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

William G. Gale, David C. John, and Bryan Kim

Retirement Security Project
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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 who 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