

The Case For Employer-Sponsored Retirement Plans

Benefits and Accomplishments

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THE
SPARK
Institute, Inc.

SHAPING
AMERICA'S
RETIREMENT

www.sparkinstitute.org

ABOUT THE SPARK INSTITUTE

The SPARK Institute represents the interests of a broad based cross section of retirement plan service providers and investment managers, including members that are banks, mutual fund companies, insurance companies, third party administrators and benefits consultants. Our members include most of the largest firms that provide record keeping services to employer-sponsored retirement plans, ranging from one participant programs to plans that cover tens of thousands of employees. The combined membership services more than 62 million employer-sponsored plan participants.

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INTRODUCTION

This white paper is the first installment in a series developed by The SPARK Institute to demonstrate that employer-sponsored retirement plans, particularly 401(k) plans,¹ are the most effective, secure and viable way for American workers to save and invest to reach their retirement goals. This installment highlights the benefits and accomplishments of employer-sponsored retirement plans and demonstrates their contributions in helping American workers save for retirement. The second and third installments examine “Coverage, Participation and Retirement Security” and “Fees and Expenses,” respectively. We will release additional installments in order to address new issues and developments as appropriate.

Our series of white papers examines the myths and demonstrates the value, benefits, effectiveness, security and viability that make employer-sponsored retirement plans the best way for American workers to save and invest to reach their retirement goals.

¹ Employer-sponsored and workplace retirement savings plans are defined herein as any workplace retirement plan, including 401(k), 457, 403(b) or retirement savings plans offered through collective bargaining (e.g. Taft-Hartley). Employer-sponsored and workplace retirement savings plans, as used herein, do not include Individual Retirement Accounts.

EXECUTIVE SUMMARY

There are many myths, misperceptions and misunderstandings about the employer-sponsored retirement plan system and its accomplishments and effectiveness in helping American workers save and invest for retirement. The SPARK Institute's series of white papers examines the myths and demonstrates the value, benefits and effectiveness that make employer-sponsored retirement plans the best way for American workers to save and invest to reach their retirement goals.

The SPARK Institute believes that:

- ▶ The employer-sponsored retirement plan system is a successful, fundamentally sound, competitive and innovative system that (1) provides the best way for American workers to invest and build savings to reach their retirement goals, and (2) provides helpful services and good value for the cost, including more affordable investment options than retail investment products.
- ▶ Plan sponsors play a critical role in providing a valuable and cost-effective way for employees to save for retirement.
- ▶ Employer-sponsored retirement plans include a number of features that encourage participation and deliver education and advice that help American workers build retirement savings. Many of these features are not available through other savings vehicles.
- ▶ Just as the employer-sponsored retirement system has incorporated innovations and improvements in the past to bolster its mission and to adapt to changes in the financial environment, it has the capacity to accommodate future innovations and improvements. Changes can be readily made without abandoning the current system.

*Employer-sponsored retirement plans
have generated trillions of dollars in
assets accumulated for retirement.*

Recommendations

Given the numerous economic and social benefits of employer-sponsored retirement plans, especially in assisting Americans accumulate and grow assets for their retirement years, The SPARK Institute recommends that policy makers focus their attention on making the employer-sponsored retirement plan system stronger. Employers should be encouraged to continue to adopt and maintain retirement plans so that all workers have the opportunity to enjoy a financially secure retirement. Additionally, The SPARK Institute encourages the strengthening of the Social Security system so that, together with employer-sponsored plans, it can help American workers achieve their retirement goals.

DISCUSSION

The intent of this white paper is to demonstrate the valuable role that employer-sponsored retirement plans play in preparing American workers for retirement. Employer-sponsored plans have accomplished a great deal since their inception. These accomplishments can be seen through the summary statistics that are highlighted below. We also describe the features and benefits that are available only through such employer-sponsored retirement savings vehicles like 401(k) plans.

401(k) plans have, since their inception, helped tens of millions of American workers save and increase their retirement savings for their post-work years.

