Financial Engines

ERISA Advisory Council Hearing
Retirement Income Solutions in a Defined Contribution Plan

Jason S. Scott
Managing Director, Financial Engines Retiree Research Center

August 30, 2012

financial engines
retirement help for life®

Introduction

I would like to thank the ERISA Advisory Council for this opportunity to testify. My name is Jason Scott and I am the Managing Director of the *Retiree Research Center* at Financial Engines.

Co-founded in 1996 by Nobel Prize-winning economist Bill Sharpe, Financial Engines works with America's leading employers and retirement plan providers to make retirement help available to approximately 8 million 401(k) participants.[1] Financial Engines is the largest, independent Registered Investment Advisor (RIA) in America.[2] We are not a fund manager nor do we offer any investment products. We are an independent provider of investment advice and discretionary asset management services. Income+, a recent enhancement to our managed account service, helps turn a retiree's 401(k) into flexible but steady payouts that can last for life.[3] Unlike retail investment advisors who typically target clients with half a million in assets or more, Financial Engines provides personalized help and asset management to individuals with more modest balances. Currently, the median account balance we manage is $40,000.[4] Efficient use of technology and the economies of scale available in a 401(k) plan facilitate providing personalized help at this asset level.

Our 14 years of experience providing independent advisory services to millions of employees has given us insights into the lifetime income preferences of both participants and plan sponsors. In addition, over the past six years, the *Financial Engines Retiree Research Center* has conducted extensive research on economic and behavioral issues related to lifetime income, publishing a number of papers in academic and industry journals.

In my testimony today, I will focus on four key points:

First, defined contribution plans should play a primary role in helping working Americans achieve lifetime retirement income.

Aside from Social Security, defined contribution plans represent the largest source of potential retirement income for millions of American workers. Most defined contribution plan participants, however, are largely uninformed about how to efficiently turn these assets into retirement income. It is hard enough for most participants to figure out how much to save and invest in the years <u>before</u> retirement. It is even more difficult to know how to invest and draw down the assets so one doesn't run out of money <u>in</u> retirement.

[1] As of 6/30/2012.

[2] <u>InvestmentNews</u>, November 2011.

[3] Lifetime income guarantee requires purchase of out-of-plan annuity.

[4] As of 6/30/2012.

Providing retirement income solutions through DC plans offer significant advantages to participants.[5] These advantages include:

- Cost – The buying power of DC plans generally results in lower investments costs to participants
- Access – In a retail environment, the highest quality help is typically offered to the highest balance individuals. Service providers working with a plan are generally required to offer access to all participants.
- Efficacy – Plans successfully encourage saving and investing by using plan level defaults. Similar efficacy gains could occur with retirement income defaults.

My second point is that workable lifetime income solutions must meet the needs of both participants and plan sponsors.

Financial Engines spent years researching an income solution that recognizes the diversity of participant needs and addresses the practical needs of plan sponsors.

In our participant research, we found that participants generally seek safety, control and flexibility in any lifetime income solution. In particular, these five features were important to participants:

1. Income payments that are stable over time with no major declines (Safety)
2. Income payments that can last for life (Safety)
3. Protection from poor market performance before and during retirement (Safety)
4. No irrevocable commitments. Ability to reverse any decision (Control / Flexibility)
5. Access and control of assets at all times (Control / Flexibility)

This last point – maintaining access and control – is especially important to retirees. To be successful in defined contribution plans, lifetime income solutions must allow participants to maintain control of their retirement assets while still providing income. Participants do not want to be "locked in" to a decision that they cannot change, particularly early in retirement when uncertainty is at its greatest.

Participants cannot take advantage of a plan provided income solution unless plan sponsors are willing to add that option. In our discussions with plan sponsors, they identified several key requirements for any viable income solution given the current environment:

1. **No hassle**: Retirement income solutions should be operationally easy to add to the plan. Sponsors do not want to undertake complex and costly changes to their plan, communications infrastructure, or recordkeeping systems to support retirement income.

[5] See also attached SIEPR Policy Brief by Jason S. Scott, February 2011.

2. **No lock-in**: Income solutions must be easy for sponsors to remove if they decide that their participants would be better served by a new solution in the future. Sponsors do not want to be locked into a particular product, insurance company, vendor, or recordkeeper.

3. **No risk**: Sponsors want to avoid any increase in fiduciary risk. Wishing to avoid legal or regulatory uncertainty, sponsors will generally only consider solutions that work under the current regulatory rules and Department of Labor guidance.

4. **No conflicts**: Sponsors value independence.

