S. Hrg. 112–765

SIMPLIFYING SECURITY: ENCOURAGING BETTER RETIREMENT DECISIONS

HEARING

OF THE

COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS

UNITED STATES SENATE

ONE HUNDRED TWELFTH CONGRESS

FIRST SESSION

ON

EXAMINING SIMPLIFYING SECURITY, FOCUSING ON ENCOURAGING BETTER RETIREMENT DECISIONS

FEBRUARY 3, 2011

Printed for the use of the Committee on Health, Education, Labor, and Pensions

Available via the World Wide Web: http://www.gpo.gov/fdsys/

U.S. GOVERNMENT PRINTING OFFICE

80–703 PDF WASHINGTON : 2013

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS

TOM HARKIN, Iowa, *Chairman*

BARBARA A. MIKULSKI, Maryland	MICHAEL B. ENZI, Wyoming
JEFF BINGAMAN, New Mexico	LAMAR ALEXANDER, Tennessee
PATTY MURRAY, Washington	RICHARD BURR, North Carolina
BERNARD SANDERS (I), Vermont	JOHNNY ISAKSON, Georgia
ROBERT P. CASEY, JR., Pennsylvania	RAND PAUL, Kentucky
KAY R. HAGAN, North Carolina	ORRIN G. HATCH, Utah
JEFF MERKLEY, Oregon	JOHN McCAIN, Arizona
AL FRANKEN, Minnesota	PAT ROBERTS, Kansas
MICHAEL F. BENNET, Colorado	LISA MURKOWSKI, Alaska
SHELDON WHITEHOUSE, Rhode Island	MARK KIRK, IIllinois
RICHARD BLUMENTHAL, Connecticut	

PAMELA J. SMITH, *Staff Director and Chief Counsel*
LAUREN McFERRAN, *Deputy Staff Director*
FRANK MACCHIAROLA, *Republican Staff Director*

C O N T E N T S

STATEMENTS

THURSDAY, FEBRUARY 3, 2011

SIMPLIFYING SECURITY: ENCOURAGING BETTER RETIREMENT DECISIONS

THURSDAY, FEBRUARY 3, 2011

U.S. SENATE,
COMMITTEE ON HEALTH, EDUCATION, LABOR, AND PENSIONS,
Washington, DC.

The committee met, pursuant to notice, at 2:03 p.m. in Room SD–430, Dirksen Senate Office Building, Hon. Tom Harkin, chairman of the committee, presiding.

Present: Senators Harkin, Bingaman, Hagan, Merkley, Franken, Whitehouse, Blumenthal, Enzi, and Murkowski.

OPENING STATEMENT OF SENATOR HARKIN

The CHAIRMAN. The Committee on Health, Education, Labor, and Pensions will please come to order.

I want to welcome everyone to the latest in our series of hearings focusing on retirement security. This is our first hearing looking specifically at how to make retirement plans work better.

There is no question that it's getting harder and harder for the average person to retire. Families are facing unprecedented challenges. Saving for retirement is just not an option for many. Wages have been stagnant for about 20 years, and people are working longer and harder than ever before, yet they still do not seem to meet the costs of basic everyday needs like education, transportation, and housing, let alone save enough to support them in their old age. Even people who want to prepare for retirement often find it difficult to do so. Over a quarter of workers do not have any meaningful retirement savings at all. Zero. And only a small percentage of people have a traditional pension.

These days the vast majority of people with any retirement plan at all have a 401(k). But 401(k)s often do not provide real retirement security. They, of course, leave workers exposed to the vagaries of the market and do not necessarily provide workers with a guaranteed lifetime income stream like a traditional pension plan. That means families relying on a 401(k) have to roll the dice and pray that they do not outlive their retirement savings.

We've taken some important steps to improve the 401(k) system by requiring more transparency, but we still have a long way to go before the 401(k) system works for everyone. Just recently I heard from a carpenter who told me that when he tried to sign up for his plan, his employer handed him a list of investments two pages long and a 5-inch binder full of prospectuses. Well, if you're working all day, trying to raise a family, you don't have time to pour through all of that and try to figure out what to do. There has to be a way to make saving for retirement simpler.

Automatic enrollment was a good first step. There's a considerable amount of evidence that people are more likely to participate if they are automatically enrolled. The Pension Protection Act of 2006, which we all worked on and Senator Enzi was very much involved in, helped encourage automatic enrollment by removing some of the barriers and giving employers some peace of mind. Now more and more plans are using automatic enrollment, and that has gotten more people saving.

The question today is whether we can do more. Can we apply the lessons of automatic enrollment elsewhere? Can we do a better job getting people the information they need to make better financial decisions?

One way to encourage people to boost savings is to give them an estimate of how much monthly retirement income a person can expect from their 401(k). Now, people already get that kind of estimate on their annual Social Security statement. I just got one several days ago. It tells you exactly how much you get when you retire. It's very helpful. Of course, I commend Senators Bingaman, Isakson and Kohl for the work they have already done on this issue.

Another way to encourage people to save is to allow for more financial education, especially among young people just entering the workforce. Every day we see people coming up with new and innovative ways to educate people about personal finance. And when people are engaged, they tend to save more. One study found that 18 percent of people that use an online retirement calculator increase their contribution rate. Well, that's going to have a long-term positive effect. How can we promote that?

As we look at ways to improve 401(k) plans, it's important to remember that making plans simpler and more automatic does not always mean that they are safer or more secure. Target-date funds are a good example. Those funds show considerable promise as an easy way for people to manage their retirement accounts. But the effects of the Great Recession highlighted that there is a still a lot that needs to be done to make target-date funds safe for workers and retirees.

Going forward, any steps that we may take to make 401(k)s simpler must be accompanied by protections to insure that participants are being treated fairly and getting the best possible value. We also need to remember that a simpler 401(k) is not going to help the millions of American families barely scraping by. Those people deserve a secure retirement, too. And I plan to address the challenges they face and the need for improved access to the pension system in future hearings on this subject in this committee.

Retirement issues have always been an area of great bipartisan interest, so there is a real opportunity to work together to improve retirement security for families all across America.

I am confident the hearing today will give us all a lot to think about. I look forward to working with my colleagues to find practical solutions to solve this retirement crisis in America. I thank you all for being here today, and I will yield to Senator Enzi.

STATEMENT OF SENATOR ENZI

Senator ENZI. Thank you, Mr. Chairman. It's my understanding that one of our witnesses is stuck in Chicago.

The CHAIRMAN. That's right. We are going to have a video hook-up for him.

Senator ENZI. That's a terrible place to be stuck.

[Laughter.]

The CHAIRMAN. I didn't say that, did I?

[Laughter.]

I go through Chicago all the time.

Senator ENZI. Oh. I've never made it through yet, so I'll have to get some advice from you. But it's been over 2 years ago that you and I held some very successful hearings on the 401(k) fee disclosure.

The CHAIRMAN. That's right.

Senator ENZI. At that time, the Department of Labor had issued a proposed regulation on how to disclose fees, and I believe that our hearing improved the outcome of the final regulations issued by the Department last year. That's why I'm grateful we're holding another hearing on the 401(k) system, to see what's working and what may need to be improved.

One of the hallmarks of the Pension and Protection Act of 2006 was the provision to allow companies to automatically enroll their employees in a 401(k) plan and to allow companies to match contributions. Statistics have shown that automatic enrollment is a tremendous success, with a great number of new employees being automatically enrolled. The surge took place from 2006 to 2009. But since then, the numbers leveled off. While some of the leveling off can be attributed to the economy, it may be that we just caught the easy fish and still haven't caught the hard ones. It appears that the large companies took advantage of automatic enrollment. However, automatic enrollment may have been more difficult for smaller sized companies to adopt. According to Fidelity Investments' analysis of 17,000 retirement plans, more than 50 percent of the companies with 5,000 workers or more adopted automatic enrollment, but only 15 percent of the companies with fewer than 500 employees adopted automatic enrollment of employees.

A friend of mine, in Sheridan, who has multiple companies throughout the United States, has a 401(k) plan that he matches very generously for every employee, and he has tremendous success signing people up. But it's because part of their orientation as being part of the company is that if they don't put in the amount of money that it takes to get it matched, he's not sure they're smart enough to work for him. And people should take advantage of those things. I, being a former small businessman, my wife Diane and I had shoe stores in Wyoming, and consequently, I think we can do more to help small companies. I've done accounting for a number of small companies, and some had 401(k) plans, and some didn't. So, I'm interested in introducing legislation this spring that would simplify the 401(k) system even more for small business owners. Getting the small businesses and their employees into the system is a critical step toward ensuring a strong retirement for more people.

Another key group of individuals who need to become invested is Generation Y, or, the Millenials, who are just entering the workforce for the very first time. All experts agree that having workers start investing early in their careers will save them from catch-up investments later in their lives. Hewitt just released a report on the 20-something generation, and they found that, due to lack of participation in defined contribution plans, low savings rates, and high rates of cash-out, 8 in 10 Generation Y workers will not meet their financial needs in retirement unless they significantly improve their savings and investing behaviors.

Now, with tuition at an all-time high, Americans now owe more than $875 billion in student loans. I can sympathize with students entering the workforce trying to pay off their student loans, while they pay rent or buy a house, and starting a family, and then have to save for retirement as well. Many entering the workforce are unprepared for this new financial reality. I've also noted that a lot of them make more money than their parents did, but they're not sure what to do with it all. They know that their parents have a car and a boat and a house, and a snowmobile, and other things, and what they don't realize is that they accumulated those over time while they took care of some of their retirement things. And so, they run out and buy all those things, and then they get in financial trouble.

I've been involved in financial literacy for a long time. When I was mayor, we had to find somebody that could provide financial literacy to these young people that were making so much money. The group that was most interested in doing it was the church. But people didn't see that as a relative place to go because they're always asking for money. Fortunately, the credit union stepped up and provided a program, and that had some credibility to it, and that's been expanded in the meantime. There's a Jump$tart program now in Wyoming and much of the United States that helps to provide that kind of advice to young people. It's a tremendous help. Dave Ramsey also has some courses that people on my staff have taken a look at, and it does help them to get out from under their credit card debt. I know of a couple of instances where they not only have done that, but they followed the whole plan. They have no debt, own their home, and have six months worth of finances in the bank. They're taking financial literacy very, very seriously. I have been sponsoring and passing legislation that would improve Federal Government literacy programs.

But one of the concerns I have now is that for young workers, the best one, and the program they're most likely to hear about, or, hear little about, especially from the newer employer, is this 401(k) opportunity. That's because when they go to work there, they're dumped with this pile of papers that they have to make decisions on and wander through, not just on the 401(k), but all the other Federal forms that we force them to fill out as well. I think that takes away from the big decision they have to make about retirement.

The people that are doing the plans are a little reluctant to do them because there is some liability that we placed on them now, too, because they have to help these people make the right decision, and nobody knows what the right decision is until after the market is done. They have to make all their decisions before the market. So, I do think there are some things that we can do, and I'm pleased that we have some experts that can give us some advice on what can be done to make these more workable for business, more workable for the employee, and more workable for a lifetime of security.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you, Senator Enzi. You're right. We do have a great panel of distinguished witnesses and experts.

First we have Jean Chatzky, the financial editor for NBC Today. If she looks familiar, that's because you've been watching the Today Show. Ms. Chatzky will provide a general overview of retirement savings in America and focus on the fact that people do not save enough.

Next we have Lori Lucas. She is an executive member of the Defined Contribution Institutional Investment Association, and is the executive vice president and Defined Contribution Practice Leader at Callan Associates. Ms. Lucas will summarize some of the research regarding automatic enrollment and escalation, and give some recommendations.

Dr. Julie Agnew is an associate professor of Finance and Economics, and the co-director of the Center for Interdisciplinary Behavioral Finance Research at the William and Mary Mason School of Business. She is going to discuss the role investor psychology and financial literacy play in making retirement decisions.

Finally, we'll hear, I hope by video hookup, Dr. Jeffrey Brown, the William K. Karnes Professor of Finance in the College of Business at the University of Illinois. Dr. Brown will discuss the ways to shift the way people think about retirement saving away from asset accumulation to a broader concept of retirement security. So, I hope that hookup works all right.

We'll start with Jean Chatzky.

Thank you very much.

By the way, all of your statements will be made a part of the record in their entirely. We'll just go from left to right, starting with Ms. Chatzky. If you could just sum it up in 5, 7, 8 minutes, something in that neighborhood, I'd appreciate it.

Ms. Chatzky, welcome. Please proceed.

STATEMENT OF JEAN CHATZKY, FINANCIAL JOURNALIST AND AUTHOR, NEW YORK, NY

Ms. CHATZKY. Thank you so much. Good afternoon, Mr. Chairman. I want to thank you and the members of the committee for taking the time to address this crucial issue.

Magazine covers and television ads show us a consistent picture of retirement. They show us a couple lazing on a beach and another on a golf course. Unfortunately, for most Americans these are fantasies. Data from the Employee Benefits Research Institute shows us that even for good-earning Baby Boomers and Generation Xers, there is a 50 percent chance of running out of money in retirement. That means they're not going to have enough to pay for the basics, let alone added health care expenses that can run six figures, even more.

According to the research, 4l percent of the people in the lowest 25 percent of American earners, the lowest quartile, were likely to run short of money after 10 years in retirement, and 57 percent after 20 years. Of course, those percentages continue to shrink as earnings increase, but 5 percent of the highest 25 percent of American earners are likely to run short of money after 10 years in retirement, and 13 percent after 20 years. And I have to say, as I watch Willard Scott wish a happy birthday to what seems like more centenarians every single week, that is not a comfortable proposition.

Fortunately, we now have at our fingertips other research that points the way toward solving this problem, or at least getting a jump on it. The passage of the Pension Protection Act in 2006 brought down those barriers for those employers who wanted to auto-enroll people, as you said, into their retirement plans, and it has been hugely successful. In companies that have automatic enrollment, 80 to 90 percent of people are in the company retirement plans. In companies that don't have it, only half that many people, particularly younger and lower income workers that you were talking about, participate. And 401(k) participation alone reduces the risk of running out of money to 20 percent. That's huge.

But it's not enough. Going further to solve this problem, to encourage even more Americans to put more of their hard-earned dollars away for tomorrow, is a matter of doing three things.

First, using the incentives at your disposal to encourage more employers, particularly the small ones, to offer plans and to put an alternative in place for those that don't. Workplace retirement savings works because it's easy. By taking the money out of employees' hands before they have a chance to spend it, it's as if it was never there to begin with. For that reason, the Auto IRA proposal that was raised last fall needs to be revisited. By requiring employers who don't sponsor plans to auto-enroll workers into individual IRAs, you cross the first hurdle. You make sure individuals have retirement plans. Of course, employees will always have the right to opt out. But inertia will win, and they won't.

Second, you need to encourage workers to save more. The financial community and the media have led workers astray when it comes to successfully achieving retirement savings goals. First, Americans were told that investment selection, that picking the right stocks and mutual funds, was the key to success. Next they were told it was all about asset allocation, deciding how much of your retirement pie you wanted to put in stocks and in bonds and in cash. Neither of these things solves the problem. The only thing that will get most Americans to a comfortable retirement nest egg is saving more money. I attached in my written testimony an analysis by Principal Financial that compares the three approaches. You should take a look, because it's eye-opening. You encourage saving more, again, by letting behavioral finance work its magic. Automatically escalating workers' contributions until they hit that maximum contribution levels is key because, again, we don't miss money when we don't see it in the first place.

But the third component—educating workers—is also crucial. It also works. The SMarT savings program, an approach which is short for Save More Tomorrow™, developed by behavioral economists Richard Thaler of the University of Chicago and Shlomo Benartzi out of UCLA, the SmarT program is an auto-escalation program which requires annual contribution increases of 3 percent until you max out. It was recently offered, accompanied by financial counseling, to every employee at a company with 300 workers. One-hundred sixty of them took advantage, and after 3 years, the savings rate of these employees jumped from 3½ percent to almost 12 percent. It tripled. Other companies have seen even greater success.

As Baby Boomers age, we will continue to see a shift in the message emanating from Wall Street. There will be more talk about annuitizing, managing retirement income, and making your money last. That's all well and good. But it's useless if we don't tackle the accumulation problem first. We need to make sure that Americans have enough money to begin with.

Thank you so much.

[The prepared statement of Ms. Chatzky follows:]

PREPARED STATEMENT OF JEAN CHATZKY

SUMMARY

Data from the Employee Benefits Research Institute shows us that even for good-earning Baby Boomers and Generation Xers, there's a 50 percent chance of running out of money in retirement. Fortunately, we now have at our fingertips other research that points the way toward solving this problem: The passage of the Pension Protection Act in 2006, brought down the barriers for those employers to auto-enroll people into their retirement plans. In companies that have automatic enrollment, 80 percent to 90 percent of people are in the company retirement plan. In companies that don't have it, half that many people are in. And 401(k) participation reduces the risk of running out of money to 20 percent. That's significant—but not enough. We need to do three things.

First, use the incentives at your disposal to encourage more employers—particularly small ones—to offer plans. The Auto IRA proposed last fall should be revisited. By requiring employers who don't sponsor plans to auto-enroll workers into individual IRAs, you cross the first hurdle. You make sure individuals have retirement plans. Second, encourage workers to save more. A successful retirement does not depend on investment choice or asset allocation, it hinges on *saving more money*. (Analysis attached.) Automatically escalating workers contributions until they hit the maximum contribution levels is key. And third, couple both of these initiatives with education to explain to workers why they need to do the right thing.

As Baby Boomers age, we will continue to see a shift in the message emanating from Wall Street. There will be more talk about annuitizing, managing retirement income, making your money last. It's useless if we don't tackle the accumulation problem first. We need to make sure Americans have enough money to begin with.

Good afternoon. I want to thank the committee for taking the time to address this crucial issue. Magazine covers and TV ads show us a consistent picture of retirement. A couple lazing on the beach. Another on the golf course. Unfortunately, for most Americans these are fantasies. Data from the Employee Benefits Research Institute shows us that even for good-earning Baby Boomers and Generation Xers, there's a 50 percent chance of running out of money in retirement. This means they're not going to have enough money to pay for the basics, let alone the added health care expenses that can run six-figures or more.

According to the research, 41 percent of people in the lowest 25 percent of American earners ($0—$11,700 a year) were likely to run short of money after 10 years in retirement, and 57 percent after 20 years. Those percentages continued to shrink as earnings increased, but 5 percent of the highest 25 percent of American earners ($72,000 and up) are likely to run short of money after 10 years in retirement and 13 percent after 20 years. As I watch Willard Scott wish a happy birthday to what seems like more centenarians every week, that's not a comfortable proposition.

Fortunately, we now have at our fingertips other research that points the way toward solving this problem. The passage of the Pension Protection Act in 2006, brought down the barriers for those employers who wanted to auto-enroll people into their retirement plans. It's been hugely successful. In companies that have automatic enrollment, 80 percent to 90 percent of people are in the company retirement plan. In companies that don't have it, half that many people (particularly younger and lower income workers) are in. And 401(k) participation reduces the risk of running out of money to 20 percent. That's significant.

But it is not enough. Going further to solve this problem—to encourage even more Americans to put more of their hard-earned dollars away for tomorrow is a matter of doing three things.

First, use the incentives at your disposal to encourage more employers—particularly small ones—to offer plans. And put an alternative in place for those that don't. Workplace retirement savings works because it's easy. By taking the money out of employees' hands before they have the chance to spend it, it's as if it was never there to begin with. For that reason, the Auto IRA proposed last fall should be revisited. By requiring employers who don't sponsor plans to auto-enroll workers into individual IRAs, you cross the first hurdle. You make sure individuals have retirement plans. Of course, employees will have the right to opt out. But inertia will win—and most won't.

Second, encourage workers to save more. The financial community—and the media—has led workers astray when it comes to successfully achieving retirement savings goals. First, Americans were told that investment selection, picking the right stocks and mutual funds, is the key to success. Next, they were told it was all about asset allocation, deciding how much of your pie to put in stocks and bonds and cash. Neither of these things is true. The only thing that will get most Americans to a comfortable retirement stash is *saving more money*. (I have attached an analysis by Principal Financial that compares the three approaches. It is eye-opening.) You do this, again, by letting behavioral finance work it's magic. Automatically escalating workers contributions until they hit the maximum contribution levels is key. We don't miss the money when we don't ever see it in the first place.

[Note: Attachment(s) to this statement may be found at *www.principal.com/retirement/docs/other/h2317.pdf*].

But the third component—educating workers—is also crucial. And it works. The SMaRT savings program (an approach, short for Save More Tomorrow, developed by behavioral economists Richard Thaler of the University of Chicago and Shlomo Benartzi of UCLA) is an auto escalation program, which requires annual contribution increases of 3 percent until you max out. It was recently offered—accompanied by financial counseling—to every employee at a company of 300 workers. More than half, 160, took the bait. And after 3 years, the savings rate of these employees had gone up from 3.5 percent to 11.6 percent. It tripled. Other companies have seen even greater success.

As Baby Boomers age, we will continue to see a shift in the message emanating from Wall Street. There will be more talk about annuitizing, managing retirement income, making your money last. That's all well and good. But it's useless if we don't tackle the accumulation problem first. We need to make sure Americans have enough money to begin with.

Thank you.

The CHAIRMAN. Thank you very much, Ms. Chatzky. Now we will turn to Lori Lucas.

Ms. Lucas, welcome. Please proceed.

STATEMENT OF LORI LUCAS, EXECUTIVE MEMBER, THE DEFINED CONTRIBUTION INSTITUTIONAL INVESTMENT ASSOCIATION, WASHINGTON, DC

Ms. LUCAS. Thank you. Good afternoon, Mr. Chairman and members of the committee.

Thank you for this opportunity to testify on this very important topic.

My name is Lori Lucas, and I'm the Defined Contribution Practice Leader at Callan Associates, one of the largest investment consulting firms in the country. I am also the executive chair of DCIIA's research committee, that's the Defined Contribution Institutional Investment Association, and they are a non-profit organization dedicated to enhancing the retirement security of American workers.

Like Jean said, the passage of the 2006 Pension Protection Act provided valuable safe harbors that allowed plan sponsors to more freely offer automatic enrollment and automatic contribution escalation in their 401(k) plans and other DC plans. That was a huge way that plan sponsors saw the ability to increase the prevalence of these features in their plans, so that going from a very nominal amount of plans offering them prior to the Pension Protection Act, we now see that about half of DC plans offer automatic enrollment and automatic contribution escalation.

Research shows that these auto features greatly enhance saving levels for American workers. They are very effective in getting people to save more. However, we can do more with automatic contribution escalation and automatic enrollment. That's because what we're finding is that they tend to be very conservatively implemented by plan sponsors. To give you an example, they may have as their initial contribution rate under automatic enrollment a mere 3 percent or 4 percent of pay as the initial deferral rate. Then they might automatically escalate people up to just 6 percent of pay. Because of the inertia among plan participants, participants are likely to stay at these levels for many years and not increase them on their own. To put that into context, the typical financial planner will tell you that you need to save between 10 and 15 percent of pay every year during your working life in order to have sufficient income at retirement. You can see the disconnect there, and the need to improve how these are being implemented.

However, a recent EBRI–DCIIA study showed that just by tweaking the way that automatic enrollment and automatic escalation are implemented can have a very profound and dramatic increase on retirement income savings levels. What DCIIA found was that by increasing the cap on automatic contribution escalation to levels of, say, 15 percent, and increasing the initial deferral in automatic enrollment to, say, 6 percent, the majority of workers were able to save enough to replace 80 percent or more of income in retirement. This is a pretty dramatic increase and really shows the importance of robust implementation of these auto features.

Policymakers can help. How they can help, first of all, is by revisiting the safe harbor for non-discrimination testing on automatic enrollment that was implemented in the Pension Protection Act. This safe harbor requires that the initial deferral under automatic enrollment start at at least 3 percent of pay. We ask that that be increased to at least 6 percent of pay to get people started on the track faster. We also note that the automatic contribution escalation cap under the safe harbor is 10 percent. We ask that that be increased to at least 15 percent, noting that when people actually choose on their own what they want their cap for automatic contribution escalation to be, that they tend to choose at least 15 percent or more. And remember, people can always opt out.

The second thing we ask is that policymakers make it clear to plan sponsors that it is a good thing to robustly implement automatic features, albeit in a prudent and reasonable way, but to make it a robust implementation. Unfortunately, what we're seeing happening is that plan sponsors are looking at the non-discrimination testing safe harbor requirements and inferring, even if they're not doing the non-discrimination testing safe harbor, that those are the proper way, or, those are the proper defaults that they should be using under automatic enrollment and under automatic contribution escalation, and that's one of the reasons these are being so conservatively implemented. We ask that it be clear that there's no fiduciary safe harbor, or no fiduciary guidance implied outside of the non-discrimination testing safe harbor for those that use automatic enrollment and automatic contribution escalation.

Finally, we ask for a fiduciary safe harbor for monthly income projections in retirement, so that people can actually see how much their savings will translate into when they get to retirement. We believe that this will help them to save at higher levels and discourage opt outs from these auto programs.

In the past, participants might have relied on the stock market to fill in the gap of poor savings habits. Certainly the last decade has shown us, if nothing else, that the stock market will not bail us out if we're not saving enough and we're not saving early.

The auto features are a tremendous boon for retirement savings, but they really do need to be properly implemented. What we ask is that the proper implementation be taken into consideration as a key goal for policymakers.

Thank you for this, the opportunity to testify.

[The prepared statement of Ms. Lucas follows:]

Prepared Statement of Lori Lucas

Summary

Since the 2006 passage of the Pension Protection Act (PPA), which provided valuable guidance and safe harbors to plan sponsors seeking to implement automatic enrollment and automatic contribution escalation, prevalence of these features within 401(k) plans has increased dramatically.

Research finds that such features greatly improve the expected level of savings that workers can achieve in retirement. However, research also concludes that many plans implement auto features in a way that is too conservative—reducing the probability that workers will succeed in saving enough to retire comfortably.

A study by EBRI and DCIIA finds that more robust implementation of auto features—such as increasing the automatic contribution escalation rate cap—can dramatically improve savings outcomes for American workers. Yet, policies such as the PPA non-discrimination testing safe harbor, actually discourage plan sponsors from robust implementation, and in fact encourage them to be overly conservative with their automatic contribution escalation rate caps and other auto features.

Policymakers can help by:

- Revisiting the PPA non-discrimination safe harbor to:
  - increase the maximum allowed cap from 10 percent to a higher level, or eliminate it altogether so that plan sponsors can choose their own cap.
  - start the automatic enrollment deferral at 6 percent immediately, as opposed to starting it at 3 percent and having it escalate to 6 percent.
- Providing guidance explaining that there is no "inferred" safe harbor for non-safe harbor plans and that the deferral amounts for the non-discrimination safe harbor should not be viewed as fiduciary guidance.

Policymakers could also explore ways to incentivize plan sponsors to adopt auto features: One way is to ease the company contribution requirements under the automatic enrollment non-discrimination testing safe harbor.

Finally, policymakers may wish to consider a fiduciary safe harbor that would support plan sponsors in educating participants on how their savings translates into expected income in retirement. This could reduce opt-outs and increase savings rates.