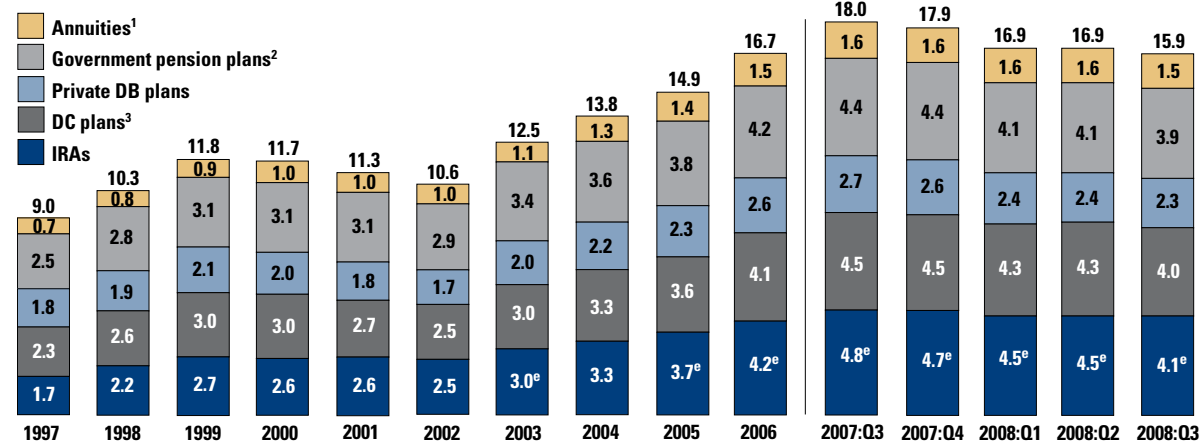
- ▶ In just over 25 years, for example, the number of employers offering a 401(k) plan grew dramatically from zero to nearly 493,000.

- ▶ During the same period, the number of employees participating in 401(k) plans grew from zero to almost 73 million at the end of 2008.²

- ▶ Employer-sponsored retirement plans have generated trillions of dollars in assets accumulated for retirement. At year-end 2007, more than \$17 trillion had been set aside for retirement in the United States (See Figure 1). This is almost double the amount 10 years earlier.

In just over 25 years, for example, the number of employers offering a 401(k) plan grew dramatically from zero to nearly 493,000.

Figure 1
U.S. Retirement Assets Trillions of dollars, end-of-period, 1997 - 2008: Q3



e - estimated

¹ Annuities include all fixed and variable annuity reserves at life insurance companies less annuities held by IRAs, 403(b) plans, 457 plans, and private pension funds (including 401(k) plans).

² Government pension plans include federal, state, and local pension plans. Federal pension plans include U.S. treasury security holdings of the civil service retirement and disability fund, the military retirement fund, the judicial retirement funds, the Railroad Retirement Board, and the foreign service retirement and disability fund. These plans also include securities held in the Nation Railroad Retirement Investment Trust and Federal Employees Retirement System (FERS) Thrift Savings Plan (TSP).

³ DC plans include 403(b) plans, 457 plans, and private employer-sponsored DC plans (including 401(k) plans).

Note: Components may not add to the total because of rounding.

Sources: Investment Company Institute, Federal Reserve Board, National Association of Government Defined Contribution Administrators, American Council of Life Insurers, and Internal Revenue Service Statistics of Income Division.

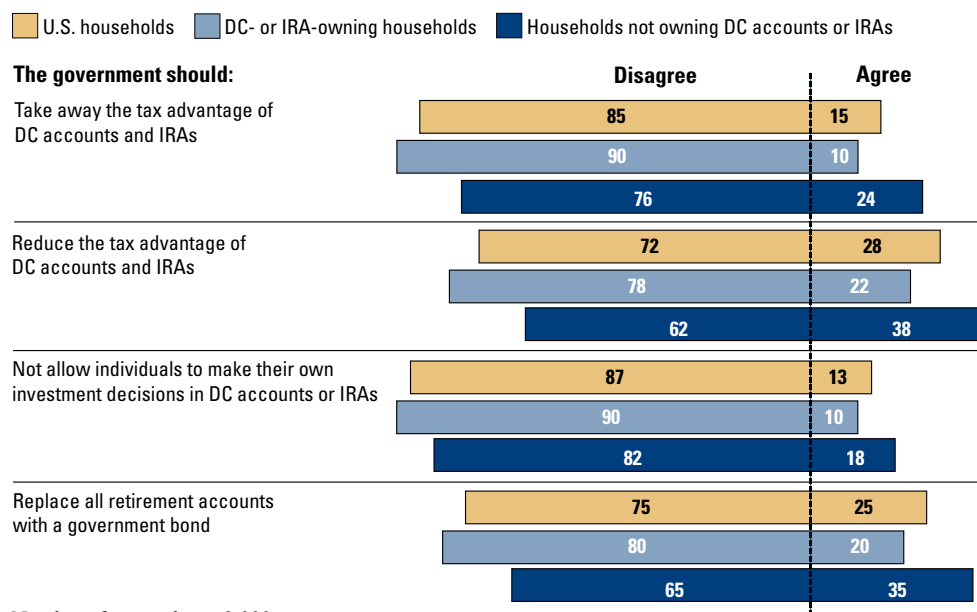
² The SPARK Institute data.

