonds because they are vulnerable to these bubble environments, and the way you prevent that is with some other hedges, such as precious metals, alternatives, real estate, perhaps.

And the third, I agree with my co-panelists, financial literacy is critical. I have enormous confidence in the ability of the American people to make smart decisions about their own money, but financial expertise is no different than any other expertise. You need some training and some familiarity with it.

Senator TESTER. Well, I want to thank you. Actually, we are going into another area that is something that I, quite frankly, think about personally, and that is the impact on my inability to save enough money is going to impact me working longer, which is going to impact the job market, which is going to—when I sell off what investments I have, what impact is that going to have on the investment markets, and the list goes on and on and on. And if I am in that boat, there are probably a lot of other folks that are in that boat, too.

I just want to thank you all for your testimony today. I very much appreciate you coming in and giving us your insights and your perspectives about retirement savings and security issues facing this country. I think the picture is clear from each one of you. It is concerning in each different area, and unquestionably, I think, much needs to be done to communicate facts and data that you folks have provided here today, along to those preparing for retirement, and I hope this hearing will raise an awareness of this challenge and facilitate education to improve this Nation's retirement preparedness, confidence, and security. There are bills out there that I am hopeful will surface to the top and get written up that we can flesh out and really address some of these issues.

And so I look forward to working with you all in the future to discuss some of these issues and hopefully do some things that will be good to help move the country forward as far as it goes through retirement security.

The hearing record will remain open for 7 days for any additional comments and for any questions that might be submitted for the record.

Once again, thank you all for being here. This hearing is adjourned.

[Whereupon, at 3:34 p.m., the hearing was adjourned.]

[Prepared statements and additional material supplied for the record follow:]

Testimony of

Michael Calabrese
Senior Research Fellow, Asset Building Program
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Before the

Economic Policy Subcommittee
Committee on Banking, Housing and Urban Affairs
United States Senate

Retirement (In)security: Examining the Retirement Savings Deficit

March 28, 2012

Thank you, Mr. Chairman and members of the Committee, for this opportunity to testify today. I am a Senior Research Fellow at the New America Foundation, a nonpartisan policy institute here in Washington. New America's Asset Building Program develops and incubates innovative policy proposals to enable low- and middle-income families in the U.S. and around the world to accumulate savings, access financial services, develop financial capability, and build and protect productive assets across the life course.

There is no question that a widening retirement savings gap, exacerbated by rising longevity and health care costs, is creating widespread insecurity. Most individuals are simply not saving enough over their working life to supplement the meager benefits they will receive from Social Security. America's *real* retirement security crisis is not Social Security solvency or the many big firms freezing or terminating their traditional pension plans. The larger problem is that the majority of American adults do not participate in *any* retirement saving plan—whether pension or 401(k) or Individual Retirement Account (IRA). Participation in employer-sponsored plans peaked in the late 1970s and appears to be at its lowest level in more than 30 years. Employer-sponsored plans cover fewer than half of all private sector workers, leaving a projected majority of baby boomers and Generation Xers even more dependent on Social Security than their parents' generation is today. Coverage and participation rates are strikingly lower among workers who are low-income, young, work part-time, or work at small firms.

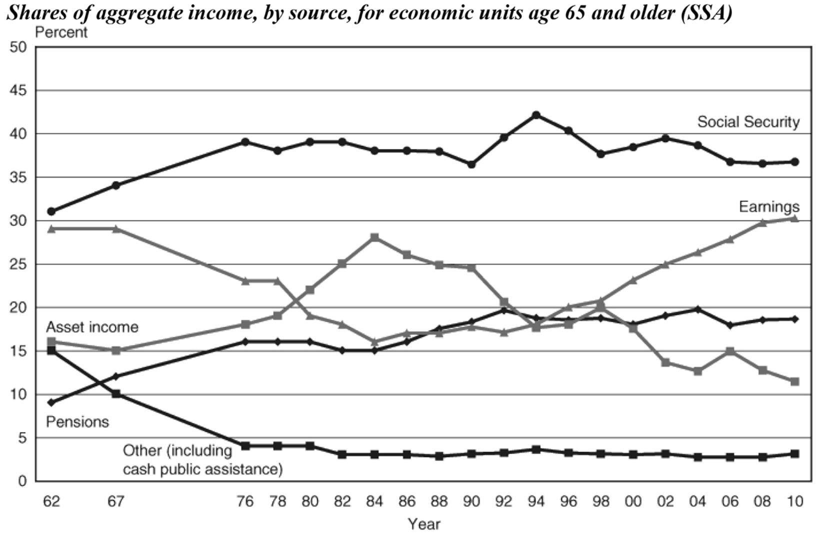
Although the focus today is saving for retirement, it's important as well for policymakers to view this deficit as the culmination of a generalized savings gap. Individuals and families have multiple savings needs that become more or less salient at different stages of life. Establishing a saving habit, regardless of purpose, increases economic security in the near term and better positions an individual or couple to achieve a secure retirement decades down the road. Research and demonstration projects have shown that even those with very low incomes have been able to save when given access to meaningful savings incentives and institutional support structures. This insight means that policies that facilitate saving and asset building from childhood through retirement can pay large social and economic dividends. At the end of this testimony I mention a number of policy innovations that speak to this broader context.

The Retirement Saving Deficit

The result of excluding half the nation from an automatic, managed and subsidized private saving plan is that too many individuals and families are headed toward retirement age with little more than Social Security's safety net. Today nearly two-thirds of beneficiaries rely on Social Security for a majority of their income. More troubling is that more than one-third of beneficiaries (36%) rely on Social Security for 90 percent or more of their income—a dependency ratio that is even greater for widows (46%).[1] This reliance on Social Security has increased in recent years and is likely to increase further as fewer and fewer retirees receive traditional pension income. The Center for Retirement Research estimates that the replacement rate of pre-retirement income levels is between 20 and 30 percent lower, respectively, among retired couples and single people who do not have pension income.[2]

For those 65 and older, rising income from continuing to work is replacing steadily declining income from non-pension assets. As the chart just below indicates, since the mid-1980s the share of income for Americans 65 and older coming from wages has doubled (rising steadily to 30%) while the share from asset income has plummeted from more than 25 percent to about 12 percent, the lowest level in half a century. Meanwhile, the share of income from pensions and Social Security has been relatively flat over the past decade.

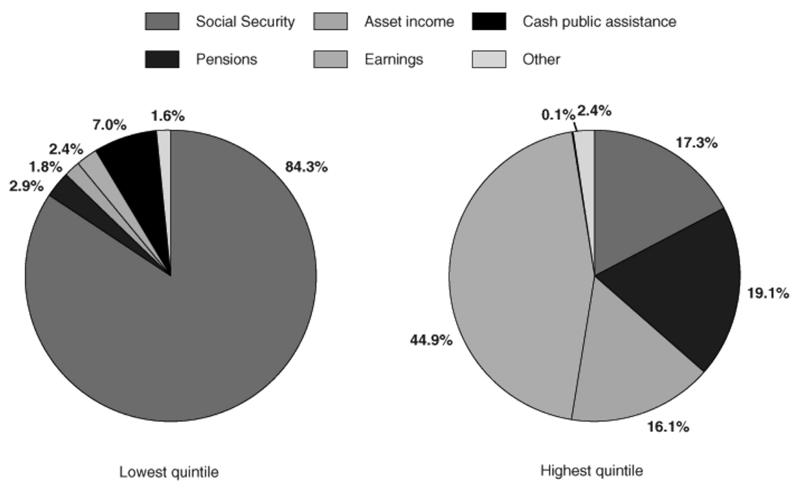
Shares of aggregate income, by source, for economic units age 65 and older (SSA)



This seems to confirm what some recent opinion surveys have shown, which is that a steadily growing portion of the workforce will continue to work at least part-time well beyond the "normal" retirement age of 65 or even 67 (as it phases in for Social Security). While remaining employed will help compensate for a rising disparity in the ownership of income-producing assets (outside of retirement accounts), it will also impact labor markets by potentially reducing the availability of work, opportunity and rising real wage levels for younger workers.

Not surprisingly, the lowest-earning 40 percent of working adults are accumulating very little in the way of financial assets. Elderly in the lowest income quintile receive on average only about 5 percent of their income from either pension or asset income. And because retirees with low career earnings, or substantial time out of the work force, receive minimal Social Security benefits, the Urban Institute estimates that about 36 percent of the elderly received benefits in 2009 that fell below the individual poverty line.[3] Among those over 65 in the top 20 percent by income, earnings provide the largest (and growing) source of income (45%), while income from pensions and other assets is about 35 percent.

Shares of aggregate income for lowest and highest income quintiles by source, 2010 (SSA)



Of course, the problem of a widening retirement saving deficit is not limited to relatively low-wage earners ending up overly dependent on Social Security and Medicare to make ends meet once they stop working. The National Retirement Risk Index (NRRI) indicates that a majority (51 percent) of working-age households are "at risk" of not having enough retirement income to maintain their pre-retirement level of consumption. Based on a 2009 update of the Federal Reserve's most recent triennial Survey of Consumer Finances, the NRRI measures the percentage of working-age households that are at risk of being unable to maintain their pre-retirement standard of living. The most recent NRRI suggests a worsening trend, with 41 percent of Early Boomers, 48 percent of Late Boomers, and 56 percent of Gen Xers "at risk" of not saving enough to maintain their standard of living in retirement.[4] These "at risk" estimates rise if health care cost inflation is factored in.

These shortfalls represent a cumulative $6.6 *trillion* "retirement income deficit" according to the Center for Retirement Research, which created the NRRI.[5] This $6.6 trillion (roughly $22,000 per capita) represents the present value of the saving and investment shortfall needed to ensure, on average, retirement security for every American. When the Center adjusted the Fed's household financial survey data in late 2009 to account for the economic downturn, it found that the overall share of households "at risk" had jumped 7 percentage points since 2007, to 51 percent. This reflected the impact of declining home equity values due to the bursting of the housing bubble, the stock market crash, and the ongoing rise in Social Security's full retirement age (as the new age 67 threshold phases in).

The Retirement Readiness Rating, calculated by the Employee Benefit Research Institute, similarly estimates that nearly one-half of Early Boomers (47.2 percent) and 44.5 percent of Gen Xers are on track to retire without sufficient income to pay for both "basic" cost of living expenses and uninsured health care costs.[6]

While there is a range of views about what income replacement rates are "adequate" and how precisely to measure the nation's retirement saving gap, there is no question that tens of millions of working-age adults, including one-third or more of those over age 50, are not accumulating nearly enough financial assets to maintain their standard of living while compensating as well for the likelihood of a longer life span and far higher out-of-pocket medical costs than current or previous generations of retirees.

Limitations of the Current Employer-Based System

Quite simply, pensions are how Americans save. With over $16 trillion in assets, traditional pension trusts and 401(k)-style saving plans account for the vast majority of financial assets accumulated by households – as well as a vital source of patient capital for American business. For workers with access to either a DB or DC plan, America's employer-based private pension system provides powerful saving incentives—both tax breaks and employer contributions—as well as the convenience and discipline of automatic payroll deduction.

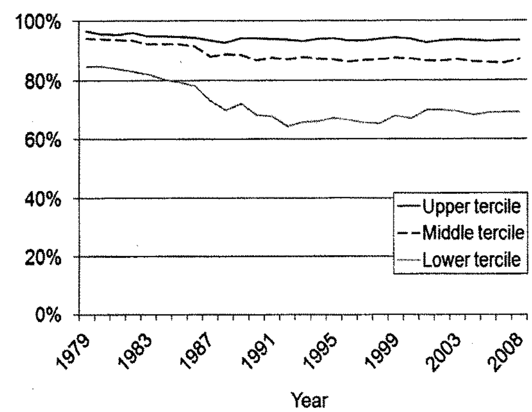
The transformation of the American private pension system over the past 25 years from traditional, employer-paid defined benefit plans (DBs) to predominantly voluntary, contributory plans has widened the nation's retirement saving deficit. As we've turned into more of a do-it-yourself 401(k) nation, several flaws in the employer-based system have been exacerbated. One is ***inclusion***. Employer-sponsored plans cover fewer than half of all private sector workers, leaving more than 75 million workers—including a disproportionate share of low-income, part-time, small business and minority employees, as well as the self-employed—without an easy, automatic, incentivized and professionally-managed infrastructure to facilitate saving throughout a career.

Only 43.2 percent of all private-sector workers age 25-to-64 participated in an employer-sponsored retirement plan in 2008, a striking decline from the 50.3 percent participation rate in 2000.[7] Only 55.4 percent of workers in their prime saving years (age 45 to 64) participate in a retirement plan. The percentage of private sector workers whose employer even sponsors a plan (whether or not they are eligible or participate) fell to 53.2 percent in 2008. One result is that roughly one-third of all households accumulate no pension plan saving during their entire work life and end up relying almost exclusively on Social Security.[8]

While participation is somewhat higher among full-time workers (51 percent), participation rates are also strikingly lower among workers who are low-income, young, work part-time, or work at small firms. Approximately 85 percent of Americans without a pension benefit at work shared one or more of these four characteristics, according to a General Accounting Office study. Minorities also participate at substantially lower rates, primarily because they are less likely to work at a firm that sponsors a pension or 401(k)-type plan.[9] While 56.6 percent of whites employed full-time and year-round participated in employer-sponsored plans in 2008, black and Hispanic workers participated at rates 10 and 26 percentage points lower, respectively.[10]

Not surprisingly, pension coverage is lowest among workers whose savings would truly *add to* net national saving: workers who earn less than the median wage. Even if a lower-wage worker is inclined to save, fewer than 40 percent of private sector workers in the bottom income quartile work for a firm that sponsors a retirement plan, while 72 percent of top quartile earners work at firms offering qualified plan coverage, typically a 401(k) with employer matching contributions.[11]

Pension Participation Rate for Private Sector Male Workers Age 25-64 at Employers with Pensions, by Earnings Tercile, 1979-2008



Source: Karamcheva and Sanzenbacher, calculations from 1980-2008 CPS.

A second, related problem is the lack of pension ***portability***. Labor market mobility is increasing and job tenure is steadily decreasing. The typical worker will change jobs seven or more times after age 25 and, even if they are fortunate enough to have pension coverage in every job, will face eight or more years of ineligibility for automatic saving and the incentive of matching deposits. Meanwhile, at least one in four U.S. workers are in non-standard work arrangements (part-time, temporary and contract workers) that rarely include pension coverage. While a "free agent" workforce may be good for productivity and flexibility, it makes the current payroll-based pension system increasingly inadequate.

This lack of a system to facilitate seamless coverage contributes to low participation rates and accumulations. Even if a worker has coverage today, he or she may not have access to a plan next year in a new job. And even if the worker's new employer sponsors a plan, new hires are not eligible to participate for at least one year. The result is gaps in coverage. And although a long-tenured worker in a traditional pension plan will vest in monthly income for life (or a lump sum), those who terminate in less than five years can end up with no retirement accumulation at all for that period.

A third fundamental flaw in the current system is ***tax incentives*** that are not targeted on the public policy goal of promoting retirement saving at the margin – and, in particular, on nudging the middle-to-low-income earners who have the greatest difficulty sacrificing current income for saving. A tax deduction for saving will typically contribute $35 in federal expense for every $100 saved by a top-bracket earner – and no subsidy at all for most of the lowest-earning 40 percent who would be more powerfully motivated by a matching tax credit deposited directly into their account (which would also serve to build their asset accumulation and not simply reduce their tax bill). While the affluent can respond to tax incentives for saving by *shifting* rather than actually increasing their net saving effort, households that would not otherwise save generate net new national saving.

A final set of challenges relate to income ***adequacy*** **and** ***longevity***. Even among those workers who are currently participating in a 401(k) or other defined contribution plans, saving is not continuous enough, accumulations are not large enough, and lump-sum withdrawals in retirement are often depleted too quickly, exacerbating the risk of outliving assets. Even an essentially voluntary saving system like the Auto-IRA needs to design in a set of "nudges" strong enough to push the typical middle- to lower-income worker toward a higher contribution rate (6 to 12 percent or more), reinforced by the incentive of additional matching contributions (from both tax credits and employer contributions), and converted as a default into a secure stream of income for life.

We might at least expect the workers lucky enough to participate in 401(k)-type plans to be accumulating significant savings. Among the subset of high-tax-bracket earners with steady access to a 401(k), this is the case. However, in general workers approaching retirement age are not accumulating enough saving to generate adequate income throughout retirement. According to a Congressional Research Service analysis of the Fed's most recent Survey of Consumer Finance, the median value in 2007 of all retirement accounts owned by households headed by persons 55 to 64 was $100,000. For a 65-year-old man, $100,000 would be sufficient to purchase a level, single-life annuity paying out $700 per month for life (based on interest rates in 2009). Because women have longer average life expectancies, a 65-year-old woman could generate annuity income of only $650 per month.[12]

Not surprisingly, 401(k) participation and accumulation rates in the bottom three quintiles of the earning distribution are far lower. Even among longer-tenured 401(k) participants in their 50s and 60s who are earning between $40,000 and $60,000 the median account balance was just over $81,000 in 2009, according to the EBRI/ICI 401(k) database.[13]

Another reason that participation rates have declined, particularly among lower-income earners, is the simple fact that 401(k) plans are voluntary and typically require workers to make investment decisions they may feel unprepared to make. Unlike traditional DB pensions, with 401(k)-type plans individuals must *choose* to save. Unfortunately, the incentives are often not nearly compelling enough, particularly for low-income workers who, unlike high-income earners, receive little if any tax subsidy for saving. As a result, the shift from DB pensions – which automatically enroll and contribute on behalf of all workers – to 401(k)-type plans coincided with a sharp decline in pension participation among the lower-income workers and lower future accumulations. One recent study showed that although access to an employer plan has remained roughly the same since 1979, the participation rate among the lowest-earning third of workers has declined far more than among middle- or upper-income earners (see chart below).

The trend toward automatic enrollment and default investment options in 401(k) plans, encouraged by the Pension Protection Act of 2006, is already showing progress in reversing this trend, especially among the middle-third of workers as ranked by income. However, even if middle- to lower-income workers who are currently eligible for a 401(k) in their current job participate, they are far less likely than high earners to have the consistent, career-long access to a good pension or 401(k). And since President Bush signed the Pension Protection Act of 2006, little progress has been made in narrowing the nation's retirement saving deficit.

Toward a More Inclusive and Seamless Retirement Saving System

Every working American needs access to both a potent tax incentive to save and the infrastructure of automatic payroll deduction into a portable, professionally-managed account *whether or not* his current employer sponsors a retirement plan. The fact that so few workers save regularly in IRAs reinforces what demonstration projects in asset-building among low-income families have found: it is not primarily access to a savings account that spurs participation, but the four "I's"—Inclusion, Incentives, Infrastructure, and Inertia.

- Eligibility and design criteria that emphasizes ***inclusion***, both permitting and encouraging every working adult not currently able to participate in a qualified employer-sponsored plan to contribute to their "career account" by payroll deduction, bank debit, tax refund designation, or other means.

- A tax ***incentive*** for saving that is more inclusive—and targeted toward lower-income earners who find it most difficult to save—by expanding the Savers Credit, making it refundable and a more generous match for low-wage workers, and depositing it directly into the individual's account.

- An account-based ***infrastructure*** that enables every worker to save by automatic payroll deduction and facilitates career-long portability through a central and low-cost default account and clearinghouse function.

- Default options that convert myopia into positive ***inertia***, through automatic enrollment and payroll deduction, automatic escalation, automatic asset allocation, automatic rollover, and automatic annuitization.

The most promising legislative proposal to facilitate a universal saving system is the Automatic IRA, which would require employers that do not sponsor a qualified retirement plan to automatically enroll most of their employees in a payroll-deposit IRA account. Variations of this proposal have been discussed since 1999[14] and previously introduced in the House and Senate on a bipartisan basis.[15] Although the Auto-IRA could be implemented without a change in tax incentives, a matching credit for initial saving by middle-to-low income workers could give nearly all Americans a saving vehicle as easy and appealing as a good 401(k) account is today. For example, in his 2008 campaign President Obama proposed expanding the existing Savers Credit "to match 50% of the first $1,000 of savings for families that earn under $75,000" and to make the credit refundable so that lower-income workers without income tax liability to offset could still receive a tax break for voluntary saving in any qualified retirement account.[16]

Despite the current fiscal squeeze, now is precisely the wrong time to back away from proposals to make our retirement saving system dramatically more inclusive and effective at stimulating substantial new saving that will spur growth and reduce dependency longer term. To meaningfully address our retirement security crisis, the Auto-IRA should be implemented as a more truly Universal 401(k) system, with full access, robust incentives, a workable infrastructure, employer contributions, and an effective set of default features capable of maximizing savings behavior.

Five policy design features would effectively transform the Auto-IRA into a more universal 401(k) include:

- ***A refundable Savers Credit*** as a matching contribution deposited directly into the worker's account. The match rate should be higher for those less likely and able to save—and apply to at least the first $2,000 of savings each year.

- ***Every worker not currently eligible to save in a qualified plan should be included*** for automatic enrollment and mandatory payroll deduction by employers, or assisted in making deposits directly in the case of the self-employed and others without access to payroll withholding.

- ***A low-cost clearinghouse enabling career-long portability*** should be the default option available to every participant—and include special arrangements for the self-employed and others not eligible at work. Individuals should be able to choose to use a particular IRA provider, or to roll out balances later, but not the employer on their behalf.

- ***Employers should be able to contribute*** on a non-discriminatory basis (flat dollar or flat percentage amount for every eligible worker). Contribution limits should be higher than IRA limits, which are too low for middle-income earners to achieve an adequate replacement of pre-retirement earnings.

- ***Five default features—enrollment, escalation, investment, rollovers, annuitization – need to be required and robust,*** not left to the discretion of employers or financial providers.

Under a universal saving plan with these key attributes, all workers not participating in an employer plan, including recent hires, part-time employees, and temporary and other contingent workers, would be automatically enrolled and contribute by payroll deduction, although an individual could opt out and choose not to save. The government would match voluntary contributions by workers and their employers with refundable tax credits deposited directly into the worker's account. Workers participating in their employer's 401(k) or other qualified plan would receive stronger tax incentives to save, but otherwise see no difference. Contributions for workers not participating in an employer plan would be forwarded to a federally-chartered clearinghouse, which would manage small accounts at low cost and could even convert account balances into guaranteed income for life at retirement.

A Wider View: Lifelong Saving and Asset Building

The retirement savings deficit is not the only savings deficit that the American people face. Individuals and families have multiple savings needs that become salient at different stages of life. A policy agenda aimed at narrowing the retirement savings deficit will be most effective if it is informed by this reality. For young adults, the motivation to save for the purchase of a home, or for a child's higher education, or to insure against a future loss of income, may be far greater than for retirement. Indeed, these needs may actively prevent some individuals from committing to retirement savings. Establishing a saving habit, regardless of purpose, increases economic security in the near term and better positions that individual or couple to achieve a secure retirement decades down the road. Accordingly, a range of policy supports designed to target those who find it most challenging to save and invest is required.

The retirement savings gap is the culmination of a generalized savings gap, a problem compounded by a lack of access to high-quality financial services. Research and demonstration projects in recent years have shown that even those with low incomes have been able to save when given access to meaningful savings incentives and institutional support structures. This insight means that policies that facilitate saving and asset building from childhood through retirement can pay large social and economic dividends.

Expanding savings and asset ownership is especially consequential for families with lower incomes and limited resources. This is because the path toward upward economic mobility and stability is usually paved with assets that smooth income fluctuations or seed investments that pay off down the line. Research has shown that higher personal saving promotes the upward mobility of both individuals over their own lifetime as well as their children. For example, 71 percent of children born to high-saving, low-income parents move up from the bottom income quartile over a generation, compared to only 50 percent of children from comparably low-income but low-saving households.

In contrast, a lack of savings contributes to asset poverty, higher consumer debt levels and higher bankruptcy rates, all of which have negative ramifications both in the short run and for the odds of ending up with adequate saving in retirement. Asset-poor families are also far more likely to experience other economically disruptive events including divorce, involuntary job loss and health-related work limitations.

Over the past decade New America's Assets Building Program has developed, tested and advocated a series of innovative policy initiatives and changes aimed at encouraging savings and asset ownership opportunities for people who have limited resources at their disposal. While our *Assets Agenda*[17] describes a wider range of new federal policy proposals, as well as private sector financial innovations and efforts, I will touch on just a few in this testimony.

Promote Savings Accounts from Birth and Childhood

One very promising way to encourage savings is to begin the process early in life with children's savings accounts (CSAs). This approach can provide both widespread exposure to the savings process and a platform for future savings over the life course.[18] The key goal is the development of a savings habit – and to nudge young families toward internalizing a culture of savings. Recent research and successful demonstration projects suggest that children's savings accounts would increase a sense of financial inclusion; promote financial literacy and fiscal prudence; protect against economic shocks; improve access to education; improve health and education outcomes; contribute to the development of a "future orientation"; and, over the long term, improve livelihoods. Specific legislative and other policy initiatives promoting this goal include:

The ASPIRE Act: The America Saving for Personal Investment, Retirement, and Education Act (ASPIRE Act) proposes a system of universal children's savings accounts. Under the act, which was first introduced in 2005 with bipartisan support, the federal government would provide every child with an account at birth—a Lifetime Savings Account—endowed with $500 and backed by progressive, targeted incentives. Funds would be held in default investment plans, but account holders would have the option to roll out their resources to other account providers. At age 18, account holders could use accumulated funds to pay for college, buy a home, or build up a nest egg for retirement.

PLUS Accounts: Children's accounts can also be linked explicitly to savings for retirement. The government could open a Portable, Lifelong and Universal Savings (PLUS) Account for every newborn at local financial institutions. These accounts would be endowed with a onetime deposit of $1,000 and withdrawals limited to promoting retirement security. PLUS Accounts could be established for all working citizens under the age of 65, with a mandatory 1 percent of a worker's pretax paychecks withheld and automatically deposited into his or her account. In addition, workers would be allowed to voluntarily contribute up to 10 percent of their pretax income. Senator Jeff Sessions (R-AL) supported this idea in a *Washington Post* op-ed in 2006.

Young Savers Accounts: Presently, there are no age restrictions on owning a Roth IRA, but since only individuals with earned income are eligible, most children are unable to take advantage of this tax-advantaged savings vehicle. Young Savers Accounts (YSAs) would create a "Kid's Roth"—a place for children's savings with favorable tax treatment. Like Roth IRAs, YSAs would permit penalty-free withdrawals for postsecondary education and the purchase of a first home. Contribution limits would be based on parents' earned income, but contributions could be made by children, parents, grandparents, and others. Contributions to a child's YSA would count toward the parent's annual limit for Roth IRAs (now $5,000 for those aged 49 and under), so no new tax shelter has to be created. Contributions made by low-income families would qualify for the Saver's Credit and deposited directly into the account. Legislation proposing a very similar "401Kids Savings Account" was introduced in the 111th Congress (H.R. 30) and co-sponsored by 17 Republican representatives.

Expanding Access to Quality Financial Services

One reason the sort of automatic workplace saving system described above is needed is the lack of financial literacy and even of basic access to quality financial services among a substantial share of the population. An estimated 7.7 percent of the U.S. population, or 9.9 million households, lack a checking or savings account with an insured, mainstream financial institution. Nearly one of every five households earning less than $25,000 a year is unbanked, and 70 percent of the unbanked population makes less than $30,000 annually.[19]

A growing number of households are also considered to be under-banked. These households report having at least a basic bank account, but also rely on alternative financial services, such as a payday lender, check-casher, or car title loan, at least once within the past year. An estimated 50 million consumers are considered under-banked. This sector's services typically charge high interest rates and upfront fees, and do not offer tools or opportunities to save or build wealth.

Some recent pilot projects suggest promising alternatives to conquer this basic lack of access to mainstream and cost-effective financial services. One promising strategy is to create access points where individuals already spend time and transact business. This is the key focus of the AutoSave pilot, a workplace-focused effort to connect employees with savings accounts and direct deposit transactions dedicated to those accounts. While 401(k)s are restricted, long-term and single purpose, AutoSave is aimed at initially promoting precautionary, unrestricted saving among individuals with very limited liquid assets. Just like the Auto-IRA, the AutoSave pilot uses principles grounded in behavioral economics (automation, ease of access, default options) to encourage and sustain saving among less experienced consumers.[20]

Another promising approach is "Bank on USA," which began as a pilot project in San Francisco that brought together multiple stakeholders to try to remove barriers to bank account ownership and connect the unbanked with a financial institution. The program was a major success and has spawned similar efforts across the country. The Obama administration proposed creating a $50 million "Bank On USA" grants program administered through the Treasury Department to promote this approach and related initiatives on a national level.

Thank you for this opportunity to testify today and for the Committee's interest in this critical national issue.

