Traditional DB Final Pay Plan
Society

Society's Needs & Risks (Composite Rating)				
Criteria	**Objective**	**Rating**	**Evaluation**	**Effect of moral hazard**
Adequate	Protects vulnerable citizens.	**Yellow-Green**	Protects those who are able to hold down employment for long periods of time; less protection for workers who change jobs frequently.	Adequacy depends on employer paternalism including the willingness to maintain benefit levels. Would employers provide benefits to all low-paid employees without statutes requiring such coverage?

Those who have the hardest time preparing for retirement should be well protected

DB designs protect all worker, but only if you're able to hold down a job for a long period of time with a particular employer.

But, society only gets these benefits if an employer sets up a generous plan. And, if you took off coverage restrictions, would employers cover all workers (or only the well paid?

Retirement 20/20

Measurement Framework

Society

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Traditional DC	Adequate	Protects vulnerable citizens.	**Red-Yellow**	If the employer contribution is paid as a match, low-paid individuals may have difficulty earning the match. All participants vulnerable to poor investment choices, swings in markets. No risk pooling. Individual accounts have higher administrative fees than pooled accounts.	Regulators may be susceptible to lobbying by investment firms to make investment choices available that aren't always in individuals' best interest. Program adequacy dependent on employer paternalism (employer contribution level, paid directly or as a match).

Those who have the hardest time preparing for retirement should be well protected

DC plans don't do a good job protecting vulnerable citizens – no risk pooling, not everyone can save, and everyone can make bad choices.

Plans are subject to poor design choices or failure to protect citizens against unscrupulous investment advisors.

Society

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Traditional DC	Adequate	Protects vulnerable citizens.	**Red-Yellow**	If the employer contribution is paid as a match, low-paid individuals may have difficulty earning the match. All participants vulnerable to …	Regulators may be susceptible to lobbying by investment firms to make investment choices available that aren't always in individuals' best interest …
Dutch collective	Adequate	Protects vulnerable citizens.	**Green**	Establishment of plans by industry group/occupation can ensure widespread access, consistent coverage and adequate benefit levels.	Does not rely on employer paternalism to maintain benefit levels. Conditional indexation could negatively affect adequacy.

Those who have the hardest time preparing for retirement should be well protected.

Because plans are established by industry, individuals don't have to stay with one employer to get full benefits. As such, easier to protect citizens.

Because the plan has risk sharing elements (conditional indexation) could have a situation where benefits are inadequate due to foregone indexation

Traditional Final Pay DB Plan
Employer

Employer Needs & Risks (Composite Rating:)				
Criteria	**Objective**	**Rating**	**Evaluation**	**Effect of moral hazard**
Responsive to owners	Responds to needs of owners, e.g., shareholders for public companies, which may limit amount of risk to be taken.	**Red-Yellow**	Financial commitment may extend beyond lifespan of employer. Can decrease or eliminate future benefit accruals. Can be impediment to other business decisions.	Managers have concerns around cost volatility, particular accounting cost, which may lead to practices that are not in the best interests of owners. Can mitigate volatility but it has not been common practice.

Owners of companies don't take (undue) risk that doesn't support core business; Big factor: can plan respond to changing business conditions?

DB plan formulas only change prospectively, plan obligations long duration. Plan can continue to grow as company shrinks so plan dwarfs balance sheet and ER becomes a hedge fund that makes widgets. With proper hedging, this wouldn't happen (so red-yellow not red).

Managers' interest (bonus) creates a moral hazard which may lead managers to take risk when the best interest of owners might be to hedge risks.

Employer

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Traditional DC	Responsive to owners	Responds to needs of owners, … which may limit amount of risk to be taken.	**Green**	Known financial commitment. No long-term commitment.	Moral hazard not significant.

Owners of companies don't take (undue) risk that doesn't support core business; Big factor: can plan respond to changing business conditions?

DC plan poses no risk to owners. Short-term commitment. Employer can instantly change cost level as it is cash only.

Managers can't make the plan less responsive to owners. Therefore no moral hazard exists.

Employer

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Traditional DC	Responsive to owners	Responds to needs of owners … which may limit amount of risk to be taken.	**Green**	Known financial commitment. No long-term commitment.	Moral hazard not significant.
Dutch collective	Responsive to owners	Responds to needs of owners, … which may limit amount of risk to be taken.	**Yellow**	Contribution levels not set by employers, so they may be faced with higher costs when unable to pay them for other business reasons. Only choice would be to push to employees which may not be feasible.	In case of market downturn or severe economic event, would employers be asked to step in and rescue plans?

Owners of companies don't take (undue) risk that doesn't support core business; Big factor: can plan respond to changing business conditions?

