April 28, 2010

The Honorable Herb Kohl
Chairman
Special Committee on Aging
United States Senate

Subject: Retirement Income: Challenges for Ensuring Income throughout Retirement

Dear Mr. Chairman:

As the life expectancy of Americans continues to increase, the risk that retirees will outlive their assets is a growing challenge.\(^1\) Today, couples both aged 62 have a 47 percent chance that at least one of them will live to their 90\(^{th}\) birthday.\(^2\) In addition to the risk of outliving ones’ assets, the sharp declines in financial markets and home equity during the last few years and the continued increase in health care costs have intensified workers’ concerns about having enough savings and how to best manage those savings in retirement.\(^3\)

Given your interest in options for ensuring income throughout retirement and the recent request from the Departments of the Treasury and Labor for information

\(^1\)Since 1970, life expectancies at age 65 have risen by about 2 years for women and nearly 4 years for men.

\(^2\)These life expectancies are based on Social Security cohort life tables for people born in 1950. See Felicitie C. Bell and Michael L. Miller, *Life Tables for the United States Social Security Area 1900-2100*, Actuarial Study No. 120, SSA Pub. No. 11-11536 (Washington, D.C., Social Security Administration, Office of the Chief Actuary, August 2005).

regarding lifetime income options, you asked us to examine (1) options retirees have for drawing on financial assets to replace preretirement income and options retirees choose, and (2) how pensions, annuities and other retirement savings vehicles are regulated.

In summary, retirees with savings have several options for lifetime income, but largely rely on investment income or draw down their assets as needed. However, many retirees lack substantial retirement savings. The regulation of private pensions is largely governed by the Employee Retirement Income Security Act of 1974 (ERISA), but a multiplicity of laws and regulations govern the management of other assets.

To identify options for drawing on financial assets and determine what options retirees choose from, we reviewed relevant documentation and interviewed officials from the Departments of Treasury and Labor and the Securities and Exchange Commission. We also interviewed representatives of trade associations, such as those for state insurance commissions, and the mutual fund and insurance industries. In addition, we interviewed representatives of large firms that offer mutual funds and annuities. To determine how annuities and other retirement savings vehicles are regulated, we reviewed documentation and interviewed officials from these same agencies and associations and reviewed applicable laws and regulations.

We conducted this engagement from January 2010 to April 2010 in accordance with all sections of GAO’s Quality Assurance Framework that are relevant to our objectives. The framework requires that we plan and perform the engagement to obtain sufficient and appropriate evidence to meet our stated objectives and to discuss any limitations in our work. We believe that the information and data obtained, and the analysis conducted, provide a reasonable basis for our findings and conclusions.

Background

Social Security benefits are the foundation of retirement income for nearly all households with someone aged 65 or older—providing annually inflation-adjusted income for life—and are the source of half or more of total income for about 64 percent of those households. For retired Social Security beneficiaries with the lowest lifetime earnings (up to $9,132 in 2010), Social Security replaces 90 percent of their average annual indexed lifetime earnings if benefit receipt begins at full

U.S. Department of the Treasury and U.S. Department of Labor, Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans, 70 Fed. Reg. 5253 (Feb. 2, 2010). The Department of Labor and the Department of the Treasury (the “Agencies”) are currently reviewing the rules under the Employee Retirement Income Security Act (ERISA) and the plan qualification rules under the Internal Revenue Code to determine whether, and, if so, how the Agencies could or should enhance, by regulation or otherwise, the retirement security of participants in employer-sponsored retirement plans and in individual retirement accounts (IRA) by facilitating access to, and the use of lifetime income or other arrangements designed to provide a lifetime stream of income after retirement.

For nearly one-third of such households, Social Security benefits are the source of 90 percent or more of income. See Social Security Administration, Income of the Aged Chartbook, 2006 (Washington, D.C., 2006).
retirement age. For those at the highest level of earnings covered by Social Security ($106,800 in 2010), Social Security replaces about 26 percent. At the median income level, Social Security replaces an estimated 47 percent of average annual indexed lifetime earnings.

The age for receiving normal or “full” Social Security retired worker benefits had been age 65. However, under current law, the full retirement age is gradually increasing, beginning with retirees born in 1938, and will reach age 67 for those born in 1960 or later. People may still choose to retire at the early eligibility age of 62 and receive reduced benefits. The reduction for early retirement takes into account the longer period of time over which benefits are paid. Similarly, those who retire later receive a commensurate increase in benefits, which takes into account the shorter period of time over which benefits are paid. On balance, the differences in age at which benefits are taken leave the trust fund in approximately the same financial position.

For the first time since 1983, the Social Security trust funds are currently paying out more in benefits than they are receiving through payroll tax revenue, but trust fund interest income more than covers the difference, according to the Social Security Administration. Additionally, the Social Security trust funds will be able to pay all promised benefits for about another 27 years, according to the 2009 report of the Social Security trust fund’s Board of Trustees. At that time, the Social Security trust funds are forecasted to be able to pay only 76 percent of scheduled benefits. However, Social Security reforms could eliminate or reduce the size of this reduction in scheduled benefits through measures to increase expected revenue or decrease the expected growth of benefits.

