Testimony before the 2018 Advisory Council on Employee Welfare and Pension Benefit Plans Working Group regarding Lifetime Income Solutions as a Qualified Default Investment Alternative (QDIA) – Focus on Decumulation and Rollovers

- Good afternoon, my name is Christopher Jones and I am the Chief Investment Officer at Financial Engines. Founded in 1996 by William Sharpe, winner of the Nobel Prize in Economics in 1990, and Joseph Grundfest, a former SEC Commissioner and Professor of Law at Stanford University, Financial Engines is the largest independent registered investment advisor In America[1]. Today we serve over 1.0 million clients on a discretionary basis with over $169 billion in assets under management[2].
- Financial Engines was founded with the goal of providing unbiased, affordable, high-quality, personalized investment advice to everyday working Americans. Unlike most RIAs, our average balance is about $150,000 and our median balance is only $67,000. We offer advisory services to plan participants through over 760 leading employers, including 148 of the FORTUNE 500 – and reach over 10 million participants representing over $1.2 trillion in defined contribution retirement assets[3]. In addition, we serve more than 40,000 retail customers through over 140 advisor center locations around the country. For all our advisory services, both for ERISA assets and for our retail business, Financial Engines acts as a fiduciary to our clients.

[1] For independence methodology and ranking, see Investment News RIA Data Center. (http://data.investmentnews.com/ria/).
[2] Data as of March 31, 2018.
[3] Data as of March 31, 2018.

- Financial Engines has extensive experience with helping plan participants and other clients with creating sustainable lifetime income from their savings. Two-thirds of our assets under management are with people 50 years of age or older. In 2011, Financial Engines introduced Income+, an innovative in-plan retirement income solution for creating lifetime retirement income in DC plans. The service has since been adopted by over 440 large plan sponsors representing more than $740 billion in plan assets, and is the leading solution for generating income from DC plan accounts. Income+ provides participants with a professionally managed portfolio that generates sustainable lifetime income from their 401(k) accounts, including monthly income payouts, and the optional ability to annuitize the income stream by purchasing annuities outside of the plan. Income+ is qualified as a QDIA, and we have many plan sponsors defaulting their older participants into the service.
- Generating lifetime income from DC balances has been an important topic in the DC plan space for over a decade. I would like to share some key insights on the issue based on our extensive experience in working with both plan participants and large plan sponsors.
- My testimony will address three main topics:

  1) The importance of defining Lifetime Income solutions as broader than just annuity products
  2) The challenges of creating Lifetime Income in the context of a QDIA
  3) The critical role of Social Security claiming strategies in developing an efficient Lifetime Income strategy for a given household

Lifetime Income is More than Just Annuities:

- While annuities can play an important role in the generation of Lifetime Income for DC plan participants, they are not the only approach to help participants create sustainable income in retirement. Annuities provide the important economic benefit of allowing participants to pool mortality risk. However, there are costs associated with this ability to pool mortality risk. One cost is illiquidity – an irrevocable decision to translate wealth into future income. The cost of giving up liquidity is forgoing the ability to change your mind in the future. In a world of uncertain future income needs, health outcomes, and inflation, the option value of being able to change your plans is significant. For instance, if you are facing an uncertain future due to a serious chronic health condition, purchasing an annuity is likely a bad economic deal as annuities are priced assuming a certain level of adverse selection (the annuity pool is generally assumed to be healthier than average). Secondly, there are the fees (both explicit and implicit) charged by the insurance company to provide the annuity product. In many cases these fees can be exorbitant, particularly when the products contain a myriad of complex contract provisions and when they involve commission-based salesforces. While many annuity products provide flexibility on the annuitization decision, it is important to keep in mind that this flexibility comes with additional costs borne by the investor.
- Beyond annuities, there are many products and services that can help participants create sustainable retirement income, including managed accounts, managed drawdown funds, bond ladders, and traditional asset-based strategies.

In many client situations, these alternative solutions may prove to be superior to annuity products in helping a participant to reach their goals. Any QDIA regulation should include a variety of products and services that may be suitable for a given household (much as today's QDIA regulations include balanced funds, managed accounts and target date funds), and must not deem annuities as having preferential treatment.

QDIA for Lifetime Income:

- A decision by a plan sponsor to default a participant into a Lifetime Income QDIA must be based on evidence that such a default is in the best interests of the participant. Unfortunately, the question of an optimal retirement income strategy is highly dependent on the facts and circumstances of the individual or household.
- There is no one-size-fits-all solution for Lifetime Income for participants. Each household has unique needs and circumstances that affect their need for marginal annuitized income. There are many factors that can substantially impact the need for annuity income:
    - Access to Social Security income,
    - Access to traditional DB pension income,
    - Health status and longevity expectations,
    - Liquidity needs,
    - Risk tolerance, and

  - Costs and fees associated with available annuity income products

- Each of these characteristics can drastically affect the utility of additional annuity income for a given household, including whether additional annuity income is desirable at all.

- Another key issue is the timing of the annuitization decision. For most participants, it is not economically advantageous to purchase annuity income prior to reaching their early 70's. Before this age, it is generally less expensive to "self-insure" by using traditional fixed income and equity products rather than annuity products to provide income during the early years of retirement. This is because the probability of living through this period is very high for most people. This makes defaulting younger participants into annuity products a dubious proposition from an economic perspective. The reason for this is that insurance companies require a profit margin for annuity products that often makes the tradeoff between the value of pooling mortality risk and the costs of insuring mortality risk in the early years of retirement unfavorable to the participant. For most insurance products, the lower costs of "self-insuring" against mortality in the early years of retirement outweigh the marginal mortality discount until they reach their early 70s. This is validated by the average age of annuity applicants in the retail world, which is in the early 70s.