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[4] Alicia Munnell, Anthony Webb and Francesca Golub-Sass, "The National Retirement Risk Index: After the Crash," Center for Retirement Research at Boston College, Issue In Brief 9-22 (Oct. 2009), available at http://crr.bc.edu/special_projects/national_retirement_risk_index.html.
[5] *See* "The Retirement Income Deficit," Retirement USA, as calculated by Center for Retirement Research, available at http://www.retirement-usa.org/retirement-income-deficit-0.
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[7] Patrick Purcell, "Pension Sponsorship and Participation: Summary of Recent Trends," Congressional Research Service (Sept. 2009). CRS estimates are based on the U.S. Census Bureau's *Current Population Survey* (CPS). The 2008 levels are also substantially lower than the late 1970s peak in private sector pension coverage; in 1979, 51 percent of wage and salary workers age 25-64 participated. *See* Alicia Munnell and Laura Quinby, "Pension Coverage and Retirement Security," Center for Retirement Research, Issue in Brief No. 9-26 (Dec. 2009).
[8] Alicia Munnell and Laura Quinby, "Pension Coverage and Retirement Security," Center for Retirement Research, Issue in Brief No. 9-26 (Nov. 2009).
[9] *See* Alicia Munnell and Christopher Sullivan, "401(k) Plans and Race," Center for Retirement Research, Issue in Brief No. 9-24 (Nov. 2009).
[10] *Ibid.*, at p. 11.
[11] *Id.*, at p. 13. CPS data show that 73 percent of private sector workers in the highest earning quartile worked for an employer sponsoring a qualified plan, compared to only 59 percent among third quartile earners and 38 percent among workers in the lowest earning quartile.
[12] Patrick Purcell, Congressional Research Service, "Retirement Savings and Household Wealth in 2007," Report for Congress 7-5700 (April 8, 2009).
[13] Jack VanDerhei, Sarah Holden and Luis Alonso, "401(k) Plan Asset Allocation, Account Balances, and Loan Activity in 2009," Employee Benefits Research Institute, Issue Brief No. 350 (Nov. 2010), at pp. 20-21.
[14] In testimony to the House Education and Labor Committee in September, 2000, the author proposed requiring firms with more than 25 employees to offer "payroll deduction IRAs" to all "employees at firms without pension coverage who only have recourse to IRAs, " as well as to require "automatic plan enrollment" in 401(k)-type plans. Michael Calabrese, "How to Improve Pension Coverage for American Workers," Testimony before the Subcommittee on Employer-Employee Relations, House Committee on Education and the Workforce (September 14, 2000); *see also* Michael Calabrese, "Individual Career Accounts: Universal 401(k)s," Pension Rights Center, Proposal Summary presented at *Conversation on Coverage* conference (July 1, 2001).
The Automatic IRA that is the focus of this paper, with an emphasis on default features such as automatic enrollment and investment, was developed by Mark Iwry, a former Brookings Institution scholar (currently at Treasury Department) and David John of the Heritage Foundation. *See, e.g.,* Mark Iwry and David John, "Pursuing Universal Retirement Security through Automatic IRAs," Brookings Institution, Retirement Security Project Paper 2007-2 (2007).
[15] [15] Bipartisan legislation based on the Iwry/John proposal – The Automatic IRA Act of 2007 – was introduced in the Senate (S. 1141) by Sens. Jeff Bingaman and Gordon Smith, and in the House (H.R. 2167) by Reps. Richard Neal and Phil English. The most recent Senate version of the bill was introduced in September 2011 by Senator Bingaman (D-NM) without a GOP co-sponsor.
[16] "Barack Obama's Plan to Strengthen Retirement Security," Obama for America, 20 08 campaign fact sheet. *See also* "Blueprint for Change: Barack Obama's Plan for America, Obama for America (2008), at 17, available at http://www.miafscme.org/PDF%20Files/ObamaBlueprintForChange.pdf.
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Hearing on:

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Retirement (In)security: Examining the Retirement Savings Deficit

Jack VanDerhei, Research Director, Employee Benefit Research Institute

Contents

1 Introduction

Mr. Chairman and members of the committee, thank you for your invitation to testify today on retirement security in America . I am Jack VanDerhei, research director of the Employee Benefit Research Institute. EBRI is a nonpartisan research institute that has been focusing on retirement and health benefits for the past 34 years. EBRI does not take policy positions and does not lobby.

The testimony draws on the extensive research conducted by EBRI on these topics over the last 13 years with its Retirement Security Projection Model® as well as annual analysis of tens of millions of individual 401(k) participants dating back in some cases as far as 1996.

Today's testimony will deal with the following topics:

- What is the size of Americans' retirement savings gap?
- To what extent has this deficit been impacted by economic conditions over the past several years?
- What are the economic impacts of the retirement savings deficit on capital and labor markets and on individuals?
- What are the most effective and efficient strategies to encourage and facilitate greater savings for retirement?

2 What is the size of Americans' retirement savings gap?

2.1 How can this gap be best measured - are there specific metrics that should be considered?

The concept of measuring retirement security – or retirement income adequacy – is an extremely important topic. EBRI started a major project to provide this type of measurement in the late 1990s for several states that were concerned whether their residents would have sufficient income when they reached retirement age. After conducting studies for Oregon, Kansas and Massachusetts, we expanded the simulation model to a full-blown national model in 2003 and in 2010 updated it to incorporate several significant changes, including the impacts of defined benefit plan freezes, automatic enrollment provisions for 401(k) plans and the recent crises in the financial and housing markets.[1]

When we modeled the Baby Boomers and Gen Xers in 2012 (Figure 1) between 43.3–44.3 percent of those households were projected to have inadequate retirement income for even BASIC retirement expenses plus uninsured health care costs. Even though this number is quite large, the good news is that this is 5-8 percentage points LOWER than what we found in 2003.

The improvement over the last nine years is largely due to the fact that in 2003 very few 401(k) sponsors used automatic enrollment (AE) provisions and the participation rates among the lower income employees (those most likely to be at risk) was quite low. With the adoption of AE in the past few years, these percentages have often increased to the high 80s or low 90s.

Although there do not appear to be any major trends by age, Figure 2 shows that the lower-income households are MUCH more likely to be at risk for insufficient retirement income (even though we model our basic retirement expenses as a function of the household's expected retirement income). The 2012 baseline ratings for Early Boomers ranges from a projection that 87 percent of the lowest-income households are at risk to only 13 percent for the highest income households. Similar trends are evidenced for both the Late Boomers and Gen Xers.

While the lack of retirement income adequacy for the lowest income households should be of great concern, even more alarming is the rate at which they will run "short" of money during retirement. As documented in VanDerhei and Copeland (July 2010), 41 percent of early boomers in the lowest income quartile could run short of money within 10 years after they retire.[2]

While knowing the percentage of households that will be at risk for inadequate retirement income is important for public policy analysis, perhaps equally important is knowing just how large the accumulated deficits are likely to be. Figure 3 provides information on the average individual retirement income deficits by age cohort, as well as family status and gender, for baby boomers and Gen Xers. These numbers are present values at retirement age and represent the additional amount each individual in that group would need to have accumulated at age 65 to eliminate their expected deficits in retirement (which could be a relatively short period or could last decades). The values for those on the verge of retirement (Early Boomers) vary from approximately $22,000 (per individual) for married households, increasing to $34,000 for single males and $65,000 for single females. Even though the present values are defined in constant dollars, the Retirement Savings Shortfalls (RSS) for both genders increases for younger cohorts. This is largely due to the impact of assuming health care-related costs will increase faster than the general inflation rate.

While the RSS values in Figure 3 may appear to be relatively small considering they represent the sum of the present values that may include decades of deficits, it is important to remember that less than half of the households modeled were considered to be "at risk." In other words, the average RSS values represented in Figure 3 are reduced by households assumed to have zero deficits. Figure 4 portrays the average RSS values for those households where a non-zero deficit was simulated. Obviously, the RSS values in Figure 4 would be expected to be larger than the corresponding RSS values in Figure 3, sometimes considerably so. Now the values for Early Boomers vary from approximately $70,000 (per individual) for married households, increasing to $95,000 for single males and $105,000 for single females.

The aggregate deficit number with the current Social Security retirement benefits and the assumption that net housing equity is utilized "as needed" is estimated to be $4.3 trillion.[3]

2.2 Do individuals understand how to calculate how much they will need for retirement?

Less than half of workers (42 percent) in the 2012 Retirement Confidence Survey (RCS)[4] report they and/or their spouse have tried to calculate how much money they will need to have saved so that they can live comfortably in retirement. This is comparable to most of the percentages measured from 2003–2011, but lower than the 53 percent recorded in 2000 and the 47 percent in 2008 (Figure 5).[5]

The likelihood of doing a retirement savings needs calculation increases with household income, education, and financial assets. In addition, married workers (compared with unmarried workers); those age 35 and older (compared with those age 25–34); retirement savers (compared with nonsavers); and participants in a defined contribution plan (compared with nonparticipants) more often report trying to do a calculation.

The 2012 RCS showed that workers often guess at how much they will need to accumulate (42 percent), rather than doing a systematic retirement needs calculation. The propensity to guess or do their own calculation, together with current feelings of financial stress, may help to explain why the amounts that workers say they need to accumulate for a comfortable retirement appear to be rather low. Thirty-four percent of workers say they need to save less than $250,000 (up from 26 percent in 2007). Another 18 percent mention a goal of $250,000–$499,999. Twenty percent think they need to save $500,000–$999,999, while fewer than 1 in 10 each believe they need to save $1 million–$1.49 million (6 percent) or $1.5 million or more (9 percent) (Figure 6). Savings goals tend to increase as household income rises.

Workers who have done a retirement savings needs calculation tend to have higher savings goals than do those who have not done the calculation. Twenty-two percent of workers who have done a calculation, compared with 9 percent of those who have not, estimate they need to accumulate at least $1 million for retirement. At the other extreme, 27 percent of those who have done a calculation, compared with 39 percent who have not, think they need to save less than $250,000 for retirement.

Two-thirds of retirees (64 percent) indicate they did some type of financial planning for retirement. Thirty-four percent of these retirees say they began to plan 20 years or more before they retired and 27 percent report beginning to plan between 10 and 19 years before retirement. However, 17 percent say they started planning five to nine years before retirement and 15 percent started less than five years before that point (Figure 7).

3 To what extent has this deficit been impacted by economic conditions over the past several years?

3.1 Impact of the financial and housing market crisis in 2008 and 2009 on retirement readiness

The analysis in VanDerhei (February 2011) was designed to answer two questions:

1. What percentage of U.S. households became "at risk" of insufficient retirement income as a result of the financial market and real estate market crisis in 2008 and 2009?
2. Of those who are at risk, what additional savings do they need to make each year until retirement age to make up for their losses from the crisis?

As one would expect, the answer to the first question depends to a large extent on the size of the account balance the household had in defined contribution plans and/or IRAs as well as their relative exposure to fluctuations in the housing market. The resulting percentages of households that would not have been "at risk" without the 2008/9 crisis that ended up "at risk" vary from a low of 3.8 percent to a high of 14.3 percent.

The answer to the second question also depends on the size of account balances and exposure to the equity market; however, it is a more complicated question involving both the proximity of the household to retirement age (the closer to retirement age, the fewer years of additional savings available), the relative level of preretirement income, and the desired probability of adequate retirement income.

Looking at all households that would need to save an additional amount (over and above the savings already factored into the baseline model), the median percentage of additional compensation for Early Boomers desiring a 50 percent probability of retirement income adequacy would be 3.0 percent of compensation each year until retirement age to account for the financial and housing market crisis in 2008 and 2009. Similar values are 0.9 percent for Late Boomers and 0.3 percent for Gen Xers. A 90 percent probability of retirement income adequacy would require an even larger increase: The median percentage of additional compensation for Early Boomers desiring a 90 percent probability of retirement income adequacy would be 4.3 percent, to account for the financial and housing market crisis in 2008 and 2009.

Looking only at those households that had exposure to the market crisis in 2008 and 2009 from all three fronts (defined contribution plans, IRAs, and net housing equity) shows a median percentage for Early Boomers of 5.6 percent for a 50 percent probability and 6.7 percent for a 90 percent probability of retirement income adequacy. Younger cohorts experience a similar increase, going from the all-household analysis to the more select group.

3.2 What factors in the decades prior to the crisis contributed most to retirement insecurity?

3.2.1 Coverage and participation in employment-based retirement plans

Previous research by EBRI has demonstrated that one of the most important factors contributing to retirement income adequacy for the Boomers and Gen Xers is eligibility to participate in employment-based retirement plans. VanDerhei (August 2011) provides information on how the relative value of the defined benefit accruals impact retirement income adequacy. Figure 8 categorizes any positive value for a defined benefit accrual into quartiles for each income group. The largest reduction in at-risk ratings between the highest and lowest income-specific defined benefit value quartiles takes place for the lowest-income quartile. For these households, the at-risk ratings drop 36 percentage points, from 82 percent to 46 percent. Households in the second income quartile drop 25 percentage points (from an at-risk rating of 58 percent for those in the lowest defined benefit value quartile to 33 percent for those in the highest defined benefit value quartile) while those in the third and highest income quartile drop 24 and 21 percentage points, respectively.

VanDerhei (September 2010) provides similar information for eligibility in defined contribution plans for Gen Xers in 2012 (Figure 9). In this case we see that the number of future years the workers are eligible for participation in a defined contribution plan makes a tremendous difference in their at-risk ratings, even after adjusting for the worker's income quartile. For example, those in the lowest income quartile with no future years of eligibility are simulated to run short of money 86.8 percent of the time, whereas the same income cohort with twenty or more years of future eligibility would only experience this situation 61.1 percent of the time. A similar, albeit less dramatic, situation exists for the highest income quartile. In this case, those with no future years of eligibility in a defined contribution plan are simulated to run short of money 16.8 percent of the time, dropping to only 5.4 percent of the time for the highest income quartile with 20 or more years of eligibility.

Copeland (October 2011) provides the percentage of the work force that has participated in an employment-based retirement plan from 1987-2010. Figure 10 shows that the even though the percentage of the population covered depends to a large extent on how the population is defined, the values within any work force subset has been relatively constant over this 24 year period. In 2010, slightly more than ½ (54.5 percent) of all full-time, full-year wage and salary workers ages 21-64 were participating in an employment-based retirement plan according to calculations based on the 2011 March Current Population Survey.[6] However, when the same information is filtered to exclude workers with less than $10,000 in annual earnings as well as those working for employers with less than 100 employees, the participation percentage in 2010 increases to 67.5 percent.[7]

3.2.2 Defined benefit freezes

The dawn of the new year in 2006 began with a flood of news reports about the "new" trend among private defined benefit plan sponsors of "freezing" their pension plans for current or new workers. In reality, these decisions have been quite prevalent in recent years, and are part of the well-documented and long-term decline of "traditional" pension plans; what's unusual is the large size of some of the employers that have recently announced pension freezes, and the frequency of the announcements.

While it is obvious that pension plan freezes affect some workers negatively, it is *not* obvious *which* workers are affected, nor *to what degree* they are affected by a pension freeze. There are many reasons for this, most importantly the unique characteristics and terms of each pension plan and each freeze, and the age and characteristics of the workers. VanDerhei (March 2006) provides a detailed analysis of how pension freezes are likely to impact existing employees as a function of plan type and employee demographics.

The literature documenting the evolution from defined benefit (pension) to defined contribution (primarily 401(k)-type) retirement plans over the last 20 years is replete with studies analyzing the change in the relative composition of plans and participants; however, very few have focused on the sizeable number of large plan sponsors that have had *both* defined benefit and defined contribution plans in place, certainly since the advent of the 401(k) plan in the early 1980s. For these employers, the primary decision in many cases is not whether to retain *both* forms of retirement plan, but the relative financial value of each in terms of future accruals or contributions. While this may not be considered to be an optimal choice for some sponsors, after recognizing certain legal and/or financial constraints, such as the inability to terminate an underfunded pension plan (with the exception of certain sponsors satisfying the bankruptcy conditions necessary to trigger pension insurance coverage by the Pension Benefit Guaranty Corporation, or PBGC) and the imposition of a 20 percent or 50 percent excise tax on the recoupment of excess assets in the case of a reversion, the best available choice may be to gradually reduce the relative value of the defined benefit plan in the future by the imposition of a pension freeze.[8]

VanDerhei (March 2006) analyzes the financial consequences of a pension freeze for the general population of participants in private defined benefit plans in 2006. This is accomplished by utilizing the accumulation portion of the RSPM. Briefly, the model takes the current population of workers in the private sector in 2006, statistically attributes whether or not they are participating in a defined benefit plan and, if so, what type of plan and the attendant generosity parameters.

The model incorporates a stochastic job tenure algorithm that provides information on how long the employee has already participated in the defined benefit plan and how much longer after 2006 he or she is likely to remain with the employer. With this information, the reduction in the future estimated defined benefit income as a result of a pension freeze in 2006 can be estimated, and the indemnification contribution rate for each defined benefit participant can be determined.

This calculation will be sensitive to the choice of the rates of return on various asset classes—and it is clear that there is no consensus on what future returns in the financial markets will be for the next 30 years. Therefore, RSPM suppresses the stochastic rate of return mechanism typically employed by this type of analysis and substitutes a constant rate of return of either 4 percent nominal per year or 8 percent. This allows readers to choose which rate they believe is more likely for the future and use the corresponding set of results.

In addition, one more modification is made by RSPM before undertaking this analysis. It is a well-known fact that job tenure is longer for defined benefit participants than for either defined contribution participants or workers in general, given the financial consequences of job change upon employees participating in a final-average defined benefit pension plan. Therefore, the typical tenure distributions are replaced with those for participants *exclusively* in defined contribution plans to account for the increased job mobility that is likely to accompany the pension freeze.

4 percent rate of return: The median indemnification contribution rate for a career-average defined benefit pension plan is 11.6 percent, assuming a 4 percent rate of return (Figure 11). An indemnification contribution rate of 18.8 percent would be sufficient to cover 75 percent of the employees covered by this type of plan. The median rate for a final-average plan is larger, as expected: 13.5 percent, and the threshold rate for the 75th percentile increases to 21.0 percent. Cash balance plans have a median indemnification contribution rate of 4.6 percent, with a 75th percentile threshold rate of 6.3 percent using the current interest credits. These values increase to 5.7 percent and 7.3 percent if, instead, the cash balance plans are assumed to credit interest at the intermediate long-term assumption for the interest rate of the Treasury special public-debt obligation bonds issuable to the OASDI trust funds, as specified in the 2005 Trustees of the OASDI Trust Funds Report (5.8 percent).

8 percent rate of return: If the rate of return assumption is increased to 8 percent nominal (Figure 12), the median indemnification contribution rate for a career-average defined benefit plan is 6.6 percent. An indemnification contribution rate of 14.8 percent would be sufficient to cover 75 percent of the employees covered by this type of plan. The median for a final-average plan is 8.1 percent and the 75th percentile threshold increases to 16.0 percent. Cash balance plans have a median indemnification contribution rate of 2.7 percent, with a 75th percentile threshold of 4.5 percent using the current interest credits. These values increase to 3.1 percent and 5.2 percent if the cash balance plans are assumed to credit interest at 5.8 percent.

Copeland and VanDerhei (2010) simulated the impact of such freezes on expected future pension wealth for new employees. Looking at this portion of pension wealth provides one estimate of the impact on overall retirement wealth but it is incomplete, since many sponsors either increase employer DC contributions or set up new DC plans coincident with the pension freeze. Factoring in these enhanced DC contributions (if any), we estimate the net loss that future employees may experience is small overall, amounting to a 0.5-2 percentage point reduction in replacement rates. Some employees, as many as 30 percent of the under age 35 group, may even be better off in retirement due to the enhanced contributions.

3.2.3 Risk management techniques in retirement

Another factor that contributed to retirement insecurity in the last few decades is the sub-optimal risk management strategies chosen by individuals at retirement age. VanDerhei (September 2006) illustrates this in terms of a "building block" approach whereby investment risk, longevity risk and the risk of "stochastic" health care risks are added sequentially to a simulation model showing the overall strategies necessary to achieve a 50, 70 and 90 percent probability of success for stylized individuals at various retirement ages.

While it is true that the first two risks enumerated above (investment and longevity) have, in many cases, been shifted from the employer to the employee as a consequence of the evolution from defined benefit structures to defined contribution plans,[9] these can be dealt with through a combination of post-retirement investment strategies, as well as annuitization of some or all of the account balances at retirement.[10] However, regardless of the asset allocation and/or degree of annuitization utilized by the retiree, there remains a considerable chance that they (or their spouse) may encounter a lengthy stay in a nursing home that may leave the family unit with a much higher probability of "running short" of money in retirement. VanDerhei (2005) uses the EBRI RSPM model to evaluate the impact of purchasing long-term care insurance on retirement income adequacy. The analysis suggests that this may be a particularly powerful risk management technique, especially for retirees in the second and third income quartiles.[11]

4 What are the economic impacts of this deficit on capital and labor markets and on individuals?

4.1 To what extent has market volatility over the past several years impacted individuals' risk tolerance or asset allocations?

Figure 13 provides evidence from VanDerhei, Holden, Alonso and Bass (2011) on the average asset allocation of 401(k) participants from the EBRI/ICI Participant-Directed Retirement Plan Data Collection Project for selected years between 1999 and 2010, inclusive. Although any time-series comparison of asset allocation from this database needs to be accompanied by the caveat that the universe of data providers (as well as plan sponsors and participants) has gradually changed over this time period, the overall asset allocations to equity funds per se have fluctuated as one would expect with changes in the equity markets. Overall, 53 percent of 401(k) assets in the EBRI/ICI database were in equity funds at year-end 1999. This value decreased to 37 percent at the end of 2008 and then increased to 42 percent by year-end 2010.

However, one needs to be extremely careful in interpreting these results since two other trends were taking place at the same time. First, the overall allocation to company stock decreased substantially during this period. In the 1999 EBRI/ICI database, almost 1/5th of all 401(k) money (19 percent) was invested in company stock. By 2010, this value had decreased to only 8 percent. Moreover, during that period the percentage of newly-hired (those with two or fewer years of tenure) 401(k) participants in a plan offering company stock as an investment option that held company stock decreased from 61.0 percent to 33.0 percent.

During the same time there was a substantial change in the amount of money held in balanced funds, increasing from 7 percent in 1999 to 18 percent in 2010. Looking at recently hired 401(k) participants provides a more focused method of analyzing the change in participant's investment choices without a confounding impact of the change in market values on current account balances. VanDerhei, Holden, Alonso and Bass (2011) find that, in 1999, 31.3 percent of recently hired 401(k) participants held balanced funds but that by 2010 this figure had increased to 63.0 percent . The EBRI/ICI data base was not able to bifurcate the balanced fund category into target date funds and non-target date balanced funds until 2006 but even during that five year period there has been a tremendous increase in the percentage of recently-hired participants holding these funds: 28.3 percent at year-end 2006, increasing to 47.6 percent by year-end 2010.

Moreover, of the recently-hired participants investing in balanced or target date funds, the percentage choosing them as essentially their exclusive investment has increased dramatically. VanDerhei, Holden, Alonso and Bass (2011) found that in 1998, only 7.3 percent of recently-hired participants who invested in balanced funds had at least 90 percent of their portfolio in these funds. This value had increased to 69.8 percent by 2010. When a similar analysis was done for target date funds in 2010, a total of 73.6 percent of the newly-hired 401(k) participants holding target-date funds had at least 90 percent of their portfolio invested in target date funds.

Comparing the overall 1998 average asset allocations of newly-hired 401(k) participants with those in 2010, VanDerhei, Holden, Alonso and Bass (2011) find that aggregating across all age groups, equity funds decreased from 64.8 percent to 38.0 percent and company stock decreased from 8.6 percent to 4.3 percent. However this was at least partially offset by an increase in balanced funds from 9.1 percent to 30.7 percent.

Another possible area of interest would be participant trading activity during this period of time. In an analysis of Vanguard participants, Utkus and Young (2011) find that the percentage of participants trading in 2008 (16 percent) was actually lower than what it was in 2005 (19 percent) and similar to what it had been in 2007 (15 percent). The value decreased to only 13 percent in 2009. They also find that 27 percent of the participants traded over the 2007-2010 period but that only 3 percent of the participants sold out of stocks entirely and that 1 percent traded to 100 percent equities. Five percent of the participants decreased equities by more than 10 percentage points during this period but that was partially offset by 4 percent of the participants who increased equities by 10 percentage points or more.

While it is difficult to predict the extent to which market volatility over the past several years will have a long term impact on individuals' risk tolerance or asset allocations, the increasing utilization of AE since the passage of the Pension Protection Act of 2006 has resulted in more 401(k) assets invested in target date funds due to the qualified default investment alternative regulations. Moreover, given the relative inertia experienced with respect to asset allocation for participants automatically enrolled in 401(k) plans, this is likely to be the case even if AE utilization stays constant in the future. Therefore, there is every reason to expect that participant asset allocations will have less reaction to market volatility as the fund managers continue to rebalance during market cycles.[12]

4.2 Are there other ways that individuals have responded to recent market conditions?

In an analysis of Vanguard participants, Utkus and Young (2011) find that the percentage of participants stopping contributions was 2.8 percent in 2005 and then decreased to 2.5 percent in 2006 and 2.4 percent in 2007 before increasing slightly to 3.1 percent in 2008. The value decreased to 2.9 percent in 2009 and was estimated to be only 2.0 percent in 2010.

With respect to plan loans, in the 15 years that the EBRI/ICI database has been tracking loan activity among 401(k) plan participants, there has been little variation.[13] From 1996 through 2008, on average, less than one-fifth of 401(k) participants with access to loans had loans outstanding. At year-end 2009, the percentage of participants who were offered loans with loans outstanding ticked up to 21 percent and remained at that level at year-end 2010. However, not all participants have access to 401(k) plan loans—factoring in all 401(k) participants with and without loan access in the database, only 18 percent had a loan outstanding at year-end 2010. On average, over the past 15 years, among participants with loans outstanding, about 14 percent of the remaining account balance was taken out as a loan.

The percentage of participants taking hardship withdrawals appears to have increased slightly during this period. In an analysis of Vanguard participants, Utkus and Young (2011) find that 1.7 percent of the participants took a hardship withdrawal in 2006. This value increased to 1.8 percent in 2007 and 2.0 percent in 2008 before reaching 2.2 percent in 2009 and 2010.

In the wake of the 2008 financial crisis, a number of employers chose to reduce, suspend, and/or terminate their matching contributions.[14] A Towers Watson analysis of 260 companies that made changes to employer match contributions to deal with the recent economic crisis finds 231 originally suspended their matches, while 29 chose to reduce them. According to Towers Watson, the majority of the analyzed companies chose to reinstate their match (75 percent). Of those that reinstated their match, 105 companies (74 percent) reintroduced the original match amount. Among these plan sponsors, the most frequent match formula before and after the crisis was 50 percent of up to 6 percent of salary. The median duration for match suspensions was 12 months, for companies with quantifiable dates. Most companies reinstated their match after nine or 12 months.

By the middle of 2009, almost 10 percent of Fidelity recordkept defined contribution plans suspended or reduced their contribution dollars, although by December 2010, 55 percent of plan sponsors indicated they planned to reinstate their match within the next 12 months. Fidelity also reported that among larger companies, those with more than 5,000 employees, most (71 percent) had already reinstated or planned to reinstate their match. More than 60 percent of employers with a plan size of between 500-999 employees had already reinstated or indicate they plan to reinstate their match — up from 38 percent just 10 months earlier. As for employers with fewer than 1,000 workers, Fidelity noted that the applicable percentage was over 46 percent.

In February of 2012, the IRS interim report of responses from its 401(k) Compliance Check Questionnaire revealed the number of 401(k) plan sponsors that:[15]

- Suspended or discontinued matching contributions in their plans increased from 1 percent in 2006 to 4 percent in 2008.

- Suspended or discontinued the non-elective contribution in their plans increased from 2 percent in 2006 to 5 percent in 2008.
- Reduced non-elective contributions in their plans increased from 1 percent in 2006 to 5 percent in 2008.

A common concern with respect to plan sponsors suspending their contributions is the potential impact on employee savings. For example, if an employee were contributing 6 percent of compensation to receive the maximum match from a plan with a 50 percent match on the first 6 percent of compensation, would a suspended match end up decreasing the total contribution for the employee from 9 percent to 6 percent, or would the reduced incentive drive this down below 6 percent (perhaps to zero)?

In an attempt to provide preliminary evidence with respect to the impact of suspending employer contributions on employee behavior, VanDerhei (November 2009) analyzed all 401(k) plans in the EBRI/ICI 401(k) database with more than $100,000 in employer contributions in 2007,[16] and none in 2008.[17] The percentage of 401(k) participants continuing to contribute in 2008 after a suspension in employer contributions was analyzed as function of a match rate proxy.[18]

For all plans with a match rate proxy of less than 50 percent, the percentage of 401(k) participants continuing to contribute in 2008 was at least 86 percent. However, the percentage decreased substantially for those with more generous match rate proxies. For participants with a match rate proxy between 50 and 100 percent, only 80 percent of the participants continued to contribute after the suspension. For those with match rate proxies in excess of 100 percent, the percentage was only 73 percent.

4.3 What are the long term impacts of recent market volatility on retirement savings?

Figure 14 shows EBRI projections of the estimated percentage of consistent participants who have more money in their 401(k) accounts on March 1, 2012 than they did at the market high (October 8, 2007). The results are displayed by age and tenure and, as expected, 401(k) participants with relatively short tenure have a higher percentage of having recovered given that their ratio of contributions to account balance is likely to be much larger. Overall 95 percent of the participant balances were projected to have recovered to their level at the market high, though less than 90 percent of those with more than 20 years of tenure were likely to have recovered to that level.[19]

4.4 To what extent will the retirement of the Baby Boomers impact capital and labor markets?

This question is particularly problematic for several reasons. First, with respect to the impact on capital markets, assumptions will need to be made with respect to what the Baby Boomers will do with their asset allocations in retirement as well as the rate at which they will spend-down the assets in their retirement accounts. Unfortunately there is extremely limited information at the current time to allow informed estimates in this regard. However, as part of its research mission, EBRI's Center for Research on Retirement Income is currently integrating administrative records of millions of 401(k) participants with those of IRA account holders. One of the first publications from this endeavor (scheduled for later in 2012) will be to investigate the change in asset allocation at retirement and to track subsequent changes as retirees age. A follow-up study is planned that will begin to link successive years of the integrated defined contribution/IRA data and track the spend-down behavior of retirees as a function of several demographic and portfolio characteristics.

Secondly, the impact on labor markets will depend to a large extent on when the Baby Boomers choose to retire (at least initially). Much of the public policy research in this area has assumed that employees will retire at age 65 and then attempt to assess the probability of "success." While success is certainly defined in several different ways, all of the models identify at least a significant percentage of the population as failing to meet that criteria. Since the genesis of the RSPM project in the late 1990s, the model had always assumed a retirement age of 65. While there was abundant evidence of many individuals retiring earlier (e.g., as soon as they became eligible for Social Security retirement benefits at age 62), the model was constructed to measure the households probability of retirement income adequacy if this temptation were avoided and retirement deferred to age 65.[20] However, even with this admittedly optimistic assumption, the results in both 2003 and 2010 showed that the median additional percentage of compensation that would be required for retirement income adequacy at more than a 50 percent probability would exceed 25 percent of compensation annually (until age 65) for many age/income combinations.

As a result, the 2011 version of RSPM added a new feature that would allow households to defer retirement age past age 65[21] in an attempt to determine whether retirement age deferral is indeed sufficiently valuable to mitigate retirement income adequacy problems for most households (assuming the worker is physically able to continue working and that there continues to be a suitable demand for his or her skills). The answer, unfortunately, is not always "yes," even if retirement age is deferred into the 80s.

