Review of Pension Revolution: A Solution to the Pensions Crisis
By Keith P. Ambachtsheer.

Reviewer: John H. Biggs, Retired Chairman and CEO of TIAA-CREF
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For the last 30 years Keith Ambachtsheer has used his perch in Canada as a pension consultant and the Director of a pension research center at the University of Toronto to gather data, study, comment on and promote improvement in the pension practices in North America (using international experience from his Dutch homeland and a few exemplary British models). His personal hero is Peter Drucker, and the Ambachtsheer style suggests Drucker: placing down-to-earth business pension matters in a big-picture framework of global social issues with macro-economic implications.

Ambachtsheer’s views are well-known to students of pension fund management. This is his third book and he has written innumerable articles, editorials in pension trade magazines along with his regular news-letters to his advisory service clients.

Pension Revolution introduces to a wider audience some new ideas from the academic world: the startling implications for pension finance from the work on behavioral finance, a shift in analysis on defined benefit (DB) conflicts and finance from contingent options theory, and a much strengthened point of view on governance.

However, the title words of pension “revolution” and “crisis” seem strident when we stand back and look at the relative success of the evolving pension system in the countries he primarily covers: North America, UK, Netherlands, Australia—countries that have done a comparatively good job in funding employer and individual pension plans. He does not discuss the truly critical countries—Japan, most of continental Europe—where the generous Pillar 1 pay-go systems are being hit with a true demographic crisis. And those countries have little in the Pillar 2 and 3 private funding.

For example, in the U.S. we have Pillar 2 and Pillar 3 funding of well over one year’s GDP. On 12-31-2006 we will have roughly $16 trillion in assets compared to $13 trillion in GDP, for a 120% ratio. DB assets will be roughly equal to our Projected Benefit Obligations, all on a market value basis and
with reasonable discount rates. On the other hand France, Germany and Italy don’t have even 10% of their GDP in Pillars 2 and 3, accompanied by worse demographics than the U.S.

Ambachtsheer states at the beginning of Pension Revolution that the “the old pension paradigm is dead, and a new paradigm is needed” and that the “the 2001 to 2005 experience has shown the old pension paradigm to be fatally vulnerable to adversity, and in urgent need of renewal”. And yet his solutions use the core elements of the “old paradigm” in his revolution, but with better governance and the automatic features that are now being widely adopted. The core of the real long term “evolution” is the dramatic shift to defined contribution (DC) plans, a change in the last thirty years which Peter Drucker knew nothing about when he was writing in 1976. This is the change that has brought about the strange alliance of workers and investors that Drucker predicted in his The Unseen Revolution. How Pension Socialism Came to America.

Ambachtsheer sees the pension adversity of the 2001 to 2005 period as the result of a “perfect storm”, when we had the “freak” situation of simultaneous declining asset prices and declining interest rates (with consequent sharp increases in pension liabilities). He omits the third element (don’t “perfect storms” require three events to be called “perfect”?). September 11, 2001 was that third element in the U.S., creating a financial disaster for the airlines and consequent frightening increases in the PBGC liabilities. He does have an interesting chapter on the UAL bankruptcy, but it is used more for illustrating the contested governance issues in a DB plan.

Pension Revolution includes 46 chapters of largely 4 to 5 page reviews of letters he has sent to his consulting clients over the last 5 years. Their style is informal, and journalistic. The book, consequently, is quite repetitious and frequently disjointed. The central points could be condensed into a brief paper, which Ambachtsheer has in fact done in the 2007 January/February issue of the Financial Analysts Journal.

The central theme in Pension Revolution is his description of TOPS, The Optimal Pension System, a kind of vision of how an ideal pension system should be organized. The author of this review, for obvious reason, welcomes the selection of TIAA-CREF as a model of the ideal TOPS system.
Ambachtsheer’s vision for a well designed structure is a DC plan which would avoid all the fuzzy conflicts and risk features of a DB plan, with an overlay of (1) provisions avoiding “human foibles” (the behavioral finance contribution) and (2) a governance structure that eliminates the agency conflicts and high costs of for-profit suppliers. The second overlay was a major theme for Peter Drucker.

