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Practical Issues in Public Pension Design

Comparison of Global Pension Systems - Lessons Learned

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Lundbergh: Before I start, I have to make a confession. So I started out doing a lot of modeling, thinking about modeling, and then I drifted into how I can figure out how are decisions made in this world? Why do we end up making strange decisions when it comes to pension policy? So that's sort of my journey. I'm a petitioner. I've done some work for the Swedish government. I've been quite active in the pension debate both in Netherlands and the UK, and I've been traveling around trying to learn from other pension systems. So what I'd done is I sort of put this together in this presentation. It's going to be very low-level. I'm going to be very cynical. So this going to be more like what's going on in pension policy world. Why is it so difficult to solve something as simple as pension? Pension is not difficult. You work, you put money aside, you retire, you get an income, and then you die. How difficult can it be? But as we know, there's a lot of things in there making it difficult.

But before we start, I want to sort of paint a picture of another place. This is a picture of an island in the South Sea. They used to be very remote, far away from anything, and there were kind of pre-industrial tribes living on these islands. And during the Second World War, when the Americans were moving towards Japan, they built landing strips because they were strategically very conveniently located. The locals living there, they thought like, "Wow, this is amazing. The gods are coming in the silver birds," and they could benefit from all the cool stuff, all the fruits from the industrial revolution like fabric, canned beans, and all other good stuff. Then, of course, the war moved on and the Americans went away. The people living there, they said, "We want our gods back. We want this to work the way it used to work," so they created a model of reality based on the knowledge they had. They didn't understand about the great scheme of the war. They didn't understand aerodynamics. But they thought if they recreate the condition when the gods came, they must come. So they're probably sitting around the campfire discussing, and probably, someone came with the idea, and they all self-organized around this model and started to build, you know, landing strips and they put out torches along the landing strip to emulate the light. They built a small hut, put a strawman inside with a headset made out of coconuts, and on top of it, they had an antenna out of bamboo. And they waited, and no planes came.

So this is known as cargo cult. The interesting part is a physicist, Feynman, he used this as an example, that a lot of scientists, we fall in love with our models. We think the model is reality even if data doesn't fit our model. You could argue that these pre-industrial tribes, they didn't know better, but we know better. So, actually, as a scientist or a policymaker, you need to try to see the world for what it is, not for what you want it to be. So the biggest problem when it comes is actually ourself, our brain. We're wired, you know...we hate ambiguity. We want to be in control of our future. We want a model that makes me feel if I do this, the following is happening. And if the model doesn't work, we use our own brain capacity to rationalize why this is a good model because it provides the comfort, the false comfort of having a model and structures you know how to do it. This is challenging because the model is so beautiful and we want to believe it, so we fall for the fatal attraction of this beautiful theoretical model. And then we thought to make policy based on this model, and that's when things go astray.

So this is sort of...have this always in the back of your mind. What is the model people are basing their assumptions on when they come up with something? Often, the model, once you accept assumption, is fully internally consistent and make perfectly sense. But if the assumption is wrong, well, it doesn't matter how beautiful your model is. It's just wrong. So let's think about it...you know, I think, like, the big challenge here is how do you do pension policy or how do you deal with a political truth? Well, I think of it like the real world is what we see outside, and then we have the pension policy, there are two big steps in between. First, you have the economist making a model, then you have politicians adapting the model, and then you start implementing policy. It's a long way from the real world to the policy that is implemented. So I thought, like...in London there's a school called London School of Economics and Political Science. I always forget about that. So, politics and economics is very closely related. So I put up a set of famous, you know, economists up there, and if you like, to the left, you pick Karl Marx here, right, and you say, "This is the only way you can run the world." If you're a believer in the free market will solve everything, you adopt market freedom.

So the problem is, politicians, they pick a theory and say, "This is how we should solve the problems." I did some pension work in Sweden, and this was the absolute biggest problem, that there was so much beliefs and so little facts. I mean, you put fact on the table, people didn't want to see it. They did this, because it didn't fit their political belief. But if you'll say, "Which kind of political belief do I have?" Well, you shouldn't say this in America, but I'm a Marxist, not the guy with the beard but the guy with the mustache. Groucho Marx said, "Politics is the art of looking for trouble, finding it everywhere, diagnosing it incorrectly and applying the wrong remedies." He knows a lot about pension policy. And when you're thinking about dealing with this, this is the true challenge. This is not really...it doesn't matter how brilliant your risk-sharing equation or the intergenerational options you have in your scheme. This is what you have to deal with, to get the politicians to actually make decision-based on evidence rather than political beliefs. It can be done, but you have to take the debate to a complete different level. You have to go down in a very basic level to explain why it makes sense.

