

Retirement Readiness

Larry Zimpleman

Chairman, President, and Chief Executive Officer
Principal Financial Group

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First of all, thanks for the opportunity to be here today to talk about a topic – retirement readiness – that I believe is one of the most important issues facing the Baby Boom generation. Kudos to Drake and the committee for having this symposium

To put the issue in perspective, I need to start with some history. ERISA was passed in 1974 and at that time, defined benefit plans were the predominant type of retirement plan. There were roughly 30 million participants covered by DB plans and 60-65% of all retirement plans were DB plans. Fast forward to a more recent period and now there are only 16 million people covered by a DB plan and they make up less than 10% of all retirement plans. Further, DC plans now cover almost 75 million workers vs. only 10 million when ERISA was passed. Today, 78% of all workers consider a DC plan to be their primary retirement plan.

We could spend hours discussing why this mega-shift occurred, but that isn't the purpose of this symposium. What we know is that the U.S. is today and will be in the future a DC retirement plan system. What can we do to better ensure that we get good outcomes from these plans?

No doubt everyone here today understands that the investment risk was shifted from employers to plan participants when we went from DB to DC plans. What may be less obvious is that we went from plans where workers were automatically enrolled to plans where workers had to:

1. Choose whether or not to participate;
2. Decide what contribution they wanted to make; and
3. Choose how to invest the contributions.

What we know today is that if workers are left to their own decision making they do not make decisions that are always in their own best interest. So – if we stay with this “voluntary and elective” system, we know:

1. 35% of workers will not join the system;
2. They will save half of what they should (say 4-6% vs. 10%); and
3. They will make poor investment decisions.

This will create a sub-optimal outcome for virtually 100% of those in a DC plan. Interestingly, those at the very lowest income levels may not be hurt the worst because Social Security will replace as much as 90% of their pre-retirement income. Those who will be hurt the most will be those in broadly the middle income segment where Social Security only replaces about 35-40% of pre-retirement income when they need an 85% replacement ratio.

After 30+ years of 401(k) plans, we now know how to protect middle income workers from their own poor decision-making. Behavioral finance tells us how to do this. Not only is it about helping middle income workers save more to increase their replacement ratios, it is about saving more to offset increasing longevity we are now seeing. Roughly, a couple aged 65 today has a 45-50% chance that one or both of them will live to age 90 – a retirement period of 25 years. Few retirees are prepared for this.

Proper plan design using auto enroll, auto escalate and default investment options is the key to retirement readiness. Those of us who work in the business can no longer stay silent when we see poor plan designs that we know will produce poor plan outcomes.

What is a plan design that works?

1. We auto enroll (and re-enroll) all workers. That improves participation to 85-90%;
2. The default contribution is set at 6% of pay which is the level needed to get the full employer match;
3. We auto-escalate contributions by 1% per year to a total of 11% over 5 years; and
4. The default investment option is a target date lifecycle fund.

Reasonable projections would show that this plan design would be expected to produce an 85% replacement ratio (with Social Security) for a worker starting at age 30 with a salary of \$32,000.

Simply put, we use plan design to put “guard rails” on so each participant will make good decisions vs. bad decisions.

Is it happening? Unfortunately, the answer is “no”.

1. Only 50% of plans use auto enroll;
2. Only 20% of plans use auto escalate; and
3. Only 5% of plans escalate to a 10% or higher contribution.

If there is any “good news,” it is that you can’t go to an industry conference today where you don’t hear the term “retirement readiness.” Many are talking about – but not enough plan sponsors are taking action. I can say that at Principal, we will be pushing the concept of retirement readiness hard with plan sponsors and advisors. There is simply too much at stake.

A couple of concluding comments on related topics:

1. Financial literacy – one of the reasons we get these bad retirement outcomes is that we don’t teach financial literacy in our schools. That needs to change. Fortunately, there are some great technology platforms out there today to teach financial literacy.
2. Even if we get middle income workers to save 10-12% of their income for retirement, we still have the issue of how best to distribute those assets over the expected time of retirement. So, in the same way as we have auto-enroll and auto-escalate, we need to develop an approach to “auto annuitize.” That may not actually be an

annuity but it should be a phased draw-down of some type. I expect we'll see more work in this area in the coming years.

Thanks again for allowing me to speak on this important topic. I'd love to hear your reactions and be happy to try to answer any questions you may have.