



Rational Pension Products for Irrational People

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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 simple questions about desired outcomes
 - Hard to forecast one's future preferences (dynamic inconsistencies)
 - Hard to forecast future real prices (esp. for health costs)

- Semi-customized 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
 - dedicated institutions
 - They are principally dedicated to profit making
 - Thus, some surplus must be removed from individuals to pay for profits
 - collective 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 agency problems
 - 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 like 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.