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Pension Research Council**

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May 3, 2010

The Honorable Phyllis Borzi
Assistant Secretary, Employee Benefit Security Administration
US Department of Labor
Washington, DC 20210-0002

The Honorable J. Mark Iwry
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Deputy Assistant Secretary for Retirement and Health Benefits
US Department of the Treasury
Washington, DC 20220-0002

Nancy J. Marks
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US Department of the Treasury
Washington, DC 20224-0002

RE: RIN 1210-AB33

Dear Ms Borzi, Mr. Iwry, and Ms Marks:

As the Director of the Pension Research Council and Boettner Center at the Wharton School of the University of Pennsylvania, the oldest pension research group in the United States, I am pleased to respond to your Request for Information Regarding Lifetime Income Options for Participants and Beneficiaries in Retirement Plans. Replies to several of your questions are provided, based on my over 30 years of research and consulting in the retirement security arena. I have not dealt with all the questions but rather focused my remarks on areas of particular relevance to my own research, teaching, policy, and industry work.

The Administration is to be commended is to be congratulated for highlighting this important issue and focusing regulatory attention on the matter. We are pleased to offer our perspective based on our extensive experience serving the needs of plan sponsors and participants.

The following are key points addressed in the submission:

- There is an increasing need for lifetime payout products as Baby Boomers move into retirement, as these products help protect against rising longevity risk.
- Nevertheless many workers do not appreciate the need for lifetime income and policies to enhance their appeal may be needed.
- Increased financial literacy and education for participants may be needed, along with greater transparency and standardization in the lifetime income product marketplace.
- Pension plan sponsors will be more likely to offer payout products with longevity protection if additional safe harbor provisions and guidelines are made available.

Thank you for your kind consideration. If you need additional information, please contact me at mitchelo@wharton.upenn.edu or at 215 898 0424.

Sincerely yours,

A handwritten signature in black ink, appearing to read "O. S. Mitchell". The signature is fluid and cursive, with the first letter of each name being capitalized and prominent.

Dr. Olivia S. Mitchell
Executive Director, Pension Research Council
The Wharton School, University of Pennsylvania

Responses to RFI on Lifetime Income Options in Retirement Plans (RIN 1210-AB33)

Submitted May 3, 2010, by Dr. Olivia S. Mitchell

1. From the standpoint of plan participants, what are the advantages and disadvantages for participants of receiving some or all of their benefits in the form of lifetime payments?

Payout programs which provide periodic and regular income for the remainder of one's life are useful in several ways. They help participants payout assets so as to minimize or eliminate running out of money due to longevity risk. They can also be a convenient tool for participants seeking an income stream from a pool of saving. In this context, guaranteed lifetime income benefits protect beneficiaries from outliving their assets so they will be less likely to be destitute in old ages. Additionally, a steady stream of income will benefit the financially less literate who are unable to budget and plan effectively. And older retirees who may lose the ability to manage their finances will be better protected against mis-selling of financial products. Disadvantages of lifetime income payments include the fact that that buyers must trust financial providers to remain solvent, to provide benefit flows that are inflation-protected, and that are not eroded by fees and charges. Also, a subset of retirees is already well covered by pre-existing annuities (via Social Security and defined benefit pensions) so will not need additional annuitization from their defined contribution plans.

Ultimately, enlightened plan sponsors will view plan education and advice as central to helping participants spend their retirement assets wisely, in all types of plans.

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

At retirement, most who have the option to take a lump sum do so because of several reasons:

- *In defined benefit plans:* participants may be concerned about underfunding in the plans so they may fear sponsor bankruptcy risk (particularly when promised benefits exceed the PBGC maximum); also the discount rate used in computing their lump sums may be favorable;
- *In defined contribution plans:* Many plan sponsors tend not to offer annuities 'inside' the plans, fearing that if they do it will expose them to potential fiduciary liability claims if the annuity provider fails to make good.
- *In all plan types:* there are a number of behavioral finance errors participants may make. For instance they may believe they can invest 'better' than the plan sponsor and overestimate their expected returns; they may not fully understand that sponsor fees and charges may be less than what they pay managing the money on their own. Also financial advisers may recommend taking the lump sum so they can earn commissions on the money management. Participants also tend to underestimate the chance they will live

very long lives, hence not be aware of the benefits of longevity risk protection; conversely they suffer from lump-sum illusion, thinking that a small accumulation will be sufficient to live on for a long time. In many cases annuity products are very complex, with numerous riders and fees, which makes the product very difficult to understand. And those with small account balances will find that annuitization is expensive and not very appealing.

