Statement before the Senate Committee on Health, Education, Labor, and Pensions

For a hearing on Taking a Serious Look at the Retirement Crisis in America: What Can We Do to Expand Defined Benefit Pension Plans for Workers?

on

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Introduction

Chairman Sanders, Ranking Member Cassidy, and members of the Senate Health, Education, Labor, and Pensions Committee, I appreciate the opportunity to testify on the state of retirement in the United States and the role of defined benefit pensions in promoting a secure retirement.

I am Dan Doonan, and today I am testifying on behalf of the National Institute on Retirement Security (NIRS) as the organization's executive director. NIRS is a non-partisan, non-profit think tank located here in Washington, D.C. that was established in 2007 to contribute to informed policymaking by fostering a deep understanding of the value of retirement security to employees, employers, and the economy. We enjoy a broad membership base that includes financial services companies, retirement plan sponsors and service providers, labor unions, and other nonprofits such as AARP.

In recent years, Congress has made progress working to address the retirement crisis in America. Both the Setting Every Community Up for Retirement Enhancement (SECURE) Act enacted in 2020 and The SECURE 2.0 Act passed in 2022 are steps in the right direction toward getting Americans back on track for a secure retirement. However, much work remains to ensure that working Americans can be self-sufficient in retirement after a lifetime of work.

Today, I will provide insight on the scope of Americans' alarming retirement savings shortfalls, the importance of pensions, the trend of employers returning to pensions, and some potential policy solutions that would facilitate a "pension renaissance."

But first, it is important to note how the pension industry has modernized and improved since the early days. When plans were created in the 1940s and 1950s, liabilities and contribution amounts were calculated with pencil and paper. Pay-go funding was common, and we all know that approach is expensive.

Today, prefunding of pensions is commonplace following the passage of The Employee Retirement Income Security Act of 1974 (ERISA), when personal computers were in their infancy. Today, actuaries use highly sophisticated financial modeling programs to perform stress testing to understand how resilient plans would be under various scenarios. As a result, employers and trustees plan sponsors and trustees are better informed about a plan's fiscal risks. In addition, a valuation report today most likely has future mortality improvements already built into the pension plan financial projections. And today, benefits often are designed to be more risk-averse and increasingly spread risk across a plan's stakeholders. Collectively, these changes are substantial when discussing the role pensions can and do play in not only providing retirement security for workers now and in the future, but also for the important role they play for employers and the economy.

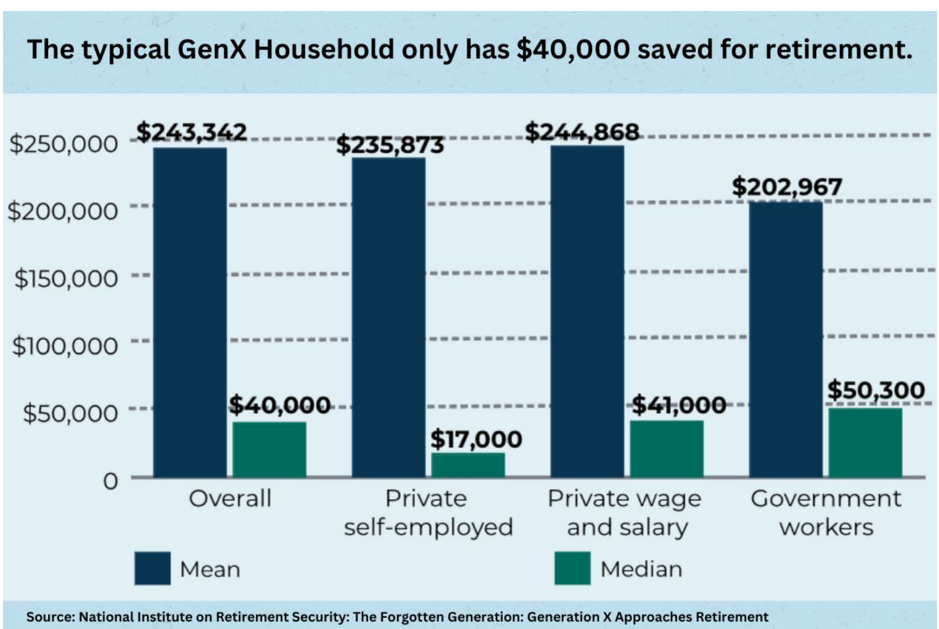
Most Americans Won't Have Enough Money for a Financially Secure Retirement, and They're Worried About It

Today, retirement security is out of reach for many Americans. The data indicate that most Americans, particularly middle-class workers, are falling far short when it comes to saving enough money for a financially secure retirement.

NIRS recently examined the retirement savings of Generation X, a generation that is quickly approaching retirement and the first generation to mostly enter the workforce following the shift from defined benefit (DB) pensions to 401(k)s and other defined contribution (DC) plans in the private sector.

