Nout Wellink: How regulators contribute to a sustainable pension industry

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Bank for International Settlements, at the Fortis pensionfund seminar, Utrecht, 15 February 2006.

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A seminar on the consequences of new legislation and other rules for pension funds cannot take place without the pension regulator, not least because it is his duty to enforce compliance with the new rules and regulations. After all, the objective is to ensure that the pension quality promised is actually delivered. I was therefore only too keen to take this opportunity to exchange views with you on "how regulators contribute to a sustainable pension industry".

I have taken the liberty to split my theme. In the first part of my address, I wish to look at the concept of sustainability and what it means for the Dutch pension system. Sustainability depends on three elements: discipline, transparency and a strong pension industry. In the second part, I will discuss the close link between pension supervision and these three elements, and their contribution to a durable pension system.

The messages I wish to convey are:

- First of all, a durable pension system is based on discipline: everyone must stick to the rules of the game. The future is unknown and the ensuing risks to the sustainability of our system are considerable. From the perspective of sustainability, both cost-effective contributions and adequate buffers are a sine qua non.
- In the second place, sustainability goes hand in hand with transparency. Pension funds need to be sufficiently transparent about what their participants, including future participants, may expect.
- Thirdly, a durable pension system depends upon a strong pension industry. Legislators, regulators and the sector have a shared interest in maintaining and propagating the comparative advantages of the Netherlands when it comes to pension provisions.

A durable pension system calls for discipline

Let me begin with the importance of discipline. For a pension system to be durable, all players must abide by the rules. At the heart of the rules in the Netherlands lies a funding system, where commitments are sufficiently covered by provisions and risks by appropriate reserves. We need to beware of slackening discipline and refrain from allowing deviations from the rules out of short-term considerations. That was true yesterday, it is true today and it will be true tomorrow. I expressly mention "yesterday", because it was only a short while ago, to be precise in the 1990s, that discipline throughout the sector was under pressure. Contributions were less than cost-effective, pension rights were made more generous and pension funds' risk profiles were tightened. All this against the background of a falling cover ratio, at current prices.

From 1999 on, the average nominal cover ratio at market value dropped sharply, from nearly 200% at end-1999 to 120% in 2002. However, the sustainability of stable-value pensions can be determined more accurately on the basis of the real cover ratio, in combination with the formulated indexation ambition. The real cover ratio may be roughly approximated by the nominal cover ratio, adjusted for actual price inflation. The real cover ratio then shows a similar picture to the nominal cover ratio, falling from nearly 150% at end-1999 to around 80% in 2002. As a result, full protection of nominal pension rights against inflation was no longer within reach, let alone inflation-proof pensions. Since 2002, both the nominal and the real cover ratio have stabilised. Today, the nominal cover ratio has been hovering somewhere between 120% and 130% for some time, while the real cover ratio is still well below 100%.

The fall in the cover ratio since 1999 was due to the trend-based decline in long-term interest rates, the sharp drop in share prices and, not to forget, the relatively low pension contributions. In this context, we do well to recall what was known as the Broad Revaluation. In the early 1990s, it was rational for pension funds to set low contributions, so as to prevent the tax authorities from creaming off pension capital. Contributions were consequently not cost-effective. By 2001, when the economic

tide had turned, pension contributions became subject to upward pressure. The average annual contribution as a percentage of remuneration went up markedly, from less than 8% in 2000 to nearly twice that figure in recent years. Since 2004, however, this rise has levelled off, and contributions have now stabilised at around a level which is cost-effective. Estimations for 2006 even indicate a slight decline in the average contribution.

We see from this recent past that buffers are essential to a durable pension system. The trouble with the discussion about buffers is that it generally makes allowance for the risk of under-funding, but fails to take into consideration the degree of under-funding. The importance of buffers for durable pensions and stability shows up in probability calculations, which take into account both the chance and the measure of under-funding. An average pension fund, which invests half its capital in corporate equities, with a duration gap of around ten years, and a cover ratio of 130%, has a chance of about 2.5% of facing under-funding within the next year. This degree of risk, viz. 1 in 40, is considered acceptable by politicians. However, when the cover ratio falls to 105%, this chance rises to about 1 in 3. I can hear you thinking that this is a totally different matter and you are right. So you see how important it is to look at both the chance and the measure of under-funding. As soon as the average pension fund's cover ratio falls below the required 130%, not just the risk of under-funding goes up, but so does the measure of under-funding. (When a fund's cover ratio is 105%, that ratio will, by the time the fund is confronted by under-funding within one year, have dropped to 90%.)

