Netspar

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# NETSPAR MAGAZINE

Fairer Distribution of Costs and Benefits under the new FTK

No More Changes without Generational Analysis

## Theme: Generation Effects of the New Pension Contract

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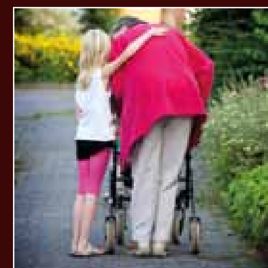

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*Jan Koeman, head of pensions at the Dutch Ministry of Social Affairs and Employment (SZW), has talked to a lot of pension fund managers in the past few months. He has been touring the Netherlands informing people about the pensions framework memorandum of Minister Henk Kamp ever since it was released in late May.*

# FAIRER DISTRIBUTION OF COSTS AND BENEFITS UNDER THE NEW FTK

*by Frank van Alphen*

Koeman says that these presentations help dispel some misunderstandings about the SZW memorandum. "The Pension Agreement triggered a sharp public reaction, in part because of the suggestion that indexation would follow sooner if new rules were adopted. That was not so wise, in hindsight," he admits.

"Opponents have likened it to a shell game: You change the rules a bit and, presto, all your problems disappear," Koeman continues. "But that criticism overlooks all of the pension accord's good points." Some of that criticism was aimed at how investment risk was being shifted to employees. This was particularly egregious to the Netherlands Trade Union Confederation (FNV). The trade union coined it the "Casino Pension" and took to the streets in protest.

Political youth organizations, the alternative trade union AVV, and renowned economists, such as Sweder van Wijnbergen and Theo Kocken, issued dire warnings against passing the buck to the younger generations. It was suggested that pension funds would use an artificially high discount rate related to their investments

Jan Koeman

to lard their accounts and then distribute the money to retirees. If the returns turned out to be disappointing, young people would be left holding the bag.

It was that second point of criticism, in particular, that the ministry chose to address as it finalized the pension agreement. To start with, the Dutch administration had the Netherlands Bureau for Economic Policy Analysis (CPB) analyze what the generational effects of the pension agreement would be. (See the article elsewhere in this issue.) There have also been studies of the legal ramifications of converting old pension rights to a new pension contract and of any potential European obstacles to such a conversion. The new Financial Assessment Framework (FTK) is scheduled to take effect in 2014.

A great many parties were involved in finalizing the pension agreement, a process that took longer than expected. "In addition to the regulators, experts, insurers, and funds, we were also regularly in contact with representatives of both youth and senior organizations. Those were some interesting meetings," Koeman recalls.

According to Koeman, the core components of the framework memorandum can be summarized in five points, which are clear improvements on the current rules governing pension funds. All of these points relate, to a greater or lesser degree, to the fair distribution of costs and benefits among the different generations and to making the system shock-resistant.

The first issue is that of transparency. "The current contracts tend to be vague on the issue of risk distribution," Koeman says. It was not until the pension funds had to draft recovery plans that they were forced to specify how they planned to spread the pain.

"Under the new rules," he continues, "funds must report ahead of time how they apportion losses among older and younger participants."

The second area in which the rules are being tightened is communication. "As it is now, participants only get the news in bits and pieces that their pension is worth less and will consequently be decreased," Koeman says. "Under the new FTK, pension funds must provide more information about the implications of non-indexation and the risks to which participants are exposed."

The Netherlands Authority for the Financial Markets (AFM) recently also called for more detailed information for participants. The regulatory agency feels that pension funds provide younger workers, in particular, with an overly rosy picture of the pension benefits they will receive. There is a very real risk that as a result of, say, a divorce or missing indexation, a pension could end up being considerably lower than what a forty-year-old is promised on his pension statement.

Pension funds have complained in recent years about the yo-yoing coverage ratio. Fluctuating interest rates can cause the coverage ratio to plummet or skyrocket in a short period of time. This is the third core component of the framework memorandum, according to Koeman. "Under the new FTK, that unnecessary volatility in coverage ratios will be a thing of the past, due to more stable rates and averaging the coverage ratio over twelve months," he says.

The fourth issue that Koemen views as an important step forward is the manner in which rising life expectancy is to be integrated into the pension contract. "The increase in life expectancy is a gradual process," he says. "Under the current rules, pension funds have to integrate that increase into their figures all at once and pass it on to their participants." With the life expectancy adjustment mechanism (LAM), it becomes possible to absorb that cost hike in increments.

