

Written Testimony of Aron Szapiro  
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Health, Employment, Labor, and Pensions Subcommittee  
House Committee on Education and Labor  
"Improving Retirement Security and Access to Mental Health Benefits"  
March 1, 2022

Chairman DeSaulnier, Ranking Member Allen, and members of the subcommittee. Thank you for this opportunity to appear before you to discuss ways to improve the U.S. retirement system.

My name is Aron Szapiro, head of retirement studies and public policy at Morningstar, Inc. and Morningstar Investment Management LLC. I also lead our Center for Retirement and Policy Studies, which released new research this week addressing some of the issues we are discussing at this markup today, and which I have included in this written testimony.<sup>1</sup>

There are several important policy changes before the committee today. I will start with a discussion on clarifying how plan sponsors should use environmental, social, and governance, or ESG, information when selecting investments for their retirement plans. As requested, I am also covering two additional important issues: 1) fee disclosures and 2) provisions to expand access to lifetime income products in employer-based plans.

Morningstar's mission is to empower investor success. I bring several perspectives from across Morningstar to this testimony. We offer a variety of services to retirement plan sponsors and participants, including fiduciary services and managed accounts. So, I bring the perspectives of my colleagues who work every day to help investors reach their retirement goals. Morningstar also has specific expertise in ESG analysis, and I have gathered our views on some of the ESG issues in this testimony from financial professionals across our organization. First, we categorize and rate different pooled investments such as mutual funds based on their ESG attributes, and we also identify funds in our database that claim ESG or sustainable investing is core to their investment approach. Second, our equity analysts use ESG analysis as part of their approach to assessing investments. Finally, our Sustainalytics division is a leading provider of ESG ratings and data.

## 1. ESG Information and Selecting Investments for Retirement Plans

### **Evaluating Long-Term Risks, Including ESG Risks, Is Fundamental to Investing**

Proposals to encourage plan sponsors to consider ESG information as part of a prudent process for selecting plan investments, such as the Department of Labor's proposed regulation "Prudence and

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<sup>1</sup> Please see <https://www.morningstar.com/lp/retirement-plan-landscape> to download the full report.

Loyalty in Selecting Plan Investments and Exercising Shareholder Rights," are consistent with common practices that asset managers use to integrate ESG considerations into their investment processes and selections.

ESG risk analysis can be part of any prudent investment analysis—and should not be called out for special, unique scrutiny. Indeed, many asset managers view ESG risk as a pecuniary matter that is fundamental to evaluating the likely risk-adjusted performance of an investment.

This view has become widespread in the past decade, and especially the past five years, as ESG issues are increasingly seen as potentially material to the performance of an investment and as more-robust ESG data and analytics have become available, allowing asset managers greater insight into material ESG issues.

To provide a specific example, many firms have some financially material amount of exposure to climate risk. Those without a plan to transition away from fossil fuels or with physical assets vulnerable to severe weather risk may be caught flat-footed in the face of new regulation or environmental realities.

Or, to take another example, companies with poor human capital management may find it not only difficult to retain the talent they need to remain competitive, but they also could face regulatory risks and reputational risks from customers.

Beyond managing ESG risks, many participants want investment options that align with their personal values, especially around many sustainability-related issues. To the extent that plans can offer options that support these values without sacrificing risk-adjusted returns—and over the past half-decade data shows many sustainably-oriented funds performed well—such investment alternatives could encourage people to save, or save more, for retirement, furthering the overall goal of enhancing U.S. retirement security.<sup>2</sup> While professionals often focus on returns, encouraging more contributions is also an important way to help workers build sufficient retirement savings. Offering appealing investment options may encourage people to save; Congress should enable plans to offer such options.

### **Defined-Contribution Plans Sometimes Offer Sustainable Options, but Plan Investments Take on High Levels of ESG Risk**

Plan sponsors appear to have shied away from considering ESG information and analysis, in part because of regulatory uncertainty.

