

## MEMO

**TO:** Connecticut Retirement Security Board Subcommittee  
**DATE:** April 20, 2015  
**FROM:** Mercer & Oliver Wyman  
**SUBJECT:** Plan Design Variables

### Introduction

This memo discusses three aspects of the Connecticut Retirement Security program that we believe are important to aligning program design with the Retirement Security Board's goals: (1) whether the default retirement account should be pre- or post-tax (2) whether opt-out rates would be lower and other policy objectives better met via a defined contribution plan versus an individual account and (3) presentation and modelling of guarantees. Below we discuss additional considerations in deciding between a traditional versus Roth IRA relative to the goal of increasing retirement adequacy. We then discuss the potential drivers for private sector employees potentially preferring some form of a sponsored defined contribution plan to either IRA design alternative. Finally, we provide some initial thoughts on modelling contribution guarantees and how this point should be presented in the survey.

To aid the Retirement Security Board in evaluating what follows, we provide below Bureau of Labor Statistics data (Table 1). This data indicates that nationally 75-86% of workers considered below middle class income level<sup>1</sup> with access to a work place savings plan participate in these plans. We think this statistic is important, because it suggests that lower income workers will save if given the opportunity.

TABLE 1: PARTICIPATION BY WAGE

Annual earnings \$2010	Any Retirement plans		
	% employers offering plan	% participate general population	% participate where plan available
<\$25k	44	33	75
\$25k-\$49k	72	61	86
\$50k-\$99k	85	80	94
\$100k +	87	84	96

\* Source: U.S. Bureau of Labor Statistics publication, "National Compensation Survey: Employee Benefits in the United States, March 2013."

<sup>1</sup> Pew Charitable Trusts Stateline blog (2015) estimate the lower bound salary to be considered middle class in Connecticut is c.\$44,800 and the upper bound is c.\$134,000 with a median of c.\$67,000. For simplicity and to accord with the Bureau of Labor Statistics cut-off, we deemed low income workers to be below \$50,000.

## **Roth versus Traditional IRA**

Based on our recent discussion with the Subcommittee, we take as given that the market survey must first test the variables that the legislation specified. The Center for Retirement Research (CRR) has recommended the base case scenario test assume a Roth IRA. As the legislation is silent on this aspect and the Task Force has yet to take a view, we understand that, pending further guidance from the Retirement Security Board, both Roth and traditional IRA options will be tested. While the feedback from the employee survey will be useful input into design, we believe the Retirement Security Board should also consider the following points in considering the Roth versus traditional IRA options:

1. The target population
2. Impact of taxes

### ***The target population***

We understand one of the primary reasons for recommending a Roth IRA as the default design option is that the program's target population includes low-income workers, who may need to withdraw funds from their savings account to meet spending needs even before retirement. For individuals with pre-retirement spending requirements, a Roth IRA may be preferable because contributions can be withdrawn tax free versus incurring ordinary income taxes plus a 10% early withdrawal penalty under a traditional IRA.

The legislation appears to set out the objective of expanding retirement plan coverage to all private-sector employees. While the legislation discusses preventing workers from falling back onto the state for welfare purposes, it does not explicitly focus on expanding coverage only to low-income workers. To help inform whether a Roth or traditional IRA is a better design option, it would be useful if the Retirement Security Board could provide guidance as to whether the target population is the entire uncovered population or whether lower income workers' needs should be given more weight.

If lower income workers are the primary target population, we think analysis around the ages of these workers and their overall expected income trajectory is important to determining whether they will remain low income workers and how the Connecticut Retirement Security savings program will fit into their savings and spending profile over time.

We understand the market survey will test whether workers in Connecticut value tax-free access to their contributions (Roth IRA) versus increased take-home pay (traditional IRA) or if contributing any money is too great a burden for either design, leading them to opt out. Separate from consideration of the survey results, we suggest that data around the actual incidence of hardship withdrawals and loans from pre-tax retirement savings should be considered to understand the impact of the 10% penalty on aggregate savings levels in practice.

