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SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
SUBCOMMITTEE ON ECONOMIC POLICY
HEARING ON THE STATE OF US RETIREMENT SECURITY:
CAN THE MIDDLE CLASS AFFORD TO RETIRE?
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2:30pm ET

Good afternoon Chairman Merkley, Ranking Member Heller and members of the subcommittee. Thank you for this opportunity to talk about retirement security and the critical impact it plays in our economy.

My name is Kristi Mitchem. I am an Executive Vice President for State Street Global Advisors, the investment management arm of State Street Bank and Trust Company. State Street Global Advisors is a leading asset management firm, entrusted with over $2.3 trillion in assets under management[1]. Importantly, State Street Global Advisors is one of the largest providers of defined contribution (DC) services worldwide, managing more than $305 billion in retirement plan assets on behalf of employers and retirement plan participants. Our size and penetration within the DC marketplace affords me the opportunity to interact with US DC plan sponsors on a regular basis, informing my perspective.

Having worked with retirement plan sponsors for a decade, I recognize the important role that employers can play in assisting workers with retirement preparation. My objective today is to highlight the success that the largest employers in the United States have had in helping their workers achieve retirement adequacy and to suggest ways in which we can make this success

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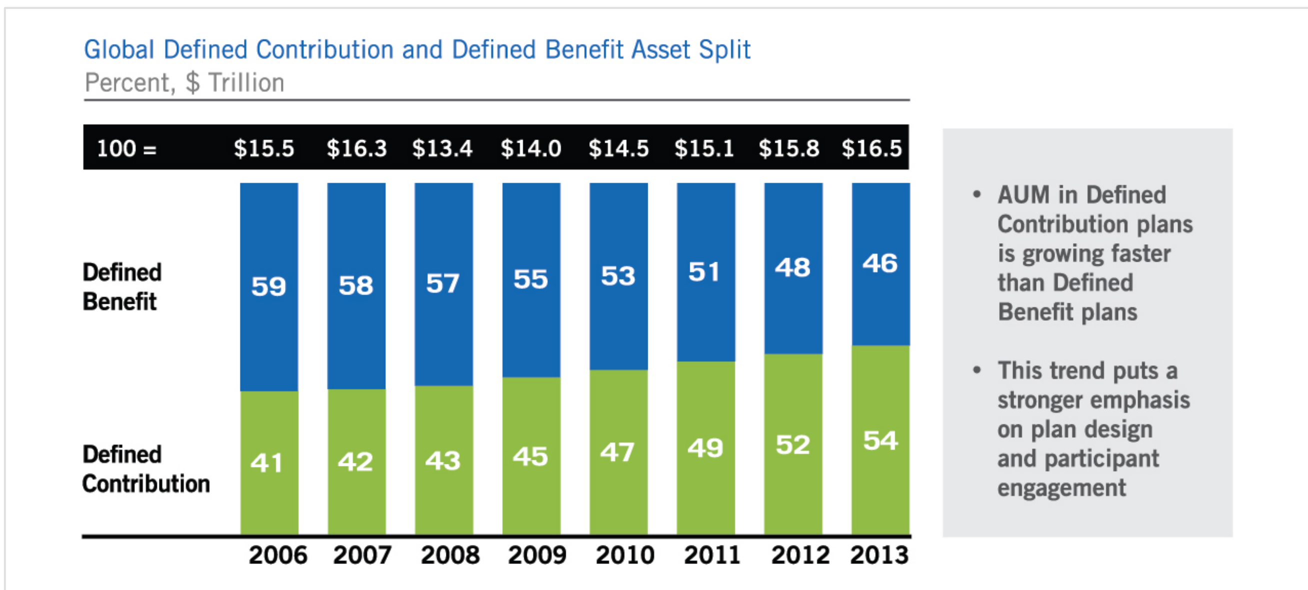
[1] As of December 31, 2013.

[2] Bureau of Labor Statistics.
[3] GAO Study on Challenges and Prospects of Employees of Small Businesses, July 16, 2013.
[4] PLANSPONSOR DC Survey 2013.
5 Ibid.
6 Inside the Structure of Defined Contribution/401(k) Plan Fees: A Study Assessing the Mechanics of the ‘All-In’ Fee 2011. Deloitte.
[7] EBRI Retirement Security Project Model findings from EBRI/Jack Vanderhei testimony to the United States Senate Committee

more universal by removing barriers that currently prevent many smaller companies from offering well-structured retirement savings programs.