5. **No high or hidden fees**: In today's fee-conscious environment, sponsors want cost-effective solutions that help participants get full value from their accumulated account balances. Sponsors generally do not like offerings with either high fees or fees hiding behind complexity.

My third point is that these sponsor and participant requirements can be met within the current regulatory environment. Financial Engines recently introduced Income+, and early participant response has been positive.

In January 2011, Financial Engines introduced Income+, a retirement income solution which is an enhancement of our managed account service.

Income+ leverages a liability-driven investing (LDI) approach used in defined benefit plans and applies it to defined contribution plans. Applying LDI investing and using a plan's existing investment options, we create portfolios that are designed to generate steady retirement payouts. Combined with an optional out-of-plan annuity purchase and continued allocations to equity, this strategy provides payouts that can go up with the market and last for life. Income+ is designed to provide income payouts that are highly stable over time, while providing built-in upside if markets perform well.

So, how are participants responding to Income+?

We believe that the early Income+ enrollment results are encouraging. Within plans offering Income+, the average participant enrollment rate for participants age 60 and older was higher compared to the enrollment rate for the same age group across all plans that offer Financial Engines' managed accounts but without Income+. The study also found that default enrollment and help from an investment adviser were important enrollment factors. Some sponsors have offered Income+ on a default basis, automatically enrolling all participants age 60 and older into professional management with Income+. When default was the enrollment approach used, the average enrollment rate was more than four times higher than the average opt-in enrollment rate (47% vs.10.4%).[6]

[6] Please see the attached report, Financial Engines® Income+ Early Results, for information concerning coverage and methodology.

My last point is that the real power of the defined contribution plan, as it relates to retirement income, is its flexibility. This flexibility can produce significant benefits when applied to maximizing multiple sources of retirement income.

Among our clients, the median 401(k) account balance for men age 60 and older is $82,000 and $46,000 for women age 60 and older.[7]

For many, we believe the best use of retirement accounts is as a bridge to fund retirement in the early years, allowing the deferral of Social Security benefits for as long as possible. Based on our analysis, optimal Social Security decisions, especially for married women with low balances, can create more retirement income wealth than the woman has accumulated in her 401(k).[8]

We have been testing with employers and participants the concept of applying Income+ so that 401(k) payouts are high in the early years of retirement while Social Security is being deferred. We are very encouraged at the reaction we are getting from both. Without help, I believe few individuals will recognize how to integrate 401(k) spending and Social Security decisions, and thus many will forgo an opportunity to dramatically improve their retirement security.

Employers are crucial to bringing this type of help to the broadest number. Outside of the 401(k) system, most participants have no place to turn for high quality, objective help. Most participants are ignored by the financial services industry due to their relatively small investible assets. The scale economies of defined contribution plans make it possible for <u>all</u> participants to benefit from institutionally priced products and services that they would otherwise not be able to access.

In conclusion, I would like to offer three recommendations for the Advisory Council's consideration:

1. **Plan sponsors should be encouraged to offer in-plan retirement income help.**

   For the vast majority of Americans to have a chance at a secure retirement, we believe defined contribution plans must facilitate the ability to turn retirement plan assets into income. In-plan solutions likely have advantages in terms of cost, access and efficacy. Without a strong commitment by sponsors to help participants with these income decisions, the 401(k) system will fail in its central mission to provide retirement security for employees.

   Moreover, the fiduciary role that plan sponsors play is instrumental in making sure participant interests are protected. Given the unfamiliarity of lifetime income products to plan participants, it will be important that plan sponsors select and monitor appropriate solutions for their employees.

2. **Available retirement income options should include an option that is personal and flexible.**
   Retirement income decisions are often personal and complex, particularly in the early years of retirement. Many participants will require a personalized approach that retains

[7] As of July 2012, Financial Engines Data Warehouse.

[8] Financial Engines Retiree Research Center, 2012.

maximum flexibility. Mandated solutions that ignore these participant requirements will fail to serve the needs of many, if not most, participants.

3. **Plan sponsors should be given clear guidance that prudent retirement income help should include consideration of the broader retirement picture, particularly Social Security.**
   Saving for retirement is fragmented. Households often have multiple 401(k)s and IRAs, and, for married couples, dual sources of Social Security. Often larger benefits are possible when considering how all the retirement pieces fit together. Particularly for participants with low retirement savings, fully maximizing all sources of income will be imperative if they are to achieve adequate retirement security.

We look forward to continued discussions with you and the industry on these important issues. I would again like to thank you for this opportunity to provide testimony.

Attachments:

SIEPR Policy Brief, February 2011.
Financial Engines® Income+ Early Results, July 2012.