ERISA's Unintended Consequences

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Recent discussions about the crisis in financial services have questioned whether a free market system appropriately allocates resources in society. For example, *The Economist*, in a recent series of articles about the crisis points out that the financial services industry's share of total corporate profits climbed from 10% in the early 1980s to 40% at its highest point in 2007. "It is hard to believe," says *The Economist*, " that financial services create enough value to command such pre-eminence in the economy."

The extraordinary share of corporate profits commanded by the financial services industry also enabled the industry to pay higher wages than other enterprises and thereby attract the best and brightest employees. Many of these employees devoted their time and attention to producing and marketing a vast array of financial derivatives and pooled investment vehicles. In turn, the use of these products appears to have caused the current crisis. This suggests that the financial rewards paid to encourage bright people to create innovative financial products not only failed to benefit society, but caused harm.

Finally, some have argued that the enormous profits enjoyed by the financial services industry were false, based on valuation methodologies that have turned out to be erroneous. Since a large share of the profits in this business tend to be divided among employees and allocated to those groups or individuals who contribute the most to the bottom line, there have been calls to recoup this compensation from those who appear to have earned it improperly.

Perish the thought! It is only with the omniscience of hindsight that we can say with authority that things were overvalued in 2007. Many would argue that things are undervalued now. The sad fact is that we don't know any better way of allocating resources in society than through the operation of markets. That said, government intervention to prevent market collapse indicates that current prices, whether too low or too high, are not the result of private market forces.

Nevertheless, it goes without saying that we need to determine the causes of the current crisis if we have any hope of avoiding the next one. Among other things, it seems obvious to all but the most rabid free marketeer that our regulation of the financial services industry is due for an overhaul. But, that is a long way from

saying that something other than markets should be used to allocate resources in our society.

The Congress that created our existing financial services regulation in the 1930s thought that much of the damage inflicted by the financial services industry of the day was caused by the harmful use of "pools and puts." By pools, Congress meant "investment trusts," which were similar to private equity or hedge funds. By puts, they meant derivatives. Since variations on that theme seem the root of the current crisis, arguably we haven't learned much since then.

But, how is that possible? Nobel prize-winning economists have studied the causes of the Great Depression in excruciating detail, making every effort to learn from the history of that tragic period. Things got out of hand because of the law of unintended consequences.

The cause of the current crisis began in 1975 with the passage of the Employment Retirement Income Security Act of 1975, known fondly as "ERISA." Until the passage of ERISA, pension promises were unfunded. Employers promised their employees that they would receive a pension if they kept their jobs for 20 years, but this promise was what lawyers call a "unilateral contract." That is, the obligation to pay pension benefits commenced when the employee completed 20 years of service and was payable, like all of the employer's other contracts, out of the employer's general funds. ERISA required employers to set aside money to pay pension obligations in a trust beyond the reach of creditors.

ERISA was a very good idea. But, one unanticipated result of the legislation was the aggregation of extremely large sums of investable capital. In other words, ERISA created many large pools. Moreover, ERISA became the gold standard for protecting pension benefits. It wasn't long before government employees demanded the funding of their benefits, resulting in the creation of enormous pools of investable capital. Recent debate over the social security system has focused on its funding. The practice of funding pension benefits has been adopted throughout the industrialized world. All of this meant more and larger pools.

It wasn't long before pension funds owned majority interests in most of the S&P 500, and still the money kept rolling in. Private equity and hedge funds were playthings of the wealthy, of no great significance to the economy, until CALPERS, TIAA-CREF and an assortment of other public and private pension funds began searching for better ways to invest assets. Pension funds transformed the managed funds industry, producing riches beyond all visions of avarice for those who could satisfy, at least temporarily, the lust of these great funds for stable, positive, abnormal returns.

The toxic derivatives produced by investment banks were intended to satisfy the relentless quest for greater returns sought by hedge funds and their pension fund investors. These instruments only do their magic when enormous amounts of capital are employed, and pension funds are the only non-governmental investors that have at their command capital in such huge amounts.

The architects of ERISA intended to correct some abuses and facilitate the creation of a workable, private pension scheme. This was a necessary and laudable enterprise. But, righteous causes are not exempt from the law of unintended consequences.

Pools and puts are dangerous. This was the lesson left to us by the 1930s Congress. They are not less dangerous in different disguises. Layered pools, where one pool invests in another pool, amplify the hazards. Mix in some derivatives and other forms of leverage, and the danger becomes explosive.

In all of their habitats, pooled investment vehicles must be guarded and restrained. No plan of "re-regulation" of the financial services industry will be adequate that fails to tame the huge beasts spawned by ERISA.

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