Financial Engines

Testimony for IRS Hearing on Proposed IRS REG-110980-10

Modifications to Minimum Present Value Requirements for Partial Annuity Distribution Options under Defined Benefit Pension Plans

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Introduction

I would like to thank the Treasury Department and the IRS for the opportunity to provide testimony at today's hearing. My name is Jason Scott and I am the Managing Director of the *Retiree Research Center* at Financial Engines.

Financial Engines is the largest independent Registered Investment Advisor (RIA) in America with advisory services available to approximately eight million 401(k) participants.[1] We also provide discretionary professional management services to over 580,000 401(k) plan participants and help them with their retirement planning needs from saving and investing for retirement to creating steady lifetime income in retirement.[2]

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.

Let me begin by saying, I strongly support the stated objective to "make it simpler and easier for a plan to offer an optional form of benefit that is a combination of a single-sum payment and an annuity." For defined benefit pension plans, additional distribution options could substantially alter the amount of annuity income selected by individuals.

My comments today emphasize that there are many ways to combine a single sum payment and an annuity. Offering a desirable mix of distribution options is vital to encouraging participants to maintain at least some degree of retirement income security. I have three suggested enhancements to the typical slate of distribution options that could improve retirement security.

1. <u>A longevity annuity option should be available.</u>

2. <u>Final retirement decisions are best made in retirement not before retirement. A partial distribution option that defers a final payout decision until a few years into retirement could substantially reduce the cash-out propensity</u>.

3. <u>Single sum payouts from the defined benefit plan should take advantage of the services and institutional pricing available from the defined contribution plan.</u>

To help illustrate my comments, I will refer to a sample set of distribution options. A typical defined benefit pension plan may currently have two options for a retiring employee:

[1] <u>InvestmentNews</u>, November 2011.
[2] As of 3/31/2012.

Option 1 – The Full Immediate Annuity – Offers $2,000/month income at age 65, or

Option 2 – The Full Cash-out Option – Offers $300,000 cash-out at age 65

The proposed regulation encourages the creation of a third option:

Option 3 – The Partial Immediate Annuity Option – Offers $1,000/month plus $150,000 cash-out.

The partial immediate annuity option allows participants to satisfy liquidity needs while retaining income security. By eliminating the all-or-nothing nature of the current choice, the partial immediate annuity option could significantly increase the fraction of participants selecting at least some insurance protection.

Based on my research, however, a longevity annuity option could be an even more attractive combination of security and liquidity.

My first point is that a longevity annuity option should be available.

I have published two relevant articles on the topic of longevity annuities. In one article, recently published in the Journal of Risk and Insurance[3], I demonstrate that all optimal distribution bundles that include a partial cash allocation and a partial annuity allocation rely on a longevity annuity for the insurance allocation. The key insight was that insurance protection provided by annuity payouts is relatively low early in retirement when mortality is low, and relatively high later in retirement when mortality is high. Thus, taking early income payouts as cash, while retaining late life insurance protection, maximizes the insurance protection for any given level of liquidity.

The second article, published in the Financial Analysts Journal, quantified the impact of various distribution combinations.[4] Findings from this research indicated that for a typical retiree, allocating 10–15 percent of wealth to a longevity annuity creates insurance benefits comparable to an immediate annuity allocation of 60 percent or more.

A sample longevity annuity option consistent with the previous options would be:

Option 4 – The Longevity Annuity Option – Offers $2,000/month income at age 85 plus $255,000 cash-out

Compared to the partial immediate annuity option, the longevity annuity option offers more longevity protection while simultaneously providing substantially higher levels of liquidity. A participant focused on liquidity may still be willing to sacrifice a small amount of liquidity, in this example 15%, for significant longevity protection.

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[3] Scott, Jason S., John G. Watson, and Wei-Yen Hu. 2011. "What Makes a Better Annuity?" *Journal of Risk and Insurance.* 78(1): 213-244.
[4] Scott, Jason S. 2008. "The Longevity Annuity: An Annuity for Everyone?" *Financial Analysts Journal*. 64(1) (January – February): 40-48.

