

THE PENSION CRISIS: SIX LESSONS LEARNED AND A WAY FORWARD

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What have we learned from the seemingly endless recent run of pension crises, which have lasted some seven years and have encompassed both DB and DC plans?

Having lost assets and then regained them, both kinds of pension plans should be on a path to being healthy, yet they are not. For many plans, liabilities still exceed assets, some by vast amounts. In many cases there is no feasible plan for making up the difference — even the generally prosperous state of Illinois is near bankruptcy because of pension shortfalls. In the eurozone, concerns about the solvency of Greece pivot on pension liabilities.

LESSON 1: LIABILITIES MATTER. SAVINGS MATTER.

When pensions and pension-like retirement income programs were first implemented (privately at American Express in 1875, then by governments starting with Bismarck's system in Prussia in 1889 and progressing to Social Security in the U.S. in 1935), the liability was small because life expectancy at retirement was short. More than a century of economic growth later, we are richer, healthier, and we live much longer.²

In addition to living longer without the associated adjustment to the amount saved, the current pension crisis episode has seen both DB and DC pension plan liabilities grow rapidly because interest rates have declined to all-time low levels.

By liabilities we mean, of course, the amount one has to save in order to be able to generate the desired level of lifetime income. For DB plans, these are the present value of the pension benefit promises made by the plan. For DC plans, while the equivalent liabilities are not recognized on conventional balance sheets, they are just as real as if accounting conventions required them to be recorded on one's personal balance sheet. Pension promises, by a formal pension plan or to oneself, are the *economic liability* of the plan, and they must be matched by assets or the plan will fail—ignoring the liability or making wishful assumptions about them will not make them go away.

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² For some basic data on changes in incomes and life expectancies over roughly the last 200 years, see Siegel, Laurence B. [2012], "Fewer, Richer, Greener: The End of the Population Explosion and the Future for Investors," *Financial Analysts Journal*, Vol. 68, No. 6 (November/December).

LESSON 2: INVESTMENT SKILL IS NOT A PANACEA.

The second lesson is: investment skill matters less than you think. One reason we have a crisis is that we think we can solve the pension problem by being the smartest investors in the room.

It would be nice if skillful investing could generate huge excess returns relative to average investing. But that is not today's reality. Most DB portfolios are pretty well diversified and close to the efficient frontier, and target-date funds have moved a great many DC-plan investors toward the efficient frontier as well. The search for the Perfect Portfolio is less likely to be fruitful than the search for behavioral, institutional, and policy changes designed to help the pension beneficiary. Such changes are the focus of this article.

LESSON 3: AGENCY COSTS MATTER.

When one group of people makes a promise that a different group has to keep, that structure creates incentives for poor decision-making and a potential crisis. Economics categorizes this friction or inefficiency as an agency cost, analogous to the friction created when business owners hire professional managers, who do not own the business, to run it for them.

In the public pension sector, this agency problem is made worse by a double agency relationship. Those who make the pension promise in one period are no longer in office when the bulk of the pension payments must be made. In addition, the officials making the pension promises are, in many cases, elected by those who benefit from the payments. In all these situations, the agents are spending other people's money — the taxpayers' money — and not their own. No wonder there is a public pension crisis!³ Agency costs can do great damage to what should be, and can be, a very valuable benefit to workers: a well-run public pension plan.⁴

LESSON 4: PEOPLE RESPOND TO INCENTIVES. BEHAVIOR MATTERS.

The University of Rochester professor Steven Landsburg, author of *The Armchair Economist*, wrote, "Most of economics can be summarized in four words: 'People respond to incentives.'" Although everyone knows this at some level, good economics is distinguished, Landsburg wrote, by taking it seriously all the time.

The idea that incentives matter — a lot — is closely related to the observation, made famous by the Nobel Prize-winning psychologist Daniel Kahneman and his collaborator Amos Tversky, that human behavior differs considerably from what is predicted by conventional economics. These principles apply to saving and investing

³ The private DB pension situation is not much better, but at least corporate managers are spending money over which they have unambiguous authority. The fact that we don't have a healthy private DB system is evidence that agency costs are very destructive.

⁴ For a discussion of the virtues of a well-run DB plan and what is lost when DC plans are substituted for it, see, for example, Waring, M. Barton, and Laurence B. Siegel [2007], "Don't Kill the Golden Goose: Saving Pension Plans," *Financial Analysts Journal*, Vol. 63, No. 1 (January/February). One important point the authors make is that longevity-risk pooling makes it possible to pay benefits much more cheaply than if every retiree has to save to his or her maximum life span.

as well as to almost every other aspect of life. In retirement investing, for example, auto-enrollment, auto-escalation, and qualified default investment alternatives (QDIAs), are effective “nudges” — small, subtle influences that convey big behavioral benefits.

