

The Ambachtsheer Letter

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TURNING RETIREMENT SAVINGS INTO PENSIONS:

SHOULD WE LET 'THE MARKET' SORT IT OUT?

"When transaction costs or behavioral patterns produce large departures from the predictions of the ideal neoclassical equilibrium for a given institutional structure, new institutions tend to develop...In the longer run, after institutional structures have had time to fully develop, the predictions of the neo-classical model will be approximately valid for asset prices and resource allocations...."

From "The Design of Financial Systems"
Robert Merton and Zvi Bodie, 2004

"Informational asymmetry and misaligned interests with regard to the global for-profit financial services industry drive a material wedge between workers and their retirement money. The result is that many workers pay too much for retirement-related services in relation to their true economic value....This wedge is a material impediment to achieving workers' retirement goals...."

From "Pension Revolution"
Keith Ambachtsheer, 2007

The Society of Actuaries (SOA) is to be commended for its leadership role in examining how society-at-large might strengthen pension arrangements for today's and tomorrow's workers. The inaugural 2006 event of its *Retirement 20/20* project was titled "Building the Foundations for New Retirement Systems", from which six key themes emerged, including: "*Retirement systems should be better aligned with markets.*" A follow-up SOA event was organized last month to explore the implications of these themes in greater detail. Professor Zvi Bodie of Boston University and this author were asked to stage a debate on the role markets should play in turning retirement savings into pensions. This *Letter* briefly summarizes the essence of the debate and elaborates on its key conclusions...at least from the perspective of this debater. (Feedback from forum participants ranked the debate high in both content and entertainment value).

The quotes above came from the Merton-Bodie paper "The Design of Financial Systems: A Synthesis of Function and Structure" (Harvard Business School Working Paper No. 02-074, 2004), and from our new book *Pension Revolution: A Solution to the Pensions Crisis* (Wiley, 2007). They fairly summarize the starting positions of the two debaters. Bodie believes that markets

will eventually sort things out, and offer workers the savings and annuity products they need to engineer smooth financial transitions from work to retirement. Further, markets will perform these services at 'fair value' prices. Ambachtsheer, on the other hand, is not so sanguine about markets eventually sorting things out. The current situation where many workers are not making adequate, effective retirement provision, and are often paying too much for the provisions they have made, will persist even into that nebulous period economists are fond of calling 'the longer run'. In our view, only pro-active third party intervention will change the current state of dysfunctional disequilibrium in the retirement provision 'industry'.