FEDERAL RETIREMENT THRIFT INVESTMENT BOARD
1250 H Street, NW Washington, DC 20005

THRIFT SAVINGS PLAN

June 14, 2007

MEMORANDUM FOR BOARD MEMBERS SAUL, FINK, SANCHEZ, WHITING, AND DUFFY

FROM: GREG LONG, Executive Director

SUBJECT: Recommendations for Automatic Enrollment, Default Fund, and Roth Account

The FRTIB recently completed significant research and data collection to support our recommendations with regard to automatic enrollment, changing the default fund, and adding a Roth feature. The research and analysis included a review of 401(k) industry data and trends, a review of TSP-specific data, consideration of TSP participant survey findings, feedback from the Employee Thrift Advisory Council (ETAC), agency/uniformed services feedback, and a cost analysis. I provide a summary of the research and analysis for each potential program change in the following pages.

The conclusions derived from these efforts lead me to make the following recommendations:

1. I recommend that the FRTIB formally submit proposed legislation to require that civilian Federal agencies and the uniformed services automatically enroll newly hired (and rehired) TSP-eligible employees and service members in the TSP, unless the employee/member makes an affirmative election not to participate.

2. I recommend that the FRTIB legislative proposal also include language allowing the FRTIB to change the TSP default fund from the G Fund to an age-appropriate L Fund for all newly enrolled participants.

3. At this time, I recommend that the FRTIB not seek legislation regarding Roth accounts within the TSP.

<u>Automatic Enrollment</u>

Program Description

If Congress enacts automatic enrollment legislation, all newly eligible employees/members who do not affirmatively decline to contribute a portion of their pay to the TSP would automatically have 3% of their basic pay deferred on their behalf. In other words, if they do not opt out of the

TSP or elect to contribute some amount of pay, payroll offices would automatically deduct and submit employee contributions to the TSP on their behalf. In order to simplify the enrollment process, we will use procedures similar to the Federal Employees' Group Life Insurance (FEGLI) model, where employees must make an opt-out decision before the end of their first pay period. The agency automatic (1%) and agency matching contributions would begin based on the current statutory waiting period schedule. For a rehired employee, this may mean that agency contributions begin immediately with the automatic enrollment contributions.

To minimize concerns that some automatically enrolled participants would want to stop participation and have their contributions returned, we will include a 90-day grace period from the date of first contribution. During this grace period, the participant may withdraw the current market value of his/her employee contributions. If elected, the withdrawal will be taxable as ordinary income in the year distributed, but will not be subject to the early withdrawal penalty. After this grace period expires, a participant could stop or change contributions at any time, but the account will be subject to normal withdrawal rules.

We will modify the standard "Welcome to the TSP" letter sent to all new participants for automatically enrolled participants. Additionally, we will use the custom messaging capability in the annual participant statement to remind these participants that they have been automatically enrolled and that they can change or stop their contributions at any time.

Industry Trends

Automatic enrollment has been used by some private sector 401(k) plans for many years. However, many plan sponsors avoided automatic enrollment because of state laws on wage garnishment and concerns about maintaining 404(c) fiduciary protection because the employee did not make the investment election. The enactment of the Pension Protection Act (PPA) of 2006, has provided relief for these concerns, and many believe that this legislation will cause the majority of 401(k) plans to adopt automatic enrollment programs in the near future.

In February 2007, Hewitt Associates released results of their survey of 146 large company retirement plans, which found that 58% of these plans have, or will have, automatic enrollment programs in place before the end of 2007. Fidelity reported in February 2007 that, among the more than 15,000 defined contribution plans overseen by Fidelity Investments, automatic enrollment in these plans surged in 2006, up 95% from the previous year

Studies which survey a broad array of plans, such as the survey conducted by the Profit Sharing/401(k) Council of America (PSCA), are not yet available for the 2006 plan year. However, the 2005 PSCA survey reports that 34% of large plan sponsors adopted automatic enrollment. This statistic is prior to the enactment of the PPA in 2006. Mr. David Wray, the Executive Director of the PSCA, has stated that he believes the PPA will substantially increase the use of automatic enrollment among 401(k) plans.

