



# 401(k) Plans and Retirement Savings: Issues for Congress

**John J. Topoleski**  
Analyst in Income Security

January 7, 2011

**Congressional Research Service**

7-5700

[www.crs.gov](http://www.crs.gov)

R40707

**CRS Report for Congress**  
*Prepared for Members and Committees of Congress*

---

## Summary

Over the past 25 years, defined contribution (DC) plans—including 401(k) plans—have become the most prevalent form of employer-sponsored retirement plan in the United States. The majority of assets held in these plans are invested in stocks and stock mutual funds, and the decline in the major stock market indices in 2008 greatly reduced the value of many families' retirement savings. The effect of stock market volatility on families' retirement savings is just one issue of concern to Congress with respect to defined contribution retirement plans.

This report describes seven major policy issues with respect to defined contribution plans:

1. *Access to employer-sponsored retirement plans.* In 2007, only 61% of employees in the private sector were offered a retirement plan of any kind at work. Fifty-five percent were offered a DC plan. Only 45% of workers at establishments with fewer than 100 employees were offered a retirement plan of any kind in 2007. Forty-two percent were offered a defined contribution plan.
2. *Participation in employer-sponsored plans.* Between 20% and 25% of workers whose employer offers a DC plan do not participate. Workers under age 35 are less likely than older workers to participate.
3. *Contribution rates.* On average, participants in DC plans contributed 6% of pay to the plan in 2007. The median contribution by household heads who participated in a DC plan in 2007 was \$3,360. This was just 22% of the maximum allowable contribution of \$15,500 in that year.
4. *Investment choices.* At year-end 2007, 78% of all DC plan assets were invested in stocks and stock mutual funds. This ratio varied little by age, indicating that many workers nearing retirement were heavily invested in stocks and risked substantial losses in a market downturn like that in 2008. Investment education and target date funds could help workers make better investment decisions.
5. *Fee disclosure.* Retirement plans contract with service providers to provide investment management, record-keeping, and other services. There can be many service providers, each charging a fee that is ultimately paid by participants in 401(k) plans. The arrangements through which service providers are compensated can be very complicated and fees are often not clearly disclosed.
6. *Leakage from retirement savings.* Pre-retirement withdrawals from retirement accounts are sometimes called "leakages." Current law represents a compromise between limiting leakages from retirement accounts and allowing people to have access to their retirement funds in times of great need. In general, borrowing from a 401(k) plan poses less risk to retirement security than a withdrawal. Pre-retirement withdrawals can have adverse long-term effects on retirement income.
7. *Converting retirement savings into income.* Retirees face many financial risks, including living longer than they expected, investment losses, inflation, and possible large expenses for medical care and long-term care. Annuities can protect retirees from some of these risks, but few retirees purchase them. Developing policies that motivate retirees to convert assets into a reliable source of income will be a continuing challenge for Congress and other policymakers.

## Contents

New Challenges to a Secure Retirement Income.....	1
Access to Employer-sponsored Retirement Plans.....	2
Plan Sponsorship by Small Employers .....	2
Defined Contribution Plans for Small Employers .....	3
“Safe-Harbor” 401(k) Plans .....	4
Savings Incentive Match Plans for Employees of Small Employers (SIMPLE).....	4
Simplified Employee Pension (SEP) .....	4
Plan Sponsorship Remains Low Among Small Employers.....	5
Policy Issue: Automatic IRAs.....	5
Participation in Employer-sponsored Retirement Plans.....	6
Sponsorship Rates and Take-up Rates.....	6
Policy Issue: The Retirement Savings Tax Credit.....	8
Contributions to Retirement Savings Plans .....	10
Household Contributions to DC Plans in 2007.....	10
Household Contributions by Age of Household Head .....	11
Household Contributions by Household Income .....	11
Policy Issue: Automatic Contribution Escalation .....	13
Investment Choices and Investment Risk.....	13
Policy Issue: Investment Education and Investment Advice.....	15
Investment Education.....	15
Investment Advice .....	16
Investment Advice Regulations and Legislation.....	17
Policy Issue: Life-cycle Funds and Target Date Funds .....	17
Fees and Fee Disclosure.....	18
The Administrative Structure of 401(k) plans .....	19
Policy Issue: Requiring Clearer Disclosure of Fees.....	20
Leakage from Retirement Savings Plans.....	21
Hardship Distributions .....	21
Borrowing from Retirement Plans .....	22
Leakages When Switching Jobs.....	22
Policy Issue: Preserving Retirement Savings .....	23
Converting Retirement Savings into Income.....	24
Policy Issue: The Role of Income Annuities in Retirement.....	25
Automatic Trial Income .....	26
Advanced Life Deferred Annuity.....	26
Conclusion.....	27

## Figures

Figure 1. Percentage of Defined Contribution Plan Assets Invested in Stocks, 2007.....	15
Figure 2. The Structure of a Typical Defined Contribution Plan.....	19

## Tables

Table 1. Participation in Employer-Sponsored Retirement Plans, 2003 and 2007 .....	3
Table 2. Participation in Defined Contribution Plans: 2004 and 2007 .....	7
Table 3. Monthly Household Contributions to Defined Contribution Plans in 2007 .....	12

## Contacts

Author Contact Information .....	28
Acknowledgments .....	28

## New Challenges to a Secure Retirement Income

Over the past 25 years, defined contribution (DC) plans have become the most prevalent form of employer-sponsored retirement plan in the United States. According to the Bureau of Labor Statistics (BLS), 51% of workers in the private sector participated in an employer-sponsored retirement plan of some kind in 2007. Only 20% of all private-sector workers were covered by traditional pensions—also called defined benefit or “DB” plans—whereas 43% participated in 401(k) plans and other DC plans.<sup>1</sup> Twelve percent of workers participated in both types of plan.<sup>2</sup>

One of the key distinctions between a defined benefit plan and a defined contribution plan is that in a DB plan, it is the employer who bears the investment risk. The employer must ensure that the pension plan has sufficient assets to pay the benefits promised to workers and their surviving dependents. In a DC plan, the worker bears the investment risk. The worker’s account balance at retirement will depend on how much has been contributed to the plan over the years and on the performance of the assets in which the plan is invested. In a typical 401(k) plan, a worker must decide whether to participate, how much to contribute, how to invest the contributions, what to do with the account if he or she changes jobs, and how to take money out of the account after retiring.

The majority of assets held in DC plans are invested in stocks and stock mutual funds, and as a result, the decline in the major stock market indices in 2008 greatly reduced the value of many families’ retirement savings.<sup>3</sup> According to the Federal Reserve Board, assets held in DC plans fell from \$3.73 trillion at year-end 2007 to \$2.66 trillion at year-end 2008, a decline of 28.7%.<sup>4</sup> The decline would have been even greater if not for ongoing contributions to the plans by workers and employers.

The effect of stock market volatility on families’ retirement savings is just one issue of concern to Congress with respect to DC plans. Other issues that have received attention in hearings and through proposed legislation include increasing access to employer-sponsored plans, raising participation and contribution rates, helping participants make better investment choices, requiring clearer disclosure of fees charged to plan participants, preserving retirement savings when workers face economic hardship or change jobs, and promoting life annuities as a source of retirement income.

---

<sup>1</sup> Not all DC plans are 401(k) plans, but 401(k) plans hold about 67% of DC plan assets. Other DC plans include 403(b) plans for non-profit employers, 457 plans for state and local governments, and miscellaneous other DC plans. Increasingly, 403(b) plans and 457 plans operate similarly to 401(k) plans. In this report the terms “401(k)” plan and “defined contribution” plan are used interchangeably unless a distinction is noted in the text.

<sup>2</sup> U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in Private Industry in the United States, March 2007*, Summary 07-05, August 2007. The sample represented 108 million workers.

<sup>3</sup> On October 11, 2007, the Standard & Poor’s 500 Index of common stocks reached an intra-day high of 1,576, an all-time record for the index. On March 6, 2009, the S&P 500 fell to an intra-day low of 667, a decline of 57.7% from its all-time high. Over the next three months, stock prices climbed 41%. The S&P 500 closed at a value of 943 on June 1, 2009. This was 40% lower than the index’s highest level in October 2007. By July 7, the S&P 500 had fallen to 881.

<sup>4</sup> Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States: Flows and Outstandings*, Fourth Quarter 2008, March 12, 2009, p. 113.

This CRS report describes these seven major policy issues with respect to DC plans:

- access to employer-sponsored retirement plans,
- participation in employer-sponsored plans,
- contribution rates,
- investment choices,
- fee disclosure,
- leakage from retirement savings, and
- converting retirement savings into income.

## Access to Employer-sponsored Retirement Plans

According to the National Compensation Survey (NCS), 61% of private-sector workers were employed at establishments that offered one or more retirement plans in 2007. Twenty-one percent worked for employers that offered a DB plan, 55% worked for employers that offered a DC plan, and 15% worked for employers that offered both types of plan.<sup>5</sup> Thus, almost 4 out of 10 workers in the private sector did not have the opportunity to participate in a retirement plan where they worked. Moreover, there is a substantial disparity in sponsorship of retirement plans between large employers and small employers. Workers at establishments with fewer than 100 employees are much less likely to have access to an employer-sponsored retirement plan than are workers at larger establishments. (See **Table 1.**) Policies that would increase the number of small employers that offer retirement plans could expand access to these plans to include millions more workers.

### Plan Sponsorship by Small Employers

Surveys of households and employers illustrate the gap in retirement plan sponsorship between large and small employers. Data collected by the Bureau of the Census indicate that there were 75 million private-sector workers between the ages of 25 and 64 who were employed year-round, full-time in 2007. Thirty million of these workers, or 40%, worked for employers that did not sponsor a retirement plan of any kind. Of these 30 million workers, 19.1 million, or 64%, worked for firms with fewer than 100 employees.<sup>6</sup> Likewise, data from the Department of Labor's 2007 National Compensation Survey show that 78% of workers at establishments with 100 or more employees worked for employers that sponsored retirement plans in 2007, compared with just 45% of workers at establishments with fewer than 100 employees.

---

<sup>5</sup> U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey, March 2007, Summary 07-05*, August 2007. In contrast, the BLS data indicate that 89% of workers in state and local governments were offered a retirement plan of some kind. Eighty-three percent of state and local workers were offered a DB plan, 29% were offered a DC plan, and 23% were offered both types of plan. See *National Compensation Survey: Employee Benefits in State and Local Governments in the United States, September 2007, Summary 08-01*, March 2008.

<sup>6</sup> The Census Bureau data are from a CRS analysis of the March 2008 Current Population Survey (CPS). The National Compensation Survey is a survey of business establishments. The CPS is a survey of households. The CPS asks households about the number of workers employed by the firm where the respondent is employed. A firm may consist of more than one establishment. Some small establishments are operating units of larger firms.