- Because of the complexity of many Lifetime Income products, it is crucial that the fiduciary bar for a Lifetime Income QDIA must be high. Either sponsors or product providers should act in a fiduciary capacity to ensure that participant interests are adequately protected.

- Participants are easily confused by complex product provisions and features, and it is difficult to determine whether specific products offer attractive outcomes for a given participant relative to reasonable alternatives.

- Many Lifetime Income products are high priced and involve long periods of “pre-paying” for benefits that are only delivered many years in the future (e.g. the option to annuitize at retirement). If the participant chooses not to annuitize at retirement, this may result in a significant loss as the participant paid for a benefit that they ultimately did not collect. Moreover, this property makes it difficult for sponsors to replace an existing vendor without harming those participants who pre-paid for benefits they have yet to collect.

- In addition, portability is a crucial concern for any QDIA Lifetime Income solution. It’s important to recognize that ever-higher employee turnover creates significant challenges for annuity-based Lifetime Income products that are impossible or difficult to roll over to a new employer’s plan.

- Annuity products are subject to default risk for the guaranteeing insurance company. Because annuity products involve a contract with the participant that can last decades, the risk of default is a significant factor (as we observed during the financial crisis of 2008/2009). While there are State funded back-stops to cover insurance company defaults, they do not cover the full range of potential annuity income levels (most State annuity insurance pools have limits on the level of income protected).

- Sponsors have many important needs with respect to retirement income solutions including:
    - Liquidity for participants,
    - Portability across recordkeeping platforms,
    - Low costs (now and in the future),
    - Avoidance of fiduciary lock-in (e.g. being tethered to a single insurance company for decades). Sponsors do not want to be locked into a product, insurance company, vendor or recordkeeper, and
    - Low hassle and administrative costs. Sponsors do not want to undertake complex and costly changes to their plan, communications infrastructure, or recordkeeping systems to support retirement income.
- In addition, the industry is beginning to recognize that the right QDIA may differ for different segments of the workforce, with some progressive plan sponsors offering “smart” or “dynamic” defaults. As one example, we work with a large plan sponsor who has decided to use target date funds as the default for participants under 45, and managed accounts with our in-plan retirement income solution for those over 45, with a transition from target date funds to managed accounts when participants attain age 45.

<u>Lifetime Income QDIA and Social Security</u>

- By far the least expensive and most reliable form of annuity income for most participants is Social Security. It is crucial that before any participant is defaulted into a private annuity product, that they have first maximized their claiming strategy for Social Security benefits. In many cases, deferring Social Security benefits will yield significantly higher income levels than the purchase of private annuity income products.

- For the vast majority of participants, maximizing Social Security first before contemplating additional private annuity income is a crucial requirement for maximizing household retirement income.
- For households with modest income or those with significant traditional defined benefit income, the utility of additional annuity income may be negative in some cases. That is, defaulting such a participant into a private annuity product may make them worse off than alternative investment strategies. This is particularly true if the defaulting results in an inability to optimally defer the start of Social Security benefits.

Financial Engines in-plan solution:

- Financial Engines has extensive experience in providing sustainable retirement income for participants with its Income+ service launched in 2011. The service offers:
    - Flexibility in payout timing and magnitude,
    - Total liquidity for participants,
    - Portability across recordkeepers,
    - Low costs,
    - Immunization from market and interest rate changes,
    - Fiduciary protection from an independent fiduciary, and

  - Access to an advisor to help navigate complex decisions

- Financial Engines has established connections with 10 of the leading retirement plan providers to deliver Income+ to plan sponsors and their participants. Income+ is by far the leading retirement income solution among large plan sponsors with over 440 sponsors contracted to offer the service, representing $720 billion in retirement assets and over 6.3 million participants[4] (including 85 Fortune 500 companies).

- We have learned from this experience that offering flexibility to both participants and plan sponsors is crucial to achieving good outcomes. We strongly encourage the Department of Labor to consider flexibility as a key objective in the definition of any Lifetime Income QDIA regulations.

Conclusion:

- We believe there is a significant opportunity to leverage DC plans to help participants generate lifetime income. The buying power of the large DC plans helps to lower participant costs. And through the DC plan platform and its broad deployment, access to help is available to all participants, not just those with high balance accounts. Finally, DC plans represent the simplest and best way for individuals to save, invest and drawdown in retirement. And reducing complexity helps people to overcome inertia and encourages participation.
- That said, the fiduciary bar for Lifetime Income as QDIA should be high, given the level of complexity in many solutions. We encourage industry and regulators

[4] Data as of May 31, 2018.

to approach this topic with a broad understanding of the types of solutions available, and to acknowledge the highly diverse retirement income needs of participants, as well as the critical role that Social Security annuity income plays for most American families. Annuities have a role to play in the efficient generation of Lifetime Income, but they are only one part of complex puzzle.

- In addition, there are other aspects of plan design that could better optimize DC plans for decumulation. For example, facilitating roll-ins to the plan and allowing partial withdrawals are tactics that may encourage participants using DC plans for income in retirement, rather than taking lump sum distributions at retirement. In addition, complementary services—such as access to an unbiased advisor—are also helpful for enabling participants to navigate the complex and emotional decisions around retirement.
- I would like to thank the Council for this opportunity to provide testimony. Financial Engines looks forward to continuing to work with plan sponsors and regulators to ensure that all participants have appropriate access to sustainable lifetime income solutions through their DC plan.