So when I did my work for the Swedish government, the biggest challenge was actually communicated, so it sort of landed well with the politicians. What I proposed from a content perspective, we say, "Yeah, whatever. That's nothing particular." But, ask if they could decide upon it, that was a miracle. So if you look around, what's had happened with pension policy? In the past, most pension solutions were pay as you go, so no one basically had an interest. It was social policy. Money were coming in and you paid out pension, so you didn't have to worry about it. When we moved to funded pensions, we had this pile of cash in the middle. And you know what that...the effect that has on people, is the same effect as a pile of shit has on flies. Everybody gathers around it, and want to get their share, politicians, service providers, everyone. So what's happening?

You know, the country who were the first one out was Chile and Australia. It started in the '80s moving to a defined contribution kind of world. So I spent some quality time going through all the policy decisions that were made in Australia and Chile step-by-step to see what went on. And the amazing part, they're based on a different part of the world and had a very, very similar trajectory. First, step one, okay, in Chile they called in the Chicago Boys. You heard about that? Pinochet, he basically said, "We need to move to defined contribution, so we move to defined contribution. If you don't agree, you go to prison," except for the military who retained the defined benefits. So he pushed it very quickly over. He got policy advice to say, "Well, consumers are perfectly rational, and if you apply financial incentives, people would say, 'More.'" So, in a couple of decades, they started with this and realized, actually, people don't say, "More," just because they have a fiscal advantage or financial incentive because they don't really think about pensions in the first place. The only people using this was basically high-net-worth individuals and used it for, you know, fiscal planning.

So they did a couple of rounds of reforms to improve it, to close the loopholes, and, of course, people are very quick at finding new loopholes. And, eventually, they came to the conclusion, "This is not working. Financial incentives don't work, so we go all heavy-handed in and say, "It's going to be mandatory. You have to save for pension." So everybody saves, a lot of money start flowing in, and then they said, "But if we're going to determine how people are going to invest, that's going to be troublesome because if it doesn't work out, they're going to point finger at us." So let the market solve it, right? Market mechanism is a great thing. It's going to clear the market between quality and price, and all the good money is going to go to the best funds, right? So they implemented that. They had review after review because this didn't really work. There was a lot of commission fees involved. In Chile, they had basically to shift from one provider to another, you will get a couple of sneakers. And you pay dearly for those sneakers because of its massive transfer costs. So it's a lot of things going on in here which didn't work, so they said, "Well, if the model works but if we just do this, it's going to be better. So let's do more financial education. Let's add more transparency, and then people who are forced to save in the first place going to be very interested in making financial decision and thinking about how to do their investment management."

Well, I think this has gone around a couple of times. Chile and Australia are not there yet, but, you know, the solution seems to be, which you see in many countries, there's going to be sort of an intervention, typically the government or the labor market partners, the unions and the employees together, go in and try to create a default solution and move it from being a retail problem into an institutional solution. So when you think about this, the question is they spent the better time of, say, 20, 30 years going through this, but the question is if you look at the data, if you look at what people do, is this the right way to go? Or should you basically say, "Hey, this is not the way it's going to work. People are not interested in saving for pension." It's good for them to do it, so you make it mandatory and make it sort of you don't have to make decision, a lot of defaults. But the question is, what is, then, a good default? But I see this as a very challenging journey that every country is making. The question is, where are you going to end up on that journey? That's in different countries in different places. In Holland, you're pretty much there UK has moved in that direction, too, with an auto-enrollment and NEST which is a sort of government intervention in the market, which pulled down the price dramatically on pension savings.

So I'm going to give you now a couple of observation from different countries. So I'm going to start with my favorite one, the Australian notch. The big issue in Australia today is how they're going to deal with the payout phase because people have a big...to save, they're mandatory to save. And then they take the cash as a lump sum, renovate the house and travel to Europe or America. So you wonder, "Are Australians more short-sighted or, you know, don't they plan for the future? What's going on here?" And, actually, selling income products in Australia, well, you really have to search hard to find one. So what's going on? Well, the Age Pension which is state pension in Australia, is designed in such a way that if you have a lot of wealth, it doesn't matter if it's pension wealth or other wealth, you're going to get less Age Pension. So it's sort of the Age Pension is there for those who really need it, and you should save for your own pension. The problem is, you can't take money out and invest it in your house. That's an exempt asset, so you don't have to bring it up, your primary house, as an asset in this comparison. So people take a lump sum, renovate the house, and then they travel to Europe. Well, this is a massive deal, right? If you take the cash, travel to Europe, instead of saving it, well, for every two Australian dollar you draw down in pension income, you lose one in Age Pension if you're in the right bracket.

So you have an implicit marginal tax of 50% of the money you already paid tax for. So, for them, they have a perfect notch to take the money, renovate the house, then you get a 50% discount on traveling to Europe. And then they have the pensioner card which is a beautiful thing which gives you a lot of discount when you want public transport, electricity, and other stuff, and you can only get that if you have Age Pension. So this from the state perspective, pushes behavior massively in Australia. So, actually, designing a good payout product in Australia is really, really difficult because the government is pushing people into short-sightedness.

