Nout Wellink: Pension in motion - the Netherlands in an international perspective

Speech by Dr Nout Wellink, President of the Netherlands Bank and President of the Bank for International Settlements, at the ABP/PGGM-Congress "Pension Plan Design for the Future", The Hague, 25 April 2005.

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"The Dutch pension system is among the best in the world. But does it have a future?" This is how the opening question reads on the invitation to this two-day conference. A challenging question, to be sure, one that is bound to release many emotions. For a discussion of pension and the future cannot be held without raising the need for reforms. And politicians do not win public favour with proposals towards reforms. On the contrary, strikes and mass demonstrations are their lot all over Europe and even in the Netherlands.

Even so, many citizens, the younger generation in particular, seem convinced of the need for pension reforms. The main cause – the ageing of the population – is leading to increasing fiscal pressure in most Western countries. Considerable fiscal deficits or pension contribution rises are imminent if we do not take action. In this address, I will therefore look at the situation in several European countries. Has any progress been made yet? And how is the Netherlands doing in this context? Subsequently, I will highlight two other themes: transparency and freedom of choice.

Transparency is a very topical theme for pension funds in the Netherlands. Greater transparency is vital for the system to be future-resistant. Transparency regarding the financial position, the risks and the risk distribution. For the traditional actuarial and accounting techniques no longer afford consistent insight into the financial position of pension funds. Deficits are not identified in time, and once they are established, it is not always clear by which party they should be absorbed. Things just have to improve. The Financial Supervisory Framework will bring relief. This is my first message for you.

My second message concerns freedom of choice. The increasing diversity of labour patterns among workers calls for customization of pensions schemes. However, the Dutch appear to hold pension security very dear. Greater freedom of choice must therefore not be provided at the expense of pension security. More than that, for the truck system that is typical of our system, a high degree of security is a prerequisite. People must be able to rely on a given minimum level of pension rights. Above that level, they could be allowed more freedom of choice in the risks they run. How Dutch pension funds will be able to realise such a system is what I'm going to explain next.

Europe

First, the situation in Europe. Everywhere in Europe, life expectancy is rising and birth rates are falling. In particular in countries relying heavily on the pay-as-you-go system, the attendant increase in the "grey" pressure leads to ever higher pension contributions. This situation applies to most European countries. Exceptions are the United Kingdom, Denmark, Sweden, Ireland and our own country, where money is set aside for pension, the so-termed second-pillar. A number of countries, like Germany, are seeking to develop a capital-funded private pillar, but it will take a lot of time and a long period of double burdens before this goal is achieved.

Countries like the United States and the United Kingdom, which were already convinced of the need for adjustments decades ago, started reforming their pension systems in recent years. As early as 1983, the United States decided to raise the age of retirement stepwise from 65 to 67 between 2003 and 2022. The United Kingdom, too, has a long tradition of pension reforms. As early as in the 1970s, it was recognised that something had to be done in order to raise private pension savings and reduce the state pension's share. To this end, enterprises were initially stimulated to set up collective pensions schemes. However, this plan failed under Thatcher. Her government encouraged citizens to build up their old age pensions individually. Thousands of those risking this change were set back for large amounts on being wrongly advised by questionable intermediaries. As a result, the cutbacks in state pensions were not set off by improvements in private arrangements.

The pension issues have meanwhile been brought home to continental European countries, too. Solutions are proving politically nettlesome, though. Most countries are taking the first cautious steps now. For example, in a large number of countries the ages of retirement and early retirement or the

number of years of service required for entitlement to pension benefits are being revised. In Italy, for one, the retirement age of men will be raised from 57 to 62 years, between 2008 to 2014, while in France not the pensioning age, but the number of years of service will be increased, i.e. to 40 in 2008.

In a number of countries, the austerity measures are combined with the introduction of a flexible age of retirement. Workers in Finland, for example, may choose to retire at an age between 63 and 68. Every year they postpone retirement they secure a higher pension. Italy and Sweden are interesting cases when it comes to life expectancy risk. They have converted their system into a Notional Defined Contribution (NDC) system, which provides for a closer link between the contributions paid and the pensions paid and uses the life expectancy at the moment of retirement as a basis for the pension rights. In other words: the costs of a longer life expectancy are no longer shouldered by the next generation, but translated into lower pensions.

The Dutch situation

Indeed, rising life expectancy is one of the main causes of the increasing burden. As a result of rising life expectancy, many more people reach the age of 65. When, back in 1957, the Netherlands adopted the old-age pension system for people aged 65 and upwards, the average age of death was still about 61 years. It would last another small decade before the average age of death for men had risen above 65 years. At the time, men did not reach the age of 65 as a rule. By the time you were 65, you were simply unable to work anymore. If we were to extrapolate this line of reasoning, the age of retirement would need to be raised to 79 on the grounds that the current average age of death is 75. This comparison, while absurd, serves to demonstrate how much better and, hence, more expensive our pension provisions have become. The number of people receiving an old-age pension has grown substantially because the age of retirement has remain unchanged. To avoid an abrupt adjustment of the age of retirement, it is therefore advisable to start discussing a system by which the average age of retirement is gradually raised, while allowing individual flexibility as to the age of retirement and, hence, freedom of choice as to the height of the pension benefit.

