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Guarantees in the new pension scheme

"Protection of pension benefits through personal wealth is more transparent and effective than through the solidarity reserve. It also prevents new pay-as-you-go funding."

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When designing new pension plans, much attention is paid to limiting (the risk of) pension reductions. The so-called Ortec method does this by using the solidarity reserve from which pension income is supplemented, if necessary. We propose an alternative method, the variable benefit with guarantee, which prevents pension reductions through an appropriate implementation of hedge and excess return allocation. This method can eliminate pension cuts altogether. We compare the two approaches in several areas.

Principal Findings

- In the benefit phase, the variable benefit with guarantee leads to equal pension adjustments for all participants without redistributive effects.
- With the variable annuity with guarantee, multiple bad investment results result in a nominally constant pension income for the oldest participants.
- With protection via the solidarity reserve, many bad investment results in succession still lead to a reduction in the benefit.
- In the variable annuity with guarantee, participants finance protection against pension reductions with a lower starting pension payment (compared to a classic variable annuity.
- In contrast, with the variable annuity with guarantee, participants do not have to contribute to the protection of retiree benefits during the accrual phase.

	Method			
	Variable	Ortec-10%SR-25%	Ortec-10%SR-5%	VUG
Probability of reduction	33%	0,5%	3%	0%
Probability of reduction given reduction previous period	33%	46%	34%	0%
Magnitude of cut 5% percentile	8%	10%	7%	0%
Magnitude of cut 1% percentile	11%	13%	9%	0%

Table 2: Probability of year-on-year pension reduction in the benefit phase for retirees in steady state for various methods. We also report the probability of pension reduction in the event of a pension reduction in previous period. Both probabilities are shown for i) one variable payment, ii) Ortec method with maximum size of the solidarity reserve of 10% compared to fund assets and pay out a maximum of 25% thereof (identical to 'Ortec-10%SR' in table 1), iii) Ortec method with size of the solidarity reserve of 10% compared to fund assets and pay out a maximum of 5% thereof (Ortec-10%SR-5%) and iv) the variable annuity with guarantee (VUG). We also display the percentage reduction in case a reduction occurs, for the 5% and 1% percentile of all percentage reductions.

Key Takeaways for the Industry

- The Ortec method reduces the probability of reductions, but reductions remain possible.
- The variable annuity with guarantee finances the costs of the protection, without pay-as-you-go financing, on the retirement date and thus prevents possible unwanted effects, for example in the event of value transfer.

Want to know more? Read the paper **'Garanties in het nieuwe pensioenstelsel' (In Dutch)**