Statement for the

U.S. Senate Committee on Health, Education, Labor and Pensions

Hearing on:

Simplifying Security: Encouraging Better Retirement Decisions

February 3, 2011

by

Jeffrey R. Brown, Ph.D.
University of Illinois at Urbana-Champaign College of Business
515 E. Gregory Drive
Champaign, IL 61820

brownjr@illinois.edu
www.business.illinois.edu/jbrown

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.

[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 (2006-08), 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 (2001-02). 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.

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) 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 age 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.

[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.

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 U.S. – 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]

---

[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).

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 U.S. From this perspective, Social Security plays a vital role in providing a guaranteed income floor.

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.

---

[5] See, for example, Munnell 2003.

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 U.S. 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.

[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."

In short, whereas annuities look risk 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 divided 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]

[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

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).

---

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.

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.

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): 304-309.

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 - 591.

Davidoff, Thomas, Jeffrey R. Brown, and Peter Diamond. 2005. “Annuities and Individual Welfare,” *The American Economic Review*, Vol 95, No. 5, December, pp. 1573 - 1590.

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): 453-458.

Yaari, Menahem E. 1965. “Uncertain Lifetime, Life Insurance, and the Theory of the Consumer.” *Review of Economic Studies* 32(2): 137–150.