Then, this is another very intriguing thing. What is fair? I mean, probably, a philosopher has been debating that for centuries. In Sweden, they have built a very beautiful first pillar pension system. They keep track on every Swedish krona going into the system, and your pension from the state pension system is a function on how much you put aside and the return on your assets. They have an individual defined contribution scheme, like a 401(k), and they have a notional defined contribution pay-as-you-go scheme. If you're a nurse, you're pretty low paid in Sweden. You save your money, you do the thing, and you can see exactly how much your savings building up to your pension. And this is state pension. This is social security, right? But it's self-funded social security. Your neighbor might be an alcoholic who never worked in his life. He going to get social benefits roughly the same amount. You have a lot of nurses going to the media saying, "This is unfair. I worked my whole life, I've done right for me, and, listen, this dude has basically done nothing, but get more or less the same pension as me. I did my part of the contract. Why don't I get a better pension?" It's framing, right?

In Holland, which is a complete different country, everybody pays in money into a collective pool. No one knows who paid in what. Fairness, then, is to say, "Well, if everybody gets the same out of this collective pool, that's fair, right?" It doesn't matter how rich you are or how poor you are. If you just lived in Netherlands for 40 years, everybody get the same state pension. No one in Holland thinks that system is unfair. In Sweden, you have more or less the same system, but people perceive this as highly unfair. So the thing about pension policy, it's not what is true fairness, it's also how is fairness perceived by the members. Then, this one, you know about the split brain problem? If you're, like, a neuroscientist, they have found people who have very little connection between the right and the left part of the brain, and, basically, you don't really know what one hand or the other was doing. When you look at pension policy, it's almost like a split-brain patient.

In here, you have the Department of Social Affairs. They are basically in charge of the pension system, the pay-as-you-go and a lot of stuff. As soon as you get a funded pension, Ministry of Finance comes in and they say, "These are financial assets. It should be our area of responsibility." So no one in government in most countries are responsible for the overall package that your pension becomes a good solution, taking state pension, private savings, and the fiscal system for paying out...for drawing your money down. The UK is a brilliant example of this. They did...auto-enrollment was a big reform in the UK because no one really wanted to save for pension, so they said, "We're going to make it mandatory." But in the UK, you cannot make it mandatory because I say, "You have to save." You say to me, "Well, Stefan, that's a nanny state, I decide what to do, so I want to have the option to get out if I don't want to save."

So they basically called in a lot of behavioral scientists to create a system where basically [inaudible 00:18:16] keep people in saving for the pension. Auto-enrollments were thought really, really carefully. You start with a low level of contribution and increasing it over time. Beautiful pension policy based on behavior. Then Osborne, the finance minister, he came up with a pension freedom act that if you save for pension, you should be allowed, it's your money, you should be able to draw it down as a lump sum. There's no default, they know structure. So one brain does a perfect job, the other one doesn't even have a default for the payoff phase. Let people make their own choices. And, of course, in England, advice is regulated and you have to pay to get advice, and advisors are liable, so people don't get advice. So the government comes up, "We should have guidance," which is sort of, you know, advice without responsibility.

So, here, you can see Sweden has the same. It's always a fight between Ministry of Social Affairs and Ministry of Finance when it comes to dealing with the funded part of the pension system. If you're going to do a good pension policy, social security first pillar, and your second pillar has to be woven into one package with a clear goal, and that is a true challenge because the policy department basically are faced with a split-brain challenge. I think you have the same here, right? Yeah. So what can you do about your looming defined benefit problem? So I'm not pretending I'm going to solve it for you, it's a big problem, but maybe you should be a bit creative. Particularly, if you're in a state, where you do...can reduce pension benefits.

So the most interesting country for you to study is Sweden, and since this is Minnesota, it's like the Swedish heritage is pretty close. They have a first pillar part of the pension system. It used to be a defined benefits system based on assumption of 3% growth perpetually. If that worked, the system would be imbalanced. If there would be something else, it would break down. In the middle of the '90s, they did a massive reform saying, "Let's get rid of this defined benefits system in the first pillar and replace it, what they call notional defined contribution. So, basically, they said, "We're going to take away the hard guarantee," and the motivation was, if there's coming tough times for a country, why should retirees not be affected at all, while you have to close down schools and other parts of the productive part of society? So they used it as a fairness argument that, you know, if it's hard times, everybody should share the pain equally. So they wanted to reform the pension system into a pay-as-you-go system with a buffer.

Think of it what you can do when you defined benefit schemes here. If the funding is not enough, why not think of it as a pay-as-you-go system with a buffer to take care of demographic humps among the civil servants? There are always going to be civil servants whether you like it or not, so they are probably one of the few where you can actually say, "This is going to be a perpetual population. People are going to work for the state." So you could think in terms of transforming this into a pay-as-you-go system with a buffer where you have a mechanism to reduce pension in payments, and that must be based on fair market valuation, arbitrage-free valuation. If you do that, you can create a fair generational neutral system which is going to make it possible for the state to actually continue to run the business and perhaps not increase the taxes too much to have a fully-funded system. This is something I should definitely recommend you to study. It's not a perfect system, but there are some ideas in there that you might use. Because if there ain't no money, there ain't no money, right? You cannot cut the hair of a bald man, right?