For Gen Xers (those born between 1965 and 1980), the bottom half of earners have only a few thousand dollars saved for retirement. While the typical Gen X household has an average savings of more than $243,000, the median household has only $40,000 in retirement savings. This contrast is common in our research, as retirement savings are highly concentrated among the highest earners.[1]

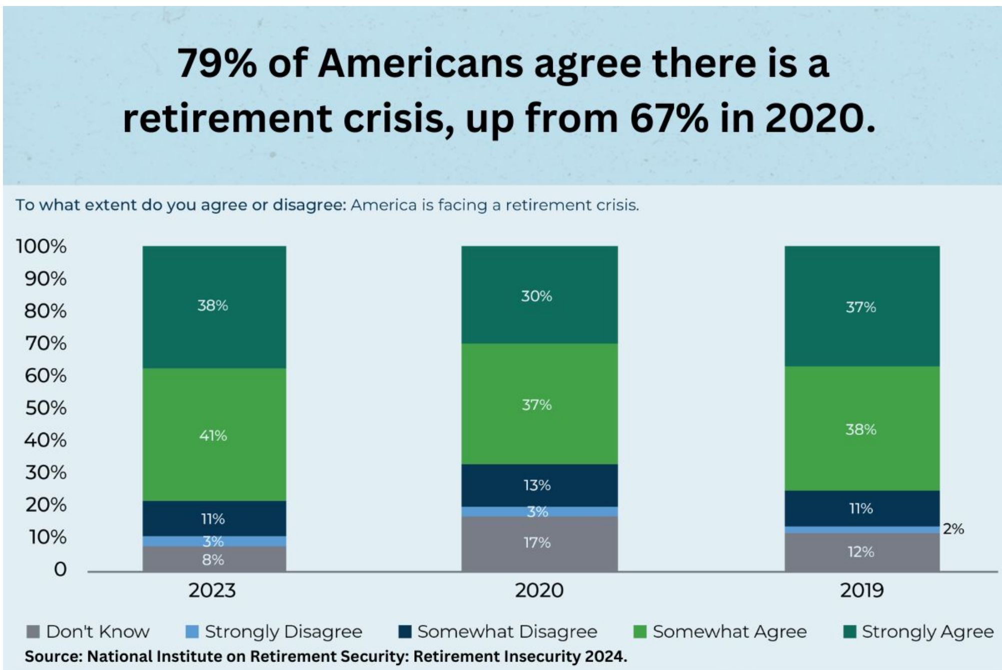
This means the vast majority of Gen Xers are not even close to having enough savings to retire, which isn't surprising given the terrible retirement hand that has been dealt to the latchkey generation. Most Gen Xers don't have a pension plan, they've lived through multiple economic crises, and wage growth lagged for many years during their careers. And the cost of retirement is growing.



More broadly, the National Retirement Risk Index finds that half of U.S. households will not be able to maintain their standard of living when they retire even if they were to work until age

65 and annuitize all financial assets.[2] Some estimates calculate that the median American household needs at least $470,000 more in their retirement account.[3] When Americans don't have enough money to sustain their standard of living, they are vulnerable to falling into poverty. This puts more pressure on strained public assistance programs, and it creates financial burdens for families that have to support older family members.[4]

NIRS research also finds that Americans understand the scope of the retirement crisis. A new national survey released yesterday finds Americans continue to have a high level of anxiety about retirement. When asked if the nation faces a retirement crisis, 79 percent of Americans agree there indeed is a retirement crisis, up from 67 percent in 2020. More than half of Americans (55 percent) are concerned that they cannot achieve financial security in retirement.[5]



The U.S. Lacks Universal Retirement Plan Coverage While Retirement Costs are Rising

Another problem when it comes to preparing for retirement is that retirement plan coverage is not universal in the U.S. Almost half of private sector employees ages 18 to 64, or 57 million Americans, do not have the option to save for retirement at work. This is important to note because a wide body of research finds that payroll deduction is the key to helping households build retirement savings and establish retirement security.[6] The share of Americans lacking workplace retirement plans has remained stubbornly high for decades, and it's a chronic impediment to financial security for far too many American workers.

Looking ahead, the burden of preparing for retirement is increasing as workers live longer, face large risks without risk pooling, and deal with rising costs. Escalating housing, healthcare, and long-term care costs in retirement are creating retirement obstacles for Americans. Unlike retirement income, where there are public, employer, and individual efforts to save, there are few systemic efforts to save resources for future long-term care costs, which can vary from fairly small amounts to hundreds of thousands of dollars. As such, public programs now pay for 71.4 percent of long-term care costs. This need is projected to increase even more as the Baby Boomers continue retiring.[7] Crucially, retirees often don't know if they will have no or low long-term care costs or if they will be among the unlucky few who have costs that reach six figures, which makes preparing for these costs challenging.

Compounding the challenges facing retirees, the number of Americans age 65 and older who are cost-burdened by housing costs has increased as more seniors are carrying mortgage debt into retirement. Healthcare costs continue to rise for all Americans, but these costs are higher for older Americans, who are more likely to have multiple chronic health conditions. Furthermore, lower-income seniors spend a greater proportion of their income on healthcare costs than their more affluent peers.

Meanwhile, the shift from pensions to 401(k) plans has pushed more retirement risk onto workers. While investment decisions can be made well, often, timing is everything. The difference between retiring and buying an annuity in 1999 and 2009 could not have been made up for with better asset allocations or investment decisions, as the external factors were simply so different. Unfortunately, we should expect more older workers to face involuntary retirement during bad economic times.

