NEW IDEAS FOR PENSION REFORM

Background Paper and Bibliography

for the

Employee Benefits Committee

May 10, 2014

by

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by Professor Jonathan Barry Forman

I. THE PROGRAM AND SPEAKERS

Saturday, May 10, 2014
8:30 AM – 11:30 AM
Employee Benefits Committee
Chair: Martha L. Hutzelman, Law Office of Martha L. Hutzelman, Columbus, OH

9:30 AM New Ideas for Pension Reform (Presented jointly by the Committee on Tax Policy and Simplification and the Employee Benefits Committee)

This panel will examine several recent ideas for pension reform, including Senator Orrin Hatch's proposed Secure Annuities for Employee (SAFE) Retirement Act and Senator Tom Harkin's proposed USA Retirement Funds proposal. The panel will also consider how so-called "tontine" annuities and other pension designs could be used to improve retirement income security.

MODERATOR: Professor Kathryn J. Kennedy, John Marshall Law School, Chicago, IL, http://www.jmls.edu/directory/profile.php?lastfirstname=Kennedy_Kathryn

PANELISTS: Preston Rutledge, Tax and Benefits Counsel, Senate Finance Committee, Republican Tax Staff, U.S. Senate, Washington, DC, http://www.zoominfo.com/s/#!search/profile/person?personId=1602830849&targetid=profile

Michael Kreps, Senior Pension & Retirement Counsel, Senate Committee on Health, Education, Labor & Pensions, U.S. Senate, Washington, DC, http://www.linkedin.com/pub/michael-p-kreps/17/99/609

Rowland Davis, RMD Pension Consulting, Chicago, IL & Senior Fellow at the Center for American Progress, Washington, DC, http://www.americanprogress.org/about/staff/davis-rowland/bio

Professor Jonathan Forman, University of Oklahoma, Norman, OK, http://www.law.ou.edu/content/forman-jonathan-b

II. SENATOR ORRIN HATCH'S PROPOSED SECURE ANNUITIES FOR EMPLOYEE (SAFE) RETIREMENT ACT

Hatch Unveils Bill to Overhaul Pension Benefit System, Secure Retirement Savings (June 9, 2013), http://www.hatch.senate.gov/public/index.cfm/releases?ID=bb7de6e5-a45f-4851-b17e-2c9c6dce972b:[1]

> *The SAFE Retirement Act of 2013* streamlines current pension programs by providing states, employers, and American workers with stronger tools for providing pensions and better secure retirement savings. Specifically, the Hatch plan takes a three-prong approach to pension reform:
>
> **Public Pension Reform:** This legislation creates a new pension plan, called the SAFE Retirement Plan, with stable, predictable costs that state and local governments may use to deliver secure pension benefits. This new tool eliminates pension plan underfunding prospectively while delivering lifetime retirement income to employees. SAFE Retirement Plans are state regulated, market based, fixed annuity solutions to the retirement income crisis in the states, with a consumer safety net, only minimal involvement by the federal government and no federal taxes.
>
> **Private Pension Reform:** The SAFE Retirement Act includes a host of common-sense and long-overdue reforms that will especially help small- and mid-sized employers establish and maintain retirement savings plans for their employees. The SAFE Retirement Act also creates an innovative new plan called the Starter 401(k), a retirement savings plan that allows employees to save up to $8,000 per year, more than in an IRA, but does not involve the administrative burden or expense of a traditional 401(k) plan. The Starter 401(k) is perfect for a small or start-up business that is not in a position to contribute to a plan but wants to help its employees save.
>
> **Access to Professional Investment Advice:** The SAFE Retirement Act also takes action to stop the Department of Labor from unilaterally over-regulating 401(k) plans and IRAs. The legislation restores jurisdiction over the fiduciary rules in the Tax Code to the Treasury Department. In addition, Treasury will consult with the Securities and Exchange Commission in prescribing rules relating to the professional standard of care owed by brokers and investment advisors to IRA investors. This legislation is consistent with the bipartisan and bicameral effort to convince the Labor Secretary to preserve access to professional investment advice for middle class investors.

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[1] See also *Secure Annuities for Employee (SAFE) Retirement Act of 2013* (summary of the legislation, 2013), http://www.hatch.senate.gov/public/_cache/files/730c41a0-4bc6-48ba-aabf-2075b08a853c/SAFE%20Retirement%20Act%20Summary.pdf.