Winkelmann: Thanks for that.

Lundbergh: Yeah. Netherlands is another interesting country. They are probably the one with the best pension systems in the world. It's well funded. It used to be defined benefit, but around year 2000 with the IT bubble and the crash, they realized this system is not sustainable. So what they did, they removed the sponsor covenant from these occupational pension schemes. Basically, they said, "There's not going to be anymore guarantees from the employers, but all the sort of benefits, all the money that's in the scheme has to be used to pay the members." So you move from a very hard defined benefit scheme into a softer version. So instead of cutting it in sort of a defined benefit to a certain level and then a defined contribution, they created what they call a collective defined contribution. And if you like complex, contrast, all of us call this complex defined contribution because they have a lot of discussion of formulas and assumptions in it, but, eventually, the Ministry of Finance put down their foot and said, "You have to value your liabilities on a market rate. And based on that, if you're too far away, you need to cut benefits." And that's going to affect pension and payments but also the benefits you have when you're building up. And when things are getting better, the number's going to increase and there's going to be a catch up if you have amazingly cool growth over your portfolio. Yes?

Audience: Just a question. In the U.S., in many ways, I mean, and most people think about their defined benefit plan as compensation. They worked for it. Now, in these alternatives you're describing, do you think people think of it as the same compact between, in this case, the government and the individual?

Lundbergh: Well, this is a contract between the unions and the employer organizations. So the spirit is this is not the financial contract, it's a social contract. And it's very close to defined benefit in spirit, but the Dutch made a bad mistake without sorting out the rules, what's going to happen if you end up having less return than you expected or if interest rate goes down more than you expected and you didn't hedge? So they moved into...basically, removed the covenant, but they didn't sort of take care of the accounting around it, and that's the problem in Netherlands. But this could also be a way of thinking about it, can we soften the benefits in one way or another if you want to stay a funded scheme? Because you have nightmares in this country, right? I read about the Teamsters who had, you know, a full defined benefit scheme and it was, like, chopped to almost, like, 60% or something. It was, like, a horrible amount. If you're, like, retired, all of a sudden, your stable income is gone.

Audience: Thank you for bringing up one of my historical experiences.

Lundbergh: Yeah. And then you have United Kingdom. You have to thank the Brits for a lot. You learn a lot from other people's mistakes, and the Brits have been very generous to share their mistakes with us. In the second pillar, if you're a government employee, you have full benefit, defined benefit. It's no funding whatsoever. It's a pay-as-you-go scheme, straight off the budget of the government. They're really scared now because, I say, with the baby boomers retiring, the cost for paying pension is going to go up dramatically. So, in that case, the U.S. public schemes are, at least, partly funded. Okay, I have to admit that the local governments, they do all, like, 50% funded on a buyout basis. They have done no reform whatsoever. It's a massive... If you say this is a massive, off-balance sheet bet the UK government has, and it's, like, you know, astronomic if you think in terms of how much money it would be if they would move into a funded scheme. They try to move to a defined contribution scheme but they can't because they have to pay pension twice for a transition period, right? You have to continue paying your defined benefit and you have to start paying contributions. So they don't know how to get out of this, so if you're thinking about defined benefit... I mean, this is my interpretation of the public pension schemes in the UK, I mean, that's scary stuff.

So what are the lessons for you to think about? Well, I would say if you're going to move to softer pension rights, you need to apply arbitrage-free valuation. No bullshit with expected returns on that kind of stuff. Because when you do that, you create sort of a system where you have to take risk, otherwise, you're going to have an accounting problem, while, in reality, you might actually want to de-risk. So that's a really bad idea. Only apply observable parameters in your model or your formula because the politician will always start and say, "If we increase growth a little bit to, like, 8%, we won't have any problem, because then we can continue to pay our pensions." So there's going to be a lot of playing. In Sweden, where they made this income pension which I talked about, the politician told the policymakers, "Please, don't introduce anything we can negotiate over because we want to protect the system from ourselves." That was a politician's attitude. So, basically, it's a mechanical thing and the politician's going to say, "Well, it's the rule. There's nothing we can about it." So it sort of worked that way.

And then think about it, the problem with today's defined benefit schemes is that you're going to pay full pension until you can't. So you're going to get a very good pension if you're old, and damn your civil servants, they might not even get pension at all. So you need to make the system fair between generations, and the only way to do that is to adjust the pension payments. And if you design a system anyway, make sure it's robust against demographic humps. So it shouldn't matter if you're a baby boomer generation or a young guy or girl today. You should more or less have a system which is neutral against that, and clear ownership rights, who owns what if we need to change something in the system, so you don't have an endless negotiation where everybody feels like losers.