In doing so, sponsors have left the U.S. defined-contribution system in the aggregate tilted toward investments with more ESG risks. Unless retirement plan sponsors are convinced that ESG risks are overstated, they may wish to re-examine their investment choices using an ESG lens.

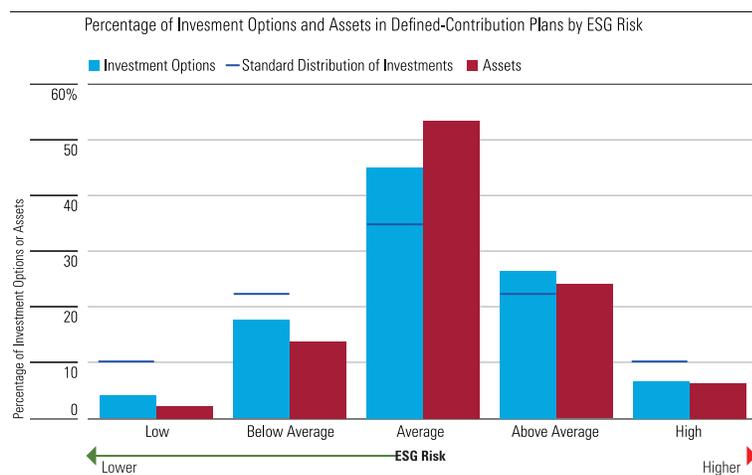
The evidence that defined-contribution plans are often not helping their participants avoid ESG risks comes from an analysis of ESG risk in defined-contribution plan investment options. The ESG Risk Rating is a measure developed by Morningstar's Sustainalytics division, which seeks to capture the degree to

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<sup>2</sup> Stankiewicz, A. January 2022. "Sustainable Funds U.S. Landscape Report: Another Year for Broken Records." Morningstar Manager Research. <https://www.morningstar.com/lp/sustainable-funds-landscape-report>. The report finds that slightly more than half of sustainable funds finished in the top half of their Morningstar Category, led by equity funds.

which companies fail to manage environmental, social, and governance risks, potentially imperiling their long-term economic value. Exhibit 1 shows that U.S. retirement plans offer investment options that are more likely to have higher ESG risk compared with the overall distribution of ESG risk in investments that Morningstar rates. The exhibit measures the percentage of assets that are in the various categories of ESG risk assigned by the Morningstar® Sustainability Rating™ for funds, or globe rating. On an asset-weighted basis, plan participants generally do not invest in strategies with low levels of ESG risk. Specifically, just 4% of investment options and 2% of assets are in strategies with the lowest level of ESG risk, but 10% of all strategies rated by Morningstar are in this category.

Exhibit 1: Percentage of Investment Options and Assets in Defined-Contribution Plans by ESG Risk



Source: Morningstar investment data matched with Form 5500 data for 2019 and the Morningstar® Sustainability Rating™

As many as 48% of retirement plans with at least 100 participants already offer investment strategies that use ESG analysis to evaluate investments, but most of these do so in a limited way. (In a recent comment letter to DOL, Morningstar identified 36% of plans as having ESG investment options, and we have since expanded our ability to identify investments on Form 5500.)

Although the department identifies 9% of plans using ESG strategies as a best guess in the regulatory impact analysis, I believe the true number is quite a bit higher, at least among plans with more than 100 participants. Part of the difference in estimates may result from using different definitions for an ESG fund. I begin the analysis by generating a list of funds that as of 2019 used Morningstar's broadest definition of ESG, which includes any fund with a prospectus that references considering ESG information for selecting securities. I then match those funds to data in the publicly available the 2019 Form 5500, which results in the finding that 48% of plans with more than 100 participants offered at least one fund with an ESG component. I believe this percentage is almost certainly higher today as funds increasingly reference ESG analysis in their prospectuses.

Morningstar's data team has refined this definition, and as I get 2020 and 2021 defined-contribution plan filings, I will be better able to separate funds that have a clear commitment to ESG analysis from those that do not.

