You Get What You Pay For: Guaranteed Returns in Retirement Saving Accounts

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Introduction

- Several states are considering guaranteed returns as a part of state-level retirement programs
  - Some U.S. plans have these features already
- Stock market volatility during the Great Recession created recent interest in guarantees
- Paper highlights some key issues and aspects related to the offering of a guaranteed return

Key Conclusions

- Guarantees can and do exist, but you don't get something for nothing
  - The benefits of such guarantees appear to be smaller than commonly appreciated
  - The costs are higher than commonly appreciated and are imposed on either taxpayers or savers (not insurers)

Guaranteed Minimum Return

- The minimum can vary
  - Zero nominal return (“return of principal”)
  - Zero real return (“inflation protection”)
  - Some explicit positive return (either real or nominal)
  - Linked to a market return (bonds, stocks)
- Can apply to:
  - returns during a given year for contributions made in the past
  - returns over several years for contributions made in a given year
- Can be constant or vary over time
- Can be enforced:
  - annually
  - at the end of a specified period
  - when triggered by an event (e.g., worker leaving firm)

For all minimum return guarantees

- If the investment earns less than the minimum, the insurer “tops off” the saver’s return
- If the investment earns more than the minimum return, no insurer payment is made, and the saver keeps the upside
- Saver gets a put option from the insurer

Net Benefits

- Guarantee of retirement saving only provides partial portfolio protection
  - The basic retirement package for most people is dominated by Social Security and Medicare
  - For those with large amounts of retirement saving returns, the guarantee is less needed
  - For those with small amounts of retirement saving returns, the guarantee provides limited benefits
- Under most guarantee proposals, savers explicitly or implicitly pay for the guarantee

Economy-Wide Costs

- The costs are the economic resources needed to provide the guarantee
- The economic costs do not depend (to a first order approximation) on <u>who</u> provides the guarantee
- Government budget documents will systematically understate the economic costs
  - Discounting at the government's borrowing rate
  - Focus on cash flow rather than economic resources

Who Pays?

- Taxpayers or savers will bear the costs
  - Taxpayers, if funded by general revenues
  - Savers, if funded by (or accompanied by):
    - Explicit premiums
    - Rate of return collars
    - Portfolio constraints
    - Reserve fund

Premiums

- Typically paid by either the worker/saver or the employer

- Probably borne by the worker via lower net take-home wages in either case

Rate of Return Collars

- Combines a minimum guaranteed return to savers with a maximum return
- Any returns above the maximum go to the insurer
- The saver pays for this by forgoing upside returns
- Note that cash balance plans have collared returns (minimum return = maximum return)

Portfolio Constraints

- Market returns can be insured at (virtually) no cost to the insurer if sufficient constraints are placed on the saver's portfolio
  - A T-bill return can be guaranteed by requiring the saver to put all funds in T-bills
  - An S&P 500 return can be guaranteed by requiring the saver to put all funds in the S&P 500 index fund
- The saver pays for this guarantee by forgoing the option to change the investment
- This is effectively a DIY guarantee
  - Costless to the insurer
  - Worthless to the saver

Portfolio Constraints

- The costs rise when assets and liabilities are mismatched – when savers want "to have their cake and eat it too"
  - E.G., if savers want a T-bill guaranteed return but want to invest in the stock market and keep the upside

Reserve Fund

- Guaranteed minimum return combined with trustees determining any additional payment based on reserve fund strategies
  - TIAA "Traditional Annuity"
  - Ghilarducci proposal

- Saver pays for this by accepting lower than average returns

Conclusions

- It is possible to provide guarantees to retirement saving returns
  - Many countries and some private plans in the U.S. offer guaranteed returns
- But
  - Savers typically pay for the guarantee via lower returns (explicitly or implicitly)
  - If not savers, then taxpayers
  - You get what you pay for