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Regulatory Problems in Privatizing Social Security

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Abstract

This working paper, which will appear as a chapter of Framing the Social Security Debate (forthcoming Fall 1998) (Brookings Institution Press), discusses two regulatory problems associated with the privatization of social security: first, the risk that political interference with social security investments in equity securities will disrupt private capital markets and reduce returns on social security assets, and, second, risks associated with variations in investment return that individual participants might experience under a privatized social security system. In brief, the paper suggests that, while the investment of social security assets in private equity markets could give rise to problems of political interference in those markets, there are various ways in which such investments could be structured and managed that would reduce the likelihood of these problems actually arising. As to concerns that political interference might reduce expected returns on social security assets, the paper argues that past experience in other areas of financial regulation suggest that any reduction in returns from political interference is likely to be less substantial than the expected increase in financial returns associated with transferring a portion of social security investments into equity markets. With regard to variations in individual returns, the paper reviews various reasons why some individuals might be expected to experience lower rates of return under a privatized social security system than they do under our current system, even though privatization might generally be expected to increase average returns on social security assets. The paper then considers a variety of regulatory tools that could be employed to reduce the range of variation in individual returns.

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How should a privatized social security system be regulated? Are existing legal structures adequate to police a privatized social security system ? Or are the problems associated with a privatization sufficiently novel or acute to require new regulatory mechanisms? If new regulations are required, what sort of supervisory controls be incorporated into reform proposals and what protections can we reasonably expect them to afford social security participants? These are the questions that this essay explores.

In Part I, I discuss one regulatory problem associated with social security privatization: the possibility that political considerations will interfere with the way in which social security assets are invested in the private capital markets, a topic which Theo Angelis has explored with considerable care and insight in the preceding chapter. In Part II, I broaden the analysis to consider other regulatory problems of social security reform and, in particular, the financial risks that social security privatization would impose on individual participants. I conclude with a discussion of the regulatory techniques that could be used to mitigate those problems and briefly consider how regulatory considerations should be factored into the on-going debate over social security reform.

I. Public Interference with Private Capital Markets

As someone who spends much of his time dealing with the regulation of financial

intermediaries and capital markets, I greatly enjoyed Mr. Angelis's paper. While the expanding body of academic literature on social security reform alludes to the regulatory challenges of privatizing social security, Mr. Angelis's paper is one of the first to attempt a carefu99l review of an important aspect of such reforms: the concern that political considerations will interfere with the investment of social security funds in public capital markets. This possibility arises whether the trust fund's own assets are invested in the capital market or the investments are made through some sort of individual accounts. In either case, the government may be tempted to intrude into our capital markets in novel and potentially troubling ways.

If a substantial portion of the social security assets were invested in the private equity markets, Congress or other government officials might well be tempted to utilize that investment authority to influence the management of private corporations — either directly through the proxy process or indirectly through eligibility requirements for inclusion in the trust fund portfolio.[1] While it remains a matter of speculation whether Congress or regulatory agencies charged with overseeing Trust fund assets would in fact attempt to manipulate the trust fund in this way, the concern is sufficiently serious that it warrants careful consideration before we adopt proposals that would move substantial amounts of private capital under the control of the trust fund or its managers. The critical question is whether social security privatization can be structured so as to minimize the risks of disrupting our equity markets without imposing undesirable collateral consequences. Although Mr.

[1] One could, I suppose, distinguish between government actions designed to enhance corporate performance and initiatives intended for collateral purposes unrelated to shareholder return. In practice, however, this distinction is hard to maintain, as it will often be possible to recharacterize collateral purposes as having a positive effect on performance. For this reason, my analysis makes no distinction between appropriate and inappropriate government initiatives in corporate governance.

Angelis refrains from offering a definitive answer to this question, I think it is probably fair to say that the paper is at least susceptible to the interpretation that problems of corporate governance are substantial and not easily resolved.[2] While I am sympathetic to the concerns he raises, I am somewhat more optimistic on both counts.

As Mr. Angelis suggests, a first line of defense against political manipulation of trust fund investments is to move investment control and shareholder voting decisions out of the hands of government officials and under contractual assignment of private investment managers of the sort that routinely manage private pension today and also manage investments of the federal Thrift Savings Plan. As long as these managers were selected, retained, and perhaps even compensated based on their skill in matching as close as possible the performance of broad market indices, competitive pressures would do much to insure than individual managers did not manipulate their investment authority to curry favor with government officials.[3] Such a structure should also make it difficult for trust fund administrators surreptitiously to establish alternative investment criteria on

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[2] I gather that is how my fellow discussant Warren Batts interprets the analysis.

[3] For this competition to succeed, it would be desirable for the trust fund's portfolio to be divided up into several pieces, perhaps a half a dozen, and to have the contracts subject to renewal periodically. In addition to making it easier to police management fees and account performance, dividing up the portfolio would reduce the volume of holdings of any manager. To the extent one is concerned about the overall size of the funds portfolio, investment managers could be limited to holding no more than one percent of the overall market.

their own initiative.

