

The Automatic 401(k): A Policy Perspective

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common sense reforms
real world results

Adequacy of retirement saving

- Significant share of low- and middle-income families appear to be undersaving for retirement
- Median value of 401(k)s+IRAs for households on verge of retirement: only about \$10,000

Two core impediments to retirement saving

- Complicated and difficult
 - Inertia and “freezing” in response to complexity translate into non-saving
- Upside-down incentives
 - Weak financial incentives for moderate and lower-income household to save

Problem #1: Complexity/decision-making

As pension system shifts to 401(k)s,
workers must:

- Decide whether to participate
- Decide how much to contribute
- Decide how to invest
- Decide when and how to take the money out

Making It Easier: Automating the 401(k)

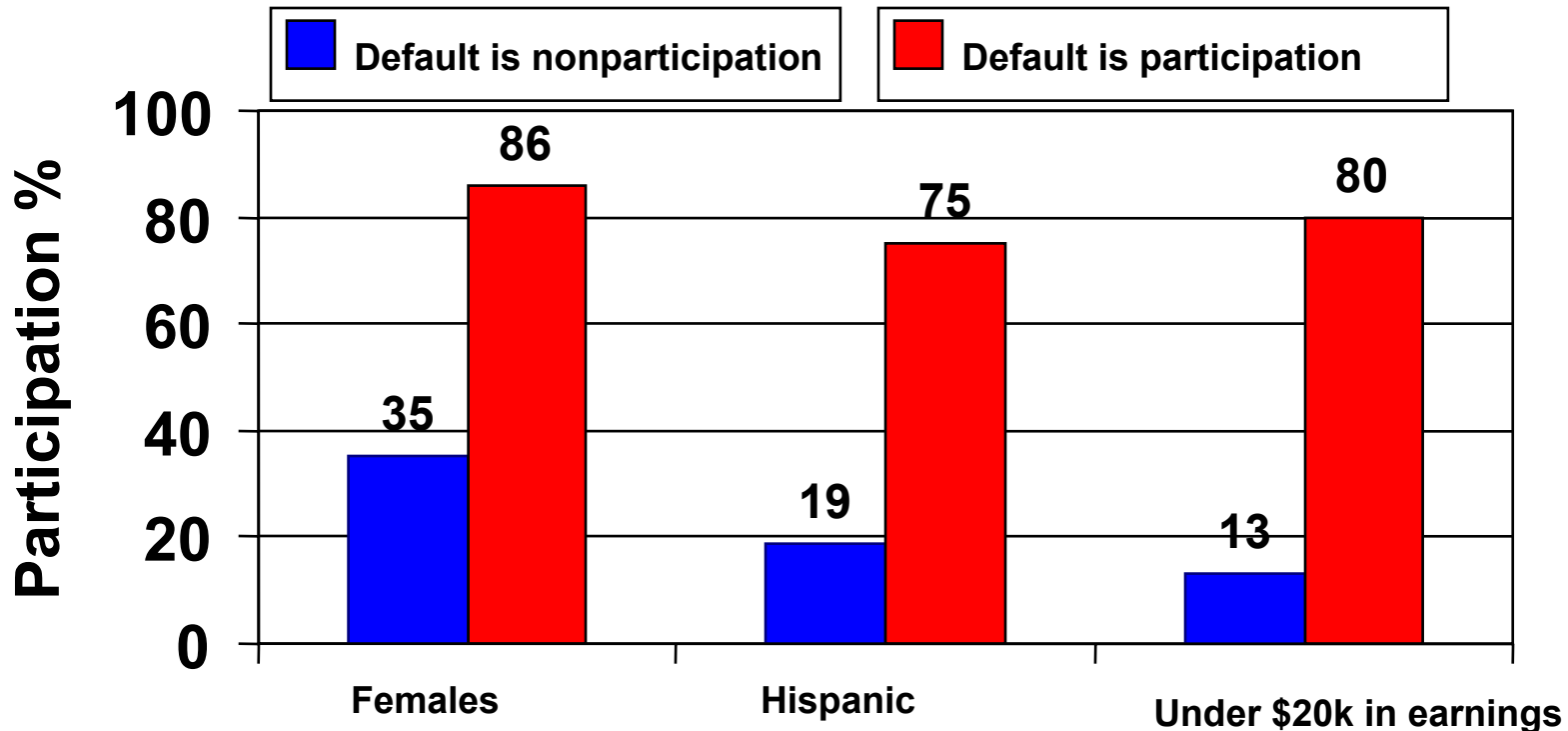
Where we are now:

- Employee must
 - Actively elect to join
 - Decide how much to contribute
 - Decide how to invest
 - Decide what to do at a job change

Where we should be:

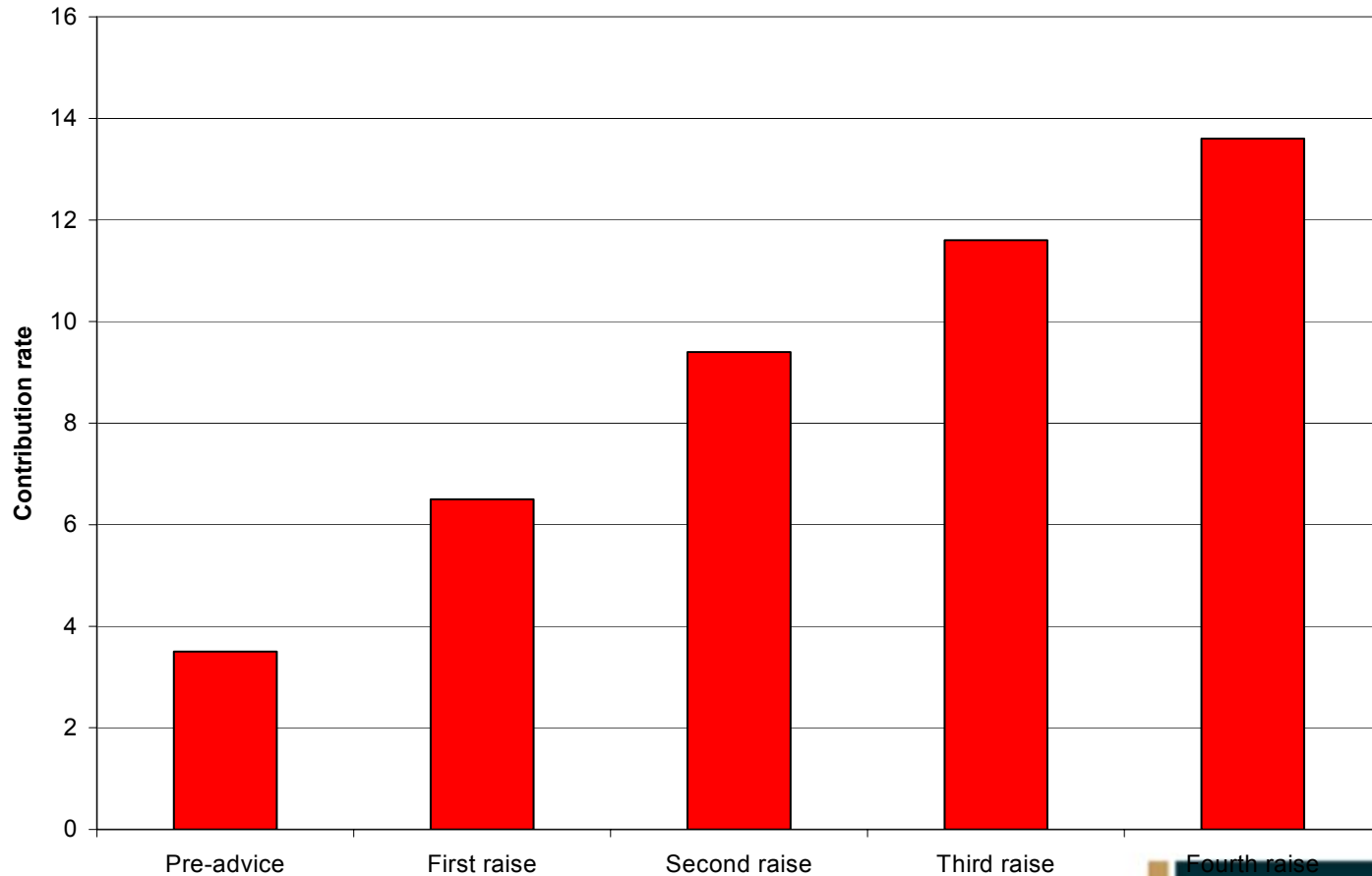
- Defaults at each step
 - Automatic enrollment
 - Automatic escalation
 - Default investment in well-designed fund
 - Default rollover at job change

Impact of 401(k) Auto Enrollment



Actual results for employees with between 3 and 15 months tenure. Study by Professor Brigitte Madrian, University of Pennsylvania's Wharton School, and Dennis Shea, United Health Group.

