Spotlight

Guaranteed Returns in Retirement Savings Plans: Are They Worth the Cost?

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State-sponsored retirement savings plans could help millions of private-sector workers who are not covered by an employer plan to build financial security. Several features will help such plans be more effective and produce more secure retirements. This report discusses investment guarantees that promise to deliver at least a certain level of return. It also covers both the costs of such guarantees and their potential value to savers.

Introduction

Several states have recently created state-sponsored retirement savings plans for employees of small businesses, and many other states are considering doing the same.[1] A key element in the design of such plans is the decision whether to provide a minimum level of guaranteed returns to savers. Continued concerns about retirement security—as well as lingering apprehension from the 2007–09 financial crisis, which showed just how quickly assets accumulated over a lifetime can lose their value—are behind the desire for guaranteed returns.

Guarantees are a classic example of the economics dictum that it is impossible to get something for nothing. In principle, rate-of-return guarantees are simple: they protect savers from losses and ensure that they receive a minimum return on their investments. In practice, however, guarantees raise a number of complex issues and are more costly than one might think. First, someone—the saver, the plan sponsor, or the taxpayer—has to pay for the guarantee. When the government pays, it tends to severely underreport the real economic costs of the guarantee in budget documents. Those costs are resources that must be forgone to finance the guaranteed return. Guarantees offered by private insurers reflect their true economic costs more accurately, and they are often quite expensive. Second, the net benefits of rate-of-return guarantees may not be as obvious as they seem, because (a) markets often respond quickly and (b) social security, Medicare, and housing constitute the majority of most people's retirement resources.

Types of Guarantees

A standard rate-of-return guarantee is an insurance policy that ensures that a saver receives at least a minimum return on his or her investments. When

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those investments earn less than the guarantee during a set time period, the saver receives the difference between the actual earnings and the amount promised by the guarantor. If the investments earn more than the guarantee, the investor receives the investment earnings; the insurer (either government or private) does not make a payment. (Guarantees with more complex designs, discussed later, have different payout structures.)

The most common form of guarantee provides a minimum annual rate of return on principal investments (e.g., 3 percent). But guarantees come in many forms. Some insure only the principal. Others adjust the guaranteed return for inflation or cover longer periods. Some base the guarantee on the rate of return on a specific type of government bond, government bond portfolio, or market portfolio.

A number of existing and proposed plans in the United States and in other countries around the world offer minimum rate-of-return guarantees.[2] Several Latin American countries have instituted guarantees, often in conjunction with social security reforms. Denmark, Germany, Japan, Switzerland, and other member countries of the Organisation for Economic Co-operation and Development offer variants of a guaranteed rate of return.

The Teachers Insurance and Annuity Association (TIAA) offers a traditional annuity with a guaranteed minimum rate of return. The guarantee is set annually at the time of contribution and remains valid until distributions for contributions made in that year begin. The rate for new contributions is adjusted each year in conjunction with economic conditions and has recently varied between 1 and 3 percent, adjusted for inflation. The TIAA Board of Trustees may also declare, on a year-to-year basis, additional rates of return for a specific year only, but those rates are not guaranteed for future years. TIAA credited such additional amounts every year from 1948 to 2010.[3]

Cash balance plans are a hybrid form of pension. From the saver's perspective, cash balance plans closely resemble retirement savings plans; in legal terms, however, they are defined benefit plans and are regulated accordingly. Cash balance plans provide their participants notional accounts to which the plans credit an annual return. The plans essentially offer a guaranteed return, with both the minimum and the maximum rate set at the same level.

There have been numerous proposals for minimum guaranteed rates of return in the United States. Martin Feldstein and Andrew Samwick propose private accounts in Social Security with a real principal guarantee (an inflation-adjusted minimum return of zero).[4] Feldstein and Elena Ranguelova propose "accumulated pension collars" (minimum and maximum returns) on private retirement accounts as a way of ensuring that partial privatization of Social Security does not reduce benefits relative to current law.[5] Teresa Ghilarducci proposes retirement savings accounts managed by a government entity with a minimum guaranteed real return of 3 percent. Her proposal would set up a system, similar to the TIAA example, whereby trustees would build and manage a reserve fund and could allocate additional rates of return to savers.[6] The California Secure Choice Retirement Savings Investment Board is investigating the feasibility of providing a minimum guarantee, and the Connecticut Retirement Security Board is considering a state-run automatic Individual Retirement Account program with a minimum guarantee.

Benefits of Guarantees

The benefits of guarantees depend on several factors. These factors include the expected level and variability of savers' retirement wealth, the savers' aversion to risk, and the share of retirement wealth that savers expect their guaranteed accounts to generate. The value of a guarantee also depends on certain psychological factors, including an individual saver's aversion to experiencing a loss if an investment does not produce the expected results or aversion to feelings of regret if a forgone investment would have proved profitable.

Costs of Guarantees

Guarantees are not free. In some cases, savers or plan sponsors pay for the guarantees through

insurance premiums. Alternatively, the costs of the guarantees may be implicit. For example, as in the TIAA example, savers may allow the insurer to manage the fund and to pay a minimum return plus any additional amount that trustees deem appropriate. The costs to savers take the form of the lost opportunities for higher returns.

