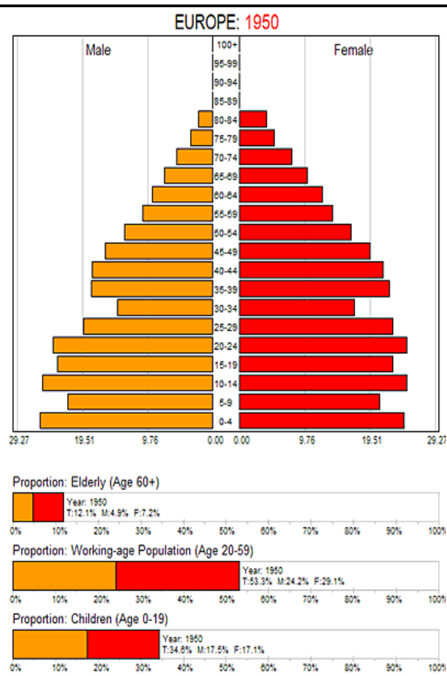
Pensions Conference 2012

B3: An analysis of pension security and economic efficiency

Con Keating

1 June 2012



Pension Economics

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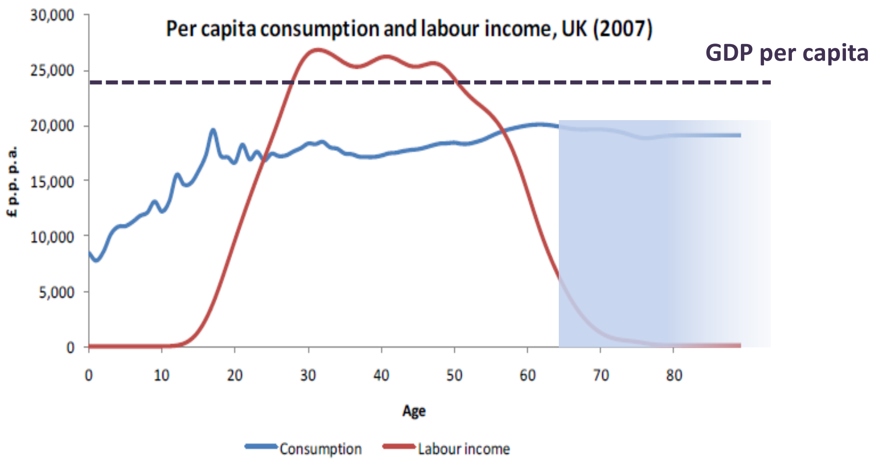
- A pension is an income in retirement
- It is the finance of consumption in older age

Individual Pensions



A pension is a stream of future cash-flows, not some capital sum today

DC arrangements are strictly just tax-advantaged savings schemes

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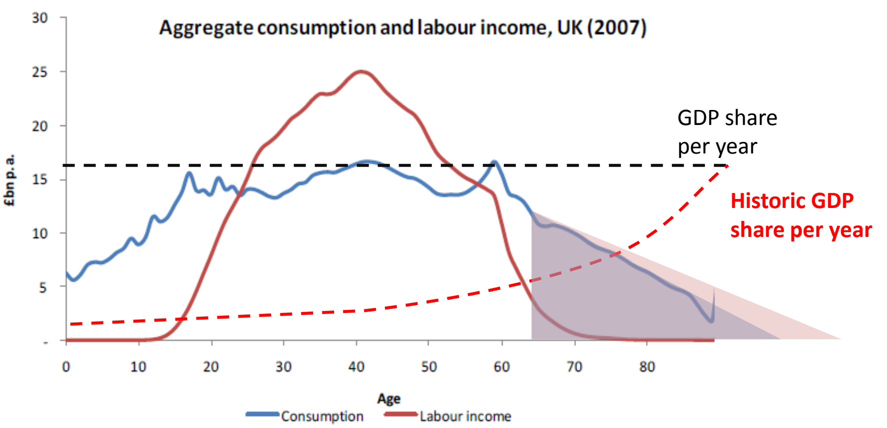
The Aggregate Problem

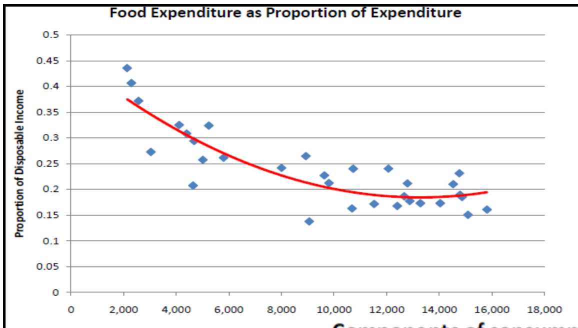


The collective problem is less than half of the sum of the individuals'.