## Taxes

Roth and traditional IRAs have different tax consequences for the saver. In addition to differences in marginal tax rates at contribution, as noted above, the income and taxation trajectory is important to assessing the aggregate benefit of pre- and post-tax options. Generally, a Roth IRA is better aligned to people who have adequate retirement savings and expect to be subject to a higher tax rate during retirement due to lack of deductions (e.g., for mortgage interest or dependents). A traditional IRA better supports low-income workers that are at risk of experiencing poverty in retirement. Lower income workers generally need to maximize take-home pay while saving, which a traditional IRA promotes. Additionally, lower income workers will most likely be subject to low tax rates during retirement, which means the tax rate at drawdown remains low.

TABLE 2: IRA TAXATION EXAMPLE IMPACT ON TAKE-HOME PAY

	3% Contribution		6% Contribution	
	Traditional IRA	Roth IRA	Traditional IRA	Roth IRA
Salary (\$43,000 each)	\$86,000	\$86,000	\$86,000	\$86,000
Contributions	\$2,580	\$2,580	\$5,160	\$5,160
Take-home pay	\$67,070	\$66,564	\$64,995	\$63,984

*\* Assumptions: married filing jointly, both spouses earn the same salary (\$43,000), 2 dependents, 2 personal exemptions, child tax credit, standard deduction.*

Anecdotal evidence from large 401(k) recordkeepers indicates that companies with pre- and post-tax savings options in their 401(k) plans automatically enroll employees, including lower income employees, into pre-tax savings options. Employers select the pre-tax option because they believe that lower income workers will have lower tax rates in retirement. Additionally, employers believe that individuals who start at the lower end of the wage scale but experience income increases as their careers progress, are more likely to alter where their contributions go over time; so the default to pre-tax savings is a better starting position for all workers.

## Individual Retirement Account versus Sponsored Plans

Recognizing that the market survey must cover the drafted legislation and there are cost constraints in expanding the scope of the project, Mercer asks that the Subcommittee include in the analysis the question of whether individuals prefer their own retirement savings account, i.e. IRAs, versus an employer sponsored plan. Overall, we believe that if employers are engaged and supportive of the savings process by offering a plan to their employees rather than simply facilitating automatic

enrollment in an IRA program (whether Roth or traditional), the Connecticut Retirement Security program will be more successful in achieving its goals.

We know that private sector retirement savings solutions exist today; however, for small employers these options are generally of relatively high cost and can have low quality. 71% of companies responding to a recent survey feel responsible for helping their employees achieve a financially secure retirement<sup>2</sup>. Cost concerns, lack of interest and the size of the company are employers' three most common reasons cited for not planning to offer a plan in the next two years. 33% of employers that do not offer 401(k) plans indicated they would be "likely to consider" a multiple employer plan. As such, there is evidence of potential unmet employer sponsor demand that a state-intermediated alternative might meet.

Reasons for considering sponsored plans versus individual accounts are:

- 401(k) style plans allow greater overall savings and wealth accumulation with the ability to include both pre-tax and Roth contributions, making them more flexible across different income levels and anticipated tax planning situations, and helping achieve a goal of higher average income replacement ratio in retirement.
- As Table 1 above shows, an employee's access to an employer-sponsored retirement plan is a primary driver of improved participation rates. Lower income employees are still likely to participate, where there is a plan.
- Some members of the Subcommittee expressed additional goals of improving overall retirement replacement income across the population and discouraging employers from eliminating existing plans in favor of a potentially wage / savings reducing option, e.g. an IRA where company match would not be allowed. If workers are indifferent to an IRA versus a workplace program, we believe that the overall program design should include incentives to encourage continued employer-sponsored solutions to maximize wealth accumulation opportunities and lower the state's implementation costs.
- ERISA has played a positive role in protecting participants. Moving from employer-sponsored plans to individual IRA accounts either means forgoing most of this protection or creating incremental cost to re-create similar protections at the state level and enforcing them. While ERISA may discourage smaller employers from providing plans, Mercer believes that there are ways to manage the fiduciary liabilities and governance requirements at the state level, so that ERISA and the Department of Labor may be relied upon to support the governance process without placing an undue burden on the state or employers.
- The published costs of IRA administration and investments do not appropriately reflect the expense profile that the state is likely to encounter in promoting, managing and monitoring the program. While Mercer is considering a wide range of potential legal and operating structures

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<sup>2</sup> 15th Annual Transamerica Retirement Survey released in April 2015.

to efficiently organize and support an IRA platform, we would also like to understand whether the legislature's objectives of increasing savings could be met by providing better small employer options and / or if employees would prefer their employers' involvement to a more impersonal, auto-enrollment platform with mandated investment options (or vice versa).