INTRODUCTION

Good morning Mr. Chairman and members of the committee. Thank you for the opportunity to testify at this important hearing.

My name is Lori Lucas and I am the Defined Contribution Practice Leader at Callan Associates—one of the largest independently owned investment consulting firms in the country. Our client services include strategic planning, plan implementation, monitoring and evaluation, and education and research for institutional investors such as sponsors of pension and DC plans. We were founded in 1973 and we have $1 trillion in assets under advisement.

I am also the executive chair of the Research and Surveys Committee of the Defined Contribution Institutional Investment Association (DCIIA). Founded in 2010, DCIIA is a non-profit association dedicated to enhancing the retirement security of American workers. DCIIA fosters a dialogue among the leaders of the defined contribution community including investment managers, consultants, law firms, recordkeepers, insurance companies, plan sponsors and others committed to the best interests of plan participants.

In today's testimony I will address the following topics:

- How automatic features are being implemented in DC plans.
- How current implementation of auto features is impacting American workers' retirement income adequacy.
- How we can raise the bar and dramatically improve outcomes through the use of auto features.

PREVALENCE AND IMPLEMENTATION OF AUTO FEATURES IN DC PLANS

Prior to the Pension Protection Act (PPA) of 2006, which provided valuable safe harbors to plan sponsors seeking to implement automatic enrollment and automatic contribution escalation, just one in five (19 percent) 401(k) plans automatically enrolled employees. For the majority of those plans, the money market or stable value fund was the default investment fund, and participants were commonly defaulted into the plan at just 2 percent or 3 percent of pay. Meanwhile, just 9 percent of plans offered automatic contribution escalation prior to the 2006 passage of the PPA.[1]

Today, half of DC plans automatically enroll participants. In most cases, new hires are automatically enrolled, although 4 in 10 large plans have done a one-time automatic enrollment sweep for existing employees. Today, asset allocation-type vehicles are the most common default investment fund by far, largely as a result of the PPA's qualified default investment alternative (QDIA) provisions. However, the common default contribution rate remains modest at 3 percent to 4 percent of pay.

Also, currently nearly half of DC plans offer automatic contribution escalation. The majority does not link automatic contribution escalation to automatic enrollment, but offers it as an opt-in option. Most plans with automatic contribution escalation as a default increase participant contributions by just 1 percent of pay annually, and cap annual contributions at low rates, such as 6 percent—which might be the company's match threshold.[2]

According to the preliminary results of a 2011 DCIIA survey of more than 100 plan sponsors, there are many reasons that plan sponsors do not offer automatic enrollment including: it is seen as unnecessary because plan participation is already sufficiently high, it doesn't fit into the plan's corporate culture because it is too paternalistic, it is inappropriate in the current economic environment, and it is too costly from a company matching perspective. Only a small percentage of plan sponsors who do not offer automatic enrollment are very likely to do so within the next 12 months.

Those plan sponsors who do not offer contribution escalation either haven't considered it, find it too paternalistic, or find it inappropriate in the current economic and legal/regulatory environment. Plan sponsors who do not offer contribution escalation say that increased regulatory/legislation changes/or support would encourage them to do so, such as by having the safe harbor rules extended to higher levels of auto escalation. Otherwise, those who don't currently offer automatic contribution escalation are not very likely to do so in the next 12 months. Those who do not offer automatic contribution escalation as a default also cite the fact that their employees would be upset if they increased rates automatically. Others mention that it is too paternalistic or that they haven't really considered it.

[1] Hewitt Associates. 2005 Trends and Experiences in 401(k) Plans Survey.

[2] Callan Associates. 2011 Trends in DC Plans Survey. Preliminary results of 2011 DCIIA Auto Features Survey.

Today, I would like to make the case that automatic enrollment and automatic contribution escalation are two DC plan features that can dramatically improve the retirement income adequacy of American workers in DC plans. However, these features must be more widely used by plan sponsors and more robustly implemented in order to have the necessary impact on workers' retirement savings.

IMPACT OF AUTO FEATURES ON RETIREMENT INCOME ADEQUACY OF AMERICAN WORKERS

Research by Jack VanDerhei of the Employee Benefit Research Institute (EBRI) in 2010 simulated the savings differences generated by plans with automatic enrollment versus voluntary enrollment by comparing large 401(k) plans given actual plan design parameters based on participant data from EBRI's 401(k) database. The analysis looked at all workers, not just those eligible for 401(k) plans. According to the analysis, when workers aged 25 to 29 under voluntary enrollment are compared to those under automatic enrollment of the same age cohort, the difference in projected median 401(k) balances is four times higher in the auto-enrolled group. Voluntary enrollment was at one and a half times final earnings whereas automatic enrollment resulted in six times final earnings. This shows the importance of automatic enrollment in improving retirement savings levels of workers over their full career.

EBRI and DCIIA then collaborated on a project analyzing how the probability of reaching a "successful" retirement income level changes with different 401(k) plan design variables and assumptions. While the definition of success using this simulation model can be quite complex, the analysis starts out with a very simple definition for this application: namely, a 401(k) accumulation large enough that, when combined with the worker-specific benefits projected under Social Security, will provide a total real replacement rate of 80 percent.

In other words, for purposes of this analysis, we will define an 80 percent income replacement rate as "success." Eighty percent is in the typical range of replacement rates suggested by many financial consultants. Importantly, this new analysis looks at workers eligible for 401(k) plan participation over 30 to 40 years—not all workers regardless of eligibility.

The analysis found that in the base case—that is, the way that automatic enrollment and automatic contribution escalation are implemented across thousands of DC plans—the probability of replacing 80 percent of income in retirement for workers who spend a full career in the DC system is 45.7 percent for low-income workers and 27 percent for high-income workers. In other words, these statistics also show that the current implementation of auto features is not likely to generate sufficient retirement for most workers.

However, when the implementation of auto features was more robust, coupled with improvements in employee behavior (described below), the picture changes. The analysis assumed the following changes to the way auto features are implemented in DC plans:

- Increase in the contribution rate cap (e.g., from 6 percent to 9 percent, 12 percent or 15 percent of compensation).
- Increase in the annual contribution rate change (2 percent vs. 1 percent of compensation).
- Successfully educate employees so that they don't opt out of the automatic escalation program.
- Encourage employees to remember and implement their previous level of contributions and not merely accept the new low default-contribution rate under automatic enrollment when they change employers.

In the best-case scenario—when all of these positive changes were made to auto features and implementation was robust—the probability of success increased dramatically. In fact, for the lowest quartile income level, the probability of replacing at least 80 percent of pre-retirement income increased 33.5 percentage points from 45.7 percent to 79.2 percent. For other quartiles, the probability improvement was similar. In my experience, there are few DC plan feature changes that can result in such dramatic improvements in retirement income adequacy.

The results essentially reflect the fact that when auto features are implemented conservatively—such as with a low initial contribution default, a small annual increase, and a low cap on contributions—participants are not prone to override these defaults, instead remaining with them for many years. This type of participant inertia has been well-documented for over a decade by researchers such as Brigitte Madrian and David Laibson of Harvard University. Even employees who might have participated more robustly under voluntary enrollment (such as with a 7 percent to 8 percent initial contribution to the plan) are likely, according to this behavioral research, to remain with the auto features' less robust defaults, resulting in low quality participation. As Choi, et al. concluded in their paper, "Saving for the Path of Least Resistance," "sophisticated employers should choose their plan defaults carefully, since these defaults will strongly influence the retirement preparation of their employees." [3]

RAISING THE BAR ON THE USAGE OF AUTO FEATURES IN DC PLANS

Given these results, why do plan sponsors implement automatic features conservatively when it comes to contribution levels? The reasons include:

(1) ***Desire to minimize opt-outs:*** plan sponsors widely believe that more modest contribution rate defaults minimize opt-outs, and encourage employees to remain in the plan under automatic enrollment and in the program under automatic contribution escalation.

(2) ***Cost:*** more aggressive defaults (e.g., escalating deferrals at a 2 percent rather than a 1 percent rate; or defaulting at a higher initial contribution rate under automatic enrollment) may result in increased matching costs. This can be difficult for plan sponsors to support, especially in harsh economic times.

(3) ***Safe harbor effect:*** even plan sponsors who are not seeking a non-discrimination testing safe harbor under the PPA may infer that it is more prudent from a fiduciary perspective to adopt the QDIA safe harbor for required defaults. Currently, these defaults are conservative when it comes to deferral rates.

The last consideration is one of particular note for policymakers. Plan sponsors are as subject to behavioral biases as any other individual. It is my experience and that of other DCIIA members that the signals being sent by the defaults, which are used in the automatic enrollment non-discrimination testing safe harbor, are influencing plan sponsor decisions when it comes to the implementation of auto features even for non-safe harbor plans. The safe harbor requires that automatic enrollment start at at least 3 percent and increase to at least 6 percent over 4 years. The maximum allowed cap under the safe harbor is 10 percent. It is important to note that the EBRI/DCIIA study found that the single most important factor in improving retirement income adequacy through more robust auto features was raising the automatic contribution escalation cap. At a minimum, guidance should be given to explain that there is no "inferred" safe harbor for non-safe harbor plans and that the deferral amounts for the non-discrimination safe harbor should not be viewed as fiduciary guidance.

Ideally, the safe harbor cap should be revisited, increasing the maximum allowed cap from 10 percent to a higher level, or eliminating it altogether so that plan sponsors can choose their own cap. Additional, the automatic enrollment deferral should start at 6 percent immediately, as opposed to starting it at 3 percent and having it escalate to 6 percent.

As mentioned, a key reason that some plan sponsors do not implement automatic enrollment at a higher rate (or at all), and do not incorporate automatic contribution escalation aggressively (or at all) is the cost associated with matching contributions. Therefore, policymakers may also wish to explore ways to incentivize more robust implementation of these features. One way is to ease the company contribution requirements under the automatic enrollment non-discrimination testing safe harbor.

Finally, it is important to educate plan sponsors about likely opt-out rates under various default deferral scenarios. Namely, there is no empirical evidence that the average plan experiences a higher opt-out rate when the default deferral level is 6 percent than when it is 3 percent. Because automatic contribution escalation is still relatively new and not yet widely adopted, we don't have enough empirical evidence that would confirm or refute the notion that opt-outs are likely to increase with more robust caps and higher rates. However, most initial indications are that these design features have little to no impact on opt-out rates. Further, research shows that when participants do proactively choose their own automatic contribution escalation maximum cap, it most commonly is 15 percent or higher.[4]

Opt outs can also be mitigated by educating employees on the value of high retirement savings rates. One way to do this is to show workers what their savings may

[3] Saving For Retirement on the Path of Least Resistance by James J. Choi Harvard University; David Laibson Harvard University and NBER; Brigitte C. Madrian University of Chicago and NBER; Andrew Metrick University of Pennsylvania and NBER; Originally prepared for Tax Policy and the Economy 2001 under the title "Defined Contribution Pensions: Plan Rules, Participant Choices, and the Path of Least Resistance" Revised in 2004 to include additional data and analysis.

[4] Hewitt Associates. "Improving Defined Contribution Plan Utilization through Retirement IMPACT." September 2005.

translate to in monthly retirement income. Many recordkeepers already provide monthly retirement income projections on DC participant Web sites and on statements. Some also even provide "gap" analysis—that is, the amount of additional savings plan participants need to achieve in order to replace sufficient income in retirement. Policymakers can encourage the use of such projections by providing a fiduciary safe harbor for plan sponsors.

CONCLUSION

In the past, DC participants—and plan sponsors—may have relied on the stock market to fill in the gap of workers' low savings and help them generate a sufficient 401(k) retirement nest egg. However, the last few years have shown that the market cannot be expected to "bail out" workers who do not save enough. Indeed, a recent Callan Associates study showed that the annualized total returns experienced by DC plan participants since early 2006 has been 0.11 percent: virtually all of the growth in participant balances over that time came from plan sponsor and participant contributions.[5] It follows then, that to ensure retirement income security for workers, plan sponsors must commit either to contributing more or to finding ways of increasing participant savings.

The EBRI/DCIIA study demonstrates that automatic enrollment and automatic contribution escalation provide a good starting point to improve worker behavior with regards to savings. However, insufficient attention has been given to ensuring that plan defaults lead to robust outcomes from a retirement income adequacy standpoint. The good news is that much can be done from a plan sponsor, policymaker and provider perspective to facilitate positive outcomes within the context of the existing framework of automatic enrollment and automatic contribution escalation. Thoughtful plan design and communication can materially alter the long-term savings levels of millions of Americans. In contrast, the alternative—plan design and communication that do not consider long-term income replacement ramifications—may have painful long-term social and economic consequences when it comes to American's retirement security.

[Editor's Note: Due to the high cost of printing, previously published materials are not reprinted in the hearing record. Appendix materials "The Impact of Auto-Enrollment and Automatic Contribution Escalation on Retirement Income Adequacy" may be found at *http://www.ebri.org/pdf/briefspdf/EBRI_IB_011-2010_No349-EBRI-DCIIA.pdf* and "Raising the Bar: Pumping Up Retirement Savings" may be found at *http://www.dciia.org/info/publications/Documents/DCIIA%20rESEARCH%20.*]

The CHAIRMAN. Thank you, Ms. Lucas.

Now we turn to Dr. Agnew.

Dr. Agnew, welcome. Please proceed.

STATEMENT OF JULIE AGNEW, Ph.D., ASSOCIATE PROFESSOR OF ECONOMICS AND FINANCE, WILLIAM AND MARY MASON SCHOOL OF BUSINESS, WASHINGTON, DC

Ms. AGNEW. Mr. Chairman and members of the committee, thank you for the opportunity to testify in front of you today. It's an honor to appear in front of this committee.

Today the goal of my testimony is to share with you findings from recent research that demonstrates the clear role investor psychology and financial literacy plays in retirement decisions, as well as highlight ways, in light of these results, that we might improve the way people make decisions.

As the committee is well aware, and clearly, from the testimony that's come before me, research has proven that automatic features in retirement plans work. The success of these features is also proof that investor psychology matters. Unfortunately, as automation in plans becomes more widespread, plan sponsors and policymakers may come to view plan communications and financial literacy programs generally as not needed and believe those who opt

[5] Callan Associates. Callan DC Index™. June 2010.

out of these automatic features, that they do so for informed reasons. In my testimony today I will highlight research that suggests just the opposite, and I'll argue for the need for more effective financial education programs that begin early and continue through life, as well as the need for simple communication materials that by design are easy to understand and accessible to individuals—and this is very important—who have limited interest in finance, insufficient financial knowledge, nor the time to devote to investment decisions.

Speaking to financial education, the research suggests that Americans may have limited financial knowledge. Numerous academic studies have shown that individuals do not understand basic financial concepts. Even more worrisome is that the research suggests that those with the most limited financial knowledge are the least aware of their deficiency, so they may not even seek advice when they need it. Furthermore, additional studies show that vulnerable groups, such as those with low income, low education, and women, are more likely to fall in this category. This is a concern, as the pension landscape in the United States continues to shift toward the defined contribution world and the responsibility to make financial decisions is increasingly placed on the individual. How can we expect individuals to make sound decisions when they do not understand their investment choices, nor appreciate the need to save?

Yet, it's not just general literacy that's important. Many participants simply do not understand the features in their plan. We were curious why individuals might quit an automatic enrollment plan, and we surveyed employees from two different plans. Interestingly, we found 18 percent of those who had quit thought that they were participating, even though they made that active choice. And 8 percent were not sure of their status. Moreover, we also find that those who were, who quit were more likely to not understand that they had a plan match. Thus, plan sponsors must clearly explain the benefits offered to participants and non-participants, and periodically remind all employees of the personal choices they have made.

When communicating with individuals or designing choices offered in plans, materials from plan sponsors and government agencies must be kept simple and engaging, and the set of choices limited. Through my work with CIBFR at the Mason School of Business, it's clear from the focus groups we have held that retirement-related decisions and understanding financial products is overwhelming for many, and related to a high level of anxiety and stress. When individuals become overwhelmed or lack sufficient knowledge to make a decision, they can easily experience what's called information overload. When individuals experience information overload, it can impair their judgment. We have found individuals with low financial literacy typically are more likely to experience information overload. In addition, I'd like, while my testimony goes into detail about information overload, to highlight two additional benefits for limiting this.

First, we find that people experiencing less information overload are more confident with their decisions when they're made. Second, regardless of the financial outcome, they're more satisfied with their choice. This is a worth outcome in itself. Finally, while automatic enrollment is a success, we should not believe that those that quit these plans are doing it for fully informed reasons. As mentioned earlier, these individuals might not understand the features of the plan. We have also found that those that quit tend to not trust financial institutions. Given recent market events, this is certainly not irrational. But perhaps a better understanding of how their plans work would reduce the mistrust attributable to simple lack of literacy.

In closing, recognizing the psychology of investing has led to useful changes in plan design. This research is important and must be continued. However, I also believe there needs to be a better job at integrating financial education into the daily lives of Americans at an early age, and at points where they're making important financial decisions. Financial experts should be used to make sure that the correct lessons are taught, and marketing experts should be involved so that people actually listen and are engaged in the message. We also must test to make sure these methods are effective, because we have too many examples today of programs that simply do not work.

[The prepared statement of Ms. Agnew follows:]

PREPARED STATEMENT OF JULIE AGNEW, PH.D.[1]

Chairman Harkin, Ranking Member Enzi and members of the committee, thank you for inviting me to testify. It is an honor to appear before this committee. Today, the goal of my testimony is to share with you the findings of recent academic research that demonstrates the clear role investor psychology and financial literacy plays in retirement decisionmaking, as well as highlight for you ways, in light of these results, that we might improve the way people make decisions.

As the committee is well aware, research has proven that automatic features in retirement plans work. The success of these features is also proof that investor psychology matters or else these design changes would be ineffective. Unfortunately, as "automation" in plans becomes more widespread, plan sponsors and policymakers may come to view plan communications and financial literacy programs generally as superfluous, and that those who opt-out of the automated features opt-out because they are simply informed individuals making calculated choices about their future. In my testimony today, I will highlight research that suggests just the opposite and I will argue for the need for more effective financial education programs that begin early and continue through life, as well as the need for simple communication materials that by design are easy to understand and accessible to individuals who have limited interest in finance, insufficient financial knowledge and/or time to devote to investment decisions.

Speaking to financial education, the research suggests that Americans today have limited financial knowledge. Numerous academic studies have shown that individuals do not understand basic financial concepts. Even more worrisome is that research suggests that those with the most limited knowledge may be unaware of their deficiencies and therefore may not seek or even realize they need assistance. Furthermore, additional studies show that vulnerable groups, such as those with low incomes, limited education, and women, are most likely to fall into this category and those in this category are more likely to succumb to behavioral biases. This is a concern as the pension landscape in the United States continues to shift towards a defined contribution world and the responsibility to make financial decisions is increasingly placed on the individual. How can we expect individuals to make sound decisions when they do not understand their investment choices nor appreciate the need to save?

[1] Much of this testimony is based on collaborative works with Lisa Szykman, Steve Utkus and Jean Young funded through grants from the Boston College Center for Retirement Research, the Boston College Center for Financial Literacy, FINRA Investor Education Foundation and the Social Security Administration. All errors and opinions are my own and do not represent the views of the Social Security Administration, FINRA nor the two centers at Boston College.

Yet it is not just general literacy that is important, participants may be failing to participate because they do not understand the features offered in their plan. We were curious about why individuals might quit an automatic enrollment plan, and so we surveyed employees in two different plans. Interestingly, we found that 18 percent of those who had quit did not realize that they were not participating despite making this active choice and 8 percent were not sure of their status. Moreover, we also found that those who quit were more likely not to know that their plan offered a match. Thus, plan sponsors must clearly explain the benefits of their plan to both non-participants and participants and must periodically remind all employees of the personal choices they have made.

When communicating with individuals or designing the choices offered in plans, materials from plan sponsors and government agencies must be kept simple and engaging and the set of choices limited. Through my work with the Center for Interdisciplinary Behavioral Finance Research at the Mason School of Business, it is clear from the focus groups we have run that making retirement-related decisions and understanding financial products is overwhelming for many and is often associated with high levels of stress and anxiety. When individuals become overwhelmed or lack sufficient knowledge to make a decision, they can easily experience what we call "information overload." When individuals experience information overload, it can impair their judgment by causing them to limit their research related to the decision, rely on simple rules of thumb or resign themselves to passively accept the default as it represents for them "the path of least resistance." We have found individuals with low financial literacy typically are more likely to experience information overload. More about this can be found in my written testimony but I would like to highlight two additional benefits of limiting information overload beyond helping people make more informed decisions. First, we find that those experiencing less information overload are more confident with their decisions when they are made and, second, regardless of the financial outcome they tend to be more satisfied with their choice. This is a worthy outcome in itself.

Finally, while automatic enrollment is a success, we should not believe that those who quit are always individuals making fully informed decisions. As mentioned earlier, these individuals might not understand the features of the plan. We have also found that those who quit tend not to trust financial institutions. Given recent market events, this is certainly not irrational, but perhaps a better understanding of how their plans work and their asset choices would reduce the mistrust attributable to simple lack of financial literacy.

In closing, recognizing the psychology of investing has led to useful changes in plan design. This research is important and must be continued. However, I also believe that more needs to be done to better integrate financial education into the daily lives of Americans starting at an early age and at points where important financial decisions are being made. Financial experts should be used to make sure that the correct lessons are being taught and marketing experts should be involved so that people actually listen and are engaged in the message. We also must test to make sure these methods are effective, because we have too many examples today of programs that do not work.

The remainder of my testimony elaborates further on these comments.

INVESTOR PSYCHOLOGY AND RETIREMENT DECISIONS [2]

Over the past 10 years, administrative data from 401(k) plans have provided academics a rich and fruitful context for investigating behavioral finance theories. This growing area of research has enhanced our understanding of the psychology of investing, provided substantial support for various theories, and led to significant changes in retirement plan design that have improved overall savings outcomes.

This section provides a high level overview of some of the research findings in the area. I highlight several studies that relate to four important retirement decisions. Those decisions are whether or not to participate in a plan, how much to contribute to a plan, how to allocate and trade assets and what to do during the distribution phase. While this summary is *not* at all comprehensive, the intent is to convince the reader by the end of this section that investor psychology should not be ignored when discussing retirement decisionmaking or making policy. For those interested in more details, the appendix includes a recently published book chapter with a more complete overview.

[2] A more comprehensive overview of this growing research area can be found in the book Behavioral Finance: Investors, Corporations and Markets (2010). The full citation can be found in the reference section. This section summarizes and provides direct excerpts from the *one chapter in the book*. Please refer to this chapter in the appendix for more details.

Participation

Brigitte Madrian and David Shea's (2001) seminal study on 401(k) participation led to widespread changes in plan design and is one of the best examples of how applying behavioral finance research can improve financial outcomes.[3] These authors analyze one 401(k) plan transitioning from a voluntary (opt-in) enrollment arrangement to an automatic (opt-out) enrollment arrangement. According to rational-choice, this change in enrollment method should not affect participation levels if individuals have well-defined preferences because a person will always optimize and select the best option (Johnson and Goldstein, 2003). Contrary to this expectation, the authors find participation levels for employees at similar points in job tenure increase significantly when automatic enrollment is introduced, from 37 percent to 86 percent. In addition, participation rates between demographic groups equalize.[4] This dramatic increase in participation may be due to, among other things, the tendency for individuals to procrastinate or because employees view the default choice as an implicit endorsement from the company.

Additional research finds other behavioral factors affecting participation rates. For example, Esther Duflo and Emmanuel Saez (2002, 2003) find that peers influence individuals' choices. Furthermore, the number of investment choices offered in a plan may influence participation. Too many choices may overwhelm individuals and make them less likely to make a decision. In a voluntary plan, the absence of a decision translates into non-participation. Sheena Sethi-Iyengar, Gur Huberman and Wei Jiang (2004) find evidence that this type of "choice overload" discourages plan participation. Their analysis suggests that for every 10 funds added to an investment menu, the probability of participation decreases by 1.5 to 2 percent.

Less is known regarding why individuals may opt-out of an automatic enrollment plan. However, we do find in a study that combines survey evidence with 401(k) administrative data that trust in financial institutions matters.[5] Those who distrust financial institutions are more likely to opt-out of automatic enrollment. This is consistent with previous research that has shown that distrust of financial institutions influences general financial behavior, particularly among households in the lower socio-economic strata.[6] It is important to note that distrust is not necessarily irrational and that we gathered the data prior to the recent financial crisis.

Contribution Levels

Determining how much to contribute to a plan is another important decision individuals face when enrolling in their 401(k) plan. Highlighting the influence of the default bias, James Choi, David Laibson, Brigitte Madrian, and Andrew Metrick (2004) report that 80 percent of automatically enrolled participants in their study accept both the default contribution rate and the default investment fund. Consistent with the status quo bias and inertia, they find that 3 years later, over half of these participants maintain these default options. Given that plan providers often set the default contribution rate very low, this has become one of the few downsides of the trend towards automatic enrollment.[7]

In an effort to increase contribution levels, especially as automatic enrollment has caused many to anchor at low rates, some plans have implemented an auto escalation feature that takes advantage of information learned about investor psychology. First engineered by Thaler and Bernatzi (2004), their auto escalation scheme called Save More Tomorrow™ allows participants to "'lock-' in" in to future increases in savings which helps them overcome self-control issues. In addition, the program minimizes regret by timing future contribution increases with pay raises. The plan also relies on inertia, the tendency for participants to not change their options. In their study, they find that after the fourth pay raise SMarT participants contribute on average 13.6 percent to the plan compared to an 8.8 percent contribu-

[3] For those plans not willing to switch to automatic enrollment, researchers understanding behavioral finance have devised new approaches that work with voluntary schemes. They include active choice (Carroll, Choi, Laibson, Madrian and Metrick (2009)), social marketing (Lusardi, Keller and Keller (2008)) and Quick Enrollment™ (Choi, Laibson, and Madrian (2009)).

[4] These findings have been supported by several other studies including Choi, Laibson, Madrian and Metrick (2002).

[5] See Agnew, Szykman, Utkus and Young (forthcoming).

[6] Research suggests that poorer individuals have a culture of distrust of financial institutions (Bertrand et al., 2006; Szykman, et al., 2005). In a focus group conducted by Szykman et al. (2005) respondents expressed feelings of alienation as well as an underlying belief that banks cannot be trusted to do the right thing. The respondents also stated that they avoided doing business with banks because of these perceptions. Finally, Guiso et al. (2007) found that lack of trust can explain why some people do not invest in the stock market. Additionally, they find that countries with low stock participation rates have low trust levels.

[7] See Nessmith, Utkus, and Young (2007).

tion rate for those who instead consult with an advisor. The contrast is even more dramatic when comparing contribution rates with those who opt not to see a financial consultant (6.2 percent) or decline participation in the SMarT plan (5.9 percent).