Pensions Are Critical for Rebuilding the American Dream of Retirement

Americans are best positioned to be self-sufficient in retirement when they have the so-called "three-legged retirement stool"– a defined benefit (DB) pension, individual savings in a 401(k)-style defined contribution (DC) plan, and Social Security. Over the past four decades, however, many private sector employers moved away from pensions following a change in the law, shifting workers to 401(k) accounts. It's important to note that 401(k)s were originally intended to supplement pensions and Social Security, and the low savings levels make it painfully clear that 401(k)s just can't do the job designed for a pension.

According to the *Wall Street Journal*:

> *"Many early backers of the 401(k) now say they have regrets about how their creation turned out despite its emergence as the dominant way most Americans save. Some say it wasn't designed to be a primary retirement tool and acknowledge they used forecasts that were too optimistic to sell the plan in its early days. Others say the proliferation of 401(k) plans has exposed workers to big drops in the stock market and high fees from Wall Street money managers while making it easier for companies to shed guaranteed retiree*

> *payouts. The great lie is that the 401(k) was capable of replacing the old system of pensions."* [8]

So, if we are serious about rebuilding retirement security for Americans, increasing pension coverage must be part of the retirement equation. And the ground indeed is shifting with respect to employers offering pensions, likely driven by several factors such as employers' desire to provide retirement benefits in the most cost effective manner, employees' desire for lifetime income, and the critical need to recruit and retain workers amid an increasingly tight labor market.

Last year, the UAW's negotiations with The Big Three Automakers called for a restoration of pension benefits. While only increases to 401(k)s were part of the final deal, the UAW has signaled it will continue to advocate for pensions. Also last year, IBM announced it would reopen its pension plan and end its 401(k) matching contributions. Starting in 2024, IBM is now funding a five percent credit to employees in a "Retirement Benefits Account." This new retirement offering is a cash balance plan, a type of pension the company will create within its legacy "frozen" pension plan. The return to pensions is expected to result in substantial cash savings for IBM, could help recruit and retain workers amid a competitive labor market, and offers employees the security of a guaranteed lifetime annuity in retirement.[9]

In the wake of the IBM announcement, there has been speculation that other companies could follow suit, especially as research finds there is a good business case for companies to re-open pension plans. A recent JP Morgan Asset Management study indicates that a well-funded corporate pension plan "offers the most cost-efficient mechanism to finance retirement benefits for employees" and can be "accretive to earnings while also reducing corporate leverage."[10] On the public sector side, the town council in Trumbull, Connecticut, recently voted unanimously to resume offering pensions to its police officers to address troubling workforce shortages after switching to a DC plan ten years ago.[11] In Alaska, policymakers on both sides of the aisle are pursuing a return to pensions for public employees as the state faces a deeply troubling shortage of employees who deliver essential public services.[12] West Virginia closed its pension plan for teachers in 1991, only to re-open it in 2005. Overall, the few states that switched from a pension to a DC plan found that costs rose, negative cash flow grew, and employee turnover increased.[13]

Importantly, Americans have a highly favorable view of pensions. More than three-fourths of Americans have a favorable view of pensions, while 77 percent agree that the disappearance of pensions makes it harder to achieve the American Dream. Eighty-three percent of Americans say that all workers should have a pension so they can be independent and self-reliant in retirement.[14]

Our Savings-Based Systems Require Too Much of Individuals

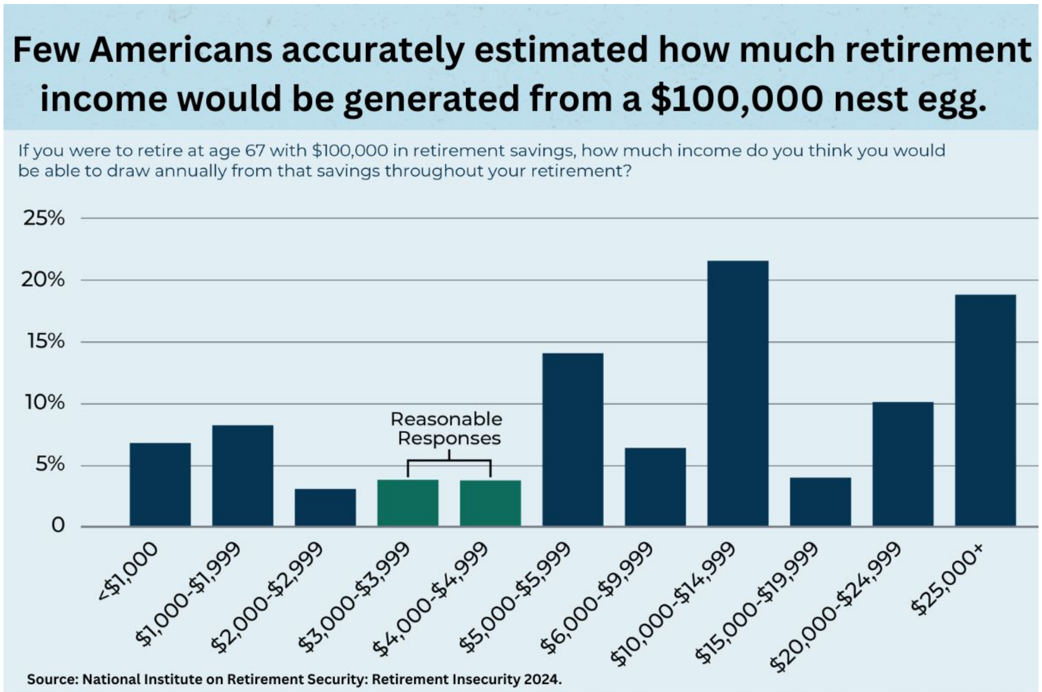
It's important to note that individualized 401(k)s were never intended to replace pensions – they were meant to be a supplemental vehicle. We're expecting 401(k)s to do a job they weren't designed for. Moreover, all the risk is shifted onto employees. An individualized system requires a great deal of financial knowledge and significant effort by employees from the start of their career and throughout their life.