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6Social Security benefits for retired workers at full retirement age (age 66) in 2010 provide 90 percent of the first $761 of average monthly indexed earnings, 32 percent of additional earnings up to $4,586, and 15 percent of earnings above $4,586, up to the limit on the annual base of covered earnings each year or $106,800 per year ($8,900 per month) in 2010. See Social Security Administration, Your Retirement Benefit: How It is Figured, (Washington, D.C., January 2010).


8Those born in 1938 were the first to be affected when they turned 62 in 2000 and faced a greater reduction for retiring at that age.

9The Social Security Administration estimates that over the next several years, trust fund income, excluding trust fund interest, will fluctuate above or below trust fund expenses and beginning in 2016, expenses will exceed income.

While Social Security is the largest source of retirement income for households with someone aged 65 or older, other financial assets such as pension income from defined benefit (DB) and defined contribution (DC) plans and private savings (bank account balances and individual retirement account (IRA) funds)\textsuperscript{11} and nonfinancial assets such as home equity are important sources of retirement income.\textsuperscript{12} See fig. 1 for additional information. However, these sources are not large compared with income from work. In 2007, before the recent recession, half of the households with someone aged 55 to 64 had financial assets of $72,400 or less, not much more than the median working income of $54,600 in the same year.\textsuperscript{13}

\textsuperscript{11}IRAs are retirement savings arrangements which allow workers to make tax-deductible and nondeductible contributions to an individual account. For workers who meet certain conditions regarding their income or who are not otherwise eligible to participate in their employer’s pension plan, contributions to a regular (traditional) IRA receive favorable tax treatment; workers may be eligible to take an income tax deduction on some or all of the contributions they make to their IRA. Amounts withdrawn from the IRA are fully or partially taxable in the year withdrawals are made. If the taxpayer made only deductible contributions, withdrawals are fully taxable. Investment income on funds in the account is tax deferred until funds are withdrawn. Workers below certain income limits may also contribute to Roth IRAs, which do not provide an income tax deduction on contributions, but permit tax free withdrawals. Individuals may also transfer funds to a Roth IRA, but must pay taxes on the amounts transferred.

\textsuperscript{12}A DB plan promises to provide a benefit that is generally based on an employee’s salary and years of service. Typically, DB annuity payments are received on a monthly basis by the retired participant and continue as long as the recipient lives. DC plan benefits, primarily those from 401(k) plans, are based on the contributions and investment returns in individual accounts. For each participant, typically the plan sponsor may periodically contribute a specific dollar amount or percentage of pay into each participant’s account.

Figure 1: Sources of Income for Households with Someone Aged 65 and Older, 2008

Notes: Data reported by the Social Security Administration for pension income includes regular payments from IRA, Keogh, or 401(k) plans. Nonregular (nonannuitized or lump sum) withdrawals from IRA, Keogh, and 401(k) plans are not included. Data reported for income from assets includes interest income, income from dividends, rents or royalties, and estates or trusts.

DB plans, DC plans, and IRAs are subject to various provisions of ERISA, and the Internal Revenue Code of 1986 (the Code). ERISA was enacted to protect the interests of employee benefit plan participants and their beneficiaries. ERISA sets certain minimum standards for pension plan participants and their beneficiaries. For example, Title I of ERISA requires sponsors to disclose to participants certain plan information, such as the summary plan description, which describes the rights and obligations of participants and beneficiaries under the plan. Title I also establishes standards for plan fiduciaries, individuals who generally exercise discretion or control over the management of the plan or the disposition of plan assets. Title I of ERISA is enforced by the Department of Labor’s Employee Benefits Security Administration (EBSA).

The Internal Revenue Service (IRS), under Title II of ERISA and the Code, generally ensures that plans meet certain requirements for tax qualification which enable these plans to make tax deductible contributions and earn interest on a tax exempt basis. These features encourage employers to establish and maintain pension plans for their employees.
ERISA, under Title IV, also established the Pension Benefit Guaranty Corporation (PBGC). PBGC provides plan termination insurance for defined benefit plans that terminate with insufficient funds to pay benefits promised under the plan. Specifically, participants in such plans, who meet certain requirements, are entitled to receive payments up to certain prescribed limits to replace benefits lost because of the plan’s insufficiency at plan termination.14

Although total pension participation has remained at about 50 percent of the private sector workforce, there have been important changes in the types of pension plans offered by employers. DB plans have become less prevalent in the last three decades. In 2007, 32 percent of households had a DB plan benefit from current or former employment and 38 percent had a DC plan benefit.15 From 1990 to 2007, the number of active participants in private sector DB plans fell by 26 percent, even as the workforce increased by 22 percent. In recent years, a number of employers have closed their DB plans to new participants or limited or frozen the additional accruals of benefits to current participants.16

Meanwhile, since 1990, participation in self-directed DC plans such as 401(k) plans has grown dramatically in popularity. From 1990 to 2007, the number of active participants in DC plans increased from about 35 million to 67 million, respectively.17 DC plans, such as 401(k) plans, typically allow participants to decide how much to contribute, decide how contributions are to be invested, and decide how the balances will be spent during retirement. Generally, unlike DB plans, investment risk and the potential for greater returns are directly borne by the participant rather than the plan sponsor and benefits are not insured by the PBGC. In recent years, some DC participants have chosen to direct their contributions to so-called target-date funds or have their assets invested in these funds as a plan-specified qualified default investment alternative (QDIA).18

14During 2010, for example, the maximum guarantee is $42,660 for a single-employer pension plan life annuity at age 62 with no survivor benefits, and is lower at younger ages and higher at older ages. The guarantee is annually adjusted for inflation.

