

GAO

Testimony

Before the Special Committee on Aging,  
U.S. Senate

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For Release on Delivery  
Expected at 2:00 p.m. EDT  
Wednesday, October 28, 2009

## 401(K) PLANS

# Several Factors Can Diminish Retirement Savings, but Automatic Enrollment Shows Promise for Increasing Participation and Savings

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GAO

Accountability \* Integrity \* Reliability

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Highlights of [GAO-10-153T](#), a testimony to the Special Committee on Aging, U.S. Senate

### Why GAO Did This Study

Over the past 25 years, the number of defined benefit (DB) plans has declined while the number of defined contribution (DC) plans has increased. Today, DC plans are the dominant type of employer-sponsored retirement plans, with more than 49 million U.S. workers participating in them. 401(k) plans currently cover over 85 percent of active DC plan participants and are the fastest growing type of employer-sponsored pension plan. Given these shifts in pension coverage, workers are increasingly relying on 401(k) plans for their pension income.

Recently, policy makers have focused attention on the ability of 401(k) plans to provide participants with adequate retirement income and the challenges that arise as 401(k) plans become the predominant retirement savings plan for employees. As a result, GAO was asked to report on (1) challenges to building and maintaining of savings in 401(k) plans, and (2) recent measures to improve 401(k) participation and savings levels.

### What GAO Recommends

GAO is not making new recommendations as part of this testimony. In a recent report on leakage—actions that reduce savings prior to retirement—we called for measures to improve the information participants receive about the disadvantages of early withdrawals, and for a change in law to permit continued contributions immediately after hardship withdrawals.

[View GAO-10-153T](#) or [key components](#). For more information, contact Barbara D. Bovbjerg at (202) 512-7215 or [bovbjergb@gao.gov](mailto:bovbjergb@gao.gov).

## 401(K) PLANS

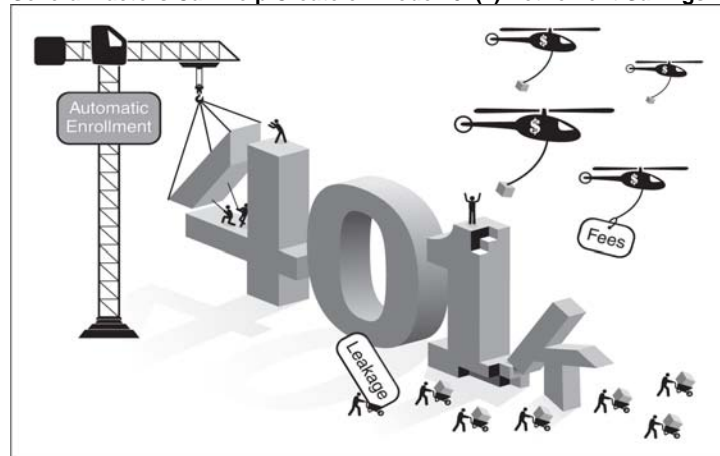
### Several Factors Can Diminish Retirement Savings, but Automatic Enrollment Shows Promise for Increasing Participation and Savings

#### What GAO Found

There are challenges to building and saving through 401(k) plans. While low participation rates may be due, in part, to the fact that some workers participate in DB plans, there is also a large portion of workers who do not have access to an employer-sponsored retirement plan, as well as some who do not enroll in such a plan when an employer offers it. We found that for those who did participate, their overall balances were low, particularly for low-income and older workers who either did not have the means to save or have not had the opportunity to save in 401(k)s for much of their working lifetimes. There are also challenges workers face in maintaining savings in 401(k) plans. For example, 401(k) leakage—actions participants take that reduce the savings they have accumulated, such as borrowing from the account, taking hardship withdrawals, or cashing out the account when they change jobs—continues to affect retirement savings and increases the risk that 401(k) plans may yield insufficient retirement income for individual participants. Further, various fees, such as investment and other hidden fees, can erode retirement savings and individuals may not be aware of their impact.

Automatic enrollment of employees in 401(k) plans is one measure to increase participation rates and saving. Under automatic enrollment, which was encouraged by the Pension Protection Act of 2006 and recent regulatory changes, employers enroll workers into plans automatically unless they explicitly choose to opt out. Plan sponsors are increasingly adopting automatic enrollment policies, which can considerably increase participation rates, with some plans' rates reaching as high as 95 percent. Employers can also set default contribution rates and investment funds. Though target-date funds are a common type of default investment fund, there are concerns about their risks, particularly for participants nearing retirement.

Several Factors Can Help Create or Erode 401(k) Retirement Savings



Source: GAO analysis.