The fifth point in the framework memorandum has to do with the way funds are allowed to index pension rights. At present, funds can offer full indexation as soon as their coverage ratio tops 120 percent. "In terms of the new real pension contract, this doesn't take

Koeman:

*"Under the new FTK, pension funds must provide more information about the implications of non-indexation and the risks to which participants are exposed."*

future liabilities adequately into account," says Koeman. Under the new FTK, funds can only index once they have enough money to provide indexation for future generations, as well. This also prevents them from distributing the money too quickly.

The last two points (LAM and indexation) only apply to the real pension contract, with the funds incorporating the increase in pensions needed to keep pace with inflation into the liabilities. "With the real pension contract, shortfalls can be more gradually managed than with the nominal pension contract. What's more, there's no need for the kind of balancing act of a nominal contract, where you have to invest to be able to index, while at the same time promising a nominal payout," contends Koeman.

Koeman thinks that plenty of fund managers will embrace the new rules once any potential legal uncertainties have been eliminated. "I've noticed that managers have started to think more positively about the option of a real pension contract. The challenge now is to convince participants of the benefits, as well."

# NO MORE CHANGES WITHOUT GENERATIONAL ANALYSIS

Researching the generational effects of any changes proposed in the pension sector has become standard practice. Last year, the Netherlands Bureau for Economic Policy Analysis (CPB) had to develop a method for such calculations entirely from scratch. Now, all of the individual funds can find out whether the costs and benefits are indeed shared fairly between young and old.

*by Frank van Alphen*

In June of last year, the Dutch administration, together with the Lower House, asked the CPB to calculate the generational effects of the Dutch Pension Agreement. The move was hardly surprising, given the critics' assertions about the unfair impact on younger workers, in particular. Under the worst-case scenario, they would be footing the bill for the generous pensions of the current generation of retirees and older workers.

At the time, though, the CPB did not have a model for such calculations. "We developed a wonderful tool," says Casper van Ewijk, CPB Deputy Director. "Our model can answer the politicians' question as to which generation loses out if you operate according to certain assumptions at a pension fund. It is a zero-sum model. You cannot just secretly sweep problems under the rug. If one of the generations receives a euro more, then another age cohort will receive a euro less." Van Ewijk discussed the study at a Netspar meeting on June 22nd at the offices of the Social and Economic Council of the Netherlands (SER) in The Hague.

The CPB analyzed the generational effects of two pension contracts that are based on the pension agreement reached by employers, trade unions, and the Dutch Cabinet in 2011 and the new Financial Assessment Framework (FTK). The new rules are slated to take effect in 2014. At that point, funds will be able to choose between a nominal pension contract very similar to the existing contract and a real pension contract that makes maintaining purchasing power a central priority.

The CPB performed its study based on an average-performing pension fund, with asset allocation evenly split between stocks and bonds. The fund's age distribution is typical of the Dutch population. "That means," says economist Van Ewijk, "that the results for individual funds could vary. Funds will have

Casper van Ewijk

to figure out for themselves what the generational effects of certain measures will be in their particular case."

The first part of the analysis involved examining how the new rules would impact the existing nominal pension contract. This scenario takes a nominal pension as its starting point. The fund endeavors to provide conditional indexation, but this is not reflected in the coverage ratio, because that is calculated according to the nominal obligations. These obligations resemble a guarantee, but as recent developments in the pension sector have shown, that guarantee is not set in stone.

Under the new FTK, the interest rate and graduated scale for this nominal contract will change. For durations over twenty years, the yield curve is extrapolated toward 4.2 percent over a total period of 60 years. This is the ultimate forward rate (UFR), which was set by the 27 EU member states and consists of the long-term inflation assumption (2 percent) and the average long-term real interest rate (2.2 percent).

The graduated indexation scale that funds can use is more restrictive under the new rules. Full indexation is only allowed when they have enough reserves to index future generations, as well. In other words, a fund can only increase pension benefits if it has a nominal funding rate of about 125 percent, which is equivalent to a real coverage ratio of 100 percent.

"When you apply the new rules to the existing contract, there are no major generational effects," Van Ewijk says. "At most, the existing generation might receive a slight advantage." This is due primarily to the UFR. The somewhat higher long-term interest rate produces an increase of 5 percentage points in the solvency ratio for the average pension fund. An increase of that order mitigates the need to decrease pension benefits, mostly to the benefit of current retirees and older workers.

It is worth noting, though, that this effect is partially counterbalanced by the more restrictive indexation ladder, which places a cap on pension indexation, and that adversely affects older participants.

The CPB's figures also indicate that the transition from a nominal to a real pension contract does not have any disproportionate generational effects either. Though, in this case, too, retirees and older workers fare incrementally better than younger participants. "This effect is caused primarily by the longer recovery term. With a nominal contract, the fund has three years to recover. For real contracts, the recovery term has been extended to ten years. That means the funds do not have to cut as deeply into payouts when there's a shortfall," Van Ewijk explains.