My second point is that a partial payout option that defers a final payout decision until a few years into retirement could substantially reduce the cash-out propensity.

Retirement is a time of significant uncertainty for many people. Questions such as:

How much will I need to live on?

How much will health care cost?

Will I have to work part-time?

What do I do if I have an unexpected expense?

create a high level of insecurity for most people. Given this uncertainty, many participants put a very high premium on liquidity. Even with better options available, forcing a final decision <u>at</u> retirement creates the potential for a significant bias towards liquidity.

In contrast, asking a participant to make a distribution decision after experiencing retirement for a couple of years could result in a dramatically different answer. Studies generally report that individuals in retirement highly value annuity income. In addition, a recent LIMRA study of 55,000 annuity purchases found that the average purchaser age was 73, suggesting that annuity appeal is higher in retirement rather than prior to retirement.[5]

Partial distribution options could defer the final annuity choice and facilitate more informed participant decision-making. For example, consider the following distribution option:

Option 5 – The Deferred Decision Option – Offers $1,975/month at age 65 with a cash-out option that lasts for two years.

With this option, the participant can take income for a couple of years, and then decide if they need or want liquidity. This option would also allow the participant to decide at any point during the first two years to take the full lump sum. Without this option, liquidity feels like the best way to handle all of retirement's uncertainty. Now, with a deferred decision option, a participant can experience income while still preserving their option for future liquidity. Low mortality rates early in retirement ensure that the overall income impact of selecting this option is modest.

The ability to defer decisions and retain options is a powerful motivator in times of uncertainty. Using that behavioral trait to encourage individuals to make their final decision when they have better information about the realities of retirement could substantially improve income security.

My third point is that single sum payouts from the defined benefit plan should take advantage of the services and institutional pricing available from the defined contribution plan.

Finding help in the retail environment is often extremely challenging since most retail financial advisors target higher balance participants, ignoring the rest. In a recent analysis,

[5] LIMRA. 2010. "Guaranteed Income Annuities (2010)."

InvestmentNews reported the average account balance advised by the top retail RIAs was approximately $900,000.[6] In contrast, investment help available from within the defined contribution pension plan is available regardless of balance. For comparison, as of March 31, 2012, the median portfolio balance for members in the Financial Engines' managed account service was $41,000. In addition, according to two recent studies, investment costs in large defined contribution plans are significantly less, on average, than the cost of retail alternatives.[7]

While some degree of liquidity is likely desirable for many defined benefit participants, those participants could still benefit by keeping their liquid assets within their employer sponsored pension plans. Mechanisms encouraging the use of the defined contribution plan, such as defaulting defined benefit cash-outs into the defined contribution plan, would provide an additional layer of benefits to participants and help limit asset flows out of the employer-based pension system in general.

In conclusion, many participants must choose between all income and all liquidity. Simplifying the rules to encourage partial distribution options is vitally important. My comments today center on key aspects of distribution options that I believe can significantly improve participant decisions and result in enhanced retirement security. Ideally, participants could choose a longevity annuity, could choose to experience steady income prior to finalizing their decision, and would use their employer's defined contribution pension plan for liquid assets. When considering regulation revisions, I encourage you to consider any changes that could facilitate offering these options. Even simply altering some of the examples provided to illustrate these alternative distribution options could encourage sponsors to explore these enhancements.

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

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[6] InvestmentNews April, 2012. Analysis of 100 top RIAs by assets under management. Retail analysis removed the two employer based RIAs included in the top 100 RIAs.

[7] For estimated retail fees see: Investment Company Institute. 2010. "Trends in the Fees and Expenses of Mutual Funds, 2009" Research Fundaments, April. 19(2). For estimated large sponsor fees see: Deloitte and Investment Company Institute. 2009. "Defined Contribution /401(k) Fee Study."