Rebuilding Workers' Retirement Security: A Labor Perspective on Private Pension Reform

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The Labor Movement and Employer Pensions

- Employer pension system created through collective bargaining.
- Employer pension coverage has declined as labor movement has weakened.
- Single Employer Pensions particularly faced multiple problems.

Case Study in Managing Risk within Single Employer Pensions

- With changes in GAAP accounting for pensions and changes in PPA, employers more directly exposed to short term volatility in plan assets/
- Employers looking to exit plans in part to avoid impact of market volatility on employer financials and cost of capital
- Unions caught between employer unwillingness to either bear volatility in the service of higher returns, or provide funding at levels that would be required for more conservative investment strategies.

Possible Solution– Portfolio Insurance with a Twist

- The labor movement looked into a new type of portfolio insurance for employers.
- Key idea was that pension funds, if demographically diverse, could withstand volatility in assets that employers could not.
- Regulatory system post-PPA did not recognize this feature of pension funds.
- Pension fund should be able to purchase portfolio insurance cheaply so long as that insurance only settled in cash if pension assets fell so low that the pension fund could not meet obligations.
- Insurance, if issued in the form of a derivative, should be bookable as a plan asset– effectively keeping plan assets stable as portfolio assets fluctuated.

Pension Portfolio Insurance Meets the Financial Crisis

- The AFL-CIO met with a number of large international financial institutions to see if this product could be made into a reality.
- Swiss Re put a lot of effort into it, and we had a rough proposal, with pricing in the spring of 2008.
- Capital market conditions moved dramatically against ideas of this kind– volatility skyrocketed, and the basic assumption that counterparties existed on any scale for this type of transaction turned out not to be true– at least not in the world as it actually existed in 2008.

Lessons From This Experience

- Private market solutions to very large scale risk issues may simply not be available even if they can be imagined.
- Just when you really need risk management solutions is when they will not be available.
- If we had succeeded in designing what we were interested in– our counterparties would likely not have been able to honor their obligations, or funds would not have been able to renew their insurance contracts– this is the AIG CDS lesson.

Plan B– Public Policy Solutions to the Problems of Retirement Related Risk

- The AFL-CIO started in 2006 to develop policies promoting large scale reform of the pension system.
- Influenced by experience of labor movements in Australia and the Netherlands around universal funded benefit plans.
- Growing urgency based on realization that retirement security for union members will not be sustainable without retirement security for the workforce at large.

Relative Importance of Risk Management in the Retirement Crisis

- Getting risk management right important, but less important than having adequate funding.
- Adequate funding requires both adequate contributions and system design to prevent leakage.

Risk Problems

- Investment Risk
- Longevity Risk
- Employer Credit Risk

Policy Approaches to Risk Problems

- Investment Risk– encourage collective, professional asset management at the level of asset allocation as well as in terms of day to day asset management. 10% limit on employer stock in DC plans.
- Longevity Risk– Mandatory annuitization, much tougher limits on ability to withdraw.
- Employer Credit Risk– Move toward universal portability and away from pension being integrated with employer finances.

Risk Unaddressed– Market Timing

- No way to address market timing properly without a true defined benefit structure– portfolio insurance runs into the problems discussed above.
- Australian-type solution could encourage growth of true defined benefit coverage– but would not mandate it.
- Social Security and macroeconomic risk.

Conclusion

Voluntary, individualized retirement provision is a clear failure. The result is a bitter irony– a society that is dramatically wealthier than it was in the 1960’s, and yet unable to provide the most basic good– a financially secure old age– to its citizens to the extent we could in the 1960’s. That represents not a failure of risk management, but a failure of politics.