Although workers at small establishments are less likely to be offered a retirement plan, when one is offered, they are as likely as employees at larger businesses to participate in the plan. In 2007, for example, 70% of workers at establishments with 100 or more employees were offered a DC plan, and the take-up rate among those offered a DC plan was 76%. At establishments with fewer than 100 employees, 42% of workers were offered a DC plan, and the take-up rate among those offered a DC plan was 79%.<sup>7</sup>

**Table 1. Participation in Employer-Sponsored Retirement Plans, 2003 and 2007**

(Private-sector workers; in percentages)

Establishment Size	2003	2007	2003	2007	2003	2007
	Offered any plan		Participated in any plan		Take-up rate	
100 or more workers	75	78	65	66	87	85
Under 100 workers	42	45	35	37	83	82
All Workers	57	61	49	51	86	84
	Offered a DB Plan		Participated in DB plan		Take-up rate	
100 or more workers	34	34	33	32	97	94
Under 100 workers	9	9	8	9	89	100
All Workers	20	21	20	20	100	95
	Offered a DC Plan		Participated in DC plan		Take-up rate	
100 or more workers	65	70	51	53	78	76
Under 100 workers	38	42	31	33	82	79
All Workers	51	55	40	43	78	78

Source: U.S. Department of Labor, Bureau of Labor Statistics, National Compensation Survey.

Notes: Data represent 102 million workers in 2003 and 108 million workers in 2007. The take-up rate is the percentage of workers offered a plan who participated in the plan. In 2007, for example, 55% of workers were offered a DC plan and 43% of workers participated in a DC plan. Therefore, the take-up rate was  $.43/.55 = .78$ .

Workers at firms with fewer than 100 employees comprised 44% of all private-sector workers in the United States in 2007. If employees at small firms had been offered DC plans at the same rate as employees of larger firms, an additional 11.4 million workers would have had the opportunity to participate in employer-sponsored retirement plans in 2007. If take-up rates among these employees had been the same as at firms that already offered DC plans, an additional 9.0 million workers would have participated in DC plans in 2007.<sup>8</sup>

## Defined Contribution Plans for Small Employers

Qualified retirement plans, including 401(k) plans, must comply with the Employee Retirement Income Security Act (ERISA) and the Internal Revenue Code (IRC). Among the requirements for retirement plans to receive favorable tax treatment is that they are prohibited from discriminating in favor of highly-compensated employees (HCEs) in terms of contributions or benefits.<sup>9</sup> This

<sup>7</sup> Bureau of Labor Statistics, National Compensation Survey, March 2007.

<sup>8</sup> CRS calculations based on analysis of the Census Bureau's March 2008 Current Population Survey.

<sup>9</sup> Under I.R.C. §414(q), for 2009 a highly compensated employee is anyone who owned 5% or more of the firm at any time during 2008 or 2009 or anyone whose compensation in 2009 exceeds \$110,000. The employer can elect to count only workers in the top 20% of employee compensation as an HCE, but must count all 5% owners.

assures that rank and file employees as well as owners and managers benefit from the tax breaks that Congress has granted to tax-qualified retirement plans. The nondiscrimination tests compare the participation rates and plan contributions for HCEs to those of other employees.<sup>10</sup> In a small firm, relatively modest changes in employee participation or contributions can make the difference between the plan passing or failing the nondiscrimination test. If the plan fails, some of the contributions made by HCEs must be returned to them and included in their taxable income for the year. A plan that fails the nondiscrimination test also can lose its tax-qualified status, but this penalty is applied only in rare circumstances.

To encourage more employers, especially small employers, to sponsor retirement plans, Congress has authorized several kinds of defined contribution plans that are exempt from some administrative requirements that otherwise would apply. In some cases, plans that adopt certain characteristics that favor rank-and-file workers are exempt from nondiscrimination testing.

### **“Safe-Harbor” 401(k) Plans**

In 1996, Congress authorized a “safe-harbor” 401(k) plan that exempts the plan sponsor from the annual nondiscrimination tests in exchange for the employer agreeing to make contributions to the plan. In a safe-harbor 401(k), the employer must either contribute an amount equal to 3% of pay on behalf of each *eligible* employee or match the first 3% of salary deferrals of each *participating* employee on a dollar-for-dollar basis and match the next 2% of employee deferrals at 50 cents per dollar.<sup>11</sup> Any firm with one or more employees can establish a safe-harbor 401(k).

### **Savings Incentive Match Plans for Employees of Small Employers (SIMPLE)**

The Small Business Job Protection Act of 1996 (P.L. 104-188) authorized the Savings Incentive Match Plan for Employees of Small Employers (SIMPLE). In exchange for mandatory employer contributions, the plan is exempt from the nondiscrimination tests. An employer that sponsors a SIMPLE must either contribute an amount equal to 2% of pay on behalf of every *eligible* employee or match 100% of the first 3% of each *participating* employee’s contributions to the plan. The maximum allowable employee contribution to a SIMPLE is \$11,500 per year in 2010 and 2011. Participants aged 50 and older can make additional contributions of up to \$2,500 to a SIMPLE plan. SIMPLE plans can be established only by employers with fewer than 100 employees that do not already have retirement plans.

### **Simplified Employee Pension (SEP)**

In the Revenue Act of 1978 (P.L. 95-600), Congress authorized a defined contribution plan called the Simplified Employee Pension (SEP) for firms that do not already sponsor a retirement plan. Only the employer can make contributions to a SEP, and the employer can decide from year to

---

<sup>10</sup> A plan must satisfy one of two tests: either the proportion of non-highly compensated employees (NHCEs) covered by the plan must be at least 70% of the proportion of highly compensated employees (HCEs) covered by the plan, or the average contribution percentage for NHCEs must be at least 70% of the average contribution percentage for HCEs. Plans that have employer matching contributions are subject to the “actual contribution percentage” (ACP) test, which measures the contribution rate to HCEs’ accounts relative to the contribution rate to NHCEs’ accounts.

<sup>11</sup> The maximum annual employee salary deferral into a 401(k) plan is \$16,500 in 2009 (I.R.C. §402(g)). Employees aged 50 and older can contribute an additional \$5,500. The total annual addition to a 401(k) plan—comprising the sum of employer and employee contributions—is limited to \$49,000 in 2009 (I.R.C. §415(c)).

year whether to contribute to the plan. Employer contributions must be made on behalf of all eligible employees, and the contributions must be the same percentage of pay for all eligible employees. Contributions cannot exceed an amount equal to 25% of pay up to a maximum of \$49,000 in each year 2010 and 2011 (indexed to inflation). Participants are fully and immediately vested in the employer's contributions to the plan. Any firm with one or more employees can establish a SEP.

## Plan Sponsorship Remains Low Among Small Employers

Despite the availability of the SEP, SIMPLE, and safe-harbor 401(k), there has been relatively little growth in retirement plan sponsorship among small firms over the past 20 years. According to the Bureau of Labor Statistics, 36% of employees at small private-sector establishments participated in an employer-sponsored retirement plan of some kind in 1990.<sup>12</sup> By 2007, the participation rate in all types of retirement plans among employees at small private-sector establishments had increased by just one percentage point to 37%.<sup>13</sup>

One reason that small firms are less likely than large firms to offer retirement plans is that small employers are much more likely than large employers to go out of business in any given year. For example, over the six years from 2000 through 2005, an average of 10.2% of firms with fewer than 20 employees went out of business each year. Among firms with 20 to 99 employees, an average of 4.6% of firms went out of business annually, whereas among firms with 500 or more employees, an average of 2.3% of firms went out of business each year.<sup>14</sup> Because small firms face relatively greater uncertainty about their survival from year to year, their owners are less likely to offer a retirement plan to their employees.

## Policy Issue: Automatic IRAs

Because small employers are less likely to sponsor retirement plans for their employees, policy analysts have continued to search for ways to help employees of these firms save for retirement. One proposal that has received considerable attention is to promote the adoption of payroll deduction IRAs by employers who do not sponsor retirement plans. Some such proposals would require employers above a certain size who do not sponsor a retirement plan to allow employees to contribute to an IRA through payroll deduction.<sup>15</sup>

Payroll deduction IRAs are not subject to the Employee Retirement Income Security Act. Small business owners who are concerned about the administrative burden of complying with ERISA might be willing to set up a payroll deduction IRA for their employees. Although some small business owners who already have retirement plans for their employees might drop these plans in

---

<sup>12</sup> U.S. Department of Labor, Bureau of Labor Statistics, *Employee Benefits in Small Private Establishments, 1990*, Bulletin 2388, September 1991.

<sup>13</sup> U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey, March 2007*, Summary 07-05, August 2007.

<sup>14</sup> U.S. Small Business Administration, Office of Advocacy.

<sup>15</sup> In the 111<sup>th</sup> Congress, Sen. Jeff Bingaman introduced S. 3760, the Automatic IRA Act of 2010, which would provide for Auto IRAs. Rep. Richard Neal introduced companion legislation, H.R. 6099. Further background on the Auto IRA proposal can be found in *Pursuing Universal Retirement Security Through Automatic IRAs*, by J. Mark Irwy and David C. John, available at [http://www.brookings.edu/papers/2009/07\\_automatic\\_ira\\_irwy.aspx](http://www.brookings.edu/papers/2009/07_automatic_ira_irwy.aspx).

favor of payroll deduction IRAs, many will not because it would reduce their opportunity to save for retirement on a tax-deferred basis. In 2011, the annual contribution limit for an IRA is \$5,000 whereas the maximum employee contribution to a 401(k) is \$16,500. A small business owner who sponsors and participates in a 401(k) plan can save more for retirement on a tax-deferred basis than he or she could save in an IRA. If IRA contribution limits were the same as 401(k) contribution limits, small business owners would be more likely to drop 401(k) plans for IRAs.

One possible area of concern with respect to payroll deduction IRAs is that because they are not subject to ERISA, workers who save through these plans do not have the same rights and protections as participants in 401(k) plans. The participation and vesting requirements of ERISA are not relevant to payroll deduction IRAs, but ERISA has rigorous fiduciary standards that provide important protections to plan participants. Not all of these protections extend to IRAs.

## Participation in Employer-sponsored Retirement Plans

Even when an employer offers a retirement plan, not all employees choose to participate. In 2007, about 75% of employees whose employer sponsored a 401(k) plan participated in the plan, and about 78% of eligible employees participated in DC plans of all types.<sup>16</sup> Participation in a 401(k) plan usually requires the employee to elect to contribute to the plan. Although some 401(k) plans now automatically enroll eligible employees, almost two-thirds of DC plans continue to require employees to elect to participate.<sup>17</sup>

### Sponsorship Rates and Take-up Rates

Participation rates are affected both by access to retirement plans and take-up rates among employees who are offered a plan. The take-up rate is the percentage of employees offered a plan who choose to participate. For example, only 32% of workers under the age of 35 participated in DC plans in 2007.<sup>18</sup> (See Table 2.) Although this was due in part to the relatively low percentage of these workers whose employers sponsored plans, another important factor was the low take-up rate among younger workers who were offered a plan. Only 70% of workers under age 35 whose employer sponsored a DC plan participated in the plan in 2007. In contrast, the take-up rate among workers aged 35 to 44 was 82%, and the take-up rate among workers aged 45 to 54 was 83%.<sup>19</sup>

---

<sup>16</sup> U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey, March 2007*, Summary 07-05, August 2007.

