Statement
of

Susan L. Breen-Held
Pension Actuary
The Principal Financial Group®

Submitted to the
The Senate Health, Education, Labor,
and Pensions (HELP) Committee
Hearing on
"Pension Modernization for a 21st Century Workforce"

September 20, 2012

Introduction

My name is Susan Breen-Held. I am a pension actuary at the Principal Financial Group®. I have been with The Principal® for 33 years; the last 30 have been spent consulting with plan sponsors on the design and funding of defined benefit plans.

The Principal is a global investment management leader including retirement services, insurance solutions and asset management. Retirement is our core business and largest operating segment.

For more than 70 years we have helped millions of people save for retirement. We are the number one provider of defined benefit plans, serving more than 2,400 defined benefit plans with nearly 333,000 eligible participants[1]. We are also one of the largest recordkeepers of defined contribution plans with nearly 30,000 defined contribution plans nationally and more than 3.3 million participants[2], representing more than $14.5 billion in assets[3].

We continue to support American workers as they enter retirement, providing monthly income annuity payments to more than 254,000 retirees[4].

[1] PLANSPONSOR DB Administration survey, April, 2012
[2] Based on number of recordkeeping plans, PLANSPONSOR Recordkeeeping Survey , June 2012
[3] As of June 30, 2012
[4] Ibid.

Question One

Defined benefit pension plans have provided a secure retirement for millions of middle class Americans, but it is clear that the traditional pension system is in decline and that existing defined benefit pension models may not be well-suited for some of our 21st century workforces. What should our pension system look like to meet the challenges of the global economy and the need to provide retirement security for working Americans?

Thank you for this opportunity to discuss ways to help ensure adequate retirement income for all Americans by improving the employer-based retirement system.

I speak today on behalf of our core constituency: small and medium-sized employers, who are the economic backbone of this nation.

While the question focuses on traditional defined benefit plans, some of my comments will also address defined contribution plans. Both are critically important sources of retirement income.

We believe the soundest way to help ensure adequate retirement income for all Americans is through a holistic approach: strengthening each part of the nation's retirement system.

The good news is we have a very firm foundation upon which to build. We don't have to start over nor should we. Instead we should build on what's working and draw from the lessons we've learned as the system has evolved over time.

What we have learned is that voluntary employer-sponsored plans, and defined benefit plans in particular, are one of the most efficient ways to provide retirement benefits. The factors that have fueled success include:

- The flexibility of the system that meets the varying needs of employers.
- The stable, guaranteed benefit from defined benefit plans that is a valuable commodity to the participants.
- The features in defined contribution plans that help make it easier and more enticing to save such as automatic enrollment and increases, fiduciary oversight, worksite guidance and education, tax deferrals, and savings incentives for both the employer and the employee.

Among the factors that challenge the system are complexity, administrative burden, cost, global competition, economic instability and human behavior.

We need to make sure that any changes focus on alleviating the challenges and removing the barriers without inadvertently removing or weakening the features and incentives that are working well today.

Here are some high level recommendations to enhance both the defined benefit pension system and the defined contribution system. Some of these ideas are based on results from "The Principal Retirement Readiness Survey—2011[5]", a major survey we conducted of 1305 small and medium-sized employers. Some of the respondents offered a defined contribution plan and some did not. (See attached)

[5] The Principal Financial Group Retirement Readiness Survey commissioned by The Principal conducted by Harris Interactive online. Data was gathered from May 17 through June 17, 2011 from 1305 employers.

- **Make the system simpler for employers and workers.**

  - Simplify the rules, plan designs and regulations to make it easier for employers to establish and operate retirement plans. The complexity and administrative burden drives up costs.
    - In our Retirement Readiness Survey, nearly a third of small employers we surveyed said the costs of establishing and administering a plan are reasons they aren't offering one.

  - For defined contribution plans: make it easier and more attractive to increase the use of automatic enrollment features at higher contribution levels which nudge workers into saving at what we believe are more adequate levels.

- **Give to employers more reasons to voluntarily offer a retirement plan**

  - As onerous as defined benefit plans can be, this is critical.

  - Small employers have all they can do to keep the business running. If they are going to voluntarily invest time and money to offer a retirement plan, they need to know it will benefit the business and the owners need to receive some benefit as well.

  - We know that incentives work for defined contribution plans. In our Retirement Readiness Survey:
    - 92 percent of the employers we surveyed say tax incentives are important in their decision to offer a defined contribution plan.
    - 75% say tax deferral incentives are the most attractive retirement plan feature to employees
    - More than 80 percent say participation and savings would decrease if the incentives were removed
    - Just over half of employers not offering a plan (53 percent) are not aware of the start-up tax credit given to employers who start a DC/401(k) plan.
    - Only 17 percent are aware of how the start-up tax credit works.