Thus, to a considerable degree, privatization can be structured to impose institutional barriers to insulate investment management from political pressures. Structural restraints of this sort cannot, however, guarantee Congress will not subsequently enact new legislation establishing political criteria for trust fund investments or even imposing such criteria in the first place, notwithstanding the recommendation of experts advisers to pursue the sort of hands-off strategy that Mr. Angelis suggests.

Assessing this risk is a matter of political prediction and, as such, inherently debatable. From my perspective as a student of financial regulation, it is by no means clear that Congress would choose to interfere with trust fund investment management in the ways outlined in the Angelis paper. Most financial intermediaries — even those such as registered investment companies and private pension plans that are regulated exclusively at the federal level — are not subject to politically-motivated restraints on investment, at least not of the sort Mr. Angelis discusses,[4] even though there have been, from time to time, politicians who have expressed an interest in imposing such requirements.[5] The one substantial exception to this point is the Community Reinvestment Act of 1977, which requires federally insured depository institutions to serve the credit needs of local low

[4] To be sure, some analysts characterize portfolio restrictions as motivated to serve the political interests of management. See (Roe 1994). But these restrictions also serve the more public-spirited goal of enhancing diversification.

[5] The states, in contrast, have demonstrated somewhat greater interest in imposing politically motivated investment restrictions, both on insurance companies and banks. See, e.g., Metropolitan Life v. Ward, 470 U.S. 869 (1985) (reviewing states requirements that insurance companies invest locally). This difference between state and federal tendencies in this area may suggest that state experiences with public pension fund restrictions may not be a reliable guide of the political economy at the federal level.

and middle income borrowers. Although originally understood as an initiative to prevent red-lining in certain credit markets, the CRA is sometimes characterized as federal credit allocation scheme. So, the field of federal financial institutions regulation does offer an example of social financial engineering. The statute is, however, extremely controversial in the banking community, and has been widely criticized in the industry.

But, let's suppose that Congress overcame these structural impediments and proposed to play politics with trust fund investments along the lines Mr. Angelis fears. How bad would it be? The paper focuses our attention on several distinct harms: one is a potential deterioration in return on fund investments -- that is an injury to the fund itself -- and the second is an interference with corporate management -- that is an interference in the real economy.

A. Rate of Return Concerns

Let me begin with rate of return concerns. Suppose Congress were to limit trust fund equity investments to the S&P 500 minus firms engaged in the sale of tobacco. It is certainly conceivable that such a limitation could impair the returns of the fund's equity investments.[6] However regrettable, this potential loss of economic return is not necessarily a grounds for prohibiting trust fund investments in equity markets. If one accepts rate of return as the relevant metric,[7] the critical question is not whether a politically constrained stock index would underperform a pure index; rather

[6] Although it is also possible that, at least in some markets, such a restriction could improve returns.

[7] And this is a contested point, as discussed earlier in this conference. (Geanokpolos, Mithcell & Zeldes, 1998).

the question is whether politicians would sufficiently mismanage the trust fund's equity investments to reduce the fund's return from its current all Treasury investment posture.

One cannot answer this question with confidence. But, if one looks at the available data, there is some grounds for hope here. Throughout this conference and in the Advisory Council's report released last year, the conventional assumption is that the real long-term rate of return on equity investments will be on the order of seven percent per annum, whereas the equivalent return on current trust fund holdings is 2.3 or 2.4 percent. So, under the assumption that the expected real rate of return on equity investments is 450 basis points above expected returns on the trust fund's current portfolio — and that's the assumption that drives the privatization proposals analyzed in the paper — the relevant question is whether the cost of politically constrained baskets of equities would eat up all of this differential.[8] If one examines the empirical literature on the costs of social investing, much of which is summarized in Mr. Angelis's paper, one finds an estimated effect of one or two percentage points,[9] or less than half of the assumed differential.[10] To be sure, one can find illustrations of states (and foreign governments) making spectacularly poor investments with public pension assets. But, as far as I can tell, these errors occur when the assets have been directly under

[8] This figure would be lower but still substantial if privatized funds were divided between bonds and equity.

[9] See Romano (1993); see also Mitchell & Hsin (1994).

[10] Returning to the CRA illustration for a moment, if one asks the question of how much this most visible form of federal credit allocation has cost, the answer is that it has a relatively small impact on the overall performance of depository institutions. Even critics of the statute estimate its cost at on the order of 12 basis points of industry assets, see (Independent Bankers Association of America (1993) (estimating the direct costs of CRA compliance), further suggesting, at least to me, that the worst case effects of social investment are likely to eat up only a small fraction of the increase in rates of return that privatization of fund assets would be expected to generate.

government control and allocated to specific politically favored investments. The costs of a politically constrained portfolio index would likely, at least in my view, be substantially less severe.