Automatic Escalation: “Save More Tomorrow”



Source: Thaler and Benartzi

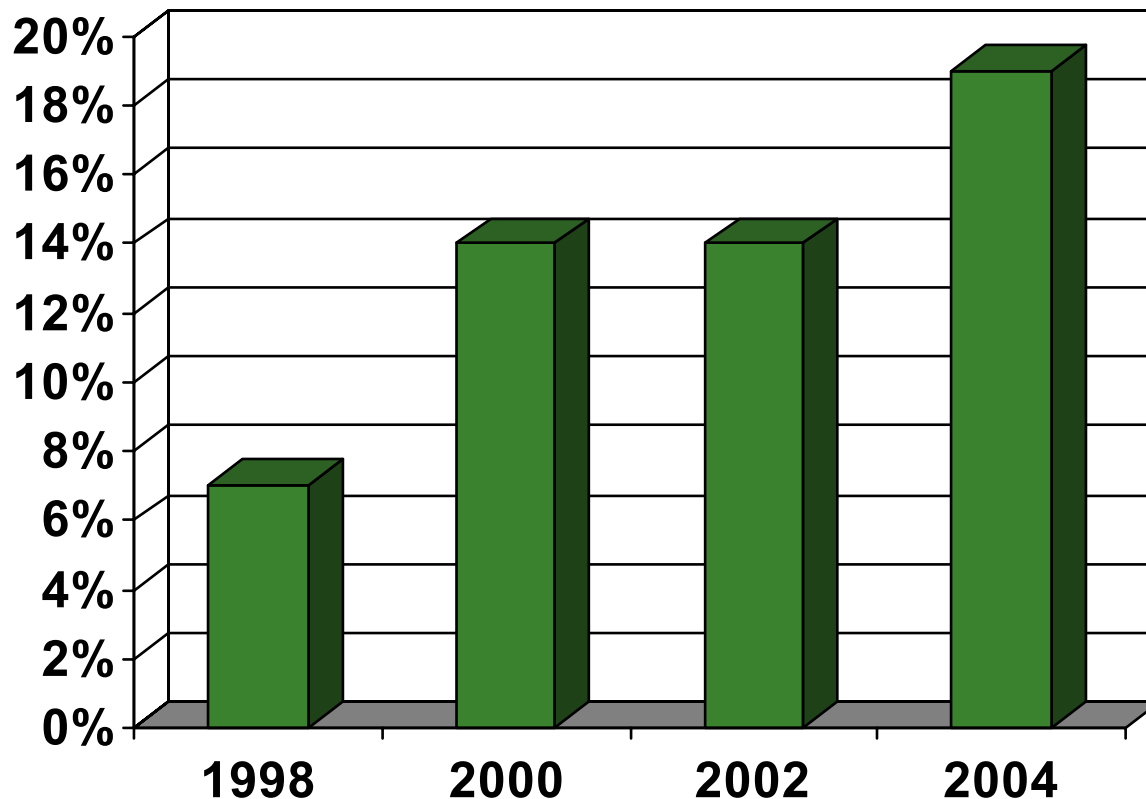
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Automatic 401(k): Automatic Enrollment

Profit Sharing/401(k) Council of America:

- 8 percent of plans surveyed had automatic enrollment
 - 24 percent of plans with at least 5,000 employees