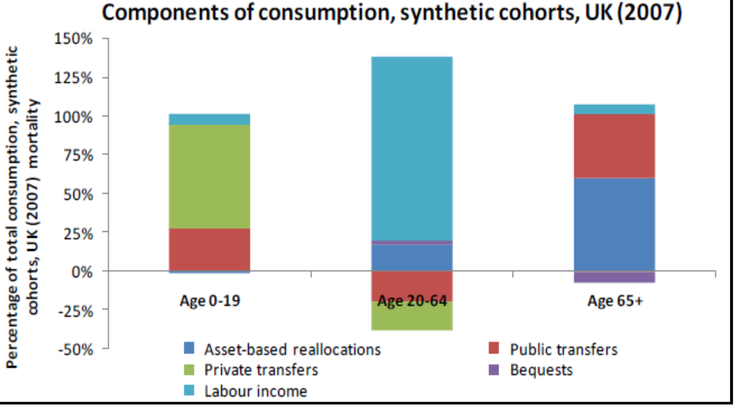
Perceptions matter. Ninety years ago, the idea that retirement income today would be more than eight times that of a 90 year-old at that time would have simply been incredible

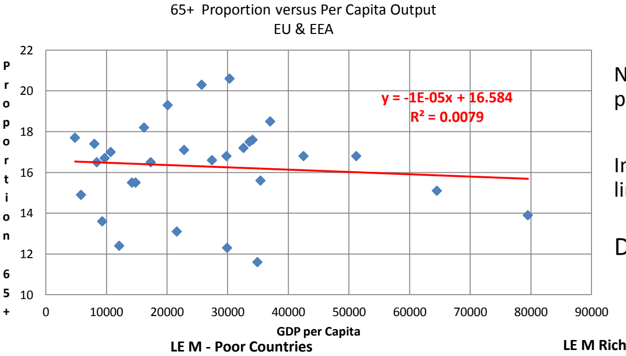
The longevity problem is minor

One important caveat: We do not know to what extent this consumption is constrained by wealth or income.



Changing consumption patterns



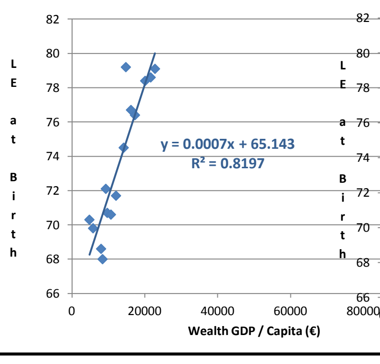


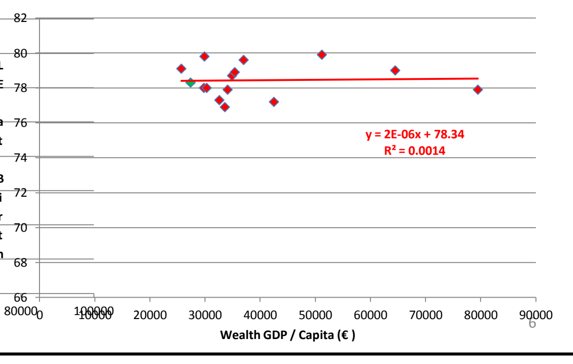
Ageing Effects

No evidence that an increasing proportion of elderly lowers GDP

Increasing LE for rich countries is limited by bio-medical advances

Diminishing returns?



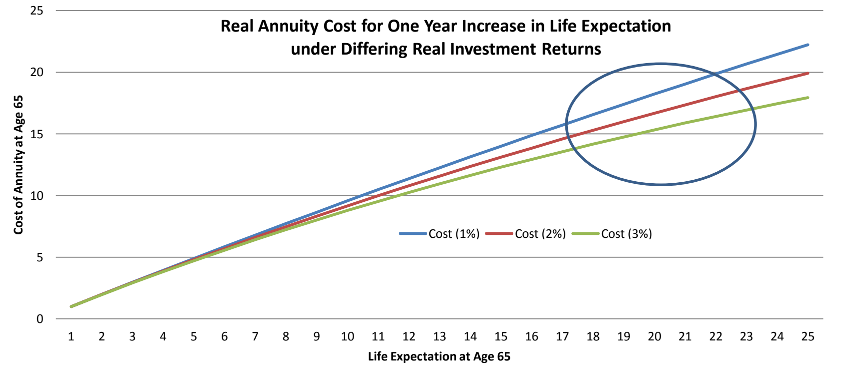


IMF Conclusions

A three year error in LE over 40 years is equal to 50% of current GDP

But in current terms the GDP over this period is 4,000% of current GDP under no growth and 6100% under 2% real growth – between 1.25% and 0.81% of total output