TSP Data and Participant Feedback

The participation rate for FERS employees who are receiving agency automatic (1%) contributions in the TSP stands at 86%. Therefore, 14% of FERS participants, or approximately 257,000 participants, are not contributing to the TSP. The FERS participation rate has reached a plateau, hovering between 85% and 87% since 1997. This participation rate has remained steady despite significant enhancements to the plan during the same period, such as the move to daily valuation, the addition of new funds, and the removal of open seasons. In the uniformed services, approximately 26% of members contribute, and 74%, or about 1.5 million members, do not.

Within the recent TSP survey, we asked participants whether they thought automatic enrollment of new employees in the TSP is a good idea. The survey findings showed that respondents were strongly in favor of automatic enrollment. Overall 66% of respondents responded favorably, 20% were opposed, and the balance expressed no opinion. These figures were slightly lower among uniformed service members where 63% of respondents were in favor of automatic enrollment.

Employee Thrift Advisory Council Feedback

At the June 12, 2007 meeting, the Council expressed support for automatic enrollment.

Agency and Service Feedback

Automatic enrollment will require payroll and personnel offices to modify their procedures. In acknowledgment of this, we solicited agency and uniformed services feedback and issued a detailed memorandum on how the FRTIB anticipated this program change would be structured and the impact it would have on the payroll and personnel offices.

Agency and uniformed services feedback on automatic enrollment from the payroll/personnel office staff is mixed, but generally favorable. While most respondents favorably view the intent of automatic enrollment, there are concerns regarding implementation. The most significant opposition was directed at a proposed 90-day waiting period before automatic contributions would begin. During this period the payroll/personnel offices would have tracked participants who did not make a contribution election, sent reminder notices to these participants, and initiated contributions after the 90-day period expired. After hearing these concerns, we modified our proposal, adopting an approach similar to the FEGLI model, where contributions will begin immediately unless the employee opts out before the end of the first full pay period.

Feedback on the effort required to implement procedural and system changes varies, but the most common responses suggested that it would take six to twelve months to implement the changes. While implementing this program will require significant work by some agencies, the obstacles are not insurmountable.

Cost

We would need to make modifications to the TSP recordkeeping system in order to implement automatic enrollment. Required programming includes the addition of a new status code to identify automatically enrolled participants, the issuance of a different welcome letter to these participants, and the modification of the withdrawal process to support the return of employee contributions during the 90-day grace period. We estimate the cost for these system modifications at $500,000 to $1,000,000.

As automatic enrollment will apply only to newly hired or rehired employees, a broad communication campaign to all participants is not required. Agency/uniformed services communication of this feature will occur as part of standard new employee orientations, which address all benefit programs. Our website and primary print brochures, such as the *Summary of the Thrift Savings Plan* and *Managing Your Account,* will need minor text updates; but these items are revised periodically, so increased costs are minimal. The majority of plan forms will remain unchanged, but a new form for requesting a return of contributions during the 90-day grace period will need to be created. The cost to create a modified version of the welcome letter to all automatically enrolled participants is minimal. We expect that the total cost for our communication efforts would be less than $100,000.

Automatic enrollment is designed to increase TSP participation. However, because automatic enrollment applies only to new hires, a substantial increase in the TSP participation rate among civilian employees may not be apparent for several years. It will likely be more apparent among the uniformed services considering that 2007 recruiting goals among the active, reserve, and guard components exceed 300,000. We should be prepared for an increased volume of Web site inquiries, phone calls, interfund transfers, loans, and withdrawals. Over time, this will require additional staffing in our service centers. While this is difficult to gauge with accuracy, we estimate that this will result in increased contractor costs of approximately $150,000 per year over the next several years.

