Pensions risk could be traded under new DC design

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NETHERLANDS – A proposal for a new type of guaranteed defined contribution pension scheme has been unveiled, which splits members into age-based funds and then allows them to trade certain benefits between each other.

The idea was floated at a DC risk-sharing conference, hosted by Exeter University and Netspar, last week and delivered by Xiaohong Huang, a PhD student from Erasmus University in the Netherlands.

The new scheme framework, according to Huang, would split members into separate 'generational' funds based on their age and give them the ability to invest under specific lifecycle or target date strategies. The scheme's design would then encourage risk-sharing among the age groups either by allowing groups to buy and sell either the surplus assets once all members die or buy and sell some of the benefits that members may own.

The actual trading practice is a little complicated but would essentially require older members seeking to sell the rights to any surplus assets, for example, to do so through a call option traded with younger members, while younger members could give up some of their later pension benefits by selling a put option to older participants.

What members could effectively do is trade in a manner which might provide three guarantee options, according to Huang: at a nominal rate, under an accrued rights rate or at a higher value real rate guarantee which would cost approximately 5% of an 18% contribution rate over 40 years under a real rate guarantee (at 60% cost over 40 years or 1.2% per annum above existing charges).

The concept is merely academic theory at this stage, stressed Huang, but could offer members improved potential returns while limiting any moral hazard - as trading could only take place at the beginning of a young fund's life within an individual industry-wide or company pension fund to prevent adverse selection. It would also allow younger members to sponsor older participants but without carrying the higher financial burden.

The format of each fund within the pension plan could also allow members to continue to invest after retirement age and without the need to buy an annuity, according Huang, as the actual rules and strategy of the fund – such as indexation and accrued rights - would be agreed by all members of the age-based fund at its formation.

One flaw in the plan as pointed out by conference delegates, however, is a past academic study showed that signatories might eventually renege on any agreement should the risk become too great for either party involved in the longevity/benefit trading.

The research project is being conducted with Ronald Mahieu, associate professor of financial econometrics at Tilburg University and was presented at the conference as one way in which defined contribution guarantees might be achieved.

If you have any comments you would like to add to this or any other story, contact Julie Henderson on + 44 (0)20 7261 4602 or email julie.henderson@ipe.com

Author: Julie Henderson

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