B. Manipulation of Voting Rights for Political Ends

A distinct question is whether large trust fund investments in equity markets might introduce political considerations into fundamental issues of corporate governance. Several members of the Advisory Committee took this concern seriously enough to recommend that trust fund voting rights be cleansed: either through the statutory elimination of those voting rights (for securities held by the trust fund), or through the adoption of a voting convention that mirrors the votes of other shareholders.[11]

An important contribution of the Angelis paper is its attempt to understand the ramifications of cleansing the voting rights of what could become a potentially large block of securities. I'd like to focus on one component of his argument here: the possibility that cleansing voting rights would tend to entrench management and weaken the mechanisms of shareholder control.[12] In raising this

[11] See Advisory Council on Social Security (1997, vol. 1, p. 26). While much anecdotal evidence at the state level has supported the view that government pension plans are prone to shareholder activism, it is not clear that this phenomenon would be replicated at the federal level with social security trust fund assets, particularly if voting rights were delegated to private investment managers, as they are with the federal Thrift Savings Plan. Moreover, if, as I have suggested above, the resources were divided up among multiple advisers, voting power would be more diffuse, and no single manager could speak for all trust fund shares. See supra note 3. In this section, however, I accept the assumption that concern over corporate governance issues necessitate a cleansing of voting rights, and then ask the question of whether cleansing the shares would have an adverse effect on corporate governance.

[12] Space and time constraints prevent me from exploring a second potential problem of cleansing "voting rights": the possibility that this loss of rights would cause the trust fund to "lose" the premium associated with voting. In essence, this point is another "rate of return" worry: divesting voting rights will detract from fund performance. Whether or not the divestiture of voting rights will have this effect is, it seems

concern, Angelis postulates a public firm with a large block of stock under management control — say, twenty-five percent of outstanding shares. If the trust fund were to take another twenty-five percent of that company's shares out of circulation, management's share of the voting shares that retained voting rights would rise to thirty-three percent, and its ability to block outside bids would be enhanced.

In many public companies, however, management controls no such substantial block of votes. Where activists institutional shareholders own several significant shares — say three- to five-percent blocks — the introduction of a large block of cleansed trust fund shares will enhance the power of outsiders, presumably improving the market's ability to monitor shareholders. In essence, the cost of seeking corporate control will decline, at least for those companies in which activist institutional shareholders already have substantial blocks.

A separate and intriguing question is the effect of cleansed voting rights for companies in which neither management nor outsiders have large consolidated holdings. Although the matter is hardly free from doubt, I believe the answer must turn on the issue of whose shares the trust fund purchases. If we knew, for example, that the trust fund were to purchase its shares solely from

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to me, a difficult question of economics. The voting rights need not, after all, be lost forever and could reemerge when sold to other parties. There would, moreover, be many other aspects of privatization — most notably the entrance of such a large and long-term investor in the equity markets — that could, it would seem to me, have even larger effects on equity returns and these might easily swamp the voting rights issue. In any event, many of these effects would, presumably, be incorporated into equity prices as soon as the parameters of the privatization proposal were adopted and well before the trust fund acquired any shares.

individual investors, who are the least likely to participate actively in corporate governance issues, then the cleansing of their voting rights would tend to improve management discipline, because the remaining shareholders would be proportionately more activist. On the other hand, if it is the activists who sell out, the effect could easily be in the other direction.

Just as the macro-economic effects of Social Security privatization depend on the how the public adjusts its savings and investment patterns in response to the change, so too it seems to me do the corporate governance ramifications of the proposal depend on how the ownership patterns of public corporations are affected. It seems entirely plausible, as Mr. Angelis suggests, that for some corporations there may be an entrenchment of management, but for many others it may cause an increase in shareholder discipline. To answer this question, one would need to examine with greater care the ownership structures of the companies in which the fund was to invest, and also determine to the extent possible the identity of shareholders whom the trust fund would succeed.

C. Political Influence Could Also Reach Individual Accounts

A final point I would like to address are the implications of this paper for the debate over whether Social Security should retain its current defined benefit format or move to a defined contribution format. Several of the Advisory Council members who support the Individual Account plan — a defined contribution alternative — did so partially on the grounds that the risks of political interference were too great if equity investment were made in a defined benefit format.[13]

One of the most interesting aspects of the Angelis paper is that its analysis does not for the

[13] See Advisory Council on Social Security (1997, vol. 1, p. 155) (Statement of Edward M. Gramlich and Marc M. Twinney).

most part turn on whether the investments are made in defined benefit or defined contribution form. After all, the primary line of defense against political manipulation that the paper considers are: first, delegation of investment management to private firms selected by a politically independent board and second, limitations of account investments to broad market indices, such as the S&P 500. (I would also add a requirement that the funds be delegated to multiple managers so that inter-manager comparisons on costs and performance would be possible.) All of these first-line structural restraints could be imposed whether or not the investments were held directly by the trust fund or allocated to individual accounts. Similarly, the voting rights of equity investments could be cleansed whether held in individual accounts or directly by the fund.[14]