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Mr. Chairman and Members of the Committee:

I am pleased to be here today to discuss participation and savings in 401(k) plans. While the percentage of U.S. workers participating in a pension plan has remained around 50 percent of the private-sector workforce, since the early 1980s pension coverage has seen a noticeable shift away from “traditional” defined benefit (DB) plans, in which workers typically accrue benefits based on years of service and earnings, toward defined contribution (DC) plans in which participants accumulate balances in personal accounts. Currently, there are more than 49 million U.S. workers participating in employer-sponsored DC plans. Further, 401(k) plans are the fastest growing type of employer-sponsored pension plan and currently cover over 85 percent of active DC plan participants. Given the decline of DB plans and the growth of 401(k) plans, many workers are increasingly relying on 401(k) plans for their pension income.

DC plans, including 401(k) plans, provide participants tax-deferred savings vehicles, portability, and the transparency of known account balances. However, they shift much of the responsibility of saving for retirement, and most of the risk, to employees. Under such plans, workers must contribute a portion of their pay and manage the investment of their plan assets throughout their lives. As 401(k) plans become an important source of workers’ retirement income, policymakers are focusing on the adequacy of such plans for building and maintaining retirement savings. Overall issues, such as workers arriving at retirement with insufficient savings to support themselves, are a major concern, but other issues are beginning to require attention, such as participation levels in 401(k) plans and “leakage”—which occurs when participants tap into their savings before retirement. In addition, issues surrounding the fees charged to 401(k) plan participants continue to receive attention. Further, Congressional interest in automatic enrollment, including plan features associated with automatic enrollment, such as target-date funds (TDF), has called attention to options for expanding retirement plan coverage.<sup>1</sup>

My statement today is based on our body of work on 401(k) plans and retirement income security.<sup>2</sup> My remarks focus on (1) challenges to

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<sup>1</sup>Throughout this testimony, we consider a worker to be covered by an employer-sponsored plan if the employer offers a retirement plan, the worker is eligible to participate under the plan’s rules and the worker chooses to participate in it.

<sup>2</sup>For a list of the GAO reports and testimonies referenced in this testimony, see appendix I.

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building and maintaining savings in 401(k) plans and (2) recent measures to improve participation and savings levels. We conducted our work in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In summary, there are various issues affecting workers' abilities to build and maintain savings in 401(k) plans. First, we found that participation in DC plans was low. While low participation rates may be due, in part, to the fact that many workers participate in DB plans, there are also some workers who do not have access to an employer-sponsored retirement plan or who do not take the actions required of them to enroll in such a plan. In addition, for those who do participate, savings levels are low. We found that low-income and older workers had particularly low savings balances, which is not surprising given the fact that older workers may not have had the opportunity to save in 401(k) plans for much of their working lifetimes and low-income workers may not have the means to save. However, the low savings levels become increasingly important as DC plans become an important source of retirement income. Second, leakage and fees can erode participants' retirement savings before retirement. Leakage can result in significant losses of potential income from the loss of compound interest as well as the financial penalties associated with early withdrawals. In addition, fees and conflicts of interest—such as undisclosed compensation arrangements between pension service providers—can also diminish retirement savings. Because the risk of investment is largely borne by the individual participant in a 401(k) plan, participants can be vulnerable to any decision, including those involving conflicts of interest, that could result in higher fees or other outcomes that can lower investment returns for participants. Recent changes in federal law, such as provisions explicitly permitting automatic enrollment in 401(k) plans (unless a worker opts out), show promise for increasing 401(k) participation and savings. However, there are concerns about some of the features associated with automatic enrollment, such as the common use of target-date funds as default investments.

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## Background

Both DB and DC plans operate in a voluntary system with tax incentives for employers to offer a plan and for employees to participate. In the past, DC plans, such as 401(k) plans, were supplemental to DB plans. However, over the past several decades, there has been a shift in pension plan

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coverage; the number of DC plans has increased while the number of DB plans has declined. Today, DC plans are the dominant type of private-sector employee pension. Compared to DB plans, DC plans offer workers more control over their retirement asset management and greater portability over their retirement savings, but also shift much of the responsibility and certain risks onto workers. Workers generally must elect to participate in a plan and accumulate savings in their individual accounts by making regular contributions over their careers. Participants typically choose how to invest plan assets from a range of options provided under their plan and accordingly face investment risk. There are several different categories of DC plans, but most are types of cash or deferred arrangements in which employees can direct pre-tax dollars, along with any employer contributions, into an account, with any asset growth tax-deferred until withdrawal.

One option available under some 401(k) plans is automatic enrollment, under which workers are enrolled in a 401(k) plan automatically, unless they explicitly choose to opt out. However, automatic enrollment has not been a traditional feature of 401(k) plans and, prior to 1998, plan sponsors feared that adopting automatic enrollment could lead to plan disqualification.<sup>3</sup> In 1998, the Internal Revenue Service (IRS) addressed this issue by stating that a plan sponsor could automatically enroll newly hired employees and, in 2000, clarified that automatic enrollment is permissible for current employees who have not enrolled.<sup>4</sup> Nonetheless, a number of considerations inhibited widespread adoption of automatic enrollment, including remaining concerns such as liability in the event that the employee's investments under the plan did not perform satisfactorily, and concerns about state laws that prohibit withholding employee pay without written employee consent. More recently, provisions of the Pension Protection Act of 2006 (PPA) and subsequent regulations further facilitated the adoption of automatic enrollment by providing incentives

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<sup>3</sup>A plan must be considered "qualified" to obtain favorable tax treatment under federal law. One requirement for a qualified 401(k) plan is that participants must elect to have the employer provide an amount of salary to the employee in cash or to defer the amount of salary and deposit the amount in the employee's plan account.