Using the threshold of retirement income adequacy described above (essentially sufficient retirement income to pay for basic retirement expenses and uninsured medical costs for the entire retirement period), RSPM baseline results indicate that the lowest preretirement income quartile would need to defer retirement age to 84 before 90 percent of the households would have a 50 percent probability of success. Although a significant portion of the improvement takes place in the first four years after age 65, the improvement tends to level off in the early 70s before picking up in the late 70s and early 80s. Households in higher preretirement income quartiles start at a much higher level, and therefore have less improvement in terms of additional households reaching a 50 percent success rate as retirement age is deferred for these households.

The problem with using a 50 percent probability of success, of course, is that households is in a position where they will "run short of money" in retirement one chance out of two. While most households (at least those that are cognizant of these risks) are likely to have a risk aversion level that would make this risk assumption untenable, switching to a higher probability of success will significantly reduce the percentage of households capable of satisfying the threshold at any given retirement age. For example, if the success rate is moved to a threshold of 70 percent, only 2 out of 5 households in the lowest-income quartile will attain retirement income adequacy even if they defer retirement age to 84. Increasing the threshold to 80 percent reduces the number of lowest preretirement income quartile households that can satisfy this standard at a retirement age of 84 to approximately 1 out of 7.

One of the factors that makes a major difference in the percentage of households satisfying the retirement income adequacy thresholds at any retirement age is whether the worker is still participating in a defined contribution plan after age 65. The increase in the percentage of households that are predicted to have adequate retirement income as a result of defined contribution participation varies by retirement age, preretirement income quartile and probability of retirement income adequacy, but this factor alone results in at least a 10 percentage point difference in the majority of the retirement age/income combinations investigated.

Another factor that has a tremendous impact on the value of deferring retirement age is whether stochastic post-retirement health care costs are excluded (or the stochastic nature is ignored). In essence, the true value of deferring retirement age is substantially muted if the full stochastic nature of nursing home and home health care costs is not appropriately modeled. This is especially true for those desiring a high probability of a successful retirement. Figure 18 shows that the value of deferring retirement age (even as much as 20 years), as those with at least an 80 percent probability of success decreases considerably when the impact of stochastic health care costs are excluded. For the lowest preretirement income quartile, the value of deferral (in terms of percentage of additional households that will meet the threshold by deferring retirement age from 65 to 84) decreases from 16.0 percent to 3.8 percent by excluding these costs. The highest preretirement income quartile experiences a similar decrease, from 12.8 percent to 2.6 percent.

5 What are the most effective and efficient strategies to encourage and facilitate greater savings for retirement?

5.1 Automatic enrollment

VanDerhei and Copeland (2008) simulated the impact of 401(k) sponsors changing from voluntary to automatic enrollment; however, given its close proximity to the passage of the Pension Protection Act of 2006 (PPA) there was no way of knowing what the AE plan design parameters in that legislation would look like. As a result, the PPA safe harbor provision was used as a prototype in the 2008 study. Moreover, there was no way of knowing the plan design parameters of 401(k) sponsors that would subsequently choose to adopt AE. As determined in a joint EBRI/Mercer study (VanDerhei, July 2007), there is a high correlation between those employers that choose to adopt AE for their 401(k) plans and those that froze/closed their defined benefit (DB) pension plans. Fortunately, EBRI was able to circumvent these limitations in late 2009 with data on actual retirement plan sponsor activity from Benefit SpecSelect™ (a trademark of Hewitt Associates LLC).

VanDerhei (April 2010) simulated the difference between AE and voluntary enrollment by comparing large 401(k) sponsors with actual plan design parameters. Figure 15 shows only post-2009 accumulations (and rollovers) and, as expected, the simulated balances (as a multiple of final earnings) would be minimal for older age cohorts. However, for those with a major portion of their careers remaining, the differences in additional accumulations due to auto-enrollment prove to be quite significant: When workers currently ages 25–29 are compared, the median 401(k) balances increase from approximately 1.5 times final earnings under voluntary enrollment to more than 6.0 times final earnings in the auto-enrollment scenario.

The 6.0 multiple in Figure 15 might appear to be too small to reach conventional retirement income targets.[22] Therefore, Figure 16 recasts the AE results from Figure 15 for just the youngest cohort and provides further breakouts by the number of years eligible for participation in a 401(k) plan as well as the relative income level. For those workers assumed to be eligible (whether or not they choose to participate) for more than 30 years, the median multiples range from approximately 7.6–8.5 times final salary, depending on salary level.

VanDerhei and Lucas (2010) demonstrate the profound influence of plan design variables, as well as assumptions of employee behavior in auto-enrollment 401(k) plans. Even with a relatively simple definition of "success," large differences in success rates can be seen, depending on which plan design factors and employee behavior assumptions are used:[23]

- The probability of success for the lowest-income quartile increases from the baseline probability of 45.7 percent to 79.2 percent when all four factors are applied.
- The impact on the highest-income quartile is even more impressive, with an increase in the probability of success from 27.0 percent to 64.0 percent.

When viewed in isolation, it is clear that the impact of increasing the limit on employee contributions is much greater than any of the other three factors. However, the importance of including one or more additional factors, along with the increase in the limit on employee contributions, can more than double the impact of increasing the limit by itself.

5.2 What incentives have the greatest bearing on the behavior of employers and employees

5.2.1 Tax incentives

Two major proposals have recently emerged that could have an impact on employment-based retirement plan designs, specifically 401(k) plans:

- The National Commission on Fiscal Responsibility and Reform proposal on federal debt reduction, "The Moment of Truth," issued in December 2010. The document puts forth a tax reform plan that would modify private-sector retirement plans by capping annual "tax-preferred contributions to [the] lower of $20,000 or 20% of income" (page 31). This is often referred to as the "20/20 cap."
- A plan (Gale, 2011) that would modify the existing tax treatment of both worker and employer 401(k) contributions and introduce a flat-rate refundable credit that serves as a federal matching contribution into a retirement savings account.

Some of the financial projections associated with these proposals have assumed status quo, meaning no behavioral changes by either the employers that sponsor 401(k) plans or the workers who participate in them if those proposals were to become a reality, and that current rates of worker deferrals, employer matching contributions, and plan availability would remain unchanged.

Previous EBRI research has provided an initial quantification of how these proposals would likely affect individual participant retirement savings, by age and income.[24] These earlier projections, however, were not based on survey evidence of how employers—the sponsors of private-sector 401(k) retirement plans—would be likely to react to potential changes in the tax treatment of these contributions, or how those decisions might, in turn, affect participant-savings accumulation. Additionally, while those projections incorporated the potential impact of the specific provisions of the Gale proposal, they were based on worker responses to generic questions about changes to the taxability of 401(k) contributions.

Integrating new data from plan sponsors, VanDerhei (March 2012) provides a perspective on the impact of a scenario where the current tax treatment of employer and worker pre-tax contributions was modified such that workers would have to pay federal taxes on these amounts currently, rather than on a deferred basis, as under current law, and participants would receive an 18 percent government match (as contemplated in the Gale proposal).

In September 2011, the U.S. Senate Finance Committee held a hearing on "Tax Reform Options: Promoting Retirement Security." One of the primary topics during the hearing was an assessment of the potential benefits and consequences that may result from a proposal to modify the federal tax treatment of 401(k) plan contributions in exchange for a flat-rate government match. Gale (2011) updated a 2006 analysis by Gale, Gruber, and Orszag and analyzed a plan that would change the treatment of retirement saving in three ways:[25]

"First, unlike the current system, workers' and firms' contributions to employer-based 401(k) accounts would no longer be excluded from income subject to taxation, contributions to IRAs would no longer be tax-deductible, and any employer contributions to a 401(k) plan would be treated as taxable income to the employee (just as current wages are). Second, all qualified employer and employee contributions would be eligible for a flat-rate refundable tax credit, given to the employee. Third, the credit would be deposited directly into the retirement saving account, as opposed to the current deduction, which simply results in a lower tax payment than otherwise."

Regarding the proposed tax credit, Gale (2011) reports estimates from the Tax Policy Center for both an 18 percent credit and a 30 percent credit. The paper includes a distributional analysis of the winners and losers under the two versions of the proposal; however, the underlying analysis holds retirement saving contributions constant for both employers and participants (page 6). Gale mentions that the proposal "could conceivably affect incentives for firms to offer 401(k)s or pensions" (page 7) but concludes that this seems unlikely. He also dismisses as likely overstated the concern that the tax credit/matches called for in the proposal may discourage employer matches to 401(k) plans, but offers no supporting data for this assumption

These two papers provide an interesting analysis of a proposal with profound public-policy implications. The assumptions based on responses (or lack thereof), both from individual workers and the plan sponsors themselves, will likely be the focus of serious debate. Moreover, public policy consideration of this proposal will undoubtedly be subject to a cost-benefit analysis beyond the assumption that retirement savings contributions will remain constant on the part of participants and/or plan sponsors.

On a cautionary note, it is admittedly very difficult to determine how those workers not currently covered and/or participating in a defined contribution plan would react to this set of incentives, and EBRI will continue to work with actual participant data to better assess some of the behavioral tendencies of this group. Until this type of information is available, it will be quite difficult to fully assess the "benefit" portion of the cost-benefit analysis suggested above. EBRI did provide an analysis of some of the likely "costs" in terms of reduced retirement benefits for those currently in the 401(k) system at a September 2011 Senate Finance Committee hearing. However, no information on plan sponsor reaction to the proposal was available at that time. Consequently, the 2011 EBRI analysis presented there was based on several alternative scenarios.[26] Moreover, the information used to model potential 401(k) participant reaction to the proposal was limited to "an analysis of two new questions from the 21st wave of the Retirement Confidence Survey (RCS) reflecting how workers indicated they would likely react if they were no longer allowed to defer retirement savings plan contributions from taxable income."[27]

5.2.1.1 New Survey Analysis

5.2.1.1.1 Plan Sponsors

In recent months, two surveys have provided additional information on potential responses from plan sponsors with respect to this type of proposed modification of the 401(k) system. A survey conducted on behalf of The Principal Financial Group (2011) determined that if workers' ability to deduct any amount of the 401(k) contribution from taxable income was eliminated, 65 percent of the plan sponsors responding to the survey would have less desire to continue offering their 401(k) plan.[28]

A separate survey by AllianceBernstein in 2011 provided plan sponsors with the following question and potential responses:[29]

Suppose U.S. legislation were enacted such that employees were no longer allowed to deduct retirement savings plan contributions from their federal taxable income. In addition, suppose that the employee had to pay federal income tax on anything an employer contributed to the employee's retirement savings account in the year it was contributed. In exchange for this modification of the current tax incentives, assume the U.S. government would match 18% of whatever was contributed to a retirement savings plan. What do you believe would be the most likely change to your plan?

- No change
- Terminate our plan
- Reduce our average employer match
    - 1–24%
    - 25–49%
    - 50–74%
    - 75–100%
- Begin to provide an average fixed contribution
- Increase a current, average fixed contribution
    - 1–24%
    - 25–49%
    - 50–74%
    - 75–100%
- Don't know / not sure
- Other

Responses were obtained from 1,018 plan sponsors grouped into the following size categories based on total retirement plan assets:

1. <$1 million.
2. $1 million–$10 million.
3. $10 million–$50 million.
4. $50 million–$250 million.
5. $250 million–$500 million.
6. >$500 million.

5.2.1.1.2 Participants

With respect to potential worker reactions to this proposal, a new set of questions concerning participant behavior in response to the specific federal tax modifications proposed in Gale (2011) was included in the 2012 RCS. Specifically, workers currently contributing to a workplace retirement plan were asked:

1. Suppose you were no longer allowed to deduct your retirement savings plan contributions for federal income tax purposes and that anything your employer contributed to your retirement savings this year on your behalf was also treated as part of your taxable income. Suppose the government matched 18% of contributions so that for every $100 you or your employer contributed to your retirement savings plan this year, the government would contribute $18. What do you think you would be most likely to do?[30]
   a. Stop contributing altogether
   b. Reduce the amount you contribute
   c. Continue to contribute what you do now
   d. Increase the amount you contribute

Follow-up questions were asked of those who indicated they would either increase or decrease the amount they currently contribute:

2. By about how much do you think you would reduce your contribution? Would you:
   a. Reduce it by about a quarter
   b. Cut it in half, or
   c. Reduce it by about three-quarters

3. By about how much do you think you would increase your contribution? Would you increase it by about
   a. A quarter
   b. Half
   c. Three-quarters, or
   d. Double it

5.2.1.1.3 Impact on 401(k) Balances at Retirement Age[31]

VanDerhei (March 2012) utilizes the defined contribution participant responses to the RCS questions above, as well as the plan sponsor responses to the AllianceBernstein survey, to parameterize the voluntary enrollment module of RSPM in order to estimate the likely impact of the proposed federal-tax modifications on projected 401(k) balances at retirement age, assuming the modifications took effect immediately.

Prior to estimating the potential impact on accumulations resulting from 401(k) contribution changes, a set of baseline results first needs to be run to determine the likely values if the various tax reform options are not imposed on the current 401(k) system. The model used in this article is based on the 401(k) voluntary-enrollment modules from RSPM. It is similar in many respects to the one used in Holden and VanDerhei (2002) in that it looks only at current 401(k) participants and does not attempt to include eligible nonparticipants[32] or workers who are currently not eligible.[33] However, unlike the 2002 model, this analysis assumes no job turnover, withdrawals, or loan defaults.[34]

Using the 401(k) voluntary enrollment modules from RSPM, VanDerhei shows in the November 2011 *Issue Brief* that the median real-replacement rates at age 67 from 401(k) balances exclusively for participants currently ages 25–29 by income quartiles.[35] The values vary from a low of 53 percent for the lowest-income quartile to a high of 77 percent for the highest-income quartile.[36] The simulated rates of return are explained in more detail in VanDerhei and Copeland (2010), but they are based on a stochastic process with a mean equity return of 8.9 percent and a mean fixed-income return of 6.3 percent (expressed in nominal terms).

5.2.1.1.3.1 Age and Salary

Figure 17 shows the baseline average percentage reductions in 401(k) account balances at Social Security normal retirement age due to expected modifications of plan sponsors and participants in reaction to the proposal to modify the federal tax treatment of employer and worker contributions for 401(k) plans in exchange for an 18 percent match from the federal government, by age and age-specific salary quartiles.[37] The average percentage reductions for the youngest cohort (those currently 26–35) are largest for those in the lowest-income quartile (22.2 percent).[38] The reductions for the youngest cohort decrease to 13.0 percent for those in the second-income quartile and reach a minimum of 6.1 percent for those in the third-income quartile. The reductions increase to 10.8 percent for those in the highest-income quartile.

Measuring the impact on older cohorts (those over age 35) is somewhat problematic in that the values are influenced by plan-sponsor and participant reactions to the tax proposal as well as the distribution of tenure with the current employer within each age group. For example, if a 401(k) participant in the oldest cohort (those currently 56–65) has recently changed jobs and has a relatively low account balance in his or her current 401(k) plan, any reported decrease in contributions would have a much larger impact than it would on the same individual (with the same survey response) had that worker not recently changed jobs and had a significantly larger 401(k) balance. Therefore, the analysis in VanDerhei (March 2012) filters out anyone over age 35 whose tenure with their current employer is less than their current age minus 30.[39]

The average-percentage reductions for the "long-tenure" cohort currently ages 36–45 are again largest for those in the lowest-income quartile (24.9 percent). The reductions for this age cohort decrease to 7.2 percent for those in the second-income quartile and then increase to 10.0 percent for those in the third-income quartile. The reductions increase to 17.1 percent for those in the highest-income quartile.

The average-percentage reductions for the "long-tenure" cohort currently ages 46–55 are largest for those in the lowest-income quartile (21.1 percent). The reductions for this age cohort decrease to 9.9 percent for those in the second-income quartile and then increase to 11.6 percent for those in the third-income quartile. The reductions increase to 14.1 percent for those in the highest-income quartile.

Analysis of the oldest cohort (those currently 56–65) show a marked decrease in the average percentage reductions for the "long-tenure" cohort in the lowest-income quartile (12.7 percent), although it should be noted that the average reduction will be most muted by previous account balances for 401(k) participants in this age group. Moreover, the lowest-income quartile no longer has the largest reduction, as the reduction for the second-income quartile is slightly larger at 13.3 percent. The reductions for this age cohort decrease to 11.4 percent for those in the third-income quartile and then decrease to 8.7 percent for those in the highest-income quartile.

5.2.1.1.3.2 Plan Size

An interesting finding of the AllianceBernstein survey of plan sponsors with respect to potential federal tax modifications is the impact of plan size on the expected plan sponsor response. The reasons to expect an increased sensitivity by smaller plans to federal tax modifications has previously been documented by others.[40] However, Figure 18 shows the average percentage reductions in 401(k) account balances at Social Security normal retirement age due to expected modifications in response to the proposal to modify the federal tax treatment of employer and worker contributions for 401(k) plans in exchange for an 18 percent match from the federal government, by plan size and age-specific salary quartiles for workers currently ages 26–35.[41] For all four income quartiles, the average percentage reduction for plan sponsors in the two smallest plan size categories (less than $1 million and $1–$10 million in assets) are more than 1.5 times the value of the average percentage reduction for plans sponsors in any of the larger-size categories.

5.2.2 Impact of Employer Matches on 401(k) Saving

It is understood that 401(k) plans differ from traditional employment-based defined benefit pension plans in that employees are permitted to make voluntary pre-tax contributions. Hence, the sensitivity of participation and contributions to plan characteristics—notably the employer matching rate—may play a critical role in retirement saving.

It has long been assumed that matching employer contributions—the allure of "free money" to participants (and would-be participants)—provided a strong financial motivation to contribute to defined contribution plans, notably 401(k)s. Industry surveys have suggested that employee contribution levels tend to cluster around the matching levels—and that has reinforced the notion of a cause-and-effect connection.

5.2.2.1 Reasons for employers to provide matching contributions

Historically, providing employer matching contributions to 401(k) plans was thought to be a primary means of increasing the likelihood of passing the nondiscrimination (ADP) tests (Brady, 2006). However Ippolito (1997) provides an economic analysis of the feasibility of this approach and determines that an alternative explanation might be more plausible: In essence, employers use the 401(k) match to attract and retain a workforce with specific characteristics and matches are used to reward workers with lower discount rates. Mitchell, Utkus, and Yang (2006) posit that employee demand could be another alternative explanation, with the result that that highly compensated employees demand more generous tax-deferred employer matches. Both of these latter arguments see the employer match as a workforce management tool, rather than a regulatory response.

5.2.2.2 Empirical studies on the impact of matching contributions on participation

In the last 20 years, several empirical studies[42] have analyzed the effect of the existence of matching contributions on the probability of participating in 401(k) plans that use voluntary enrollment. The magnitude of the results vary considerably depending on the type of database used, the methodologies employed, and the assumptions utilized; however, the overall consensus is that, for 401(k) plans that have not employed automatic enrollment, an employer match has a positive impact on plan participation.

An important caveat is that most available survey data do not contain detailed information on plan design. In an attempt to mitigate this problem, Mitchell, Utkus and Young (2007) use 2001 data on 500 401(k) retirement plans covering nearly 740,000 employees to evaluate how employer matching incentives influence retirement saving. Their analysis of the impact of employer matching contributions on participation included two important innovations: First, they evaluated employee saving behavior separately for NHCEs and HCEs at the firm level. Second, in an attempt to deal with nonlinear 401(k) matching formulae (explained in more detail later), they bifurcated the formulae into an "incentive element" (the degree to which the employer matches various increments of employee compensation) and a "liquidity element" (indicating how much the employee must contribute in order to receive the entire employer incentive payment).

The authors analyze the data with OLS regression and find that each $0.10 increase in the match rate raises NHCE participation rates by around 1 percentage point. However, for this group, the participation incentives are statistically insignificant between 3 and 6 percent of pay, and turn negative for matches above 6 percent of pay.

The authors conclude that the incentive effects of employer matching contributions are quite small. Summarizing their empirical results as follows (Mitchell, Utkus and Young, 2007):

> The empirical model implies that close to 65 percent of NHCEs at the typical firm would join their 401(k) plan regardless of the presence of a match. Plan participation would be estimated to rise over a narrow range, by five to 15 percentage points, responding to a range of match offerings, from a modest ($0.25 per dollar on the first three percent of pay) to a very generous match ($1.00 per dollar up to six percent of pay). At the modal promised employer match ($0.50 per dollar on six percent), over one–quarter of NHECs fails to participate in the 401(k) plan; even with a generous match, more than 20 percent still fails to join.

Given that the participation percentages for certain groups of eligible participants (especially the young and low income) have increased substantially under automatic enrollment (AE), many have wondered whether the matching contributions would continue to be associated with higher participation rates under these plans.

Beshears, Choi, Laibson, and Madrian (2007) estimated the employer match's impact on savings plan participation under automatic enrollment in two ways:

- They analyzed a plan sponsor with an AE 401(k) plan that replaced its employer match with a non-elective contribution.[43] They found that plan participation rates decreased by 5 to 6 percentage points at most among new hires after the plan change.[44]
- They pooled data for nine firms with automatic enrollment to identify the relationship between participation rates and the match and found that a 1 percentage point decrease in the maximum potential match was associated with a 1.8 to 3.8 percentage point decrease in plan participation at six months of eligibility.

Based on these findings, the authors estimate that for a typical employer match (viz., 50 percent match on the first 6 percent of pay), eliminating the match under an AE plan could reduce plan participation by 5 to 11 percentage points.

Dworak-Fisher (2008) uses microdata from the National Compensation Survey (NCS) to offer a new line of research on the impact of employer matches on 401(k) participation rates. The author splits the participants into three different income groups and concludes that:

- For those with the lowest income, employer matches have little or no effect on participation, while automatic enrollment has dramatic effects, but
- Among workers in the middle income group, employer matches have substantial effects that may be larger than the effects of automatic enrollment.

It should be noted, however, that the author use NCS microdata from the respondents initiated in 2002 and 2003, and that only a small percentage of the plans in the sample (6 percent) were governed by automatic enrollment provisions.

5.2.2.3 Empirical studies on the impact of matching contributions on contribution behavior in voluntary enrollment 401(k) plans[45]

While the logic behind an employer match increasing the *incentive* for an employee to contribute to a 401(k) plan appears uncontroversial, the analysis becomes more complex with respect to the *level* of contributions the employee will make. This may happen for two reasons:

- While a larger match rate will provide a larger financial incentive for the employee to contribute (at least within a specified range), the employee may have a certain target in mind with respect to the total (employee and employer) contribution that needs to be made each year to satisfy their financial planning objectives. For example, if the employee has determined that he or she needs to save a total of 9 percent of compensation, the required employee contribution would be 6 percent if the employer matched 50 percent up to 6 percent of compensation but only 4.5 percent if the employer matched 100 percent up to (at least) 4.5 percent of compensation. Thus, for some employees, a higher match rate may result in a lower employee contribution rate.
- Empirical analysis emphasizing the match rate exclusively (as opposed to the match cap or the interaction between the two) may provide unexpected results. For example, if the employee's primary concern is to make sure they receive the maximum match possible from the plan sponsor, they would be more likely to contribute at least as much as the match cap. In this case, an employer match of 50 percent of the first 6 percent of compensation would likely generate a larger employee contribution rate than one matching 100 percent of the first 3 percent of compensation—even though the maximum total employer match for that single worker would be 3 percent of compensation in either case.

This helps explain some of the early empirical work in this area. For example, using plan data from Form 5500 filed annually by ERISA-qualified plans with the IRS, Papke (1995) finds that substantial employee contribution increases occur when an employer moves from a zero to a small or moderately sized match rate proxy, but that at higher match rates employee contributions fall. Using a subset of the EBRI/ICI 401(k) database with salary information, Holden and VanDerhei (2001) performed a regression analysis of the influence of the match rate on participants' contribution rates and found that participant before-tax contribution rates fell minimally as the employer match rate rose.[46] However, that analysis also found that as the match cap chosen by the employer increased, participant contribution rates rose.

Kusko, Poterba, and Wilcox (1994) utilized employee-level data from the 401(k) plan at a medium-sized U.S. manufacturing firm to analyze the participation and contribution decisions of workers eligible for this plan. Their analysis suggested that contribution decisions of eligible employees are relatively insensitive to the rate of employer matching on worker contributions and that most employees maintain the same participation status and contribution rate year after year despite substantial changes in the employer's match rate. Moreover, they find that institutional constraints on contributions, imposed by either the employer or the IRS, are an extremely important influence on contributor behavior.

This was confirmed by Yakoboski and VanDerhei (1996) when they analyzed the 401(k) participant data from three large 401(k) sponsors. Moreover, they found a significant amount of clustering around the match cap. For example:

- Company A had a maximum pretax contribution of 9 percent of earnings and a match rate of 30 percent for the first 5 percent of earnings. A total of 21 percent of participants contributed 5 percent of pay to the plan and 45 percent contributed 9 percent of pay while 1 percent contributed up to the 402(g) maximum for that year. The average deferral percentage for Company A was 6.7 percent.

- The non-highly compensated employees in Company B were allowed to contribute a maximum of 15 percent pretax and had a 100 percent match for the first 3 percent of earnings. Twenty-one percent of all non-highly compensated participants contributed 3 percent of pay while 10 percent contributed 15 percent and only 0.1 percent contributed at the 402(g) limit. The average deferral rate was 5.4 percent.
- The highly compensated employees in Company B were allowed to contribute a maximum of 10 percent pretax and had a 100 percent match for the first 3 percent of earnings. Fifteen percent of all highly compensated participants contributed 3 percent of pay while 10 percent contributed 10 percent and 15 percent contributed at the 402(g) limit. The average deferral rate was 5.9 percent.
- Company C had a maximum pretax contribution of 16 percent of earnings and a match rate of 2/3 for the first 6 percent of earnings. A total of 30 percent of participants contributed 6 percent of pay to the plan and 7 percent contributed 16 percent of pay while 12 percent contributed up to the 402(g) maximum for that year. The average deferral percentage for Company A was 6.3 percent.

Even though this analysis includes the experience of only three plan sponsors, the conclusion should be obvious: In addition to individual-specific characteristics (e.g., age, wage and tenure), employee contribution behavior will undoubtedly be influenced to a large extent by plan design variables (viz., the match cap and plan limits for pretax contributions) as well as the 402(g) limits.

VanDerhei and Copeland (2001) attempted to deal with these plan design influences on employee contribution behavior by working with a small subset of the EBRI/ICI 401(k) database.[47] There was sufficient information to track accurately 137 different "pure" matching formulas, that is, one without a nonelective contribution.[48] Participants in the database were excluded if they were under age 20 or over age 64, had been with the current employer for less than one year, and/or had less than $10,000 in earnings. After applying each of these screens and deleting any participants with existing account balances who did not make employee contributions in 1998, a total of 163,346 participants were available for analysis.

In previous research, the level of contributions was estimated by assuming that they were a function of demographic variables and some measure of a match rate of the plan. However, this approach fails to account for the fact that some plans have different match rates for different levels of the percentage of compensation contributed. For example, a plan may offer a dollar-for-dollar match for the first 2 percent of compensation contributed and a 50 percent match for the next 3 percent of compensation contributed. In addition, the strategy does not clearly distinguish between a plan that matches 50 percent of contributions for the first 4 percent of compensation from those plans that match 50 percent of contributions for the first 6 percent of compensation. Since the data used in this research contain plan-specific matching formulas, the actual match rate at each percentage level of contributions is known. Therefore, VanDerhei and Copeland (2001) used an estimation procedure that takes advantage of knowing the differing incentives that an employee eligible to contribute to a 401(k) faces at each percentage of compensation level of contributions.

The parameters of a model for the first increment can be estimated from the entire sample by dividing it into two groups: those who make the contribution and those who do not. The parameters of a model for the second increment can be estimated by dividing the subsample of those who make the first incremental contribution into those who make the next 1 percent of compensation contribution and those who do not. Successive iterations are estimated until the maximum plan limit of all match formulas is obtained. In this model, the decision of an eligible employee is examined at each of level of possible contributions for the employee. Consequently, the changes in the incentives of contributing an additional percentage of compensation are captured through this strategy as well as the ability to control whether or not the participant is allowed to contribute (e.g., in some plans an HCE might be cut off from making additional contributions after 6 percent of compensation, while an NHCE may be allowed to contribute to 15 percent of compensation).

The application of this model is illustrated in Figure 8 of VanDerhei and Copeland (2001) with an example of the computation of the probability that a 22-year-old employee with one year of tenure with the current employer and wages of $15,000 who already contributed 4 percent of compensation will contribute an additional percent. This value is estimated to be as low as 81 percent if this is the last interval of compensation that is matched by the employer (i.e., the additional match is equal to zero). In contrast, the same employee is estimated to have a 90 percent probability of contributing the extra percent of compensation if they would forfeit the option to earn an extra 1 percent of employer match if they continued to contribute to MAXMATCH. In each of the three illustrated intervals, the model predicts that those with the lowest estimated probability of contributing the extra percent of compensation when the additional match is set equal to zero (young employees and those with lower levels of wage and tenure) will experience the most sensitivity to increases in the additional match level.

Figure 19 provides predicted contributions for stylized participants under typical plan matching formulas. This shows that older participants and those with higher levels of wage and tenure are expected to have higher employee contributions for a given plan design. However, this also allows one to investigate how the change in plan design will impact the expected contribution behavior. For example, a change from a 50 percent match on the first 6 percent of compensation to a 75 percent match over the same range results in an expected increase in employee contributions for all of the stylized participants. Moreover, this figure demonstrates the ability of the model to predict contributions under a two-tier matching formula (e.g., a 75 percent match on the first 2 percent of compensation, decreasing to 50 percent for the next 3 percent of compensation) as well as the ability to model employees participating in a plan with no employer match.

5.2.2.4 The impact of adopting automatic enrollment on employer contribution rates

Soto and Butrica (2009) conclude that among a sample of large 401(k) plans, match rates are lower among firms with automatic enrollment than among those without automatic enrollment after controlling for firm characteristics. However, there were two major limitations of this analysis:

- This study was based on U.S. Department of Labor Form 5500 data that *do not include* specific information on 401(k) match rates. Instead, the authors constructed an estimate for the match rate as the ratio of employer-to-employee contributions for each 401(k) plan.
- They merged the Form 5500 data with information on automatic enrollment from the *Pensions & Investments* database of the top 1,000 pension funds, which includes a flag indicating whether plan administrators reported offering automatic enrollment in their defined contribution (401(k)-type) plans. However, this database does not report the year that the automatic enrollment provision was adopted, so there is no way to tell from this data source how long auto-enrollment had been implemented in a plan.

