Global Opportunities for Retirement Plan Innovation

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Agenda

I. Standard Designs of DB and DC Plans
Are Deeply Flawed

II. Risk Sharing in Hybrid Plans:
Singapore and Netherlands.

III. Reforms to Remedy Specific Problems
with DB or DC Plans

I.A. Problems with Standard DB Plans

- With proper accounting,
  substantially underfunded.

-With adverse demographics,
 funding deficits will grow

-Plan sponsors not want
 all investment and longevity risks

- Cutting benefit schedules is
  legally/politically explosive

I.B. Problems with Standard DC plans

- Employees are not well suited to bear all investment and longevity risks.

- Contribution levels are too low, especially in voluntary plans

- Plan expenses are too high, especially if multiple alternatives

- Many participants lack knowledge to make good investment choices

Hybrid Plans in Singapore: Public Pool+Optional DC Plan

1. Mandatory participation, high contribution levels

2. Fully vested and fully funded individual accounts

3. Government investment pool,
   with interest credited annually

4. Above certain account levels,
   may invest in private funds

5. Life annuities plus other retirement investments

Hybrid Plans in Singapore (Continued)

- Advantages over DB Plans

— No unfunded liabilities for employers

— Range of private fund options

- Advantages over DC Plans

— Quasi-guaranteed returns in government pool

— Low administrative and investment expenses

- Significant Issue: Longevity Risk

—Response: partial deferred annuity
(e.g., payouts start at age 80.)

—Response: annual “bonus” to
low savers after age 65

Hybrid Plans in Netherlands: Collective Defined Contribution (CDC) Plans

1. Industry-wide participation, high contribution levels

2. Pooling of contributions; no individual ownership

3. Pool managed by experts without individual choice

4. Schedule of expected benefits, with COLAs after retirement

5. Schedule backed by reserve buffers:
- However, if buffer too low,
- COLAs and benefits reduced

Hybrid Plans in Netherlands (Continued)

- Advantages over DB plans.

— No unfunded liabilities for employers

—Portable by employees within industries

- Advantages over DC Plans

— Managed by professionals with better returns.

— Low administrative and investment expenses.

— Pooling of investment-longevity risks.

- Significant issues: lower returns and longer lives.

  — Response: higher buffer targets;
  smoothed (lower) discount rates

  — Response: raised retirement age;
  auto-linked to life expectancy

IIIA. TARGETED REFORMS: Higher Participation Rates

- Mandatory may not be politically feasible

- Move from opt-in applications to
  auto enrollment with opt outs.

- Require employers without retirement plans to
  CONNECT their payroll systems to public pools

— no employer contribution
— opt out for employees

- Part-time or temp workers
  -Allow to join company plan
  -Use automated payroll deduction

IIIB. TARGETED REFORMS: Less Political Influence

- The Chinese pension system is run by provinces and cities, which pay legacy pension to former SOEs

  —The national government should take over the legacy pensions

  — If the provinces and cities transfer pensions to a national fund.

- US State and local governments run many underfunded DB plans

  -Political pressure for high discount rates and risky assets

  -Plan trustees should not be elected officials or political appointees

IIIC TARGETED REFORMs: Sustainable Benefit Schedules

- Netherlands changed its pension formula from final to average pay

  —Final pay is easily manipulated
  —Use average pay over 3-7 years

- Netherlands has a flexible COLA depending on investment results

  —COLAs should accurately measure purchasing power
  —Prepare participants for possible COLA waivers

- Netherlands is increasing retirement age with an automatic link

  — Retirement age should rise gradually with life expectancy
  — But exception for physically demanding jobs

IIID. TARGETED REFORMS: Protecting Lifetime Income

- Economists often argue for life annuities
  so retirees will not outlive their savings.

- But participants reluctant to annuitize to retain optionality —
  e.g., for medical emergencies or bequests to children

- Helpful responses (from Singapore)
  -- Partial annuitization of account balances at retirement
  -- Longevity annuities (with early death protections)

Conclusions

- Standard models of DB and DC plans:
  Both have serious design flaws

- Better risk sharing through hybrid plans:
  Examples: Cash balance plans and CDCs

- Need more research to analyze
  different forms of risk sharing

- In any event, countries should adopt targeted reforms to

  1. increase plan participation
  2. decrease politicization of plans
  3. make benefit formulas more flexible
  4. respond to longer life expectancies
  5. reduce administrative-investment expenses