III. Senator Tom Harkin's Proposed USA Retirement Funds Proposal

Harkin Unveils Legislation to Address Retirement Crisis, Rebuild Private Pension System (January 30, 2014), http://www.help.senate.gov/newsroom/press/release/?id=841825d1-509e-4934-9d7e-968d0853b795:[2]

> Harkin's legislation would create a new type of privately-run retirement plan that combines the advantages of traditional pensions—including lifetime income benefits and pooled, professional management—with the portability and ease for employers of a 401(k). The key features of USA Retirement Funds include:
>
> **Universal Coverage**: USA Retirement Funds would be available to everyone, including the more than 61 million people without access to a workplace retirement plan and the 14.5 million people who are self-employed.
>
> **Automatic Enrollment**: Employees would be automatically enrolled at a rate of 6 percent per year, but could choose to raise, lower, or stop their contributions.
>
> **Secure Lifetime Income**: Benefits would be paid monthly for life, and participants would be shielded from market volatility and other risks.
>
> **Lower Costs**: Pooled, professional management and risk sharing will reduce the cost of retirement by up to 50 percent.
>
> **Portability**: People would be able to take their benefit with them as they change employers.
>
> **Simple and Easy for Businesses**: Small businesses can easily participate and would not have to take on risk or undue administrative burden.

IV. The Center for American Progress's Proposed Secure, Accessible, Flexible, and Efficient, or SAFE, Retirement Plan

See generally Rowland Davis & David Madland, *American Retirement Savings Could Be Much Better* (2013), http://www.americanprogress.org/wp-content/uploads/2013/08/SAFEreport.pdf:[3]

> The personal retirement-savings plans that most Americans use, such as 401(k)s and Individual Retirement Accounts, or IRAs, are unnecessarily costly and needlessly risky.

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[2] See also *Help Chairman Tom Harkin Introduces the USA Retirement Funds Act* (long summary of the legislation, 2014), http://www.help.senate.gov/imo/media/doc/USARF%20Summary%20-%20Long.pdf.

[3] See also David Madland, *Making Saving for Retirement Easier, Cheaper, and More Secure* (Center for American Progress, 2012), http://www.americanprogress.org/wp-content/uploads/2012/09/MadlandBunkerRetirementBrief.pdf.

But instituting another kind of retirement plan that combines the best elements of both defined-contribution and defined-benefit plans—such as the Center for American Progress's proposed Secure, Accessible, Flexible, and Efficient, or SAFE, Retirement Plan, or the related USA Retirement Funds proposal from Sen. Tom Harkin (D-IA)—could provide a more secure retirement at a far lower cost, according to a new analysis by the Center for American Progress.

These two proposals, also known as collective defined-contribution plans, improve upon the 401(k) model in a number of ways. As described in greater detail in a fall 2012 report, titled "Making Saving for Retirement Easier, Cheaper, and More Secure," CAP's SAFE Retirement Plan combines elements of a traditional pension—including regular lifetime payments in retirement, professional management, and pooled investing—with elements of a 401(k), such as predictable costs for employers and portability for workers.

Some of the SAFE, Retirement Plan's key features include the following:

- Plans would be organized as nonprofit organizations run by independent boards with significant participant representation. Their sole objective would be to maximize long-term benefits for all participants.
- Plans would be available to all workers regardless of whether their employer offered retirement benefits prior to the introduction of the plan.
- Investments would be professionally managed. SAFE Retirement Plan boards would be able to contract with professional investment-management providers.
- Benefits would be portable when workers change jobs and would be payable for life.
- Each worker would select a plan, and his or her employer would only need to facilitate enrollment and any required payroll deductions. If employers make contributions, employer costs would be fixed as a percentage of pay, and employers would not be faced with administrative or fiduciary obligations.
- The risks of the SAFE Retirement Plan would be spread among workers and retirees rather than borne solely by employers, as they are in a traditional pension plan, or individual workers, as they are in a 401(k).
- While payout levels in the SAFE Retirement Plan would not be guaranteed, the plan would be far less risky for workers and retirees than a 401(k), with a higher likelihood of achieving target benefit levels.
- The plan would also be much more efficient than a 401(k) in achieving required investment returns at a low cost.
- This hybrid model would not require employers to take on the risk of guaranteeing returns as they must with traditional pensions, nor would it impose any additional costs or risk on government.