The temptations for political intervention also appear largely symmetric. With both a defined benefit plan and a defined contribution plan organized along the lines of the federal thrift savings plan, politicians will face the temptation of manipulating a large body of capital market investments to fulfill social goals. To be sure, one might suppose that there would be strong public resistance to political efforts to interfere with returns on individual accounts.[15] But given the special role of the social security trust fund in our public debate, one might imagine equally strong opposition to political attempts to exploit trust fund assets for the benefit of "special interests." This political resistance could be enhanced if there were clear indices — such as an undiluted market index —

[14] As described in some detail below, one could also combine substantial restraints on financial risk with a defined contribution privatization proposal.

[15] This was perhaps my intuition and I gather that of Mr. Angelis, but it's interesting to note that my fellow discussant Francis Cavanaugh has the opposite intuition — that politicians might be more inclined to impose political consideration on individual account plans.

against which the costs of social engineering of trust fund assets could be measured.

So, one important lesson of the Angelis paper is that, at least in choosing between direct trust fund investment and the individual account approach, concerns over political interference in investment strategy do not point strongly in one direction or the other.[16]

II. Regulating a Privatized Social Security System

The need to constrain political interference in asset management is, however, only one of the regulatory challenges of social security privatization. A separate, and from my perspective even more important, concern is the amount of financial risk that participants in a privatized social security system would assume, particularly if privatization were implemented with IRA-style, personal security accounts.[17] This section reviews the regulatory challenges of privatization and then considers the kinds of regulatory regimes that could be deployed to mitigate those challenges.

A. Regulatory Challenges for a Privatized Social Security System

Granting social security participants unbridled discretion to invest all or a substantial portion of their social security contributions raises a host of regulatory challenges. In light of the number of participants involved — many of whom will be first time investors — and the aggregate amount of assets available for management, the potential for abuse and over-reaching will be great. The sort

[16] On the other hand, if one were concerned that privatization of social security was likely to prompt inappropriate government intervention when the capital markets fall, it is not clear to me whether such an action would be more likely with the Maintain Benefit approach (where the government shoulders the risk) or with an Individual Account approach (where individuals bear the losses directly).

[17] Advisory Council on Social Security (1997, vol. 1, pp. 30-33) (describing proposal for personal security accounts).

of scam-artists and scoundrels that have perpetuated penny-stock fraud and boiler-room operations will be attracted to individual social security accounts like moths to a flame. At a minimum, millions of participants -- even those who restrict their investments to bank CD's and money-market money funds -- may overpay for investment services, particularly in the early years as the market for account management works itself out, and some will undoubtedly suffer from outright fraud. Even if instances of wrongdoing were limited to a few percent of participants, the absolute number of abuses could be extremely high.

Fraud aside, the actual returns received on individual social security accounts may be much more problematic than many privatization proposals suggest. For the most part, discussions of social security privatization proceed on the assumption that average rates of return on capital market investments will exceed the risk-free rate paid on government securities and substantially beat the implicit return on current social security contributions. Even if this is true on average, actual returns on individual accounts will vary. Returns on many individual accounts will fall below the average.[18] Indeed, if individuals are given any substantial degree of latitude in determining how to invest their social security accounts, it is all but certain that some participants will do worse on their investments than they would under the current social security system. By assuming financial risks, participants will experience variations in the rates of return earned on their accounts. Put differently, privatizing social security will not offer participants a costless exchange of low-returns for high-returns. Rather, it offers a trade-off between the current system's low average, no-variance returns and a new

[18] Depending how returns are distributed — for example, if the performance of the median account is below the average — more than half of all account will do worse than the average. See, e.g., Shoven (1998) (reporting data on a large number of hypothetical portfolios in which mean returns exceed median returns).

system's higher-average, higher-variance returns.

Absent effective regulatory safeguards, several factors could contribute to variation in returns on individual accounts, including the following:

1. Variations in Administrative Costs

As has been noted elsewhere, individual accounts would have relatively high administrative costs: both in terms of the direct fees paid to account managers and in terms of indirect costs from account managers obtaining less than optimal execution practices, brokerage commissions, and other services.[19] One effect of high administrative costs would be to lower average performance on individual accounts, but high costs can also generate variations in return. The level of administrative costs could vary considerably across individual accounts. The wealthy (with other assets available for management) could easily find themselves paying much lower administrative costs than poorer participants. In the financial markets, service providers often reduce fees in order to reach wealthier customers to whom other products might be marketed. Similarly, sophisticated participants can be expected to search for lower cost providers better than those who lack investment experience. In addition costs for smaller accounts would likely be higher, as a percentage of assets under management, than costs for larger accounts.