15This includes plans to which the family head or their spouse has rights from current or former employment. See Federal Reserve Bulletin, February 2009.

16See GAO, Defined Benefit Pensions: Plan Freezes Affect Millions of Participants and May Pose Retirement Income Challenges, GAO-08-817 (Washington, D.C.: July 21, 2008). About 3.3 million active participants in the study population, who represent about 21 percent of all active participants in the single-employer DB system, were affected by a freeze.


18Target-date funds allocate investments among various asset classes with the goal of reducing investment risk as the retirement date approaches. These funds differ widely in their allocations among asset types before and during retirement. See GAO, Retirement Savings: Automatic Enrollment Shows Promise for Some Workers, but Proposals to Broaden Retirement Savings for Other Workers Could Face Challenges, GAO-10-31 (Washington, D.C.: Oct. 23, 2009).
At retirement, DC participants’ face a number of choices regarding their account balances, such as leaving money in the plan, purchasing some form of an annuity, or transferring or rolling over their balance into an IRA. Employers who sponsor qualified plans and enable departing participants to receive lump sum distributions must give participants the option to have these amounts directly transferred into an IRA or another employer’s tax-qualified plan (if that plan accepts rollovers).

Several Lifetime Income Options Are Available for Retirees with Retirement Savings, but Most Opt to Invest Savings

With the long-term shift toward self-directed 401(k) type plans, an increasing number of retirees face decisions about how to allocate their balances at retirement and have many options. One key decision for many retirees is to choose between continuing to manage self-directed investment balances and using all or a part of the balance to purchase an annuity that would provide income for the remainder of their lives.

Options for Lifetime Retirement Income Streams

Retirees have three primary options to generate a lifetime income stream. First, participants in DB plans can receive their benefits as a lifetime annuity. Second, retirees with DC plan assets can purchase individual life annuities provided by insurance companies that offer retirement income on a lifetime basis. A third option, which would enhance the Social Security lifetime income stream, is to defer retirement under Social Security by a few years (up to age 70) in order to receive higher monthly benefits.

DB Plans. According to the Survey of Consumer Finances, about 32 percent of households in 2007 had a traditional DB plan promising a specific level of income during retirement. According to the IRS, the average taxable pension and annuity

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20An annuity is an insurance agreement or contract that comes in a number of different forms and can (1) help individuals accumulate money for retirement through tax-deferred savings, (2) provide them with monthly income that can be guaranteed to last for as long as they live, or (3) do both.


22Such annuities provide lifetime benefits calculated based on years of service and average annual earnings over a specified number of years, typically at the end of a retiree’s career.

23In this context, the survey includes a DB plan with a portable cash option, which would allow the worker to receive a lump sum in lieu of regular payments during retirement.
income was $19,500 in 2007. Some of these plans, together with Social Security benefits, can provide substantial income. However, although private sector DB plans are required by law to offer a benefit in the form of an annuity, a growing number of these plans are also offering lump sum options at retirement. According to investment company officials we spoke with, many workers retiring with a DB plan choose a lump sum over an annuity. However, nearly one-third of participants in single-employer DB plans are enrolled in hybrid plans, such as cash balance plans. Cash balance plans often express benefits as account balances rather than monthly annuity benefits, and offer lump sum payouts as well as annuity payments.

Annuities. Few households—about 6 percent—owned individual annuities in 2007. However, only 3 percent ($8 billion) of the total amount of annuities sold in 2008 were fixed immediate annuities, designed solely to provide lifetime income. According to the Insured Retirement Institute, the majority of annuities sold are deferred annuities, which are rarely converted to lifetime income. In 2008, less than 1 percent of deferred annuities sold were converted to lifetime income.

Annuities offering lifetime income generally provide retirees more income than they would receive from conservative investments, such as bonds. For example, in April 2010, according to an annuity market quote website, a $100,000 annuity purchase would provide $6,480 per year as long as the purchaser or their spouse is alive. This annual amount is 25 percent greater than the $5,200 of income that would be available from a highly rated $100,000 30-year corporate bond. However, the

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23This trend has likely been assisted by the growing popularity of cash balance pension plans, which are DB plans that express their benefit as an account balance. Although cash balance plans are required to offer an annuity, most cash balance plans also offer a lump-sum benefit. See GAO, Private Pensions, Information on Cash Balance Pension Plans, GAO-06-42 (Washington, D.C.: Nov. 3, 2005).

