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Elaboration key to pension deal

Retirement age must be raised as soon as possible

Assessment framework, communication and rights merger crucial

Theme: Pension Agreement

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Economist and risk expert agree:

ELABORATION KEY TO PENSION DEAL

The Pension Agreement between the social partners and the government is basically an excellent deal. In particular because it indicates that there are no longer pension guarantees, and because the level of the future pensions will mainly depend on the financial markets. However, the correct elaboration of parts of the deal will be critical for whether its target – a sustainable pension system – will be met, underline both Theo Kocken, Professor Risk Management at Amsterdam's VU University, and Lans Bovenberg, Professor Economy at Tilburg University.

By Leen Preesman

"The Pension Agreement contains sound elements. It makes clear that generous unconditional pension rights don't exist, and that unconditional rights can't be accrued from contributions and investments. And that, as a result, benefits need to be decreased during bad times. But much depends on how several parts of the deal will be shaped. A wrong elaboration can turn out to be a disaster," states Theo Kocken, who is also CEO of Cardano Risk Management.

"The deal is an in-between step, as so much needs to be worked out," agrees Lans Bovenberg, referring to the series of additional surveys that are currently conducted. "It is important that it offers clarity about the lack of guarantees. And that nominal guarantees will make way for conditional but real pension promises, aimed at covering the inflation risk," he comments.

Bovenberg:

'Decrease pension accrual in second pillar'

What part of the current pension deal must really change?

Kocken: "The agreed return-linked discount rate for liabilities. It could tempt pension funds to develop a too rosy view of their coverage ratio, and therefore increases the risk of indexation at the expense of the younger participants. We need to adopt a legally supported arbitrage-free discount rate, that prevents a transfer of pension rights between the generations. Both younger and older participants must keep on trusting each other."

"We need to introduce a market-consistent rating of liabilities, that can't be changed through pension funds decisions, on for example, the investment policy," states Bovenberg, who is also founder of Netspar. "However, pension schemes must keep the option of adjusting their investment approach when the world is changing. But this should not lead to a redistribution of pension rights between the generations. If this happens at a large scale, the participants who pay the price might lose their trust in the collective system."

Is a rise of the retirement age of the state pension AOW from 65 to 66 in 2020, and to 67 in 2025, sufficient for a sustainable pensions system?

"If we don't want that the younger generations get the bill later, the agreed increase is too slow," comments Kocken. "In order to keep the system affordable, the retirement age should actually rise one year in every five years. We should end up with a retirement age of 69, or even 70, in twenty years time."

Kocken says he is also wondering why rich pensioners will receive the agreed extra rise of the AOW benefits of 0.6% as well. "The required assets for this additional increase could better be deployed through enabling workers on low income to keep on retiring at 65," he points out.

Bovenberg has a less radical view on the issue. "The AOW age must be raised earlier and step by step," he agrees indeed, "but in my opinion we should start decreasing the yearly pension accrual in the second pillar. This would be effective for workers on a middle and higher income, because they tend to live up to fifteen years longer, and also grow old in a better health."

According to the economist, the increase of the retirement age for the second pillar has a delayed effect. "Because of the capital-funded system, it takes a long time before it affects the age at which workers leave the labor process," he explains.

Otherwise, Bovenberg considers the current crisis a blessing in disguise. "It is causing a faster increase of the retirement age of higher educated workers," he points out. "But also the taxation of pensions should actually be implemented sooner and more thoroughly than currently planned. This might further accelerate the increase of the retirement age of middle and high income workers."

How do you assess the feasibility of merging existing and new pension rights?

Kocken: "A collective merger seems to be complicated from a legal point of view. However, to gain sufficient support among participants, it must be made absolutely clear that all generations will benefit from the new pensions contract. Therefore, the wording of the intended new arrangements must be improved.
The way pension funds deal with conditional rights, and whether the future discount rate is fair to all generations, will affect all participants."

"The current pensions contract must be clearly defined before it can be properly compared with the intended new contract," Bovenberg adds. "The definition of new arrangements must be flexible. It should not fix a pension fund's risk profile for eternity, but allow for adjustments. However, the main condition is that changes don't come at the expense of groups of participants: the market value of the pension claims must remain unaltered."