Savers can also pay for guarantees by accepting restrictions on their investments. Restrictions on a saver's portfolio may greatly reduce an insurer's costs, but they impose costs on the saver. For example, if savers are required to invest their contributions in Treasury bonds, a guaranteed minimum return equal to the Treasury bond rate (less an administrative fee) can be insured at virtually no cost to the insurer. But those are precisely the conditions under which the guarantee is worthless to savers, because they can receive the Treasury bond rate anyway if they simply invest in Treasury bonds. A hypothetical guarantee of this type may be inexpensive for insurers, and it might even be a deal savers would be willing to accept, but it would not be costless. In particular, savers would be forgoing the opportunity to earn higher returns.

For example, one study found that if savers placed their entire portfolio in equity, it would cost 3.6 percent of contributions to guarantee a return of principal (a nominal zero return) over 10 years and 16.1 percent of contributions to guarantee a Treasury bond rate. If the saver were required to hold half of the portfolio in bonds and half in equity, these costs would fall to 0.2 percent and 8.1 percent of contributions, respectively. But of course the expected return to the saver on the split portfolio would be lower than on the all-equity portfolio.[7]

Another way savers can pay for a minimum guarantee is by selling a portion of their upside potential returns.[8] In this scenario, savers are guaranteed a minimum rate of return, but there is a ceiling on the maximum return they can keep, with any actual return above that ceiling going to the insurer. This setup is usually known as a *collar*. For example, savers might be guaranteed that their investments will earn no less than 3 percent annually. In exchange, the savers forfeit to the insurer any upside beyond a specific ceiling (e.g., 6 percent annually). Savers' portfolios would thus be collared to generate a 3 to 6 percent annual rate of return. An appropriately designed collar allows savers to receive a guaranteed rate of return and the insurer to be compensated for the risk it is underwriting.

What would happen if the government paid for guarantees? The overall economic costs would still be the same as if a private entity provided the insurance. But the government's budget would show the costs the government incurs, not the economic value of the government's risks. Thus, guarantees offered by the government may look like a good deal, but the true economic costs of those guarantees are not accurately reported in the budget. And this problem is not just a reporting issue; the government (i.e., taxpayers) and the economy still have to bear the costs of the guarantees.

Conclusion

Rate-of-return guarantees for retirement savings plans are getting a lot more attention in the wake of the recent financial crisis, when savers near retirement suffered steep losses. Although guarantees in various forms clearly offer some benefits to savers, those benefits come at a cost. The costs can be paid in many different ways, including insurance premiums, caps on the maximum returns that savers can receive, and portfolio restrictions. The last option may also serve to cap returns and limit savers' potential risk. Government provision of guarantees is not a panacea—it simply hides the economic costs of the policy.

1 Pension Rights Center, "State-Based Retirement Plans for the Private Sector" (fact sheet, Pension Rights Center, Washington, DC, 2015).

2 Marie-Eve Lachance, Olivia S. Mitchell, and Kent Smetters, "Guaranteeing Defined Contribution Pensions: The Option to Buy Back a Defined Benefit Promise," *Journal of Risk and Insurance* 70, no.1 (2003): 1–16, doi:10.1111/1539-6975.00044; John A. Turner and David M. Rajnes, "Retirement Guarantees in Voluntary Defined Contribution Systems," in *The Pension Challenge*, ed. Olivia S. Mitchell and Kent Smetters, (New York: Oxford University Press, 2003), 251–67; John A. Turner and David M. Rajnes, "Guarantee Durability: Pension Rate of Return Guarantees in a Market Meltdown" (paper presented at the 10th anniversary conference of the Center for Research on Pensions and Welfare Policies, Collegio Carlo Alberto, Torino, Italy, September 24–25, 2009).

3 John Biggs, "How TIAA-CREF Funded Plans Differ from a Typical 401(k) Plan." *Trends and Issues*. February 2010: TIAA-CREF Institute.

4 Martin Feldstein and Andrew Samwick, "Potential Paths of Social Security Reform," *Tax Policy and the Economy* 16 (2002): 181–224.

5 Martin Feldstein and Elena Ranguelova, "Accumulated Pension Collars: A Market Approach to Reducing the Risk of Investment-Based Social Security Reform," *Tax Policy and the Economy* 15 (2001): 149–65.

6 Teresa Ghilarducci, "Guaranteed Retirement Accounts: Toward Retirement Income Security" (EPI Briefing Paper 204, Economic Policy Institute, 2007). See also Teresa Ghilarducci, Robert Hiltonsmith, and Lauren Schmitz, "State Guaranteed Retirement Accounts: A Low-Cost, Secure Solution to America's Retirement Crisis" (Schwartz Center for Economic Policy Analysis, New School, 2012).

7 Marie-Eve Lachance and Olivia Mitchell, "Understanding Individual Account Guarantees," in *The Pension Challenge: Risk Transfers and Retirement Income Security,* ed. Olivia Mitchell and Kent Smetters (Oxford, UK: Oxford University Press, [YEAR]), 159–186. See also Marie-Eve Lachance and Olivia S. Mitchell, "Guaranteeing Individual Accounts," *American Economic Review* 93, no. 2 (2003): 257–60.

8 Feldstein and Ranguelova, "Accumulated Pension Collars"; Kent Smetters, "Controlling the Cost of Minimum Benefit Guarantees in Public Pension Conversions," *Journal of Pension Economics and Finance* 1, no. 1 (2002): 9–33.

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