Effects of financial market turmoil on pensions
Tuesday, October 7th, 2008

I am testifying before the House Committee on Education on Labor this afternoon on the effects of recent financial market developments on pensions; click [here](#) for the testimony. The key points of the testimony include:

- The turmoil in financial markets has affected many aspects of the economy, including pensions. The most direct effect on pensions is through the prices of financial assets such as corporate equities and bonds. The Standard & Poor’s 500 stock market index, for example, has fallen by more than 25 percent over the past year as the outlook for the economy and corporate profits has worsened. Because the majority of pension assets are held in equities, drops in stock prices have had a significant adverse effect on pension plans.

- Data from the Federal Reserve suggest that the decline in the value of financial assets cost pension funds roughly $1 trillion—almost 10 percent of their assets—from the second quarter of 2007 to the second quarter of 2008, the latest period for which data are available. There has been a significant further drop in asset prices since the end of the second quarter, and it is plausible that the cumulative decline in pension assets over the past year and a half amounts to about $2 trillion.

- In a defined-benefit pension plan, benefits are specified by a fixed formula unrelated to the value of the pension fund. The sponsor of the plan is generally responsible for financing the benefits and must therefore make larger contributions when the value of the assets held by the pension fund declines. By CBO’s estimates, the value of the assets held by defined-benefit plans has declined by roughly 15 percent over the past year. Because of the way the obligations of the plans are calculated, their funding position (that is, the relationship between their assets and liabilities) is also affected by the level of interest rates. Those rates have increased over the past year, lowering the discounted value of plans’ liabilities by roughly 5 percent to 10 percent and partially offsetting the drop in asset values. Overall, according to CBO’s estimates, defined-benefit plans’ assets net of liabilities may have decreased by 5 percent to 10 percent over the past year.

- Changes in asset prices have also affected the value of assets in defined-contribution pension plans. In those plans, the resources available to workers upon retirement depend directly on the value of assets in their plan account. Defined-contribution plans apparently are more heavily weighted toward stocks than defined-benefit plans are; over two-thirds of the assets in defined-contribution plans are invested in equities (either directly or through mutual funds). Because of that heavy emphasis on equities, the value of assets in defined-contribution plans may have declined by slightly more than that of assets in defined-benefit plans.

- Some people on the verge of retirement might respond to a decline in financial markets by working longer. In 2006, 36 percent of people age 65 and older were in families with earnings; that share could rise somewhat over the next few years, both because of underlying trends in the labor market and because of the recent turmoil in financial markets.

- Although severe stresses in financial markets almost inevitably cause wrenching adjustments by workers and employers, the risks can be attenuated by sensibly designing pension plans. For example, although workers enrolled in defined-contribution plans may not be able to avoid bearing the risks associated with broad price changes in financial markets, they can avoid unnecessary risks associated with a lack of diversification. Such unnecessary risks can arise, for example, by overweighting portfolios with individual stocks rather than diversified index funds.