- The Sub-committee had directed us to consider possible developments over the next three years. At the federal level, regulators are looking closely at the states' "Secure Choice" and similar initiatives, as well as considering federal reforms to increase coverage and portability. We believe that federal action or reform will most likely coalesce around a sponsored plan solution. Mercer suggests the program design phase should consider scenarios in which there is federal action that might render an account-based approach uneconomic or less desirable. To help inform planning for such a scenario, we believe having some insight into individuals' preferences for individual retirement accounts or sponsored plans would be useful.

## **Guarantee**

Mercer would like the Subcommittee to consider how the contribution guarantees should be modelled, as well as how this design element is tested in the survey. In our view, the modelling should be forward looking and in line with expense estimates that current market providers agree reflect the market cost of delivery. For the survey results to be meaningful, we think the potential market cost of delivering this guarantee should also be described and disclosed in the survey questions.

The proposed guarantee modeling reflects expectations that might apply over the very long term (i.e., after the economy and capital markets have reverted to levels of inflation and interest rates that are more consistent with those experienced over the past 80 years), as opposed to the current starting conditions. The modelling also appears to be on a gross of fees basis. Mercer thinks the following items should be specifically included in the modelling:

- An administrative and investment expense ratio associated with offering and operating the plan should be deducted from the expected return estimates. As was communicated during the recent Sub-committee meeting, our working estimate for the administration and investment expense ratio to provide the plan is 0.75%.
- Expected forward-looking nominal and real returns for bonds currently available in the market are much lower than the proposed historical figures. If the portfolio were invested at AA, the gross nominal yield-to-maturities currently available at maturities of 5, 10, 20, and 30 years are 2.2%, 3.2%, 4.0%, and 4.3%, respectively. If we assume the TIPS curve represents consensus expectations of breakeven inflation, the corresponding forward-looking real expected returns are 0.4%, 1.3%, 2.1%, and 2.2%, respectively. Net of an expense ratio around 0.75%, this data implies a significantly different distribution of future outcomes than has been modelled in the CRR paper.
- While we can debate the forward-looking expected return to equities, Mercer believes these expected returns are likely to be lower than the historical returns over the period used as

assumptions in the CRR model. Our current forward-looking nominal and real return assumptions for global all country equities are 7.3% and 5.1%, respectively.

Our view is that once the forward-looking, market verified costs are incorporated that value of the guarantee will be eroded. If this view holds, we think the survey should explicitly reflect the cost of the guarantee to ensure that responders have adequate information on which to base a decision.

## **Conclusions**

On the issue of whether the default retirement account should be pre- or post-tax, Mercer believes the decision should reflect the balance that the Retirement Security Board establishes between targeting a relatively high income replacement ratio in retirement, e.g. a goal of 80%, and minimizing the proportion of the target population that experiences poverty in retirement. All else equal, we believe the former objective will be better supported on average by a Roth IRA (because the proportion of pre-tax income that can be contributed is higher), and the latter objective by a traditional IRA (because an individual with constrained spending will contribute more if they can contribute out of pre-tax income).

Because we believe that employers are important partners in a successful program and that employees would have greater opportunity to maximize savings within a DC plan versus a retirement account, we would like to understand whether workers prefer an employer plan. We believe the Connecticut Retirement Security program can provide credible incentives to bring employers into the process, which increases the likelihood of overall success. Finally, we believe that federally crafted solutions are likely to center on employers, so we would like to consider a program design that is compatible with potential federal outcomes.

The contribution guarantee modelling should be forward looking and have expense estimates that we can verify with current market providers in terms of the cost to deliver the guarantee. For the survey results to be meaningful, we believe the potential market cost of delivering this guarantee should be described and disclosed in the question.