Supporting Arguments

Arguments supporting automatic enrollment include that the 14% of FERS employees and the 75% of uniformed service members who are not contributing to the TSP are less likely to be financially self-sufficient in retirement than their participating counterparts. Furthermore, non-contributing FERS participants are failing to build the third leg of their three-legged retirement stool. TSP was designed to play an important role along with Social Security and the FERS annuity in the generation of retirement income for these participants. Failure to participate in the TSP undermines the stability of that three-legged approach.

While some non-contributors have intentionally decided not to participate, a significant number of them are not participating because they have placed a low priority on returning the form, believe they cannot afford to participate, or have not put any consideration into retirement planning. Automatic enrollment addresses all three of these issues. The same inertia that prevents some employees from opting into the TSP will stop them from opting out of the TSP. Similarly, the automatic enrollment of participants before they have received their first paycheck will help illustrate the affordability of the TSP and its pre-tax deferrals. At the same time, the ability to terminate contributions at any time and the 90-day grace period provides a way out for those who truly cannot afford to participate. Lastly, many employees, particularly younger ones, put no thought into retirement planning because retirement is in the distant future. Automatic enrollment will help ensure that these individuals don't miss out on the returns of long-term investing.

Academic research examining whether automatic enrollment increases rates of participation is compelling. In plans with a matching feature, automatic enrollment typically translates to participation rates in the low 90 percent range. If the FERS participation rate increases by just 1%, that equates to approximately 19,000 employees who will have an improved ability to live comfortably in retirement. Because of the lower rate of participation among uniformed service members, potential increases in members benefiting from automatic enrollment are substantially larger.

However, automatic enrollment is not aimed only at increasing participation numbers. It is meant to help employees prepare for retirement. With the passage of the Pension Protection Act of 2006, which created incentives and safe-harbors for automatic enrollment, Congressional support for automatic enrollment was clearly demonstrated. It is likely in recognition that, with increased longevity, increased health care costs, and decreased retiree health insurance coverage, there will be greater demands on an individual's retirement income, and automatic enrollment is a way to boost the amount of retirement income.

Opposing Arguments

Arguments opposing automatic enrollment include that the rate of FERS participation, currently at 86%, is high relative to the typical 401(k) plan and that automatic enrollment will likely increase FERS participation by only a few percentage points. Adopting a policy that requires changes to the recordkeeping system, to TSP communication material, and to personnel/payroll office practices that will result in only a small increase in TSP participation, may not be in the best interest of the participants and beneficiaries. Additionally, unlike many private sector employees, civilian employees and uniformed services members are covered under a defined benefit plan. Lastly, the TSP was intended as a voluntary program and automatic enrollment is an overly paternalistic approach that imposes the will of the Government on employees and service members.

Conclusion

Automatically enrolling all new civilian employees and members of the uniformed services will help ensure they are prepared for retirement. In light of the strong support from current participants, support from ETAC, Congressional support of automatic enrollment as evidenced by passage of the PPA, and clear market acceptance of this design, I recommend that the FRTIB pursue legislation that would enable automatic enrollment in the TSP. While concerns over implementation costs and challenges are legitimate, they are outweighed by the benefits of automatic enrollment.

Default to L Funds

Program Description

Currently, a new participant account is established in the TSP recordkeeping system after the receipt of the initial contribution. At that time, the contribution allocation is defaulted to a 100% investment in the G Fund. After the initial contribution is processed, the participant is sent a welcome letter and instructed to provide contribution allocation direction to the TSP via web, phone, or paper. When received, the asset allocation is adjusted to match the participant's instructions. If the participant does not provide any instructions, all future contributions default to the G Fund.

