Comments on

"Affordable Retirement Income through Savings and Annuities"

By Charlene Moriarty

The Fuerst model scored high points among the judging panel, based on the measurement criteria used. I, for one, find it to be a very elegant private sector solution to many of the pitfalls of the current Tier II retirement system in North America today.

The exodus from DB to DC plans continues unabated. As industry professionals, we are all too aware of the implications of this phenomenon: transfer of investment and longevity risk to stakeholders who are least equipped to assume such risks. These transfers have taken place because employers are themselves no longer willing or able to carry the investment and longevity risks associated with DB Plans. In a DC plan however, employers face a new type of risk, as do their employees: the risk that employees won't have enough money to retire on, because of either poor investment decisions or bad luck or both. As a fiduciary, the employer must ensure that the investment choices adequately meet the needs of employees and that they are receiving enough information and education to make informed decisions.

The Fuerst model is essentially a DC model, with these major pitfalls removed or at least mitigated.

With the Fuerst model the employer is relieved of the fiduciary burden of plan sponsorship. The employer's role is relegated to that of a conduit, providing the mechanism for payroll deductions and remittances to the member's individual account.

For the employee, it mitigates much of the investment risk by requiring investment of a significant portion of the funds (50 percent is suggested) in government-indexed linked securities. Target date funds would also be available for a portion of the contributions. The net effect is that there is very little room for members to be adversely affected by poor investment decisions. And investment in TIPS ensures that the growth in the funds at least keeps pace with inflation.

The most valuable and innovative feature of the Fuerst model in my view is its proposed approach for handling the spend-down phase. One of the largest pitfalls of a traditional DC plan for employees is that it continues to expose individuals to both longevity and investment risk, at a time when they are potentially most vulnerable. Broadly speaking, the two choices available with DC money are to continue to invest it and draw down the balance over the remainder of the individual's lifetime, or to purchase an annuity that guarantees a fixed income for the annuitant's lifetime. Either option utilizes funds very inefficiently. With the former option, a retiree must be overly conservative in the amounts withdrawn each year, to ensure he will not outlive his retirement income. With the latter option, the cost of annuity guarantees in today's market is very expensive. It's expensive primarily because an insurance company takes on at least three types of risk in exchange for a guaranteed annual income and charges the annuitant for these risks: longevity risk, investment risk, and expense risk. Although the longevity risk is pooled among a large number of annuitants, insurance companies recognize that only the healthy are likely to elect annuity options and therefore price the annuities accordingly. The investment risk is covered through conservative investments and choice of assumptions. The expense risk is covered through conservatively estimating the administrative expenses over the length of the contract.

The Fuerst model essentially accepts the notion that income guarantees are at best expensive and at worst illusory. The proposed system of participating variable annuities (PVAs) makes annuities affordable first of all by removing the guarantee and replacing it with a reasonable assurance of a fairly steady lifetime income in retirement. Although the investment risk is passed on to the annuitant, it is kept to a minimum, since companies issuing the annuity contracts must invest the proceeds in index-linked securities (at least for the mandatory annuitization portion). Since 50 percent of the member's individual account must be used to purchase a PVA, this mandatory feature allows for a much more efficient pooling of longevity risk by reducing the degree of anti-selection inherent in a voluntary system.

To ensure efficient pooling of mortality risk, a mechanism would be created to pool mortality experience of all companies issuing PVAs. Clearly some government involvement is required for this annuitization solution to work. Fuerst recognizes this and proposes the creation of a government agency—the Longevity Pooling Agency—whose primary role would be to license and regulate the financial institutions issuing PVAs, as well as setting the mortality tables and interest rate to be used for the standard pricing of annuities.

Challenges of the Fuerst Model

Clearly the Fuerst model would work best as a mandatory system. The mandatory nature would ensure a quick buildup of the economies of scale and would be most effective in reducing anti-selection when annuitizing. It also serves to enforce some coverage for the self-employed and employees of organizations who do not currently sponsor any type of pension or retirement savings plan.

Implementation would present some challenges, particularly in setting up the government agency to regulate and monitor the financial institutions licensed to administer these plans and issue PVAs, and to set the mortality tables and hurdle rates. But I believe that if the political will were there, these challenges would not be insurmountable. The market infrastructure is already largely in place.

It is interesting to note that the Canadian federal government recently promulgated the Pooled Registered Pension Plans (PRPP) Act, which seems to parallel the Fuerst model, at least in the accumulation phase. Under this new legislation a PRPP will be a DC plan administered by a third party—a financial institution authorized by the federal government to administer such a plan. As in the Fuerst model, the employer is relieved of the fiduciary burden of plan sponsorship. But this is where the similarities end. In all other respects, the PRPP is a traditional DC plan with the plan members still bearing all the investment and longevity risk, and no special plan features to mitigate those risks.

The biggest challenge of the Fuerst model is finding the political will to implement features that are bound to be unpopular among some groups. Mandatory participation, restrictions on investment choices, forced annuitization are bound to elicit strong objections from citizens at different ends of the wealth spectrum: from the rich who want control over their own money, from the poorer folk who may feel the financial strain of forced participation, and from middle class families who might prefer using the money toward paying off a mortgage or saving for their children's education.