<sup>4</sup>Rev. Rul. 98-30, 1998-1 C.B. 1273. The IRS held that employer contributions made to a plan on an employee's behalf, in lieu of cash payment, are considered elective contributions, so long as the employee has an opportunity to receive cash instead and has not affirmatively expressed a desire to do so. In a subsequent ruling, the IRS determined that contributions made on behalf of either a newly hired or current employee in lieu of cash compensation were valid elective contributions. Rev. Rul. 00-8, 2000-1 C.B. 617.

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for doing so and by protecting plans from fiduciary and legal liability if certain conditions are met.<sup>5</sup> In September 2009, the Department of the Treasury announced IRS actions designed to further promote automatic enrollment and the use of automatic escalation policies.<sup>6</sup>

The Employee Retirement Income Security Act of 1974 (ERISA),<sup>7</sup> as amended, defines and sets certain standards for employee benefit plans, including 401(k) plans, sponsored by private-sector employers.<sup>8</sup> ERISA establishes the responsibilities of employee benefit plan decision makers and the requirements for disclosing information about plans.<sup>9</sup> ERISA requires that plan fiduciaries, which generally include the plan sponsor, carry out their responsibilities prudently and do so solely in the interest of the plan's participants and beneficiaries.<sup>10</sup> The Department of Labor's (Labor) Employee Benefits Security Administration (EBSA) is the primary agency responsible for enforcing Title I of ERISA and thereby protecting private-sector pension plan participants and beneficiaries from the misuse or theft of pension assets.<sup>11</sup> EBSA conducts civil and criminal investigations of plan fiduciaries and service providers to determine whether the provisions of ERISA or other relevant federal laws have been violated. In addition to Labor's oversight, the Securities and Exchange Commission (SEC) provides oversight for 401(k) investments. For example, the SEC, among other responsibilities, regulates registered securities including company stock and mutual funds under securities law.

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<sup>5</sup>Pub. L. No. 109-280 § 902, 120 Stat. 780, 1033-39 (codified at 26 U.S.C. §§ 401(k)(13), 401(m)(12), 414(w) and 29 U.S.C. § 1144(e), and Automatic Contribution Arrangements, 74 Fed. Reg. 8,200 (Feb. 24, 2009).

<sup>6</sup>Rev. Rul. 2009-30, 2009-39 I.R.B. 391 (demonstrating ways 401(k) plan sponsors can include automatic contribution increases in plans) and Notice 2009-65, 2009-39 I.R.B. 413 (providing sample automatic enrollment plan language 401(k) plan sponsors can adopt with automatic IRS approval).

<sup>7</sup>Pub. L. No. 930-406, 88 Stat. 829.

<sup>8</sup>26 U.S.C. § 401(k).

<sup>9</sup>29 U.S.C. § 1021.

<sup>10</sup>29 U.S.C. § 1104. For example, any person who makes investment decisions with respect to a qualified employee benefit plan's assets is a fiduciary. The duties the person performs for the plan rather than their title or office determines whether this person is a plan fiduciary. 29 U.S.C. § 1002(21)(A).

<sup>11</sup>EBSA shares responsibility for enforcing ERISA with the Internal Revenue Services and the Pension Benefit Guarantee Corporation.

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## Low Participation and Saving Rates Affect the Building of 401(k) Savings While Other Factors Affect Participants Ability to Maintain Retirement Savings

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### Challenges to Building and Maintaining 401(k) Savings

One issue of concern with DC plans is that participation and saving rates have been low. In 2007, we reported that the majority of U.S. workers, in all age groups, did not participate in DC plans with their current employers. In fact, only about half of all workers participate in any type of employer-sponsored retirement plan at any given time. According to data from the Current Population Survey, about 48 percent of the total U.S. workforce was not covered by an employer-sponsored plan in 2007.<sup>12</sup> About 40 percent worked for an employer that did not sponsor a plan, and about 8 percent did not participate in the plan that their employer sponsored. Certain segments of the working population have consistently had much lower rates of employment with employers sponsoring a plan, and lower participation rates than the working population overall, such as lower-income workers, younger workers, workers employed by smaller companies, and part-time workers who typically lack coverage compared to all full-time workers.

According to our analysis of the 2004 Survey of Consumer Finances, only 62 percent of workers were offered a retirement plan by their employer, and 84 percent of those offered a retirement plan participated. Participation rates were even lower for DC plan participants since only 36 percent of working individuals participated in a DC plan with their current employers at the time of our report. Although our analysis focused on DC

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<sup>12</sup>The Current Population Survey is a monthly survey conducted by the U.S. Census Bureau among a nationally representative sample of approximately 100,000 households, primarily in order to estimate the rates of employment and unemployment. During March of each year, the survey includes supplemental questions about retirement plan participation and other financial matters.