The first overlay of “foibles” are those addressed by automaticity—opt-out arrangements for enrollment avoiding the need for any deliberate action to opt-in, simple default investment options and semi-compulsory (at least requiring deliberate opt-out) annuitization provisions. The logic of this is now well-known, and is even embedded statutorily in the recently enacted Pension Protection Act in the U.S.

One of the adverse developments in the U.S. is the evolving move toward giving lump-sum options upon retirement, a standard feature of a 401(k) plan. Sadly there has been a major trend under DB plans to grant such an option, driven in part by the widening use of hybrid plans, like “cash balance” plans.

At TIAA-CREF every effort has been made to present the DC plan as an income replacement vehicle, by providing annual projections, not of lump-sums, but of monthly incomes that current accumulations and future contributions would provide. Additionally the variable and fixed annuities are designed with flexible payout arrangements and investment options, with the latter including not only guaranteed fixed income but also several stock funds, real estate, nominal bond funds as well as inflation indexed bonds. Changes in investment choices can be easily made after annuitization. I believe this model, which is rare, captures the goal Ambachtsheer has for his TOPS plan.

On governance TOPS’s vision seems more utopian. Ambachtsheer wants non-profit, or mutual, or “shareowner cooperatives”, or “single purpose pension co-ops” to be the governing entities of pension funds. TIAA-CREF does happen to fit that definition, but few other such entities exist. Mutual life insurance companies are down to just a few surviving entities—although those few are of extremely high quality. Vanguard is unique in the U.S. mutual fund business as a non-profit mutual. State pension systems might be so described except they suffer from severe political conflicts. Drucker also predicted the growth of conflict free institutions, without a
distorting profit motive, or conflicts with related business activities. Accordingly, he fearlessly predicted the demise of universal banks providing pension investment services.

Perhaps a better emphasis might be placed on low-cost suppliers of pension services, allowing for the possibility that for-profit institutions might meet that goal. At last there are signs in the U.S. that the public is waking up to the fact that some very high costs are eating away returns in their 401(k) investments. However, the experience in the U.S. mutual fund business does not give much hope for broad progress. Inexpensive “direct written” funds, purchased with a simple call to a call-center, represent a way to avoid high cost broker/agent sold mutual funds. Yet, less than 20% are sold by the direct route.

Pension Revolution has much excellent material on the governance aspects of pension funds. Ambachtsheer frustrated this reviewer in speaking of pension fund “governance” in general without distinguishing the very different structures faced by different entities. The TOPS agenda seems best applicable to state and municipal plans or large multiemployer plans like TIAA-CREF. The governance issues for corporate sponsored plans seem very different. In typical American corporate plans the difficulty is how to divert the financial management function from the style and compensation arrangements appropriate for the core business over to the difficulties of creating an effective investment environment, with a very different risk and reward orientation.

High on the Ambachtsheer agenda is a governing board that knows how to govern, leaving management to an effective CEO sensitive to the asset-liability mismatch or surplus risk (a DB issue) and a well articulated investment policy. Much of the book is devoted to defining such a policy. He comes down firmly on using active management, separating out short and long-term styles. He sees risk as clearly as a financial economist, needing a liability driven strategy, which ironically undercut his devotion to the Drucker “pension revolution” by favoring much more DB investing in bonds. Drucker and Ambachtsheer see the revolution coming from the workers owning the means of production through their majority position in holding company stocks—but bond holders are hardly revolutionaries. On the other hand, the massive move to DC plans with a transparent and direct interest by participants in company stocks does lead to a revolutionary
worker/investor coalition. This will be expressed in a new-found assertiveness by institutional investors.

Ambachtsheer shows a thoughtful, comprehensive way that pensions could be improved. Although “crisis” and “revolution” may be exaggerations, it is understandable that the prophets of needed change like Drucker, the financial economists and Ambachtsheer are tired of being ignored.