

Choosing Retirement Plans: Comment

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Choosing Retirement Plans

I am pleased to discuss George Loewenstein's article, "Costs and Benefits of Health- and Retirement-Related Choice" and to relate it to how people make choices in retirement plans. I will first summarize the main points of Loewenstein's paper and then indicate areas of agreement and disagreement. For the bulk of my remarks, I will discuss the experience of Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF), as reflected in three areas where people in the educational sectors have choices in retirement plans: (1) among pension plan types -- that is, between defined benefit and defined contribution plans; (2) among pension plan providers or companies; and (3) among investment accounts.

Loewenstein proposes the key factors that policymakers, both in the private sector and especially in the public sector, should consider in deciding whether and how to offer citizens, taxpayers, retirees, participants and employees choices among alternative options in health, retirement, insurance, and other economic areas. He lists briefly the benefits of choice; describes in detail the costs of choice (in terms of time, error, and regret); sets forth the criteria for the legitimate expansion of choice; evaluates recent expansions of choice; and concludes that most of these expansions have, on net, been negative. I agree with Loewenstein that whether and how to offer choice should entail a balancing of benefits and costs, that framing alternatives and designing defaults is critical to the success of a choice-based health or retirement program, and that offering choice is more natural in some areas than in others. But I think that he underemphasizes the benefits of choice, particularly over long time periods, and also underestimates people's desire to have alternatives available, even when not utilized.

As Loewenstein indicated, one of the benefits of choice is allowing people to select options tailored to their individual needs and tastes. These benefits may not occur immediately, but as people learn about the availability of options and their usefulness, benefits will accrue over time. For example, in the last decade TIAA-CREF has introduced to participants a wide variety of investment and retirement income options in their pension plans. Not all the options were utilized widely at first, but they are being used increasingly by significant segments of the population. And new options are often demanded by the population, or at least some segments of the population, particularly when they see these options already available to their colleagues, family members, and friends. So far, in the many surveys and focus groups of participants and plan administrators, TIAA-CREF officials have yet to hear in any significant way that the increase in available choices is not worthwhile. Of course, education, framing and a sensible menu of options help.

I now turn to TIAA-CREF's experience with choice in retirement plans in the education sectors. For the most part, higher education institutions can be divided into three groups with respect to the primary retirement plans offered employees: (1) almost all private institutions have defined contribution plans exclusively, (2) a declining number of public institutions require enrollment in a defined benefit plan sponsored by a state or local government, and (3) many public institutions that give employees (sometimes only faculty) a choice of enrolling in a public retirement plan or one of several defined contribution plans approved by the institution. For this latter group, the choice of retirement plan type is very important, because the decision may affect the size of their retirement benefits. The most favorable option will depend on the person's age at employment, the probability of remaining with the current employer until retirement, expected retirement age, risk preferences, the effect of inflation before and after retirement, and other factors that differentially affect the value of defined benefit relative to defined contribution pensions.

Robert L. Clark, Loretta Harper, and M. Melinda Pitts, in a study sponsored by TIAA-CREF, examined the choice of pension type and plan at North Carolina State University (NCState), where newly hired faculty can choose between a defined benefit plan and one of three defined contribution plans.¹ NCState faculty are given thirty days after being hired to make the pension choice; employees

who take no action are automatically enrolled in the state plan. The decision between the state plan and one of the defined contribution plans is irrevocable; among the defined contribution plans, shifts and partial selections can be made. Within one year after the introduction of a defined contribution plan in 1971, a majority of new hires enrolled in the defined contribution plan, and this enrollment share has increased over time.

Clark, Harper, and Pitts examined the plan type choices participants made and related those choices to participant socioeconomic characteristics, as well as preferences and opinions expressed in a special survey. They found that faculty hired at older ages, who anticipated remaining at NCState until retirement, were already enrolled in the state plan at a prior job, had lower current salary, or were hired just after the introduction of the defined contribution plan were more likely to choose the defined benefit plan. These are entirely rational and sensible choices consistent with predictions based on economic theory concerning the relative value of pension plans to individuals. Most faculty did not view the choice as a difficult financial decision, and they devoted relatively limited time to making the decision, although 17 percent of the faculty indicated in the survey that, in retrospect, they were not at all confident in their decision; most of the people in this latter category had chosen the state-defined benefit plan.

