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Submitted Electronically

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5665
U.S. Department of Labor
200 Constitution Avenue, NW.
Washington, DC 20210

RE: Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement plans

Financial Engines welcomes the opportunity to respond to the Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans of the Employee Benefits Security Administration's ("EBSA"), Department of Labor, and the Internal Revenue Service, Department of Treasury, published on February 2, 2010. Our comments are focused on three different aspects of the issue:

- Defined Contribution plans and lifetime income (Question 8)
- Lifetime income options (Question 2)
- Default considerations (Question 11)

Defined Contribution Plans and Lifetime Income

Unlike Defined Benefit (DB) pension plans, the vast majority of Defined Contribution (DC) pension plans do not provide options to help participants produce lifetime income. An important first question is – Should DC plans provide lifetime income options? Our belief is that in order for the vast majority of Americans to improve their chance of a secure retirement, DC plans and DC plan sponsors should play a large and positive role in helping plan participants create lifetime income.

Key advantages of offering lifetime income solutions within DC plans include:

- **Access** – A majority of individuals have account balances that are too low to attract help in the retail environment.[1] However, by aggregating many lower balance individuals, DC plans can potentially change the economics to make solutions viable for much lower account balances. For example, a face to face session with an individual with $50,000 in investable assets may not be viable in a retail environment, but a seminar with 50 similarly-situated participants at a given plan sponsor may be economically feasible.
- **Fees** – Plan sponsors will be able to negotiate on behalf of their plan participants to get improved pricing for lifetime income solutions. Just as plan sponsors often are able to offer lower expense ratio investment options, sponsors will also likely be able to negotiate institutional pricing for lifetime income solutions. Lower costs generally translate into improved income for plan participants. In addition, fee disclosure requirements should lead to better transparency and a clearer understanding of the various pricing elements of the solutions for participants.
- **Quality** – Due diligence on a myriad of lifetime income solutions can be a daunting task for many individuals. Lifetime income solutions available inside a DC plan give plan participants the ability to benefit from the due diligence review performed by the DC plan sponsor. This due diligence, particularly when performed by a plan sponsor acting as a fiduciary, can be important as the potential complexity of lifetime income solutions offered to participants increases.

Given the benefits to plan participants from DC plan based lifetime income solutions, we believe it is critical for the Department of Labor and Department of Treasury to take action to reduce barriers and encourage plan sponsors to offer lifetime income solutions.

Lifetime Income Options

The marketplace for lifetime income is rapidly innovating new solutions. Innovation is occurring in both the insurance industry (e.g., longevity insurance, guaranteed minimum withdrawal benefits, accumulation phase income credits, etc.) and in the asset management industry (e.g., fixed horizon payout funds, fixed percentage payout funds, inflation protected payout funds, etc.). While innovation is occurring, it is less clear which types of solutions will ultimately be favored by individuals. Given the current pace

[1] Cerulli Associates, 2009 estimates that 55% of households age 55-70 and 61% of households age 70+ have less than $250,000 in investable assets (often viewed as a minimum asset level given customer acquisition and retention costs).

of innovation and uncertainty associated with the ideal lifetime income solution, we believe it is important that policy decisions not impede the creation and ultimate deployment of new and innovative lifetime income solutions in DC plans.

Immediate annuity options

Economic theory suggests that immediate annuities are highly desirable and predict widespread immediate annuity purchases by individuals. In practice, however, only a tiny minority of individuals actual purchase an immediate annuity. Acknowledging this reality, Question #2 asks:

> Currently the vast majority of individuals who have the option of receiving a lump sum distribution or ad-hoc periodic payments from their retirement plan or IRA choose to do so and do not select a lifetime income option. What explains the low usage rate of lifetime income arrangements? Is it the result of a market failure or other factors (e.g., cost, complexity of products, adverse selection, poor decision-making by consumers, desire for flexibility to respond to unexpected financial needs, counterparty risk of seller insolvency, etc.)? Are there steps that the Agencies could or should take to overcome at least some of the concerns that keep plan participants from requesting or electing lifetime income?

Likely all of the identified factors play a role in making lifetime income less desirable. However, one aspect of this issue receives little attention, but deserves highlighting. Often the choice of purchasing lifetime income (or "annuitizing"), is evaluated as a binary yes/no decision. Considering the decision to annuitize as a now or never decision suggests dramatic benefits to annuitizing now. However, an individual always has the option of annuitizing some assets at a later point in time. In reality, the decision is best characterized as a now or later decision rather than a now or never decision.

