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Testimony of Aaron Friedman
Before the Connecticut Retirement Security Board
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INTRODUCTION

Good Afternoon. My name is Aaron Friedman, and I am an Assistant Vice President at Principal Financial Group, where, among other things, I serve as the National Practice Leader for retirement plans for tax-exempt organizations. I have lived in Trumbull, Connecticut for the last 23 years, and I work in Shelton. My background and experience includes 28 years in industry with expertise as an actuary, a consultant around retirement plan design and operation consistent with the tax code and ERISA, as well as product and investment design and compliance. I am here on behalf of the Securities Industry and Financial Markets Association (SIFMA), a national trade association which represents hundreds of securities firms, banks and asset managers, including Principal Financial Group.

I appreciate the opportunity to appear before you today. I hope you have had a chance to review SIFMA's fairly detailed written response to your request for public comment. I would like to highlight a couple key points in that document and then spend the rest of my allotted time speaking specifically about investments.

We would all agree that there is a retirement savings challenge in this country today. Individuals need to save more for retirement and need to better understand the benefits of compounding interest, diversification, and not accessing retirement savings accounts for other purposes. Where we might disagree is how best to meet that challenge.

SIFMA strongly feels that the existing private market is well suited to address the retirement needs of investors. And we are all aware of and support the new federal retirement program created by President Obama known as myRA (My Retirement Account). This payroll deduction program, which will be rolled out in late 2014, is described as a "simple, safe, affordable" way to save for retirement. It is backed by the U.S. Government, has Roth IRA tax advantages, and is portable for employees. Information can be found on the U.S. Treasury website at www.treasurydirect.gov/readysavegrow/readysavegrow.htm. We would encourage you to fully evaluate this new <u>federal</u> program before creating an expensive <u>state</u> alternative. Furthermore, SIFMA supports additional tax incentives to encourage more employers to provide retirement savings plans as well as possible public/private partnerships to highlight existing low-cost retirement savings options.

INVESTMENTS - ACCESS

The market for retirement savings alternatives in Connecticut is robust and highly competitive. There are currently 25,833 individuals in Connecticut working in the securities industry and a total of 114,325 people in the State employed by entities falling within the broader category of finance and insurance. These industries all provide numerous fairly priced retirement savings options, including 401(k), 403(b), 401(a), and 457(b) plans as well as SIMPLE, SEP and traditional and Roth IRAs. In fact, earlier this year, ThinkAdvisor rated Connecticut as the #1 state for 401k(s) in the country based on its concentration of strong plans, with plans measured on their design, management and performance. In addition, for those without an employer option, IRAs are also readily available on-line and at most financial institutions in the State.

With plenty of low cost savings options available, access is not the problem. The question then becomes, <u>what factors other than access may be preventing workers from saving for retirement?</u> Certainly, educating people about the importance of saving for retirement would encourage those who have the resources but haven't prioritized the issue. A study from the Investment Company Institute, however, shows the primary reason that people don't save is competing financial needs. (*ICI Research Perspective Volume 17, No 7., October 2011*) If lack of resources is the fundamental issue, then a new retirement system with an employee opt-out capability, however well-intentioned, will not address the problem.

It is also critically important that any proposal does not encourage employers with strong existing plans to switch over to the State provided alternative. The State is looking to enhance, not reduce, retirement savings. Offering options that encourage employers that are already providing retirement plans to re-evaluate their offerings does not satisfy that objective.

INVESTMENTS – OBJECTIVES AND OTHER CONSIDERATIONS

In order to discuss investments, it is first important that we start with a context. Investments and investment products do not exist in a vacuum, but serve to meet specific needs and achieve particular objectives. The fact of the matter is that different people with different levels of income, financial sophistication, and different time horizons will all have different objectives and different needs from their investments.

<u>The question of retirement adequacy and savings rates:</u>

As we look to identify the needs that have to be satisfied, it is paramount that we acknowledge the tremendous cost of retirement savings. The RFI asks for recommendations on default contribution rates, but that avoids the critical questions of <u>what level of retirement income is the Board trying to achieve and over what time frame?</u> Some examples might help the discussion.

Examples:

Annual Contribution Rate	Annual Return	Income Replacement Ratio for a Person in the system 40 years	Income Replacement Ratio for a Person in the system 20 years
3%	3%	approx. 10%	< 5%
6%	3%	approx. 20%	<9%
6%	6%	approx. 40%	11-12%

These projections are done assuming 1.5% average wage increase and individual annuity purchase rates. Assumptions could be changed, but they will not significantly change the magnitude of the results.

I note that the Center for Retirement Research at Boston College has gone as far as to say the savings rate should be 14% of income over a career. Contribution rate is important over a career, but even more important is the effect of compounding higher returns over a career. This is essential to getting to successful income replacement rates. An important thing to note – to generate higher returns you must take on higher market risks.