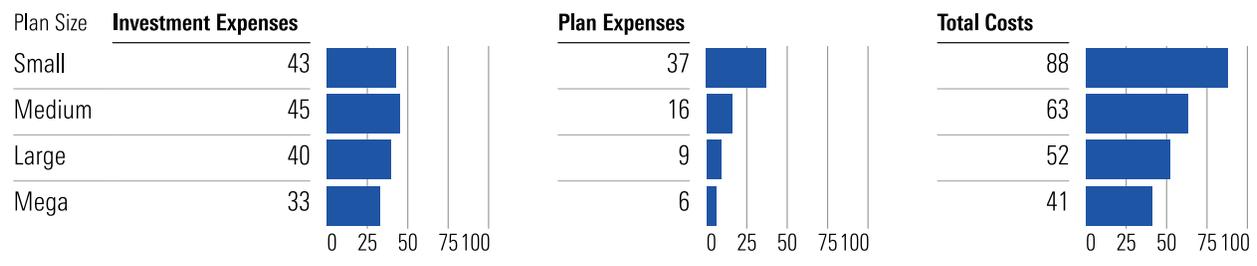
## 2. Fees Vary Widely Across Plans, Highlighting the Importance of Clear Disclosures for Participants, Plan Sponsors, Third-Party Benchmark Providers, and the Employee Benefits Security Administration

Morningstar has long advocated for increased fee transparency into retirement plan lineups. Proposals to require a review of the investment lineup fee disclosures (also called 404(a)5 disclosures) to plan participants are important, as participants do not always understand the fees they pay.<sup>3</sup> Congress could also consider reviewing publicly available fee disclosures on Form 5500, which could help plan sponsors, regulators, and third-party benchmark providers better educate plan sponsors about whether the fees in their lineup are reasonable.

### Participants at the Largest Plans Pay About Half as Much as Those Working for Employers With Small Plans, Imperiling Their Retirement Goals

The larger the plan, the less expensive it is likely to be for its participants to invest for retirement, as illustrated in Exhibit 2. I examine the asset-weighted expenses associated with the plan investments, the overall plan administration expenses, and the total cost, which is the sum of both these numbers on a plan-by-plan basis.

**Exhibit 2: Median 2019 Defined-Contribution Total Costs by Plan Size (in Basis Points)**



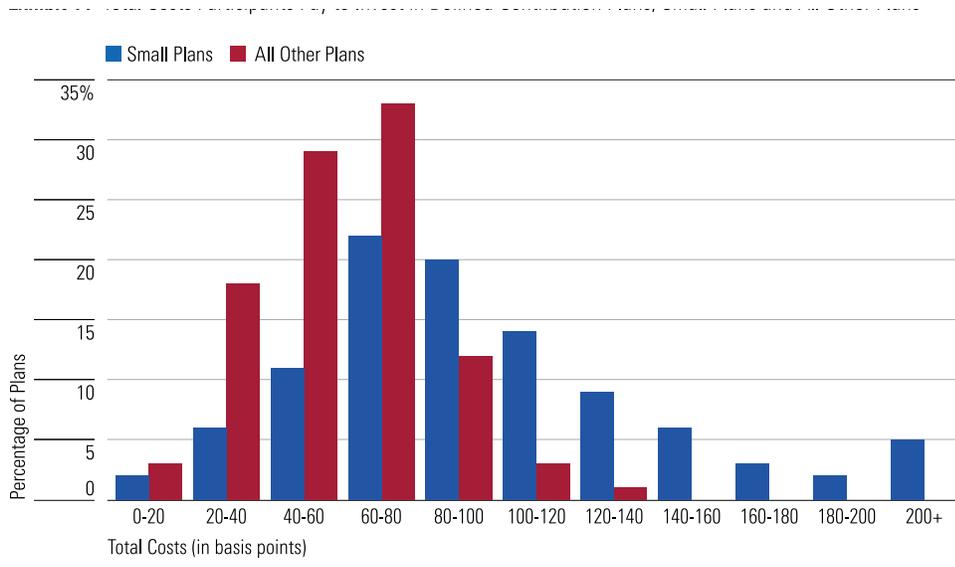
Source: Morningstar investment data matched with Form 5500 data for 2019.