Kocken:

'A wrong elaboration of the Pension Agreement can become a disaster'

Bovenberg says that he prefers a collective merger of existing and new pension rights. "The effects of merging individually are very difficult to explain to the participants, and the implementation will be very expensive," he points out. "However, if a collective merger turns out to be impossible, than rights must be joined on an individual basis. If we don't combine old and new pension rights, we remain stuck with the system of nominal guarantees. And if the government also requires to invest nominally, it will become difficult to compensate for inflation. This will be disastrous, in particular for younger participants."

"Combining pension rights individually seems very difficult practically," Kocken responds. "All 400 pension funds need to offer their participants a choice, and all administrative systems need to be tuned to individual contracts. This will mean an immense undertaking," he outlines the problem. "That said, the advantage of joining individually, is the lack of legal problems."

The risk expert reminds of the fact that the Pensions Agreement allows pension funds to continue with the existing arrangements, based on hard nominal rights and a conditional indexation potential. "Look at the occupational pension funds, for example. They do have a low but guaranteed pension accrual indeed, but they do grant a generous indexation." Bovenberg: "Schemes that stick with the nominal system, should face tighter rules of the financial assessment framework."

What should the future pensions supervision look like?

The future discount rate and discipline in investment policy, as well as the interpretation of communication, will be critical for the required supervision, underline both professors. "We don't need an extra supervisor for pension funds, alongside De Nederlandsche Bank and the Authority Financial Markets," Kocken adds. "DNB and the AFM are perfectly capable to assess the risks of the financial markets."

"Communication to the participants will become very important, and must focus on the risks of the accrual of a real pension," Bovenberg says. "And in order to increase clarity for participants, communication should also be carried out in terms of purchasing power.
The AFM must oversee whether pension funds can fulfil their promises. And DNB must make sure that the schemes assets are sufficient."

Kocken: "Actually, pension funds should have the option to offer their participants a combination contract, with an age-linked ratio of guaranteed and conditional pension rights. Even if this offers certainty of a lower pension, it will create trust among the participants."

Bovenberg: "The employees would like to have a kind of ownership, which should be better spelled out in the new pensions contract." In Kocken's opinion, this should even have top priority. "We must prevent that a different discount rate is applied to improve pension funds coverage ratio. This would amount to defining away the problem, as well as theft of pension rights from younger participants," he argues.

Will the new pensions contract be simple enough to explain to the participants?

"The pension funds must limit themselves to the key issues," Kocken says. "They need to explain that the system is fair, and that their pension rights can only be eroded by developments on the financial markets."

"The participants must be provided with an insight into the accrued value of their pension assets," underlines Bovenberg. He suggests to include this amount in the uniform pension statement (UPO). "In addition, the UPO should also indicate what happens to the pension benefit in a stress scenario."

Kocken: "If all crucial elements of the Pensions Agreement have been worked out thoroughly, the deal will be well explicable. A clear elaboration will prevent that the various parties will interpret the agreements differently."

Do pension funds need to keep financial buffers, even when they focus on real pensions?

"The collective reserves must be kept as low as possible," Bovenberg says. "We must avoid any temptation to hand out anything, as the notion arises that there are anonymous assets belonging to nobody." In his opinion, there should be a direct allocation of assets in terms of individual pension rights. "For example, through already incorporating uncertainties into pension claims. And through a not too high discount rate, as the inflation compensation has already been assimilated into the individual claims."

Kocken: "To prevent that buffers – ideally the conditional rights within the combination contract – are redistributed among the generations in an unbalanced way, we just need to grant ownership of these rights. There is nothing wrong with collective risk-sharing and cushioning shocks in pensioners' income. But this needs to happen transparently and fairly..."

Gerard Rutten, CEO of DSM Pension Services on Pensions Agreement:

'ASSESSMENT FRAMEWORK, COMMUNICATION AND RIGHTS MERGER CRUCIAL'

"The most important point of the Pensions Agreement is that the new pensions contract clearly indicates what will happen in case of headwind. That the instrument of pension contribution is finite, and how the risks will be shared when the financial markets fluctuate. And that we also need to take into account that not only the yearly indexation is not secure during volatile investment markets, but also that the accrued pension rights might suffer as a result."