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plans as a group, 401(k) plans make up the vast majority of DC plans. At the household level, participation rates were also low; only 42 percent of households had at least one member actively participating in a DC plan. Further, only 8 percent of workers in the lowest income quartile participated in DC plans offered by their current employer.<sup>13</sup>

Participation rates are low partly because not all employers offer a retirement plan, and even when employers offer such plans, workers may not participate. Some small employers are hesitant to sponsor retirement plans because of concerns about cost. In addition, DC participation rates for the U.S. workforce may be low because some employers sponsor a DB plan rather than a DC plan. When companies do sponsor employer plans, some workers may not be eligible to participate in their employers' plan because they have not met the plan's minimum participation requirements. In addition, workers may choose not to enroll, or delay enrolling, in a retirement plan for a number of reasons. For example, they may think—in some cases, incorrectly—they are not eligible. They may also believe they cannot afford to contribute to the plan and, for low-income workers, it may be difficult for them to contribute. Also, some may be focused on more immediate savings objectives, such as saving for a house. Many non-participants may not have made a specific decision, but rather fail to participate because of a tendency to procrastinate and follow the path that does not require an active decision.

We also found that, for workers who participated in DC plans, plan savings were low. The median total DC account balance was \$22,800 for individual workers with a current or former DC plan and \$27,940 for households with a current or former DC plan. We reported that the account balances of lower-income and older workers were of particular concern. For example, workers in the lowest income quartile had a median total account balance of only \$6,400. Older workers, particularly those who were less wealthy, also had limited retirement savings. For example, those aged 50 through 59 and at or below the median level of wealth had median total savings of only \$13,800. The median total savings for all workers aged 50 through 59 was \$43,200.

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<sup>13</sup>See GAO, *Private Pensions: Low Defined Contribution Plan Savings May Pose Challenges to Retirement Security, Especially for Many Low-Income Workers*, [GAO-08-8](#) (Washington, D.C.: Nov. 29, 2007).



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We noted that the low level of retirement savings could be occurring for a couple of reasons. Workers who participated in a plan had modest overall balances in DC plans, suggesting a potentially small contribution toward retirement security for most plan participants and their households. For individuals nearing retirement age, total DC plan balances were also low, because DC plans were less common before the 1980s and older workers likely would not have had access to these plans their whole careers. Given trends in coverage since the 1980s, older workers close to retirement age were more likely than younger ones to have accrued retirement benefits in a DB plan. In addition, older workers who rely on DC plans for retirement income may also not have time to substantially increase their total savings without extending their working careers, perhaps for several years.<sup>14</sup> Further, the value of the income tax deferral on contributions is smaller for lower-income workers than for similarly situated higher-income workers, making participation less appealing for lower-income workers.

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#### 401(k) Leakage Erodes Retirement Savings Levels

In addition to somewhat small savings contributions, 401(k) participants can take actions, such as taking loans, withdrawals, or lump-sum cashouts,<sup>15</sup> that reduce the savings they have accumulated. This “leakage” continues to affect the retirement security of some participants.<sup>16</sup> While participants may find features that allow access to 401(k) savings prior to retirement desirable, leakage can result in significant losses of retirement savings from the loss of compound interest as well as the financial penalties associated with early withdrawals. Current law limits participant access to 401(k) savings in order to preserve the favorable tax treatment for retirement savings and ensure that the savings are, in fact, being used to provide retirement income.<sup>17</sup>

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<sup>14</sup>See GAO-08-8.

<sup>15</sup>We use the term “cashout” to refer to a lump-sum distribution made to an employee at job separation.

<sup>16</sup>In this testimony, we use a standard definition of leakage—that is, participants tapping into their accrued retirement savings—typically through loans, withdrawals, and lump-sum cashouts—prior to retirement. We do not take into account other events that could adversely affect participant balances, such as participants not taking advantage of the full employer matching contribution or participants contributing less than the annual federal limit.

<sup>17</sup>26 U.S.C. § 401(k)(2)(b).

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The incidence and amount of the principal forms of leakage from 401(k) plans have remained relatively steady through the end of 2008. For example, we found that approximately 15 percent of 401(k) participants between the ages of 15 and 60 initiated at least one form of leakage in 1998, 2003, and 2006, with loans being the most popular type of leakage in all 3 years. We also found that cashouts made when a worker changed jobs, at any age, resulted in the largest amounts of leakage and the greatest proportional loss in retirement savings.<sup>18</sup> Further, we reported that while most firms informed participants about the short-term costs of leakage, few informed them about the long-term costs.