- **Address the challenge of retirement income:**

  - The vast majority of the employers in our Retirement Readiness survey agree that placing retirement income illustrations on benefits statements would be helpful but two-thirds are concerned about the liability if employees don't end up with the amount they projected.

  - Educating employees about retirement income will help them better value the guaranteed income provided by a defined benefit plan.

  - Providing a safe harbor or regulatory guidance that the retirement income projection is an estimate and not a guarantee will help alleviate fiduciary concerns.

I can elaborate on these recommendations as our discussion continues.

Question Two

What would make it easier and attractive for businesses – especially small businesses – to provide their employees with a traditional pension benefit? Would reducing the employers' risk and plan complexity help?

Plan sponsors tell us one of the biggest problems with defined benefit plans is volatility caused by market interest rate fluctuations. This volatility has a significant negative impact on funding. When interest rates go down, funding must increase, which puts tremendous pressure on the capital needed to keep the business operating. Many plan sponsors have coped with funding volatility and the resulting heavy cash requirements by freezing their defined benefit plans. That is not the result any of us want.

The industry has helped address some of the volatility with different ways of managing investments. Congress helped address volatility with a recent law, "Moving Ahead for Progress in the 21st Century Act", P.L. No. 112-141[6], that provides interest stabilization. It allows sponsors to reference a longer-term interest rate that would be less affected by market swings. This measure is yet another positive step back to a longer view of pension plan funding. The measure also provides the counter-cyclical funding that sponsors need requiring lower contributions during difficult economic times and higher amounts in better times.

However, the law doesn't go far enough. It doesn't offer the same protection for future years. Restoring the 10% corridor for all years, as was originally proposed, would strengthen protections for sponsors and also generate tax revenues in the near term. Relieving volatility concerns helps support existing plans and could spur creation of new ones.

In addition to expanding the new law, we offer three other steps that we believe would encourage small employers to maintain or create defined benefit pension plans:

- **First, give employers a reason to offer defined benefit plans.**
    - Deciding whether to offer a retirement plan is a business decision. For a smaller business to invest the time and money to establish or maintain a plan, there must be a benefit to the business and to the employer.
    - The current structure provides only a minimal benefit to the employer and other highly compensated employees.
    - The current compensation and total benefit limits allow the defined benefit plan to replace only a small portion of the decision-makers' or other highly compensated employees' income. Thus they have little incentive to take on the risk of sponsoring or maintaining a defined benefit plan.
    - We recommend raising the compensation and benefit limits so that the employer and highly paid employees have more of a stake in the defined benefit plan.
    - We also recommend waiving all compensation limits in the first five years after defined benefit plan's creation. This would provide an incentive to increase the number of defined benefit plans in existence, expand the working population covered by those plans and help assure that more employees have more adequate retirement income.
    - These steps could be tied to features that would benefit the rank and file such as immediate vesting or benefit accruals.

[6] "Moving Ahead for Progress in the 21st Century Act", P.L. No. 112-141, enacted July 6, 2012

- We've seen this working very effectively in the defined contribution world where safe harbor rules allow the employer to establish contribution levels that provide reasonable savings opportunities for both highly compensated and non-highly compensated employees.
- We see strong positive results from cash balance plans that can provide incentives to owners and higher income employees.
  - The average employer contribution to retirement accounts where companies have both a 401(k) and a cash balance plan is 6% of pay, compared to 2.3% of pay in companies with only a 401(k).
  - This kind of arrangement is so attractive to employers that despite the severe economic slump between 2008 and 2010, there was a 38% increase in new cash balance plans[7].
- We need to provide similar incentives to traditional defined benefit plans.

- **Second, reduce administrative costs.**

  - The new law I referenced earlier is expected to significantly increase what is already a burdensome number of calculations for defined benefit plans.
  - We recommend reducing the number of different calculations that are required for **small** plans, which are generally defined at 100 lives or less.
  - This could be accomplished by exempting small plans from some testing or lengthening the time between tests, for example from every year to every three years.
  - Limit the amount of government reporting for the smallest of plans. This would be an enormous help to these smaller organizations.
  - These ideas could reduce the sponsors' administrative costs while posing little additional risk on the Pension Benefit Guaranty Corporation (PBGC).
  - One of the last things these employers need is an increase of their PBGC premiums. Such an increase would only serve as a barrier—and for many smaller employers an insurmountable one—to maintaining and creating defined benefit plans.

[7] 2012 National Cash Balance Research Report, Kravitz, Inc.

Question Three

What do employees need from a pension plan to ensure that they will have a secure retirement?

- First and foremost, employees need the defined benefit plan to be there and allow continual benefit accrual. A traditional pension plan provides a foundation for a total retirement program, enhancing the savings in a defined contribution plan and supplementing Social Security.