The authors ran regression analysis on this database and produced a finding that:

> *suggests a negative relationship between automatic enrollment and match rates and is statistically significant at the firm-level. In particular, match rates are about 7 percentage points lower among firms with automatic enrollment than among those without automatic enrollment, after controlling for firm characteristics.*

The authors correctly point out that although the regressions *suggest* a relationship between automatic enrollment and match rates, they do not necessarily imply that auto-enrollment *causes* lower match rates; however, this crucial qualification has been generally ignored in third-party accounts of the study.

These conclusions conflict with previous EBRI research,[49] which surveyed defined benefit plan sponsors administered by Mercer Human Resource Consulting to gauge their recent activity and planned modifications to their defined benefit (pension) and defined contribution (401(k)-type) plans. The survey also was able to determine what, if any, increases in employer contributions to defined contribution plans were made in conjunction with reductions to their defined benefit plans.

Although the association between the adoption of automatic enrollment and employer contributions to 401(k) plans was not the focus of the study, one-third of the defined benefit plan sponsors surveyed indicated that they had already increased or planned to increase their employer match to a defined contribution plan, and 20.9 percent indicated that that they had already increased or planned to increase their nonmatching employer contributions to a defined contribution plan. There was some overlap between the two groups, but overall, 42.5 percent of the defined benefit plan sponsors surveyed indicated that they had already increased or planned to increase their employer match and/or nonmatching employer contribution to a defined contribution plan. This was particularly evident among defined benefit plan sponsors that had closed a defined benefit plan to new hires, frozen their defined benefit plan to all members in the last two years, or planned to do so in the next two years.[50]

Moreover, the 2007 EBRI study found an extremely large correlation between the adoption of automatic enrollment for a 401(k) plan and the freezing or closing of the defined benefit plan.[51] Of those defined benefit plan sponsors that had closed their defined benefit plans in the last two years, 80.5 percent had either already adopted or were currently considering adopting automatic enrollment features for their 401(k) plans. Of those defined benefit plan sponsors that had closed their defined benefit plans in the last two years, 76.1 percent had either already adopted or were currently considering adopting automatic enrollment features for their 401(k) plans.[52]
VanDerhei (April 2010) analyzes in detail plan-specific data of approximately 1,000 large defined contribution plans for salaried employees from Benefit SpecSelect™ (a trademark of Hewitt Associates LLC) in 2005 and 2009. From that information, a subsample of plan sponsors was created that had adopted automatic enrollment 401(k) plans by 2009, but did not have them in 2005 (the last observation that was not influenced by PPA). The following information was coded for each plan:

- The default contribution rate for the AE plan in 2009.
- The entire match rate contribution formulae for both years.[53]
- All nonelective contributions paid to the defined contribution participants by the employer.

Whether plan sponsors were more or less generous after adopting AE was measured with three different metrics:

- The average 2009 first-tier match rate was 87.78 cents for each dollar contributed, while the average 2005 first-tier match rate was 81.26 cents for each dollar contributed. The difference of 6.52 cents for each dollar contributed suggests that, to the extent that this sample is representative of the universe of large 401(k) sponsors, those sponsors adopting AE were *more generous* to the 401(k) participants when measured by this variable after automatic enrollment was implemented than they were before.
- The average effective match rate[54] for 2009 was 4.32 percent of compensation, but only 4.00 percent of compensation in 2005. The increase of 0.32 percentage points again suggests that

large 401(k) sponsors adopting AE were *more generous* to the 401(k) participants when measured by this variable after the adoption of automatic enrollment than before.

- The average total employer contribution rate[55] for 2009 was 6.35 percent of compensation and 5.46 percent of compensation in 2005. The increase of 0.89 percentage points once more suggests that those large 401(k) sponsors adopting AE were *more generous* to the 401(k) participants when measured by this variable than before.

This information was then combined with the defined benefit information for the same sponsor in an attempt to analyze whether EBRI's 2007 findings of the association between defined benefit freezing/closing and enhanced 401(k) contributions were corroborated. Figure 1 of VanDerhei (April 2010) demonstrates that the average improvements for all three metrics were much higher for sponsors that had frozen/closed their defined benefit plans than for the overall average. For example, the change in the total employer contribution rate for all frozen plans was 1.64 percent of compensation versus 0.89 percent for the overall average. Employers that had closed their defined benefit plans to new employees had an even larger average improvement: 2.82 percent of compensation. The defined benefit plan sponsors that had frozen or closed their plans were then split into those that had done so prior to adopting AE and those that had changed their defined benefit plans between 2005 and 2009. If the hypothesis that the 401(k) improvements were a result, at least partially, of a simultaneous quid pro quo for the decreased accruals in the defined benefit plan, one would expect that the earlier modifications would be less generous than the modifications that took place approximately at the time of the conversion to AE. In fact, this is exactly what is found for all six comparisons in the study. For example, the average total employer contribution improvement for firms that had frozen their plans prior to 2005 was 0.69 percent of compensation, compared with 2.45 percent for those that froze between 2005 and 2009. Similar evidence is found for those that closed their pension plans to new employees: The average improvement in total employer 401(k) contribution was only 0.56 percent of compensation for those that closed prior to 2005, but 3.34 percent for those that closed the plan between 2005 and 2009.

6 Appendix A: Brief Description of RSPM[56]

One of the basic objectives of RSPM is to simulate the percentage of the population that will be "at risk" of having retirement income that is inadequate to cover basic expenses and pay for uninsured health care costs for the remainder of their lives once they retire.[57] However, the EBRI Retirement Readiness Rating™ also provides information on the distribution of the likely number of years before those at risk "run short of money," as well as the percentage of compensation they would need in terms of additional savings to have a 50, 70, or 90 percent probability of retirement income adequacy.

Appendix C describes how households (whose heads are currently ages 36–62) are tracked through retirement age, and how their retirement income/wealth is simulated for the following components:

- Social Security.
- Defined contribution balances.
- IRA balances.
- Defined benefit annuities and/or lump-sum distributions.
- Net housing equity.[58]

A household is considered to run short of money in this model if aggregate resources in retirement are not sufficient to meet aggregate minimum retirement expenditures, which are defined as a combination of deterministic expenses from the Consumer Expenditure Survey (as a function of income), and some health insurance and out-of-pocket health-related expenses, plus stochastic expenses from nursing home and home health care expenses (at least until the point they are picked up by Medicaid). This version of the model is constructed to simulate "basic" retirement income adequacy; however, alternative versions of the model allow similar analysis for replacement rates, standard-of-living calculations, and other ad hoc thresholds.

The version of the model used for the analysis in this testimony assumes all workers retire at age 65 and immediately begin to withdraw money from their individual accounts (defined contribution and cash balance plans, as well as IRAs) whenever the sum of their basic expenses and uninsured medical expenses exceed the after-tax[59] annual income from Social Security and defined benefit plans (if any). If there is sufficient money to pay expenses without tapping into the tax-qualified individual accounts,[60] the excess is assumed to be invested in a non-tax-advantaged account where the investment income is taxed as ordinary income.[61] The individual accounts are tracked until the point at which they are depleted; if the Social Security and defined benefit payments are not sufficient to pay basic expenses, the entity is designated as having "run short of money" at that time.

7 Appendix B: Brief Chronology of RSPM

The original version of RSPM was used to analyze the future economic well-being of the retired population at the state level. EBRI and the Milbank Memorial Fund, working with the governor of Oregon, set out in the late 1990s to see if this situation could be addressed for Oregon. The analysis[62] focused primarily on simulated retirement wealth with a comparison to ad hoc thresholds for retirement expenditures, but the results made it clear that major decisions lie ahead if the state's population was to have adequate resources in retirement.

Subsequent to the release of the Oregon study, it was decided that the approach could be applied to other states as well. Kansas and Massachusetts were chosen as the next states for analysis. Results of the Kansas study were presented to the state's Long-Term Care Services Task Force on July 11, 2002,[63] and the results of the Massachusetts study were presented on Dec. 1, 2002.[64] With the assistance of the Kansas Insurance Department, EBRI was able to create Retirement Readiness Ratings based on a full stochastic decumulation model that took into account the household's longevity risk, post-retirement investment risk, and exposure to potentially catastrophic nursing-home and home-health-care risks. This was followed by the expansion of RSPM and the Retirement Readiness Ratings to a national model and the presentation of the first micro-simulation retirement-income-adequacy model built in part from administrative 401(k) data at the EBRI December 2003 policy forum.[65] The basic model was then modified for testimony for the Senate Special Committee on Aging in 2004 to quantify the beneficial impact of a mandatory contribution of 5 percent of compensation.[66]

The first major modification of the model was presented at the EBRI May 2004 policy forum. In an analysis to determine the impact of annuitizing defined contribution and IRA balances at retirement age, VanDerhei and Copeland, 2004, were able to demonstrate that for a household seeking a 75 percent probability of retirement income adequacy, the additional savings that would otherwise need to be set aside each year until retirement to achieve this objective would decrease by a median amount of 30 percent. Additional refinements were introduced in 2005 to evaluate the impact of purchasing long-term care insurance on retirement income adequacy.[67]

The model was next used in March of 2006 to evaluate the impact of defined benefit freezes on participants by simulating the minimum employer-contribution rate that would be needed to financially indemnify the employees for the reduction in their expected retirement income under various rate-of-return assumptions.[68] Later that year, an updated version of the model was developed to enhance the EBRI interactive Ballpark E$timate® worksheet by providing Monte Carlo simulations of the necessary replacement rates needed for specific probabilities of retirement-income adequacy under alternative-risk-management treatments.[69]

RSPM was significantly enhanced for the May 2008 EBRI policy forum by allowing automatic enrollment of 401(k) participants with the potential for automatic escalation of contributions to be included.[70] Additional modifications were added in 2009 for a Pension Research Council presentation that involved a winners/losers analysis of defined benefit freezes and the enhanced employer contributions to defined contribution plans provided at the time the defined benefit plan was frozen.[71]

A new subroutine was added to the model to allow simulations of various styles of target-date funds for a comparison with participant-directed investments in 2009.[72] In April 2010, the model was completely re-parameterized with 401(k) plan-design parameters for sponsors that have adopted automatic-enrollment provisions.[73] A completely updated version of the national model was produced for the May 2010 EBRI policy forum and used in the July 2010 *Issue Brief*.[74]

The new model was used to analyze how eligibility for participation in a defined contribution plan impacts retirement income adequacy in September 2010.[75] It was also used to compute retirement savings shortfalls for Baby Boomers and Generation Xers in October 2010.[76]

In October 2010 testimony before the Senate Health, Education, Labor and Pensions Committee on "The Wobbly Stool: Retirement (In)security in America," the model was used to analyze the relative importance of employer-provided retirement benefits and Social Security.[77]

In February 2011, the model was used to analyze the impact of the 2008-2009 crisis in the financial and real estate markets on retirement income adequacy.[78]

An April 2011 article introduced a new method of analyzing the results from the RSPM.[79] Instead of simply computing an overall percentage of the simulated life paths in a particular cohort that will not have sufficient retirement income to pay for the simulated expenses, the new method computed the percentage of households that would meet that requirement more than a specified percentage of times in the simulation.

As explored in the June 2011 *Issue Brief*, the RSPM allowed retirement-income adequacy to be assessed at retirement ages later than 65.[80]

In a July 2011 *Notes* article[81], it provided preliminary evidence of the impact of the "20/20 caps" proposed by the National Commission on Fiscal Responsibility and Reform on projected retirement accumulations.

The August 2011 *Notes* article[82] evaluated the importance of defined benefit plans for households, assuming they retire at age 65, while demonstrating the impact of defined benefit plans in achieving retirement income adequacy for Baby Boomers and Gen Xers.

Finally, the September 2011 Senate Finance testimony[83] analyzed the potential impact of various types of tax-reform options on retirement income adequacy. This was expanded in the November 2011 EBRI Issue Brief[84] and a new set of survey results were added to the model in the March 2012 Notes article.[85]

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9 Endnotes

1 A brief description of the EBRI Retirement Security Projection Model® (RSPM) is provided in Appendix A followed by a chronology of its development and utilization in Appendix B.

2 It should be noted that the baseline assumptions used in the 2010 analysis did not allow for the utilization of net housing equity to ensure retirement income adequacy. A future publication will include a 2012 update for this analysis with housing equity used "as needed."

[3] This number is somewhat smaller than the $4.6 trillion reported in VanDerhei (October 2010); however, the baseline assumptions used in the 2010 analysis did not allow for the utilization of net housing equity to ensure retirement income adequacy. When the 2012 analysis is repeated with the same assumptions as used in 2010, the aggregate deficit increases to $4.8 trillion.

[4] These findings are part of the 22nd annual Retirement Confidence Survey (RCS), a survey that gauges the views and attitudes of working-age and retired Americans regarding retirement, their preparations for retirement, their confidence with regard to various aspects of retirement, and related issues. The survey was conducted in January 2012 through 20-minute telephone interviews with 1,262 individuals (1,003 workers and 259 retirees) age 25 and older in the United States. Random digit dialing was used to obtain a representative cross section of the U.S. population. To further increase representation, a cell phone supplement was added to the sample. Starting with the 2001 wave of the RCS, all data are weighted by age, sex, and education to reflect the actual proportions in the adult population. Data for waves of the RCS conducted before 2001 have been weighted to allow for consistent comparisons; consequently, some data in the 2012 RCS may differ slightly with data published in previous waves of the RCS. Data presented in tables in this report may not total to 100 due to rounding and/or missing categories.

[5] Helman, Copeland and VanDerhei (2012)

[6] In Dushi, Iams, and Lichtenstein (2011), the results from another individual response survey, the Survey of Income and Program Participation (SIPP), are compared with tax records, where they found that a number of individuals said they made contributions to a defined contribution plan but the tax records said they didn't and others made contributions according to the tax records but didn't report the contributions in the survey. When the percentages are netted out, the tax records show a 5 percentage point higher level of participation than what the survey responses show. Consequently, there are issues with the accuracy of certain individual responses in retirement plan participation.

[7] Figure 30 from Copeland (October 2011).

[8] It should be noted that there is more than one definition of a pension freeze:

- ***A "hard freeze"*** is one in which no additional benefits will accrue to any current plan participants from either additional tenure or increases in compensation.
- ***A "soft freeze"*** will generally limit increases for current participants in accrued benefits for additional years of participation, but the definition of compensation used in the formula may be allowed to increase.
- In addition, a plan sponsor may choose to implement a ***partial freeze*** in which the plan is frozen for some but not all participants.

[9] This is true only in those cases in which the defined benefit participant ends up with an annuity in retirement. Those who have been cashed out or chose to take a lump sum distribution would still need to deal with (post-retirement) investment risk and longevity risk on their own.

[10] In recent years the longevity risk may also be dealt with via longevity insurance or longevity annuities. See Park (2011) for more detail.

[11] Those in the lowest income quartile will be more likely to benefit from Medicaid while those in the highest income quartile are more likely be able to self-insure the risk without a catastrophic impact on their future retirement income.

[12] Utkus and Bapat (2011) analyzed defined contribution plan participants at Vanguard and found that five-year returns (2005-2010) for single target-date investors ranged from 3.62 percent to 4.65 percent per year for the 5th and 95th percentiles with a mean of 3.93 percent. Among participant-directed funds, five-year returns ranged from -0.02 percent to 8.09 percent per year for the 5th and 95th percentiles with a mean of 3.76 percent.

[13] VanDerhei, Holden, Alonso and Bass (2011).

[14] It should be noted that some plan sponsors may have turned to their 401(k) plans as a means of freeing up cash flow that is required for their legally required minimum contributions to defined benefit plans. A review by Salisbury and Buser (2009) of 251 401(k) plan sponsors that have suspended matching contributions for their approximately 4.4 million workers finds that those employing 50 percent of the workers also maintained an open defined benefit plan. An additional 16 percent of workers were with employers that were still obligated to fund a frozen defined benefit plan. Further, 8 percent of the workers were with an employer that had both an open and a frozen defined benefit plan that carried funding obligations.

[15] Twelve hundred 401(k) plan sponsors were randomly selected to complete the 401(k) Questionnaire via a secure website.

[16] More refined analysis is currently underway to link the 2006 and 2007 contributions on a plan-specific basis and filter out mid-year suspensions.

[17] All plans were still active as of year-end 2008.

[18] The proxy was plan aggregate employer contributions divided by employee contributions for 2007. This is obviously only a rough proxy and will be inaccurate to the extent nonelective contributions exist for the plan and/or employees contribute in excess of the maximum amount needed to obtain the full match. This analysis is currently being refined using year-end 2010 data.

[19] It should be noted that this analysis was done using both new contributions and investment return to offset the investment losses experienced during the market crisis. Based on an analysis of more than 3 million participants from more than 2,000 plans, Utkus and Young (2011) found that the median rise in account balances between December 2007 and December 2010 was 31 percent. A subsequent analysis of nearly 2 million participants during the same time period by Utkus and Bapat (2011) showed a positive average annual total return (0.11 percent). The latter were based on investment results alone – before considering the effect of contributions.

[20] While 65 seems to still be a societal norm, even Social Security has now adopted a later age for full benefits.

[21] VanDerhei and Copeland (2011). A future version of the model will include the ability to model retirement ages prior to Medicare eligibility.

[22] It is important to note that this models *all U.S. workers*. As a result, the balances will be significantly smaller than simulation models of those *current 401(k) participants* (Holden and VanDerhei, 2002) or those eligible for participation (Holden and VanDerhei, 2005).

[23] The simulation model analyzes how success changes with:

- The maximum level of employee contributions allowed by the plan sponsor (6, 9, 12 and 15 percent of compensation).
- The annual increase in contributions (1 vs. 2 percent of compensation).
- Whether employees are assumed to opt out of the automatic escalation.
- Whether employees are assumed to remember/retain their previous level of contributions when they change jobs vs. reverting back to the plan's initial default.

[24] VanDerhei (September 2011).

[25] Gale (2011).

[26] The analysis for the Senate Finance Committee hearing modeled the following scenarios:

- Employer contributions are modified in such a manner that the total match (employer plus government match) remains constant.
- All plan sponsors drop the plan match, and all employees receive a 30 percent match from the government.
- All plan sponsors drop the plan match, and all employees receive an 18 percent match from the government.

In later EBRI analysis (VanDerhei, November 2011), the following scenarios were added:

- No plan sponsors drop the plan match, and all employees receive an 18 percent match from the government.
- No plan sponsors drop the plan match, and all employees receive a 30 percent match from the government.

[27] VanDerhei (September 2011). The 2011 RCS questions were fielded in January 2011 and therefore did not ask 401(k) participants about the specific provisions used in the September 2011 Gale proposal.

[28] This survey was conducted online within the United States by Harris Interactive commissioned by the Principal Financial Group from May 17–June 17, 2011. It surveyed 798 employee-benefit decision makers for companies with three to 1,000 employees that do offer defined contribution retirement plans. These decision makers were selected from a Principal Financial Group client list, and their data were not weighted.

[29] A similar question was asked with the 30 percent government match provision suggested in Gale, Gruber, and Orszag (2006).

[30] A similar question was asked for a 30 percent government match. However, follow-up information for those indicating an increase or decrease in contributions is not available.

[31] The results assumed none of the 401(k) participants were automatically enrolled in these retirement plans; instead, they presumed that workers' rate of contribution after the first year were driven primarily by age and income characteristics rather than tenure with the current employer, as they might be in auto-enrollment plans with an automatic escalation of worker contributions. The exclusion of auto-enrollment plans in this analysis was necessary given the current modeling assumption of no job change. It would be very difficult to provide an accurate analysis of the average percentage reductions in 401(k) balance under auto-enrollment if the plans included an automatic escalation provision. For example, if a participant's contribution rate had already been escalated to 8 percent of compensation at one employer, and upon job change was automatically enrolled into another 401(k) plan, would they "remember" their current rate of deferral and start deferring in the new plan at that rate, or would their contribution rate drop to the default rate of the new plan? Undoubtedly many 401(k) participants in this automatic enrollment situation follow the latter approach. As additional information becomes available on workers' behavioral responses to auto-enrollment, EBRI will update this analysis to provide a more robust model.

[32] See Holden and VanDerhei (2005).

[33] See VanDerhei and Copeland (2008).

[34] The full stochastic nature of the model will be included in future analysis.

[35] It is important to note that the annuitized accumulations in this analysis are from 401(k) contributions exclusively and do not include projected Social Security retirement benefits. This is in contrast to other EBRI research (e.g., VanDerhei and Lucas, November 2010) that includes both components. However, in the previous analysis, the experience of all workers (not just those who were currently 401(k) participants) was simulated and job change was allowed.

[36] These estimates compare quite favorably to those in Holden and VanDerhei (2002) when the difference between nominal and real replacement rates are considered. However, this is to be expected given the assumptions listed above (especially the lack of job turnover and therefore the suppression of cashouts prior to retirement).

[37] The baseline results in Figures 17 and 18 were simulated assuming the midpoint value for each category in the AllianceBernstein survey. Sensitivity analysis of this assumption is shown in Figures 3 and 4 of VanDerhei (March 2012) for the minimum reduction in account balances, and in Figures 5 and 6 of the same publication for the maximum reduction in account balances. The average percentage reductions in account value in Figure 3 vary from 3.1 to 19.7 percent (depending on income quartile) for 401(k) participants currently 26–35 under the minimum reduction scenario. Figure 5 shows that they vary from 8.8 to 24.4 percent (depending on income quartile) for 401(k) participants currently 26–35 under the maximum reduction scenario

[38] Under the baseline assumptions, the average percentage reduction in employee contributions for this group in response to the proposal is 14.3 percent. Account balances will also be reduced due to the plan-sponsor reaction.

[39] For example, a 40-year-old participant would need to have a tenure of at least 10 years with the current employer to be included in this analysis. Alternative specifications of minimum tenure were used with essentially the same results.

[40] See pages 10–11 of Miller (2011) for an example.

[41] Given the much larger simulated account balance reductions for smaller plans shown in Figure K, it is important to note that the plan-size distribution used in this simulation model is based on those found in the EBRI/Investment Company Institute (ICI) 401(k) database, not the universe of 401(k) plans. Evidence of the magnitude of possible statistical bias in this regard can be found in VanDerhei, Holden, Alonso and Bass (2011). The third panel of Figure 4 (page 8) in that publication shows the distribution of plans in the EBRI/ICI 401(k) database in 2010 vs. 2008 Department of Labor (DOL) Form 5500 for all 401(k) plans and suggests an under-representation of small plans for the EBRI/ICI 401(k) database. The plan-size variable was specified in terms of participants instead of assets, but a similar distribution would be expected in the latter case. If this is indeed the case, the RSPM estimates for overall average benefit reductions presented here would be expected to be smaller than those that would be evidenced by the full 401(k) universe.

[42] Andrews (1992); Even and Macpherson (1996); Basset, Fleming and Rodrigues (1998); Even and Macpherson (2005); Englehardt and Kumar (2007); GAO (1997); Kusko, Poterba and Wilcox (1998); Mitchell, Utkus and Yang (2007); Papke (1995) and Papke and Poterba (1995); Yakaboski (1994);

[43] The original matching contribution was 25 percent on the first 4 percent of pay contributed. It was replaced with an employer contribution equal to 4 percent of pay plus an annual profit-sharing contribution

[44] The average employee contribution rate fell by 0.65 percent of pay.

[45] Although the impact of matching contributions on employee contribution behavior has been studied extensively in voluntary enrollment 401(k) plans, there has been relatively little research on automatic enrollment plans at this point in time. Nesmith, Utkus and Young (2007) provide evidence that new employees hired under automatic enrollment 401(k) plans have participation rates nearly double those for new employees hired under voluntary enrollment 401(k) plans (86 percent versus 45 percent). However, they show that overall plan contribution rates under automatic enrollment fall because many new participants who would have voluntarily chosen a higher contribution rate remain at the low default levels. Additional research in this field has been conducted on a relatively small sample of 401(k) plans in Madrian and Shea (2001); Choi, Laibson, and Madrian (2004); and Choi, Laibson, Madrian, and Metrick (2006)

[46] This result is from a regression on a sample of all participants (whether contributing or not) for whom match rate and match level information was provided or derived. The regression model included age, tenure, salary, plan loan provision (yes/no), employer match rate, and employer match level variables to examine their effects on participant before-tax contribution rates.

[47] The EBRI/ICI 401(k) database has detailed individual participant records (including demographic information and contribution behavior) from more than 60,000 plans (VanDerhei, Holden, Alonso and Bass, 2011). However, because of strict confidentiality standards, no information on the plan sponsor's identity was included.

[48] Even for those plans without nonelective contributions, we found several participants with employer contributions that were not equal to the predicted amount based on the plan's matching formulas and the employee's before-tax or after-tax contributions, or both. This may be because of the 401(k) plan using a different definition of compensation than that contained in the database, and we attempted to control for this unknown effect by computing the difference between actual and predicted employer contributions (as a percentage of compensation) and excluding any participant with more than a 0.2% of compensation differential.

[49] See VanDerhei (July 2007).

[50] The percentage of defined benefit plan sponsors that indicated that they had already increased or planned to increase their employer match and/or nonmatching employer contribution to a defined contribution plan varied from 62 percent for those that had frozen the defined benefit plan in the last two years to 81 percent for those that planned to close the plan for new members in the next two years.

[51] As hypothesized in VanDerhei (July 2007), some employers that have discontinued accruals in the defined benefit plans may want to continue to have a very large percentage of their eligible employees participating each year. As shown in many industry studies, the participation rates among eligible young and low-income employees are significantly higher in general under 401(k) plans with an automatic enrollment feature.

[52] Similar levels applied to those defined benefit plans that were to be closed or frozen in the next two years.

[53] It is important to keep in mind that many of the plans will use a multi-tier formula (which is another reason why using simple averages of employer-to-employee contributions is problematic).

[54] The effective match rate is a measure of the total amount of employer's contribution via the matching formulae for the employee IF the employee contributes enough to receive the full match. This simultaneously controls for the match rate, the maximum amount matched, and the possibility of multiple-tiered formula. For example, an employer that matches 100 per-cent of the first 1 percent of compensation and 50 percent of the next 5 percent would have an effective match of: 1*1+.5*5 = 3.5 (percent of compensation).

[55] This is the sum of the effective match rate and the nonelective contribution rate.

[56] This material first appeared in VanDerhei and Copeland (July 2010).

[57] The nominal cost of these expenditures increases with component-specific inflation assumptions. See the appendix for more details.

[58] Net housing equity is introduced into the model in three different mechanisms (explained below).

[59] IRS tax tables from 2009 are used to compute the tax owed on the amounts received from defined benefit plans and Social Security (with the percentage of Social Security benefits subject to Federal Income Tax proxied as a function of the various retirement income components) as well as the individual account withdrawals.

[60] Roth IRA and 401(k) accounts are not used in this version of the model but will be incorporated into a forthcoming EBRI publication.

[61] Capital gains treatment is not used in this version of the model.

[62] VanDerhei and Copeland (2001).

[63] VanDerhei and Copeland (July 2002).

[64] VanDerhei and Copeland (December 2002).

[65] VanDerhei and Copeland (2003)

[66] VanDerhei (January 2004).

[67] VanDerhei (2005).

[68] VanDerhei (March 2006).

[69] VanDerhei (September 2006)

[70] VanDerhei and Copeland (2008).

[71] Copeland and VanDerhei (2010).

[72] VanDerhei (2009).

[73] VanDerhei (April 2010).

[74] VanDerhei and Copeland (2010).

[75] VanDerhei (September 2010).

[76] VanDerhei (October 2010a).

[77] VanDerhei (October 2010b).

[78] VanDerhei (February 2011).

[79] VanDerhei (April 2011).

[80] VanDerhei and Copeland (June 2011).

[81] VanDerhei (July 2011).

[82] VanDerhei (August 2011).

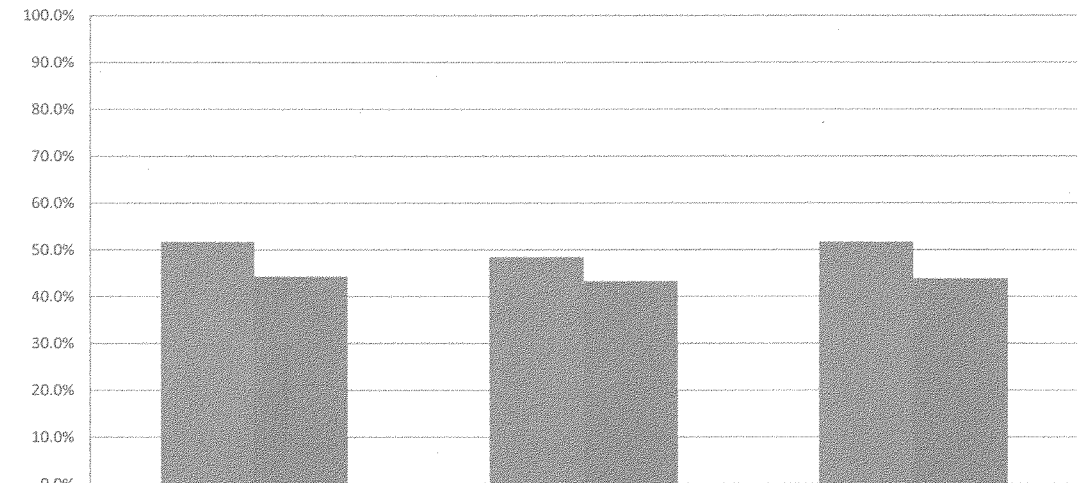
[83] VanDerhei (September 2011).

[84] VanDerhei (November 2011)

[85] VanDerhei (March 2012).