For an individual to plan for their retirement, one must estimate the needed income, convert to a dollar amount, and plan a savings rate to hit that amount. Additionally, post-retirement years can bring the biggest and inefficiencies challenges, as retirees must ensure they spend down their nest egg at the right rate so it doesn't run out.

As detailed in the new NIRS public opinion research report, we asked Americans how much retirement income they believed they could get from $100,000 of savings at retirement. The responses were alarming.

If one applies the four percent rule, a $100,000 nest egg would produce about $4000 of income in the first year of retirement and then increased by inflation each subsequent year. But the research finds that only eight percent of respondents indicated that $100,000 in savings would generate $3000 to $4,999 annually in income throughout their retirement starting at age 67.

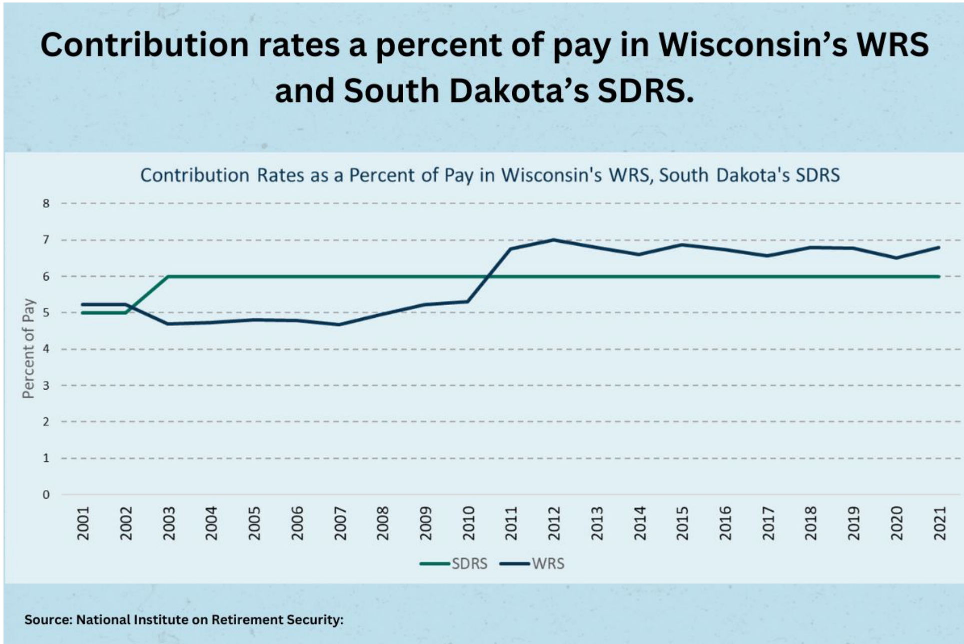
Most respondents wildly overestimated the level of income that could be produced from that $100,00 nest egg. Nineteen percent indicated that sum would produce $25,000 or more while 21 percent thought it would generate $10,000 - $14,999 in annual income through retirement. The data suggests that Americans largely are unaware of how much they need to save to produce a desired level of retirement income.



The Range of Pension Plan Benefit Designs Continues to Grow, With More Focus on Risk-Management

Many assume that all pension plans have similar benefit designs. Nothing could be further from the reality that exists today.

In the public sector, two pension plans often are highlighted because they deliver stable costs for employers, while providing reliable benefits for members: the Wisconsin Retirement System (WRS) and the South Dakota Retirement System (SDRS). As noted in the chart below, contributions have been remarkably stable through very volatile years.



These results were achieved through good management, but also a flexible benefit design that provides higher post-retirement benefit adjustments when the plan is healthy and adjusts when markets cause the plan's funding level to drop.

Given the cost stability throughout the Great Recession, many other plans have begun to adopt similar provisions. And, it would be reasonable for a private employer that is interested in pensions, but leery of financial risk, to study these examples.

When private employers began eliminating cost-of-living adjustments (COLAs), they cut the cost of benefits. But they also eliminated one of the best tools for designing a pension that has more stable costs. A contingent COLA benefit can mean that the guaranteed benefit is 20-33 percent less than what is being planned for, which creates a large risk buffer.