Viewed in this context, the benefits of purchasing an immediate annuity at retirement are much less compelling. Annuity fees imply that, even with a goal of maximizing retirement income, an individual might still rationally defer the annuity purchase to a point when they are older. The essential comparison is between the extra "mortality return" earned by annuitizing early versus the marginal fees avoided by delaying the annuity purchase.[2] Since annuity fees can often be large compared to the mortality return for younger retirees, women and especially couples, deferring the annuity purchase until a more advanced age is often desirable. For younger retirees, the

[2] See Milevsky and Young, 2005 or Scott et al., 2009 for a discussion of the impact of fees on the decision to defer the annuity purchase.

mortality return from annuitizing is low because they are very likely to be alive in the next few years. It may be cheaper to fund these years of retirement with lower cost fixed income instruments, rather than pay the higher fees associated with annuities.

Further, there are more considerations than simply maximizing lifetime income. Earning the “mortality return” involves giving up the flexibility associated with a liquid pool of assets. Given all of the changes that occur at retirement, it is no surprise that many individuals place a high value on the flexibility available from a liquid pool of assets. Finally, for many individuals, an immediate annuity is an unfamiliar product that differs significantly from the investments they have become accustomed to during their years of accumulating wealth. Given this type of choice, it is not too surprising that retirees overwhelming choose a lump-sum over lifetime income at retirement.

While we believe immediate annuities are important lifetime income options, we do not believe policy decisions are likely to change the fundamental preference retiring individuals have for the flexibility and liquidity associated with a pool of assets. As such, we believe it is crucial that new policies allow for innovative lifetime income solutions that more closely align with individual preferences.

Hybrid lifetime income options

Hybrid solutions combine investments and insurance to create lifetime income. A hybrid solution can overcome some of the problems identified with immediate annuities. The previous discussion argued that, at retirement, an immediate annuity offers a dubious combination of inflexibility, unfamiliarity and low or negative economic urgency. However, the situation changes at more advanced ages. As an individual ages, the economics of an annuity become increasingly compelling (i.e., the mortality return substantially exceeds plausible insurance fees). A hybrid solution combining investments and flexibility in early retirement followed by insurance and security in late retirement could be much more desirable to individuals. The hybrid option could be delivered in a number of different ways including a variable annuity insurance product or as a managed account. In a managed account option, the management would create income in the early retirement years while always maintaining sufficient assets to give participants the option of increasing the income payout through an annuity purchase. The advantage of the hybrid approach is that as the insurance becomes compelling, the hybrid solution facilitates a shift from a highly liquid and flexible solution to one more focused on guaranteed lifetime income.

Given the alignment between hybrid solutions and participant preferences, we believe it is important that future policy decisions support the development and deployment of hybrid lifetime income options for DC plan participants.

Advisor-assisted options

While hybrid solutions allow for a tradeoff between flexibility and income, they still face the problem that the annuity remains an unfamiliar choice. Without some sort of assistance, it is unlikely that many individuals will independently decide to annuitize late in retirement. There are a number of ways to address this issue. First, a plan sponsor could create education materials to help their participants better understand the ever-improving potential for insurance to provide lifetime income. Unfortunately, educating DC plan participants has met with mixed to poor results historically. An alternative approach is to offer an advisor-assisted lifetime income option. An advisor could augment many lifetime income options. For discussion purposes, consider access to an advisor as a component of the hybrid lifetime income solution. The purpose of the advisor would be to explain the flexibility versus security trade-off associated with annuitization. While advisors are uncommon in the retail environment for individuals with modest balances, the economies of scale associated with a DC plan may be one of the few areas where independent advisor assistance is economically feasible.

Similar to hybrid solutions, advisor-assisted options may ultimately prove to be the option most preferred by DC plan participants. Therefore, we believe it is important that future policy decisions support the development and deployment of advisor-assisted lifetime income options for DC plan participants.

Longevity insurance options

The interaction between required minimum distribution (RMD) rules and longevity insurance offers a good example of the potential for unintended consequences associated with policy decisions. Current RMD rules discourage the use of longevity insurance as a lifetime income solution. As discussed below in the longevity insurance overview, the efficiency of longevity insurance relies on the gap between the purchase date of the insurance and the date income begins. By delaying the beginning of the income phase, an individual can purchase income at a substantial discount. A typical policy might have a purchase date at age 65 with income beginning at age 80. Mortality between 65 and 80 creates a substantial discount on late-life income.

