Pensions science

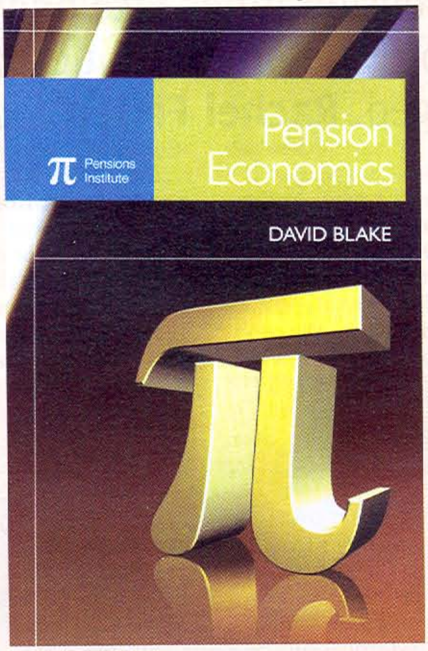
Pension Economics
by David Blake
ISBN 13 978 0-470-05844-2
256 pages hardback
Price £29.99 (€45.66)
John Wiley & Sons

Pension Economics is aimed at what David Blake calls in the preface of this book a pension scientist. This is someone who can deal competently with the multidisciplinary nature of pensions. Many professionals working in the pension area have a deep understanding of their specific expertise, but do not have a good idea about the big picture of how the various aspects of pensions fit together. Blake's book is the first of a series of books developed at the Pensions Institute at Cass Business School aimed at training professionals who can put the various pieces of the complex pension puzzle together.

The first chapter of Pension Economics provides an excellent overview of the various types of pension schemes. I have never seen such a concise description of pension institutions that was so crystal clear. The introductory chapter points out that pension economics is about consumption smoothing. In particular, pensions help to smooth consumption across time, contingencies and people. Pension institutions thus involve saving, insurance and redistribution.

The book then moves on to discuss how individuals and corporations make decisions on pensions in chapters 2 and 3. The second chapter on individuals takes a traditional economic approach by assuming rational decision making in a life-cycle context. The chapter focuses on saving and retirement decisions. A nice empirical section tests and estimates the model on the basis of UK data. The chapter restricts itself to deterministic models. In the next edition of the book, I would like to see a section on optimal life-cycle investment in the presence of financial risk. Indeed, risk is a key consideration in individual decision making on pensions.

The third chapter on corporate pension decision-making is more comprehensive in that it pays attention to not only risk but also several other factors affecting corporate pensions. Indeed, this chapter illustrates the breadth of pension economics. Among other topics, it deals with pensions as part of explicit and implicit labour contracts, mandatory retirement, agency problems associated with complex multiple-agency relationships in pension governance, taxation, corporate governance, pension fund insurance, imperfect capital markets, and moral hazard and adverse selection in disability insurance. Together with chapter 7, this chapter constitutes the core of the book. It provides an extensive discussion of pensions in employment contracts by carefully exploring which market imperfections can explain why employers offer pension insurance.



Blake contrasts the implications of a spot labour market with those of a model with firm-specific human capital in which firms and workers conclude implicit long-term employment contracts. I found this discussion and the link to various ways to measure the value of corporate pension liabilities (ie, on the basis of an ongoing rather than termination basis) enlightening. Also the extensive treatment of various agency costs in pension funds is very clear. Other subjects, such as the taxation of pensions and disability insurance, receive a more cursory treatment.

Chapters 4, 5 and 6 explore the macroeconomic implications of pensions and aging in the context of overlapping generations (OLG) models. These chapters are more abstract and technical than the other chapters in the book, which rely more on intuitive reasoning and graphical illustrations. To illustrate, chapters 3 and 4 are of equal length, but chapter 3 includes only 17 mathematical equations while chapter 4 contains no less than 205 (!) of them. I did not find these chapters the strongest part of the book. Indeed, quite similar treatments can be found in macroeconomic textbooks.