Gerard Rutten

By Leen Preesman

Gerard Rutten – chief executive officer of DSM Pension Services (DPS), the provider of the pension fund of DSM Netherlands – cautiously indicated that he is optimistic about the Pensions Agreement. But at the same time he is making clear that the entire deal depends on the further elaboration of it. "The final combination of the pensions contract and the financial assessment framework will be decisive for the future pensions promise," he said.

"In addition, many uncertainties remain as long as the current surveys into various aspects of the Pensions Agreement haven't been concluded. And only then we can examine how we need to set up the communication towards pension funds' participants. This must encourage participants to take action for additional pensions saving," Rutten pointed out.

He said to be aware that conveying a message about uncertainty is far more difficult than an explanation about guarantees. "Proper communication is crucial but, to be honest, at the moment I don't know how it should be done either," he summarized the complexity of the issue.

The pensions sector hasn't even been able to fully explain the current and more simple pensions contract to the participants, according to Rutten. "Communication about the new arrangements is like a pilot's pre-flight announcement that the altitude will be 5,000 meters on average, implying that it could be zero as well. But participants want to be sure that they will arrive safely of course!"

Rutten: "Therefore I am concerned about the feasibility of the future pensions contract and the financial assessment framework, and also about how to explain these topics. In my opinion, the legislator should introduce only a single integrated assessment framework, rather than the envisaged two-track supervision for existing pension rights and new claims under the future contract."

The CEO of DPS – also the Chairman of the Foundation for Company Pension Funds (OPF) – further stressed that pension funds boards need more clarity about the leeway they have from the new pensions contract. He indicated that the concept contract, drawn up by the Labor Foundation (STAR), seems to put an increased onus on the social partners of employers and employees to establish policy on contributions, indexation and right cuts.

"However, the boards must be able to check whether the agreed arrangements are matched by the income model, founded on contributions and expected returns on investments, that comes with it. Clarity is also required on which party will manage the agreement on balanced risk sharing. In short, pension funds boards must keep sufficient space to manoeuvre, in order to live up to their responsibility."

Another tricky issue for Rutten, is the proposed merger of existing pension rights and claims under the new pensions contract. "This is technically very complicated and also contains legal risks. That is why it is yet not clear to me whether incorporating rights into one contract is feasible. If this turns out to be impossible, then we will end up with a modern pensions contract which will only be applicable to new pension rights. In this case, the practical value will be limited."

According to Rutten, it is also still unclear which party will be responsible for the merger project. Whether it will happen collectively or individually, this task is too complicated for pension funds. He made clear that they will need legal support for this.

The CEO of DPS further said that he is in strong support of mandatory financial buffers for pension funds, even when they adopt arrangements based on conditional but real pension rights. He stressed: "The financial reserves have proven their value during the past year, and they will remain necessary in the future. A buffer is the answer to uncertainty that participants like to hear."

Rutten also indicated that he doesn't associate a new discount rate based on expected returns with 'a perverse stimulus' for irresponsible indexation decisions, as some critics of the proposed discount criterion have argued. "On the contrary. It makes me extra aware of the obligation to sensibly and de-centrally apply our investment policy. Like one is supposed to do with an old-age facility, which takes the pension promise and social purpose into account. And that is quite different from an investment fund," he responded. "Moreover, the legislator should simply make it impossible to explore the limits."

In his opinion, a discount rate based on expected returns, can even be applied as a balance mechanism for the degree to which the financial interests of (younger) generations are taken into account. "This, as part of the task on balanced assessment of interests between the generations that pension funds already have anyway, and which we can direct through indexation and rights cuts."

Rutten expects that the effects of the new pensions contract will be relatively limited for the 5 billion Euros pension fund of DSM. "We already have a collective pension plan with the steering instruments of a fixed contribution and discount rules," he explained. "With these elements, the collective defined contribution arrangements are already more conditional than the traditional defined benefit plans. That is why I regard the CDC scheme as a precursor of the new pensions contract."