- ▶ Approximately 40% of that \$17 trillion in retirement savings was invested in employer-sponsored plans; another 26% of the assets was invested in IRAs.
- ▶ Recognizing that most of the accumulation in IRAs is the result of rollovers from employer plans, employers had facilitated the accumulation of more than \$11 trillion in retirement savings.³
- ▶ At year-end 2007, total retirement market assets represented almost 40% of U.S. households' financial assets. In 1977, shortly after the Employee Retirement Income Security Act of 1974 (ERISA) became law, retirement assets of all types – including defined benefit (DB) plans, public and private, excluding only Social Security – represented only 14% of households' financial assets.⁴
- ▶ Based on the Boston Research Group's annual DCP survey, the average participation rate in 401(k) plans in 2008 was estimated to be 77%. Participants contributed, on average, 6% of pay.⁵
- ▶ A recent opinion survey of U.S. households owning retirement accounts, as well as households without retirement accounts, suggests that American workers are wary of proposals to revamp the existing system.⁶ Of all households surveyed, 75% do not want to see existing retirement accounts replaced with a government bond, and 85% do not want the tax advantages of retirement accounts taken away. (See Figure 2).

Figure 2

Households' Opinions of Suggested Changes

Percentage agreeing or disagreeing with each statement by ownership status, fall 2008.



Number of respondents: 3,000

Note: Figure plots percentage of households who "strongly agreed" or "somewhat agreed" with the statement in the "Agree" column and the remaining households who "somewhat disagreed" or "strongly disagreed" in the "Disagree" column.

Source: Investment Company Institute tabulation of GfK OmniTel survey data (October, November and December 2008).

³ Investment Company Institute (ICI), Research Fundamentals, February 2009.

⁴ ICI Fundamentals, July 2008, Vol. 17, No. 3.

⁵ DCP 2008, Boston Research Group.

⁶ ICI report, "Retirement Saving in the Wake of Financial Market Volatility," December 2008.

- ▶ Research clearly demonstrates that despite the recession and stock market decline, participants in 401(k) plans are not reacting out of panic but, rather, are staying the course. Studies show that Americans continued to invest in their 401(k) plans amid the economic turmoil. Less than 4% took a withdrawal in 2008, and only 3% stopped contributing to their plans.⁷ In short, it does not appear that they have lost faith in their 401(k) plans.

The previous data dramatically highlights the significant role that employer-sponsored retirement plans play in a worker's retirement readiness.

The U.S. Department of Labor ("DOL") also recognizes the vital contribution of employer-sponsored plans in enabling Americans to accumulate and build up retirement savings.

Of all households surveyed, 75% do not want to see existing retirement accounts replaced with a government bond, and 85% do not want the tax advantages of retirement accounts taken away.

"401(k) plans can be a powerful tool in promoting financial security in retirement," says the DOL. "They are a valuable option for businesses considering a retirement plan, providing benefits to employees and their employers."

The DOL lists the following reasons why it is beneficial for employers to launch 401(k) plans:

- ▶ A well-designed 401(k) plan can help attract and keep talented employees.
- ▶ It allows participants to decide how much to contribute to their accounts on a before-tax basis.
- ▶ Employers are entitled to a tax deduction for their contributions to employees' accounts.
- ▶ A 401(k) plan benefits a mix of rank-and-file employees and owner/managers.
- ▶ The money contributed may grow through investments in stocks, mutual funds, money market funds, savings accounts, and other investment vehicles. Employees are able to choose their own investment funds.
- ▶ Contributions and earnings generally are not taxed by the federal government or by most state governments until they are distributed.
- ▶ A 401(k) plan may allow participants to take their benefits with them when they leave the company, easing administrative burdens.⁸

Employer-sponsored plans, besides offering portability to participants, have given them access to education and advice. What's more, employee assets in defined contribution plans belong to them and cannot be withheld should anything happen, financially or otherwise, to their employers' businesses.