<sup>17</sup> The participation rate in 401(k) plans is from the Profit Sharing/401(k) Council of America's 51<sup>st</sup> Annual Survey of Profit Sharing and 401(k) Plans. The participation rate in DC plans of all types is from the Department of Labor's National Compensation Survey.

<sup>18</sup> This participation rate is based on a CRS analysis of the Federal Reserve Board's 2007 Survey of Consumer Finances. Similarly, a CRS analysis of the Census Bureau's Survey of Income and Program Participation (SIPP) showed that only 30% of workers under age 35 participated in a defined contribution plan in 2006.

<sup>19</sup> The take-up rate is calculated as the percentage of workers who participated divided by the percentage offered a plan. For workers under age 35, the take-up rate in 2007 was  $.318/.456 = .697$ .

**Table 2. Participation in Defined Contribution Plans: 2004 and 2007**  
(Working household heads and spouses under age 65)

	Offered a DC Plan		Participated in DC Plan		Take-up Rate	
	2004	2007	2004	2007	2004	2007
<b>Age</b>						
55 to 64	49.9	48.2	43.1	40.2	86.5	83.5
45 to 54	50.1	54.6	40.0	45.3	79.9	83.0
35 to 44	48.4	49.0	38.2	40.2	79.1	82.1
Under 35	42.4	45.6	28.6	31.8	67.5	69.7
<b>Size of Firm</b>						
500+ employees	67.7	70.4	52.8	57.0	78.0	80.9
100-499 employees	56.1	58.7	41.4	45.8	73.7	78.0
20-99 employees	43.6	46.3	34.3	34.9	78.8	75.4
Under 20 employees	14.9	11.9	11.9	9.2	80.1	76.9
<b>Education</b>						
College graduate	58.6	59.5	49.1	50.6	83.8	85.0
Some college	46.3	50.5	35.1	39.3	75.7	77.9
High school less	37.8	39.4	26.5	28.6	70.2	72.7
<b>Household Income</b>						
Top quartile	60.9	61.5	53.0	53.9	87.1	87.5
Second quartile	52.6	54.5	41.4	45.6	78.7	83.8
Third quartile	43.5	46.3	31.1	33.6	71.4	72.5
Bottom quartile	25.8	29.7	13.9	17.0	54.1	57.4
<b>Total</b>	<b>47.3</b>	<b>49.4</b>	<b>36.7</b>	<b>39.2</b>	<b>77.5</b>	<b>79.3</b>

Source: CRS analysis of the Federal Reserve Board's 2004 and 2007 Survey of Consumer Finances.

Notes: Data represent 112 million workers in 2004 and 115 million workers in 2007. Education is the highest level of education completed by the head of household. The take-up rate is the percentage of workers offered a plan who participated in the plan. In 2007, for example, 49.4% of workers were offered a DC plan and 39.2% of workers participated in a DC plan. Therefore, the take-up rate was  $.392/.494 = .793$ .

In contrast to the lower participation rate of younger workers compared with older workers, participation rates among employees of small firms are lower than those of employees of larger firms mainly because a smaller proportion of workers at small firms are employed by firms that sponsor retirement plans. Among employees who are offered a retirement plan, take-up rates are similar for employees of small firms and large firms. The data presented in Table 2 show that in 2007, only 9% of workers employed at firms with fewer than 20 employees participated in a DC plan, compared with 35% of workers at firms with 20 to 99 employees, 46% of those at firms with 100 to 499 employees, and 57% of those at firms with 500 or more employees. However, only 12% of workers at firms with fewer than 20 employees were offered a DC plan, compared with 46% of those at firms with 20 to 99 employees, 59% of those at firms with 100 to 499 employees, and 70% of workers at firms with 500 or more employees. Take-up rates were similar among employees at small firms and large firms. The take-up rate in 2007 among employees at firms with fewer than 20 employees was 77%, whereas the take-up rates among workers at firms

with 20 to 99 employees and firms with 100 to 499 employees were 75% and 78%, respectively. The take-up rate at firms with 500 or more employees was slightly higher (81%).<sup>20</sup>

Access to employer-sponsored retirement plans and participation in plans also differ between better-educated and less-educated workers and between workers in higher-income and lower-income households. Only 39% of workers in households in which the household head had a high school education or less worked for an employer that sponsored a DC plan in 2007, compared with 60% of workers in households in which the household head was a college graduate. The take-up rate among the less-educated group was 73%, compared with 85% for those in the better-educated group. Similarly, only 30% of workers in households in the bottom quartile of household income worked for an employer that sponsored a DC plan in 2007, compared with 62% of workers in households in the top income quartile. The take-up rate among workers in the bottom income quartile was just 57%, compared with 88% among workers in the top income quartile.

These results imply that policies intended to raise participation in retirement plans should be designed with the situation of the target population in mind. Efforts to increase plan participation among younger workers should be focused on the low take-up rate among young employees who are offered a plan, perhaps by encouraging firms to adopt automatic enrollment or to provide more education for workers about the importance of saving for retirement. Policies designed to raise participation among employees of small firms will need to target the low sponsorship rate among small employers, which may require finding new ways to make offering a retirement plan less burdensome and costly to small employers. Less-educated workers may need more guidance, perhaps in the form of investment education and investment advice, than better-educated workers. Workers in lower-income households, who may be hesitant to opt into a 401(k) plan that will reduce take-home pay, may be more receptive to plans that devote a portion of future pay increases to the retirement plan.

### **Policy Issue: The Retirement Savings Tax Credit**

Congress has established tax incentives to encourage employers to sponsor retirement plans and employees to participate in these plans. Employer contributions to qualified plans are a tax-deductible business expense, and neither contributions—whether made by the employer or the employee—nor the investment earnings on those contributions are taxed as income to the employee until they are withdrawn from the plan.<sup>21</sup>

Because higher-earning workers pay higher marginal tax rates than lower-earning workers, the tax deduction for contributing to a retirement plan is worth more to a worker in a higher tax bracket than it is to a worker in a lower tax bracket. For a worker with a marginal income tax rate of 35%, contributing \$1 to a 401(k) plan costs just 65 cents after taking the tax deduction into account. For a worker with a marginal income tax rate of 20%, contributing \$1 to a 401(k) plan costs 80 cents on an after-tax basis. Moreover, both economic theory and empirical evidence suggest that the propensity to save rises with income. Because higher-earners would save much of their income even without tax incentives to do so, a substantial share of the tax revenue lost

---

<sup>20</sup> All figures cited in this paragraph are from the Federal Reserve Board's 2007 Survey of Consumer Finances.

<sup>21</sup> A notable exception to this rule is the Roth 401(k). In a Roth 401(k), the employee's salary deferrals into the plan are made with after-tax income. In retirement, the part of the withdrawals attributable to the employee's contributions and investment earnings on those contributions is tax free.

through the deduction for contributions to retirement plans does not result in a net increase in national saving. Consequently, some economists have suggested that the tax incentives for retirement saving are “upside down.” Most of these tax breaks are enjoyed by higher-wage workers who would be likely to save part of their income even without a tax deduction, rather than by low-wage workers who might respond to an effective tax incentive with new saving.

One strategy for increasing contributions to retirement plans would be to provide tax incentives that are targeted to low- and middle-income workers. To provide an additional incentive for lower-income workers to contribute to retirement savings plans, Congress in 2001 authorized a new retirement savings tax credit, sometimes called the “saver’s credit.” In 2011, single taxpayers with adjusted gross income (AGI) up to \$17,000 are eligible for a credit of 50% on qualified retirement contributions up to \$2,000. For single filers with AGI of \$17,001 to \$18,250, the credit is 20%, and for single filers with AGI of \$18,251 to \$28,250, the credit is 10%. Married couples filing jointly with AGI up to \$34,000 are eligible for a credit of 50% on qualified retirement contributions up to \$2,000. For married couples with AGI of \$34,001 to \$36,500, the credit is 20%, and for married couples with AGI of \$36,501 to \$56,500, the credit is 10%.

The saver’s credit is now claimed on about 5 million tax returns each year.<sup>22</sup> The maximum credit is \$1,000. The average credit in 2007 was \$167. Although the saver’s credit provides an incentive for lower-income workers to save for retirement, its effect has been limited because the credit is non-refundable and phases out steeply over a range of income that is relatively low. A nonrefundable credit reduces taxes owed by the amount of the credit. However, if the individual or family owes no income tax after having taken the exemptions and deductions for which they are eligible, a nonrefundable credit has no value.<sup>23</sup> This is the case for many households with modest earnings who might benefit from the saver’s credit if the credit were refundable.<sup>24</sup>

H.R. 1961 of the 111<sup>th</sup> Congress would have increased the rate of the tax credit for retirement savings contributions, made the credit refundable, and required the credit to be paid into retirement accounts. The income limit for the maximum credit of 50% of contributions would have been increased to an adjusted gross income of \$32,500 for individuals and \$65,000 for couples. The credit would have phased out between \$32,500 and \$42,500 for individuals and between \$65,000 and \$85,000 for married couples filing jointly. The bill would have set the maximum amount of an employee contribution that is eligible for the credit at \$500 for an individual and \$1,000 for a couple. The contribution limits would have increased by \$100 and \$200, respectively, each year until 2020. After that time, the limits would have been indexed to the rate of inflation.

---

<sup>22</sup> For more information, see CRS Report RS21795, *The Retirement Savings Tax Credit: A Fact Sheet*, by John J. Topoleski.

<sup>23</sup> Some tax credits—such as the earned income tax credit (EITC) for low-income families—are refundable.

<sup>24</sup> Consider, for example, a young married couple with one child, for whom the husband is the sole breadwinner. In 2007, 25% of all workers aged 18 to 34 who worked year-round, full-time had earnings of \$21,000 or less. Taking into account the standard deduction in effect for 2007 (\$10,700) and three personal exemptions (\$3,400 X 3 = \$10,200), a couple with gross income of \$21,000 would have had taxable income of \$100. The child tax credit of \$1,000 would reduce their tax liability to zero. For this couple, the saver’s credit would have no value because it is not refundable.

## Contributions to Retirement Savings Plans

If an employee elects to participate in a 401(k) plan, the next important decision he or she must make is how much to contribute to the plan. Studies have shown that employees are more likely to contribute to a plan if it provides matching contributions, and the amount that an employee contributes to a plan can be influenced by the formula for the matching contribution.<sup>25</sup> About two-thirds of all 401(k) plans offered an employer matching contribution in 2007.<sup>26</sup> The most common matching formula was 50% of the first 6% of pay contributed by the employee, for a total employer contribution equal to 3% of employee pay.