And the final part is, listen, if you don't have a strong covenant, if you don't have anyone backing your benefits, you need to apply proper risk management when you're managing your assets to make sure that you can survive low interest rates regimes. That if your investment return doesn't come, that you sort of take care of that. You know, think of it, like, hope for sunshine but prepare for a storm, kind of mentality. It requires a lot of different stuff from the pension officer running this scheme because all of a sudden, it's not like in the long run, things will work out, and if it doesn't, well, the taxpayer will cover the bill. You actually have to think about what other problems that can occur down the road, and you know, to think about that and manage risk in a good way. I think the Swedish system could be kind of an idea if you want to implement this because it's not going to cost a lot of money and you move into from a funded system to a pay-as-you-go system with a buffer. That might be a solution, but, of course, there's tons of agency issues here from politicians who basically don't want to pay, right?

Defined contribution, Kurt, you said, basically, there's going to be a huge problem because people haven't saved. It's not a financial problem. It's not like the... I say, it's not a financial problem because liabilities are the same as your assets by definition, but it's going to be a societal problem. At some point, what are you going to do when you have a big chunk of the population who basically have nothing to live from, what are you going to do? So, eventually, it's going to cost money if you don't deal with it. So the idea here is, like, think about...be a bit proactive. The more you get people into saving, the more you create a lifelong income, the easier it will be for people dealing with social security in the future because you force people to save so that they can take care of themselves in retirement.

So, actually, just because you're doing defined contribution doesn't mean the problem has changed. You save money, you want a retirement income, it's just the mechanism in between has changed. Now, people tend to think of DC as, "This is my wealth management thing," right? The bigger the pot, the better. The more dollars I have in my pension account, the better off I am. But, you know, getting a lifelong income, that's something completely different than having a big amount of cash, and risk, should it be measured in losing money on your investment account, or should it be, "I cannot really get the income level I wanted?" So here is, again... I think the Netherlands have done pension policy in a good way. Remember, Netherlands is a very collective society.

A friend of mine, she's a salesperson from the U.S., she said, "Being, like, in Holland is like being in a "Star Trek" movie. They're all like the Borg." We dress the same, we speak with one voice. So it's a very homogeneous country, and they agreed to sort of have a good social contract. So what the interesting part is, it's quasi-mandatory, so anybody...sort of everybody's part of the collective agreements one way or another. There are ways out if you're really creative so you don't have to set pension money aside, but most organizations do that, so everybody working more or less have a pension saving scheme. Another thing is you can choose either between the collective defined contribution, the old pension funds with soft defined benefit rights, or individual defined contribution which is basically a 401(k), and it's all taken care of by the social partners. So, actually, if you work in a company in Holland, you cannot choose your pension provider, your employer does that, or you end up in the social partner-controlled pension fund. You cannot leave the fund as long as you're working for the company. If you shift jobs, you can do a transfer. But then, they were pretty hard on saying, "Hey, independent financial advisers can be very creative by selling products where they have a kickback," so they forbid that.

And they also said, "For the payout phase, you have to take it as an annuity, life-long." You can have a fixed annuity, a real annuity, you can have a variable annuity, but you have to pool your individual longevity risk. This is so cool because there's not a discussion, and you can say...if I'm the government, you could say, "Well, people don't have to pay taxes on the money they put aside. They're going to pay taxes when they draw down the income." So if I do it this way, I'm going to also spread my tax revenues in a clever way. So a lot of old people, they're going to pay taxes and you cannot just take it as a lump sum.

Audience: How much discretion is there in the magnitude of contributions in?

Lundbergh: There's not a big discretion. There's also a fiscal limit, so more than $150,000 U.S., that's sort of the cap on your salary that goes in where you pay your percentage of into your pension scheme. And that percentage is a function on how old you are, so, basically, even in defined contribution plan, when we talk about contribution, they don't have a flat contribution, they think in terms of fiscally that you're in a defined benefit scheme where when you get older, you can put aside more and more money, and when you're young, you can put aside very little. But the point I think here is, like, you have to take a lifelong income, and that's by the government saying, "That's the way it is, like it or not." The interesting part with this, I think, like, pooling individual longevity...I mean, obviously diversification is the free lunch. I mean, the only risk you cannot deal with is how long you're going to live, so pooling individual longevity, that's a free dinner in terms of what you get back. If you die, well, you don't need the cash anyway, and if you live for a very, very long time, it's nice you have some income, you know, when you're old. So I think they basically got a lot of stuff right, the Dutch, but it's very paternalistic and heavy-handed, "This is the way it is." Question?

Audience: But the very fact of just you pulling an annuity doesn't really solve the problem of, you know, how much you're going to end up with in retirement, right? I mean, so, okay, how am I going to be guaranteed to have the money that...like a guaranteed income?

Lundbergh: Well, buying a guaranteed income is really expensive, so you have to do a trade-off between income security and a bit of a variable annuity. But the idea here is you pool your individual longevity, you're forced to do that. So when you get, like, 85 or something, you're probably going to get more coming from other people dying than...