2. Other Sources of Variations in Financial Performance

A variety of factors could lead to variations in the rate of return on individual account performance. From my perspective there are four principal sources of such variation:

a). Inter-generational variation. Because the private capital markets do not outperform risk-free portfolios in a uniform manner, some generations will do better than others with their individual accounts. Those whose retirement years fall in a period of low

[19] Some indirect costs may not show up directly in administration fees, but will tend to lower portfolio performance over time. Less than optimal execution practices, for example, will have this effect.

asset prices will fare worse than those who retire in strong markets. Thus each generational cohort will not necessarily earn the long-run average market return.

b) Variation from Asset Allocation Decisions. Even those within the same generational cohort will experience substantially different rates of return. The degree of variation will increase the greater the choice of investments available to account participants. If one considers the closest current analog to individual accounts — 401(k) plans — the data reveals that there is considerable variation in the ways in which individuals invest their accounts: with some investing little in the stock market and others completely invested in the equities.[20] Different decisions about how to allocate account assets will lead to substantial differences in performance of accounts over time.

c) Variation from Differences in Portfolio Balancing Strategies. Portfolio rebalancing decisions will exacerbate variations in performance. Consider two individuals of the same generation with the same level of contributions to an individual account. Suppose both invest only in either diversified stock funds or diversified bond funds, moving back and forth based on their own sense of which market is likely to perform better in the next quarter. Depending on the skill and/or luck with which they move their accounts between these two asset classes, these two individuals could enjoy dramatically different rates of return, even though they both followed the same asset allocation strategy. If a person made particularly bad decisions in this regard — constantly selling low and buying high — it is quite possible that person to experience poor account performance even though both bonds and stock performed well over-all. Differences in allocation strategies translate into variations in return — that is, financial risk.

d) Variation from the Selection of Investment Managers. Finally, even within asset classes, there are likely to be substantial differences in financial performance over time. If one looks to the most common vehicle for individual investment in the stock market — stock mutual funds — one also sees considerable variation in performance between the best and

[20] See Employee Benefit Research Institute (1996)

worst funds over any period of observations. So even with individuals in the same generational cohort with the same allocation and timing strategy — 100 percent investment in the stock market all the time — there is likely to be variation in performance, unless the individuals used funds based on the same market index or otherwise equivalent portfolios.

As a result of all the foregoing factors, the actual rate of returns for a large number of participants in individual accounts could be expected to fall well short of average returns for certain asset classes. It is, moreover, quite possible that some fraction of individual account participants will do less well than the implicit rate of return currently generated on OASDI contributions.[21]

B. Designing a Regulatory Structure to Mitigate the Risks of Privatization

From a regulatory perspective, the most interesting question about social security privatization is the extent to which privatization legislation should and could address the regulatory challenges of fraud, excessive administrative costs, and variations in returns across individual accounts. As explored below, numerous regulatory options are available, and many might be used to dampen the risks that privatization could impose on social security participants. Regulatory restraints would, however, limit the investment choices available to social security participants, and thus conflict with the goals of individual autonomy and freedom that underlie many privatization proposals. In the end, framers of privatization legislation must balance the need for regulatory protections against the desirability of enhancing participant autonomy.

[21] In a recent paper relying on Monte Carlo simulations, Professors Bodie and Crane demonstrate how standard retirement investment strategies might be expected to underperform the government risk free rate of return under various circumstances. See Bodie & Crane (1998). Part of the public debate over social security reform should, in my view, entail an extension of this sort of analysis to present the expected distribution of returns from competing proposals for privatization. Such analyses would help counteract the current emphasis on predicted average returns.

1. Establishing the Locus of Regulatory Supervision

An initial question about regulating the privatization of social security is determining at which entities the regulation would be directed. As the contribution to social security individual accounts would presumably come from payroll taxes, a natural target of regulation could be employers. (ERISA's regulation of employer-sponsored pension plans provides a model for such a regulatory system.) One could imagine imposing a legal duty on all employers to offer their employees an appropriate investment vehicle or range of investment vehicles for their privatized social security accounts.[22]

There are, however, substantial drawbacks to an employer-based system of regulation. Most importantly, it would extend regulation to a huge number of entities: all employers in the United States. Beside straining supervisory resources, this approach would be costly and of dubious efficacy inasmuch as many employers are small businesses or individuals, lacking in the experience necessary to assume substantial responsibilities for overseeing investment management. As a result of the problems associated with comprehensive regulation of employers, I suspect that social security privatization regulation would have only limited application to employers, perhaps requiring only that whatever portion of their employees' social security contributions are earmarked for privatized

[22] The ERISA safe-harbor regulations establishing an appropriate range of choices for 401(k) accounts offer one model for national standards of eligibility. See ERISA § 404(c), 29 U.S.C.A. § 1104 (West 1998); 29 C.F.R. § 2550.404c-1 (1998) (implementing regulations). An approach of this sort would establish general parameters regarding the type of investment choices employers must offer their employees, but then allow individual employee considerable latitude in deciding how to allocate their retirement investments within these general parameters.

accounts are transferred to eligible account managers in a timely manner.[23] Under such a system, the critical issue will be determining who is an eligible provider and under what restrictions will such account managers operate.