Unlike most other European countries, the Netherlands is so fortunate as to have built up high pension reserves. As a result, the ageing of the population affects our total pension benefits to a lesser degree. All the same, our second-pillar pensions are sensitive to the ageing of the population. This sensitivity is reflected, among other things, in the effectiveness of the contribution instrument: it is becoming increasingly difficult to absorb setbacks with contribution adjustments. In recent years, many arrangements have been converted from final pay to average pay schemes, with conditional indexation of pension accruals and benefits. This permits a more flexible use of the indexation instrument and makes for a different risk distribution between the parties concerned. Through this development, our system seems to be shifting towards a “defined contribution” system, for lower than expected investment results and reduced indexation will result in lower benefits. However, it certainly still is not a DC system in all respects. In a DC system, the risks are entirely borne by the individual worker, while average pay schemes are characterised by risk sharing and intergenerational solidarity. If returns are lower than expected, the active and next generation may be resorted to in order to safeguard post-actives’ benefits. However, the use of indexation as a steering instrument increases the risk of erosion of the future value of our pensions. This risk is directly related to the indexation ambition and the corresponding contribution reduction that pension funds will be required to formulate under the Financial Supervisory Framework.

Social partners are of course free to determine the indexation ambition themselves, but everybody should bear in mind that their pension’s value will be considerably eroded if during the accrual phase indexation is incomplete. Proceeding from 2% indexation, one-third of the total capital accumulated at the age of 65 is made up of these indexation allowances. To the extent that full indexation is too ambitious, a stable value pension must surely be feasible? This ambition may be pegged to the ECB’s inflation target of 2%, the lowest indexation percentage that a pension funds should strive to ensure.

Transparency

The adjustments in the supervisory framework and the transition to the average pay scheme are closely related to the financial recession that pension funds have faced in recent years. This brings me to transparency. Owing to the traditional actuarial and accounting techniques, the actual financial position of pension funds was insufficiently transparent. Pension funds were required to value their

investments at current prices, whereas liabilities were valued at a fixed actuarial interest rate of 4%. This led to a situation that prevented timely identification of hidden surpluses and deficits. Due to this lack of transparency, the higher yields realised during the stock market boom were translated too soon into contribution reductions and more generous pensions, without it being evident how lower-than-expected yields would have to be absorbed. To many Dutch pensioners it came as a complete surprise that "lower than expected investment yields" could mean no or lower indexation. Apparently, they had failed to read the key features document, or gave up reading when they came to the small letters section. Nearly all pension regulations contain an escape clause that renders indexation only obligatory if permitted by the funds available. This makes it imperative, though, that the actual value of these funds can be verified. Transparency is therefore of the utmost importance. And transparency is just what was lacking. I shall show this to you on the basis of the following two figures (see Annex).

The first figure reflects two funding ratios. The blue curve represents the traditional funding ratio, the red curve the funding ratio based on market rates. The figure shows that the funding ratio based on the fixed actuarial interest rate rose in the second half of the nineties and did not decline until after 1999, when the creeping slump had set in. If you just look at the liabilities side, thing become a lot clearer yet.

The blue curve stands for the liabilities at the fixed actuarial interest rate. The red one, for the liabilities at the market rate. What may be concluded from this chart is that the room for indexation did not start to narrow until as late as 2000, but, due to the declining trend in the capital market interest, already in the early nineties. In fact, the use of a fixed actuarial interest rate has masked half of the actual increase in pension liabilities.

The financial problems in recent years have made all the parties concerned more aware of the risks incurred by pension funds. Implementation of the financial supervisory framework should enhance transparency and consistency between the values of investments and liabilities, making hidden reserves visible. Compare this to the Tower of Winds by the renowned Japanese architect Toyo Ito. The Tower of Winds, a ventilation tower for the subterranean space of Yokohama station, is equipped with 2,000 computer-steered light bulbs that respond to wind, sound and temperature. In daytime, the light is reflected by aluminium panels, bringing out the building's cylindrical shape. In night time, the lamps transform the tower into a transparent structure. Our pension system should eventually resemble that Tower, looking beautiful during the day, and revealing its internal structure and robust foundation during the night.