The maximum permissible annual contribution to a retirement plan is limited by federal law, but very few workers contribute amounts near the annual legal maximum.<sup>27</sup> Many employees contribute only enough to receive the full amount of the employer matching contribution. Those who elect not to contribute to a plan that offers a match, or who contribute less than the amount necessary to receive the full match, are in effect choosing to reduce their own compensation below the maximum available to them.<sup>28</sup>

In defined contribution plans, the benefit available to the worker at retirement is the amount in his or her account. The account balance depends on the amount that the employer and employee have contributed to the plan, the investment gains or losses on those contributions, and the fees charged to participants. Research has shown that, historically, the most important factors affecting workers' retirement account balances at retirement are the number of years over which they have contributed and the amounts that they contributed each year to their retirement plans.<sup>29</sup> Consequently, persuading workers to save more and to begin saving earlier are two of the most effective ways of increasing workers' income in retirement.

### Household Contributions to DC Plans in 2007

**Table 3** shows households' monthly contributions to DC plans in 2007 both in dollars and as a percentage of household earnings. The top panel of the table shows contributions categorized by the age of the household head, the middle panel shows contributions categorized by household income, and the bottom panel shows contributions by all households that contributed to a DC plan.

In 2007, the median monthly contribution to defined contribution plans by households in which at least one worker aged 25 to 64 participated in a DC plan was \$290. This is equivalent to \$3,480

<sup>25</sup> See, for example, CRS Report RL33116, *Retirement Plan Participation and Contributions: Trends from 1998 to 2006*, by Patrick Purcell, and CRS Report RL30922, *Retirement Savings and Household Wealth in 2007*, by Patrick Purcell.

<sup>26</sup> Employers often suspend the match during difficult times. According to the Pension Rights Center, between June 2008 and June 2009, nearly 300 medium and large employers had announced plans to suspend, reduce, or delay their 401(k) matching contributions.<sup>26</sup> See [http://www.pensionrights.org/pubs/facts/401\(k\)-match.html#](http://www.pensionrights.org/pubs/facts/401(k)-match.html#).

<sup>27</sup> The limit in 2009 is \$16,500 (I.R.C. §415(c)).

<sup>28</sup> With respect to after-tax income, even non-participants in plans that do not offer a matching contribution are reducing their total income by not contributing. Nevertheless, because contributions to a 401(k) plan reduce a worker's take-home pay, some workers are willing to give up higher future retirement income for higher current income.

<sup>29</sup> For more information, see CRS Report RL33845, *Retirement Savings: How Much Will Workers Have When They Retire?*, by Patrick Purcell and Debra B. Whitman.

on an annual basis.<sup>30</sup> As a percentage of household earnings, the median contribution by households in which one or more workers participated in a DC plan was 5.1% of earnings. Twenty-five percent of households that contributed to a DC plan in 2007 contributed \$660 or more per month, and 25% contributed \$130 per month or less. As a percentage of earnings, 25% of households participating in DC plans contributed 8.3% of earnings or more to the plan in 2007, and 25% of participating households contributed 2.9% of earnings or less to the plan.

### **Household Contributions by Age of Household Head**

Households headed by persons under age 35 contribute less to DC plans, both in dollars and as a percentage of household earnings, than households headed by individuals aged 35 and older. In 2007, the median monthly contribution to DC plans by households headed by persons under age 35 in which at least one worker participated in a plan was \$190. Among households headed by persons aged 35 to 44, the median monthly contribution was \$310, and among households headed by persons aged 45 to 44, the median monthly contribution was \$368. The median monthly DC plan contribution among households headed by persons aged 55 to 64 was \$330 in 2007.

As a percentage of total household earnings, the median monthly contribution to DC plans by households headed by persons under age 35 in which at least one worker participated in a plan was 4.2% of earnings. The median contribution among households headed by persons aged 35 to 44 was 5.2% of earnings. Among both households headed by persons aged 45 to 54 and households headed by persons aged 55 to 64, the median contribution to DC plans in 2007 was 5.7% of household earnings.

### **Household Contributions by Household Income**

As one might expect, household contributions to DC plans vary substantially by household income. This is likely to be the case both because higher-income households have more disposable income to save and also because, as was discussed earlier, the tax deduction for retirement savings is more valuable to higher-income households than to lower-income households. In addition, higher-income households are more likely than lower-income households to have more than one worker contributing to a DC plan.

In 2007, the median monthly contribution to DC plans among households in the top income quartile in which one or more workers participated in a plan was \$750. Among households in the bottom income quartile in which one or more workers participated in a DC plan, the median monthly contribution to DC plans was \$100. As a percentage of income, the median contribution among households in the top income quartile was 6.6% of household earnings, whereas among households in the bottom income quartile, the median contribution was 4.3% of household earnings.<sup>31</sup>

---

<sup>30</sup> This takes into account contributions by both the household head and his or her spouse. Among household heads who contributed, the median monthly contribution was \$280, or \$3,360 on an annual basis. This was just 22% of the maximum permissible employee salary deferral under I.R.C. §402(g) in 2007, which was \$15,000.

<sup>31</sup> In Table 3, households are grouped by income quartile. Income includes earnings and unearned income, such as interest, dividends, rent, and transfer payments. Contributions are reported as a percentage of total household earnings.

**Table 3. Monthly Household Contributions to Defined Contribution Plans in 2007**

	Monthly Contributions in Dollars	Percentage of Household Earnings
<b>Age of Householder</b>		
<b>55 to 64</b>		
75 <sup>th</sup> percentile of contributions	\$790	9.9%
50 <sup>th</sup> percentile of contributions	330	5.7
25 <sup>th</sup> percentile of contributions	133	3.1
<b>45 to 54</b>		
75 <sup>th</sup> percentile of contributions	810	8.5
50 <sup>th</sup> percentile of contributions	368	5.7
25 <sup>th</sup> percentile of contributions	158	3.1
<b>35 to 44</b>		
75 <sup>th</sup> percentile of contributions	750	8.6
50 <sup>th</sup> percentile of contributions	310	5.2
25 <sup>th</sup> percentile of contributions	150	2.9
<b>Under 35</b>		
75 <sup>th</sup> percentile of contributions	360	6.0
50 <sup>th</sup> percentile of contributions	190	4.2
25 <sup>th</sup> percentile of contributions	87	2.5
<b>Household Income</b>		
<b>Top income quartile</b>		
75 <sup>th</sup> percentile of contributions	1,292	10.0
50 <sup>th</sup> percentile of contributions	750	6.6
25 <sup>th</sup> percentile of contributions	380	3.6
<b>Second income quartile</b>		
75 <sup>th</sup> percentile of contributions	500	8.2
50 <sup>th</sup> percentile of contributions	303	5.1
25 <sup>th</sup> percentile of contributions	170	3.0
<b>Third income quartile</b>		
75 <sup>th</sup> percentile of contributions	250	6.1
50 <sup>th</sup> percentile of contributions	160	4.4
25 <sup>th</sup> percentile of contributions	90	2.5
<b>Bottom income quartile</b>		
75 <sup>th</sup> percentile of contributions	160	6.2
50 <sup>th</sup> percentile of contributions	100	4.3
25 <sup>th</sup> percentile of contributions	50	2.5
<b>All Contributing Households</b>		
75 <sup>th</sup> percentile of contributions	660	8.3
50 <sup>th</sup> percentile of contributions	290	5.1
25 <sup>th</sup> percentile of contributions	130	2.9

**Source:** CRS analysis of the Federal Reserve Board's 2007 Survey of Consumer Finances.

**Notes:** Households are grouped by total income, including earnings and all other income. Contributions are reported as a percentage of total household earnings. Among households in which there was a worker under age 65 in 2007, those with income of \$100,780 or more were in the top income quartile and those with income under \$33,940 were in the bottom income quartile. Median income for these households was \$59,650.

## Policy Issue: Automatic Contribution Escalation

Employer matching contributions have been shown to raise participation rates in 401(k) plans. Many employees, however, contribute just enough to receive the full employer match. Employer matching contributions usually phase out at relatively low employee contribution rates. Matching contributions on employee salary deferrals of more than 6% of pay are relatively uncommon. Consequently, employer matching contributions are not as effective at raising employee contribution rates over time as they are at inducing employees to start contributing to the plan. Just as automatic enrollment has proven to be an effective means of raising participation rates in 401(k) plans, automatic contribution escalation can raise contribution rates.

The Pension Protection Act of 2006 sought to encourage employers to adopt automatic enrollment as a feature of their retirement plans by granting an exemption to certain regulations to plans that include a “qualified automatic contribution arrangement.”<sup>32</sup> One of the features that a qualified automatic contribution arrangement must include is automatic escalation of employee contributions. Employee deferrals must be equal to specific percentages of pay unless the employee elects a different percentage. The minimum required deferral amount is 3% of pay in the employee’s first year of participation, 4% in the second year, 5% in the third year, and 6% in the fourth and later years. The automatic deferral cannot exceed 10% of pay, but participants can elect a higher deferral rate, provided their total deferrals for the year do not exceed the annual limit under I.R.C. § 402(g). In 2011, this limit is \$16,500.

A qualified automatic contribution arrangement also must include employer contributions. The employer contribution can be either a non-elective contribution equal to at least 3% of pay for all employees or a matching contribution equal to 100% of the first 1% of salary deferred and 50% of deferrals from 1% of pay to 6% of pay. Other matching formulas are permitted if they result in matching contributions that are at least equal to the amount provided under the prescribed matching formula, do not increase as the employee’s rate of deferral increases, and do not apply to deferrals in excess of 6% of pay.

In 2007, the median employee salary deferral into employer-sponsored defined contribution plans was 6% of pay; however, 25% of workers who contributed to a DC plan deferred 3.9% of pay or less. Qualified automatic contribution arrangements that include automatic contribution escalation could raise employee contribution rates for a substantial percentage of participants. Employees could elect not to participate or to lower their contributions. The experience of most plans with automatic enrollment has been that the majority of participants who are automatically enrolled continue to participate. There is less evidence on the long-term effects of automatic contribution escalation on employee contributions because not as many plans have yet adopted automatic escalation.

## Investment Choices and Investment Risk

A worker who has elected to participate in a 401(k) plan and has decided how much to contribute to the plan usually also must decide how to invest these contributions. More than 90% of 401(k) plans allow employees to direct the investment of their contributions, and three-fourths of plans

---

<sup>32</sup> Section 902 of P.L. 109-280 exempts plans with a qualified automatic contribution arrangement from the nondiscrimination tests.

allow employees to direct the investment of the employer's contributions.<sup>33</sup> In order for a plan sponsor to be relieved of liability for investment losses in a participant-directed retirement plan, participants must be given a choice of at least three investment alternatives, each of which must have different risk and return characteristics.<sup>34</sup> Most plans offer participants more than the minimum number of investment choices required by law. In 2007, the average 401(k) plan offered participants 18 investment options.<sup>35</sup> The investment options most commonly offered were actively managed U.S. stock funds (77% of plans), actively managed international stock funds (73%), indexed U.S. stock funds (70%), and actively managed U.S. bond funds (64%).<sup>36</sup>

Participants in 401(k) plans bear the risk of investment losses. An individual's retirement account might suffer investment losses because the particular stocks, bonds, or other assets in which he or she has chosen to invest decline in value. Diversification can reduce the risk associated with investing in specific assets because declines in the value of some assets may be fully or partially offset by gains in the value of other assets. Stock and bond mutual funds, for example, help protect individuals from investment risk by purchasing securities from many companies in a variety of industries. In a stock mutual fund, investment losses from companies that are performing poorly may be offset by investment gains from companies that are performing well.