Here are some economic and behavioral-based incentives that will increase savings and retirement income:

- To qualify as a DC plan, the sponsor must implement auto-enrollment, auto-escalation, and qualified default investment alternatives (QDIAs).
- Remove the IRA and 401(k) contribution caps and let people save as much as they can for retirement on a tax-deferred basis. (SEP-IRA contribution caps, which apply to the self-employed, have already been raised to realistic levels, around \$50,000 per year.) Because of required minimum distributions, taxes will eventually be paid on these balances, so the net cost to the government is not large.
- To qualify as a DC plan, the sponsor must default all participants within ten years of retirement into a Qualified Life Annuity Contract (QLAC) with all or a large part of their savings. By doing so, the participants gain access to longevity pooling—lifetime income—at institutional pricing, with administrative efficiency and ERISA protection⁵.
- Legislation should require a certain percentage of U.S. government debt to be issued in inflation-adjusted form, that is, as TIPS bonds. A TIPS bond with a duration matched to that of the pension promise is the ideal hedge for the risks of that promise. While TIPS with maturities up to 30 years have been issued, that is not long enough – a pension promise can extend over 80 years (age 25 to 105). Moreover, there is not much depth to the TIPS market even at 30 years. The market should be both deepened and lengthened. Maintaining a deep, long-horizon market in TIPS also has the secondary benefit of limiting the government’s incentive and ability to debase its own promises to bondholders and helping to keep a stable price level.
- A nationally regulated market for insurance contracts should be established. Currently, insurance companies are legally allowed to offer individual annuity contracts and each state sets its own regulations with its own insurance commissioner and regulatory structures. The inefficiency of having 50 separate sets of regulations, the associated agency costs, and challenges of portability can be removed with a regulatory structure parallel to that of banking, where a bank can be nationally chartered or state chartered.

LESSON 5: LONGEVITY POOLING IS SECOND IN IMPORTANCE ONLY TO THE SAVINGS RATE.

It does not take a PhD or Nobel Prize in economics to understand the benefits of longevity-risk pooling. With longevity pooling, one needs to save only to one’s life expectancy, or average age at death, say 85; that’s 20 years of payments if they start at age 65. Without longevity pooling, each retiree needs to save enough to pay for

⁵ Under ERISA, the plan sponsor would be responsible for hiring and monitoring the QLAC suppliers. After leaving the plan, the participant can stay with that provider, switch to another, or opt out. They could also opt out beforehand, when they are employees.

his or her maximum possible life span, say 105 or 40 years of payments. Thus the pension liability is potentially twice as big when savers cannot pool their longevity risk.

How can individuals get institutional quality access to longevity pooling, or annuities? QLACs (mentioned above), nationally regulated insurance markets, deep TIPS markets enabling suppliers to reliably hedge their promises, and two-way market making in annuity contracts are structural changes that can reduce the magnitude of the challenge faced by the individual in managing his or her retirement liability, and by DB plans in providing more options to economically and reliably fulfill lifetime income promises.

LESSON 6: START NOW.

While we have outlined some proposals for a much better set of institutions and practices, today's investors cannot wait for these proposals to be implemented. They need help now.

Savings rates can be increased using auto-enrollment, auto-escalation, and investor education. Inflation hedging can be achieved using a laddered TIPS portfolio up to the maturity of the longest existing TIPS, and to some extent through proxy hedges such as equities. Longevity pooling can be arranged in the private market for deferred annuities. (Deferred annuities can be combined with conventional investing to achieve lifetime income protection without transferring most or all of one's wealth to the annuity provider, as one is required to do when purchasing an immediate annuity.⁶)

In other words, don't wait for a perfect world to do what is best for yourself and your employees. Many of the tools and technologies needed for effective pension and retirement-savings management already exist, some in well-engineered and fairly-priced packages and others more roughly. While working toward a more complete and efficient market in pension and retirement tools, the existing ones should be used vigorously and enthusiastically.

CONCLUSION

A reliable pension is very valuable — to the employee, the employer, and society. While each of us has unique circumstances and needs, we all have a common interest in making both DB and DC pensions work. This task includes saving more to match our ever-lengthening lives, gaining access to efficient longevity pooling, and demanding legislative and regulatory policies — from ERISA to insurance regulation to employment rules—that create employee and employer incentives to make these valuable pension promises last a lifetime.

⁶ See Sexauer, Stephen C., and Laurence B. Siegel [2013], "A Pension Promise to Oneself," *Financial Analysts Journal*, Vol. 69, No. 6 (November/December). Jason Scott [2015], in "The Longevity Annuity: An Annuity for Everyone?" *Financial Analysts Journal*, Vol. 71, No. 1 (January/February), shows that deferred annuities are almost always preferable to immediate annuities.