Rethinking Old Age Security in the Aftermath of the Global Financial Crisis

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The 2008 Financial Crisis was a cataclysmic event

- From which we learned much about financial markets
- From which we learned much about risk management
- This talk will explore some of the lessons and their implications for certain aspects of the reform of Chile's pension system
  - Will touch on only a limited number of issues
- Further insights from advances in behavioral economics

Even before the crisis, the role of private fully funded pension funds had been oversold

- In “Rethinking Pension Reform: Ten Myths about Social Security Systems,” Peter Orzag and I had explained that most of the arguments that had been put forward for a privately managed defined contribution “second pillar” were wrong
- With strong implication that those countries that had based their old age pension system on the “3 pillar” model should rethink their system
- The crisis has reinforced that conclusion

Macroeconomic myths

- Myth #1: Individual accounts raise national savings
- Myth #2: Rates of return are higher under individual accounts
- Myth #3: Declining rates of return on pay-as-you-go systems reflect fundamental problems
- Myth #4: Investment of public trust funds in equities has no macroeconomic effects

Microeconomic myth

- Myth #5: Labor market incentives are better under individual accounts
- Myth #6: Defined benefit plans necessarily provide more of an incentive to retire early
- Myth #7: Competition ensures low administrative costs under individual accounts

Political economy myths

- Myth #8: Corrupt and inefficient governments provide a rationale for individual accounts
- Myth #9: Bailout politics are worse under public defined benefit plans
- Myth #10: Investment of public trust funds is always squandered and mismanaged

The financial system has failed

- The financial system did not function well then
  - and we now realize, was not functioning well before the crisis
  - and has not been functioning well since
- It did not manage risk well; it did not allocate resources well
- It provided *very* bad advice
- It was rife with conflicts of interest
- Fraud, market manipulation, other bad practices were/are pervasive
- Lack of competition—above competitive charges

The financial system has failed

- High transactions costs
  - Enriching the financial sector at the expense of the rest of the economy
  - A negative sum game
- Costs of these mistakes to the US economy, to the global economy, and to families in America and around the world has been enormous
- Huge fiscal costs—the state had to bail out the financial sector. In pensions, in Chile, the state (the taxpayer) had to pay the very high cost of transition to a funded system, and then act as a guarantor of last resort during the crisis, subsidizing pensions’ top-ups—the tax payer had to pay twice.
- All of this has important implications for the reliance on the private sector in the second pillar, an important part of national pension programs

Regulations failed to prevent these problems

- Even when there were laws in place which gave the regulator authority to act—regulatory capture
- Financial sector enormously clever in evading regulations
- But the financial sector has also been very successful in limiting the scope of regulation
  - Even after the failings have been exposed

Public pension programs should provide a modicum of old age security

- Public social security programs do this
  - Insure against the risk of inflation
  - Retirees don’t have to worry about the fluctuations in the stock or bond market or the short term interest rate
  - Even prevent *relative* deprivation, by adjusting payments to changes in wage levels more generally
  - They are based on solidarity and collective financing, having positive redistribution effects

The failure of private programs in risk management

- Defined contribution programs do none of this
  - Those retiring in 2008 exposed to enormous risk as a result of collapse of stock market prices
  - Compounding the problem posed by the collapse of housing prices, the other principal asset for most Americans
- QE made it clear that there was no private asset that individuals could buy that would protect them
  - Those who invested in stocks saw their wealth evaporate
  - Those who held their wealth in supposed safe government T-bills kept their wealth, but saw their income evaporate

The failure of private markets in advice on risk management

- Encouraged households to move into balloon mortgages and other risky financial products
  - Partly incompetence
    - Didn’t understand risk
  - Partly rampant conflicts of interest—the incentive of those in the financial sector is to maximize fee income
    - But they have continued to resist regulations which would curb their bad practices (e.g. imposing fiduciary standards)
      - Evidence is that in US, the failure, even today, to abide by such standards is costing retirees tens of billions of dollars a year
  - They actively engaged in “fishing for fools”—for people they could take advantage of
  - Actively engaged in discriminatory and predatory lending practices

Behavioral Economics

- Provided new insights into limitations in individuals abilities to judge risks and make intertemporal (savings) decisions
  - Markedly different from that of the "rational" decision making underlying flawed rational actor/rational expectations model
- Incentives do not work
- Individuals can be easily influenced ("nudged")
- Objective of advertising is to move them to buy products that maximize revenue of those in the financial sector
  - Financial sector has excelled in exploiting these market irrationalities—and looking for those who they can most profitably exploit
    - Although sometimes they have been hoisted on their own petard
- Highlights the importance of public programs/public defaults

Consequences of the reliance on the private sector in the second pillar

- Poor coverage, high level of insecurity, significantly lower pension incomes, high fiscal costs, greater inequality
  - All to enhance the income of the financial sector
  - Negative sum game

There are alternatives

- Government fund in Canada has high returns, low volatility, low transactions cost—and immune from political influence
- Large numbers of successful sovereign wealth funds and government run pension funds (Netherlands, Norway)
- Public pension systems with very low transactions costs and good “customer service”
- About 23 countries privatized pensions in earlier decades, in recent years about 7 of these countries have reversed, partially of fully re-nationalizing their pension systems, and several other countries are considering

Policy Recommendations

- Stronger "first" pillar—necessary to avoid old age poverty and provide a minimal level of old age security
- *Public* second pillar
  - With an important redistributive component—topping up contributions of low income individuals
  - With some element of intergenerational smoothing—avoiding *relative* old age poverty, especially important in economies where incomes are growing
  - With an important defined benefit ("insurance") component, smoothing out stock market and interest rate volatility and providing some insurance against inflation
    - Government has a responsibility for macro-management; should be partially accountable for consequences of macro-economic fluctuations
  - Voluntary transition of those in existing investment vehicles to new program

- Public option(s) for the third pillar
  - There should be at least an alternative investment vehicle where individuals can feel secure that transaction costs are low, that they are not being preyed upon, etc.
  - Can be alternative options with different risk
  - Better guidance on risk management
- Better regulation of all investment vehicles
  - Particularly if they are eligible for favorable tax treatment
  - Fiduciary standards, maximum transaction costs, strong disclosure requirements, etc.

Concluding Comments

- Markets with imperfect and asymmetric information are often neither efficient nor stable
  - Financial markets illustrate
    - Financial sector took advantage of others
  - Crisis exposed the depths of the problems
- There are huge costs to not having a good pension program
  - Insecurity, old-age poverty, inequality
  - Can even have macro-economic consequences (built-in automatic destabilizers)
- Current arrangements inadequate
  - Reforms could be an important move in creating a better system