⁷ ICI report, "Retirement Saving in the Wake of Financial Market Volatility," December 2008.

⁸ "401(k) Plans for Small Businesses," Department of Labor (EBSA) Publication, 4222.

BENEFITS

Numerous features of employer-sponsored retirement plans, in particular 401(k) plans, provide benefits to American workers that are not available through other retirement vehicles. These benefits are hard to ignore. They help explain the successes highlighted in the previous statistics.

A. Readily available savings vehicle – Many individuals who fail to save for their retirement recognize, nonetheless, that they should be accumulating savings for their post-work years. They might even want to save. But they simply never get around to it or don't have any idea how to begin. Employer-sponsored plans educate individuals on the importance of retirement readiness and provide a vehicle through which workers can easily invest. A recent household survey sought to understand what features workers valued in their employer-sponsored retirement savings plans. Responses showed that 90% of workers agreed that their employer-sponsored retirement plan helped them “think about the long-term, not just my current needs.” Another 88% agreed that payroll deductions make it easier to save.⁹

B. Fiduciary oversight – Generally, a company that offers an employer-sponsored retirement plan has a number of legal obligations regarding the operation of the plan, including certain fiduciary responsibilities. The fiduciary responsibilities include choosing and monitoring the investment options offered under the plan, hiring and monitoring service providers, and ensuring that fees and services are reasonable. Employer-sponsored plans provide participants with this added layer of oversight and protection, benefits not available through other arrangements. Plans are obligated to be managed in the best interests of the participants.

When individuals are not part of an employer-sponsored plan, the tasks they must confront when saving for retirement can be overwhelming. The decisions involved include when to start saving, what type of savings vehicle is appropriate, what vendor should be selected, and what investments are most suitable.

It becomes much easier for individuals to save when they participate in employer-sponsored plans.

Under an employer-sponsored plan, however, the vast majority of these difficult decisions are answered through the availability of the plan, the role played by the employer, and the services provided by the vendor – including investment education. It becomes much easier for individuals to save when they participate in employer-sponsored plans. In addition, the

plan's service provider and employer both have a vested interest in seeing eligible employees participate and succeed. They help bring about such success by providing education, guidance and tools for employees. On the other hand, employees who do not have a plan at work do not have ready access to such benefits, and, for the most part, are left to fend for themselves.

One of the most complex decisions facing an investor is how to select from the thousands of investment options available to the public, offered by hundreds of different service providers. The fiduciary obligations of the plan sponsor, however, make the sponsor responsible for the selection and monitoring of investment options made available to plan participants. In carrying out this responsibility, employers often leverage intermediaries, such as financial advisors, and use their expertise to help select and monitor investment options. Without this service and direction, many American workers may never attempt to tackle the overwhelming

⁹ ICI report, “Retirement Saving in the Wake of Financial Market Volatility,” December 2008.

task of choosing an investment option that is appropriate for them. In addition, under employer-sponsored plans, many special investment funds are made available to 401(k) plan participants. Some of these funds offer asset allocation mixes that can be designed to meet an individual participant's unique investment needs. They can greatly alleviate the decision-making process for the participant.

C. Employer subsidy of fees – Employers often share the costs associated with administrative expenses incurred to implement and maintain their employer-sponsored retirement plans. This employer funding can reduce, and in some instances eliminate, the plan administrative fees assessed against a participant's retirement plan account. In addition, fees associated with the research surrounding the initial offering or establishment of a plan, as well as any discretionary plan design fees, are borne by the plan sponsor. These and other plan business activities are defined as “settlor expenses” that are required to be paid solely by the plan sponsor, and therefore not assessed against a participant's account.

D. Lower-priced share classes – Employer-sponsored retirement plans are often afforded the ability to provide lower-priced share class investments to their plan participants, thus lowering the cost – or fees – of investment funds for those choosing to participate. Lower-priced shares increase savings available at retirement for those American workers taking advantage of an employer-sponsored plan. These lower-priced share classes are typically not available to individual investors outside of the employer-sponsored retirement plan system.

