The Economist

Buttonwood

Marshmallows and markets

Could guarantees make pensions more appealing?

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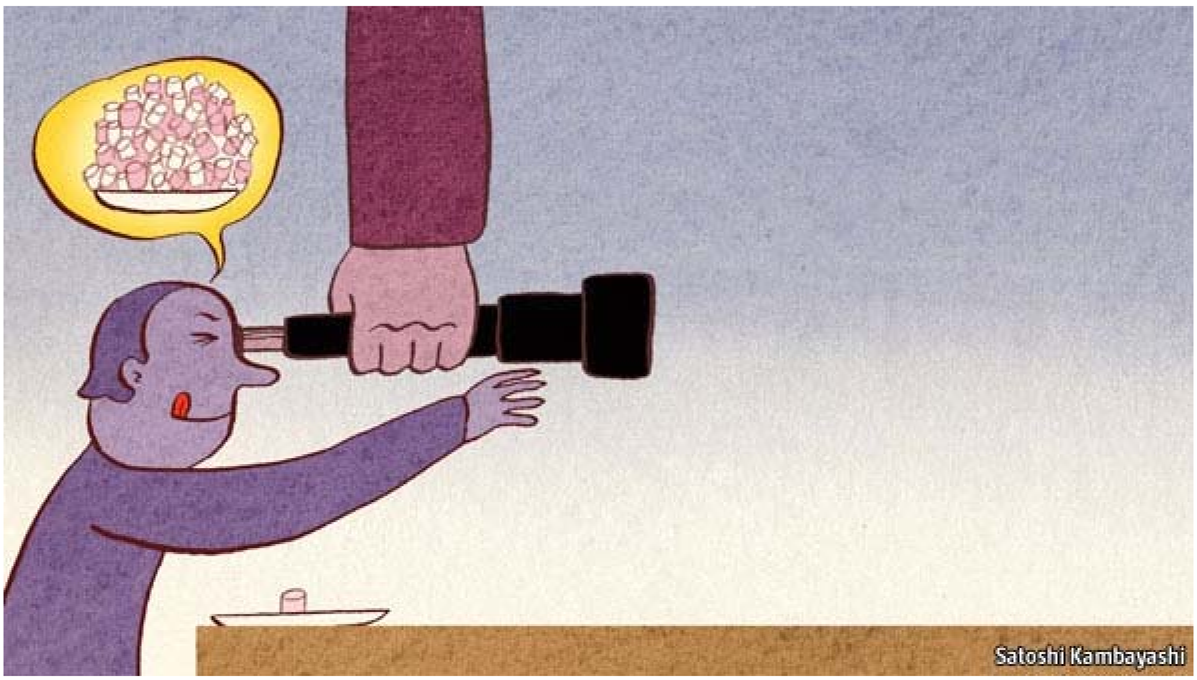

MOST people pay careful attention to their wage packets. But they tend to be much less interested in their pensions, even though their financial well-being in the last 20-30 years of their lives depends on them.

That is a great pity, since responsibility for pension provision has been steadily shifting from the company to the individual. Around 70% of American retirement schemes are now defined-contribution (DC) plans, under which the final pension amount is dependent on investment performance. In Britain the proportion of pension assets represented by DC plans rose from 8% in 2001 to 39% in 2011.

Poor stockmarket performance has reduced the return that investors get on their savings. Meanwhile, very low interest rates and improved longevity mean that a much larger pension pot is required to generate a given retirement income. According to Alexander Forbes, a consultancy, the average British 30-year-old in 2000 could have expected a pension contribution of 12% of wages to generate a retirement income of 67% of their final salary; a 30-year-old today could expect an income worth only 39% of final salary.

The greater cost of providing a pension is the main reason why companies have stopped providing defined-benefit (DB) schemes, under which they promised workers a specified pension, and switched the burden to employees. But the risk also makes pensions a very unsatisfactory product for employees. They put money aside every month but have no idea how much they will receive.

Most humans have a problem with deferred gratification. A famous test for children offered them a single marshmallow up front, or two if they waited; only 30% had the necessary self-control to delay. Pension saving is even more of a test of patience: workers have to wait 40 years or more for the pay-off. Their pension pots may not even be worth the sum total of their contributions; they may have swapped marshmallows for gruel.

It would surely make pension saving more attractive if workers could be given a much better idea of the eventual rewards for their thrift. A new report (http://www.actuaries.org.uk/sites/all/files/documents/pdf/guarantee-products-dc-report-final-print-version-a4.pdf) from the British Institute and Faculty of Actuaries examines whether it might be possible to offer guaranteed pensions in the DC market.

There is a simple way of offering a (virtually) guaranteed pension. If investors buy index-linked government bonds, their savings will be protected against inflation unless the government defaults. But this is expensive because the returns are so low. That expense explains why most corporate and government pension funds have followed the strategy of taking more risk (usually by buying equities) in the hope that excess returns from the market will let them make lower contributions.

In theory, you could insure against equity risk in the derivatives market by buying a put option (the ability to sell shares at a set price). Over the long run equities normally rise in value (although that is not certain, as Japanese investors know all too well). Even so, buying a long-term put option is actually more expensive than buying a short-term contract.

So the actuaries examine other approaches, using sophisticated hedging techniques that rebalance the portfolio to avoid substantial losses. The idea is to take advantage of the higher returns that equities can generate but in a low-risk fashion that means the cost of purchasing a guarantee is reduced.

Although this seems a sensible way forward, a couple of caveats are needed. First, the actuaries cannot say how much a guarantee would cost. They can calculate only the maximum a pension scheme should pay for a guarantee without making the strategy self-defeating. And any guarantee will involve only the return on contributions; it will not protect the worker against inflation.

The second caveat is that a guarantee is only as good as the guarantor. Pensions are long-term products and the recent crisis has demonstrated that insurance companies and investment banks (the likely guarantors) cannot be relied upon to survive for decades.

That raises the question of whether the government should step in. Governments may not want to add to their unfunded long-term liabilities. But if a guarantee could be provided for low-risk DC schemes, workers might be persuaded to save more. And if they do not save more than they do now, they may end up relying on government benefits in any case.

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