Asset Allocations and Trading

Another challenging decision that investors face is how to allocate their savings among assets and when, if at all, they should trade their positions. Selecting a portfolio is a complicated decision that can be overwhelming to many. As a result it is not surprising that the research shows that many individuals exhibit behavioral biases when making these choices and often rely on simple rules of thumb. For example, owning a portfolio with a high concentration of company stock (that is, the stock of your employer) is not consistent with the diversification recommendations of financial experts because company stock performance is correlated with employment. It became clear following the WorldCom and Enron debacles that overinvestment in company stock was a frequent practice and led to financial ruin for many employees. Researchers suggest that one reason participants invest in company stock is a familiarity bias.[8] They buy what they know. In addition, other research, including my own, finds that the allocation to company stock is higher when the past performance of that stock is higher.[9] Individuals investing in this manner are most likely practicing what is called "excessive extrapolation" which can be a poor way to choose allocations.

As a cautionary example against excessive extrapolation, investors in Sweden's pension scheme may have been using historically high 5-year fund returns to aid in their fund selection. During the first year of the program, a technology and health-care fund recorded the best 5-year fund performance out of all 456 funds. An information booklet given to all the participants reported these returns. Interestingly, this fund received the largest percent of the contribution pool (4.2 percent) when the default fund is excluded (Cronqvist and Thaler, 2004). Unfortunately for those who selected this fund, by 2003 the Internet bubble had burst and this fund had lost 69.5 percent of its value.

Regarding trading, unlike retail brokerage accounts, trading in 401(k) plans is characterized by extreme inactivity, or inertia.[10] Although this behavior in certain cases could be consistent with the implications of models for optimal portfolio choice, it could also be the result of procrastination. In this case, if a participant is defaulted into a fund that is inappropriate for his or her risk characteristics, the optimal action would be to trade out of the funds.

Distribution Phase

While many researchers have devoted time to studying how behavioral factors influence decisions in the accumulation phase, it is not until recently that academics have turned their attention to understanding the psychology behind how individuals make investment and consumption decisions upon retirement. Recent research has addressed one such decision, the decision to buy an annuity, and suggests that framing plays an important role in this choice.[11] In an experimental study I conducted with Lisa Anderson, Jeff Gerlach and Lisa Szykman (2008), we find a significant influence of negative message framing on whether our experimental participants chose an annuity option or an investment option. Brown, Kling, Mullainathan and Wrobel (2008) also find significant results related to the influence of framing on the attractiveness of annuities. They use an Internet survey to demonstrate that the demand for annuities can be influenced by whether the consumer is viewing the annuity from a narrow investment frame or a broader consumption frame. The authors find that individuals in the consumption frame prefer annuities to other non-annuitized products and the reverse holds for the investment frame.

Research using administrative data and experimental data shows that excessive extrapolation may also come into play in the annuity decision.[12] Both types of research show that individuals are more inclined to avoid annuities when markets have exhibited higher returns in the past.

---

[8] For example, see Huberman (2001).

[9] See Benartzi (2001), Choi et al. (2004), Huberman and Sengmueller (2004), Agnew (2006) and Brown et al. (2007).

[10] For example, see Odean (1999), Ameriks and Zeldes (2001), Madrian and Shea (2001), Agnew, Balduzzi and Sunden (2003), Mitchell, Mottola, Utkus and Yamaguchi (2006).

[11] For an overview of the research in this area, please see Brown (2008).

[12] See Agnew, Anderson and Szykman (2008), Chalmers and Reuter (2009) and Previtero (2010).

FINANCIAL LITERACY, FINANCIAL CAPABILITY AND PLAN KNOWLEDGE

The research presented in the previous section should make clear that behavioral biases influence all types of retirement related investment decisions. In some cases, a behavioral bias may actually result in a favorable outcome. For example, the default bias results in more people saving when automatic enrollment is used. However, the default bias can also lead to lower savings rates and the wrong portfolio allocation if those defaults are not carefully chosen for the participants in the plan. Moreover, the Swedish pension example mentioned earlier demonstrates the downside of choosing allocations based on prior returns. There is some evidence that those with lower financial literacy may be more susceptible to behavioral biases. Supporting this we find, in an experimental study examining portfolio choice, that individuals with lower financial literacy are more likely to choose the default option versus those in the high literacy category (20 percent vs 2 percent).[13]

Unfortunately, the evidence related to financial literacy in the United States is grim. In a paper prepared for the Financial Crisis Inquiry Commission, Annamaria Lusardi (2010) provides an overview of research in this area. The results are disappointing but perhaps not surprising given recent economic events. Many Americans lack basic financial knowledge. A large number cannot carry out simple interest-rate calculations, let alone correctly answer questions about asset types. Lusardi cites several studies that suggest that those with less literacy are less likely to plan for retirement, accumulate wealth and participate in the stock market among other things. She also describes the results of a National Financial Capability Study funded by FINRA Investor Education Foundation. In the study, financial capability is measured in terms of "how well people make ends meet, plan ahead, choose and manage financial products, and possess the skills and knowledge to make financial decisions." The results from this study are equally troubling and suggest more needs to be done to improve American's ability to make informed and sound financial decisions.

In my research, we find similar evidence of low financial literacy. In one study, we find that only 37 percent of the participants understood that high-yield bonds funds were not invested in bonds with strong credit ratings. In addition, while 84 percent of respondents knew they could lose money in a stock fund, only 43 percent realized there was also that risk in a bond fund.[14] We also find that individuals' perception of their own relative knowledge and their actual financial literacy score are often different. This suggests that some people may not know how little they know. This could be an issue if they do not realize that they need to improve their education. Unfortunately, we find those with the least education show the weakest correlation between their tested ability and their own perception.[15] This result is also supported by the nationally representative data sample in the National Financial Capability Study.

In addition to low financial literacy, we find that many individuals are unaware of their own plan's features. We find that the probability of participating in an automatic enrollment plan decreases if the participant is not aware that they have a match.[16] It is logical that individuals will not react properly to economic incentives when they do not understand what incentives they are offered. As a result, more needs to be done to explain the benefits in plans clearly to employees.

Also disturbing is the evidence of a lack of basic awareness regarding individuals' personal financial decisions. For example, in the two automatic enrollment plans we studied, 18 percent thought they were participating even though they opted out of the plan and 8 percent of the non-participants were unsure of their status. This lack of basic awareness regarding personal financial decisions is also reflected in the National Financial Capability Study where 12 percent of those surveyed could not recall how much they had paid down on their house and 10 percent did not know the mortgage interest rate they were paying.[17] Thus, plan sponsors cannot assume that individuals are aware of the choices they have made in their plans and periodic reminders of their decisions and the possible consequences could be helpful. Finally, there is an alternative explanation for why individuals who are in automatic enrollment plans are more aware they have a match than those who opt-out. It could be that they become aware after they participate through the quarterly statements they receive. Thus, they are learning because they are participating. If this alter-

[13] See Agnew and Szykman (2005).
[14] See Agnew and Szykman (2005).
[15] See Agnew and Szykman (2005).
[16] See Agnew, Szykman, Utkus and Young (forthcoming).
[17] Summary of these results can be found in Lusardi (2010).

native theory holds, then it supports adding additional features to plan designs, such as periodic re-enrollment of those who opt-out.

FINANCIAL LITERACY AND INFORMATION OVERLOAD

Beyond not being able to make an informed decision, low financial literacy may make individuals overwhelmed by financial information and by the presence of too many choices.[18] This leads to what we call "information overload." When individuals experience information overload, it can impair their judgment by causing them to limit their research related to the decision, rely on simple rules of thumb or resign themselves to passively accept the default as it represents for them "the path of least resistance." We find in an experiment that the percentage of those reporting information overload decreases with tested financial knowledge. Thus, those with lower financial literacy may be more susceptible to information overload.[19]

There are a number of variables that may contribute to overload. One source could be how information about choices is presented to investors. Effectively communicating choice information has long been a topic of interest for consumer researchers, and nutritional labeling provides a good example of how information can be presented in a simple and easily comparable format.[20] Another potential source of information overload is the number of investment options offered in the plan. Research shows that too many choices hamper decisionmaking. As mentioned earlier, one study finds that 401(k) plans with more options tend to result in lower participation rates.

We conducted an experimental study to see if reducing the number of investment choices reduced reported information overload when making a portfolio allocation decision.[21] In the experiment, individuals were asked to make a portfolio allocation from either a large number of funds (60) or a small number of funds (6). The number of fund choices impacted the reported overload of the high-knowledge individuals in the sample. This group experienced statistically greater feelings of overload with more choices. However, low-knowledge individuals were overwhelmed regardless of the number of choices offered. This indicates that changes in plan design, such as decreasing the number of choices may be effective in reducing information overload, but not for all participants. In this case, it only helped those with above average knowledge. For the low-knowledge, a very vulnerable group, it did nothing. Thus these results provide justification for continued financial literacy efforts alongside behaviorally motivated plan design changes.

In a separate study of participants' choice between an annuity vehicle and an investment option, we also found that those who reported less information overload when making their decision were also more confident at the time they made the decision.[22] In addition, after the experiment was completed and participants knew the final financial outcome, those with less information overload were still more satisfied regardless of how well they did financially. One way to interpret this finding is that when individuals understand their decision, they are less likely to regret it because they understood the consequences when they made it. Thus by empowering investors through financial education, simplified plan design and effective communication, we help investors make more thoughtful and confident decisions. In addition, it may also benefit plan sponsors and the entire industry by producing more satisfied consumers.

Anecdotally, participant remarks in recent focus groups conducted in conjunction with projects affiliated with the Center for Interdisciplinary Behavioral Finance Research and funded by the new Financial Literacy Research Consortium suggest that individuals are often overwhelmed. Many individuals in the groups expressed great anxiety related to retirement decisionmaking. In one set of focus groups, participants were asked to choose two or three pictures that represented how they felt emotionally about retirement. They were asked to draw them from a sample of several hundred pictures cut out of various magazines and acquired from different sources. The moderator encouraged them to choose pictures that represented their

[18] See Agnew and Szykman (2010).
[19] See Agnew and Szykman (2011).
[20] The economics of information literature suggests that consumers tend to use information more extensively if it costs less in time and/or money to acquire (Stigler, 1961, Nelson, 1970, 1974). These findings suggest that when information is easier to obtain and evaluate, consumers are more likely to use it when making decisions or choices. For example, in the nutritional labeling literature, it has been shown that as dependable information becomes easier to utilize (such as information presented in a standardized format), consumers use the information more to determine food quality, acquire more nutrition information prior to purchase, and improve their overall decision quality.
[21] See Agnew and Szykman (2005).
[22] See Agnew and Szykman (2011).

hopes and dreams, as well as their anxieties. The pictures chosen were varied. Some images depicted idyllic scenes, such as a loving couple relaxing in a hammock or a man peacefully fishing in the glow of a sunset. However, many images were disturbing and chosen because they demonstrated participants' feelings of being stressed and trapped. Several participants chose the picture below.

It should be noted that these selections occurred just a year following the 2008–9 financial crisis and one of the worst economic recessions in U.S. history. Thus it is hard to know whether these images are accurate images of respondents long-term retirement prospects, or simply an emotional reaction to recent experience.

In the end, it is clear that many Americans are feeling overwhelmed at the present time, and that more can be done to help them make more informed decisions. That said, given evidence suggesting that most Americans are not interested in finance, the financial lessons must be taught in an engaging manner that recognizes that people have limited time and interest. To do this effectively, we must use an interactive approach and include financial experts, educators and marketers. One approach that I support is to begin financial education early on in elementary school and to repeat the important themes with age-appropriate lessons on through the college years. In addition, making instruction and information easily available to Americans when they experience important life events, such as a marriage or a death in the family, could capture people when they are most interested and motivated to learn. In this regard, several interesting projects designed to engage Americans are currently being developed by the three Centers affiliated with the Financial Literacy Research Consortium funded by the Social Security Administration. I believe efforts like these and others have a great deal of merit.

References

Agnew, Julie R. 2006. Do behavioral biases vary across individuals? Evidence from individual level 401(k) data. *Journal of Financial and Quantitative Analysis* 41:4, 939–61.

Agnew, Julie R. 2010. Pension participant behavior. In *Behavioral Finance: Investors, Corporations and Markets*, (eds.) Kent Baker and John R. Nofsinger, 577–94. Kolb Series: John Wiley & Sons, Inc.

Agnew, Julie R., Lisa Anderson, Jeff Gerlach, and Lisa Szykman. 2008. Who chooses annuities?: An experimental investigation of gender, framing and defaults. *American Economic Review* 98:2, 418–22.

Agnew, Julie R., Lisa Anderson, and Lisa Szykman. 2010. An experimental study of the effect of prior market experience on annuitization and equity allocations. Working Paper. College of William and Mary.

Agnew, Julie R., Pierluigi Balduzzi, and Annika Sunden. 2003. Portfolio choice and trading in a large 401(k) plan. *American Economic Review* 93:1, 193–215.

Agnew, Julie R., and Lisa R. Szykman. 2005. Asset allocation and information overload: The influence of information display, asset choice, and investor experience. *Journal of Behavioral Finance* 6:2, 57–70.

Agnew, Julie R., and Lisa R. Szykman. 2010. Information overload and information presentation in financial decisionmaking, In *The Handbook of Behavioral Finance*, (ed.) Brian Bruce. Edward Elgar Publisher.

Agnew, Julie and Lisa Szykman. 2011. Annuities, financial literacy and information overload, In *Financial Literacy: Implications for Retirement Security and the Financial Marketplace* (eds.) Olivia S. Mitchell and Annamaria Lusardi, 260–97. Oxford, UK: Oxford University Press, forthcoming.

Agnew, Julie, Lisa Szykman, Steve P. Utkus and Jean A. Young. Forthcoming. "Trust, Plan Knowledge and 401(k) Savings Behavior." *Journal of Pension Economics and Finance*.

Ameriks, John, and Stephen P. Zeldes. 2001. How do household portfolio shares vary with age? Working Paper, Columbia University.

Benartzi, Shlomo. 2001. Excessive extrapolation and the allocation of 401(k) accounts to company stock. *Journal of Finance* 56:5, 1747–64.

Bertrand, Marianne, Sendhil Mullainathan, and Eldar Shafir. 2006. Behavioral economics and marketing in aid of decisionmaking among the poor. *Journal of Public Policy and Marketing* 21:2, 8–23.

Brown, Jeffrey R. 2008. Understanding the role of annuities in retirement planning. In *Overcoming the saving slump: How to increase the effectiveness of financial education and savings programs*, (ed.) Annamaria Lusardi, 178–208. Chicago: University of Chicago Press.

Brown, Jeffrey R., Jeffrey R. Kling, Sendhil Mullainathan, and Marian V. Wrobel. 2008. Why don't people insure late-life consumption? A framing explanation of the underannuitization puzzle. *American Economic Review* 98:2, 304–09.

Brown, Jeffrey R., Nellie Liang, and Scott Weisbenner. 2007. Individual account investment options and portfolio choice: Behavioral lessons from 401(k) plans. *Journal of Public Economics* 91:10, 1992–2013.

Carroll, Gabriel, D., James Choi, David Laibson, Brigitte C. Madrian, and Andrew Metrick. 2009. "Optimal Defaults and Active Decisions." *Quarterly Journal of Economics* 124:4, 1639–74.

Chalmers, John and Jonathan Reuter. 2009. How do retirees value life annuities? Evidence from Public Employees. Working paper.

Choi, James J., David Laibson, and Brigitte Madrian. 2009. Reducing the Complexity Costs of 401(k) Participation through Quick Enrollment™. In *Developments in the Economics of Aging*, (ed.) David A. Wise, 57–82. Chicago: University of Chicago Press.

Choi, James J., David Laibson, Brigitte C. Madrian, and Andrew Metrick. 2002. Defined contribution pensions: Plan rules, participant decisions and the path of least resistance. In *Tax Policy and the Economy*, (ed.) James M. Poterba, 67–113. Cambridge, MA: MIT Press.

Choi, James J., David Laibson, Brigitte C. Madrian, and Andrew Metrick. 2004. For better or for worse: Default effects and 401(k) savings behavior. In *Perspectives on the economics of aging*, (ed.) David A.Wise, 81–121. Chicago: University of Chicago Press.

Cronqvist, Henrik, and Richard H. Thaler. 2004. Design choices in privatized social security systems: Learning from the Swedish experience. *American Economic Review* 94:2, 424–28.

Duflo, Esther, and Emmanuel Saez. 2002. Participation and investment decisions in a retirement plan: The influence of colleagues' choices. *Journal of Public Economics* 85:1,121–148.

Duflo, Esther, and Emmanuel Saez. 2003. The role of information and social interactions in retirement plan decisions: Evidence from a randomized experiment. *Quarterly Journal of Economics* 118:3, 815–842.

Guiso, Luigi, Paola Sapienza, and Luigi Zingales. 2008. Trusting the stock market. *Journal of Finance* 63:6, 2557–600.

Huberman, Gur. 2001. Familiarity breeds investment. *Review of Financial Studies* 14:3, 659–80.

Huberman, Gur, and Paul Sengmueller. 2004. Performance and employer stock in 401(k) plans. *Review of Finance* 8:3, 403–43.

Johnson, Eric J., and Daniel Goldstein. 2003. Do Defaults Save Lives? *Science* 302:5649, 1338–9.

Lusardi, Annamaria. 2010. "America's Financial Capability." Paper prepared for the Financial Crisis Inquiry Commission.

Lusardi, Annamaria, Punam Anand Keller, and Adam M. Keller. 2008. "New Ways to Make People Save: A Social Marketing Approach." In *Overcoming the Saving*

Slump: How to Increase the Effectiveness of Financial Education and Savings Programs, (ed.) Annamaria Lusardi (ed.), 209–36. Chicago: University of Chicago Press.

Madrian, Brigitte C., and Dennis F. Shea. 2001. "The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior." *Quarterly Journal of Economics* 116:4, 1149–87.

Mitchell, Olivia S., Gary R. Mottola, Stephen P. Utkus, and Takeshi Yamaguchi. 2006. The inattentive participant: Portfolio trading behavior in 401(k) plans. Pension Research Council Working Paper, PRC WP 2006–5, The Wharton School.

Nelson, Phillip. 1970. "Information and Consumer Behavior." *Journal of Political Economy* 78, 311–329.

Nelson, Phillip. 1974. "Advertising as Information." *Journal of Political Economy* 83, 729–54.

Nessmith, William E., Stephen P. Utkus, and Jean A. Young. 2007. Measuring the effectiveness of automatic enrollment. Vanguard Center for Retirement Research, Volume 31.

Odean, Terrance. 1999. Do investors trade too much? *American Economic Review* 89:6, 1279–98.

Previtero, Alessandro. 2010. Stock market returns and annuitization. Working Paper, UCLA Anderson School of Management.

Sethi-Iyengar, Sheena, Gur Huberman, and Wei Jiang. 2004. "How Much Choice is Too Much? Contributions to 401(k) Retirement Plans." In *Pension Design and Structure: New Lessons from Behavioral Finance*, (eds.) Olivia S. Mitchell and Stephen P. Utkus, 83–95. Oxford University Press.

Stigler, George. 1961. "The Economics of Information." Journal of Political Economy, 69, 213–255.

Szykman, Lisa, Don Rahtz, Michael Plater, and Greg Goodwin. 2005. Living on the edge: Financial services for the lower socio-economic strata. Working Paper, College of William and Mary.

Thaler, Richard H., and Shlomo Benartzi. 2004. Save more tomorrow: Using behavioral economics to increase employee saving. *Journal of Political Economy* 112:1, 164–87.

APPENDIX

CHAPTER 31

PENSION PARTICIPANT BEHAVIOR [1]

(By Julie Richardson Agnew, Associate Professor of Finance and Economics, College of William and Mary)

INTRODUCTION

Over the past 25 years, the United States has witnessed a dramatic shift in pension coverage (for an overview, see Poterba, Venti, and Wise, 2008). For years, Social Security and defined benefit plans provided many employees guaranteed support in retirement. In both cases, difficult savings and investment decisions were not the responsibility of the participants. Today, the landscape has changed dramatically. While policymakers debate serious concerns about the long-term solvency of the Social Security system, defined contribution plans have become the most common pension offering. From the employer's perspective, this change is beneficial because defined contribution plans are less expensive to administer and shift the portfolio risk entirely to the employee. From the employee's perspective, defined contribution plans offer portability but also involve the personal responsibility of making critical savings decisions. For many, these new and challenging financial decisions are overwhelming and further complicated by a lack of financial literacy, interest, and time. One unintended consequence of this shift is that it has provided academics a rich context for investigating behavioral finance theories. Over the past 10 years, this growing area of research has enhanced our understanding of the psychology of investing, provided substantial support for various theories, and led to significant changes in retirement plan design that have improved overall savings outcomes. The purpose of this chapter is to summarize the most significant findings in this area that relate to behavioral finance and highlight the successful plan design changes that have resulted.

[1] From *Behavioral Finance: Investors, Corporations and Markets, Kent Baker and John R. Nofsinger, Editors. John Wiley & Sons, Inc., 2010. Reprinted with permission of the Publisher.*

This chapter contains six main sections. The first five sections address the behavioral aspects of five important financial decisions investors must make in their retirement plans: (1) whether to participate in the plan, (2) how much to periodically contribute, (3) where to allocate assets, (4) when to rebalance allocations, and (5) how to handle the sum they have accumulated once they retire. The final section discusses how financial literacy and lack of interest may contribute to the influence of biases and heuristics in these decisions.

THE PARTICIPATION DECISION

When employers first introduced defined contribution plans, employees typically joined their retirement plan under a voluntary enrollment arrangement. This meant they had to consciously "opt-in" to participate. Early studies largely focused on rational explanations for nonparticipation. Often studies used either 401(k) administrative data or survey evidence to investigate the role of plan features and individual characteristics. Researchers often found that plan design elements—such as employer matches and individual characteristics like age, salary, ethnicity, and job tenure—mattered for participation rates. Munnell, Sundén, and Taylor (2001/2002) provide a concise survey of this early work. By the late 1990s, a growing interest in behavioral reasons for nonparticipation was emerging that led to research evidence supporting several behavioral biases. Today, the retirement savings decision is clearly a function of a complex set of factors. In addition to rational explanations for nonparticipation, behavioral biases can play an important role.

A popular Madrian and Shea (2001) study led to widespread changes in plan design. The authors analyze one 401(k) plan transitioning from a voluntary (opt-in) enrollment arrangement to an automatic (opt-out) enrollment arrangement. According to rational-choice theory, this change in enrollment method should have no effect on participation levels if individuals have well-defined preferences because a person will always optimize and select the best option (Johnson and Goldstein, 2003). Contrary to this expectation, the authors find participation levels for employees at similar points in job tenure increase significantly when automatic enrollment is introduced, from 37 percent to 86 percent. In addition, participation rates between demographic groups equalize. The authors are careful in their analysis and make sure that none of the economic characteristics such as the vesting schedule, number of investment options, access to loans, and level of employer matching change during the study. As a result, their findings strongly point to behavioral explanations. Madrian and Shea provide a thorough summary of several behavioral theories that explain their findings and highlight procrastination, in particular, as a very likely cause.

So what causes individuals to procrastinate when making important decisions about their long-run financial well-being? At first this might seem puzzling, but the complexity of these decisions and their high stakes are the very reasons individuals most likely delay decisionmaking. O'Donoghue and Rabin's (2001) model predicts that an individual's tendency to procrastinate increases the more important the goal and the more options that are available. In addition, the perceived complexity of the decision is further complicated by the well-documented lack of interest and knowledge of finance among workers that is discussed in the last section of this chapter.

Procrastination may also be influence by how aware individuals are of their own self-control problems. Time-inconsistent behavior, such as neglecting to save for retirement, can result when individuals' lack of self-control causes them to pursue immediate gratification over long-term benefits (Thaler and Shefrin, 1981). O'Donoghue and Rabin's (2001) model suggests that the more ignorant individuals are regarding their own self-control, the more likely they are to procrastinate. Laibson (1997) and Diamond and Koszegi (2003) provide additional research on time-inconsistent behavior and retirement that focuses specifically on hyperbolic and quasi-hyperbolic discounting.

Madrian and Shea (2001) also suggest that the status quo bias may influence their findings. The status quo bias is the tendency for individuals to do nothing or maintain their current or previous decision. In Samuelson and Zeckhauser's (1988) experimental testing of this phenomenon, they find that subjects are significantly influenced by the status quo even if they do not recognize a bias. According to these authors, rational reasons including transaction costs (such as information search costs) and uncertainty, as well as cognitive misperceptions (such as loss aversion and anchoring), can all lead to the status quo bias. They also mention that psychological commitments such as regret avoidance can play a role. Obviously, each of these factors could come into play in retirement decisionmaking. Therefore, the different participation rates that Madrian and Shea find are also consistent with this theory.

The number of choices the individual must make also contributes to nonparticipation. As mentioned earlier, O'Donoghue and Rabin's (2001) model predicts that additional choices can increase the probability of procrastination. In the case of 401(k) plans, if the individual chooses to participate, he or she then faces several additional decisions such as how much to save and how to allocate his or her portfolio across a variety of investment options. This may lead to what is called choice overload.

Iyengar and Lepper (2000) test the choice overload theory in an innovative study using consumer goods in field and laboratory experiments. In one experiment, they present supermarket shoppers with either a display of 24 exotic jams (extensive choice condition) or six exotic jams (limited choice condition). While they find more people are drawn to the extensive choice display (60 percent versus 40 percent), the individuals who view the limited choice display are actually more likely to purchase the jams than those who view the extensive choice set (30 percent versus 3 percent). Thus, Iyengar and Lepper conclude that too much choice can be demotivating.

To test the influence of the number of fund choices on retirement plan participation, Sethi-Iyengar, Huberman, and Jiang (2004) use 401(k) administrative data provided by Vanguard. They find that the probability of participation decreases as the number of funds in the investment menu increases. Their analysis suggests that for every 10 funds added to an investment menu, the probability of participation decreases by 1.5 to 2 percent.

Beyond plan features, peer effects may also influence participation. Survey studies by Lusardi and Mitchell (2006) and van Rooij, Lusardi and Alessie (2007) report that a high percentage of respondents consult with family and friends when making financial decisions. In a study of employees at a university offering a tax-deferred account, Duflo and Saez (2002) find evidence of peer effects in their analysis of participation rates and investment decisions. Using an administrative dataset, they find that when participation rates increase by 1 percent in a department, the probability of an individual participating in that department increases by 0.2 percent.

In a separate paper, Duflo and Saez (2003) study the role of social interactions by conducting a field study in which they invite individuals who do not participate in their university retirement plan to attend a benefits fair that encourages enrollment. They promise the invitees a $20 reward for attending. The authors draw these "treated" individuals from a random subset of departments to estimate the role of social interaction effects. The results show that the treatment significantly affects the attendance at the benefits meeting. The treated individuals are five times more likely to attend the benefits meeting versus the control sample. In addition, Duflo and Saez note a significant spillover social effect. Individuals not given invitations but working in a department with treated individuals are three times as likely to attend the fair versus their controls in departments without invited employees. The treatment also affects plan participation rates. Treated departments report higher participation rates. Interestingly, whether an individual receives an invitation letter does not influence participation: What matters is whether the individual is in a treated department. Duflo and Saez's results suggest that small financial rewards and/or peer effects can significantly influence important decisions like retirement savings.