E. Institutionally-priced guaranteed income for life products – Employer-sponsored retirement plans provide participants with opportunities to purchase institutionally priced products that guarantee that they will not outlive their assets. These products may be purchased with all or part of a participant's account balance and are available during the active accumulation phase or at the time that a participant retires. Having access to these products increases the likelihood that participants will consider their individual circumstances and needs and make appropriate distribution choices that enhance their retirement security.

F. Automatic enrollment – Through the Pension Protection Act of 2006 (“PPA”), Congress introduced a series of incentives for plan sponsors and fiduciaries to encourage broader adoption of automatic enrollment. This innovative plan design automatically enrolls eligible employees in their workplace savings plans. Early studies indicate positive results. For participants with income of less than \$30,000, automatic enrollment increased the participation rate from 44% to 80%. And for participants ages 25–34, automatic enrollment increased participation from 56% to 86%.¹⁰ These hikes in participation rates demonstrate the impact this particular plan feature can have on those American workers least active in saving for retirement.

According to Congressional testimony delivered in June 2006, the national average participation rate in 401(k) plans increased from an estimated 75% to between 85% and 95% of eligible employees when automatic enrollment was used.¹¹ The success of this defined contribution plan feature has gained attention, so much so that President Obama's 2010 budget includes a provision requiring automatic enrollment in employer-sponsored plans or the use of automatic IRAs by employers who do not sponsor a plan. Based on the results to date, allowing employers more time to adopt automatic enrollment as a feature of their employer-sponsored plans will likely continue to result in increased employee participation

G. Qualified Default Investments Alternatives (“QDIAs”) – Again, through the PPA, Congress introduced reform that provides fiduciary protection to plan sponsors who default participants into a QDIA in the

¹⁰ *Pensions & Investments*, “In defense of the 401(k),” February 9, 2009.

¹¹ The Retirement Security Project, February 2007.

absence of participant direction. These default investments, such as target-date or balanced funds, provide participants with an investment option that better positions the individual for a long-term investment horizon. Target-date funds, with clear asset allocation disclosures, also serve as a form of investment advice for those workers who choose to participate in their workplace savings plan, but recognize their limited investment knowledge.

H. Employer matching contributions – These contributions, a design feature offered only in defined contribution plans, are viewed by some as an immediate return on participant contributions. The most

Employer match designs serve as an incentive for eligible workers to participate in their retirement plans, encouraging them to set aside their own money towards their retirement.

common matching contribution formula equates to \$0.50 on the dollar on the first 6% of pay that is deferred. A significant majority of plans offer a match. Those plans with a match design have experienced increased participation rates in the non-highly compensated employee population by as much as 10% for the common match rate described above, and by as much as 15% for richer match formulas.¹² Employer match designs serve as an incentive for eligible workers to participate

in their retirement plans, encouraging them to set aside their own money towards their retirement.

Other studies on the effects of employer matching contributions demonstrate that participation rates are significantly influenced by higher match contribution rates. Workers covered by a plan with a 50% match rate, as opposed to 25%, were 8% more likely to participate. Workers covered by a 75% match rate, as opposed to 25%, were 15% more likely to participate. And, when the match design was 100% on a defined percentage of compensation, studies indicate that participants were 20% more likely to contribute to their plans.¹³ In addition to providing an incentive, the match directly adds value to the employees' retirement savings accounts, often by thousands of dollars by the time they retire.

These results cannot be ignored when the benefits of 401(k) savings plans are considered. These studies indicate a direct correlation between match offerings and plan participation. In short, it can be concluded that employer matching contributions are a critical design feature influencing participation in 401(k) plans.

I. Participant Education and Advice – Decisions on whether to participate in employer-sponsored savings plans, how much to contribute, and how to allocate assets are not made easily, as these decisions impact the take home pay of American workers and their long-term investment horizons. Employer-sponsored retirement plans serve as a means to educate the workforce on the significance of retirement readiness. Currently, no other savings vehicle promotes this valuable learning process.