2. Defining Eligibility to Provide Services to Privatized Accounts

Eligibility to offer investment services to privatized social security account could be determined in any number of ways. At one extreme, the government could offer a limited number of investment choices, and all participants would have to choose among those options. This is, in essence, what the Advisory Council's Individual Account option would provide. Typically, however, privatization proposals contemplate that individual accounts will be managed by or invested in regulated financial intermediaries: that is, banks, insurance companies, investment companies, and perhaps registered broker-dealers or investment advisers. So, at the other end of the spectrum, a wide range of financial intermediaries could be eligible to offer privatized social security accounts.

[23] It would also be appropriate to grant such obligations an appropriate priority should the employer become insolvent.

While all major categories of financial intermediaries in the United States are subject to supervision, the content and intensity of oversight varies considerably from sector to sector.[24] In some fields, the degree of supervision is extensive. For example, banks, insurance companies, and money-market mutual funds are subject to strict investment restrictions and mandatory capital requirements. Social security accounts invested directly in these intermediaries (through bank deposits, insurance policies, or money market mutual fund shares) should incur relatively low levels of financial risk.[25] Accounts invested through other intermediaries (registered broker-dealers, investment advisers, other investment companies, or even bank trust departments) would, however, assume higher degrees of financial risk. Existing regulatory safeguards in these other fields consist primarily of open-ended fiduciary standards and disclosure obligations, which are not designed to insulate investors from variations in returns, and experience shows that individuals who invest through these intermediaries enjoy widely different rates of return.

In addition to exposing social security participants to a wide and potentially confusing range of investment choices, the supervisory difficulties in allowing all regulated intermediaries to manage social security accounts are daunting. Despite a recent flurry of large mergers, the American

[24] See Jackson & Symons (1998)

[25] Certain bank and insurance products are protected by public insurance programs — although the accounts of those near and in retirement could easily exceed current coverage levels.

financial services industry remains highly fragmented; tens of thousand of regulated entities and individual offer financial services. Ensuring uniform oversight of such a large number of potential account managers would be a daunting challenge, particularly in policing abuses of fraud and over-reaching, which typically necessitate labor-intensive investigations and individual prosecutions. This supervisory task would be greatly simplified if the number of eligible providers were limited in some substantial manner. While certain elements of the financial services industry would undoubtedly resist such restrictions, I would be inclined to limit eligibility for account management to a relatively small number of intermediaries with excellent records of supervisory compliance. To ease supervision and reduce the likelihood of compliance problems, the number of eligible providers could be restricted to, say, fifty or even fewer well-established and well-capitalized financial institutions, all of whom have substantial incentives to avoid supervisory problems. One would probably want to allow for new entrants every year or so, both to keep the system dynamic and to replace manager that merge or otherwise go out of business.

4. Developing a New Level of Regulation for Privatized Accounts

However many financial intermediaries are ultimately authorized to manage individual retirement accounts, the question then arises what legal regimes should govern the terms under which these intermediaries can accept individual social security accounts. Conceivably, privatization legislation relying exclusively on existing regulatory structures could be adequate to safeguard participant investments. (Accounts placed with insurance companies would be protected through insurance regulation; accounts with banks, through banking regulation, etc.) This would, however,

be a risky strategy both for account participants and, perhaps also, the financial services industry.[26] More likely, in my view, privatization legislation will include a meta-level of regulation to establish a new system of rules governing private social security account investments, thus ensuring that there be some uniformity and consistency in regulation for all participants.[27]

Such an over-arching regulatory structure might address any number of issues, but I would be inclined to focus on the following areas:

a. Regulation of Account Fees & Other Administrative Expenses

As explored above, the absolute amount and variation in fees charges on privatized social security accounts is a matter of potential concern. To maintain competitive pressure on these charges, privatization legislation could mandate disclosure rules comparable to those the SEC has developed for the mutual fund industry.[28] Care would have to be taken to ensure that these disclosures reflect indirect compensation, such as soft dollar arrangements and similar practices, whereby advisors can increase their revenues without direct charges to account participants. To the

[26] The risk to the financial services industry is that problems with privatized social security accounts could lead to increased regulation of large portions of the financial services industry, not just those portions managing social security accounts.