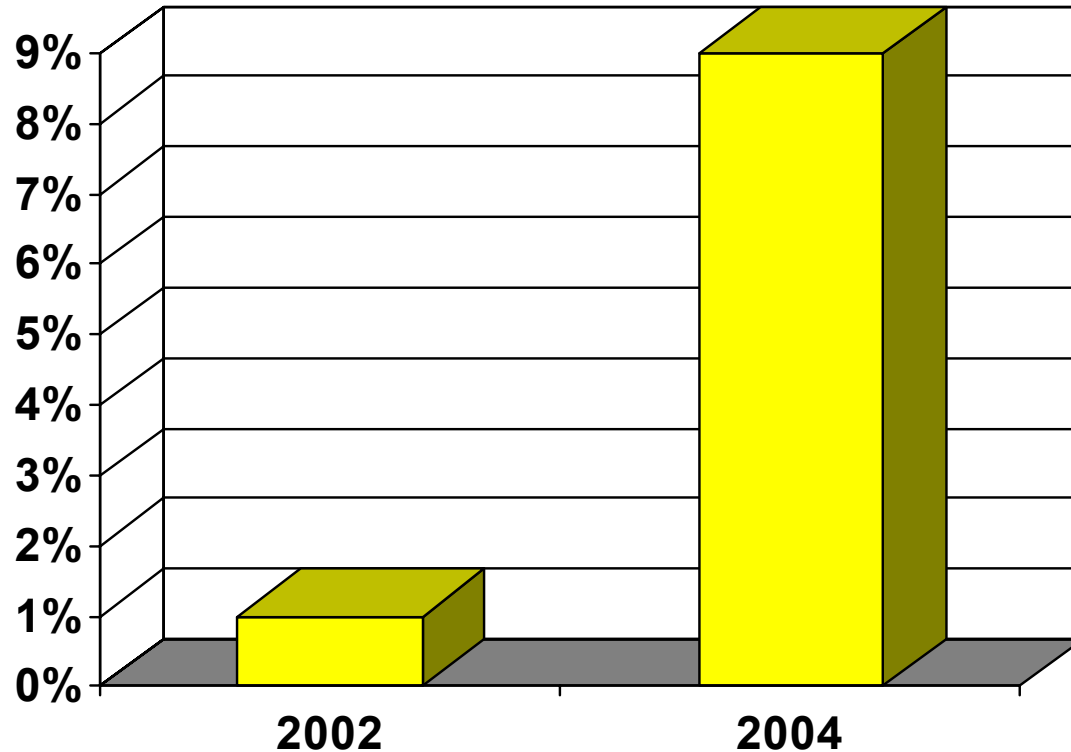
Automatic Enrollment: Trends



- 2005 Hewitt Universe Benchmarks Survey, Hewitt Associates, LLC.

Note: 458 employers participated in the survey, representing 2.5 million participants and \$264 billion in plan assets. Median size of surveyed employers is 3,700 employees; average is 14,183.

Automatic Escalation: Trends



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Automatic 401(k): Trends (cont.)

- 47 percent of employers said they are either “Somewhat Likely” or “Very Likely” to focus on implementing automatic features over the next year.

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Note: 458 employers participated in the survey, representing 2.5 million participants and \$264 billion in plan assets. Median size of surveyed employers is 3,700 employees; average is 14,183.

Obstacles

- Hewitt survey – those uncomfortable with automatic features raise concerns such as:
 - ❑ Employee acceptance (33 percent)
 - ❑ Fiduciary responsibility (28 percent)
 - ❑ Prefer to use safe harbor (12 percent)
 - ❑ Too costly (9 percent)

Policy steps: The easy ones

- Clarify federal ERISA preemption of state law to permit auto enrollment
- Provide measure of fiduciary liability protection for well-designed default investments
- Allow short grace period for employees to opt out and receive penalty-free refund of deferrals

Policy steps: Other possibilities

- Explore reforms to non-discrimination rules
- Incorporate key features within TSP

A caution: The asset tests

- In 2000, about one-fourth -- 27 million out of 105 million -- of U.S. households participated in state or Federal means-tested benefit programs (Food Stamps, SSI, Medicaid, TANF)
- Asset tests in these means-tested benefit programs often impose steep implicit tax on retirement saving
- Rules are also complicated and seemingly arbitrary
 - Food Stamp Program exempts 401(k)s but not IRAs, so workers rolling over can be disqualified
- Paper exploring problem and solutions posted at www.retirementsecurityproject.org

Further challenge: Withdrawal stage

- Woman aged 65
 - Roughly 20 year life expectancy, to age 85
 - Probability of living past 90: more than 30 percent
 - Probability of living past 95: almost 15 percent
- Inflation at 3 percent per year:
 - 10 years: -25 percent in real terms
 - 25 years: -52 percent in real terms
- Inflation-adjusted annuity. But no inflation protection and roughly 15 percent expected value loss from purchasing individual life annuity (Jeffrey Brown, Olivia Mitchell, and James Poterba, "Mortality Risk, Inflation Risk, and Annuity Products," National Bureau of Economic Research, Working Paper 7812, July 2000).

Conclusions

- Policy-makers can help households save by creating a better environment for automatic 401(k)s
- Need to fix asset tests
- Need to explore ways of facilitating actuarially fair, inflation-adjusted life annuities