24This estimate, from the Survey of Consumer Finances, is only for annuities which had investments in stocks. According to the Survey of Consumer Finances, for households with someone aged 55 to 64 in 2007, the median estimated value of annuities and other managed assets, such as trusts and hedge funds, that included investments in stocks was $59,000. An estimated 4.5 percent of all households had such annuities and 1.7 percent had other managed assets.

25Single premium immediate annuities are usually purchased with a lump sum and payments begin immediately or within one year of the purchase date. Sales of single premium immediate annuities totaled $264 billion in 2008, according to data from Morningstar, Inc. and LIMRA, compiled by the Insured Retirement Institute.

26Deferred annuities are retirement savings vehicles that allow purchasers to save money for retirement, defer taxes on investment income, and have an option to start receiving lifetime income at a future date.

27These amounts assume that both husband and wife are age 66 and they select an option providing a continuation of payments until both die without any term certain or death benefit options.

28Based on statistics provided by the Federal Reserve in “Selected Interest Rates” on April 22, 2010, the bond would provide $5,200 annually. This is for a $100,000, 30-year noncallable “AAA” rated corporate bond.
principal amount of the bond would typically be available in 30 years, whether or not the purchaser or spouse is alive.

Lifetime income annuities have several disadvantages. Many retirees lack sufficient financial assets to buy an annuity that would replace more than a small fraction of their preretirement income. According to the Survey of Consumer Finances, about 39 percent of households at or nearing typical retirement ages lacked a retirement account such as a DC plan or IRA, as of 2007. For those who have such plans, the median total value was about $98,000. In addition, most life annuities are designed to provide a constant level of income, but the premium is generally not available to cover large unplanned expenses. Thus, insurers and financial planners often urge that retirees only use a portion of their assets to purchase annuities. According to insurance industry representatives, few annuities provide monthly lifetime income with payments adjusted for inflation. The effects of inflation can be significant. For example, over the last 30 years inflation has eroded the value of a dollar by 63 percent.\(^{29}\) This is an important consideration, particularly as older retirees may face increasing challenges re-entering the labor force. Lastly, annuities generally leave nothing for heirs; payments end at the death of the annuitant (and his or her spouse, in the case of joint and survivor annuities).

Some disadvantages of annuities can be addressed by options available from insurers, but monthly income is then often reduced or the total cost to purchasers is increased. For example, some insurers provide opportunities to cancel an annuity for a limited period of time in exchange for lower monthly payments. Annuities are available with limited death benefits, but annuities with this feature also have lower monthly payments.\(^{30}\) To provide some protection against inflation, some insurers provide an option to automatically increase monthly payments each year at a pre-set rate, such as 2 or 3 percent. Some insurers provide an option to receive payments indexed for inflation, but the initial amount of annual income available with these options is much less than an annuity without inflation adjustments. For example, as of April 2010, an inflation-indexed joint annuity provided by The Vanguard Group with a $100,000 premium could provide $4,646 of income in the first year—30 percent less than an annuity without inflation adjustments. However, the annual income from an inflation-indexed joint annuity is more than twice as much as would be available from a $100,000 U.S. Treasury Inflation Protected Security (TIPS) (providing about $2,000 per year, in addition to inflation adjustments). Some insurers offer variable annuities that provide lifetime income based on guaranteed minimum growth in the initial premium even if the variable annuity balance drops to zero. However, such options

\(^{29}\)This reflects the change in the Consumer Price Index for all urban consumers (CPI-U) through March 2010, and is equivalent to a 3.4 percent annual rate of inflation.

\(^{30}\)For example, an annuity premium of $100,000 could provide $540 per month as long as an annuitant (currently aged 66) or spouse (currently aged 66) is living. Selecting an option to provide this monthly amount to a named beneficiary starting after the annuitant and spouse both die and continuing until 20 years after the annuity payments began would reduce the monthly amount by $15. If either the annuitant or spouse dies after the 20\(^{th}\) year, the beneficiary would not receive any payment.
can also increase expenses. For example, one variable annuity prospectus we reviewed indicated that maximum expenses for a $10,000 investment and a 5 percent annual rate of return could exceed $7,000 over a 10-year period.  

A retiree’s frame of reference may explain why many retirees do not prefer lifetime income streams over lump sums. Analyses of Health and Retirement Study data suggest that choosing a lifetime income stream is highly associated with having a traditional DB plan—a pension plan that workers understand is a source of lifetime income. Other factors, even those that could logically influence the selection of an annuity, such as perception of one’s health or income and plans to leave a bequest to heirs, were not statistically associated or were less highly associated with the selection of annuity income. One study we reviewed analyzed people’s evaluations of annuities by asking them hypothetical questions about whether they would exchange a portion of their Social Security benefit for a lump-sum payment. Asked about an annuity choice in this context, 41 percent of survey respondents preferred an annuity over a lump sum if the amount of the lump sum was actuarially equivalent. About 30 percent of respondents indicated that they would select the annuity even if the lump sum were increased by 25 percent, raising the value of the lump sum above the value of the annuity.

