Collective pensions and the global financial crisis: the case of the Netherlands

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Outline

- The Dutch second pillar system:
  - Nominal annuities + “conditional indexation”

- Impact of the financial crisis
  - Benefit cuts could be unavoidable
  - Inflation compensation unlikely for 10-15 years unless system is adjusted

- Current reform process:
  - Real pension income rather than nominal pension wealth as target variable
  - How can shocks be shared with participants in system in “DB – tradition”
  - Do (nominal) guarantees add value ?

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Dutch pension system

- First (= public) pillar aimed at poverty alleviation
  - Related to minimum wage (=social assistance benefit)
  - Not earnings related

- Second (= occupational) pillar is quite important
  - Corporatist tradition: unions and employers
    - Sectoral funds
  - Private but with public assistance
    - Semi-compulsion: > 90 % covered
    - Tax benefits
  - Run as DB plans
    - Ambition: earnings-related annuities

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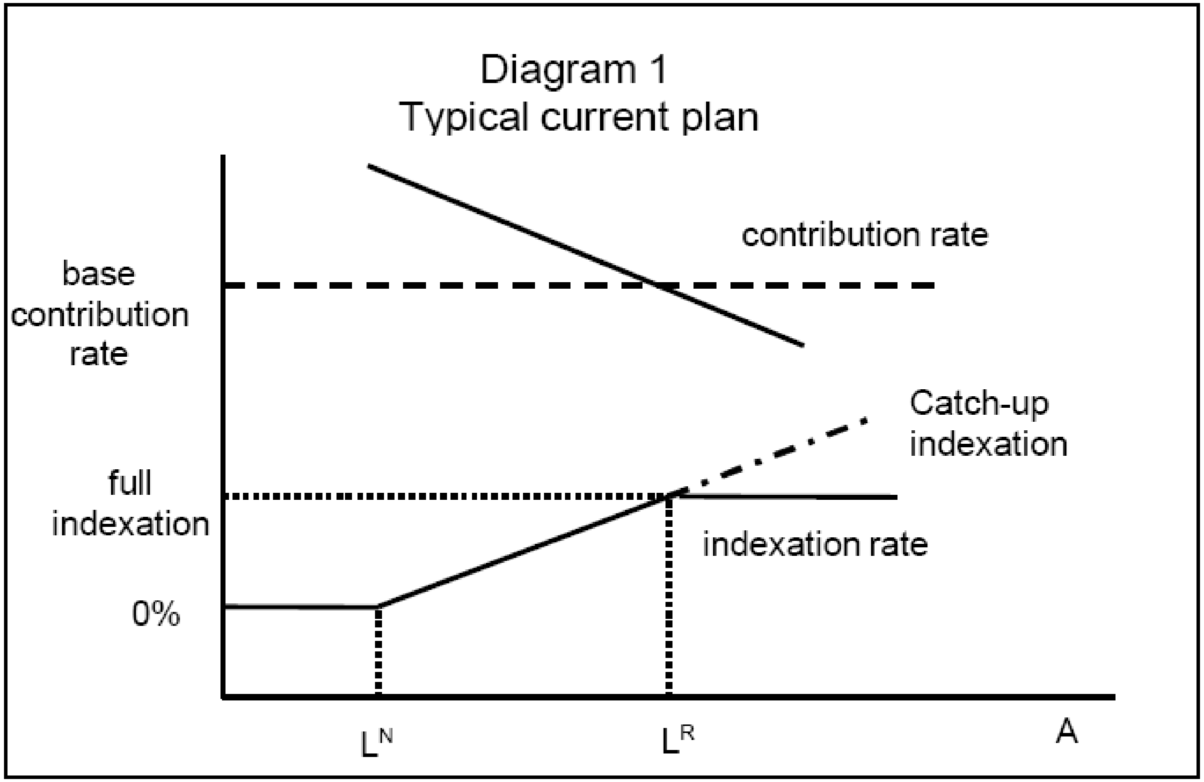
The conditional indexation and distribution mechanisms in second pillar