If the L Fund default is adopted by the TSP, all newly enrolled participants will have their contributions defaulted to the age-appropriate L Fund as determined by their agency-reported date of birth. In this model, we will assume that age 65 will be the draw-down date for the participant's TSP account, and contributions will be defaulted to the L Fund with the time horizon that most closely matches the calculated draw-down date for the participant. For example, a newly enrolled participant who was born in 1967 will reach age 65 in the year 2032. This participant will be defaulted to the L 2030 Fund, and all contributions will be directed to this fund until the participant changes the allocation. Additionally, the TSP welcome letter will be modified to discuss the benefits and risks of the L Funds and instruct participants as to how they can move to the risk-free G Fund or other asset allocation.

Industry Trends

Plan fiduciaries are now, and have been, permitted to select a default fund that they determined was in the best interests of plan participants. However, concerns with liability caused many plan sponsors and their fiduciaries to select default funds with the lowest risk for investment loss, which often meant stable value or money market funds. These liability concerns have been alleviated by the PPA, which directed the Department of Labor to issue regulations providing safe harbor protections for selection of an appropriate default fund. The resulting proposed regulation (final regulations are expected by September 2007) defined three types of acceptable Qualified Default Investment Alternatives (QDIA). They are lifecycle or target date funds, balanced funds, and managed accounts. Many believe that this regulation will encourage the majority of 401(k) plans to adopt target-date asset allocation funds, similar to the L Funds, as the default investment.

In February 2007, Hewitt Associates released results of their survey of 146 large company retirement plans, which found 43% of these plans intend to change their default fund to a QDIA. Fidelity reported in February 2007 that the number of defined contribution plans using Fidelity Freedom Funds (which are similar to the L Funds) as a default option surged in 2006, up 130% from the year before.

Studies which survey a broad array of plans, such as the survey conducted by the Profit Sharing/401(k) Council of America (PSCA), are not yet available for the 2006 plan year.

However, the 2005 PSCA survey reports that 54% of plan sponsors with automatic enrollment were defaulting participants into a lifestyle, target date, or balanced fund as compared to 40% that defaulted to a stable value or money market fund. This is prior to enactment of the PPA of 2006, which is widely expected to increase the use of target-date default funds.

TSP Data and Participant Feedback

While the G Fund provides protection against investment loss, long-term investment solely in the G Fund may not provide returns sufficient to meet retirement needs. Therefore, it became important to determine how long it takes participants to change the default allocation and make their first contribution allocation or interfund transfer decision. An equally important question is how many participants do not make any decision for an extended time period. To answer this, we looked at participants who enrolled during the first quarter of 2004 (the first full plan year under the new recordkeeping system) and tracked their behavior over time. Almost 26% of these participants made an investment decision, either a contribution allocation or interfund transfer, within the first calendar quarter following their enrollment, but investment decision activity drops off significantly after that point. Tracking these participants through the first quarter of 2007, we find that 48% of participants who enrolled in first quarter 2004 did not make any investment decision in the three years following enrollment and remained 100% invested in the G Fund during this period. Most concerning was that 62% of these "non-allocators" were under 40 years old.

Within the recent survey, we asked participants whether they thought participants who do not provide investment direction to the TSP should be defaulted to the L Funds or the G Fund. The survey findings showed that respondents were strongly in favor of defaulting to the L Funds. Overall, 49% of respondents preferred the L Fund as the default option, while 27% preferred the G Fund and the remaining 24% had no opinion. Preference for the L Fund was strongest among uniformed service members where 54% of respondents favor the L Fund.

Employee Thrift Advisory Council Feedback

At the June 12, 2007 meeting, the Council expressed support for changing the default fund to an age-appropriate L Fund.

Agency and Service Feedback

Changing the default fund will not require payroll or personnel offices to modify any procedures or systems. Therefore, we did not solicit feedback from the agencies or uniformed services on this program change.

Cost

We would need to make limited modifications to the TSP recordkeeping system in order to change the default fund. The most significant programming requirement is the calculation of the participant's draw-down date in order to default the participant to the L Fund with the appropriate time horizon. We estimate the cost for these system modifications at $150,000 to $200,000.