Blake argues that the continuous-time Blanchard-Yaari OLG model investigated in chapter 5 is more realistic than the two-period Diamond-Samuelson OLG model explored in chapter 4. However, whereas generations are continuously born in the Blanchard model, this model relies on the counterfactual assumption that the probability of death is independent of age and thus lacks life-cycle saving. Also the statement that an economy may be able to move from a pay-as-you-go system to a funded scheme in a Pareto-improving manner in the presence of endogenous labour supply and distortionary labour taxation can be questioned. Such a Pareto-improving transition is feasible only if initial intragenerational distribution is inefficient. These gains from eliminating such inefficiencies can in fact be reaped also without funding the pension system, and are therefore not directly related to the question whether or not to fund pensions.

Chapter 7 turns to risk sharing and redistribution. This chapter is well written and carefully distinguishes between various pension risks. Risk sharing in both complete and incomplete markets is discussed. The extensive discussion of intergenerational risk sharing in social security is well done. In contrast to risk sharing in personal, corporate and state pensions, redistribution issues in these schemes get a more superficial treatment.

The last chapter of the book provides an excellent overview of the recent literature on behavioural finance. This literature departs from the traditional economic view of self-interested, rational man. Instead, it stresses bounded rationality, bounded self-control and bounded self-interest. This chapter discusses the implications of this literature for saving and portfolio decisions during the so-called accumulation phase (when pension wealth is being accumulated) and annuity decisions during the decumulation phase (when pension wealth is run down). This chapter provides practical advice for how to exploit framing and inertia effects in designing pension schemes. As such, it is a nice complement to chapter 2, which takes a more normative approach to individual decision-making.

I have been looking for a textbook for my course 'Introduction into economics and finance of pensions and aging' in the new Netspar MSc programme on the Economics and Finance of Aging at Tilburg University. This MSc programme, which started in September 2006, intends to do exactly what David Blake is aiming at: training well-rounded professionals who are able to see the links between the various parts of the complex pension puzzles that corporations, governments, and financial institutions are trying to solve. I am glad to report that I have found the book I was looking for. It is highly recommended reading for anyone aspiring to be a pension scientist.

Lans Bovenberg is Professor of Economics at Tilburg University, the Netherlands and scientific director of Netspar – a public-private research network on pensions, ageing and retirement

SPS Conferences *is delighted to announce*

Liability Driven Investing Strategies for Pension Funds

Thursday 1 March 2007
The Courthouse Hotel Kempinski, London

Speakers include: **Brandon Horwitz,** *Portfolio Manager, LDI Funds, Morgan Stanley Investment Management,* **Chris Johnson,** *Director, Institutional Business Development UK & Ireland, Crédit Agricole Asset Management,* **Antigone Theodorou,** *AXA Investment Managers,* **Iain Lindsay,** *Head of Global Fixed Income, Goldman Sachs Asset Management,* **Kathleen Currie,** *Head of Liability Driven Investing, HSBC Investments,* **Mitesh Sheth,** *Investment Director, Henderson Global Investors.* There will also be a Pension Fund Case Study Session which will include presentations from: **Penny Green,** *Chief Executive, SAUL Trustee Company* and **Nigel Casson,** *General Manager, Invensys Pension Scheme.*

Alpha Invesment Strategies for Pension Funds

Tuesday 13 March 2007, The Berns Hotel, Stockholm

Speakers include: **Martin Källström,** *Head of Financial Risk Consulting, AON Consulting,* **Euan Munro,** *Head of Multi Asset Solutions, Standard Life Investments,* **Gideon Smith,** *Portfolio Manager, AXA Rosenberg Investment Management,* **Vineet Budhraja,** *Director, Senior Research Analyst, Citigroup Alternative Investments,* **Axel Hansing,** *Partner, Coller Capital,* **Anthony Gelderman,** *Counsel, Bernstein Litowitz Berger & Grossman LLP,* **Sean Manns,** *Chief Operating Officer, Concordia Advisors LLC* and **Bruce Brittain,** *Executive Vice President, PIMCO Europe Limited.*

For further details and a personal invitation (a limited number of complimentary places are available to approved pension funds) please contact: **Trevor Cook at:**

SPS Conferences
Informing Pension Funds

Tel: +44 1438 712345, Fax: +44 1438 718883
Email: trevor@spsconferences.com
Website: www.spsconferences.com