The marginal annuity cost of an extra year of life



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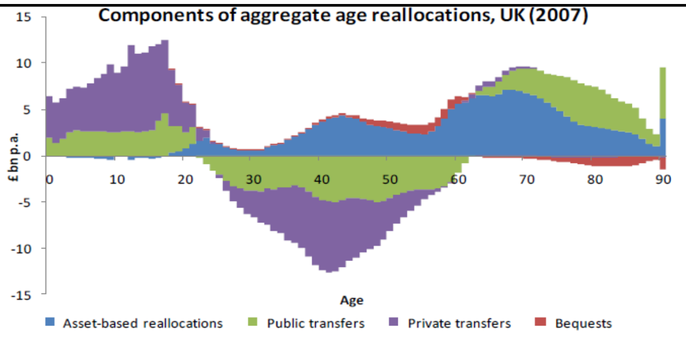
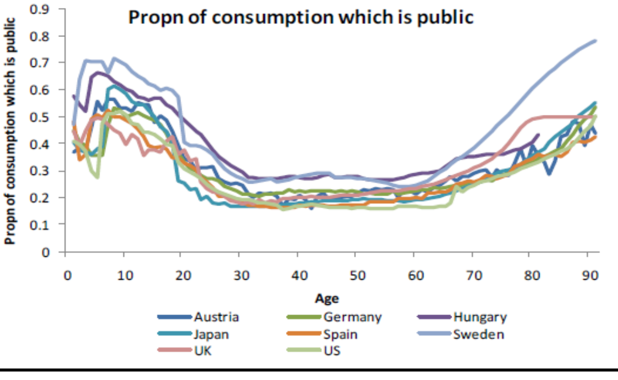
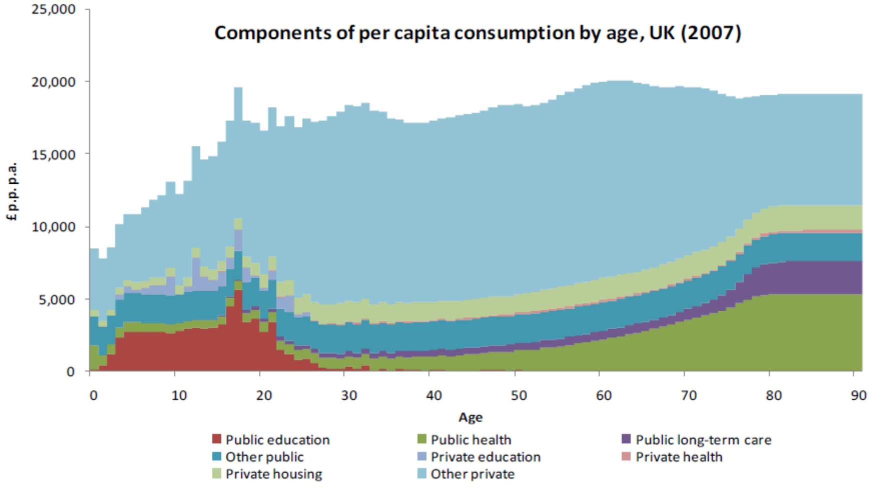
The State





A sense of proportion

The role the State



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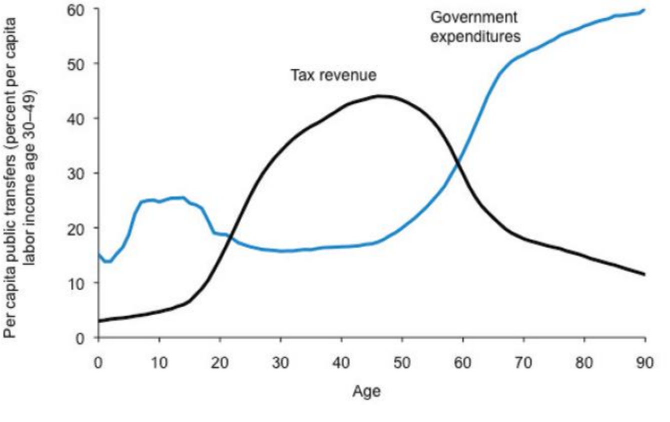
A comparison of Transfers and Taxes



The average of twenty developed countries

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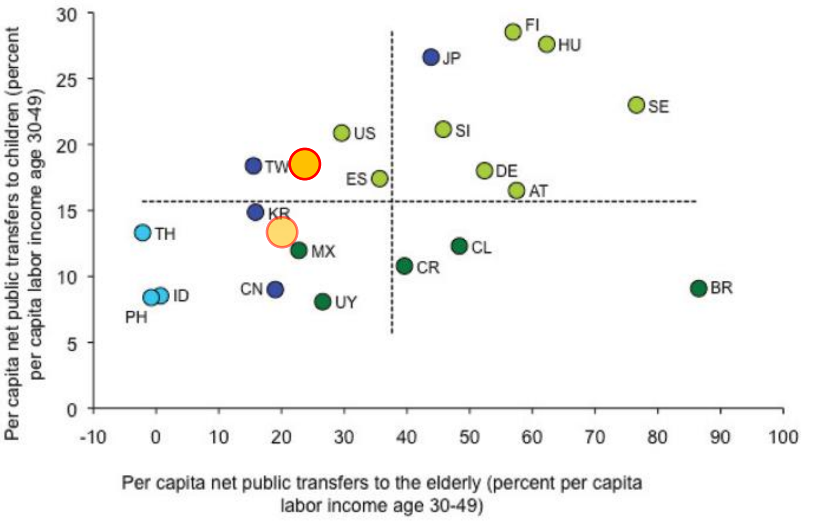
Young versus Old