As the change to an L Fund default will apply only to newly hired or rehired employees, a broad communication campaign to all participants is not required. Agency/uniformed services communication of this feature will occur as part of standard new employee orientations, which address all benefit programs. The communication materials that must be modified for the default change are the same that would be modified for automatic enrollment. Therefore, if the default fund is changed in conjunction with automatic enrollment, communications costs will be zero. If implemented on a stand-alone basis, costs for the L Fund default will be somewhat less than automatic enrollment and we estimate them at under $75,000.

We do not expect that a change to the default fund will have a material effect on staffing needs.

Supporting Arguments

Arguments supporting the L Fund default include that, while the G Fund offers no risk of investment loss, the potential for investment returns with this fund is poor when compared to long-term equity market performance. The L Funds, which allocate assets among the individual TSP funds, are designed to maximize expected performance for the amount of risk taken. Furthermore, the design of the L Funds automatically addresses changing asset allocation needs as participants near their draw-down dates. Therefore, for long-term investors, which include the vast majority of newly hired Federal employees and uniformed service members, the L Fund is a more appropriate default option.

Opposing Arguments

Arguments opposing the L Fund default include that by defaulting participants to the L Funds, we are exposing a participant's retirement savings to the risk inherent in the capital markets without their explicit approval. In periods of negative capital market performance, it is likely that participants will complain that the TSP forced them into a fund that caused them to lose money.

Conclusion

Given the strong support from existing participants, support from ETAC, clear market acceptance of lifecycle funds as a default option, and safe harbor protections under PPA, combined with the limited cost for implementation, I recommend that the FRTIB seek legislative authority to make the L Fund the default option with the TSP.

Roth Accounts

Program Description

The addition of a Roth feature will allow participants to select different tax treatments for their future TSP contributions. Standard (non-Roth) employee contributions are made on a pre-tax basis and reduce a participant's income subject to Federal and (most) state taxes. These contributions and their related earnings are then taxed as ordinary income when withdrawn.

Roth contributions, on the other hand, are after-tax contributions – they are not excluded from current taxable income. The intended benefit of a Roth account is that these contributions and their associated earnings are withdrawn tax-free. Roth contributions generally are considered more favorable for participants who expect their tax rates in retirement will exceed their current levels.

However, in order to realize the benefit from a Roth account and receive tax-free earnings, the distribution from the account must be "qualified." A qualified distribution must satisfy two requirements:

1. The participant must have attained age 59 ½, become disabled, or died; and

2. The participant must have at least 5 years of participation in the Roth account. This 5-year non-exclusion period begins on the first day of the first taxable year in which a participant first makes Roth deferrals to the plan. *Note: A participant may rollover an eligible Roth 401(k) account from a prior plan. In those situations, the non-exclusion period begins with the first date of Roth deferrals to the prior plan. That date must be provided with the rollover.*

The earnings portion of a non-qualified distribution from a Roth account is subject to ordinary income tax and a 10% early withdrawal penalty. If only part of the account is withdrawn, non-qualified distributions must be treated as a pro-rata return of after-tax contributions and taxable earnings. (The after-tax contributions are not subject to income tax.) In other words, the participant cannot elect to withdraw only contributions, thereby leaving the taxable earnings to be withdrawn at a later date.

The different tax treatment of earnings with standard (pre-tax) and Roth accounts creates an incentive to invest differently within these accounts. Generally, a long-term investor with a balanced portfolio will allocate more aggressive investments to the Roth account, while keeping the more conservative investments within the pre-tax account.

Contributions to a Roth account will count against the elective deferral and other Internal Revenue Code limits (e.g., $15,500 for regular contributions and $5,000 for catch up contributions in 2007) just as pre-tax contributions do. Consequently, a Roth account would <u>not</u> allow a participant to contribute any more money than the law currently allows. The amount of any agency matching contributions credited to the participant's TSP account will not be affected by whether the employee elects to contribute to a Roth account or not.