Notes: Mega plans have more than \$500 million in assets; large plans have \$500 million or less in assets, but more than \$100 million; medium plans have \$100 million or less in assets, but more than \$25 million; and small plans have less than \$25 million in assets. The median total cost is not the sum of the medians for investment expenses and plan expenses. Rather, I start with the sum of the investment expenses and plan expenses for each plan and then take the median.

<sup>3</sup> U.S. Government Accountability Office. 2021. "401(k) Retirement Plans: Many Participants Do Not Understand Fee Information, but DOL Could Take Additional Steps to Help Them." <https://www.gao.gov/products/gao-21-357>

The spread of fees that plan participants pay is particularly wide among smaller plans. Exhibit 3 shows the total costs for small plans and all other plans. The distribution of total costs for small plans is much wider than for larger ones, meaning a worker is much more likely to be in an expensive plan if her employer's plan is small. Nonetheless, not all small plans are expensive. Some employers with small plans report total costs that are competitive with larger plans. In fact, 23% of small plans cost participants less than the median cost of 63 basis points for medium plans.

**Exhibit 3: Total Costs Participants Pay to Invest in Defined-Contribution Plans, Small Plans and All Other Plans**



Source: Morningstar investment data matched with Form 5500 data for 2019.

Notes: Small plans have less than \$25 million in assets, and all other plans have \$25 million or more.

**In Addition to Requiring a Review of the 404(a)5 Disclosures, Reviewing Form 5500 Fee Information Could Benefit the System**

Workers at employers with smaller plans who are saving just as much as those at employers with larger plans could have around 10% less in assets at retirement because of higher fees.<sup>4</sup> One way to help address this issue would be to arm plan sponsors with better data and benchmarks by examining and, where appropriate, reforming plan disclosures.

Form 5500, Annual Return/Report of Employee Benefit Plan, provides information on more than 730,000 retirement plans, including more than 141 million participants across all plans. Moreover, the Form 5500 helps track more than \$10.7 trillion in assets held for these savers to help support their retirement.<sup>5</sup>

<sup>4</sup> I use the difference between 88 basis points and 41 basis points and assume constant contributions over 35 years and steady 7% returns for this simple example.

<sup>5</sup> Employee Benefits Security Administration, U.S. Department of Labor. 2021. "Private Pension Plan Bulletin: Abstract of 2019 Form 5500 Annual Reports." <https://www.dol.gov/sites/dolgov/files/EBSA/researchers/statistics/retirement-bulletins/private-pension-plan-bulletins-abstract-2019.pdf>

Revising Form 5500 to display the investment options, qualified defaults, and fees for each would improve the retirement system. First, it would be much easier for regulators, third parties, and plan sponsors to compare plans' investment lineups to see the variety of investment options available to plan participants. Second, it would be much easier to see how much of a saver's hard-earned money goes into investments, how much goes toward investment management (picking which individual stocks and bonds to buy and sell), and how much goes to third parties for related services.

Providing third-party benchmark providers with better retirement plan data would make it easier for everyone to compare retirement plans. Right now, ordinary people can easily compare the cost and quality of different mutual funds on Morningstar.com or similar sites. But if they try to assess what a 401(k)'s strengths and weaknesses are, no one can tell them because the data is not out there. Some providers, such as Morningstar, take the data that does exist to give their best assessment, but there are limits to what they can do.

The DOL has recently proposed some changes to these Form 5500s that could help improve the quality of these disclosures.<sup>6</sup> An additional review could help modernize the form, helping reduce the costs for participants to save for retirement.

### 3. The U.S. Employer-Based Retirement System Could Help More People Convert Their Savings Into Lifetime Income

A perennial issue for decades has been finding ways to ensure that American workers who rely on defined-contribution plans do not outlive their savings. This problem has few easy solutions, but bold policy shifts could help more workers hedge their longevity risk, which could help ensure more retirees meet their financial retirement goals.