The CPB has demonstrated that there are no inequitable generational effects associated with transitioning to a real pension contract. According to Van Ewijk, pension funds would be well advised to switch to the new contract. "The real contract provides a better pension," says the CPB Deputy Director.

The findings of the CPB study are a boost for the architects of the pension accord, which was bombarded with criticism. "We had to present the accord, at the time, as a generation-proof pension," Chris Driessen, pension expert at the Netherlands Trade Union Confederation (FNV), says with a sigh at the Netspar meeting.

In Van Ewijk's view, the advantages of the new contract are its greater transparency and better manageability. "It is more transparent because participants, who expect an inflation-proof pension, can see how their pensions are doing. The fixation on a nominal amount leads people to believe that the pension is secure, when all the while you have a huge inflation risk, for example," he says.

Van Ewijk points out that, in his opinion, the current nominal pension contracts also carry generational risks that are rarely acknowledged. For instance, under the current contract, funds can change the investment mix substantially without having to analyze the generational impact. If a fund decides to make the mix less risky by switching to bonds, that is good for older participants, while adversely affecting younger ones.

The real pension is more manageable because such eventualities as disappointing returns or increased life expectancies can be more gradually absorbed. That means that in bad times, pension payouts do not have to be cut by, say, 10 percent: any such setbacks can be spread out over 10 years.

Another proponent of the real pension contract is Professor Kees Goudswaard, who was hired by the Dutch government in 2009 to study the "future-proofness" of the Dutch pension system. "It is essential that we start thinking in terms of purchasing power," the Leiden economics professor says. "With the real pension contract, the cuts are more frequent but less deep than with the nominal pension contract. It is a superior contract."

Despite the positive recommendations from Van Ewijk and many other pension experts, pension managers are extremely hesitant to move old pension rights into the real pension contract. They fear participants will legally challenge any such decision, because their nominal rights were converted into a real contract with no nominal guarantees, collectively and unsolicited. The funds feel that the government should contend with this risk.

Van Ewijk regrets that so many funds are taking the position they have. "Our study shows that the generational effects are minimal. That makes it tough to assert a legal claim that a particular group is being shortchanged. Moreover, the nominal system is subject to much greater generational effects if a fund decides to change its investment mix."

Even with the finalization of the pension agreement by the Dutch Ministry of Social Affairs and Employment and the CPB study, it would appear that not everything has been settled yet. Earlier this summer, a debate broke out about whether applying a higher UFR interest rate at the end of the year was fair to younger participants. That higher rate will result in less-drastic cuts to payouts, which could negatively impact people who have thirty years to go before they retire.

Theo Kocken is Professor of Risk Management at VU University Amsterdam and CEO of the Cardano Group. He is one of the most outspoken opponents of the proposal to increase the interest rate using the UFR

method and was also present at the Netspar meeting. He quips that UFR stands for "Utterly Fatal Regulation." Increasing the interest rate toward some "arbitrary market-independent" rate of 4.2 for durations of 20 years and up will only produce an artificially inflated coverage ratio, according to Kocken. "That works out badly for young people, because funds will then start indexing sooner or make fewer cuts than necessary," he says

The fact that the UFR takes effect for insurers at the end of this year is no reason to also implement it for pension funds. "This interest rate has no intergenerational effects for insurers, because they have their equity capital as a buffer. Pension funds are subject to intergenerational effects, because they have no buffer," Kocken asserts. He has another problem with the UFR, too. "If all of the Dutch pension funds start using it, then other parties will know exactly what they need," he points out. "Those parties – think of the hedge funds – will anticipate this and act accordingly."

The professor of risk management is not alone in raising this criticism. The CPB also has reservations about the UFR. It writes that the decision to apply UFR for durations longer than 20 years on the yield curve can produce imbalances in supply and demand for interest rate swaps with certain durations.

Kocken, along with Professor Sweder van Wijnbergen, thinks pension funds are right not to switch over to the new real pension contact. They are of the belief that the path is unnecessarily complicated and will lead to lawsuits. These two economists say the solution is much simpler: just modify two rules that apply to the current nominal pension contract.

The first rule relates to interest rates. Kocken believes that a variation of the UFR method could be workable. He is primarily opposed to the abrupt transition to this market-independent interest rate after 20 years.
The professor feels that market interest rates can prevail up to 30 years, whereupon the interest rate could be gradually extrapolated to the UFR level.