As we reported in August of 2009, experts identified three legal requirements that had likely reduced the overall incidence and amounts of leakage, and another provision that may have exacerbated the long-term effects of leakage. Specifically, experts noted that the requirements imposing a 10 percent tax penalty on most withdrawals taken before age 59½, requiring participants to exhaust their plan's loan provisions before taking a hardship withdrawal and requiring plan sponsors to preserve the tax-deferred status of accounts with balances of more than \$1,000 at job separation all helped reduce 401(k) leakage.<sup>19</sup> However, experts also noted that the requirement for a 6-month suspension of all contributions to an account following a hardship withdrawal exacerbated the effects of leakage.<sup>20</sup> Treasury officials told us that this provision is intended to serve as a test to ensure that the hardship is real and that the participants have no other assets available to address the hardship. However, a few outside experts believed that this provision deters hardship withdrawals and noted that it seems to contradict the goal of creating retirement income. One expert noted that the provision unnecessarily prevented participants who were able to continue making contributions from doing so. For example, an employed participant taking a withdrawal for a discrete, one-time purpose, such as paying for medical expenses, may otherwise be able to continue making contributions. In our August 2009 report, we recommended that Congress consider changing the requirement for the 6-month contribution suspension following a hardship withdrawal. We also

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<sup>18</sup>See GAO, *401(k) Plans: Policy Changes Could Reduce the Long-term Effects of Leakage on Workers Retirement Savings*, [GAO-09-715](#) (Washington, D.C.: Aug. 28, 2009).

<sup>19</sup>26 U.S.C. § 72(t), 26 C.F.R. § 1.401(k)-1(d)(3)(iv)(E)(1), and 26 U.S.C. § 401(a)(31).

<sup>20</sup>26 C.F.R. § 1.401(k)-1(d)(3)(iv)(E)(2).

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called for measures to provide participants with more information on the disadvantages of hardship withdrawals.<sup>21</sup>

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## Fees and Conflicts of Interests Can also Hinder Participants' Ability to Maintain Retirement Savings

Although participants may choose to take money out of their 401(k) plans, fees and other factors outside of participants' control can also diminish their ability to build their retirement savings. Participants often pay fees, such as investment fees and record-keeping fees, and these fees may significantly reduce retirement savings, even with steady contributions and without leakage.<sup>22</sup> Investment fees, which are charged by companies managing mutual funds and other investment products for all services related to operating the fund, comprise the majority of fees in 401(k) plans and are typically borne by participants. Plan record-keeping fees generally account for the next largest portion of plan fees. These fees cover the cost of various administrative activities carried out to maintain participant accounts. Although plan sponsors often pay for record-keeping fees, participants bear them in a growing number of plans. We previously reported that participants can be unaware that they pay any fees at all for their 401(k) investments.<sup>23</sup> For example, investment and record-keeping fees are often charged indirectly by taking them out of investment returns prior to reporting those returns to participants. Consequently, more than 80 percent of 401(k) participants reported in a nationwide survey not knowing how much they pay in fees.<sup>24</sup>

The reduction to retirement savings resulting from fees is very sensitive to the size of the fees paid; even a seemingly small fee can have a large

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<sup>21</sup>See [GAO-09-715](#).

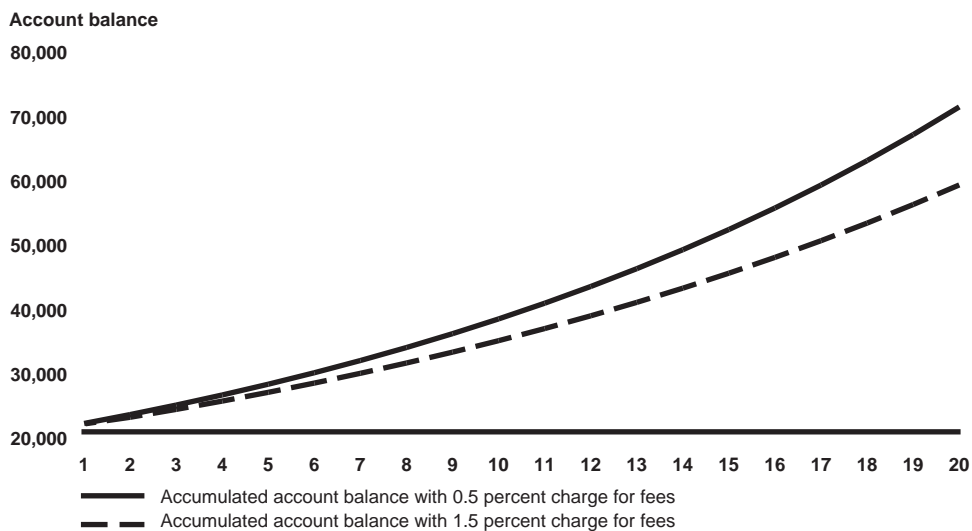
<sup>22</sup>Investment fees pay for: selecting a mutual fund's portfolio of securities and managing the fund; marketing the fund and compensating brokers who sell the fund; and providing other share-holder services such as distributing the fund prospectus. As participants accrue earnings on their investments, they also pay a number of fees, including expenses, commissions, or other charges associated with operating a 401(k) plan. Record-keeping fees cover a variety of activities such as enrolling plan participants, processing participant funds selections, preparing and mailing account statements, and other related administration activities. Unlike investment fees, plan record-keeping fees typically apply to the entire 401(k) plan rather than the individual investment options.