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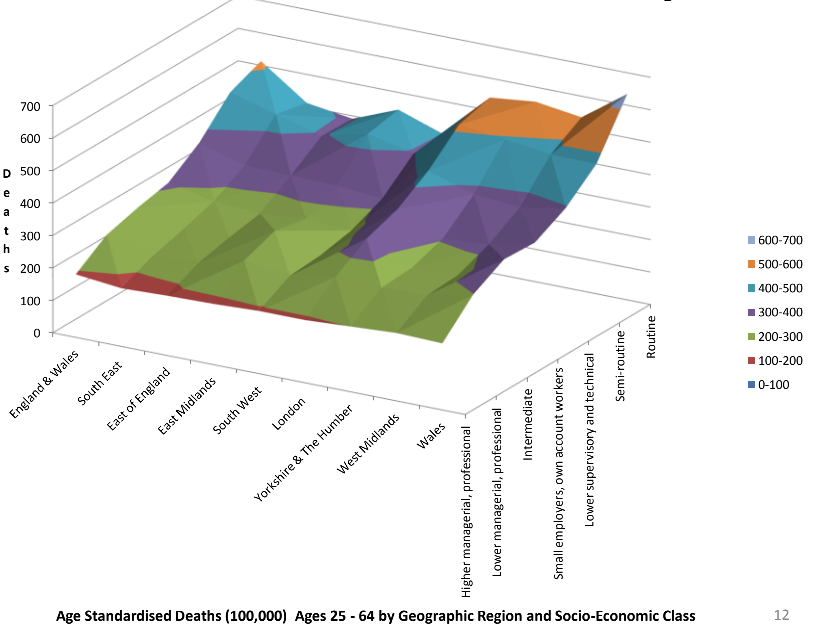
Raising Normal Retirement Age is profoundly inequitable

Things not to do



Age Standardised Deaths (100,000) Ages 25 - 64 by Geographic Region and Socio-Economic Class
All causes of death 2001 -2003

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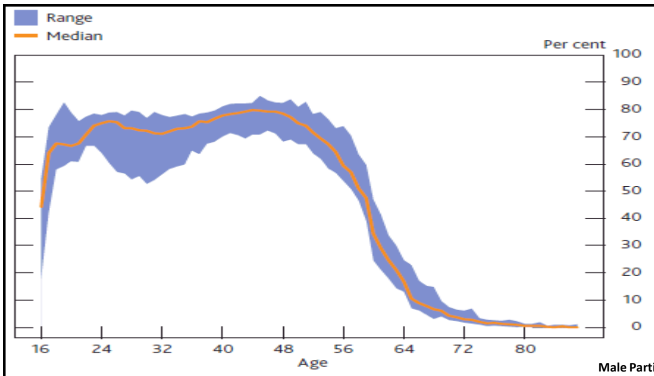


Things to do

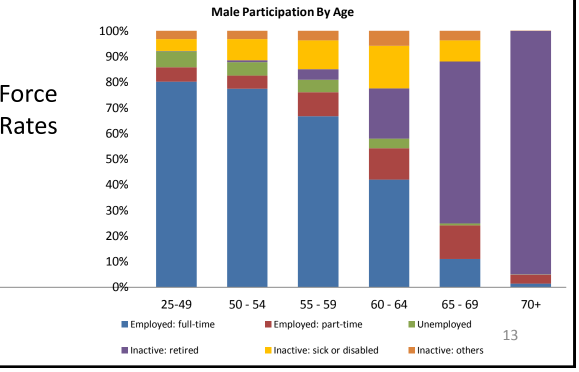
Immigration works

Increasing Productivity

Tertiary education policy is suspect

Female participation rates

Labour Force Participation Rates



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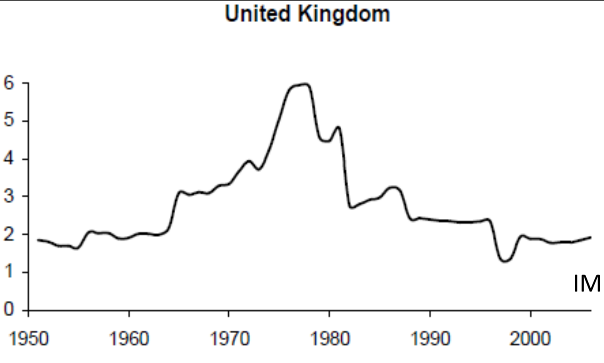