Retirement Today

For nearly 50 years, the retirement landscape was dominated by defined benefit (DB) plans, which provided many Americans with a monthly lifetime pension. But in more recent decades, the number of Americans covered by DB plans has diminished substantially. We have shifted to a system that is much more dependent on self-funded DC plans. By year-end 2013, DC plans were more prevalent than DB plans in the United States, as well as globally. This trend is likely to continue as plan sponsors increasingly look to reduce their pension liabilities.



Source: McKinsey Retirement Practice; Estimated figures, 2010.

DC plans are now the primary source of retirement benefits for millions of Americans. We believe these plans have the potential to provide retirement security to the majority of American

workers. However, realizing this potential will require substantial progress from where we are today. We recognize and applaud regulators and legislators for acknowledging the existing issues around access, participation and cost.

In developing solutions to these problems it may be useful to consider how and where we are having success in retirement preparation today. Specifically, we believe that many of the largest and most sophisticated plans in the United States have designed and implemented adequate, self-funded retirement plans. The challenge we face is determining the public policy shifts necessary to close the gap between large and small employers with regard to DC plan provision and structure.

The "Great Divide"

When it comes to retirement planning and preparation, we believe the "Great Divide" is more around employer size than employee income level. Large employers are much more likely to provide a retirement plan. And when they do, the plan produces better results for those employees that participate in it. Comparing data from large and small plans across a number of dimensions illustrates the impact of employer size on retirement readiness.

- Access: 89% of large companies offer DC plans[2]; however only 14% of small employers sponsor some type of plan for their employees to save for retirement.[3]
- Participation Rate: The average participation rate in the largest plan segment is close to 80%. For the smallest companies that offer a plan, participation rates dip down to 74.2%.[4]
- Savings Rates: In the largest plans, the average savings rate is 7.3% while for the smallest plans it is 5.6%.[5]

[2] Bureau of Labor Statistics.
[3] GAO Study on Challenges and Prospects of Employees of Small Businesses, July 16, 2013.
[4] PLANSPONSOR DC Survey 2013.
5 Ibid.

- Account Balances: The average account balance in the largest plans is about two times the average across all plan sizes – $140,000 compared to $63,878.[6]

DC Advances within the Large Plan Market

The largest plan sponsors are clearly outpacing small employers in the race to provide a viable replacement for DB plans; the question then becomes why have they been able to create more successful defined contribution offerings.

The answer in my view lies in the fact that the largest plans in the US are leveraging changes in public policy and incorporating insights from behavioral finance to drive real improvements in retirement readiness. Specifically, they are taking the following actions to automate good behaviors, simplify choices and enhance transparency:

- Automatically enrolling new employees.

6 Inside the Structure of Defined Contribution/401(k) Plan Fees: A Study Assessing the Mechanics of the 'All-In' Fee 2011. Deloitte.

- Automatically increasing contribution rates for participants over time.
- Offering their participants a more streamlined and simplified menu of investment choices to help participants make better investment choices.
- Embracing well-diversified target date funds as default investment options to aid participants in managing key investment risks.
- Negotiating lower investment fees on behalf of participants across all types of investments and asset classes.
- Utilizing high-quality, low-fee index based investments where appropriate on retirement plan investment menus.

Comparing Characteristics of Smaller and Larger Plans

DC PLAN FEATURES	MICRO <$5MM	SMALL $5MM-$50MM	MID 50MM-$200MM	LARGE $200MM-$1B	MEGA $1B+
Auto-enrollment	23.4%	43.1%	55.5%	57.3%	61.4%
Participation Rate	74.2%	77.7%	78.6%	77.9%	80.1%
Deferral Rate	5.6%	6.0%	6.3%	6.7%	7.3%
Auto-escalation	12.1%	26.2%	38.3%	46.6%	54.2%
Target Date Fund Usage	58.9%	74.0%	78.1%	81.8%	84.8%
Use of Collective Investment Trusts (CITs)	7.3%	8.8%	14.4%	27.8%	50.7%
Average Expense Ratio of 0.25-0.50% (25-50 bps)	10.6%	14.9%	19.6%	32.1%	45.3%

Source: PLANSPONSOR DC Survey 2013.

Helping Small Employers Increase Plan Sponsorship

So how do we translate the successful evolution of DC plans sponsored by large employers into success for the small employer market? First, we must remove current obstacles that make plan sponsorship more challenging for small employers. Unlike large employers, small businesses often do not have the time, resources and expertise to administer a retirement plan. The administrative burdens and fiduciary responsibilities associated with plan sponsorship can be overwhelming and inhibit adoption.