Postponing the Receipt of Social Security Benefits. About half of people begin drawing Social Security retirement benefits the first year they are eligible (age 62), but waiting to draw benefits until a later age would increase annual benefits and increase earnings from work. Social Security provides an average of about $11,786 annually if begun at age 62, $15,715 if begun at full-retirement age, and $19,487 at age 69. A big advantage to postponing Social Security benefits is that unlike most

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31By comparison, total expenses over 10 years would be about $1,573 for a $10,000 investment in a mutual fund with expenses of 1.22 percent per year and an annual (pre-expense) return of 5 percent.


35Under Social Security, retiree benefits are reduced for retirees who start drawing benefits before their full retirement age and increased for those who delay the start of benefits up to age 70. Another option for retirees who have assets and have begun receiving Social Security benefits is to repay benefits received and have Social Security recalculate their benefit as of a later start date.

36These estimates are based on average awards to retired workers age 62 in 2008. For example, a retiree who lives until nearly age 82 (the average male life expectancy at age 62) would receive $233,724 if starting benefits at age 62 and $248,772 at age 66. Delaying receipt of Social Security

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annuities provided by insurers, Social Security benefits are annually adjusted for inflation. To delay receipt of benefits, retirees can either continue to work after age 62 or draw on their own financial assets to replace the income Social Security would have provided. The cost of buying an equivalent inflation-adjusted annuity from an insurer would be about 68 percent more than the total amount of the benefits foregone from age 62 until age 66. Nonetheless, among workers born in 1940, for example, an estimated 42 percent started drawing Social Security retired worker benefits within 2 months of reaching age 62.

Delaying Social Security benefits is not an option for many who cannot work and lack sufficient assets to live in retirement without the benefits. Workers who have shorter life expectancies, such as some minorities and less educated workers, are less likely to be better off by delaying the start of benefits, as they may not live long enough for the total amount of the higher delayed benefits to exceed the total amount of the lower benefits they would receive if benefits begin at age 62. The decision of when to begin receiving Social Security benefits is further complicated for married couples. When the first spouse dies, the remaining spouse who is at full retirement age or older receives a benefit which is the greater of the remaining spouse’s earned benefit or a survivor benefit based on the deceased spouse’s record. If the higher earning spouse begins receiving Social Security benefits early, the surviving spouse may receive a lower survivor benefit.

Many Retirees Largely Rely on Investments

Retirees largely rely on investment income or draw down their assets as needed, rather than supplement their Social Security or DB income with another form of lifetime income. Although this typically involves more risk, it allows retirees to retain access to their savings and the opportunity to realize additional increases in wealth. Others have ample assets and are able to draw exclusively from investment income to cover retirement expenses.

According to the Survey of Consumer Finances, in 2007 most households (59 percent) with a head of household aged 55 to 64 held at least one retirement account, such as an IRA or DC plan, from a current or former employer of either the worker or spouse. For households with such accounts, the median combined value was $98,000. A survey by the Investment Company Institute indicates that upon retirement, 45 percent took a lump sum and transferred some or all of their DC funds to other

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benefits as a strategy to increase monthly benefit amounts may not be advisable if the retiree does not expect to live long or if he or she will not need the higher benefits and their risk-adjusted rate of return is high enough to warrant early receipt of reduced benefits. In some cases, higher Social Security benefits may cause retirees to have higher effective income tax rates.

37For these reasons, some insurance providers and financial advisors recommend that retirees use a portion, not all, of their savings to purchase lifetime income. Insurers now offer variable annuity purchasers the option to invest their savings with death benefits, or a guaranteed minimum level of lifetime income or withdrawals.
accounts, such as an IRA, 18 percent took an annuity, and just 6 percent took installments. According to the survey, among IRA holders, 37 percent indicated they were not at all likely to make a withdrawal until age 70 ½, while another 27 percent indicated they were not very likely to make such a withdrawal. Among those withdrawing IRA funds, 64 percent took an amount based on the IRS annual required minimum distribution. Furthermore, an estimated 44 percent withdrew funds for living expenses, 19 percent for health care expenses, and 15 percent for home expenses. Households with younger workers generally have lower balances in DC plans and IRAs, but they also have the opportunity to begin tax-qualified savings from an earlier age, have more years to save, and have more years to receive a return on their investments.

Other investments—bank account balances, stocks, bonds, and mutual funds held outside of retirement plans—are important sources of income for some retirees. An estimated 21 percent of households headed by someone aged 55 to 64 held stocks directly, with a median value of $24,000, while 14 percent held pooled investment funds, such as mutual funds, with a median value of $112,000. Only 2 percent held bonds directly, which had a median value of $91,000. About 21 percent of these households had one or more certificates of deposit, with a median total value of $23,000. Other assets include life insurance and savings bonds. An estimated 35 percent of these households had cash value life insurance, with a median value of $10,000.

Retirees typically invest in a mix of equities or funds invested in equities and other assets, such as bonds, in order to provide investment income and appreciation to fund retirement over a long period. Studies of market rates of return indicate that an investor could withdraw 4 percent of the amount of a well-managed diversified portfolio, adjusting the initial withdrawal amount for inflation. For example, one such study found that an investor would have an 11 percent chance of running out of money at some point over 30 years. However, the chances of running out of money are higher if the investor incurs substantial investment losses early in retirement.