A broader form of investment risk is *market risk*, which is the possibility of an overall decline in a broad class of assets, such as stocks. Even a well-diversified portfolio of stocks, for example, will not protect the value of an individual's retirement account from depreciating if stock values fall across the board, as they did in 2008. This is why most investment advisors recommend diversification not only within a class of assets—by buying broadly diversified stock mutual funds instead of individual stocks, for example—but also diversification across asset classes. Bond prices have historically been less volatile than stock prices, and there have been long periods when returns on stocks and bonds have not been closely correlated. Life-cycle funds and target date funds diversify across classes of assets by buying shares in stock mutual funds, bond funds, and sometimes other investments as well.

Although most financial advisors recommend diversifying investments across classes of assets and periodically re-balancing accounts to maintain appropriate diversification, relatively few plan participants put this advice into practice. The assets of DC plans are heavily invested in stocks and stock mutual funds. At year-end 2007, 78% of all DC plan assets were invested in stocks and stock mutual funds. Investment in stocks and stock mutual funds varied little by age, indicating that many workers nearing retirement were heavily invested in stocks, and risked substantial losses in a market downturn like that in 2008. According to the 2007 Survey of Consumer Finances, nearly 30% of DC plan participants between the ages of 35 and 54 had 100% of their account balance invested in stocks in 2007. Twenty-eight percent of participants aged 55 to 64 had their entire account balance invested in stocks and stock mutual funds. (See **Figure 1**.)

Because many plan participants lack basic financial literacy, policy analysts have suggested that plans should take steps to help participants make better investment choices or adopt plans that automatically allocate contributions among various classes of investments. Investment education and target date funds are two approaches to achieving asset diversification in DC plans.

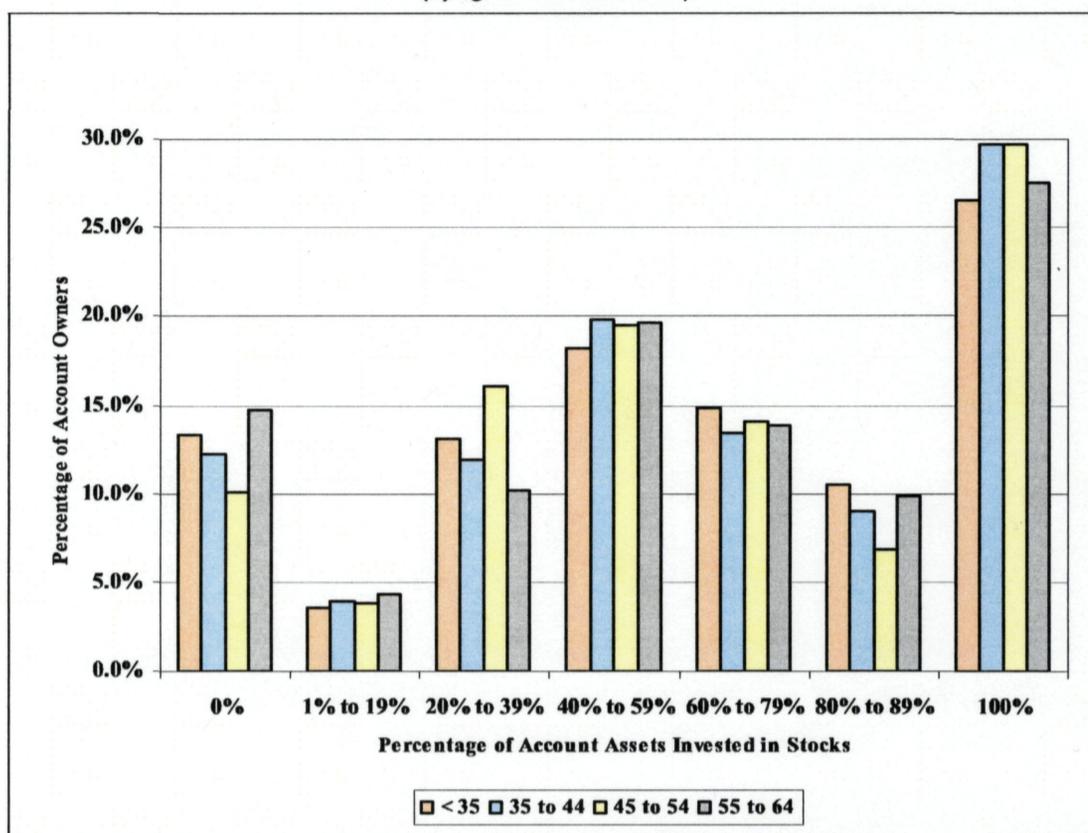
<sup>33</sup> U.S. Department of Labor, Bureau of Labor Statistics, National Compensation Survey.

<sup>34</sup> ERISA §404(c). Employer stock cannot be one of the three core investment choices.

<sup>35</sup> Profit Sharing/401(k) Council of America, 51<sup>st</sup> Annual Survey.

<sup>36</sup> Profit Sharing/401(k) Council of America, 51<sup>st</sup> Annual Survey.

**Figure I. Percentage of Defined Contribution Plan Assets Invested in Stocks, 2007**  
(By age of account owner)



Source: CRS analysis of the Federal Reserve Board's 2007 Survey of Consumer Finances.

Notes: Household heads under age 65 with a defined contribution plan.

## Policy Issue: Investment Education and Investment Advice

To make informed decisions about how much to save for retirement and how to invest these savings, plan participants need to understand certain basic principles of finance. For example, an individual who understands the risk-and-return characteristics of stocks and bonds will be better able to balance the risk of investment losses with the expected rate of return from each kind of investment compared to someone who lacks this understanding. Not everyone understands investment risk, however, and many people make decisions about their investments that are not well-informed. Some 401(k) plan sponsors have attempted to help employees make better investment decisions by providing investment education, offering investment advice, and adding "life-cycle funds" or "target date funds" to their plans.

### Investment Education

According to Hewitt Associates, more than 90% of all 401(k) plans offer some form of investment education. Typically, investment education is offered through enrollment kits, seminars and workshops, and internet sites. Investment education helps plan participants understand the importance of saving for retirement. It typically focuses on educating individuals

about basic tenets of finance, such as the effects of compound interest and the difference between stocks and bonds. Employees who understand how investment gains compound over time are more likely to start contributing to the plan, to continue to contribute to the plan, and to raise their contributions as their earnings rise over time. Participants who understand that the higher expected rate of return on stocks compared to bonds comes at the cost of greater price volatility will be better able to balance their tolerance for risk with their desire for higher returns when choosing investments. Even with more investment education, some employees will choose not to participate in retirement savings plans because they prefer higher current income to higher income in retirement. For workers who discount future income heavily, changing their default participation status to automatic enrollment may be more effective than investment education.

### Investment Advice

Investment education consists mainly of giving plan participants general information about the basic principles of finance that they need to be informed investors. Investment advice, on the other hand, is tailored to the individual and often involves recommending specific investments. Some plan sponsors have been reluctant to offer investment advice both because of the cost of paying professional advisors and concerns about possible legal liability for investment losses incurred by plan participants. Almost half (49%) of all 401(k) plans offered investment advice to plan participants in 2007, up from 35% in 2000.<sup>37</sup>

Even if a plan offers a range of low-cost, diversified investment options and offers investment education and investment advice, it is not unusual for some participants to make investment choices that may prove to be unwise in the long run. For example, some participants invest too much of their retirement savings in the stock of their employers. This exposes them to the risk of losing their retirement savings as well as their jobs if the firm goes out of business. Others invest too conservatively while they are young—putting most of their contributions into low-yielding money market funds, for example—even though their longer investment horizon would suggest that they could take on more risk. Sound investment advice can help plan participants avoid these common mistakes.

Under ERISA, providing investment advice is a fiduciary act. A plan sponsor could be held liable for investment losses incurred by a participant who follows investment advice offered by a plan or its agent. The Pension Protection Act of 2006 (PPA) amended ERISA to allow plan sponsors who follow certain procedures to provide investment advice without being held liable for investment losses of participants who act on the advice.<sup>38</sup> In general, to be permissible under the provisions of the PPA, the advice must be provided for a fee rather than a commission, or it must be based on a computer model that meets requirements set forth in statute and regulations. The advisors must disclose their fee arrangements to plan participants and inform them of their affiliations with investments they recommend and with the developer of the computer model. The model on which the advice is based must “operate in a manner that is not biased in favor of

---

<sup>37</sup> Profit Sharing/401(k) Council of America, 44<sup>th</sup> Annual Survey and 51<sup>st</sup> Annual Survey.

<sup>38</sup> Section 406(a)(1)(C) of ERISA prohibits a fiduciary from engaging in a transaction when he knows or should know that such transaction constitutes a direct or indirect furnishing of goods, services, or facilities between the plan and a party in interest. Section 601 of the PPA amended §408(b) of ERISA to add an exception to the transactions prohibited by ERISA for an “eligible investment advice arrangement.” For more information, see CRS Report RS22514, *Investment Advice and the Pension Protection Act of 2006*, by Jon O. Shimabukuro.

investments offered by the fiduciary adviser or a person with a material affiliation or contractual relationship with the fiduciary adviser.”<sup>39</sup>

### **Investment Advice Regulations and Legislation**

On January 21, 2009, the Department of Labor (DOL) published a final regulation on the investment advice provisions of the PPA. On March 19, the department delayed the effective date of the regulation for 60 days, pending further review and receipt of additional public comments. On May, 21, 2009, the department announced that the regulation would not be implemented until November 18, 2009. On November 20, 2008, DOL announced that it was withdrawing the final rule.<sup>40</sup>

The investment advice provisions of the PPA allow investment advice to be provided to plan participants by individuals with a financial interest in the investments that they recommend, provided that they disclose this information to plan participants. On April 23, 2009, Representative Robert Andrews introduced H.R. 1988, the Conflicted Investment Advice Prohibition Act of 2009. This bill would allow investment advice to be provided to plan participants only by independent investment advisers who are registered under the Investment Advisers Act of 1940 and who meet certain other qualifying requirements. The bill would prohibit advisers from managing any investments in which any of the assets of the plan are invested, and it would prohibit plans in which individuals direct the investment of their accounts from contracting with investment advisers who are not independent advisers. Independent advisers would be required to provide participants with documentation of the historic rates of return of investment options available to the plan, and to notify participants that the investment adviser is acting as a fiduciary of the plan.