We believe that if smaller companies could have access to a multiple-employer plan (MEP) through an industry group or other association, they would be more likely to offer a workplace retirement plan. We would therefore suggest that you consider changes to current policy that would support the growth of multiple-employer DC plans. Specifically, we would recommend that: 1) the current DOL nexus requirement be eliminated for participant-funded retirement programs, and; 2) a safe harbor be offered to participating members of a multiple-employer DC plan, provided that certain best-in-class plan design features are incorporated. Developing and encouraging the use of MEPs would reduce the barriers to plan adoption among small companies by spreading administrative and personnel related costs across a number of employers. Importantly, it would also help smaller plans achieve the kind of fee leverage that larger plans now enjoy. In other words, access to MEPs would make retirement plan provision more attractive to small employers and allow participants in these plans to keep more of what they save through lower plan expenses.

A Future Model for Small Employers

As discussed above, we believe one potential way to close the gap between large and small plans would be to create a safe harbor for employers that participate in well-structured, multiple-

employer DC plans. These well-structured MEPs should mimic the largest plans in the US by leveraging automation and simplification to drive better participant outcomes. In our view, the features required for safe harbor coverage should include:

- Auto enrollment starting at a minimum of 6% with default into an indexed target date fund.
- Automatic contribution rate escalation at a minimum of 1% annually up to a cap of 15%.
- A simplified investment menu including an index target date fund, a limited number of core options and a lifetime income option to help manage longevity risk.
- A loan program available only for hardship to prevent plan leakage.
- A total plan expense ratio under a certain limit based on the size of the MEP.
- An optional employer match or discretionary profit-sharing type contribution.

In order to make participation in MEPs easier and more attractive, we believe the following additional changes in public policy should also be considered:

- Removal of testing and reporting requirements for employers under a certain size.
- Acceptance of aggregated 5500-type reporting with a breakdown of contribution amounts by participating employers.
- Alterations to the tax code to prevent disqualification of a multiple-employer plan despite a violation by one or more participating members.

We believe granting small businesses the ability to participate in simplified MEPs would send an important signal to the retirement market. This change would inspire DC plan service providers and investment managers to create more products tailored to small businesses, providing a broader range of choices and greater economies of scale to an underserved market segment.

Are Large Plan Advancements Sufficient?

In the sections above we explored the differences between large and small plans and suggested potential ways to replicate the large plan experience in the small plan market. One critical question that we have not explicitly addressed, however, is whether or not well-structured plans, such as those currently prevalent at the larger end of the market, are capable of delivering retirement security to the middle class. In order to answer this question, we look to data produced by the Employee Benefit Research Institute (EBRI). In December of 2013[7], EBRI's Retirement Security Projection Model (RSPM) analyzed the potential of DC plans to produce "adequate" income replacement for retirement. EBRI data shows that when plans adopt automatic enrollment and auto escalation, retirement adequacy rates are high. According to EBRI, 85% to 90% of younger middle class workers participating in plans with auto features are expected to replace 80% of their income in retirement.[8] Importantly, lower income quartiles also do well under the auto feature condition, with 90% of lower income workers expected to replace 80% of their pre-retirement income.

Despite these encouraging statistics, there is more that plan sponsors can and should do to improve the retirement prospects of those with fewer years to retirement and to provide a buffer for newer employees. In our view, two of the most impactful steps that plan sponsors could take

[7] EBRI Retirement Security Project Model findings from EBRI/Jack Vanderhei testimony to the United States Senate Committee on Finance, Subcommittee on Social Security, Pensions, and Family Policy, Hearing on Retirement Savings for Low-Income Workers. Statement of record, Wednesday, February 26, 2014.

[8] EBRI Assumptions: "…assuming current Social Security benefits are not reduced, 86% of workers in the lowest-income quartile with more than 30 years of eligibility in a voluntary enrollment 401(k) plan are simulated to have sufficient 401(k) accumulations that, when combined with Social Security retirement benefits, would be able to replace at least 60% of their age 64 wages and salary on an inflation-adjusted basis. When the threshold for a successful retirement financing is increased to 70% replacement, 76% of these workers will still meet the threshold, based solely on the combination of projected 401(k) savings and Social Security combined. At an 80% replacement rate, 69% of the lowest-income quartile will still meet the threshold. It should be noted, however, that the percentage of those in the highest-income quartile deemed to be "successful" from just these two retirement components drops to 59% from 83% when measured against the 60% threshold."

to further increase retirement adequacy would be to utilize more aggressive defaults and incorporate lifetime income options in their plan menus.