The point I wish to make is that, if our pension system is to be durable, such a situation needs to be avoided. Prevention is better than cure. We saw that low cover ratios necessitate much higher contributions, as well as lower indexation. In addition, low cover ratios hamper value transfers and labour mobility, and create uncertainty when the sponsor goes bankrupt. Adequate buffers, on the other hand, allow of stable contributions and lasting indexation. Buffers furthermore offer protection against downward risks, as well as the advantage of extra return, which can be used to realise indexation ambitions.

But back in 2002, there was no question of sustainability. In its Quarterly Bulletin, the Nederlandsche Bank began to draw attention to the pension sector's financial position. One article was titled "Sustainability under pressure". The tone was sombre. Today, more than three years later, much has changed for the better. Far-reaching measures have been taken to put the Dutch pension system back on track again. The number of pension funds with a funding problem has fallen drastically, contributions are practically cost-effective again and the average cover ratio has all but recovered to the minimum desired level. This is good news.

Transparency and sustainability go hand in hand

Now let's look at my second message: sustainability and transparency go hand in hand. Pension funds need to be sufficiently transparent about what their participants can expect to get. Transparency rules out surprises and thus enhances confidence among participants. This is a major principle of our pension system. After all, people trust that pension entitlements, accumulated during their active life, are paid out upon retirement. A recent survey by the Nederlandsche Bank shows just how much they value pension security. Nearly half the respondents are prepared to pay a higher pension contribution for more certainty about their eventual pension benefit. Only one in five participants opts for an arrangement without guarantees; the remainder are indifferent. It was noted that pension fund managers and participants may disagree on this point.

In the Dutch system, transparency also means being open about the pros and cons shared with future generations. Future generations are stakeholders because they, too, will join the pension system at some point in time. With a view to the continuity of the system, access should be and remain attractive. In other words, sustainability also means that the needs of the current generation are not met disproportionately at the expense of future generations. Risk-sharing within and between generations forms an essential element in the collective Dutch pension system and offers many advantages. It makes the pension system more stable and more durable. After all, pension arrangements are about spreading risks, the main risks being: longevity risk, inflation risk and investment risk. When these risks are spread widely and over time, all participants stand to gain in terms of prosperity: in economics, this is known as a Pareto improvement. Where pensions are concerned, this advantage is reflected in a stable income pattern over the individual's life cycle.

The prosperity gains of our collective system should not be taken for granted. Spreading risks among generations works so long as future generations are not saddled with an unduly heavy burden; if they

are, a funding system will be confronted with an unsustainable situation sooner or later. New entrants facing a situation where they are required to pay disproportionately more for their own pensions over a long period of time will vote with their feet. Or the mandatory nature of the pension system will be called into question. To prevent this from happening, discipline is needed so as not to overburden future generations, and transparency to keep up support for the distribution of the advantages and the disadvantages. A sustainable pension system stands to benefit from a durable distribution of the pluses and the minuses.

A durable pension system depends on a strong pension industry

This brings me to my third message. Apart from discipline and transparency, a durable pension system calls for a strong pension industry, with healthy pension funds, which flourish in a dynamic environment characterised by lasting expertise in managing pension risks. Legislator, regulator and the sector have a common interest in maintaining and propagating the comparative advantages of the Netherlands in terms of pension provisions.