Nominal fully funded

Real fully funded

Funded rate

Strengths Dutch occupational schemes

- Advanced risk management aimed at earnings-related annuities
  - Integrate accumulation and decumulation
- Protection against behavioral biases
  - Automatic enrollment: high coverage
  - Limited set of choices offered
- Low expenses, buying power, reduced selection
- Completion of financial markets
  - Generations trade risks that are not yet traded on financial markets (longevity, standard-of-living, (wage)inflation)
  - Pooling of longevity risks avoids selection in annuity insurance

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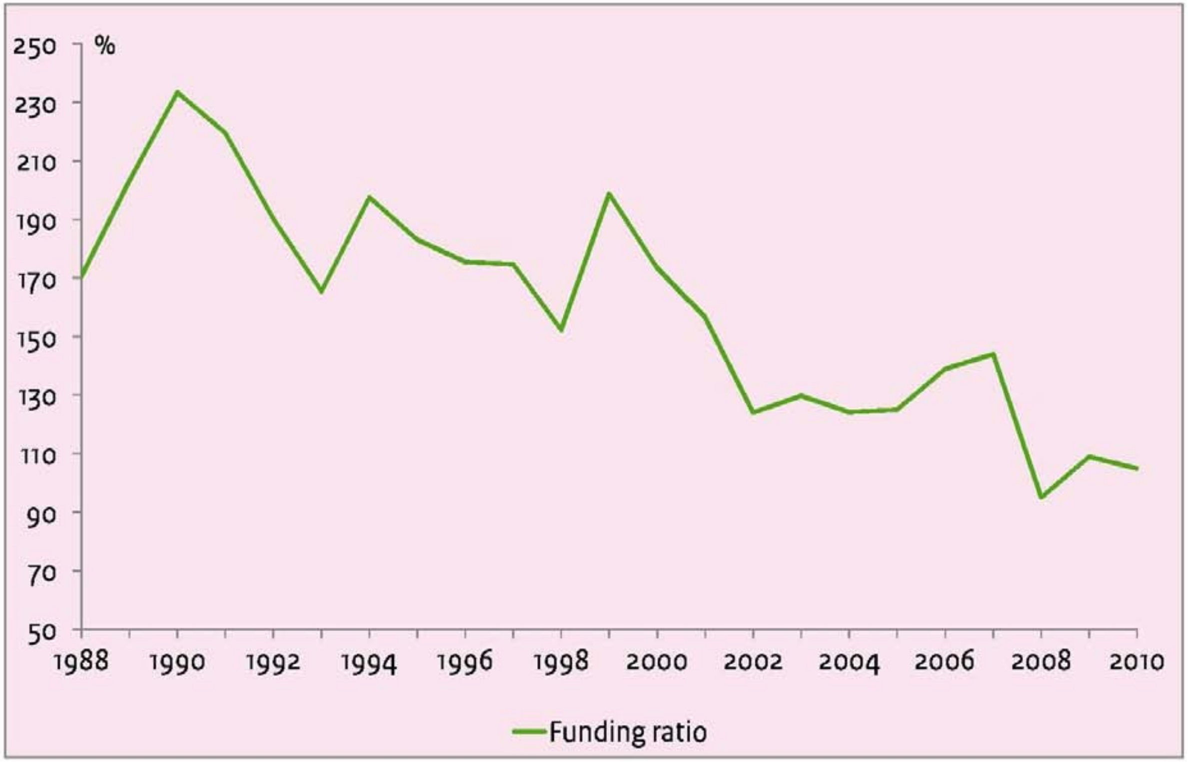
Impact of financial crisis on (nominal) average funded ratio



Impact of crisis

- Funded rates dropped from full real funding to (less than) full nominal funding
- Indexation of benefits is skipped, probably for many years
- Cutting nominal benefits has been an important option in 2009 and 2010 and occurred for some funds

- Ambiguous status of nominal guarantees: are nominal benefits to be protected or is indexation ambition dominant ?
- Ownership of buffer is ambiguous
- Participants became aware they are ultimate risk bearer
- Inadequate communication about real pension income
- Supervision and value transfers focus on nominal guarantee
- One size fits all under discussion
- Retirement age to be linked to reduction in mortality rates

