



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.

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:

'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

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."

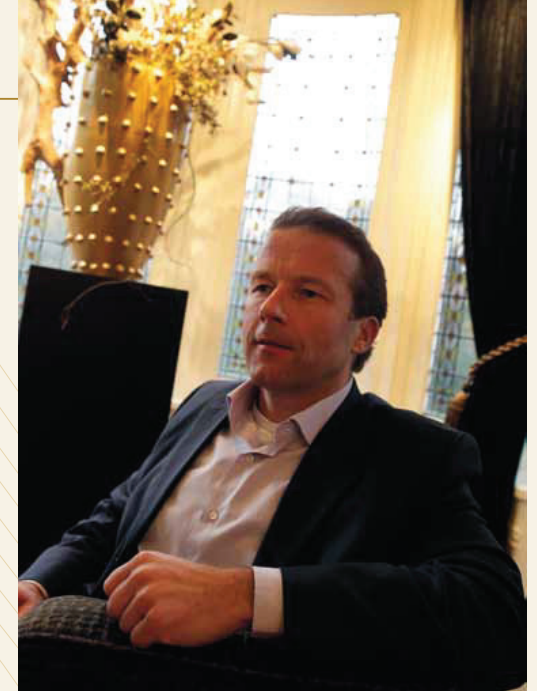
According to the economist, the increase of the retirement age for the second pillar has a delayed effect. "Because of the capital-funded system, it takes a long time before it affects the age at which workers leave the labor process," he explains.

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..."