Industry Trends

While Roth IRAs have been in existence since 1997, Roth accounts within 401(k) plans are a relatively new concept. Designated Roth contributions were authorized by the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA). Effective January 1, 2006, private sector

401(k) plans could accept after-tax Roth contributions for their participants; this feature is commonly called a Roth 401(k). The EGTRRA provision, which was originally scheduled to expire after 2010, was made permanent by the PPA.

In April 2007, a Vanguard survey reported that among 1,972 plans using the Vanguard recordkeeping system, the overall adoption rate for a Roth feature is 14%. The adoption rate for large plans (over 5,000 participants) is 8%. The survey also noted the highest adoption rates were by plans in the business/professional services industry (21%), followed by plans in the finance/insurance industry (18%). Participants in the plans who adopted Roth had a higher average household income ($111,334) than the household income ($98,940) in the plans that did not adopt a Roth feature. Within plans that adopted a Roth feature, the number of participants who use the feature is 5% of all eligible participants.

The Profit Sharing/401(k) Council of America (PSCA) conducted a survey in early 2007 specific to the use of the Roth 401(k). This survey reports that 22% of plan sponsors adopted a Roth feature in 2006. The adoption rate is strongest among small plans. Among large plans (over 5,000 participants), 14% have adopted a Roth feature. Within plans that adopted a Roth feature, the number of participants that use the feature is 8% across all plans, and only 1% in large plans.

TSP Data and Participant Feedback

Within the recent survey we asked participants whether they agreed or disagreed with the following statement: "The TSP would be a better program if it provided an option to contribute to a Roth 401(k) account." Overall, 60% of participants agreed, showing strong support for a Roth feature. However a significant number (approximately 12 percent of all respondents) were unable or unwilling to respond to this item, suggesting a potential lack of awareness and understanding of what a Roth 401(k) option is. Support for a Roth account was strongest among the uniformed services, where 66% of respondents agreed. While 60% of respondents prefer adding a Roth account to the TSP, only 32% of participants report that they have a Roth IRA account.

Employee Thrift Advisory Council Feedback

At the June 12, 2007 meeting, the council expressed support for not pursuing legislation on a Roth feature at this time, with an understanding that we would revisit this issue in the future. The representative of the uniformed services specifically noted that the possibility of a Roth feature was a matter of interest to those service members that are likely to complete their military career in their 40's and move into a second career.

Agency and Service Feedback

The addition of Roth accounts will require payroll and personnel offices to significantly modify both procedures and systems. To solicit feedback from these offices, we issued a detailed memorandum on how the FRTIB would structure a Roth feature and the impact we anticipate it would have on these offices.

Feedback on Roth from the payroll/personnel offices was mixed, but generally unfavorable. Some respondents favorably view the flexibility that Roth accounts would provide. However, concerns over required massive implementation efforts and participant communication challenges were strongly and frequently voiced. Several offices made clear that they anticipate significant programming challenges, especially with their online enrollment programs and with the W-2 tax reporting and correction process. They expect a post-implementation period that would be riddled with adjustments and programming modifications.

Reports on the effort required to implement procedural and system changes vary, but the most common responses suggested that it would take one to two years to implement. The lengthy implementation period underscores the scope and complexity of this project.

Cost

We would need to make substantial modifications to the TSP recordkeeping, accounting, and payroll interface systems to accept and properly track Roth contributions and distributions. Significant changes would be required by each functional area (contributions, loans, withdrawals, etc) in the TSP systems. The primary changes are listed below:

- Because the TSP must be able to distinguish Roth contributions from regular contributions, the Agency Payroll Interface (API), which accepts and edits use to the payroll offices' contribution files submitted to the TSP, would require the addition of separate payment records for Roth contributions and catch-up contributions. Further, because Roth contributions would be governed by the same rules as regular pre-tax contributions, separate late payment and negative adjustment records would also be necessary.

- Current API edit processes would need to be modified to ensure that the total of pre-tax and Roth contributions do not exceed statutory limits (e.g., $15,500 for regular contributions and $5,000 for catch-up contributions in 2007).