Trust may also influence participation. Research suggests that a lack of trust in financial institutions can influence general financial behavior, specifically among lower socioeconomic households. For example, studies by Szykman, Rahtz, Plater, and Goodwin (2005) and Bertrand, Mullainathan, and Shafir (2006) show that poor individuals consciously avoid doing business with financial institutions due to their lack of trust in them. In addition, Guiso, Sapienza, and Zingales (2008) find that lack of trust may explain why some individuals do not invest in the stock market.

To explore the role of trust in 401(k) participation, Agnew, Szykman, Utkus, and Young (2009) use a dataset that combines survey data with administrative data from three plans, two featuring automatic enrollment and one with voluntary enrollment. They find lack of trust in financial institutions lowers the probability of participating in an automatic enrollment plan. For a married male with average demographic characteristics based on the data sample, a low level of trust corresponds to a 15 percent lower probability of participation.

Taken together, the research described above suggests that non-economic or behavioral motivations can influence participation. Proponents of Thaler and Sunstein's philosophy of libertarian paternalism would argue that private and public institutions have a responsibility to help guide people toward welfare-promoting choices without eliminating freedom of choice (Thaler and Sunstein, 2003; Sunstein and Thaler, 2003). Recent and significant changes in plan design and enrollment techniques in retirement plans suggest that many plan sponsors are acting consistently with this philosophy.

The most notable change in retirement plans is the widespread adoption of automatic enrollment. At the time of Madrian and Shea's (2001) study, this feature was still relatively uncommon but in 2007 the Profit Sharing/401(k) Council of America estimated that 53 percent of large plans automatically enrolled participants (Wray, 2009). This change in plan design has led to a significant increase in participation rates. While the trend toward automatic enrollment continues, some company sponsors remain resistant to this change and prefer the voluntary enrollment approach. Fortunately for these plan sponsors, a growing understanding of behavioral finance has led to some new approaches that work with voluntary schemes. While the three alternatives discussed below are successful, none increase participation to the level of automatic enrollment.

Active choice is an alternative method that institutes a deadline to require workers to decide whether to participate. Without default options, workers must make explicit decisions related to contribution rates and allocations. Under active choice, Carroll, Choi, Laibson, Madrian, and Metrick (2009) find that enrollment after three months is 28 percent higher compared to a voluntary arrangement. They also demonstrate that if individuals are likely to procrastinate and have heterogeneous optimal savings rates, then this method is socially optimal.

A second approach uses social marketing to promote participation. Lusardi, Keller, and Keller (2008) employ surveys, focus groups, and in-depth interviews to identify three barriers to savings by participants. Considering these obstacles, they devise a planning aid that helps at-risk, new employees overcome self-control issues. Thirty days after the first intervention, they find the participation rate tripled compared to the control group.

Finally, Choi, Laibson, and Madrian (2009) study a program instituted by Hewitt Associations called Quick Enrollment™. This enrollment method reduces the complexity of the decision by requiring employees to consider only two choices between nonparticipation and participation with contribution rate and asset allocation defaults. They find that quick enrollment triples 401(k) participation rates after 3 months for new employees and increases participation by previously hired workers by 10 to 20 percent. However, the authors find evidence of a default bias associated with the contribution rate and asset allocations.

CONTRIBUTION LEVELS

Once the employee is enrolled in the plan, there are still several important decisions remaining. For those who have been voluntarily enrolled, he or she must now decide how much of his or her paycheck to contribute to the plan. Research shows that contribution rates often cluster around several points. Benartzi and Thaler (2007) explain that this is evidence that individuals may be using different savings heuristics. They describe several heuristics based on these commonly found clusterings, including a "multiple-of-five heuristic," a "maximum contribution heuristic," and an "employer match heuristic."

In contrast to the voluntarily enrolled participants, automatically enrolled participants are not required to choose a contribution rate because a default rate is available. In the case of automatically enrolled participants, researchers commonly observe a strong default bias with the contribution rates anchored to the default. Highlighting the influence of the default bias, Choi, Laibson, Madrian, and Metrick (2004) report that 80 percent of automatically enrolled participants in their study accept both the default savings rate and the default investment fund. Consistent with the status quo bias and inertia, they find that 3 years later, over half of these participants maintain these default options. Given that plan providers often set the default contribution rate very low, this has become one of the few downsides of the trend toward automatic enrollment (Nessmith, Utkus, and Young, 2007).

Once the individual sets or accepts a contribution level, Choi, Laibson, Madrian, and Metrick (2009) find that a naïve reinforcement learning heuristic may lead to subsequent changes in the contribution level. According to this heuristic, individuals increase weights on strategies with which they have personally experienced success even when future success is not logically related to past experience. Using administrative data, the authors find that investors who have positive savings outcomes in their 401(k) plans (either high average returns and/or low variance returns) increase their savings rates more than others with different experiences.

In an effort to increase contribution levels, especially as automatic enrollment has caused many to anchor at low rates, several plans have implemented a new feature that takes advantage of information learned about investors' psychology. Engineered by Thaler and Bernatzi (2004), the Save More Tomorrow Plan™ (SMarT) takes into account the self-control problems. As a result, the program requires employees to commit far in advance to increases in contribution rates. This "future lock-in" is known to overcome participants' problems with self-control and is effective in enabling individuals to select what they "should" do over what they "want" to do (Rogers and Bazerman, 2008). The SMarT program also mitigates feelings of loss by timing the contribution rate increases with future raises. Inertia works to the participants' advantage because a suboptimal decision is to change once the initial decision to enroll in the program is made. That said, consistent with libertarian paternalism, employees may opt out of the program at any time.

The results from the first implementation of the program show dramatic increases in savings for SMarT participants. In addition, as status quo bias theory would predict, few people drop out. After the fourth pay raise, SMarT participants contribute on average 13.6 percent to the plan. This compares to an 8.8 percent contribution rate for those who instead consulted with an advisor. The contrast is even more dramatic when comparing contribution rates with those who opt not to see the financial consultant (6.2 percent) or decline participation in the SMarT plan (5.9 percent).

ASSET ALLOCATION DECISIONS

Once the individual decides on or accepts a contribution rate, he or she must decide how to allocate the portfolio. This can be challenging because research suggests that individuals may not have well-defined portfolio preferences (Benartzi and Thaler, 2002). Not surprisingly, as with participation and contribution rate decisions, defaults appear to have an influence (Choi, Laibson, Madrian, and Metrick, 2002, 2004). As mentioned earlier, Choi, et al. (2004) report that in their study, 80 percent of automatically enrolled participants accept the default investment fund. Similarly, in an analysis of 50 retirement plans, Nessmith et al. (2007) find that new hires in automatic enrollment plans are three times as likely to put all of their contributions in the default investment fund compared to new hires in voluntary plans. They also find that 51 percent of individuals remain in the plan default after 2 years.

While the influence of defaults is obviously powerful, evidence suggests that the default bias can be overcome through committed and sustained efforts to encourage active choice. One of the most interesting examples of this is the Swedish pension system. Under the Swedish pension scheme, individuals may invest in up to five funds out of a menu of over 400 fund choices. In 2000, the first year of the plan, the Swedish government undertook a large advertising campaign to increase public awareness of options. In the first year of the system, a large percentage of citizens made an active fund allocation choice (67 percent). As a result, the initial appearance was that Swedish investors were far less susceptible to the default bias than U.S. investors (Engstrom and Westerberg, 2003). However, by 2003, the advertising level had decreased, and 91.6 percent of new participants chose the default fund (Cronqvist and Thaler, 2004), demonstrating that the default bias is not limited to U.S. investors and cannot be overcome without sustained efforts.

In addition to the default bias, other behavioral biases can influence allocations. Company stock investment provides an excellent case study. Given the well-known benefits of diversification, it is puzzling that investors would invest substantial amounts in one security, especially one highly correlated with their own human capital. Several studies detail the potentially large welfare costs associated with company stock investment (Muelbroek, 2002; Poterba, 2003; Even and Macpherson, 2008). Despite these costs, participants still concentrate their portfolios in company stock, and recent research suggests that behavioral biases may be to blame.

For example, Huberman (2001) suggests that a familiarity bias may influence an investment choice. He asserts that some investors are not optimizing their portfolios based on risk and return but rather choosing to invest in what they know. Huberman finds evidence of this in investing patterns associated with U.S. Regional Bell Operating Companies. Along similar lines, Cohen (2009) suggests that loyalty may come into play. He finds that employees of stand-alone firms invest 10 percent more in company stock than employees in conglomerates.

Benartzi (2001) suggests that there may also be an endorsement effect when the employer restricts the employer match to company stock. Brown, Liang, and Weisbenner (2006) provide more information about why employers might provide matching contributions in company stock. Contrary to rational expectations, Benartzi finds that when the employer match is in company stock participants allocate *more* of their own contributions to this security (18 percent versus 29 percent). He theorizes that employees are interpreting the company stock match as implicit investment advice. Using pooled cross sections of data, Brown, Liang, and Weisbenner (2007) find similar evidence. However, when they control for firm-level fixed effects, they find this relationship between match policy and employee contributions to company stock disappears.

Excessive extrapolation may also affect company stock allocations. Benartzi (2001) finds that discretionary contributions to company stock with the poorest 10-year stock performance were lower than those with the best performance (10.4 percent versus 39.7 percent). Additional studies also find links between past company stock returns and company stock holdings (Choi et al., 2004; Huberman and Sengmueller, 2004; Agnew, 2006; Brown et al., 2007).

Moving beyond company stock allocation decisions, research suggests that excessive extrapolation can also be a factor in other asset choices. Returning to the Swedish pension scheme example, investors may have been using historic 5-year fund returns to aid in their fund selection process. During the first year of the program, a technology and health-care fund recorded the best 5-year fund performance out of all 456 funds. An information booklet given to all participants reported these returns. Interestingly, this fund received the largest percent of the contribution pool (4.2 percent) excluding the default fund (Cronqvist and Thaler, 2004). Unfortunately for those who selected this fund, by 2003 the Internet bubble had burst, and this fund had lost 69.5 percent of its value. This example is a cautionary tale about the potential pitfalls of using simple allocation heuristics.

Past research also suggests that the investment menu may affect asset allocations. Benartzi and Thaler (2001) find some evidence that individuals follow a naïve diversification strategy called the "1/*n* heuristic." Based on this rule of thumb, investors divide their contributions equally among the n choices available. Depending on the fund menu, this strategy can easily result in portfolios that are inconsistent with the investors' risk preferences and lead to large *ex ante* welfare losses as documented by the authors. This rule of thumb appears to become less popular as the number of fund choices increases. Huberman and Jiang (2006) find that for a menu with a large number of funds, individuals follow a slightly different heuristic, which they refer to as the "conditional 1/*n* rule." Agnew (2006) also finds evidence of the conditional 1/*n* rule. According to the conditional rule, participants will divide their allocations equally among the number of funds they choose. The number of funds chosen is not necessarily equal to the total number of funds offered. Huberman and Jiang (2006) point out that this may not be an irrational strategy.

Brown et al. (2007) provide further evidence of menu-driven effects. They use aggregate data and find that the number and mix of investment options significantly affects the allocation of contributions. They estimate that increasing the share of equity funds from 1/3 to 1/2 increases overall participant allocations to equity funds by 7.5 percentage points. Using individual-level administrative data, Agnew (2006) also finds evidence of mental accounting (Kahneman and Tversky, 1984; Thaler, 1985, 1999) when company stock is present. In a variation on the conditional 1/*n* heuristic, Agnew finds that individuals appear to allocate their contributions to company stock and then divide equally their remaining allocations to the other asset holdings. From these results, participants are apparently treating company stock as a separate asset class. This finding supports earlier work by Benartzi and Thaler (2001). Finally, Choi, Laibson, and Madrian (2008a) find mental accounting present when employees do not choose their own match allocation.

Once again highlighting the importance of choice architecture, Benartzi and Thaler (2007) report surprising results related to subtle changes to the investment form design. They test whether the number of lines on a fund election form can influence the number of funds in which participants invest. In an experiment using Morningstar.com, they asked participants to allocate money among eight hypothetical funds. Participants received one of two possible computer forms, one featuring four lines with a hyperlink to invest in more than four funds and one with eight lines. The number of lines did significantly influence the behavior. Only 10 percent of individuals presented with the four-line form chose more than four funds compared to 40 percent of those viewing the form with more lines. Benartzi, Peleg, and Thaler (2008) provide further discussion about choice architecture.

This research has helped plan sponsors recognize the complexity of the allocation decision and the tendency of employees to rely on simple heuristics when making allocation choices. In response, 401(k) providers have become proactive in improving plan design and introducing new products intended to simplify the process and improve savings outcomes. Target date funds (sometimes referred to as Life-Cycle funds) are a recent example of this type of new product. These funds have rapidly become a common offering in 401(k) menus since the 2006 Pension Protection Act authorized that they could be used as default options. Nessmith and Utkus (2008) estimate that participants invested $183 billion in these funds in 2007, and 81 percent of plans with auto-enrollment used them as their default. While not without controversy, these funds are theoretically an effective tool to help individuals maintain a portfolio mix that is appropriate over the long term. One advantage of these funds is that they reduce the complexity of the allocation decision for the investor because the participant need only choose a fund with a date similar to his or her expected retirement date. Once a participant decides to invest in a target date fund, the status quo bias and inertia keep the participant's investment decision on track. Viceria (2008) provides more details about how the first generation of these products relates to academic models of asset allocation and suggests improvements for future products.

While an innovative and a seemingly error-proof solution, the way target date funds are actually used in individuals' portfolios is perplexing and suggests that individuals may not fully understand this growing asset class. Nessmith and Utkus (2008) find that just over half of target date fund investors are "pure" investors who hold only one single target date fund when these products are offered, while the remaining group represents "mixed" investors who combine target date funds with other investment options. In an analysis of a similar type of fund that is based on risk preferences, so-called lifestyle funds, Agnew (2007) finds similar "mixed" portfolio results. Of the participants in her sample, 36 percent held at least one lifestyle fund, and of that group nearly half (47 percent) invested in multiple lifestyle funds.

Whether these "mixed" portfolios are due to participants optimizing their overall portfolios or a result of naïve decisionmaking is unclear. However, there is growing evidence that a lack of financial understanding about these new products may drive this behavior, and this is discussed later in the financial literacy section. In addition to financial literacy, Nessmith and Utkus (2008) propose several rational and behavioral explanations for the mixed portfolios including naïve diversification, inertia, and employer matching effects. Future research will need to test all these theories. However, existing evidence shows that defaults can encourage more pure "single selection" investing. Mitchell, Mottola, Utkus, and Yamaguchi (2008) find that participants are more likely to be "pure" investors when the default option is a target date fund. Once again, if individuals have well-defined preferences, the presence of a default should not matter.

With regard to company stock investment, Bernatzi and Thaler (2003) are developing a new program based on behavioral finance principles similar to their SMarT program discussed earlier. The results of this program are still to be tested.

TRADING

Once retirement participants make an asset allocation, they must then decide if and how to rebalance their portfolio over time. Unlike retail brokerage accounts, trading in 401(k) plans is characterized by extreme inertia (Odean, 1999; Ameriks and Zeldes, 2001; Madrian and Shea, 2001; Agnew, Balduzzi, and Sundén, 2003; Mitchell, Mottola, Utkus, and Yamaguchi, 2006). Agnew et al. (2003) find that, on average, investors trade only once every 3.85 years. Mitchell et al. (2006) discover that almost 80 percent of the 1.2 million workers they study do not trade over a 2-year period. This behavior is consistent with the implications of models of optimal portfolio choice with realistic transaction costs (Lynch and Balduzzi, 2000). However, such behavior can be a concern if it results from procrastination. For example, if a participant is defaulted into a fund that is inappropriate for his or her risk characteristics, the optimal action would be to trade out of the fund.

This inertia appears to persist even in times of market turmoil (Mottola and Utkus, 2009). However, evidence suggests that a very small subset of individuals may be reacting to market returns. Mottola and Utkus report spikes in the number of investors who completely abandoned equities during the months of extreme market downturns in 2008. However, the number of traders represents an extremely small proportion of the sample. This type of trading is consistent with a positive feedback strategy where investors buy assets that are increasing and sell assets that are falling. Using data from only one 401(k) plan, Agnew et al. (2003) find evidence of positive feedback trading with a one-day lag. Using a more comprehensive but aggregated dataset of retirement asset flows representing 1.5 million participants over a 5-year period, Agnew and Balduzzi (2009) find additional evidence of feedback trading within the day. Taken together this evidence is a cause for concern as it suggests that some investors may deviate from their long-run investment objectives in response to one-day market returns.

Trading in 401(k) trading plans has also been shown to be influence by access to the Internet. Choi, Laibson, and Metrick's (2002) study finds that trading frequency after 18 months of access to Web trading nearly doubles relative to a control group of individuals without access. This finding may be a result of the fact that Web trading reduces time and other transaction costs. Mitchell et al. (2006) also discover that the most active traders use the Internet. Yamaguchi, Mitchell, Mottola, and Utkus (2006) find that active trading does not lead to higher risk-adjusted returns but passive rebalancing through balanced and life-cycle funds does. Given the documented inertia and the benefits of rebalancing, plan sponsors have introduced life-cycle funds that automatically adjust portfolio shares over time, as well as managed account services.

DISTRIBUTION PHASE

While many researchers have devoted time to studying how behavioral factors influence decisions in the accumulation phase, far fewer have studied how these influences affect how individuals make investment and consumption decisions upon retirement. For most defined contribution plans, the default is for participants to withdraw their money in a lump sum after a certain age. At this point, participants face complicated decisions. Should annuities play a role in their retirement portfolio? How should they allocate assets, and how much should they consume so that they do not run out of money?

In response to these questions, theoreticians contend that single, premium lifetime immediate annuities should play a role in retirement portfolios. However, the actual market for these products is relatively small, which is puzzling to academics whose models of rational behavior predict a much larger demand. Even when theoreticians add extensions to the basic model, such as adverse selection and bequest motives, they cannot explain the small size of the actual market. This well-known fact is commonly referred to as "The Annuity Puzzle." Brown (2008) provides a thorough and informative summary of the past theoretical and empirical literature and challenges researchers to consider behavioral explanations in the future. He offers framing, complexity, mental accounting, loss aversion, misleading heuristics, regret aversion, and the illusion of control as possible behavioral reasons for the annuity puzzle.

One recent study by Hu and Scott (2007) explores how several behavioral theories such as cumulative prospect theory, loss aversion, and mental accounting can explain the low demand for immediate annuities. They find behavioral reasons for the popularity of guaranteed period life annuities.

Two new studies examine the role of framing in the annuity decision. Agnew, Anderson, Gerlach, and Szykman (2008) use a large scale-laboratory experiment to investigate the influence of negative message framing. They are motivated by the framing work of Tversky and Kahneman (1981) and more recent studies in the health communications literature that examine how positive and negative messages influence recommended health behaviors (Block and Keller, 1995). Agnew et al. ask participants to play a retirement game with real money where they must choose between an annuity and an investment. Before making their decision, the participants see one of three brief presentations that either (1) favor the annuity choice by emphasizing the potential losses associated with investing in the market and outliving resources, (2) favor the investment choice by emphasizing the potential loss from dying early after purchasing an annuity, or (3) favor neither choice. The presentations were factual but played on the participants' aversion to loss. Agnew et al. report a sizeable and significant influence of the message frame.

Using a different type of frame, Brown, Kling, Mullainathan, and Wrobel (2008) also find significant results related to the influence of framing on the attractiveness of annuities. They use an Internet survey to demonstrate that the demand for annuities can be influence by whether the consumer is viewing the annuity from a narrow investment frame or a broader consumption frame. They present individuals with product choices that represent annuities and competing non-annuitized products like savings accounts. Some participants view the product choices from an investment frame where they are discussed in terms of their account values and earnings. Other participants are presented with the same products but they are discussed in a consumption frame. In this case, the discussion centers around how much the consumer can spend over time with each option. The authors find that individuals in the consumption frame prefer annuities to other non-annuitized products, and the reverse holds for the investment frame. For example, Brown et al. (2008) find that 21 percent of participants in the investment frame compared to 72 percent in the consumption frame prefer the life annuity to a savings account.

Finally, very recent working papers suggest that the decision to annuitize may also be influence by past market returns. Using administrative data, Chalmers and Reuter (2009) and Previtero (2010) find an inverse relationship between past market returns and the probability of annuitization. Agnew, Anderson, and Szykman (2010) find similar evidence using a laboratory experiment.

These early results suggest that using behavioral finance to explain annuity demand is a promising area for future research. As more becomes known about the psychology behind this decision, there are opportunities for plan providers to devise products and programs that make annuities more attractive. However, as Brown

(2008) points out, the irreversibility of the annuity decisionmakes this a more challenging task. For example, simple plan solutions used in the accumulation phase such as choosing optimal defaults are more difficult to implement in the case of annuities because the decision cannot be undone.

FINANCIAL LITERACY

One reason that individuals may succumb to behavioral biases is that they lack financial literacy and are subsequently overwhelmed by the decisions they face. Widespread evidence demonstrates that there is a substantial lack of financial literacy both in the United States and abroad (Lusardi and Mitchell, 2007). If people do not understand their financial choices or cannot grasp general financial concepts, they can easily make mistakes and may be more likely to fall back on simple heuristics.

This could easily be the case with investment in company stock and "mixed" target date investing. An earlier section of this chapter raised these asset allocation issues. In both cases, evidence suggests that individuals may not understand these assets. Several studies demonstrate that individuals often do not realize that investment in company stock is riskier than investing in the market (for example, Agnew and Szykman, 2005; Lusardi and Mitchell, 2008). Benartzi (2001) reports that 84 percent of the respondents in a Morningstar survey made this mistake. In addition, a recent study by Envestnet finds that 40 percent of respondents in a small survey strongly agreed or somewhat agreed that target date funds provide a guaranteed return, while 30 percent agreed that they could save less money using these vehicles and still have sufficient funds to retire (Behling, 2009). Additional studies show misunderstanding of other basic products.

Yet more than general financial literacy is important to pension participants. How well individuals understand their own plan features is also paramount. Choi, Laibson, and Madrian (2008b) find that 21 percent of participants who contribute at a rate below the match threshold knew their match rate compared to 41 percent of those above the match threshold in their sample. According to Chan and Stevens (2006), individuals who are knowledgeable about their plan features are five times more responsive to plan features than the average individual.

One issue facing plan sponsors is that efforts designed to help investors, such as simplifying investment materials or reducing plan choices, may be ineffective for the financial illiterate. For example, Agnew and Szykman (2005) use a laboratory experiment to test how the number of investment choices and information presentation influence decisionmaking. While reducing the number of choices decreased feelings of information overload for those with above-average financial literacy, it did nothing for those with below-average literacy. They remained simply overwhelmed. Not surprisingly, individuals with below-average financial knowledge were more likely in the Agnew and Szykman study to choose the default option than those with above-average knowledge (20 percent versus 2 percent), suggesting that low literacy may make individuals more susceptible to biases.

As the shift toward defined contribution plans continues, improving financial literacy becomes increasingly important. However, evidence is mixed about the success of current educational efforts. While employer-sponsored seminars suggest that individuals have good intentions to improve savings behavior after attendance, there is growing evidence that they do not follow through with their intentions (Clark and d'Ambrosio, 2008). Choi et al. (2002) find that after one seminar nearly every worker not participating in the plan indicated his or her intention to join, but only 14 percent actually followed through. In addition, individuals do not seem to learn from the experiences of others. Choi, Laibson, and Madrian (2005) find that even when Enron employees were losing their retirements because of investing in company stock, there was little change in company stock holdings by employees in other 401(k) plans.

Educators must also consider that individuals tend not to be interested in financial matters or financial planning, and this leads to inattention. MacFarland, Marconi, and Utkus (2004) find that at least half of their sample of retirement investors had limited interest in topics often presented in current financial education programs. Additionally, Lusardi and Mitchell (2006) discover that only 18.5 percent of their sample was able to determine how much they needed to save, develop a savings plan, and actually stick to it. In addition, individuals may not even realize that they lack financial literacy and therefore need assistance. Agnew and Szykman (2005) find that certain groups (for example, low-income individuals) have a low correlation between their own perceived knowledge and their score on a literacy test. Lusardi and Tufano (2009) find similar evidence for older individuals.

This suggests that educators must recognize psychological biases and be creative in their approach to teaching. Tufano and Schneider (2008) provide a review of existing financial literacy programs that include new and innovative approaches for low- and moderate-income families. In addition, Lusardi (2008) provides insights into improving the effectiveness of programs in the United States, and Fox, Bartholomae, and Lee (2005) present information regarding the importance of financial education evaluation.

SUMMARY AND CONCLUSIONS

The retirement research literature provides solid evidence that behavioral biases influence every financial decision related to retirement. In view of the documented lack of financial literacy and interest in retirement planning, overwhelmed investors often resort to simple heuristics. The findings in the literature clearly show that even the most subtle details in plan design influence behavior. A successful working relationship between practitioners and academics in this field has resulted in numerous plan design changes that have improved savings outcomes. While the literature in this field is now extensive, there is still more work to be done, particularly related to the distribution phase of retirement and the role of annuities. In addition, financial education programs can become more effective by incorporating what is known about behavioral biases and investor psychology. Given the increasing responsibility of individuals for their own retirement, the behavioral literature should continue to grow quickly for years to come and motivate further successful changes to plan design.

DISCUSSION QUESTIONS

1. Given participants' documented behavioral biases in retirement decisionmaking, should plan sponsors and policymakers focus on automating plan design to avoid common mistakes made by plan participants, or work on improving financial education?
2. Until recently, there has been little behavioral research related to the distribution phase of retirement, and specifically annuities. Discuss some possible behavioral theories that might explain the annuity puzzle.
3. Investing a large portion of one's wealth in an employer's company stock is contrary to sound investment principles. Discuss some theories that might explain this questionable investment behavior.
4. Discuss three successful changes to plan design that have improved savings outcomes, and explain how they relate to behavioral finance. Are there any associated drawbacks?

REFERENCES

Agnew, Julie R. 2006. Do behavioral biases vary across individuals? Evidence from individual level 401(k) data. *Journal of Financial and Quantitative Analysis* 41:4, 939–61.

Agnew, Julie R. 2007. Personalized retirement advice and managed accounts: Who uses them and how does advice affect behavior in 401(k) plans? Working Paper, College of William and Mary.

Agnew, Julie R., Lisa Anderson, Jeff Gerlach, and Lisa Szykman. 2008. Who chooses annuities: An experimental investigation of gender, framing and defaults. *American Economic Review* 98:2, 418–22.

Agnew, Julie R., Lisa Anderson, and Lisa Szykman. 2010. An experimental study of the effect of prior market experience on annuitization and equity allocations. Working Paper, College of William and Mary.

Agnew, Julie R., and Pierluigi Balduzzi. 2009. The reluctant retirement trader: Do asset returns overcome inertia? Working Paper, College of William and Mary.

Agnew, Julie R., Pierluigi Balduzzi, and Annika Sundén. 2003. Portfolio choice and trading in a large 401(k) plan. *American Economic Review* 93:1, 193–215.

