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Made to measure is the best fit for future pensioners

Changes in accounting rules are forcing companies that report under International Financial Reporting Standards or US Generally Accepted Accounting Principles to confront the economic reality of obligations under defined benefit pension plans. For most companies such plans are unaffordable; as a result we are seeing a shift to defined contribution plans, coupled with a growing interest in immunising existing obligations through "liability driven investment" strategies, which seek to match plan assets with the company's pension obligations. Both trends are ill-conceived as long-run solutions.

The shift to defined contribution plans does eliminate the company's financial liability for pension provision. But it does not provide the individual with advice and tools needed to save sufficiently and efficiently enough to ensure a satisfactory retirement income. The individual needs a savings plan tailored to specific needs that takes account of issues such as long-term healthcare and his home's value.

The plan should allow him to judge how much to save to achieve his minimum and desired living standard in retirement and protect him against inflation and longevity risk. It should be simple and require him only to make decisions the consequences of which he can sensibly evaluate; ie his savings rate, planned retirement date and minimum and desired retirement living standard. It should not require him to make frequent micro investment decisions.

Such a plan – a structured defined contribution plan (SDCP) – may seem a tall order but a combination of financial engineering and modern web-based technology makes it feasible. It is, of course, likely that an SDCP would require a higher (possibly substantially higher) savings rate than currently envisaged in defined contribution plans but the unpalatable reality is that most of us simply do not save enough. The SDCP would enable the individual to make sensible trade-offs between current consumption and standard of living in retirement.

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The SDCP approach represents a more effective way to deal with pension provision in the future but it does not address the issue of how best to deal with existing obligations under defined benefit plans. Accounting changes have stimulated a shift in pension asset allocation from equities to fixed income instruments, primarily in order to reduce volatility of accounting earnings. The premise is that it makes sense to match pension fund liabilities with assets that have a similar duration and stable return. Under a mark-to-market regime such as IFRS 17 (or what we anticipate will be the new US GAAP rules) such a policy will indeed reduce reported income statement volatility and imply a lower expected return. Some advanced investment strategies will seek to preserve a portion of the higher expected return from risky assets by investing some of the pension plan's assets in derivatives or hedge funds.

The flaw in this approach is that it fails to take into account that the economic risks and returns of the pension fund's assets belong to the company – not the beneficiaries under the plan. A pension obligation is a liability of the sponsor company which is in effect secured by the assets of the plan. From an economic standpoint the pension plan's assets and liabilities should be consolidated with all the company's other assets and liabilities. This would permit the company's management to allocate capital to those activities in which it has a comparative advantage.

This approach would in most cases lead to a reallocation of pension fund assets from equities to fixed income securities, but the motivation would be that the company had better uses for its risk-taking capacity (eg organic investment, acquisitions, dividends and share buybacks) than to finance investments in equities – or derivatives and hedge funds for that matter – with pension obligations that are in effect long-term loans from its employees. Immunisation at the pension plan level may well represent a step forward from the conventional approach of investing a large proportion of a defined benefit plan's assets in equities, but it is at best an incomplete one.

The long debate about expensing of stock options for accounting purposes has finally produced a more effective approach. We believe the debate about pension accounting will be equally heated but also eventually lead to a more useful accounting regime, more efficient capital allocation and development of a more effective form of pension provision.

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