Nout Wellink: Challenges and opportunities for corporate pension fund management

Speech by Dr Nout Wellink, President of the Netherlands Bank and Chairman of the Basel Committee on Banking Supervision, at Hoofdkantoor Shell, Den Haag, 26 June 2007.

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The organizers have asked me to contribute to this seminar in honour of Peter Bronkhorst, who is stepping down as Managing Director of the Shell Asset Management Corporation. In view of Peter's outstanding contributions to the Dutch pension business in general, and to that of Shell in particular, I decided to agree to this request. An additional reason, of course, is that this is an excellent opportunity to address a prominent group of asset managers. Although it is tempting to resort to breezy lightheartedness on a festive occasion such as today, I have opted for substance, as Peter Bronkhorst is widely known as a man of content and professionalism.

Given today's theme – Challenges and Opportunities for Corporate Pension Fund Management – I would like to discuss some challenges that pension funds have recently encountered. More specifically, I would like to explore how company pension funds have dealt with these challenges in the Netherlands and in the US. In this respect, it is interesting to compare the Dutch corporate pension industry with its American equivalent, as they have chosen different routes to cope with the increasing burden of aging: whereas the Americans have individualized their pension system to a large extent, collectivity was preserved in the Netherlands.

In evaluating these different routes, I will emphasize four key messages. First, I will argue that a clear separation between a sponsor and its pension fund is a desirable feature of any pension system. Second, I will point at the added value of collective pension plans over individual ones. Third, I will argue that this collective nature saddles pension fund asset managers with an important social mandate. And fourth, I will also point at an opportunity in the pension delivery market, which I challenge you to seize.

Comparison of the Dutch and American pension system

Since most of us are more familiar with the Dutch pension system, I will start with a brief overview of the American system. The US pension system is characterized by a relatively small government-imposed pay-as-you-go system. This benefit constitutes only 45 percent of total retirement income in the US. Here, the Netherlands and the US are comparable. Indeed, the Dutch state pension scheme is also fairly small, as it provides the average employee with about 50 percent of his total pension benefit. At the same time, about 55 percent of total US retirement benefits is provided through a funded system. In the Netherlands, too, funded pensions are fairly popular, constituting about 50 percent of total retirement benefits. Notwithstanding these similarities, there are also differences. In particular, pension benefit replacement rates differ widely between the two countries: whereas the US have an average pension replacement rate of 51 percent, this rate amounts close to 84 percent in the Netherlands. Also, US pension funds have shifted much more risk towards their participants while the Dutch pension system provides its participants with a relatively high degree of certainty on the expected pension benefits.

Within the class of funded US pension benefits, we primarily need to distinguish between two cases. First, there are the traditional company-linked defined benefit pension schemes, which are losing popularity for reasons which I will set out later. The decline of these defined benefit pension schemes has been reflected in a rise of the so-called 401(k) plans. These pension plans, which are named after a section of the US tax law, are individual saving plans that allow workers to save for their retirement under a favourable tax regime. The tax incentive is derived from the deferral of taxes on pension savings and returns. Under such a plan, the employee chooses to transfer a certain portion of his wage to a 401(k) account, from which he can draw after retirement. These 401(k) plans are typically of a defined contribution nature and at times depend heavily on the investment capabilities of the individual concerned.

The benefits of legal separation between sponsor and pension fund

Traditional US company pension plans clearly resemble Dutch company pension plans. Both are collective in nature, both invest pension assets on their participants' behalf, and both provide a defined pension benefit.

However, the legal setting in which these company pension funds have to operate, varies between the two countries. In the US, company pension funds are rarely financially separate from the sponsor company, so that pension assets are ill-protected against employer bankruptcy. The Dutch system, on the other hand, is characterized by legal separation between the sponsor and the pension fund, so that bankruptcy of the sponsor does not necessarily have fatal consequences for the fund.

To me, this legal separation between sponsor and pension fund has two crucial advantages. First, it excludes insidious conflicts of interest. After all, if the sponsor and the pension fund are not separated, it is not entirely clear for whose benefit a pension fund is run. For shareholders or participants? In this respect, experience in the US has shown that in some cases pension fund surpluses were channelled back to the sponsor, while deficits were borne by pension fund participants via premium increases or entitlement cuts. This criticism admittedly also applies to the behaviour of some Dutch pension funds in the 1990s. But the new Financial Assessment Framework, which became active as of January 1st, 2007, has made the situation more balanced by explicitly spelling out the modalities under which contribution holidays can take place.