Agnew, Julie R., and Lisa R. Szykman. 2005. Asset allocation and information overload: The influence of information display, asset choice, and investor experience. *Journal of Behavioral Finance* 6:2, 57–70.

Agnew, Julie R., Lisa Szykman, Steve Utkus, and Jean Young. 2009. Literacy, trust and 401(k) savings behavior. Working Paper, Center for Retirement Research at Boston College, Boston College.

Ameriks, John, and Stephen P. Zeldes. 2001. How do household portfolio shares vary with age? Working Paper, Columbia University.

Behling, Ellie, 2009, Planadvisor Web site: *http://www.planadviser.com/research/article*.php/4285, May 6.

Benartzi, Shlomo. 2001. Excessive extrapolation and the allocation of 401(k) accounts to company stock. *Journal of Finance* 56:5, 1747–64.
Benartzi, Shlomo, Ehud Peleg, and Richard H. Thaler. 2008. Choice architecture and retirement savings plans. Working Paper, UCLA.
Benartzi, Shlomo, and Richard Thaler. 2001. Naïve diversification strategies in retirement savings plans. *American Economic Review* 91:1, 79–98.
Benartzi, Shlomo, and Richard Thaler. 2002. How much is investor autonomy worth? *Journal of Finance* 57:4, 1593–616.
Benartzi, Shlomo, and Richard Thaler. 2003. Using behavioral economics to improve diversification in 401(k) plans: Solving the company stock problem. Working Paper, UCLA.
Benartzi, Shlomo, and Richard Thaler. 2007. Heuristics and biases in retirement savings behavior. *Journal of Economic Perspectives* 21:3, 81–104.
Bertrand, Marianne, Sendhil Mullainathan, and Eldar Shafir. 2006. Behavioral economics and marketing in aid of decisionmaking among the poor. *Journal of Public Policy and Marketing* 21:2, 8–23.
Block, Lauren, and Punam Anand Keller. 1995. When to accentuate the negative: The effects of perceived efficacy and message framing on intentions to perform a health-related behavior. *Journal of Marketing Research* 32:2, 192–203.
Brown, Jeffrey R. 2008. Understanding the role of annuities in retirement planning. In *Overcoming the saving slump: How to increase the effectiveness of financial education and savings programs*, (ed.) Annamaria Lusardi, 178–208. Chicago: University of Chicago Press.
Brown, Jeffrey R., Jeffrey R. Kling, Sendhil Mullainathan, and Marian V. Wrobel. 2008. Why don't people insure late-life consumption? A framing explanation of the under-annuitization puzzle. *American Economic Review* 98:2, 304–09.
Brown, Jeffrey R., Nellie Liang, and Scott Weisbenner. 2006. 401(k) matching contributions in company stock: Costs and benefits for firms and workers. *Journal of Public Economics* 90:6-7, 1315–346.
Brown, Jeffrey R., Nellie Liang, and Scott Weisbenner. 2007. Individual account investment options and portfolio choice: Behavioral lessons from 401 (k) plans. *Journal of Public Economics* 91:10, 1992–2013.
Carroll, Gabriel D., James Choi, David Laibson, Brigitte C. Madrian, and Andrew Metrick. 2009. Optimal defaults and active decisions. *Quarterly Journal of Economics* 124:4, forthcoming.
Chalmers, John and Jonathan Reuter. 2009. How do retirees value life annuities? Evidence from Public Employees. Working paper.
Chan, Sewin, and Ann Huff Stevens. 2006. What you don't know can't help you: Pension knowledge and retirement decisionmaking. Working Paper, New York University.
Choi, James J., David Laibson, and Brigitte Madrian. 2005. Are empowerment and education enough? Underdiversification in 401(k) plans. *Brookings Papers on Economic Activity 2*, 151–98.
Choi, James J., David Laibson, and Brigitte Madrian. 2009. Reducing the complexity costs of 401(k) participation through Quick Enrollment™. In *Developments in the economics of aging*, (ed.) David A. Wise, 57–82. Chicago: University of Chicago Press.
Choi, James J., David Laibson, and Brigitte C. Madrian. 2008a. Mental accounting and portfolio choice: Evidence from a flypaper effect. Working Paper, Harvard University.
Choi, James J., David Laibson, and Brigitte C. Madrian. 2008b. $100 bills on the sidewalk: Suboptimal investment in 401(k) plans. Working Paper, Harvard University.
Choi, James J., David Laibson, Brigitte C. Madrian, and Andrew Metrick. 2002. Defined contribution pensions: Plan rules, participant decisions and the path of least resistance. In *Tax policy and the economy*, (ed.) James M. Poterba, 67–113. Cambridge, MA: MIT Press.
Choi, James J., David Laibson, Brigitte C. Madrian, and Andrew Metrick. 2004. For better or for worse: Default effects and 401(k) savings behavior. In *Perspectives on the economics of aging*, (ed.) David A. Wise, 81–121. Chicago: University of Chicago Press.
Choi, James J., David Laibson, Brigitte C. Madrian, and Andrew Metrick. 2009. Reinforcement learning and savings behavior. *Journal of Finance*, forthcoming.
Choi, James J., David Laibson, and Andrew Metrick. 2002. How does the internet affect trading? Evidence from investor behavior in 401(k) plans. *Journal of Financial Economics* 64:3, 397–421.
Clark, Robert, and Madeleine d'Ambrosio. 2008. Adjusting retirement goals and savings behavior: The role of financial education. In *Overcoming the saving slump:*

How to increase the effectiveness of financial education and savings programs, (ed.) Annamaria Lusardi, 237–56. Chicago: University of Chicago Press.

Cohen, Lauren. 2009. Loyalty-based portfolio choice. *Review of Financial Studies* 22:3, 1213–45.

Cronqvist, Henrik, and Richard H. Thaler. 2004. Design choices in privatized social-security systems: Learning from the Swedish experience. *American Economic Review* 94:2, 424–28.

Diamond, Peter, and Botond Koszegi. 2003. Quasi-hyperbolic discounting and retirement. *Journal of Public Economics* 87:9-10, 1839–72.

Duflo, Esther, and Emmanuel Saez. 2002. Participation and investment decisions in a retirement plan: The influence of colleagues' choices. *Journal of Public Economics* 85:1, 121–48.

Duflo, Esther, and Emmanuel Saez. 2003. The role of information and social interactions in Retirement Plan Decisions: Evidence from a randomized experiment. *Quarterly Journal of Economics* 118:3, 815–42.

Engstrom, Stefan, and Anna Westerberg. 2003. Which individuals make active investment decisions in the new Swedish pension system? *Journal of Pension Economics and Finance* 2:3, 225–45.

Even, William E., and David A. Macpherson. 2008. Pension investments in employer stock. *Journal of Pension Economics and Finance* 7:1, 67–93.

Fox, Jonathan, Suzanne Bartholomae, and Jinkook Lee. 2005. Building the case for financial education. *Journal of Consumer Affairs* 39:1, 195–214.

Guiso, Luigi, Paola Sapienza, and Luigi Zingales. 2008. Trusting the stock market. *Journal of Finance* 63:6, 2557–600.

Hu, Wei-Yin, and Jason S. Scott. 2007. Behavioral obstacles to the annuity market. *Financial Analysts Journal* 63:3, 71–82.

Huberman, Gur. 2001. Familiarity breeds investment. *Review of Financial Studies* 14:3, 659–80.

Huberman, Gur, and Wei Jiang. 2006. Offering versus choice in 401(k) plans: Equity exposure and number of funds. *Journal of Finance* 61:2, 763–801.

Huberman, Gur, and Paul Sengmueller. 2004. Performance and employer stock in 401(k) plans. *Review of Finance* 8:3, 403–43.

Iyengar, Sheena S., and Mark R. Lepper. 2000. When choice is demotivating: Can one desire too much of a good thing? *Journal of Personality and Social Psychology* 79:6, 995–1006.

Johnson, Eric J., and Daniel Goldstein. 2003. Do defaults save lives? *Science* 302:5649, 1338–9.

Kahneman, Daniel, and Tversky, Amos. 1984. Choices, values and frames. *American Psychologist* 39:4, 341–50.

Laibson, David. 1997. Golden eggs and hyperbolic discounting. *Quarterly Journal of Economics* 112:2, 443–377.

Lusardi, Annamaria (ed). 2008. *Overcoming the saving slump: How to increase the effectiveness of financial education and savings programs*. Chicago: University of Chicago Press.

Lusardi, Annamaria, and Olivia S. Mitchell. 2006. Financial literacy and planning: Implications for retirement well-being. Pension Research Council Working Paper, PRC WP 2006-1, The Wharton School.

Lusardi, Annamaria, and Olivia S. Mitchell. 2007. Financial literacy and retirement preparedness: Evidence and implications for financial education. *Business Economics* 42:1, 35–44.

Lusardi, Annamaria, and Olivia S. Mitchell. 2008. Planning and financial literacy: How do women fare? *American Economic Review* 98:2, 413–7.

Lusardi, Annamaria, and Peter Tufano. 2009. Debt literacy, financial experiences, and overindebtedness. Working Paper, Harvard Business School.

Lusardi, Annamaria, Punam Anand Keller, and Adam M. Keller. 2008. New ways to make people save: A social marketing approach. In *Overcoming the saving slump: How to increase the effectiveness of financial education and savings programs*, (ed.) Annamaria Lusardi, 209–36. Chicago: University of Chicago Press.

Lynch, Anthony W., and Pierluigi Balduzzi. 2000. Predictability and transaction costs: The impact on rebalancing rules and behavior. *Journal of Finance* 55:5, 2285–309.

MacFarland, Donna M., Carolyn D. Marconi, and Stephen P. Utkus. 2004. "Money attitudes" and retirement plan design: One size does not fit all. In *Pension design and structure: New lessons from behavioral finance*, (eds.) Olivia S. Mitchell and Stephen P. Utkus, 97–120. New York: Oxford University Press.

Madrian, Brigitte C., and Dennis F. Shea. 2001. The power of suggestion: Inertia in 401(k) participation and savings behavior. *Quarterly Journal of Economics* 116:4, 1149–87.

Mitchell, Olivia S., Gary R. Mottola, Stephen P. Utkus, and Takeshi Yamaguchi. 2006. The inattentive participant: Portfolio trading behavior in 401(k) plans. Pension Research Council Working Paper, PRC WP 2006–5, The Wharton School.
Mitchell, Olivia S., Gary R. Mottola, Stephen P. Utkus, and Takeshi Yamaguchi. 2008. The dynamics of lifecycle investing in 401(k) plans. Pension Research Council Working Paper, PRC WP 2008-01, The Wharton School.
Mottola, Gary R., and Stephen P. Utkus. 2009. Flight to safety? Market volatility and target-date funds. *Research Note* March, 1–4.
Muelbroek, Lisa. 2002. Company stock in pension plans: How costly is it? Working Paper 02-058, Harvard Business School.
Munnell, Alicia H., Annika Sundén, and Catherine Taylor. 2001/2002. What determines 401(k) participation and contributions? *Social Security Bulletin* 64:3, 64–75.
Nessmith, William E., and Stephen P. Utkus. 2008. Target-date funds: Plan and participant adoption in 2007. Vanguard Center for Retirement Research, Volume 33.
Nessmith, William E., Stephen P. Utkus, and Jean A. Young. 2007. Measuring the effectiveness of automatic enrollment. Vanguard Center for Retirement Research, Volume 31.
Odean, Terrance. 1999. Do investors trade too much? *American Economic Review* 89:6, 1279–98.
O'Donoghue, Ted, and Matthew Rabin. 2001. Choice and procrastination. *Quarterly Journal of Economics* 116:1, 121–60.
Poterba, James M. 2003. Employer stock and retirement savings accounts. *American Economic Review* 93:2, 398–404.
Poterba, James M., Steven F. Venti, and David A. Wise. 2008. The changing landscape of pensions in the United States. In *Overcoming the saving slump: How to increase the effectiveness of financial education and savings programs*, (ed.) Annamaria Lusardi, 17–46. Chicago: University of Chicago Press.
Previtero, Alessandro. 2010. Stock market returns and annuitization. Working Paper, UCLA Anderson School of Management.
Rogers, Todd, and Max H. Bazerman. 2008. Future lock-in: Future implementation increases selection of "should" choices. *Organizational Behavior and Human Decision Process* 106:1, 1–20.
Samuelson, William, and Richard Zeckhauser. 1988. Status quo bias in decision-making. *Journal of Risk and Uncertainty* 1:1, 7–59.
Sethi-Iyengar, Sheena, Gur Huberman, and Wei Jiang. 2004. How much choice is too much? Contributions to 401(k) retirement plans. In *Pension design and structure: New lessons from behavioral finance*, (eds.) Olivia S. Mitchell and Stephen P. Utkus, 83–95. Oxford University Press.
Sunstein, Cass R., and Richard H. Thaler. 2003. Libertarian paternalism is not an oxymoron. *University of Chicago Law Review* 70:4, 1159–202.
Szykman, Lisa, Don Rahtz, Michael Plater, and Greg Goodwin. 2005. Living on the edge: Financial services for the lower socio-economic strata. Working Paper, College of William and Mary.
Thaler, Richard H. 1985. Mental accounting and consumer choice. *Marketing Science* 4:3, 199–214.
Thaler, Richard H. 1999. Mental accounting matters. *Journal of Behavioral Decision Making* 12:3, 183–206.
Thaler, Richard H., and Shlomo Benartzi. 2004. Save more tomorrow: Using behavioral economics to increase employee saving. *Journal of Political Economy* 112:1, 164–87.
Thaler, Richard H., and Hersh M. Shefrin. 1981. An economic theory of self-control. *Journal of Political Economy* 89:2, 392–406.
Thaler, Richard H., and Cass R. Sunstein. 2003. Libertarian paternalism. *American Economic Review* 93:2, 175–9.
Tufano, Peter, and Daniel Schneider. 2008. Using financial innovation to support savers: From coercion to excitement. Finance Working Paper No. 08-075, Harvard Business School.
Tversky, Amos, and Daniel Kahneman. 1981. The framing of decisions and the psychology of choice. *Science* 221:4481, 453–8.
Van Rooij, Maarten, Annamaria Lusardi, and Rob Alessie. 2007. Financial literacy and stock market participation. NBER Working Paper Number 13565.
Viceria, Luis M. 2008. Life-cycle funds. In *Overcoming the saving slump: How to increase the effectiveness of financial education and savings programs*, (ed.) Annamaria Lusardi, 140–77. Chicago: University of Chicago Press.
Wray, David. 6/12/2009. Telephone Conversation with President of the Profit Sharing/401k Council of America. *Source of Statistics*: Annual Surveys of Profit Sharing and 401(k) Plans. The Profit Sharing/401k Council of America.

Yamaguchi, Takeshi, Olivia S. Mitchell, Gary R. Mottola, and Stephen P. Utkus. 2006. Winners and losers: 401(k) trading and portfolio performance. Pension Research Council Working Paper, PRC WP 2006-26, The Wharton School.

ABOUT THE AUTHOR

Julie Agnew is an associate professor of finance and economics at the Mason School of Business, the College of William and Mary, and co-director of the Center for Interdisciplinary Behavioral Finance Research (CIBFR). Her research focuses on behavioral finance and its relationship to decisions made in individuals' retirement plans. Several leading academic journals have published her research using data from 401(k) plans and laboratory experiments. Often cited in the business press, she frequently speaks at academic and practitioner conferences in the United States and abroad. She is a TIAA-CREF Institute Fellow, a member of the Defined Contribution Plans Advisory Committee (DCPAC) for the Virginia Retirement System, and a research associate for the Center for Retirement Research at Boston College. Dr. Agnew earned her BA in economics from the College of William and Mary and her PhD in finance from Boston College. A former Fulbright Scholar to Singapore, she began her professional career in investment banking and equity research at Salomon Brothers and Vector Securities International.

The CHAIRMAN. Thank you, Dr. Agnew.

Now we'll turn to Dr. Brown. Welcome to Washington.

Mr. BROWN. Thank you very much.

The CHAIRMAN. He's in Chicago. You're in Chicago right now. He couldn't make it.

Mr. BROWN. Yes, technically, I'm in Champaign, IL.

The CHAIRMAN. Dr. Brown, welcome again. Your testimony will be part of the record. Please proceed.

STATEMENT OF JEFFREY R. BROWN, Ph.D., WILLIAM G. KARNES, PROFESSOR OF FINANCE, UNIVERSITY OF ILLINOIS AT URBANA—CHAMPAIGN COLLEGE OF BUSINESS, CHAMPAIGN, IL

Mr. BROWN. Thank you.

Chairman Harkin, Senator Enzi, and members of the committee, thank you for the opportunity to discuss the important issue of retirement income security with you today. I sincerely wish that I could be there in person, but the severe winter weather we've had here recently made travel impossible, so I'm grateful to the committee staff, as well as our own IT support here at Illinois for allowing me to testify from a distance.

I'd like to briefly summarize a few key points from the longer written testimony that I previously submitted. The primary overriding message that I would like to leave you with today is that I think it's time that we shift America's conversation about retirement away from one that is solely focused on wealth accumulation, to one that is focused on the broader concept of retirement income security.

As was noted earlier, saving, investment and wealth accumulation are absolutely critical for retirement security. But they're not enough. True retirement security also depends upon having part of one's retirement resources in the form of a guaranteed income stream that cannot be outlived. In short, we need to focus on more than just getting people to retirement. We need to focus on getting people through retirement.

Life annuities are products that allow individuals to convert a lump sum of wealth into a guaranteed income stream that will last for as long as they live. There are decades of economic theory that indicate how valuable annuities can be as part of a retiree's retirement plan. Unfortunately, annuitization is on the decline, for a number of reasons which I outlined in my testimony, including the declining role of Social Security going forward, the shift we've witnessed over the last few decades away from defined benefit plans, which typically paid out in the form of annuity, and to defined plans, like 401(k)s, that more often than not do not even offer access to guaranteed income options. Third, the limited size of the retail annuity market.

In order to encourage annuitization, I'd like to briefly mention three ideas, and there are a few others in my testimony that I submitted earlier. The first is captured in the Lifetime Income Disclosure Act, with, which a couple members of your committee were instrumental in putting forth in the last session. I've conducted academic research that shows that Americans' views about annuities are very strongly influenced by the framework in which this information is presented. For example, when viewed through a frame that emphasizes wealth accumulation and investment features, only 20 percent, only about 1 in 5 individuals, think that an annuity looks attractive in comparison to a simple savings account. The same holding finds when comparing an annuity against other financial products.

In contrast, when viewed through what we call a consumption frame, or a frame that really emphasizes one's ability to buy the goods and services that they want during retirement, 70 percent of individuals find an annuity attractive.

This is a pretty remarkable shift in preferences from what's essentially a very small change in the way the information is portrayed or presented. This research suggests that when plan sponsors are issuing their annual or their quarterly statements about, for example, 401(k) balances, that what we should really also be telling them is how much retirement income those accounts will be able to provide. The Lifetime Income Disclosure Act could be a very important step in reframing the conversation and discussion in a way that encourages annuitization. This legislation, which, if properly designed, could be implemented at very minimal cost to employees and employers, and could have a very significant impact on the way individuals evaluate how well-prepared they are for retirement.

Second, I would strongly encourage Congress to rethink the required minimum distribution rules. These rules were written, really, from a tax policy perspective to ensure that qualified plan assets were eventually subject to income taxation. But, from a perspective of retirement income policy, these rules were poorly conceived. They encourage individuals to deplete their assets more quickly than may be optimal, and they have a number of unintended consequences, including discouraging some forms of annuitization.

Finally, I think there's a strong case to be made for extending the idea of automatic enrollment to the annuitization phase, and thinking about automatically annuitizing a portion of qualified plan assets in order to overcome some of the institutional and behavioral biases that currently stand in the way of retirement income security.

However, as I outline in my testimony, there are a number of reasons to perhaps go slowly on this front. Before Congress implements such a policy, I think it would be very useful to have more research to help us understand both the intended and unintended consequences for both plan participants and plan sponsors.

One thing that Congress and, or the Department of Labor could do would be to provide some safe harbor protection to employers who would be willing to be leaders or innovators in this area so that we could all learn from their experience.

Just to conclude, I certainly agree that it is extraordinarily important that we have policies in place to encourage participation in retirement plans, to encourage saving, to encourage wealth accumulation. But we also need to ensure that public policy is equally supportive of the second half of the retirement income security equation, which is encouraging individuals to annuitize some of their retirement assets so that they can have an adequate income stream for as long as they live.

Thank you for the opportunity to speak to you today, and I look forward to your questions.

[The prepared statement of Mr. Brown follows:]

PREPARED STATEMENT OF JEFFREY R. BROWN, PH.D.

Chairman Harkin, Senator Enzi, and members of the committee, I am Jeffrey Brown, the William G. Karnes Professor of Finance in the College of Business at the University of Illinois at Urbana—Champaign.[1] I thank you for the opportunity to appear before you today to discuss the important issue of how to improve our system of retirement security.

To start, I would like to ask a question, *Why do we save for retirement*?

This may seem like a simple question. There are many possible answers, but I would like to focus on two, each of which sounds plausible, but each of which has very different implications for the optimal design of a retirement system:

1. "We save so that we will have a large sum of money in our account at retirement."

OR

2. "We save so that will have the income we need to maintain our standard-of-living throughout retirement."

The first answer focuses solely on the accumulation of wealth. In essence, it focuses only on getting people *to* retirement.

The second answer focuses on getting people not just to retirement, but also *through* retirement.

In this sense, the second answer is much more complete. It recognizes that while saving, investment and wealth accumulation are a necessary condition for retirement security, they are not sufficient. This second answer recognizes that true retirement security also depends on having part of one's retirement resources in the form of a guaranteed income stream that cannot be outlived.

Ensuring that one's nest egg lasts a lifetime is a complex financing planning exercise because people face uncertainty about asset returns, interest rates, inflation, expenses and, perhaps most importantly, uncertainty about how long one can expect to live.

The good news is that financial products exist that help individuals address these complex planning problems. For example, a life annuity is an insurance product that allows an individual to convert a lump-sum of wealth into a stream of income that is guaranteed to last for as long as an individual (and if desired, his or her spouse)

[1] I also serve as Director of the Center for Business and Public Policy at the University of Illinois, as Associate Director of the NBER Retirement Research Center, and as a Trustee for TIAA. Previously, I served on the Social Security Advisory Board (2006–8), on the staff of the President's Commission to Strengthen Social Security (2001), and as Senior Economist with the President's Council of Economic Advisers (2001–2). All views presented in this testimony are my own, and do not reflect the views of any of the organizations with which I am affiliated.

lives.[2] As I will discuss below, economic theory suggests that life annuities can be enormously valuable to retirees.

Unfortunately, the U.S. retirement system has evolved over the past 30 years into a system that focuses almost entirely on wealth accumulation. Many of our public policies, our plan designs, and our financial planning tools have been designed as if the first answer provided above—that we save in order to have a large sum of money in our account at retirement age—is the end goal.

We have paid far too little attention to the equally important issue of how to ensure that one's accumulated resources are sufficient to last for a lifetime.

The one, over-riding message that I would like to leave you with today is that we need to shift America's conversation about retirement away from a conversation solely focused on wealth accumulation and to a conversation about the broader concept of retirement income security.

In support of this message, I will proceed with my testimony as follows:

First, I will provide a very brief overview of the academic research that indicates the importance of guaranteed lifetime income.

Second, I will briefly discuss a number of factors—including the declining role of Social Security, the shift from defined benefit (DB) to defined contribution (DC) plans, and the limited size of the private annuity market in the United States—which suggest that Americans are becoming increasingly exposed to longevity risk (i.e., the risk of outliving one's resources).

Third, I will briefly describe research that I, and co-authors, have undertaken on how the psychological concept of "framing" can have an important impact on people's perception of the value of life annuities. I will specifically discuss the implications of this research for the Lifetime Income Disclosure Act.

Last, but not least, I would like to briefly discuss a few other policies that might be used to encourage retirement income security.

1. THE IMPORTANT ROLE OF LIFE ANNUITIES: A BRIEF REVIEW OF ECONOMIC THEORY

Within the economics discipline, there is a very large research literature exploring the role of life annuities in improving the well-being of consumers who face uncertainty about their length-of-life. While the literature is too large to fully summarize here, a fair characterization of the core theoretical result is that life annuities can substantially improve consumer well-being.[3]

This finding arises from two related benefits: First, annuities provide a higher rate of return, contingent on survival, than otherwise similar, but non-annuitized, assets. This arises because the resources of those annuitants who die relatively early can be used to increase the rate of return to those who live longer than average. This extra return is sometimes referred to as the "mortality premium."

Second, life annuities guarantee that the annuitant will receive income for as long as he or she lives.

In essence, life annuities eliminate the need to trade-off two risks for retirees: (i) that if they consume too much, they will run out of money before they die, and (ii) that if they want to set aside enough money to live on even if they live to extremely advanced ages, they must consume much less during the entirety of their retirement years.

Simulation studies have suggested that the benefits from having access to life annuities is equivalent—in terms of consumer well-being—to a substantial increase in financial wealth.[4]

2. ARE AMERICANS UNDER-INSURED AGAINST LONGEVITY RISK?

There are several factors suggesting that Americans are becoming increasingly exposed to the risk of outliving their resources (a risk sometimes referred to as "longevity risk.")

Let's begin with the U.S. Social Security system. While there are many ways to describe the Social Security system, for today's purposes it is instructive to understand that it is the only meaningful source of inflation-indexed, annuitized income available to most retirees in the United States. From this perspective, Social Security plays a vital role in providing a guaranteed income floor.

---

[2] For purposes of this testimony, I am using the term "life annuity" to refer to products which guarantee income for as long as the annuitant lives. This excludes some products with the term "annuity" in the name that do not offer life-contingent payouts.

[3] The seminal paper in this area is by Yaari (1965). The results of his paper were generalized and extended in Davidoff, Brown and Diamond (2005).

[4] See, for example, Mitchell et al. (1999) and Brown (2001).

However, Social Security will play a declining role going forward. Even without further policy changes, the combination of the increasing normal retirement age, and the fact that Medicare premiums—which are netted out of Social Security checks for most Americans—are rising faster than inflation, means that net Social Security replacement rates are projected to decline in the future.[5]

Furthermore, we must face that undeniable fact that the United States is on an unsustainable fiscal path, and that the growth in entitlement programs like Social Security (and even more importantly, Medicare and Medicaid) must be reined in.

Taken together, these facts make it apparent that future generations of retirees should not be relying on Social Security to play as large of a role in their retirement as the program has done for past generations.

Turning to the private sector, the past three decades have witnessed a substantial decline in the role of DB plans in the private sector. Further, many of those that remain are substantially underfunded. This fact poses risks both for retirees (in particular, those whose benefits exceed the amount insured by the Pension Benefit Guaranty Corporation, or PBGC) as well as for taxpayers (given the large projected deficits facing the PBGC that will ultimately require an infusion of taxpayer funds to avoid a reduction in insured benefits).