Challenges

1. It may not be appropriate to take on those levels of risk for individuals with shorter time horizons. They might not have the time to recover from inevitable market downturns.

2. Not everyone has the same level of risk tolerance. Even those with longer time horizons may have different risk tolerances and needs.

In the world of investing, investments must be suitable to individuals' needs and risk tolerances. There are significant regulations to ensure that investments are suitable to the investor's needs, objectives and risk tolerance. **One size does NOT fit all.**

Variations in the market

There is a great deal of variation in product structure to satisfy the needs, objectives and risks tolerances in a diverse population. They range from insurance company guarantees to balanced target date funds that become more conservative over time to aggressive portfolios that allow individuals to balance their own risk tolerances against potential returns. Investment styles can be active or passive, or a combination. Because of this variation and diversity, it is essential that there are resources to help. The resources include:

- Online tools
- Telephonic support
- Access to financial professionals that can help navigate the options.

INVESTMENT - PRODUCTS

To a large extent, specific products and product types are tied to the legal structure of the plan. For example, there are different products that can be offered to plans qualified under section 401(a) of the internal revenue code that cannot be offered to IRAs.

SIFMA believes the only way to address the diverse needs, objectives and risk tolerances of a diverse population is to <u>provide a diverse set of options for individuals which would be suitable to their needs</u>**.** There must also be resources available to help individuals navigate the complexity. There are several categories that should be taken into account.

1. <u>Stable Value.</u> A typical stable value fund is a conservative bond portfolio that seeks conservation of principal that is complemented with insurance contracts that allow market fluctuations to be smoothed out over time. A stable value fund is only available to 401(a) plans and government 457 plans. Due to rules under the Securities Act of 1933, they are not available to IRAs. These tend to be used by those with short investment timelines or those that are risk averse.

2. <u>Insurance Company Guaranteed Contracts/Annuities.</u> These are also used by those with short investment time horizons or those that are risk averse. In these products, the insurance company guarantees principal and a rate of interest and takes on all of the risk. Individuals do not see any market fluctuation. These products can be used with IRAs.

3. <u>Indexed Annuities.</u> These are technically fixed annuities that buy options on the stock market so have the potential for gain above the minimum guarantee. It is important to understand that these do not “insure” the stock market. Although these are suitable in some cases, they tend to be expensive and securities regulators have paid a great deal of attention to ensuring they are not misused.

4. <u>Target Date Funds.</u> These are balanced portfolios of both stocks and bonds that are managed with a higher allocation to stocks in early years and gradually introduce more conservative bonds over time as it gets closer to the targeted “retirement date”.

5. <u>Target Risk Funds.</u> These are a mix of stocks and bonds that are targeted to an individual’s tolerance for risk. They do not change the allocation over time.

6. <u>A general mix of funds with different investment objectives</u>. This is necessary for individuals that want to customize their investment portfolio by themselves or in conjunction with a financial professional.

7. <u>Active versus Passive strategies.</u> It is appropriate to include both active and passive strategies. While this is a topic that has been debated for many years, the fact is that both strategies have advantages and disadvantages, and options need to be available to meet the preferences of individuals.

LEGAL CONSIDERATIONS

ERISA considerations

1. It is extremely important that the ERISA applicability question be addressed early in the Board's review process. The US Department of Labor is the regulator responsible for enforcement. The SIFMA comment letter provides the appropriate questions to ask formally of the Department of Labor. We would encourage you to look closely at a 2012 Advisory Opinion to Governor Malloy which found that an ERISA exemption for governmental plans does not apply when the plan participants are not government employees. The ERISA decision, of course, has a significant impact on cost and liability.

2. In addition, with respect to risk management, ERISA has played a positive role in protecting plan participants in ERISA-covered plans. ERISA sets forth many requirements regarding prudence and risk management, including making timely contributions, mapping and defaulting investment options, analyzing and understanding plan expenses, reporting, and more. We would suggest the Board adopt a risk management structure consistent with ERISA regardless of DOL's determination on ERISA applicability. Liability and risk - for the state and for participants - do not disappear in the event that the plan is deemed ERISA exempt.

Securities considerations

1. In the event that the Board is considering that the state will manage investments, SIFMA recommends that this Board vet the requirements for registration under the Federal Securities Act of 1933 and the Investment Company Act of 1940. Any discussion of the cost of investment management would change significantly with the addition of registration and compliance costs.

2. Whether the plan's investments are managed by the state or existing market products are used, the Board should vet the requirements of the Federal Securities Exchange Act of 1934 which applies rules to those acting as a broker/dealer, including the suitability requirements mentioned earlier.

3. The Board should also vet the state securities laws of neighboring states to ensure there will be no violations on behalf of commuters from those states.

This Board has a very important task ahead of it. I'm confident when you review the facts, the real hurdles to savings and the robust offerings that already exist in the marketplace, that the Board will make responsible recommendations. I appreciate the opportunity to provide feedback, and I look forward to your questions.