Testimony for the ERISA Advisory Council to address
What useful information do participants need to make an informed decision in a risk transfer transaction, and how would you suggest getting this information to participants?

by Annamaria Lusardi, May 20, 2015

Thank you for inviting me to testify about information that participants need to make informed decisions in pension risk-transfer transactions. This is an important issue, and I am grateful for the opportunity to testify. My name is Annamaria Lusardi and I am the Denit Trust Chair of Economics and Accountancy at the George Washington University School of Business and the founder and academic director of the Global Financial Literacy Excellence Center (GFLEC).

In my testimony, I would like to make four main points. First, this is a very important and timely issue. With the shift from defined benefit (DB) to defined contribution (DC) pensions, most of the risks regarding pensions have been shifted from employers and pension providers to pension participants. We have focused a lot on the accumulation of pension wealth versus the drawdown of that wealth, but what people do with their accumulated pension wealth is important and consequential. Moreover, as mentioned in the January 2015 Report of the General Accountability Office (GAO), even in traditional DB pensions, pension providers have offered participants the choice to take their pensions as a lump sum, thus shifting the responsibility for managing pension wealth after retirement and insuring for longevity and other risks to pension participants. As I have argued in many of my research papers, participants are ill-equipped to deal with this new responsibility, in particular when it comes to understanding and managing risk. The second point I would like to make has to do with the information that participants need when asked to choose to take their pension as a lump sum versus an annuity. While the information is listed and discussed in the GAO Report, it is also critically important to consider the ways that information is provided, particularly when faced with participants who display very low levels of financial literacy. Third, I would like to offer some suggestions on the provision of information, in particular about risk. Fourth, I would like to make some remarks on ways to improve the current retirement system so that participants are more empowered to make the decisions they now face and that are going to become even more important going forward.

The first point I would like to make with regard to the decisions that participants face when given the option to take their pension as a lump sum is that the level of financial literacy of most participants is very low. This fact is barely mentioned in the GAO Report but, in my view, is important. For more than ten years now I have documented that most individuals do not possess the knowledge of the fundamental concepts that form the basis for financial decision making, for example, knowledge of the workings of interest compounding or the effects of inflation.[1] Moreover and most importantly for the topic of this testimony, individuals have the most difficulty grasping the concept of risk and understanding the workings of risk diversification. In

[1] This research work is summarized in Lusardi, A. and O. S. Mitchell (2014), "The Economic Importance of Financial Literacy: Theory and Evidence," *Journal of Economic Literature*, March 2014, vol. 52(1), pp. 5-44. See also Lusardi, A. (2015), "Financial Literacy: Do People Know the ABCs of Finance?" forthcoming *Public Understanding of Science*.

my recent paper titled "Risk Literacy," I document that people not just in the United States but also around the world display very little understanding of risk.[2] Specifically, people do not know about probabilities and cannot calculate an expected value. They also do not know about the relationship between risk and return. Moreover, they do not know how to diversify risk. This lack of "risk literacy" is particularly worrisome when we consider the choice between a lump sum or an annuity and the decisions involved in managing that lump sum.

The research on financial and risk literacy offers two additional findings for the topic under considerations. First, there are subgroups of the population that are particularly vulnerable when it comes to understanding risk and the workings of risk diversification; these subgroups are women and older adults. Women display much lower financial literacy than men. Moreover, when confronted with questions assessing knowledge of risk, women disproportionately tend to respond "I do not know" to the questions, a finding that is consistent in all surveys I have studied and that holds true across countries. The proportion of "do not know" responses is particularly sensitive to the way the questions—in particular the questions assessing risk—are framed. For example, questions that are heavy in economic and financial jargon elicit a very high share of "do not know" responses among women. Older adults, in particular those 60 and older, also display very low levels of financial and risk literacy. We do not know whether this is an age effect, due perhaps to a decline in cognitive abilities, or a cohort/generation effect due, for example, to the fact that older individuals lived in different economic circumstances and may not have been exposed to financial education in school and/or the workplace. Unfortunately, decisions about whether or not to annuitize wealth are made at older ages. Second, notwithstanding this severe lack of financial knowledge, when asked to assess their own financial literacy, most individuals (as many as 75%) gave themselves very high scores, well beyond what the scores resulting from the financial literacy questions would imply. The biggest mismatch between self-assessed and objective knowledge is found among older respondents; not only do they score lowest on the financial literacy questions (in comparison to other age groups), but they also give themselves the highest scores in terms of self-assessed knowledge. This mismatch could result in older individuals relying on their limited knowledge and skills and not asking for advice or consult advisors about managing their pension.