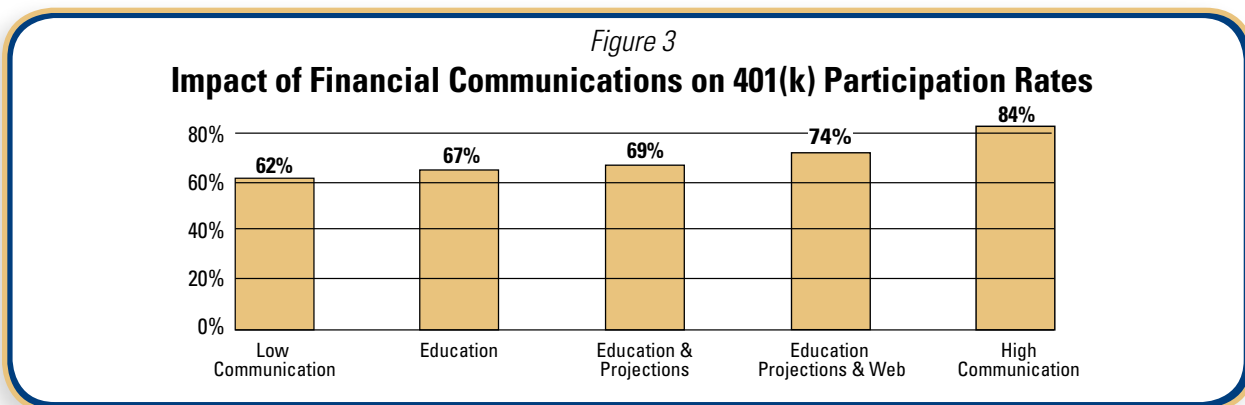
The Pension Research Council conducted a study that, in conjunction with data from Watson Wyatt, supports the fact that education programs have significant impact on an individual's 401(k) participation and savings decisions.¹⁴ Plan education, retirement income projection tools, and access to web-based education

¹²The Vanguard Group, "401(k) Plan Design: Match, Loan, and Investment Menu Effects," December 2005.

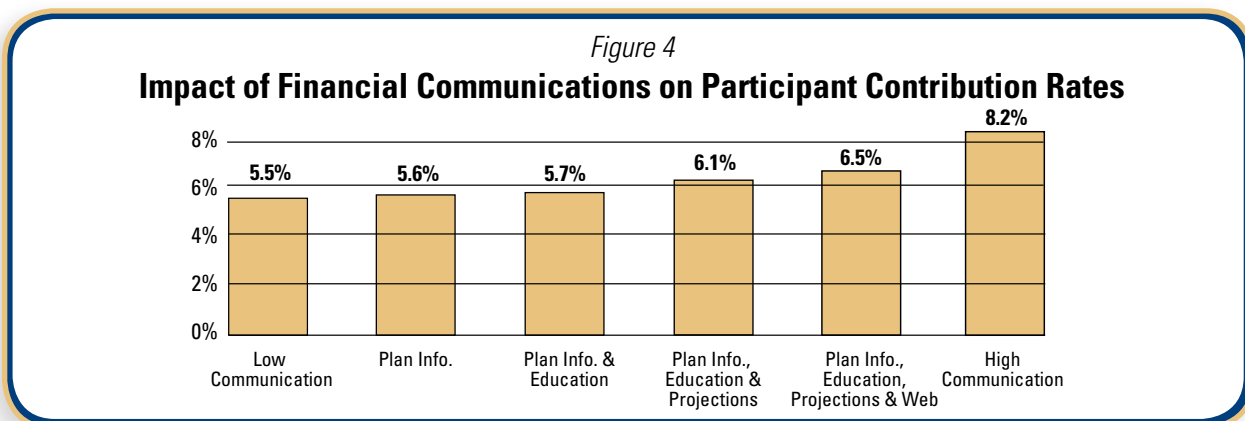
¹³Steven A. Nyce. 2005. "The Importance of Financial Communication for Participation Rates and Contribution Levels in 401(k)Plans," Pension Research Council WP2005-03, The Wharton School, University of Pennsylvania. <http://www.pensionresearchcouncil.org/publications/document.php?file=13>.

¹⁴Ibid.

materials all contribute to increased participation and contribution rates. Richer education programs can raise participation rates to an estimated 84%, whereas the study found participation rates of only 62% for plans offering a basic education program. (See Figures 3 and 4).