To encourage participants to do more to elect lifetime income instead of lump sum payouts, the Agencies could:

- Increase participants' awareness of longevity risk using benefits calculators that emphasize "tail" survival risk, instead of focusing on life expectancy;
- Encourage annuitization in both defined benefit and defined contribution plans with tax advantages, particularly if the payouts are inflation indexed;
- Clarify safe harbor practices for plan sponsors seeking to include annuities as default payout options;

Nevertheless,, as per current practice, most retirement income decisions are likely to utilize nonguaranteed or portfolio-based solutions rather than annuity contracts.

3. What types of Lifetime Income are currently available to participants directly from plans (in plan options), such as payments from trust assets held under a defined benefit plan and annuity payments from insurance contracts held under a defined contribution or defined benefit plan?

It is unusual for defined contribution plans to offer annuities in the current payout environment. Some provide a means for participants to take minimum distributions as required by law, though a common approach seems to be to roll over the funds to an IRA and then use some withdrawal rule of thumb (e.g. 4% per year). This does not provide longevity risk protection. Defined benefit plans traditionally only offered an annuity option but currently a great many offer lump sum payouts which participants tend to take.

4. To what extent are the Lifetime Income options referenced in question 3 provided at retirement or other termination of employment as opposed to being offered incrementally during the accumulation phase, as contributions are made? How are such incremental or accumulating annuity arrangements structured?

A handful of insurance companies offer deferred annuity purchases during the worklife, in the context of defined contribution plans. The recent global financial crisis seems to be spurring employee interest in such products.

5. To what extent are 401(k) and other defined contribution plan sponsors using employer matching contributions or employer non-elective contributions to fund Lifetime Income? To what extent are participants offered a choice regarding such use of employer contributions, including by default or otherwise?

This is a very new area and not much information is available as of yet. I believe that using employer and/or employee non-elective contributions to purchase deferred annuities would be an attractive idea to make sure part of the retirement accumulations take the form of an annuity. However the details matter, including fees and charges.

7. What product features have a significant impact on the cost of providing lifetime income or other arrangements designed to provide a stream of income after retirement, such as features that provide participants with the option of lifetime payments, while retaining the flexibility to accelerate distributions if needed?

Most products providing longevity risk protection are offered by insurers, so costs will vary state-to-state depending on local state insurance regulations. In addition macroeconomic conditions will be influential including the interest rate and inflation environment; mortality patterns (current and predicted) are also important. Finally, product-specific features will vary.

8. What are the advantages and disadvantages for participants of selecting Lifetime Income payments through a plan (in-plan option) as opposed to outside a plan (e.g., after a distribution or rollover)?

Having an in-plan option for annuitization is likely to be less expensive than retail purchase; there is less adverse selection and the potential for scale economies will make the product cheaper. On the other hand, if the in-plan annuity is priced using unisex tables, this will make it less attractive to men than to women.

9. What are the advantages and disadvantages from the standpoint of the plan sponsor of providing an in-plan option for lifetime income as opposed to leaving to participants the task of securing a lifetime income vehicle after receiving a plan distribution?

A possible disadvantage from the plan sponsor's perspective is that the sponsor will likely have some fiduciary liability for the in-plan option. It would also be necessary to clarify who bears the costs of selecting the provider, etc.

10. How commonly do plan sponsors offer participants the explicit choice of using a portion of their account balances to purchase a lifetime annuity, while leaving the rest in the plan or taking it as a lump sum distribution or a series of ad hoc distributions? Why do some plan sponsors make this partial annuity option available while others do not? Would expanded offering of such partial annuity options -- or particular ways of presenting or framing such choices to participants -- be desirable and would this likely make a difference in whether participants select a lifetime annuity option?

I am unaware of any data with which to answer the factual question. As noted above, partial/no annuitization may be suitable for someone with a generous defined benefit plan or for whom Social Security provides a high replacement rate. Annuitization may have an unintended and perhaps undesirable effect of raising incomes to the point where some retirees may become ineligible for government benefit programs (e.g. Medicaid, SSI). On the other hand, if Social Security benefit growth must be curtailed, given the program's financial problems, the value of annuitization can be expected to grow.