### **Policy Issue: Life-cycle Funds and Target Date Funds**

Even if a plan participant understands the basic principles of finance, he or she may have neither the time nor the inclination to monitor and manage a retirement account. Because many plan participants lack either the aptitude, interest, or time to manage their retirement accounts, plan sponsors have begun to add “life-cycle funds” or “target date funds” to their 401(k) plans. These plans are designed to allocate the participant’s investments between stocks and bonds in a way that takes into account his or her risk tolerance and expected date of retirement. Although these funds have proved popular with participants and have won the approval of many investment professionals, the sharp downturn in stock prices in 2008 showed that they are not without problems. Many target-date funds for people expecting to retire in 2010 or 2011 were heavily invested in stocks and lost 25% to 30% of their value in 2008.

Life-cycle funds and target date funds are similar. Many financial analysts consider target date funds to be a subset of the category of funds called life-cycle funds. A life-cycle fund is a mutual fund in which the allocation of assets among stocks, bonds, and cash-equivalents (money market funds, for example) is automatically adjusted during the course of the participant’s working life. As the participant nears retirement age, the investment allocation is shifted away from higher-risk investments, such as stocks, and moves toward lower-risk investments, such as bonds and cash

---

<sup>39</sup> 29 U.S.C. § 1108(g)(3)(B)(i)-(v).

<sup>40</sup> *Federal Register*, Vol. 74, No. 223, November 20, 2009, p. 60156.

equivalents. A target-date fund is a life-cycle fund designed to achieve a particular (generally conservative) mix of assets at a specific date in the future, which is usually the year when the participant expects to retire.

Although life-cycle funds and target date funds are typically designed with the intent of achieving more rapid growth in the early years of the participant's career and greater stability of asset values in the later years, they can contain any mix of stocks, bonds, and cash. There are no industry standards or federal regulations that specify what allocation of assets is required for a life-cycle fund or a target date fund that is intended for plan participants of a given age or with a particular investment time horizon. Currently, less than 5% of DC plan assets are invested in life-cycle funds. Analysts expect this percentage to rise over the next 10 years because the Pension Protection Act allows companies to use life-cycle funds as the default investment option for employees who are automatically enrolled in a 401(k) plan and who do not select an investment fund for their 401(k) contributions.<sup>41</sup>

Allocation of assets among stocks, bonds, and cash-equivalents varies greatly among target date funds with the same target retirement date. A recent study by Morningstar, Inc. found that among target-date 2010 funds that were at least three years old, stock allocations ranged from 14% of assets to 63% of assets. In December 2008, the average 2010 fund had more than 45% of its assets invested in stocks. Fund performance also varied greatly during the bear market of 2008. The S&P Target Date 2010 Index Fund, a benchmark of fund performance, fell 17% in 2008. The fund holds 60% of its assets in bonds and other fixed-income securities and 40% in equities. In comparison, the Deutsche Bank DWS Target 2010 Fund fell just 4% in 2008, whereas Oppenheimer's Transition 2010 fund fell 41%. In January, 2009, the Thrift Savings Plan's "L2010 Fund" for federal employees who plan to retire in 2010 held 70% of its assets in bonds and 30% in stocks. Shares of the L2010 Fund fell 10.5% in 2008.

In a letter sent to Secretary of Labor Hilda Solis in February 2009, Senator Herb Kohl, chairman of the Senate Special Committee on Aging, urged the Secretary to "immediately commence a review of target date funds and begin work on regulations to protect plan participants."<sup>42</sup> In her reply to Senator Kohl on March 26, Secretary Solis stated that the Department of Labor would, in coordination with the Securities and Exchange Commission, begin a review of target date funds to determine if these funds should be subject to further federal regulation.<sup>43</sup>

## Fees and Fee Disclosure

Another issue that has concerned Congress is the effect of fees on retirement account balances. Retirement plans contract with service providers to provide investment management, record-keeping, and other services. There can be many service providers, each charging a fee that is ultimately paid by plan participants. The arrangements through which service providers are compensated can be very complicated. Because the structure of 401(k) fees is opaque to most plan participants, it is very difficult for them to judge whether they are receiving services at a price they would be willing to pay in a more transparent market transaction.

---

<sup>41</sup> Under the PPA, a target date fund is a "Qualified Default Investment Alternative" (QDIA).

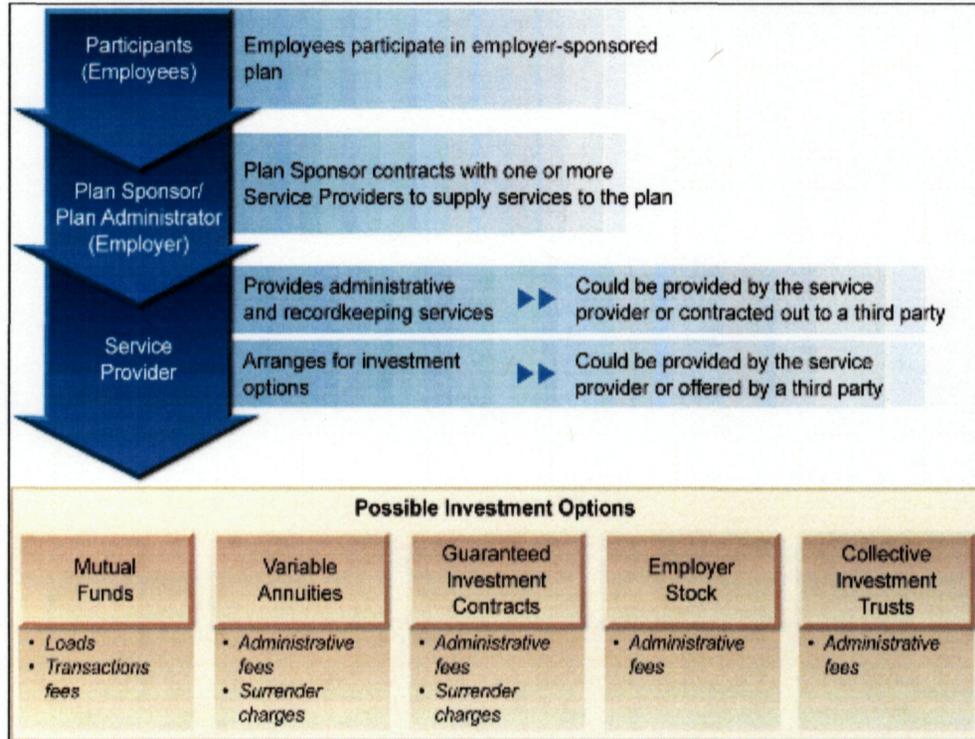
<sup>42</sup> See <http://aging.senate.gov/record.cfm?id=308665>.

<sup>43</sup> *Investment News*, "Labor Department, SEC to probe target date funds," April 3, 2009.

## The Administrative Structure of 401(k) plans

Figure 2 illustrates the administrative structure of a typical 401(k) plan. Plan participants have individual accounts to which the employees, the employer, or both contribute. As the plan sponsor, the employer arranges for one or more third parties to provide various services for the plan. Services include recording transactions, arranging for loans, cashing out departing employees' accounts, and contracting with the funds into which participants can direct their contributions. Employers can purchase services separately from several service providers or they might purchase two or more services from a single service provider. Services may be priced individually or purchased in a bundled arrangement. In a bundled arrangement, several services are offered to the plan for a single fee. The service provider sometimes contracts out the provision of these services to one or more third parties.

Figure 2. The Structure of a Typical Defined Contribution Plan



Source: Congressional Research Service.

Fees vary from plan to plan. They are affected by the amounts and kinds of services offered to plan participants and also by the size of the plan. As a percentage of plan assets, fees are negatively correlated with the number of plan participants and the average account balance. In general, the greater the number of plan participants and the larger the average account balance, the lower the fees will be as a percentage of plan assets. A recent survey conducted by Deloitte Consulting for the Investment Company Institute looked at fees in plans ranging in size from those with fewer than 100 participants and less than \$1 million in total assets to plans with more

than 10,000 participants and assets of more than \$500 million.<sup>44</sup> The study looked at fees for administration, recordkeeping, and investment management, which were combined into a single “all-in” fee, expressed as a percentage of plan assets. The median fee for all plans in the survey was 0.72% of plan assets, or approximately \$350 for an account with the median balance of plans in the survey, which was \$48,500. The study found that 10% of plans had total fees of 0.35% of assets or less and that 10% of plans had total fees of 1.72% of assets or more.

### Policy Issue: Requiring Clearer Disclosure of Fees

The firms that provide record-keeping, investment management, and other services to 401(k) plans charge fees for these services, and many of these fees are passed on to plan participants. Fees for some services are charged for each transaction, while others are charged as a flat fee per account per year, and still others—such as investment management—are typically charged as a percentage of total plan assets. Small differences in fees can yield large differences in account balances at retirement, especially in the case of yearly or recurring fees.<sup>45</sup> For example, after 20 years, an initial \$20,000 account balance earning 7% yearly would be worth about \$70,000 if fees were equal to 0.5% of plan assets each year. The account would have a balance of about \$58,000, or 17% less, if fees amounted to 1.5% per year. Over the course of 30 years, a participant in a plan charging fees equal to 1.5% of assets would pay almost \$33,000 more in fees than he or she would have paid if the annual fees were 0.5% of assets.<sup>46</sup>

Section 404(a) of ERISA states that plan sponsors are responsible for “defraying reasonable expenses of administering the plan.” This has been interpreted by the Department of Labor as imposing a duty on plan sponsors to assure that expenses—including fees—are reasonable. Plan sponsors are not required to minimize fees, but they are required to make sure that plan fees are “reasonable.” This standard allows for wide variation in fees across plans. Although sponsors of DC plans are required by law to assure that fees are reasonable, they do not have the same financial incentive to keep fees low as do the sponsors of DB plans. In a DC plan, many fees are passed through to the plan participants, while in a DB plan most fees are paid by the plan sponsor.<sup>47</sup> If plan participants were better-informed about the fees that they pay and the services they receive in return for those fees, they could question plan sponsors about fees that they believe to be unreasonable. Therefore, policies that increase the transparency of fee arrangements could result in participants paying lower fees.

Plans are required by law to disclose some of the fees that plan participants pay. However, the information is not always easily accessible or easily understood by the average participant. On July 16, 2010, DOL issued final regulations requiring greater disclosure of fees.<sup>48</sup>

Members of Congress have been developing legislation that would require greater disclosure of fees to participants. Several bills were introduced in the 111<sup>th</sup> Congress to increase fee disclosure.

<sup>44</sup> Defined Contribution/401(k) Fee Study, Deloitte Consulting LLP, Spring 2009. The report is available on the ICI website at [http://www.idc.org/pdf/rpt\\_09\\_dc\\_401k\\_fee\\_study.pdf](http://www.idc.org/pdf/rpt_09_dc_401k_fee_study.pdf).

<sup>45</sup> See CRS Report RL34678, *Fee Disclosure in Defined Contribution Retirement Plans: Background and Legislation*, by John J. Topoleski.

<sup>46</sup> The examples are based on an account with an initial balance of \$20,000 growing at an average annual rate of 7.0%.

