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MORE PENSION WISDOM FROM EUROPE:

THE GENEVA REPORT ON PENSION REFORM

"Rather than following the usual two-handed approach of economists, we take a clear stance on a number of controversial issues…".

From "Dealing with the New Giants: Rethinking the Role of Pension Funds" published jointly by ICMB and CEPR, July 2006

Eight Hands, Four Economists, and One Point of View

Given that the cited new study on global pension reform was authored by four economists, there were actually eight hands involved in writing this powerful new analysis of global pension ills and how they could be cured. All the more remarkable that the eight-handed four economists laid out only two possible future pension scenarios, clearly rejecting one scenario in favor of the other. Adding to our sense of wonder was the fact that the four-man team included a Brit (Andrew Roberts), a Dutchman (Lans Bovenberg), a Frenchman (Benoît Coeuré), and an Italian (Tito Boeri). Maybe there is something synergistic to this EU idea after all!

The reason for reviewing the new Geneva Report on pension reform in this September *Letter* is clear. The report is a logical sequel to the recent Turner Pensions Report out of the U.K. about which we wrote positively in our February *Letter*, and to the July *Letter* where we wrote on creativity and innovation (or lack of it) in the pensions field. The Geneva Report echoes some of the key pension reform ideas in the Turner Report, and applies healthy doses of clear, integrative thinking to developing these ideas further, as well as to producing some new ones relevant not only to Europe, but to the rest of the developed world as well.

And what do we mean by 'clear, integrative thinking'? Let us count the ways. The report distinguishes between such micro issues as life-cycle financial planning, financial illiteracy, principal-agent issues, and pension fund governance on the one hand, and macro issues such as economic stability and growth, capital market pricing, entrepreneurship, and innovation on the other. It assesses the potential for market-, and financial engineering-based solutions to such challenges as managing asset-liability mismatch risk and longevity risk in pension arrangements. It examines the respective roles of financial capital, human capital, and labor market flexibility in stabilizing life-time consumption. Maybe most importantly, it leads to a number of clear, powerful pension policy implications.

Powerful Pension Policy Implications

So let us go directly to the bottom line. What are these "clear stances on a number of controversial issues" that the report authors claim to be taking? Here is how we would summarize them:

- National Pillar #1 pay-go systems should continue to offer a basic pension for workers with low lifetime incomes.
- Workers with higher incomes should supplement this basic public pension with funded private pension provisions in order to maintain their standard of living in retirement.
- For these higher income workers, membership in a stand-alone, collective occupational pension plan should be mandatory. These pension plans should offer only limited investment choice, with well-thought-out default options for those who would prefer not to, or refuse to make choices themselves.
- Such default options should recognize that young workers are endowed with substantial human capital and have considerable capacity to bear financial risk, thus able to supply long-horizon, risk-bearing capital to financial markets. These risky, defined-contribution claims should gradually shift into guaranteed defined-benefit claims as participants grow older and become more dependent on pension wealth for their consumption.
- Stand-alone pension plan organizations must be well-governed, with a clear separation between the oversight function and the executive management function.
- 'Mark-to-market' disclosure of the assets and liabilities of traditional DB pension plans should be welcomed, as it enhances market discipline, transparency, and risk management.
- In DB plan cases where asset-liability mismatch risk is currently excessive, interest rate swap overlays can, and should be executed to reduce balance sheet risk without giving up diversification and returns.
- The general move away from sponsoring DB plans by corporations should be welcomed, as in dynamic economies with competitive labor markets, most corporations are in fact ineffective, inefficient, often-conflicted guarantors of pension claims.
- Countries with aging populations need strategies to protect long-run labor supply. Fertility can be enhanced by more flexible life-cycle policies that lead to a better parental reconciliation of work and family. The resulting higher effective retirement ages raise the return on human capital, and also act as buffers for absorbing financial market and longevity risks

Having summarized the report authors' "clear stances on a number of controversial issues", we now comment on a number of these stances in greater detail.

Labor Markets and Human Capital

The 'labor markets and human capital' part of the report is probably the biggest mind-stretcher for readers with a bread-and-butter pension fund management mindset. Yet, from an integrative thinking perspective, it may be one of the report's most valuable contributions. Aging not only increases the need for more financial capital, but also for more investment in human capital. With increased longevity, we need to foster higher returns on human capital to increase welfare and consumption. Yet, with the historical emphasis on early retirement, human capital is depreciated early. Further, people have been concentrating their work effort in the relatively short period of time during their lives in which they also raise their children. This has increased the opportunity costs of raising children in terms of foregone career opportunities. This has been an important contributor to falling birth rates in the developed world.

How do we extend working life and get a better reconciliation of family, fertility, and career? Not an inconsequential question. One answer is to foster lifetime education so that human capital doesn't depreciate too rapidly (i.e., learned skills don't become obsolescent). Another answer is to move life course patterns towards longer, more flexible, active periods in which people are engaged in the labor market. Such a move would have powerful societal benefits. For example, it would ease career pressure at that biologically-determined time when parents could create, and care for young children. Later in life, fulfilling work provides stimulus, companionship, and extended health. Finally, with better-maintained human capital, older workers can bear more risk as they accumulate pension rights, thus potentially keeping costs in check and at the same time providing economies with additional risk capital.

The report's message in these matters is clear. Pension reform cannot just be about pension legislation, regulation, arrangements, institutions, and financial strategies, narrowly defined. In the broader scheme of things, education strategies and how labor markets function are just as important.