It is also notable that both the WRS and SDRS pension plans have provided post-retirement increases in most years, with the WRS averaging 2.93 percent increases since 1990. And the SDRS has provided increases that averaged 2.33 percent since 2014. So, flexibility does not have to accompany benefit inadequacy.

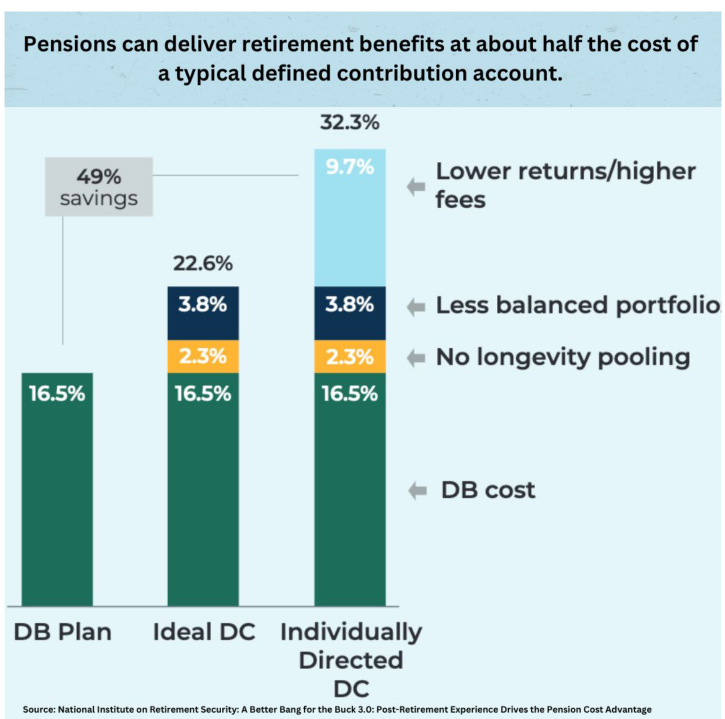
Pensions Are the Most Cost-Efficient Way to Deliver Retirement Security

Pensions are critical to retirement security because they are designed to provide *lifetime retirement income* with minimal effort from employees. Pension assets are pooled, and investments are managed by professionals who are required to act in the best interest of the retirement plan participants. At retirement, employees with a pension receive a predictable monthly paycheck for life.

For workers lacking a pension, retirement is more complex and expensive when relying on a 401(k) savings account. Rather than retirement income guarantees, DC plans are designed to accumulate *retirement savings*. Individuals bear the full responsibility for saving, making investment decisions, and determining how to spend down their savings at just the right rate. Research indicates that all of these tasks are complex for individuals, especially spending down savings. Retirees can draw down funds too quickly and risk running out of money. Or, retirees can hold on to funds too tightly resulting in a lower standard of living in retirement.

Another issue associated with DC plans is modifying investments over time. Retirement experts typically advise younger individuals in 401(k) plans to have a larger portion of their savings invested in stocks, which usually have higher returns but also greater risks. As one gets closer to retirement, experts often suggest moving savings away from stocks into safer, lower return assets like bonds. This shift helps guard against a large drop in retirement savings near and at retirement. But this loss of investment returns makes retirement all the more expensive.

Importantly, a typical pension is substantially more cost-efficient than a typical DC account, providing the same retirement benefit as a 401(k)-style account at about half the cost. Or, said another way, to achieve a target retirement benefit that replaces 54 percent of an individual's final salary, a pension plan requires contributions equal to 16.5 percent of payroll. In contrast, an individually directed DC account requires contributions almost twice as high as the pension plan, at 32.3 percent of payroll.[15]



Our analysis finds there are three primary reasons behind pension plans' substantial cost advantage over DC accounts.

- First, pensions pool longevity risks across a large number of individuals. The pooling of longevity risk enables DB pension plans to fund benefits based on average life expectancy and pay each worker monthly income no matter how long they live. In contrast, DC plan participants must have excess contributions saved in the event they live longer than the average life expectancy. This is important because saving and spending down savings in an individual account looks very different if a person lives to age 70 versus 100.

- Second, pensions have higher investment returns as compared to individually directed DC plans. Defined benefit pensions have higher net investment returns due to professional management, along with lower fees stemming from economies of scale.