I do not want to leave you with the impression that I believe that an infinity of choices among plan types, providers and investment accounts is necessarily and automatically a good thing. Pension plan sponsors have a role in placing some reasonable limits on choice. As an example of what not to do, in the optional retirement plan for higher education institutions in Texas, currently any plan provider can offer an unlimited choice of investment options. As a result, in the pension plans at some community colleges, there are seventy-five to one hundred providers that offer ten or more investment choices each; plan participants at Texas community colleges therefore face more than a thousand investment options! At this scale, there are diminishing -- no, negative -- returns from choice. Indeed, in recognition of this problem, the University of Texas system within the Texas optional retirement plan has recently reduced the number of approved providers to eight. More generally, I believe the plan sponsor should offer participants sensible investment options, with a range of risk and return opportunities.

I will now look at how TIAA-CREF participants have exercised their investment options. As mentioned earlier, in the last decade TIAA-CREF has expanded the menu of basic asset classes and investment accounts offered to its participants. A majority of participants favor diversification among asset classes. In 1986, 45 percent of total contributions were allocated fifty-fifty to equity and guaranteed investments, and 32 percent of contributions were allocated to a combination of equity and guaranteed classes in other proportions. As of September 1998, 15 percent of premiums were being allocated on a fifty-fifty basis among equity and guaranteed classes, and almost 50 percent of contributions were allocated to other combinations of the various asset classes. There was a distinct increase in allocations to the equity asset group both through increases in 100 percent allocations to the equity class and in asset combinations that included equity assets and other asset classes as well.

Looking at this experience, the 1995 theory of Shlomo Benartzi and Richard Thaler, as cited by Loewenstein, even if was true at some time, is no longer the case.² TIAA-CREF participants, as shown by their asset allocation choices, do not seem fearful of the riskiness of equity investments. Evidence on contribution flows in other defined contribution plans is consistent with the TIAA-CREF experience on this score. I would also note that although TIAA-CREF participants have embraced the new investment accounts and asset classes, there is very little evidence from TIAA-CREF in support of the 1998 Benartzi and Thaler theory cited by Loewenstein.³ Only a handful of our participants divide their contributions evenly across the investment accounts or asset classes.

In a study which I conducted with my TIAA-CREF colleagues, John Ameriks and Frank King, we also looked at the asset allocation behavior of TIAA-CREF participants by age, gender, and size of account.⁴ We found that younger segments of the population contributed more to equity and fixed-income asset classes compared to the guaranteed asset class than older participants. We also found that men contributed more to equity than women, although the differences were not large and were shrinking over time. Finally, we found that participants with the smallest account sizes -- generally newer, younger participants -- had the most allocated to equity. These patterns of investment behavior do not seem unreasonable.

In conclusion, although policymakers surely have to weigh the benefits and costs of providing options in various health, retirement, and insurance programs, when carefully designed, efficiently administered, and built upon a solid public-defined benefit program, choice-based defined contribution retirement programs improve the welfare of the affected populations.

Note

1. Robert L. Clark, Loretta Harper, and M. Melinda Pitts, "Faculty Pension Choices in a Public Institution: Defined Benefit and Defined Contribution Plans," *TIAA-CREF Research Dialogues*, 50 (March 1997).
2. Shlomo Bernartzi and Richard Thaler, "Myopic Loss-Aversion and the Equity Premium Puzzle," *Quarterly Journal of Economics*, 110 (1995), pp. 75-92.
3. Shlomo Bernartzi and Richard Thaler, "Naive Diversification Strategies in Defined Contribution Saving Plans," Working paper. Anderson School at UCLA, 1998.
4. John Ameriks, Frank King, and Mark Warshawsky, "Premium Allocations and Accumulations in TIAA-CREF--Trends in Participants' Choices among Asset Classes and Investment Accounts," *TIAA-CREF Research Dialogues*, 51 (July 1997).