Besides making visibility of reserves mandatory, the Financial Supervisory Framework contains stricter provisions regarding cost-effective contributions, with a view to creating more clarity about the market-comparable costs of pension commitments. Moreover, funds should offer more insight into the way they have distributed the risks between the parties concerned. They must communicate their indexation ambition to the participants in unambiguous terms. A great challenge lies ahead of them within this scope. They must be open about the risks run by each individual, as well as about the consequences of these risks, for running risks means suffering pain every now and again. The parties concerned might arrive at the conclusion that the decisions made were ill-advised. How is one to explain that the risk was deliberately taken and that the decisions made on the basis thereof were good, but that there is always a chance that things go wrong? In an unpredictable world, ex ante "good" decisions may prove "wrong" ex post, if the risk materialises. The very fact that pension funds take risks also obliges them to render an account for their policy, as such conduct will ensure the public's confidence in the system. This also fits in with the demands made by today's society on institutions. In short, for a system to be future-resistant all parties involved must be aware of the risks they run and the possible consequences thereof. Transparency regarding the financial position of funds is a prerequisite to this end.

Freedom of choice

This brings me to my second theme: freedom of choice. Not only is it necessary for participants to know the risks they run, but for pension funds it is equally important to know what risks their participants are willing to run. When it comes to their pension provisions, the Dutch turn out to be risk-averse and consider themselves financially incompetent. This emerged from a recent survey by De Nederlandsche Bank. The outcome of this survey is that the vast majority of Dutch workers are not interested in a transition to a DC system. The majority value security and are willing to pay for that. This means that more freedom of choice must not be provided at the expense of pension security. More than that, for the truck system characterizing our present system a high degree of security is a

prerequisite. People must be able to rely on a given minimum level of pension rights. Above that level, they could be allowed more freedom of choice regarding the risks they run.

What can pension funds do to accommodate these preferences and the diversity of risk profiles? By offering a lower, but guaranteed indexed pension, supplemented with an individual pension build-up based on a risk profile of the participant's free choice. This does not imply that participants must be showered with thousand-and-one different options. In his book "The Paradox of choice: why more is less", Barry Schwartz explains that maximum freedom of choice is not necessarily always better. There is a boundary across which more freedom leads to diminishing returns. People tend to grow depressed when offered abundant freedom of choice. The sense of not having enough time to make the right choice causes stress and, not seldom, to disappointments. Also experiences in Sweden, where workers may choose from 650 different collective investment schemes for their public DC pension show that an abundance of choice is felt to be a burden.

Pension funds had therefore better offer a limited number of risk profiles. Subsequently, participants can choose the risk profile that suits them best. The risk-averse will opt for a no-risk profile; those willing to run high risks, for a high-risk profile. And, naturally, those finding themselves in between these two categories will pick the low-risk variety. The security of the basic pension in any case offers participants a minimum guaranteed pension they can fall back on.

For the guaranteed basic pension, pension funds should make sure that the mismatch risk is minimal. This is in compliance with the Financial Supervisory Framework, which makes clear that either side of the balance sheet is sensitive to market rate changes and, hence, makes the interest rate risk visible. The interest rate risk is determined by the difference in maturity between investments and liabilities. As, at present, the average maturity of fixed interest assets of the pension funds varies from 5 to 7 years and that of liabilities runs to 15 years on average, a mismatch, also referred to as "duration gap", is in evidence. This gap renders pension funds vulnerable to interest rate decreases. It is expected that pension funds will shift their focus to the overall risk profile in order to close this gap. They can do so by buying bonds with a longer maturity or off-balance sheet products like swaps, futures and swaptions. And to hedge the inflation risk, they can include index loans or index swap products in their investment mix.

The European governments are meanwhile responding to the risen demand for long-term loans from both European and American pension funds. Recently, the French government issued a 50-year loan. Also Greece, Germany and Italy recently sold long-term paper. And, this month, the Dutch government will issue a 30-year loan. The market for index loans is still limited, but if demand picks up, index loans will automatically become an attractive financing instrument for general government. General governments are able to complement the current financial markets by issuing index loans. They are in a unique position to do so, since tax revenues are positively correlated to wage movements.

A continuously changing world calls for regular assessments of new developments and subsequent adjustments. Or as John Kenneth Galbraith puts it in his History of Economics: "In fact, economic ideas are always a product of their own time and place, they cannot be seen apart from the world they interpret. And that world changes – is, indeed, in a constant process of transformation – so economic ideas, if they are to retain relevance, must also change."

This is why this conference is a laudable initiative. Today and tomorrow you will be learning a great deal about innovations in the financial markets and the new possibilities to combine collectivity and risk sharing with more freedom of choice and tailor-made pension schemes. Stability of pension values, transparency and freedom of choice are the chief challenges in the process towards a future-resistant system. For our system to be sustainable, it is necessary that everybody knows the risks and the possible consequences thereof. The Financial Supervisory Frameworks offers a solution. Moreover, participants should be allowed more freedom of choice regarding the risks they run. Pension funds can provide this by offering a specific guaranteed minimum pension, supplemented with an individual pension build-up based on a risk profile of the participant's own free choice.

I wish you much inspiration in the next few days and much wisdom in the years ahead. And please try to keep your emotions under control. As the Dutch pension system is among the best in the world, we would like things to stay as they are.