Figure 1

EBRI Retirement Readiness Rating™ (RRR): 2003 vs. 2012
(Status Quo for Social Security, Housing Equity Used "As Needed")
Percentage of population at risk* for inadequate retirement income, by age cohort (baseline assumptions)

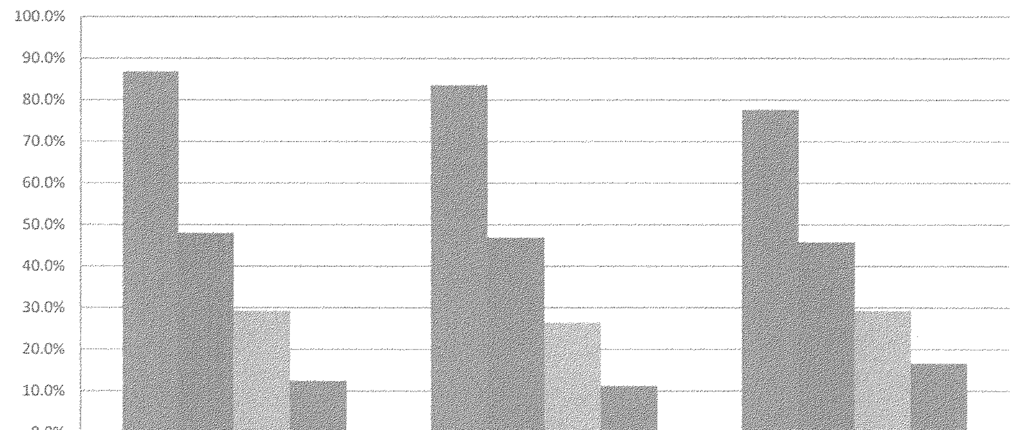


	Early Boomers	Late Boomers	Gen Xers
EBRI 2003 RRR	51.7%	48.5%	51.7%
EBRI 2012 RRR	44.3%	43.3%	43.9%

Sources: EBRI Retirement Security Projection Model™ versions 1501 and 1502.
* See text for definition of "at risk"

Figure 2

EBRI Retirement Readiness Rating™ (RRR): 2003 vs. 2012
(Status Quo for Social Security, Housing Equity Used "As Needed")
Percentage of population at risk* for inadequate retirement income, by age cohort and income quartile (baseline assumptions)

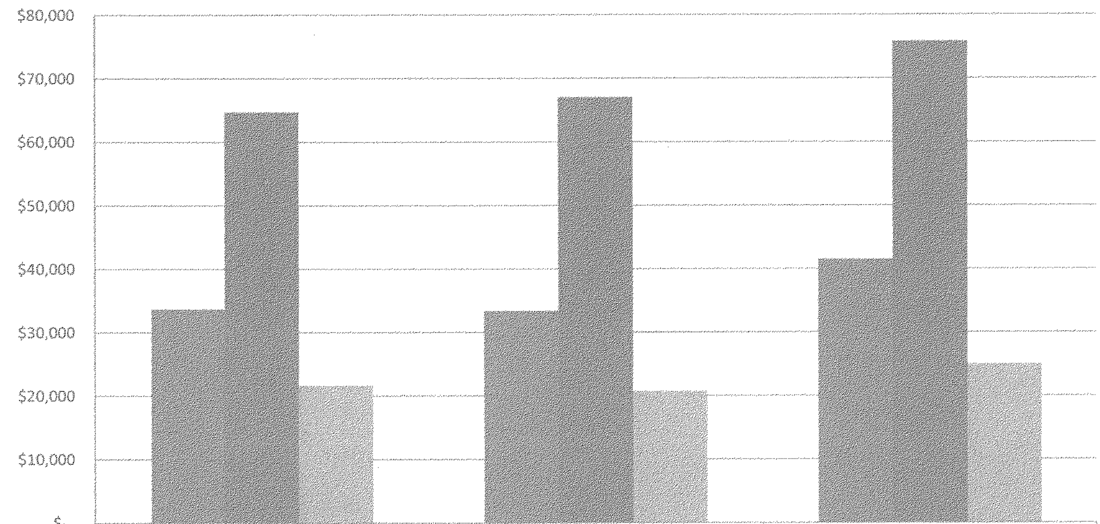


	Early Boomers	Late Boomers	Gen Xers
Lowest income quartile	86.8%	83.6%	77.7%
2	48.0%	46.9%	45.8%
3	29.3%	26.5%	29.3%
Highest income quartile	12.5%	11.2%	16.7%

Sources: EBRI Retirement Security Projection Model® versions 1501 and 1502.
* See text for definition of "at risk"

Figure 3

2012 Unconditional Retirement Savings Shortfall* numbers by age cohort, martial status and gender

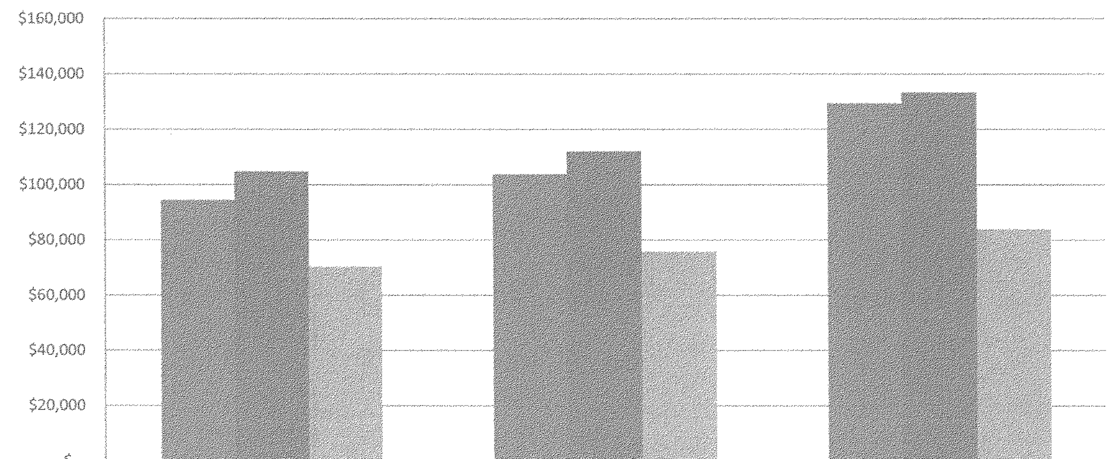


	Early Boomers	Late Boomers	Gen Xers
Single Male	$33,704	$33,420	$41,529
Single Female	$64,749	$67,057	$75,827
Married	$21,672	$20,738	$25,018

*The Retirement Savings Shortfalls (RSS) are determined as a present value of retirement deficits at age 65.
Sources: EBRI Retirement Security Projection Model® versions 1501 and 1502.

Figure 4

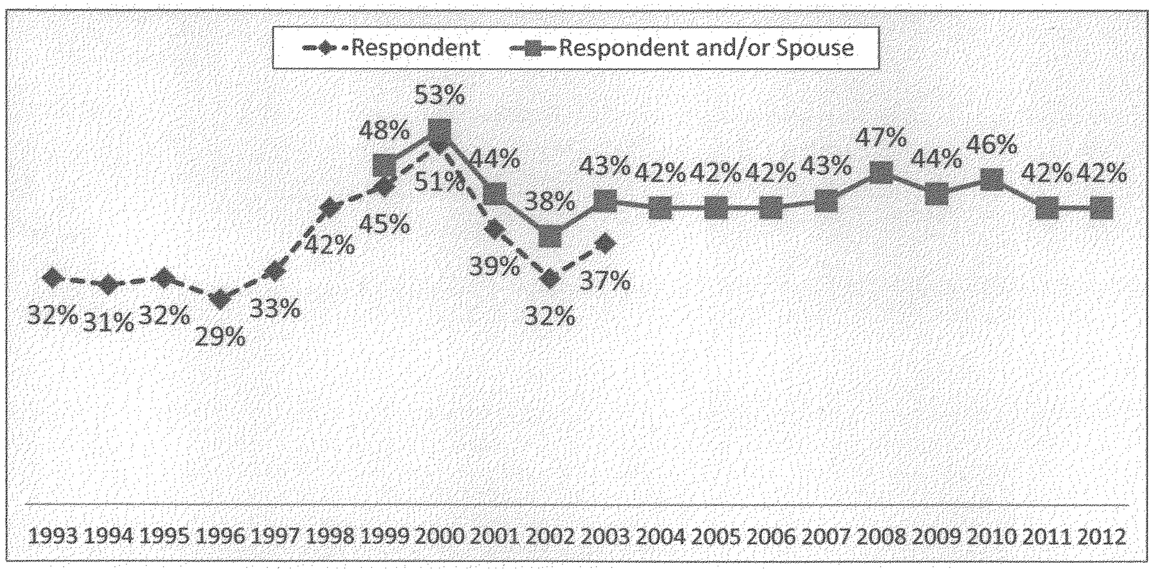
2012 Conditional Retirement Savings Shortfall* numbers by age cohort, martial status and gender



	Early Boomers	Late Boomers	Gen Xers
Single Male	$94,509	$103,918	$129,398
Single Female	$104,799	$112,120	$133,349
Family	$70,440	$75,849	$83,970

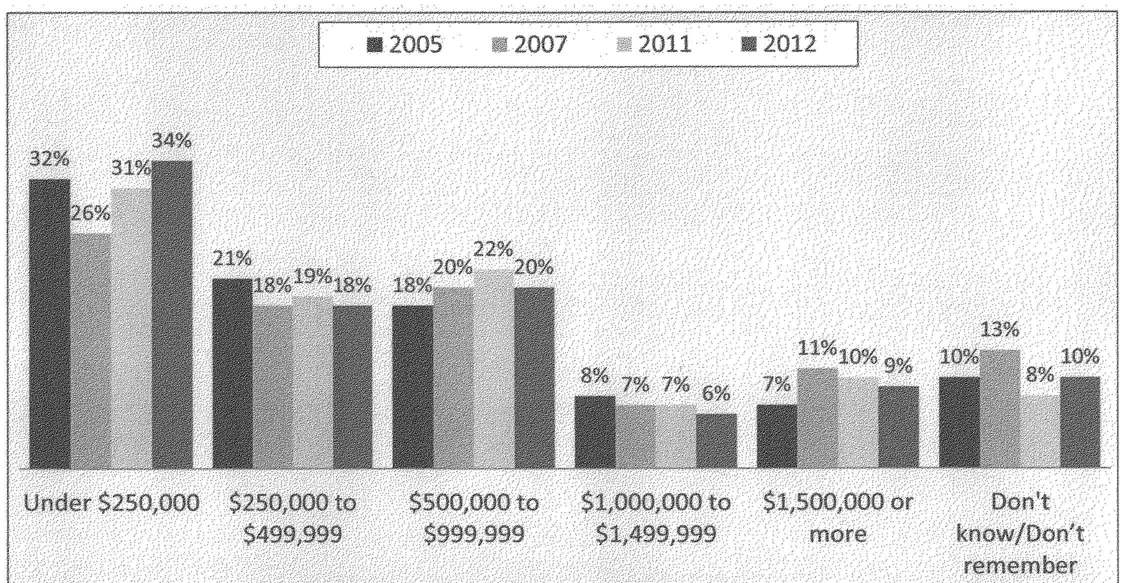
*The Retirement Savings Shortfalls (RSS) are determined as a present value of retirement deficits at age 65.
Sources: EBRI Retirement Security Projection Model® versions 1501 and 1502.

Figure 5
Workers Having Tried to Calculate How Much Money They Need to Save for a Comfortable Retirement



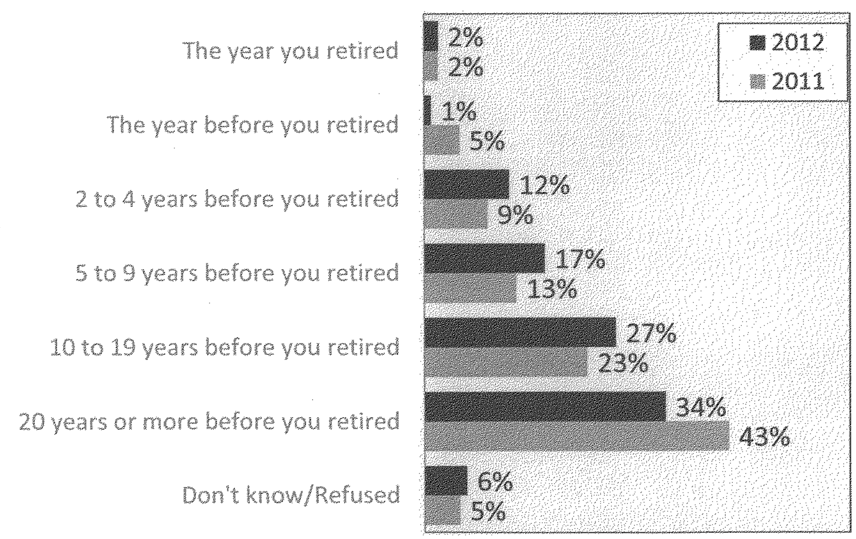
Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 1993–2012 Retirement Confidence Surveys.

Figure 6
Amount of Savings Workers Think They Need for Retirement



Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2005–2012 Retirement Confidence Surveys.

Figure 7
Timeframe When Retirees Began to Plan Financially for Retirement, Among Retirees Who Planned for Retirement

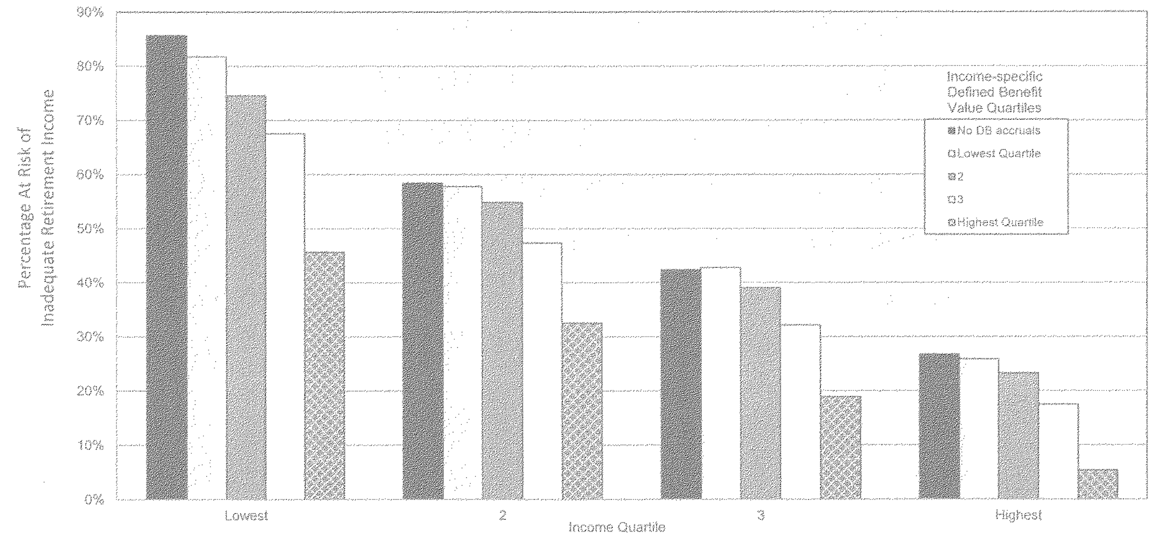


Source: Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2011–2012 Retirement Confidence Surveys. 3

Figure 8

Impact of Income and Relative Value of Defined Benefit Accrual at Retirement Age on At-Risk* Probabilities

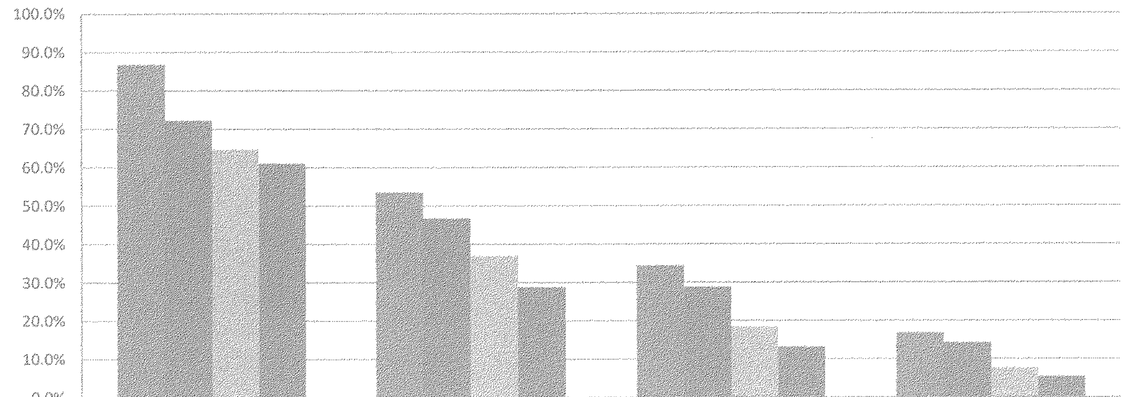
Percentage of population "at risk" for inadequate retirement income, by age-specific remaining career income quartiles and income-specific defined benefit value quartiles (baseline assumption)



Source: EBRI/ERF Retirement Security Projection Model® version 110714e.
* An individual or family is considered to be "at risk" in this version of the model if their aggregate resources in retirement are not sufficient to meet aggregate minimum retirement expenditures defined as a combination of deterministic expenses from the Consumer Expenditure Survey (as a function of income) and some health insurance and out-of-pocket health-related expenses, plus stochastic expenses from nursing home and home health care expenses (at least until the point they are picked up by Medicaid). The resources in retirement will consist of Social Security (either status quo or one of the specified reform alternatives), account balances from defined contribution plans, IRAs and/or cash balance plans, annuities from defined benefit plans (unless the lump-sum distribution scenario is chosen), and (in some cases) net housing equity (either in the form of an annuity or as a lump-sum distribution). This version of the model is constructed to simulate "basic" retirement income adequacy; however, alternative versions of the model allow similar analysis for replacement rates, standard-of-living, and other ad hoc thresholds.

Figure 9

Impact of future years of 401(k) eligibility on 2012 at-risk* ratings for Gen Xers by income quartile



	Lowest income quartile	2	3	Highest income quartile
0	86.8%	53.6%	34.4%	16.8%
1-9	72.3%	46.8%	28.8%	14.3%
10-19	64.7%	37.0%	18.4%	7.6%
20+	61.1%	28.8%	13.2%	5.4%

*An individual is considered to be at-risk in this version of the model if their aggregate resources in retirement are not sufficient to meet aggregate minimum retirement expenditures defined as a combination of deterministic expenses from the Consumer Expenditure Survey (as a function of income) and some health insurance and out-of-pocket health-related expenses, plus stochastic expenses from nursing home and home health care expenses (at least until the point they are picked up by Medicaid). The resources in retirement will consist of Social Security (either status quo or one of the specified reform alternatives), account balances from defined contribution plans, IRAs and/or cash balance plans, annuities from defined benefit plans (unless the lump-sum distribution scenario is chosen), and net housing equity (in the form of a lump-sum distribution). This version of the model is constructed to simulate "basic" retirement income adequacy; however, alternative versions of the model allow similar analysis for replacement rates, standard-of-living and other thresholds.

Source: EBRI Retirement Security Projection Model,® Version 120201.

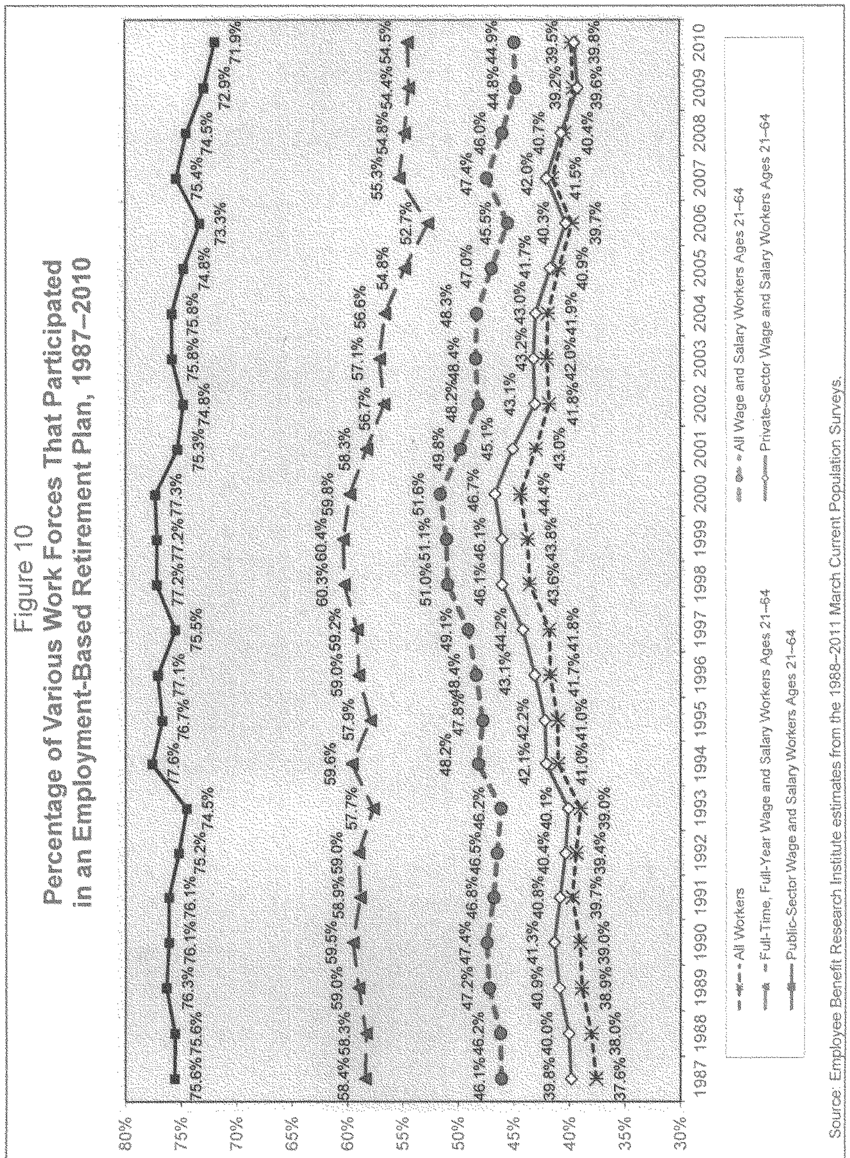
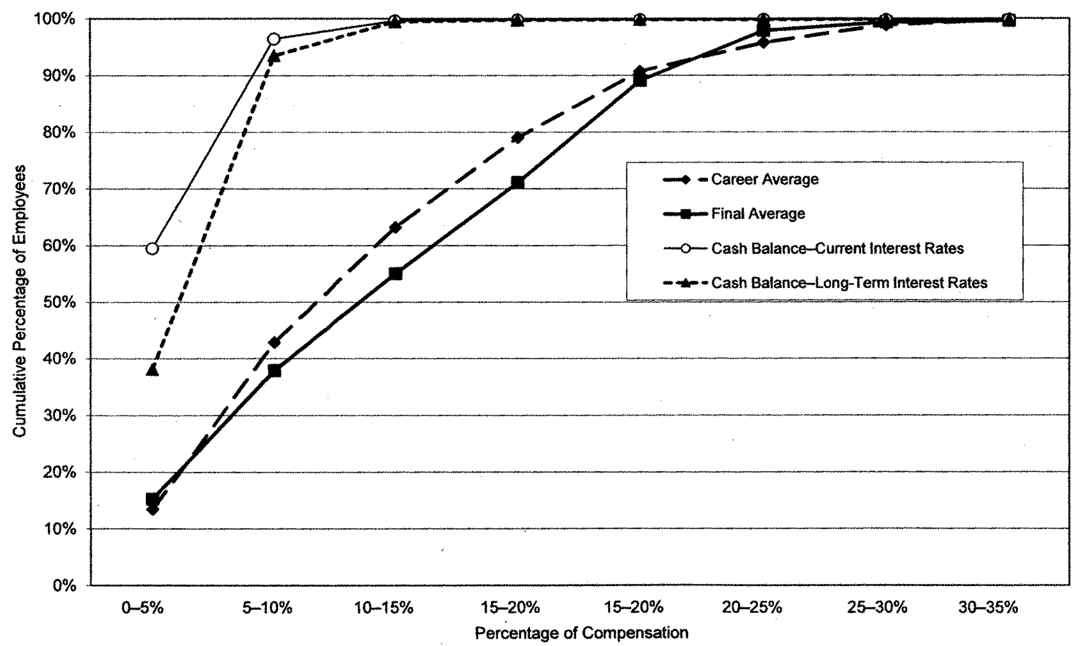


Figure 10
Percentage of Various Work Forces That Participated
in an Employment-Based Retirement Plan, 1987–2010
All Workers
Full-Time, Full-Year Wage and Salary Workers Ages 21–64
Public-Sector Wage and Salary Workers Ages 21–64
All Wage and Salary Workers Ages 21–64
Private-Sector Wage and Salary Workers Ages 21–64
Source: Employee Benefit Research Institute estimates from the 1988–2011 March Current Population Surveys.

Figure 11
Cumulative Distribution Function of the Percentage of a Worker's Annual Pay Needed to Offset the Impact of a Pension Freeze in 2006, by Pension Plan Type
(assumes 4% annual rate of return)

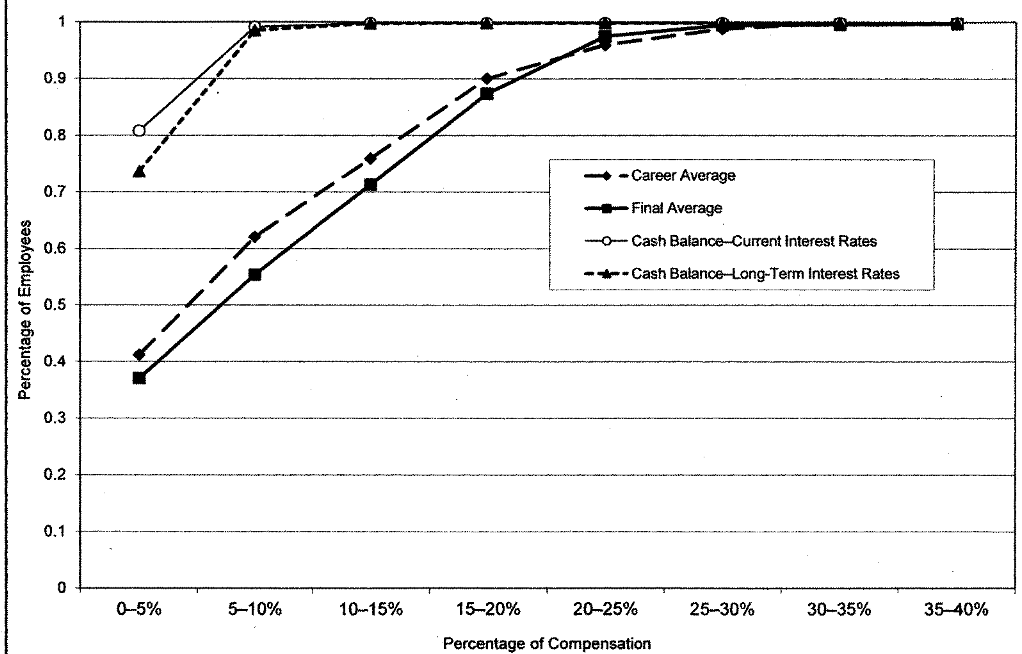


Source: Author's tabulations from the EBRI/ERF Retirement Income Projection Model.

Figure 12

Cumulative Distribution Function of the Percentage of a Worker's Annual Pay Needed to Offset the Impact of a Pension Freeze in 2006, by Pension Plan Type

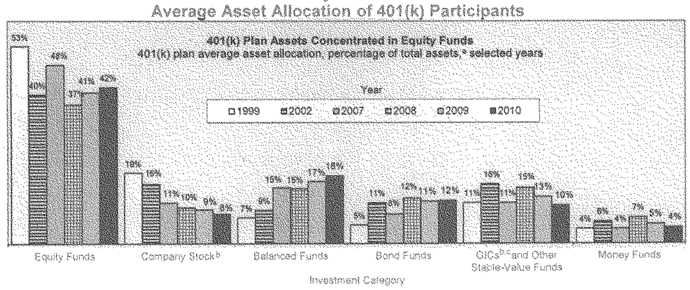
(assumes 8% annual rate of return)



Source: Authors' tabulations from the EBRI/ERF Retirement Income Projection Model.

Figure 13

Average Asset Allocation of 401(k) Participants



Source: Tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project.

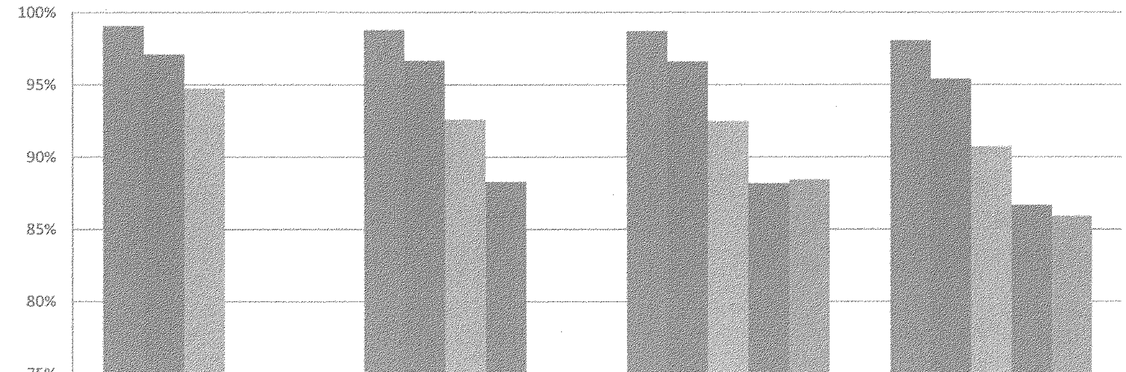
[a] Minor investment options are not shown, therefore, percentages do not add to 100 percent. Percentages are dollar-weighted averages.

[b] Not all participants are offered this investment option.

[c] GICs are guaranteed investment contracts.

Note: "Funds" include mutual funds, bank collective trusts, life insurance separate accounts, and any pooled investment product primarily invested in the security indicated.