- The contribution submission edits and the reports back to the payroll offices would need to be revised to include the Roth contributions.

- The TSP accounting system would need to be modified significantly to track Roth contributions and earnings.

- Rollover processing in the recordkeeping system would need to be modified to accept rollovers of eligible Roth accounts from prior plans and to accept the start date of the 5-year non-exclusion period from these rollovers.

- The recordkeeping system would need to be modified to allow separate contribution allocations and interfund transfers for pre-tax and Roth monies in order to accommodate different investment goals for these monies.

- Contributions and earnings in the Roth account would not eligible to be borrowed. However, these contributions and earnings would be considered in determining the amount that can be borrowed. Consequently, when Roth account value exceeds 50% of the total vested account value, this will result in a decrease to the potential amount available for a loan. The recordkeeping system would need to be modified to adjust the calculation of the maximum loan amount.

- The withdrawal program would need to be revised for the special Roth rules and to accommodate the separate withdrawal treatment of Roth and pre-tax monies, e.g., the rollover of Roth monies to a Roth IRA and monthly payments of pre-tax money. Forms 1099-R issued in conjunction with a withdrawal would separately reflect the pre-tax and Roth portions of withdrawals.

- The TSP Web site, ThriftLine, TSP participant statements, and other system-generated TSP participant communications would need to be modified to separately reflect all Roth contributions and earnings. Additionally, these same systems would be updated to allow and reflect different investment allocations and withdrawal treatments for Roth and standard (pre-tax) accounts.

We estimate the cost for the changes outlined above at $2 million to $3.5 million dollars. These represent costs applicable to just the FRTIB and not those required by the agencies and uniformed services for modification of their processes and systems.

The advantages and disadvantages of Roth are not-straightforward and vary among participants. Educating all 3.7 million current participants would require a broad communication and education campaign. However, exactly how big of a "splash" that we want to make with this campaign would significantly affect costs.

Almost all print brochures would need significant changes, and a new brochure specific to our Roth feature would be required. Enrollment forms, tax notices, withdrawal forms, and loan forms will need significant changes; most other forms will need minor changes. A special mailing to all participants would be required to explain these changes; and postage costs for a group this large are very expensive. Because of the complexity of the topic, payroll/personnel offices have already requested that we send a DVD to all participants, in a process mimicking our communication effort with the launch of the L Funds. If we chose to forgo the DVD, total communication costs would be approximately $5,400,000. If we include the DVD, projected costs rise substantially to over $13 million.

In addition to the system changes and communication efforts described above, the TSP would provide the agencies and uniformed services with updated participant communications materials. We would also provide updated information and training manuals to the personnel offices because they may receive complex questions concerning the Roth feature from employees. The public information section of the TSP Web site would be updated to reflect the Roth feature, and we would need to build new educational calculators for the Web site to allow participant comparison of Roth and pre-tax contributions.

We expect that adding a Roth feature would significantly increase the number and duration of calls at our service centers. Call volumes would likely spike sharply in the year of roll-out and moderate in future years. The nature of these calls is beyond the current skill level of the participant service representatives (PSR). Unlike many similar private sector organizations, our PSRs do not have security licenses and are not trained in tax planning strategies. We anticipate the need to create a special Roth telephone servicing unit and to hire an external company to staff this servicing unit. In addition, our current telephone system does not allow PSRs to directly transfer callers to an outside facility. If a special Roth servicing unit were to be established, a new or modified telephone system would be needed to support the direct transfer of callers. Through conversations with third-party providers of tax and investment counseling services, we estimate that this would increase our contractor costs by $4 million to $6 million in the first year, moderating to $1.5 to $2.5 million per year in following years.

Supporting Arguments

Arguments supporting Roth accounts include that Federal income tax rates are low relative to historical averages and, given the current budget deficits, shifting demographics, and Social Security funding concerns, tax rates are likely to increase in the future. Additionally, even if Federal income tax rates do not increase, they are at least unpredictable, so diversifying your exposure to future tax rates is a wise strategy.