V. Tontine Pensions

See generally Jonathan Barry Forman & Michael J. Sabin, *Tontine Pensions: A Solution to the State and Local Pension Underfunding Crisis*, 163 University of Pennsylvania Law Review ___ (forthcoming 2014), http://ssrn.com/abstract=2393152:

> In a simple tontine, a group of investors pool their money together to buy a portfolio of investments, and, as investors die, their shares are forfeited, until the entire fund finally goes to the last survivor. For example, on the TV show "Mash," Colonel Sherman T. Potter, as the last survivor of his World War I unit, got to open the bottle of French cognac that he and his buddies bought (and share it with his Korean War compatriots). This Article shows how variations on the tontine principle—that the share of each, at her death, is enjoyed by the survivors—can be used to develop a variety of attractive retirement income products including tontine pensions.
>
> Unlike traditional pensions—which are frequently underfunded, tontine pensions would always be fully funded. Also, unlike traditional pensions—where the employer must bear all the investment and actuarial risks—with a tontine pension, the employer would bear neither of those risks. These two features would make tontine pensions particularly attractive to employers who care about providing retirement security for their employees but who want to avoid the risks associated with having a traditional pension.
>
> Tontine pensions could also solve the chronic underfunding problem of State and local pension plans. For our example, we show how California could replace its $71 billion underfunded teachers' pension (CalSTRS) with a tontine pension and never again have to worry about underfunding attributable to future benefit accruals.
>
> There is another feature of tontine pensions that we find particularly attractive. A tontine pension would closely resemble an actuarially fair variable life annuity, but it could be run by a low-fee discount broker. As no money would need to be set aside for insurance agent commissions or for insurance company reserves, risk-taking, and profits, a discount broker could manage a tontine plan for as little as 0.30% of assets under management. That means that tontine pensions would be able to provide significantly higher benefits to retirees than commercial annuities and other retirement income products.

VI. Other Recent Proposals

A. MyRAs

In his *2015 Federal Budget*, President Barack Obama recently proposed that the government offer no-fee starter retirement savings accounts known as "MyRAs" (short for My Retirement Accounts) that would be taxed like Roth IRAs: earnings generally can be withdrawn tax free after age 59½.[4] Participants in these new accounts would earn interest at the same variable interest rate as the federal employees' Thrift Savings Plan (TSP) Government Securities Investment Fund.

B. Cap the Total Accumulation of Retirement Benefits

In his *2014 Federal Budget*, President Barack Obama proposed an overall cap on the total amount that individuals could accumulate in their tax-favored retirement plans.[5] More specifically, once an individual had accumulated enough to provide a joint and survivor annuity of $205,000 a year starting at age 62, the proposal would prohibit further contributions under such plans. The maximum annuity cap was designed to equal the maximum annuity that can be paid by a qualified defined benefit plan ($205,000 in 2013 and $210,000 in 2014),[6] and the Treasury estimated that the maximum permitted accumulation for an individual in 2013 was around $3.4 million.[7]

C. Cap Contributions at the Lesser of 20% of Compensation or *$20,000*

In 2010, the National Commission on Fiscal Responsibility and Reform (co-chaired by Erskine Bowles and Senator Alan Simpson) suggested an annual cap on retirement

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[4] *See*, *e.g.*, U.S. Department of the Treasury, *myRA: A Simple, Safe, Affordable Retirement Savings Account* (2014), http://www.treasurydirect.gov/readysavegrow/start_saving/retirementaccountfactsheetenglish.pdf.

[5] U.S. Department of Treasury, *General Explanation of the Administration's Fiscal year 2014 Revenue Proposals* 165 (2013), http://www.treasury.gov/resource-center/tax-policy/Documents/General-Explanations-FY2014.pdf; Joint Committee on Taxation, *Description of certain revenue provisions contained in the President's fiscal year 2014 budget proposal* 136 (JCS-4-13, 2013), https://www.jct.gov/publications.html?func=startdown&id=4538. Tax-favored retirement plans include traditional IRAs (including SEPs and SIMPLE IRAs), Roth IRAs, qualified retirement plans (e.g., I.R.C. § 401(k) plans), I.R.C. § 403(b) plans, and governmental I.R.C. § 457(b) plans.

[6] I.R.C. § 415(b)(1)(A); Internal Revenue Service, *IRS Announces 2014 Pension Plan Limitations: Taxpayers May Contribute up to $17,500 to their 401(k) plans in 2014* (IR-2013-86, October 31, 2013), http://www.irs.gov/uac/IRS-Announces-2014-Pension-Plan-Limitations;-Taxpayers-May-Contribute-up-to-$17,500-to-their-401(k)-plans-in-2014.