THEME

Professor Roel Beetsma about Pensions Agreement:

"RETIREMENT AGE MUST BE RAISED AS SOON AS POSSIBLE"

Also in the opinion of Professor Roel Beetsma, the Pensions Agreement is a big step towards a sustainable pensions system. "In particular the explicit link between retirement age and life expectancy is an excellent part of the covenant," he said.

By Leen Preesman

At the same time, he noted that some elements of the accord need to be accentuated, in order to make the pensions deal more effective. The retirement age for the state pension AOW must be raised sooner, and the agreed discount rate for liabilities based on expected returns should be abandoned, according to the Professor at Macroeconomics at the University of Amsterdam (UvA).

He also believes that collectively and voluntarily merging of existing and new pension rights is crucial for a balanced distribution of pension assets among the generations.

"Rather than raising the AOW age by one step from 65 to 66 in 2020 and, most likely, a similar increase in 2025, the official retirement age should already start rising in the short term by one month or a month and a half a year," he argued. "Time and time again, it turned out

that the predictions of Statistics Netherlands are trailing behind the actual mortality figures. That is why the increase of the AOW age can't start soon enough.
If we start with a yearly increase of a month and a half next year, the coverage ratio of pension funds will rise by approximately over 2% straight away, because of the resulting decrease of liabilities."

Beetsma has another reason to take the bull by the horns now. "If the retirement age is raised gradually and automatically, the discussions will fade away. However, under the current plan, there is a risk that when the actual increase is near in 2019, the whole discussion within politics and the labor will erupt again, and the deal might collapse yet," he pointed out. "Don't forget that the political clout of the fast growing numbers of older workers will have further increased by then."

Professor Beetsma takes a negative view on a new and return-linked discount rate. "I agree with the critics who fear that pension funds might be tempted to influence their funding ratio through an increase of their investment risk, for example by raising their equity portfolio," he said. "The risk pension schemes are allowed to take, should mesh with the age structure and other characteristics of their participants, as well as their participants' risk appetite."

"Moreover, in my opinion, such a sudden transition, from the risk-free swap rate to a return-linked discount rate, should not be carried out. It will merely mean an optical improvement. The liabilities will decrease abruptly and the coverage ratio will rise at the same time, while the pension assets remain unchanged," he explained. "As a consequence, pension funds will increase indexation at the expense of the younger generations. Such redistribution will involve many tens of billions of Euros."

Therefore, the average swap rate of the preceding two or three years is a better way for discounting liabilities, Beetsma thinks. "By that, not only the widely challenged effect of the daily rate fluctuation, and the resulting volatility of schemes' funding, can be avoided. The topic will also remain comprehensible," he stressed.
"And the latter is important for the debate, which is necessary for creating support."

In the Professor's view, all existing pension rights should be placed into one new pensions contract. "Excluding old claims from the contract will be disadvantageous for younger participants. The announced tighter supervision on delivering nominal guarantees, will cause pension funds to limit their investment risks, which will subsequently lead to lower benefits.
The combination of inflation and increased longevity will erode pension assets, and will drain the system ultimately," he predicted.

That said, Beetsma noted that not all legal experts seem to agree whether merging existing and new pension rights can be enforced. "Therefore, it is also important that the transition to a new pensions contract will happen on a voluntary basis."
A new supervisor for the pensions sector, alongside watchdog De Nederlandsche Bank (DNB), is not essential, in the Professor's view. "At most, the supervision on pension funds should be split off, to prevent that DNB in its supervisory role needs to take measures on one side that can negatively affect pension funds at the other side," he made clear.

Otherwise, the macroeconomist thinks that quite a few uncertainties remain about the conditional but real pension rights in the new contract. "As it will no longer offer hard guarantees, there will be no lower limit that triggers action," he said. "Therefore the supervision should focus on communication to participants about the question whether their pension plan is actually delivering on its promise. The supervisor should also check whether the interests of participants are balanced, and whether the say and expertise is evenly distributed between the board members."

In Beetsma's view, the vital communication to pension funds' participants must focus on the most important elements of the new pensions contract, such as the connection between investment risk and benefits, as well as the necessity for additional individual pension saving. "The question is whether participants feel the need for an explanation of all details."
About the necessity of financial buffers, the Professor is clear. "Every system requires reserves to cushion risks. We must prevent that a setback will directly affect benefits."