#### **Although Many Workers Could Benefit From Lifetime Income Solutions, the U.S. Employer-Based Defined-Contribution System Mostly Serves as an Accumulation System Today**

Many Americans would benefit from an increase in guaranteed income in retirement to hedge against the risk of outliving savings, and the proportion for which lifetime income solutions are needed is only growing. There is no one-size-fits-all solution. Retirees have a wide variety of lifetime income needs, depending on their preferences (such as for bequests or to maintain liquidity), their savings levels, the replacement rate they receive through Social Security, and other factors. Products such as deferred-income annuities and single-premium immediate annuities could provide needed stability in their financial plans.<sup>7</sup> A lack of lifetime income options will become more acute for retirees in the future, as

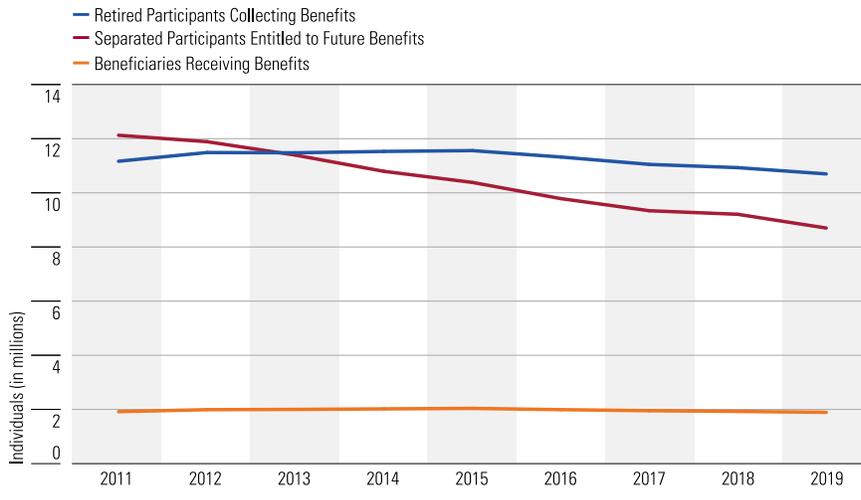
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<sup>6</sup> Employee Benefits Security Administration, U.S. Department of Labor. 2021. "Proposed Rule: Annual Reporting and Disclosure." <https://www.federalregister.gov/documents/2021/09/15/2021-19713/annual-reporting-and-disclosure>.

<sup>7</sup> Blanchett, D. "Allocating to a Deferred Income Annuity in a Defined Contribution Plan." *The Journal of Retirement*. Spring 2015. <https://jor.pm-research.com/content/2/4/54>

today many retirees have life annuities through coverage from private-sector defined-benefit plans, as shown in Exhibit 4. (Public-sector plans continue to cover new workers in many cases.<sup>8</sup>) As workers with access to only defined-contribution plans approach retirement, they face the challenge of managing their assets in decumulation to generate steady income in retirement.

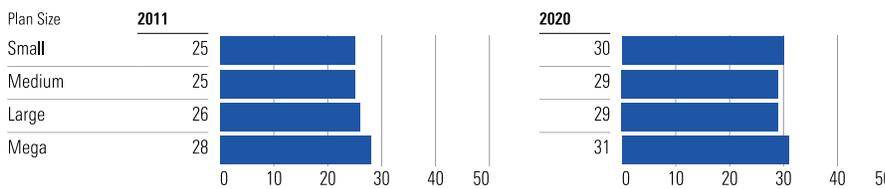
**Exhibit 4: Retired and Separated Defined-Benefit Plan Participants and Beneficiaries, 2011 to 2019**



Source: Morningstar analysis of Form 5500 data.

Despite the benefits of guaranteed income, employer-sponsored plans do not generally offer annuity products.<sup>9</sup> In fact, most participants take their assets from retirement plans to individual retirement accounts, or IRAs, when they retire. Exhibit 5 illustrates the modest gains that plans have made in growing the portion of their participants who are retired or separated.

**Exhibit 5: Percentage of Plan Participants Who Are Retired or Separated by Plan Size**



Source: Morningstar analysis of Form 5500 data and 2020 projections based on available filings.