[27] This supplemental level of regulation could build on existing regulatory structures in various ways. For example, if one conceptualized eligible providers as advisers to social security participants, the regulatory structure could mandate that account assets could only be invested in certain kinds regulated intermediaries: for example, well-capitalized FDIC-insured banks or mutual funds regulated under the Investment Company Act of 1940 with more than $1 billion in assets. The provider's selection of investment vehicles and recommendations to account participants would be governed by the meta-regulation I recommend, but the underlying investments would be regulated under existing regulatory systems — that is bank regulation and the 1940 Act. Our private pension regulation system has elements of this sort of jurisdictional allocation for plan assets placed in guaranteed insurance accounts and certain regulated investment companies. See ERISA § 401(b)(1), (2), 29 U.S.C.A. § 1101(b)(1) (West 1998); see also Langbein & Wolk (1995) (describing jurisdictional compromise).

[28] For a recent overview of SEC reforms in this area, see Proposed Amendment to Mutual Fund Registration Form, 62 Fed. Reg. 10,898-01 (Mar. 10, 1997).

extent that there is concern over fee differentials across account participants, regulations might also establish a ceiling on maximum fees. More direct controls over fees are also conceivable, but as our experience with fixed commissions and insurance rate regulation has demonstrated, price controls of this sort are difficult and costly to administer effectively.

b. Establishing Fiduciary Obligations to Participants

Another potentially appropriate regulatory mechanism would be the imposition of a fiduciary obligation on the part of eligible providers to recommend only "suitable" investments to social security participants and otherwise act in the best interest of those participants. Analogs of open-ended obligations of this sort already exist in the field of securities regulation and pension law,[29] but they do not exist in all sectors of the financial services industry. While there are unquestionably costs associated with duties of this sort, such an obligation would establish important minimal standards of conduct and prohibit a wide range of abuses, which are difficult to proscribe prospectively.[30]

c. Direct Regulation of Account Investments

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[29] See, e.g., NASD Conduct Rule 2310, reprinted in NASD Securities Dealers Manual (CCH) 4261 (1997); ERISA § 404(a)(1), 29 U.S.C.A. § 1104(a)(1) (West 1998).

[30] Articulating the precise scope of such a duty is beyond the scope of this essay. Drafters of privatization legislation should, however, consider the extent to which participants will be permitted to waive these fiduciary obligations. Supposing, for example, that a participant wanted to invest his or her entire account in a single high-technology start-up firm — an investment strategy widely perceived to be unsuitable for a retirement account. Could the participant insist on such an investment? Should it make a difference that the participant's eligible provider recommended the stock for a portion of the participant's account? Other related issues, such as the extent to which social security accounts can be pledged or otherwise alienated, would also need to be addressed. See ERISA § 206(d), 29 U.S.C.A. § 1056(d) (West 1998).

The need for open-end fiduciary obligations would lessen if privatization regulation also included direct regulation of account investments, as discussed infra. In that case, fiduciary protections would not need to extend to asset selection, but might be appropriate for advisory services and other aspect of account management.

A more difficult question is the extent to which privatization legislation should more directly influence the investment decisions of account participants. One could rely solely on the protections afforded through an open-ended fiduciary duty imposed on eligible providers, supplemented with appropriate disclosures regarding the intermediaries' recommendations. There are, however, other regulatory alternatives: most notably, imposing mandatory portfolio restrictions on participant accounts or, less intrusively, simply requiring the eligible providers make certain kinds of investments available to participants.[31] The restrictions discussed below could be imposed as either mandatory restrictions or required options.

Diversified and Lower-Risk Investments. The primary justification for attempting to narrow the range of possible investment is to reduce the financial risk that account participants assume. The greater the choice of investment, the greater the possibility for variations in return across participants and the more likely some group of participants will in fact do worse than they current do with implicit rates of return on their social security contributions. At a minimum, it seems to me, it would be desirable to steer participants towards either diversified pooled accounts (e.g., mutual funds, qualifying insurance products, and perhaps appropriately constrained trust accounts) or relatively low risk instruments (inflation-indexed government bonds, bank CD's, regulated annuities). To simplify participant choice, the number of investment choices might also be restricted to a relatively

[31] Traditional bank and insurance regulation has relied heavily on portfolio restrictions; ERISA's new safe-harbor rules for 401(k) accounts are an illustration of a regime that simply requires that certain investment options be made available. See supra note 22.

small number for each type of investment.

Indexed Portfolios. Steering participants to diversified pools will not, however, eliminate all financial risk. Even within the U.S. stock market, diversified pools have heterogenous returns, leading to financial risk for participants. One could substantially limit this sort of risk by requiring that the diversified pools be based on broad market indices, albeit at the cost of denying supra-market returns for those lucky enough to invest in the more successful actively managed accounts.[32] (The use of indexed portfolios would also make it easier for participants to compare the past performance and administrative costs of different eligible service providers.)

Limitations on Rebalance and Asset Allocation Decisions. Even limiting investments to indexed funds will not, however, reduce all forms of financial risk. As mentioned above, allocations of funds between indices and timing decisions in switching between indices presents residual risks, which could in theory be diminished through limitations on both allocation decisions and the timing of re-allocating portfolios. Regulatory restrictions could discourage account participants from adjust their portfolios too frequently. For example, participants could be precluded from changing investment strategies more frequently than once a year.