This past year, Netspar's board and the executive board of Tilburg University have been discussing a new position for Netspar within Tilburg University. This process has resulted in Netspar being assigned a new organizational position starting January 1st, 2012: it will be governed by a foundation that will decide policy and budget issues for Netspar Center, a unit under Tilburg University's Executive Board.

A NEW POSITION FOR NETSPAR

From its creation, Netspar has been an institute within TiSEM, the Tilburg School of Economics and Management. Gradually, however, both Netspar's partners and TiSEM itself became aware that this position no longer fits the current state of development of either Netspar or TiSEM. Netspar's broad mission and interdisciplinary and interuniversity activities were increasingly difficult to fit within one disciplinary school. Moreover, the existing structure does not adequately accommodate the current position of the parties that fund Netspar: the growing involvement in recent years of Netspar's partners justifies a more balanced distribution of powers and responsibilities between the university and external partners.

Under the new construction, all Netspar partners will have a seat on the Council of the Netspar Foundation. This Council will appoint a Supervisory Board, which will in turn appoint an Executive Board. The Executive Board of the Netspar Foundation will as well be appointed as the Board of Netspar Center within Tilburg University. All parties concerned – Tilburg University, TiSEM and Netspar – are convinced that Netspar can continue to evolve in this way as a national multidisciplinary network for innovation on the important social issue of pensions and aging.

Netspar's Supervisory Board from January 1st, 2012 will consist of:
Jean Frijns (chairman)
Jeroen van Breda Vriesman (Eureko / Achmea)
Philip Eijlander (TiU)
Marco Keim (AEGON)
Dick Sluimers (APG)
Job Swank (DNB)
Harmen Verbruggen (VU)

GETTING THE BEST PENSION RETURN FOR EVERY EURO IS WHAT MATTERS MOST

With the adoption of the new Pension Agreement, the Netherlands would appear to have finally paved the way for collective defined contribution systems. This is a logical development, according to Laurens Swinkels, Vice President of Investment Solutions for the global asset manager Robeco. The current defined benefit plans are being increasingly replaced by a model aimed at an inflation-linked pension with collective elements. As an experienced investor with extensive expertise in pension investments, Robeco is in an excellent position to manage pension plans not only in the Netherlands, but also in a pan-European environment. Arriving at even better pension solutions, however, will require a great deal more research, and that is where Netspar can play a valuable role.

Laurens Swinkels

With over eighty years of investment experience, Robeco possesses a wealth of knowledge and expertise that we can use to help companies provide a good pension plan for their employees. In terms of collective DC plans – the model for the new Dutch Pension Agreement – we have led the field in the Netherlands for over twenty years now. As for the more traditional DB plans, we offer integrated asset management and are a strategic partner for pension funds, providing everything from ALM to daily management of a multi-manager portfolio. I see our vast experience in institutional investing as an absolute advantage, especially in these times. We have our finger on the pulse of the market and know how it operates. And with our background as a pension provider, we can also make the link to the liabilities side.

Cross-border Pension Plans

One trend we have noticed is companies preferring to contract out their entire pension portfolio to a single party who can take over the reins for them – and this is happening not only here in the Netherlands, but internationally, as well. Multinationals want to have control from their head office over the pension plans for all of their employees, even in other countries. Robeco has responded to this need by establishing a Premium Pension Institution, Robeco PPI, earlier this year. Robeco is one of the first companies in the Netherlands to offer such a PPI solution. It allows us to manage cross-border pension plans – and even incorporate other risks, such as those linked to death, disability and longevity (the so-called biometric risks), into the collective pool. The PPI places these with an insurer, and in the case of Robeco PPI, that insurer is Generali.

International developments are behind this shift from DB to DC plans. One is not necessarily better or worse than the other. The essential thing, to our mind, is that the participants get their money's worth. Getting the best pension return for every euro is what matters most to us. The key elements of a good pension plan are a low, transparent fee structure, a simple administrative process and clear communication with participants. With Robeco PPI, we have introduced a new kind of player, alongside insurers and public and private sector pension funds, who can address these needs.