These comparative advantages are considerable. The Netherlands not only has one of the best capitalised pension sectors in the world, it also has much experience of pension insurance. This country harbours much knowledge and skills in the areas of asset-liability management, portfolio management, actuarial expertise, information technology, tax and pension legislation and administrative processes. Here, major advantages of scale can be had. Where asset pooling is concerned, too, the Netherlands offers a surprising potential investment alternative, a restricted fund for mutual account, comparable to much-praised Luxemburg and Irish constructions. Finally, the Netherlands has an edge in that both pension funds and regulators have wide experience with the implementation of the prudent person rule (which entails: (i) expert portfolio management, (ii) the investment of assets in the interest of (former) participants so that (iii) the safety, quality, liquidity and return on the portfolio as a whole is guaranteed,(iv) alignment of the risk and return profile of the entire portfolio to the fund’s liability structure and (v) sufficient diversification of investments.) In short, even though it is rarely mentioned in the media, the Netherlands has as much to offer as other countries, and even more.

But there is no cause for complacency. Maintaining a sound starting position is not a matter of course. Where possible, we must continue our efforts to capitalise on national and especially international developments. Take, for example, the EU pension directive which entered into force in September 2005. This directive allows European employers to place pension commitments with pension funds in another EU Member State. Given its comparative advantages and its avant-garde position in the development of risk-based capital requirements for pension funds, the Netherlands is an attractive domicile for such institutions. Here lie opportunities for the Dutch pension industry. In conjunction with the Ministries of Social Affairs & Employment and of Finance, a working group of the Nederlandsche Bank are currently investigating how the Netherlands could become even more attractive as a domicile for pension funds. The working group are putting out their feelers within the sector, but welcome suggestions. I hereby invite you all to submit ideas on the Bank’s website, info@dnb.nl, which is open around the clock.

How the regulator contributes to sustainability

Having explained the importance of durability for the Dutch pension system, I would now like to take a closer look at the role of the regulator. By exercising supervision, the Nederlandsche Bank contributes to durable old age pensions and a strong pension industry. Supervision contributes to three principles which are related to the themes mentioned earlier, i.e. discipline, transparency and a sound pension industry. These principles are: (1) identifying risks, (2) preventing rising deficits, but should these occur, (3) applying a customised approach to the resolution of the problems, effected as soon as possible. These principles form the foundations of the Financial Assessment Framework.

The Framework does not prescribe the substance of pension arrangements; that is the province of the social partners. Furthermore, as regulator, the Nederlandsche Bank is not responsible for the quality of pension arrangements. Incidentally, this does not mean that the Bank does not have an opinion on what constitutes quality. In my capacity as economic advisor, I have pointed out on several occasions that pension arrangements should include a serious indexation ambition. Nominal guarantees are nice, but protection of purchasing power is nicer still. A serious indexation ambition must therefore be

at least in line with the ECB's objective of price stability, i.e. around, but not more than 2% inflation annually.

The Financial Assessment Framework contains standards for overseeing compliance with the pension contract. Basically, financial supervision addresses the question whether a pension fund's assets are proportionate to its liabilities and prevailing risks. In other words, it seeks to prevent under-funding. This is the foundation of the funding system; in combination with adequate buffers, cost-effective contributions and sufficiently inflation-proof pensions, it makes for a durable pension system.

But even in a sound, durable pension system, under-funding can never be ruled out altogether or only at a very high cost. Should an unhoped-for financial disaster take place, a customised plan, which takes into account the fund's efforts to prevent under-funding, and ensures that the interests of the participants are best served will take effect. Such a customised plan is set in motion only if the pension fund's management has deployed its instruments to the full, and the employer or the industry involved, have done their utmost.

It is important that the problems be solved as fast as is possible, because prolonged under-funding has several harmful consequences. For instance, a financial shortfall has major consequences for participants in the event that the sponsor goes bankrupt. Under-funding also precludes indexation, and eats into retirees' purchasing power. All this may be detrimental to the system's durability.

Conclusion

A durable pension system requires discipline, transparency and a strong pension industry. It is these three elements which the Financial Assessment Framework seeks to achieve by (1) emphasising the identification of risks, (2) directing policy at preventing deficits, and (3) customising any remedies, should the deficits arise after all. This is how the regulator contributes to the durability of the pension system and a correspondingly durable pension industry. Here, today and in the future.