There is a consensus that workplace pension systems around the world are sick, so are there strong views on what the cure is. Many commentators continue to say the answer is to reverse the decline in the use of defined benefit (DB) plans. DB plan enthusiasts point out that widespread adoption of this form of pension arrangement would cure the workplace pension systems’ coverage, adequacy and security ills in one fell swoop. While I agree with the consensus that the globe’s workplace pension systems are seriously ill, I disagree that the cure lies in placing a DB chicken in every worker’s pension pot. Why? DB plans suffer from a fatal flaw.

So we should not be surprised that when financial surpluses appear on DB plan balance sheets, there are fights about who “owns” them. In corporate contexts, the surpluses of the 1990s frequently led to ownership disputes between plan members and shareholders, with regulators and even the courts having to step in to arbitrate these tiffs. When surpluses turn to deficits at times of financial distress, plan members duke it out with corporate bond and shareholders about how the financial pain should be allocated.

Beneath all these game theory-based actions lies the common thread that collective risk-bearing arrangements such as DB plans do not eliminate risk. They merely offer opportunities to shift it from the strong to the weak.

DC PLANS ARE NOT THE ANSWER EITHER
If not DB chickens, what should we stuff in the pension pots of workers around the world? There are strongly held views that defined contribution (DC) plans are the answer. Here employers and workers make contributions into employee pension accumulation accounts, with employees typically allocating contributions among a dozen or more investment options. It is certainly true that DC arrangements eliminate most of the DB plan ambiguity about risk bearing and asset ownership. However, the typical DC plan has three serious flaws of its own. First, behavioural finance research confirms that most people are hesitant, inconsistent, even irrational planners and decision makers regarding their own financial future. Second, informational asymmetry and misaligned interests with regard to the global for-profit financial services industry drive a material wedge between workers and the retirement

EXCERPT FROM

Pension Revolution: A Solution to the Pension Crisis

By Keith Ambachtsheer

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money they do accumulate. The result is that many workers pay too much for retirement-related financial services in relation to their true economic value. These excessive fees paid over a working lifetime are another important factor why so many workers are underachieving their pension goals. The third DC plan flaw is that these arrangements leave plan members bearing the full burden of longevity risk. Surely we should not expose the many millions of retirees around the world to the material risk of outliving their money.

The optimal pension system or TOPS, a cure that is both revolutionary and thoroughly practical at the same time. TOPS addresses the human foibles problem through auto-enrolment, and “autopilot” mechanisms that dynamically adjust individual contribution rates over time, and ties the optimal investment policy for each individual participant to their age, all with the goal of delivering a target pension within reasonable bounds. The point of the “autopilot” mechanisms is that these adjustments to contribution rates and investment policy are made automatically over time, without requiring any intervention by TOPS participants. Similarly, TOPS deals with longevity risk by including the purchase of deferred life annuities over time as part of the “autopilot” investment policy design. As the annuity portfolio is priced and managed in accordance with insurance company principles, there will be no fist fights over the ownership of any balance sheet surpluses or deficits.

**EXPERT PENSION CO-OPS**

To address agency issues, TOPS arrangements are run by arm’s-length, expert pension co-ops in order to manage the inherent conflicts and too-high costs the for-profit financial services industry brings to the table.

Instead, pension delivery institutions need to be set up as strong, arm’s-length, expert organizations with the sole mandate to create value for plan participants. The key is for pension funds to be able to manage from the inside out, rather than being managed by external agents from the outside in for their own purposes.

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**Pension Revolution**

**Pension Revolution: A Solution to the Pensions Crisis**

**By Keith Ambachtsheer**

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**Review by Marcel Théroux**

Noted pension expert Keith Ambachtsheer has written a new book that should be of vital interest to all connected to the pension industry. *Pension Revolution: A Solution to the Pensions Crisis* (2007, Wiley) is an edited compilation of 44 previously released Ambachtsheer Letters, client advisory publications containing “Research and Commentary on Pension Governance, Finance and Investments.”