<sup>23</sup>See GAO, *Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees*, [GAO-07-21](#) (Washington, D.C.: Nov. 16, 2006).

<sup>24</sup>AARP Public Policy Institute, "Pension Participant Knowledge About Plan Fees," *Data Digest* (November 2004).

negative effect on savings in the long run. As shown in figure 1, an additional 1 percent annual charge for fees would significantly reduce an account balance at retirement.

**Figure 1: Effect of 1-Percentage Point Higher Annual Fee on a \$20,000 DC Plan Balance Invested over 20 Years**



Source: GAO analysis.

Although all 401(k) plans are required to provide disclosures on plan operations, participant accounts, and the plan's financial status, they are often not required to disclose the fees borne by individual participants. These disclosures are provided in a piecemeal fashion and do not provide a simple way for participants to compare plan investment options and their fees. Some documents that contain fee information are provided to participants automatically, whereas others, such as prospectuses or fund profiles, may require that participants seek them out. According to industry professionals, participants may not know to seek such documents.<sup>25</sup>

Most industry professionals agree that information about investment fees—such as the expense ratio, a fund's operating fees as a percentage of its assets—is fundamental for plan participants to compare their options. Participants also need to be aware of other types of fees—such as record-

<sup>25</sup>See [GAO-07-21](#).

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keeping fees and redemption fees or surrender charges imposed for changing and selling investments—to gain a more complete understanding of all the fees that can affect their account balances. Whether participants receive only basic expense ratio information or more detailed information on various fees, presenting the information in a clear, easily comparable format can help participants understand the content of disclosures. In our previous reports, we recommended that Congress consider requiring plan sponsors to disclose fee information on 401(k) investment options to participants, such as the expense ratios, and Congress has introduced several bills to address fee disclosures.<sup>26</sup>

SEC identified certain undisclosed arrangements in the business practices of pension consultants that the agency referred to as conflicts of interest and released a report in May 2005 that raised questions about whether some pension consultants are fully disclosing potential conflicts of interest that may affect the objectivity of the advice.<sup>27</sup> The report highlighted concerns that compensation arrangements with brokers who sell mutual funds may provide incentives for pension consultants to recommend certain mutual funds to a 401(k) plan sponsor and create conflicts of interest that are not adequately disclosed to plan sponsors. Plan sponsors may not be aware of these arrangements and thus could select mutual funds recommended by the pension consultant over lower-cost alternatives. As a result, participants may have more limited investment options and may pay higher fees for these options than they otherwise would.

Conflicts of interest among plan sponsors and plan service providers can also affect participants' retirement savings. In our prior work on conflicts of interest in DB plans, we found a statistical association between inadequate disclosure of potential conflicts of interest and lower investment returns for ongoing plans, suggesting the possible adverse financial effect of such nondisclosure. Specifically, we detected lower annual rates of return for those ongoing plans associated with consultants that had failed to disclose significant conflicts of interest. These lower

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<sup>26</sup>H.R. 1984, H.R. 2989, and S. 401, 111<sup>th</sup> Cong. (2009).

<sup>27</sup>Plan sponsors pay pension consultants to give them advice on matters such as selecting investment options for the plan and monitoring their performance and selecting other service providers, such as custodians, administrators, and broker-dealers. Office of Compliance Inspections and Examinations, *Staff Report Concerning Examinations of Select Pension Consultants* (U.S. Securities and Exchange Commission: May 16, 2005).

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rates generally ranged from a statistically significant 1.2 to 1.3 percentage points over the 2000 to 2004 period.<sup>28</sup> Although this work was done for DB plans, some of the same conflicts apply to DC plans as well. Problems may occur when companies providing services to a plan also receive compensation from other service providers. Without disclosing these arrangements, service providers may be steering plan sponsors toward investment products or services that may not be in the best interest of participants.<sup>29</sup>

Conflicts of interest may be especially hidden when there is a business arrangement between one 401(k) plan service provider and a third-party provider for services that they do not disclose to the plan sponsor. The problem with these business arrangements is that the plan sponsor will not know who is receiving the compensation and whether or not the compensation fairly represents the value of the service being rendered. Without that information, plan sponsors may not be able to identify potential conflicts of interest and fulfill their fiduciary duty. If the plan sponsors do not know that a third party is receiving these fees, they cannot monitor them, evaluate the worthiness of the compensation in view of services rendered, and take action as needed. Because the risk of 401(k) investments is largely borne by the individual participant, such hidden conflicts can affect participants directly by lowering investment returns.