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38Investment Company Institute, Defined Contribution Plan Distribution Choices at Retirement: A Survey of Employees Retiring Between 2002 and 2007, Investment Company Institute Research Series (Washington, D.C., Fall 2008). Nine percent of respondents indicated they had multiple dispositions which may have included some of the other categories but were not included in the totals reported.

39This excludes households that had withdrawn funds in tax year 2008. The IRS generally requires account holders to begin taking minimum withdrawals from IRAs and qualified DC plans beginning in the year they reach age 70 ½. The Worker, Retiree, and Employer Recovery Act of 2008 waived this requirement for 2009.

40This analysis by T. Rowe Price assumes inflation will be 3 percent each year and that the retiree maintains 40 percent of the portfolio in stocks and 60 percent in bonds throughout retirement. The estimated chance of running out of money over 35 years is 23 percent.
To help investors manage funds in retirement, financial firms offer retirees a variety of retirement income funds or target-date funds. The Vanguard Group, for example, provides pay-out funds targeted to pay 3 percent, 5 percent, or 7 percent of the market value of investments, depending on whether investors seek to achieve long-term growth in their portfolios, to maintain the inflation-adjusted value of the original investment, or to maintain the nominal value of the investment. However, these funds remain subject to investment risks. These Vanguard Group funds, for example, reduced monthly payouts by about 16 to 18 percent for 2009 following the decline of financial markets in 2008.

Some retirees choose to hold bonds to provide income during retirement. Bonds can provide a steady source of income, but are subject to the risk of default. Also, if a bond is not held to maturity, the sale price may differ from the purchase amount depending on market rates of interest at the time of sale. For example, if the market rate of interest is higher than it was at the time of purchase, the sale price of the bond will be lower than the purchase amount. The amount of interest income available from a bond portfolio may decline if newly purchased bonds offer lower rates of interest than bonds that mature. Highly-rated corporate bonds currently offer yields that exceed 5 percent, but the payments are not adjusted for inflation and inflation erodes the value of the principal invested. Inflation-adjusted bonds, such as TIPS available from the U.S. Treasury, offer lower interest rates—currently about 2 percent. To boost the level of distributions, PIMCO offers mutual funds that distribute interest and principal from investments in TIPS on a schedule over 20 or 30 years. These PIMCO funds provide dependable sources of income with inflation adjustments, but the balance drops to zero when the bonds mature.

**While ERISA Largely Governs the Operation of Pension Plans, a Multiplicity of Laws and Regulations Govern the Management of Other Assets**

ERISA continues to provide the basic framework for the regulation of private pensions, even as pensions continue to shift from DB to DC plans. ERISA and its regulations specify, among other requirements, the duties of a plan fiduciary; the type of plan transactions that are prohibited; and the required disclosure of plan features to plan participants. However, once an individual withdraws his or her funds from either a DB or DC plan for retirement, a multiplicity of laws and regulations typically take precedence, depending on the investment decisions that the individual makes with those funds.41

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41 Public plans are generally governed by the applicable state laws or for federal employees by other federal statutes. State and local employee DB retirement plans are generally protected by state and local laws and overseen by boards of trustees. Meanwhile, the DB retirement plans for federal employees are also protected by federal laws and regulations, but administered by the Office of Personnel Management. U.S.C. § 831 and §§ 841-846. Also see GAO, *State and Local Government Retiree Benefits: Current Status of Benefit Structures, Protections, and Fiscal Outlook for Funding Future Costs*, GAO-07-1156 (Washington, D.C.: Sept. 24, 2007). Nontax-qualified pension plans are governed by other laws, including the American Jobs Creation Act of 2004.
ERISA Largely Governs the Operation of Pension Plans

Under ERISA there is a comprehensive regulatory scheme which provides certain protections for privately sponsored employee pension benefit plans and their participants and beneficiaries. Several federal agencies are charged with enforcing these protections. EBSA, within the Department of Labor, enforces ERISA Title I requirements, which include minimum plan standards for participation; vesting and accrual of benefits; and fiduciary responsibility requirements respecting the exercise of any discretion, control, or management of the plan or its assets. Under Title II of ERISA, which addresses the tax qualified status of pension plans, the IRS ensures that these plans maintain their qualified status under the Code. The PBGC, under Title IV of ERISA, provides plan termination insurance for defined benefit pension plans which terminate with insufficient assets to pay promised benefits under the plan.

Individuals who have left the regulated environment of ERISA-covered plans and now seek to secure their retirement savings in the commercial and retail market face a myriad of decisions and investment or insurance products in which to invest their retirement savings. While ERISA regulations address the potential for conflicted advice, the environment in the retail market is quite different.\(^{42}\)

Once an individual withdraws his or her funds from either a DB or DC plan, a multiplicity of laws and regulations typically takes precedence, depending on the investment decisions that the individual makes with those funds. In this instance, the individual is no longer a plan participant governed by ERISA, but is now essentially a retail investor governed by the laws and regulations that are pertinent to the particular product or asset in which they choose to invest whether or not the funds are in an IRA.\(^{43}\) The different laws, regulations, and agencies that may come into play vary depending on the type of assets held.