VanDerhei, J. "Deferred Income Annuity Purchases: Optimal Levels for Retirement Income Adequacy." Jan. 3, 2019. Employee Benefit Research Institute. <https://www.ebri.org/content/deferred-income-annuity-purchases-optimal-levels-for-retirement-income-adequacy>.

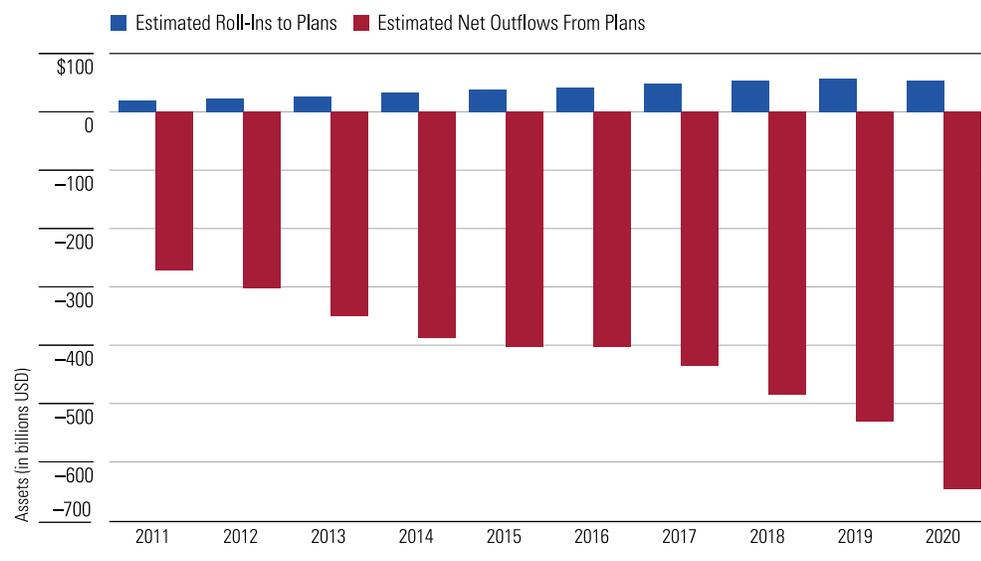
<sup>8</sup> Bureau of Labor Statistics, U.S. Department of Labor. 2021. "National Compensation Survey: Employee Benefits in the United States." <https://www.bls.gov/ncs/ncspubs.htm#/ncs/ncspubs.htm>.

<sup>9</sup> U.S. Government Accountability Office. 2016. "401(k) Plans: DOL Could Take Steps to Improve Retirement Income Options for Plan Participants." <https://www.gao.gov/products/gao-16-433>

Notes: Mega plans have more than \$500 million in assets; large plans have \$500 million or less in assets, but more than \$100 million; medium plans have \$100 million or less in assets, but more than \$25 million; and small plans have less than \$25 million in assets. Plans with fewer than 100 participants do not report this data, so the small category may not be fully representative. I exclude participants who have no assets in the plan.

Further, assets flow out of retirement plans rather than being used to purchase longevity insurance through retirement plans. Most of these withdrawals happen when workers switch employers or retire. I estimate that almost \$4.61 trillion flowed out of defined-contribution plans from 2011 to 2020, mostly in the form of rollovers and cash-outs but including some benefit payments. I estimate the employer-sponsored retirement system was able to retain just \$395 billion of these outflows, when participants shifted money into another defined-contribution plan through a roll-in. Defined-contribution plans, therefore, lost a net of \$4.21 trillion from these outflows. Exhibit 6 shows how small roll-ins are relative to net outflows from the defined-contribution system. Rollovers include all direct and indirect transfers of money from a defined-contribution plan to IRA. Cash-outs include complete or partial withdrawals of a balance or structured withdrawals for retirement income.

**Exhibit 6: Estimated Net Outflows From and Roll-Ins to Defined-Contribution Plans, 2011 to 2020**



Source: Morningstar analysis of Form 5500 data and 2020 projections based on available filings.