We previously recommended that Congress consider amending the law to explicitly require that 401(k) service providers disclose to plan sponsors the compensation that providers receive from other service providers. Although Congress has not changed the law, Labor has proposed regulations to expand fee and compensation disclosures to help address conflicts of interests.<sup>30</sup>

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<sup>28</sup>See GAO, *Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans*, [GAO-09-503T](#) (Washington, D.C.: Mar. 24, 2009).

<sup>29</sup>In addition, plan sponsors, being unaware, are often unable to report information about these arrangements to Labor on Form 5500 Schedule C. See [GAO-07-21](#).

<sup>30</sup>Labor published a notice of proposed rulemaking (NPRM) on July 23, 2008 (73 Fed. Reg. 43,014) but the regulation has not yet been finalized.

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## Automatic Enrollment, One Option for Increasing 401(k) Participation and Savings, Shows Promise

A recent change in law to facilitate automatic enrollment shows promise for increasing participation rates and savings. Under automatic enrollment, a worker is enrolled into the plan automatically, or by default, unless they explicitly choose to opt out. In addition, for participants who do not make their own choices, plan sponsors also establish default contribution rates—the portion of an employee’s salary that will be deposited in the plan—and a default investment fund—the fund or other vehicle into which deferred savings will be invested. The Pension Protection Act of 2006 and recent regulatory changes have facilitated plan sponsors’ adoption of automatic enrollment.<sup>31</sup> In fact, plan sponsors have increasingly been adopting automatic enrollment policies in recent years. According to Fidelity Investments, the number of plans with automatic enrollment has increased from 1 percent in December 2004 to about 16 percent in March 2009, with higher rates of adoption among larger plan sponsors. Fidelity Investments estimates that 47 percent of all 401(k) participants are in plans with automatic enrollment. Employers may also adopt an automatic escalation policy, another policy intended to increase retirement savings. Under automatic escalation, in the absence of an employee indicating otherwise, an employee’s contribution rates would be automatically increased at periodic intervals, such as annually. For example, if the default contribution rate is 3 percent of pay, a plan sponsor may choose to increase an employee’s rate of saving by 1 percent per year, up to some maximum, such as 6 percent.

One of our recent reports found that automatic enrollment policies can result in considerably increased participation rates for plans adopting them, with some plans’ participation rates increasing to as high as 95 percent and that these high participation rates appeared to persist over time.<sup>32</sup> Moreover, automatic enrollment had a significant effect on subgroups of workers with relatively low participation rates, such as lower-income and younger workers. For example, according to a 2007 Fidelity Investments study, only 30 percent of workers aged 20 to 29 were participating in plans without automatic enrollment. In plans with automatic enrollment, the participation rate for workers in that age range

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<sup>31</sup>Pub. L. No. 109-280 § 902, 120 Stat. 780, 1033-39 (codified at 26 U.S.C. §§ 401(k)(13), 401(m)(12), 414(w) and 29 U.S.C. § 1144(e), and Automatic Contribution Arrangements, 74 Fed. Reg. 8,200 (Feb. 24, 2009).

<sup>32</sup>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).

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was 77 percent, a difference of 47 percentage points. Automatic enrollment, through its default contribution rates and default investment vehicles, offers an easy way to start saving because participants do not need to decide how much to contribute and how to invest these contributions unless they are interested in doing so. However, current evidence is mixed with regard to the extent to which plan sponsors with automatic enrollment have also adopted automatic escalation policies. In addition, many plan sponsors have adopted relatively low default contribution rates. While the adoption rate for automatic enrollment shows promise, a lag in adoption of automatic escalation policies, in combination with low default contribution rates, could result in low saving rates for participants who do not increase contribution rates over time.

Another recent GAO report offers additional evidence about the positive impact automatic enrollment could have on workers' savings levels at retirement. Specifically, we projected DC pension benefits for a stylized scenario where all employers that did not offer a pension plan were required to sponsor a DC plan with no employer contribution; that is, workers had universal access to a DC plan. When we coupled universal access with automatic enrollment, we found that approximately 91 percent of workers would have DC savings at retirement. Further, we found that about 84 percent of workers in the lowest income quartile would have accumulated DC savings.<sup>33</sup>

In our work on automatic enrollment, we found that plan sponsors have overwhelmingly adopted TDFs as the default investment. TDFs allocate their investments among various asset classes and shift that allocation from equity investments to fixed-income and money market investments as a "target" retirement date approaches; this shift in asset allocation is commonly referred to as the fund's "glide path."<sup>34</sup> Recent evidence suggests that participants who are automatically enrolled in plans with TDF defaults tend to have a high concentration of their savings in these funds. However, pension industry experts have raised questions about the risks of TDFs. For example, some TDFs designed for those expecting to

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<sup>33</sup>See GAO, *Private Pensions: Alternative Approaches Could Address Retirement Risks Faced by Workers but Pose Trade-offs*, [GAO-09-642](#) (Washington, D.C.: July 24, 2009).