Tax Incentive Values High Earners 5x GDP

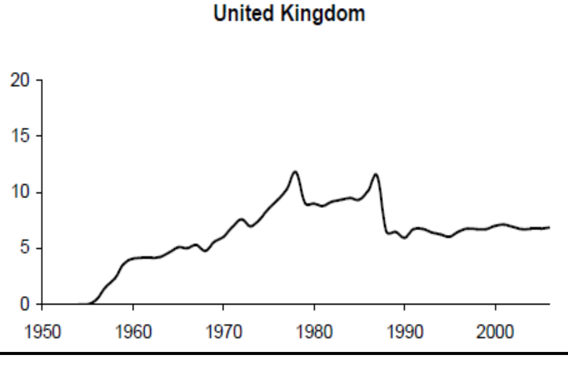
Investment Gain % p.a.

IM Fees have a natural ceiling

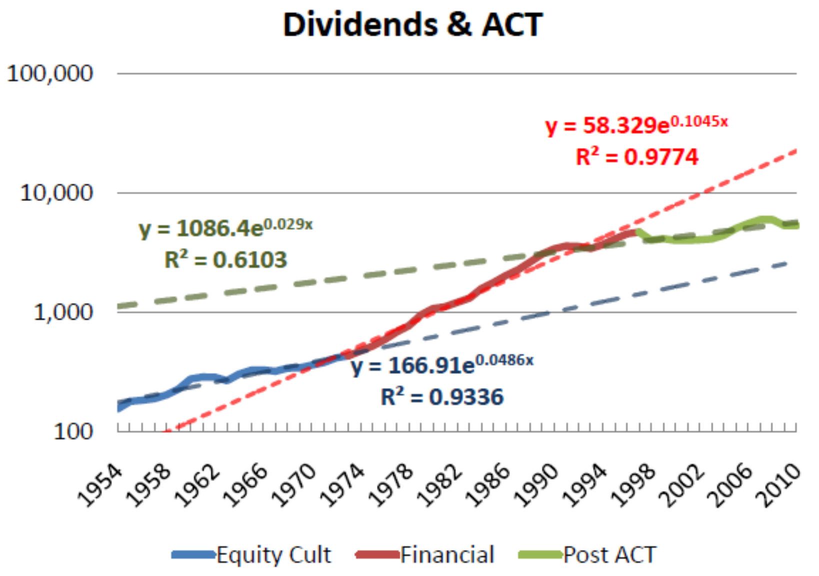
Income Smoothing
Tax Progressivity
Effective tax rate saving

Abolition of the age-related higher thresholds lower this by 3.3%

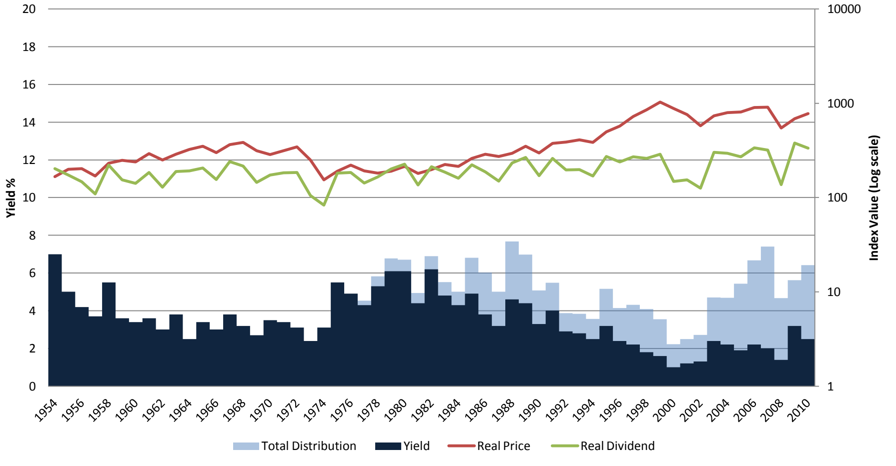
Tax-Free Lump Sum is unlikely to persist



