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Constructing New Retirement Systems

Pension Research Council Conference
30 April – 1 May 2009



Overview

- Retirement 20/20
- Insurance vs. Investment
- Choice vs. Default
- Measurement Framework: (initial) lessons learned



Retirement 20/20

- Systematically explore new retirement systems (tier II) that go beyond DB/DC
- Initial focus: stakeholder needs, risks and roles
 - Society, Individuals, Employers & Markets



Current environment



- Balance tipping toward choice & investment
 - Based on employer risks and preferences
- Does this produce the optimal outcome for all stakeholders?



Insurance vs. Investment

- Society prefers a degree of insurance
- Individuals do better with insurance
 - Need wealth cushion (health & long-term care)
- Employers should be indifferent
 - Today, prefer DC (investment) model because it poses less risk to employer



Insurance vs. investment

- Markets are indifferent
 - Unresolved debate: Investment of retirement assets in risk-free or risky assets
- If we move away from the employer as insurance guarantor, will we need new market hedging instruments?



Choice vs. default

- Caveats:
 - Any choice system needs strong defaults to succeed
 - Role of signaling
 - Cost of choice
 - ◆ Insurance: anti-selection
 - ◆ Investment: poor choices



Choice vs. default

- Society likes defaults (offer protection)
 - Cost to society of choice
- Individuals want choice but often make poor choices (behavioral economics)
 - Role of signals



Choice vs. default

- Employers are indifferent to (individual) choice
 - But want more employer choice (models)
- For markets, choice provides opportunity for innovation
 - But, for individuals, defaults (standardized products) increases comparability, decreases costs



Measurement Framework

- Tool to assess how well particular designs meet stakeholders needs and risks
 - Role alignment
- Objectively measure new plan designs
- Also consider effects of “moral hazard”



Society's Needs & Risks (Composite rating ■)				
Plan being evaluated: Traditional Final Pay DB US/Canadian, corporate sponsor, single employer. Assumes plan is properly funded and administered.				
Criteria	Description	Rating	Evaluation	Moral hazard (& adjusted rating)
Adequate	Protects vulnerable citizens.	Yellow-Green	Protects those who are able to hold down employment for long periods of time; less protection for workers who change jobs frequently.	Adequacy depends on employer paternalism including the willingness to maintain benefit levels. Would employers provide benefits to all low-paid employees without statutes requiring such coverage? ■
Affordable	Does not take resources from other social needs. Ensures risk pooling done efficiently.	Yellow-Green	Private employer sponsorship does not put cost burden on state; however costs are generally tax deductible and tax sheltered pre-retirement. May not pool risks efficiently in markets	Managers may not use market hedging, preferring to gamble on market returns. ■
Sustainable	Sustainable across and within generations. Equitable across and within generations.	Green	Can be funded to directly allocate costs back to the current generation of owners/shareholders.	Can be tempting to push costs to future generations of owners/shareholders. ■



Measurement Framework

The average rating of yellow-green is a composite of the nine society subcategories.

The ratings for the nine-subcategories are shown in the color line. They are color grouped so you can see how many of each rating were received.

Ratings for each subcategory were adjusted for the effects of moral hazard. This shows the new color line after moral hazard is considered as well as a new composite rating.

<p>Society (composite rating)</p>	<p>Meets society's needs and risks.</p>	<p>Yellow-Green</p>	<p>Individual criteria ratings:  Plans protect long-service workers well (less so short-service workers) avoiding the need for more government sponsored benefits.</p>	<p>Adjusted composite rating:  Ratings after moral hazard:  System depends on employer paternalism, and employer moral hazards require government regulation, which destabilizes system.</p>
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Traditional Final Pay DB Plan				
US/Canadian, corporate sponsor, single employer. Assumes plan is properly funded and administered.				
Criteria	Description	Rating	Evaluation	Effect of moral hazard
Self-adjusting	Automatically adjusts to changing demographic and economic conditions.			
Aligns roles with skills	Aligns stakeholders' roles well with skills.			
New norms for work and retirement	Could support flexible work arrangements, e.g. phased retirement, return to work, etc.			
Alignment with markets	Could use market mechanisms effectively to hedge risks.			Rating after moral hazard: 
Society (composite rating)	Meets society's needs and risks.		Individual criteria ratings: 	Ratings after moral hazard:  Adjusted composite rating: 
Individuals (composite rating)	Meets individuals' needs and risks.		Individual criteria ratings: 	Ratings after moral hazard:  Adjusted composite rating: 
Employers (composite rating)	Meets employers' needs and risks.		Individual criteria ratings: 	Ratings after moral hazard:  Adjusted composite rating: 
Markets (composite rating)	Meets markets' needs and risks.		Individual criteria ratings: 	Ratings after moral hazard:  Adjusted composite rating: 



Measurement Framework

- To date reviewed DB, DC, Ontario Teachers Pension Plan, Dutch industry wide schemes, United Methodist Church Plan
- More to evaluate
- *Preliminary* lessons learned



Preliminary lessons learned

- Strong governance
- Aligning roles with skills
- Self-adjusting mechanisms
- Member solidarity
- Independence from employer
- Use of groups
- Default free discount rates



Conclusions

- Retirement system need a degree of insurance
 - Protect society, individuals
- Consider (carefully) role of choice
 - Choice brings cost
 - At a minimum, provide strong defaults
- Rethink role of employers
 - Should tier II be reliant on employer sponsorship?
- Market evolution
 - Products, investments/hedging mechanisms



Conclusions

- Measurement framework
 - Strong governance
 - Possible new design features that could be borrowed
- 800 lb gorilla: Health (& long-term) care
 - Will we able to do the right thing for retirement without fixing health (& long-term care)



Thank you!