- One way to keep the defined benefit plans alive is to make sure that government agencies provide clear and timely guidance for the laws that Congress enacts. This allows sponsors to react with confidence and in a timely fashion to design and operate plans. This Committee's influence in this area has proven to be invaluable to plan sponsors in the past, and is much appreciated.

- Plan participants themselves need a better understanding of the advantages and value of defined benefit plans. The more participants appreciate a defined benefit plan, the more the plan can benefit the business as an attraction and retention tool which can help drive demand for continuing or establishing a defined benefit plan.

    - Participants have a much greater awareness of defined contribution plans because they are easier to understand and have been more widely promoted.

    - This isn't the case with defined benefit plans. Participants don't have to take action to participate nor do they receive much education about defined benefit plans. In the past, defined benefit plans have tended to be invisible except to those employees approaching retirement.

    - We are beginning to see the first signs that young people increasingly value defined benefit plans. As an industry we need to build on this trend and focus greater attention to educating participants on the value of defined benefit plans.

A word about defined contribution plans

Because most Americans with a defined benefit plan also have a defined contribution plan, providing an **income replacement orientation** to defined contribution plans only serves to increase appreciation of defined benefit plans while at the same time increasing the chances of providing more adequate retirement income.

The next generation of defined contribution plans is borrowing from some of the best features of defined benefit plans. It begins with better a definition of what it may take to achieve a more secure retirement.

- We define true retirement readiness as having enough savings to replace 85 percent of pre-retirement income.

- In order to save enough to meet that goal, our analysis indicates Americans need to save, on average, between 11 and 15 percent of their income over the course of a career—including employer contribution from either a match or defined benefit plan.

- In an analysis we conducted, which measured the impact on retirement account balances of three key variables: investment performance, asset allocation and the amount the participant is saving, we found that while investment performance and asset allocation are important, **in the long run the amount of savings has the biggest impact on the ending account balance[8].**

- We are encouraging plan sponsors to redesign their plans in a way that sets participants up to save successfully. We can do some of this now, but we need help from Congress and regulators to encourage sponsors to take these actions.

- **Here are the five plan design features we believe can lead to true retirement readiness:**

  1. **Offer automatic enrollment—with at least a six percent default deferral rate.**
     - Our analysis[9] of participants in plans through The Principal shows 6% drives better saving behavior without hurting participation.
       - Only 19% opted out at 6% compared to 15% opting out at 3%.
       - When 6% default rate is combined with an employer match, 61% of participants reached an overall savings rate of more than 11 percent of pay.

  2. **Couple automatic enrollment with an annual automatic escalation of the deferral rate - and make it the default:**
     - Automatic enrollment alone likely won't encourage participants to increase their salary deferrals over time.
     - Automatic escalation harnesses the power of inertia**:**
       - Our analysis[10] shows that 80% of participants use automatic escalation when it's the default while only 6% use it when it's a feature they have to choose.

  3. **Apply automatic enrollment to all employees at least one time and consider re-enrolling all employees periodically**
     - This ensures that more than just new employees reap the benefits of automatic enrollment

  Congress can encourage these auto savings changes by providing additional incentives for employers who add auto escalation and by removing the 10 percent cap on default deferrals.

  4. **Employers can re-structure the employer match** in a way that requires participants to contribute more in order to get the full match but doesn't change the employer's cost.
     - Participants tend to save up to the employer match or the automatic enrollment default rate and not beyond.
     - Our analysis[11] shows participants contribute more when employers stretch the target match rate and it has not hurt participation and participants defer up to the higher level.

---

[8] "Pursuing "Retirement Plan Success" During Participants' Accumulation Years" The Principal Financial Group, April 2010
[9] Analysis of participants in plans through The Principal 12/31/2010
[10] Analysis of participants in plans through The Principal 12/31/2010
[11] Analysis of participants in plans through The Principal 12/31/2010

5. **Professionally managed investment options:** offering target date or target risk investment options as the default investment provides built-in diversification and simplicity for participants who seek a do-it-for-me choice.

- **Plans need to focus education on retirement income needs**

    - **Illustrating projected monthly income in retirement on benefits statements** can be a savings motivator. Learning that a $50,000 balance at age 65 would amount to only about $275 a month[12] for life can be a real wakeup call.
    - **But as I said earlier, employers have grave concerns about liability if the ultimate savings falls short of the projections.**
    - Employers need regulatory guidance that they won't be liable.

I appreciate the opportunity to appear before you today. We look forward to working with you as you consider ways to help protect and expand defined contribution plans and help Americans have a more secure lifetime income at retirement. I would be happy to answer any questions you may have.

t12091703sp – 09/2012

[12] Principal Financial Group Income Annuity Quote for a 65 year old, unisex pricing, with installment refund, August 30, 2010.