To a lawyer, even one knowledgeable in pension matters, this book is the literary equivalent of a cold shower. Ambachtsheer advocates the creation of a new model for retirement saving: The Optimal Pension System (TOPS). Under that system, employees would automatically be enrolled at contribution rates set high enough to produce reasonable income replacement rates on retirement. Investments would be made under an “autopilot” program, with severely limited investment choices.

Why would employers participate in a TOPS arrangement? Because employees who participate in clearly articulated and well-understood retirement savings arrangements are more productive than those who do not. Why would employees switch to TOPS from an existing arrangement? Because TOPS would deliver bigger pensions, and their employers would not need to act as sponsors.

Smaller pension plans, he says, cannot deliver dollar for value to stakeholders. The unit administrative and pension costs are too high. They can’t afford the necessary internal expertise. If these plans had good governance practices, they would merge or outsource to a more economical provider. As to DC pension plans in North America, he concludes that there are “too many choices at too-high cost with too little oversight that has the best interests of plan participants foremost in mind.” Why are there no participant-driven DC business models? Because there is no profit incentive to create such models.

Ambachtsheer also has bad news for the larger DB plans and their investment funds, recognizing that these plans only thrive in industry-wide and public sector labour markets and are disappearing from the private sector labour market. A risk premium should not be embedded in the interest rate used to discount actuarial liabilities. Both liabilities and assets should be “marked to market.” Only in this way will the balance-sheet mismatch risk become transparent. Old portfolio theory is inadequate and should be replaced with integrative investment theory (IIT). IIT incorporates recent academic technical developments, strongly critical of the Efficient Market Hypothesis, as well as the economic concepts of “asymmetric information” and “principal-agent theory.”

This book is required reading. To the lawyer, it reads like a list of potential new courses of action. While we are not qualified to opine on many of the issues discussed, the writing is clear, focused and passionate. It is rare indeed that one encounters a book of this intellectual breadth and depth.

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To be effective, expert pension co-ops need to operate with investment beliefs that are relevant, research-based and responsive to new information and insights. Based on observed behaviour, the investment beliefs of most of the globe’s pension funds cannot pass this important test. Instead, the beliefs of many funds seem to be based on historical rules of thumb, anecdotes and what they are told by the for-profit financial services industry they should believe.

TOPS TIPPING POINTS

If TOPS, with its autopilot and expert co-op features, is such a great idea, why doesn’t it exist already? But it does! The Teachers Insurance and Annuity Association–College Retirement Equities Fund (TIAA-CREF) the $350 billion retirement system for over three million current and retired U.S. college education and research employees runs on TOPS principles. Through worklife-long employer-employee contributions as high as 18% of pay, millions of TIAA-CREF participants have converted sufficient pension capital into life annuities to live comfortably for the rest of their lives, decade after decade. Founded through a Carnegie grant in 1918, it may well be the most successful workplace pension plan of all time.

So the TOPS solution naturally emerges, stabilizing lifetime consumption patterns across the economy, while at the same time creating a new class of independent, wealth-creating, long-horizon investors. North Americans haven’t even begun to talk about the pros and cons of mandatory workplace pension participation. Which brings me to another reason for current “no TOPS” condition in most of the developed world: a systemic failure to apply integrative thinking to solving pension problems. It has been a sad experience to watch some of the finest minds in global pensiondom earnestly attempt to “fix” DB plans so that these arrangements will become not only manageable and sustainable, but wildly popular as well. It is hard to imagine a more futile exercise.

A final note of optimism. The winning conditions for a successful global workplace pension revolution have never been more favourable than today. There is a growing consensus across the globe that something must be done. The Dutch and the Australians have already demonstrated the societal value of broad-based workplace pension plan participation. The British are seriously considering it. TOPS, the optimal pension system, has already been invented and successfully road-tested. Across the globe, it could be adopted at the national level, at regional levels, at an industry-by-industry level or at the individual employer level.

Keith Ambachtsheer is president of KPA Advisory Services in Toronto. He provides strategic advice to governments and institutional investors around the world.

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