<sup>47</sup> Even if fees charged to a DB plan are paid for from plan assets, this increases the sponsor’s funding obligation.

<sup>48</sup> *Federal Register*, Vol. 75, No. 135, July 16, 2010, p. 41599-41638.

On February 10, 2009, Senator Tom Harkin introduced S. 401, the Defined Contribution Fee Disclosure Act. On April 21, 2009, Representative George Miller introduced H.R. 1984, the 401(k) Fair Disclosure for Retirement Security Act. On June 24, the House Education and Labor Committee ordered the 401(k) Fair Disclosure and Pension Security Act reported to the House. The bill reported by the committee was numbered H.R. 2989. This bill combined H.R. 1984 with H.R. 1988, the Conflicted Investment Advice Prohibition Act, which was introduced by Representative Robert Andrews. On June 9, 2009, Representative Richard Neal introduced H.R. 2779, the Defined Contribution Plan Fee Transparency Act, which was referred to the Committee on Ways and Means.

## Leakage from Retirement Savings Plans

The tax incentives that Congress has authorized for retirement savings accounts are designed to assure that the money workers have set aside for retirement remains in the account until they are near retirement age. In recognition of needs that may arise over the course of an individual's life, Congress has allowed certain exceptions to the general restriction on access to these accounts before retirement. Each exception, however justifiable on its own merits, increases the danger that workers will reduce their retirement savings before they have reached retirement.

Pre-retirement withdrawals from retirement accounts are sometimes described as "leakages" from the pool of retirement savings. Congress has used a combination of regulation and taxation to limit and discourage pre-retirement access to money in retirement accounts, but it has not completely prohibited pre-retirement access to these accounts because this access is important to many plan participants. Research has shown that workers are less likely to put money into a retirement account if they believe that the money will be inaccessible in the event of emergency. Consequently, current law represents a compromise between limiting leakages from retirement accounts and allowing people to have access to their retirement funds in times of great need.

Leakages from retirement plans can take a variety of forms, including "hardship" withdrawals from the plan prior to retirement, borrowing against plan assets, and cashing out plan assets upon separation from employment.

### Hardship Distributions

The tax code permits 401(k) plans to make distributions available "upon hardship of the employee."<sup>49</sup> Although the Internal Revenue Code (IRC) allows plans to make these distributions available, it does not require them to do so. Federal regulations specify that a hardship distribution can be made only on account of "an immediate and heavy financial need of the employee" and cannot exceed the amount of the employee's previous elective contributions.<sup>50</sup> Qualifying expenses include medical care for the participant or family members, the purchase of

---

<sup>49</sup> 26 U.S.C. §401(k)(2)(B)(i)(IV). All distributions are taxable, except any portion that is attributable to after-tax contributions. I.R.C. §72(t) lists limited cases in which distributions made before age 59½ are not subject to the 10% additional tax on early distributions.

<sup>50</sup> 26 C.F.R. §1.401(k)-1(d). Regular matching contributions and discretionary profit-sharing contributions may also be distributed on account of hardship if the plan so provides. See 26 C.F.R. §1.401(k)-1(d)(3)(ii).

a principal residence, college tuition and education expenses, expenses to prevent eviction or foreclosure on a principal residence, and funeral expenses.

A hardship distribution must be limited to the amount needed to meet the employee's immediate financial need plus any taxes that will result from the distribution. Plan participants are prohibited from making contributions to a plan for a period of six months after a hardship distribution, and consequently they forego any employer match on contributions during that time. Hardship distributions are always subject to ordinary income taxes, and unless the distribution is used for a purpose specifically designated in law, the distribution will be subject to a 10% early withdrawal tax penalty unless the plan participant is over age 59½.<sup>51</sup>

## Borrowing from Retirement Plans

The IRC allows participants in employer-sponsored retirement plans to borrow from their accounts, but plans are not required to allow such loans. A loan cannot exceed the greater of \$10,000 or 50% of the participant's vested benefit in the plan, up to a maximum of \$50,000. Most loans from retirement plans must be paid back within five years, although loans used to purchase a home can be repaid over 15 years. If repayment ceases, the IRS will treat the full amount of the loan as a distribution from the plan, and it will be subject to income tax and possibly to an early distribution penalty. Most plans require employees who separate from the employer before the loan is repaid to repay the balance immediately or the loan will be treated as a taxable distribution from the plan.<sup>52</sup>

For the plan participant, borrowing from a 401(k) plan is usually preferable to taking a hardship withdrawal. With a loan, the account balance is not permanently reduced because the loan will be repaid into the account, generally within five years. Unlike a hardship distribution, after which employee contributions must be suspended for six months, the participant can continue to contribute to the plan while the loan is outstanding. Also unlike hardship distributions, loans are not subject to income taxes or the early withdrawal penalty if repayments continue on schedule.

According to the Federal Reserve Board's Survey of Consumer Finances, 9.5% of households in which the householder or spouse participated in a DC plan had one or more plan loans outstanding in 2007. The mean balance of all loans from DC plans was \$6,683 and the median loan balance was \$5,000. Ten percent of households with loans from DC plans had outstanding loan balances of \$15,000 or more and 10% of households had loan balances of \$1,000 or less.

## Leakages When Switching Jobs

Leakages from retirement savings can occur when workers change jobs.<sup>53</sup> A participant in a retirement plan usually has several options to choose from when leaving a job. He or she can

---

<sup>51</sup> The exceptions to the 10% additional tax are listed at 26 USC, §72(t).

<sup>52</sup> Loans are not permitted from IRAs, but money in an IRA can, in effect, be "borrowed" for 60 days because the law states that any distribution from an IRA that is not deposited in the same or another IRA within 60 days is a taxable distribution. (26 U.S.C. § 408(d)).

<sup>53</sup> More information is available in CRS Report RL30496, *Pension Issues: Lump-Sum Distributions and Retirement Income Security*, by Patrick Purcell, *Pension Issues: Lump-Sum Distributions and Retirement Income Security*, by Patrick Purcell.

- keep the account in the former employer's plan;
- roll over the account into the new employer's retirement plan;
- roll over the account into an Individual Retirement Account (IRA); or
- receive the account balance directly as a distribution from the plan.<sup>54</sup>

## Policy Issue: Preserving Retirement Savings

Congress has amended the IRC several times to encourage workers who change jobs to leave their accrued retirement benefit in the former employer's plan or to roll over the account into an IRA or another qualified retirement plan. For example:

- Section 72(t) of the IRC imposes a 10% tax in addition to ordinary income taxes on distributions from retirement plans received before age 59½ that are not rolled over into an IRA or another tax-qualified plan within 60 days.<sup>55</sup>
- The Unemployment Compensation Amendments of 1992 (P.L. 102-318) require employers to give departing employees the option to transfer a distribution directly to an IRA or to another employer's plan. If the participant instead chooses to receive the distribution, the employer is required to withhold 20%, which is applied to any taxes due on the distribution.<sup>56</sup>
- IRC §411(a)(11) allows a plan sponsor to distribute to a departing employee his or her accrued benefit under a retirement plan without the participant's consent only if the present value of the benefit is less than \$5,000.<sup>57</sup> The Economic Growth and Tax Relief Reconciliation Act of 2001 (P.L. 107-16) requires that if the present value of the distribution is at least \$1,000, the plan sponsor must deposit the distribution into an IRA unless otherwise instructed by the participant.

In developing policies to prevent leakages from retirement savings, Congress has attempted to promote the preservation of savings until workers retire while recognizing that they may have to take money from their accounts in times of financial hardship. An example of how these goals have been balanced is the treatment of distributions when a worker leaves a job in which he or she participated in a retirement plan. In this situation, Congress has sought to *encourage* recipients to roll over pre-retirement distributions from retirement plans, but it has not *required* such distributions to be rolled over into an IRA or another retirement plan. Current law allows accrued benefits worth less than \$5,000 to be cashed out automatically, but it requires the plan

---

<sup>54</sup> If the individual chooses this option, federal law requires 20% of the account balance to be withheld and forwarded to the IRS toward any income tax and tax penalties owed.

<sup>55</sup> Under IRC §72(t), the 10% penalty is waived if the distribution is made in a series of "substantially equal periodic payments" based on the recipient's life expectancy or if the recipient has retired from the plan sponsor at age 55 or older. Other exceptions to the 10% additional tax apply under special circumstances. See CRS Report R40192, *Early Withdrawals and Required Minimum Distributions in Retirement Accounts: Issues for Congress*, by John J. Topoleski.

<sup>56</sup> If the distribution is not rolled over within 60 days, the 20% withheld is applied to the taxes owed on the distribution. If the distribution is rolled over within 60 days, the 20% withheld is credited toward the income tax that the individual owes for the year. If the participant has received the distribution in cash, then to roll over the full amount of the distribution, the recipient must have access to other funds that are at least equal to 20% withheld by the employer.

<sup>57</sup> Distributions of \$5,000 or more require the participant's written consent. The \$5,000 limit was established by the Taxpayer Relief Act of 1997 (P.L. 105-34). The amount had been set at \$3,500 by Retirement Equity Act of 1984. It was originally established at \$1,750 by ERISA in 1974.

participant to agree in writing to a distribution of more than \$5,000. The law allows workers to take cash distributions from plans when they leave a job, but it requires 20% to be withheld against taxes owed, and it places an additional 10% tax on amounts that are not rolled over into another retirement account within 60 days of the distribution.

Current law on pre-retirement distributions represents a compromise between competing goals. Stricter limits on access to retirement savings prior to retirement could lower participation or contributions. Research has shown that participation in plans that do not permit plan loans or hardship distributions is lower than in plans that allow these kinds of access to funds held by the plan. Allowing easier pre-retirement access to retirement accounts could lead to more leakages from the plans, depleted account balances, and poorer retirements for many. Moreover, to the extent that retirement accounts could be freely tapped before retirement, they would not be retirement accounts at all, but merely tax-deferred general-purpose savings accounts.

In summary, the laws that Congress has passed with respect to taxation of early distributions from retirement plans represent a compromise among several competing objectives, including

- encouraging employees to participate in retirement plans;
- promoting the preservation of retirement assets;
- allowing participants to have access to their retirement savings when they would otherwise face substantial economic hardship; and
- assuring that the tax preferences granted to retirement savings plans are not used for purposes other than to fund workers' financial security during retirement.