But if a government's goal in implementing a retirement system is to increase pension coverage among the poorly covered sectors of society, then some individual choice must be sacrificed in the interests of the public good. If a government is concerned about economic and social impact of poverty in retirement because of the poor savings choices made by its citizens, then it behooves them to implement a retirement system that protects all its citizens (at least to some degree) against the potential consequences

retirement savings losses and poor retirement planning. As more and more citizens rely on retirement income from DC pension and retirement savings plans, these issues will become increasingly critical for governments to deal with. Canada's PRPP remains a voluntary system; hence the goal of increased pension coverage is not likely to be achieved. And it does not provide participants with any protection against longevity or investment risk. In Canada, significant attention has been paid to the fall in pension coverage. Since 2006 the there have been numerous commissions, public consultations, and research working groups launched at both the provincial and federal levels to assess the current state of the Canadian retirement system and develop recommendations for improving and increasing pension plan coverage where necessary. It's distressing to find that, at the end of the day, the Canadian government couldn't come up with something more imaginative than a basic voluntary DC plan design, with no attempt to address some of its major flaws.

Picking the minimum required contribution rate would present a challenge. Too high a contribution rate would place an undue burden on the lower paid and would be politically unpopular, and too low a contribution rate would render the system expensive and ineffective. Fuerst suggests an acceptable minimum to be in the range of 5 percent to 10 percent of pay. In Canada, integration with the Canada/Quebec Pension Plan contributions would make sense. Someone who has earned the Year's Maximum Pensionable Earnings (YMPE)[1] throughout his working life will have about 36 percent of his final earnings before retirement covered under Canada's government programs. For someone earning double the average wage, this replacement ratio drops to about 18 percent. Using conservative assumptions similar to those employed by Fuerst, over a 35-year working career, a minimum required contribution rate of 4 percent on earnings up to the YMPE and 8 percent on earnings in excess of the YMPE can be expected to generate replacement ratios (taking into account government programs) of close to 50 percent for the average wage earner and about 36 percent for someone earning double the average wage. Striking the right contribution rate depends on what the goals should be for a mandatory Tier II retirement system. The 4 percent/8 percent structure illustrated above provides meaningful retirement income protection; however, it does not (nor should it) eliminate the necessity for personal savings or voluntary retirement plans to maintain one's standard of living in retirement.

Could the Fuerst Model work under a voluntary retirement system? Certainly, economies of scale are necessary to make this system work effectively. However, perhaps the model for the spend-down phase can be made to work under the current voluntary system. In Canada, assets in DC pension plans alone amount to about $41 billion,[2] covering almost one million participants. It used to be that members retiring from a DC pension plan were required to purchase annuities with their DC funds by the time they reached the age of 80. This requirement was eventually removed in all provincial jurisdictions. Today, members retiring from DC plans have the option to annuitize or to transfer their funds to an individual retirement vehicle with legislated maximum annual withdrawal limits. Most choose the latter option. If forced annuitization on retirement was legislated for at least a portion of a member's DC funds, then this may eventually provide the economies of scale needed to make PVA's an effective and affordable alternative.

The final challenge facing the Fuerst Model that I think is worth discussion is the potential shortage of supply of inflation-protected securities to cover the increasing demand as the system matures. What

[1] These are the maximum earnings upon which Canada/Quebec Pension Plan contributions and benefits are based. The YMPE approximates the average wage in Canada is set at $50,100 for 2012.

[2] Statistics Canada 2010. These figures are for pure DC plans. They do not include DC assets and membership within registered pension plans that have both a DB and a DC provision. As such, they underestimate the total amount of DC assets and membership within the registered pension plan framework in Canada.

impact would such shortage have on real rates of return and hence the affordability of PVAs? Fuerst mentions this possibility in his paper and suggests that, should this occur, other high-quality fixed-income securities could be allowed. But what if there becomes a shortage of high-quality debt generally? The potential shortfall in the supply of suitable fixed-income securities to cover the demands created by this type of mandatory retirement system is, in my view, an important issue to consider. What would be the macroeconomic implications of such a significant increase in the demand for high-quality fixed-income investments, and how would this affect the supply of equity capital? Should markets and society be concerned about this? These issues highlight one of the key macro-economic advantages of DB plans that receives very little attention. The assets backing DB pension plans are a major source of equity capital to both business and government. Because of their long-term investment horizon, they are a prime source of long-term investment capital for large projects that can be used to support a country's future production capacity. By transferring investment risk from individuals to collectives, they also help achieve a more efficient allocation of savings. In my opinion, this speaks to a significant weakness of a DC type of design for a mandatory Tier II retirement system when compared to a DB type of design. DB plans are simply more financially efficient at pooling risk and deploying capital. Macro-economic factors such as these need to be taken into account in the design of a retirement system.

The strength of the Fuerst model, when measured against some of the *Retirement 20/20* criteria for a model retirement system, is that it does a good job of aligning stakeholder roles with their skills. The markets play a significant role in hedging and pooling risks; the regulators (as society's agents) provide the oversight necessary to ensure legal compliance, transparency, and standardization. Employers are relieved of the burden of plan sponsorship and can therefore focus more on their core business. And, last but not least, employees are provided with reasonable assurance of retirement income protection. Given the inexorable move toward DC plans in North America there is dire need for alternatives to the current options available to retirees. The Fuerst Model, in this regard, presents an alternative well worth considering.

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