As a result of quality education programs, contribution rates have also been estimated to increase to as high as 8.2%, almost 3% greater than plans offering minimal education programs.¹⁵



Advice programs support those participants who recognize their limited investment knowledge, or simply seek the expertise of a professional financial advisor. Until recently, however, many plan sponsors did not actively take steps to offer specific advice to workers regarding investments in their retirement plans, fearing potential fiduciary liability. Over the last several years, regulators and legislators have seen the need to provide clarification and support to employers regarding participant advice. In 1992, the DOL issued an Interpretive Bulletin which distinguished participant education from investment advice. The Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”) allowed retirement planning advice to qualify as a nontaxable fringe benefit, in an effort to promote further participant education. And most recently, the PPA signaled Congress’ support of advice programs, (level-fee arrangements or computer models), provided that the advice does not favor investments that would produce additional revenue for the service provider, resulting in potential prohibited transactions.

¹⁵ Steven A. Nyce. 2005. “The Importance of Financial Communication for Participation Rates and Contribution Levels in 401(k) Plans,” Pension Research Council WP2005-03, The Wharton School, University of Pennsylvania. <http://www.pensionresearchcouncil.org/publications/document.php?file=13>.

Advice programs, such as managed accounts, have been introduced to employer-sponsored plans. These programs provide professional portfolio construction and management to those participants who may be uncomfortable making independent investment decisions, or who choose to benefit from professional advice. Such programs provide an effective way to assist participants in improving their asset allocations by diversifying in accordance with their age, risk tolerance, and retirement goals. A recent study of about 12,000 participants enrolled in managed accounts showed an increase in their expected returns by an average of 82 basis points.¹⁶ (See Figure 5).

Figure 5

Portfolio Risk/Return Characteristics
Expected real returns after fund expenses¹

Quintile	Before managed account	After managed account	Methodology adjustment ²	Change in expected return	Percentage change
5	7.36%	6.10%	-0.20%	-1.46%	-20%
4	5.68%	5.92%	-0.18%	0.06%	1%
3	4.54%	5.83%	-0.14%	1.15%	25%
2	3.51%	5.74%	-0.11%	2.12%	60%
1	1.74%	5.42%	-0.08%	3.60%	207%
Total	4.86%	5.83%	-0.15%	0.82%	17%

Projected returns are based upon Financial Engine’s forecasting methodology, which projects the likelihood of various investment outcomes that are hypothetical in nature. The expected returns do not reflect actual results and are not a guarantee of future results.

¹ Expected returns used to calculate portfolio returns are after fund expenses but before any separate fee charged by the managed account service.

² These adjustments reflect changes over time in Financial Engines’ expected returns and/or covariance matrix.

J. Ability to save more, tax deferred – In addition to the many benefits outlined above, employer-sponsored plans offer participants the ability to set aside more of their own earnings for retirement on a tax deferred basis. The maximum legal 2009 contribution limit for IRAs, including the proposed Automatic IRA, is \$5,000, with an additional \$1,000 for workers age 50 and over. Meanwhile, the 2009 limit for contributions to 401(k) plans is \$16,500, with a catch-up contribution limit of \$5,500. Therefore, the 2009 pre-tax deferral limit for an individual age 50 or over, who chooses to participate in an employer-sponsored 401(k) plan, is \$22,000.

Regulations and tax provisions should be designed to encourage saving for retirement by offering tax incentives to those who are able to, and choose to, contribute to these retirement vehicles. Accumulating sufficient savings to provide for a reasonably secure retirement promotes a number of socially desirable outcomes, including less dependency on Social Security and other government benefit programs. Employer-sponsored retirement plans offer the greatest potential for American workers to invest their own money, tax deferred, and build assets in preparation for their post-employment years.

¹⁶ The Vanguard Group, “Managed Accounts and Participant Portfolios,” July 2006.

CONCLUSION

Given the numerous economic and social benefits of employer-sponsored retirement plans, The SPARK Institute recommends that policy makers focus their attention on making the employer-sponsored retirement plan system stronger. Employers should continue to be encouraged to adopt and maintain retirement plans so that all workers have the opportunity to enjoy a financially secure retirement. Additionally, The SPARK Institute encourages the strengthening of the Social Security system so that, together with employer-sponsored plans, it can help American workers achieve their retirement goals.