A second rule that could help make the Dutch pension system more robust and fairer for young and old, according to Kocken and Van Wijnbergen, would be a more symmetrical balance between raising and lowering nominal value. Under the current system, any setbacks must be absorbed within three years, whereas windfalls get distributed to participants much more slowly. That is disadvantageous for older people. If the decrease in nominal value could be spread out over as long a period of time as the increase in nominal value, this mechanism would be generation-proof, in Kocken's opinion.

And that is a point Kocken's proposal shares with the real pension contract. Proponents of the latter also like to use the argument that cuts would have to be less severe than under the current contract.

Theo Kocken

## INTERNSHIPS THROUGH THE NETSPAR NETWORK

Tilburg University, working in close conjunction with Netspar, has offered an MSc program in Economics and Finance of Aging (EFA) since 2006. One of the essential aspects of this one-year program is the internship. MSc students are required to do an internship and encouraged to find a position at one of Netspar's partners in the pension, insurance, or banking industry or with the civil service partners (ministries, SVB, AFM, DNB).

These internships are great opportunities for both the students and the Netspar partners. For the companies and organizations, they provide not only an excellent recruitment opportunity, but also access to extensive research on topics that might be lower priority, but are nonetheless very important. Students get a chance to experience working in the pension sector, while obtaining their master's degree. With the Netspar Center acting as the hub and the intermediary between students and partners, intern candidates can be easily connected to research topics. Students can apply for interesting "jobs" at the Netspar Center, and Netspar partners can choose from among a pool of qualified applicants to find the best candidate for their relevant topics. APG has made optimum use of this opportunity over the past few years, as APG internship organizer Ruben Laros (EFA alumnus and former APG intern himself) says below.

It may be hard for some people to grasp, but there actually is a group of young, talented people willing to work in the field of pensions. Most of them end up going for a master's degree at Tilburg University, especially the Master of Economics and Finance of Aging (EFA). An important part of that program is doing an internship with one of the Netspar partners.

# THE NETSPAR INTERNSHIP AT APG

Over the last five years, APG has developed an extensive internship program for these students. At the time of writing, APG has seven interns writing their master's theses on pension-related topics. When these students graduate, we will have had 35 students who obtained their master's degree through an APG internship. Most of these were EFA master degrees, though some were Quantitative Finance and Actuarial Science masters. We have had a nice 50/50 mix of men and women and the pleasure of working with 12 different nationalities.

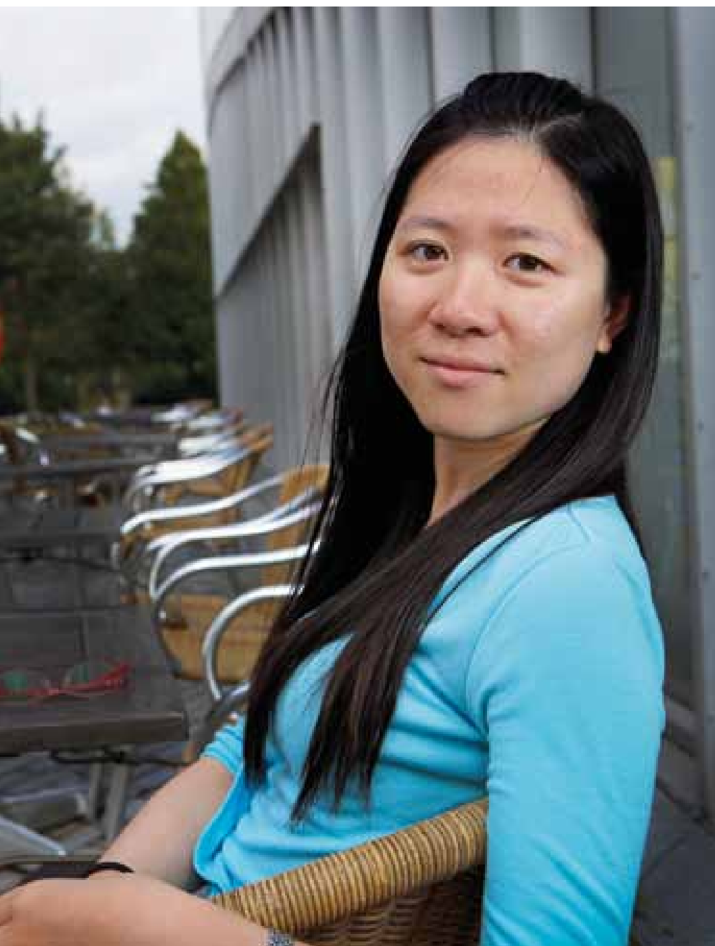
For the students, this is a great way to write their thesis. For the company, it is a great way of doing research that would not be done otherwise. Experts at APG write a research proposal for the students and develop it in

*Wenyong Tan, intern at APG's Innovation Centre, writing her thesis on Target Date Funds:*

*"t is a valuable and unforgettable experience. Working with smart and altruistic people, I sharpen my analytical skills and get a deeper perspective on the industry under inspirational guidance."*

accordance with the university supervisor. The student then has four months to do the literature research, build up a methodology, and produce his or her results. Meanwhile, we ask them to give a presentation on their progress at an internal seminar once a month. All the APG supervisors and other students attend these seminars to make sure that the student gets feedback from people with different backgrounds and ideas.