Gordon's Great Theft - ACT



Buy-backs

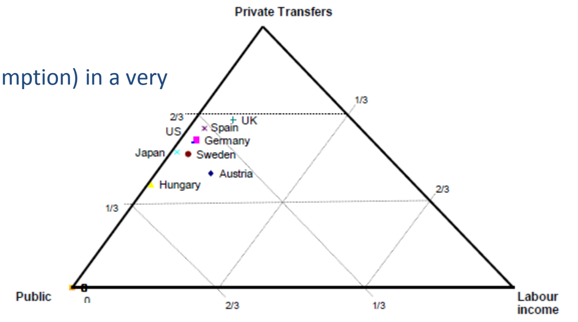


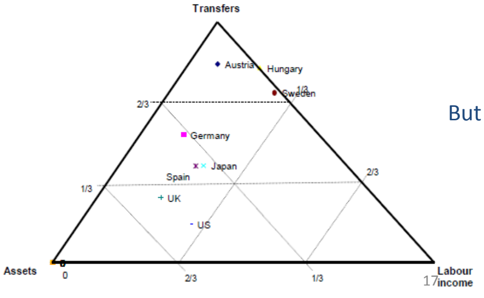
ACT encouraged buy-backs rather than traditional dividends

The governance aspects are suspect

A conundrum

We finance education (0-19 consumption) in a very similar manner internationally





But not retirement

Funding

- The principal arguments revolve around funded and unfunded, or more correctly, book-reserve schemes
- Private sector funded arrangements are believed to be more efficient than state sponsored
- But Private Sector funded DB exhibits an income yield of less than 2%
- And state owned enterprises produce a surplus of £28.8 billion – an income yield of approximately 3.3% if all government debt is attributed to them
- A pension is simply a claim on future production
- The question becomes: which is the most efficient way to organise those claims
- The answer is for those claims to be made directly by producers – the employer, and leads to occupational schemes.
- These are not solely devices to resolve the individual’s saving problem.
- In the private sector, companies make promises on their future production routinely.
- These are the equities and bonds which finance their investment and operations.
- In the public sector these promises are supported by the state’s regalian power to tax

Savings and Investment

- If we are to acquire claims on future production, we must defer some current consumption. This is saving.
- But if the saving is to be productive we need to invest those savings.
- One of the problems of pension provision is that the individual sees savings as inviolable in nominal value
- While the reality is that investments may produce widely varying outcomes and intermediate values.
- If the outcome is less as a share of GDP than the current consumption forgone, there is a welfare loss – this is the equitable return
- It is not the pure liquidity preference rate of the "risk-free" of financial theory
- For the saving to be fair to the individual and inter-generationally the sum of the proportional consumption forgone should equal the sum of the post-retirement proportional consumption in a lifetime.
- To illustrate this point, suppose we save 10% of our income, 6.6% of per capita GDP, over a thirty five year working career, then in a twenty five year retirement we expect to receive a pension of 9.3% of GDP, or 13.8% of (national) income, before considering any liquidity preference accrual/discount rate.
- If we wish a pension of 60% of wage income, the liquidity preference rate must be 5.47% on average

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Equitable results

- Is this liquidity preference rate reasonable?
- In this stylised illustration, one third of GDP has been attributed as accruing to capital invested.
- If we make the assumption that the economy has aggregate investment of 2.8 times annual GDP,
- Then the realised implicit liquidity preference rate , the return on capital employed in the economy, would be 11.7%
- Though this is an ex-tax calculation, it is clear that pensions are perfectly affordable and sustainable.
- Redistributive taxes on investment income would need to be greater than 53% for the pension to be unachievable.
- In fact the return on investment at the level of the economy is tax-advantaged in that debt is tax-deductible. The effect of this tax subsidy is to increase the return to capital to 11.7% from 9.9%
- It is of similar magnitude to the investment accrual tax subsidy.
- This simple calculation makes no assumptions about growth rates. It merely states the problem in constant terms and considers averages.

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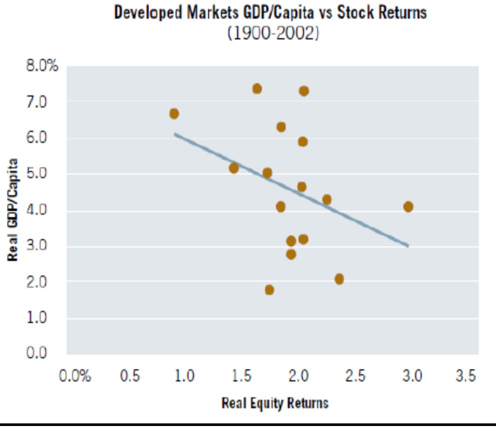
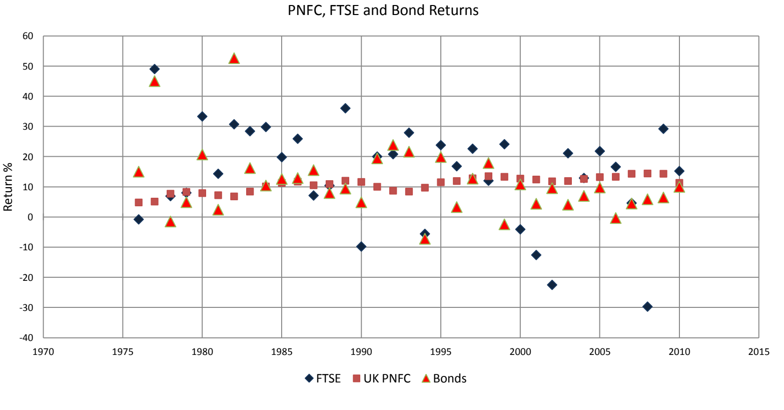
Investment Opportunities