Second, a crucial advantage of the legal separation between a sponsor and its pension fund is that not all the employees' eggs are put in a single basket. In the absence of such a separation, the system creates concentration risk for employees as it makes both their human and financial capital dependent upon one and the same firm. Consequently, if a firm were so unfortunate as to go bankrupt, its employees would lose not just their jobs, but their pension entitlements as well. This concern is increasingly problematic in modern dynamic economies where company lifetimes are decreasing. With the introduction of new accounting rules, which require companies explicitly to report their pension liabilities on their balance sheets, many companies discovered that they had actually been transformed into asset managers and life insurers, at great distance from their core business. For example, with pension liabilities amounting up to $11 billion, General Motor's pension obligations roughly equalled its market capitalization, which amounted to $12 billion at the end of 2005. In fact, some US companies (including some airline companies) had to renege on their pension promises by entering into Chapter 11 insolvency protection. Via this route, they were able to transfer their pension obligations to the pension benefit guarantee corporation and to continue their business, with lower implied pension benefits for retirees.

These considerations lead to the first important message I would like to emphasize today, namely that the separation between a sponsor and its pension fund should be a key feature of any pension system, to be fervently preserved and promoted.

By contrast, in the US the aforementioned problems are mitigated in another way. There, companies introduced individual 401(k) plans, which do not appear on their balance sheets as a liability. This switch has the advantage that employees' pension assets are no longer exposed to employer bankruptcy; on the downside, however, benefits are now of a defined contribution nature. The risks are then placed squarely on participants' shoulders. In this respect, a further development of risk-pricing would help gain deeper insight into risk differences between pension systems. This brings me to a second key issue in the design of corporate pension plans: how to decide on investment policy and who should bear the residual risks?

Investment policy and responsibility

Let me put this more bluntly: is a shift to defined contribution schemes the optimal way to reduce pension risks for employers? I doubt it. In 401(k) plans, the individual decides what part of his wage he wishes to transfer to his 401(k) account. Moreover, notwithstanding recent initiatives that offer participants responsible investment-packages as a default, the majority of the plans still give contributors a substantial say in the investment policy. This all means that many 401(k) plans rely heavily upon individual responsibility as well as financial literacy. However, not everyone is able to understand the complex world of pension finance, as the average employee is not as well educated in finance as you all probably are.

Let me clarify this by asking two basic questions, which were also put to a large group of American workers:

- Suppose you have €100 in a savings account and the interest rate is 2 percent per year. After five years, how much do you think that you would have in the account if you left the money to grow: more than, less than, or exactly €102?
- Now imagine that the interest rate on your savings account is 1 percent per year and inflation 2 percent per year. Would you then be able to buy more than, exactly the same as, or less than today with the money in the account?

It may come as a surprise to you, but research has shown that over 50 percent of US pension plan participants could not answer these two simple questions correctly. And add to this, as pension-expert David Blake noted more than once, that 50 percent of the individuals does not even know what 50 percent is!

Moreover, the man in the street is not an expert on risk diversification: in for example the well-known Enron case, employees had invested 60 percent of their 401(k) assets in Enron stock. On average about one-fifth of all 401(k) assets are invested in own company stock. Although this is understandable since an employee is always relatively confident of his own firm's prospect, this again leads to the undesirable situation where human and financial capital are tied to the wellbeing of one and the same firm.

Additionally, under 401(k) plans, it is up to participants to decide what amount to reserve for pension purposes. Here, the problem is that the typical 401(k) participant seems to have commitment problems: estimates indicate that the typical 401(k) participant approaching retirement has saved less than $50,000, instead of the $300,000 he would have accumulated under a defined benefit system. Procrastination behaviour – based on thoughts such as "I will start saving tomorrow" – as well as limited rationality seem to abound.

Given these examples, my second main message is that since individuals only seem to be rational up to a point, there is considerable value in preserving the collective nature of our system. In such a system, participants automatically contribute enough towards their old age financing while professional asset managers make sure that the contributions are well invested from a risk-return perspective. This ensures that every individual is provided with a reasonable pension benefit after retirement. Moreover, collective pension systems are cost efficient, as they exploit economies of scale, and enable intergenerational risk-sharing which is welfare-enhancing to risk-averse individuals.