Protection from Inter-Generational Variation. Finally, to deal with the risks of inter-generational variation in returns, regulations could steer account participants into purchasing some sort of insurance, guaranteeing a minimal rate of return on their account balances.[33] Insurance companies have for many years offered similar products, in the form of variable annuities with guaranteed minimum rates of return, and it is conceivable that similar products could be developed

[32] Largely because of the problems associated with direct participant investment in the market place, some privatization proposals — most notably the individual account and Maintain Benefit proposals of last year's Advisory Council report — specify that privatization should take the form of investments in broad market indices: based for example on the S&P 500 or other recognized indices

[33] As discussed above, one very important risk that indices do not eliminate is the possibility that stock returns will underperform historic averages — that is, inter-generational risk discussed above. It remains possible that the real rate of returns on stocks will be substandard during any particular period. It is, in theory, possible to design an investment product that eliminates some of the downside risk of stock market investments through some form of dynamic hedging strategy.

for privatized social security accounts.[34]

d. Allocation of Supervisory Jurisdiction

A final question of regulatory design is the allocation of regulatory jurisdiction over privatized social security accounts. There are two important dimensions of jurisdiction: the authority to promulgate regulations and the authority to enforce those regulations. Both functions could be centralized with the Social Security Administration or some other appropriate agency. Or, the jurisdiction could be divided between the Social Security Administration and the various regulatory agencies with primary supervisory over the financial intermediaries licensed to be eligible providers. For example, the SSA could promulgate a system of regulation that the bank regulators would impose on banks, insurance regulators impose on insurance companies, etc. Alternatively, both supervisory functions could be delegated to the primary regulators, allowing a number of agencies to issue authoritative (and potentially conflicting) interpretations of the enabling statute. Our financial system has illustrations of each approach to allocating jurisdiction,[35] although in this context — where an important public goal would be to encourage participants to make comparison

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[34] It is, in theory, also possible to design an investment product that eliminates some of the downside risk of stock market investments through some form of dynamic hedging strategy. While it might be difficult to devise a regulation that would require equity investments of a PSA-style accounts to be hedged in this way, if the stock portfolios were centrally managed (as in the Maintain Benefit or Individual Account proposals), hedging strategies of this sort might be both feasible and desirable. For a discussion of hedging strategies of this sort, see (Gordon (1997); see also Bodie & Crane (1998).

[35] See Fein (1995) (reviewing various examples of jurisdictional coordination).

across sectors of the financial services industry — I believe centralization/uniformity of rule-making functions (of the sort that would define disclosure standards for performance and administrative fees) would be desirable.

C. The Role of Regulatory Safeguards in the Debate Over Social Security Reform

As this menu of regulatory restraints reveals, it is possible both to adopt a PSA-style privatization proposal and at the same time adopt regulatory structures that will substantially constrain the financial risks that participants will assume. As a practical matter, the more of these constraints one imposes, the more sensible it would be to rely on an individual account-style approach where the government itself provides the investment choices. After all, a full menu of regulatory restraints will leave very little room for market competition, while entailing substantial supervisory and compliance costs. Indeed, to the extent one were to impose the full menu of regulatory constraints on social security participants — that is, mandating that equity investments be hedged to mitigate inter-generational variations in returns — one would have come very close to converting a defined contribution program into a defined benefit plan. At that point, I would question whether it would make a good deal more sense to go with a true defined benefit plan, such as the Advisory Council's Maintain Benefit approach, which is likely to be a good deal more straight-forward to implement and administer.

If, however, the framers of a privatized social security system seek some compromise between the current define benefit program and a new PSA-style initiative, a number of intermediate regulatory solutions are available. Regulatory structures could steer participants towards certain investment choices without formally mandating them, while at the same time prohibit or at least strongly discourage clearly inappropriate investment choices. While these intermediate solutions

will necessarily expose participants to some degree of financial risk, appropriately structured regulatory restraints can reduce the number and severity of potential bad outcomes.[36] Though not a complete substitute for the kind of social insurance the social security system currently provides, regulatory safeguards can dampen the volatility of privatized social security system, thereby protecting the interests of future social security participants and their beneficiaries.

As the national debate on social security reform turns to the various privatization proposals, discussions should include careful attention to the efficacy and completeness of the regulatory system that competing proposals contemplate. Rather than focusing solely on the average rate of return a particular proposal contemplates, analysts should also consider the full distribution of returns that participants can be expected to realize over time. The regulatory protections built into each proposal will have a substantial effect on these expected distributions. Carefully constructed and sensibly administered regulations can do much to soften the potentially harsh realities of social security reform.

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[36] As suggested above, see supra note 21, Monte Carlo simulations offer one technique for evaluating the distributional implications of various reform proposals. Alternative regulatory restraints could and, in my view, should also be evaluated in this manner.

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