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Perspectives from Anna: Thoughts on the Future of Pension Regulation

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The 2015 Pension Research Council annual symposium topic was "Implications of the New Regulatory Order for Retirement Risk Management." It was exciting for me because it made me think about things I do not often contemplate. This perspective provides insight into those thoughts. All of the papers will be posted as working papers on the [Pension Research Council website.](https://pensionresearchcouncil.wharton.upenn.edu) I encourage you to read the papers and find your own issues of interest.

I have used an idea shared by Emily Kessler, an actuary from the Society of Actuaries staff and one of the discussants in the program. Emily compared the ideas to a cubist perspective and illustrated her point with examples of the work of Picasso and Braque. There are different viewpoints and stakeholder perspectives on the topics. The cubist shows you the object as you might see it from all sides. The papers and discussion provided a perspective that combined multiple, often conflicting, viewpoints. The discussion did not reconcile the different viewpoints but allowed you to see them side by side.

CONTEXT

The background for the symposium is the aftermath of the 2007–09 financial crisis combined with population aging, low financial literacy, and the shift from defined benefit to defined contribution plans.

CAN SYSTEMS FAIL OR BE DISRUPTED?

Since 2008, there has been a growing focus on the possibility of system failure and what is needed to prevent it. There was quite a lot of discussion of systemic risk, or of risks which were large enough to cause significant problems within the system or to cause general system failure.

Concern about system failure leads to an awkward situation with regard to regulation. Two contradictory propositions co-exist. There is concern about the need to strengthen regulation, with a focus on capital requirements, operational risk and liquidity. At the same time, there is concern that regulations are already too complex, too expensive to deal with and confusing, partly because of multiple sources of regulation.

A number of financial institutions have been identified as too big to fail, and designated as "systemically important financial institutions." The insurance companies include Prudential Financial, MetLife and AIG. (Globally there are nine insurance companies on this list.) These institutions are subject to additional regulation. While most insurance company regulation is state-based in the United States, the added layer of regulation is federal. In addition to the focus on economic exposure of very large organizations, there was also a focus on how much damage a single unethical individual could do if well-organized enough.

The regulation of systemically important entities grew up in the world of bank regulation. Several papers looked at the challenges involved in extending these concepts to other types of large institutions (how do the risk transfers implicit in insurance, asset management and pensions correlate to those in banking) and to what extent is regulation needed to prevent their entry as "unauthorized banking" facilities versus what is known about these entities as unique potential contributions to financial instability?

We should also remember that these systems have a variety of guarantee arrangements, which are part of the system. States have state insurance departments which in turn work with state guarantee funds, which could fail. Pensions are guaranteed in the United States up to defined limits by the Pension Benefit Guaranty Corp. (PBGC) which also could fail. There are pension protection funds in other countries as well.

How will changes in the requirements for insurers, asset managers and pension funds affect the underlying retirement system? How will the cost of insuring longevity risk change as a result? These answers will depend on the evolving regulatory system.

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LOCAL OR INTERNATIONAL ISSUES?

The regulatory issues were generally identified as international. There are parallel and similar issues facing regulators in many countries, and the regulators work together in international organizations. Many of the larger financial institutions operate internationally today. Some solutions may be adopted only locally but others will reflect recommended international practice. Within the United States, there is a parallel issue as insurance is regulated primarily by the states, and the state insurance departments work together through the National Association of Insurance Commissioners (NAIC). It seems likely that change is coming. The papers provided some historical context together with identification of some of the concerns today.

THE ISSUES RELATED TO RETIREMENT SYSTEMS, FINANCIAL INSTITUTIONS AND REGULATION

When we think about the retirement system and regulation, we need to think about four sets of institutions: pension funds, insurance companies, banks and mutual funds. Protecting individuals, ensuring sustainability and stability are common concerns across all of these institutions. All are subject to operational risk.

Insurance companies and pension funds are subject to longevity risk. One of the papers offers an international comparison of the regulation of longevity risk, and how it differs between these two types of institutions, country by country. Discussions of longevity risk are often in the context of fixed retirement ages. If they were in the context of fixed periods of retirement, the discussion would be very different.

Liquidity is a concern in all of these institutions, but the requirements and specific issues are very different. Appropriate disclosures are always a concern. One of the papers dealt with this topic.

MARKET VALUES OR SMOOTHING: WHAT ACCOUNTING APPROACH WORKS FOR ME

Pension funds are very long-term arrangements. Traditionally, smoothing was used in pension accounting and measuring costs. It has been demonstrated that this practice did not meet the needs of shareholders well. However, others have argued that smoothing is appropriate as pensions are a long-term arrangement. This debate continues to this day.

One of the papers looked at this issue from the perspective of the individual. That paper, "Accounting and Actuarial Smoothing of Retirement Payouts in Participating Life Annuities," demonstrated that smoothing is valuable to the individual and proposed the use of participating contracts to achieve it. Under the arrangement presented, smoothing proved valuable to multiple stakeholders. Another paper, "Mark to Market Accounting for United States Corporate Pensions: Implications and Impact," examined the results of companies that had adopted market values in their accounting, and compared them to a group of companies that remained with Generally Accepted Accounting Principles (GAAP). That paper found that the change did not seem to matter. The market value impacts were backed out when incentive pay was determined and when analysts were looking at the companies. (This analysis does not consider an early-mover advantage; the very first companies to adopt this approach appear to have received an anomalous benefit from the change.)

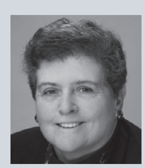
ISSUES FOR THE FUTURE OF THE RETIREMENT SYSTEM

A number of other issues were discussed:

- Demographics raise concern in many quarters. In the luncheon speech, Lady Barbara Judge of the U.K. Pension Protection Fund took the position that people need to work longer. Others asked where jobs for seniors would come from and pointed out that people in some jobs wear out.
- The closing panel focused on the importance of risk sharing and pointed out that many public plans have adopted risk-sharing arrangements.
- There was quite a disagreement over the importance of education and its value. Hazel Bateman from the University of New South Wales in Australia pointed out that it is extremely important, but this was countered with discussion indicating that in many situations, individuals simply will not understand the point.
- There was another discussion about the appropriate way to measure benefit adequacy for policy purposes. Andrew Biggs presented his ideas for ways to adjust replacement ratios, and others disagreed.

CONCLUSION

The symposium served to bring out a range of issues, make one think of the uncertain future and point out how different the perspectives on many of these issues are. Thank you to the Pension Research Council for sponsoring this discussion. ■



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