However, this type of insurance policy is disadvantaged given current RMD rules. If purchased with qualified dollars, the value of this policy counts in the RMD calculation, but the policy itself does not generate any income until age 80. What happens if there are insufficient funds outside of the insurance policy to pay for the required minimum distribution implied by the value of the policy? That concern has kept longevity insurance providers from accepting qualified dollars for policies with payouts that begin after age 70.

To remedy this situation, we strongly recommend that longevity insurance policies be exempted from the RMD calculation. Current RMD rules exempt immediate annuity purchases from the RMD calculation. Extending that exemption to cover longevity insurance is justified on the grounds that under many circumstances a portfolio combining liquid assets and longevity insurance can create a more desirable lifetime income solution (higher income and/or increased flexibility). In fact, given the policy benefits of sharing mortality risk, consideration should be given to exempting any insurance contract that focuses solely on life-contingent payments. Current RMD rules unnecessarily hinder the development of lifetime income solutions based on longevity insurance and should be updated accordingly.

Current RMD rules have an unintended consequence of placing longevity insurance at a disadvantage in the market place. We believe future regulatory guidance should ensure that longevity insurance-based solutions and other innovative approaches remain viable alternatives.

Longevity Insurance Overview

Longevity insurance (sometimes referred to as a deferred annuity or a longevity annuity) allows an individual to purchase life-contingent income that begins at a future date. For example, a longevity insurance policy purchased at age 65 may have income payments that do not begin until age 80. The payouts from the policy are inexpensive because they are contingent upon living to an advanced age to collect. Recent research has demonstrated that longevity insurance arrangements maximize the income benefit per insurance premium dollar spent. For example, Scott, 2008 estimates that “for a typical retiree, allocating 10%-15% of wealth to a longevity annuity creates spending benefits comparable to an immediate annuity allocation of 60% or more.” Moreover, since insurance costs tend to be proportional to the premium payment, longevity insurance can help minimize insurance costs (see, for example, Scott et al., 2009).

Longevity insurance research implies that individuals looking to allocate only a portion of their assets to insurance can typically improve their income level by utilizing longevity insurance instead of traditional immediate annuities. Since few individuals want to fully annuitize their assets, longevity insurance could play an important role in the creation of desirable and palatable lifetime income solutions.

Defaults Considerations

The automatic 401(k) is proving to be very effective in creating participant success by default. Since the decisions required by participants for successfully drawing down income during retirement are far more complex, extending the automatic 401(k) in the retirement phase will be critical. However, the circumstances faced by retiring plan participants can vary widely. As such, different plan sponsors may feel different defaults are most appropriate for their plan population. Thus, similar to the accumulation phase, a menu of “qualified” defaults is likely necessary to give plan sponsors needed flexibility. Given the substantial impact a default can have on participant outcomes, many plan sponsors will require an explicit “safe harbor” in order to adopt a lifetime income default. As such, determining which lifetime income solutions qualify as approved defaults will be a critical policy decision. To help identify candidate default solutions, we believe the following characteristics are important:

- **Fee reversibility** – In the accumulation phase, qualified default arrangements must be fully reversible at no cost for 90 days. A similar guideline should apply to retirement defaults.
- **Liquidity** – Some insurance products, such as an immediate annuity, exchange liquidity for additional retirement income. However, a default that involves the loss of liquidity could be a significant shock to unaware participants. To manage this concern, we recommend either an extended period where liquidity is retained or a requirement that loss of liquidity requires a proactive participant decision.
- **Death benefit** – Insurance that maximizes income will not pay a death benefit. However, in a default context, the lack of a death benefit could also be surprising to the heirs of DC plan participants. Similar to liquidity provisions, we

recommend either an extended period where a death benefit is retained or a requirement that loss of a death benefit requires a proactive participant decision.

- **Conflicts** – If the retirement default is an advisory relationship that helps participants with drawdown decisions, existing rules governing prohibited transactions should extend to lifetime income services. Participants should be protected from advice that could be influenced by conflicts of interest associated with the compensation of the advisor.
- **Role of Fiduciary in Selecting Default**– If a retirement income solution is made a plan default, we recommend that the plan sponsor still play a fiduciary role in the selection and monitoring of any such default.

Thank you for considering these comments. Please do not hesitate to contact me if you have any questions or if I can be of any assistance.

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