Guarantees make pensions more appealing

Finance

The poor performance of the stock market has reduced the returns of investors on their savings and the declining interest rates mean that a large pension pot would be required to generate a certain retirement income. The cost of providing pensions to employees has increased thus the shift to defined contribution plans. According to the article, most employees have a problem with deferred gratifications and only a few have the self-control to delay their pensions. Employees have to wait for a long period up to 40 years for the pension to pay-off, but the pension pot may not be worth their contributions (Buttonwood 73).

According to the author, the British Institute and Faculty of Actuaries have examined whether there are possibilities of offering guaranteed pensions in the Defined Contributions market. The article offers a simple method of offering (virtually) guaranteed pension if investors buy the index-linked government bonds since savings are protected against any inflation and the government cannot default (Buttonwood 73). However, the returns are low, and thus why most government pension and corporate funds have invested heavily in equities hoping excess returns in the equity market will make them make lower contributions. Accordingly, one can hedge against the equity risk by buying derivatives such as a put option that guarantees the derivative holder the option of selling the shares at a set price but over the long term put options will be more expensive than short-term contracts (Buttonwood 73).

Other approached of offering the guaranteed pensions in the DC market include using complex hedging strategies that rebalance the portfolio to eliminate any substantial losses. This involves using the high returns of equities in a low-risk manner thus reducing the costs of purchasing a guarantee (Buttonwood 73).

Conclusion

However, the actuaries have failed in calculating the costs of guarantee, and protection against inflation. From this perspective, pensions are long term financial products thus investment banks and insurance companies cannot be reliable to provide a guarantee from the experience of the recent financial crisis. The government may be unwilling to add to unfunded long-term liabilities, but if a guaranteed would be provided for the low-risk defined contribution schemes, then employees may be persuaded to save more. Unless employees save more, they will just end up relying on government pension benefits.