In the place of DB plans, we have seen the 401(k) plan emerge as the dominant form of retirement plan in the United States. While 401(k) plans have many advantages for both employers (e.g., reduced funding uncertainty) and employees (e.g., increased portability), the recent financial crisis and recession clearly exposed the long-standing inadequacy of appropriate risk management in the 401(k) system. A prominent example of this is the near absence of guaranteed income options in the typical 401(k) plan. It has been estimated that fewer than one-in-four 401(k) plans offer participants the option of converting a portion of their account balances into life annuities.

Further, many Americans do not have access to a retirement plan of any kind through their employer. For these individuals, as well as for those with 401(k) plans that lack an annuity option, it is possible to purchase guaranteed lifetime income through the retail market. However, the market for such products continues to be small relative to the retirement income needs of Americans.

As a result of these factors, it is clear that the relative dearth of opportunities to insure against longevity risk is a serious issue for U.S. retirement policy.

3. "FRAMING ANNUITIES"—IMPLICATIONS FOR PUBLIC POLICY

Much of the academic research on annuities has focused on how to explain the lack of a more robust annuity market. Having concluded that this literature was limited in its ability to explain empirical regularities in this market, I began to work with several colleagues to explore various psychological, or behavioral, biases that might be limiting the demand for annuities.

In 2008, we published a paper in the *American Economic Review* (Brown, et al. 2008) showing that individuals' perceptions of life annuity products are strongly influenced by what psychologists and economists call "framing." Framing is simply the idea that people may be induced to change the behavior by changing the *way* information is communicated (even when the actual information *content* is itself unchanged.)[6]

Our paper was motivated by a simple insight. As noted earlier, the dominant frame in the U.S. retirement system is an "investment," or wealth accumulation, frame. Individuals have been conditioned to think of account balances as the appropriate yardstick for measuring their retirement preparedness.

In such an investment frame, life annuities look relatively unattractive. Indeed, they may even look risky, because the amount of money that one receives depends on how long one lives.

In contrast, when viewed through a frame that emphasizes the ability to sustain monthly consumption during retirement, life annuities are quite attractive because they can guarantee this outcome.

In short, whereas annuities look risky in an investment frame, they look like a valuable form of insurance in a consumption frame.

In our study, we conducted a survey of over 1,300 Americans age 50+ and presented them with information about various financial products. We randomly di-

[5] See, for example, Munnell 2003.

[6] In perhaps the most famous example of framing, Tversky and Kahneman (1981) showed that citizens would choose very different policies to address a public health threat depending upon whether the information was provided in terms of "lives saved" or "lives lost."

vided individuals into groups that were presented with the same information but in different frames.

Our results were supportive of the importance of framing. When viewed through an investment frame, only about 20 percent of individuals thought a life annuity looked attractive in comparison to a simple savings account. When viewed through a consumption frame, over 70 percent of individuals preferred the annuity. This is a remarkable shift for what is essentially a small change in the way the information is portrayed.

This research has led me to believe that one simple, but potentially very powerful, way to encourage annuitization is to change the way that plan sponsors communicate about participants' 401(k) plans. Put simply, rather than focusing solely on how much wealth one has accumulated in their plan, we should be telling people how much retirement income their account balance will be able to provide them.

This research has implications for the bipartisan Lifetime Income Disclosure Act that was introduced in 2009. Indeed, the research suggests that the core idea of that act—to require that plan sponsors provide information about the retirement income that their 401(k) could provide—could help re-frame the retirement discussion in a way that encourages annuitization. If enacted, this legislation could have—over time—a very significant impact on the way individuals evaluate their preparedness for retirement.

Of course, it is important that the provisions of the Lifetime Income Disclosure Act, if passed, be enacted in a manner that keeps the message simple for consumers. It is equally important that the rules be structured to keep the cost of compliance to a minimum, particularly for small businesses. We must remember that employers who offer retirement plans to their employees do so voluntarily. Thus, even the most well-intentioned policy can end up harming retirement security if it imposes costs on employers that lead them to stop offering an employer-provided plan.

Fortunately, the Lifetime Income Disclosure Act should impose minimal, if any, additional costs on employers, at least as long as it is efficiently designed and implemented. For example, in order to avoid forcing small employers to become annuity valuation experts, the Department of Labor could provide a very simple table or formula (i.e., based on standard annuitant mortality tables and an interest rate assumption) that converts a given account balanced into a monthly or annual annuitized income stream. If implemented in a simple way, plan sponsors would be sending the same quarterly or annual statements that they do now, but with two numbers (account balance and monthly income) instead of one (account balance).

Of course, some plan sponsors may wish to provide more comprehensive or detailed projections—and, indeed, some already do so. The act should certainly allow plan sponsors to continue to provide such projections. In addition, plan sponsors who offer annuities in their plan should be permitted to use actual annuity payouts from their plan, rather than the example payouts.

4. OTHER POLICIES TO ENCOURAGE ANNUITIZATION IN QUALIFIED PLANS

In addition to reporting 401(k) and other DC balances in terms of monthly income, there are numerous other policies that Congress could consider to encourage annuitization. As noted above, it is extremely important to weigh the advantages of these approaches against the potential costs of imposing additional burdens on plan sponsors.

a. Required Minimum Distributions (RMD's)

The required minimum distributions appear to have been designed solely from the perspective of tax policy—in essence, with the goal of ensuring that the income is eventually subject to income taxation.

From the perspective of retirement policy, these rules run counter to the idea of promoting retirement income security. The rules encourage individuals to spend their resources down more quickly than is, in all likelihood, optimal for most retirees. Indeed, simple simulations have shown that following some of the RMD rules can lead to the virtual exhaustion of all of one's retirement wealth long before individuals reach their maximum possible lifespan.[7]

As such, Congress may wish to consider how to design the RMD's from the perspective of promoting retirement income security.

b. Annuities in Qualified Default Investments Alternatives (QDIAs)

The Pension Protection Act took a very important step in recognizing that individuals who are automatically enrolled into a 401(k) or other qualified plan should have their contributions placed in a well-diversified investment vehicle.

[7] For example, see Brown et al (1999).

Looking to the future, I would like to see the market evolve in the direction of incorporating lifetime income into these life-cycle or target-date funds.

To put it simply, in addition to thinking about the "glide path" for the allocation between stocks and bonds (and other asset classes), I would like to see products which also automate the "glide path" between annuitized and non-annuitized assets. The gradual, and partial, annuitization of accounts would be a very natural and very welcome evolution of these plans.

I am not suggesting that such an approach be mandated. Rather, I would like to see such an approach encouraged—or at least not discouraged—through the regulatory framework. Providing plan sponsors with clear fiduciary safe harbors for providing such products is one important consideration.

c. Auto-Annuitization

Research in behavioral economics has clearly demonstrated the strong influence that default options can have on behavior. As you know, the Pension Protect Act took very important steps in expanding automatic enrollment in 401(k) plans, as well as the automatic escalation of contributions.

Looking to the future, it is reasonable to ask whether "automatic annuitization" is a natural next step in this progression.

As I have written elsewhere, this idea has considerable merit as a way of overcoming the policy, institutional and behavioral biases that currently stand in the way of annuitization.[8]

However, the merits of this idea must also be weighed against the fact that designing an "auto annuity" program is much more complex than automating other aspects of the 401(k). There are several reasons for this. First, as noted above, most 401(k) plans sponsors do not even offer life annuities through their plans. Thus, it is not a simple matter of defaulting individuals into an already-existing option. Requiring plan sponsors to provide access to annuities would impose additional cost and complexity on plan sponsors.

Second, unlike the state of affairs prior to the passage of the Pension Protection Act—when academic researchers had produced substantial empirical evidence about the effects of automatic enrollment—we have very little empirical evidence on how an annuity default would work in practice. Ideally, some plan sponsors will take the lead in voluntarily adopting such an approach in the coming years so that the program can be carefully evaluated. But no such studies exist today in a U.S. context.

Third, the "downside risks" to consumers in an automatic annuity program are greater than is the case with automatic enrollment. Under auto-enrollment, if an individual determines that it was a mistake to be enrolled, they can "undo" it by pulling their money out of the qualified plan at a relatively low cost. In contrast, typical life annuity contracts are often irreversible (to avoid adverse selection), and it could actually harm some consumers if they were automatically annuitized when an annuity was clearly sub-optimal for them (e.g., someone with a terminal disease and a short remaining life expectancy).

It is possible to design an auto-annuity program that overcomes this and other problems (see Brown 2009 for an example of such a framework). However, doing so is necessarily a complex exercise.

All-in-all, while I continue to believe that automatic annuitization may be a desirable feature of DC plans, it is premature to consider such an approach in the near-term. At minimum, we need much more research to fully understand both the intended and unintended effects on plan sponsors and participants.

With this in mind, policymakers might wish to consider whether there are steps that could be taken to encourage plan sponsors to implement such a program voluntarily. For example, it might be desirable to provide fiduciary safe harbors for plan sponsors who wish to do so.

5. CONCLUSIONS

It is important to continue to pursue policies that encourage Americans to save and invest. However, it is equally important that plan participants have the knowledge, the opportunity, and the access to products which allow them to convert their accumulated savings into a secure source of retirement income. The Lifetime Income Disclosure Act would be a useful first step in changing the national conversation about retirement in this direction.

---

[8] In 2009, I authored a white paper (Brown, 2009) on behalf of the American Council of Life Insurers in which I discussed the case for an automatic annuitization policy, and outlined how such a program could be implemented. While that research was sponsored by the ACLI, the views and opinions expressed therein are mine alone and do not necessarily represent the views of the ACLI or its member companies.

Thank you for the opportunity to speak here today. I would be happy to take your questions.

REFERENCES

Brown, Jeffrey R. 2009. "Automatic Lifetime Income as a Path to Retirement Income Security." White Paper prepared for the American Council of Life Insurers.
Brown, Jeffrey R. 2001. "Private Pensions, Mortality Risk, and the Decision to Annuitize," *Journal of Public Economics*, Vol. 82, No. 1, October, pp. 29–62.
Brown, Jeffrey R., Jeffrey Kling, Sendhil Mullainathan, and Marian Wrobel. 2008. "Why Don't People Insure Late Life Consumption? A Framing Explanation of the Under-Annuitization Puzzle." *American Economic Review*, 98(2): 304–9.
Brown, Jeffrey R., Olivia S. Mitchell, James M. Poterba, and Mark J. Warshawsky. 1999. "Taxing Retirement Income: Non-Qualified Annuities and Distributions from Qualified Accounts," *The National Tax Journal*, Vol. LII, No. 3, September, pp. 563–91.
Davidoff, Thomas, Jeffrey R. Brown, and Peter Diamond. 2005. "Annuities and Individual Welfare," *The American Economic Review*, Vol 95, No. 5, December, pp. 1573–90.
Mitchell, Olivia S., James M. Poterba, Mark J. Warshawsky and Jeffrey R. Brown. 1999. "New Evidence on the Money's Worth of Individual Annuities," *The American Economic Review*, Vol. 89, No. 5, December 1999, pp. 1299–1318.
Munnell, Alicia H. 2003. "The Declining Role of Social Security." Boston College Center for Retirement Research. Just the Facts Issue No. 6.
Poterba, James M. 1997. "The History of Annuities in the United States." NBER Working Paper No. 6001.
Tversky, Amos and Daniel Kahneman. 1981. "The Framing of Decisions and the Psychology of Choice." *Science*, 211(4481): 453–58.
Yaari, Menahem E. 1965. "Uncertain Lifetime, Life Insurance, and the Theory of the Consumer." *Review of Economic Studies* 32(2): 137–50.

The CHAIRMAN. Thank you so much, Dr. Brown. Can you hear us and see us all right?

Mr. BROWN. I sure can. Thank you.

The CHAIRMAN. Thank you very much. We'll start our 5-minute rounds of questioning. I'll start with Ms. Chatzky. I think there's a lot of misinformation about investments. A lot of fact sheet marketing materials. I get them in the mail and I look at them, and they sound great. I don't understand a lot of them, to tell you the truth, and I'm sure a lot of other people don't. But, where does a person go to really get good, impartial advice about 401(k) plans?

Ms. CHATZKY. They tend to go to the benefits department at their employer. They tend to read Money Magazine, USA Today, listen to what's happening on CNBC. The answer is, they often wind up with information overload, feeling confused and unable to make a decent decision. Anything that we can do to simplify the process, to make the defaults better—and I understand all of the limitations of the target date funds, but I think that was definitely a step in the right direction. To provide children as young as middle school, but definitely into high school and college, with more financial education so that they understand how to read the basic documents and how to speak the basic language, will be moving the ball forward.

The CHAIRMAN. Anyone else want to respond to that question? Where do you get more impartial information? That's readable. It's so confusing. I'm a college-educated person, graduate, law degree, and I can't understand it. How do you expect the average person out there that doesn't have any financial information or advice to understand?

Ms. AGNEW. Well, I have a Ph.D., and I know that some of the information that I'm presented is also confusing to read. Oftentimes, it's because plans are thinking about, perhaps, some legal concerns that, it needs to be written in a language where they will not be sued. But unfortunately, what happens then is that it's written in a way that the average person can't understand it. So, it really, it does need to be simplified.

I do believe that, you said middle school. I even think getting into elementary school and teaching lessons about savings, making these things familiar, so that when individuals are actually faced with a decision when they graduate from college, that they're able to understand it, is incredibly, incredibly important.

There are ways to make the information easier. There was a lot of work done in the nutritional labeling research area. I think most of us can go to a cereal box and understand how to compare calories and sugar content. And we need to be able to do that when we're looking at plans. We need to make this information very clear.

I do know that there are efforts out there right now. I know the Social Security Administration has funded a financial literacy research consortium, and the job there is to produce literacy products that are unbiased, that help people make a good decision. I think those are worthy efforts that should be pursued.

Then, finally, I'd like to say, Anna Maria Lucardi at Dartmouth has done some very, very good research. One of her research pieces was using social marketing to get people to participate in 401(k) plans. Basically, she held focus groups with the people at Dartmouth, found out what was keeping them from participating, came up with a one-pager with steps on what they needed to do to participate—it was an automatic enrollment—saw how that worked, tweaked it again with more focus groups, and eventually was able to significantly increase participation by simply making things easier to understand, and the steps that need to be taken easier to understand. So, I think there's a lot we could do.

Ms. LUCAS. Chairman Harkin, I would like to just add that I think what we're getting at is the reason why auto features have become so critical to 401(k) plans and other defined contribution plans. Because it's not only difficult for people to understand this very complex topic. They don't have time, they don't have the interest. And so, they're really faced with the notion that, I have many things on my plate, and this is my last priority. To simplify, sometimes it's not even enough. What we do find is that people will respond to something as simple as a postcard that says, if you want to enroll in this plan, check the box. Something as simple as that, they will respond to. But, as you said, getting reams of paper is, they're not going to go through it. It's going to be a very low priority.

The good news is that as people get older and retirement approaches, say, in their 40s, and they do begin to pay a lot more attention to this, they will use things like managed accounts, and actually input their circumstances and situation into the software to understand what is a better allocation for them than a simple target date fund. But for young people, the decisionmaking has to be so simple and so straightforward. That's the reason that defaults are critical for people in their twenties who are just starting out.

The CHAIRMAN. Dr. Brown, did you want to weigh in on this at all?

Mr. BROWN. Sure. Yes. I think I agree with most everything that's been said. I will say that, I think it was Ms. Chatzky that pointed out that one of the first places people go is to their HR office, to their employer.

The CHAIRMAN. Yes.

Mr. BROWN. I think it's very important to remember in this process that the employer does play oftentimes a very important intermediary role, and, in many cases is a trusted source of information. For good reasons, we have put restrictions on what employers can do in terms of providing advice and so forth to the employees. But I think we need to be careful not to go so far as to make employers or plan sponsors, who would like to provide access to unbiased advice, be concerned about doing so out of fear of violating fiduciary rules.

Employers really do play a central role in all of this, and I think the more we can do to make that easier for them to pass along useful information, the better.

The CHAIRMAN. Well, thank you all very much. My time has well run over. But, you raise a question about, how about the small employer that doesn't have an HR department.

Senator ENZI. That's right.

The CHAIRMAN. But, I'll yield to Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman. I'm working on a solution to that. Yes. I'm going to have a bill that will allow small businesses to group together to do a 401(k) plan, so that they can hire some expertise that can handle all the problems that come up with that.

Ms. Lucas, in your testimony you mentioned some problems with non-discrimination and other tests that have to be done. Could you run through a few of those? Just mention them? Problems that employers have to run into in order to be able to do one of these 401(k)s?

Ms. LUCAS. Yes. One of the things that was very attractive with the Pension Protection Act was the non-discrimination testing safe harbor that allowed plan sponsors who used automatic enrollment and several other criteria, to not have to engage in non-discrimination testing, which can be costly and difficult for them, and an obstacle for plan sponsors. These safe harbors that eliminate the need to do non-discrimination testing is very, very important.

I think the non-discrimination testing safe harbor was very well received. But the way that it was implemented within the legislation was quite conservative, and so you expect that, because people could opt out, maybe you would have a pretty high contribution escalation cap, so that people who are automatically enrolled, could be escalated to 15 or 20 percent of pay, which is quite a robust rate, and if they didn't like to be escalated up to 15 or 20 percent of pay over time, they could simply opt out. Instead, the cap was put at a very low 10 percent of pay. Why that seems strange to me was that when we did analysis of participants that we saw who had actually gone in and proactively selected to choose what they would like their automatic contribution escalation cap to be, they chose a much higher number than 10 percent. They wanted to be escalated up to 15 percent or more. There's an artificial barrier that's been put in these safe harbors that are actually inhibiting people from saving as much as they might naturally want to.

Senator ENZI. Thank you. As the accountant, I have some more technical questions, but I won't put those out for everybody. But I would appreciate an answer from you when we get them to you.

Professor Agnew, I understand that you ran some focus groups, and when they were presented with the normal 3 inches of paper that employers have to give employees, that there's a little bit of stress involved, and sometimes they break down crying. I'd like to know what you think we ought to do to relieve that stressful situation. What kind of things could we be doing?

Ms. AGNEW. Well, it was very enlightening. We've done a series of focus groups for several different projects. I was actually surprised at the reactions when we asked people to express their feelings towards making retirement decisions. If you see in my testimony, there's a picture at the very end. I know others can't see it. But it's a little bit disturbing. People obviously are very concerned. This picture shows a fellow getting shaved. He's in a chair, and the person shaving has a long knife, but looks very distracted, like he's about to cut his throat. This is how some people, or, many people in our focus group are feeling about these things. I think that what we learn from these focus groups is, a lot of people just were saying, there are so many different choices, I just don't know what to do. I'd like somebody to help me and to tell me what to do.

There was also this feeling of mistrust. It was interesting, one of our focus groups was asking about target-date funds. One thing that you find with target-date funds is, they're designed that you just invest in one target-date fund. You're going to retire in 2020, and so you buy the 2020 fund. But we find, actually, that there are many people that invest in multiple target-date funds, or target-date funds and additional funds. What we've learned is that many people don't understand what the target-date funds is. Some did, and were actually trying to dial up the risk and were just fine. Others had trust issues, and they didn't want to put it all in one fund. They wanted to move it around. A certain level of mistrust is a bit healthy, especially in this environment. But if it's because you just don't understand the product, I think we need to do better in terms of explaining these products. Everybody on the panel has already mentioned, people have limited time—

Senator ENZI. Yes.

Ms. AGNEW [continuing]. And have limited interest. So, we have to figure out how to catch them. Once again, going back to the marketers. The marketers know how to get people in 30 seconds to think about things that they might not normally think about. By engaging them with financial experts, I think we can get important messages across.

Senator ENZI. Well, the Department of Labor has refused to embrace some of the new technologies that could provide more information to people, too. They consider some of the comparison tools to be investment advice, and that has some fiduciary duties attached to it, too, that I think we need to solve. I have a lot more questions, but my time has run out.

The CHAIRMAN. Interesting.

Senator Bingaman.

Senator FRANKEN. Yes. Thank you all for your testimony.

The CHAIRMAN. I said Senator Bingaman.

Senator FRANKEN. Oh. I'm sorry, Senator.

[Laughter.]

Bingaman, Franken, they just sounded the same to me. I'm sorry.

[Laughter.]

Senator BINGAMAN. I'll jump ahead of you here.

Senator FRANKEN. You're ahead of me.

STATEMENT OF SENATOR BINGAMAN

Senator BINGAMAN. Let me thank the Chairman and Senator Enzi for having the hearing. I think it's very useful.

Dr. Brown spoke about the Lifetime Income Disclosure Act. Johnny Isakson, Herb Kohl, and I introduced the bill today. I wish all members would look at that. I think it's a very good proposal. What it does, basically, is provide the opportunity for us to do the same things with regard to 401(k) plans that Congress did in 1989 with regard to Social Security. Back in 1989, Congress enacted a provision leading all Americans to receive annually a benefits statement from Social Security that tells you how much you can expect to receive each month when you retire. What our bill does is to say we should do the same things with 401(k) plans. We should have protections for the employer to hold them harmless, as long as they follow the procedures set forth by regulations. I think it's a very good bill. I hope we can get it passed in this Congress.

Mr. Brown, you spoke about this bill in your testimony. Maybe you'd want to make another comment on it.

Mr. BROWN. Sure. I'm quite supportive of this bill. As I mentioned in my opening remarks, our research suggests that when you get people to think in terms of monthly income in retirement, they have different preferences. They express different views about what's important to them. I think it's a more accurate view, in the sense that, ultimately, when we're planning for retirement, that monthly or annual consumption is what we're ultimately saving in order to provide for. I think that this act could be a very important first step in sort of changing the conversation, and changing the way that people think about retirement planning.

Senator BINGAMAN. Yes. My understanding is that this information changes people's view of their retirement assets, and in doing so, it encourages them to save more, which is one of the big things that I think I was hearing from the witnesses we ought to be doing.

Ms. Chatzky.

Ms. CHATZKY. That's absolutely one place where I think it could be incredibly useful, but not the only place. Senator Enzi spoke about the student loan problem that we're having in this country right now, and the fact that the student loan debt is out of control. I believe that if students were shown the monthly pay back amount that they were taking on at the time they borrowed, we would make big strides to solving that problem, too.

Senator BINGAMAN. That's another good suggestion. Let me also—

Mr. BROWN. Could I add one other comment?

Senator BINGAMAN. Yes. Sure.

Mr. BROWN. In general, there is a phenomenon known in the behavioral economics literature that people are not very good at being able to translate lump sums of wealth into flows of income, and vice versa. Ms. Chatzky's right, that that is a more general phenomenon than what we have just in the context of retirement income. But this is clearly a case where it's really, really important. If you ask people, What would you think if you had $100,000 in retirement? They feel like that's a lot of money. Then when you tell them what that translates into in terms of the actual monthly income that it can provide, suddenly they don't feel so rich anymore. That's where the incentive to save more comes in. So, I think it's quite important.

Senator BINGAMAN. Great.

Ms. Chatzky, you also talked about the Auto IRA bill. Well, that's another bill I hope all Senators will look at. I introduced that in the last Congress. We're going to try to introduce it again, but we'd like to get some cosponsors. We think that that bill is designed in a way that does not put a burden on small business, but does provide an opportunity for folks that don't have 401(k)s to still put some money away in a retirement account before they actually get it in their paycheck. That's the purpose behind it. I think it would be a major step for the American worker.

Ms. Lucas, there is a T. Rowe Price study on the same issue that Dr. Brown was just talking about on the question of savings patterns that people will follow in their 401(k) plans based on their knowledge about what this translates into on a monthly basis. Are you familiar with that?

Ms. LUCAS. Well, there have been a number of recordkeepers, T. Rowe Price among them, who have done an excellent job of providing projections for participants for their retirement needs. So, you'd look on their Web site. It might be on their statement. It tells you, if you continue to save at this level, given what we know about you, at retirement here's what it will translate into monthly income. It might even have a gap analysis on it in case you are not saving enough. It might say, you need to save X amount more in order to reach a 80 percent income replacement level. So, there's a lot of good work that's already being done, very sophisticated work. It would be my hope that whatever the bill is that is being proposed would also provide a fiduciary safe harbor for this type of analysis that's already being done by many of the recordkeepers.

Senator BINGAMAN. Thank you very much, Mr. Chairman.

[Prepared statement of Senator Bingaman follows:]

PREPARED STATEMENT OF SENATOR BINGAMAN

I would like to thank Chairman Harkin and Senator Enzi for convening this afternoon's hearing, to highlight how insights from behavioral economics can be applied to raise our Nation's retirement savings rate.

As this committee is well aware, defined benefit pension plans—to which employers make regular fixed contributions—have become relatively rare. So those who receive any form of workplace retirement account are increasingly offered the opportunity to contribute to defined contribution plans, like 401(k)s, to which their employer may or may not provide a matching contribution.

But the shift from DB to DC plans means that plan participants need to be even more proactive in planning for their retirement. Right now, 401(k) plan statements typically provide a total account balance, but not a monthly income equivalent. This leaves many participants unprepared to evaluate whether they are saving adequately to maintain cost of their current standard of living in retirement. Take for instance a 55-year-old secretary at a law firm in Albuquerque with a $75,000 balance in her 401(k). That balance may be significantly larger than her annual salary. But while she may think that is enough to carry her through retirement, in reality, even when combined with Social Security, that $75,000 probably will not last long enough. We need to ensure that she has the benefit of full information.

And to address this challenge, I am pleased to have joined today with our fellow committee member, Senator Isakson, as well as with Senator Kohl, to reintroduce the Lifetime Income Disclosure Act. Our bill would require DC plans annually to include "lifetime income equivalents" on benefit statements they already provide employees. A lifetime income equivalent is the monthly payment that would be made if the employee's total account balance were used to buy a guaranteed lifetime income product that begins at the plan's normal retirement age.

In 1989, Congress passed legislation that has resulted in all Americans receiving an annual Social Security benefit statement, which informs them how much to expect in monthly benefit payments at retirement. Our bill would round out the retirement income picture. Knowing the amount of monthly income they can expect from Social Security and their DC plan will help employees determine whether they are on the path to a secure retirement. Undoubtedly, many will decide to dial up their contribution rates.

We have worked hard to ensure that this proposal does not impose a burden or potential liability on employers. So the act directs that within a year, the Department of Labor must issue assumptions that employers may use in converting a lump sum amount into a lifetime income equivalent. DOL would further be directed to issue, within a year, a model disclosure. And the act also provides employers with a clear path to avoid any liability whatsoever.

Mr. Chairman, our proposal is a small step, but one that can make a significant difference in beginning to tackle a key policy challenge. I am pleased that the act enjoys the support of many leading voices on retirement policy, from AARP to the National Women's Chamber of Commerce to American Society of Pension Professionals and Actuaries, the Nation's leading association of retirement plan professionals. And I look forward to working with you, Chairman Harkin, with Senator Enzi, and with all of our colleagues on this committee to enact this common-sense approach into law.

Senator ENZI [presiding]. Senator Murkowski.

STATEMENT OF SENATOR MURKOWSKI

Senator MURKOWSKI. Thank you, Mr. Chairman. Senator Bingaman, I am looking at the legislation that you have introduced, the Lifetime Income Disclosure Act, as one way to again help with this financial literacy. I guess, a question that I would ask of you, Mr. Brown, and something that I'm still looking into, is this concern about any associated liability that may attach about assumptions that are made. Can you just speak to that as an issue?