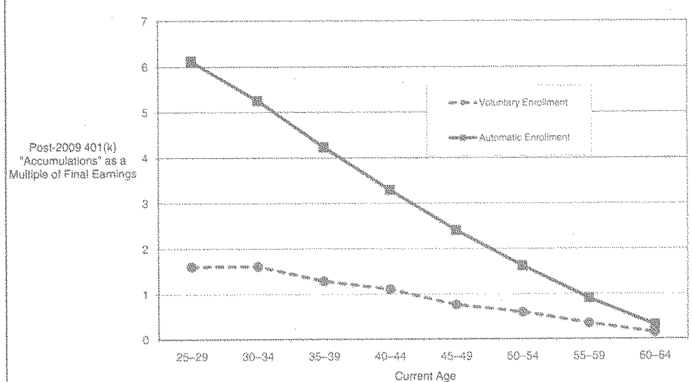
Figure 14
Estimated percentage of consistent participants who have more money in their 401(k) accounts on 3/1/12 than at market high (10/9/07,) by age and tenure



	26-35	36-45	46-55	56-65
1-4	99%	99%	99%	98%
5-9	97%	97%	97%	95%
10-19	95%	93%	92%	91%
20-29		88%	88%	87%
30+			88%	86%

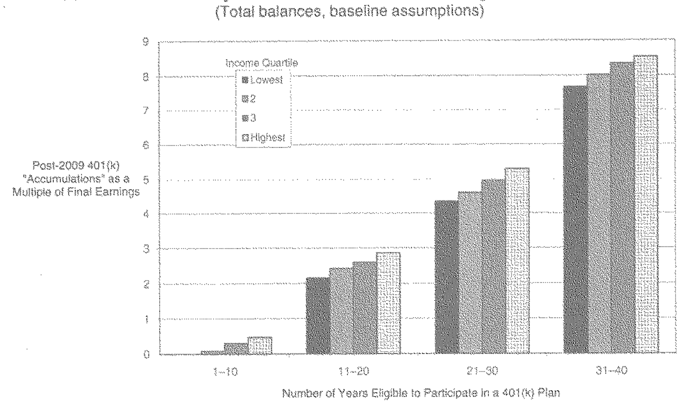
Sources: EBRI estimates based on tabulations from EBRI/ICI Participant-Directed Retirement Plan Data Collection Project. The analysis is based on all participants with account balances at the end of 2007 and 2008 and contribution information for those years.

Figure 15
Auto-Enrollment (With 2009 Formulae)
vs. Voluntary Enrollment (With 2005 Formulae): 50th Percentiles
(assuming future eligibility is a function of current eligibility)



Source: EBRI/ERF Retirement Security Projection Model,® versions 100205a1 and 100205b1. See text for explanations of models and assumptions.

Figure 16
Employees Currently Ages 25–29:
Median 401(k) Accumulation Multiples for Auto-Enrollment With 2009 Plan Formulae
as a Function of Salary Quartile and Number of Years Eligible for a 401(k) Plan
(Total balances, baseline assumptions)

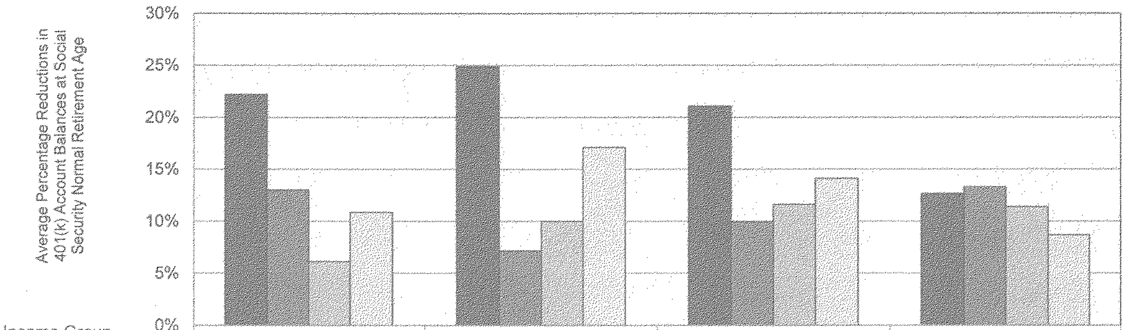


Source: Source: EBRI/ERF Retirement Security Projection Model,® version 100205a4 . See text for explanations of models and assumptions.

Figure 17

Simulated Impact of Proposal to Modify the Federal Tax Treatment of Employer and Employee Contributions for 401(k) Plans In Exchange for an 18% Match From the Federal Government, by Age and Age-specific Salary Quartiles: Midpoint estimates

Assumption for this run: Employer increases or decreases to contributions are represented by the midpoint of the range denoted on the AllianceBernstein survey



Income Group	26–35	36–45	46–55	56–65
Lowest income quartile	22.2%	24.9%	21.1%	12.7%
2	13.0%	7.2%	9.9%	13.3%
3	6.1%	10.0%	11.6%	11.4%
Highest income quartile	10.8%	17.1%	14.1%	8.7%

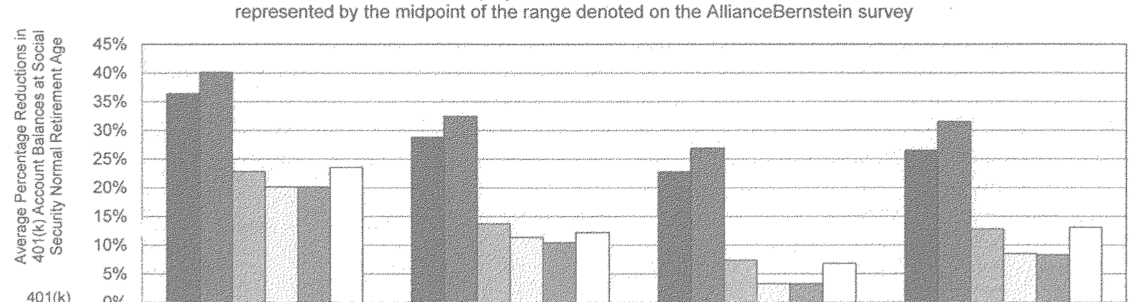
Source: Author's calculations based on results from EBRI Retirement Security Projection Model Version 1471, and responses to AllianceBernstein (2011) and Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2012 Retirement Confidence Survey.

Note: This simulation models only the financial impact of the expected reduction in 401(k) account balances for employees who are not automatically enrolled by modifying the behavior of plan sponsors and participants and does not attempt to assess behavioral modifications on the part of eligible nonparticipants. The simulated rates of return are the same as in VanDerhei and Copeland (July 2010). This version of the analysis assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in a future analysis. Results for participants currently older than 35 are limited to high-tenure participants as explained in the text. Plan sponsor and participant reactions to the proposal are explained in the text. Employer increases or decreases to contributions are represented by the midpoint of the range denoted on the AllianceBernstein survey.

Figure 18

Simulated Impact of Proposal to Modify the Federal Tax Treatment of Employer and Employee Contributions for 401(k) Plans In Exchange for an 18% Match From the Federal Government for Employees Currently 26–35, by Plan Size and Age-specific Salary Quartiles: Midpoint Estimates

Assumption for this run: Employer increases or decreases to contributions are represented by the midpoint of the range denoted on the AllianceBernstein survey

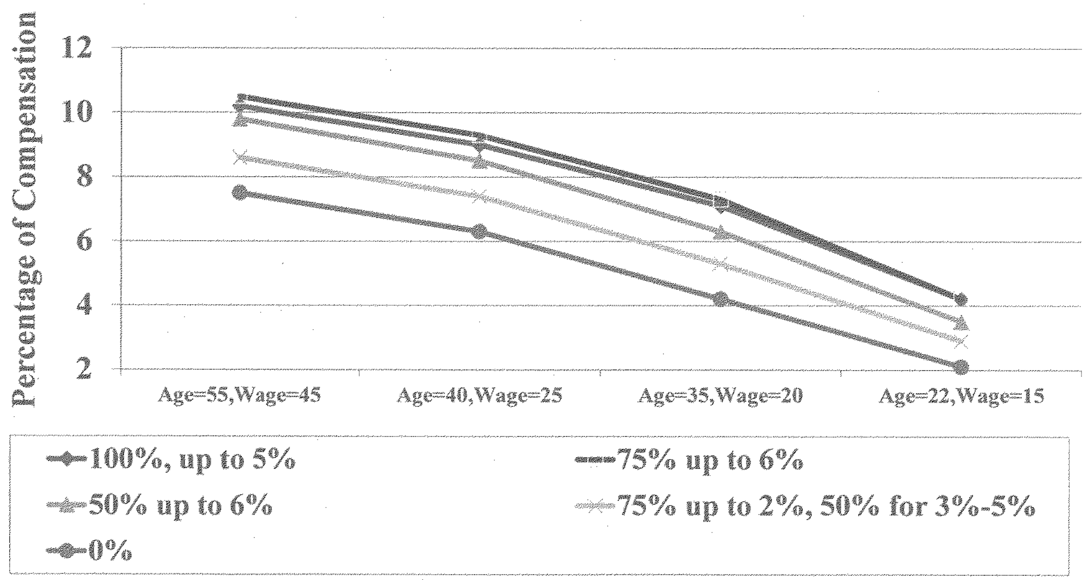


401(k) Plan Size	Lowest income quartile	2	3	Highest income quartile
<1M	36.4%	28.8%	22.8%	26.5%
1–10M	40.1%	32.4%	26.9%	31.5%
10–50M	22.8%	13.7%	7.4%	12.8%
50–250M	20.2%	11.4%	3.3%	8.5%
250–500M	20.2%	10.4%	3.2%	8.3%
>500M	23.5%	12.2%	6.8%	13.1%

Source: Author's calculations based on results from EBRI Retirement Security Projection Model Version 1472, and responses to AllianceBernstein (2011) and Employee Benefit Research Institute and Mathew Greenwald & Associates, Inc., 2012 Retirement Confidence Survey.
Note: This simulation models only the financial impact of the expected reduction in 401(k) account balances for employees who are not automatically enrolled by modifying the behavior of plan sponsors and participants and does not attempt to assess behavioral modifications on the part of eligible nonparticipants. The simulated rates of return are the same as in VanDerhei and Copeland (July 2010). This version of the analysis assumes no job turnover, withdrawals or loan defaults. The full stochastic nature of the model will be included in a future analysis. Plan sponsor and participant reactions to the proposal are explained in the text. Employer increases or decreases to contributions are represented by the midpoint of the range denoted on the AllianceBernstein survey.

Figure 19

Predicted Employee Contributions for Selected Persons and Plans



Source: VanDerhei and Copeland, "A behavioral model for predicting employee contributions to 401(k) plans." North American Actuarial Journal (First Quarter, 2001)

Testimony of James G. Rickards
Senior Managing Director, Tangent Capital Partners LLC, New York, NY

Before the Subcommittee on Economic Policy
Committee on Banking, Housing & Urban Affairs
United States Senate
March 28, 2012

Written Statement

Retirement (In)security: Examining the Retirement Savings Deficit

Introduction

Mr. Chairman, Mr. Ranking Member and members of this Subcommittee, my name is James Rickards, and I want to extend my deep appreciation for the opportunity and the high honor to speak to you today on a subject of the utmost importance to the financial well being of scores of millions of Americans. The Subcommittee on Economic Policy has a long and distinguished history of examining the validity and efficacy of policies pursued by the Congress, the Administration and government agencies. In the wake of a stock market collapse in 2000, a housing market collapse in 2007 and a banking collapse in 2008, government policy choices to repair the damage have never been more important. Everyday Americans are frightened, confused and in many cases angry at the results of government stewardship of economic policy. A proper understanding of the impact of policy is critical and this Subcommittee is well placed to advance that understanding.

As a brief biographical note, I am an economist, lawyer and author and currently work at Tangent Capital in New York City where I specialize in capital raising and alternative investing. My colleagues and I provide expert analysis of global capital markets to investors, fund sponsors and government agencies. My writings and research have appeared in numerous journals and I am an Op-Ed contributor to the Financial Times, Washington Post and New York Times and a frequent commentator on CNBC, CNN, Fox, NPR and Bloomberg. My recent book, *Currency Wars: The Making of the Next Global Crisis* is a national bestseller.

Summary: The Problem with the Fed's Zero Rate Policy

The Federal Reserve began to cut interest rates in 2007 in response to a financial crisis resulting from a collapse in housing values. The Fed Funds rate was lowered from 5.25% in August, 2007 to effectively zero by December 2008 and it has remained at that level ever since. The Fed has declared an intention to keep short-term interest rates at this near-zero level through late 2014. If this intention is fulfilled, the entire course of the zero rate policy will have lasted six years, an unprecedented and extraordinary policy move on the part of the Fed.

The Fed's rationale for this policy has gone largely unexamined and unchallenged. Seasoned economists and everyday Americans have deferred to the Fed's expertise and have trusted the Fed to do the right thing to fix the economy in the aftermath of the Panic of 2008. The view is that Chairman Bernanke knows best and debate is unnecessary.

It should come as no surprise that an unprecedented policy should have unprecedented and unexpected results. There is ample evidence that the Fed's policy has failed to achieve its goals and is leaving the U.S. economy worse off when compared to a more normalized interest rate regime.

The principal victims of the Fed's policies are those at or near retirement who face a Hobson's Choice of gambling in the stock market or getting nothing at all. A summary of these deleterious effects on retirement income security, explained in more detail below, includes the following:

- *Increasing income inequality.* Zero rate policy represents a wealth transfer from prudent retirees and savers to banks and leveraged investors. It penalizes everyday Americans and rewards bankers, hedge funds and high-net worth investors.

- *Lost purchasing power.* Zero rate policy deprives retirees and those nearing retirement of income and depletes their net worth through inflation. This lost purchasing power exceeds $400 billion per year and cumulatively exceeds $1 trillion since 2007.

- *Sending the wrong signal.* Zero rate policy is designed to inject inflation into the U.S. economy. However, it signals the opposite – Fed fear of *deflation*. Americans understand this signal and hoard savings even at painfully low rates.

- *A hidden tax.* The Fed's zero rate policy is designed to keep nominal interest rates below inflation, a condition called "negative real rates". This is intended to cause lending and spending as the real cost of borrowing is negative. For savers the opposite is true. When real returns are negative the value of savings erodes – a non-legislated tax on savers.

- *Creating new bubbles.* The Fed's policy says to savers, in effect, "if you want a positive return invest in stocks." This gun to the head of savers ignores the relative riskiness of stocks versus bank accounts. Stocks are volatile, subject to crashes, and not right for many retirees. To the extent many are forced to invest in stocks, a new stock bubble is being created which will eventually burst leaving many retirees not just short on income but possibly destitute.

- *Eroding trust and credibility.* Economics has been infused in recent decades with the findings of behavioralists and social scientists. While this social science research is valid, the uses to which it is put are often manipulative and intended to affect behavior in ways deemed suitable by Fed policy makers. This approach ignores feedback loops. As retirees realize the extent of market manipulation by the Fed they lose trust in government more generally.

The effects on retirees and retirement income security are both the intended and unintended results of the Fed's efforts to revive the economy through a replay of the debt-fueled borrowing and consumption binges of the past fifteen years. Beginning with Fed rate cuts in 1998, which fueled the tech stock boom-and-bust, through the rate cuts of 2001, which fueled the housing bubble, until today the Fed has resorted to repetitive bouts of cheap money for extended periods. This monetary ease has found its way into inflated asset values that in turn provided collateral for debt-driven consumption. These binges drove the economy until the inevitable asset bubble collapses caused a contraction in consumption and launched another cycle. At no time were savers rewarded for prudence.

Solutions are straightforward. The Fed should raise interest rates immediately by a modest amount of one-half of one percent and signal that other rate increases will be coming. The White House and Treasury should signal that they support the Fed's move and support a strong dollar as well. The Fed and Treasury could commit to facilitate the conversion of savings into private sector investment by closing or breaking-up too big to fail banks whose balance sheets are littered with distressed assets. This will facilitate the creation of clean new banks capable of making commercial and industrial loans to small businesses and entrepreneurs.

The result, over time, would be to replace a consumption and debt driven economy with a savings and investment driven economy that rewards prudence and protects the real value of the hard earned assets of retirees and near-retirees.

The Goal of Federal Reserve Policy – Inflation and Financial Repression

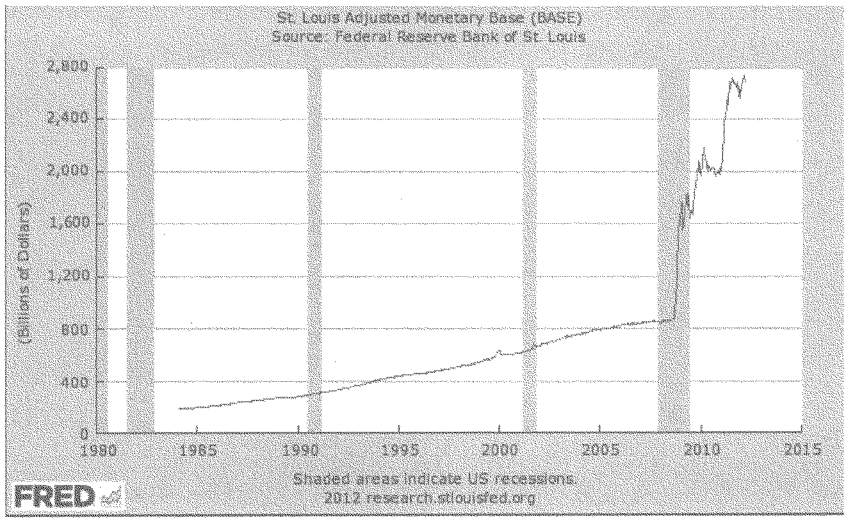
Federal Reserve policy today is driven by fear of deflation and its consequences. Deflation raises the real value of debt, which increases the burden on debtors and eventually leads to defaults and acute stress on the banking system. Individuals and institutions increase cash holdings since the value of cash increases in deflation. This creates a liquidity trap and can cause economic activity of all kinds to slow sharply.

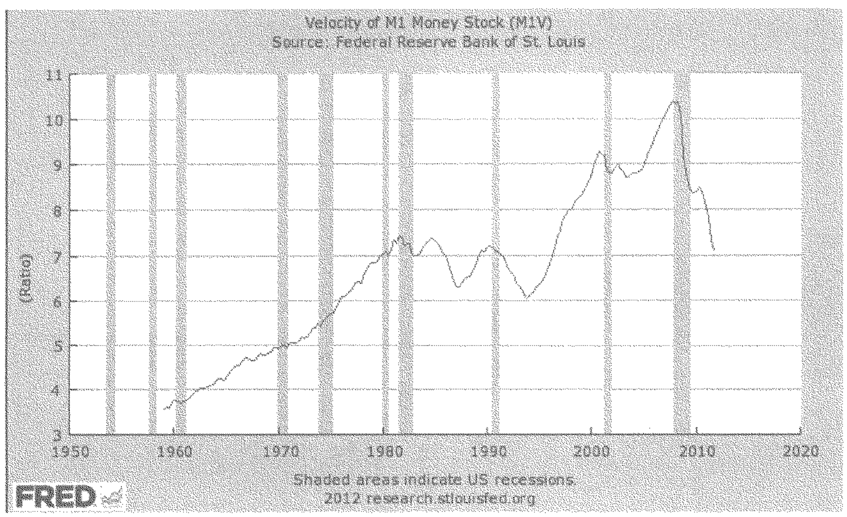
The Fed insists this deflationary dynamic must be avoided at all costs in a healthy economy. This was the lesson of the Great Depression of the 1930's as understood by Chairman Bernanke and other scholars.

If deflation is the enemy, it follows that the goal of policy is to create inflation. This is difficult to do because policy driven inflation is muted by the deflation that comes from deleveraging. Therefore, the Fed must go to progressively greater lengths to cause inflation. Measures include (a) cutting interest rates, ultimately to zero, (b) quantitative easing, i.e. printing new money through the purchase of securities, (c) extending the average maturity of the Fed's balance sheet by selling short-term securities and using proceeds to purchase longer-term securities and (d) importing inflation from abroad by cheapening the exchange value of the dollar to increase the price of imports, e.g. starting "currency wars."[1]

Beyond these inflation-inducing tools, the Fed manipulates the behavior of consumers and savers by setting expectations. Inflation can be identified as the excess of nominal growth in GDP over real growth. Nominal growth is the product of money supply times velocity or turnover of money. Real growth is constrained by workforce participation and the productivity of that workforce. To create inflation, the Fed must find some combination of increases in money supply and velocity that exceeds the growth in the workforce and its productivity.

The Fed can increase the base money supply almost at will. The Fed's problems begin with velocity. If the money supply is increasing but velocity is declining at the same rate, nominal GDP will not change at all. This is the dilemma the Fed has been facing for the past four years. As illustrated in the following charts[2] prepared by the Federal Reserve Bank of St. Louis, base money supply has more than tripled since 2008, however, velocity has plunged more than 30% in the same time period.





Monetary policy can therefore be understood as a "Great Race" between increasing money and declining velocity. The declining velocity greatly hinders the Fed's ability to pump up nominal GDP to the level needed to cause inflation.

The problem with velocity is that it is fundamentally a behavioral phenomenon. This means that the Fed cannot control velocity directly but only indirectly through the manipulation of expectations. Creating inflation that exactly meets expectations and roughly matches nominal interest rates creates no change in behavior because it is already priced into expectations.

The Fed must therefore attempt two things simultaneously. It must cause inflation that exceeds expectations in order to induce a kind of "shock effect" that might frighten consumers into spending more. It must also cause inflation that exceeds nominal interest rates so as to create negative real rates – a strong inducement to borrow money. This combination of negative real rates and an inflationary scare may induce the kind of lending and spending that expands the consumption component of GDP and gets the economy growing again.[3]

Another arrow in the Fed's quiver of ways to increase velocity is the so-called "wealth effect." The idea is that increasing levels of consumer wealth, reflected mainly in housing prices and stock prices, tend to produce the kind of consumer optimism that results in more spending and higher velocity. The Fed's efforts to prop up the housing market have produced modest results because of the sheer size of the mortgage debt that needs to be written off, the excess inventory of homes and the difficulty in obtaining mortgage loans given high unemployment and impaired credit scores.

The Fed's efforts to prop up the stock market have been more successful. The popular Dow Jones Industrial Average has almost doubled in the past four years. However, the hoped for behavioral impact of this new bubble has been muted because of relatively low participation by many individuals who lost a substantial portion of their retirement savings in the Panic of 2008 and have remained wary of the market ever since. This wariness was exacerbated by the still unexplained "flash crash" of May 2010.

None of this behavioral manipulation can be admitted freely because it clashes with the Fed's mandate to maintain price stability. More to the point, the Fed cannot acknowledge that its goal is inflation in excess of expectations because to do so would be to change those expectations which would lead to market driven adjustments in nominal rates and reduce the shock effect. This makes the Fed's goal of changed behavior and increased velocity more difficult to achieve.

In summary, the Fed's goals are to maintain nominal interest rates in the range of zero to 2% while seeking inflation in the range of 4%. The result will be negative real rates that encourage borrowing and an inflation scare that stimulates spending. The combination of lending and spending should increase velocity which, when combined with the already ample money supply, should expand nominal GDP in such a way as to ease the real burden of government debt and reduce the government debt-to-GDP ratio. This policy of slow, gradual inflation and negative real interest rates pursued over a ten to fifteen year period is considered an effective way to erase the burden of government debt without hyperinflation or default.

The academic name for this policy is "financial repression." [4] This policy of financial repression also involves the use of heavily regulated banks as captive buyers of government debt. The banks have relatively low capital requirements on their government securities holdings and use low cost deposits to fund those holdings. The resulting low risk leveraged spreads provide reasonably high returns on equity for the banks.

The Impact of Fed Policy on Retirement Income Security

The Fed's policy of financial repression, implemented in part through its current zero rate policy is based on flawed economic theory and represents an assault on savers for the benefit of bankers and other leveraged investors.

A neo-Keynesian school that places all of its bets on the idea of "aggregate demand" dominates the Fed's understanding of economics. Aggregate demand is the sum of spending of all kinds including consumption, investment (excluding inventories), government spending and spending on net exports. This spending can be fueled by income or debt.

When private spending is too low, government spending can be used as a substitute. When private incomes are too low, debt can be substituted for income. When private debt is too low, government debt can be substituted for private debt. In the neo-Keynesian view, government borrowing and spending step in when private borrowing and spending are inadequate to fill the potential aggregate demand in the economy.

Through its focus on aggregate demand, the Fed has lost sight of the role of savings in the economy and the powerful linkages between savings and investment. There is a real multiplier effect from private investment on GDP compared to the illusory multiplier effect of increased government spending.[5]

In the Fed's view, savings are the enemy of aggregate demand since any private savings represent a reduction in spending for a given level of income. The result is a war on savings.[6] The Fed's policy is to drive savers either to consume more due to wealth effects or fear of inflation or to invest in riskier assets such as stocks in order to earn returns in excess of inflation. The goal is either to increase velocity directly through consumption or indirectly through wealth effects. Retirees and savers who protest that inflation is eroding the real value of their savings are told, in effect, to invest in stocks if they want positive real returns.

Yet, retirement savings, represented by relatively safe instruments such as bank certificates of deposit, U.S. Treasury securities, high quality municipal bonds and certain money market funds are not interchangeable with stocks. Stocks are risky, occasionally illiquid, volatile and offer no promise of the preservation of capital. The mantra of "stocks for the long run" lies in ruins after the twelve-year stretch from December 1999 to December 2011 when leading stock indices showed no gains. Based on extreme global monetary ease, there is good reason to believe that strength in stock indices in 2012 is another bubble in the making that will leave investors in tears. In any case, stocks can be highly inappropriate for retirees who should be looking for preservation of capital and steady income to provide income security for the remainder of their lifetimes.

The economic damage being done to retirement income security by the Fed's zero interest rate policies includes:

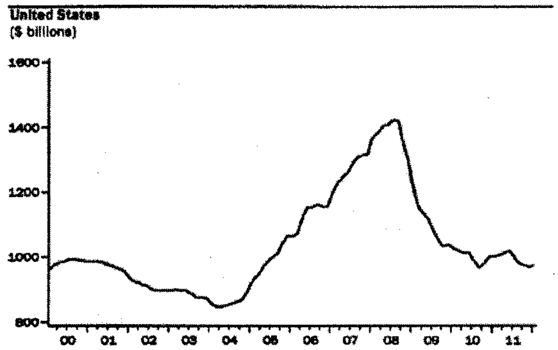
Increased income inequality. As inflation increases and nominal interest rates are held artificially low, the real value of retiree savings and the income produced by those savings declines. However, this decline in wealth and income is not shared by all. More sophisticated investors and those who are alert to the tell-tale signs of inflation can weather the storm by incurring debt or investing in hard assets that retain value in inflation such as land, fine art, precious metals and certain companies that own hard assets such as railroads, mines and utilities. These differing responses are the result of gaps in risk appetite and financial literacy.

Not all investors are created equal when it comes to an understanding of the dynamics at play and the opportunities for defensive investing. Indeed, many Americans, especially retirees, are all too trusting of the Fed's pledge to maintain price stability when, in fact, the Fed has reduced the purchasing power of the dollar by over 95% since its founding in 1913.

The Fed's easy retort is that incomes have more than kept pace with declining purchasing power. Yet this is only true on average. Americans are not uniformly average in their experience of inflation. There are winners and losers. In recent decades the winners have been a minority and the losers have been a majority with the result that relative income inequality in the United States as measured by the Gini Coefficient is at an all time high and approaching the levels of Mexico.[7] Retirees and those nearing retirement are the losers to the extent they seek to preserve capital and avoid risky assets.

Lost purchasing power. The Fed's war on savings is premised on the idea that savings represent a reduction in spending and therefore aggregate demand. This seems to ignore the lost spending from the diminished return on savings. The following chart prepared by Haver Analytics and Gluskin Sheff shows that personal interest income has fallen by over $400 billion per year and over $1 trillion in the aggregate since 2008 as a result of the Fed's zero rate policies.

CHART 2: PERSONAL INTEREST INCOME



Shaded regions represent periods of U.S. recession
Source: Haver Analytics, Gluskin Sheff

While not all of this lost income would necessarily have been spent, it seems likely that the propensity to spend would be large due to high unemployment and the diminished availability since 2008 of other sources of funds such as home equity loans. This lost income, once converted into spending, could have added significantly to GDP over the past four years and must properly be counted as an offset to whatever benefits the Fed claims for its zero rate policy. This lost income effect is especially hard on retirees who may lack other sources of income such as wages or business revenues.

Fed Policy Sends the Wrong Signal. As described above, the Fed is engaged in an effort to modify behavior by engineering negative real interest rates and an upside surprise in inflation. These are the primary justifications for its zero rate policies. However, the Fed's understanding of behavioral effects ignores second order effects and positive feedback loops.

President James Bullard of the Federal Reserve Bank of St. Louis pointed out this flaw in Fed policy in a seminal paper, "The Seven Faces of 'The Peril'" published in 2010.[8] Bullard posits a theoretical dual equilibrium in inflation expectations. One equilibrium points toward higher inflation and higher interest rates. The other equilibrium points toward deflation and lower interest rates.[9] The Fed intends that its zero rate policy through 2014 should ignite inflationary expectations.

In fact, everyday Americans discern the Fed's fear of *deflation* implicit in a zero rate and prepare for a deflationary outcome by increasing savings and reducing debt – exactly the opposite of the Fed's desired outcome. Although Bullard is a "dove" on monetary policy, he recommended consideration of an increase in interest rates precisely to tip expectations in the direction of inflation. Bullard's insightful analysis suggests that the Fed is its own worst enemy when it comes to stimulating the economy.

Inflation is a hidden tax on retirees and near-retirees. When the rate of inflation exceeds the rate that can be earned on savings, a situation that prevails today, the result is a diminution in the real value of those savings. Inflation that exceeds the rate of return by 2% will cut the real value of those savings by 75% in an average lifetime. Inflation that exceeds the rate of return by 4% will cut the value of those savings in half between the time a girl is born and when she goes to college. Rates of inflation of 2% or 4% are not benign, they are cancerous.

To hear Chairman Bernanke talk about how he targets 2% inflation but would not be surprised if actual inflation "...might move away from...desired levels...", as he did in response to a reporter's question at a recent press conference, is to witness a gun held to the head of savers in America.[10] This destruction of real wealth by government fiat for the benefit of banks is no different than a tax used to redistribute wealth from targets to beneficiaries.

Inflation is even better than a tax from a political perspective because it requires no debate, no legislation and no accountability. It requires only the persistence of the Board of Governors of the Federal Reserve in the service of illusory wealth effects and negative real interest rates. Retirees and near-retirees understand inflation for the tax it is.

Creating New Asset Bubbles. Real wealth, including wealth in the form of stock prices, comes from innovation, entrepreneurship, hard work, risk taking, savings and investment. It does not come from printing money. The Fed's efforts to inflate stock prices in pursuit of wealth effects by printing money and manipulating expectations to increase velocity cannot by itself create wealth but can temporarily inflate asset prices into periodic bubbles.