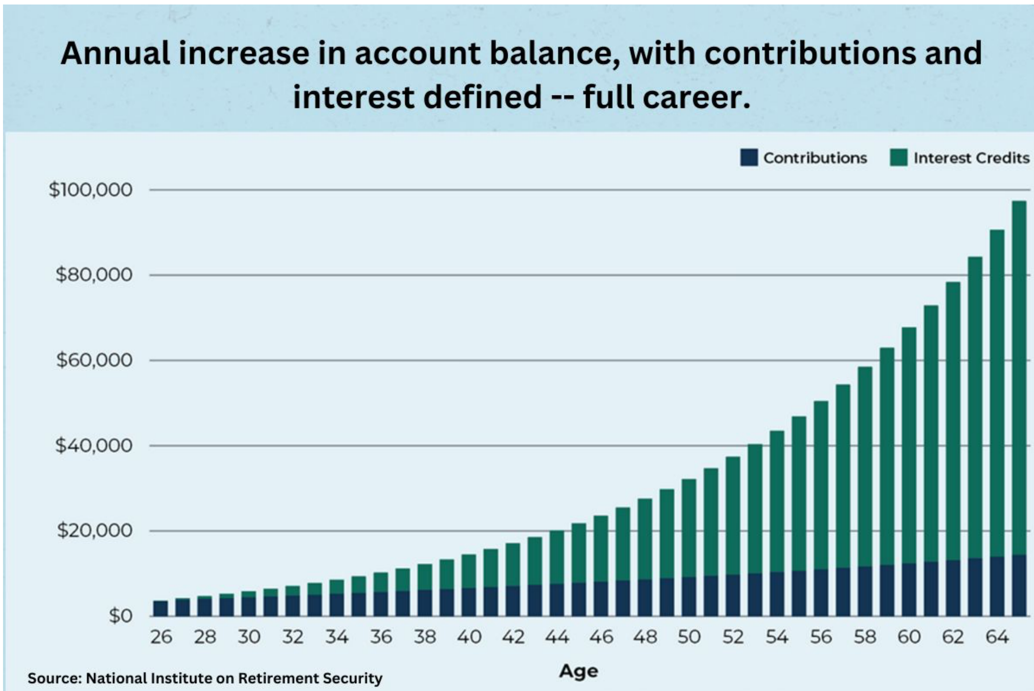
- Third, pensions have optimally balanced investment portfolios. Pensions are "ageless" and therefore can perpetually maintain an optimally balanced investment portfolio rather than the typical individual strategy of down-shifting over time to a lower risk/return asset allocation. This means that over a lifetime, pensions earn higher investment returns as compared to DC accounts.

To be fair, 401(k)-style DC plans have improved significantly since this issue was first examined in 2008, especially when it comes to fees, investment options, and investor behavior. For example, investment fees within employer-provided plans have been cut by about half since 2000. And there is a growing use of auto-enrollment, auto-escalation, and target date funds to help address individual investor missteps on investments and asset allocation. Additionally, annuities continue to garner interest among policymakers as a means to convert DC account balances into a lifetime income stream within employer plans.

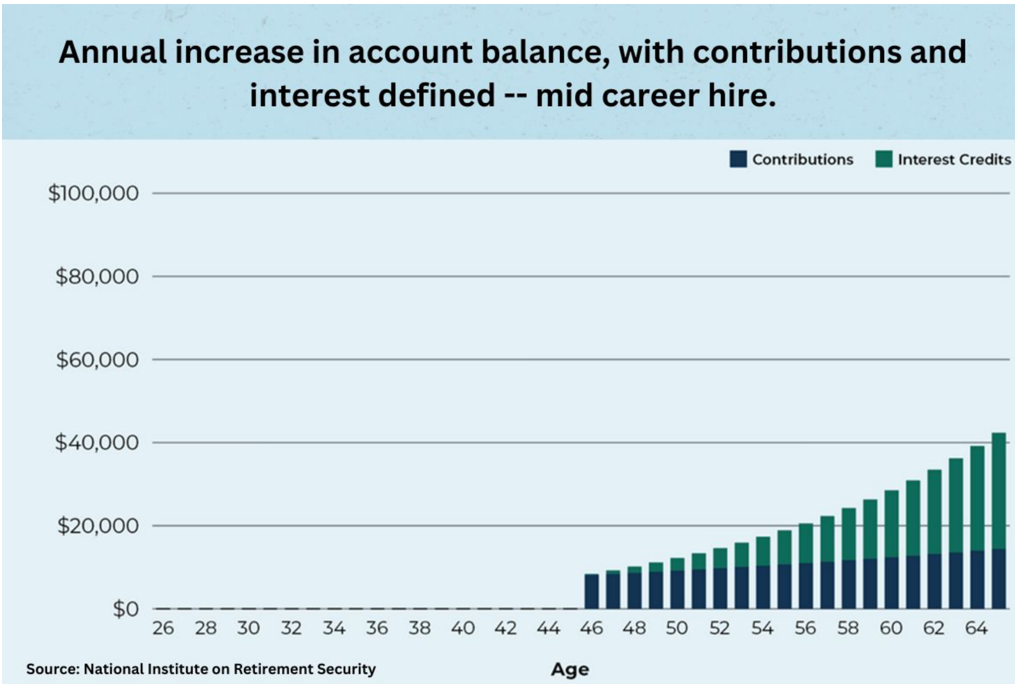
But even with these improvements, 401(k) accounts just can't replicate the efficiencies that are embedded in the very structure of pension plans. When NIRS most recently examined the differences in economic efficiency between these two plan types, we explained how four-fifths of the inefficiency occurs after retirement. Defined contribution plans can be effective vehicles for accumulating savings, but they provide no means for transforming savings into income today, what economists call the "decumulation phase" of saving. Additionally, individual savers typically exit a wholesale, employer-provided plan at retirement and instead face a more expensive retail environment for attempting to turn those savings into income. This post-retirement inefficiency should not go unappreciated when considering the value that pension plans offer to working people.