[7] U.S. Department of Treasury, *supra* note 5, at 166.

contributions.[8] The proposal would cap the total employer and employee retirement plan contributions at the lesser of 20% of the employee's compensation or $20,000. This so-called "20/20" proposal, which would limit the ability of high-income individuals to use retirement tax expenditures, was offered as a part of the Commission's larger plan to raise revenue in order to cut deficits and reduce marginal tax rates.

Along the same lines, the Congressional Budget Office recently outlined a proposal to reduce the current limits on annual contributions to retirement plans.[9] Under the proposal, the maximum individual contribution would be limited to $15,500 per year for 401(k)-type plans and $5,000 per year for IRAs; and the proposal would also limit the total of employee and employer contributions to defined contribution plans to $46,000.[10] This proposal would raise $6.7 billion in Fiscal Year 2015 and around $89 billion over ten years.[11]

D. Other Ideas

- Rowland M. Davis, *The Tracker Plan: A Controlled Risk Defined Contribution Retirement Program*, 46(3) John Marshall Law Review 681 (Spring 2013), http://repository.jmls.edu/cgi/viewcontent.cgi?article=1214&context=lawreview:

  > The Tracker Plan is designed so that financial risk can be shared between the participant and employer, but it is a defined-contribution program in the sense that any residual risk ultimately falls to the participant.

- Donald E. Fuerst, FSA, *Affordable Retirement Income Through Savings and Annuities* (prize-winning paper, Society of Actuaries, Retirement 20/20 call for models to consider

[8] National Commission on Fiscal Responsibility and Reform, *The Moment of Truth* 31 (2010), http://www.fiscalcommission.gov/sites/fiscalcommission.gov/files/documents/TheMomentofTruth12_1_2010.pdf.. See also Jack VanDerhei, *Capping Tax-Preferred Retirement Contributions: Preliminary Evidence of the Impact of the National Commission on Fiscal Responsibility and Reform Recommendations*, 32(7) EBRI Notes 2 (Employee Benefit Research Institute, 2011), http://www.ebri.org/pdf/notespdf/EBRI_Notes_07_July-11.TaxCap_UnionHI.pdf.

[9] Congressional Budget Office, *Options for Reducing the Deficit: 2014 to 2023* 133-34 (2013), http://www.cbo.gov/sites/default/files/cbofiles/attachments/44715-OptionsForReducingDeficit-2_1.pdf.

[10] Under current law, the total of employer and employee contributions to a defined contribution plan cannot exceed under $52,000 in 2014. I.R.C. § 415(c)(1)(A); Internal Revenue Service, *supra* note 6.

[11] Congressional Budget Office, *supra* note 9, at 134.

ways to reform the retirement system, 2010), http://retirement2020.soa.org/Files/2010-fuerst.pdf:

> This paper proposes a new system for accomplishing affordable retirement security. Compulsory savings for all workers is combined with new transparent investment vehicles designed to promote competition based on expense levels, fund performance and customer service. At least 50 percent of all accounts are invested in Treasury inflation-protected securities (TIPS) to preserve purchasing power. The balance of accounts can be invested more aggressively to provide growth. Employers may voluntarily supplement retirement savings.

- George A. (Sandy) Mackenzie & Jonathan Barry Forman *Reforming the Second Tier of the U.S. Pension System: Tabula Rasa or Step by Step?*, 46(3) JOHN MARSHALL LAW REVIEW 631 (2013), http://repository.jmls.edu/cgi/viewcontent.cgi?article=1213&context=lawreview:

> This article focuses on how to reform America's employer-sponsored pension system. It begins with an overview of the current retirement system, which includes both Social Security and private pensions. Next, this article considers how much retirement savings workers will need to ensure that they have adequate incomes throughout retirement. Finally, the article offers some recommendations about what a good, second-tier (employer-sponsored) pension system would look like.

- John A. Turner & Nari Rhee, *Lessons for Private Sector Retirement Security from Australia, Canada, and the Netherlands* (National Institute on Retirement Security, Issue Brief, August 2013), http://www.nirsonline.org/storage/nirs/documents/International%20Paper/final_international_august_2013.pdf:

> This paper provides international perspectives on retirement security by outlining social security and universal, quasi-universal, and voluntary employer-provided retirement plans in Australia, Canada, and the Netherlands. These countries have levels of development similar to the U.S., and have established retirement income systems that are recognized for their high quality in terms of adequacy, sustainability, and integrity. The goal of this paper is to assess the level of security and risk provided by each country's retirement system through the layers of income replacement provided by government, employer, and individual programs. In addition, this paper highlights key issues and lessons for consideration by U.S. policymakers and stakeholders.