CHASM | Centre on Household Assets and Savings Management

Briefing Paper

Risk Sharing in Defined Contribution Pension Schemes

Growing concern about the risks that individuals face in defined contribution (DC) pension schemes and what industry and government can do to share some of the burden of risk prompted Paul Cox of Birmingham Business School to host a conference on risk sharing in DC pension schemes. Compared to defined benefit (DB) schemes, individual members In DC schemes have been left to share three types of risk: market, inflation and longevity, none of which are straightforward to understand. The conference heard speakers discuss how the risks associated with DC schemes can be distributed and shared, as well as possible products and solutions. The conference proceedings can be found in the May 2011 issue of the Journal of Risk. During the conference there were 4 main areas of discussion:

1. The use of investment return guarantees. Guarantees limit the potential for investment losses associated with investing in growth assets, such as equities. One proposal involved a minimum-return guarantee consisting of a swap. There was discussion of what type of third party (government, central bank or insurer) could, or would, underwrite and intermediate the swap given the long term nature of pension investment. A second proposal was for a DC scheme to purchase a series of short-term investment return guarantees in the market. There was discussion of the relatively high cost of these, the preferences and characteristics of individuals that most desire them, and the main beneficiaries. This found that rather than benefiting those on low income and with more limited retirement assets, investment guarantees benefit most those on high incomes and with significant retirement assets. This occurs because the State social security system already acts as a guarantee, which people on low incomes are closer to. A third presentation suggested the trading of financial surpluses or deficits from cohorts of members as they retire from target date retirement funds. There was discussion of the need for a buyer of last resort to be available if counterparties for the

surpluses or deficits cannot be found – one with a strong covenant and the financial capital to hold open financial positions across generations if need be.

2. The use of target-date funds and lifestyling. Target-date funds and "lifestyling" of a portfolio of diversified assets are a possible alternative to risk-sharing because they are carried out with a view to reducing the amount of inappropriate risk borne by individual members of DC schemes at different points in their age profile. Fitting investment risk more appropriately to age and/or other characteristics may reduce or remove the need for investment risk sharing.
3. The use of collective DC schemes. Actuarial participants presented the case that, so long as growth assets with uncertain capital return and distributions are among the basic building blocks of DC schemes, questions of risk sharing are likely to present themselves. This has been starkly highlighted by the financial crisis. The proposed solution was a collective DC scheme and a target investment return. Together, these give individual members' greater certainty concerning their retirement income. The collective DC scheme would provide a vehicle for both the accumulation and decumulation stages, including payment of pensions.
4. Sharing of interest rate, longevity and inflation risk through deferred annuities, longevity bonds and inflation-linked bonds.

The challenge to the business sector from the conference is to develop products and solutions for members of DC schemes. Propositions need to be scalable and packaged for the wider mass market, be fit for purpose, do what they say they do, and be communicated in plain language.

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