Wenyong Tan



More important, however, is the fact that for many students, this is their first experience with a full-time job in a professional environment. It is encouraging to see how much the students learn in their time at APG. While they are doing relevant research, we also hope to help them develop their soft skills. In the future, we would like to emphasize this even more, since we believe this shapes them and gives them high potential in the pension sector.

At the same time, APG benefits greatly from their research. We have had students digging into very different areas of study: ALM, risk management, market analyses, behavioral economics, communication, generational accounting, and pension design. Many of these theses have served as the basis for articles, NEA papers, and further research, and even won a number of Netspar thesis awards. Besides that, it is good to have fresh, young people of different nationalities in the office. Their ideas are not tainted by conventional wisdom and can sometimes catch colleagues off guard. And, when we have drinks, they do not need to go off home to their kids, which some of the younger colleagues (including yours truly) appreciate.

In addition to writing a good thesis, we ask one other thing of them: that they return the favor at some point in their career. Just as we have helped them by supervising them, we expect them to one day do the same for a student who is looking for an internship. Consider it intergenerational knowledge-sharing at work.

Ruben Laros
APG – Strategy and Policy

# RECENTLY PUBLISHED PAPERS

This page offers the recently published papers in the Netspar papers series. More papers and all pdf versions can be found on our website www.netspar.nl.

Discussion Papers (DP) are produced by all Netspar researchers and Ph.D. students who are involved in one or more Netspar research programs or themes. A DP aims at publication in high-standard scientific journals. It is usually the output of a research proposal funded by Netspar. It is published on the Netspar website jointly with a management summary. The DPs are discussed during Netspar activities and digitally published on our website and SSRN.

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## NEA (Netspar Economic Advice) Papers

describe and motivate the position of the author on a policy-relevant topic. In contrast to the PPs, these papers contain strong statements. Although Netspar as such is impartial, individual researchers of Netspar may very well have (and express) a personal opinion. Netspar simply offers a forum for in-depth discussion. The authors present the NEA Papers at meetings and discuss them with the audience. NEA Papers are also published in a booklet series.

**Bovenberg, Lans**
*Naar een duurzaam financieringsmodel voor hypotheken* (NEA 47)
**Leeuwen, Jacqueline van**
*Toezicht door DNB op de toepassing van de prudent person-regel in relatie tot het nieuwe pensioencontract* (NEA 46)
**Mahieu, Ronald and Alexander de Roode**
*Hoe reëel is reëel?* (NEA 45)

## 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.

**Jong, Frank de and Peter Schotman**
*De RAM in het nieuwe pensioenakkoord* (Design 10)
**Nijman, Theo and Bas Werker**
*Marktconsistente waardering van zachte pensioenrechten* (Design 9)
**Knoef, Marike, Rob Alessie and Adriaan Kalwij**
*De inkomensverdeling en levensverwachting van ouderen* (Design 8)
**Broeders, Dirk, Niels Kortleve, Antoon Pelsser and Jan-Willem Wijckmans**
*The design of European supervision of pension funds* (Design 6)
**Fouarge, Didier, Andries de Grip and Raymond Montizaan**
*Hoe gevoelig is de uittredeleeftijd voor veranderingen in het pensioenstelsel?* (Design 7)

2011

**Brink, Ton van den, Hans van Meerten and Sybe de Vries**
*Regulating pensions: Why the European Union matters* (Design 5)

# CHANGE OF ADDRESS

Netspar moves by October 1st 2012 to another office on Tilburg University campus. You will find us as of then at the Cobbenhagen Building, Room C 1.25. Our mailing address remains PO Box 90153, 5000 LE Tilburg, the Netherlands. Telephone numbers stay the same.

## Colophon

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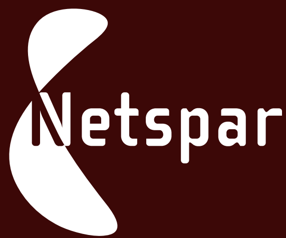

Network for Studies on Pensions, Aging and Retirement

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.

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