EBRI and other industry associations, such as the Defined Contribution Institutional Investment Association (DCIIA), have done extensive research in the area of defaults and demonstrated the strong relationship between initial deferral rates and retirement adequacy. Because many employees will "stick" at the default rate, it is important for plan sponsors to choose default savings rates that are high enough to provide for adequate savings. Increasing the default savings rates from 3% to 6% can impact accumulated balances substantially.[9] If we double the savings rates of 45-year-old middle-class workers, their accumulated balances at retirement would grow by 41%.[10]

The provision of lifetime income is another key enabler of retirement success because investors in these types of strategies benefit from managing longevity risk. In DC plans where a lifetime income product is not offered, participants are required to generate enough savings within their personal retirement plan accounts to support themselves in the event that they live well past the average life expectancy (age 82). Investors in lifetime income products transfer the risk of outliving their assets to an insurer who, by pooling many individuals together, can manage to the mean life expectancy rather than the outer bounds of longevity. The broad adoption and usage of retirement income products in the US would materially increase the probability of success for many savers by decreasing the accumulated savings needed to achieve adequacy by approximately 20 percent.[11]

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[9] DCIIA: The Impact of Auto-Enrollment and Automatic Contribution Escalation on Retirement Income Adequacy, Jack VanDerhei, Employee Benefit Research Institute, and Lori Lucas, Callan Associates.

[10] Based on SSgA assumptions: beginning saving at age 25 at 3% per annum, increase of savings to 6% per annum at age 45. Contributions are made annually with a static return of 5% per annum and wage growth estimated at 3% per annum.

[11] SSgA calculation comparing the present value of a cash flow from age 65 to the 90% joint survivor age (98) to the present value of a mortality weighted joint survivor cash flow from 65 until death. Mortality assumptions based on Social Security cohort life table for birth year 1950 and cash flows discounted by the Treasury yield curve from 3/3/14.

The Voice of the Participant

One very important voice, which we have not considered as part of our testimony up to this point, is the voice of the participant—the employee who is or will participate in a workplace savings plan. If participants tolerate but do not accept automation, it is unlikely to have lasting impact. Further, if income options are offered but not embraced, participants will not experience the benefits of longevity hedging. At State Street Global Advisors, we regularly survey participants on their attitudes toward a range of issues and have explored both of these questions. The good news is, our survey results have shown that Americans want to save for retirement, believe in automation and would like to see lifetime income strategies incorporated into DC investment menus.

Highlights from State Street Global Advisors Participant Surveys

In our 2011 DC Investor Survey, we found:

- On average participants thought that they should be saving approximately 14% of their pre-tax wages in a retirement plan.
- 74% of participants surveyed indicated that they wanted their employer to automatically make them do something to prepare for retirement.

In our 2012 DC Investor Survey, there was a similar desire for higher savings rates and automation.

- More than half of participants surveyed indicated they would increase their savings up to 10% or more if automatically increased by 1% a year.

With regard to income strategies, our 2013 DC Investor Survey showed the increasing need for addressing the decumulation phase of retirement.

- Over 60% of those surveyed said they plan to take monthly withdrawals.
- 7 out of 10 recognize they will need an additional source of guaranteed income in retirement, separate from Social Security.

Concluding Comments

One of the unique facets of the US retirement system is that the employer plays a central role in helping individuals to plan and save for retirement. What may not always be well understood, however, is that this workforce-centered design actually motivates savings in individuals who otherwise would not contribute. A recent research piece by Holden and Bass (2013) reports that half of DC participants strongly or somewhat agree with the statement "I probably wouldn't save for retirement if I didn't have a retirement plan at work." And for those with a household income of less than $50,000 a year, that response rate increases to nearly 70%.

Given the important role that employers play in enabling retirement savings, it is only natural that any exploration of how to improve the system begin with an examination of why certain employers are achieving success and others are not. In our view, the dominant explanatory variable is plan size. We have presented solid evidence that the largest employers in the world are creating plans that work by incorporating auto features and using their size and scale to drive down costs. We believe the next step in the evolution of DC plans should be to bring aspects of that model to a wider range of plan sponsors. In our view, this can be accomplished in part by supporting the creation of well-structured multiple-employer DC plans.

Thank you again for the opportunity to testify on the importance of ensuring retirement security for America's middle class. I welcome any questions you may have.

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