My third main message, which follows from my second, is that you should all realize that the collective nature of our system brings important fiduciary responsibilities for you as pension fund asset managers. Keep in mind that compulsory participation implies that participants are not free to choose which pension fund to join, unless they move to another company or industry. In this way, your power to raise contributions is very similar to the government's power of taxation, from which one normally also cannot escape. Consequently, you bear an important social responsibility – even more so than "ordinary" companies. Therefore, pension fund management requires good governance as well as transparency to allow pension plan participants to see what is being done with their money on their behalf. In addition, the compulsory nature of participation implies that you should not only look at private returns, but also try to take social returns into account, as society as a whole has given you the mandate to raise your funds. In this light, I applaud the recent initiatives that discourage socially irresponsible investments.

My final message is more of a provocation to you all. In most western countries, pension systems have already been individualized to some degree as part of the shift from defined benefit towards defined contribution systems. To a lesser degree, this has also occurred in the Netherlands, with the introduction of conditional indexation and life course arrangements. In this context, I foresee market opportunities for new pension products that are tailored to individuals, but maintain the benefits of collectivity. This involves both assisting individuals with complex choices and making risk pooling instruments more readily available.

Peter Bronkhorst

Having stated these messages, I finally turn to today's overarching theme: Peter Bronkhorst's retirement. From my story, one may infer that I believe that a good asset manager should be both prudent and astute.

Peter Bronkhorst possesses both these characteristics. This is also reflected in the performance of Shell's pension fund. During Peter's period of office, Shell's pension fund portfolio out-performed that of most other Dutch pension funds: as noted in its yearly report, Shell's pension portfolio earned an average annual rate of return of 6.8 percent over the period from 2001 to 2005, when Peter led the predecessor of SAMCo, as compared to 4.5 percent for the average Dutch pension fund over the same period. In Peter's last year, 2006, I am told that SAMCo even realized a rate of return equal to 17% – about 7 percentage points higher than the average Dutch pension fund. That is what I would call a generous farewell gift! But Peter's strong track record was not only established in the upswing. In fact, Peter guided Shell's pension portfolio through the perfect storm that hit the financial markets in 2001. Peter's investment policy enabled the Shell pension fund to compensate its participants fully for inflation in all years he was in charge.

Besides this, Peter deserves merits for bundling Shell's pension assets in the Netherlands. This is favourable for the Shell pension fund itself as research has shown that there are substantial economies of scale in pension fund provision. Apparently, the Dutch entity was the better place to deliver these economies of scale. In this context, bundling these activities in the Netherlands also brings positive externalities to the Dutch economy as it preserves and creates high-skilled employment in our country. In this way, it seems to me that Peter has fulfilled his social mandate in an exemplary fashion.

Finally, one of my colleague-directors at the Dutch Central Bank – Dirk Witteveen, who as pension supervisor got to know Peter Bronkhorst fairly well – praises Peter for the binding role he fulfilled between social partners and pension funds when the sector was in disarray in the wake of the 2001 financial market storm. During this period, Peter kept a constructive, open attitude that contributed to agreement on the necessary adjustment measures. With the recovery of the Dutch pension system now well-established, this all seems like long ago, but we wouldn't be sitting so comfortably now if it hadn't been for the necessary measures taken and for Peter's contribution to implement them.

Conclusion

I am coming to the end of my speech. I have stressed four important interconnected messages, relevant for the future world of pension finance. First of all, I believe that we should preserve and promote a clear separation between a sponsor and its pension fund. Second, I have pointed out the added value which collective pension arrangements have over individual ones by protecting pension plan participants against their own shortcomings, by exploiting economies of scale, and by enabling intergenerational risk-sharing. Third, I have emphasized that asset managers need to realise that their fiduciary mandate saddles them with important social responsibilities. Last, I challenge you to come up with pension products that are tailored to individual preferences, but are also able to maintain the benefits of collectivity.

I congratulate Peter Bronkhorst on the excellent job he has done in these respects. The flipside is that I regret his stepping down from a prominent position in the pension industry. As a real – and therefore internationally oriented – Dutchman, Peter was often able to build bridges, even in intense debates. Now time has come for you, Peter, to harvest, as a pensioner, the fruits of the seeds you have sown. I wish you all the best in the future.