- The state employee problem is interesting in this light. By operating a book-reserve system, it lowers current taxes, allowing tax-payers, including its employees, to consume or invest that much more, as is their wont.
- The tax-payer problem is that the only investment rate of return available to them is that available in financial markets
- Financial market returns do not mirror these economic returns.
- Contrary to the opinions of many financial analysts, economic growth does not drive financial market performance.
- Growth is driven principally by new investment and that is marginal to the stocks of investment traded in financial markets.



Investment

- Moreover, this economic income (other than in the case of pensions) is subject to taxation.
- 11.7% becomes 5.3% in the hands of the 40% tax-payer.



- The message is clear at the level, at the level of the economy adequate pensions are clearly affordable

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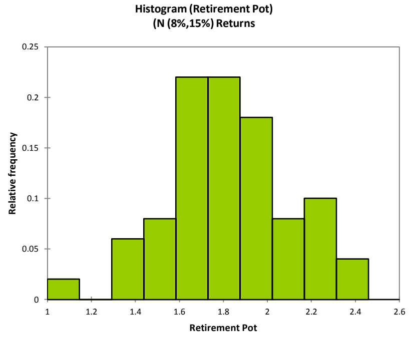
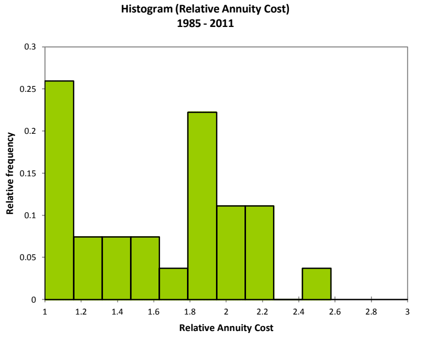
Pension Design

- The trend is clearly to individual provision in the form of DC
- The individual is probably unable and unwilling to undertake the management of a pension funding arrangement.
- The individual standing alone faces greater risk and uncertainty than the individual in a collective arrangement
- And then there are the uncertainties of annuitisation





- The unfortunate may receive just 17% of the lucky

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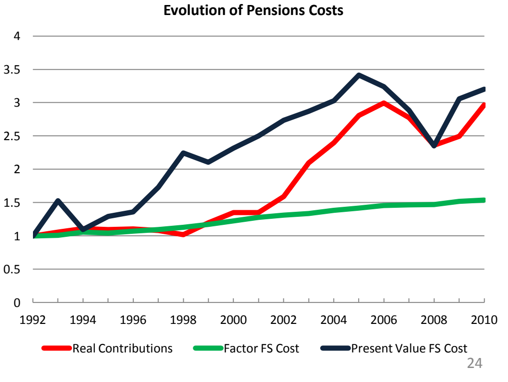
Risk & Return

Risk means more things can happen, than will happen.

- The **primary advantage** of DB over DC lies in the **sponsor guarantee:**
- The bulk buy –out funding level is the value of this aspect: 50%+ today.
- Then there are further institutional design advantages of DB over DC which are overwhelming, and stem from:
- **Risk Pooling, Risk Sharing, Time Continuity, Economies of Scale and Scope**
- The disadvantages and costs stem from incorrect accounting and regulation.



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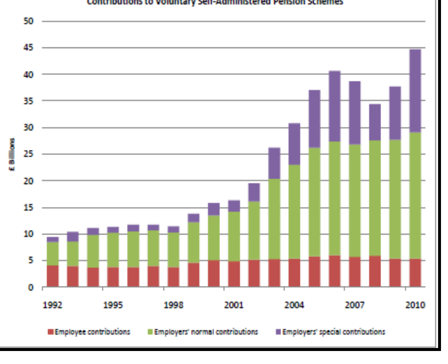
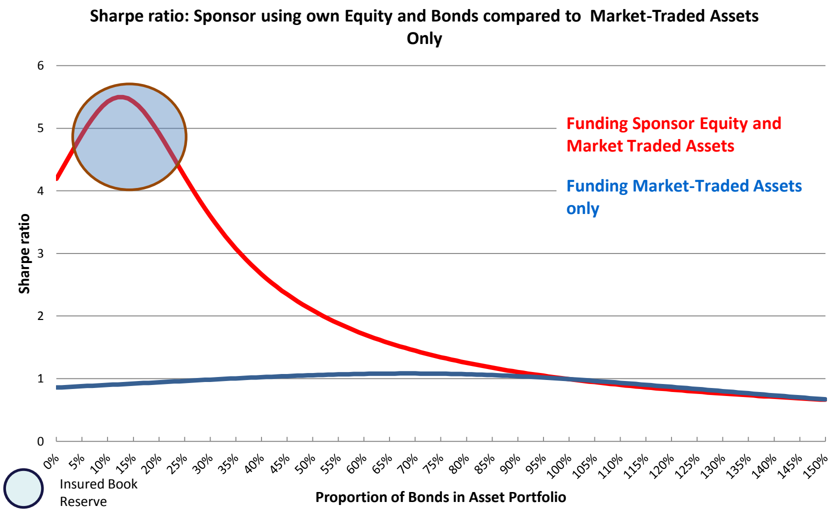