\(^{42}\)On March 2, 2010, the Department of Labor proposed a new rule relating to the provision of investment advice to participants and beneficiaries in individual account plans. The new rule would implement provisions of a statutory-prohibited transaction exemption, and would replace guidance contained in a final rule, published in the Federal Register on January 21, 2009, that was withdrawn by the Department by a Notice published in the Federal Register on November 20, 2009. See “Investment Advice Participants and Beneficiaries,” Proposed Rule 75 Fed. Reg. 9360 (2010). Prohibited transaction rules for investment advice apply to both employer plans and IRAs. However, ERISA fiduciary standards do not apply to IRAs.

\(^{43}\)Some IRAs, including those in Savings Incentive Match Plan for Employees of Small Employers (SIMPLE), are DC plans subject to various ERISA rules for plan sponsors. IRS and Labor share oversight responsibilities for all types of IRAs, but gaps exist within Labor’s area of responsibility. IRS has responsibility for tax rules governing how to establish and maintain IRAs, while Labor has sole responsibility for oversight of fiduciary standards for employer-sponsored IRAs, and has issued guidance to employers related to payroll-deduction IRAs regarding when such an arrangement would be a pension plan subject to Labor’s jurisdiction. 29 C.F.R. § 2510.3-2(d) and 29 C.F.R. § 2509.99-1. Labor does not have jurisdiction to oversee payroll-deduction IRA programs that are operated within the conditions of their guidance. See GAO, Individual Retirement Accounts: Government Actions Could Encourage More Employers to Offer IRAs to Employees, GAO-08-590 (Washington, D.C.: June 4, 2008).
• **Securities**—stocks and bonds. To enable investors to make informed investment decisions, the Securities and Exchange Commission (SEC) requires firms that sell securities to the public to disclose detailed information about the securities and the firm, such as information about the firm’s management, the intended uses for the funds raised through the sale of the securities, risks to investors, and financial information about the firm.

• **Mutual funds.** Mutual funds—a form of open-end investment company that raises and pools capital from shareholders and invests it in a portfolio of securities—are generally required to register with the SEC. The SEC has promulgated regulations that aim to protect public investors and prevent fraud. For example, SEC regulations impose certain disclosure, recordkeeping and governance requirements on mutual funds, such as requiring funds to inform investors of fees and the potential risks associated with investing in the fund. Mutual funds are typically managed by investment advisers, who are also subject to regulation by the SEC.

• **Annuities.** Annuities are regulated either (1) exclusively under state law or (2) under both state laws and federal law, depending on the features of the particular annuity and whether it is marketed as an investment. Section 3(a)(8) of the Securities Act of 1933 exempts any annuity contract or optional annuity contract issued by a corporation that is subject to the supervision of the state insurance commissioner, bank commissioner, or similar state regulatory authority from the provisions of the Securities Act. The exemption, however, is not available to all contracts that are considered annuities under state law. For example, while traditional fixed annuities44 are exempt, variable annuities45 are generally not exempt, as shown in Table 1. Indexed annuities, which offer a return computed by reference to an outside index such as the S&P-500 Composite Stock Price Index, are hybrid financial products in which the insurer and the purchaser share the investment risk to varying degrees. Accordingly, indexed annuities may or may not qualify under the Section 3(a)(8) exemption and, therefore, may be regulated by state law and the federal securities laws, depending on the degree to which the

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44A traditional fixed annuity is a contract issued by a life insurance company, under which the purchaser makes a series of premium payments to the insurer in exchange for a series of fixed periodic payments from the insurer to the purchaser at agreed upon later dates.

45A variable annuity is a financial product under which purchasers pay premiums that are invested in securities, typically mutual funds and the benefit payments vary with the value of the investments. The purchaser of this product generally assumes all the investment risk because the insurer’s obligation to the purchaser is only to pay him a proportionate share of the present value of the investment portfolio. The Supreme Court has held that a variable annuity does not fall within Section 3(a)(8) because it places all of the investment risks on the purchaser, and none on the company. SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959), quoted in, American Equity Investment Life Ins. Co. v. SEC, 572 F.3d 923, 926 (D.C. Cir. 2009).
insurer is assuming the investment risk vis-à-vis the purchaser and the manner in which the annuity is marketed. Annuities are generally supervised by state insurance departments, which regulate sales and marketing practices and policy terms and conditions to ensure that consumers are treated fairly when they purchase insurance products and file claims in addition to reserve requirements of the insurance companies offering annuities. Because variable annuities are subject to federal securities laws, they are regulated by the SEC including regulation of disclosure and sales practices, while the insurance aspects of the product are regulated by the applicable state agency. Indexed annuities are also regulated by the SEC, in addition to states. To help guide states in their oversight, the National Association of Insurance Commissioners (NAIC) has proposed language for “model laws and regulations” for legislators to consider or modify for their respective states. Finally, the states, through state guarantee associations, have a role in protecting annuity owners against insurer insolvency. However, coverage for annuities varies from state to state and is not available for variable annuities.

<table>
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<th>Tables 1: Regulators that Oversee Annuities</th>
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<td>Types of Annuities</td>
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Source: GAO analysis of federal and state laws.