<sup>34</sup>For example, a TDF could be designed for workers expecting to retire many years in the future and would typically have a much greater allocation to equities and a lesser allocation to fixed-income investments. As the workers near retirement age, the allocations would shift, resulting in a greater allocation to fixed-income investments.



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retire in or around 2010 lost 25 percent or more in value following the 2008 stock market decline, leading some to question how plan sponsors evaluate, monitor, and use TDFs. GAO will be addressing a request from this committee to examine some of these concerns.

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## Concluding Observations

DC plans, particularly 401(k) plans, have clearly overtaken DB plans as the principal retirement plan for U.S. workers and are likely to become the sole retirement savings plan for most current and future workers. Yet, 401(k) plans face major challenges, not least of which is the fact that many employers do not offer employer-sponsored 401(k) plans or any other type of plan to their workers. This lack of coverage, coupled with the fact that participants in 401(k) plans sometimes spend their savings prior to retirement or have their retirement savings eroded by fees, make it evident that, without some changes, a large number of people will retire with little or no retirement savings.

Employers, workers, and the government all have to work together to ensure that 401(k) plans provide a meaningful contribution to retirement security. Employers have a role in first sponsoring 401(k) plans and then looking at ways to encourage participation, such as utilizing automatic enrollment and automatic escalation. Workers have a role to participate and save in 401(k) plans when they are given the opportunity to do so. In addition, both employers and workers have a role in preserving retirement savings. Government policy makers have an important role in setting the condition and the appropriate incentives that both encourage desired savings behavior but also protects participants. Recent government action that has helped enhance participation in 401(k) plans is a good first step. But action is still needed to improve disclosure on fees, especially those that are hidden, and measures need to be taken to discourage leakage. As this Committee and others move forward to address these issues, improvements may be made to 401(k) plans that can help assure that savings in such plans are an important part of individuals' secure retirement.

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Mr. Chairman, this completes my prepared statement. I would be happy to respond to any questions you or other Members of the Committee may have at this time.

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## Contacts and Staff Acknowledgments

For further questions about this statement, please contact Barbara D. Bovbjerg at (202) 512-7215 or [bovbjergb@gao.gov](mailto:bovbjergb@gao.gov). Individuals making key contributions to this statement included Tamara Cross, David Lehrer, Joseph Applebaum, James Bennett, Jennifer Gregory, Angela Jacobs, Jessica Orr, and Craig Winslow.

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# Appendix I: Selected GAO Reports and Testimonies Related to 401(K) Plans

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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.: October 23, 2009.

Retirement Savings: Better Information and Sponsor Guidance Could Improve Oversight and Reduce Fees for Participants. [GAO-09-641](#). Washington, D.C.: September 4, 2009.

401(k) Plans: Policy Changes Could Reduce the Long-term Effects of Leakage on Workers' Retirement Savings. [GAO-09-715](#). Washington, D.C.: August 28, 2009.

Private Pensions: Alternative Approaches Could Address Retirement Risks Faced by Workers but Pose Trade-offs. [GAO-09-642](#). Washington, D.C.: July 24, 2009.

Private Pensions: Conflicts of Interest Can Affect Defined Benefit and Defined Contribution Plans. [GAO-09-503T](#). Washington, D.C.: March 24, 2009.

Private Pensions: Fulfilling Fiduciary Obligations Can Present Challenges for 401(k) Plan Sponsors. [GAO-08-774](#). Washington D.C.: July 16, 2008.

Private Pensions: GAO Survey of 401(k) Plan Sponsor Practices ([GAO-08-870SP](#), July 2008), an E-supplement to [GAO-08-774](#). [GAO-08-870SP](#). Washington, D.C.: July 16, 2008.

Private Pensions: Low Defined Contribution Plan Savings May Pose Challenges to Retirement Security, Especially for Many Low-Income Workers. [GAO-08-8](#). Washington, D.C.: November 29, 2007.

Private Pensions: Information That Sponsors and Participants Need to Understand 401(k) Plan Fees. [GAO-08-222T](#). Washington, D.C.: October 30, 2007.

Private Pensions: 401(k) Plan Participants and Sponsors Need Better Information on Fees. [GAO-08-95T](#). Washington, D.C.: October 24, 2007.

Employer-Sponsored Health and Retirement Benefits: Efforts to Control Employer Costs and the Implications for Workers. [GAO-07-355](#). Washington, D.C.: March 30, 2007.

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Private Pensions: Increased Reliance on 401(k) Plans Calls for Better Information on Fees. [GAO-07-530T](#). Washington, D.C.: March 6, 2007.

Employee Benefits Security Administration: Enforcement Improvements Made but Additional Actions Could Further Enhance Pension Plan Oversight. [GAO-07-22](#). Washington, D.C.: January 18, 2007.

Private Pensions: Changes Needed to Provide 401(k) Plan Participants and the Department of Labor Better Information on Fees. [GAO-07-21](#). Washington, D.C.: November 16, 2006.

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