Optimal Funding

What if we allow self-investment?



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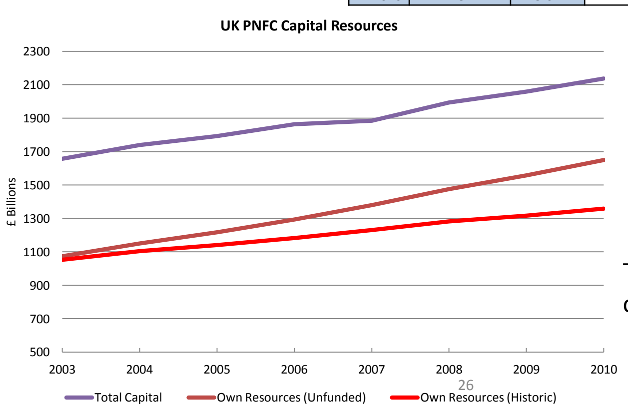
What if we had allowed book-reserve pensions in PA 2005?

PNFCs would have markedly Lowered their bank dependency

	Contributions			Relative Liability Cover			
	Earnings Cover			PPF		Factor FS Cost	
	Historic	Unfunded		Historic	Unfunded	Historic	Unfunded
2003	5.98	6.10		1.70	1.75	1.70	1.75
2004	5.77	6.02		1.59	1.68	1.67	1.76
2005	5.12	5.48		1.42	1.54	1.64	1.78
2006	5.17	5.72		1.53	1.73	1.61	1.82
2007	5.63	6.42		1.45	1.69	1.61	1.88
2008	6.06	7.09		1.33	1.61	1.60	1.93
2009	4.94	5.93		1.50	1.88	1.54	1.92
2010	4.57	5.62		1.41	1.83	1.57	2.03



The problem is that some companies go bust

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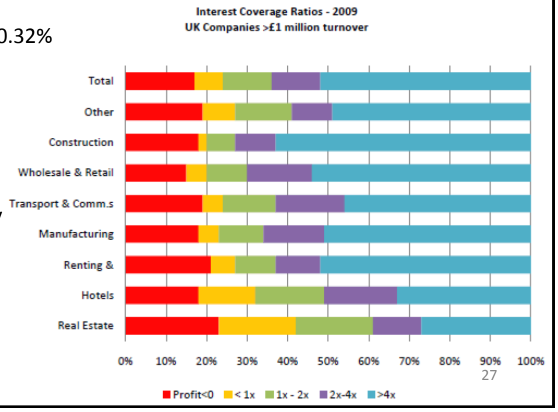
Corporate Insolvencies

- Companies are twice as likely to merge or be acquired as to become insolvent
- In the UK the insolvency rate has averaged 1.2% p.a. over the past 30 years
- But fifty percent of companies do not survive their fifth birthday
- The loss rate that prompted all of our recent legislation, at 50% funding, was less than £6 billion – rather less than special contributions in every year since 2002
- Gazelle reported cumulative failure of just 7% since 1985 – 0.3% p.a. for FTSE 100
- The Swedish PRI-Pensiongaranti insures schemes against sponsor insolvency and reports losses averaging 0.3%
- The German PSV reports losses of 0.32%
- There is evidence from Germany that companies with book-reserve schemes are 50% less likely to fail than companies at large.
- The diversity of companies admits an insurance solution to insolvency and pension security



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Concluding Remarks

- DB pensions are affordable and sustainable
- And optimal solutions to the retirement income problem
- Exaggerations and misrepresentations abound
- Longevity is simply not that great a problem
- Accounting, Regulation and Funding are greater issues
- The trend to individual provision is misguided and will prove costly
- Assured occupational book –reserve DB may be provided at about half the cost of funded DB
- Which, in turn provides, pensions at about half the cost of DC
- Alan Rubenstein – CEO, PPF - **Funding trumps Covenant**
- Rephrased: **Seatbelts trump Brakes**
- The fixation with risk is likely misplaced
- It is uncertainty which admits the possibility of profit from enterprise
- And greater social welfare.

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The End?

"We structured the deal so it won't make any sense to you."

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