Rational Pension Products for Irrational People

Zvi Bodie & Henriette Prast

Discussant: Theo Diasakos

Individual Pension Products

- The Issue
  - current social security and private pension systems under pressure
    - population ageing, increased labor mobility, increased capital mobility
- The Trend
  - individualization of investment planning for retirement
- The Rationale
  - Tailoring to individual needs and preferences
- But
  - sub-optimal individual decision-making
    - people save too little and start too late (self-control issues)
    - averse to spending time on pension planning
    - lack knowledge & expertise in financial investment-making
    - likely to receive poor advice from experts

Current Attempts to Address the Issue

- Policy Makers
  - increase consumer awareness
  - call for transparency by plan providers
  - financial education

- (U.S.) by default, enter into life-cycle mutual fund
    - all risk passes on to the participant
  - people want and need guarantees for retirement income
  - support for mandatory defined benefits is high
    - prohibitively expensive premium on individual contracts

This Paper

- Remove the savings/investment decision from individual
  - ask only simple questions about desired outcomes
    - desired level of post-retirement income
    - desired post-retirement real living standard (individual defined benefit)
- Semi-customized plans of guarantees (fully- are too costly)
  - to groups of agents with similar preferences and risk
    - e.g. groups of co-employees
- Financial intermediaries as plan providers
  - dedicated institutions
    - knowledge, expertise, specialization, economies of scale (low transaction costs)
  - collective contracts
    - cost reduction via large scale purchase/insurance of annuities

This Paper

- Sponsors to intermediate between agent and provider
  - reduce agency problems
    - will not want to be the residual risk-bearer
    - threat of reputation damage
- Government to complete missing markets
  - supply fixed-income securities with longer duration than in current markets
    - large-size, long-dated, default-free, inflation-indexed securities

Dilemmas of an Economic Theorist

- Remove the savings/investment decision from individual
  - ask only <u>simple</u> questions about <u>desired</u> outcomes
    - Hard to forecast one's future preferences (dynamic inconsistencies)
    - Hard to forecast future real prices (esp. for health costs)

- <u>Semi-customized</u> plans of guarantees (fully- are too costly)
  - semi-pooling & semi-separating
    - the v. high and v. low risk/income agents are most easily identifiable
    - likely to hit hard the poorer agents for the benefit of the wealthier ones while leaving a low-efficient pooling middle

Dilemmas of an Economic Theorist

- Financial intermediaries as plan providers
  - <u>dedicated</u> institutions
    - They are principally dedicated to profit making
    - Thus, some surplus must removed from individuals to pay for profits
  - <u>collective</u> contracts
    - large scale purchase/insurance of annuities is subject to economy-wide risk
    - i.e. it does not circumvent the economy-wide causal issues of the problem (ageing of population, increased labour & capital mobility)
- Sponsors intermediate between agent and provider
  - reduce <u>agency problems</u>
    - pension funds affect balance sheet, leverage etc.
    - threat of reputation damage not credible in worst case scenario
      - pension fund in greatest risk of disappearing when bankruptcy

Dilemmas of an Economic Theorist

- Government to hold the bucket
  - increase in systemic risk – moral hazard
    - changes in risk of financial markets
      - government will have to be the lender of last resort
      - politically impossible to let plans go under
      - plan providers rip the profits but do not share the costs
    - changes in risk of company failure
      - increase in economy-wide risk
  - decrease in available funds
    - part of agent's funds goes into profits of plan providers
    - sponsoring role of employer increases its bargaining power
      - lower wages, lower private funds
  - Hard to raise more taxes in today's internationalized environment

Dilemmas of an Economic Theorist

- Hybrid between government- & privately-funded system
  - social welfare
    - Not really a combination
    - works exactly likely the privately-funded plans
  - Hybridization of the decision-making process
    - the sponsor convexifies between the agent and the plan provider
    - decreases the adverse selection problem
    - by introducing a moral hazard one
    - and creating systemic risk

An Afterthought

- Simplify the individual savings/investment decision
  - Ask people to choose between investing in a collection of long-term bonds
    - Such long-lived assets have to be provided even if the currently proposed system is to work
  - They ought to be supplied by the government anyways
    - So why do we need the financial intermediaries?
    - The government could supply them directly
    - More complicated financial retirement packages exist already in the market
    - No need to increase their supply/scope. They don’t simplify the agents’ decision making problem.