Asset bubbles have a feel-good quality while they are being inflated and can temporarily mitigate the worst effects of deflation and deleveraging in the wake of panics and crashes. Yet, in the end, they lead to new panics and crashes and the destruction of bubble "wealth" and real wealth besides. The damage done by the Panic of 2008 has resulted in millions of Americans withdrawing from the stock market in order to protect wealth even if it means negative real returns. Recent advances in stock market prices have proceeded with relatively low volume and narrower participation than past advances.

The longer this persists, the more likely retirees will succumb to the temptation to seek positive real returns in the stock market rather than remain in relatively safe investments. This shift will likely coincide with the final phase of the bubble to be followed by another collapse and loss of more retirement savings. There is nothing wrong with investing in stocks that grow based on long-term fundamentals. Yet, stocks are an ill-advised investment for retirees for so long as stock values are the plaything of Fed officials engaged in behavioral experiments.

Erosion of Trust and Credibility. The most pernicious effect of Fed policy on retirees and near-retirees is a lost of trust in the Fed itself. The Fed controls interest rates. It influences the exchange value of the dollar. It intervenes to control stock prices. It does so not in pursuit of its mandate of price stability but in pursuit of the behavioral chimeras of velocity, wealth effects and expectations.

This is not too difficult for everyday Americans to understand despite the advance applied mathematics and arcane jargon in which such interventions are couched. Again, the outcome is the opposite of what the Fed intends. Instead of increased lending and spending, the Fed is confronted with increased confusion, fear and anger. The result is that scores of millions of Americans try to preserve wealth as best they can through deleveraging and liquid savings even at the risk of wealth erosion due to the Fed's zero rate policies.

Reward Savers and Those near Retirement - Don't Penalize Them

It is a false dilemma to suppose that monetary policy is a choice between encouraging savings, which reduces aggregate demand, and discouraging savings to increase aggregate demand through consumption or wealth effects. In a well-functioning banking system, savings can be a source of real returns for savers *and* a source of aggregate demand through investment.

As late as the 1980's, large money-center commercial banks operating through syndicates made five-to-seven year commercial and industrial loans to finance massive private sector investments in projects like the Alaska pipeline, fleets of Boeing 747 aircraft, railroad rolling stock and other critical infrastructure. These projects were financed in large part with the savings of everyday Americans including retirees. Savers received a positive return on their money and the banks made good spreads and fees on the lending business. The government was not in the business of picking winners and losers although the government did create a favorable investment climate with accelerated depreciation and investment tax credits on qualified assets.

The 1980's were the apogee of sound policy. With Paul Volcker at the Fed and Ronald Reagan as president, Americans could count on sound money, less government intrusion in the investment process and a favorable business environment. America was open for business and was a destination for savings from around the world.

Today the United States does not have a well functioning banking system because of repeated regulatory failures by the Fed and other agencies since the repeal of Glass-Steagall in 1999 and the repeal of derivatives regulation in 2000. The conveyor belt between savings and investment traditionally provided by banks is broken.

With the repeal of Glass-Steagall in 1999 and derivatives regulation in 2000, the door was open to break down the traditional banking functions and allow banks to become highly leveraged machines for securitization and proprietary trading.

Securitization breaks the bond between lender and borrower because the bank cares only about selling the loans not collecting on them at maturity. This destroys the incentive to allocate capital to the most productive long-term uses. Proprietary trading induces banks to trade against their own customers to the detriment of long-term banker-client relations. These conflicts and short-term perspectives came to a disastrous conclusion in the Panic of 2008. Productive private sector investment and capital formation have been the victims.

It is not too late to turn back from the Fed's ruinous policies. The path to improved income security for retirees and near retirees consists of:

- Raising interest rates in stages to provide positive real returns to savers.

- Banning over-the-counter derivatives that serve no role in capital formation but greatly increase systemic risk.

- Breaking up too big to fail banks that pose systemic risk.

- Offering real price stability. Two percent inflation is not benign, it is cancerous.

- Create a favorable investment and growth climate by ending regime uncertainty in areas such as taxes, healthcare, regulation and other government impositions.

The United States, indeed the world, is mired in a swamp of seemingly unpayable debt. In these circumstances, there are only three ways out – default, inflation and growth. The first is unthinkable. The second is the current path of the Fed although it can only be pursued in stealth. The third is the traditional path of the American people. Growth does not begin with consumption, it begins with investment. Only when private productive investment is encouraged and pursued does consumption follow as the fruit of that investment.

America's retirees and near retirees are ready, willing and able to provide the prudent savings needed to fuel investment and growth. All they ask in return is stable money, positive returns and a friendly investment climate. The Fed's policy of money printing and negative returns is anathema to investment and growth. Until the Fed's war on savers is ended and reversed income security for retirees will be an illusion.

Endnotes

[1] The view that monetary ease can be effected and inflation created even when interest rates are at zero by cheapening the currency was advanced in, Svensson, Lars E. O., "Escaping a Liquidity Trap and Deflation: The Foolproof Way and Others," Working Paper No. 10195, National Bureau of Economic Research, December, 2003.

[2] These charts are prepared by and available from the Federal Reserve Economic Data (FRED) series issued by the Federal Reserve Bank of St. Louis, http://research.stlouisfed.org/fred2/

[3] Chairman Bernanke revealed his willingness to tolerate inflation in excess of the 2% targeted rate in his press conference following the Federal Open Market Committee meeting on January 25, 2012. See, Transcript of Chairman Bernanke's Press Conference, January 25, 2012, question and answer with Greg Ip of the Economist, pp 12-13, http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20120125.pdf

[4] See, Reinhart, Carmen M. and Sbrancia, Belen, "The Liquidation of Government Debt", Working Paper 16893, National Bureau of Economic Research, March, 2011, http://www.nber.org/papers/w16893.

[5] For evidence that the government spending multiplier is less than 1 and therefore destroys rather than creates wealth once all secondary effects are accounted for, see, Fredman, Charles; Kumhof, Michael; Laxton, Douglas; Muir, Dirk; Mursula, Susanna, "Global Effects of Fiscal Stimulus During the Crisis," International Monetary Fund, February 25, 2010; Barro, Robert J. and Redlick, Charles J., "Macroeconomic Effects From Government Purchases and Taxes," George Mason University, Working Paper No. 10-22, July 2010; and Woodford, Michael, "Simple Analytics of the Government Expenditure Multiplier," Paper presented at the meetings of the Allied Social Science Associations, January 3, 2010.

[6] The Fed is not unaware of the impact of its policies on the portfolio performance of those institutional investors such as insurance companies and pension funds who have large portfolios of fixed income assets intended to match retirement and other liabilities to their policy holders and beneficiaries. See, Transcript of Chairman Bernanke's Press Conference, January 25, 2012, question and answer with Scott Spoerry of CNN, pp 26-28, http://www.federalreserve.gov/mediacenter/files/FOMCpresconf20120125.pdf. However, this view is tinged with some derision of those who seek safe forms of savings. In a conversation between a senior official of a large investment bank and a member of the Federal Open Market Committee, the FOMC member justified the economic damage to pension funds and insurance companies caused by the Fed's zero rate policy by saying, "..they're not systemic...". In other words, the Fed views its mandate as propping up systemically important too big to fail banks even at the expense of the institutional retirement savings industry.

[7] CIA World Factbook, U.S. Government Printing Office, 2010.

[8] Bullard, James, "Seven Faces of 'the Peril,' "Federal Reserve Bank of St. Louis Review, September/October 2010 http://research.stlouisfed.org/publications/review/10/09/Bullard.pdf

[9] Bullard's dual equilibrium model bears some resemblance to the dual equilibrium between monetary expansion and contraction posited by Ben Bernanke in his landmark paper, "The Macroeconomics of the Great Depression: A Comparative Approach," Journal of Money, Credit and Banking (1995).

[10] See note 3, op. cit.

ADDITIONAL MATERIAL SUPPLIED FOR THE RECORD

STATEMENT FOR THE RECORD

THE FINANCIAL SERVICES ROUNDTABLE

On

The Senate Banking Committee, Subcommittee on Economic Policy hearing entitled:

"Retirement (In)security:
Examining the Retirement Savings Deficit Economic Policy."

March 28, 2012

The Financial Services Roundtable (the "Roundtable") respectfully offers this statement for the record to the U.S. Senate Banking Committee, Subcommittee on Economic Policy hearing entitled: "Retirement (In)security: Examining the Retirement Savings Deficit Economic Policy."

The Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

THE ROUNDTABLE SUPPORTS RETIREMENT SECURITY:
The Roundtable shares Congress' and the Obama Administration's goal of increasing opportunities for Americans to save and plan for their retirement. More specifically, we support increased incentives and opportunities for Americans to save and invest. The increased life span of the average American and the growing number of baby boomers nearing retirement age makes prudent retirement planning a critical issue. It is our belief that providing these opportunities is important because savings increase domestic investment, encourage economic growth, and result in higher wages, financial freedom, and a better standard of living.

Our nation's current retirement system has enhanced the retirement security of tens of millions of American workers by increasing retirement savings and the quality of life during their retirement years. In fact, Americans have increased their participation in 401(k) plans by 250 percent (250%) over the last twenty-five years.[1] The financial services industry has played a key role in helping to increase the number of Americans who plan and save for their retirement. The financial services industry currently manages over $17 trillion of retirement savings, which represents 36 percent (36%) of all U.S. household assets.[2] The U.S. retirement market is projected to grow to nearly $22 trillion by 2016.[3] That represents a 30 percent (30%) increase in retirement savings over a four-year period. According to a recent Gallup poll, nearly two-thirds of non-retirees (64%) now look to IRAs and 401(k)s as major funding sources when they retire.[4]

The one vital component of retirement savings that American workers can control is *when they start saving.* American workers give themselves the best chance at a secure retirement by saving early. Even small monthly amounts of money into a 401(k) or IRA early in life can make a real difference in an individual's ability to retire comfortably. This is not to say that saving early can guarantee a perfect retirement. But when individuals embrace saving for retirement as early as possible and make it a priority throughout their earning years, they put the power of compound interest to work in their favor. For example, saving just $50 more away a month could mean thousands of dollars of additional retirement savings. The Roundtable knows more work has to be done to increase the number of people who plan and save for their retirement. To be sure, there are still roadblocks to helping people save, but private sector action paired with targeted congressional policies will continue to encourage people to plan, save, and grow their retirement savings.

CONCLUSION:
In closing, strengthening the retirement security of all Americans is a priority for the Roundtable. The Roundtable believes that most Americans should approach retirement with a comprehensive strategy that incorporates a number of retirement vehicles. We support public

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1 Oliver Wyman, Inc., OLIVER WYMAN REPORT: ASSESSMENT OF THE IMPACT OF THE DEPARTMENT OF LABOR'S PROPOSED "FIDUCIARY" DEFINITION RULE ON IRA CONSUMERS (Apr. 12, 2011)

2 http://www.ebri.org/research/?fa=genretire

3 http://www.bankinvestmentconsultant.com/news/cerulli-predicts-retirment-market-will-exceed-22-trillion-by-2016-2677132-1.html

4 http://www.gallup.com/poll/150215/Investors-Feel-Affected-Social-Security-Medicare-Changes.aspx

policies that encourage greater employer and employee participation in retirement planning and savings. In the current economic climate, it is essential that Congress, the Obama Administration, and private industry continue to actively collaborate in order to increase the number of people saving for retirement and the amount of money they save. The Roundtable stands ready to work with policymakers and other stakeholders to preserve, promote and expand the current workplace-based retirement system to help strengthen retirement security for all Americans.

AARP
The power to make it better.

STATEMENT FOR THE RECORD

SUBMITTED TO THE

SENATE BANKING, HOUSING AND URBAN AFFAIRS' SUBCOMMITTEE ON ECONOMIC POLICY

on

Retirement (In)Security: Examining the Retirement Savings Deficit

March 28, 2012

AARP
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Government Affairs

Introduction

On behalf of our members and all Americans age 50 and over, AARP would like to thank Chairman Tester and Ranking Member Vitter for convening today's hearing to highlight the important issues surrounding the significant gap between what financial assets Americans will need to acquire to maintain their standard of living in retirement and what they are on a path to acquire. AARP appreciates the opportunity to submit written comments on some of the significant issues surrounding the current and future state of retirement security of American workers and their families.

A major priority for AARP has long been to assist all Americans in accumulating and effectively managing the resources they need to supplement Social Security and maintain an adequate standard of living throughout their retirement years. Unfortunately, both economic and social trends over recent decades, and notably developments affecting employer-provided pensions, have made the necessity of achieving and maintaining an adequate income in retirement more challenging than ever before. According to a recent calculation by the Center for Retirement Research at Boston College, the "retirement income deficit" for American households ages 32 to 64 is estimated to be roughly $6.6 trillion. In fact, 60 percent of workers in 2012 reported that the total value of their entire household's savings and investments (not just for retirement), was less than $25,000.[1] These trends require the thoughtful and timely attention of Congress, the President and Executive Branch agencies. They also serve to underscore the critical importance Social Security plays, and will play, in the retirement security of both current and future generations of Americans.

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[1] R. Helman, M Greenwald, et al., *The 2012 Retirement Confidence Survey: Job Insecurity, Debt Weigh on Retirement Confidence, Savings* 16 (EBRI, Mar. 2012), *available at* http://www.ebri.org/pdf/briefspdf/EBRI_IB_03-2012_No369_RCS2.pdf

Social Security was designed to provide only a foundation of an individual's retirement security and was never intended to be the sole source of income for people who have retired. However, due to shortcomings in other traditional components of the retirement security framework that help individuals achieve and maintain an adequate level of income for their golden years – employer-based pension plans, personal savings, and affordable health care – many Americans rely, and will continue to rely, on Social Security as their primary, if not sole, source of family income for their retirement.

Employer-Based Pension Coverage

It is widely accepted that workplace retirement plans are an efficient and effective means for individuals to save and earn benefits for their own retirement. As a result, AARP strongly believes that all workers need access to a workplace retirement plan that supplements Social Security's strong foundation. Since the enactment of the Employee Retirement Income Security Act (ERISA), the focus has been on three central issues: coverage and participation; security; and adequacy.

Unfortunately, employer-provided retirement plan coverage in the U.S. private-sector labor force has generally hovered around a modest 50 percent for decades,[2] with larger employers more likely than smaller ones to offer retirement plans.[3] Overall, roughly 78 million American workers (both public and private) do not have access to a workplace retirement plan, such as a pension or 401(k) plan. As a result, few of these individuals save for retirement on their own, and many are currently retired, or will retire, with less than enough money to meet their basic needs.

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[2] S. Mackenzie & K.B. Wu, *The Coverage of Employer Provided Pensions: Partial and Uncertain* at 7 (AARP 2008).
[3] *Id.* at 15.

In response to this significant problem, AARP has been a strong supporter of proposals such as the Auto IRA, which would help bridge this coverage gap and provide access to a workplace retirement vehicle to tens of millions of American workers.[4] Specifically, this proposal, introduced as S. 1557 in the current Congress, would allow workers without access to an employer plan to voluntarily fund their own individual retirement accounts (IRA) through payroll deductions. Harnessing the power of regular, automatic payroll deductions at work would encourage and simplify saving and significantly improve the retirement security of millions of Americans. Moreover, these accounts would be portable, so workers could take them to another job.

In addition, these automatic accounts involve little or no cost for most employers. Because Auto IRA would establish simple individual retirement accounts rather than employer-sponsored retirement plans, employer responsibilities under this proposal are much more limited. For instance, Auto IRA employers would neither select, hold, nor manage investments, nor would they be required to provide contributions to employee accounts. Finally, Auto IRA provides tax credits for employers to help offset any limited costs of setting up these accounts.

In addition to coverage issues, the actual participation rate of workers in private-sector pension plans varies with age, income, education, ethnicity, size of employer and type of employment. Older, better-educated, full-time, better-paid workers are more likely to be plan members than younger, less educated, part-time, lower-paid workers.[5]

[4] G. Koenig, *The Case for Automatic Enrollment in Individual Retirement Accounts* (AARP Public Policy Institute, February 2012)

[5] S. Mackenzie & K.B. Wu, *The Coverage of Employer Provided Pensions: Partial and Uncertain* 2, 7-12 (AARP 2008).

In an effort to increase participation rates in 401(k) plans, AARP supported the auto-enrollment provisions in the bipartisan Pension Protection Act. A May 2011 Aon Hewitt study found that "(t)hree in five employers automatically enrolled employees into their defined contribution plans in 2010, up from 24 percent in 2006. For employees who were subject to automatic enrollment, Aon Hewitt's analysis found that 85.3 percent participated in their DC plan, 18 percentage points higher than those that were not subject to automatic enrollment."[6]

The Move from Defined Benefit to Defined Contribution

For those workers who are fortunate to work for employers who offer access to a workplace retirement vehicle, many of their employers have moved away from providing defined benefit (DB) plans and increasingly offer only defined contribution (DC) plans, such as 401(k) plans. While DC plans can be valuable to many, they transfer investment, longevity, inflation, and interest rate risks entirely to the individual, and could make it more likely that an individual would outlive his or her retirement nest egg. Today, only about 17 percent of workers have DB pension coverage on their current job, compared to 41 percent who have DC plan coverage.

The shift away from DB plans to DC plans places significant responsibility on individuals to make appropriate decisions concerning their contributions, their investments and how they will manage their money once they retire so that they will have adequate income to fund their retirement years. Unfortunately, the technical demands of investment management and the associated risks are more than many individuals are able or willing to handle. While DC-type plans can be an effective savings vehicle for retirement –

[6] Aon Hewitt News Release, May 24, 2011 (http://aon.mediaroom.com/index.php?s=43&item=2285)

especially if individuals take all the right actions and markets achieve historical rates of return – in practice these conditions will not all be met. Many people fail to make optimal choices at every step along the way, as evidenced by generally less than adequate DC account balances. According to a 2011 Fidelity report, the average 401(k) account balance was only $71,500 at the end of 2010.[7] Moreover, even if DC plan members make all the right decisions, if they happen to retire in a down market, much like the recent economic downturn, their account balances may still not be adequate for retirement.

There is also substantial confusion among 401(k) plan participants as to the fees they pay. The fee information participants currently receive about their plan and investment options is often scattered among several sources, difficult to access, or nonexistent. Even if fee information is accessible, plan investment and fee information is not always presented in a way that is meaningful to participants. Fees are important because of their impact on the level of assets available for retirement.

The Government Accountability Office estimated that $20,000 left in a 401(k) account that had a 1 percentage point higher fee for 20 years would result in an over 17 percent reduction – over $10,000 – in the account balance. We estimate that over a 30-year period, the account balance would be about 25 percent less. Even a difference of only half a percentage point, or 50 basis points, would reduce the value of the account by 13 percent over 30 years. In short, employers – as well as employees – need to be aware that fees and expenses can have a huge impact on retirement income security levels. 401(k) plan participants therefore have a need and a right to receive timely, accurate, and

[7] Fidelity News Release, February 23, 2011 (http://www.fidelity.com/inside-fidelity/employer-services/q4-2011-401k-update)

informative fee disclosures from their 401(k) plans to help them better prepare for a financially secure retirement.

Because fees reduce the level of assets available for retirement, we have supported both Congressional and regulatory efforts to increase disclosure requirements so that fiduciaries and participants can receive the information they need to make informed choices about these investments. AARP supports increased disclosure of fees charged by service providers to fiduciaries.[8] Provider fees should be disclosed both to participants and employers, and clearly explained to participants on their annual statements. Moreover, participants should have the right to receive more detailed fee information on request.

In contrast to DC plans, DB plans generally provide a predictable monthly retirement benefit to employees, lower fees, and professional management of retirement assets. It has been demonstrated that DB plans are also more efficient as well – that is, they cost less to achieve a particular level of retirement income than defined contribution plans.

The Shift from Annuitized to Lump-Sum Distributions

The share of traditional plans offering a lump-sum distribution option has increased in part because plan sponsors are able to shed longevity risk and pension costs by increasing the take-up of lump-sum distributions by plan members. As for DC plans,

[8] S. Mackenzie, *Determining whether 401(K) plan fees are reasonable: Are disclosure rules adequate?* (AARP Sept. 2008), *available at* http://www.aarp.org/research/ppi/econ-sec/pensions/articles/i8_fees.html.

although more of their participants may be interested in the annuity option than had been previously thought, the lump sum option is still the overwhelming choice.[9]

Traditional DB plans have historically provided lifetime streams of income, while only a small fraction of DC plans offer an annuity or other lifetime income option. Moreover, many DB plan sponsors today offer lump-sum benefits and many retirees are opting for them. Younger workers are more likely than older workers to have only a DC plan, and the number of workers retiring and receiving their retirement account balances as a lump-sum is growing. It is not clear how, or how well, beneficiaries will manage those assets throughout decades of retirement.

AARP is concerned that – unlike the case with Social Security benefits – many Americans will outlive the retirement assets they have accumulated due to the combined effects of longer life expectancies and the overly optimistic assumptions many individuals make when spending down these assets. Effectively managing this decumulation phase of retirement can be especially complicated, but it is essential for the long term economic security of millions of American workers who can no longer count on the guaranteed lifetime income stream once overwhelmingly provided by workplace DB pension plans.

In response, AARP is pleased to support S. 267, the bipartisan Lifetime Income Disclosure Act – legislation that would provide individuals with a better understanding of the lifetime value of their 401(k) plan assets by including in a yearly benefit statement a conversion of their total accrued benefits into a monthly dollar amount as if they had opted

[9] An AARP survey of the distribution choices made by workers and retirees with pension plans found that there was definite interest in the annuity option. Specifically, it found that about 31 percent of workers and 25 percent of retirees with DC plans that offered one or more options other than lump sum withdrawal were planning to select or had already selected the annuity option. See Kathi Brown et al. 2010. *Annuities and Other Lifetime Income Products: Their Current and Future Role in Retirement Security*. AARP Public Policy Institute, Factsheet 189 (May).

to receive a lifetime annuity. This conversion would help provide a more meaningful long term perspective to 401(k) plan participants than is generally presented under current practices by giving them a more accurate picture of the lifetime value of their plan and helping them make better decisions about how much they may need to save and how best to manage their retirement assets.

Fiduciary Standards

The impact of conflicted or inappropriate advice on individuals' private retirement savings can be devastating. Accordingly, the importance of strong fiduciary standards cannot be understated and such measures are essential to protect the security of individuals' hard earned retirement assets both now and in the future.

Because the growth in 401(k) plans places significant responsibility on individuals to make appropriate investment choices so that they have adequate income to fund their retirement, AARP supports the goal of increasing access to investment advice for individual account plan participants so that participants may be better empowered to achieve their retirement savings objectives. To that end, we have consistently asserted that such advice must be subject to the Employee Retirement Income Security Act's (ERISA) fiduciary rules, based on sound investment principles and protected from conflicts of interest. The recent financial turmoil and scandals on Wall Street once again underscore the imperative that such advice be independent and non-conflicted.

AARP supports regulations to ensure that participants are provided with objective, non-conflicted investment advice. Consistent with a recent AARP poll, Americans believe that advice should be suitable for their needs, objectives and risk tolerance. AARP supports the Department of Labor's review of the definition of fiduciary regulation given that the current manner in which employee benefits are provided is significantly different from the situation in 1975, as is evident with the shift from defined benefit plans to defined contribution plans. Not only has the financial industry's emphasis shifted to accommodate the demand for individual investment advice in 401(k) plans, but the variety and complexity of investments has radically changed. Consequently, AARP believes that a revision of this regulation to reflect the practices in the current market place would better protect the interests of plans and their participants and beneficiaries.

Healthcare

Another key factor to consider when evaluating the retirement security of Americans and their families is the impact of high, and increasing, healthcare costs. Skyrocketing costs plague our entire health care system, burden individuals and employers, and threaten the sustainability of Medicare and Medicaid, vital programs that tens of millions of Americans rely upon. Seniors spend a disproportionate share of their income – nearly 20 percent – on health care costs, which continue to increase at rates well above the rate of overall inflation. We must transform the delivery of health care and bring down costs throughout the system to keep Medicare and Medicaid affordable now and strong for future generations.

These healthcare cost trends are not sustainable and Congress must work thoughtfully to find ways to hold down these costs, and not simply shift them to individuals and other payors. However, it is important to realize that Medicare is just one part of our nation's health care system, which includes a vast array of other payers, including public, individual, and employer-based health insurance. For families and workers, soaring costs compound job losses and other financial problems. Since 2001, family premiums outpaced both earnings and overall inflation.[10] The average annual premium for family coverage increased to $15,073 in 2011, more than double the figure in 2000.[11] And the more employees must pay, the less likely they are to enroll in employer plans.[12] People with private non-group insurance are even worse off; three-quarters of those age 50 to 64 buying coverage on the individual market spent at least 10 percent of their after-tax income on health care. Their average out-of-pocket costs for premiums and health care are two and half times more than the costs of those with employer coverage.[13]

As you examine how to address the growing cost of health care programs, we urge you to reject arbitrary limits and cost shifting and focus instead on ways to make the delivery of health care to all Americans more efficient and cost-effective. Arbitrary cuts simply shift costs on to other payers of health care services, particularly beneficiaries and their families, and undermine current and future beneficiaries' access to quality care.

Social Security

AARP strongly believes that the trends and factors discussed above, as well as the recent economic crisis, highlight the importance of Social Security's guaranteed benefit as the foundation of retirement income for all Americans. In the face of declining traditional pensions or the outright lack of pension coverage, low personal savings rates, diminished home values, longer life expectancies and higher healthcare costs, the guaranteed benefit of Social Security will be increasingly important to future generations of Americans.

[10] HRET/Kaiser Family Foundation. *2011 Employer Health Benefits Survey*
[11] Ibid.
[12] Kaiser Family Foundation. February 2007. *Snapshots: Health Care Costs. Insurance Premium Cost-Sharing and Coverage Take-up.*
[13] Smolka G, Multack M.,Figueiredo C. February 2012. *Health Insurance Coverage for 50- to 64-Year-Olds. AARP Public Policy Institute Insight on the Issues.* Available at: http://www.aarp.org/health/medicare-insurance/info-02-2012/Health-Insurance-Coverage-for-50-64-year-olds-insight-AARP-ppi-health.html

Social Security is currently the principal source of income for nearly two-thirds of older American households receiving benefits, and roughly one third of those households depend on Social Security benefits for nearly all (90 percent or more) of their income. Despite its critical importance, Social Security's earned benefits are modest, averaging only about $1,200 per month for all retired workers in December 2011. Nonetheless, Social Security keeps countless millions of older Americans out of poverty and allows tens of millions of Americans to live their retirement years independently, without fear of outliving their retirement income. Social Security also provides critical income protection for workers and the families of those who become disabled or deceased.

Social Security benefits are financed through payroll contributions from employees and their employers, each and every year, throughout an individual's working life. According to the Social Security Trustees, the program has sufficient assets to pay 100 percent of promised benefits for nearly a quarter century, and even with no changes, can continue to pay approximately 75 percent of promised benefits thereafter. While Social Security faces financial challenges in the future, it is not in a crisis now. Because Social Security is not in crisis, and because the retirement deficit facing Americans today is so great, AARP strongly believes that a debate to address the financial challenges that Social Security faces should focus on preserving and strengthening the retirement security of Americans and their families for generations to come.

Older Workers

AARP also believes that Congress should assist those who want or need to work longer. Eliminating barriers to gainful employment and promoting job opportunities for older workers, including combating age stereotypes, is particularly important. Age discrimination remains a significant barrier to older workers who are unemployed and seeking work, or older workers who wish to remain in the workforce. According to a recent AARP survey, more than half of workers 50 and older who had recently experienced unemployment cited age discrimination as a significant barrier in finding a new job. Although age discrimination is a serious and growing problem, a 2009 decision by the U.S. Supreme Court departed from decades of precedent and significantly narrowed the scope of legal protections for workers who've experienced age discrimination. This is why AARP is urging Congress to enact the bipartisan Protecting Older Workers Against Discrimination Act, S. 2189, which would restore and reaffirm the law so that older workers are on the same legal footing as other workers in challenging discrimination.

Retirement Security Tools

Finally, AARP appreciates that today's hearing may seek to explore the tools that are currently available for individuals to use to make better decisions about planning for their own retirement. As you may know, AARP has been actively engaged in an effort to provide such retirement security tools to individuals for free online. For instance, AARP has developed, or has partnered with other organizations to launch:

- AARP Social Security Benefits Calculator - The AARP Social Security Benefits Calculator is part of AARP's "Ready for Retirement?" effort (www.aarp.org/readyforretirement), a ten-step approach to envisioning and planning for a secure retirement, which includes creating a budget and preparing for the unexpected. For many, one of the most important retirement-related decisions is when to claim Social Security benefits. The calculator allows users to customize their estimates by calculating spousal benefits and taking into account the impact of continuing to work while collecting benefits. Users have the opportunity to print a personalized summary report. You can find the calculator at www.aarp.org/socialsecuritybenefits. The calculator is available in Spanish at www.aarp.org/calculadoradesegurosocial.

- AARP Retirement Calculator - AARP's Retirement Calculator takes each aspect of financial planning for retirement into consideration, from Social Security benefits to pension, retirement accounts, inheritances and budgeting for lifestyle changes. Through this simple, step-by-step tool, users can begin to envision their financial plan during retirement. You can find the Retirement Calculator at www.aarp.org/retirementcalculator. The calculator is available in Spanish at www.aarp.org/calculadorajubilacion.
- 401(k) Fee Calculator - The AARP 401(k) Fee calculator helps consumers discover the hidden fees that might come with their 401(k) account. The calculator provides individuals with a personalized report detailing how much they might pay in fees, as well as how that could affect their retirement savings. You can find the 401(k) Fee Calculator at www.aarp.org/401kfees.

Conclusion

Over the past 25 years, there has been a slow and steady erosion of the adequacy and security of employer provided pensions, an important component of our retirement security framework. As a nation, we need to refocus our efforts on the critical need for all American workers and their families to accumulate and effectively manage the resources they require to achieve an adequate standard of living throughout their retirement years.

Once again, AARP would like to thank Chairman Tester and Ranking Member Vitter for holding today's important hearing. We look forward to working with you and the other Members of this Committee to help ensure that as many Americans as possible are able to achieve a secure and adequate retirement.