Audience: Oh, yeah, it's a pool, oh, yeah, yeah, yeah, it's a pool. Okay.

Lundbergh: So I think this is a very beautiful system. It works because you have a very coherent culture and people say, basically, "This is what you want." Of course, there's a lot of debates of opening it up and make it more like a UK style, but, actually, I think this is pension, this is social security, so I like this kind of system. There was a question up there, you and you.

Audience: Yes. The variable or fixed annuities, are they important? Are they privately-managed?

Lundbergh: They are privately-managed.

Audience: Okay. But every manager gets, in effect, the same economic deal?

Lundbergh: Yeah. So, basically, you have to buy a sort of annuity product somewhere. If you're in this collective defined contribution, it's already built into the product. So it's a bit like a TA product here in the U.S., the Teachers' Annuity, and if you're an individual defined contribution, it's more like you take a craft annuity out of it. You had a question?

Audience: What's the incentive to move to the individual defined contribution? Is there any, I mean, how do they choose that?

Lundbergh: It's the employer who choose it.

Audience: Oh, it's the employer's choice?

Lundbergh: Yeah. So if you're working for sort of the government or other issues, you typically end up in the pension fund for the government called ABP, which you probably heard of. That's the biggest one, not because they're brilliant, because there's a lot of civil servants involved. So that's why it's a big chunk of money, but in there, you have a payout product in the package.

Audience: What about PGGM?

Lundbergh: It's the same deal. Well, it's everyone working in the health care sector, and that's very close to the government. It's sort of privatized but it used to be a public...

Audience: Am I correct in understanding that the size of your contribution affects the size of your retirement income, but if you die sooner or even before retirement, the money stays in the system?

Lundbergh: Yes.

Audience: Let me try and summarize this system especially because you seem to like it. So it's essentially mandatory, so it's equivalent to a tax. It's forced amortization. One question that I want to see is, when these funds are collected and managed by these financial providers, what sort of restrictions are there on the kinds of portfolios that they can choose? Is that something that's chosen separately by each employer or each group of millions of employers or are there strong regulations about what...

Lundbergh: If you're in the individual defined contribution plan, then they basically, have a default which your employer can agree with the service provider, and it's typically at the age 55, you move into bonds not because of the market moves but because you...

Audience: But that's something your employer dictates, but...

Lundbergh: Exactly. But you can opt out from the default and change the mix.

Audience: And change the mix. You can do that. Now, the second question...

Lundbergh: If you're in the collective defined contribution...

Audience: In this context, normally, if there is a strong social safety net available, you would think that there are pretty strong incentives for you to adopt a lot of risk in your portfolio because you are protected from downside risk by the social safety nets. And if you happen to do really well, then that's great, you get to keep the money. So, somehow, how are those incentives... My impression, for example, in the Chilean program, until they stepped in and told the providers exactly what portfolios they could hold, was that there were lots of incentives to take on those additional kinds of risk. How do they protect you from that kind of behavior?

Lundbergh: If you're in a collective defined contribution, that's more like run, like an insurance company like TIA annuity.

Audience: Right. No, what's to prevent those guys from saying...If it's the entire economy, I understand. They're going to internalize all the effects. If it's a relatively small portion of the economy, you might think that there are strong incentives to, you know, moral hazard in effect services.

Lundbergh: I think most people get stuck in the default no matter what it is. So, you know, most people, I think probably 5% or so, probably you in the room would be candidates for actually having a view, but most people take whatever is offered as a default, they stay with it. So I think the interesting part here is, like, everybody has to save. It's a sort of percentage of your salary, and you have to take a lifelong income. So I like this system in its very paternalistic way because it makes sure that everybody has a decent income in retirement.

Audience: At this level, this is not that different from what we in the United States call the Social Security System. Everybody has to save, so to speak, pay taxes, so the key difference is that it's a funded system rather than an unfunded system. Is that in some sense the same...

Lundbergh: But this is occupational pension. You have the state pension which is the same for everyone, that's the foundation and this is a top up on it.

Audience: This is a top up on the state pension? Okay.

Audience: If you could look at the different levers on that and you think about, "Okay, what makes a good system," if I hear, simplistically, one lever is, do people put money into the system or not? And you're saying, basically, incentives don't work. You have to require...

Lundbergh: Force people to save, mandatory.

Audience: Secondly, how is the money invested? What you're saying is it pays off to be more institutional. The third thing is what agreements do you have the government to do it? The fourth thing is what choices... And you're saying, in Australia, it's unfortunate because people tend to be shortsighted if they have any choices. And, finally, is the question of...

Lundbergh: They're not shortsighted in Australia. I mean, the system is set up that what they do is actually rational, it's just the government give individuals a wrong notch.

Audience: Right, because they tend to. And then, finally, is the question of we were all wrong because people are living too long, right? And then regardless of what we knew 20 years ago, we'll never... So which one are the systems that you say, how do the good systems take care of all these kind of little fair levers of this...