11. Various "behavioral" strategies for encouraging greater use of lifetime income have been implemented or suggested based on evidence or assumptions concerning common

participant behavior patterns and motivations. These strategies have included the use of default or automatic arrangements (similar to automatic enrollment in 401(k) plans) and a focus on other ways in which choices are structured or presented to participants, including efforts to mitigate “all or nothing” choices by offering lifetime income on a partial, gradual, or trial basis and exploring different ways to explain its advantages and disadvantages. To what extent are these or other behavioral strategies being used or viewed as promising means of encouraging more lifetime income? Can or should the 401(k) rules, other plan qualification rules, or ERISA rules be modified, or their application clarified, to facilitate the use of behavioral strategies in this context?

Many studies in the behavioral economics and finance arena have reported that so-called default provisions such as auto-enrollment and target maturity date investments help participants accrue more retirement wealth. There is far less empirical evidence on the impact of defaults for the payout phase. It is likely that default provisions will be insufficient to get the assets to “stick” in payout products without investment in education and information regarding longevity risk.

12. How should participants determine what portion (if any) of their account balance to annuitize? Should that portion be based on basic or necessary expenses in retirement?

Economic models show that the optimal demand for annuitization depends on households other assets (defined benefit and social security benefits, housing assets, financial assets, insurance), human capital (susceptibility of labor income to shocks including health shocks), risk aversion, and bequest intentions. It would be useful to provide participants with a calculator that can help assess retirement income needs and how to translate these income flows into present values needed to buy annuities.

Some countries such as Singapore have recently mandated deferred annuities that should be sufficient to pay the government-set poverty or subsistence income level; the remainder of one’s account can be taken out as a lump sum if desired.

13. Should some form of lifetime income distribution option be required for defined contribution plans (in addition to money purchase pension plans)? If so, should that option be the default distribution option, and should it apply to the entire account balance? To what extent would such a requirement encourage or discourage plan sponsorship?

See question 12: retirees could be informed if they have sufficient income to ensure at least a poverty or subsistence amount from all available income sources including the pension annuity.

14. What are the impediments to plan sponsors' including lifetime income options in their plans, e.g., 401(k) or other qualification rules, other federal or state laws, cost, potential liability, concern about counterparty risk, complexity of products, lack of participant demand?

To date the payout products are difficult to compare and hard to assess in terms of their “money’s worth.” It would be useful to have a common metric to compare these with, particularly guaranteed lifetime/minimum withdrawals benefits. The patchwork of state

insurance laws and guarantee funds make it difficult for participants to figure out and value insurers' credit worthiness.

15. What are the advantages and disadvantages of approaches that combine annuities with other products (reverse mortgages, long term care insurance), and how prevalent are these combined products in the marketplace?

Product complexity is a problem for plan sponsors and participants; it would be useful to have a common metric to compare them with (e.g. the "money's worth" net of fees). Bundling can permit less expensive products since providers may achieve a natural hedge by offering two types of cover: e.g. life insurance and annuities. On the other hand, it is unclear that non-job-related products like reverse home mortgages will easily be bundled with factors more related to the job (e.g. life and disability).

16. Are there differences across demographic groups (for example men vs. women) that should be considered and reflected in any retirement security program? Can adjustments for any differences be made within existing statutory authority?

Those with lower than average life expectancy will, on average, receive a lower money's worth than those anticipated to live longer. For instance, women live longer on average than men, so they are more likely to benefit from longevity insurance than men. Similarly, racial and ethnic minorities have different expectancies and so may benefit differentially than the majority population. Also Blacks, Hispanics, and women are also less financially literate and knowledgeable, suggesting they may benefit more from advice and product explanations.

17. What information (e.g., fees, risks, etc.) do plan participants need to make informed decisions regarding whether to select lifetime income or other arrangements designed to provide a stream of income after retirement? When and how (i.e., in what form) should it be provided? What information currently is provided to participants, who typically provides it, and when and how is it provided to them?

Participants tend to underestimate their chances of survival to age 85, implying they will undersave and under annuitize. Accordingly more information could be provided regarding how expensive it is to retire, what Social Security benefits might be and how much more they will be if retirement is deferred, and how expensive healthcare (including long-term care) might be. This will make annuities more salient and a logical solution to the longevity risk problem.

This information can be provided via on-line calculators, employer education seminars, and webinars.