Beyond Employer-Sponsored Plans, Regulation of Investment Advice Is Two-Tiered

While plan sponsors and pension plan trustees of employer-sponsored retirement plans are held to a federal standard of care with respect to investment advice, so too are investment advisers and brokers who offer investment advice outside of such

46In January 2009, the SEC issued new rule 151A, which is intended to clarify the status under the federal securities laws of indexed annuities and to provide the protections of the federal securities laws to investors in indexed annuities that impose significant investment risks. Following adoption of rule 151A, petitions were filed in the U.S. Court of Appeals for the District of Columbia Circuit for review of the rule. On July 21, 2009, the Court held that the Commission’s interpretation of “annuity contract” was reasonable and denied the petitions with respect to that issue. However, the Court granted the petitions with respect to the petitioners’ alternate ground that the Commission failed to properly consider the effect of the rule on efficiency, competition, and capital formation and accordingly remanded the rule for reconsideration. The remedy remains under consideration by the Court.
plans and directly to retirees. While investment advisers are subject to a federal fiduciary duty, brokers are subject to a “suitability” standard, which is generally considered to be a lower standard of responsibility than the fiduciary standard. Investment advisers are required to manage their client’s portfolio such that investments are not just suitable, but are in the best interest of the client.  Any broker who provides investment advice solely incidental to his or her services as a broker-dealer and does not receive any special compensation for such advisory service is excluded from the definition of “investment adviser” under the Investment Advisers Act of 1940, and hence, not subject to the attendant federal fiduciary duty. Nevertheless, when making investment recommendations to clients, such brokers are required to (1) have a reasonable basis for their recommendations and (2) make only recommendations that are suitable for the client’s specific investment objectives, financial situation, and needs. Broadly stated, the suitability doctrine refers to the obligation to recommend to a client only those specific investments that are suitable to the investment objectives and peculiar needs of that particular client.

Concluding Observations

Given the long-term trends of rising life expectancy and the shift from DB to DC plans, aging workers must increasingly focus not just on accumulating assets to ensure an adequate retirement income at the point of retirement but also on how to manage those assets to have an adequate income throughout their retirement. Workers are increasingly finding themselves depending on retirement savings vehicles that they must self-manage, where they not only must save consistently and invest prudently over their working years, but must now continue to make comparable decisions throughout their retirement years. These decisions may prove difficult for many, as workers are faced with a large variety of available investment options, governed by a multiplicity of laws, regulations, and agencies. These decisions may prove challenging even for the minority of workers with significant retirement savings. However, for the majority of workers who approach retirement

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47 Pension plan consultants who do not exercise discretion or control over pension plan assets and who are registered investment advisers are subject to the fiduciary duty imposed under the Investment Advisers Act of 1940.

48 The anti-fraud provision of the Investment Advisers Act of 1940 has been construed by the U.S. Supreme Court as imposing on investment advisers a fiduciary obligation to act in the best interests of their clients. See SEC v. Capital Gains Bureau, 375 U.S. 180 (1963). A number of obligations flow from this fiduciary duty, including the duty to fully disclose any conflicts the adviser has with his clients.

49 The term “broker” or “stockbroker,” as defined by the Securities Exchange Act of 1934 refers to “any person engaged in the business of effecting transactions in securities for the account of others, but does not include a bank.”

50 A broker who is not subject to the Advisers Act may nonetheless be subject to a fiduciary duty under state law.

51 The suitability standard is based on the principle that a broker who makes a recommendation is viewed as making an implied representation that he or she has adequate information on the security in question for forming the basis of his opinion.
with small account balances—workers with balances of $100,000 or less—the stakes are far greater. Although, retirement savings may be larger in the future as more workers have opportunities to save over longer periods through strategies such as automatic enrollment, many will likely continue to face little margin for error. Poor or imprudent investment decisions may mean the difference between a secure retirement and poverty, which highlights the need for improving financial literacy. How we address this issue for the already large segment of the population depending on limited retirement savings to ensure income adequacy throughout retirement continues to be one of the key policy challenges facing the Congress and the nation.

We provided officials from the Department of the Treasury, IRS, Department of Labor, and the SEC with a draft of this report. Officials from the Department of Labor and SEC provided us with informal technical comments that we have incorporated in the report, where appropriate.

As agreed with your office, unless you publicly announce its contents earlier, we plan no further distribution until 30 days after the date of this letter. At that time, we will send copies of this report to the Secretary of the Treasury, Commissioner of Internal Revenue, Secretary of Labor, Chairman of the SEC, and other interested parties. In addition, this report will be available at no charge on GAO’s Web site at http://www.gao.gov.

If you or your staff have any questions concerning this report, please contact me at (202) 512-7215 or jeszeckc@gao.gov. Contact points for our offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff who made key contributions to this report were Michael J. Collins, Assistant Director; Benjamin P. Pfeiffer; Bryan G. Rogowski; Patrick S. Dynes; Joseph A. Applebaum; Susan C. Bernstein; and Roger J. Thomas.

Sincerely yours,

Charles Jeszeck
Acting Director, Education, Workforce, and Income Security Issues
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