Mr. BROWN. Sure. I'd be happy to.

I always think it's very important to step back and remember that plan sponsors are not under any obligation to offer a plan in the first place, and that under current law they're not obligated to offer a lifetime income option. Anytime that we impose fiduciary risk or a liability on them we've run the risk, no matter how well intended the regulation is, we've run the risk of providing a disincentive for them to be providing these plans in the first place. So, I think it's very important that we keep an eye on that at all times.

I think, in this context I think it can be easily handled in the sense that if, for example, the Department of Labor were to lay out a very simple formula or a table that plan sponsors can look up and simply say, well, if an individual has, say, $100,000 in their account, here is the amount that they can now report to that individual as an example of the monthly income that they would receive, and that as long as a plan sponsor follows that, it essentially provides them a safe harbor so that they are protected from those fiduciary concerns.

However, I do agree with the prior comment as well, that there are a number of companies out there that are actually doing a very sophisticated job, probably a more sophisticated job than we would expect through a safe harbor provision. I think it's also important that we allow those companies to continue to do that as well.

I do think it's an important concern, but I think it's one that could be quite easily addressed in the legalization.

Senator MURKOWSKI. Let me ask you this as a general question, some discussion about financial literacy amongst young people, and how we effectively reach out to them. I think we're all learning the benefits, certainly, of the social media and Facebook and Twitter, and some of the other methods of communication, videos out there on YouTube. Are we using these tools in any kind of an education effort to reach out to the kids that are my kids age, that really could care less at this point in time about their future retirement? What's available to them? Ms. Chatzky.

Ms. CHATZKY. I have a 16-year-old and a 13-year-old.

Senator MURKOWSKI. So, you're engaged.

Ms. Chatzky. So, I'm in there.

Senator MURKOWSKI. Yes.

Ms. CHATZKY. One of the things that I know from dealing with my own kids and their friends is, you have to get them where they are. You have to reach them at a point where they actually have a reason to want the information, even if their reason isn't the same as your reason. I have believed for quite some time that a very effective way to move some financial education through the channels would be to put 10 to 20 financial education questions on the driver's license permit exam.

[Laughter.]

Senator MURKOWSKI. There you go.

Ms. CHATZKY. Well, and it makes economic sense, because auto insurers price based on your credit score. So, if we could work together with them to show that these kids who pass this section of the exam are more likely to have better credit scores simply because they understand the information, then parents who pay those premiums would have an incentive to get their kids to study for that portion of the test.

Senator MURKOWSKI. Interesting.

Any other suggestions, Ms. Agnew? Got any great ideas?

Ms. AGNEW. Well, I think that's a fantastic idea. You definitely— I have three children, and you have to get them where they are. I do think that there are ways we might be able to integrate it into the school, but I'm not saying another requirement for the schools.

I was talking to a superintendent of the school district yesterday, and they're tight-staffed, and to ask a teacher to come up with more to teach in a limited amount of time is a lot to ask for. But I think there's a lot that could be done with people in academia that could put together some off-the-shelf lessons that could be integrated into the school, that could pool and hit on standards that need to be met in math and social studies.

I think that there are ways that we in academia can help the actual schools. Make it fun, though. It has to be fun. Worksheets don't work for 7-year-old boys,.

Senator MURKOWSKI. Well, and I know my time is up. But, I think an important thing to recognize is, we can't talk about investments unless you've saved for it. We save pennies with the kids when they're little, but then when they hit 17 and 19, like my boys are, they're saving for the car, and beyond that, there's not a lot that they are saving individually. As parents, we try to set the example—save for college, save for their future. But are we doing a better job generally with young people in encouraging them to save? I don't think that we are. But do the statistics prove me wrong?

Ms. Lucas.

Ms. LUCAS. I'd like to go back to automatic enrollment again. The amazing thing about automatic enrollment is that, regardless of demographic group—young people, old people, low salary workers, high salary workers, across different ethnic groups—the opt-out rate is almost identical, and so we see people in their twenties who, if they were to save on their own, maybe half of them or less would save. Under automatic enrollment, closer to 90 percent are saving, just because of inertia. They are in the plan, and somehow, even though they've said, "Oh, I can't afford to save." When it's taken out of their paycheck before they have an opportunity to spend it, suddenly they can afford to save.

Senator MURKOWSKI. So, we help them along initially with the enrollment.

Ms. LUCAS. I think automatic enrollment for young people is really one of the most effective ways to get them to save in the plan.

Ms. CHATZKY. We can do the same for our kids. If, it's parental. It's not systematic. If we want our kids to be savers, then we take part—saving money is no fun, but having money saved is a lot of fun. So, we force them into a position where we take part of their allowance, and that goes into savings. And when they see that money piling up, all of a sudden we can feel good about that.

Senator MURKOWSKI. Thank you, Mr. Chairman.

The CHAIRMAN [presiding]. Thank you, Senator Murkowski.

Senator Franken.

STATEMENT OF SENATOR FRANKEN

Senator FRANKEN. Thank you, Mr. Chairman.

Ms. Chatzky, Ms. Agnew, you both have been talking about financial literacy, and possibly teaching that in school. This committee is reauthorizing ESEA this year, we hope. I'd just like to ask you some questions about how to do that. You've been talking about it a little bit. I know we don't want to put another burden on people and require them to do another thing. But this seems to be a good—I like your idea about putting it in math. I liked your idea about putting questions about financial literacy for your driver's permit.

I think we should be teaching home ec again, and home ec should really be home ec. It should be home economics, including how to cook healthy food, and fruits and vegetables, and the whole panoply of home economics and family economics.

You know, we're talking today, really, about defined contribution plans because the defined benefit plans are basically going away. One, I just wanted to touch on Social Security a little bit, because Social Security is still a defined benefit plan. What percentage of people rely on Social Security, Ms. Chatzky, for almost all, or all of their retirement?

Ms. CHATZKY. I don't actually know the numbers off the top of my head.

Senator FRANKEN. Does anyone?

Ms. CHATZKY. Thirty-seven.

Senator FRANKEN. Thirty-seven percent. OK. And compared to other defined benefit pensions in this country, how's Social Security doing in terms of solvency, would you say?

Ms. CHATZKY. I would say there are an awful lot of people out there who are convinced that it won't be there for them.

Senator FRANKEN. That doesn't answer my question, though, really.

Ms. CHATZKY. If you look at the numbers, it's 2037 that it's supposed to, the trust fund is supposed to run out of money. At least, that's the last number that I saw. So, not well.

Mr. BROWN. Senator, can I jump in here?

Senator FRANKEN. Yes. Please.

Mr. BROWN. Yes. The difficulty in comparing Social Security to either private sector or public sector defined benefit plans is that both in the public and private sector, either by choice or by requirement, they're trying to fully fund their pensions. Social Security's not really designed as a fully funded retirement system. It's a pay-as-you-go system, where today's retirees are supported by the tax payments of today's workers. So, the difficulty facing Social Security is the fact that, because we don't do a lot of pre-funding, just the demographic changes that we have coming make that a difficult system to sustain without having tax rates rising. In a sense, even poorly funded State and public defined benefit plans are better funded than Social Security, in the sense that they actually have made an attempt to pre-fund the benefits.

Senator FRANKEN. Right. But, this was started in 1935, and has worked in this system. In 2037 Social Security doesn't run out of money, so, that's the day until which everyone is guaranteed the full benefit. And at that time—you said it exactly right—you're paying for your parents. It's a generation legacy that started then, right?

Mr. BROWN. That's correct.

Senator FRANKEN. Let me talk about annuities a little bit. We have some testimony in a Special Committee on Aging hearing that said that most seniors actually believe they're going to live a shorter period of time than they actually are, actuarially. Is that correct?

Mr. BROWN. There have been a number of academic studies done comparing expectations to actual survivor tables. What we find is that, on average, that's right. But what that disguises is, a large number of Americans are overly optimistic, and a large number overly pessimistic. So, there are a lot of people who fall under the category. There are others on the other side.

Senator FRANKEN. I know I'm out of time. I just want to ask one question. Can I ask one more question about annuities? Is distrust of financial institutions, that they're going to be there 20 years from now, a big part of people's reluctance to buy annuities?

Mr. BROWN. Yes. The concern about what economists call counterparty risk, the concern of whether the insurance company will be there, is something that we think is driving some consumers' aversion to annuities. Not a lot of empirical evidence to support just how important it is, but I certainly believe that it is a factor, and ever more so after the most recent recession and financial crisis in which some of the longstanding financial institutions ceased to exist. That is an issue that, there are some ideas out there about how to address it. But it's certainly one that needs some thought.

Senator FRANKEN. Thank you.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

Senator BLUMENTHAL.

STATEMENT OF SENATOR BLUMENTHAL

Senator BLUMENTHAL. Just, first, about appealing to potential young drivers. I don't know whether you've been through the driver's application process with any of your children, but it can be a very trying time, and so, focusing their attention on retirement then may not be the best way to do it.

[Laughter.]

Having been through the process with four children.

I want to raise a larger issue which concerns the confidence people have in the financial system these days. Having just been through a deeply traumatic experience, many of them losing their life savings, I'd be interested in your perspective on, No. 1, isn't it necessary to restore confidence in this system which has really betrayed so many of our seniors, as well as other age groups? In particular, to pursue, perhaps even more aggressively some of the regulatory reforms that the Congress adopted during the last session? Because many of these regulations, obviously, will be issued in the next 6, 12 months.

Ms. LUCAS. I'd be happy to address that. At Callan Associates we have an index called the Callan DC Index, in which we track the movement of money across participants' plans. And while, certainly, participants did move money, more often than not, toward principal preservation vehicles during the financial crisis, we did see that the money was remarkably sticky within target-date funds. They were not moving money out of target-date funds. And in fact, every quarter throughout the financial crisis, there was net inflows into target-date funds. Further, there's very little evidence that people reduced their savings levels during the financial crisis.

So, I think you can look at 401(k) participants' inertia as a very positive thing during times like that, that certainly they do not tend to react in a large number, they stick with their allocations and be very willing to continue to look to the long term, as opposed to having knee-jerk reactions.

Senator BLUMENTHAL. Do the rest of you concur on that view?

Ms. AGNEW. I do. I've done some research in inertia, and it is a fact that in some cases it actually is helpful with people not reacting. One study I did do using some data, though, did show that there was a very, very small portion of people that did have reactions. The problem was, inertia then took hold and they never switched back their allocations. So, you know, I do agree, as long as the institutions are acting correctly, I think it's good to instill confidence in people in the institutions.

Senator BLUMENTHAL. The other trend that, obviously, is at play here is the higher ratio of debt to wealth. I wonder if you could comment on whether you've seen any impact as a result, whether there's any research that shows any impact resulting from that current economic trend. Obviously, the debt ratios are coming down now. But, it's still an important factor.

Ms. CHATZKY. We know as consumer debt picked up the savings rate went down. I think if you look at whether it's mortgage debt or auto loan debt or credit card debt, debt is really a savings killer. Particularly, that high interest rate credit card debt. There are a number of pieces of research that would support that. We have seen the savings rate come back a bit over the last couple of years. I think we want to get on that band wagon, and we want to encourage people to soft-pedal the plastic, and really continue to put more away, if that's the path that they've gotten themselves on.

Senator BLUMENTHAL. So, soft-pedaling the plastic really is profoundly important, not only in an immediate economic sense, but also in terms of the long-term trends that you've identified?

Ms. CHATZKY. I believe that it is. We're starting to see, particularly in the younger generation, more of a reliance on debit, less of a reliance on credit, a shift toward the other products in the marketplace. Again, not enough education out there about what are the differences, what are the pros and the cons of all of these tools, because that's what they really are, and how to use them wisely. But I think things are moving in the right direction.

Senator BLUMENTHAL. My time is up. But I want to thank you for being here today and giving us this very, very important and helpful testimony.

Thank you, Mr. Chairman.

The CHAIRMAN. Thanks, Senator Blumenthal.

Senator Whitehouse.

STATEMENT OF SENATOR WHITEHOUSE

Senator WHITEHOUSE. Thank you, Chairman.

First of all, thank you for what you've said about the need to clarify for folks who are looking at retirement what their real situation is, and give people a better appreciation of what they have to look forward to.

I noticed in Ms. Chatzky's testimony, you said that 50 percent of even, I think your phrase was "good-earning baby boomers and Gen-Xers" will run out of money in retirement. Some of the other figures you used were that 41 percent of Americans who are in the lowest income quartile, the lowest income, 25 percent, would run out of money in 10 years. Even in the top 25 percent income bracket, that 5 percent would run out money in 10 years, and 13 percent would run out of money in 20 years. So, even for top earners I assume that actuarially somebody who's a top earner can be expected to live, on average, more than 20 years after retirement, correct?

Ms. CHATZKY. I think actuarially, I mean—

Senator WHITEHOUSE. That was the breakdown.

Ms. CHATZKY [continuing]. I don't know where the breakdown is. But I would assume, with better access to healthcare and the access to the best doctors, sure, those numbers would go up.

Senator WHITEHOUSE. So, for those people who are running out, those 50 percent of the population, their only safeguards at that point are Social Security and Medicare, correct?

Ms. CHATZKY. Correct.

Senator WHITEHOUSE. Without them, what?

Ms. CHATZKY. They move in with the kids.

Senator WHITEHOUSE. I'm sure a lot of kids will be thrilled to think about that.

[Laughter.]

At the time that they're running out, 10 years or 20 years after their retirement, do you have any information on what their earning capacity is at that point?

Ms. CHATZKY. I don't. This is an EBRI study that I was citing. I'd be happy to forward it to your office.

Senator WHITEHOUSE. Presumably, it's pretty negligible.

Ms. CHATZKY. Twenty years out, yes.

Senator WHITEHOUSE. Say, you've retired at 65, you're now 85.

Ms. CHATZKY. I would say negligible.

Senator WHITEHOUSE. It's a tough time to be asked to go back into the job market, isn't it?

Ms. CHATZKY. Yes.

Senator WHITEHOUSE. So, it reinforces how vital Social Security and Medicare are to our safety net and to assuring that Americans have a decent standard of living in their old age.

Ms. CHATZKY. Absolutely.

Senator WHITEHOUSE. All right. I appreciate your testimony very much. Thank you all.

The CHAIRMAN. Thank you, Senator Whitehouse.

Senator Merkley.

STATEMENT OF SENATOR MERKLEY

Senator MERKLEY. Thank you very much for the testimony from all of you. This is near and dear to my heart because when I was the director of a non-profit I wanted to encourage all my employees to start with the assumption that they would sign up and then decide later if they wanted to opt out, knowing from a variety of sources that they're much more likely to save especially if they start savings early in their career. We had a lot of young employees who we would help over the long term.

I have had one concern about the default sign-up. That is, how a company goes about setting out the default allocation of the funds that are being saved. We had a company in Oregon, PGE, that had a situation where the employees' funds were largely invested in Enron stock, and there was a lot of risk to that concentration in a single area. So, are there any guidelines for companies that are kind of best practices about starting? If they're starting with a default option—and I understand they have to give 30 days notice to the employee, and give the employee an opportunity to change it—is there any kind of best practices guideline that encourages companies to start with, a diversified portfolio, or in some other way, reduce the risk profile of the choice?

Ms. Lucas.

Ms. LUCAS. I would like to address that. I think one of the key features, and most important features, for a defined contribution perspective of the Pension Protection Act, was that it did provide a safe harbor called the Qualified Default Investment Alternative safe harbor, for plans that wanted to adopt automatic enrollment. It was hugely successful. It outlined that there are three possible, qualified default investment alternatives, target-date funds, asset allocation funds, and managed accounts, all of which are well-diversified investment vehicles. Today, according to a recent survey that I saw, about 70 percent of plan sponsors are using target-date funds, highly diversified, well-managed funds for the qualified default investment alternative. If you look at prior to that, sometimes, indeed, company stock was the default, often it was stable value. So, plan sponsors were simply putting people in stable value at a 3 percent contribution rate, and then saying, "Good luck getting to your retirement." So, this has been a very big improvement in getting people to save in a well-diversified plan.

Senator MERKLEY. When you speak about safe harbor, essentially, let me describe what I think you mean, and then you can clarify if that's right. Companies were told, you're immune from lawsuits if you put folks into this structure as a default option. Additional legal protection. Is that what the safe harbor means?

Ms. LUCAS. Certain legal protections. The plan sponsor is liable for the selection of the fund, but the individual is responsible for any losses within the fund. So, the plan sponsor is not liable, as long as it's a prudent fund, for losses within that fund. It doesn't immunize them against lawsuits, but it forms a defense within a lawsuit.

Senator MERKLEY. Anyone else want to come in on this?

Earlier you addressed teenagers and how to do better financial education with teenagers. I wanted to ask you to address either the challenge of financial education for low-income families, or financial education specifically for women, whether there is any distinction, or any special strategies or, for that matter, special strategies for men that we should be thinking about?

Ms. CHATZKY. I'll address the women question. I do think, and it's definitely controversial, because we know that stocks are not pink or blue, right? Money's green. It's definitely a controversial proposition. But, women are behind the 8 ball, because we live longer. We're the ones who still take breaks from the workforce to care for the kids and to care for older parents. As a result, our retirement balances, even if we have the same starting salary, tend to be lower than those of men. So, an argument should be made that women almost need the education more, to a greater degree. If you look at survey after survey, you'll see that women are not feeling prepared at all.

There is an argument to be made for educating women in groups of women, that there are certain comfort zones where people feel more able to receive the information, more able to take it in. I believe that that, almost a Weight Watchers type model where people come together and they have a group, and they discuss the issue. Whether it's in churches, which have been a great place to receive this information over years, or schools, or other sorts of community outposts is, might be helpful. If we could come together on a single curriculum that would provide the information, through an organization like Jump$tart, or through the government, I think that would be very, very helpful. Because right now there are so many forces working toward the same direction, the same mission, but competing endeavors that a lot of times we find that we're getting in each other's way.

Mr. BROWN. Could I throw something in here?

Senator MERKLEY. Yes.

Mr. BROWN. Thank you. There undoubtedly is important heterogeneity within the population in terms of how effective, and the type of financial education that's needed. This may sound a little self-serving coming from an academic researcher, but I think one of the important things that I would stress in all of this is how important it is to have well-designed research to actually assess the effectiveness of any financial literacy intervention.

We do know that financial literacy programs can be effective, but they also can be quite expensive, and it's important if we have to stretch resources to dedicate to this that we really study that. Oftentimes, you know, studies will find that it's very simple things that get in the way of a program being effective. Dr. Agnew mentioned earlier the Financial Literacy Research Centers that are sponsored through Social Security. They're doing a lot of work in this area. There are other organizations doing that as well. I just thought that it's really critical as we move forward in this area.

Senator MERKLEY. Thank you very much to all of you. My time's expired. I very much appreciate your testimony.

The CHAIRMAN. Thank you, Senator.

Ms. Chatzky, going back to a point that was raised earlier, I think by Mr. Franken, the Social Security trustees say that by 2037 the Social Security Trust Fund will then only be able to pay out 75 percent of benefits. It will not go broke.

Ms. CHATZKY. Right.

The CHAIRMAN. And that 75 percent continues, and I don't know the answer. I think it's 25 years or 30 years until all the baby boomers die off, then it bounces back up slightly.

Ms. CHATZKY. OK.

The CHAIRMAN. To the response that you gave about a lot of young people don't think it's going to be there. I run into that in town meetings all the time, and when I talk to young people, ask them if they believe that Social Security will be there for them, and not very many people raise their hands.

I always like to inform them that, I ask them if they believe that the United States of America will exist, will even exist when they're that age. Every hand goes up. Well, I say to them, if the United States of America exists, your Social Security will be there for you, because it is the only retirement system backed by the full faith and credit of the U.S. Government. It has to pay it out. So, therefore, if the United States of America exists, Social Security will have to pay it out, because it is backed by the full faith and credit of the U.S. Government. None of these other retirement systems are. Financial institutions can go bankrupt, you can lose your money, all kinds of things. They're not backed by the full faith and credit of the U.S. Government. That's why I've always been such a strong supporter of a basic social safety net that is backed by the strength and power of who we are as a nation. And that's what Social Security is.

Over and above that, you need some retirement security to have a little bit better lifestyle. You mentioned, correctly, that, I think, right now it's around 35 percent— somewhere in that neighborhood—of present retirees, depending on Social Security for 100 percent of their retirement income. I think a lot of people in that regard probably wish they could have saved more when they were younger. But when you're young, you have a short horizon. The horizon is very short. So, that's why this whole idea of financial literacy, of getting young people involved in automatic savings as early as possible in their lifetimes, where you build up a culture, a culture of saving, is so important. We've just not had that very much in our country. We've become more a culture of debt than of savings. So, I'm hopeful that, again, what, or, if I've heard all of you, Dr. Brown, everybody say is that we do need to have a better sense of—you say financial literacy, but, what it means to save money, and what it means to save, not just for wealth accumulation, but what it means for how you will live when you are in the later part of your life.

I'm always looking for ways of, that we can promote, or incentivize at the earliest possible time in life, that you could, you would have something that all the time would remind you that you're putting money away for retirement.

I would throw one out for your consideration. That every single dollar of Federal money that goes out, or State money, or local tax money, anything that goes out, from the public treasury of any sort, that goes out in any form of a payment to any individual, that right off the top, a certain portion is taken and is put into a retirement account. Not Social Security. I'm not talking about Social Security. I'm talking about a 401(k) type of a system. And so, that could be everything from your local Head Start recipient, at the earliest possible age, to maternal and child health care programs, to education, of course, all kinds of things. So that right off the top you know that a certain amount of that money is going to be put into a retirement system. As I said, not Social Security. I'm talking about over and above what Social Security is, which is not, as someone pointed out, it's not a retirement saving. It's a generational transfer of money, is what Social Security is.

Again, I go off on this vein only to encourage you to help us start thinking about different ways, I'm looking for new ideas on how we can start this younger generation, knowing that whenever they make a buck, some of that is put away, automatically put away, for retirement. How we do it in concert with the Constitution. It has to be constitutional. But somehow starting this at the earliest possible age. Like I said, there may be ideas out there. Dr. Brown, maybe you have some thoughts. We need to have the best ideas on how we start this culture of savings in our country.

I don't know if any of you have a response. I went over my own time just talking. Didn't even ask a question. But do any of you have any responses to that, or any other ideas on starting this, either now or later on?

Well, with that, I'll turn to Senator Enzi.

Senator ENZI. Thank you, Mr. Chairman. We were talking earlier about driver's licenses and financial literacy. I'm usually in Wyoming on the weekends. I usually get there on Friday and quite often talk to some school classes. And one of the things that fascinates me is finding out how much they think they could make when they're in junior high, if they get a high school diploma and go into the job market. Most of them expect that they will make $50,000 a year. I take copies of Parade Magazine with me. They do, I think it's a semiannual review of what real people make. And that's usually quite an eye-opener to find out that some people in real estate make $3,000 a year. Of course, they include the sports figures, too, so there are still going to be kids out there dribbling a basketball so they can make $25 billion a year. But that's been a big help in financial literacy.

It's kind of interesting how this committee has changed, because before the downturn one of the things we were concentrating on was how to keep people in the job market longer so that all the jobs could be filled. Of course, now we have a surplus of workers compared—although the front page of the paper, the Washington Post, yesterday pointed out that there are a lot of jobs in the United States, but we don't have the skills to match up to them. So, I'm going to put in a plug for getting my Workforce Investment Act passed.

[Laughter.]

That's one of the ways for them to stay viable, which is if they stay in the market longer.

Ms. Chatzky, you said that people aren't saving enough, and I think that everybody would agree with you on that. What strategies would work best for someone who has been in the workplace a few years? I'm not talking about those 8th graders that I talk to, or the seniors, but the ones in between. What retirement savings advice would you give to young workers? How much of their paychecks should they be putting away?

Ms. CHATZKY. I tell them, something. Because you have to start someplace. Although I completely agree in theory with Lori's suggestion to increase the default to 6 percent, I worry that might, I think it needs to be tested and to see where people feel like the number is so high that they would start opting out. If you've tested it already, and I don't know, please forgive me.

People need to start where they feel that they can start, and then they need to ratchet it up from there. I would love to see everybody putting aside 10 to 15 percent, including what sort of match, whatever match they're getting from their company. I think if we look at the data, that's the range that shows to work. But people start to feel good about their savings when they're putting away 5 percent, we know, and they start to feel that it's possible when they put away something.

Senator ENZI. Ms. Lucas.

Ms. LUCAS. I did test it.

[Laughter.]

There is no empirical evidence at all that opt-out rates increase when the automatic enrollment default is 6 percent versus 3 percent. Opt-out rates are the same. I think plan sponsors are, harbor the myth that opt-out rates will increase, but we've done tests on it, and we see no empirical evidence.

I'd also like to say, you know, I have done a number of surveys of participants in 401(k) plans, asking them, "Why don't you save." They invariably say, "Well, I can't afford to save." Then you keep kind of going through the questions and asking them a variety of different questions, and it becomes apparent that the reason they don't save is not because they can't afford to save, but because they don't want to. They have other priorities. They want to spend. Perhaps they want to save for other things. It's not that they don't have the wherewithal to save. It's just, it's not a priority. That's why you can increase the automatic enrollment default. You can get, they can, actually, save more, and not suffer from not being able to make ends meet.

Senator ENZI. I think you suggested, too, that with the optimal escalation, that the top level ought to be raised, too. But here's a little different question. Is there an optimal level for employer contributions? Has anybody had any experience with that? What encourages the people the most to get into that?

Ms. LUCAS. I could answer that. What we find is that, as long as the employer contributes something, that has a huge impact. It almost doesn't matter whether it's 25 cents on the dollar or 50 cents on the dollar, as long as there's a contribution.

What does make a big impact is the level at which the contribution ends. So, if they only contribute, if they're doing 50 cents on the dollar up to 6 percent, people will contribute up to 6 percent. If it's a smaller amount, up to 8 percent, they will contribute up to 8 percent. So, there's a huge influence in terms of the level at which the employer contribution ends. We often encourage employers to have very high levels of—it can be economically neutral for them, but get the level of the employer contribution to a very high level of pay deferral.

Senator ENZI. Thank you. And for all of you, are there any viable advice options, viable places to get investment advice? I know one of the automatic things would be at universities, but a lot of people don't go to the university, don't start making those decisions until after they've been to the university, and maybe miss that. So, what are some viable options for investment advice?

One of the problems that businesses run into is whether, when they elicit those investment advice places, whether they're going to be liable for the advice that their employee gets.

But putting that part aside, what are the good sources of investment advice?

Ms. CHATZKY. Sorry. I think it's the job of the employer, it should be the goal of the employer to make the least biased sources of that investment advice available. The Morningstar Ratings, for example. If you're offering your employees mutual funds, that would allow them to compare them like they compare one car against another car when they're shopping.

There are a number of—Value Line—and a number of different organizations that do these unbiased comparisons. I think just putting them out there in as simple and abbreviated form as possible, while still containing the necessary information, would be helpful.

Senator ENZI. OK. Anyone else? Yes.