Optimal Risk-Sharing

On the question of optimal pension plan design, the report authors are of the view that employers, especially corporate ones, are far from ideal pension guarantors for a number of reasons. At the same time, the authors believe that collective pension funds can create considerable value for participants relative to leaving people to accumulate pension wealth on their own. Specifically, expert, arms-length pension delivery organizations can help workers design and implement the low-cost, optimal life-cycle strategies that are critical to maintaining stable lifetime consumption patterns. In parallel, through their investment operations, these pension organizations can contribute to the stabilization of economic activity in general, and to the stabilization of capital markets activity in particular.

So far so good, but now comes the hard part. How should pension plan participants share financial markets and demographic risks? The report authors make the sensible point that whatever risk-sharing deal is struck, it should be defined before-the-fact, rather than negotiated after some 'bad news' shock from the financial markets, or the demographic front hits the pension plan radar screen. Another sensible point they make is that tying future generations into risk-sharing pension deals may be welfare-enhancing in theory, but is problematic in practice. There are strong practical incentives for the current generation of pensioners and older workers to spend surpluses now, and to shift the negative financial consequences of asset shortfalls into future generations. So where does that leave us with regard to workable risk-sharing pension deals? Here we found the report long on words, and short on clarity. It seems to us that the bottom line is that individuals begin their working lives by accumulating claims on an optimally-managed risky investment portfolio, and say 40 or so years later, end their working lives with claims on an optimally-managed annuity portfolio. We don't know if the authors would agree because they don't really directly say.

Optimal Pension Fund Organizations

We were pleased to discover that the report contained a chapter titled "Informational Asymmetries and the Optimal Organization of Pension Funds". We were further pleased to discover that most of the authors' views in that chapter were closely aligned with our own. For example, this observation is right on the money from our perspective: "…the constellation of stakeholders gravitating towards pension funds (e.g. trade union representatives, trustees, advisors, auditors, law-makers, regulators) makes information asymmetry and conflicts of interests a key concern…". This leads them to the logical conclusion that "agency problems are best addressed by non-profit, collective pension funds".

In commenting on how these non-profit, collective pension funds should be organized, we fully agree with the report's broad recommendation that there should be a clear separation between a fund's oversight function (e.g., its board of trustees or supervisors) and the fund's operational management function. However, we would quibble with some of the report's more specific recommendations and assumptions regarding fund governance and organization design such as:

- The enforcement of stakeholder rights within pension funds should be underpinned by direct plan member voting mechanisms.
- Pension funds should have investment committees to make investment decisions. This includes decisions regarding asset allocation, individual portfolio activity, diversification, and corporate control of companies the fund has invested in.
- The underlying assumption of the report writers seems to be that the non-profit, collective pension funds they envision would fully outsource investment management, benefit administration, and related IT services.

Counterpoints to these recommendations and this assumption might be:

- There is no doubt that the board of trustees (or supervisors) of a non-profit, collective pension fund must be accountable to its 'owners' (i.e. plan members) for achieving the fund's mission in a cost-effective manner. Consequently, there must be clear mechanisms through which this accountability is enforced (e.g. election/confirmation of board members by plan members or their representatives). However, democratic decision-making processes become dysfunctional if they lead to majorities (e.g. current pensioners and older workers) oppressing minorities and/or other parties (e.g., younger workers and future generations) through direct voting mechanisms. So functional pension fund democracy involves striking a delicate balance.
- Our personal experience is that a pension fund investment committee that leads a separate life from that of a fund's board of trustees can be a double-edged sword. On the one hand, such a committee can indeed bring specialized investment expertise to the fund's oversight function. On the other hand, the existence of such a committee raises serious legitimacy issues. Who selects its membership? Who is the committee accountable to? How is its effectiveness to be judged? The bottom line is that, ideally, the entire board of trustees acts as a pension fund's investment committee. This bottom line has two obvious implications. First, at least part of the board must be populated by people with investment experience at the strategic level. Second, the experience and skill level of the fund's internal investment management team is such that it generates a high level of trust at the board level, and thus has earned the authority to manage the details of the investment function on a fully delegated basis.
- It is not clear, ex-ante, what a non-profit, collective pension fund with effective oversight and management functions would outsource, and what it would decide to do itself internally. Absent external rules, constraints, or agency issues, it would depend solely on an ongoing series of cost-effectiveness judgments. We know of a number of high-performance pension fund organizations that have chosen to internalize 85% of its investment management processes, and an even higher proportion of its benefit administration and IT support functions. The key is the availability of benchmarking disciplines that allow competent boards of trustees (or supervisors) to assess whether plan members are receiving maximum 'value for dollars' (or euros) relative to the alternatives. Such benchmarking disciplines in fact exist.

A Powerful Pension Vision

The new Geneva Report on pension reform makes a major contribution to an emerging powerful new vision of the role and functioning of workplace pensions in the developed world. Serious students of pension reform owe it to themselves to read this study.

"Dealing with the New Giants: Rethinking the Role of Pension Funds", by Tito Boeri, Lans Bovenberg, Benoît Coeuré, and Andrew Roberts. ICMB (International Center for Monetary and Banking Studies), Geneva, and CEPR (Centre for Economic Policy Research), London, July 2006.

Published by KPA Advisory Services Ltd., 151 Bloor Street West, Suite 702, Toronto ON CANADA M5S 1S4
416.925.7525 www.kpa-advisory.com