Putnam INVESTMENTS

March 2012 | Putnam Perspectives

Resisting the policy threat to retirement savings

Edmund F. Murphy III
Head of Defined Contribution, Putnam Investments

Key takeaways

- The emergence of an "assured income" gap will require millions of future retirees to find ways to finance and structure lifelong income solutions for themselves.
- Defined contribution plans have the potential to become a powerful engine for renewed economic growth.
- Americans overwhelmingly oppose moves to reduce the tax advantages or contribution limits to workplace savings programs.

This paper focuses on some of the critical challenges we face in retirement policy in the United States, particularly in the context of our national effort to find solutions for containing our soaring deficits.

From our perspective, the key to solving these challenges is not to view America's retirement savings frameworks as the problem, but rather to see these savings as part of a sustainable solution.

We believe that robust retirement savings can play a vital, positive role in restoring Americans' confidence and financing a great future for the United States. But it can only do this, we contend, if we approach the challenge with vision and courage.

Insights for real-world policy

It may seem counterintuitive, but the strongest driver of retirement policy is life itself. One of the most important stories that is not yet taken account of by policy is how rapidly human longevity is increasing.

In the course of a single lifetime — from 1950 to 2025 — human life expectancy will have risen by 50%, from age 48 to age 72.* Obviously, this global average is buoyed by medical advancement in developed countries, but the upward trend in life expectancy is truly global.

This may well be the most astonishing gain in human well-being in all of recorded history. But this sheer explosion in longevity is putting huge strains on retirement systems all over the world, and it is a critical part of the financial crisis destabilizing Europe today.

"We are on the right track to solving the challenge of retirement wealth accumulation."

* U.N. Population Division, 2010.

The United States is hardly immune to this trend. In our case, the number of citizens over age 65 will nearly double from just over 40 million today to over 72 million by 2030 as the huge Baby Boom generation edges into retirement.*

The percentage of working-age Americans will decline over the same period — from 63% to 57% — even though the absolute number of working-age Americans will rise from 195 million to 213 million people.* This increase in America's future workforce carries some real benefits, especially relative to countries like Japan, Germany, and China, whose working-age populations will decline, even drastically in some cases, over the course of this century. But in the near term, there is no escaping the pressure that an aging population will put on our key entitlement programs — Social Security and Medicare.

In fact, absent real reform, these critical support programs for the elderly are on track to absorb as much of U.S. GDP by mid century as the entire federal government has typically taken in by way of tax revenue since 1970 (Figure 1).

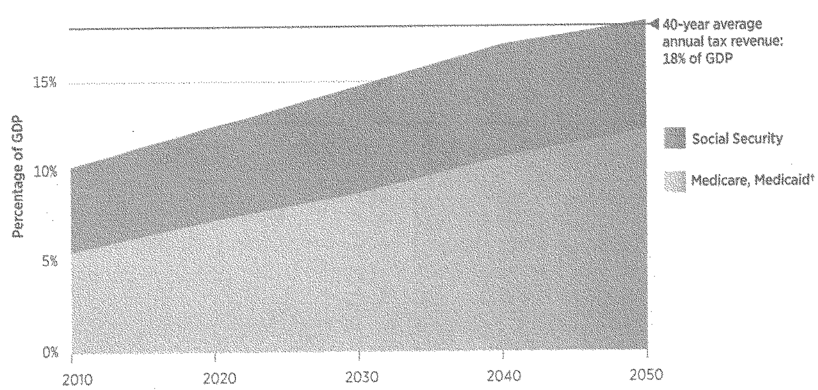
* U.S. Bureau of the Census, 2008 and 2011.

As Douglas Elmendorf of the Congressional Budget Office said in testimony to the Select Committee on Deficit Reduction in 2011, the rising pressure on our old-age support systems will force us to choose among three unattractive options:

- Raising the share of revenues going to the federal government well above the long-term average of 18%
- Cutting back substantially on Social Security and Medicare
- Slashing federal spending on everything from the Marine Corps to National Public Radio

Needless to say, the political environment fostered by the pending fiscal challenge will be difficult. Both sides of the aisle will almost surely have to offer up painful concessions in order to get on top of these long-term deficit drivers. The challenge will be unavoidable. If we don't actively curb deficits, we will be subject to highly negative global market forces. To see this in action, we need to look no further than Europe, where the threat of catastrophic fiscal meltdowns are forcing politicians' hands every day.

Figure 1: Entitlement costs will dominate future federal budgets

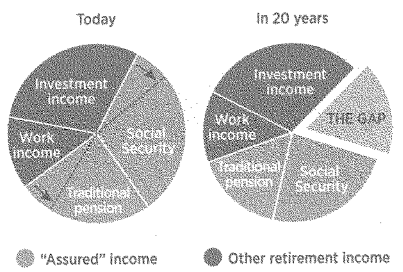


Source: Congressional Budget Office; Office of Management and Budget. Illustration uses the CBO's extended-baseline budget scenario. Tax revenue average from 1971 to 2010.

† Includes major mandatory health-care programs: Medicare, Medicaid, exchange subsidies, and the Children's Health Insurance Program (CHIP).

Even as we try to get long-term deficits under control, we will see strong downward pressure on the incomes of future retirees. Under current law — even before the implementation of potential reforms — Social Security's replacement rate is programmed to decline from nearly 40% earlier in this decade to under 30% by 2030. The rising age for full eligibility in Social Security and deductions for Medicare premiums are driving this trend. What's more, as traditional defined benefit (DB) pension plans dwindle in number, they are sure to provide a gradually smaller percentage of future retirees' incomes.

Figure 2: The emerging gap in "assured" retirement income sources



For illustration purposes only.

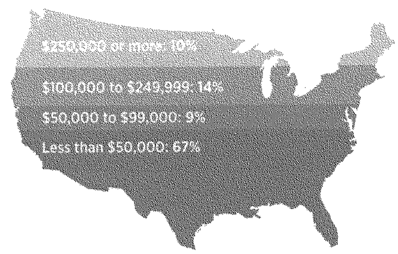
As Figure 2 shows, the emergence of an "assured income" gap will require millions of future retirees to find ways to finance and structure lifelong income solutions for themselves.

This gap could, in theory, be filled by higher personal and workplace savings, but the sad fact is that most Americans are not saving enough to finance secure 20- or 30-year retirements. That is particularly distressing when we consider that 20- to 30-year retirements have become a fact of life for a majority of Americans.

The savings picture is sobering no matter what perspective one takes. As the Employee Benefit Research Institute reports, two thirds of all workers saving for retirement report total assets under $50,000 (Figure 3). And only about one quarter of U.S. workers have assets of $100,000 or more.

Figure 3: Most Americans are not saving enough

Reported total savings and investments for all U.S. workers



Source: The 2011 Retirement Confidence Survey, EBRI, April 2011. Findings among those providing response (does not include value of primary residence or defined benefit plans).

The factors contributing to this retirement unpreparedness are many, but personal debt and housing price declines are key. In reality, we have just completed a generation-long experiment in leveraging up household debt in the United States. If we consider that the process of "deleveraging" has only just begun, the risks to national solvency become even more pronounced.

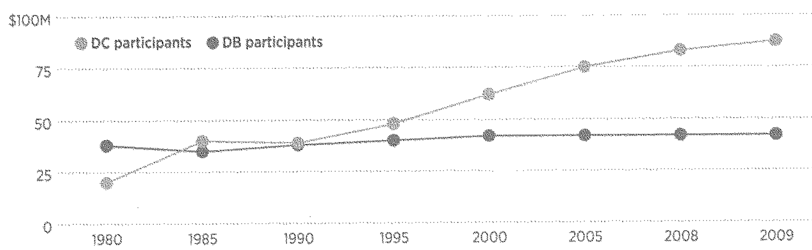
Savings in the United States: a source of long-term strength

Though it is not easy to save, we believe savings is the key to our national fiscal puzzle. Furthermore, we believe the savings incentives already in place provide a strong foundation on which we can build a lasting solution to the retirement income gap.

Simply put, America needs to transition away from soaring public and private spending, leverage, and debt-fueled excess. The cure, in other words, is a revitalized economic model based on savings, investment, new business formation, job creation, and economic growth. Economic growth, in fact, is the least painful solution to our deficit issues — and the best path back to sustained national solvency. And if growth is to be the solution, it needs to be based on personal solvency, rooted in strong household balance sheets and robust retirement savings.

Figure 4: Defined contribution: a strong base to build on

American workers covered by workplace retirement plans (in millions)



Sources: Private Pension Plan Bulletin, Abstract of 2008 Form 5500 Reports, U.S. Department of Labor, December 2011. Most recent data available.

The good news is that we have created a still-growing defined contribution (DC) workplace savings system — predominantly composed of 401(k) plans — that reaches more than 87 million workers (Figure 4). Another 40 million people continue to enjoy DB plan coverage, although this number is flat to down outside the public sector. We believe that these programs, particularly in the DC space, are the best and most natural place to begin shoring up Americans' retirement income security.

In our view, there are three reasons why the DC system is the most appropriate cure to our retirement savings problem.

- **Evolution:** DC plans have continued to evolve — and improve — with bipartisan political support.
- **Innovation:** Better DC plan design can go a long way toward filling the retirement income gap.
- **Results:** An increasing number of American workers are gaining access to DC plans.

The passage of the Pension Protection Act of 2006 (PPA) was a watershed moment in retirement-related legislation. With the PPA, we effectively promoted DC workplace savings programs into America's primary retirement system, and we did it without engaging in divisive political battles or alienating the people these programs were designed to serve. In this sense, the political viability and general popularity of DC systems make them the obvious base for renewing retirement income security in America.

The PPA endorsed three game-changing innovative elements of DC plan design:

1) Auto-enrollment: This feature allows workplace savers to be automatically signed up for their plans each year — unless they actively "opt out."

2) Auto-escalation of savings: This feature allows DC plan sponsors to put employees on an escalating ladder for savings deferral over time. We believe deferrals should start at 6% or more, and rise quickly to 10% or more.

"We believe the key policy challenge going forward should be to secure access to workplace savings for all workers and then to generalize best practices such as deferral rates of 10% or more."

3) Asset allocation guidance: Balanced funds or "lifecycle" funds that steadily dial down risk as retirement "target dates" near were given the green light to be used as default investment approaches.

These core plan design elements, sanctioned by legislators on both sides of the aisle, better equip "auto-pilot" DC plans to meet the challenge of asset accumulation.

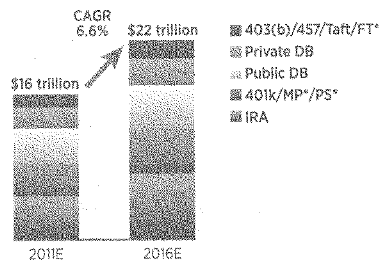
A 2011 Putnam survey found that workers who have access to workplace savings plans, choose to defer 10% or more, and receive Social Security in retirement are on track to replace upward of 100% of their pre-retirement income — success by any reasonable measure. In other words, we are on the right track to solving the challenge of retirement wealth accumulation. For this reason, we believe the key policy challenge going forward should be to secure access to workplace savings for all workers and then to generalize best practices such as deferral rates of 10% or more.

Interestingly, our research also shows the amount of money one makes has the least relevance for whether pre-retirement incomes can be matched in retirement. The two most important factors are access and savings behavior. That suggests that if we could find a way to ensure access for all workers to DC plans and get all of them to save 10% or more, we could effectively immunize America's workforce against the risk of elderly poverty — and help limit the need for further government spending on retirees.

We are already seeing the changes endorsed by the PPA drive a resurgence in workplace savings. Far from being a "mature" market, DC savings are again growing rapidly and are projected to grow to over $5.5 trillion in the next few years. This surge in workplace savings is fueling a rise in total U.S. retirement assets — including IRAs, whose growth comes primarily from massive rollover flows out of workplace plans as the Baby Boomers reach retirement age at the rate of 7,000-plus per day. Despite two serious market slumps in the past decade, total U.S. retirement savings are estimated at $16 trillion today, and could grow to roughly $22 trillion by 2016 (Figure 5).

Figure 5: Retirement assets: a growing source of U.S. strength

U.S. retirement assets, 2011E–2016E



* FT = Federal Thrift, MP = Money Purchase, PS = Profit Sharing.

Sources: Department of Labor, ICI, U.S. Census Bureau, Federal Reserve, PBGC, EBRI, Cerulli Associates, Putnam analysis, 2012.

This vast pool of retirement savings already provides a powerful source of investment capital and fiscal strength for America, especially relative to nations that depend much more heavily on pay-as-you-go government transfer programs.

Risks to retirement savings success

Ironically though, amid today's era of burgeoning fiscal deficits, we face a new risk aimed at the heart of our retirement savings system. It stems from well intentioned, but seriously misguided, efforts to put our fiscal house in order.

Figure 6 shows a variety of tax "expenditures" submitted last September to the Select Committee on Deficit Reduction. As this illustration demonstrates, retirement savings deferrals — for DC as well as DB plans — are high on the list, second only to the tax costs associated with employer-based health care, and just ahead of tax breaks for mortgages and capital gains.

Figure 6: Retirement incentives in budget hawks' sights

Major income tax "expenditures," 2010–2014 (in billions)

Source: Douglas Elmendorf, CBO Director, Testimony to the Select Committee on Deficit Reduction, September 13, 2011.

That puts the tax deferrals that help make workplace savings and IRAs feasible in the crosshairs of budget hawks. There is precedent for harmful "cost saving" that should serve as a cautionary tale today. The last major tax overhaul in 1986, for example, cut deeply into incentives for retirement savings and stymied the growth of the IRA market for years.

We have already seen how many millions of Americans are well short of saving enough to ensure a secure retirement — and how replacement rates from "guaranteed" sources like Social Security and DB pensions are on track to decline. Against this backdrop, policy should be moving in every way possible to raise savings levels and extend access to on-the-job savings to as many workers as possible. In today's environment, policy moves that attempt to cut public deficits by undercutting private savings are simply misguided, inappropriate, and potentially quite harmful to Americans and the nation as a whole. Personal solvency and national solvency, we believe, are mutually reinforcing and should never be put at cross purposes.

One of the most common arguments for cutting or curbing savings tax deferrals rests on claims of "distributional justice." In other words, these deferrals supposedly benefit the wealthy far more than average workers. This assumption is flat wrong.

In fact, the majority of these tax advantages (62%) go to workers who earn less than $100,000 per year, while the remaining 38% goes to those who earn more (Figure 7). But let's compare these tax deferrals — which, we should recall, are postponements and not the forgiveness of taxes — to the income taxes the recipients actually pay. Middle- and low-income workers pay 26% of federal income taxes. In other words, they receive twice as large a share of savings tax breaks as the share of income taxes they actually pay. Workers who earn more than $100,000 pay 75% of all federal income taxes. So, more affluent earners get almost exactly half the share of savings tax breaks as they pay in taxes.

On its face, this basic differentiation in the tax-deferral and tax-payment structure is progressive, which is not unsurprising given that we currently have a progressive income tax. And when we consider that every serious Social Security reform proposal protects low-income workers, as we believe is only right, the brunt of tax increases and benefit reductions from any reform would likely fall on upper-middle-income and wealthy Social Security recipients. But how would it be fair — or politically feasible, for that matter — to simultaneously undercut the private savings efforts of these more affluent earners — and taxpayers?

There is another reason for caution with respect to any deficit or tax code changes that undercut workplace savings or the incentives many businesses have to offer them. Access to workplace savings is vital to low- and moderate-income workers. Workplace savings are quite simply the only regular savings option these workers have. Over 71% of workers earning between $30,000 and $50,000 do save for retirement — but only if they have access to payroll-deduction savings plans at work. Among moderate-income workers who lack access to savings at work, fewer than 5% set money aside to prepare for retirement. Thus, capping or eliminating incentives for workplace and other retirement savings is exactly the wrong direction to go.

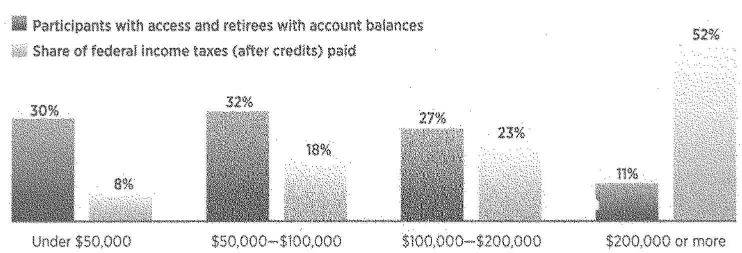
The reason for this is that many small business owners and companies are motivated to offer plans to their employees by the $50,000-per-year maximum that these owners can set aside for themselves under current law. If that cap is reduced to $20,000 per year — as the Simpson-Bowles Deficit Commission has recommended — many business owners could easily become more selective about whom they would offer workplace savings programs. Rather than setting up savings plans for their entire workforce, business owners could just cover themselves and a fraction of their employees. Capping or cutting incentives for tax-deferred savings could thus have a devastating, unintended impact by sending millions of low- and moderate-income workers toward retirement with essentially no savings at all.

What makes this seem even worse, from our perspective, is that we believe the revenue "gains" to the Treasury from such a policy shift are overstated by 50% or more. In our view, these gains are overstated by a genuinely bizarre budget methodology that looks out only 10 years and undercounts the flow-back to Treasury as retirement savings are drawn down — and taxed — as ordinary income. Budget hawks also seem oblivious to the damage they might inflict on low- and moderate-income workers' chances for retirement security by dramatically undercutting the willingness of business owners to offer plans in the first place. Instead of making what we believe would be a huge mistake of cutting back on savings deferrals, we believe policymakers should be doing everything they can to expand — and even mandate — workplace savings coverage to the millions of people who lack it.

That is why we support the concept of the automatic payroll-deduction IRA, which was recently re-introduced by Congressman Richard Neal of Massachusetts. That is also why we support a Sense of Congress resolution in defense of savings incentives, which was recently introduced with more than 100 co-sponsors from both major parties. We believe incentives for retirement savings are fundamentally good policy.

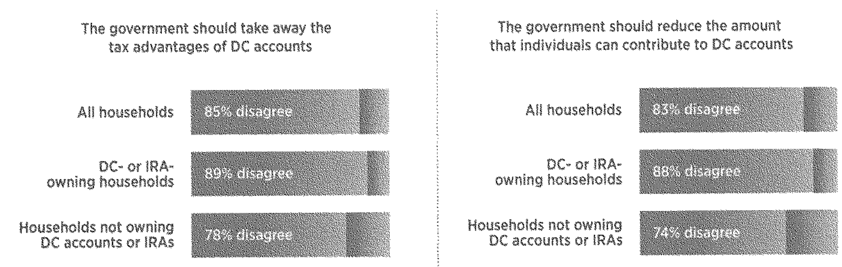
Figure 7: Who benefits? Who pays?

"Tax expenditures" versus share of federal income taxes paid, by income level



Source: American Society of Pension Professionals and Actuaries, 2011.

Figure 8: Americans oppose cutting or capping savings incentives



Source: America's Commitment to Retirement Security, Investor Attitudes and Actions, Investment Company Institute, January 2012.

What's more, support for retirement savings is also good politics, as a recent survey by the Investment Company Institute makes clear (Figure 8). Whether they participate in a DC plan or own an IRA, Americans overwhelmingly oppose any move to take away the tax advantages these accounts enjoy or reduce the amounts that individuals can contribute to them. Retirement savings deferrals are extremely popular. Proposals to cut or curb them are politically toxic.

Conclusion

We live in a globalized economic and financial world, and the United States, like every country interested in guarding its fiscal health, is caught up in a "race to solvency." Nations everywhere are struggling to achieve fiscal balance and growth policies that will secure and sustain access to global capital markets and investment flows. That is the prize for countries that "win" this race. The alternative is to lose global market confidence and risk the kind of debt-driven crisis Europe is struggling with.

At Putnam, we believe that strong national savings policies are vital to success in this competition. We support every effort to sustain and strengthen all of America's retirement savings systems — public and private. We would like to see existing workplace savings plans step up to the best practices endorsed by the PPA, with auto-enrollment, savings escalation to 10% or more, and automatic access to balanced investments. And we would encourage both sides of the political aisle to come together on a true "grand bargain" to make Social Security solvent for generations to come. Social Security is simply indispensable for low- to moderate-income workers, and valuable even for the affluent. Making the system solvent would have a hugely positive impact on national confidence and, we believe, on the American people's sense that our government — and the leaders of our two major parties — can actually meet difficult challenges for the sake of our nation.

"Opportunity of a lifetime: Using lifetime income scores to assess and improve retirement preparedness," Putnam, 2011. The Putnam Lifetime Income Survey, with research methodology provided by the Putnam Institute, was conducted online by Brightwork Partners and completed in the first quarter of 2011. The survey of 3,290 working adults age 18 to 65 was weighted to U.S. Census parameters for all working adults.

The views and opinions expressed are those of Edmund F. Murphy III, Director, Defined Contribution Services. They are subject to change with market conditions and are not meant as investment advice. Mr. Murphy is affiliated with Putnam Retail Management.

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Financial Security. For Life.

The American Council of Life Insurers

Written Statement for the Record

for

"Retirement (In)security: Examining the Retirement Savings Deficit."

Committee on Banking, Housing, and Urban Affairs
Subcommittee on Economic Policy

United States Senate

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United States Senate
March 28, 2012

The American Council of Life Insurers (ACLI) commends this Committee for holding this hearing on the growing retirement security crisis. We applaud Chairman Tester (D-MT) and Ranking Member Vitter (R-LA) for holding this particular hearing focusing on the need for more Americans to save for their retirement in a challenging economy.

THE AMERICAN COUNCIL OF LIFE INSURERS

The American Council of Life Insurers is a national trade organization with over 300 members that represent more than 90% of the assets and premiums of the U.S. life insurance and annuity industry. ACLI member companies offer insurance contracts and investment products and services to qualified retirement plans, including defined benefit pension, 401(k), 403(b) and 457 arrangements and to individuals through individual retirement arrangements (IRAs) and on a non-qualified basis. ACLI member companies also are employer sponsors of retirement plans for their employees. As service and product providers, as well as employers, we believe that saving for retirement, managing assets throughout retirement, and utilizing financial protection products are critical to shoring up the retirement savings deficit facing individuals and alleviating the financial burden on public safety net programs.

Seventy-five million – or two out of three – American families count on life insurers' products for protection, long-term savings, and a guarantee of lifetime income when it's time to retire. Given today's economic uncertainties, the financial and retirement security these products provide has never been more important. To provide context about the extent to which the life insurance industry protects American families, in 2010 alone, American families received $58 billion in life insurance death benefits, $70 billion in annuity payments, $16 billion in disability income insurance benefits, and $7 billion in long-term care insurance benefits.

RETIREMENT SAVINGS OPPORTUNITIES HAVE BEEN SUCCESSFUL

The ACLI strongly supports the current defined benefit (DB) and defined contribution (DC) retirement system and believes expanding this system should be a national goal. People are living longer than ever. According to the Center for Disease Control, a 65 year-old can expect to live to age 83.6. Yet many Americans are unprepared for retirement. In its 2010 Retirement Readiness Rating, the Employee Benefit Research Institute (EBRI) found that 47.2 percent of workers born between 1948 and 1954 are "at risk" of not having enough retirement income to pay for basic expenses. Moreover, according to the 2007 Federal Reserve Survey of Consumer Finances, the most recent available survey, 50 percent of Americans 50 to 64 years old have 16 months or less of savings, even though many will live more than 20 years in retirement.

The ACLI believes that by supporting and expanding the current voluntary employer-based retirement system, individuals will have a simple, efficient way to save for their retirement. Workers' money goes directly to their retirement savings account through payroll deduction and this money is often matched by the employer. Recent changes in law put in place by the

2006 Pension Protection Act (PPA) – such as auto-enrollment and auto-escalation – are improving the rates at which people save for their retirement at the workplace. Lower-income workers also benefit from targeted tax breaks that provide an additional incentive to save through the use of the Saver's Credit. Under the current system, individuals also benefit from the employer's role as a fiduciary who oversees investment management, monitors plan fees and services, and selects quality investment alternatives. This structure allows individuals to have access to well thought out, low-cost investment options.

Fortunately, even if an employer does not sponsor a retirement plan, both the business owner and his employees can save for their retirement in an individual annuity. Annuities can be used to fund an individual retirement account and to accumulate additional retirement savings. Moreover, an individual annuity provides guaranteed lifetime income in retirement.

Unfortunately, proposals that would dramatically change the current tax incentives for retirement savings have been put forward and analyzed by members of Congress. These proposals tend not to focus on how policymakers can achieve better retirement savings outcomes, but rather focus on collecting additional revenues. Independent analysis has generally found that these proposals would be detrimental to retirement savings and would disproportionately – and negatively – impact younger and lower income workers.

In his testimony before the Senate Finance Committee in 2011, Dr. Jack VanDerhei discussed EBRI's analysis of one such proposal put forward by Dr. Bill Gale that would transition the current deduction-based retirement system into a system incentivized by refundable tax credits for retirement savings. EBRI's analysis of this proposal found that the lowest income workers would be most likely to react to such a change by reducing their retirement savings (56.7% of respondents to their survey would reduce savings). Additionally, EBRI found that a proposal of this sort would significantly reduce Americans' total retirement savings. This is especially true for younger Americans who, under EBRI's most generous assumptions, could see a reduction in their 401(k) account balances of at least 11% – however this reduction could be as high as 30 or 40% under more realistic assumptions.

Further, proposals put forward by other groups would have policymakers limit the amount Americans can save annually. In addition to sending a negative message about the importance of saving for retirement, these proposals were also found to disproportionately hurt younger workers trying to saving for retirement. We urge this Committee to preserve the current system of retirement savings incentives and examine ways to build on its successes.

Separately, some states are considering legislation to create government-sponsored retirement plans for private sector workers. These proposals raise many questions and concerns, including application of ERISA to state-run plans, increased taxpayer liabilities, and direct state competition with the private sector. Instead, states should focus their efforts on state-wide education programs that raise awareness of retirement security issues, promote retirement savings, and encourage the adoption of new plans.

PROPOSALS TO EXPAND RETIREMENT SAVINGS OPPORTUNITIES

ACLI urges this Committee to look at other proposals that would expand retirement savings opportunities. The ACLI supports reforms to and expansion of the private multiple employer plan (MEP) system to further encourage and facilitate participation by employers that are not prepared to sponsor a stand-alone retirement plan. MEPs can be an important tool to reduce costs and administrative burdens. Under a MEP, businesses join together to achieve economies of scale and advantages with respect to plan administration, and advisory services. MEPs may be a good option for employers that are not confident they can or should sponsor their own retirement plan. Participation in a MEP may facilitate a smooth transition to a stand-alone employer-sponsored retirement plan.

Additionally, the Administration has put forward the Automatic IRA (AutoIRA) proposal in its budget proposals. The proposal would require any employer in business for at least two years and having ten or more employees to automatically enroll eligible employees into a Roth IRA. If the employer offers a qualified plan, SEP or SIMPLE retirement plan for its employees, it is not required to participate. However, if the employer's qualified plan otherwise excludes a portion of its workforce (i.e., a subsidiary, or division of the company) from participation in its qualified plan, the employer must provide an AutoIRA for those excluded employees.

DEFINITION OF FIDUCIARY

Access to affordable investment advice is key to helping close the retirement savings deficit. ACLI thanks Chairman Tester and many other members of this Committee for sharing their concerns over the Department of Labor's ("Department") initial proposed rule on the definition of fiduciary for purposes of giving investment advice. In response to the concerns expressed by you and others, in September, the Department announced that it would re-propose the rule. ACLI appreciates the Department's concern that under some circumstances the current rule impinges the Department's ability to bring enforcement actions in situations that are clearly abusive. We share the Department's interest in seeing that plans and participants who seek out and are promised advice, receive advice that adheres to the standards imposed by ERISA. At the same time, we were concerned that the initial proposed rule's pursuit of this objective would have disrupted investment sales and distribution practices that are customary in the marketplace, well understood, and commonly relied upon by financial service providers, plans and participants alike. We were also concerned that these changes would result in plans, plan participants, and IRA owners having less access to investment information.

Relevant to this Committee's jurisdiction is the fact that the SEC will soon issue a Request for Information in pursuit of its rulemaking. This is in response to Section 913 of the Dodd-Frank Wall Street Reform and Consumer Protection Act that a uniform fiduciary standard be implemented for all broker-dealers, their registered representatives and investment advisors. This initiative directly impacts many of the same individuals that would be affected by the fiduciary rule being promulgated by the Department. ACLI has requested that these two agencies coordinate and issue their proposed regulations simultaneously. We hope that any re-proposed rule will advance the Department's and the SEC's enforcement objective while avoiding unnecessary disruption and negative impacts to plans, participants and individuals.

IMPORTANCE OF LIFETIME INCOME

As the first wave of the baby boom generation reaches retirement age, it is important to educate American workers about the need to consider the need to have guaranteed lifetime income in retirement. Many current retirees are fortunate in that they are receiving lifetime monthly income from both Social Security and an employer-provided defined benefit (DB) pension. That situation is rapidly changing. Today, more workers have retirement savings in DC plans, which largely do not offer the option to elect a stream of guaranteed lifetime income. This change leads to questions of how individuals will manage their savings to last throughout their lifetimes. Workers need to understand the value of their retirement savings as a source of guaranteed lifetime income. With this information, workers would be in a better position to consider augmenting their Social Security benefit with additional amounts of guaranteed lifetime income. This income may be used to meet anticipated monthly expenses and it shifts the risk of outliving one's savings to a life insurer.

ACLI thanks Senator Herb Kohl, a member of this Committee and Chairman of the Senate Aging Committee, for his continued support of the bipartisan "Lifetime Income Disclosure Act." This is the first step in helping individuals think of defined contribution plan savings as not only a lump sum balance, but also as a source of guaranteed lifetime income. With this additional income information on a benefit statement, coupled with the Social Security income statement, workers can see how much monthly income they could potentially receive in retirement. Workers can better decide whether to increase their savings, adjust their 401(k) investments or reconsider their retirement date, if necessary, to assure the quality of life they expect in retirement.

Over the long-term, the nation will benefit because people who address their long-term financial security needs today are less likely to need public assistance tomorrow. Government policies that encourage prudent behavior, such as long-term savings, should not only be maintained, they should be enhanced. Therefore, ACLI continues to urge policymakers to support and build on the current employer-based retirement system and reject any proposals that would limit Americans' opportunity to save and prepare for their retirement. We would also urge policymakers to examine ways in which Congress might better educate individuals about their lifetime income needs. ACLI looks forward to working with the Committee in taking these important steps today to help address tomorrow's retirement income security crisis.