Ms. LUCAS. I would like to offer that what we've experienced within the defined contribution system is that there's been many attempts to offer advice, online advice, and other types of services, and the utilization has been quite low. And part of it is just a lack of confidence that people have in really understanding the advice and having confidence that if they implement it, it will be good advice. So, where we've seen more, actually, more success, is through managed accounts, when not only has the advice been given, but discretionary control has been taken of the account, and the advice provider actually manages the account on behalf of the participant. That's been proven to be much more effective. It actually changed, in, getting people to have confidence in the advice that's given.

Senator ENZI. Ms. Agnew. Dr. Agnew.

Ms. AGNEW. Yes. May I also say, I did a research project where I compared people that used online advice and managed accounts, and we found that managed accounts were appealing across demographic groups. But typically, with online advice, it's people with higher salaries that were interested in using it. Basically, people are using it that understand what they're doing and they're looking for someone to say, "You're on the right path." So, it's supporting what you have just said.

Senator ENZI. Thank you.

I would mention that that takes me back to one of the ideas that I mentioned about being able to pool a bunch of small businesses to get the investment advice, because Morningstar, for example, is expensive for a small business to be able to purchase.

Ms. CHATZKY. So are managed accounts.

Senator ENZI. Yes. Yes.

The CHAIRMAN. Senator Blumenthal.

Senator BLUMENTHAL. Thank you, Mr. Chairman. I would just add a footnote to your comments, which I found very pertinent, about welcoming new ideas, particularly, ideas aimed at not only men and women, but boys and girls. Because I think that, as one of you suggested, there's never too early an age to begin. In fact, I think a very strong argument could be made that the driver's license age is almost too old, or maybe there's no place to get them at that age that will work. Maybe if you lose them at an early age, you don't reach them until some later point in their lives when they really come back to earth. So, any ideas you have about that age group, I personally would very much welcome.

The CHAIRMAN. Anything off the top of your head right now?

Senator BLUMENTHAL. Thank you, Mr. Chairman.

The CHAIRMAN. Well, thank you.

I really don't have any more. I really appreciate your testimonies and your expertise, and your views on this.

I'm anxious to see your legislation. I'd like to, because I think it has a lot of merit. I always worry about people that only have 2, 3, or 4 employees. They can't do this kind of stuff. So, if you can get consortiums of them together, that seems to make good sense.

Any closing comments or observations by anyone?

Dr. Brown.

Mr. BROWN. Yes. I appreciate the opportunity to speak here today, and I think you were asking a lot of very important questions. I look forward to continuing our communication in these areas.

The CHAIRMAN. Thank you, Dr. Brown.

Ms. Chatzky, any last thing.

Ms. CHATZKY. I would very much echo that thank you for inviting me here today. It's been very interesting.

The CHAIRMAN. Thanks for being here.

Ms. Lucas.

Ms. LUCAS. Thank you. I guess the one comment I'd like to make is that, another area that is of great concern for the overall retirement income adequacy of participants is plan leakage. Not only getting money into the plan, but keeping it there through preventing excessive loans, withdrawals.

The CHAIRMAN. Oh, yes.

Ms. LUCAS. I think that that's another very important area that needs further investigation and further support.

The CHAIRMAN. Well, I'm getting ready to gavel this shut, but you just opened up a whole new avenue, and that's the whole idea that people that get in stressful situations borrow the money out. My professional staff has told me it stayed pretty stable over the last 20 years. But, during the recent economic recession there was an uptick in loans. But, before that it was pretty stable. But it is a concern. People borrow the money out of their plan, and then they either have to pay it back, or they pay taxes on it. And the taxes are less than paying it back, so you pay the taxes, and then your plan's depleted. I think that's part of what you were getting at.

Anything else.

Dr. Agnew.

Ms. AGNEW. Well, many of the Senators asked the question, where can people get information?

I think one thing that we do need is a trusted source that people can go to. I know in New Zealand they have a Web site called sorted.org. Many New Zealanders use it, actually, to get information about different life and financial decisions. I do know that there are certain groups with the Financial Literacy Research Consortium that are working to build a Web site like that, that would be engaging people, and that people would want to go to. I think that's very much a worthwhile effort and should be pursued.

The CHAIRMAN. Thank you all, very much.

The record will stay open for 10 days for any comments or further questions.

This is an area of deep interest to this committee on both sides. And, that is, this whole idea of retirement security. We will continue to have more hearings on this this year, and trying to see what else we can do to help secure retirement savings for American citizens.

Thank you very much for being here.

The committee will stand adjourned.

[Additional material follows.]

ADDITIONAL MATERIAL

PREPARED STATEMENT OF SENATOR ISAKSON

I thank Chairman Harkin for calling this hearing and I welcome the witnesses.

I am proud to be a cosponsor, along with Senators Bingaman and Kohl, of the Lifetime Income Disclosure Act, which would amend the Employment Retirement Income Security Act of 1974 to provide 401(k) participants with an estimated monthly value of their benefits if they were to convert it to a guaranteed lifetime income stream upon their retirement.

Our bill models this notice upon the annual report workers already receive from the Social Security Administration.

As the witnesses will attest today, too many Americans are dangerously underprepared for retirement. Our bill will increase financial literacy, promote increased savings, and encourage participants to think of their 401(k) balance as a vehicle for lifetime income.

For instance, let's imagine a 29-year-old participant who has been saving for 7 years has accumulated a $10,000 account. Under the bill, he would be informed that upon his retirement at age 65, he could expect a guaranteed lifetime income stream of about $600/month. That amount tells the participant that he is doing well in saving for retirement, but has a long way to go.

The estimated value would be derived from a government formula that assumes a normal retirement age. The plan sponsors and the providers would both remain completely free from fiduciary liability on the accuracy of the estimation, as long as they used the government formula.

It is important what the bill does NOT do. It does not affect the tax treatment of 401(k) funds, nor does it mandate participants choose any particular retirement option. It merely provides participants with additional information so they can make informed choices about retirement.

I am happy to sponsor this bipartisan legislation that will foster increased preparation for retirement for millions of American workers.

PREPARED STATEMENT OF THE WOMEN'S INSTITUTE FOR A SECURE RETIREMENT (WISER)

The Women's Institute for a Secure Retirement (WISER) is pleased to submit this testimony for the record, relative to the Senate Committee on Health, Education, Labor, and Pensions hearing on encouraging better retirement decisions.

WISER is a non-profit organization whose primary mission is to focus exclusively on the unique financial challenges that women face and provide the crucial skills and information women need to improve their long-term economic circumstances and financial quality of life. WISER supports women's opportunities to secure adequate retirement income through its research, training workshops, education materials and outreach.

WISER's major objectives are to: (1) Educate women age 18–70 to improve their financial decisionmaking; (2) Provide clear up-to-date information that moderate- and low-income women can use to mitigate the risks they face with respect to retirement income security; and (3) Raise awareness among policymakers and the public on these issues.

WISER also operates the National Education and Resource Center on Women and Retirement Planning (The Center) under a cooperative agreement with the Administration on Aging. The Center is a one-stop gateway of information created with strategic public-private coalitions to provide hard-to-reach women with financial tools.

The Center's goal is to help women make the best decisions they can with their limited income.

The Center has directly reached tens of thousands of women through our workshops and our partners' workshops, and we have further reached millions with our publications and Web site. WISER's approach is to bring financial planning back to the basics, and our strength is to provide women and minorities with core financial knowledge that encourages them to make financial and retirement planning a priority in their lives. The initiative began in 1998 and now includes numerous partners, including employers, aging and women's organizations, and community organizations.

We support the committee's efforts to find ways to meet the financial capability needs of all plan participants, avoid poverty in retirement, and to raise awareness among policymakers and the public on the unique challenges women face.

RISKS WOMEN FACE

The term "lifetime" takes on a whole new meaning for retiring women. Millions of women will live a third of their lifetimes after they reach their 60s. Thirty years is a long time to make savings last, putting women at high risk for poverty in their old age.

Many of the risks women confront, like longevity, simply come with the territory of being a woman in the United States. Women get paid 78 cents on the dollar for the same work men do. Many work in low-paying industries where benefits are scarce. When it comes to family caregiving needs, the vast majority of the responsibility falls on women who take time out of the workforce to raise kids or care for adult family members. Women often end up alone in retirement, which substantially increases the risk of poverty. They are also more likely to have chronic illness and require institutional care.

The most pressing threat women face in retirement is outliving their assets. Running out of money in retirement is too large of a risk to self-insure, but that is what millions of retirees do in an era of lump sum distributions from defined contribution plans. Women need information and access to safe, affordable lifetime income products.

THE IMPACT OF RETIREMENT RISK ON WOMEN

A report recently released by the Society of Actuaries and co-sponsored by WISER, *The Impact of Retirement Risk on Women*, finds that women have special retirement planning needs that are largely being ignored. The report details why it is particularly critical that women, who outlive men by 3 to 4 years on average, understand—and act on—the post-retirement risks they face.

Here are five key reasons women's retirement could be at risk:

Reason No. 1: Planning horizons are too short. Most women can expect to live 20 or more years after age 65. However, 9 out of 10 women in retirement or close to retirement do not plan nearly that far into the future.

Reason No. 2: Outliving assets is a risk. On average, women live 20 years after age 65, while men live 17 years. So women are more likely than men to outlive their assets. In fact, 4 out of 10 women over age 65 who are living alone depend on Social Security for virtually all their income.

Reason No. 3: Married women need to prepare for widowhood. Because men tend to marry younger women, and women tend to outlive men, periods of widowhood of 15 years or more are not uncommon. The numbers show that 85 percent of women over age 85 are widows, while only 45 percent of men over age 85 are widowers. Yet there is a planning disconnect here. Only 17 percent of female retirees and 27 percent of female pre-retirees said they would be worse off if their husband passed away; the majority of married women think that their financial situation would be the same or better if their husband passes away. However, the reality is that most widows have significantly lower income after their husband dies.

Reason No. 4: Women need to plan for long-term care. Women are more likely than men to have chronic disability in their later years and need care in a long-term care facility, or need a paid caregiver. The expected *average* value of the cost of lifetime long-term care services is $29,000 for males and $82,000 for females, although these amounts can get far higher for some people.

Reason No. 5: Women have a greater need to plan for medical expenses. Retirement incomes are generally less for women than for men, but they do not have lower health care costs. And women are less likely to have medical insurance from their employer, compared to men.

For most women, there's little room for error, and being unprepared for nearly a third of their lives will have consequences.

THE NEED TO EDUCATE ON THE IMPORTANCE OF LIFETIME INCOME

Combined with Social Security, immediate annuities represent a meaningful channel through which millions of women can live out their years in comfort and dignity. Yet, despite their availability, few retirees opt for lifetime income products. Only 18.6 percent of retirees aged 65 and over receive retirement income in the form of an annuity.[1]

Education plays a crucial role in achieving lifetime income security. Policy discussions on retirement security focus largely on asset accumulation. The same holds true for all of the financial information swirling around for people to try to make sense of.

Accumulation is, of course, a critical ingredient to retirement income security. But we need to help people see the big picture: how can they make use of what they have earned and saved to make their money last as long as they do? The pursuit of lifetime income—not the prospect of a one-time lump sum check, is the goal of retirement planning. We need to build better awareness about the tradeoffs of retirement income options.[2]

We need to help participants learn how to manage assets in retirement, and reframe the discussion.

LIFETIME INCOME PRODUCT LIMITATIONS

Lifetime income products are not without their limitations. For example, they typically do not adjust for inflation, eroding the annuitant's purchasing power over time. Providers are increasingly coming up with features to address issues like this, but they come at the cost of higher expenses and lower income payout.

Also, the decision to accept a lifetime annuity is typically irreversible. Studies show that people fear this aspect, on the chance they may die long before they have received the cost of the annuity back.

THE IMPORTANT ROLE OF ANNUITIZATION

In spite of limitations, WISER sees immediate annuities as an important resource for millions of women, even those who have modest retirement assets. One hundred percent annuitization would make little sense for most (if not all) retirees. On the same hand, a retiree managing 100 percent of her retirement assets does not make much sense for most (if not all) retirees either. But we believe the option of annuitizing some portion of retirement assets is critical.

As Professor and Wharton Fellow, Dr. David Babbel, notes:

> "Lifetime income annuities may not be the perfect financial instrument for retirement, but when compared under the rigorous analytical apparatus of economic science to other available choices for retirement income, where risks and returns are carefully balanced, they dominate anything else for most situations. When supplemented with fixed income investments and equities, it is the best way we have now to provide for retirement. There is no other way to do this without spending much more money, or incurring a whole lot more risk—coupled with some very good luck."[3]

On behalf of the Women's Institute for a Secure Retirement, thank you for your consideration of this submission for the record. We welcome the opportunity to discuss these comments with committee members and staff.

PREPARED STATEMENT OF THE AMERICAN COUNCIL OF LIFE INSURERS

The American Council of Life Insurers (ACLI) commends this committee for holding hearings on the growing retirement security crisis. We applaud Chairman Harkin (D–IA) and Ranking Member Enzi (R–WY) for focusing on what can be done to help Americans save more for retirement and make informed decisions about their retirement savings. In particular, we believe that as Congress examines ways to preserve and enhance the current system, special attention should be given to help workers understand how their savings can provide them income they cannot outlive in retirement. ACLI believes that by providing a simple illustration of retirement savings as guaranteed lifetime income directly on defined contribution plan statements, workers will better understand whether they need to increase their savings,

---

[1] Employee Benefit Research Institute. *Income of the Elderly Population, Age 65 and Over: 2007*. EBRI Notes, Vol. 30, No. 5. May 2009.

[2] For an in-depth discussion, please see WISER's report: *How Can Women's Income Last as Long as They Do? Thought Leaders Discuss Managing Assets in Retirement*. June 2009.

[3] David F. Babbel. *Lifetime Income for Women: A Financial Economist's Perspective*. Wharton Financial Institutions CenterPolicy Brief: Personal Finance. 2008.

adjust their investments, or reconsider their retirement date, if necessary, to assure the quality of life they expect when they retire. It will also fundamentally change the way workers view their retirement savings, not only as a lump sum, but also as a source of guaranteed lifetime income.

The American Council of Life Insurers is a national trade organization with over 300 members that represent more than 90 percent of the assets and premiums of the U.S. life insurance and annuity industry. ACLI member companies offer insurance contracts and investment products and services to qualified retirement plans, including defined benefit pension, 401(k), 403(b) and 457 arrangements and to individuals through individual retirement arrangements (IRAs) or on a non-qualified basis. ACLI member companies' also are employer sponsors of retirement plans for their employees. As service and product providers, as well as employers, we believe that saving for retirement and managing assets throughout retirement are critical economic issues facing individuals and our Nation.

As the first wave of the baby boom generation reaches retirement age this year, it is timely that this committee is looking at the retirement savings plan system's ability to provide sufficient retirement income for these and future retirees. Many current retirees are fortunate in that they are receiving lifetime monthly income from both Social Security and an employer-provided defined benefit (DB) pension. That situation is rapidly changing. Today, more workers have retirement savings in defined contribution plans, which largely do not offer the option to elect a stream of guaranteed lifetime income. This change leads to questions of how individuals will manage their savings to last throughout their lifetime. Workers need to understand the value of their retirement savings as a source of guaranteed lifetime income. With this information, workers would be in a better position to consider augmenting their Social Security benefit with additional amounts of guaranteed lifetime income so that anticipated monthly expenses can be covered, shifting the risk of outliving one's savings to a life insurer.

With the passage of the "Lifetime Income Disclosure Act," which was reintroduced today by Senators Bingaman, Isakson and Kohl, Congress will move one step closer to helping individuals think of defined contribution plan savings as not only a lump sum balance, but also as a source of guaranteed lifetime income so that retirees can plan for a predictable standard of living. With this additional information on one's statement, workers will receive a ball park estimate, which when coupled with their Social Security statement, visually displays how much monthly income they could potentially receive in retirement based on their current savings. Workers can better decide whether to increase their savings, adjust their 401(k) investments or reconsider their retirement date, if necessary, to assure the quality of life they expect when their working days are over. From a recent survey, workers find it valuable to see how much guaranteed lifetime income they could obtain with their retirement plan savings.[1]

As an addendum to this statement, ACLI has outlined a number of other recommendations to encourage employers to offer guaranteed lifetime income options. Additionally, the prior survey notes that workers are also interested in guaranteed lifetime income options.

In conclusion, workers need additional information and access to lifetime income options if they are expected to successfully manage their savings throughout retirement. To this end, a lifetime income illustration will help workers visualize how their savings will address their basic month-to-month living expenses after retirement. Taking this important step today can help address tomorrow's retirement income security crisis.

ADDENDUM

New laws and regulations can help employers assist their employees in obtaining guaranteed lifetime income in the same way they have assisted employees in obtaining life insurance, disability insurance, and other financial protection products. New laws and regulations can also create an incentive to use guaranteed lifetime income as part of an employee's overall retirement income plan.

Recommendations to Encourage Employers to Offer Annuities

1. Provide Employers with Guidance on Lifetime Income and Education. The ACLI urges the DOL to revise and extend Interpretive Bulletin 96-1 beyond guidance on investment education to include guidance on the provision of education regarding lifetime income and other distribution options, both "in-plan" and outside

[1] ACLI Study on Retirement Choice, Mathew Greenwald & Associates 2010 (see Appendix 2).

the plan, to assist participants and beneficiaries in making informed decisions regarding their distribution choices.

2. Help Employers Select an Annuity Provider. The DOL took an important step by changing the so-called "safest annuity standard" in Interpretive Bulletin 95-1 by adopting a safe harbor for the selection of annuity providers for individual account plans. While this regulation provided some helpful guideposts, it contains a requirement that the fiduciary "conclude that the annuity provider is financially able to make all future payments." This standard is difficult to meet, in part because it is hard to know how to draw this conclusion. While it is part of a "safe harbor," this prong makes it difficult to use the safe harbor and thus is an impediment to the offer of annuities in defined contribution plans. ACLI believes that changes can be made to these rules which will make it easier for employers to meet their duties while at the same time ensuring a prudent selection. We plan to work with the Department of Labor to simplify this requirement so that an employer can more easily and objectively evaluate the financial stability of the annuity provider.

3. Annuity Administration. Employers take on a number of duties in administering a retirement plan, and the administration of an annuity option would increase those duties. The qualified joint and survivor annuity ("QJSA") rules provide important spousal protections. The notice and consent requirements provide spouses with an opportunity to consider the survivor benefits available under a joint and survivor annuity. However, these rules add an additional layer of administrative complexity as well as technical compliance issues that most plan sponsors choose to avoid by excluding annuities from their plans.

There are a number of ways that the rules can be modified to make it easier for employers to administer this important requirement while protecting survivors, including:

- model plan amendments for employers to add guaranteed lifetime income options;
- simplify QJSA notice requirements; and
- the use of electronic signatures, widely accepted in financial transactions today.

ACLI proposes allowing those employers who choose to do so to transfer the duties and liabilities of administering qualified joint and survivor annuity rules to an annuity administrator. Also, employers need guidance that confirms that a participant's purchase of incremental deferred payout annuities should not be subject to the QJSA rules until the participant has elected to take the annuity payout.

4. Partial Annuitization Option. Some employers view annuitization as an "all-or-nothing" distribution offering. In our RFI submission, we asked the Departments to provide guidance making clear that plans may provide retirees with the option to use a portion of the account value to purchase guaranteed lifetime income, including model amendments to simplify the adoption of such a provision.

Recommendations to Encourage Workers to Elect Annuities

1. Illustration. To reframe retirement savings as a source of lifetime income, ACLI supports legislative proposals to include an illustration of participant accumulations as monthly guaranteed lifetime income on defined contribution plan benefit statements. ACLI thanks Senators Kohl, Bingaman and Isakson for their bi-partisan sponsorship of S. 2832, the Lifetime Income Disclosure Act, in the 111th Congress. This bill would help workers understand how their retirement savings might translate into guaranteed lifetime income.

2. Information. The ACLI has asked the Treasury Department to modify the 402(f) rollover notice requirements and the safe harbor notice to include information on guaranteed lifetime income, including the importance of income protections and the availability of lifetime income plan distribution options, if any, as well as lifetime income options available outside the plan.

ATTACHMENTS

[Editor's Note: Due to the high cost of printing previously published materials are not reprinted in the hearing record. The material, "ACLI Retirement Choices Study," by Mathew Greenwald & Associates, Inc., April 2010 may be found at *www.acli.com*.]

"ENCOURAGE ANNUITY OPTIONS FOR DEFINED CONTRIBUTION PLANS," ACLI PROPOSAL, FEBRUARY 2009

Problem: Currently, about one-half of employees' retirement savings is in defined contribution plans. Most defined contribution plans do not contain guaranteed lifetime income (annuity) distribution options notwithstanding that annuitization of account balances on retirement is the best way of assuring that retirement funds will not be exhausted during the participant's life. Early exhaustion of account balances may also adversely affect surviving spouses.

A major reason that defined contribution plans do not provide guaranteed lifetime income options is that, if they do so, the plan must then comply with burdensome statutory requirements relating to joint and survivor annuities. The J&S rules impose costly and burdensome administrative requirements involving notifications to spouses, waivers by spouses, and prescribe the form and amount of spousal benefits. A major reason for the shift to defined contribution plans is a desire by employers to avoid the administrative cost and complexity associated with defined benefit plans, including compliance with joint and survivor annuity requirements.

A potential solution to this problem would be for the plan sponsor to outsource the administration of the joint and survivor annuity rules to the annuity provider. However, in the event of a failure of the annuity provider to properly administer the rules, the plan and plan sponsor would still be liable for a claim for benefits under Section 502 of ERISA.

Solution: Where the plan sponsor and the annuity provider have agreed that the annuity provider will be responsible for administration of the joint and survivor annuity rules, provide that enforcement actions for failure to comply with the joint and survivor annuity rules may only be maintained against the annuity provider, provided that the plan sponsor or administrator has prudently selected and retained selection of the annuity provider. Make this provision applicable only to administration of the joint and survivor annuity rules under defined contribution plans. The electronic delivery rules should be modified to allow greater use of electronic means for administration of the J&S rules.

Rationale: The ability to shift responsibility for the administration of the joint and survivor annuity rules would make guaranteed lifetime income (annuity) options more attractive to plan sponsors and could result in significantly wider availability of such annuity payment options under defined contribution plans. While this approach would retain the cost and complexity of the annuity rules, it would preserve spousal protections and would permit the plan and plan sponsor to shift responsibility to an experienced third party annuity provider. This provider would be an insurance company with experience in annuity administration and a secure financial ability to pay annuities. These factors makes shifting responsibility to annuity issuers more beneficial to and protective of plan participants, beneficiaries (including surviving spouses) and the plan sponsor than leaving responsibility with the plan and plan sponsor.

Electronic administration is more cost-efficient and has become more widely used. DOL has indicated that they are modifying their regulation on electronic delivery, although it is not known whether the modification will cover the QJSA rules.

SECTION—

(a) AMENDMENTS TO THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974.—

(1) IN GENERAL—Section 402(c) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. 1102(c)) is amended—

(A) in paragraph (2) by striking "or" at the end;

(B) in paragraph (3) by striking the period at the end and inserting "; or"; and

(C) by adding at the end the following new paragraph:

"(4) that a named fiduciary, or a fiduciary designated by a named fiduciary pursuant to a plan procedure described in section 405(e), may appoint an annuity administrator or administrators with responsibility for administration of an individual account plan in accordance with the requirements of Section 205 and payment of any annuity required thereunder."

(2) Section 405 (29 U.S.C. 1105) is amended by adding at the end the following new subsection:

"(e) Annuity Administrator

If an annuity administrator or administrators have been appointed under section 402(c)(4), then neither the named fiduciary nor any appointing fiduciary shall be liable for any act or omission of the annuity administrator except to the extent that—

(1) the fiduciary violated section 404(a)(1)—

(i) with respect to such allocation or designation, or

(ii) in continuing the allocation or designation; or

(2) the fiduciary would otherwise be liable in accordance with subsection (a)."

(3) Section 205(b) (29 U.S.C. 1055) is amended by adding at the end the following new sentence:

"Clause (ii) of subparagraph (C) shall not apply if an annuity administrator or administrators have been appointed under section 402(c)(4)."

(b) AMENDMENTS TO THE INTERNAL REVENUE CODE OF 1986—

(1) IN GENERAL—Section 401(a)(11) of the Internal Revenue Code of 1986 (relating to requirements of joint and survivor annuities and pre-retirement survivor annuities) is amended by adding at the end the following new sentence:

"Clause (iii) (II) shall not apply if an annuity administrator or administrators have been appointed under section 402(c)(4) of the Employee Retirement Income Security Act of 1974."

(c) ELECTRONIC DELIVERY

(1) IN GENERAL—The Secretary of the Department of Labor shall modify the regulations under section 104 or section 205 of the Employee Retirement Income Security Act of 1974 to provide a broad ability to administer the requirements of section 205 of the Employee Retirement Income Security Act of 1974 by electronic means.

THE SPARK INSTITUTE, INC.
SIMSBURY, CT, 06070,
February 14, 2011.

Hon. RICHARD BURR,
U.S. Senate,
217 Russell Senate Office Building,
Washington, DC 20510.

Re: Proposal for a Universal Small Employer Retirement Savings Program

DEAR SENATOR BURR: On February 3, 2011, the Senate Committee on Health, Education, Labor, and Pensions ("HELP"), held a hearing on "Simplifying Security: Encouraging Better Retirement Decisions." During the hearing Senators Enzi and Harkin, among others, called for the best new ideas that would help Americans save for a more secure retirement. The SPARK Institute [1] understands the challenges for small employers and Americans, trying to figure out how to save for retirement. Consequently, we developed a simple and cost-effective employer-based retirement savings plan alternative to the plans that are currently available and to the proposed mandatory payroll deduction IRA.

Our Universal Small Employer Retirement Savings Program (the "Program") was developed specifically to address and overcome the roadblocks in the current system that have been identified by small employers, American workers and service providers. For example, the Program addresses employers' concerns about costs, complexity and potential fiduciary liability. Simplified administration will make it possible for service providers to cost-effectively take on more responsibility for employers. The Program also leverages automatic enrollment and escalation features that have been successful in getting employees to start and continue to save. A copy of the Program is attached for your review.

We welcome the opportunity to discuss the concept with you as Congress considers new ways to help Americans save for retirement. We also welcome the opportunity to share our ideas with the HELP Committee at future hearings. If you have any questions regarding this information, please do not hesitate to contact me at (704) 987–0533.

Respectfully,

LARRY H. GOLDBRUM,
General Counsel.

[Editor's Note: Due to the high cost of printing, previously published materials are not reprinted in the hearing record. The above referenced material may be found at *http://www.sparkinstitute.org*.]

---

[1] The SPARK Institute represents the interests of a broad-based cross section of retirement plan service providers and investment managers, including banks, mutual fund companies, insurance companies, third party administrators, trade clearing firms and benefits consultants. Members include most of the largest firms that provide recordkeeping services to employer-sponsored retirement plans, ranging from one-participant programs to plans that cover tens of thousands of employees. The combined membership services approximately 70 million employer-sponsored plan participants.

[Whereupon, at 3:50 p.m., the hearing was adjourned.]