Age-based Investment Strategy

Employers are looking for good pension plans for their personnel and, beyond that, place great priority on controlling their pension commitments. In fact, the new Pension Agreement is founded on these principles. The ultimate goal is premium stabilization. The effect of this strategy, however, is that participants must now bear more of the risk than previously. If investment performance falters, then premiums remain stable but pension accrual and benefits have to be adjusted. Conversely, participants share in the profits when results are better than expected, whereas they do not do so under DB systems. This approach should have implications for the way in which pension funds structure their investment strategy.

One complication that arises in this regard is that the Pension Agreement specifies that the risk profile be determined according to the collective needs. It remains to be seen, however, whether a collective risk profile is even possible. Robeco is a proponent of age-based investing because that is the optimal investment strategy for pension investments. One of the risks of a collective risk profile in the Dutch situation, for example, is that the preferences of a relatively large group of older workers (who opt for a lower risk profile) will determine the investment strategy to the detriment of younger participants. We believe there is a need for further discourse on this.

Narrowing the Gap between Theory and Practice

The discussion about a collective versus age-based risk profile clearly demonstrates that there remains much interesting work ahead from an academic standpoint, as well. That was one of our primary reasons for entering into this partnership with Netspar. The platform that Netspar provides, bringing together academics and pension providers, helps to lift the scientific research out of the university environment so it can inform business practices. Pure academic research tends to be somewhat abstract, which can make it difficult to tie it in with actual practice. As a result, research reports sometimes disappear into a desk drawer, unfortunately. Netspar is in an excellent position to bridge that gap. The academics gravitate more toward practical implementation and the pension providers pay closer attention to the research results. One interesting line of research in this context – and one that also relates to the discussion about collective risk profiles – is the influence of human capital on the choice of investment strategy. This and other practical research topics can help us construct a better pension system. We would like to assist in those efforts, together with Netspar.

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Boender, Guus, Bas Bosma en Lans Bovenberg
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Design Papers (DESIGN) discuss the design of a component of a pension system or product. It analyzes the goals of the component and the possibilities of improving its function. A Netspar Design Paper is well accessible by specialists in the industry, responsible for designing these components. The Netspar Design Paper is to be printed, and both digitally and as a printed booklet available.

Kortleve, Niels, Wilfried Mulder and Antoon Pelsser
European supervision of pension funds: Purpose, scope and design (DESIGN 4)

Nijman, Theo and Lans Bovenberg
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Colophon

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Netspar

Network for Studies on Pensions, Aging and Retirement

Netspar, Network for Studies on Pensions, Aging and Retirement, started operations in 2005. It is a network connecting two main groups: pension practice and pension science. The first group consists of ministries, supervising agencies and other civil service institutions, pension funds, pension providers, insurance companies, banks, asset liability management companies. The second group consists of Dutch and non-Dutch pension researchers, and Dutch universities.

Mission

Netspar contributes to the ongoing improvement of financing opportunities for the 'old age' of Dutch and European citizens through network development, formulating and executing scientific research and knowledge transfer programs.

Vision

With this aim in mind, Netspar wants to secure sustainable pension and insurance systems that share risk equitably and efficiently. The network strives to set an example of how public and private parties in the service industry can cooperate with researchers in the social sciences in an efficient and mutually beneficial way to stimulate social innovation. Next to that, Netspar strives to stimulate the research and development capacity of the pension industry.

Core values of Netspar

The core values of Netspar are independence, accessibility for new entrants, and openness to dialogue and interaction between stakeholders. Netspar recognizes the importance of diverse types of knowledge, a wide range of disciplines, and methodological approaches.
It does not support particular policy positions, but is instead dedicated to promoting a wider understanding of the economic and social implications of pensions and retirement. It strives to effectively disseminate unbiased research output among public policymakers, professionals and trustees in financial institutions, and the academic community.

Netspar Partners

Tilburg University
Maastricht University
Universiteit Utrecht
university of groningen
Universiteit van Amsterdam
Erasmus Universiteit Rotterdam
VU University Amsterdam
University of Twente.
nationale nederlanden
ASR
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ORTEC Finance
AEGON
apg All Pensions Group
PGGM
cardano
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ROBECO The Investment Engineers
ZwitserLeven
SVB Sociale Verzekeringsbank
De Nederlandsche Bank
AFM