This brings me to my second point: it is unlikely that providing people with more information or the types of information that the GAO Report found missing when participants were offered a choice between a lump sum and annuitized benefits is going to substantially enhance the choice that participants will make. Simply stated, most people can hardly do a 2% calculation, let alone understand how different interest rates and mortality tables will translate into different lump sums. The research I have mentioned provides instead three basic recommendations:

1) The information has to be readily available and easily accessible as individuals are unlikely to even be looking for it. The GAO Report mentioned that participants had to actively look for information, and that it was often hard to find.

[2] See Lusardi, A. 2015, "Risk Literacy" first issue of the *Italian Economic Journal*, Spring 2015.

2) The information has to be provided in very simple ways and in plain English; in other words, complex financial jargon has to be avoided as many individuals, in particular women, find it difficult to understand that type of information.
3) Help has to be provided to conceptualize the information; for example participants may not understand that taking a lump sum means not just having access to and managing their pension but also taking up many risks, including the risk of outliving one's resources. This help should include providing tools that makes it easy for people to do calculations or make comparisons.

This all may seem very daunting, and many have interpreted lack of financial literacy to mean that people should not be in charge of making complex financial decisions, but in fact our research also shows there are simple yet effective ways to provide information that help people in financial decision-making. I would also like to mention that other fields face similar issues. For example, people are often offered choices on medical treatments, and given the geographical disparity in costs and treatments, they have to find the best hospital for their needs. These are also very complex choices. There are several papers that deal, for example, with lack of numeracy in the health domain and provide ways to address that problem.[3]

In my research, in collaboration with a group of co-authors I have designed short videos to explain, in very simple ways, concepts such as the power the interest compounding and the workings of inflation and risk diversification.[4] Concepts are embedded into a simple narrative that highlights not simply what the concept means but also how to conceptualize it. For example, the video about risk explains the concept of risk diversification using the metaphor of not putting all of one's eggs in a single basket to make clear what it means investing in just one asset or one's own company stock. We have tested the effectiveness of these videos by assessing whether financial literacy and self-efficacy (i.e., confidence in making decisions) change when exposed to the videos. We divided our participants into several groups, those exposed to the videos, those exposed to a written narrative (rather than watching the video, participants had to read the story) and a control group who was not exposed to this information.[5] We found that the videos increased financial knowledge and self-efficacy more effectively than did the print narrative. This study suggests there are ways to provide information that can be more useful and effective than the long list of documents and files that people are normally offered by pension providers.

In more recent work, we designed a visual tool aiming to explain and conceptualize risk diversification, which our research shows is one of the most difficult concepts for individuals to

[3] See, for example, Woloshin, S., L. M. Schwartz, W. C. Black, and H. G. Welch (1999), "Women's Perception of Breast Cancer: How You Ask Matters," *Medical Decision Making*, 19, pp. 221–229.
[4] Heinberg, A, A. Hung, A. Kapteyn, A. Lusardi, A. Savikhin Samek, and J. Yoong (2014), "Five Steps to Planning Success. Experimental Evidence from US Households," *Oxford Review of Economic Policy*, Winter 2014, 30(4), pp. 697–724.
[5] For more detailed information, please see the paper.

grasp.[6] The tool shows, for example, that riskier stocks provide a wider set of outcomes than less risky stocks (i.e., the original investment amount can increase a lot but it can also decrease a lot). The tool is interactive and allows users to visualize the effects of adding stocks with different properties (for example, stocks of the same versus different industries) to an existing portfolio. Our results are more preliminary here but they too suggest that these types of tools can help people understand financial concepts and learn how to apply them in making financial decisions.

The final point I would like to make is that the decisions that people have to make about their pensions are hard, and decisions about whether to take pensions as a lump sum or an annuity are particularly difficult. But people have to make these types of decisions and more so with defined contribution pension plans. Financial products that are similarly complex, such as reverse mortgages, are now available to consumers, and people are faced with the choice of whether or not to annuitize their housing wealth. Another important decision is when to start withdrawing Social Security benefits, a decision which requires the same skills needed to make a decision about taking a pension as a lump sum or an annuity. We need to do a better job equipping people to make these decisions. It is going to be hard to even provide information when financial illiteracy is so widespread. Building a robust pension system starts with adding financial literacy in school, so that individuals have at least basic financial knowledge. Without such a knowledge base, it is going to be very hard (and expensive) to help people make financial decisions. The workplace is another ideal place for providing financial education. In a world in which individuals are asked to take on the responsibility and risks connected with their own financial security, it is imperative that we find ways to equip them with the skills and the knowledge needed to make these important decisions.

[6] Lusardi, A., A. Savikhin Samek, A. Kapteyn, L. Glinert, A. Hung, and A. Heinberg (2014), "Visual Tools and Narratives: New Ways to Improve Financial Literacy," NBER Working Paper No. 20229, June 2014.