To complicate matters even more, too often, in a fully voluntary system, workers don't start participating and saving until mid-career. This impacts their account balance growth in later years, as well.

Account balance growth by year, if savings starts at age 25, with contributions and interest broken out.



Account balance growth by year, if savings starts at age 40, with contributions and interest broken out.



As the chart above shows, the total account balance growth is far lower when starting savings at a later age, simply because of the loss of time for compounding growth. A late start to saving has an extremely negative impact on the efficiency of retirement saving, as workers get less of a subsidy from investment growth.

A NIRS report, *The Hybrid Handbook,* notes that "the increase in DC account balances during the last year of the full career in the example is $97,395 (in 2061 dollars). However, by looking at the late start scenario, it is evident that more than $55,000 of that increase is due to contributions made during the first 20 years of work."[16]

Increased use of auto-enrollment will help on this front, but with only half of workers participating in workplace plans, there likely will be poor overall results into the future. And, this ignores the fact that "41.4% cashed out at least part of their 401(k)s when leaving a job – and 85% of those drained their balance entirely," which further erodes their retirement security.[17]

Pensions Also Provide Big Benefits to the U.S. Economy and Employers

Pension plans also strengthen the economy as a whole. The spending of pension benefits by retirees, referred to as "Pensionomics," has a reliable economic impact that supports economic growth and jobs in virtually every community across America, especially in rural areas. Additionally, this spending is countercyclical and continues even when the economy faces a downturn, which provides a source of sustained consumer spending during difficult economic times.

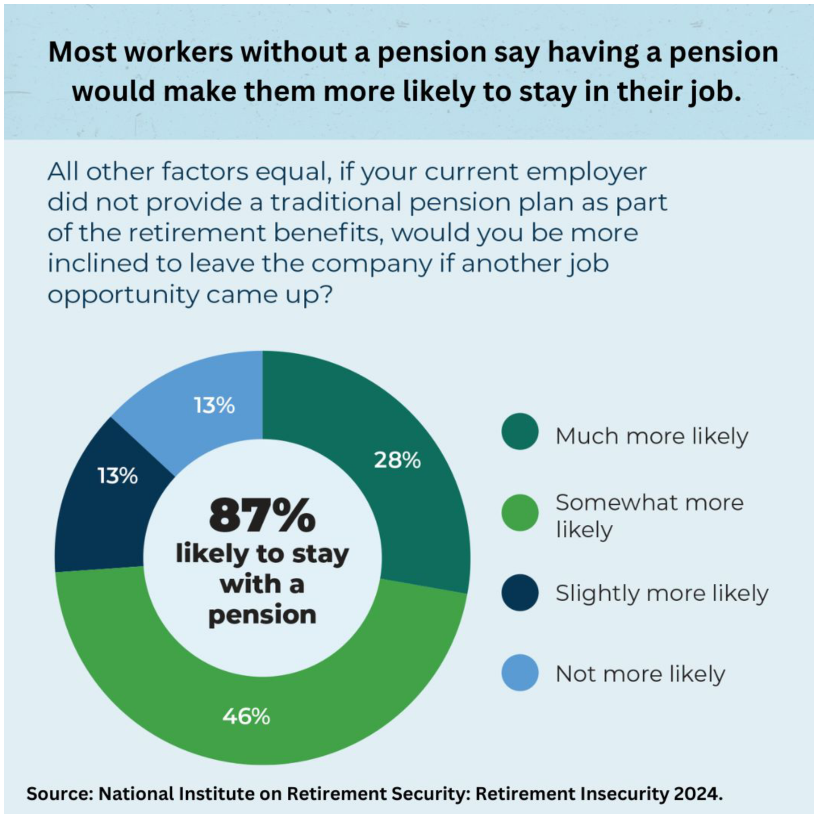
Today, nearly 25 million retired Americans and their beneficiaries in the public and private sectors receive a pension. Retirees spend that pension income on their daily needs – on goods and services like housing, medicine, utilities, transportation, food, clothing, and entertainment. And the numbers are large.

More specifically, retiree spending of public and private sector pension benefits in 2020 generated $1.3 trillion in total economic output, supporting nearly 6.8 million jobs across the nation. Also important is the tax revenue generated from pension spending. This tax revenue comes from two major sources: taxes paid by beneficiaries directly on their pension benefits and taxes from expenditures in the local economy, like sales tax on retail purchases. In 2020, pension spending added nearly $157.7 billion to government coffers at the federal, state, and local levels.[18]

Additionally, pensions provide benefits to employers. In a tight labor market, pensions can be an important tool to help recruit and retain workers. The aforementioned JP Morgan Asset Management report noted that 40 percent of private sector employees who separated from their employer during the Great Resignation cited inadequate benefit packages as a motivating factor in their decision to seek another job. Additionally, 85 percent of younger workers said that receiving a fixed, lifetime, monthly benefit at retirement is a priority.[19]

In fact, the new NIRS opinion research details workers' views on the recruitment and retention impact of pensions. We asked workers to imagine they are evaluating two new job opportunities. Both jobs are similar in all aspects (such as pay, type of work, etc.) except for one. Job A offers employees a traditional pension plan as part of the retirement benefits, and Job B offers a retirement savings plan like a 401(k). More than half (57 percent) said they are more likely to choose the job that offers a pension.