Lundbergh: I think the Dutch system is pretty good in its design. It has some flaws around there.

Audience: But it takes a forced...

Lundbergh: Everybody participate and people save a lot. You have to save for retirement income, so even if you live a long time, you can actually consume. You don't have to think about saving money in case I would live longer. The Dutch don't have...you know, we're talking, like, ordinary people, not the super wealthy. So leaving money behind for your relatives is not what you do in your pension scheme. And I think this is pretty much guided, kind of paternalistic, but if people don't want to save in the first place, this is a system where I think they got it working reasonably well. It's cost-efficient and covers a lot.

Audience: So Jeff and I have talked about what's the right benchmark for pension systems, and what I think I'm hearing you say is that the benchmark that they're using here for the system is retirement income. Is that...

Lundbergh: Yes, from the policy level, right?

Audience: Yeah, yeah, yeah.

Lundbergh: If you're in one of these individual defined contribution plans, of course they're going to tell you this is amount of Euro you have on your savings account.

Audience: How long has this been in effect, and what's the public reaction to it in terms of its efficiency?

Lundbergh: Well, up until, like, 10 years ago, the Dutch pension system was sort of the nation's pride. So it's been around since the '60s, so it's sort of...1960s, it's sort of this established system. It's pretty much in equilibrium in terms of funding. The challenge was when you had to reduce pension because your sort of liability is bigger than your assets was a big discussion who owns what? Who's going to take the pain? And that was sort of the big discussion in Netherlands, but the basic assumption was...

Audience: If I thought that the value of the annuity was a function of your wealth at the time in your collective DC or in your individual DC, and so...

Lundbergh: In individual DC, that's the case.

Audience: But not in the collective DC?

Lundbergh: Exactly, because, then, the scheme says, "Our ambition is to do this," and they want to continue to pay out because, then, it seems there's, like, no problem. So, if they can be a bit creative with accounting, that's what they used to do in the past. And then, the legislator came in very harshly and said, "You have to use an ultimate forward rate when you value your liabilities, and if you're too much out of width, you have to reduce pension and payment."

Audience: Is it also to increase... Well, increased contributions and take down risk levels and change benefits, right?

Lundbergh: Yeah. But then, there's other thing, like, what they've done in Holland, they made sure it's very difficult to be a financial advisor in Holland and earn easy cash, right? Sweden has another challenge. They basically...It's pretty much like the Dutch system, you have the traditional life which is basically an insurance product falling under the solvency regulation in Europe. And you have individual defined contribution which is basically a 401(k). They have social partners and everything, but the government said, "When you retire, you can draw down all your occupational pension savings for a minimum of five years." So what happened, because, in Sweden, they have forbidden commission-based sales, so you have a lot of these very nice independent financial advisors who convince people to draw down their pension for a really cost-efficient collective solution and buy a structured product. So, here, you can say, "The sign was actually pretty good," but because you can draw down money very quickly, kickbacks are allowed, and you actually have a very interesting mechanism in Sweden. You have, like, the auctions in Chile, you have a procurement of pension providers within the collective agreement. So the price is really, really good, but you do have transfer rights, so you can move out. So if you're a good sales organization, you call people up and say, "Hey, what if you move from this really boring pension thing which you don't know what's going to come out and invest with my cool product instead, which is sort of an equity option with protection," and people get basically ripped off. So, here, was the market...

Audience: One perspective is that they're getting ripped off. Another perspective is that they are trying to do exactly what I suggested might be the rational thing to do under these circumstances. If there's a significant enough social safety net and you are not too far away from that net, you have strong incentives to take on lots of risk that's built into a system. I'm just trying to fight a little bit against the idea that we need to protect people against themselves. It's not that. It's that we need to think about all aspects of the system including whatever social safety net, but look at the individual incentives. Individual incentives drive you to behave in a particular way. You need to protect the system against that rather than the financial advisors who wear nice suits and ties and are good-looking and ripping people off.

Lundbergh: So think about the minimum five year draw down, people want to do an early retirement at 60, use all the money, when they're 65, they fall into state pension, and then they say, "Well, I need housing allowance and other kind of social security stuff," so they are gaming... You can't game the system...

Audience: Well, no, that's right, they are gaming the system. It's not necessarily...I don't want to put all the blame on one particular industry as, in some sense, exploiting, necessarily, people's shortsightedness. No. Those guys are serving a felt need given the rest of the system is...

Audience: So if we can echo maybe his comment, if you could put a parallel into sort of you have the pension on the one side, on the other side, what happens to the people who are outside the system? So, for example, in United States, you have a lot of people who don't quite, you know, have jobs that put them to social security systems, so they don't benefit from it. So what happens in Holland or in Sweden, the people that he is referring to, that said, "I didn't work," or, "I was just a bum," like you said, the neighbor of the nurse, what do they get?