## Converting Retirement Savings into Income

A retiree who is deciding how to convert retirement savings into income will have to take into account many risks. Increases in average life expectancy mean that many retirees will have to ensure that their savings will last through a retirement that could span 30 or 40 years. Volatility in equity markets, the effects of inflation on purchasing power, and the possibility of substantial expenses for medical treatment and long-term care will further complicate this decision. Many retirees may find it more challenging to manage their financial assets in retirement than it was during their working years.<sup>58</sup>

There are a number of ways to convert retirement savings into income. One option is to purchase an annuity. A life annuity—also called an immediate annuity—is an insurance contract that provides regular income payments for life in return for an initial lump-sum premium. Life annuities can help protect retirees against some of the financial risks of retirement, especially longevity risk and investment risk. A life annuity pays income to the purchaser for as long as he or she lives, and in the case of a joint-and survivor annuity, for as long as the surviving spouse lives. Some annuities offer limited protection against inflation through annual increases in income; however, the annual increases must be paid for by accepting a lower initial monthly annuity income. Other annuities allow the purchaser to share in investment gains from growth in

---

<sup>58</sup> For more information, see CRS Report R40008, *Converting Retirement Savings into Income: Annuities and Periodic Withdrawals*, by Janemarie Mulvey and Patrick Purcell.

equity markets as a way to offset the effects of inflation. These annuities also require the purchaser to share in the investment losses if markets fall.

Relatively few 401(k) plans provide the opportunity for retiring workers to convert all or part of their 401(k) accounts into life annuities at retirement. Only 21% of plans offered an annuity option in 2007, down from 26% in 2000.<sup>59</sup> One reason few plans offer annuities is that they have proven to be unpopular in plans that offer them. Fewer than 10% of participants in plans that offer an annuity choose this option.<sup>60</sup> At retirement, most DC plan participants either take periodic withdrawals or roll the account balance into an IRA from which they take withdrawals.

Few people purchase life annuities for a number of reasons. Social Security provides benefits in the form of an inflation-adjusted annuity, and some retirees may consider this to be sufficient protection against the risk of spending all of their retirement assets before they die. In addition, about one-third of retirees receive income from defined benefit pensions, and they therefore have less need to purchase an annuity with their retirement savings. Some potential purchasers of annuities are concerned that the fees charged by insurers are too high and that the insurance companies do a poor job of explaining the fees that they charge. Others are concerned that purchasing an annuity will reduce the financial assets that they have available to meet unexpected expenses. Finally, some older persons prefer not to purchase an annuity in the hope that they will be able to leave their assets as an inheritance for their children. For these and other reasons, the number of retirees who purchase income annuities has remained relatively low compared with the number who elect to take periodic withdrawals from their retirement accounts.

### **Policy Issue: The Role of Income Annuities in Retirement**

Defined benefit pension plans are required by law to offer participants a joint and survivor annuity as the default form of benefit.<sup>61</sup> No such requirement applies to defined contribution plans. Congress could require DC plan sponsors to contract with insurance companies to offer participants the option of taking their retirement benefits in the form of an annuity, but most policy proposals have focused on making annuities a more appealing option rather than a mandatory form of benefit. For example, H.R. 2748 of the 111<sup>th</sup> Congress (Pomeroy) would amend the Internal Revenue Code to exclude from gross income up to 50% of annuity income up to an annual maximum of \$5,000 for single tax filers and \$10,000 for couples filing jointly.

Because most 401(k) plans do not offer an annuity option, retirees who wish to purchase annuities have to withdraw money from their accounts and buy annuities in the individual market. Individual annuities are more expensive than group annuities, and they place the responsibility for finding the best deal from a financially sound insurer on individuals who usually have had little or no experience shopping for annuities. Many consumers may not feel competent to do this on their own. They may be more comfortable taking periodic withdrawals from their accounts. Some retirees are reluctant to purchase a life annuity because canceling the annuity contract can be costly. The charge for canceling an annuity—the “surrender charge”—can account for more than 10% of the principal in the first year of the contract.<sup>62</sup>

---

<sup>59</sup> Profit Sharing/401(k) Council of America, 51<sup>st</sup> Annual Survey.

<sup>60</sup> Hewitt Associates, survey of 401(k) plans, various years.

<sup>61</sup> ERISA § 205; 29 USC § 1055.

<sup>62</sup> Typically, surrender charges drop by about one percentage point per year, eventually allowing penalty-free (continued...)

Many economists have found the low demand for life annuities to be puzzling in light of the protection they provide against longevity risk. Recent research has found that the appeal of annuities to potential purchasers depends greatly on whether prospective buyers understand and appreciate the value of the income security that annuities provide. Researchers have found that when annuities are portrayed—or “framed”—as investment vehicles, the lower rates of return on life annuities (which are backed mainly by bonds) can put them at a competitive disadvantage with respect to stocks and stock mutual funds. However, when the insurance aspects of annuities are emphasized—in particular, the insurance against outliving one’s assets—potential buyers have been found to be more receptive to the idea of buying a life annuity.<sup>63</sup>

### Automatic Trial Income

As a way to familiarize people with annuities, researchers at the Retirement Security Project have suggested a strategy they call “automatic trial income.” This would allow retirees to “test drive” an annuity for 24 months.<sup>64</sup> They suggest that if the default form of benefit from a 401(k) plan were a monthly check, even for only a 24-month period with the option to take the remainder as a lump-sum at the end of two years – it would help change the public’s perception of retirement accounts by framing them as an income stream rather than as a lump sum.

Under automatic trial income, at least part of the assets in a worker’s 401(k) account would be automatically paid out as income at retirement unless the individual chooses another option. Retirees would receive monthly payments from the automatic trial income plan for 24 months, at the end of which they could choose to take the remainder as a lump sum or have it converted to an annuity. To assure that only people who are near retirement have their accounts distributed as income when they leave an employer, automatic trial income could apply only to those who are 55 or older when they leave a job. To prevent small account balances from being converted to annuities, the policy could apply only to accounts above a minimum value of perhaps \$50,000.

### Advanced Life Deferred Annuity

Another annuity product, the Advanced Life Deferred Annuity (ALDA) is purchased at retirement but does not begin paying income until the purchaser reaches an advanced age, such as 80 or 85. If the purchaser dies before the age at which income payments are scheduled to begin, he or she forfeits the premium. On the other hand, because income payments are deferred until an advanced age, premiums would be relatively low compared to immediate income annuities. A recent analysis concluded that “this product would provide a substantial proportion of the longevity insurance provided by an immediate annuity, at a small fraction of the cost,” and that “few households would suffer significant losses were it used as a 401(k) plan default.”<sup>65</sup> Although the

---

(...continued)

withdrawals from the annuity.

<sup>63</sup> See “Why Don’t People Insure Late Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle,” by J. R. Brown, J. R. Kling, S. Mullainathan, and M. V. Wrobel, TIAA-CREF Institute, April 2008.

<sup>64</sup> See *Increasing Annuitization in 401(k) Plans with Automatic Trial Income* by William Gale, J. Mark Iwry, David C. John, and Lina Walker at [http://www.retirementsecurityproject.org/pubs/File/RSP\\_TrialIncomev4\(2\).pdf](http://www.retirementsecurityproject.org/pubs/File/RSP_TrialIncomev4(2).pdf).

<sup>65</sup> Guan Gong and Anthony Webb, *Evaluating the Advanced Life Deferred Annuity*, Boston College Center for Retirement Research, Working Paper no. 2007-15, September 2007.

ALDA could provide substantial insurance against living into very old age for a comparatively low premium, "it remains to be seen whether such a product would overcome annuity aversion."<sup>66</sup>

One way to help participants in 401(k) plans to begin thinking of their accounts as a source of retirement income rather than as a savings account would be to report the value of the participant's accrued benefits as a stream of monthly income beginning at age 65 in addition to reporting the account balance. To make these presentations comparable across plans, it might be necessary for the federal government to set standards on the appropriate interest rates and mortality tables for plans to use in restating account balances as streams of future income.

Some financial firms are designing managed withdrawal programs as alternatives to annuities. These are typically investment accounts with periodic distributions that are designed to assure that the account balance will not be exhausted before a specified number of years have passed. Unlike annuities, however, these accounts do not provide longevity insurance. The account owner bears the risk that investment losses or living longer than he or she anticipated will result in the account being exhausted during his or her lifetime.

## Conclusion

About half of all workers in the United States participate in employer-sponsored retirement plans, a proportion that has remained essentially unchanged since the early 1970s. Since the 1980s, the proportion of workers in defined benefit pension plans has fallen while the proportion in defined contribution plans has risen. Sponsorship of retirement plans is substantially lower among small employers than among large employers. Efforts to increase retirement plan sponsorship among small employers have had only limited success. Some policy analysts have suggested that expanding access to payroll deduction IRAs could greatly increase the number of employees at small firms who have a retirement savings account.

Even among employers who offer a retirement plan, not all workers participate. Roughly 20% to 25% of workers employed at firms that sponsor a defined contribution plan do not participate in the plan. Participation rates may rise if more firms adopt automatic enrollment, but currently, almost two-thirds of DC plans continue to require employees to elect to participate in the plan.

On average, individual workers who participate in DC plans contribute about 6% of their pay to the plan, and households with one or more participants contribute about 5% of total household earnings. One way to boost employee savings rates would be for employers to adopt automatic escalation of contributions. Employee contributions can be increased slightly each year until reaching a target contribution rate, such as 10% of pay. As with automatic enrollment, employees must be permitted to opt out of the increase or to choose another contribution rate.

In most DC plans, workers must decide not only whether to participate in the plan and how much to contribute, but also how to invest the contributions. As employers have become more aware of how daunting these choices can be for their employees, some have begun to add life-cycle funds that automatically adjust the allocation of contributions between stocks, bonds, and other investments based on the employee's expected date of retirement. The majority of plan sponsors

---

<sup>66</sup> Ibid.

also offer investment education for participants. Some employers arrange for financial planners or other professionals to offer investment advice to their employees.

Excessive fees can substantially reduce retirement account balances, but plan participants often are unable to discern from their account statements how much they are paying in fees and what services they are receiving in exchange for the fees charged to their accounts. Improving the disclosure of fees charged to participants in 401(k) plans could help to drive down fees because participants and plan sponsors would be better able to compare fees across plans and to evaluate the services provided relative to the fees charged for those services.

Although pre-retirement access to money held in 401(k) plans is limited by law, money sometimes “leaks” from workers’ accounts before they retire. This happens when a worker withdraws funds from a 401(k) plan when changing jobs, or through a hardship distribution from the plan. Current law imposes a 10% tax penalty on most withdrawals from 401(k) plans before age 59½. The tax penalty creates a disincentive for withdrawing money from the account before retirement and also helps assure that 401(k) accounts remain dedicated to preparing for retirement rather than functioning as tax-deferred general-purpose savings accounts.

Workers who are approaching retirement today are less likely than those who retired 20 or more years ago to have a defined benefit pension. Those who have retirement savings in a 401(k) plan or an IRA will have to decide how to convert their retirement savings into retirement income. One of the risks that they will face is the possibility that if they withdraw money too quickly, they might exhaust their savings while they still have many years to live. Income annuities insure retirees against the possibility of outliving their retirement savings, but for a variety of reasons income annuities have not yet proved to be a popular option for providing retirement income. One of the most important public policy challenges of the next several years will be to develop strategies that will help retirees manage their retirement savings wisely so that they can remain financially independent throughout retirement.

## **Author Contact Information**

John J. Topoleski  
Analyst in Income Security  
jtopoleski@crs.loc.gov, 7-2290

## **Acknowledgments**

Patrick Purcell was also a co-author of this report.