18. Is there a need for guidance, regulatory or otherwise, regarding the extent to which plan assets can be used to pay for providing information to help participants make informed decisions regarding whether to select lifetime income or other arrangements designed to provide a stream of income after retirement, either via an in-plan or out-of-plan option?

It would be useful to find ways for plan sponsors to provide educational material and advice regarding the sensible spending of retirement income.

20. To what extent should plans be encouraged to provide or promote education about the advantages and disadvantages of lifetime annuities or similar lifetime income products, and what guidance would be helpful to accomplish this?

In my view it would be most useful to ask plan sponsors of defined contribution plans report to participants what the annual income benefits might be from the participant's current account balance, so that each participant would gain a better idea of the potential retirement income stream could be obtained on the current market with this accrual.

21. Should an individual benefit statement present the participant's accrued benefits as a lifetime income stream of payments in addition to presenting the benefits as an account balance?

Such a report would be helpful to participants. Of course it would be necessary to provide 'safe harbors' to plan sponsors regarding standardized assumptions when projecting income payouts. It would be essential to also indicate the risks of annuitization including the loss of access and liquidity, decline in flexibility, and company default risk.

22. If the answer to question 21 is yes, how should a lifetime stream of income payments be expressed on the benefit statement? For example, should payments be expressed as if they are to begin immediately or at specified retirement ages? Should benefit amounts be projected to a future retirement age based on the assumption of continued contributions? Should lifetime income payments be expressed in the form of monthly or annual payments? Should lifetime income payments of a married participant be expressed as a single-life annuity payable to the participant or a joint and survivor-type annuity, or both?

In my view, both monthly and annual payments would be useful regarding payout options. Also both single life and joint/survivor options should also be depicted, along with the impact of taking early versus deferred benefit payments.

23. If the answer to question 21 is yes, what actuarial or other assumptions (e.g., mortality, interest, etc.) would be needed in order to state accrued benefits as a lifetime stream of payments? If benefit payments are to commence at some date in the future, what interest rates (e.g., deferred insurance annuity rates) and other assumptions should be applied? Should an expense load be reflected? Are there any authoritative tools or sources (online or otherwise) that plans should or could use for conversion purposes, or would the plan need to hire an actuary? Should caveats be required so that participants understand that lifetime income payments are merely estimates for illustrative purposes? Should the assumptions underlying the presentation of accrued benefits as a lifetime income stream of payments be disclosed to participants? Should the assumptions used to convert accounts into a lifetime stream of income payments be dictated by regulation, or should the Department issue assumptions that plan sponsors could rely upon as safe harbors?

Interest rate and load assumptions should be the same as used in generating estimated lifetime income benefits. In my view, it would be helpful to present both immediate and deferred payouts given current accruals would be most useful, as well as projections assuming current contributions continue to some future date (e.g. the normal retirement age under Social Security). Each estimate would of course need to be caveated with a statement that contributions and benefits are not guaranteed.

24. Should an individual benefit statement include an income replacement ratio (e.g., the percentage of working income an individual would need to maintain his or her pre-retirement standard of living)? If so, what methodology should be used to establish such a ratio, such as pre-retirement and post-retirement inflation assumptions, and what are the impediments for plans to present the ratio in a meaningful way to participants on an individualized basis?

Research suggests that participants do not understand percents, so replacement rates in retirement are not likely to be maximally informative. Also plan calculations generally ignore Social Security, private saving, and other sources of retirement income, as well as household liabilities (for healthcare/longterm care costs). For this reason an individual benefit statement could be wildly off target, without participant sign-off to include the other sources of retirement income.

25. How do the 401(k) or other plan qualification rules affect defined contribution plan sponsors' and participants' interest in the offering and use of lifetime income? Are there changes to those rules that could or should be made to encourage lifetime income without prejudice to other important policy objectives?

Clear and well-defined safe harbor rules would help limit sponsor liability and might enhance willingness-to-offer.

26. Could or should any changes be made to the rules relating to qualified joint and survivor annuities and spousal consents to encourage the use of lifetime income without compromising spousal protections?

Research on the REA suggests that spousal consent rules should remain in defined benefit plans.

27. Should further guidance clarify the application of the qualified joint and survivor annuity rules or other plan qualification rules to arrangements in which deferred in-plan insurance annuities accumulate over time with increasing plan contributions and earnings?

Defined contribution plans often do not use deferred annuity contracts within their retirement plans.