Young and lower paid employees are in the lowest tax brackets, and their current tax liability is very small. Therefore, the deduction offered by the standard 401(k) arrangement is of less value to them than to employees in their prime earning years. These employees will likely earn far more later in life. Even in retirement, they are likely to be paid more than they are currently earning. Therefore, even if tax rates remain unchanged, a Roth account offers significant advantages to young and lower paid employees. While a Roth IRA is available to these employees, the ease of payroll deduction, higher contribution limits and the TSP's low administration costs (and for FERS employees, the attraction of matching contributions) make a Roth account within the TSP preferable to a Roth IRA.

Employees at the highest end of the income bracket are ineligible to use a Roth IRA because eligibility is capped at $95,000 of adjusted gross income (AGI) for single filers and $150,000 AGI for joint filers. Since the income limits do not apply to Roth 401(k) accounts, a Roth account within the TSP is the only way that these employees can access these features. For some highly compensated Federal employees who expect that their income will not decrease in retirement, such as some Federal Judges, a Roth feature offers a real benefit.

Opposing Arguments

Arguments opposing a Roth feature include that, while employees at both the highest and lowest ends of the compensation spectrum could benefit from Roth accounts, most Federal employees are in the middle. For the bulk of Federal employees, their income stream is likely to be more typical, that is where both income and tax rates decline in retirement. Since the TSP's fiduciaries must act solely in the interest of the TSP's participants and beneficiaries, it might be inconsistent with this responsibility to add an expensive feature that benefits relatively few TSP participants.

Since a Roth IRA is available to all Federal employees and uniformed service members, except for those who exceed the income limits, most Federal employees who want Roth-type benefits can get them from the marketplace. It is interesting to note that the TSP participant survey showed that, despite significant support for establishing a Roth account within the TSP, Roth IRA usage among these same respondents is far weaker. This suggests that a majority is asking for a service that only a minority would actually use.

Roth implementation will complicate the answers to very commonly asked TSP questions. How should I allocate my funds? How much can I borrow? When can I take my money out? How will I be taxed? All of these questions now have straight-forward answers; but with a Roth option, all these answers will have to be qualified and may have multiple answers. This increases exponentially the possibilities for misinformation, misunderstanding, and poor retirement planning choices.

The TSP is a plan that is widely understood and appreciated because of its simplicity. Roth accounts are the antithesis of simple. For most participants, choosing between pre-tax and post-tax contributions is complicated, and they will demand help with this. Even an extensive communication campaign, with brochures, web calculators, and training, will be insufficient for many participants. They will want, and would reasonably expect, tax advice to help them make these decisions. The inability of personnel offices or the TSP to provide such advice will lead to participant frustration.

While this is still a new feature in the marketplace, initial data suggests that participant Roth usage rates are very low and long-term demand is unknown. Once the TSP offers a Roth account, it is infeasible to 'shut it off' if real usage rates prove to be weak. We must ensure that a Roth feature will have broad appeal before we add it, and the best way to assess that is to monitor the adoption rates at the plan and participant level in the 401(k) market over the next one to two years.

Adding a Roth feature to the TSP would be a major undertaking from an operational standpoint. The changes required to each agency's or uniformed services personnel and payroll systems are very significant. Major changes would also be required with the TSP recordkeeping system, accounting systems, payroll interface system, and participant communications. The large expense in time, money and manpower suggest that we want to be sure this service will have a high usage rate before we decide to implement.

Conclusion

While Roth accounts may be viewed as beneficial by a number of participants, the scope, impact, and cost of this project are huge. As of now, I am not convinced that this feature will have broad appeal, and it is not clear how participants will react to the educational efforts needed for complex tax planning issues. Therefore, I recommend that we not seek legislation to add a Roth 401(k) feature at this time but that we continue to review private sector experience with Roth accounts. I anticipate that we will revisit this issue within the next two years.