Even more striking is the retention impact of pensions. NIRS asked workers if their current employer offered a pension, would they be more likely to stay at the company longer even if another job opportunity arose. Ninety percent of workers with a pension say that a pension benefit makes them more likely to stay in their job even if another job opportunity were to come up. The results were similar for workers without pensions. The vast majority of workers (87 percent) without a pension say they'd be more likely to stay at the company longer even if another job opportunity came along if their current employer provided a pension.[20]



And as mentioned earlier, pensions are cost efficient and can contribute value to the balance sheet, and surpluses can be preserved to support future benefit costs. Pensions also can help create orderly retirement trends, which helps companies manage their workforce. If companies give pensions a fresh look and consider today's economy and workforce conditions, they may just rediscover pensions as a tool that can suit workers' needs, help attract and retain top talent, and improve the corporate bottom line.

Policy Solutions That Could Facilitate a Pension Renaissance

Below are key issues that could be addressed to help employers offer or manage a pension plan.

Discount Rate

The Pension Protection Act (PPA) of 2006 ushered in a new era of pension funding. The law required pensions to be funded using a discount rate that was tied to short-term market conditions that proved to be highly volatile. In response, there have been numerous changes that followed which provided relief and adjustments to the methodology. Relief was certainly reasonable, as the moving target under PPA proved impractical.

In general, it makes sense for Congress to prefer a discount rate that leans towards precaution, especially as it considers PBGC's financial health. However, discount rate volatility frustrates the effort to remain at or near full funding and makes pensions less attractive to employers. For instance, Moody's Seasoned Aaa Corporate bond yields drifted from eight percent to nearly two percent, then rebounded to 4.87 percent more recently. Utilizing a longer-term average (25 years) of interest rates has been a significant improvement.

Funding Practices

There is a tradeoff between assuring that tax-advantaged pension contributions are used for intended purposes and encouraging conservative funding practices that keep plans stable throughout the business cycle.

One of the simplest ways to keep pension costs stable is to simply contribute more than the expected long-term costs, particularly during favorable environments. Thus, when markets shift, the plan has a cushion and costs do not need to rise significantly. However, given the variables that sponsors face, employers often worry that a rise in interest rates or markets could leave capital stranded in an overfunded plan. This situation may also look very different in companies with growing or shrinking payrolls.

Today, Section 420 of the Internal Revenue Code transfers allow some overfunded pension assets to be used for health care costs. But, as mentioned above, most long-term care costs are paid by public programs. So, it might be worthwhile to consider allowing excess tax-advantaged pension assets to be similarly transferred to programs for employees' long-term care. Striking the optimal balance is not easy, but flexibility should be a priority as this committee thinks about excise tax policies.

Risk Sharing Plans

Congress should continue keeping an open mind about pension plan designs that have various forms of risk-sharing or risk-management provisions.

As mentioned above, there are examples in the public sector where DB plans provided adequate benefits, plans remained well-funded, and employers enjoyed stable costs, even during challenging economic circumstances. Risk sharing provisions played a role in those efforts.

It is clear that pensions improve retention for employers, which is a significant benefit. But more examples of plans that weather the business cycle in a healthy manner may be the best way to counter the conventional wisdom among corporate executives.

Such plan designs should also offer financial benefits to the Pension Benefit Guaranty Corporation's (PBGC) fiscal health.

PBGC Premiums

Employer decisions to derisk continue to be driven by PBGC per capita premiums. Given the structure of premiums, it is often the less expensive benefits that are targeted for buyouts. The more this happens, the more risk the PBGC will be insuring per capita.

These decisions are logical from the employer's point of view, but counterproductive on a systemic level. If the single-employer program can remain viable with lower premiums, it would reduce the incentive for employers to shed low-value benefits.

Conclusion

While Congress has taken steps to improve Americans' retirement prospects, much work remains to ensure Americans can be self-sufficient in their elder years. The vast majority of middle-class workers are not on track, with the National Retirement Risk Index finding that half of U.S. households will not be able to maintain their standard of living when they retire even if they were to work up until age 65 and annuitize all financial assets.

For Generation X, a generation that is quickly approaching retirement, the bottom half of earners have only a few thousand dollars saved for retirement. This means the vast majority of Gen Xers are not even close to having enough savings to retire. And when Americans don't have adequate retirement income, they are more likely to fall into poverty or turn to public assistance programs or families to make ends meet.

The move away from pensions is a major culprit in the nation's retirement crisis. While 401(k) plans are an important part of the retirement equation, they just weren't designed to replace pensions.

So, if we are serious about rebuilding retirement security for Americans, increasing pension coverage must be part of the solution. Pensions not only provide reliable lifetime income for employees, they are economically efficient, they provide workforce benefits to employers, and they provide substantial economic impacts to communities across the nation, especially rural areas.

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