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Pension agreement (June 2010)

- Public pension (AOW)
  - Retirement age linked to life expectancy
  - Benefits level somewhat increased

- Labor-force participation older workers should be stimulated

- Occupational pensions
  - Limits on pension premium as risk absorber (IFRS, relative size wage sum and pension entitlements)
  - Investment risk should be absorbed in pension rights ("soft rights", variable annuities)
  - Link retirement age to longevity
    - Macro longevity risk during accumulation phase with the participants

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Key questions managing financial risks to create variable annuity (DB tradition)

- Which financial risks to take?
  - Partial hedge of interest and inflation risk: target variable is expected real pension income
  - How beneficial or costly are (nominal) guarantees ?
- How do we want to allocate financial risk across participants?
  - More risk with young participants, e.g. age dependent indexation of return smoothing model
  - Compare life cycle and target date funds
- How do we want to communicate risk?
  - How do we help individuals with their individual risk management?

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Contract examples

- Escalating annuity:
  - Hard nominal guarantees and risky investments
  - ATP (Denmark)
    - Nominal guarantees fully hedged, collective buffer is risk taking
    - Whenever size of collective buffer large (> 25%) guarantee levels are adjusted
  - Many versions can be thought of with individual rather than collective risky investments and with individual rather than collective increase of guaranteed levels
  - Or: more risk taking while young and escalating annuity in decumulation phase
- If risky assets sufficient to have constant expected purchasing power then implicit life cycle pattern
- Guarantees are nominal only

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Contract examples

- Return smoothing model:
  - Drop guarantees and risk reduction after poor returns
  - Determine real soft funded rate as ratio of market value of assets of fund over the wealth required to offer a variable annuity with constant expected purchasing power at current projected benefit level for given risk exposure
  - Smooth shocks in real funded rate by increasing or decreasing projected benefit level (e.g. 10% of gap towards 100% funding adjusted annually)

- Less risk with elderly because of smoothing: implicit risk differentiation like in life cycle approaches

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What financial risk do we want to take?

- Do we want to have nominal guarantees?
  - **Yes**
    - People want guarantees
    - Gradual transition from current contract
    - Easy to communicate
    - Supervision easier and more objective
  - **No**
    - Do not exploit money illusion (paternalism)
      - ✓ Stimulates inadequate investment policy (nominal assets of long duration) which exposes participants to inflation risk
    - Do not exploit myopic loss aversion
      - ✓ Guarantees too expensive
        - ❖ Especially for (young) workers

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What financial risk do we want to take?

- Many DB systems have collective “buffers” that can be positive or negative (i.e. deficits)
- Do we want collective buffers ?
  - **Yes**:
    - Enables risk sharing with non-overlapping generations
    - Hide fluctuations in financial markets for participants
  - **No**:
    - Political risks + discretionary choices
    - Lack of portability
    - Lack of transparency
- Dutch system will introduce ‘soft individual rights”, linked objectively to financial markets

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How to communicate risk?

- What do people understand?
  - Pension income or pension wealth ?
  - Nominal amounts or replacement rates?
  - Risk (percentiles)

- Which stochastic models to use?
  - Model risk
  - Role supervision

- How do we help people with individual risk management?
  - Indicate adjustment saving or retirement age to reach a specific target
  - Adequate choice menu and choice architecture

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Challenges for the Netherlands

- Should we accommodate individual choice in risk exposure (also in transfers from current design) ?
- Can defaults tailor to individual heterogeneity without raising costs, selection of moral hazard ?
- Pension fund governance: which trustees ?
- Competition semi-mandatory occupational schemes (second pillar) and voluntary personal financial planning (third pillar).

Convergence in pension systems ?

- Many decisions on new design of Dutch system are still to be made

- In new Dutch second pillar system
  - more risks will be explicitly with participants
  - more choice will be offered
  - participation will remain semi-mandatory
  - many choices will remain to be made by trustees
  - annuities will remain largely mandatory

- Real annual pension income rather than pension wealth at retirement will be the main target variable

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