Good news: no long-term risk. Bad news: no control over cost (contribution level).

If there is a significant negative event, would the plan need to be rescued? Is the plan ultimately relying on employers to rescue it should the worst happen?

Markets Needs & Risks (Composite Rating:) (includes both financial markets and intermediaries (e.g. insurers))				
Criteria	**Objective**	**Rating**	**Evaluation**	**Effect of moral hazard**
Efficient risk bearing	Plan efficiently pools idiosyncratic risks and hedges systematic risks (both economic and demographic).	**Yellow-Green**	Plan efficiently pools longevity and many other retirement risks. Plan can effectively hedge investment risks although instruments aren't there for systematic longevity risks.	Managers tend not to choose risk hedging instruments. Managers may be tempted to choose risky investments that lower cost today but pass risk to next generation.

Plan efficiently uses the markets to pool and hedge risks. If risks are taken, they are understood and disclosed.

DB plans by design pool idiosyncratic risks. They can, by design, also hedge other risks. Some hedges aren't available (e.g. systematic longevity risk).

While hedges are available, they aren't used. Managers (and others) have thought of these plans as risk bearing instead of risk hedging – can you ever change that mindset?

Markets

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Traditional DC	Efficient risk bearing	Plan efficiently pools idiosyn-cratic risks and hedges systematic risks (economic and demographic).	**Red-Yellow**	Benefits of mutual funds can lower costs of investing (although they tend to have high fees). Plans do not pool risk, particularly longevity risk.	Moral hazard not significant.

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By design, does not pool idiosyncratic risks. Plan could be used to allow individuals to take risk cost-efficiently. Should also say that funds could be designed to better help individuals' hedge risks.

There aren't ways to make the risk bearing LESS efficient in a DC plan.

Markets

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Dutch collective	Efficient risk bearing	Plan efficiently pools idiosyn-cratic risks and hedges system-atic risks (economic and demographic).	**Yellow-Green**	Self adjusting mechanisms spread effect of risk back to participants immediately; mechanisms are described in design and not developed as needed. Lack of market instruments available to hedge systematic risks.	Managers tend not to choose risk hedging instruments. Managers may be tempted to choose risky investments to meet inflation promise putting future generations at risk.

Plan efficiently uses the markets to pool and hedge risks. If risks are taken, they are understood and disclosed.

Plan pools idiosyncratic risks and uses self-adjusting mechanisms to share other risks. Lack of ability to hedge certain systematic risks makes this yellow-green.

Plan has enough check and balance mechanisms that moral hazard isn't as great as DB, but there is still going to be temptation to take risk rather than hedge risk.

Traditional DB Final Pay Plan
Society

Criteria	Objective	Rating	Evaluation	Effect of moral hazard
Robust	Fair, covers great majority, creates shared economic growth, avoids moral hazards.	Yellow-Green	DB plans can provide benefits across income strata, use markets efficiently through group investing and expertise of well trained advisors. However, degree of robustness depends on employer paternalism.	Wide range of employer latitude to set benefit level and decide to follow best funding and investing policies.

How well does the plan leverage (cover rich and poor, create common goals, leverage expertise, avoid pitfalls?

If lots of employers have plans with decent formulas, then participants and taxpayers are better for their existence. But, requires employer paternalism to establish.

Even if plans are established, latitude in level of benefits and security provided by the plan, so the security isn't as strong as it could be.

Society's Needs & Risks					
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Traditional DC	Robust	Fair, covers great majority, creates shared economic growth, avoids moral hazards	**Yellow**	Designs that focus on matching favor wealthier individuals who are more easily able to save. Very hard to create shared growth for low paid.	Plans require participants join and set robust contribution levels; automatic features can offset but not completely.

How well does the plan leverage - cover rich and poor, create common goals, leverage expertise, avoid pitfalls?

Shared growth doesn't work if you don't create conditions that favor low-paid. Also inefficient re: expertise, although not stated here.

Voluntary individual participation makes it hard to create shared growth even among middle class.

Society

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Dutch collective	Robust	Fair, covers great majority, creates shared economic growth, avoids moral hazard	**Green**	Provide benefits across all income strata, use markets efficiently through group investing and expertise of well trained advisors.	Self-adjusting mechanisms could deter use of hedging mechanisms.

How well does the plan leverage (cover rich and poor, create common goals, leverage expertise, avoid pitfalls?

Plan can achieve wider coverage because it is across industry groups, not an individual employer. Leverages expertise, design minimizes pitfalls (e.g. no lump sums).

Plan could over rely on self-adjusting mechanisms, thereby taking inappropriate risk, particularly as population or industry ages.