Lundbergh: Sweden has a very...and Holland, too, they are very generous in their social security program. So, there are protection mechanism in there, so people...

Audience: That's my point.

Lundbergh: But on the other hand, if you're the government designing the system, why should it design it so that people game it?

Audience: No, no, that's...

Lundbergh: That's sort of my point, right?

Audience: I think, I take your point entirely. I would describe the kinds of Dutch and the Swedish system as, in an American context, think about we've got a baseline social security system which has pretty extensive coverage. And then, on top of that, you're layering on an additional system which we currently have in the U.S., the 401(k) system, but it's voluntary there's no required annuitization, and there are no restrictions on the kinds of portfolios that you can hold. I think you're describing a system which has...it's mandatory, on top, there are restrictions on the kinds of portfolios you can choose, and there's mandatory annuitization. That's what you're describing. The losers in that system who knows how big they are, if you are the kind of person who would like to have a very modest standard of living, but you want to leave big bequest to your children, boom, sorry, you lost out because there's mandatory annuitization. And so that's fine. I mean, it's okay. The hell with the kids, anyway. What have they ever done for us?

Lundbergh: We pay their college anyway, and university.

Audience: Yeah. So, no, I understand the...and what it does ensure is that there are no elderly people eating cat food. They might have wanted to eat cat food, but that's okay. That's them.

Lundbergh: At least they can eat the more expensive one. I'm going to jump a couple of countries here because I think the whole point is, you know, when you do pension policy, think about the end-user, think about the consumer when you design the policy. And I think...my strong belief is you should target a lifelong income because if this is part of sort of mandatory saving, I mean, why make it mandatory unless you have a purpose right? So you can't say, well, if you have social security, just run with it and people can save whatever they want. Why do you need to force people to save for pension if it's not part of making, you know, a societal purpose? And my experience is that, for most of the system, the lesson learned is that the retail model isn't clear on price and quality. So, actually, good pension systems seem to have an institutional buyer who can get a good price from the market, and then competition works actually quite good. So the interesting part here is when you look at this, I'm going to come back to what I said. You know, when you do pension policy, see the world for what it is, not for what you want it to be. And if you do that, you can do sort of fact-based pension policy rather than idealogical-driven pension policy. But this, I'm going to talk a bit more about that in the panel, but this is the true challenge. How do you get people who actually want to see the world for what they want to be to actually accept facts?

Audience: So, I want see the world for what it is. Can you go back to your previous slide? You know what this is? These principles exactly what we use in the employer-provided health insurance market in the United States. And the judgment of people who looked at that, it has turned out to be a complete unmitigated disaster. We have competition on the institutional market, not on the retail market, and so, therefore, you have a completely distorted market because these idiots in HR don't know anything about the individual person. We don't have any problems in the automobile insurance market, we don't have any problems with property insurance, or anywhere else. Health insurance, that's how it operates. So, at least in the United States, we've tried this experiment in one market, it has not turned out well. It's also a lesson worth... I'm seeing the world for what it is. I'm not seeing the world for what I want it to be.

Lundbergh: In the UK, they basically have NEST which is sort of a government entity, and they basically don't have a hardcore commercial interest. In Scandinavia and Holland, you do have a social part and union employers coming in negotiating, so then it's sort of a bit further away from the HR officer, and they're trying to do a good deal. I think when you're letting pure commercial forces in, it can work but you need pretty strong regulation, otherwise, well, you're going to have the experiment.

Audience: Can I just ask one... Just, and you can talk maybe later in the afternoon, but one thing that I don't see on there that is debatable, of course, but if I have to put in a certain amount, mandatory, and I have to take it out in a certain way, why shouldn't everybody get the same investment results? In other words, I got it coming in and I got it going out in the same way. Why shouldn't the middle be the same?

Lundbergh: Well, because you put money in different sequence depending on...

Audience: No, no. The investment products, basically...Portfolio, why wouldn't that be common across all...

Lundbergh: In the collective solution, they run it like an insurance company more or less, so it's one policy.

Audience: Right. But in the individual markets which are parts of the systems, that's not true.

Lundbergh: But there's a strong belief among many policymakers that people want to make decisions. It's really important they can make decisions, and the market, of course, is catering to that need. But once people made a choice, they typically don't change it. We have some interesting cool data from Sweden on actually how free...

Audience: Well, so we hope that they end up in the right spot, is what we're saying. They have some qualified default plan. We hope they stay there because that's best.

Lundbergh: Yeah, and I think the key issue, the default has to be really, really good, and if you have that, yeah, why bother? And in the UK, I think it's more like 94% or so are in the default. So, ordinary people, they just take the default. They hope someone actually did some thinking about it and you go for it. You don't think so much about pension. You have other more important things to think about like your work and your family. I mean, you don't want to sit, like, home on Friday afternoon thinking about going through all the possible funds you can invest in, in all the different platforms you have to be registered in. You just leave it and say, "Whatever."