28. How do the required minimum distribution rules affect defined contribution plan sponsors' and participants' interest in the offering and use of lifetime income? Are there changes to those rules that could or should be made to encourage lifetime income without

prejudice to other important policy objectives? In particular, how are deferred annuities that begin at an advanced age (sometimes referred to as longevity insurance) affected by these rules? Are there changes to the rules that could or should be considered to encourage such arrangements?

Federal tax policy requires minimum distributions to generate some level of taxable income from tax-deferred accounts while participants are in the payout phase after age 70½ ; the problem is that this income stream is not guaranteed nor inflation-adjusted, nor does it carry a longevity guarantee. The concern is that participants might tend to believe that these income streams are “appropriate” drawdown rules. An alternative is to tax annuitized payouts more favorably than phased withdrawal schemes, which would enhance the appeal of lifetime income risk protection.

29. Are employers that sponsor both defined benefit and defined contribution plans allowing participants to use their defined contribution plan lump sum payouts to “purchase” lifetime income from the defined benefit plan? Could or should any actions be taken to facilitate such arrangements? Should plans be encouraged to permit retirees who previously took lump sums to be given the option of rolling it back to their former employer's plan in order to receive annuity or other lifetime benefits?

Allowing DC participants to buy a “DB-like” benefit has been proposed by many participants. Some large employers offer this currently to their participants, though few participants are covered by this specific strategy. Currently most private sector employers disallow participants from using defined contribution assets to buy defined benefit income benefits (though this is more common in the public sector). When defined benefit plans are underfunded, allowing lump-sum payouts is costly to the plan. Additionally, the Pension Benefit Guaranty Corporation (PBGC) may not be able to guarantee employee rollovers.

31. To what extent could or should the Department of Labor make changes to the safe harbor under 29 CFR 2550.404a-4 to increase its usage without compromising important participant protections? What are those changes and why should they be made?

Existing safe harbor could be improved to recognize more payout options. Additionally, the safe harbor could better protect fiduciaries from liability resulting from negative future events that could not be foreseen. Nevertheless, it must be acknowledged that plan sponsors cannot easily evaluate insurer credit quality, so they may find it difficult to obtain competitive pricing information on an apples-to-apples basis.

32. To what extent could or should the safe harbor under 29 CFR 2550.404a-4 be extended beyond distribution annuities to cover other lifetime annuities or similar lifetime income products? To which products should or could the safe harbor be extended?

Defined contribution plan fiduciaries currently have limited relief from ERISA fiduciary responsibility provisions where participants or beneficiaries control the assets in their accounts. This could be extended to payouts as well.

36. What are the costs and benefits to a plan sponsor of offering lifetime annuities or similar lifetime income products as an in-plan option? Please quantify if possible.

Today most employees will change jobs before retirement, so they would be ill-advised to incur the costs for a guarantee from which they are likely to benefit. Lifetime payout guarantees may be more suitable for older individuals seeking to buy the guarantee and who expect to annuitize or otherwise convert their balance to a guaranteed income stream at retirement. These could be offered only on a voluntary choice basis, given the features' costs.

37. Are there unique costs to small plans that impede their ability to offer lifetime annuities or similar lifetime income products as an in-plan option to their participants? What special consideration, if any, is needed for these small entities?

Smaller retirement plans generally pay higher all-in fees because they lack economies of scale; if small plans offer certain guaranteed income products such as deferred or immediate income annuities, guarantee costs will be added to their already above-average recordkeeping and investment management fees. Moreover, small plans may lack the negotiating power of large plans to drive down such costs. For this reason, analysts conclude that small-town participants face even higher fees in guaranteed options, certain retirement income solutions and thus risk can be shown to boost fees among smaller plan participants, with only little marginal benefit. Some retirement income solutions may still be resilient to small plan cover because that segment of the recordkeeping market is more likely to be served by insurance companies.

38. Would making a lifetime annuity or other lifetime income product the default form of benefit payment have an impact on employee contribution rates? If so, in which direction and why?

Selecting as a default the lifetime income benefit would likely have an important impact on how people manage their retirement payouts. Whether it would also have an impact on individual employee contribution rates is unknown. Some workers could raise contribution rates if they believed their current contribution levels (and/or investment returns) were insufficient to fund retirement payouts. Others might conclude that the lifetime income products provided enough to establish an acceptable standard of living in retirement thereby freeing them to redirect some of their savings to other consumption.

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