Notes: See methodology section of the Morningstar Retirement Plan Landscape report for details on this calculation. Net outflows include cash-outs, rollovers, and direct payments to beneficiaries, less roll-ins captured by the defined-contribution system when participants shift money into a defined-contribution plan. Net outflows do not include other plan distributions, such as payments for insurance contracts.

**Considerations for Allowing Illiquid Annuities in Qualified Default Investment Products**

One possibility for increasing the availability of lifetime income solutions in retirement plans is to make more options possible for qualified default investment alternatives, or QDIAs. Most plans do not offer fixed annuities, which are the simplest form of annuity in which a participant receives a stream of

payments for life (starting immediately or in the future) in exchange for a payment. Many of these products come with additional benefits and "free look" periods, but ultimately, they must reduce liquidity as participants pool their longevity risk. In other words, for these products to work, they must have a pool of people, some of whom will live considerably longer than others. In that sense, they are insurance—like any other insurance product—but for the possibility of living longer than expected.

Practitioners know from experience with auto-enrollment into target-date funds, and into employer-sponsored plans more generally, that default options serve as powerful nudges. Many individuals will not change a default. Consequently, a policy recognizing annuities to be QDIAs or annuities in combination with pooled vehicles to serve as QDIAs would open the gate for employers to be more proactive in encouraging such products through default enrollment.

Nonetheless, we believe that most participants would need more than just a default allocation to guaranteed income products. In an ideal world, workers would be on a default path to guaranteed income but with multiple opportunities to receive advice or guidance on their allocations to such a product. Workers need the confidence that such an irrevocable allocation is right for them, and people's needs and wants for guaranteed income vary quite a bit. For this reason, defaults alone without such personalization might not be a magic bullet if many workers opted out. Personalization may be the best way for workers to build confidence in their annuity election.

Major consumer-protection challenges would also need to be addressed if Congress or the DOL were to open the door for such annuity products. Regulatory standards would have to be appropriately prescribed so the annuity products that are QDIAs serve the interests of retirement plan participants, particularly given the new safe harbor. The DOL could set standardized disclosure requirements and either restrict fees or make them so transparent that it would be easy to comparison shop, leading annuities permitted in employer plans to tend toward lower-cost products.

Enhancing disclosures on Form 5500 so that third parties could benchmark lifetime income products would also be important. While QDIA standards would not help increase access to annuities in IRAs directly, the greater transparency around annuities that would result from some regulatory movement in this area would benefit all individuals attempting to purchase annuities. In general, disclosures and facilitating default enrollment, automatic contributions in small amounts, and clarifying safe-harbor standards would make employers, plan participants, and IRA accountholders better able to navigate the operational and legal challenges surrounding annuity purchase decisions.

### **Managed Accounts Can Offer Personalized Advice on Product Allocation Between Investments and Annuity Options**

Although target-date funds are a sensible option for many retirement plan savers, plan sponsors often offer professionally managed accounts that create personalized recommendations for workers based on their goals, assets, savings levels, and risk tolerances, among other factors. Managed accounts can help workers and retirees set their asset allocations, set their goals for retirement, and understand how much they need to contribute to retirement to help achieve their goals. Some plan sponsors have also made these managed accounts QDIAs because of the advantages they can provide.

Managed accounts (or even other one-off advice products) could be the most appropriate vehicle within a QDIA for making product allocation decisions to annuities. Unlike with target-date funds or other defaults without personalized advice, managed accounts accommodate the wide variety of individual preferences and needs in making product allocations. As discussed earlier, while many workers might benefit from an increase in guaranteed income, some would not. Further, the exact amount of optimal guaranteed income varies. Managed accounts could also start with recommendations to help participants maximize Social Security benefits before purchasing insurance products. Nonetheless, in some cases, for certain worker populations, target-date funds with integrated annuity options could improve the welfare of most retirement plan participants, although plan sponsors would need to carefully analyze their worker population before making such an election.